

CHAPTER THREE:

# **THE FISCAL RELATIONSHIPS BETWEEN CAPITAL CITIES AND THEIR NATIONAL GOVERNMENTS**



*Photo by Michael Bonfigli*

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Hosting a Nation's government presents opportunities and challenges to any capital city. The national government can bring economic opportunities, cultural amenities, and a sense of being at the center of importance to a local citizenry. At the same time, the presence of the national government often imposes great fiscal and security burdens on its capital, as well as interfering with local governance and limiting the rights of its citizenry. The District of Columbia starkly illustrates these opportunities and challenges. On the one hand, the Federal Government strongly influences the city's economy, provides an

amazing array of cultural amenities such as the Smithsonian museums, and presents the up-close spectacle of the world's most powerful government at work. On the other hand, the Federal Government's presence imposes tremendous functional and fiscal burdens on the District. The United States government also dramatically limits local governmental autonomy and even restricts the rights and powers of District citizens to receive representation before the Federal Government.

The purpose of this chapter is to place the challenges the District faces as the United States capital into a comparative context. How do different Nations address these issues? In keeping with the main thrust of this report, this chapter focuses on the fiscal relationship between capitals and their national government and examines how the United States treats its capital city relative to other Nations.

As "data," the chapter primarily relies on the findings of several recent studies. Though organized differently and analyzed at differing levels of depth, Wolman et al,<sup>139</sup>

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Boyd and Fauntroy,<sup>140</sup> and Harris et al<sup>141</sup> present comparative case studies of various capital cities.<sup>142</sup> The fourteen cities in the studies are: Berlin, Bern, Brasilia, Brussels, Canberra, Caracas, London, Mexico City, Ottawa, Paris, Rome, Stockholm, Vienna, and Wellington. These are all from Western industrialized democracies and thus represent the type of capital city most comparable with Washington, D.C. They represent a range of governance types and contexts. Eight<sup>143</sup> are cities with large and diverse economies that play a key role in the international economy. Their economies are not heavily dependent on their national government's presence. Five<sup>144</sup> are cities contained within unitary systems. In unitary systems all local governments (including all cities) are subservient to the national government. All governing powers a city exercises (taxation, regulation, etc.) are granted (and subject to removal) by the national government. Nine of the capital cities are within federal systems. In a federal system, a constitution grants sovereignty to both the national government and to smaller governments within the Nation (such as states, city-states, or provinces). Five<sup>145</sup> of the cities in federal systems lie within special federal districts or territories comparable to the District of Columbia. In these cases, the special districts do not enjoy sovereignty but are subject to national government rule in much the same way as cities in unitary systems. Ottawa and Bern are cities within a state – and thus subject to regulation by their respective state. Berlin and Vienna are city-states.

### **Fiscal Support for Capital Cities**

Aside from the specific case of capital cities, the fiscal relationship between cities and their national governments varies enormously around the world. This makes it quite difficult to accurately compare two capital cities. What is possible, however, is to analyze how a given capital city is treated versus other cities in the same Nation. We can think about compensation along two categories.

The first is compensation for the additional expenses caused by hosting the Nation's government in categories such as security, transportation, sewage and water, and other infrastructure. The second is compensation to replace revenue lost due to restrictions on the capital city to tax, such as with exempt property. Both of these categories apply directly to the Washington, D.C. experience.

Given such a comparison, it is clear from the studies that two general conclusions can be made: 1) Seven of the fourteen Nations provide special compensation to their capital cities to make up for the added burdens of hosting the capital and/or to make up for revenue lost to exempt property; and 2) The revenue schemes used in the Nations that do not provide special compensation appear more advantageous for the capital cities relative to Washington, D.C.

### **Compensation to Capitals**

*Washington, D.C.* receives no routine payments from the Federal Government directed towards compensating the District for its capital burdens. While the Federal Government did provide such a payment at one time – \$660 million in FY 1996, for example – the payment was dropped completely in FY 1999 as a consequence of the Revitalization Act of 1997. In return, the Federal Government took responsibility for some District functions, such as the prison system and the District's pension system. The Federal Government does sometimes provide special payments to the District for burdens associated with special events, such as presidential inaugurations. However, these payments are ad hoc, often unpredictable, and unreliable.<sup>146</sup> Like virtually any other jurisdictions within the United States, the District can receive a variety of federal formula-based funds. As a single example, the District (along with all 50 states and various territories) is eligible to apply for federal matching funds to support HIV care. Likewise, the District can receive funding that is not formula based – such as

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earmarks. However, the District's lack of full representation in Congress, especially its lack of representation in the Senate, places it at a decided disadvantage relative to the fully represented states in receiving earmarks.<sup>147</sup>

Given the District's circumstances, how do the Nations we are using as comparisons treat their capital cities? Do these cities receive compensation from their national government to help defray the burdens of hosting the capital or to compensate for revenue lost due to their capital status? Of the fourteen, seven receive compensation: Berlin, Brasilia, Brussels, Canberra, Caracas, Ottawa, and Paris.

Germany provides special funding to *Berlin* to address security, capital city related infrastructure, and cultural amenities.<sup>148</sup> While it appears that Berlin does not receive full 1:1 compensation for all its costs related to serving as the capital city, the special compensation is still substantial. For example, according to Wolman et al, Berlin received €8 million towards its approximately €100 million in security costs in 2006.<sup>149</sup>

*Brasilia* receives a direct federal general subsidy accounting for about 7% of its budget,<sup>150</sup> while *Canberra*, or more precisely the Australian Capital Territory (ACT), receives specific subsidies accounting for about 6% of its budget.<sup>151</sup> The Australian government compensates the ACT for its capital status in three main ways. First, it receives compensation for carrying out municipal services, such as water and sewage, which are related or affected by the federal presence. The ACT received \$33 million (AUD) for this purpose in FY 2007. Second, Australia compensates the ACT for state functions such as police, roads, and recreation that are directly affected by the capital presence. This compensation totaled \$23.7 million (AUD) in FY 2007. Finally, the ACT receives additional revenue meant to compensate for its inability to tax

the Australian government's property and workers. This additional compensation totaled \$103.7 million (AUD) in FY 2007.

It is worth noting that both *Brasilia* and *Canberra* resemble Washington, D.C. in many ways. For example, both cities were created by their governments expressly to serve as capital cities and in both cases the Nations carved federal districts out of relatively unpopulated and undeveloped portions of existing states. Australia created the Australian Capital Territory in the southern part of New South Wales, roughly midway between the rival cities of Sydney and Melbourne. Brazil created its capital federal district out of the state of Goiás in the Nation's center. Much of the economic development problems, governance issues, and current fiscal stresses of both capitals mimic the Districts, though Canberra's level of poverty is much lower than the District's and Brasilia has the highest per capita income in Brazil. Also like the U.S. case, both the ACT and Brazil's federal district were created as enclaves of the national government orphaned from their Nations' states in federal systems. Indeed, Brasilia lacked representation in its National Congress until 1986. For many years the ACT lacked any representation in the Australian parliament. Quite limited representation, on par with what the District currently receives, was added in 1949. In increments over time representation was expanded so that today the ACT enjoys something close to the representation received by other parts of the Nation.<sup>152</sup>

*Brussels* does not receive special compensation for its capital obligations (though it does for its European Union obligations). However, Brussels does recover from the national government about 72% of tax revenue lost to exempt property.<sup>153</sup>

According to Harris et al,<sup>154</sup> greater Caracas contains two federal districts that receive

substantial support from the national government to compensate for lost property tax revenues and other costs associated with hosting the capital. About two-thirds of these districts' funding comes from such compensation though the overall impact on the Caracas budget is clearly much less.<sup>155</sup>

*Ottawa* does not receive special compensation for addressing security or other functions related to its capital status. It does, however, receive payment in lieu of taxes for property tax revenue that fully, or nearly fully, compensate for lost revenue.<sup>156</sup> According to Harris et al, these payments constitute "more than 35% of the city's revenues."<sup>157</sup>

*Paris* receives revenue redistribution from its national government under the same formulas as other French cities.<sup>158</sup> However, Paris does receive special "funding for equipment and operation of the national capital," though Boyd and Fauntroy do not provide amounts.

Aside from these cities both *London* and *Mexico City* are special cases needing clarification. There is no formal or explicit remuneration that goes to London because it is the capital city. However, London may enjoy advantages in funding because so many governmental officials and Members of Parliament reside in the city.<sup>159</sup> For example, over 11 percent of the House of Commons represent parts of London. Yet, this advantage seems more related to London's size and status as a major international city than its capital status and obligations. Legally Mexico is required to compensate Mexico City for exempt property, though the Nation apparently does so inconsistently.<sup>160</sup>

### Revenue Schemes in Comparison

While only half of the fourteen capital cities receive direct compensation due to their capital status, it is misleading to then conclude that the other seven cities suffer "unfunded mandates" on a par with

Washington, D.C. The District, like most other local governments in the United States, relies quite heavily on locally generated own-source revenue, such as the property tax. Real property taxes provided 29% of the District's local revenues in FY 2006-2007.<sup>161</sup> However, largely due to the federal presence, the amount of exempt property in the District far exceeds that in other cities. At least \$29.1 billion in federal property is exempt from property taxes, fully 32 percent of the value of non-residential property in the District as a whole.<sup>162</sup> Consequently the District relies more heavily on other forms of own-source revenue, notably income taxes on residents, than other cities.

Many of the 14 Nations in the study fund their cities quite differently and this difference makes problems, such as exempt governmental property, moot or less acute. For example, in the United Kingdom the property tax on non-residences is a national tax that is then redistributed to local governments in ways that do not penalize the communities that have extensive exempt property.

While such schemes differ in detail across the Nations, their general redistributive nature dramatically lessens the type of problem of exempt property that Washington, D.C. faces. Furthermore, in the cities where exempt property clearly is an issue - such as Brasilia, Brussels, Canberra, and Ottawa - the national government directly compensates for the lost revenue.

### Local Fiscal Autonomy

Aside from compensation to its capital cities, what level of fiscal autonomy do the capital cities in Washington, D.C. and the fourteen comparison Nations enjoy? Can they make decisions about taxation and spending without interference from the national government?

Legally Congress has authority over the District's fiscal policy. District budgets



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require congressional approval and the District functions under strict federal constraints. While on a daily basis the District has some autonomy in decision-making, those decisions are subject to congressional override.

*Mexico City's* budgets also require approval of the Mexican Congress.<sup>163</sup> Thus in this sense as well, Mexico City most closely resembles Washington, D.C. In the other 13 cases, the cities need not obtain budgetary approval from the national government. Nor is there evidence in any of these 13 cases that the national government overtly interferes with or influences local fiscal decisions.

It is also necessary to note that the national government has the technical power to interfere in many of these cases. For example, in all five unitary Nations (*London, Paris, Rome, Stockholm, and Wellington*), the national government can interfere with local decisions. However, this power applies to all local governments in these Nations, not just the capital cities. Thus in this sense the capitals are not singled out for special treatment. (London is an exception, in some respects, but not because it is a capital but rather because it comprises such a large proportion of the Nation's population, economic activity, and political power.)

In some of the other cases, the national government does have the power to directly interfere. This is most true in the unitary forms of government and in the cases of the four federal districts. In the unitary cases, there is no evidence that the capital cities are treated any differently than other

cities within the given Nation. For example, France places restrictions on Parisian taxing authority, but it places the same restrictions on all municipalities. The closest comparison to the District case is Canberra. While Wolman et al found some evidence of interference in Canberra, this interference was on social policy, not fiscal policy.<sup>164</sup>

### **Taxing Commuters**

For the District, a key constraint on its fiscal autonomy is its inability to tax non-residents employed in the city. States have the constitutional basis to tax non-residents who earn income in that state. Thus, for example, the state of New York taxes Connecticut and New Jersey citizens who work in New York City. New York City then benefits from state spending coming in part from such taxes. In some cases state legislatures allow individual cities, Philadelphia for example, to tax the income of commuters. As another example, drivers into New York City from New Jersey via the George Washington Bridge pay a toll. *London* and *Stockholm* now charge a congestion tax and many capital cities charge tolls of one sort or another.

Congressional prohibitions prevent the District from acting as a state and taxing District workers who reside elsewhere (primarily in Maryland and Virginia). If charged at current District statutory rates, a non-resident income tax would produce an estimated \$2.26 billion in annual revenues. More realistically, the ability to tax non-resident employees would allow the District to lower its statutory rates (for residents and non-residents alike) and still bring in more revenue.<sup>165</sup> Aside from the non-resident

income tax issue, certain congressional opposition inhibits the District from charging tolls on bridges entering the District from Virginia or otherwise imposing commuter or congestion taxes.

## **Conclusion**

Table 1 provides a side-by-side comparison of each city. Each of the capital cities examined differ in a variety of important ways. Yet, two common themes emerge in all the studies about these cities. First, tension always exists between capital cities and their national governments. There is no way to fully resolve these tensions simply because the preferences and priorities of the local citizenry will sometimes clash with the preferences and priorities of the national government. Second, with little exception, these 14 Nations do more to compensate their cities for the fiscal stresses created by the capital presence. Indeed, interviewees in most of the cities studied by Wolman et al expressed general satisfaction with the fiscal treatment of their city.

This satisfaction is obviously not shared by residents of the District and the evidence here suggests that the dissatisfaction has a good basis. (Indeed, recent reports that the U.S. has spent more than \$4 billion dollars to reconstruct Baghdad, the capital city of Iraq, only heighten that dissatisfaction.)<sup>166</sup> In comparison to other capital cities in major democracies, the District of Columbia receives far worse fiscal treatment from its national government.

## ENDNOTES

- 139 Wolman, Hal, Jan Chadwick, Ana Karruz, Julia Friedman, and Garry Young. 2007. "Capital Cities and Their National Government: Washington, D.C. in Comparative Perspective." A report for and funded by the Trellis Fund.
- 140 Boyd, Eugene P. and Michael K. Fauntroy. 2002. "Washington, D.C., and 10 Other National Capitals: Selected Aspects of Governmental Structure," Washington, D.C., Congressional Research Service.
- 141 Harris, Charles W., Hilary Cairns, Jeff Carpenter, and Andrew Stettner. 1997. "Foreign Capital City Governance: Representation, Governmental Structure, Finances, and Intergovernmental Relations in Six Capital Cities (Presentation to the District of Columbia Financial Responsibility and Management Assistance Authority)." Washington, DC: The D.C. Community Policy Forum and the Georgetown Public Policy Institute.
- 142 Wolman et al examined Berlin, Brasilia, Brussels, Canberra, London, Mexico City, Ottawa, Stockholm, Vienna, Washington, D.C. and Wellington. Boyd and Fauntroy examined Berlin, Bern, Brasilia, Canberra, Caracas, London, Mexico City, Ottawa, Paris, Rome, and Washington, D.C. Harris et al examined Bern, Brasilia, Canberra, Caracas, Mexico City, and Ottawa.
- 143 Berlin, Brussels, Mexico City, London, Paris, Rome, Stockholm, and Vienna.
- 144 London, Paris, Rome, Stockholm, and Wellington
- 145 Brasilia, Brussels, Canberra, Caracas, and Mexico City
- 146 An example is Hsu, Spencer. 2005. "U.S. Tells D.C. to Pay Inaugural Expenses, Other Security Projects Would Lose \$11.9 Million." *Washington Post*, January 11, p. A01.
- 147 Young, Garry. Forthcoming 2008. *The District of Columbia and Its Lack of Representation in Congress: What Difference Does It Make?* A Report prepared for the Trellis Fund.
- 148 Wolman et al, p. 16.
- 149 *Id.*
- 150 *Id.*
- 151 Wolman et al, pp. 14-16.
- 152 Wolman et al.
- 153 *Id.*
- 154 Harris et al.
- 155 See also Boyd and Fauntroy.
- 156 Wolman et al.
- 157 Harris et al, p. 62.
- 158 Boyd and Fauntroy, p 62.
- 159 Wolman et al, p. 17.
- 160 *Id.*
- 161 District of Columbia. 2007. Comprehensive Annual Financial Report.
- 162 This number is almost certainly underestimated given the lack of recent assessment of federal property.
- See Yilmaz, Yesim. 2008. "Calculating the Impact of Federal Preemptions on the District's Tax Revenue." Briefing Note (Draft), Office of Revenue Analysis, Chief Finance Officer, District of Columbia.
- 163 Wolman et al.
- 164 *Id.*
- 165 Yilmaz.
- 166 Special Instructor General for Iraq Reconstruction. *Quarterly Report and Semiannual Report to Congress*, July, 2008, p. 31. See also the recent GAO report on spending in Iraq: Government Accountability Office, *Stabilizing and Rebuilding Iraq*, GAO-08-1031, August 2008.

**Table 1  
Capital Cities in Comparison**

City	Nation	Governance System	Fiscal Support	Fiscal Autonomy
			<i>How is the capital city compensated for capital burdens or revenue losses due to capital presence?</i>	<i>Does the capital make decisions about taxation and spending without interference from the national government?</i>
WASHINGTON, D.C.	United States	federal district within federal system	The national government takes responsibilities for some functions, such as prisons, but otherwise the capital receives no compensation for national burdens. The capital receives no compensation for exempt national property and is prevented from taxing non-resident workers.	No, the capital's budgets require approval from the national government and the capital functions under strong legal and political constraints.
BERLIN	Germany	city-state within federal system	The national government provides special funding to Berlin to address security, capital city related infrastructure, and cultural amenities.	Yes, the capital has the same fiscal autonomy, including taxation, as other states.
BERN	Switzerland	city with a state within federal system	The city receives some national compensation primarily directed towards security. The city is heavily funded by its state (canton). The city cannot tax non-resident employees.	Yes, the national government has little control over the capital city.
BRASILIA	Brazil	federal district within federal system	The national government provides direct subsidies for capital burdens. It also provides compensation for exempt property revenue losses.	Largely yes, the national government has the technical power to interfere with fiscal autonomy but in practice does not.
BRUSSELS	Belgium	federal district within federal system	While the capital receives no direct compensation for federal burdens, it does reimburse the capital for most of revenue lost to exempt property.	Yes
CANBERRA	Australia	federal district within federal system	The national government pays for capital related expense such as security and infrastructure. It also compensates the capital district for its inability to tax national government property and employees.	Yes, while the national government has the technical power to interfere with capital territory fiscal decisions in practice it does not.
CARACAS	Argentina	federal district within federal system	The capital receives substantial compensation for national burdens borne and recompense for exempt property revenues lost.	Yes, while the national government has the technical power to interfere with capital territory fiscal decisions in practice it does not.

See text for sources

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LONDON	United Kingdom	city within unitary system	The capital city receives no special compensation but, as with other municipalities in the nation, receives revenue on a national redistribution basis and thus suffers little handicap from exempt property. The capital also charges a congestion tax.	No, but the limits placed on local fiscal autonomy are the same as with other cities in the Nation.
MEXICO CITY	Mexico	federal district within federal system	The national government is legally required to compensate the capital for revenue lost to property exemptions.	Technically no, the capital city's budgets require approval of the national government.
OTTAWA	Canada	city within a state within a federal system	The capital receives payments in lieu of taxes to compensate for exempt property. The capital participates as a regular municipality in its state's revenue redistribution scheme.	Yes.
PARIS	France	city within unitary system	The capital receives formal payments for capital burdens and otherwise receives redistribution from its national government under the same formulas as other cities.	No, the national government places limits on city fiscal autonomy, such as taxation powers, but under the same rules as other cities in Nation.
ROME	Italy	city within unitary system	The capital receives formal payments for capital burdens and otherwise receives redistribution from its national government under the same formulas as other cities.	No, the national government places limits on city fiscal autonomy, such as taxation powers, but under the same rules as other cities in Nation.
STOCKHOLM	Sweden	city within unitary system	No, but otherwise the capital receives redistribution from its national government under the same formulas as other cities.	Yes. The capital also charges a congestion tax.
VIENNA	Austria	city-state within federal system	No, but otherwise the capital receives redistribution from its national government under the same formulas as other cities.	Yes.
WELLINGTON	New Zealand	city within unitary system	No, but otherwise the capital receives redistribution from its national government under the same formulas as other cities.	Yes.

See text for sources