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Preface

New directions in fiscal federalism: Introduction

1. Introduction

This special issue of the Journal of Public Economics brings together a number of papers under the heading of “New Directions in Fiscal Federalism”. Earlier versions of most of these papers (with the exception of the two papers by Hindriks et al. and Itaya et al.) were presented at a conference on that theme in Lexington, Kentucky in September, 2006. The conference was co-organized by Buettner and Wildasin and was co-sponsored by the Institute for Federalism and Intergovernmental Relations (IFIR) at the University of Kentucky and by CESifo of Munich, Germany[1]. All of the papers in this special issue have undergone the journal's customary refereeing procedures.

Taken as a whole, these papers touch upon many if not all of the most important themes with which students of fiscal federalism have been concerned for several decades. The following paragraphs offer a brief introduction to these essays, organized around these key themes.

One perennial issue in fiscal federalism is the so-called “assignment problem”, that is, the problem of assigning governmental functions to different levels of government. Classical analyses of this problem have emphasized the importance of demand heterogeneity (Oates' “Decentralization Theorem”), the “technology” of public good provision (economies of scale, geographical spillovers) and, for redistributive functions, of fiscal competition. The paper by Bordignon et al. adds new insights to this problem by examining lobbying behavior at centralized and decentralized levels of government. The authors note that for some types of policies, special-interest groups in different regions may profit from common, system-wide policies (e.g., EU steel firms could profit from a high common EU tariff on steel imports), whereas for other policies, such as the advancement of local industries at the expense of producers elsewhere, the gains to an interest group in one jurisdiction would be costly for special interests elsewhere. The analysis suggests that the former types of policies are best assigned to lower-level governments, whose policymakers, while responding to local lobbying pressures, will ignore the benefits that their policies may create for special interests elsewhere; in this way, the influence of special interests is constrained. On the contrary, assignment of the latter types of activities to a central government results in a balancing of conflicting interests that improves social welfare.

Several papers deal with issues relating to intergovernmental fiscal transfers. The first two of these are empirical studies that, in different ways, recognize that intergovernmental grants are potentially endogenously determined. The analysis of Solé-Ollé and Sorribas-Navarro tackles this issue directly by examining the importance of political considerations as a determinant of grants to Spanish municipalities. This analysis exploits the institutional structure of the political system (three levels of government) that determines the magnitude of grants and the fact that different political parties may, and sometimes do, control each of these levels of government. The authors find significant effects of political control on the distribution of grant funds to municipal governments. A second empirical paper, by Dahlberg et al., studies the impact of grants on Swedish municipalities, taking care to isolate the causal impacts of grants on spending and taxes by exploiting special features of the grant distribution formula. By controlling for the endogeneity of grant funds, these authors determine that grants do have a positive impact on municipal government spending but that they do not result in lower taxes in recipient jurisdictions, a result reminiscent of (though not identical to) the ”flypaper effect”.

Two theoretical papers study informational issues in the context of intergovernmental transfers. The first, by Kotsogiannis and Schwager, focuses on the problem facing voters who are only imperfectly able to monitor and reward the performance of self-interested politicians who may divert public-sector resources as a form of rent capture. They show that, in a federation with a system of equalizing transfers, variations in observed levels of public service provision may be particularly informative about policymakers, as equalization offsets differences in fiscal capacity that might otherwise account for these variations. In this respect, equalizing transfers may increase the accountability of policymakers to the electorate. On the other hand, the complexity of the equalization system itself may make it more difficult for voters to assess the performance of policymakers. Their analysis shows

[1] A number of other papers, based on keynote lectures presented at the conference, have been published as a special December, 2007 issue of CESifo Economic Studies.

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that the amount of rents captured by politicians may either be increased or decreased in the presence of equalizing transfers, depending on which of these two effects is dominant.

A second paper on intergovernmental transfers, by Huber and Runkel, studies the interactions between grants and debt policy. A perennial question is whether such borrowing should be subject to constitutional or other types of restrictions. Member states of the European Union, for instance, are supposed to limit their borrowing by member states to 3% of GDP. However, as noted by Huber and Runkel, such limitations need not always be completely inflexible. Germany, a substantial fiscal contributor to the EU, was effectively exempted from the fiscal penalties that members states should pay, in principle, when they depart from the 3% rule. This motivates Huber and Runkel to explore the relationship between borrowing restrictions and intergovernmental transfers. They develop a model in which a “social planner” for a federation would like to transfer resources toward “more patient” governments. Assuming that “patience” is not observable, they show that a program of net transfers from impatient to patient governments, combined with borrowing restrictions that, in equilibrium, bind on patient governments, is socially optimal.

The remaining four papers all address the topic of competition among governments for mobile factors of production. Chirinko and Wilson analyze the allocation of capital among the 50 US states over a period of more than two decades, building on a theoretical model in which the demand for capital in one state depends on effective tax differentials vis-a-vis other states. In one central set of results, they find that the amount of capital in a state depends both on its own policies and on the tax policies of neighboring states and that competition for capital among states is largely zero-sum in nature, i.e., that gains in investment by one state tend to come at the expense of investment in other states. Chirinko and Wilson highlight the fact that much important variation in state level tax policies arises from investment tax credits and other special investment incentives and not merely from statutory corporation income tax rates. An important feature of their study is the development and use of a new data set that includes detailed information about state government tax policies over a period of more than two decades.

Although the mobility of capital has attracted a great deal of attention in fiscal federalism research, labor mobility is also a topic of considerable importance. Of course, this is widely recognized in the study of local government finance, but it also arises at larger geographical scales, up to and including international migration. The study by Wilson revisits the problem of the “brain drain” and, in particular, the brain drain tax proposed by Bhagwati, whereby developing countries could recoup a portion of their investment in the human capital of skilled workers who migrate to developed countries. The implementation of such a tax presents substantial challenges since expatriates cannot be compelled to pay taxes to their native countries, except perhaps with the assistance of their new host countries. Wilson notes, however, that a skilled worker's decision to emigrate is not necessarily a once-and-for-all choice, and, in particular, that return migration is possible and is likely to occur for those emigrants who fail to secure high earnings abroad. Given that emigrants value the option to return to their home country, it is possible to collect a “voluntary brain drain” tax from them. The tax is “voluntary” in the sense that the home country has no jurisdictional authority with which to enforce it, but the home country nevertheless can impose extra penalties on return migrants who fail to pay the brain drain tax. Emigrants are willing to pay the brain drain tax as an alternative to facing an extra burden should they decide later to return home without having paid the tax. Thus, the brain drain tax is not necessarily so infeasible as it might otherwise appear.

The papers by Hindriks et al. and Itaya et al. are concerned with strategic aspects of fiscal competition for capital. Hindriks et al. study a two-jurisdiction model in which governments use both tax and public infrastructure investments to compete for mobile private investment, postulating that public investment decisions are made prior to the setting of tax policies. When jurisdictions are symmetric, competition in these two policy instruments leads to low rates of taxation on capital as well as low levels of infrastructure investment. The authors also show precisely how these findings can change in the asymmetric case. In addition, they consider the impact of a fiscal equalization program on the outcome of the fiscal competition game. In the symmetric case, equalizing transfers do not affect equilibrium tax rates, but they do reduce the level of investment in public infrastructure and raise welfare in both jurisdictions. Interestingly, when they are asymmetric, it is possible that the better-off region actually benefits from the establishment of a equalization program. This analysis highlights the interplay of policy decisions at successive stages of strategic policy setting by competing jurisdictions.

Of course, governments are long-lived entities and do not necessarily set policies once and for all. The strategic policy interactions of governments can be analyzed in a repeated-game setting in order to capture the possibility that governments may find ways to cooperate with each other, as discussed by Itaya et al. These authors consider the case where there are two asymmetric jurisdictions, differing in size, productivity, or both. The jurisdictions compete for mobile private capital. Itaya et al. study the incentives of jurisdictions to sustain a cooperative tax equilibrium in which both maintain tax rates that produce higher utility than would be attainable in a one- shot policy setting game. In particular, they show how interjurisdictional disparities in capital endowments and productivity can strengthen incentives for jurisdictions to sustain cooperative policies.

As noted at the outset, the research contributions in this special issue reflect the profession's sustained interest in certain fundamental themes: the assignment of policy responsibilities to different levels of government, the role of intergovernmental transfers in a federation, and the competition for mobile resources among governments. They also exhibit a wide variety of analytical methods, and perhaps suggest directions that future research in this field may take. Of course, any attempt to predict the future evolution of research in fiscal federalism is a speculative (and somewhat perilous!) undertaking. Nevertheless, if recent developments can be taken as a guide, certain emerging trends stand out as potential guideposts for research in the near and medium terms.

As illustrated by the papers published here, the field of fiscal federalism is one in which both theoretical and empirical studies play important roles, frequently in conjunction with one another. In this respect, current research continues a longstanding tradition in the field, and one which can safely be expected to persist. Empirical work on federalism issues is naturally facilitated by the availability of cross-sectional data in multi-jurisdictional economies. Data availability, combined with a high degree of public

policy interest in subnational government finance, present unusually rich opportunities for applied research as well as for the testing of theoretical models. To name only three illustrative examples, the testing and estimation of median voter models, the analysis of the impacts of intergovernmental grants on recipient government expenditures and taxes, and the analysis of capitalization effects in hedonic price models have all been the subject of extensive theoretical, empirical, and applied policy research.

In recent years, theoretical research in fiscal federalism has built upon advances in economic theory in general with respect to the analysis of informational issues, strategic interactions, and political economy. On the empirical side, the availability of new and improved sources of data, together with the continued development of fundamental econometric methods for the analysis of cross-sectional and panel data, is permitting empirical researchers to investigate classical topics more effectively and to broach entirely new topics for empirical investigation. These developments have stimulated important new applications in the field of fiscal federalism, as the papers in this special issue demonstrate, and it seems likely that they will stimulate many more such applications in the future.

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