

Public Economics

Lec 13: Fiscal federalism

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AM's reminders

- **Next time: Q&A at the end**

Reading list

- **RG ch. 22**

Fiscal federalism

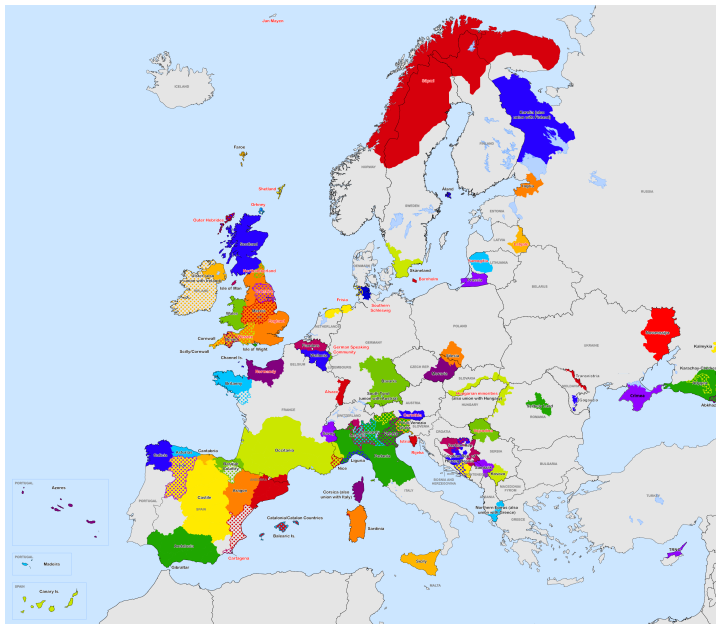
Level at which decisions should be taken (esp. taxes)

- **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 gentrification**, 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: 34% of local revenues

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

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?

- Subsidy = MPB at efficient outcome

- Practice: political consideration matter most

- **Matching close-ended grant**

- **Capped**

- **Reduces public expenditure**

- **Non-matching grant**

- **Crowd-out of expenditures**

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 (partial eq. model)

- **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 (general eq. model - requires more structure)

- **Progressive?** Capital tax - % of cap. income \nearrow with income
- **Land & structure:** \neq elasticities
- **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

For next time

- **RG, ch.22, ex 6**
- **RG, ch.22, ex 10**