

State and Local Government Expenditures

131 Undergraduate Public Economics
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FISCAL FEDERALISM

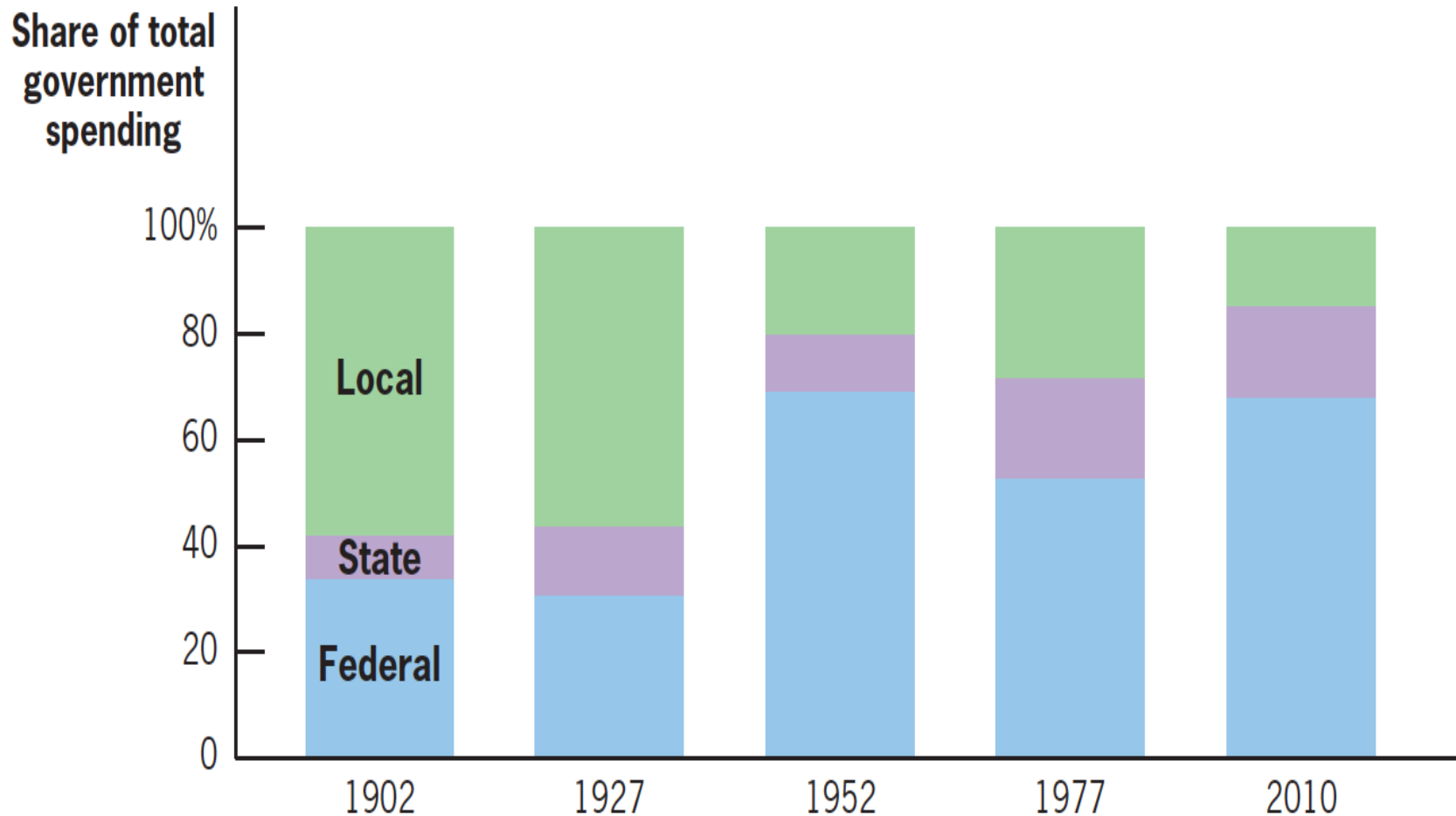
optimal fiscal federalism: The question of which activities should take place at which level of government

The distribution of government spending has changed dramatically over time in the United States

- Local state and spending have declined considerably.
- Much state and local spending now supported by intergovernmental grants [transfers from the federal government]

10.1

State and Local Spending in the United States, 1902–2010



SPENDING AND REVENUE OF STATE AND LOCAL GOVERNMENTS

Property tax: The tax on land and any buildings on it, such as commercial businesses or residential homes.

Main source of revenue from local governments due to:

1) History: real estate property is visible and hence taxable even in archaic economies with informal businesses

2) Immobile tax base: the real estate tax base cannot flee to another jurisdiction (mobility of the tax base is an issue for local governments)

Today, property tax is about 1/3 of revenue raised by state+local government (rest is 1/3 income tax, 1/3 sales taxes)

10.1

Spending and Revenue of State and Local Governments

| | Spending | | | Revenue | |
|----------------------|----------|--------|--------------|---------|-------|
| | State | \$/PC | | State | \$/PC |
| Education spending | AK | 3,010 | Income taxes | NY | 2,311 |
| | MA | 2,643 | | MT | 854 |
| | TN | 1,50 | | Many | 0 |
| Health care spending | DC | 10,349 | Sales taxes | DC | 1,847 |
| | LA | 6,759 | | Iowa | 698 |
| | UT | 5,031 | | Many | 0 |

THE TIEBOUT MODEL

What is it about the private market that guarantees optimal provision of private goods that is missing in the case of public goods?

Tiebout's insight was that the factors missing from the market for public goods were shopping and competition

The situation is different when public goods are provided at the local level by cities and towns:

Competition will naturally arise because individuals can *vote with their feet*: if they don't like the level or quality of public goods provision in one town, they can move to the next town

This threat of exit can induce efficiency in local public goods production

THE TIEBOUT FORMAL MODEL

We consider a very simple model to illustrate Tiebout's insight and theorem

Suppose there are $2 \cdot N$ families with identical income Y and 2 towns with N homes each

Towns 1 and 2 supply level G_1, G_2 of local public schools

There are 2 types of families:

1) N families with kids, with utility $U^K(C, G)$, value private consumption C and schools G

2) N elderly families, with utility $U^E(C)$, value only private consumption C

THE TIEBOUT EQUILIBRIUM DEFINITION

Allocation of families across towns is a **Tiebout Equilibrium** if and only if:

1) In each town, G is decided by median voter and financed equally by town residents with budget $Y = G/N + C$

⇒ If majority in town is elderly then $G = 0$ as this maximizes $U^E(Y - G/N)$

⇒ If majority in town is families with kids then $G = G^*$ that maximizes $U^K(Y - G/N, G)$

2) No 2 families want to exchange locations across towns

THE TIEBOUT THEOREM

Tiebout Theorem Part I: In equilibrium, families will sort themselves in towns according to their taste for public good (1 town with elderly only, 1 town with families with kids only)

Proof: Suppose elderly dominate in town 1 and $G_1 = 0$, then families with kids dominate in town 2 and $G_2 = G^*$. If there is a family with kids in town 1, then there is an elderly family in town 2 and they are willing to switch \Rightarrow not an equilibrium.

Tiebout Theorem Part II: In each town, the level of local public good is efficient

Proof: In elderly town, $G = 0$ which is efficient as nobody values G .

In kids town, G^* maximizes $U^K(Y - G/N, G)$ so that $-U_C^K/N + U_G^K = 0 \Rightarrow U_G^K/U_C^K = 1/N \Rightarrow \sum U_G^K/U_C^K = \sum MRS_{GC} = N/N = 1 = MC$ which is the Samuelson rule

THE TIEBOUT MODEL

People can vote with their feet by choosing the locality that best fits their tastes and provides the best public goods given the tax

The main message of the model is that competition across local jurisdictions puts competitive pressure on the provision of local public goods:

- 1) Public goods need to reflect tastes of local residents
- 2) Public goods need to be efficiently provided (without waste)

CENTRALIZED VS. DECENTRALIZED GOVERNMENT

Conservatives/libertarian tend to like decentralized governments over centralized governments

Conservatives/libertarian dislike redistribution and like individual choice and competition. In Tiebout model:

- 1) local governments do not do any redistribution: individuals receive in local public goods exactly what they are paying in taxes (= benefit principle of taxation)
- 2) individuals can choose (through their location choice) their preferred mix of public goods and taxes
- 3) competition between local govts forces them to provide local public good efficiently

PROBLEMS WITH THE TIEBOUT MODEL

The Tiebout model is an idealized model that requires a number of assumptions that may not hold perfectly in reality:

- 1) Individuals can move costlessly across towns (low mobility costs)
- 2) Individuals have perfect information on the benefits and taxes paid in each town
- 3) There must be enough towns so that individuals can sort themselves into groups with similar preferences for public goods
- 4) No externalities/spillovers of public goods across towns [with spillovers across towns, public goods will be under provided in Tiebout model, e.g. parks, police]

PROBLEMS WITH THE TIEBOUT MODEL

The Tiebout model requires equal financing of the public good among all residents.

Lump-sum tax: A fixed taxation amount independent of a person's income, consumption of goods and services, or wealth. Sometimes called a poll tax.

Towns typically finance their public goods instead through a property tax where rich pay more than poor (because they live in nicer houses). The problem that property taxation causes is that the *poor chase the rich* (rich also want to be with rich)

Two mechanisms prevent poor from chasing the rich:

- 1) **Housing prices:** places with rich people have high housing prices
- 2) **Zoning:** Restrictions that towns place on the use of real estate (e.g., each house must sit on a parcel of at least 6000 sq feet)

Zoning regulations protect the tax base of wealthy towns by pricing lower-income people out of the housing market.

EVIDENCE ON THE TIEBOUT MODEL

Tiebout Sorting: Resident Similarity Across Areas

A testable implication of the Tiebout model is that when people have more choice of local community, the tastes for public goods will be more similar among residents than when people do not have many choices

This fact is indeed pretty well established

More Efficiency when there is more Tiebout sorting

This fact is controversial

Evidence on the Tiebout Model: Hoxby (2000)

Hoxby (2000) considers public school districts in the US. She compares cities where:

A) There are few large school districts and hence little choice for residents (such as Miami)

B) There are many small school districts and hence a lot of choice for residents (such as Boston)

2 key findings:

I) Cities with few districts have less sorting across neighborhood (in terms of school quality) than cities with many districts (this result is well established)

II) Cities with many districts have **higher** test scores on average: this result is controversial (see Rothstein, 2007 critique)

EVIDENCE ON THE TIEBOUT MODEL

Capitalization of Fiscal Differences into House Prices

House price capitalization: Incorporation into the price of a house of the costs (including local property taxes) and benefits (including local public goods) of living in the house.

⇒ High property taxes (relative to public goods quality) depresses housing prices

⇒ Low property taxes (relative to public goods quality) increases housing prices

Example: Suppose \$1 cut in property tax (in perpetuity) with no change in value of local public good

Capitalized value: $\Delta V = 1 + 1/(1+r) + 1/(1+r)^2 + \dots = 1/[1 - 1/(1+r)] = (1+r)/r = \21 if $r = 5\%$

10.2

EVIDENCE: Evidence for Capitalization from California's Proposition 13

- California's Proposition 13 became law in 1978.
 - Set the maximum amount of any tax on property at 1% of the "full cash value."
 - Full cash value: Value as of 1976, with annual increases of 2% at most.
- Reduced property taxes immensely in some areas, little change in others.

10.2

EVIDENCE: Evidence for Capitalization from California's Proposition 13

- Each \$1 of property tax reduction increased house values by about \$7, about equal to the PDV of a permanent \$1 tax cut.
- In principle, the fall in property taxes would result in a future reduction in public goods and services, which would lower home values.
- The fact that house prices rose by almost the present discounted value of the taxes suggests that Californians did not think that they would lose many valuable public goods and services when taxes fell.

KEY CONSEQUENCE OF TIEBOUT MODEL

It is very hard for a local government to redistribute from rich to poor:

If local redistribution is high \Rightarrow

- 1) Poor flock to the city which provides welfare benefits
- 2) Rich flee to other cities to avoid paying for redistribution
 \Rightarrow Local redistribution program will break down

Redistribution programs work better if implemented at higher level: state or federal (harder to leave the state or country). At local level, need to have tax-benefit linkage to avoid migration

tax-benefit linkages: The relationship between the taxes people pay and the government goods and services they get in return.

REDISTRIBUTION ACROSS COMMUNITIES

There is currently enormous inequality in both the ability of local communities to finance public goods and the extent to which they do so.

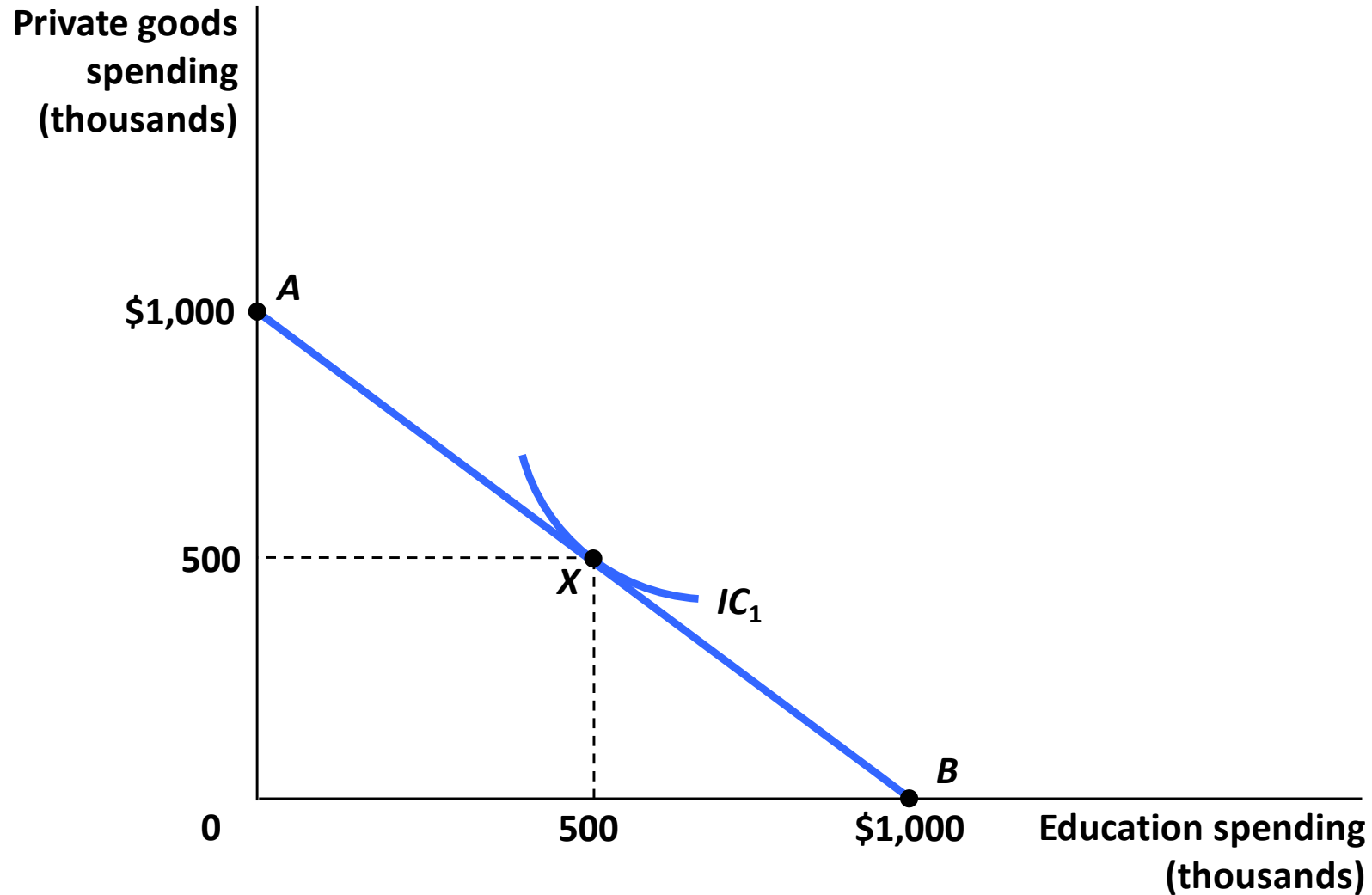
Central government can redistribute across communities **directly** using taxes and spending but also **indirectly** by giving grants to lower levels of government

Higher levels of government can redistribute across lower levels of government through *intergovernmental grants*.

We assume in graphical analysis that local community chooses public spending and private spending according the preferences of Median voter in the community

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Tools of Redistribution: Grants



Intergovernmental Grants

Higher level government can provide grants to redistribute across communities and incentivize communities to spend on public goods

Three main forms of grants:

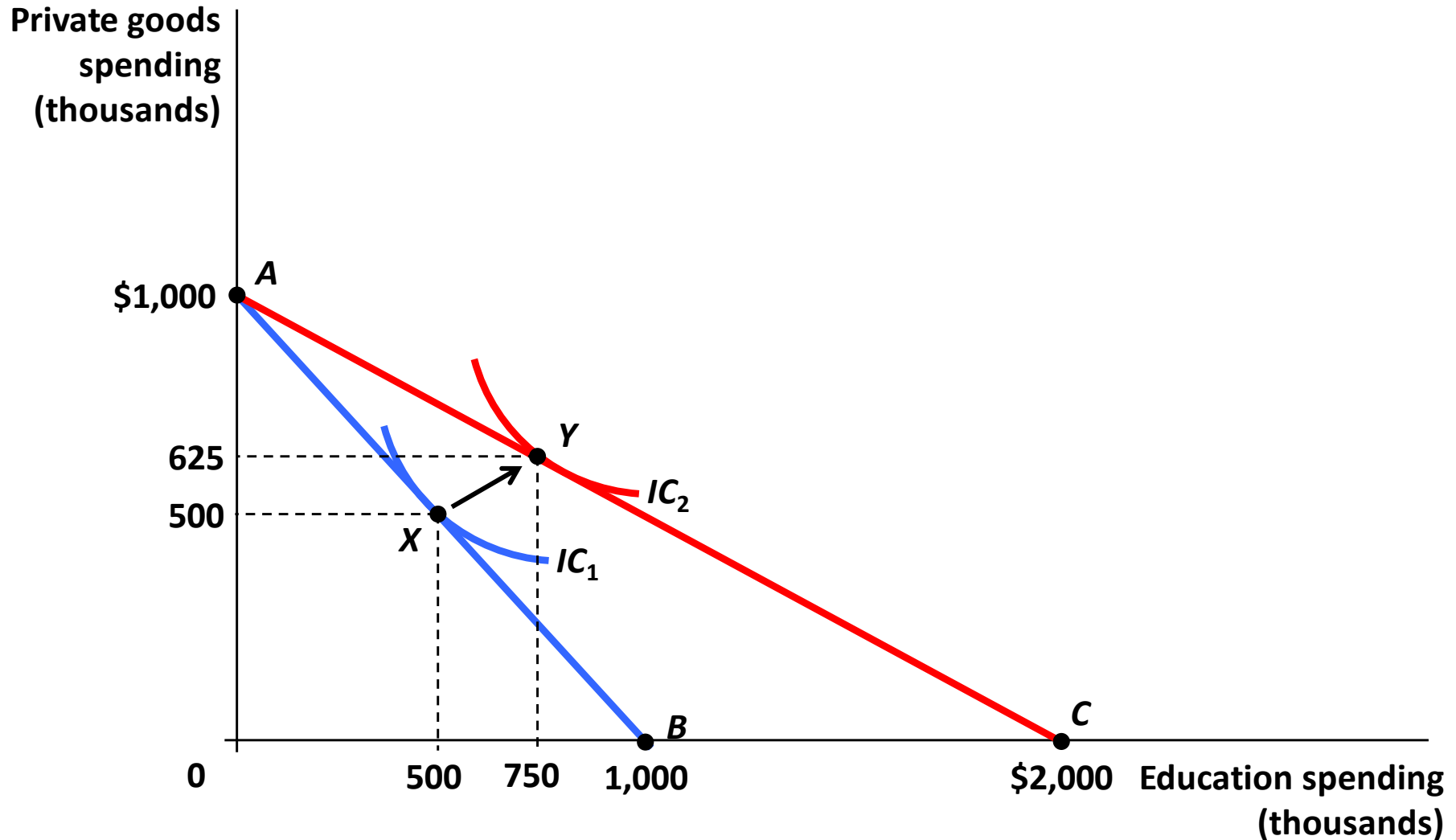
1) Matching grant: A grant, the amount of which is tied to the amount of public good spending by the local community.

2) Block grant: A grant of some fixed amount with no mandate on how it is to be spent.

3) Conditional block grant: A grant of some fixed amount with a mandate that the money be spent in a particular way.

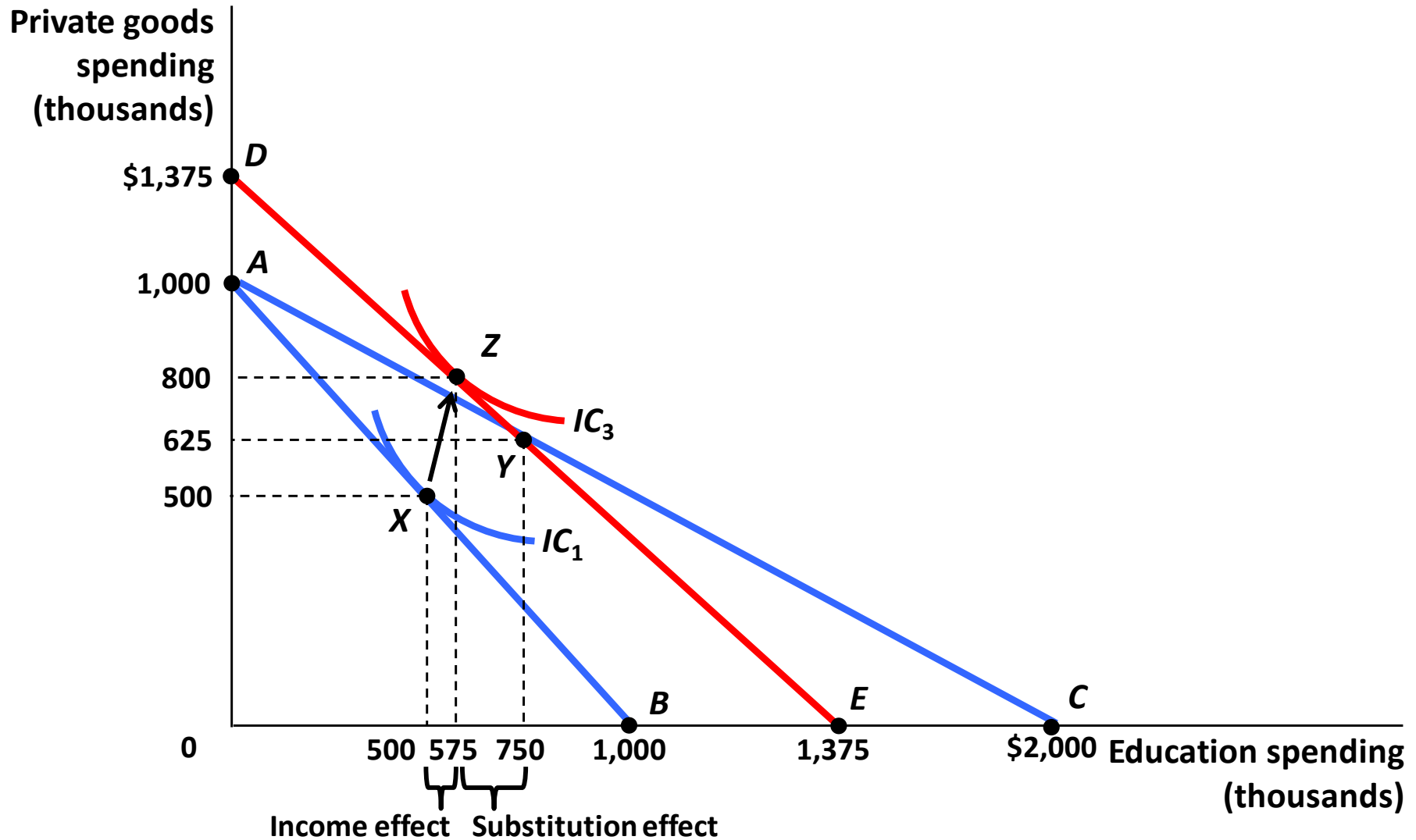
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Matching Grants



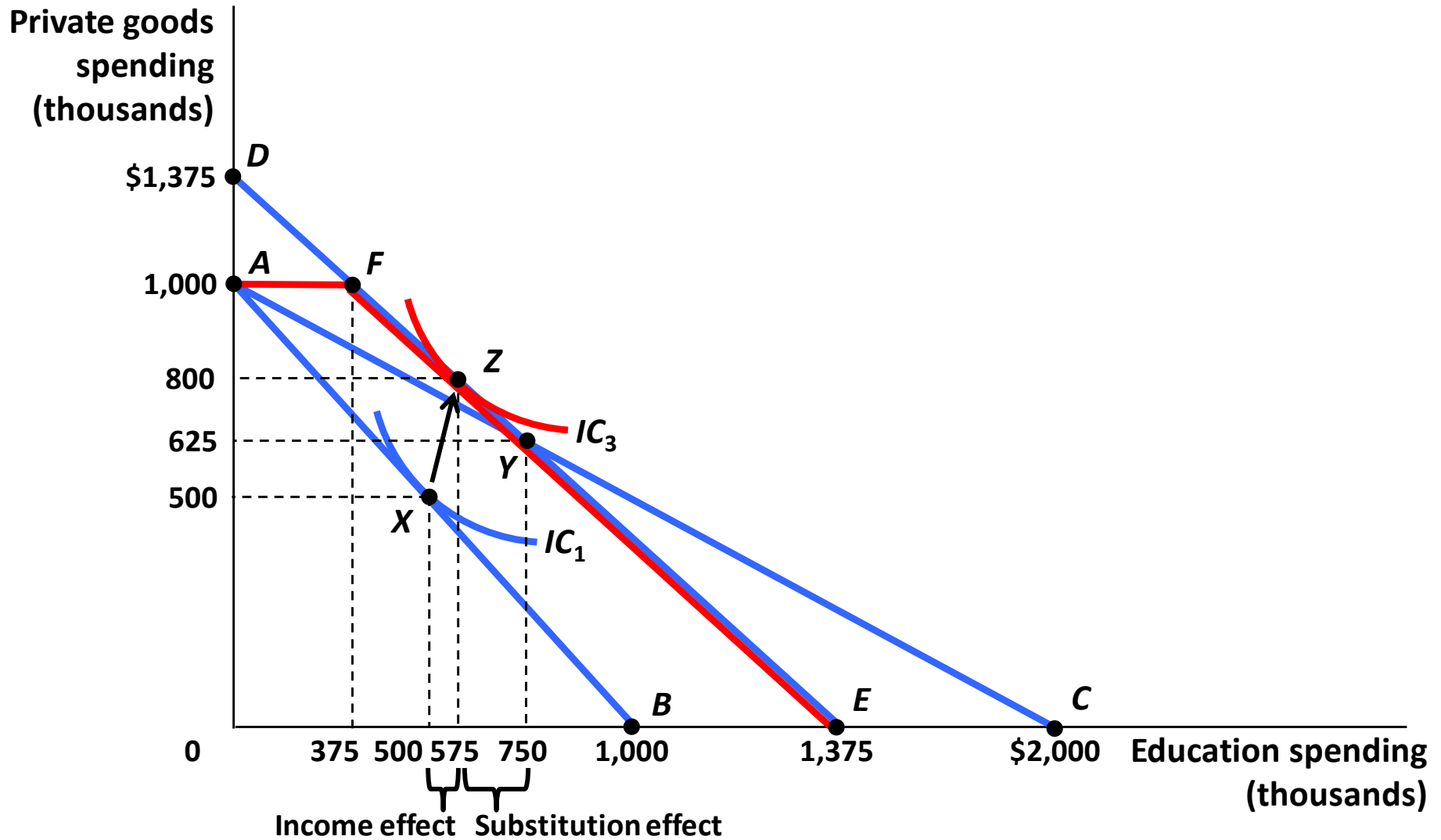
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Block Grant



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Conditional Block Grant



KEY PREDICTION OF THEORY: CROWD-OUT

In the theory presented, a \$1000 increase in private income has the same effect as a \$1000 increase in Fed block grant: both shift the budget in the same way and lead to the same outcome

Example: \$1000 private income increase leads to \$800 more in private consumption and \$200 more in local taxes and public spending. \$1000 extra fed grant leads to \$200 extra in public good spending and \$800 cut in local taxes and hence \$800 extra in private consumption

Similarly, with multiple public goods (e.g., schools and police), an extra \$1000 Fed grant for school has the same effect on schools and police than a \$1000 Fed grant for police

Money is fungible: only total resources matter for the allocation across private good and public goods at the local level

THE FLYPAPER EFFECT

Hines and Thaler JEP'95 found that the crowd-out of state spending by federal spending is low and often close to zero

Economist Arthur Okun described this as the flypaper effect because “the money sticks where it lands” instead of replacing state spending

But evidence is based on correlation [not necessarily causation as states that get grants maybe the ones that like spending the most]

Recent studies show that there is a flypaper effect in the short-run but that there is substantial crowd-out from block grants in the long-run

REDISTRIBUTION IN ACTION: SCHOOL FINANCE EQUALIZATION

School finance equalization: Laws that mandate redistribution of funds across communities in a state to ensure more equal financing of schools.

Without school finance equalization, huge disparity in property tax base and hence school funding (per pupil) across areas (example from Bay Area: Lafayette is very wealthy, Richmond is poor)

Many states (including California) impose equalization: pool local taxes at state level and redistribute them across districts

Equalization often imposed by courts without thinking carefully about economic consequences

REDISTRIBUTION IN ACTION: SCHOOL FINANCE EQUALIZATION

Tax price: For school equalization schemes, the amount of revenue a local district would have to raise in order to gain \$1 more of spending. Examples:

- 1) With no equalization, the tax price is \$1 (local govt keeps all its revenue)
- 2) With perfect equalization, the tax price is infinite (raising local revenue has zero impact on local spending)
- 3) Suppose state takes 50% of local revenue and redistributes it equally across cities: the tax price is \$2 (city needs to raise \$2 in local revenue to be able to keep \$1 extra)

CALIFORNIA SCHOOL EQUALIZATION

In 1960s-1970s, California used to have one of the best K-12 public school systems in the nation, now it has one of the worst

California used to have no school finance equalization and hence big disparities across areas

1976: Serrano vs. Priest case: Supreme court ruled that disparities above a threshold were unconstitutional

⇒ Wealthy districts forced to give all their tax revenue above the threshold to the common pool to fund poor districts

⇒ local government has no incentive to raise taxes ⇒ taxes and school funding fall in rich districts

⇒ Property taxes no longer able to fund schools adequately

10.3

APPLICATION: School Finance Equalization and Property Tax Limitations in California

If residents perceived that property taxes were “too high” in California, why did they wait until 1978 to lower them?

- Proposition 13 actually a response to school finance equalization in California.
- Taxes no longer financed local school spending; just taxes, rather than prices. Tax price became infinite.
- Voters were happy to limit property taxes once those taxes no longer brought them any benefit.

CONCLUSION

Higher levels of government are able to implement redistribution across lower levels of government either directly with means-tested programs for individuals (such as Food stamps) or through grants to local governments (such as Medicaid)

In the same way that 100% tax on individuals is counterproductive, 100% confiscation of local taxes (as in the most drastic school equalization schemes) is counterproductive (leads local governments to abandon their taxes)

Higher level government should have primary responsibility for redistribution

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