Custom Edition of

State and Local Public Finance

by Ronald C. Fisher

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Preface

State and Local Public Finance is intended to be ideal for junior and senior undergraduates who are studying public finance and who have some knowledge of economic principles. It may be used either alone or with a reading supplement in courses specifically geared toward state–local government. For one-semester or year-long courses on public finance in general, two approaches are possible: the book may be used to supplement a general text, or it may become the basis for the course, with general theory illustrated by state–local examples. For instance, the general equilibrium analysis of capital taxes can be illustrated just as well by the property tax as by the corporate income tax. For the second approach, some supplement for the federal material (such as Pechman's *Federal Tax Policy*) would be advisable.

This book may also be of interest to undergraduate students studying political science, public administration, journalism, or prelaw, as well as students in master's degree programs in public policy analysis, public administration, or planning who wish to apply their knowledge of basic economics to subnational government policy issues. Additionally, government officials, applied economists in government and consulting, and graduate students in economics may also find this book useful as both a survey of and a reference to the economics literature on state–local finance issues.

There are at least two important reasons why a book devoted solely to state and local government fiscal issues is appropriate now. First, the subnational government sector has grown to be a substantial component of the U.S. economy, representing about 40 percent of the public sector and accounting for more than 10 percent of the gross national product. Furthermore, of all services provided through the public sector, those provided by the state–local governments—education, transportation, public safety, sanitation—are the most familiar to individuals and have the greatest effect on day-to-day life. Second, parallel to the growth in the economic activity of subnational governments over the past twenty-five years, there has been substantial growth and change in the economic analysis of subnational government finance.

This book provides what has been missing—an explanation and analysis of state–local government public finance practices and problems. It not only presents detailed descriptions of significant institutions when appropriate, but it applies modern economic theory to the way these institutions finance their services and it evaluates alternative policies. Although the emphasis is on American institutions and issues, much of the economic analysis can apply to any federal system.

Relatively sophisticated economic and political issues are examined using basic concepts. Readers are expected to have knowledge of the tools of introductory microeconomics but they do not have to know the theoretical tools usually associated with intermediate-level microeconomics. (In the few cases where these techniques add to the understanding of the material, they are presented in appendixes.) One should not confuse sophistication of methodology with level of analysis, however; some relatively sophisticated economic and policy issues are examined, albeit using basic tools. For instance, it is important that students learn economists' conclusions about the demand for state–local government services, even if they do not have a good understanding of the underlying utility theory or the econometrics upon which those conclusions were based. Although not a complete survey, the intent of *State and Local Public Finance* is to represent fairly the thinking of economists about state–local issues, much of which has been developed in the past twenty years or so.

/ Organization

The text is organized into five parts. An overview of the state-local sector, a discussion of the economic role of subnational governments, and a review of the microeconomic reasons for government provision comprise Part 1. The basic fiscal institutions and the core economic theory and analysis of state-local government finance are presented in Parts 2–4: interplay between the structure and the fiscal role of subnational governments is considered in Part 2; analysis of the various state–local revenue sources is presented in Part 3; and consideration of the provision of services—demand, costs, pricing, the role of grants—is examined in Part 4. (While these core chapters can be covered in any order, they contain cross-references to material in other chapters.) In Part 5 the institutional information and economic analyses from the core sections are applied to four policy issues.

/ Acknowledgments

Many individuals contributed to this project in direct and indirect ways. Several of my teachers—Byron Brown, the late Daniel Saks, and Milton Taylor at Michigan State University, and Vernon Henderson and Allen Feldman at Brown University—were instrumental in introducing economics to me and showing me how it could be profitably employed in understanding public-sector issues. I hope that my students will benefit as much from my teaching as I did from the teaching of these men.

John Shannon of the Advisory Commission on Intergovernmental Relations helped me in the early years of my career to learn how to bridge the gap between theory and policy, and Robert A. Bowman, State Treasurer of Michigan, gave me the opportunity later to practice what I had learned.

I wish to thank the following individuals who contributed by reviewing and commenting on all or part of the manuscript at various stages of production:

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Ronald C. Fisher

Part 1

Introduction

Every person has some familiarity with state and local government fiscal policies. We attend public schools; travel on streets, highways, and buses; receive clean water and dispose of dirty water; have our trash collected; enjoy the security of police and fire protection; use public hospitals; vacation at parks and public beaches; support the less fortunate with services and income maintenance; and we pay for these services. We pay property, income, and sales taxes; excise taxes on a variety of commodities such as alcohol, tobacco, and gasoline; a number of different user fees; and we buy lottery tickets. All this encompasses state and local government finance. In this book, we will do more than reiterate personal experience, however. The task is to combine knowledge of the institutional details of fiscal policy with an analytical framework so that policy issues can be better understood.

The task begins in Chapter 1 first by providing a general overall view of those institutional facts. How large is the state and local government sector, and how has that size changed? What is the role of state and local governments compared to the federal government? What services do state and local governments provide, and how are those services financed? How are state and local governments organized? How representative is your experience, the way it is done in your state and community?

The analytical tools to analyze the institutional details and policy issues are presented in Chapter 2. Because this is an economics book, these facts are to be analyzed using standard economics methods. What is the economic role of government generally, and where do state and local governments fit in? What is meant by equity and efficiency, the traditional criteria for evaluating economic policy? What economic tools can state and local governments use to carry out their economic responsibilities in an equitable and efficient manner? From the general overview in this introductory section, the book proceeds to specific analysis of separate pieces of state and local finance and then returns, at the end, to more general analysis of broad policy issues.

1 / Why Study State and Local Government Finance?

. . . It has become evident in recent years that the serious business of governing the United States is largely being done in the states.[1]

The Wall Street Journal

The economic issues involved in the financing of state–local governments deserve and demand separate attention for three primary reasons: (a) The state–local government sector is now a substantial part of the U.S. economy, accounting for more than 10 percent of Gross National Product (GNP) and representing about one-third of the total government sector; (b) the major services provided by state–local governments—education, transportation, social services, and public safety—are those that most affect residents on a day-to-day basis; and (c) because of the *diversity* of state–local governments and the ease of *mobility* among them, the analysis of many economic issues is substantially different in the state and local arenas than for the federal government.

The importance of *diversity* and *mobility* for state–local government finance cannot be overemphasized. As you will learn in this book, there is tremendous diversity both in the structure of subnational government in different states and in the magnitude and mix of revenues and expenditures. In 1982 there were about 82,500 different state–local governments in the United States, each with independent functional responsibilities and revenue sources. Besides the fifty states, these included about 39,000 general-purpose local governments (counties, municipalities, and townships) and about 43,500 special-purpose local governments (school and other special districts). Because the boundaries of many of these jurisdictions overlap, any individual will be a member or resident of at least two subnational governments (a state and a locality) and more likely a resident of four or more (state, county, municipality, or township and at least one special district), each with separate elected officials and separate taxes and expenditures.

The division of responsibility among these different types or levels of subnational government varies by state or region. In some states such as Alaska and Hawaii, local governments play a relatively limited role with the state government being dominant. In others such as New Hampshire and New York, local governments account for the majority of state–local expenditures. The division of responsibility within the local sector also varies by state. In Maryland, for example, counties are

[1] Editorial. "Traverse City Whacks Washington." *Wall Street Journal*, 28 July 1987.

the dominant form of local government, collecting about 72 percent of local own-source revenue and making about 68 percent of all local government expenditures. At the opposite end of the spectrum, counties have no fiscal role at all in Connecticut where local government services are provided by 179 separate and nonoverlapping "towns." Perhaps a more common or typical structure is represented by that in Michigan where counties account for about 20 percent of local expenditures, municipalities and townships about 36 percent, and the rest by special districts, especially independent school districts.

In short, it can be very misleading to talk about "the services" provided by states, counties, cities, or local governments in general because there is no single structure. Similarly, even among governments that have responsibility for the same services, the quantity and quality of services provided can vary substantially. There is also great variety in the way in which subnational governments finance those services—that is, on which sources of revenue to rely. Indeed, this diversity is the essence of a federal, as opposed to unitary, system of government.

But it is the *ease of mobility* among these diverse subnational governments that causes the diversity to have economic implications. Diversity is largely uninteresting without mobility, and mobility is unimportant without the choice diversity creates. The notion of mobility here is not only physical mobility (the location of residences or businesses among different jurisdictions) but also economic mobility (the choice of where to consume or invest). In many cases, individuals can independently select the location of residence, work, investment, and consumption. Many individuals live in one city, work in another, and do most of their shopping at stores or a shopping mall in still another locality. In some cases, these activities cross state as well as local boundaries. And when individuals save through bank accounts or mutual funds, their money is invested in all kinds of projects located in many different states, localities, and even different countries. This economic mobility coupled with the choice provided by the diversity of subnational governments is largely the topic of this book.

/ Fiscal Characteristics of the Subnational Public Sector

/ Size and growth

In 1986 state–local governments spent nearly \$455 billion of resources collected from their own sources (that is, excluding spending financed by federal aid), which represented almost 11 percent of GNP (Table 1.1). When spending financed by federal grants is included, state–local expenditures represent more than 13 percent of GNP. It is also interesting to compare the state–local sector to the federal government alone. For every dollar collected from its own sources and spent by the federal government in 1986, state–local governments collected and spent about \$.44. In per-capita terms, state–local governments collected and spent about \$1640 per person in 1986, while the federal government collected and spent (including grants to state–local governments) about \$3730. If comparison is limited to spending for domestic programs by all levels of government, state–local governments col-

TABLE 1.1

The Relative Size of Federal, State, and Local Government, 1986

Government Level	*Own-Source Expenditures*[a]	*Own-Source Expenditures as Percentage of GNP*	*Expenditures After Transfers*[a]	*Percentage of GNP*
Federal	1030.2	24.5	926.2	22.0
State–Local	453.9	10.8	557.9	13.3
State	258.7	6.2	226.0	5.4
Local	195.2	4.6	331.9	7.9
Total	1484.1	35.3	1484.1	35.3

Source: ACIR, *Significant Features of Fiscal Federalism*. 1987b.

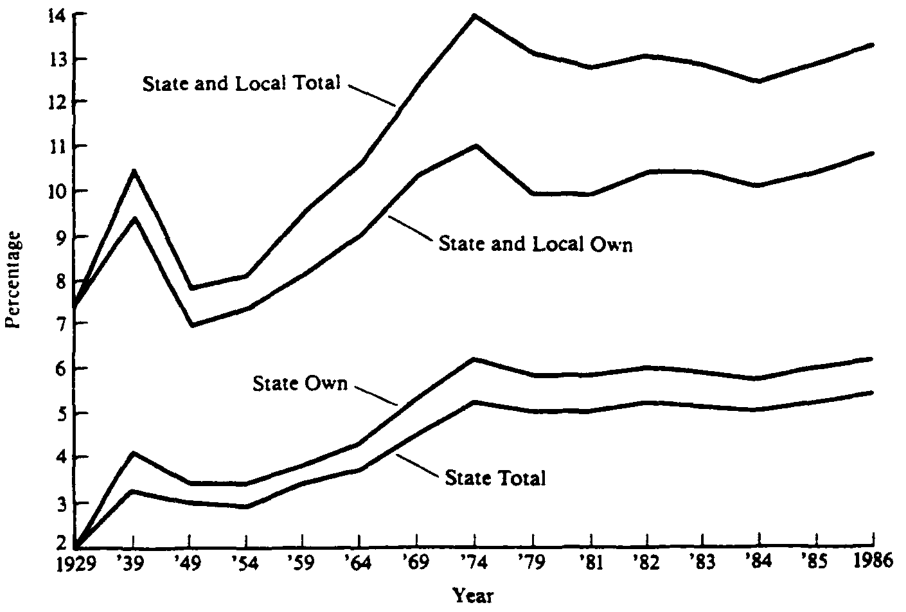
[a]Billions of dollars.

lected more than 42 percent of those funds and were responsible for spending more than 52 percent. By any of these measures, then, state–local governments are both an important component of the U.S. economy and a very large fraction of the entire government sector.

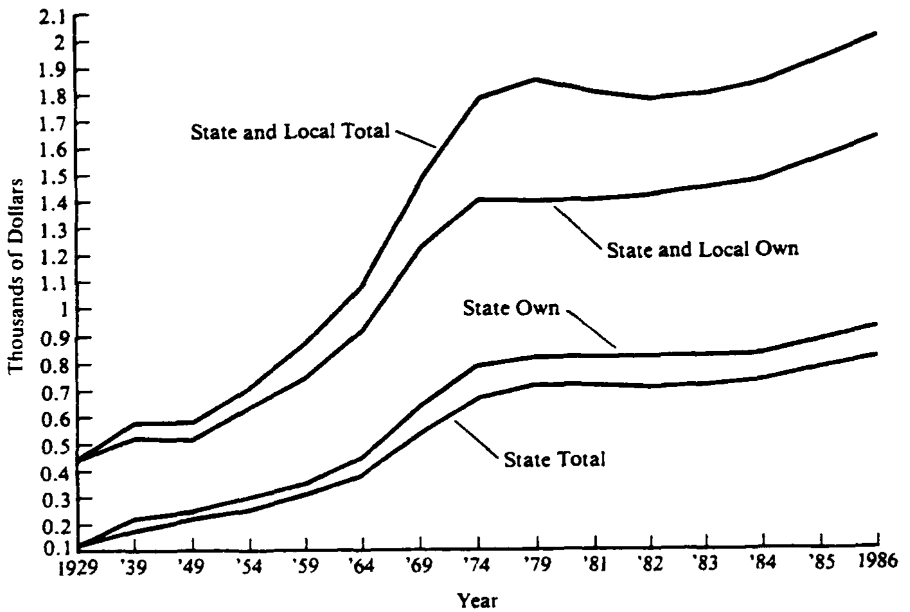
The current substantial relative size of the subnational government sector arose from a roughly twenty-five-year period of sustained rapid growth between the early 1950s and mid-1970s. This growth of total state–local government expenditures (either including or excluding spending financed by grants), both relative to GNP and in real per-capita dollars, is depicted in Figure 1.1. In 1949 total state–local spending from all sources represented slightly less than 8 percent of GNP, but by 1974 state–local spending had grown to about 14 percent of GNP. In other words, during those twenty-five years state–local spending had grown substantially faster than did the overall size of the economy. Even excluding federal grants, state–local spending from own-sources increased from about 7 percent of GNP in 1949 to about 11 percent in 1974. A similar pattern of growth is shown by per-capita, 1982 dollars, indicating that state–local spending also increased faster than population growth and inflation during this period. Not surprisingly, the pattern of growth in spending by state governments alone parallels the pattern for the entire state–local sector rather closely.

The relative growth of the state–local sector in this period is usually attributed to three factors. First, income in the United States increased rather substantially in these years; this caused an increase in demand for many different types of goods and services, some of which were largely provided by subnational governments. Second, growth in population and change in the composition of the population (especially the postwar "baby boom") also led to an increase in demand for state–local services (especially education). Third, substantial increases in manufacturing–labor productivity and thus manufacturing wages during this period created pressures to increase wages of state and local employees as well. This caused an increase in the relative cost of providing those services. In essence, spending rose faster than the economy grew because the population to be served (especially children) was

FIGURE 1.1 State–Local Expenditures, as Percentage of GNP (a) and per Capita in 1982 Dollars (b)



(a)



(b)

rising relatively fast, because the costs of providing state–local services were rising faster than average, and because consumers were demanding new or improved services from subnational governments.

Since the mid-1970s, however, the relative size of the state–local government sector has not changed substantially. In the decade from the late 1970s to the later 1980s, state–local government spending (either from all sources or only from own sources) has increased at about the same rate as the national economy. State–local government spending from all sources was about 13.1 percent of GNP in 1979 compared to about 13.3 percent in 1986; spending from own sources only was about 9.9 percent of GNP in 1979 and about 10.8 percent in 1986. A similar and clear slowdown in the growth of state–local government spending beginning in the latter 1970s is reflected by the graph of real per-capita spending in Figure 1.1b. The nearly flat growth of state–local spending (in relative terms) is particularly pronounced through 1984, with spending again having risen at a somewhat faster rate in the last several years.[2]

This pronounced change in the relative growth of state–local governments in the late 1970s has been attributed to several factors. First, income did not grow as fast in those years as previously because the economy weathered two rather long and deep recessions between 1974 and 1983. Second, the demand for school services lessened as the "baby boomers" completed school and delayed starting their own families. Third, state–local government costs, especially wages, did not increase relatively as fast in this period as previously. Fourth, federal grants to state–local governments did not grow in this period anywhere near as fast as in the previous period, although state–local spending from own sources also follows the same pattern of slowing growth. Finally, it has been suggested that the slowdown reflects a change in the tastes or preferences of consumers for government services, as reflected by the coordinated opposition to state–local taxes in the late 1970s and early 1980s—what has come to be called the "tax revolt." Whatever the combination of factors, it is clear that the past ten years or so have represented a very different environment for state–local finance than in the preceding twenty-five years.

/ *Expenditure categories*

Nearly half of the money spent by state and local governments in aggregate provides education or social services and income maintenance, as shown in Figure 1.2. In 1986 these two categories accounted for 48.3 percent of total state–local spending, with education accounting for about 30 percent and social services about 19 percent. Expenditures for transportation and public safety, the other main direct consumer services, represent about 7 to 8 percent of state–local spending, while interest on state–local government debt represents only about 5 percent of spending.

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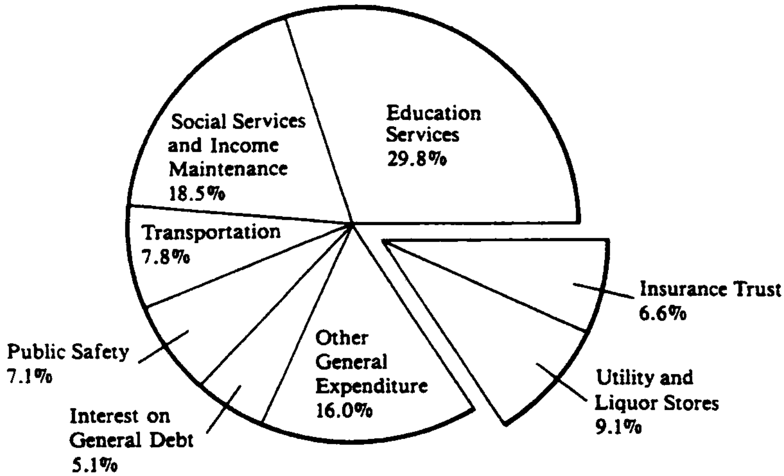
[2]In contrast to the state–local sector, federal government expenditures increased substantially faster than did GNP since 1979. Federal government expenditures, including grants paid to state and local governments, represented about 21 percent of GNP in 1979 and about 24.5 percent in 1986.

FIGURE 1.2 State–Local Government Expenditure and Revenue, 1985–86

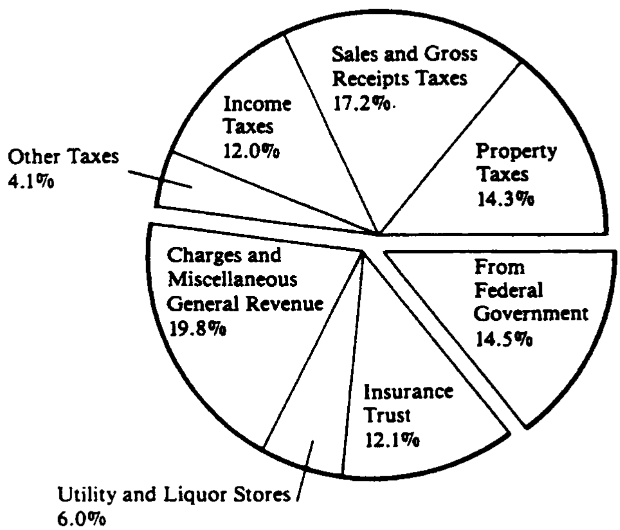
Total: $718.3 Billion



Expenditure

(a)

Total: $783.2 Billion



Revenue

(b)

The distribution of spending by category for state–local governments together masks some differences between states and local governments, on average. Figure 1.3 shows the distribution of **general expenditure** for states and localities separately. (According to the Census definition, general expenditure includes all expenditures except those for government utilities, liquor stores, and employee-retirement funds.) Education is by far the largest category of spending for both states and localities (37 percent for states and 43 percent for localities). States also spend a relatively large fraction of their expenditures on welfare, highways, and health and hospital services, while the other major expenditure categories for local governments are social services, public safety, and transportation.

/ Revenue sources

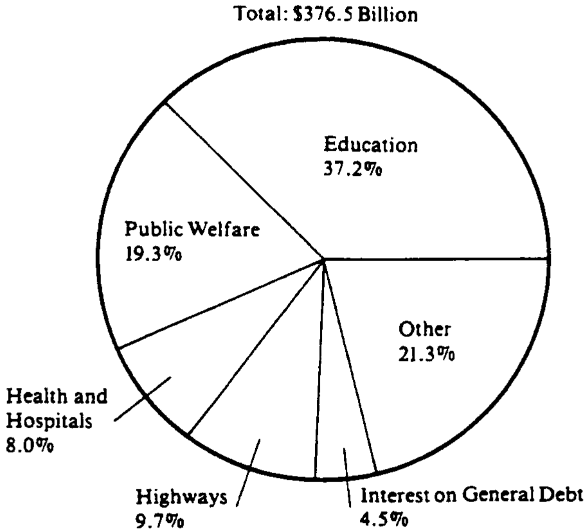
State–local governments receive revenues from a wide variety of different sources, including a number of different types of taxes, as shown in Figure 1.2b. When all revenues to all state–local governments are added together, the five major sources, all of roughly equal importance, are charges and fees (19.8 percent of the total), sales taxes (17.2 percent), federal grants (14.5 percent), property taxes (14.3 percent), and income taxes (12.0 percent). In contrast, the predominant source of revenue for the federal government is income taxes, including the personal and corporate income taxes and the Social Security payroll tax.

The composition of revenues differs between states and local governments even more than the difference in expenditure patterns, as shown by Figure 1.4. Restricting the comparison to **general revenue** (excluding utility, liquor store, and employee-retirement revenue), states get nearly 75 percent of their revenue from sales taxes (about 29 percent), income taxes (21.7 percent from individual and corporate taxes), and federal grants (24 percent). The two dominant sources of general revenue for local governments accounting for about 60 percent of the total are state grants (about 33 percent) and property taxes (28 percent). From another perspective, grants from both the federal and state government provide about 39 percent of local government general revenue. It is worth noting that these are averages for all local governments; there is substantial variation by both type of local government and state.

/ Diversity of Subnational Governments

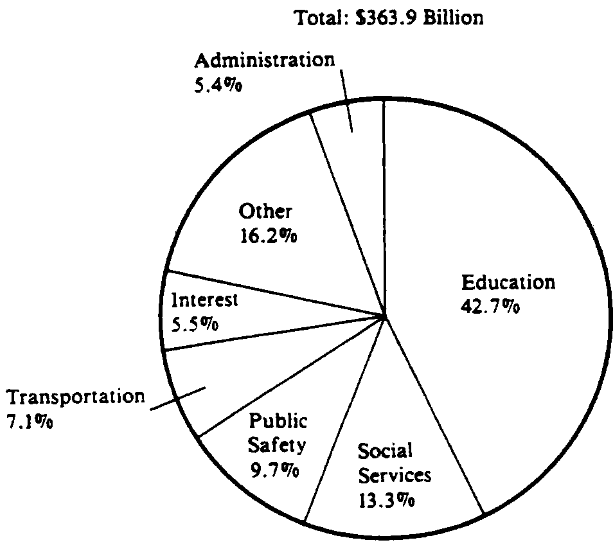
Although the statistics presented above for both the level and mix of expenditures and revenues characterize the overall state–local sector, they do not necessarily represent the fiscal picture in any individual state and local jurisdiction. As noted, diversity is the norm in subnational finance. Accordingly, some comparison of the fiscal environment in different states is shown by the data in Tables 1.2–1.4. It is not safe to simply compare the level of expenditures or revenues among states. Rather, it is necessary to standardize the data because of the different sizes and characteristics of the states. The two most common ways of standardizing are to compare the data in per-capita terms (per person) or as a percentage of income.

FIGURE 1.3 General Expenditure of State and Local Governments, 1986



State Governments

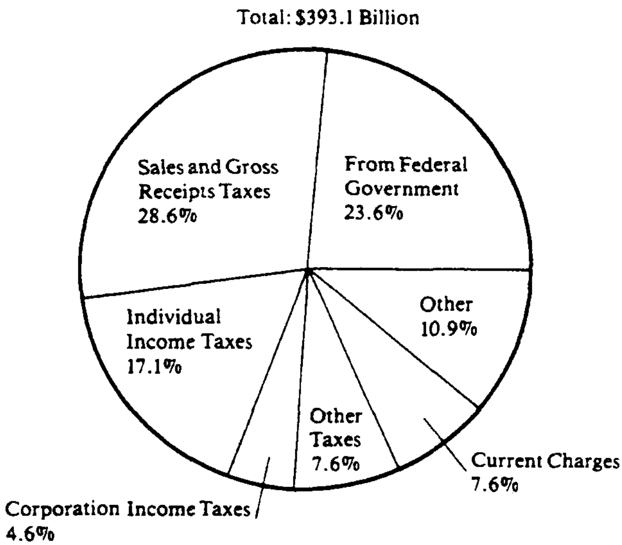
(a)



Local Governments

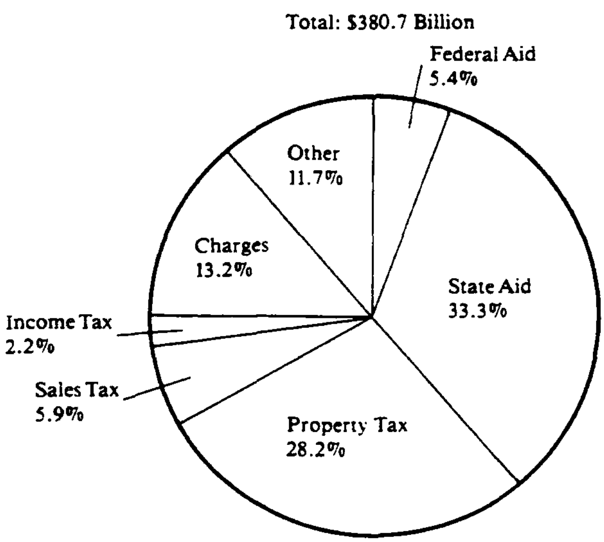
(b)

FIGURE 1.4 General Revenue of State and Local Governments, 1986



State Governments

(a)



Local Governments

(b)