

## STATE RULES AND LOCAL GOVERNANCE CHOICES

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### **ABSTRACT**

This paper evaluates the impact that states have on local governance decisions. We suggest that when states impose constraints on less politically costly tools for funding local services, cities turn to cooperation with other local governments. Cooperation is politically and administratively less desirable than other solutions to the problems associated with fragmentation: diseconomies of scale and jurisdictional externalities. But when states constrain those other mechanisms, the relative merit of cooperation increases. At the margins, more cities should cooperate and cooperate more deeply in such situations. Using a sample of 3,729 cities across 49 states, we find that in four examples of these policy tool trade-offs, our theory is generally supported.

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## INTRODUCTION

The literature about how local communities provide services to themselves has dramatically increased in recent years as scholars increasingly recognize the opportunity that local politics offers as a useful laboratory for evaluating alternative governance mechanisms. Governance, in this context, is the spider web of governmental and nongovernmental organizations arrayed to provide services to a community. In any community, this can involve the federal and state governments, counties, cities, school districts, any number of special districts organized for such narrow purposes as transportation or low-cost medical services, nonprofit organizations and for-profit government contractors.

The long-standing debate – one might even say feud – between advocates of decentralized, fragmented local government and advocates of consolidated service provision has evolved into a study of the many complex organizational structures found in everyday service provision in community across the United States. One of the central conclusions from this long debate, however, is the recognition that a fragmented local governance structure has at least some adverse consequences. Among the most discussed of these consequences is a loss of economies of scale in the production of government goods and services and jurisdictional externalities.

There are many options for overcoming these two problems. The traditional literature in public administration has advocated consolidation of local governments, but the dearth of consolidations has led some scholars to evaluate other mechanisms. This study contributes to the evaluation of one of these other mechanisms – one that presents significant political challenges but is nevertheless utilized extensively by local governments: voluntary cooperation in the form of financial transfers between local governments.

We build upon a previous model of interlocal cooperation to suggest that state-level constraints and inducements change the decision calculus of local governments considering cooperation with other local governments to achieve policy outputs. We represent the decision to cooperate and the decision about the degree of cooperation by cities using a transaction cost approach with a baseline model that accounts for a variety of local factors that impact the cost of reaching an agreement for sharing of resources through financial transfers. We augment this baseline model with data on state rules that regulate either cooperation between local

governments or financial practices that create constraints on resources. The two-stage model is tested on a large sample of cities nationally.

## **EXISTING LITERATURE**

Many different substantive research fields have evaluated the impact of state-level actions on local governments and governance generally. While much of that literature is a result of the so-called tax-revolt era of the 1970s and Proposition 13 in California, the tradition can be traced back further to at least the 1950s and the work of Tiebout and associates. Tiebout's (1956) primary concern was to show how that Samuelson's (1954; 1955) market-failure approach to public goods was incomplete because it ignored the efficiency-enhancing qualities of voter mobility within metropolitan regions. Tiebout and colleagues recognized that production efficiency may be sacrificed to allocative efficiency in a fragmented governance system, but speculated that cities might join cooperative ventures to achieve economies of scale. The Leviathan literature growing out of the work of Brennan and Buchanan (1980) studied the impact of regional or metropolitan competition on the production efficiency of local governments, and many of those studies incorporate state-level decisions in their analyses to evaluate the impact of those decisions on production efficiency (Nelson 1986; Zax 1989; Alm and Skidmore 1999; Skidmore 1999).

Nelson (1986), for example, finds that state-mandated municipal debt limits reduce local spending, while property tax limits do not. He also finds that as the state share of total state and local revenue decrease local spending. In a later study (Nelson 1997), he finds that property tax limits similarly have no effect on municipal outsourcing decisions, but that state limits on interlocal agreements increase outsourcing.

Other studies, however, find that property tax restrictions have an important effect on local decisions. Brown and Potoski (2003), for example, find that property tax limits lead to greater outsourcing to other local governments, while Johnston, Pagano and Russo (2000) find that counties turn to non-tax sources of revenue when own-source revenues are restricted by state rules. Dye and McGuire (1997) find mixed support for the impact of state-level revenue limits in Illinois while Hoene (2004) finds that while property tax revenue declined in California cities in the wake of Proposition 13, overall spending did not.

Similarly, Carr and Feiock (2001) find that state rules on annexation affect the degree to which cities utilize annexation, although they find that state rules increase the amount of annexation. The rules for annexation are complex (for a discussion, see Palmer and Lindsey 2001), and the results are sometimes inconclusive. Liner (1990), for example, finds no connection between different types of state-level constraints and local annexation practices.

McCabe (2000), in her study of special district formation, finds that annexation limits increase the use of special districts, while incorporation limits reduce the creation of special districts and revenue limits increase their creation. Carr (2006), on the other hand, finds that tax limits and incorporation limits reduces the number of special districts created.

Little, then, is clear about the impact of state-level rules on local government actions. In some cases, the impact seems clear, but in other cases, the rules are part of a complex decision process in which local leaders find themselves. Importantly, few studies have evaluated how state rules potentially impact interlocal cooperation. Brown and Potoski (2003) and Johnston, Pagano and Russo (2000) are promising and suggestive, but ultimately the story they tell about how states impact cooperation decisions is incomplete. We hope to partially fill that gap with this study, but to do so, we first need a better understanding of precisely how state decisions impact local policy tool choices.

## **THEORY AND HYPOTHESES**

Cooperation with other local governments is a difficult way for cities to overcome the challenges of fragmentation. There are fewer opportunities for credit claiming (Mayhew 1974) because responsibilities are shared and performance standards – both in terms of outputs and outcomes – must be negotiated. Other relevant policy tools for achieving similar results in many cases are more appealing. But to the extent that there is a balance between the choice of cooperation and other policy tools, that balance is altered when states impose higher costs on those other tools.

But what are those other potential tools? We present four such policy tools here. First, we argue that higher own-source revenues represents a locally controlled resource that acts, in some ways, as an alternative to cooperation. Revenue provides the mechanism by which governments get policy implemented. To the extent that cities have higher revenue, they need not rely on other mechanisms for funding policy initiatives. When revenue is in short supply,

cities opt for other mechanisms to fund policy. Thus, we anticipate that greater revenue per capita should lead to less cooperation. This hypothesis is consistent with the existing literature.

However, the story becomes more complicated when we introduce state restraints on cities' ability to raise revenue. Specifically, when states impose property tax revenue limits, we suggest, cities worry about exceeding that cap. Some studies of cooperation have included a dummy variable in their models that captures the effect of state limits on revenue, but they have not evaluated this interaction effect (Nelson 1997; Brown and Potoski 2003). When facing such a cap and when revenues are high, cities should opt for more cooperation to provide services while keeping revenue below the state-imposed cap. This suggests an interactive effect between the state-impose limit and local revenue. For cities in states without a limit, we expect the relationship between revenue and cooperation to be negative, but when states impose and limit, we anticipate that the relationship between revenue and cooperation will be positive.

The second tool we evaluate in this study is annexation, and we argue that the process works in a manner that is similar to revenues. For cities facing the need to resolve economies of scale problems, annexation provides an opportunity to expand city borders and increase the tax base without reducing political autonomy. Thus, in an environment that is conducive for annexation, cities will cooperate less. When the environment is not conducive to annexation, they will cooperate more.

But many states impose limits on annexation activity. Several studies have evaluated state annexation policies on annexation activity with mixed results (put a bunch of cites in here). We simplify the Senstock (1960) typology of annexation criteria into two types: those that require approval through a political process (combining the legislative, quasi-legislative, and popular categories) and those that require approval through an administrative process (combining the judicial and municipal categories). We argue that those annexations requiring a political process for approval have higher transaction costs relative to those requiring approval from smaller governmental organizations (courts and cities).

Third, states can impose constraints on the creation of new local governments. While such a limit may reduce the number of cities, which could potentially reduce fragmentation, it also limits the number of new special districts that can be created, which are much more prolific than cities. Special districts often are created to overcome the problems associated with fragmentation because they have taxing authority but can be much larger than the geographic

limits of a single city or even a single county (Foster 1997; McCabe 2000). They also provide opportunities for political entrepreneurs to credit-claim for a new or expanded service to the community outside of the existing local political structure. We argue that cooperation presents fewer such political opportunities, and thus state limits on incorporation of special districts should lead to greater levels of cooperation.

Finally, states can determine the share of services the state provides relative to local governments. Our argument is that when states provide a greater proportion of the share of services, the burden on local governments is reduced and the necessity for cooperation is reduced. To capture this idea, we measure the state share as a percentage of total state and local share of own-source revenues. This is a noisy signal of the state's share of services, but has been utilized in the Leviathan literature (Nelson 1986).

Some state rules, of course, affect all cities similarly. Of particular importance for the study of cooperation is whether or not states allow interlocal agreements (ILAs). By limiting the use of ILAs, states limit the option of cities to participate in financial cooperation (Nelson 1997). We suggest that in states with rules against ILAs, cooperation will be lower. This is not to say that cities in such states never cooperate. In fact, they do. But they must go to extra measures to recharacterize the agreement or seek special permission from the state legislature. Cities in states that allow such agreements thus have lower transaction costs associated with cooperative agreements.

The empirical model also includes several control variables taken from the baseline model and previous research. These variables are discussed briefly here. A full discussion of the baseline model, operationalization of the variables, and sources of data can be found in Krueger (2007).

### **Control Variables**

**Council-Manager Form.** The city manager position can be viewed as a mechanism for reducing information costs associated with policy making in a complex environment. The administrative professional with less of an interest in a particular policy than with efficient implementation is well-suited to gather diverse opinions from a variety of stakeholders, assimilate that information, and provide useful policy recommendations to part-time, less knowledgeable (but ultimately more democratically accountable) policymakers. The city

manager in such a scenario would find it in his or her career interest to help policymakers find ways to balance competing claims and goals (Feiock and Kim 2000; Feiock, Jeong and Kim 2003). Thus, the city manager can reduce the transaction costs associated with cooperation and make the option more viable for cities that are motivated to cooperate.

**At-Large District Representation.** Although one can argue that the single-member district form of representation in cities encourages policymakers to be narrowly interested in the affairs of their specific district rather than the city overall, policymakers elected to single-member districts learn quickly the art of political compromise. The city organization, focused on this need to create consensus, becomes adept at facilitating it. Cooperation between cities requires many of the same sets of compromise and deal-making skills. The organization's ability to facilitate compromise in one sphere is institutionalized and carries over to other areas. Thus, the institution of single-member districts in a city should reduce the transaction costs associated with reaching a cooperative agreement.

**Partisan Elections.** Political parties serve as preference aggregation systems that reduce disagreements in the political system. Parties are the medium through which policies are funneled. Without parties, political organizations themselves become that mechanism, and like organizations with single-member districts, must develop methods for achieving compromise and cooperation. As with single-member district cities, local governments with nonpartisan elections develop norms that reduce the transaction costs of cooperation, and we should thus anticipate that such cities would participate more often in external cooperation.

**Monitoring Sophistication.** Like all contract, local agreements require monitoring after a deal is struck. While some institutional arrangements – such as the city manager form – can improve contract monitoring through the facilitation of information exchange, we also must consider the impact of a city's sheer ability to monitor. With simple agreements, monitoring may be relatively simple and front-line administrative staff may be capable of handling this duty in addition to their regular functions. However, as agreements increase in complexity and number, the degree of sophistication required to monitor agreements increases. Thus, cities that have more sophisticated mechanisms for monitoring contract compliance will be more likely to enter

into cooperative transactions. City size can provide a rough clue about the degree of sophistication of the city's governmental organization. Cities with a larger population necessarily have larger city structures than cities with a smaller population. As a rough proxy for government sophistication, population size can be representative of the city's ability to effectively monitor cooperation. It has been hypothesized that the benefit of size to monitoring declines in importance, and thus we expect the relationship to increase at a decreasing rate, suggesting an inverted "U" shape.

**Interlocal Competition.** Tiebout (1956) and Brennan and Buchanan (1980) argue that competition drives local governments to provide public goods efficiently. Cooperation provides one mechanism for cities to achieve that efficiency. Thus, more competition should lead cities to cooperate more deeply (for a discussion of the inclusion of this variable only in the outcome equation, see Krueger 2007). But what is the relevant "market" when considering the competition between cities? Ostrom, Tiebout and Warren (1961) evaluate local government interactions in the metropolitan area because of the distributed nature of political authority in a metropolitan area (see Park 1997 for a similar use of metropolitan areas). In this study, we use the number of cities per 10,000 population in the metropolitan area that a city finds itself in as a useful proxy measure for the degree of competition, consistent with most studies in the leviathan literature on competition and expenditures per capita (but see Post (2000) and Shrestha and Feiock (2004) for an useful discussion about density of local governments, rather than number).

**Locational Factors.** Different studies have tested hypotheses about the impact of city location. Some have suggested that central cities have unique characteristics that make them more motivated to participate in collaborative agreements. This suggests that central cities are more likely to choose to collaborate and to collaborate to a greater degree. Similarly, cities outside of metropolitan areas – often with fewer resources – have been hypothesized to cooperate more and to cooperate more likely.

**Federal Grants.** Cities that receive federal funding for a variety of programs often are required as a stipulation of the grant that other stakeholders be involved in the administration of that grant. Thus, cities that receive more federal grant funding may be more likely to cooperate with

other cities because of federal imperatives to do so. Even when a federal grant does not require it, cities often work together because they know that regional solutions with significant local resources dedicated to the problem are often more appealing to federal grants administrators than solutions that are jurisdiction-bound.

**Economic Environment.** While the motivation to capture economies of scale to improve efficiency and/or effectiveness may be ever-present, that motivation may be particularly acute for cities that face more severe social and economic conditions. A higher number of unemployed residents and a higher number of working poor are utilized in this study to capture short-term and long-term, respectively, economic woes that may lead cities to more aggressively pursue the receipt of interlocal dollars. If, through cooperation, cities with more severe socio-economic conditions can free-up resources for other purposes, they can make use of those resources by providing programs to alleviate social stress. This suggests that cities with a population with greater economic needs are more likely to choose to cooperate and to cooperate to a greater degree.

**Demographic Homogeneity.** Feiock (2007) suggests that local jurisdictions with a high degree of internal homogeneity will be better able to conclude cooperative agreements because community interests will be more uniform. Goal congruency and effective communication within the community reduce the transaction costs of finding a preference point for such cooperation. This concept can be approximated by measuring the degree of racial and age homogeneity in the community. These variables are included in the model as the percentage of whites in the community and as the percentage of residents in the community over 64 or under 19 years.

## **METHODS AND RESULTS**

An empirical model of cooperation must account for both the choice of participation in a cooperative agreement and the degree of that cooperation. Our model does this by modeling the choice to collaborate as a dichotomous (yes/no) choice in the first stage, and as a continuous variable for depth of collaboration, measured in dollars, at the second stage (for those cities that chose “yes” at the first stage). The data for the degree of cooperation are left-censored. That is,

each city that opts not to cooperate has a value of \$0 for the degree of cooperation, which is equivalent to having a missing value because we do not observe the city's true preference for the amount of cooperation. Censored data are data for which we have observations of the independent variables but the dependent variable is unobserved or has a value of \$0. In such situations, ordinary least squares regression (OLS) is biased because the dependent variable is censored at \$0. For a theoretical model that suggests a two-stage empirical model and censored data, the Heckman procedure is recommended (1976; 1979). In this study, the full-information maximum likelihood method (FIML), which is consistent and asymptotically efficient, is utilized (Greene 2002).

Table 1 presents the results of the analysis. The first two columns present the coefficients and standard errors of the model without state-level controls. We present these results, previously reported in Krueger (2007), to provide a baseline for comparison with the model that includes the state level factors. Columns three and four present the coefficients and standard errors of the selection model when state level factors are included. Before turning to the state level variables it should be noted that when the state level factors are included in the model, several changes occur with the variables in the original models. For example, in the selection stage four factors – *City Manager*, *At-Large Seats*, *Expenditures Per Capita*, and *Federal Grants Per Capita* – were significant in the baseline model but are not significant with the state level controls included. On the other hand, in the baseline model the coefficient for *Anglo Population* was not statically significant but it is significant when the state controls are included in the model. In addition, *Partisan Elections* and being a *Central City* remain insignificant in the full model. As for the outcome model, two factors – *Population Over 65 and Under 19* and *Federal Grants Per Capita* were statistically significant in the baseline model but are not significant in the full model. In addition, *Debt Per Capita*, which was not significant in the original model, is now significant in the full model. In sum, the results suggest that for many of the local-level controls, the state-level controls work at least to indirectly impact the decisions to cooperate by affecting the role of local factors on the decisions of local communities to cooperate.

While the above results suggest an indirect effect of state policy tools on local level decisions to cooperate, we now turn to how these state policy tools directly affect the decision to cooperate. First, we find support for the hypotheses regarding incorporation and annexation limits. Specifically we find that local governments when constrained by limits on incorporations

are more likely to cooperate in the first place and more likely to receive more interlocal revenue. In addition, we find that cities in states where annexation is common and there are no limits on annexation, are in fact less likely to cooperate at all and will receive less revenue for cooperation. In addition, the interaction term for the annexation variables indicates that cities are more likely to decide to cooperate and receive more revenue from cooperative agreements when a city is in a state where annexation is more common but they have annexation limits.

Turning now to the revenue hypotheses, we also find strong support. As expected, those cities with higher tax revenue but no property tax revenue limit will cooperate less and receive less revenue from cooperative agreements. In addition we hypothesized that those cities with high revenues will worry more about potentially exceeding the revenue cap than those with low revenues, and will thus seek ways to keep revenues low. We find support for this hypothesis with coefficients for the interaction term for the decision to cooperate and the amount of cooperation revenue.

Finally, we find some support for hypothesis that when the state does more to provide services, or picks up the tab, a local government will be less likely to cooperate. In others words, when the state share of state and local own source revenue is greater, a city will be less likely to enter into a cooperative agreement. However, the effect of the state share of state and local revenue is statistically insignificant for the outcome stage.

In the end, we find mixed support for our findings. However what does seem clear is the process that would lead a community to enter into a cooperative arrangement is different from that which explains how much they receive from that agreement. This in fact lends support to our notion that we need to control for the selection bias that is occurring. In addition we also find a great deal of support for the idea that we need to begin to model local government decisions in a multi-level way. Without, accounting for the state level variables that constrain local decisions we are missing an important piece of the puzzle.

## **CONCLUSIONS**

Previous research on interlocal cooperation has developed strong theoretical models of cooperative choice that incorporates transactions costs and competition explanations. In this project we build on this research to better specify models of interlocal cooperation that include variables at more than one level of government. In the cooperation literature, and the literature

on local governments in general, state rules matter in substantively important ways. But to appropriately test theories of the interaction between cities and their states, we must be rigorous in our model specification.

Our study suggests that state rules on interlocal cooperation matter in important ways. The results presented above suggest that state level rules and constraints shape the decisions of local governments both directly and indirectly through various local level factors. While future research needs to further explore the role states in shaping local level decisions, what is clear is that state governments play a significant role, and perhaps more than local governments would hope for, in determining what local governments can and should do when trying to provide the services that citizens demand.

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**TABLE 1. RESULTS OF ANALYSES**

	Hypothesis	Without State Effects		With State Effects	
		Coef.	Std Error	Coef.	Std Error
<b>Stage One: Selection Equation</b>					
(Do cities cooperate? Yes or No)					
<i>State-Local Interaction</i>					
Tax Revenue Per Capita	-	-0.00044 *	0.00008	-0.00058 *	0.00010
State Property Tax Limit	+			-0.47120 *	0.08237
Revenue*Tax Limit	+			0.00038 *	0.00014
Number of Annexations in the State	-			-0.00008 *	0.00001
State Annexation Limit	+			-0.16873	0.10380
Annexations*Annexation Limit	+			0.00012 *	0.00004
State Limits on New Government Incorporations	-			1.36086 *	0.18936
State Share of State + Local Revenue	-			-0.01205 *	0.00452
State Law Allowing Interlocal Agreements	+	-0.16191 *	0.08039	0.11007	0.09109
<i>Control Variables</i>					
City Manager Form	+	0.16770 *	0.04747	0.12344 *	0.05003
Proportion of Districts Elected At Large	-	-0.10763 *	0.04861	-0.12882 *	0.05071
Partisan Elections	-	-0.04940	0.06264	-0.10141	0.06582
Monitoring Sophistication (population size)	+	0.00000 *	0.00000	0.00000 *	0.00000
Population Size Squared	-	0.00000 *	0.00000	0.00000 *	0.00000
Expenditures Per Capita	+	0.00007 *	0.00003	0.00004	0.00003
Federal Grants Per Capita	+	0.00114 *	0.00047	0.00064	0.00048
Outstanding Debt Per Capita	+	0.00003 *	0.00001	0.00003 *	0.00001
Proportion of Anglos in Population	-	0.00228	0.00150	0.00281 *	0.00158
Proportion of Population Over 65 or Under 19	-	0.01741 *	0.00430	0.01738 *	0.00452
Median Family Income	+	0.00000 *	0.00000	0.00000 *	0.00000
Unemployment Rate	-	-0.01701 *	0.00730	-0.01290 *	0.00753
Central City (Yes/No)	+	-0.00514	0.10793	0.07845	0.11141
Non-MSA City (Yes/No)	+	0.11579 *	0.05527	0.14137 *	0.05741
Region 1		0.03615	0.06476	-0.17782 *	0.08311
Region 3		0.33335 *	0.07931	0.96922 *	0.21069
Region 4		0.47875 *	0.06843	0.09358	0.08147
Region 5		0.22530 *	0.08319	-0.13848	0.09353
Constant		-0.64452 *	0.31485	-0.86089 *	0.50109
<b>Stage Two: Outcome Equation</b>					
(Degree of Interlocal Cooperation)					
<i>State-Local Interaction</i>					
Tax Revenue Per Capita	-	-0.00023 *	0.00013	-0.00052 *	0.00016
State Property Tax Limit	+			-0.54343 *	0.12123
Revenue*Tax Limit	+			0.00108 *	0.00021
Number of Annexations in the State	-			-0.00011 *	0.00002
State Annexation Limit	+			-1.11496 *	0.15076
Annexations*Annexation Limit	+			0.00013 *	0.00005
State Limits on New Government Incorporations	-			2.64579 *	0.19346
State Share of State + Local Revenue	-			0.00659	0.00628
State Law Allowing Interlocal Agreements	+	0.81807 *	0.12018	0.74400 *	0.12918
<i>Control Variables</i>					
Competition in Market		2075.6 *	663.5	2034.5 *	635.2
Expenditures Per Capita	+	0.00044 *	0.00006	0.00037 *	0.00006
Federal Grants Per Capita	+	0.00114 *	0.00062	0.00014	0.00058
Outstanding Debt Per Capita	+	-0.00003	0.00002	-0.00004 *	0.00002
Proportion of Anglos in Population	-	-0.00247	0.00226	0.00076	0.00215
Proportion of Population Over 65 or Under 19	-	0.01151 *	0.00639	0.00147	0.00613
Median Family Income	+	0.00000	0.00000	0.00000	0.00000
Unemployment Rate	-	-0.02349 *	0.01146	-0.01981 *	0.01081
Central City (Yes/No)	+	-0.12358	0.12961	-0.03489	0.12306
Non-MSA City (Yes/No)	+	0.51540 *	0.09928	0.41444 *	0.09557
Region 1		-0.07219	0.10504	-0.44092 *	0.11975
Region 3		0.06467	0.11939	1.66823 *	0.21692
Region 4		0.54387 *	0.10890	0.39701 *	0.11666
Region 5		-0.39918 *	0.12704	-0.23850 *	0.13002
Constant		0.66166	0.48500	-0.61890	0.65984