American Government Finances in the Long Run

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- American economic history
- Public Finance and federalism
- Politically sustainable policies that support economic development
- Particularly infrastructure investments

- 1.5% growth in per capita income, 1840 to 2006

Three Main Periods in American Government Finance

- 1790 – 1850
  - Activity Dominated by State Governments
- 1850 – 1933
  - Activity Dominated by Local Governments
- 1933 – Present
  - Activity dominated by federal activity, while the national government became more important

Government Debt, in Millions

	National	State	Local
1841	$5	$190	$25
share	2%	87%	11%
1902	$1,178	$230	$1,1877
share	36%	7%	57%
1982	$919,238	$147,470	$257,109
share	69%	11%	20%

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The purpose of debt

- State and local government debt, in the 19^{th} and 20^{th} centuries, is issued primarily to finance infrastructure investments.

- National government debt up to the 1950s, was issued primarily in periods of war.

- Since the 1950s, federal debt has been issued to finance ordinary expenditures.

Revenues per capita, As share of GDP

	National	State	Local	Total
1840	1.6%	1.0%	1.4%	4.0%
1902	3.0%	0.8%	4.0%	7.9%
1992	20.8%	9.3%	7.3%	37.5%

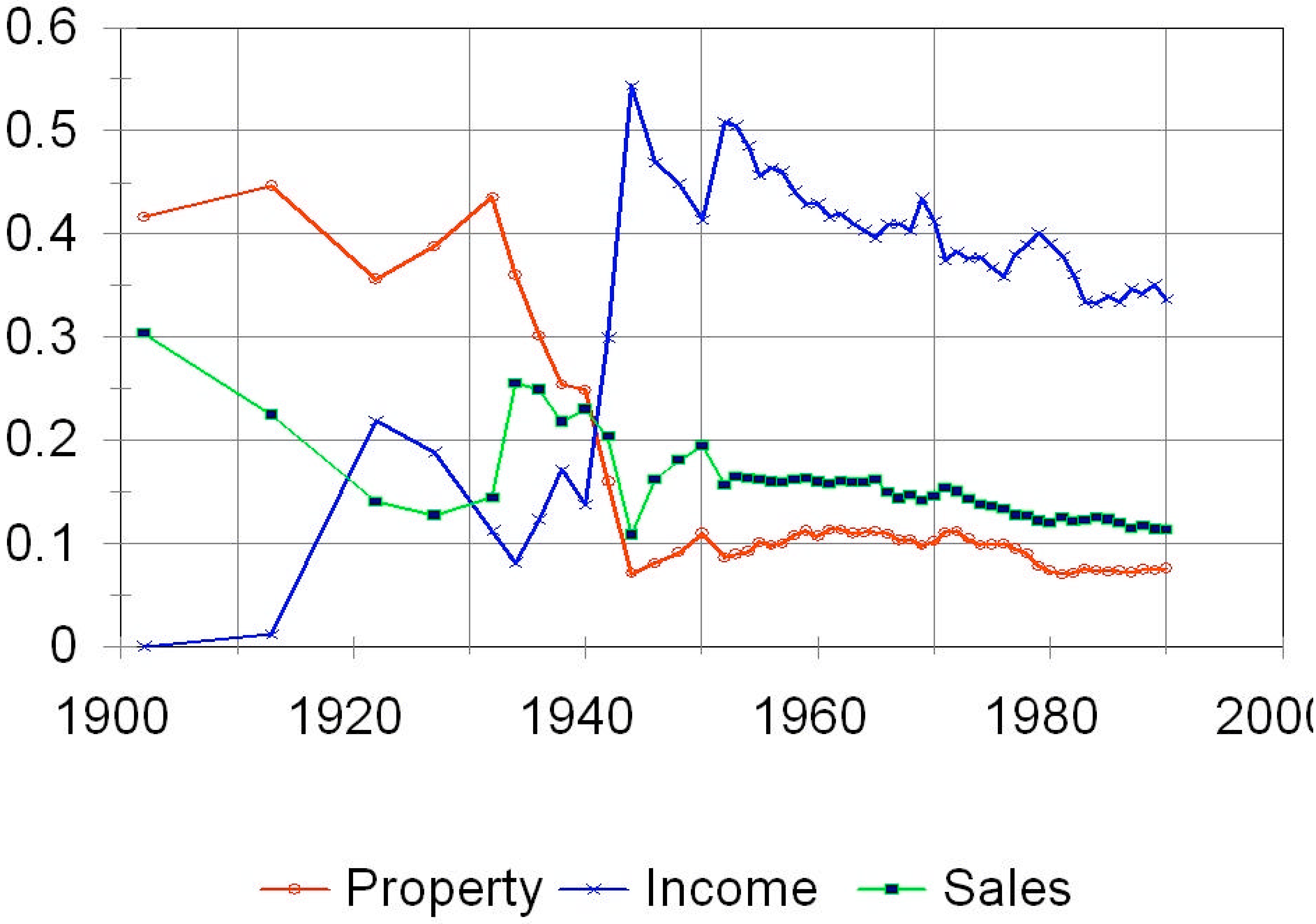
Revenue Regimes

- 1790-1850:
  – State dominated: “asset income.” Income from state investments or taxes on banks and corporations.
- 1850-1933:
  – Local dominated: property taxation.
- 1933- Present:
  – federalism (national, state, and local): income taxation.

State Property Tax Revenue Shares

	East Coast	New England	West
1835-1841	2%	45%	34%
1842-1848	17%	52%	45%
1902	55%	72%	70%

Revenue Shares, All Governments



WHY?

- The interesting questions are

1) why these changes occurred?

2) why were they stable?

The 1830s and 1840s

- State governments made large infrastructure investments in banks, canals, and railroads in the 1820s and 1830s.
- In the depression that began in 1839, states found themselves in financial straights.
- In 1841 and 1842, nine states defaulted on their sovereign debts

Democracy and Infrastructure

- The basic problem is financing projects with geographically specific benefits using geographically disbursed taxation.
- In a simple majority rule polity such projects are rarely able to command majority support and are, typically, too big to logroll.
- Three options:

- 1) Something for everyone
- 2) Benefit Taxation
- 3) Taxless Finance
  - Creating privileged public/private corporations who provide infrastructure in return for privilege. This is the European model, e.g., British East Indies Company (1600?) and the Virginia Company (1607).

Systematic Corruption

- Venal Corruption is the use of political influence to further private interests: economics corrupts politics.
- Systematic corruption is the manipulation of economic privileges to create private rents that bind private interests to the support of a political party/regime:
- Politics corrupts economics.

- Americans feared systematic corruption.

- They worried that “taxless finance” would serve as a vehicle for factions to manipulate the economy in order to gain political control.

- In response to the debt crisis, states implemented three fundamental constitutional changes to eliminate taxless finance:

1) states instituted procedural restrictions on the issue of debt by state and local governments (bond referenda).

2) states required open entry and competition in most economic activities through general incorporation acts.

- States prohibited state investment in private corporations
- States were also required to levy a “general property tax.” This constitutional change has not survived to the present, the other three have.
- These changes were politically sustainable because they were changes in economic institutions intended to produce a political result, the elimination of taxless finance and systematic corruption.

1850 to 1933: Local Finance

- State level Bond referendums made it relatively easier to borrow money at the local level.
- Majorities were easier to obtain if the geographic extent of taxation was more closely matched to benefits.
- As local governments began borrowing in earnest they, too, had some bad experiences.

- In the 1870s states began extending constitutional restrictions on state borrowing to local governments. This included strong prohibitions on public investment in private corporations.
- Again, the emphasis was on limiting taxless finance, not on limiting infrastructure investments.
- Both state and local governments tried to avoid their own, self-imposed constitutional restrictions, by creating “special” governments with a single purpose. Debt restrictions would not apply to these special governments.

- Were the debts of special governments the obligation of the state or local government that created the special government?
- By the 1930s state constitutions had been amended, yet again, to stipulate that the debts of special governments were not the “moral” obligations of the state.
- Indeed, state and local governments were constitutionally prohibited from redeeming the debts of special governments.

- This created not just a hard budget constraint,
- It effectively shifted the ultimate liability for the debts to the lenders. Their recourse for bond repayment was not the general treasury, but the revenues or user fees designated in the creation of the special government.
- Market discipline of state and local borrowing was intensified by removing the “full faith and credit” protection for lenders.
- In 2002, 2/3rds of all state and local debt is not guaranteed.

The 1930s

- The early 20th century saw a shift of comparable magnitude in the location of government activity.
- The constitutional amendment allowing the federal government to levy an income tax lowered the cost of raising revenues at the national level.
- In the crisis of the 1930s, the power to raise money at the national level was combined with the benefits of spending it at the state and local level, thus the substantial increase in grants.

- The current American system of public finance is dominated by national and state income taxation with substantial intergovernmental grants.
- The current system overlays, and to a large extent obscures, the historical and constitutional foundations of American federalism.