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## **What Should State and Local Governments Do? A Few Principles**

By

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This paper is preliminary and subject to revision. Comments and criticisms are particularly welcome.

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## 1. Introduction

This paper has been prepared as a background document for the Wisconsin Commission on State and Local Partnerships.<sup>1</sup> In this note, I would like to offer some principles related to the Commission's work, primarily from the point of view of economics. If we are to grapple successfully with the wide range of issues facing the Commission, it will be extremely useful to consider general principles that may help us focus our discussion and recommendations. Thus, some of the discussion in this note will unavoidably be a little abstract. Except for a few brief examples, this note will deliberately eschew discussion of the very important nuts-and-bolts issues that we'll ultimately have to deal with.

After this introduction, four sections follow. The second section discusses a few overarching social goals, things that are touchstones in thinking about what kind of government system "works." Section 3 is about how to identify the core functions of government. The fourth section discusses the various mechanisms governments have available to carry out these core functions. For example, should a particular core service be provided directly by the government, or should the service perhaps be provided by the private sector under regulation, or even contracted out? Can taxes, subsidies and regulations substitute, at least to some extent, for direct government provision? The final section addresses which level of government should carry out each function, i.e., what should kinds of functions be undertaken by national governments, which activities are better done by state or local governments.

While I draw many of these ideas from the economics literature on public finance and government, almost all the ideas contained in this essay have already been brought up one way or another in the Commission's deliberations. If this essay has a benefit, it is that it may integrate and clarify some of our discussion to date.

Why bother with such abstract principles? We need some principles to guide us when we go beyond "business as usual" to consider (possibly considerable) changes in the current system. General

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<sup>1</sup> The Commission, formed by Governor Tommy Thompson, is chaired by Professor Donald Kettl, and is described in detail at <http://www.lafollette.wisc.edu/reform>.

principles are also handy when we consider our charge as a Commission to consider the interests of the citizens of Wisconsin broadly and go beyond the point of view we usually take in our “day jobs.”

## 2. Overarching Social Goals of Government

Economists broadly categorize overarching social goals as those related to efficiency, and those related to equity and fairness.

Efficiency is primarily about costs, and their relationship to benefits. Given an objective, whether private or social, how can we carry it out while making the best use of society's scarce resources? On its own terms, it's a little hard to knock the concept of efficiency. Once we've decided that a certain thing should be done, it's hard to argue for a more costly way of doing it (unless the costly way has some additional benefits, which then need to explicitly be taken into account in the efficiency calculation).

Measuring efficiency is about measuring costs relative to benefits, then. In practice, measuring efficiency isn't always easy. For example, to consider the efficiency of alternative transportation systems, we have to have a pretty good handle on the costs and benefits of a wide range of alternative systems. It's usually not too difficult to reasonably estimate what it costs to build a mile of road or lay some track, or to buy a gallon of gasoline.<sup>2</sup> It's a little tougher to come up with measures of some other important costs and benefits, such as the value of cleaner air, or the value of a reduction in congestion. But *difficult* doesn't mean *impossible*; and just because something's hard to measure doesn't mean it isn't important. It is clearly better to use our best estimates of approximate costs and benefits, with a clear discussion of the limits to this knowledge, rather than throw up our hands and pretend that costs and benefits don't matter.

Equity and fairness are in some ways harder to tackle than issues of efficiency. Social scientists often differentiate between *horizontal equity* and *vertical equity*. Horizontal equity is about the equal treatment of equals. Everything else equal, most people would prefer a world in which two people in more or less equal circumstances are treated the same. For example, if we consider two people of similar

incomes, and find that one pays a much higher rate of tax than the other, we would say that horizontal equity is violated.

Of course, everything else is not always equal, and we violate horizontal equity quite deliberately all the time. Anytime we write special deductions or exemptions in the tax codes, for example, we are violating horizontal equity, presumably in the name of some other important principle or goal.

While we may argue over whether a particular exception to horizontal equity is a good idea or a bad one, in general terms horizontal equity seems to be a fairly reasonable proposition. Vertical equity, which is about the treatment of "unequals," is more problematic. To continue with the taxation example, how should rich people be taxed compared to poor? At one extreme would be taxation based on head count (a "poll tax") rather than income or some other measure of ability to pay. At another extreme would be, for example, extremely progressive systems of taxation, with very low marginal rates for low-income taxpayers and very high rates for the rich. Somewhere in between would be a tax that is a flat percentage of income.

It's almost certainly true that the majority of Wisconsin citizens prefer some progressivity in their tax system. Even this value is not universally held; and among those favoring progressivity, people will reasonably differ over what *degree* of progressivity is appropriate. Ultimately economics cannot answer this question. Economics can be useful in elucidating the consequences of a more-or-less progressive system;<sup>3</sup> but ultimately there is a value judgment lying behind most vertical equity choices that's beyond the province of economics.

As an aside, given the wide range of taxes paid by Wisconsin and other American citizens, it is not completely straightforward to tell how progressive the tax system is in practice. The codes themselves are complex; even greater difficulties arise because the legal incidence of the tax can differ from the actual or "economic" incidence. For example, landlords are legally liable for the property tax,

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<sup>2</sup> Of course these estimates will contain error, and sensitivity analysis is essential. In practice, sometimes such cost-benefit calculations are subject to non-technical errors, as when those carrying out the analysis are not sufficiently objective about the proposed activity or project.

and write the check to government. But to some extent they usually pass these costs on to tenants; the incidence of the tax is shifted.

Many economists who have studied the incidence of taxes believe that, broadly and on average, federal taxes are progressive in nature, i.e., take larger shares of income from higher income individuals. Most studies suggest that state and local taxes, on balance, are somewhat regressive, i.e. take a larger fraction of income from lower income households. At least one careful study, by Joseph Pechman, suggests that when you take all the taxes together, on average the U.S. is a flat tax world: the average tax rate for rich, poor, and middle income is about the same, about 30 percent according to Pechman's somewhat dated but still broadly relevant calculations.<sup>4</sup> This average masks very large differences in how particular *individuals* are treated at both high ends and low ends of the income distribution, i.e. whatever we think of the pros and cons of it vis a vis vertical equity the U.S. tax system doesn't perform very well by the principle of horizontal equity.

An important concept closely related to equity is *fairness*. Fairness is a little harder to define than the previous concepts, but the social philosopher John Rawls has popularized a particular way of thinking about fairness that many find helpful. Consider the following "thought experiment." Suppose the Commission were to decide on a particular set of recommendations regarding public finance. By Rawls' definition, we consider these *fair* if we broadly agree to them *in advance of knowing our own positions after the changes were put in place*. Pretend that, in a sort of *Twilight Zone* plot, each of us will be placed in a particular situation *after* the Commission's recommendations are implemented. Assume we know this, but we have no advance knowledge of what our particular situation would be. Some of us might be rich, and some poor. Some of us might work for school districts, others counties, others municipal governments, others the private sector. Some of us might live in central cities, some in suburbs, and some in rural areas. Consider other relevant breakdowns of this sort.

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<sup>3</sup> For example, economists study how much work effort changes when tax rates change, which can inform (but not resolve) the normative debate.

Let us then assume we reach a consensus to adopt a particular tax. For example, suppose for the moment we agree to adopt a sales tax, which we all know generally takes a higher fraction of poor consumers' income than of rich. Presumably we decided on this tax because of some other advantages that outweighed its regressivity. Our choice is "fair" if we view the benefits of such a tax as sufficient for most of us to support it, even though in our Twilight Zone world, after we propose it, we ourselves might well be poor. If this were the case, then this proposal passes the Rawlsian test.

### 3. The Roles of Governments and Markets: What is a "Core Function?"

In this section, we discuss the relative roles of markets and governments. In particular, we discuss how to identify "core functions" of government, i.e. necessary things that governments generally do better than the private sector.

As we all know, one way to organize the production and delivery of goods and services is through markets, usually the province of the private sector. Another way is for the public sector to take on an activity. In the modern mixed economy, government produces some things, markets produce others; but many are produced by some combination. In particular, governments often *intervene* in private market transactions.

Why are some goods publicly produced, and why do governments intervene in many private market transactions?<sup>5</sup> Sometimes markets don't work well. Economists use the jargon "market failure" to label situations in which governments may (under certain conditions to be discussed) improve on the market's allocation of goods and services. The main sources of market failure are:

- The existence of "pure public goods"
- Monopoly

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<sup>4</sup> Many other studies of incidence have been undertaken, and some have found more or less progressivity than Pechman. See the papers in Slemrod (1994), and the references therein for a more detailed introduction to this literature.

<sup>5</sup> In today's mixed economy, it's hard to think of any significant economic activity not subject to some government intervention (tax, subsidy, regulation, etc.). Perhaps it's best to think of this in relative terms, e.g. areas where governments intervene lightly, versus those where they intervene heavily.



- Spillovers/externalities
- High transactions costs/poor information
- Distributional objectives

Next we discuss each of these five sources of market failure in turn.

### *“True” Public Goods*

Economists define “public goods” rather more narrowly than common usage. “True” public goods have two central characteristics. First, one person's consumption does not exclude another's. For example, my enjoyment of clean air does not, in general, reduce yours.<sup>6</sup> Most goods do not exhibit this property of “non-rivalry in consumption.” If there is a doughnut on the table, and you and I both want it, we are “rivalrous,” i.e. if I eat it, you can't.

A second property of “true” public goods is that you cannot exclude someone who doesn't pay from consuming it. A classic example is national defense. If we choose to defend our state from foreign invasion, it is unlikely we'd be able to choose which citizens to defend based on (e.g.) whether they were current on their taxes. Since those who don't pay (or who pay little) can “free ride” on others, this property implies that it's hard to know the demand for public goods from people's statements about their willingness-to-pay. If I'm to be taxed based on my willingness-to-pay, but know that the level of service provision will be decided (and mostly paid for) by others, I have an incentive to under-report my own demand for the good.

It follows from these definitions that, in a strict sense, “true” public goods (as defined by economists) are less common than might be thought. Many things that we loosely think of public may not meet the strict test, but may in an “approximate” way. For example, consider a public park. At some point, a park is “congestible,” and the first condition is violated. And we can charge a fee and exclude those who don't pay. But for most parks, the level of congestion is not often a serious problem, and it

would in fact be costly to erect fences and post guards, collect the fees, etc. So we can think of such a park as “approximately” a public good.

Whenever a good has this “public” character, it is obvious that it will be insufficiently provided by the private sector. Private firms will find it difficult or costly to capture the benefits of provision, due to the inability to exclude those who don’t pay, or even figure out accurately what demand is. The public sector often steps in to such situations (although some problems remain, like figuring out the true demands of citizens for public goods).

### *Monopoly*

Monopoly in the strict sense is when we have one and only one provider of a good or service. Economists also use the term more loosely to indicate situations where firms have some degree of market power, even when there may be several providers.<sup>7</sup>

Monopoly can stem from several sources. Natural monopoly is caused by economies of scale (a.k.a. increasing returns or decreasing costs). Other kinds of monopoly can stem from (e.g.) government regulation, or control of “unique” factors of production.

The central efficiency problem of monopoly, familiar to anyone who’s studied a principles of economics course, is that the profit-maximizing monopolist sets her level of output such that her marginal revenue equals her marginal cost; but that (unlike the situation in competitive markets), at this level of output our monopolist can charge a price *greater* than marginal revenue/cost.<sup>8</sup> It is well known that in

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<sup>6</sup> At least, that would be true up to the point where many of us *moved* to a place with clean air, so much so that increased population reduced air quality. Thus we talk about some public goods as being *congestible*, i.e. losing this “non-rivalry in consumption” property at some point.

<sup>7</sup> That is, when we use the term “monopoly” more broadly we include cases of oligopoly, and in general any case where individual producers can affect the price of the good or service.

<sup>8</sup> Why? In mechanical terms, because the monopolist’s marginal revenue curve lies *below* the demand curve she faces (which is, by definition of monopoly, the demand curve for all members of society). Unregulated profit-maximizing monopolists rationally set the output level where their marginal revenue equals marginal cost, then price at what the traffic will bear, i.e. the price read off the (higher) demand curve. Because the monopolist faces a downward sloping demand curve, to sell another unit of output she has to reduce the price of all units sold, not just the last unit sold. Thus her marginal revenue falls faster than the demand curve. In contrast, in a competitive market each producer is a “price taker,” facing a horizontal price line, which is the firm’s demand curve.

such situations output is “too low,” and the price of the good “too high,” compared to the efficient competitive market benchmark.

Monopoly is widely accepted as a rationale for government intervention. Sometimes governments take over the production of such goods directly (e.g. some municipalities run public water and sewerage systems). In other cases governments regulate private providers, in theory trying to push them towards lower prices/higher outputs that would be obtained in a competitive market.

### *Externalities, or Spillovers*

Some costs or benefits are not reflected in market prices. Examples abound.

How I use my property affects my neighbors. Suppose a developer builds a hundred unit subdivision near your house. Suppose he pays the cost of buying the land, grading, on-site infrastructure, construction, marketing, etc. If the market is competitive, and I buy a unit, I will in turn pay these costs, as well as the developer’s “normal profit,” i.e. the cost of keeping the developer in business.<sup>9</sup> Thus consumers only purchase a unit if the private benefit *to them* equals or exceeds these private costs.

Things are not quite so neat once we introduce the concept of *externalities* or *spillovers*. These are costs or benefits that are for some reason not considered by the individuals involved in the transaction. Suppose, for example, that these newly developed housing units increase local traffic congestion, and some existing neighbors find their commutes increase. Such an external cost is not usually considered in the developer’s or the consumer’s private calculus of costs and benefits.<sup>10</sup> In this example, given congestion we can presume there will be some units for which private benefits exceed private costs, but for which external costs imply that social benefits are less than social costs.<sup>11</sup> The latter condition tells us

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<sup>9</sup> Economists distinguish between these “normal profits,” which are a cost of doing business, and “excess” or “economic” profits, which are those over-and-above required normal profits. By definition, accounting profits equal normal profit plus excess profit. In practice, either element, or their sum, can be positive or negative.

<sup>10</sup> Congestion is only one possible externality from housing development, chosen to illustrate a point. There are other possible external costs, and there are also possible external benefits.

<sup>11</sup> By definition, social costs equal private costs plus external costs. Social benefits equal private benefits plus external benefits. It follows trivially that if externalities are negligible, social and private costs and benefits are equal.

that these units would not be built, if all costs and benefits were taken into account; the former condition tells us that in fact they will be built.

There are many other possible examples, of external benefits as well as costs. How I am educated affects other citizens, for example. Many studies demonstrate that higher general levels of education benefit the broader populace, both economically and in other ways. This suggests that, since education's social benefits exceed its (substantial!) private benefits, in the absence of government intervention, at least some individuals will drop out of school at a point where the social benefits of further education actually exceeded the cost those students incurred.

In general, when significant externalities exist, government intervention can – *in principle* – improve on the private market outcome.

### *Other Market Imperfections*

There are a number of other possible sources of market imperfections. Most are ultimately due to some variant of imperfect information, or some other transaction cost. For example, the basis for much regulation such as the licensing of trades, etc. is the assumption that it's difficult for individual consumers to judge someone's ability to carry out a task. If I get a bad haircut, in a few weeks my hair grows back and I can visit a different barber. But if I need a surgeon, or someone to build the foundation for my house, and I make a mistake and choose an unqualified person, it is extremely difficult to rectify.<sup>12</sup>

Also, private markets are "incomplete." Not everything that could be bought and sold, is. This is particularly true for many possible kinds of insurance against risk. For example, consider the fact that most homeowners own one, and only one, house. If house prices fall in a particular market, those who live there take a large "hit." In fact, since there's a correlation between labor markets and housing markets, chances are that housing prices are falling when the labor market is poor. To some extent,

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<sup>12</sup> Of course such regulations also have the effect, intended or not, of limiting entry to professions and driving up the returns to those who gain entry. Striking the right balance in such regulation is no easy task.

various government housing programs (FHA, for example) as well as programs like unemployment insurance are at least partly justified as a government response to the incompleteness of these markets.

### *Interventions Based on Equity, Distributional Considerations*

So far, most of our discussion has been, explicitly or implicitly, about situations in which government interventions potentially improve the efficiency of some market outcome. But of course many government interventions are undertaken in situations where it appears that market outcomes are "inequitable" or "unjust." Certainly anti-poverty programs and transfer payments of various kinds meet this criterion. This is not to argue that there are not other reasons such programs exist: some point to bureaucratic inertia or some rent-seeking behavior;<sup>13</sup> and in a more positive light, successful antipoverty programs also yield efficiency gains, as society's members become more productive. But certainly notions of horizontal and vertical equity, and fairness, underlie much of the support such programs have.<sup>14</sup>

### *Markets or Governments?*

In much of this discussion we have concentrated on the sources of market failure. Market failure, whether of efficiency or distributive justice, is the economist's overarching justification for government action. However, it is important to note that just because we can improve on the market *in principle*, does not demonstrate we can do so *in practice*. Many examples can be found of government interventions undertaken in the name of correcting some market failure, which did not work. In other words, the existence of market failure is a necessary, but not a sufficient, condition for government intervention. We have to demonstrate some reasonable possibility that the intervention will actually improve on the (imperfect) market allocation *in practice*.

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<sup>13</sup> Economists use the term "rent-seeking behavior" for what others might call feeding at the public trough.

<sup>14</sup> In terms of our prior discussion, it is worth noting that poverty and unjust distributional outcomes generate serious *externalities*. How do we know this? Easy: many people choose to contribute (through private charities as well as government action) to alleviate at least some poverty. If you are willing to contribute to keep me from starving or being ill-housed, there is a *prima facie* case that my poverty generates external costs.

There are many reasons why successful government interventions are difficult to design and implement (Wolf 1988). First, they require lots of information. Consider our externality example, of the congestion costs of housing development. The existence of such externalities suggests that governments could improve over the private market outcome in some way, e.g. by taxing or regulating development appropriately. But what is appropriately? To do a good job, city planners and officials need to know a lot about the housing market, need to know in particular how big the external costs are (in dollar terms), and need to know how different taxes and regulations will affect developer and consumer behavior.

Another source of government failure is that sometimes public agents act in their own interest, rather than in the public interest. Perhaps even more often, these interests can become muddled and confused. A good example, albeit somewhat removed from state and local government, is that a former Air Force officer stationed at the Pentagon tells me that when fellow officers referred to "the enemy," the reference was not to a foreign power, but to the Army and the Navy.

#### **4. Incentives and Interactions: What Instruments Are Available to Governments?**

As we have already noted, one way to organize the production and delivery of goods and services is through markets, the province of the private sector. Another way is for the public sector to take on an activity directly. For example, in the United States the great majority of housing is produced and managed by the private sector. However, about two million housing units are developed and owned and managed by the public sector, as public housing. Several million other units are managed by the private sector but according to rules and regulations laid down by the public sector in return for specific subsidies and tax breaks (for example, the federal Section 8 New Construction program, and Section 42 Low Income Housing Tax Credit units). Still other units are produced with less direct public intervention but governments assist tenants with payments of rent using housing vouchers or Section 8 Existing certificates. Ultimately virtually no housing unit in the U.S. is exempt from some sort of government tax, subsidy or regulation, whether directly or through the tax code, by all levels of government.

### *Types of Government Intervention*

Most public interventions in market outcomes can be categorized as one or more of the following:

- Delineation and enforcement of property rights and contracts.
- Taxes.
- Subsidies.
- Regulations.
- Direct public provision.
- Catalyze and coordinate private sector/NGOs.

Because we have a well-developed and fairly well-functioning legal system, in the U.S. we usually take *property rights* for granted. We shouldn't. Defining and enforcing property rights is one of the fundamental functions of government. Anyone in doubt on this point should examine the experience of countries where property rights are not so well developed and contracts difficult to enforce, e.g. in the countries of the former Soviet Union.

Property rights are the precondition for a functioning market economy. In addition, since the influential work of Ronald Coase, we know that under certain conditions an exchange of property rights can handle some externality problems. The idea is a simple one, best illustrated by example. Suppose that a firm is interested in placing a factory in a small town. Suppose that this factory pollutes. (All factories do). Suppose the factory has a range of production processes and pollution control equipment available to it; and as we'd expect, the cleaner we run the factory, the greater the cost to the firm.<sup>15</sup>

The only way to have zero pollution is to have no factories. (This may be an option for some particular town, but is not an option for society in general). Let us assume that with no controls, the factory's pollution is completely unacceptable to all residents. The question is, then, how do we strike a balance between the need for factories and the need for a clean environment?

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<sup>15</sup> Coase's original article is well worth reading, but a detailed example along the lines we layout here can be found in Fischel's excellent (1985) discussion of the property rights approach to land economics.

One approach is for some outside agency to regulate the pollution level in the factory to meet certain standards. Another is to tax pollutants, to give the firm an incentive to consider the external costs of pollution in its operation. A third way, suggested by Coase's work, is to permit each side to trade with the other to reach some optimal tradeoff between the need for factories and the need for a clean environment. Coase's method requires two assumptions, the second one fairly strong. First, the property rights involved (to determine the cleanliness of the air in this case) must be clearly assigned to one side or the other (i.e. to either the factory or the town's residents). Second, transactions costs of bargaining must be zero (or at least pretty low). These low costs include the assumption that everyone has perfect information.

Coase showed that if these conditions were met, we'd obtain the same level of factory output/pollution no matter which side had the right. If the citizens have the right to perfectly clean air (i.e. no factories), the firm can compensate the citizens (directly or indirectly) up to the point where the value of the last unit of output (and its associated pollution) is equal to the value of the last particle or unit of pollution. Remarkably, if the factory has the right to build whatever it wants, under the assumptions of zero transactions costs residents can compensate the firm to lower the level of pollution, as it happens to the same level as if the citizens had the right.

Because we reach the same level of output/pollution no matter who is assigned the right, who is initially assigned the right is irrelevant to the *efficiency* outcome. But we need hardly point out that the *distributional* outcome is very different in each case: in the first, the firm pays the citizens; in the second, the citizens pay the firm. We also reiterate the obvious point that in many real world cases the assumption of low transactions costs is not met.

Some economists seem to imply that Coase's approach tells us we don't need government regulation or taxation to deal with externalities; all we need to do is define the property rights and let the market work its magic. I suggest that life is not so simple, especially since the transactions cost assumption is such a strong one. But I would also suggest that the idea of exchanging such rights or



compensating citizens for the costs of development is not a new one; local governments have been doing this, one way or another, long before Coase wrote his paper.

*Taxes* and *subsidies* are really two sides of the same coin. Governments give money, and they take it away. Often governments can reach some objective by one or the other, or both; and in addition they may have a choice of *regulating* to achieve a desired outcome.

Return to our example of a new residential development that imposes external costs from congestion on neighbors. How could government control the problem? Let us assume that government has a good handle on the size of the externality, and on how developers and consumers respond to different incentives.

If the Coasian assumptions are met, government could either give the developer the right to build whatever they want, and let neighbors arrange a deal to pay the developer to build less intensively; or they could give the neighbors the right to veto development, and permit a deal where the developer pays the neighbors to develop up to the point where social costs and benefits are equated. Who gets the right depends on whom we like: developers or neighbors. Whoever gets the right gets something of possibly great value.

Experience suggests that in these kinds of situations the Coasian assumptions are, in fact, rarely met. Another option is a regulation on development, for example a limit on building permits. Doing this well requires the government or planning authority have a clear idea of the external costs of development, and of the supply and demand for housing, in order to properly set the number of building permits. There are also different ways of assigning the (scarce) building permits. They could be granted on first come-first serve, or a lottery, or some other basis. Since restricting permits drives up the value of homes, developers who obtain them will be able to sell homes for more than would be observed without such regulation. On the other hand, if the permits were auctioned to developers, the "excess profit" would in fact end up in the public treasury.

Another approach that could be taken is to set a tax or development charge or "impact fee" on development, equal to the size of the external cost. This is a "neat" solution that economists like. If

properly set, such charges "internalize the externalities," i.e. force developers and new housing consumers to consider the costs to neighbors in their cost-benefit calculus. Put another way, after the imposition of such a tax, the new private cost is also the social cost, and the externality problem is solved.<sup>16</sup>

## **5. States, Counties or Municipalities? Choosing the Right Level of Government**

Once we've decided we need a service, what level of government (state, county, municipal, special district) should provide it? Economists suggest we should consider:

- Diversity in demand/local control.
- Economies of scale/costs.
- Spillovers/externalities.
- Integration of related services.

Actually, the first three are the "standard" criteria found in the economics literature. The fourth criterion is rarely discussed in this literature, but its importance has been highlighted in the Commission's discussion, e.g. of the criminal justice system. In the next few pages we briefly discuss each. Note that the criteria are not mutually exclusive, a point to which we will return.

### *Diversity In Demand/Local Control*

For some goods, different communities have different demands, or otherwise place a very high value on local decisions and control. Examples of goods and services that appear to fit this criterion include schools, and land use regulation.

Everything else equal, diversity in demand/local control responsibility should be shifted to a lower level, i.e. to the county or municipal level.

To the extent diversity in demand is important, it can be argued that an efficient way to structure local governments is to have a relatively large number of local governments, each offering different

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<sup>16</sup> An important distributional question remains. If the town's treasury obtains the tax revenue equal to the external cost imposed on the neighbors, will they in some way compensate the neighbors who bear the cost, or use it for

tax/expenditure packages. Individuals can then "vote with their feet," sorting themselves into the communities that closely approximate their own tastes and requirements. Charles Tiebout first rigorously analyzed the attributes of such a system, and urban economists speak of a "Tiebout world" as one with many such competing jurisdictions.

### *Economies Of Scale/Costs*

For many goods and services, costs fall as we increase the scale of the activity. Obvious examples include roads and transportation networks. Less obviously, even services generally produced at the local level have some range over which costs fall. For example, a number of studies suggest that average costs for the provision of police and fire services fall as population increases, at least up to a population of 100,000 or so.

Everything else equal, the existence of economies of scale suggest shifting responsibility to a higher level (the state or a regional entity).

If economies of scale are important over the relevant range for many local public services, then these economies can reduce the potential efficiency of a "Tiebout world" as discussed above. If they are important for some services but not others, their existence may suggest the creation of special purpose regional authorities (as many metropolitan areas do for transportation, for example.)

### *Spillovers/Externalities*

We have already discussed the fact that some activities impose costs, or confer benefits, on neighbors. Examples include land use and education. Everything else equal, the existence of spillovers suggest shifting responsibility to a higher level.

As with economies of scale, the existence of many important spillovers reduces the potential efficiency of a Tiebout world. And as before, if they are important for some services but not others, their existence may suggest the creation of special purpose regional authorities.

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general purposes? Even if the latter, neighbors are still better off under the tax, as the level of congestion is reduced.

### *Integration Of Related Services*

Many activities combine several individual services/activities; each may have their own “optimal level.” Examples include criminal justice (local police, county jails, state prisons).

Everything else equal, the existence of such integrated activities implies we must solve a coordination problem. One way to do so is to establish a metropolitan or regional authority which coordinates the efforts of lower-level agencies. Another way is to improve the exchange of information among jurisdictions, either formally or informally.

### *Providing services versus financing services*

In principle, who makes the decisions about the level of public services, and their composition, can be separated from who finances them. For example, in Wisconsin as in most states education has significant local control but significant state finance.

Mandates are unpopular with local governments because they work in the other direction. Higher levels of government impose rules and service levels upon local governments, who then have to (at least partially) finance them.

Is the separation of service provision and its finance a “good thing” or a “bad thing?” There are clearly arguments for separating some service provision from finance. Suppose schools are better run with local control and “ownership,” but tax bases/ability to pay varies tremendously by location. Arguments against separating service provision from finance can be summarized as follows: when money is manna from heaven, we may spend it less carefully than if it was raised locally.

Of course there are many kinds of taxes to be considered. Musgrave (1983) and Oates (1994) suggest the following principles for deciding which level of government is best placed to implement a given tax:

Progressive taxes and redistributive programs are best left to higher levels of government. Experience as well as theory tells us that with a mobile population, introducing a highly progressive local

tax creates perverse incentives for high-income households to "escape" jurisdictions that most need the tax base.

Lower level jurisdictions should also concentrate their tax effort on (relatively) immobile activities or factors of production. Classically, this is interpreted as a strong argument for the property tax as a source of local revenue.

If a given tax base is unequally distributed across tax jurisdictions, higher levels of government should undertake an equalization function. This is, of course, not news to anyone from Wisconsin.

Economists *love* user fees, i.e. government charges tied to the consumption of specific local public goods. In the local context, if all jurisdictions implement user fees where feasible and appropriate, perverse incentives to move (see above) are minimized.

#### *Implications of the Criteria for the Location of Public Services*

It is immediately apparent that deciding which level of government should provide goods and services is not easy. Diversity in demand argues for pushing decisions down, and more jurisdictions; economies of scale and spillovers argue for pushing decisions up, and consolidating jurisdictions. The problem is that many important local public goods exhibit all of these characteristics. For example, people seem to feel strongly about local control of public schools; there are clearly economies of scale, at least over some range;<sup>17</sup> and there are clearly large spillovers. The first argues for moving the decision lower in the hierarchy, the second and third points suggest moving the decision up.

We may consider it a disappointment that there are often no easy answers to the question "which level of government should provide a given service?" But at least the criteria discussed above help us clarify what the tradeoffs are. If at least qualitative estimates of the size of the spillovers, economies of scale, and diversity of demand are available or can be developed, these criteria may help even more in making such choices.

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<sup>17</sup> Although the existence of severe problems in many large school districts in the U.S. suggests that there is a point past which costs rise with increasing scale.

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