

## Chapter 22. Multigovernment public finance

A federal system consists of different levels of government that provide public goods and services and have some scope for making decisions. The field of fiscal federalism examines the roles of the different levels of government and the way in which they interact with each other.

The centralization ratio reflects the proportion of total direct government expenditures made by the central government. However, if local and state government spending is constrained by the central government, the centralization ratio underestimates the true extent of centralization in the system. When we look at community formation, it is easy to think of a community as a club (a voluntary association of people who band together to share some kind of benefit). The optimal community is one in which the number of members and the level of services simultaneously satisfy the condition that the marginal cost equal corresponding marginal benefit.

The ability of individuals to move among jurisdictions produces a market-like solution to the local public goods problem (*Tiebout model*). Individuals locate in the community that offers the bundle of public services and taxes they like the best. It is a market mechanism with the proportional tax on property as the price and the package of local public goods as the quantity. Key conditions of the Tiebout model:

- Government activities generate no externalities
- Individuals are completely mobile
- People have perfect information on community's public services and taxes
- There are enough different communities
- The cost per unit of public services is constant
- Public services are financed by a proportional property tax
- Communities can enact exclusionary zoning laws (statutes that prohibit certain uses of land).

Advantages of decentralization:

### *Tailoring outputs to local tastes*

Individuals with similar tastes for public goods group together, so communities provide the types and quantities of public goods desired by their inhabitants. Besides this, a local government has a greater democratic responsiveness and can better fit to citizen's preferences than the central government.

### *Fostering intergovernmental competition*

The threat of citizens 'voting with their feet', and going to other communities creates an incentive for bureaucrats to produce more efficiently.

### *Experimentation and innovation in locally provided goods and services*

A system of diverse governments enhances the chances that new solutions to problems will be sought. Smaller governments can act an innovation laboratory for taxes and public goods.

Disadvantages of decentralization:

### *Efficiency aspects on the expenditure side*