

The incentive effect of fiscal equalization transfers on tax policy^B

Thiess Buettner *

Ifo Institute and Munich University, Poschingerstr. 5 D-81679 Munich, Germany

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Abstract

A theoretical analysis considers the impact of a typical system of redistributive “fiscal equalization” transfers on the tax effort of local jurisdictions. More specifically, it shows that the marginal contribution rate, i.e. the rate at which an increase in the tax base reduces those transfers, might be positively associated with the local tax rate while the volume of grants received is likely to be inversely related to the tax rate. These predictions are tested in an empirical analysis of the tax policy of German municipalities. In order to identify the incentive effect the analysis exploits discontinuities in the rules of the fiscal equalization system as well as policy changes. The empirical results support the existence of an incentive effect, suggesting that the high marginal contribution rates induce the municipalities to set significantly higher business tax rates compared with a situation without fiscal equalization.

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1. Introduction

Redistributive fiscal transfers between jurisdictions are a common feature of many federal countries with local taxing autonomy such as Canada, Germany, and Switzerland.

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* Tel.: +49 89 9224 1319; fax: +49 89 9224 2319.

E-mail address: buettner@ifo.de.

Irrespective of whether explicitly labelled “fiscal equalization” or embedded in a system of revenue sharing, the common characteristic is that transfers are inversely related to the tax base or some corresponding measure of “fiscal capacity.” As a consequence, those schemes will tend to compensate jurisdictions for the adverse impact of a higher tax effort on the tax base. To put it differently, redistributive transfer schemes tend to lower the marginal cost of raising public funds and might, therefore, induce governments to raise even possibly distorting taxes (Smart, 1998; Dahlby, 2002). This incentive effect is not only important for the design of redistributive transfer systems but also for its effect on competition. Standard models of tax competition argue that in a decentralized setting the mobility of the tax base will tend to increase the marginal cost of raising public funds for each individual jurisdiction with adverse consequences for the supply of public services. Since redistributive fiscal transfers might have the opposite impact on the marginal cost of raising public funds, recent theoretical research suggests that a redistributive system of interjurisdictional transfers might help to restore efficiency in an otherwise inefficient equilibrium of tax competition (Bucovetsky and Smart, 2002; Koethenbueger, 2002).

However, beyond theoretical considerations little is known about the significance and strength of incentive effects from fiscal equalization on the taxing policy of local jurisdictions. A paper by Baretti et al. (2002) deals with the case of German states. As these states lack taxing autonomy, the study focuses on the related issue of revenue collection and finds a significant adverse effect of fiscal equalization. Snoddon (2003) investigates the incentive effect of fiscal equalization in Canada. Facing complex interactions in the Canadian system of intergovernmental transfers, the empirical analysis focuses on policy reforms and finds support for incentive effects of fiscal equalization. However, the analysis is concerned with tax revenue, which is only an indirect measure of tax policy. The direct impact of fiscal equalization on tax policy is considered by Dahlby and Warren (2003) using a small dataset of eight Australian states and territories. They find some limited support for an incentive effect on taxing decisions.

This paper adds to the literature by providing an empirical investigation of the incentive effect of fiscal equalization on the local choice of the business tax rate in a dataset of German municipalities. There are several reasons why German municipalities offer a promising case to study. While these jurisdictions have tax autonomy in choosing the local rate of the business tax, a substantial amount of fiscal resources is redistributed among local governments. At the same time, tax autonomy is restricted to the choice of the tax rate since tax bases are defined uniformly across the country and tax collection is centralized at the state level. Even though empirical evidence is lacking, the potential incentive for higher tax rates is mentioned regularly in debates about the equalization system in Germany’s state legislatures (e.g., Hardt and Schmidt, 1998: 160) and, occasionally, used even as a motivation for tax reform.¹ Also previous research on the impact of local tax rates on revenue indicates potentially important incentive effects, as local tax rates are shown to exert quite strong tax base effects, indicating that the tax effort of German municipalities is unusually high

¹ A good example is the 1980 reform in the state of Baden-Württemberg. This reform reduced the contribution rate determining the amount of tax revenue to be transferred into the system, where the legislator explicitly pointed at the incentive effect: “Um den Gemeinden eine Absenkung der Gewerbesteuerhebesätze zu erleichtern, hat der Gesetzgeber den Anrechnungshebesatz für die Gewerbesteuer im Finanzausgleich ab 1982 auf 290% abgesenkt,” cited from Bronner, Faiss and Fürth (1998: 81).

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