Chapter 16

LOCAL PUBLIC FINANCE

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Abstract
In this essay, we survey the literature on local public finance. The first part deals with the normative theory of local public finance, starting from the question when it is beneficial to decentralize public services. We then analyze the functioning of a system of competitive jurisdictions in the spirit of Tiebout. The final part of the essay deals with constitutional design. In particular, we ask when and how local governments have to be regulated in order to prevent destructive competition or contain monopoly power, and we describe which institutions might perform these tasks.

Keywords:
Local public finance, decentralization, Tiebout model

JEL classification: H7

Local public finance has a long tradition which may be traced back at least to the town founding era in the high middle ages (900–1350). In contrast to ancient towns and cities which had existed for many centuries as capitals and cultural or commercial centers, the towns established in the high middle ages can be regarded as entrepreneurial investments by sovereigns and other regional power holders who aimed at extending their domain. The German economic historian Dirlmeier concludes: “In the same way as a hostile fortress is neutralized by constructing an own fortress in close neighborhood, market places and towns are established and privileged in pursuit of immediate competition” (Dirlmeier, 1966, p. 3, translated by the authors). Sovereigns and
power holders granted their towns local autonomy, including in particular the right to establish their own legal order with equality before the law for the different classes of citizens living within the town walls, in short, a climate favorable for market exchange (Ennen, 1972, p. 11). In return, sovereigns and power holders claimed taxes, and other charges, such as returns from the mint. Hence, local public finance in these early times was less a problem of how the town paid for their own public services, but of how a sovereign or power holder could extract the return on his investment.

Usually the power holders claimed local taxes as a lump sum which a town was liable to pay per period, but which it could collect according to its own rules. These terms of payment turned out to be relatively conducive to urban economic development. For the towns had an incentive to raise taxes according to general non-distorting criteria. Moreover, the obligation to pay taxes in money, rather than in labor services (as under traditional feudalism), promoted the use of market exchange. This form of taxation can be regarded as the general rule from which exceptions, sometimes considerable ones, were made when wars or large infrastructure projects had to be financed.

This rule was given up in continental Europe towards the end of the 17th century. Under the influence of French absolutism, sovereigns increasingly decided to send their own tax collectors into the towns and to assess and differentiate taxes on the spot. Moreover, excise taxes levied at the town gates became more and more important. Although this system generated higher revenues in the beginning, it became hated and inefficient in the longer run because its differentiation was regarded as arbitrary, and because it discouraged investments which were the base for future economic growth. On the eve of the French revolution, the average tax burden per capita was only about half as high in France as it was in the United Kingdom; however, whereas this relatively low tax burden in France was combined with fiscal exploitation on the one hand and tax privileges on the other, in the United Kingdom—where arbitrary tax differentiation had been prohibited since the Petition of Rights (1628) and the Bill of Rights (1689)—the relatively high tax burden was more conducive to economic growth. Hartmann (1978) argues that this inequity and inefficiency of the French tax system contributed considerably to the outbreak of the revolution in France in 1789, whereas civil loyalty prevailed in the United Kingdom.

During the revolution the traditional tax system in France was swept away and replaced by a system which relied heavily on the taxation of land and local crafts. Insofar, it approached the British system which traditionally relied heavily on local land taxation. The British system also served as a model for the U.S. system of local property taxation.

Today, local governments in most countries still rely on these traditional taxes. Yet local tax bases have become too small to support higher level gov-