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Federal tax-transfer policy and intergovernmental pre-commitment

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Abstract

Federal and state governments often differ in the capacity to pre-commit to expenditure and tax policy. Whether the implied sequence of public decisions has any efficiency implications is the subject of this paper. We resort to a setting which contrary to most of the literature does not exhibit a perfect tax-base overlap. We show that a federal government's pre-commitment capacity is welfare-improving. Efficiency, however, does not improve over all decision margins. The welfare-increasing policy entails a more distorted level of public consumption. Moreover, welfare may also improve if local governments are able to pre-commit towards the upper level. The rationale is that although federal transfers are formally unconditional they nevertheless entail a tax-price effect; thereby potentially counteracting incentives to engage in a "race to the bottom" in fiscal competition among local governments.
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1. Introduction

In most countries decentralized governments have the authority to decide on local taxes and expenditures. Independently of the degree of fiscal autonomy their policy choices are significantly influenced by the fiscal relations with the federal government. Reflecting efficiency and redistributive concerns the federal and local budgets are linked via a complex set of fiscal arrangements which include equalization payments, matching grants, and revenue-sharing systems. The way in which the federal tax-transfer system influences local policy depends on the specific formula used to allocate funds to local governments.[1] However, the incentive effects of the federal tax-transfer system are also related to the pre-commitment capacity by different levels of government. As shown recently, efficiency in local fiscal choices can be realized without resorting to formulaic (Pigouvian) transfers. Depending on the governments' pre-commitment capacity, lump-sum transfers may be sufficient to overcome inefficiencies which are rooted either in a tax-base overlap or in public consumption spill-overs.[2] The unorthodox efficiency results of federal transfer policy have

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[1] See Dahlby (1996) for an analysis of efficiency enhancing formulaic grants (Pigouvian grants). Equalizing transfers may become formulaic by conditioning them on a measure of local fiscal capacity. Besides their redistributive properties they are also capable of promoting efficiency- see e.g. Koethenbuerger (2002).

[2] Boadway et al. (1998) show that if the federal government is able to pre-commit, lump-sum transfers are sufficient to correct inefficiencies in local policy choices which relate to a tax base overlap. The efficiency result extends to environments with decentralized redistribution and heterogeneous regions if federal policy instruments are sufficiently differentiated (Sato, 2000). Reversely, if local governments are able to pre-commit, federal lump-sum transfers induce local governments to efficiently contribute to a global public good (Caplan et al., 2000).

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been derived in fiscal settings with either a perfect tax base overlap or exclusive taxation by lower-level governments (Caplan et al., 2000). The paper deviates from these contributions (and from most existing analyses of federal policy making) by assuming that the federal and local taxing authority does not perfectly over-lap as e.g. observed in Canada, Germany and the U.S. We assume a two-layer federal system with source-based capital taxation at the lower governmental level and labor taxation at the upper level of government. Since capital is mobile between local jurisdictions, the capital tax is distortionary from the perspective of local governments (Zodrow and Mieszkowski, 1986). The federal government decides on lump-sum transfers to local governments which, along with capital tax revenues, are spent on public consumption. The modeling choice mirrors the tax/transfer assignment in a variety of federal states. The federal government makes unconditional transfers to state governments, most notably to address a vertical imbalance of federal and state tax revenues relative to their expenditure responsibilities or to undo horizontal imbalances in local public funds. Although conditional grants to correct inefficient incentives to compete for mobile capital are well understood in theory, their practical relevance is limited.[3] As to the allocation of tax instruments, in most countries the federal level has the income tax and the value-added tax. In a static setting both taxes primarily resort to labor income as we assume in the paper.[4] Local governments in contrast have access to a limited set of tax instruments. For instance, in Germany the only fiscally important local tax instrument is a source-based capital tax (Gewerbesteuer) (levied by municipalities). Furthermore, it appears to be a common feature of federations that states which are linked by a federal transfer system are engaged in fiscal competition at the same time — e.g. Canada, Germany, USA.

We are interested in comparing the tax and expenditure choices when either the federal or state governments are unable to pre-commit with the traditionally simultaneously determined policy choices. Existing literature is open as to which pre-commitment capacity is more suggestive in fiscal federalism. Based on institutional analysis[5], Hoyt and Jensen (1996) argue that U.S. states are able to pre-commit toward local governments. The ability reflects the constitutionally anchored state government supremacy over local governments. In contrast, states within the Russian federation are conjectured to be in a better position to pre-commit than the federal government (Keen, 1998). Furthermore, among Canadian provinces Ontario is argued to have the capacity to pre-commit since 40% of federal tax revenues stem from Ontario (Dahlby, 1996). In the European Union (EU) it is controversially debated whether Brussels has the ability to pre-commit toward member states. The “weakness” may reflect the bottom-up historical evolution of European institutions which has left significant political power with member states (Caplan et al., 2000).[6]

Also, federal governments are generically bound to equalize public funds across member states so as to enable households access to a minimum public service level irrespective of the place of residence in the federation (e.g. Boadway, 2004).[7] The primacy often coerces federal government to accommodate state governments’ finances ex-post; thereby undermining the federal pre-commitment ability.

The paper’s main results are as follows: If the federal government pre-commits towards local governments, efficiency may not improve over all public decision margins. The federal government optimally reduces transfers (and thus distortionary labor taxes) in order to strengthen local incentives to resort to capital taxation. Thereby, it exposes public expenditure levels more severely to the downward pressure exerted by fiscal competition. Despite the fact that the efficiency effects of federal policy are countervailing, overall welfare increases.

If states can pre-commit, the welfare implications are ambiguous. The welfare differential in nom-monotonically related to the degree of capital mobility. With a high capital mobility, capital taxes rise which inclines the federal

[3] Indeed, the European Union addresses inefficiencies inherent to tax competition by tax coordination agreements (involving e.g. information exchange among national fiscal authorities) rather than by implementing Pigouvian grants.

[4] The common tax base also includes capital income which, as a source of tax revenue, is of minor importance relative to labor income.

[5] Related econometric analysis is almost non-existent - the exception being Hayashi and Boadway (2001) who report mixed evidence as to whether the federal government pre-commits towards provincial governments in Canada.

[6] Two important political institutions in the EU are the European Commission (EC) and the European Council of Ministers (consisting of member states’ ministers widely representing national interests). The EC has a decisive role in legislature (e.g. EU budget legislation), but decisions taken by the EC generally need to find approval in the Council of Ministers. At least to some extent, EU decision-making suggestively resembles negotiations between member states which are pre-committed to national policies. The issue of policy commitment has received attention in the discussion on the credibility of the Stability and Growth Pact which is intended to impose fiscal discipline on member states’ public finances, see von Hagen and Eichengreen (1996). Some European member states repeatedly violated the negotiated fiscal criteria possibly anticipating that the EC is not able to commit to the enforcement procedure (prescribing fines). In fact, these states have been successful in abandoning the enforcement procedure.

[7] The underlying principle of a “social citizenship” is constitutionally anchored e.g. in Canada and Germany.

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