

## SPENDING LESSON REGARDING LOCAL GOVERNMENT COMPETITION, BUDGETARY COMPLEXITY, AND FISCAL STRUCTURE

*Research Notes, September 2004, Number 2.*

The “devolution revolution” is the long term shift in power and spending responsibilities from Washington to the states. It raises the question of what states will do with greater discretion, including how local officials will be involved, especially in light of support by several governors for further devolving authority to counties or other local units (Weissert and Schram, 1996). This note discusses the recent empirical evidence by Campbell (2005) regarding the likely behavior of local governments with respect to competition among governments, budgetary complexity, and the fiscal structure hierarchy.

In *The Power to Tax*, Brennan and Buchanan (1980) argue constraints that limit government growth must be imposed at the constitutional stage because the political process, by itself, cannot adequately constrain the natural proclivity of inefficient government growth, i.e., to act like a leviathan. The leviathan hypothesis is the proposition that indirect, post-constitutional constraints, e.g., electoral competition, are not effective constraints to the natural tendency of government to grow in an inefficient manner. In other words, effectively inhibiting the natural tendency of government growth requires direct constraints, like the following, to be imposed at the constitutional stage: restricting the number of tax bases, restricting the comprehensiveness of tax bases, restricting the ability of governments to debt finance, and restricting tax rate structures and expenditure levels. However, Brennan and Buchanan present two cases where the need for constitutional constraints may be diminished. They posit that fiscal constraints imposed at the constitutional stage may be substituted by a public sector that is (1) decentralized and (2) fragmented. They argue that decentralization and fragmentation produce greater competition and, hence, lower expenditures. Recent empirical research supports the leviathan hypothesis; Specifically, governments at the county layer are more likely to behave as leviathans than governments at the municipal layer (Campbell, 2005). The data provide four reasons for this conclusion: fragmentation, decentralization, fiscal illusion, and overlapping jurisdictions.

First, “fragmentation” refers to competition among governments. Considering two metropolitan areas with the same population, income, and taste for government, etc., a metropolitan area is more fragmented if more municipalities exist in the area, rather than fewer. More jurisdictions allow voters more choices when it comes to tax-and-spend public policies. The conclusion that counties are more likely to behave as leviathans when compared to municipalities makes sense because the existence of fewer counties results in less competition among county governments and the greater number of municipalities in an area results in more competition for each municipal government.

Second, “decentralization” refers to which layer, the county or the municipality, of government is spending relatively more of the total local government expenditures.

Considering two metropolitan areas with the same population, income, and taste for government, etc., a metropolitan area is more decentralized if the municipal governments account for the larger proportion of total municipal and county spending. The research shows that a more decentralized local government sector leads to less total expenditure when considering expenditures by both types of governments. It might seem that if the state government shifted \$1 of county spending responsibility to the municipal government, we should find an increase in the relative size of municipal expenditures of \$1 and similarly reduced county expenditures of \$1, with no net effect on the total size of the city-county government sector. However, because of the greater competition between municipalities than between counties, the empirical results show that such a shift in spending responsibility tends to increase municipal expenditure by less than \$1 while reducing county expenditure by the full \$1 of shifted responsibility. In other words, the shifting of the \$1 of spending responsibility causes total municipal and county spending to fall, constraining government growth.

Third, the research shows evidence of a flypaper effect due to “fiscal illusion” on the part of voters. A flypaper effect is found when there is evidence that an increase in aid to a jurisdiction is more stimulative on government expenditures than an equivalent increase in voters’ incomes (Fisher, 1982). Hence, if a state government handed out income directly to voters rather than as grants to the local jurisdiction, the voters would support a lower level of government spending than the government of the jurisdiction would choose. The literature identifies two different types of fiscal illusion that are relevant here. Buchanan and Wagner (1977) posit that complex and indirect tax structures will create fiscal illusion that systematically results in higher levels of public expenditures than would be found under simple and direct tax structures. This is due to individuals underestimating their marginal tax price due to the complicated budget process which leaves them unaware of intergovernmental grants, giving the government monopoly power to increase its size (Oates, 1979). A complex and indirect tax structure is one which extracts payments from citizens in ways that individuals will “sense” it less. Examples include taxing many different sources rather than just a few and withholding taxes from earnings. In addition, taxing individuals over time tends to prevent the aggregation of the entire tax burden, making it more difficult for an individual to easily ascertain his marginal tax price associated with public spending. Turnbull (1998) advances a more general notion of fiscal illusion as imperfect information or uncertainty, whether voters are uncertain about how additional taxes will translate into additional public services or to what extent additional services will increase their tax burden. The important implications of this view include: an increase in uncertainty about tax price and/or benefits reduces government spending. Risk averse individuals support a lower level of local spending when there is greater uncertainty over the tax price and the benefits received from public spending. He also shows that tax price uncertainty supports a flypaper effect while uncertainty on benefits does not and that uncertainty fiscal illusion analysis can include the effects of voters’ consistent underestimation of the tax price of public services.

Fiscal illusion is measured by the number of tax sources or expenditure categories; as the number of categories rise, it is harder for voters to be fully-informed. The empirical

evidence supports this view. Considering two municipalities with the same population, income, and taste for government, etc., a municipality is more likely to face fiscal illusion when it taxes more sources than the other municipality taxes. When measuring the complexity of taxation, categories generally include property taxes, general sales taxes, income taxes, and “other” taxes. Likewise, considering two municipalities with the same population, income, and taste for government, etc., a municipality is more likely to face fiscal illusion when it has more expenditure categories than the other municipality. When measuring the complexity of expenditures, categories generally include education, welfare, health and hospitals, highways, police, fire, parks and recreation, housing, and sewerage.

Fourth, “overlapping jurisdictions” refers to the nature of the federal system where a locality might be subject to several governments. While many scholars assume that layers in a federal system compete with one another (e.g. Frey and Eichenberger, 1996), little research has actually been done on the nature of the vertical relationship between governments. Breton (1987) states that the nature of a federal structure adds competition to that already present in a multi-party government. Therefore, if spending at one level is a substitute for spending at another level, then government growth is naturally constrained by a federal system and vertical competition exists. However, Breton argues that politicians working together to achieve a particular end can easily degenerate into “collusion, conspiracy, and connivance” (274). This might be the case when city and county officials set tax rates in conjunction with one another. Therefore, if spending at one level is a complement to spending at another level, the federal structure can actually encourage government growth. Turnbull and Djoundourian (1993) view the strategic relationship between overlapping jurisdictions as reflecting how the taxes levied and services provided at one level affect voters’ demand for public spending at another level of government. They define a complementary relationship as an increase in spending of one jurisdiction (e.g., municipality) leading to increased spending of the other jurisdiction (e.g., county). Additionally, they define a substitute relationship as an increase in spending of one jurisdiction leading to decreased spending of the other jurisdiction. In fact, empirical evidence points in the direction of complementarity. The data show that holding other things constant (including jurisdiction income and population, e.g.), when county per capita expenditures increase, this leads to increases in municipal per capita expenditures. The relationships between cities and counties, however, are not symmetric. The empirical evidence shows that greater municipal per capita expenditures do not systematically affect county per capita expenditures.

Summarizing, municipal and county governments have been found to act as leviathans, i.e., growing faster than fully informed voters under pure democracy would otherwise support. One lesson for policy makers is that when choosing between programs that spend at the different local government layers, municipalities are less likely to behave like a leviathan than counties. The greater competition at the municipal layer is more likely to constrain the natural proclivity for municipal governments to grow, making programs designed to be implemented at the municipal layer more appealing than programs designed to be implemented at the county layer.

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and opinions expressed in this publication are not necessarily those of the editor, the URAG, the Andrew Young School of Policy Studies, or Georgia State University. Geoffrey K. Turnbull is the editor of *Research Notes*.