State and Local Government Expenditures (Chapter-10)

State and Local Government Expenditures- Background

- Question: How much (if any) should the national (federal) government intervene in the provision of public goods?

- What is the optimal level of fiscal federalism?
  - **Optimal fiscal federalism:** The question of which activities should take place at which level of government.

State and Local Government Expenditures- Background

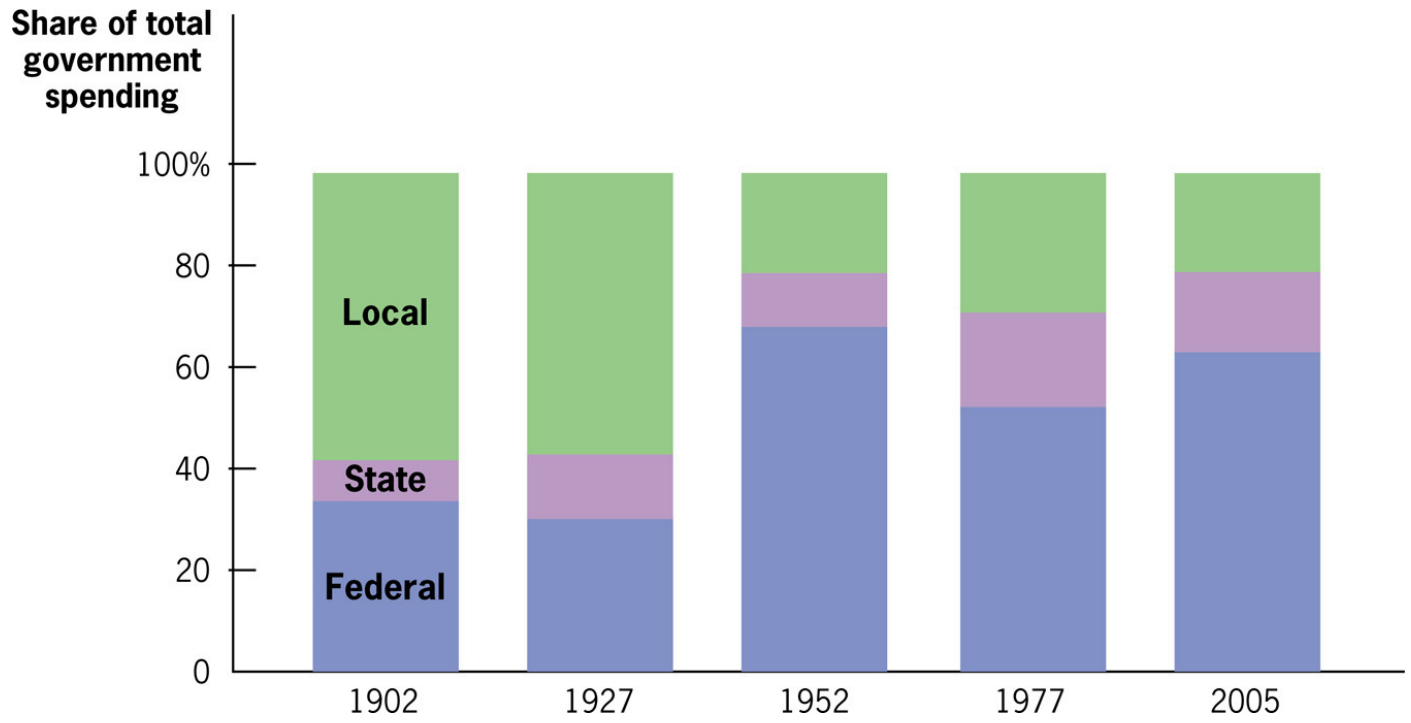
- Example: Bush administration's No Child Left Behind (NCLB) policy
  - NCLB aims at improving the educational opportunities for disadvantaged students by holding 'failing' schools accountable.
  - Harsh penalties, including elimination of principles and teachers were to be imposed on schools failing to show 'adequate' progress.
  - The adequate progress would be measured based on a standardized national test.

State and Local Government Expenditures- Background

- Example: Bush administration's No Child Left Behind (NCLB) policy
  - Proponents: Supported the federal government for intervening when it is clear that many states have failed or not even tried to close the achievement gap between white and black students.
  - Opponents: Testing students on a nationally standardized test might not reflect the varying tastes of individuals across different localities.
  - How much should the federal government intervene in the provision of education, which is a public good?

State and Local Government Expenditures-Fiscal Federalism

- Changing fiscal federalism in the United States over the years:



State and Local Government Expenditures-Fiscal Federalism

- Spending and Revenues:
  - Federal
    - Spending: Health care, national defense and social security
    - Revenues: Majority from income taxation.
  - State
    - Spending: Education, health care and public safety.
    - Revenues: Majority from property taxation.

State and Local Government Expenditures-Fiscal Federalism

- Fiscal federalism among OECD countries:

■ 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.

State and Local Government Expenditures- Optimal Fiscal Federalism

- Two major problems with government provision of public goods:
  - Preference revelation: People may misrepresent their preferences of the public goods.
  - Preference aggregation: Difficult to design mechanisms to aggregate individual preferences into social decisions.

State and Local Government Expenditures- Optimal Fiscal Federalism

- Tiebout Model:
  - According to Tiebout, the problems with public good provision were missing ‘shopping’ and ‘competition’ in the market.
    - Individuals ‘shop’ for public goods and choose the locality that provides the public good according to their tastes (competition).
    - In other words, individuals ‘vote with their feet’.
  - Under certain conditions, provision of public goods will be fully efficient at the local level.

State and Local Government Expenditures- Optimal Fiscal Federalism

- Tiebout Model:
  - Example: Two individuals, one public good. Assume that individual-1 prefers a higher level of public good than individual-2.
    - Tiebout model predicts that individual-1 moves to a locality with individuals who prefer exactly the same amount of the public good.

State and Local Government Expenditures- Optimal Fiscal Federalism

- Tiebout Model:
  - Example: Two individuals, one public good. Assume that individual-1 prefers a higher level of public good than individual-2.
    - No need for individual-1 to underreport his willingness to pay for the public good, since if he does so, he would have to move to a locality that provides lower levels of public good.
    - No preference revelation issue!

State and Local Government Expenditures- Optimal Fiscal Federalism

- Tiebout Model:
  - Example: Two individuals, one public good. Assume that individual-1 prefers a higher level of public good than individual-2.
    - No preference aggregation issue either, since each locality is homogeneous in terms of citizens' preferences for the public good.

State and Local Government Expenditures- Optimal Fiscal Federalism

- Issues with the Tiebout Model:
  - Assumes **costless moving.**
  - Assumes that individuals have **perfect information** about the localities' provisions of public goods**.**
  - Provision of some public goods require sufficient size or scale.
    - Example: Public schools.

State and Local Government Expenditures- Optimal Fiscal Federalism

- Issues with the Tiebout Model:
  - Requires lump-sum taxation, which is problematic, since it does not take into account the varying wealth of individuals.
  - Requires no spillovers/ externalities:
    - Spillover example: local park
    - Externality example: police force and crime.

State and Local Government Expenditures- Optimal Fiscal Federalism

- Evidence of the Tiebout Model:
  - Residence similarity across areas
  - Capitalization of fiscal differences into housing prices

State and Local Government Expenditures- Optimal Fiscal Federalism

- What are the normative implications of the Tiebout model for the optimal design of fiscal federalism?
  - The extent to which public goods should be provided at the local level is determined by the following three factors.

State and Local Government Expenditures- Optimal Fiscal Federalism

1. **Tax-benefit linkages:** The relationship between the taxes people pay and the government goods and services they get in return.
   - High linkage: local roads
   - Low linkage: Welfare payments

State and Local Government Expenditures- Optimal Fiscal Federalism

1. **Tax-benefit linkages:**
   - If the tax-benefit linkage is low, the public good should be provided at the federal level. If not, the public good will be underprovided by the local governments.

State and Local Government Expenditures- Optimal Fiscal Federalism

2. Positive externalities/ spillovers

- The higher the externalities/spillovers, the better it is to provide the public good at the federal level.
- Example: police force and crimes.

State and Local Government Expenditures- Optimal Fiscal Federalism

3. Economies of scale

- The public goods with high economies of scale should be provided at the federal level.
- Example: national defense.

State and Local Government Expenditures- Redistribution across Communities

- If the Tiebout model is valid, we should not worry about redistribution, since each local community is providing public goods efficiently.

State and Local Government Expenditures- Redistribution across Communities

- However, if the Tiebout model does not perfectly describe reality, there are two arguments for redistribution:
  1. **Failures of the Tiebout mechanism:** If there exist 'frictions' that prevent individuals to 'vote with their feet', then there may be some people 'stuck' in communities that provide less public good than they desire.
  - If this is the case, redistribution is necessary.

State and Local Government Expenditures- Redistribution across Communities

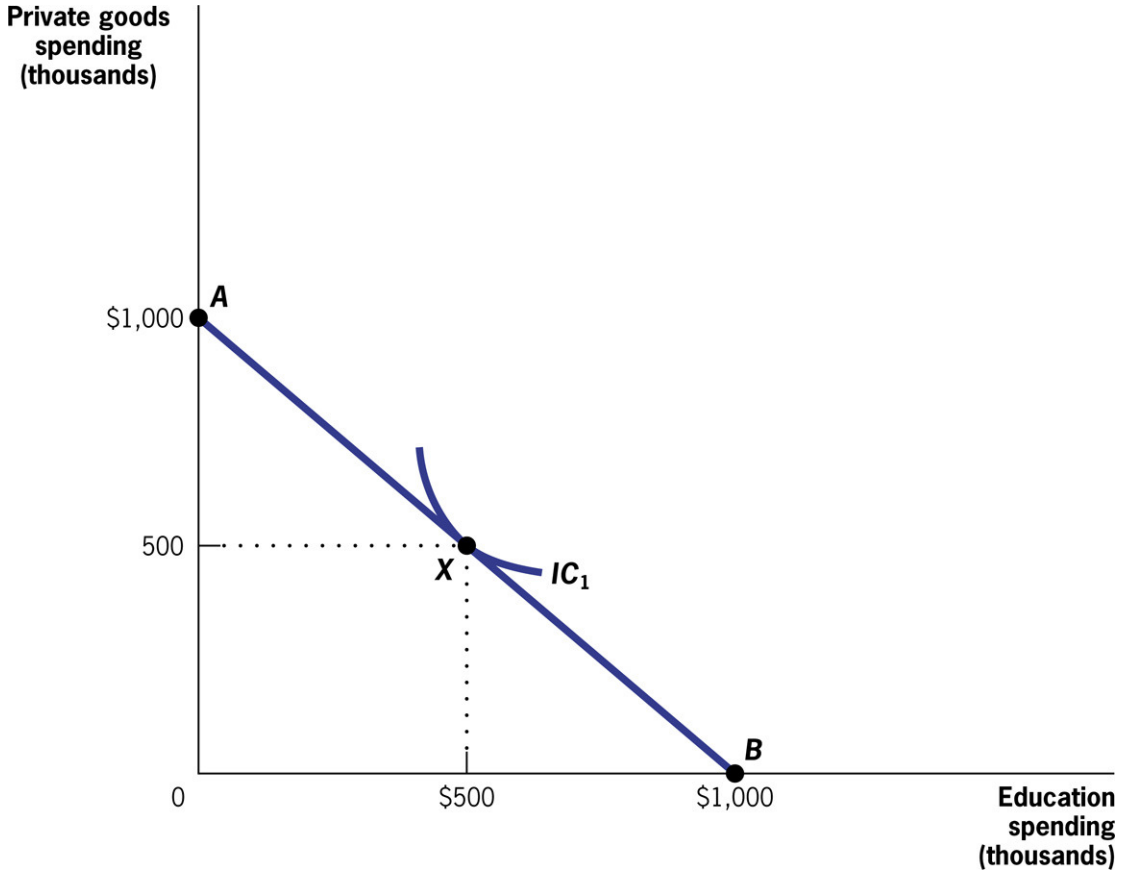
2. **Externalities:** If a large share of local tax revenue is spent on a public good with spillovers, then the government should subsidize the localities that produce the externality.
   - Example: public education.

State and Local Government Expenditures- Tools of Redistribution: Grants

- **Example:** Suppose that a town is providing only one public good, education, to its residents. The after-tax income of the residents is spent on private goods. Let the total welfare of the town equal $1 million.

State and Local Government Expenditures- Tools of Redistribution: Grants

- Initially:

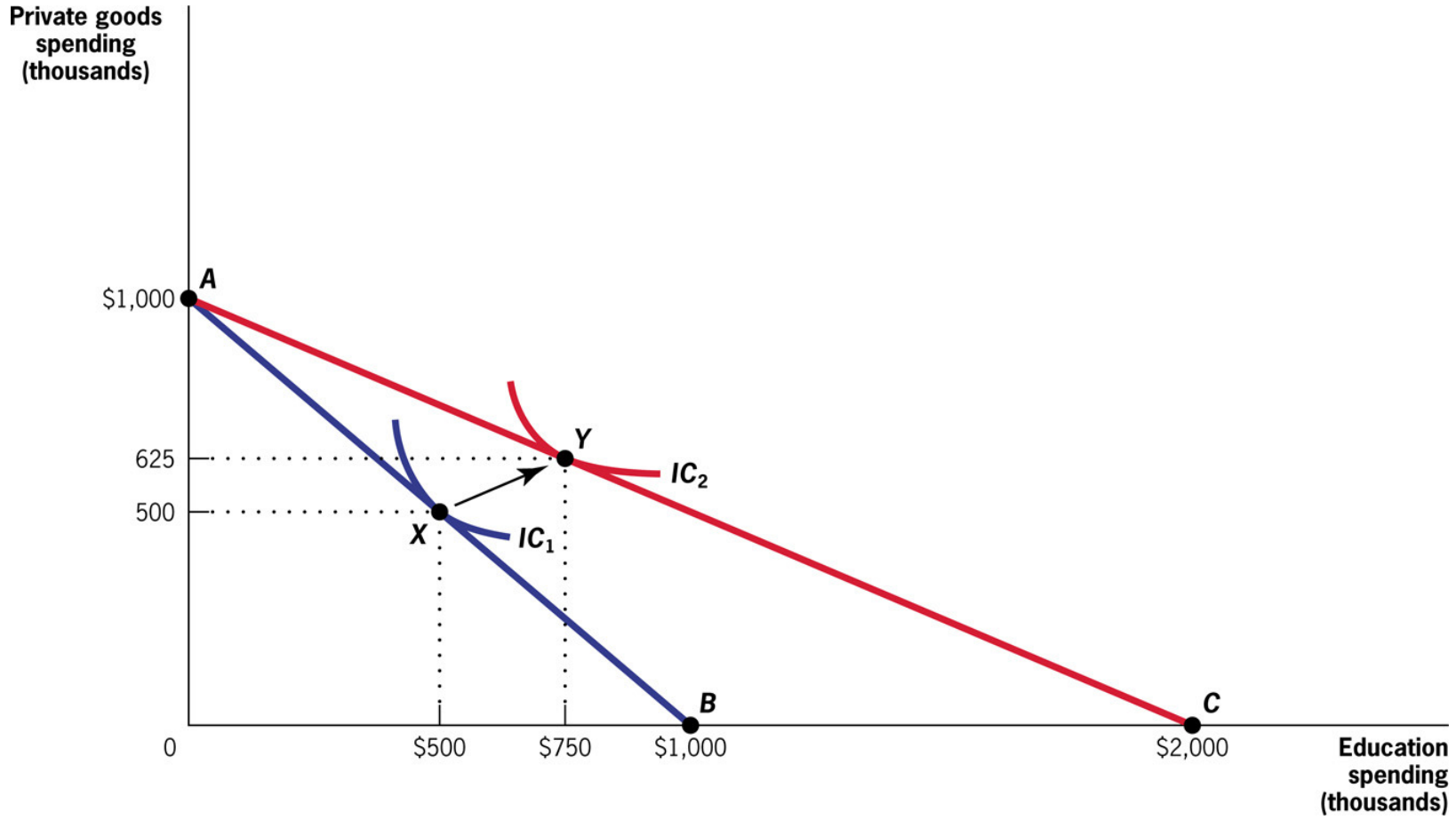


State and Local Government Expenditures- Tools of Redistribution: Grants

1. **Matching Grants:** A grant, the amount of which is tied to the amount of spending by the local community.
   - Effectively reduces the price of education to the town by half.
   - The town increases its education provision.

State and Local Government Expenditures- Tools of Redistribution: Grants

1. Matching Grants:

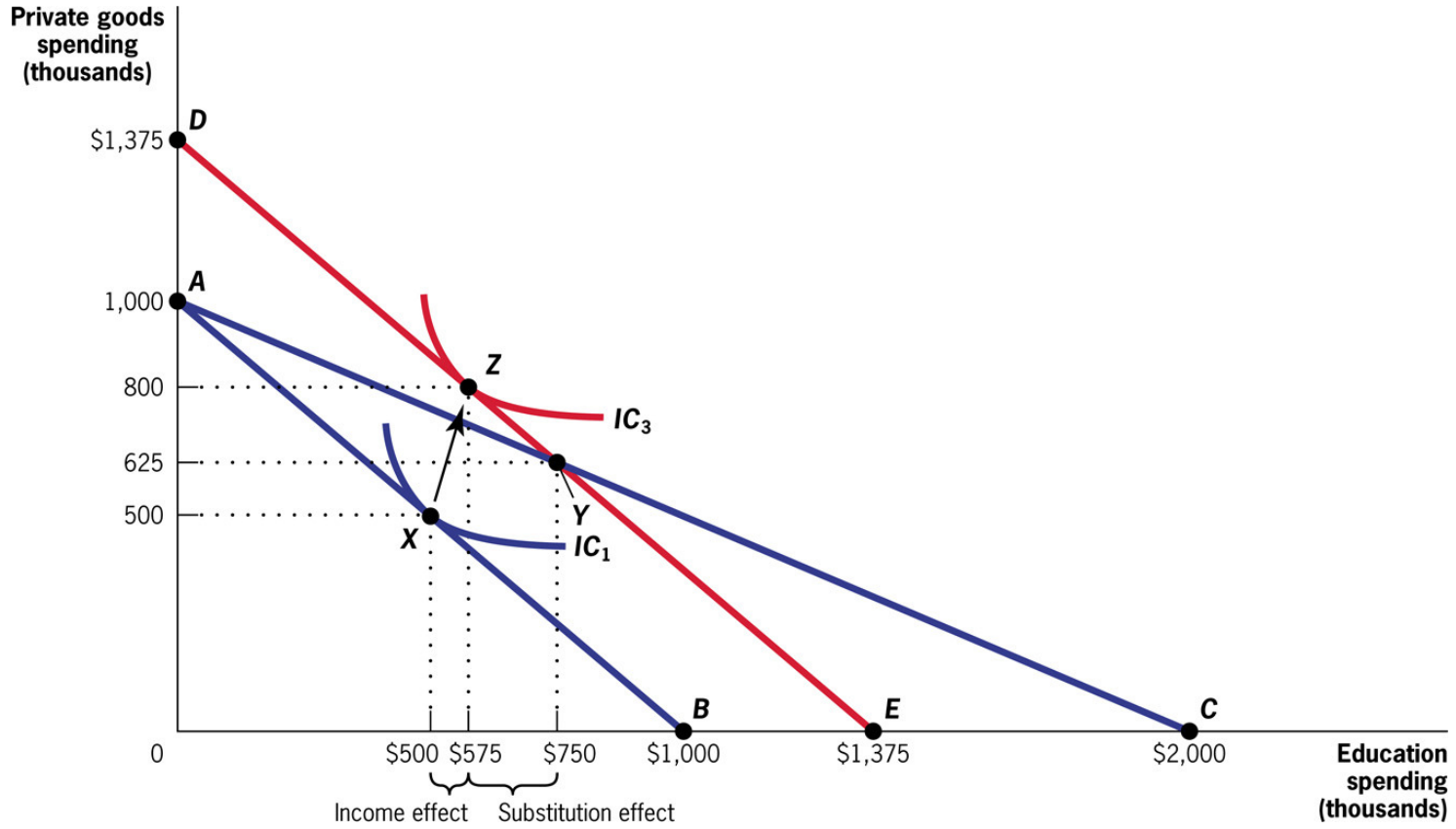


State and Local Government Expenditures- Tools of Redistribution: Grants

2. **Block Grants:** A grant of some fixed amount with no mandate on how it is to be spent.
   - Increases the wealth of the town leading to an increased provision of education.
   - Assume that the grant amounts $350,000.

State and Local Government Expenditures- Tools of Redistribution: Grants

2. Block Grants:

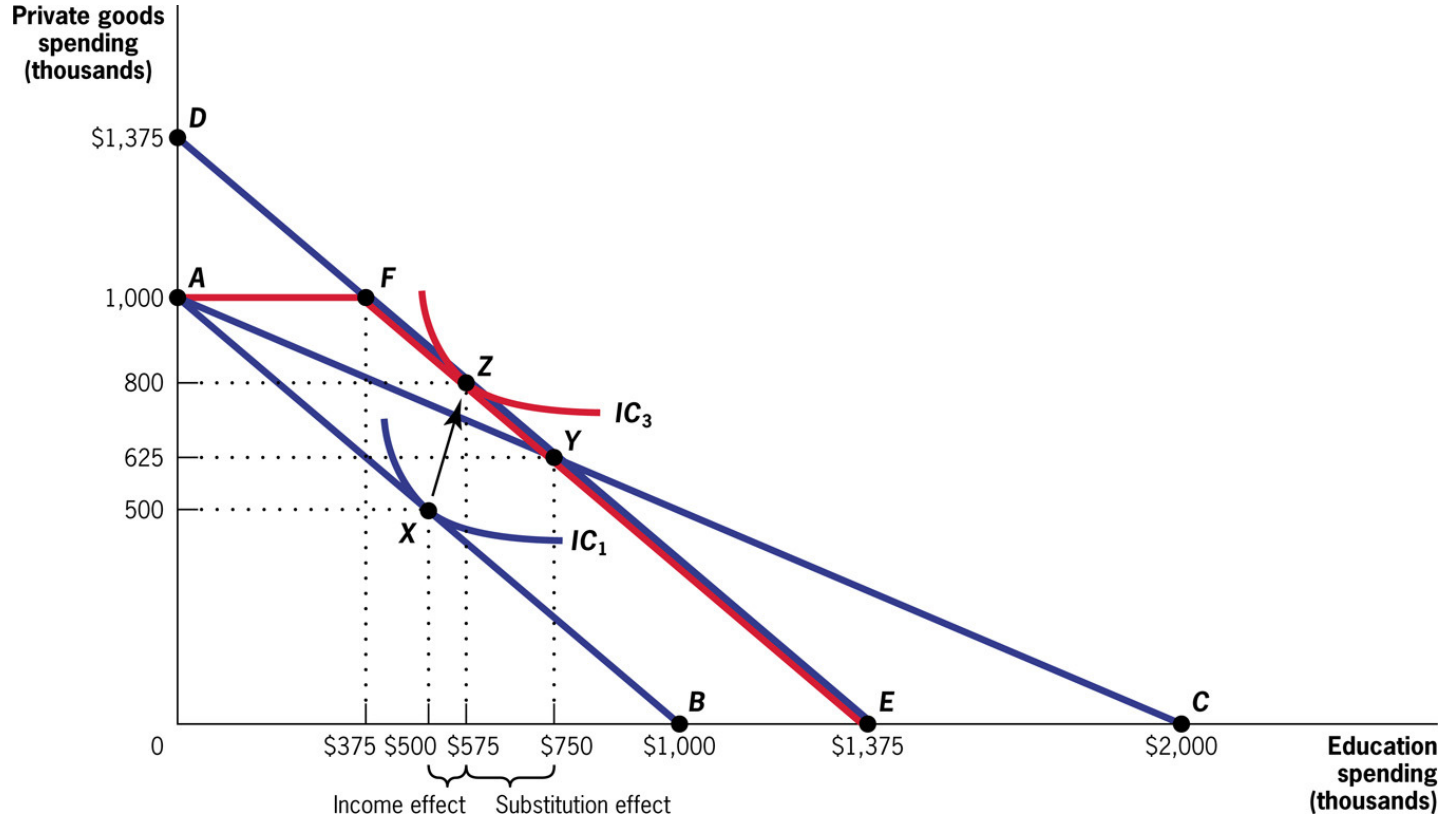


State and Local Government Expenditures- Tools of Redistribution: Grants

3. **Conditional Block Grants:** A grant of some fixed amount with a mandate that the money be spent in a particular way.
   - Increases the wealth of the town leading to an increased provision of education.

State and Local Government Expenditures- Tools of Redistribution: Grants

3. Conditional Block Grants:



State and Local Government Expenditures- Tools of Redistribution: Grants

- Comparing the three tools:
  - The increase in the provision of the public good is highest in matching grants.
  - Even though the provision does not increase as much with block grants, the town is better-off than matching grants.