

LECTURE VI

STATE AND LOCAL GOVERNMENT EXPENDITURES

- **optimal fiscal federalism:** The question of which activities should take place at which level of government.

Spending and Revenue of Local Governments

■ TABLE 10-2

Subnational Government Spending/Revenue as Share of Total Government Spending/Revenue in 2001

	Spending %	Revenue %
Greece	5.0	3.7
Portugal	12.8	8.3
France	18.6	13.1
Norway	38.8	20.3
United States	40.0	40.4
Denmark	57.8	34.6
OECD Average	32.2	21.9

Source: Joumard and Kongsrud (2003), Table 1.

Revenue Sources

- **property tax** The tax on land and any buildings on it, such as commercial businesses or residential homes.
- **fiscal equalization** Policies by which the national government distributes grants to subnational governments in an effort to equalize differences in wealth.

- Recent years have seen a move toward fiscal decentralization around the globe. In the United States, there have been increased efforts to shift control and financing of public programs to the states, as demonstrated by the welfare reform example.
- In countries as diverse as Hungary, Italy, South Korea, Mexico, and Spain, there have been efforts to shift responsibility for health care, education, and welfare from national to subnational governments.
- Thus, in most countries, spending by subnational governments has increased over the past couple of decades, often financed through grants from the national government.

The Tiebout Model

- Recall from the lecture on political economy that the major problems with government provision of public goods are the problems of *preference revelation* and *preference aggregation*:
- it is difficult to design democratic institutions that cause individuals to honestly reveal their preferences for public goods, and
- it is also difficult to aggregate individual preferences into a social decision. As a result, governments are often unable to deliver the optimal level of public goods in practice.

Intuition of the Tiebout Theorem

- In 1956, economist Charles Tiebout (pronounced TEE-bow) asked: What is it about the private market that guarantees optimal provision of private goods that is missing in the case of public goods?
- His insight was that the factors missing from the market for public goods were *shopping* and *competition*. Shopping is the fundamental force that induces efficiency in private goods markets.
- If a firm is selling an inferior good relative to its competitors, consumers will purchase from the competitors, not from the firm. This competition leads firms to produce efficiently in the perfectly competitive private goods market.

The Invisible Foot (Tiebout) Theorem

- Suppose that there are many people who divide themselves up across towns that provide different levels of public goods. Each town i has N_i residents, and finances its public goods spending, G_i , with a uniform tax on all residents of G_i/N_i . Then, individuals will divide themselves up so that each resident in any town has the same taste for public goods, and so demands the same level of public goods spending, G_i .

The Rational of the Theorem

- There is no problem of revelation because there is no incentive for people to lie with a uniform tax that finances the public goods.
- The problem of preference aggregation is also solved because everyone in town wants the same level of public goods G_i , and the town government can simply divide that amount by the population to get the appropriate financing.

- With the preference revelation and aggregation problems solved, Lindahl pricing works in the Tiebout model. Each individual reports his or her true valuation of the public good, the valuations are added, and then each individual is billed for the total cost of the public good divided by population size.
- This is an equilibrium because every person is happy to pay his or her share of the tax to get the public good, and the condition for optimal public goods provision is met because the level of public goods provided is determined by the sum of the individual benefits.

Problems with the Tiebout Model

- Perfect mobility
- Perfect information
- Economies of scale in the provision of some public goods (e.g., schools)
- Can there be enough towns so that individuals can sort themselves into groups with similar preferences for public goods? This raises a clear tension: Can we divide the population into groups of people who all have similar preferences for public goods, yet also ensure that these groups are large enough to support the economies of scale required by public goods?

Financing Problems

- The theorem requires lump sum taxes
- **lump-sum tax** : A fixed taxation amount independent of a person's income, consumption of goods and services, or wealth.
- Property tax: “Poor chase the rich”
- Zoning restrictions that towns place on the use of land protect the tax base

Externalities

- The Theorem requires no externalities and spillover effects.
- The existence of such effects brings back the free rider problem.
- There are advantages to locally provided public goods
- for small towns of similar individuals, but it may be optimal to provide public goods that have external effects or spillovers to other towns at a higher level of government that can internalize the externalities.

Evidence on the Tiebout Model

- Residence similarity across areas
- In larger metropolitan areas (that is, in suburbs near cities), where people have greater choice of which community they can live in, preferences for public goods were more similar within towns than in smaller areas with fewer independent towns to choose from.
- And, in urban/suburban areas, residents were much more satisfied with the level of public goods spending than in nonurban areas where there are fewer ways to vote with one's feet because there are fewer towns to move to.

- House price capitalization: Incorporation into the price of a house the costs (including local property taxes) and benefits (including
- local public goods) of living in the house.
- The Tiebout model predicts that any differences in the fiscal attractiveness of a town will be **capitalized into house prices**. The price of any house reflects the cost (including local property taxes) and benefits (including local public goods) of living in that house. Thus, towns that have a relatively high level of public goods, given taxes paid, will have more expensive housing; conversely, towns that have relatively high property taxes, given the public goods provided, will have less expensive housing. House pricing therefore represents voting with your pocketbook: people will pay more for a house in a town that more efficiently delivers local public goods.

Optimal Fiscal Federalism

- The Tiebout model implies that the extent to which public goods should be
- provided at the local level is determined by three factors:
- (1) **tax-benefit linkages:** To the extent to which residents view their tax payments as directly tied to goods and services that they receive. Goods with strong tax-benefit linkages, such as local roads, should be provided locally. There is a direct tax-benefit linkage to spending on local roads: higher property taxes fund better-quality roads that benefit most residents of a town. Goods with weaker tax-benefit linkages, such as welfare payments to the lowest income residents of a town, should be provided at the state or federal level. There is a very limited tax-benefit linkage to spending on welfare: the majority of residents in a town do not benefit from redistribution to low-income groups (unless they have altruistic preferences toward the local poor)

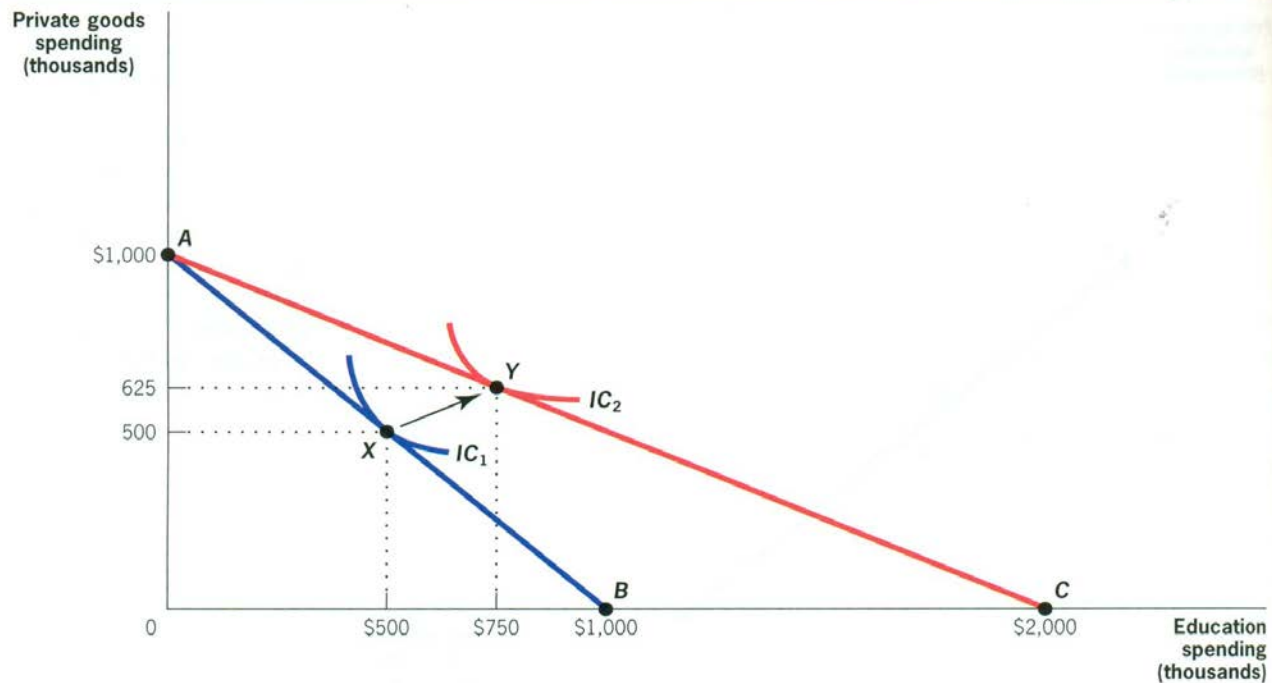
- (2) The extent of positive externalities, or spillovers, in public goods provision. If local public goods have large spillover effects on other communities, the goods will be underprovided by any locality. In this case, higher levels of government have a role in promoting the provision of these public goods (for example, through grants).

- (3) The economy of scale in the nature of public goods. Public goods that have large economies of scale, such as national defense, are not efficiently provided by many competing local jurisdictions; public goods without large economies of scale, such as police protection, may be provided more effectively in Tiebout competition.

Redistribution across communities

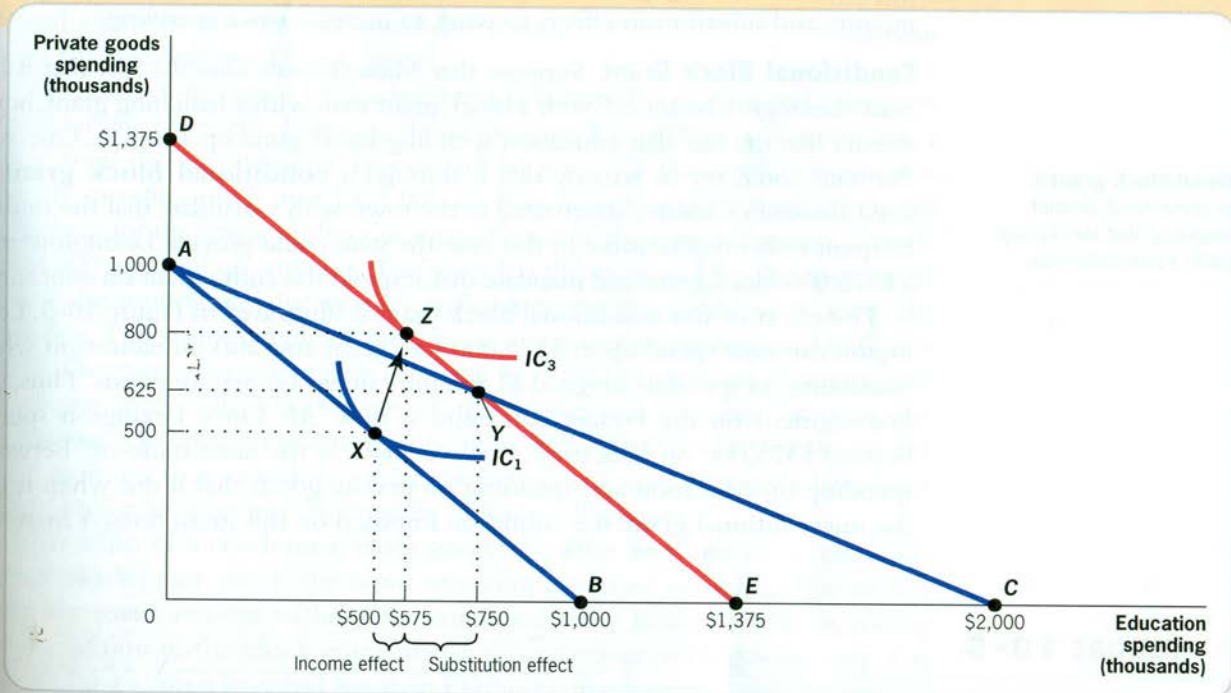
- Matching grants
- Block grants
- Conditional block grants

■ FIGURE 10-3



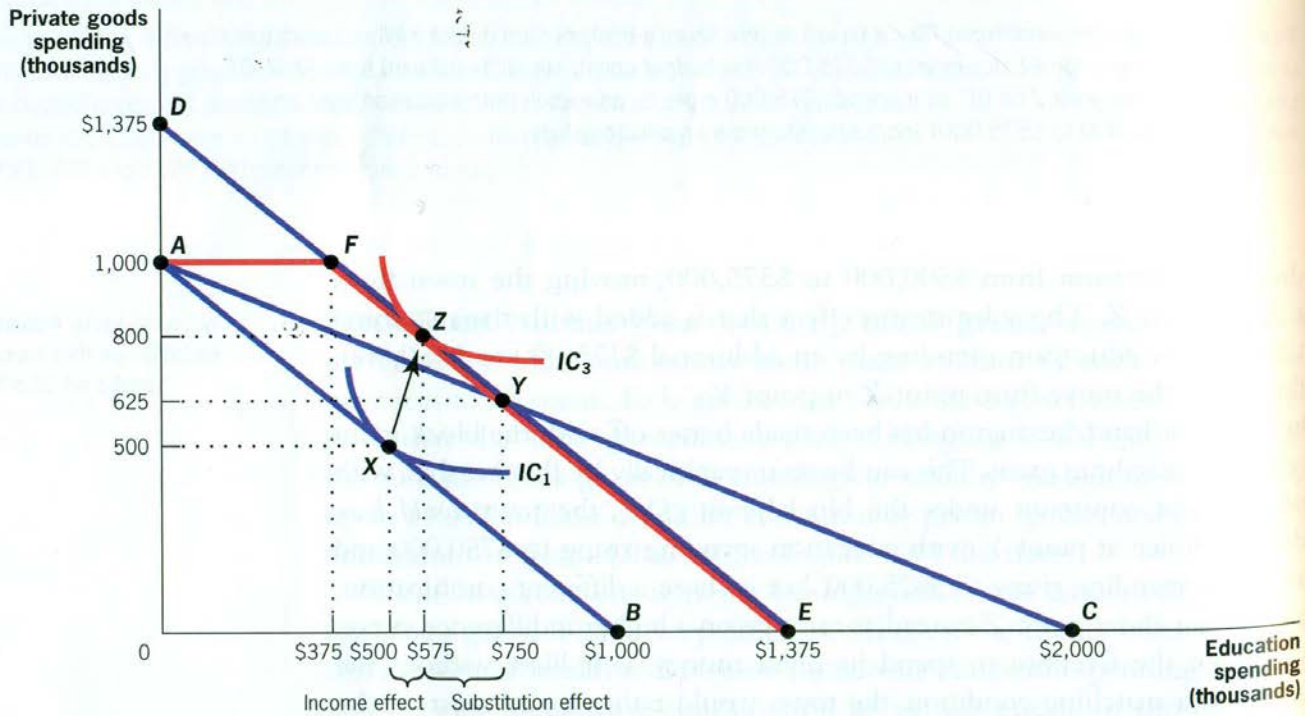
The Impact of a Matching Grant on the Town's Budget Constraint • When Lexington is offered a matching grant for educational spending, with \$1 of grant for each \$1 of local spending, the budget constraint pivots outward from AB to AC. Lexington chooses point Y on AC, as it spends \$250,000 more on education (with education spending rising from \$500,000 to \$750,000) and \$125,000 more on private goods.

■ FIGURE 10-4



The Impact of an Unconditional Block Grant on the Town's Budget Constraint • When Lexington is offered an unconditional block grant of \$375,000, the budget constraint shifts outward from AB to DE. Lexington chooses point Z on DE, as it spends \$75,000 more on education (with education spending rising from \$500,000 to \$575,000) and \$300,000 more on private goods.

■ FIGURE 10-5



The Impact of a Conditional Block Grant on Town Spending • When the town is offered a conditional block grant for education spending, it can spend up to \$375,000 on education while still spending \$1 million on private goods. Beyond point F, the conditional block grant operates like the unconditional block grant, so the budget constraint is AFE. For towns that already have high educational spending, like Lexington, the conditional grant has the same effect as the unconditional grant, causing education spending to rise by \$75,000.

EU Grants