

Berlin Applied Micro Seminar

The dynamic response of municipal budgets to revenue shocks

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Abstract:

We study the dynamic response of municipal budgets to a shift in fiscal revenues based on quasi-experimental variation in transfers within Germany's municipal fiscal equalization scheme. Because transfers depend on population counts, the 1987 Census led to sudden and permanent shifts in revenues across municipalities. Using an event-study design, we then track the causal response of municipal budgets to these revenue gains or losses. In contrast to prior work, we focus on the dynamics of this response over time. Local budgets do not adjust instantly: municipal spending adapts over three to four years, predominantly driven by capital and infrastructure investments. Spending adjusts more rapidly to negative shocks, but the response is symmetric in the long run. Local tax rates adapt more slowly, with adjustments stretching over more than a decade. We contrast these findings with prior evidence on the flypaper effect and other anomalies in local public finance.