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A General Equilibrium Simulation Study of Subsidies to Municipal Expenditures: Discussion

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DISCUSSION

EARL R. ROLPH*: Roger Gordon and Joel Slemrod in their paper examine the effects of allowing the deduction of property taxes from Adjusted Gross Income as defined by federal income tax laws, and the exemption of interest income of municipal securities from tax. They also examine the payments by federal and state governments to local governments, and local taxes paid by owners of business property. All these are treated as subsidies to local government. Consistent with the standard treatment of commodity subsidies, the authors in their simulations find that local government output is too large because the cost per unit is reduced, and hence, in the full employment world they assume, outputs of other commodities are too small. This "distortion" is discussed in terms of utility changes of some nine income groups.

If our authors are correct, why do we observe the streets of New York decorated with pot holes, and, to come to my part of the country, the streets of Berkeley littered with beer cans and cartons for months on end?

Leaving the exempt interest matter for later, what about the other claimed subsidies to local governments? We need not quarrel with our authors' facts. The payments in question are large. For example, about three-fourths of the budget of the State of California finances payments to local governments thanks in part to notorious Proposition 13.

There are however alternative interpretations of the facts. Payments by states to local governments may in part be grants. Grants may be defined as techniques whereby the government making the payment induces the receiving entity to produce the former's demand for local output. An illustration is state payments to school districts designed to induce these districts to produce extra educational services. This topic is closely allied to externalities arising from local government performance or lack thereof; it has been investigated by John Rowntree and Kjeld Philip among others [3,1]. Grants are not subsidies; hence a subsidy type of analysis has little relevance to understanding their effects.

To the extent that intergovernmental payments are not grants, they may be substitutes of higher governments' tax resources for local governments' tax resources. This question depends on how one models local government performance. Our authors, like practically all knowledgeable students of local government, bow to Charles Tiebout's famous article. But models of local government performances that are claimed to follow Tiebout remain highly diverse and they are not converging. My own preferred model treats local government as a firm [4] [5]. By compelling logic, that model holds that transfers to local governments reduce local taxation dollar for dollar.

Our authors' subsidy view may be justified by their model; if so, the appropriateness of the model needs to be explained.

The authors examine owner-occupants noting that these households, if they itemize, may deduct local taxes such as property taxes from Adjusted Gross Income. Although they mention that this permitted deduction is a subsidy to owner-occupants, they also treat the property tax as a reduction in the "tax unit cost" of public services. This position seems questionable.

Owner-occupants should be required, in a comprehensive income tax, to include

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the net imputed rent of houses in Adjusted Gross Income. Property taxes are not likely to be a good proxy for net imputed rent. For example, in California, the maximum property tax rate, with some minor exceptions, is one percent of market value. Although the numbers are not known, owner-occupants are likely to have experienced at least a return of 10% per year on market values in recent years.

Another mistake is to treat the permitted deduction as a subsidy to local governments in their simulations rather than to limit the subsidy to owner-occupants.

Their analysis is nevertheless consistent with my own analysis of the tax subsidy. The prices of rental-housing services fall, the implicit prices of owner-occupancy rise with corresponding changes in the supplies of the two kinds of tenancy. In addition, the revenue gain to the Treasury by eliminating local tax deductions on federal income tax returns would be partially offset by the decline in the incomes and hence tax liabilities of market landlords.

Tax-exemption of the interest on state and local securities, a topic that has been studied a number of times during the past several decades, is believed by our authors to reduce the rental cost of capital to local governments. Surprisingly, they claim that "the municipal bond market disappears". Although the probability of this tax-shelter disappearing must be slight, I rather doubt that interest-rate elasticity of the supply of new municipal bonds would turn out to be very high.

The authors define the cost of capital as the "real" interest rate plus depreciation. The tax exemption feature supposedly reduces the rental cost of capital. Just how does the federal tax exemption reduce the costs of operating garbage trucks in, say, Santa Monica? My answer is: approximately zero. Costs of capital refer to comparisons of expected rates of return including interest rates with rates on real assets such as garbage trucks. High interest rates, for example, may lead a local government to defer buying new garbage trucks to replace some of its aging trucks. But given whatever trucks it has, the costs relevant to scaling the intensity of use of trucks are such matters as the cost of fuel, oil, replacement parts, and wage-rates. The confusion of identifying ownership costs with operating costs was one that William A. Paton, dean of American accounting theory, tried to clear up as early as 1920.

As already suggested, the claim that American cities, towns, counties, and districts are producing menus of services in excessive quantities has not been demonstrated. Nevertheless, our authors may be right. If so, one would prefer to see more analysis to support their position.

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DISCUSSION

HAROLD BIERMAN, JR*: Basically, I liked the Fabozzi and Yaari paper and have no major criticisms. However, I do have several observations.

First, the authors should have noted the multiple internal rate of return nature of the cash flows presented in Table 1. While this is not a criticism of the authors in the current paper because they correctly illustrated the calculations using the net present method, it could be important if a practitioner computed the lessor's internal rate of return and found it to be less than .05, thus rejected the investment. The fact that another internal rate of return in excess of .35 exists might pass unnoticed.

Good examples of multiple rates of return are hard to find. We teachers cannot afford to let one pass without notice.

Secondly, while safe harbor leasing has effectively been killed by the tax act of 1982, and it would seem that safe harbor leasing is not a high priority, we should not jump to that conclusion. The 1982 tax act has defined "finance leases" to start in 1984 and finance leases will be very similar to safe harbor leases.

The third comment is of more importance than the first two. It arises not because of anything that Fabozzi and Yaari said, but rather about what was not said.

The safe harbor tax provisions effectively allowed the sale of tax credits and tax deductions from one entity to a second entity. The entity selling the tax shields was not likely to be paying taxes and the entity buying the shields was likely to be paying marginal taxes at a .46 rate.

Congress' apparent objective in passing this legislation was to give a tax break to those firms that were having tax losses and that were not able to use the tax shields directly. Prior to ERTA if such a firm bought an asset for \$1,000,000 this was the cost. If a profitable taxable firm bought the asset, the net cost and thus the risk was reduced by investment tax credits and depreciation tax deductions.

If one believes in offering the underdog a hand, then one can be sympathetic with the objective of the 1981 act. However, let us consider the merits of the device chosen to achieve the objective.

If the tax shields associated with \$1,000,000 of new equipment have a present value of \$0 to a zero tax investor and a value of \$480,000 to a firm paying taxes then with no other complexities (which are covered nicely by Fabozzi and Yaari) the firm purchasing the tax deductions (the lessor) would like to buy the deductions for \$0 but would be willing to pay more than \$0. The benefits will be split between the lessee, the lessor, and any third parties (middlemen and lawyers)