



## State and local fiscal policy and growth at the border



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### ABSTRACT

The paper studies the connection between state and local fiscal policy, as measured by the share of government spending and revenues in personal income, and the economic activity of counties that share a state border. I construct a panel of pairs of US counties that share a state border from the 1970s to 2012. Economic activity is measured by county employment, wages and business establishments. The state and local government spending and revenue shares are aggregates for the states on the respective sides of the border. I estimate distributed lag regressions of changes in economic activity on changes in state and local government budgets in two ways. The first (double difference) utilizes change in the difference between border counties. This suggests a quite modest relocation of economic activity away from states with fiscal expansion. I then look at activity on each side of the border separately and find more substantial and consistently negative effects of fiscal expansion on both sides of the border. A border county shares the negative consequences for its neighbor of growth in the size of that neighbor's state and local governments. This negative fiscal externality is roughly half the size of the direct negative effects from similar own-state spending increases, and the sum of the two is substantial economically.

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The connection between the fiscal policy of state and local governments and economic growth has been much studied over a long time. The literature varies greatly in technique and modeling, in the aspects of fiscal policy and in the kinds of economic outcomes studied. Consensus remains elusive. My goal here is to take stock of what the data say about the connection between state and local fiscal policy and economic outcomes by analyzing a variety of economic and fiscal measures over a long period that spans most of the literature with somewhat more contemporary techniques and by imposing little a priori structure on the data. I pay more attention to model identification issues than was typical earlier on in this literature. The main question I address is: what has typically happened to local macroeconomies that straddle state borders in the aftermath of changes in state and local fiscal policies?

My answer uses conventional panel methods to analyze county level data over a long period from the 1970s to date. I focus on counties on either side of a state border, because they should be unusually sensitive to differences in state and local fiscal policy. I follow a strand in the literature by using state and local budget variables aggregated across all counties in the same state as a proxy for fiscal policy in the border county. By using such proxies I hope to avoid some potentially troublesome feedback

between economic activity and spending and taxes.<sup>2</sup> The counties in my data are too small to plausibly affect the fiscal outcome in their states. Nevertheless their residents and businesses are affected directly by state taxes and indirectly by state policies on local taxation and expenditure.<sup>3</sup> The discontinuity between fiscal conditions on the two sides of a border should help identify fiscal effects on economic activity, since the bordering counties are alternatives for location of an overlapping set of businesses, consumers and residents.

In following Sections 1 first review literature most directly related to my approach as well as the much larger literature linking state and local fiscal policy to economic outcomes. Then I describe the panel data I use, the methods I employ to analyze them and the empirical results. These results need to be interpreted cautiously. In common with the literature reviewed next all my results come from observational data where none of the key variables is pre-determined. So causality cannot be presumed. I pay some attention to causality issues in shaping the analysis and extending the results. Caveats understood, the results add weight to the view that fiscal expansion of state and local governments

<sup>2</sup> For example, good economic conditions can make it easier to raise taxes and spending, but bad economic conditions also can raise the demand for countercyclical spending policies.

<sup>3</sup> For example, the period I study included a substantial shift of revenue for school budgets from local school authorities to the state government, including in some cases redistribution of local property taxes.

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has negative consequences for the economies of border areas. These include important but heretofore ignored feedback effects.

## 1. A long literature

My strategy of using state level policies to study areas around state borders is not novel. Perhaps the most well-known precursor is [Holmes \(1998\)](#), who found that the density of manufacturing establishments in the border counties of states with “right to work” laws was higher when the bordering state did not have such a law. Identification here is cross-sectional, and Holmes is careful to regard the right-to-work law as a proxy for the cumulative effects of a set of generally “business friendly” policies. That caveat applies here (and to much of the fiscal policy literature). Fiscal policies should also be thought of as part of a broader set of policies affecting local economic activity.

More recent work that focuses specifically on fiscal policy effects on border areas includes [Chirinko and Wilson \(2008\)](#), [Rathelot and Sillard \(2008\)](#), [Duranton et al \(2011\)](#) and [Rohlin et al \(2014\)](#), who focus on the location of business establishments, [Thompson and Rohlin \(2012\)](#) who concentrate on employment, and [Coomes and Hoyt \(2008\)](#), which is about population migration. All of these are motivated by the identification advantages of using a “more exogenous” policy determined outside the border area to study effects around an exogenous politico-geographic boundary. All cover a subset of the time period or the macroeconomic variables that I will examine here. The central tendency in these papers is for economic activity to prefer the low-tax side of the border, though the strength of the effect varies and is often conditioned by other policies. For example, [Chirinko and Wilson \(2008\)](#), like [Holmes \(1998\)](#), focuses on the location of manufacturing establishments in border counties. They model a binary choice in which a manufacturer locates in one state or another. They incorporate state fiscal policies and location incentives into a user cost-of-capital, which is reduced by low taxes or high incentives. In a 1977–2004 panel of counties that are near the state border they find a modest location preference for the low user-cost-of-capital state. [Rathelot and Sillard \(2008\)](#) and [Duranton et al. \(2011\)](#) analyze, respectively, the location of new French business establishments in 1993–2004 and 1984–1989 employment within UK establishments on either side of local government boundaries. In both studies sub-national tax rates are the  $x$ -variables of interest, and both find small negative effects of higher taxes.

More recent US border area studies include [Rohlin et al \(2014\)](#) and [Thompson and Rohlin \(2012\)](#). The former focuses on the location of new business establishments in 2002–2005 within grids that straddle the state border as a function of a variety of state tax and spending variables. The broad tendency is for economically meaningful negative but nuanced tax effects. For example, sales tax rates matter more in retail trade than other industries, and personal taxes affect business location more when employees have to pay taxes in their state of employment. The sales tax result echoes [Thompson and Rohlin’s \(2012\)](#) result for employment in retail establishments in areas near state borders. [Coomes and Hoyt \(2008\)](#) use Internal Revenue Service data for the 1990s to show that migrants to metropolitan areas that straddle state borders tended to locate in the lower-tax state.

Here I will focus on the whole local economy, rather than a specific industry like manufacturing, and my activity measures include total employment and pay in addition to establishment entry and exit. I also look at a considerably longer time period – from the 1970s on – than has been typical in the border area literature

The border area literature is part of a larger empirical literature on the connection between the fiscal policies of sub-national

jurisdictions and the location of economic activity.<sup>4</sup> In a survey now over 20 years old [Bartik \(1991, Appendix 2.2\)](#) found over 100 studies on this topic. The central tendency of that literature was a negative effect of taxes/spending on economic activity. But Bartik reports a considerable variety of results. He finds that, while median and mean effects are negative there is a broad range of estimates that overlaps zero. He also tries to characterize each individual study. By my reading 75 of the studies could be categorized according to the statistical (not necessarily economic) significance of the findings. Half of those (37) could be summarized as showing significant negative fiscal effects. But nearly as many (32) could not find effects distinguishable from zero.<sup>5</sup> The remainder either had significant effects that were either positive or of both signs. I dwell on this old survey because I am unaware of any newer one this comprehensive, but I doubt that the broad conclusion – a negative average effect with a broad range of estimates and statistical precision – would be much different today.

One possible source of this variety in results is the variety in modeling. For example, a common strategy is to add a menu of putatively exogenous control variables to the fiscal variables of interest. [Reed’s \(2009\)](#) summary lists more than 20 controls that are commonly used. They include variables like education, industrial composition and the political party of the governor or legislature. However, variables like these arguably influence fiscal policy or are influenced by it, and so are dubious as controls. Another group of controls measures some aspect of fiscal policy, such as the kinds of taxes (income, sales, etc.) or the allocation of spending among various functional categories like education, highways and so on. These also raise identification issues. The intent of controlling for budget allocations is to break free of a basic underlying theoretical ambiguity: taxes are bad but they finance activities that can be more or less beneficial. The difficulty is that the size of government and the allocation of its activities and taxes are chosen simultaneously, and we do not have experiments where, say, two otherwise identical states raise the same taxes by the same amount but one, say, spends the increment on education while the other spends it on highways.

Another modeling issue is the variety of implicit or explicit priors that authors impose on the process that leads from fiscal policy to economic activity. For example, as mentioned above, [Chirinko and Wilson \(2008\)](#) view the process as essentially an investment or entry/exit decision where expected rates of return have to exceed the cost of capital. [Reed’s \(2009\)](#) attempt to synthesize the literature frames the process as affecting the efficiency of the production of income, so fiscal policy affects the intercept of a Cobb-Douglas production function for income while capital and labor are pre-determined. There is a clear tension between these two views.

In what follows I try to avoid the pitfalls of committing to a particular process or list of ad hoc controls. I use a standard panel regression design to measure the relation between changes in the size of the state and local governments and the growth of the private economy. The identifying assumption is that there is limited feedback from economic growth in border counties to the political economy of taxing and spending in the whole

<sup>4</sup> There is also a substantial theoretical literature touching on this connection, but it does not lead to unambiguous predictions. A well-known strand originating with [Tiebout \(1956\)](#) stresses competition among local jurisdictions as a mechanism leading to efficient public goods provision. There would be no general reason to expect that competition to engender a correlation between fiscal policy and economic activity much less a causal relationship. The two variables would simply capture varying equilibria across jurisdictions. Systematic departures from efficient public good provision could produce such a correlation, but there is no consensus in the theoretical literature (see, for example, [Wilson, 1999](#)) about which way that correlation should go.

<sup>5</sup> I include here effects labeled “not” or “marginally” significant or “hard to say”

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