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STATE AND LOCAL GOVERNMENT CHOICES IN FISCAL REDISTRIBUTION

While it is widely held that that state and local governments should not pursue income redistribution as a budgetary objective, state and local governments do engage in budget policies that have an explicit redistributive objective. On the expenditure side, responsibilities range from health, welfare and education (each with a redistributive component). State and local governments also impose tax laws that involve redistribution including progressive income tax rates, food exemptions for the sales tax, and property tax circuit breakers In short, voters do appear willing to support state and local government redistribution policies (Martinez-Vazquez. 1981).

Federal government policies may affect the tendency of state and local governments to do redistribution. The level and composition of federal grants can affect the price of state and local expenditures. federal deductibility of state and local taxes affects the cost of tax-related redistribution, and through income effects associated with certain types of grants.

Economists have devoted relatively little attention to explaining why some state and local governments choose more progressive fiscal instruments than do others The research reported here provides an empirical model to identify the determinants of income redistribution as a budgetary choice, and estimates the strength of these determinants with state and local government panel data for a 21-year period. In particular, we study the following questions in an empirical framework

1. What are the characteristics of states that undertake higher or lower levels of distribution?

2. Are expenditure-side and tax-side distribution policy instruments substitutes or complements in state and local government budgets?

3. What can past behavior tell us about how state and local governments will react to an increase in their redistribution responsibilities in the future?

There is no unambiguous way to measure the emphasis on distribution in state and local government budgets as virtually every government service and every tax has some element of progressivity or regressivity in it. The choice we use in this research is to index the degree of distributional emphasis based on budget shares allocated to redistributive services and revenue shares raised from progressive taxes. We classify the following as redistributive services: health, welfare, and primary and secondary education. On the revenue side, the proportion of state and local governments' individual and corporate income taxes in total own source revenue is used as the indicator of the importance of distribution in the state and local government revenue budget. The appropriateness of these variables is tested by comparing these variables to other potential measures of redistribution; we believe that our measures hold up quite well.

We are seeking an explanation of what makes state and local governments choose more or less redistribution, measured as the percent of total expenditures on health, education, and welfare and the percent of revenues coming from state and local individual and corporate income taxes. We believe that this expenditure/revenue redistribution decision is made simultaneously and governments either view the expenditure side and revenue side redistribution decision as a complementary one or that one substitutes for the other. In this context, two other variables are considered as endogenous--per capita federal aid for health and welfare and the poverty rate. Federal aid for health and welfare programs will have a significant effect on the likelihood of choosing redistributive expenditure policy because of both income and substitution effects. The level of federal health and welfare aid is itself endogenous to this model because the total amount received is determined partly by state and local government expenditures on those services.

Higher poverty rates are expected to encourage more redistribution through both tax and expenditure policies, but the poverty rate is endogenous to the system because more redistributive fiscal policies could encourage in-migration of the poor or out-migration of the non-poor thereby increasing the poverty rate in a state.

A number of variables are chosen as exogenous. For each dependent variable (revenue share, expenditure share, poverty, and per capita federal aid) we rely on the literature and economic theory to determine appropriate variables. We estimate the four equation system for the period 1969-1990 for all state and local governments by state. The most important of the results is the positive and statistically significant coefficient for the endogenous revenue and expenditure distribution variables. For the period observed, states appear to view revenue- and expenditure-side distribution policies as complementary and pursue distribution objectives with both. If a state spends 1 percent more of its budget on redistributive services, it would, on average, raise about 0.35 percentage points more of its revenues from income taxes. If a state raises 1 percent more of its revenues from income taxes, it spends 0.041 percent more of its budget on social services.

Expected results are also obtained for the other two endogenous variables. A higher poverty rate, *ceteris paribus*, significantly dampens the share of social service expenditures and the share of income taxes. Budget choices in favor of redistribution tend to decrease with heavier concentration of poverty. The endogenous federal aid variable (for health and welfare) have a stimulative effect on the redistributive expenditure share in the pre-1982 period, and an even stronger effect in the post-1982 (Reagan) era, when grants were reduced and mandates were strengthened. Many of the other results are consistent with expectations.

From the regression results, we also find that, at the margin, and taking both direct and indirect effects into account, we might expect more emphasis on social services in the expenditure budgets of states that are less urbanized and have lower levels of income. On the revenue side, states with lower levels of income, less urbanized populations, and a smaller concentration of black and elderly population tend to make more use of income taxes. Prices do seem to matter. Higher federal matching grant rates lead to more redistribution, as does a larger percent of federal income tax itemizers.

What do these results suggest for future policy? We simulated two potential changes in government policy to determine the effect on redistributive expenditure and revenue shares for state and local governments. We investigated the two following policies: the elimination of the federal matching provision in state-local grants (with a hold-harmless assumption in terms of total amount of grant received) and the elimination of the federal deductibility of state income taxes.

Interestingly, our model predicts that the shift to block grants does not lead to a de-emphasis of fiscal redistribution by state and local governments. The significant relative price increase for health and welfare services raises the redistributive expenditure share fundamentally because of the relatively low price elasticity of demand for social welfare services. Thus, states would be buying less services but spending more than before. The income effect associated with the shift from matching to block grants assumed in the simulation partially offsets the effect of the change in relative prices by lowering the redistributive expenditure share. The net effect is estimated to be a 5-percentage-point increase in the expenditure share for social services. The model also predicts a 1.76 percentage-point increase in the income tax share: voters would be willing to accept some increase in the income tax share so that their redistribution target would not be met entirely on the expenditure side of the budget.

The elimination of the federal income tax deduction for state and local taxes (holding total income harmless) would reduce the number of income tax payers who itemize deductions, thereby raising the price of state income taxes and lowering the income tax share. Secondly this change would increase the level of (after tax) personal income thereby further reducing the income tax share. The total effect is that the redistribution revenue share would fall by about 1.31 percentage points. On the expenditure side of the budget there is little effect. The return of the increased federal income tax as an income supplement will lead to little change in the expenditure share on social services because other government services are more income elastic.

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