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Competition and monopoly power in local government: An extension of Caplan (2001) *

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Abstract. Caplan (2001) shows that because land is a source of immobile wealth, local governments can use the property tax to avoid competitive pressures of the Tiebout model, allowing them to deviate from citizens' preferences. In this comment I show that the property tax is not the only tax local governments can use to avoid competitive pressure. Most taxes placed on property owners allow local governments to extract some rents despite perfect citizen mobility.

1. Introduction

Caplan (2001) demonstrates that citizen mobility alone does not force local governments to conform to citizens' preferences in raising taxes and providing public goods. He shows that when local governments raise funds through the property tax they avoid competitive pressures from other local governments because the tax is simply capitalized into real estate values. Citizen mobility does not allow people to escape excessive taxation; they either stay and pay the tax directly, or sell out and pay the tax via a lower sale price. Even with perfect mobility, movers are forced to bring their tax liabilities with them, so the property tax allows competitive local governments to transform into monopolists.[1]

In this comment, I show that Caplan underestimates the number of ways local governments can extract wealth from perfectly mobile citizens. The property tax is only one of many taxes that will capitalize into land values, and allow local governments to capture rents against citizen wishes. I maintain, like Caplan (2001), the standard assumptions of perfect competition and therefore infinite elasticities for mobile goods from the point of view of local governments.

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into account and pay less for the property. The tax would be fully capitalized and the current retailer would bear the burden of the tax. If the tax is so high that it is no longer optimal to use the property as a retail establishment, then the property will sell for an even lower price, since the land is put to a lower valued use. In this case, the government would not generate any revenue from the sales tax, so it would feel some competitive economic pressure to lower the tax to the point where retailers would remain but bear the burden of the tax.[9] Citizen mobility and local government economic competition only limit the amount the government can expropriate. They do not stop government from expropriating wealth completely.

3. Conclusion

Perfect citizen mobility and the presence of alternative local governments are not enough to stop a local government from expropriating wealth from its citizens. Caplan (2001) showed that when local governments use the property tax to extract rents that it will be capitalized into land values and eliminate citizen's incentive to move to avoid the tax. He concluded that when local governments use property taxes they can avoid competitive pressures and act as monopolists.

This comment has extended the analysis to show that even with other forms of taxation, Tiebout style competition is not enough to stop local governments from extracting some rents against citizens' preferences. When a local government imposes any tax to extract rents that does not benefit members, or any potential members, of the community, it will decrease property values. When the person, who is taxed, is also a property owner, they cannot completely avoid the tax by selling their property and moving to another community, since the tax impacts the value of their immobile land. Property taxes may more completely capitalize, but other forms of taxation also partially capitalize, leaving room for local governments to extract wealth against their citizens' wishes. If land is a fixed source of immobile wealth, then Tiebout's competitive model can only constrain local governments from extracting wealth from non-property owners who can move costlessly and who do not bear the burden of tax capitalization. The local governments can expropriate wealth from property owners no matter what form of tax is imposed. Something more than economic competition from other governments is necessary to eliminate rent extraction on the local level.

Notes

1. Other influential criticisms of the Tiebout model include Buchanan and Goetz (1972) and Epple and Zelenitz (1981).
2. Also, like Caplan, I accept that people with similar public good preferences will group together. The point in this comment is to examine the extent to which interjurisdictional economic competition alone will limit the local governments' ability to extract wealth. This is best accomplished assuming no political process and purely self interested dictator city managers who want to maximize the amount of wealth they expropriate and minimize the public goods they provide.
3. Though, as Caplan shows, this is an unstable equilibrium since all the rich people will move out. In the limit he shows that the economic forces of competition would make this a self-defeating policy and the Tiebout result holds.
4. In most cases a high income person's property, can likely fetch the highest market value when sold to other high income people (in absence of the proposed tax) due to wealth constraints of poorer people.
5. Unless we assume there is a large number of potential home buyers with no income. In this case the housing prices should still be depressed since the demand for housing in that market will be restricted, but the government will not collect revenue from the new residents.
6. If the tax is raised enough and only lower income people will buy the property, capitalization will still occur but the government would face competitive economic pressure to reduce the rate to where high-income people would remain but pay the tax.
7. If there were some specific local demand for a product or service that did not completely transfer to other localities, then there would be a source of wealth the local government could partially extract from the demanders.
8. If the retail business did not also own the property then competitive pressure again eliminates the governments ability to extract rent, just like in the case of the residential tenant.
9. Excise taxes would be capitalized the same way as sales taxes. Governments would have monopoly power up until the point where it was no longer optimal to sell the product the excise tax was due on.

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2. Capitalization of non-property taxes

If local governments have monopoly power because land is immobile wealth, and they can deviate from citizens' preferences if the election process imperfectly constrains them, then Caplan underestimates the extent of local government monopoly power. He only shows that property taxes avoid the competitive pressures emphasized in the Tiebout model. [2] All taxes are in some way related to the geographic territory of the local government. When a tax is instituted that provides no benefit, some capitalization into property values occurs. Local property owners are not able to move to avoid a loss. They either pay the tax or receive a lower price from the sale of their property. Local governments have some power to extract rents. Perfect citizen mobility between jurisdictions only eliminates local governments' ability to extract rents from residents who do not own property since all of their wealth is perfectly mobile. When property owners are taxed, even on their mobile sources of wealth, it impacts the value of their immobile land, distorting incentives to move and leaving local governments with a source of monopoly power.

Caplan identifies the most extreme example of local government monopoly power, the property tax, which is 100% capitalized, and current residents must bear the full burden of taxation. When other taxes are used, citizens may avoid 100% capitalization by selling to someone who does not engage in the taxed activity. This will distort land away from its previous optimal use and the burden will have to be borne by the current owner in the form of a lower sale price, though the sale price need not drop by 100% of the value of the tax. In the case of non-property taxes, local governments will have some, but not complete monopoly power.

When Caplan analyzes the political and economic game with non-property taxes, he considers a case with two groups of voters, where the low-income voters expropriate wealth from the high-income voters through a sales tax. He shows that with mobility the high-income people simply sell their property to low income people and move to another area taking their wealth with them. The crucial assumption is that they can sell their property for its full value. In his example, the ability to sell property for its full value is possible because the lower income person expects to benefit by receiving transfers from the remaining high-income population while they have no sales-taxable wealth to lose.[3] When the local governments engage in rent extraction, however, new citizens would not expect to benefit from the policy, which causes the current resident to move. In this situation, potential buyers will pay less for the property than otherwise.

Consider a simple case of a flat income tax of 50% imposed on all residents of the community that will be extracted as a rent to finance an increase in the local city manager's salary. Potential new residents would not benefit from this tax increase, so they will pay less for any property in the city than they would have before the tax was implemented. Local real estate values will be depressed and the incentive for current residents to leave will be decreased. This tax need not capitalize 100% as Caplan shows for property taxes, because different residents and potential buyers with different incomes will not be impacted equally. A potential buyer with an income of $20,000 will pay $10,000 less for any property in the city than he would have before the tax increase. A current resident earning $100,000 could sell his property to avoid $50,000 in increased taxation. In this example, the high income earner's property could be sold to the low income earner for $10,000 to $50,000 less than the property was previously valued at.[4] When the income tax is used for rent extraction, it will be partially capitalized into land values, eroding current citizens' incentive to move and leaving some tax revenue to be collected from new residents.[5] Even with mobility, citizens have to bring some of their tax burden with them. Some competition will exist, but the local government will have some monopoly power to extract rents.

When graduated income tax rates are manipulated for rent extraction the effects are similar. If only the highest income bracket's rate is raised, only those citizens will have an incentive to move. If other high-income people would be the most likely buyers for their homes, they will pay less and partial capitalization will occur. Some local monopoly power to extract rent remains.[6]

When an income tax is placed on apartment tenants, economic competition between local governments can eliminate the ability of the local government to extract wealth. Partial capitalization into rental property values will still occur, but in this case the person with the ability to move to avoid the tax, the tenant, does not bear the burden of capitalization, so they can move and avoid paying the tax at all. In real world cases, income taxes are usually placed on the entire population of a city, not just tenants or property owners, so competition from other local governments will limit a government's ability to extract rents, but not completely.

A sales tax will partially capitalize into real estate values, limiting the competitive pressures local governments face. Assuming there are many localities in near proximity to each other, some of which do not use sales taxes, then potential buyers can easily switch purchases to another locality to avoid the tax.[7] With buyer demand near perfectly elastic, most of the burden of the sales tax will fall on the retail owner, who will have to lower prices or relocate his business to a different local government's territory. If retail space was the highest valued use of the property prior to the implementation of the sales tax, for the owner to sell and get full market value for his property, he will have to sell to another retailer.[8] The new purchaser would take the cost of the sales tax