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Introduction

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Discussions of public finance in the United States often refer to the role of "the" government. While for many purposes it is useful to think of fiscal decisions as being made by a single government, the reality is that in the United States, an astounding number of entities have the power to tax and spend. Including states, countries, municipalities, townships, school districts, and special districts, there are over 82,000 governmental jurisdictions. The interaction of state, local, and federal governments plays a crucial role in the U.S. fiscal system. In recognition of this fact, the National Bureau of Economic Research sponsored a conference on Fiscal Federalism in April of 1987. The seven papers presented at that conference, and the comments of the discussants, are contained in this volume. Although the papers cover a diverse array of subjects, they share a quantitative orientation and a concern with policy issues.

The first three papers, by John Joseph Wallis and Wallace E. Oates, Robert P. Inman, and Jeffrey S. Zax, examine the distribution of power and responsibilities among the various levels of government. The Wallis-Oates paper provides a broad historical perspective on the extent and evolution of fiscal decentralization in the state and local sector. They begin by noting that in 1902 local governments accounted for 82 percent of the tax revenues of the state and local sector; by 1981 this had fallen to 42 percent. The major part of this centralizing trend occurred in the first half of the century. Similarly, at any given point in time, there are wide variations in the extent of fiscal decentralization among states. Wallis and Oates discuss several theories that might help explain differences in fiscal

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decentralization, and then test these theories econometrically. They find that a state's share in state and local spending is inversely related to both population size and urbanization, and in some specifications of the model, it is directly related to the level of per capita income. While noting that it is very difficult to make predictions about the future course of centralization, on the basis of their results Wallis and Oates conjecture that in the future the tendency toward centralization (which has already slowed in recent decades) is likely to stop altogether.

While the Wallis-Oates paper focuses on economic explanations for the development of the federal structure, Inman concentrates on political issues. He observes that the federal fiscal structure has been evolving steadily toward the centralization of the financing of government spending. Revenues are raised centrally and then transferred, via grants-in-aid, to state and local governments. Inman explores two different hypotheses to explain this trend. In the first, federal aid is allocated to correct for the presence of market failures such as externalities. In the second, aid is allocated only when it is in the political interests of congressional representatives. Inman's examination of the relationship between the level and composition of federal grants and the structure of congressional decision-making suggests that the political theory provides a better explanation of the facts.

The paper by Zax investigates the effects of the number and types of government jurisdictions on aggregate local public debt and expenditures. From a theoretical point of view, it is unclear whether more jurisdictions will lead to greater or less spending. On the one hand, when there are fewer governments they may be able to capture economies of scale in the production and distribution of local public services. On the other hand, political and bureaucratic tendencies toward excess public spending may be reduced by competition among a large number of jurisdictions. Zax examines county-wide data and finds that aggregate debt and expenditures are positive functions of jurisdictions per capita, suggesting that small jurisdictions are inefficient. However, the data also suggest that when jurisdictions have large average "market shares," they use their market power to expand the size of the local public sector.

The next three papers, by Douglas Holtz-Eakin and Harvey S. Rosen, Lawrence B. Lindsey, and George R. Zodrow examine the relationship between the deductibility of state and local taxes on federal tax returns and the structure of subfederal public finance. This question has assumed great importance in light of the recent public debate about the merits of partially or totally eliminating deductibility. Holtz-Eakin and Rosen focus on how changes in the tax price of local spending induced by deductibility affect the mix between deductible and nondeductible revenue sources, and the level of expenditures. Their econometric analysis is based on a panel data set that tracks the fiscal behavior of 172 local governments from 1978 to 1980. They estimate that the elasticity of deductible taxes with respect to the tax price is in the range -1.2 to -1.6; the tax price has no statistically significant effect on the use of nondeductible revenue sources; and the elasticity of local expenditures with respect to the tax price is about -1.8. Hence, their estimates imply that if deductibility were eliminated, there would be a substantial decline in local government spending.

Like Inman's paper on the growth of grants, Lindsey's paper on deductibility emphasizes political issues. He emphasizes that unlike conventional price changes, changes in the price of local taxation do not translate directly through consumer optimization into changes in the equilibrium quantity of services demanded. The response depends on how the political mechanism translates the price change into a public decision. Lindsey examines the implications of several different theories for the appropriate measure of the tax price of state and local spending. Like Holtz-Eakin and Rosen, Lindsey finds that the level of state and local spending is significantly affected by deductibility. He also finds that voter-based measures (e.g., the median tax price among voters) does better at predicting state and local spending than aggregate measures of cost such as the average tax price measured over all individuals.

Both the Holtz-Eakin/Rosen and Lindsey papers examine deductibility in a partial equilibrium context. A potential problem with this approach is that the state and local sector is "large" relative to the economy as a whole. Thus, predictions regarding (say) the revenue effects of deductibility may be affected by feedbacks from other sectors of the economy. Zodrow constructs a two-sector general equilibrium model to investigate such effects. The model permits the allocation of capital to respond to changes in state and local capital taxes and the associated changes in the net return to capital, wages, and income. These in turn permit an explicit calculation of the impact of eliminating deductibility on both personal and corporate federal tax revenues. Zodrow's results indicate that the increase in federal revenue from eliminating deductibility is likely to be less than that predicted by partial equilibrium techniques. The amounts involved are substantial; the revenue shortfall is 25 to 58 percent of the partial equilibrium estimate.

The final paper, by Charles R. Hulten and Robert M. Schwab, tackles the problem of developing a set of income and product accounts for the state and local sector. Hulten and Schwab note that conventional estimates of the production of the state and local sector assume that its capital income is zero, despite the fact that the state and local sector is one of the most capital intensive in the U.S. economy. In addition to leading to a downward bias in the income of the state and local sector, this assumption obscures the existence of an important implicit subsidy in the federal fiscal system—under the federal tax code, state and local capital is treated like owner-occupied housing in the sense that the noninterest portion of income accruing to capital is excluded from the tax base. Hulten and Schwab's empirical results indicate that conventional accounting procedures underestimate the amount of income generated by the state and local sector by about $100 billion.