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1 Introduction

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In fiscal year 1981–82, the federal government's nondefense direct expenditures were $450 billion. In comparison, state and local government expenditures were $485 billion (Tax Foundation, Inc., 1983, 18). It's a small difference, not what one would have guessed in light of the relatively small amount of attention given by academics to state and local public finance. Given its size, the state and local government sector is clearly deserving of serious and sustained study.

Another reason for studying state and local public finance systems is their tremendous diversity. This diversity provides a set of "natural experiments" that can be exploited to discern the effects of government policy upon the private sector, and how government behavior itself is determined. Justice Brandeis once observed: "It is one of the happy incidents of the Federal system that a single courageous state may, if its citizens choose, serve as a laboratory, and try moral, social and economic experiments without risk to the rest of the country." These experiments provide grist for the economist's mill.

In light of these considerations, several years ago the National Bureau of Economic Research established a project on state and local public finance. A conference was held in June of 1984. Six of the papers presented at that conference, and the comments of the discussants, are contained in this volume. Although the papers cover a diverse array of topics, they share an empirical orientation and a concern with policy issues.

The first two papers, by James Poterba and by Roger Gordon and Joel Slemrod, focus on the role of tax-exempt bonds in local public

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finance. Poterba examines the yield differential between taxable and municipal securities. He considers alternative theories of how the differential is determined, and describes their implications for how changes in federal tax policy would affect the differential. His econometric work suggests that expected tax changes have an important effect on the yield spread between taxable and tax-exempt securities. On the basis of these results, he discusses the likely effects of several changes in municipal borrowing practices, and concludes that increased use of short-term borrowing instruments would reduce the cost of debt finance to state and local governments.

Roger Gordon and Joel Slemrod examine the arbitrage opportunities created by the differences between (1) the tax-exempt rate that a community faces when it borrows; (2) the taxable rate that a community can earn, free of tax, when it invests; and (3) the after-tax rate of return that the residents of the community can receive on their savings. Do community financial managers take advantage of such wedges to benefit their residents? Gordon and Slemrod provide a careful discussion of the economic and institutional considerations that might affect a community's propensity to do so. Their econometric results suggest that communities do actively engage in tax arbitrage.

The next three papers, by Michelle White, Kenneth Small and Clifford Winston, and Daniel Feenberg and Harvey Rosen, concern several different aspects of state and local tax policy. White is concerned with the important controversy concerning whether or not local taxation affects firms' location decisions. She begins by discussing alternative theories of property taxation, and the implications of each for the controversy. Her empirical work takes advantage of California data collected about the time that Proposition 13 was enacted. Proposition 13 generated exogenous (to the localities) changes in property tax levels, making them uniform throughout the state. However, other attributes of the business climate stayed about the same. Therefore, by examining location decisions before and after Proposition 13, one can study firm location decisions without having to correct for things like differential production costs. White's econometric results suggest that property taxes are a significant influence on decisions by retailing and service firms, but not manufacturing firms.

The paper by Small and Winston is concerned with a quite different tax problem: efficient road-use charges for trucks. Currently, neither federal nor state policy seriously attempts to align motor vehicle taxes with the damage the vehicles inflict on highways. Small and Winston estimate the welfare effects of instituting nationwide marginal cost pricing for heavy highway vehicles. Their analysis recognizes that a change in the current tax regime to one in which rates are based on weight per axle would induce trucking firms to use different types of trucks, and in some cases induce shippers to switch to other forms of transportation (e.g., rail). They find as a conservative estimate that by moving to marginal cost pricing, a welfare gain of $1.2 billion per year could be realized accompanied by a 17% reduction in highway maintenance and repair expenditures.

The purpose of the paper by Feenberg and Rosen is to provide consistent characterizations of state income and general sales-tax systems over time. For the period 1977–83, they compute revenue elasticities with respect to income, and marginal and average tax rates at various income levels. Such measures, which have not heretofore been available, should provide policymakers and academics with a basis for making interstate and intertemporal comparisons of tax structures. One of their findings is that if the income and general sales taxes are viewed as a single system, the average income elasticity of the revenue across states is about 1.1. This figure has not changed much over the period 1977–83. However, averages tend to mask considerable heterogeneity, both with respect to progressivity of the systems in a given year and how they have evolved over time.

The last paper in the volume, by Steven Craig and Robert Inman, examines some issues concerning the structure of U.S. federalism. They study the ramifications of the structure of federal to state grants in aid, and examine the possible allocative consequences of the "new federalism" program suggested by the Reagan administration in 1982. Craig and Inman specify and estimate a four-equation budgetary model of state spending for education, welfare, other expenditures, and revenues. An important result is that federal dollars which flow into a state via grants in aid are allocated disproportionately away from education and welfare, and toward other expenditures. When the grants come in the form of matching aid, this tendency is mitigated, but not as much as might be expected. Craig and Inman predict that if the Reagan plan were implemented, spending on welfare would be reduced, as would the size of the public sector as a whole.

Taken as a group, the papers in this volume raise important and difficult problems in state and local public finance, and make considerable progress in solving them. One is nevertheless impressed by the number of questions that are introduced and not answered in the essays. What is the optimal subsidy for locally provided capital? Can agency theory be used to explain local managers' responses to the arbitrage possibilities created by the tax treatment of municipal debt? What is the dynamic pattern of firms' responses to changes in local tax systems? What is the relation between a state's tax structure and the size of its public sector? It is hoped that this volume will stimulate research on these and related questions.

References

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