

Symposium on “New Directions in Fiscal Federalism”

An Introduction*

by

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November, 2007

* This essay is an introduction to a special issue of *CESifo Economic Studies*. The list of papers to be published in this special issue appears at the end of the document.

Issues of fiscal federalism - broadly defined to include the tax, expenditure, and debt policies of different levels of government, as well their interaction - have attracted heightened attention from academics and policymakers alike. Global changes in institutional structures and economic conditions within and among countries, including fiscal, economic, and political reforms, have highlighted the importance of the division of fiscal and political responsibilities among governments. Competition among governments, as well as the development and evolution of mechanisms of horizontal and vertical fiscal coordination and cooperation among them, have been the subject of a rapidly-developing literature. Better understanding of the fiscal policies and interactions of governments, and of their institutional and political underpinnings, presents deep intellectual challenges as well as opportunities for useful policy applications.

The five papers in this symposium are a selection of papers based on keynote addresses presented at a September, 2006 conference on “New Directions in Fiscal Federalism” in Lexington, Kentucky.[†] This conference, which was co-sponsored by the Institute for Federalism and Intergovernmental Relations at the University of Kentucky and by CESifo, brought together scholars from around the world who are engaged in theoretical, empirical, and policy research in this very active field. The conference keynote speakers, all of whom are well known for their numerous important contributions to the literature of fiscal federalism, were invited to identify and discuss major issues of interest both from the viewpoint of academic research and from the viewpoint of public policy.

Although we will not attempt to summarize the findings of these papers, a brief overview of the topics that they analyze will serve to illustrate the wide range of scientific and policy issues that were the subject of conference discussions and that characterize the field of fiscal federalism today.

In its early stages of development, beginning some decades ago, economic research in the field of fiscal federalism was especially concerned with issues of subnational government finance and with the policy issues that arise in this context in federations such as the United States and Canada. These include topics such as the taxation of local property, school finance, and local and state/provincial economic development policy. The academic literature of the subject still bears the imprint of this tradition, and, indeed, the underlying issues remain as topical today as ever. George Zodrow’s article illustrates this intellectual heritage as well as the new problems that have excited the interest of policymakers and academics dealing with state and local public finance issues, particularly in the US context but with implications for subnational government finance elsewhere in the world. Zodrow reviews the principal sources of tax revenue for state and local governments in the US – retail sales taxes, corporation income taxes, property taxes – and examines their efficiency properties, or lack thereof. Zodrow’s discussion of local property taxation pays close attention to land-use (zoning) regulations and their interactions with tax policy, an issue that has been the subject of considerable attention in the literature.

[†] All papers were subject to the journal’s customary review process.

The reshaping of government institutions, including particularly the definition of new roles for subnational governments and the restructuring of intergovernmental fiscal relations, occupies the attention of policymakers throughout the world, especially in developing and transition economies, and it has given a major impulse to academic research on fiscal federalism. There may be important lessons to be learned from the experience of developed nations like the US and Canada. But the connections between federalism and economic outcomes are complex and sometimes indirect, and it is not clear that developed country experience alone can be a guide to policy reforms elsewhere. Robert Inman considers the relationship between federalism, political and economic institutions, and a variety of economic and political outcomes using a large cross section of countries with widely-varying levels of economic development and political structures. Building upon basic theoretical insights, Inman examines empirically how and to what degree federalism contributes to improved economic performance, highlighting in particular its role in securing property rights and its dependence upon democratic governance.

Modern research on fiscal federalism studies not only the role of subnational governments within nations, but fiscal interactions among nations. Much of this research has been stimulated by the policy questions arising from European economic integration, now the subject of a rapidly-growing literature. Two papers in this symposium, one by Jens Brøchner, Jesper Jensen, Patrik Svensson, and Peter Birch Sørensen on tax coordination in the EU and one by Jacques Drèze, Charles Figuieres, and Jean Hindriks on the use of intergovernmental transfers to support redistributive policies, exemplify this branch of the subject.

The first of these papers utilizes a computable general equilibrium model to investigate the gains and losses that would arise from several possible forms of coordination among EU countries in the taxation of corporate income. This model, it may be noted, takes into account the recent expansion of EU membership to include a number of Central and East European countries. The authors find that some but not all countries may benefit from such policy coordination, indicating that some types of compensatory transfers might be necessary to induce participation by countries that would otherwise have incentives to resist coordination initiatives. Interestingly, the analysis of Brøchner et al. shows that tax coordination would differentially affect tax revenues and overall economic performance: countries that gain in GDP would tend to lose tax revenue and vice versa.

The paper by Drèze et al. examines the fundamental problem of income redistribution in an economic system where labor is mobile among regions. This problem has previously been studied in the context of federations like the US and Canada, where national governments have been heavily involved in providing grant support to encourage redistribution, in cash and in-kind, by subnational governments in support of cash and in-kind redistributive transfers. In the EU context, the power of the “central government” (i.e., the EU itself) to provide grants in support of redistribution by regional (i.e., national) governments is very limited. Furthermore, the implementation of such grants, whether in the EU context or elsewhere, requires some mechanism through which the

necessary information for policy adjustment can be assembled and utilized. Thus, Drèze et al. study this “mechanism design” issue (incidentally, the subject of the most recent Nobel prize awards in economics) in a model with decentralized policymaking in an economy with integrated labor markets.

Just as the paper by Brøchner et al. considers the question of voluntary participation by governments in the coordination of corporation income taxation, so the paper by Dreze et al. examines whether potentially welfare-enhancing grant systems could arise from voluntary contributions by independent governments in a system with no central coercive power. It should be noted that the analysis of the potential for voluntary policy coordination in these papers sheds indirect light on the mechanisms of policy coordination in nations with stronger central governments and, in particular, on the role that central governments may play either in inducing desired policy on the part of subnational governments or on the displacement of subnational policymaking responsibilities by central governments, a topic that warrants research attention in the future.

Like the paper by Dreze et al., the paper by John Wilson is concerned with labor mobility and its implications for redistributive policy. Wilson’s analysis is also motivated by issues of international labor mobility, but focuses on migration from poor to rich countries, such as global migration flows from developing to developed countries. In contrast to the EU case, in which freedom of movement is guaranteed as a basic right for all EU citizens, no such freedoms are guaranteed at the global level. This is a crucial distinction, since it means that developed countries may impose direct constraints on immigration flows if they wish and, of course, as they do. Wilson shows that host nations have incentives to regulate immigration flows. When they do so, their redistributive policies treat immigrants more generously, since more favorable fiscal treatment of immigrants does not result in added immigration inflows. Remarkably, when host nations are able to control immigration directly, the global equilibrium may be one in which the total amount of immigration actually increases relative to the case where no such controls are possible.

To close the circle, it is interesting to note that Wilson’s paper, with its emphasis on the interplay between regulatory constraints and decentralized fiscal policy, is reminiscent of the discussion of land use controls by local governments in an economy with capital mobility, reviewed in the paper by Zodrow.

As these introductory remarks make clear, the papers in this special issue span a wide range of important policy issues, all distinct and worthy of careful study in themselves and yet related in important ways. They employ a diverse range of theoretical and empirical tools, and they are sure to stimulate fruitful new lines of inquiry. In these ways, the papers presented here, as well as the other papers presented at the Lexington conference, well exemplify the rapidly-evolving modern literature of fiscal federalism.

The following papers are scheduled for publication in the special issue of *CESifo Economic Studies* on “New Directions in Fiscal Federalism”:

1. Thiess Buettner and David E. Wildasin, *Symposium on “New Directions in Fiscal Federalism”: An Introduction*
2. George R. Zodrow, *The Property Tax Incidence Debate and the Mix of State and Local Finance of Local Public Expenditures*
3. Robert P. Inman, *Federalism’s Values & Value of Federalism*
4. Jens Brøchner, Jesper Jensen, Patrik Svensson, and Peter Birch Sørensen, *The Dilemmas of Tax Coordination in the Enlarged European Union*
5. Jacques H. Drèze, Charles Figuieres, and Jean Hindriks, *Can Federal Grants Mitigate Social Competition?*
6. John D. Wilson, *The Welfare State vs. The Common Labor Market: Which to Dismantle?*