devolution: The passing or transferring of fiscal responsibilities and authority from one level of government to another.

In August 1996, Congress approved legislation ending 60-year old federal cash welfare program called Aid to Families with Dependent Children by turning the program over to the state governments. The federal government’s main role from now on will be to send a fixed sum of money, known as a block grant, to the states to let them run their own welfare programs. Medicaid, a major federal program that provides health insurance to the poor, may get the same treatment in the future.

How State and Local Governments Differ from the National Government

C States cannot pass laws that impede the movement of people or goods among them, such as placing taxes on goods imported from other states.

C Sheer number of subnational governments. In 1992, in addition to the 50 states, there were nearly 86,700 overlapping local government entities... By contrast most federal government programs are uniform across the nation.

C People can move from the jurisdiction of one local government to that of another. Tax and spending programs of state and local governments apply only to their own residents, and only residents can vote in local election.... March 1993 and March 1994 nearly 43 million people, about 17 percent of the population, changed their residence.

C State and local fiscal spending policies may affect migration among jurisdictions... The effects of in- and out-migration is likely to influence the fiscal decisions made by local government. In contrast, the federal government is not greatly concerned about people moving in or out of the country in response to its policies, except, perhaps, for illegal migration.

STATE AND LOCAL GOVERNMENT SPENDING

Combined state and local government spending amounted to $919 billion in calendar year 1994, or 41 percent of total government spending that year. This number nets out grants from state governments to local governments, but it includes the $196 billion of federal grant-in-aid to the states to spend on specified programs.

COMPOSITION OF STATE AND LOCAL SPENDING

The largest share of state and local spending is for education, which accounts for nearly a third. Public welfare (assistance to the needy) accounts for about 16 percent. Other important state spending programs are highways and health and hospital.
Table 5.1: State and Local Spending by Function, 1993 (%)

<table>
<thead>
<tr>
<th>Function</th>
<th>Local</th>
<th>State</th>
</tr>
</thead>
<tbody>
<tr>
<td>Education</td>
<td>36.8%</td>
<td>12.2%</td>
</tr>
<tr>
<td>Public Assistance</td>
<td>4.4</td>
<td>18.4</td>
</tr>
<tr>
<td>Health and Hospitals</td>
<td>7.3</td>
<td>6.0</td>
</tr>
<tr>
<td>Highways</td>
<td>3.8</td>
<td>5.7</td>
</tr>
<tr>
<td>Police, Fire, &amp; Corrections</td>
<td>8.4</td>
<td>5.0</td>
</tr>
<tr>
<td>Natural resources &amp; environment</td>
<td>7.2</td>
<td>2.1</td>
</tr>
<tr>
<td>Housing and development</td>
<td>2.4</td>
<td>0.2</td>
</tr>
<tr>
<td>Administration</td>
<td>4.6</td>
<td>2.8</td>
</tr>
<tr>
<td>Gross interest</td>
<td>4.5</td>
<td>3.2</td>
</tr>
<tr>
<td>Insurance trust</td>
<td>1.7</td>
<td>11.7</td>
</tr>
<tr>
<td>Intergovernmental</td>
<td>1.1</td>
<td>28.9</td>
</tr>
<tr>
<td>Other</td>
<td>17.8</td>
<td>3.8</td>
</tr>
<tr>
<td>Total ($)</td>
<td>$688 billion</td>
<td>$743.3 billion</td>
</tr>
</tbody>
</table>

Demand for Local Government Spending

**Median voter:** a hypothetical person whose vote is decisive in a majority election

- single-peaked preference
- single dimension
- odd number of voters
- pairwise comparison
- simple majority rule

Illustrate with a voter’s distribution

- use median income to identify
- multidimensional case
- cost of the government good to the median voter is measured by his or her tax price

\[ Q = f(\text{tax price, median income, characteristics}) \]

**tax price elasticity:** negative (-0.37 to -0.5) inelastic (necessities)

**income elasticity:** 0.6 to 0.75 for education
THE THEORY OF LOCAL PUBLIC GOODS

local public good: partially nonrival and nonexcludable to a limited geographical area.

Special Considerations

Cjurisdictional spillovers: economic domain of public good extends beyond the boundaries of the political jurisdiction

CLocal public goods and community size: why so many towns and cities? Other things matter for the optimal number and size of communities besides spreading the cost of local public goods... some local public goods may be congestible, so that the larger population causes congestion costs. The fact that some local public goods are congestible means that larger quantities of these goods are needed for larger populations, so that the extra people may just as well live in another city... The third advantage of many communities is diversity in the tastes of residents.

CAccommodating different tastes for public goods.

This example illustrates that having different communities for people with different tastes for local public goods can improve economic efficiency.

The optimal size and number of communities must balance the efficiency gains from satisfying diverse tastes against the cost of serving smaller populations. This general idea forms the basis of an important hypothesis first proposed in 1956 by Tiebout.

Tiebout’s hypothesis states that voting with one’s feet substitutes for market forces in
attaining efficient quantities of local public goods.

Assumptions

- Individuals can move costlessly (perfect mobility)
- Individuals live on dividend income
- Individuals have sufficient knowledge of alternative tax/public good packages
- Enough communities available to accommodate all tastes (diversity sufficient)
- Local public goods are financed by a per capita fee (an equal tax on every resident) or a benefit tax.
- Optimal sized community is finite and equal to smallest cost per person
- Managers repel residents above this size, and attract them below this size
- No interjurisdictional spillovers

Describe outcome of Tiebout’s Hypothesis

Limits of the Tiebout Hypothesis

- Form of government finance. If income tax, then break link with benefits. If property tax, then free riders can move in with cheap property. Zoning can circumvent.
- People are limited in their choice than Tiebout envisions. Also, jobs do play a role.
- Ignoring external benefits/costs from decision to leave or enter.

Jurisdictional Spillovers

- Can use a fiscal equivalence argument
- A Coase bargaining among neighboring jurisdictions

ECONOMIC THEORY OF FEDERALISM

Fiscal federalism: describes how the different economic functions of government are matched with the level of government best equipped to carry them out efficiently.

Benefits of Decentralization: main advantage of decentralized government lies in "diversity."

- Greater Voice: state and local governments are "closer to the people" than the national government. The reason is clear enough. A local government is elected by and responsive to a group of voters sharing common interests due to their geographic proximity to each other, whereas the national government is elected by and responsive to voters in the nation at large. Also the possibility of direct voting initiatives.

- Greater Choice: The federal government usually has, and in some cases must have,
uniform policies across the nation so that no choice is offered except by changes in the national program... Industry might move to communities with laxer standards and pay higher wages to attract workers to a community with polluted air. With local variations in air quality standards, people who want to "purchase" higher air quality could do so by moving to communities with cleaner air and lower wages.

**Competition and Innovation**: a multiplicity of governments provide many "laboratories" for experimentation, innovation, and comparisons of performance. Quicker evolution

**Benefit principle of equity**: match tastes and packages

**Benefits of Centralization**

**Internalizing jurisdictional spillovers**

**Avoid Beggar-Thy-Neighbor Policies**: A community development program may appear attractive to an individual community because it generates increased commercial activity and tax revenue. However, this may simply divert commercial activity from other jurisdictions, so that the first community gains what the others lose. If the community development policy is expensive, the cost of attracting the activity to the first jurisdiction outweighs the benefits to all jurisdictions combined. (Also case of tax competition).

**Economies of scale**

**Horizontal and Vertical Equity**: higher levels of government are better equipped to attain this sort of equity than the lower levels of government.

**INTERGOVERNMENT GRANTS**

**Intergovernment grants**: or transfer, is money transferred from one government to another, usually to aid particular types of program spending. For example, many state governments makes grants to school districts to finance the cost of running schools, and the federal government makes grants to the state governments for various functions ranging from highways to health care.

Federal grants to state and local governments, commonly called grants-in-aid, were $205 billion in the calendar year 1995. This represented 23 cents of every dollar of spending by state and local governments that year. In fiscal year 1993, grants from state to local governments were $210 billion, or 38 cents of every dollar of local government spending on general government.

**Effects of Different Types of Grants**

A noncategorical grant is a lump-sum amount that can be spent by the recipient
government as it sees fit. Such grants are called revenue sharing.

Table 2: Federal Grants to State and Local Governments by Function

<table>
<thead>
<tr>
<th>Function</th>
<th>Percent of Total Federal Grant</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>FY 1965</td>
</tr>
<tr>
<td>Health</td>
<td>5.7</td>
</tr>
<tr>
<td>Income Security</td>
<td>32.2</td>
</tr>
<tr>
<td>Education, job training</td>
<td>9.6</td>
</tr>
<tr>
<td>Transportation</td>
<td>37.6</td>
</tr>
<tr>
<td>Community development</td>
<td>5.9</td>
</tr>
<tr>
<td>Natural resources, agricultural environment</td>
<td>6.4</td>
</tr>
<tr>
<td>General government, justice</td>
<td>2.1</td>
</tr>
<tr>
<td>Other</td>
<td>0.5</td>
</tr>
</tbody>
</table>

Table 3: State Grants to Local Governments by Function

<table>
<thead>
<tr>
<th>Function</th>
<th>Percent of Total State Grant</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>FY 1965</td>
</tr>
<tr>
<td>Education</td>
<td>58.9</td>
</tr>
<tr>
<td>Highways</td>
<td>11.5</td>
</tr>
<tr>
<td>Public Welfare</td>
<td>17.2</td>
</tr>
<tr>
<td>Other Specific Functions</td>
<td>4.6</td>
</tr>
<tr>
<td>General Support</td>
<td>7.9</td>
</tr>
</tbody>
</table>
A categorical grant can be a block or matching (or combination)
A block or nonmatching grant, is a fixed amount of money that must be spent on a specified purpose.
A matching grant is a variable amount that increases as the recipient government spends more on the specified purpose.

Even for a block grant there is fungibility. If the recipient government reduces its own spending on purpose \( i \) by the full amount of the grant, the recipient has that much to spend on other things.

Matching categorical

For instance, if the match rate is one half, the recipient government can increase total spending by $3 on purpose \( i \) at a cost of $2 of its own funds. Thus the tax price of $1 of public good \( i \) to the local residents in local taxes is 67 cents, rather than $1. More generally, if the match rate is \( m \), the tax price to local residents of government spending on the specified purpose is \( 1/(1 + m) \) per dollar.

A matching grant stimulates spending on the specified purpose than a block grant does, because the matching grant lowers the price of the specified public good to the recipient jurisdiction.

The matching grant described above is called an open-ended matching grant because the granting government matches spending by the recipient government no matter how large the total grant that must be made. Most matching grants are closed ended or capped. This means that the granting government matches spending up to a maximum value. Once the cap has been reached, the amount of the grant is not increased by more spending by the recipient government. If the recipient government spends less than the cap, a closed-ended grant has the same effect as open-ended grants.
A block grant of A for local public good increases spending on it by a larger amount if the recipient government would like to spend less than the grant allows: one explanation of flypaper effect.

Flypaper effect: describes the fact that nonmatching categorical grants seem to increase spending by the recipient governments by more than they should, according to the fungibility theory. The grant seem to "stick" to the purpose for which they were
intended, and are not used for other forms of spending and tax relief.

If government spends some of its own money on G, then it isn’t corner constrained.

EQUALIZING GRANTS IN EDUCATION

One reason for intergovernmental grants is to equalize access to public goods across local jurisdiction that have different fiscal capacities. The fiscal capacity of a jurisdiction is a measure of its power to raise revenue for public purpose.

In 1994, the Medicaid match rate was 79% in Mississippi, where per capita income is $15,838 or 73% of the national average, and 50% in states with above-average per capita incomes.

The simplest form of equalizing education grant is foundation aid, a lump-sum grant paid to a school district that is equal to the minimum expenditure per pupil required of the district.

Some states use a formula that adds to the foundation grant a component called the guaranteed tax base. This component is equal to the education property tax rate set by the district times the difference between a guaranteed tax base and the tax base in the district. The combination of a foundation grant and a guaranteed tax base received by a school district can be expressed:

\[
total \text{ grant} = F + t \cdot C(B_G - B)
\]

where \( F \) is the foundation grant per student, \( t \) is the property tax rate in the district, \( B_G \) is the guaranteed tax base, and \( B \) is the tax base per student in the district.

If a district levies an education property tax rate of $20 per $1000 of assessed property value \( (t = 0.02) \) and its property tax base per student is $50,000 less than the guaranteed tax base \( (B_G - B = 50,000) \), the district receives a grant component for the guaranteed tax base of $1000 per pupil in addition to its foundation grant.

A guaranteed tax base component in the grant formula provides an incentive for the recipient district to increase its property tax rate. If the district in the above example increases its levy to $30 per $1000, its education grant increases by $500 per pupil. Thus, the guaranteed tax base lowers the price of education to the recipient jurisdiction in the same way as a matching grant.

Tax Expenditures for State and Local Government

Intergovernmental "grants" through the federal income tax system because state and local income and property taxes are deductible from taxable income and interest receipts from state and local bonds are exempt from federal income tax.

**State and local taxes:** The cost of these provisions to the federal government was $40.2 billion in 1995, including 14.6 billion resulting from the deduction for property
taxes on owner-occupied homes and $25.6 billion for other state and local taxes.

State and local govt. can borrow at lower interest rates because the interest on state and local bonds is exempt from federal income tax.

All together the federal government spends about $52 billion on state and local government grants through tax expenditures, which is about one quarter of federal spending on grants-in-aid.

If the federal marginal rate is 28%, each $1 of local taxes reduces federal taxes paid by residents by 28 cents. Effective price to local residents of $1 more local spending is 72 cents.

\[
\frac{1}{1 + m} = .72
\]

the effective match rate is nearly 39 cents per dollar of local spending.

**Intergovernmental Grant Policy**

Why make unconditional grants

- economies of scale of tax collecting
- vertical equity