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Fiscal Illusions in Municipal Finance: The Latest Research

By Mark J. Warshawsky

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In this article, Warshawsky explains the concept of fiscal illusion. He reviews the theoretical and empirical parts of the *National Tax Journal* tax paper of the year on that topic and discusses some of the implications for current policy issues, including state and local government employee pensions.

Introduction to Fiscal Illusion

Economists call a fiscal illusion a systematic misperception of key fiscal parameters, often leading to distorted behavior by citizens and governments. In particular, the failure to perceive the full extent of tax burdens can lead taxpayers to misunderstand and underestimate the true cost of public goods and services and redistribution activities by the government. Examples of fiscal illusion include debt illusion, which causes citizens to prefer bond issues over current taxes, and renter illusion, which causes renters to believe they do not effectively pay any property taxes.

In the context of the finances of the federal government, fiscal illusion is the negative of Ricardian equivalence, an economic theory under which taxpayers are indifferent to whether the government uses debt financing or tax financing because individuals would increase their savings and intended bequests to future generations to offset any increase in future taxes needed to pay for higher federal borrowing. At the state and especially local government levels, there is an added and more realistic mechanism at work to support Ricardian equivalence — the normal operation of local land markets, with aware and mobile citizen-homeowners, which capitalizes fiscal differentials into local property values. Hence, debt finance, paid by future taxes, would be capitalized into reduced current property values, thereby producing indifference among households between current taxation and borrowing by the government.

For many analysts, the assumption that citizens, even if mobile, are aware of government finances and that the state of those finances is embedded in property values is not a reasonable one, and therefore fiscal illusion should be considered the natural condition and behavioral framework. H. Spencer Banzhaf and Wallace E. Oates, professors of economics at Georgia State University and the University of Maryland, respectively, take a different approach. In their article,[1] they argue that even with rational and fully aware citizens, Ricardian equivalence will fail, and *effective* fiscal illusion (debt and renter effects in particular) should operate because of other real economic considerations and not on illusory grounds.

Some Theoretical Arguments

A critical assumption for Ricardian equivalence is that individuals can borrow and lend at the same interest rate as the government. This is certainly not true for most consumer loans, which have relatively high interest rates. Even after-tax mortgage rates, however, are typically above rates on municipal debt, according to Banzhaf and Oates, except in the case of homeowners in higher tax brackets. Additional current taxation to finance local infrastructure may require private borrowing to smooth consumption of households over time, but borrowing through the public sector debt would allow for the smoothing of consumption on more favorable terms.

Regarding the renter effect, it is possible that the additional project spending (regardless of whether it is funded with debt or with taxes) leads to lower rents as the financing for spending is negatively capitalized into land values. In this way, the incidence of government project spending falls on land owners rather than on renters. Therefore, renters should prefer higher government spending, particularly if it is not financed by sales taxes, which will clearly fall on them.

Some Empirical Evidence

Banzhaf and Oates then investigate empirically whether citizens prefer debt financing and whether renters prefer financing through property taxes by

[1]Banzhaf and Oates, "On Fiscal Illusion in Local Public Finance: Re-Examining Ricardian Equivalence and the Renter Effect," *National Tax Journal*, 66 (3), 511-540, Sept. 2013.

comparing support in local referenda for land conservation initiatives depending on their financing methods. Using data on the outcomes of referenda for the conversion of open space over the period 1998 to 2006, as well as information on proposed financing mechanisms, combined with data on community demographics (including the proportion of renters), land uses and values, county finances and political characteristics, and the extent of home rule, the authors estimate an econometric model.

They find strong support in the model for citizen preference for debt financing, noting that bond financing has a significant positive effect on referenda outcomes, even after controlling for other factors using multivariate regression. In particular, a bond referendum gathers up to an extra 10 percentage points in support over a property tax or sales tax referendum. The preference for bonds, however, erodes in richer communities, where wealthy households presumably can borrow more cheaply than poorer households, which is consistent with the theory described above of differential interest rates between governments and households. Even controlling for sample selection bias, whereby jurisdictions holding referenda or proposing particular financing mechanisms may not be a representative sample, does not overturn these results.

By contrast, Banzhaf and Oates find that increasing the share of renters by 10 percentage points actually decreases voter support for land conservation by about 5 percentage points. It may be that renters do not feel that they will benefit financially from restrictions on land use, as clearly homeowners will. Moreover, the authors can find no consistent econometric evidence that renters prefer financing by property tax or debt rather than by sales taxes.

Current Policy Implications

The finding that households prefer borrowing to current payment for large public investments is consistent with true fiscal illusion, based on a lack of information on government fiscal conditions, such that local debt issues do not get capitalized fully into local property values. It is also consistent with the theory put forward by Banzhaf and Oates that citizens prefer government bond issues over taxation because it is cheaper for them, even if there is still capitalization of bond issues in property values. Other research does seem to find this capitalization in areas such as school quality that are fairly obvious to households, as well as in more obscure areas, such as government finances. It is plausible to think that low bond ratings issued by rating agencies that are experts in government finances and have access to detailed information will eventually find themselves reflected in lower property values.

Yet the finances of government pensions do seem to be more consistent with true fiscal illusion. Underfunded municipal pensions, which are ubiquitous and massive, are largely equivalent to debt finance, but the accounting for such pension debt is complex, obscure, and, according to most analysts, wrong. This is because it significantly understates the extent of underfunding, due to overstating the discount rate used currently to calculate liabilities and costs. Moreover, the ratings agencies themselves have only just begun to give much weight to this type of debt and cost. There is some formal research that found, at least in the Chicago area in the 1980s, no evidence for capitalization of pension debt in property values, and moreover, studies generally do not find compensating differentials in public sector wages for generous pensions to workers. A recent working paper found that it was the announcement of pension troubles in San Diego in 2004 that had a negative impact on property values there (about 4 percent), but before the public disclosure of investment scandals and large-scale mismanagement of the pension plan, there was no effect.

More recent municipal pension troubles are also consistent with fiscal illusion based on faulty information and lack of public understanding. The bankruptcies of several California towns and Detroit have involved employee pensions and retiree health benefits in prominent ways that seem to have come as complete surprises to most policymakers, the media, and citizens, which would not have been the case if information about pension underfunding was widespread and understood. Similarly, the political struggle over reform and financing of public employee pensions in Illinois, New Jersey, Wisconsin, and elsewhere is prima facie evidence of true fiscal illusion, leading to the interpretation that the current troubles have been the result of past politically motivated actions to shift largely hidden liabilities to future periods.

At a minimum, the solution to this problem is providing better, more accurate, information to public sector workers regarding their pension benefits and the liabilities already owed to them. A fair and complete analysis of the sustainability of pension plans by governments is also essential in fostering public knowledge. Some would suggest that before allowing an increase or improvement in pension and retiree health benefits or a decrease in employee contributions, the matter should be put before voters in a referendum combined with complete information about the future tax implications of the proposed changes. Some analysts would go

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even further and say that the governance and disclosure requirements for good public management of employee pensions are beyond the system's capabilities, including of the citizenry. Therefore, they suggest that the switch from obscure defined benefit plans to more transparent defined contribution plans for government workers is the appropriate policy response.

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