

# Public Economics

## Lec 13: Fiscal federalism

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# AM's reminders

- **Essays online**
  - First impressions
  - Check which paper you have to discuss
- **Next time: Q&A at the end**

# Reading list

- **RG ch. 22**

# Fiscal federalism

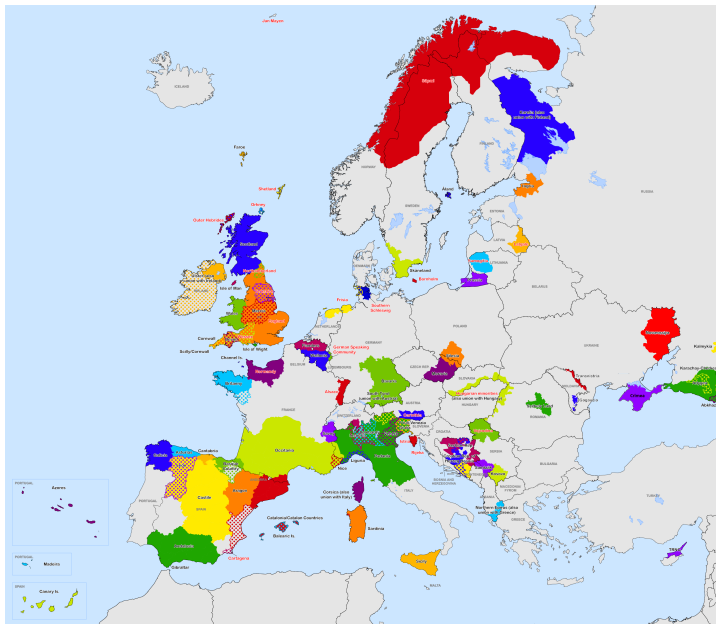
## Level at which decisions should be taken (esp. taxes)

- **Central government**
  - Federal government (US), nations
  - European Union
- **Local government**
  - States (US), regions, municipalities. . .
  - Nations

## Relevance

- United States
- European Union
- China
- Spain, Italy, UK. . .

# Separatist movements in EU



# Measuring centralization

- **Proportion of expenditure/taxes by central government**
  - **Centralization ratio**
- FRA: 81%; US: 48%
- **Issues with centralization ratio**
  - Regulations from central state
  - Accounting practices
    - **Decentralization**  $\implies$  **freedom of choice**
    - If tax rates constrained, little decentralization

# Why federalism

## Club theory & impure public good

- 1 Select **number of people** given **size**
    - ↗ people, ↘ per-capita cost
    - ↗ people, ↗ congestion
    - **Optimum:** marginal cost = marginal benefit
  - 2 Select **size** given **number of people**
    - ↗ size, ↗ per-capita cost
    - ↗ size, ↘ marginal utility
    - **Optimum:** marginal cost = marginal benefit
- **Suggests relationship between type of public good and dimension of the “club”**
    - ∃ **upper and lower bounds**

# Why federalism

- **Tailoring output to local tastes**
  - **Pol. economics:** uniform tastes  $\implies$  stable decision making
  - **More responsive to needs of citizens:** costs of obtaining and processing information
  - **Economic regulations enacted at local levels**
  - (The more decentralization, the less corruption)
- **Innovation and experimentation at the local level**
  - See lecture on **political economics**
- **Fostering intergovernmental competition**



# Tiebout model

- **Efficiency in private markets because of competition**
- **People can move & shop around municipalities**
  - **People settle in clubs offering the bundle they like best**
    - **Tax & services**
    - **Immigration policies within the EU**
  - **Pareto-efficient equilibrium**
    - None better off, otherwise they'd move
- **A market for citizens**
  - Both price (tax) and quality (service) dimension

# Tiebout model: assumptions

- 1 **Complete mobility**
- 2 **No externalities** across towns
  - Otherwise **efficiency** issues
- 3 Individuals have **complete information** on communities
- 4 **No economies of scale**
- 5 **Service financed by property tax**
  - People can't separate taxation from service provision
- 6 **Exclusionary zoning laws**
  - Can require minimum-sized houses (regulatory plan)
  - **Income segregation**  $\implies$  opportunity of free-ride
    - E.g. **Gentofte kommune (DK)**
  - **Reverse gentryfication**, musical suburbs

# Why centralization

- **Economies of scale**
  - Tax collection
  - Public goods: **Army**
  - If closed economy **market size**
- **Internalization of externalities**
  - VS **local public goods**
- **Decreased mobility of factors**
  - **More efficient taxation** (excess burden)
  - **Public good problem:** if competition  $\implies$  low taxes, underprovision of public good
    - See also international tax competition

# A trade-off

- **Boundaries:**
  - Mayors elected *to get the garbage picked up and get the streets plowed*
  - PM can't do that efficiently
- $\neq$  **goods administered at  $\neq$  levels**
  - **Needs funding at different level**
- **Beware:** too much regulation  $\implies$  confusion
  - **Roles need to be clearly distinct**
- **Size?**
  - **EU  $\rightarrow$  Nation  $\rightarrow$  Region/county  $\rightarrow$  Municipality**

# Equity: intergovernmental grants

**US:** important source of income

**EU:** lots of UE grants (agriculture, research)

**Unconditional grant**, revenue sharing

- **Lump-sum grant**
- **Commodity egalitarianism**

# Intergovernmental grants

**Conditional/categorical grants:** purpose for grants specified

- **Matching grant**

- Equivalent to **ad-valorem subsidy**, matching ratio

- $$P_1 = \frac{P_0}{1 + mr}$$

- **Positive externalities:** which **matching rate** to apply?

- **Matching close-ended grant**

- **Capped**

- **Reduces public expenditure**

- **Non-matching grant**

- **Crowd-out of expenditures**

# Intergovernmental grants

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- $$P_1 = \frac{P_0}{1 + mr}$$

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- Subsidy = MPB at efficient outcome

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# Budget constraints of local governments

- **Moral hazard**
  - **Bailouts**
  - **Grant dependence**
- **Flypaper effect**
  - **Theory:** 1\$ in private income = 1\$ grants
    - Identical shift in budget constraint
    - Grant can be used also to reduce taxes
  - **Positive analysis:**
    - 1\$ in private income  $\implies \approx 10c$  exp
    - 1\$ in grants  $\implies \approx 40c$  exp
  - **Role of bureaucrats:** citizens unaware of budget constraints



# Swedish case

- **Highly decentralized**
  - **Municipalities** have large influence
- **Central government:**
  - 67.3% tax revenues
  - 57.7% public expenditures
- **Municipalities and counties:**
  - 32.7% tax revenues
  - 28.8% (municipalities) + 14.2% (counties) expenditure
- **Local tax revenues from income taxes**
  - As in **DK**, but most other countries rely on **property taxes**

## Housing immobile: can't escape

- Favored income source for local governments
- **Tax rate** \* **assessed value**
- **Assessed ratio**
  - Typically  $< 1$
  - Adjusting ratio  $\implies$  increase taxes

# Property taxation - incidence & progressiveness

## Excise tax

- **Land:** fixed supply
  - **Incidence all on landowner**
  - **Capitalization:** price of land reflects future streams
  - **Timing and expectations crucial**
  - **Progressive:** share of income from land ↗ as income ↗
- **Structures:** perfectly elastic supply (capital mobile)
  - **Incidence all on tenants**
  - Adjusting ratio  $\implies$  increase taxes
  - **Progressiveness:**
    - Depends: how consumption of housing changes as income ↗
    - **Annual income: regressive** (transitory income)
    - **Permanent income: ongoing research**

# Property taxation - incidence & progressiveness

## Capital tax

- **Progressive:** share of capital income increases with income
- **Land:** supply fixed, owners bear burden
- **Long run:** adjustments depend on relative elasticities

## User fee

- **Tiebout model:** fee for using public services
  - **No excess burden:** tax = price for living in neighbourhood
  - In reality **tenuous link**, but explains why both local taxes and local services are capitalized in housing prices

# Public perception of property tax

## Negative

- High **salience**
- Perceived as **Regressive**
  - If shifted on tenants, can be
- Hits **liquidity constrained people**
  - Larger drop in consumption
- Impossible to shift

## Net worth tax?

- Wealth tax  $\implies$  national coordination