

LAST TOPIC: FISCAL FEDERALISM AND STATE AND LOCAL GOVERNMENT FINANCE

- CONCEPT OF FISCAL FEDERALISM
- ISSUES RELATING TO SUPPLY OF PUBLIC GOODS IN A MULTILEVEL SYSTEM OF GOVERNMENT
- TIEBOUT MODEL OF SUPPLY FOR LOCAL PUBLIC GOODS IN A SYSTEM OF DECENTRALIZED GOVERNMENTS TO ANALYSE THE RELATIONSHIP BETWEEN LOCAL GOVERNMENT FINANCE AND LOCATION DECISIONS MADE BY INDIVIDUALS.
- "INTERJURISDICTIONAL" EXTERNALITIES
- THEORY OF TAXATION WITHIN A DECENTRALIZED SYSTEM.
- THEORY OF GRANTS

FISCAL FEDERALISM IS THE DIVISION OF TAXING AND EXPENDITURE FUNCTIONS AMONG LAYERS OF GOVERNMENT

IN THE US: LEVELS OF GOVERNMENT

- FEDERAL
- STATE
- COUNTY
- CITY, TOWN, VILLAGE

IN SWEDEN: LEVELS OF GOVERNMENT

- STATE
- COUNTY ≈ 15
- CITY EX: MALMO

IN NL: LEVELS OF GOVERNMENT

- STATE
- COUNTY 12 PROVINCES
- CITY

IN THAILAND: LEVELS OF GOVERNMENT

- NATIONAL
- PROVINCES (77)
- DISTRICT OR AMPHUR
- SUB-DISTRICT OR TAMBON
- VILLAGES

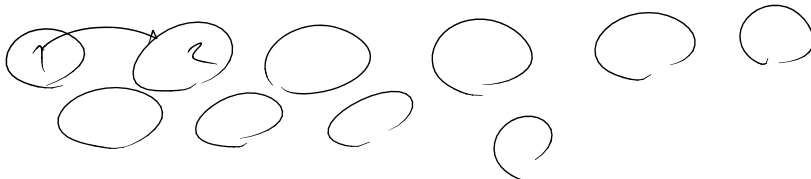
FISCAL
DECENTRALIZATION

LOCAL PUBLIC GOODS ARE GOODS WHERE THERE IS NO REFLEX TO THE GOOD WITHIN A CERTAIN GEOGRAPHIC AREA

- EX:
- LOCAL STREETS
 - PARKS
 - POLICE PROTECTION
 - FIRE PROTECTION
 - SANITATION

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- ECONOMIC STABILIZATION PROGRAM
 - NATIONAL DEFENSE
- PURE PUBLIC GOODS
- DECISIONS ARE MADE BY NATIONAL LEVEL (WHY?)



MOBILITY BETWEEN JURISDICTIONS: VOTING WITH YOUR FEET

POLITICAL JURISDICTIONS: GEOGRAPHICAL AREA WITHIN WHICH INDIVIDUALS MAKE COLLECTIVE CHOICES ON GOVERNMENT FUNCTIONS AND GOVERNMENT-PROVIDED SERVICES.

EACH JURISDICTION HAS A GOVERNING AUTHORITY AND ITS OWN POLITICAL INSTITUTIONS.

THE TIEBOUT MODEL (CHARLES M. TIEBOUT, 1956)

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JOURNAL OF POLITICAL ECONOMY

ASSUMPTION

ALL CITIZENS ARE FULLY MOBILE (ECONOMI)
AMONG COMMUNITIES AND POSSESS FULL KNOWLEDGE OF GOVERNMENT BUDGETS IN ALTERNATIVE JURISDICTIONS.

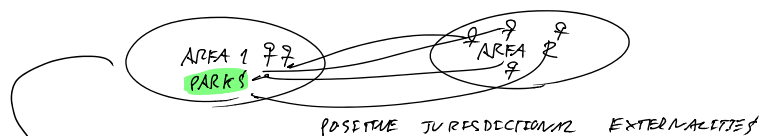
WHEN LOCAL PUBLIC GOODS ARE PROVIDED IN DIFFERENT AMOUNTS IN DIFFERENT COMMUNITIES, CITIZENS CAN MOVE FROM ONE JURISDICTION TO ANOTHER TO MATCH THEIR PREFERENCES FOR LOCAL PUBLIC GOODS.

IN THIS MODEL PEOPLE CHOOSE JURISDICTIONS AS THEY CHOOSE GOOD. EACH JURISDICTION PROVIDE SERVICES THAT COME AT PRICE (THE TAX RATE) AND PEOPLE CHOOSE HOW MUCH GOVERNMENT-PROVIDED SERVICE TO CONSUME BY CHOOSING WHERE THEY WANT TO LIVE.

INTERJURISDICTIONAL EXTERNALITIES: THERE ARE (COSTS AND)

BENEFITS ACCRUING TO CITIZENS IN ONE JURISDICTION THAT RESULT FROM THE PUBLIC GOODS CHOICES OF ANOTHER JURISDICTION.

EX: A SUBURB W/ HIGHER TAXES PROVIDE BETTER PARKS THAT BENEFIT NOT ONLY TO ITS OWN PEOPLE IN THE AREA BUT ALSO TO PEOPLE IN CLOSE-BY JURISDICTIONS.



THEORY OF TAXATION W/ A DECENTRALIZED SYSTEM

OBSERVATION #1 PEOPLE BEING TAXED CAN MOVE TO ANOTHER JURISDICTION AS A RESULT OF TAX IMPOSED ON THEM.

OBSERVATION #2 LOCAL GOVERNMENT-SUPPLIED GOODS AND SERVICES FINANCED BY LOCAL TAXES CAN HAVE AN EFFECT ON PROPERTY VALUE IN A COMMUNITY.

EX: IF A COMMUNITY USES ITS PROPERTY TAXES TO FINANCE HIGH-QUALITY SCHOOLS, THE DEMAND FOR PROPERTY IN THAT COMMUNITY COULD BE INCREASED. THE INCREASE IN DEMAND FOR PROPERTY INCREASES THE PROPERTY PRICE IN THAT JURISDICTION.

OBSERVATION #3 RELATIONSHIP AMONG TAX BASE ELASTICITY TAX RATES

OBSERVATION #3

RELATIONSHIP AMONG

- TAX BASE ELASTICITY
- TAX RATES
- TAX REVENUES

$$E_T = \frac{\Delta B/B}{\Delta t/t}$$

→ PERCENTAGE CHANGE IN TAX BASE

→ PERCENTAGE CHANGE IN THE TAX RATE

E_T = ELASTICITY OF THE TAX BASE

B = THE TAX BASE IN PAINT OR € OR \$ US

t = THE PERCENTAGE RATE OF TAXATION.

EX: IF TAX BASE IS 10 MILLION PAINT OF LABOR INCOME PER YEAR, TAX RATE IS 20 %
SO, TAX REVENUE IS $0.2 \cdot 10 = 2$ MILLION PAINT/YR.

CASE 1 WHEN E_T IS ELASTIC, $\% \Delta B > \% \Delta t$

$\uparrow t \rightarrow \% \Delta B > \% \Delta t \rightarrow$ TAX REVENUE FALLS.

$\downarrow t \rightarrow$ AS $\% \Delta B > \% \Delta t$ THEN TAX REVENUE RISES.

CASE 2 WHEN E_T IS INELASTIC, $\% \Delta B < \% \Delta t$

$\uparrow t \rightarrow$ AS $\% \Delta B < \% \Delta t$ THEN TAX REVENUE RISES.

$\downarrow t \rightarrow$ AS $\% \Delta B < \% \Delta t$, THEN TAX REVENUE FALLS.

CASE 3 WHEN E_T IS UNITARY-ELASTIC, $\% \Delta B = \% \Delta t$.

$\uparrow$ OR $\downarrow$ IN t DOES NOT ALTER TAX REVENUES.

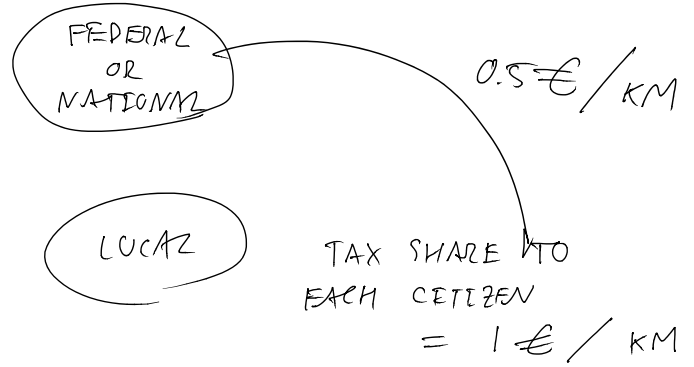
THEORY OF GRANTS

• GRANTS ARE ESSENTIALLY GIFTS OR SUBSIDIES FROM ONE LEVEL OF GOVERNMENT TO ANOTHER LEVEL.

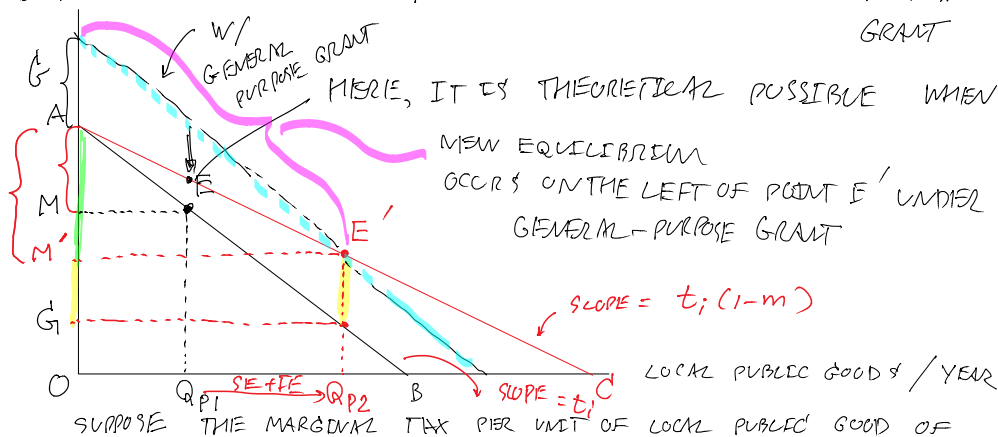
• 2 TYPES OF GRANTS

- GENERAL-PURPOSE - GRANT (LIKE DIRECT TRANSFER)
- MATCHING GRANTS
(i.e., SOME CONDITIONS WILL BE IMPOSED BY UPPER-LEVEL.)

OF GOVERNMENT.
EX: TO BUILD A NEW ROAD
(# OF KILOMETERS OR
OF MILES)



POLITICAL EQUILIBRIUM : A MATCHING GRANT VS. GENERAL-PURPOSE GRANT



INCOME ELASTICITY OF DEMAND FOR PUBLIC GOODS = 0

SO SLOPE OF THE BUDGET LINE = t_i TOO.

THE SLOPE REFLECTS THE EXPENDITURE ON PRIVATE GOODS PER YEAR THAT MUST BE GIVEN UP BY EACH CITIZEN TO FINANCE AN EXTRA UNIT OF PUBLIC GOODS, EX: KILOMETERS OF NEW ROAD PER YEAR

OF COURSE, t_i VARIES FROM VOTER TO VOTER, DEPENDING ON PREFERENCES / TASTES TOWARD LOCAL PUBLIC GOODS.

INITIALLY, POLITICAL EQUILIBRIUM IS AT E :

HE CONSUME Q_{P1} UNITS OF PUBLIC GOOD AND OM UNITS OF PRIVATE GOODS. (HIS MOST PREFERRED MIX OF EXPENDITURES TOWARD TWO GOODS)

HE GIVES UP AM OF HIS INCOME IN TAXES AND USES OM OF HIS INCOME ON EXPENDITURES TOWARD PRIVATE GOODS.

NOW... GOVERNMENT OFFERS MATCHING GRANT THAT HELPS REDUCING TAX SHARE OF EACH CITIZEN

B/F : t_i

A/F : $t_i(1-m)$

EX: IF $m = 0.5$, TAX SHARE BY EACH VOTER WOULD FALL BY 50 %

NEW EQUILIBRIUM : E' (SEE 81E)

B/F : AM OF HIS INCOME IS GIVEN UP TO CONSUME Q_{P1}

A/F : AM' OF HIS INCOME IS GIVEN UP TO CONSUME Q_{P2} .

THE FULL COST OF PRODUCING PUBLIC GOOD, HOWEVER, =

$$AM' + G$$

GRANT THAT GOVERNMENT PROVIDED

SO THIS GUY PAYS $T_i = (AM' + G_i)$ AND THEN GETS TAX CREDIT (OR REBATE) BACK BY G . SO, NET EFFECT, HE PAYS AM' .

CONCLUSION : MATCHING GRANT IS MORE EFFECTIVE COMPARED TO GENERAL-PURPOSE GRANT.

MATCHING GRANT & +ve JURISDICTIONAL EXTERNALITY.

