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:

| 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: Journard 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.
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.
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:

![Graph showing Conditional Block Grants with Private goods spending and Education spending in thousands. The graph illustrates income effect and substitution effect.]
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.