Tiebout Was Wrong… but Why?

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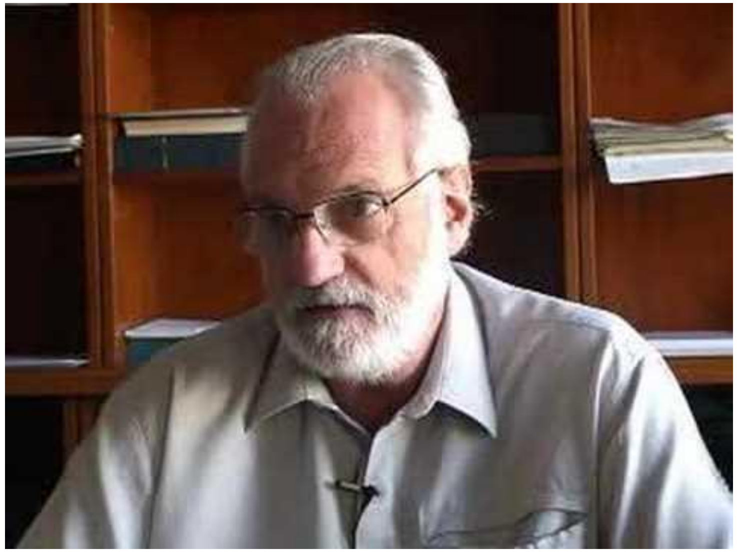


Charles Tiebout, 1924-1968

Tiebout Review

- Charles Tiebout's "A Pure Theory of Local Expenditures" (*JPE* 1956) is one of the most-cited pieces in all of social science.
- Tiebout pointed out that you can think of local governments as perfectly competitive firms; subsequent literature formalized this in great detail.
- Perfectly competitive firms are price-takers; local governments are "utility-takers."
  - If their service/tax package is worse than other localities', people and business exit.
  - If they're inefficient in *any* way, people and business exit.
- If local governments are above the Minimum Efficient Scale, competition forces them to split; if below the MES, to merge.

The Meaning of Tiebout

- Local government is efficient, or close to it.
- Public Choice problems/political failure can’t be significant at the local level.
- Local democracies can decide where to go on the service/tax frontier, but have little ability to overcharge anyone for anything.
- Even if local governments were autocracies, market forces would still tightly constrain them.
- If you don’t like your local government, move.

Tiebout Is Obviously Wrong

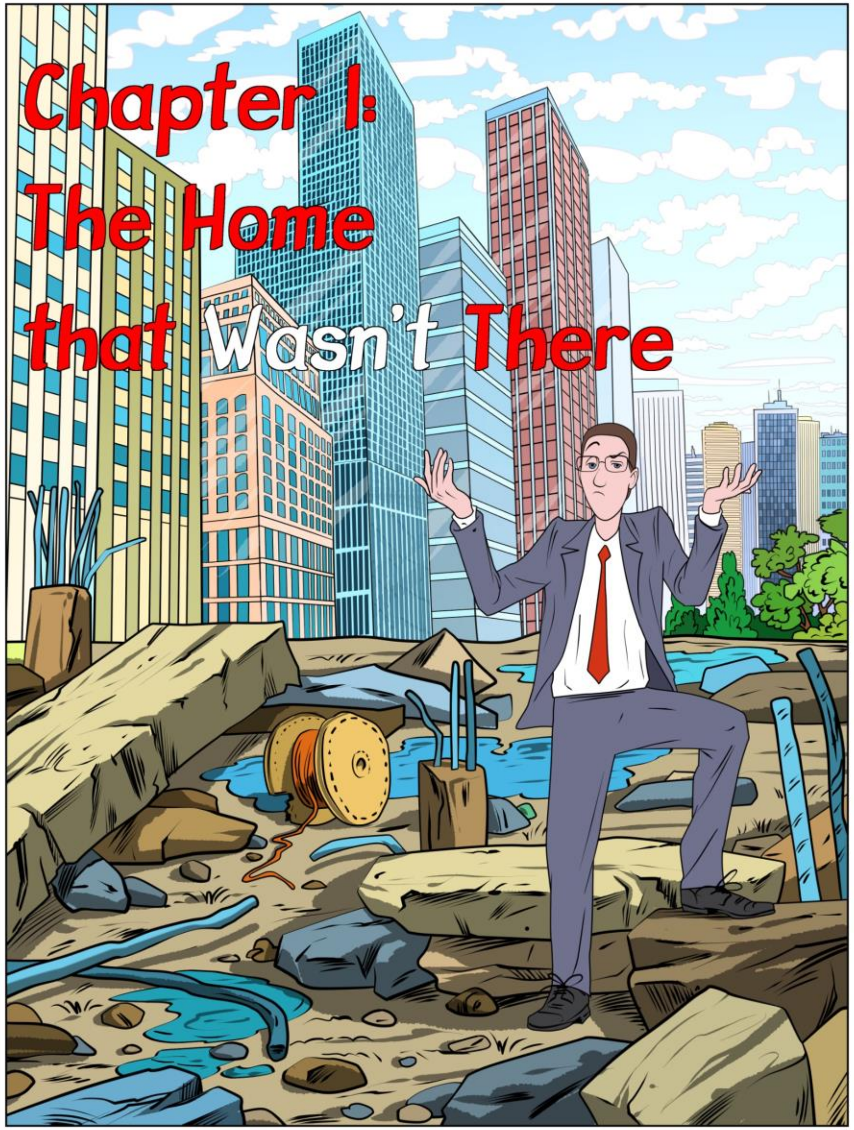
- If the Tiebout model were correct, local redistribution would be almost impossible.
- In the real world, however, local governments have long engaged in massive redistribution via public education – the main item in their budgets.
  - Rich subsidize poor
  - Childless subsidize families
  - Small families subsidize big families
- Imagine a grocery store that charged like a local government!
- Under perfect competition, there would be plenty of localities inhabited by child-free people paying ultra-low taxes.
- More local redistribution: In the real world, businesses pay normal property taxes even though they use almost *no* services.
- Ultra-inefficient local redistribution: Failure to use congestion pricing for roads and parking because it's not "fair."
  - Remember: Charging for negative externalities is even more efficient than lump-sum taxation.

Tiebout Is Non-Obviously Wrong

- Local governments have three main functions:
  - Schooling
  - Law enforcement
  - Housing regulation
- Performance on all three seems *far* below efficiency frontier.
- Schooling: Basic economic theory says vouchers are more efficient than direct government provision, but such programs remain rare.
  - Does it really matter? During COVID, almost all private schools soon reopened, but many public school systems were closed for over a year.
- Law enforcement: Research consensus is that probability matters more than severity, but status quo is low probability, high severity.
  - Moskos' *In Defense of Flogging*

The Folly of Housing Regulation

- Large body of research on housing regulation finds it has pushed U.S. housing prices to roughly *double* the physical cost of production (land included).
  - See my forthcoming *Build, Baby, Build: The Science and Ethics of Housing* (Cato Institute, 2023)
- Top regulations:
  - Height restrictions
  - Single-family zoning
  - Minimum lot size
  - Minimum parking requirements
- Measured negative externalities are mild by comparison.
  - Remember: Construction has *positive* externalities, too.
- The panacea policy: Housing deregulation would also reduce inequality, raise social mobility, help working-class males, clean the planet, cut crime, and raise fertility.



Tiebout vs. NIMBY

- Why then do we have such strict housing regulation?
- NIMBY is usual story, but Tiebout mechanism largely rules this out.
- If development raises *total* property values, Tiebout says localities will allow it.
- Note: Since Tiebout assumes perfect competition, localities can't raise quality-adjusted prices by restricting supply.
- If necessary, Tiebout governments will pay compensation to those who block development.
- But due to competition, it shouldn't be necessary.

Where Tiebout Goes Wrong: Imperfect Competition

- Despite vast number of localities nationally, demand for residence in each locality remains downward-sloping.
- Monopolistic competition: Wide range of moving costs; bad local governance only induces moderate outflow.
- Oligopoly: Regionally, most people have fairly strong regional preferences, so effective number of competitors is much smaller than it looks.
- Monopoly: Some localities have strong monopoly power because of special amenities or agglomeration externalities. (Bay Area, NYC)
- Related: Due to tax capitalization, incidence of bad local governance falls heavily on immobile land. (Caplan 2001)

Where Tiebout Goes Wrong: Non-Profit Incentives

- More fundamental problem with Tiebout: Model assumes non-profit competition works just like for-profit competition.
- Suppose you give a large class a quiz that doesn’t count for the final grade. Should you expect the large number of competitors to lead students to study hard?!
- Suppose you get rid of prizes for an athletic tournament. Should you expect athletic effort to stay the same as long as there are many contestants?!
- Suppose government imposes a 100% profit tax on a perfectly competitive market. Should we expect the intensity of competition to stay the same?!
- Key feature of local politics: Leaders’ salaries have near-zero to do with their performance. Very unlike private-sector CEOs.
- So why did Tiebout expect them to vigorously compete with each other?

Where Tiebout Goes Wrong: Political Incentives

- Tempting to say, “Reelection is the incentive for good performance.”
  - Problem: If that’s your answer, perhaps the familiar political failure arguments apply.
- Tempting to reply, “Low probability of voter decisiveness drives political failure arguments. But *p* is much higher when the electorate is much smaller.”
  - Problem: *p* is usually so small that you can multiply it 1,000,000x and it’s still ≈0.
  - Lange (1937): “[W]ould a decline of the price of soap to zero induce them [the ‘well-to-do’] to be so much more liberal in its use?”
- Upshot: We should still expect low-*p* problems to drive local political failure.
  - Rational ignorance
  - Expressive voting (Brennan and Lomasky 1993)
  - Rational irrationality (Caplan 2007)
- Including, of course, rent-seeking by public employees and NIMBYs.
- Also watch out for *perverse* political incentives (e.g. the Curley Effect).

Blaming Higher Governments

- Best defense of local government: “Tiebout would be right if state and federal governments actually allowed free competition.”
- Challenge: Localities can ignore inefficient state/federal laws via selective enforcement.
- Reply: A large share of local government funding ultimately comes from higher-level grants, distorting local priorities.
- Serious Tiebout competition, however, would undo these efforts.
  - More state/federal funding? Cut local taxes.
  - Targeted state/federal funding? Cut local spending.
- “Flypaper effect” literature finds nothing remotely like this happens. Money sticks where it hits.
- In any case, inefficiencies of public schools predated noticeable higher-level funding by over a century.
- Also: Push for better schooling and housing policies is largely imposed by *state* governments on uncooperative local governments. See California and Oregon.

What Is To Be Done?

- First step: Admit we have a problem. Local governments have three main jobs, and do all three poorly.
  - Economists in general, and Public Choice economists in particular, should stop writing local governments an intellectual blank check.
  - Don’t say: “If they’re doing it, it must be efficient.”
- Second step: Admit we have a puzzle. Tiebout’s wrong, but we still have to figure out exactly why he’s wrong.
- This is bad news if you’ve staked your career on Tiebout being right.
- But it’s good news for all active Public Choice researchers, especially young scholars with no stake in the status quo.