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Personal and regional redistribution through public finance in a federal setting☆

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ABSTRACT

Following a partial equilibrium approach, this paper studies the effect of fiscal policy on income distribution in Argentina, based on budget information corresponding to the year 2004. Specifically, it aims to provide an empirical answer to a set of questions related to the responsibility of different levels of government (national or provincial) in ensuring the equitable distribution of income; how this responsibility is accomplished in practice, when this function is shared among two or more levels of government; whether an incompatibility arises among the policies from different levels of government; and the effect of fiscal policy on personal and regional income distribution.The main results of the paper are summarized as follows. At the aggregate level, both national and provincial budgets have a redistributive impact on personal income distribution, through a combination of progressive expenditures and (slightly) regressive taxes. Regional redistribution depends on two fiscal tools: the national budget and the revenue sharing regime. The progressive effect of expenditures and taxes interacts with the geographical effect of the revenue-sharing and the national budget, reinforcing progressivity in net-receiving groups and creating a trade-off between progressivity and (negative) regional transfer in net-financing ones. Provincial budgets have more impact than the national budget, both being compatible in pursuing the redistributive goal.

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1. Introduction

Redistribution of income through public finance has been an intensive area of research in the context of the welfare state. Economic analysis has concentrated on several dimensions, such as public policy variables (taxes/expenditures), the level of government (national/sub-national), the dimension of income (personal/regional), and so on.

In the framework of a federal government, several questions have been investigated both in theory and in practice. Which level of government (national or provincial) should be responsible for correcting the distribution of income resulting from the market? (among others, see Musgrave, 1959; Oates, 1972; Pauly, 1973). If two or more levels of government share this function, how do they shoulder such responsibility? (Boadway & Shah, 2009). Is there an incompatibility between the policies from different levels of government? (Tresch, 2002). On the other hand, which is the relevant dimension of the redistribution; personal, regional, or both? Do changes in personal income distribution coincide with or trade off against changes in regional income distribution? (Oates, 1972; Tresch, 2002).

This paper aims to provide an empirical answer to most of these questions, using budget information corresponding to Argentina in the year 2004, following a partial equilibrium approach (rather than a general equilibrium analysis). It performs a comprehensive analysis of the consolidated effect of budget on income distribution at both national and provincial levels of government, covering almost all expenditures (excluding social security), revenues and transfer regimes, and distinguishing between geographical source and destination of funds.

The main results of the paper are summarized as follows. At the aggregate level, both national and provincial budgets have redistributive positive impact on personal income distribution, through a combination of progressive expenditures and (slightly) regressive taxes. Regional redistribution depends on two fiscal tools: the

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national budget and the revenue sharing regime. At the provincial level, the progressive effect of expenditures and taxes interacts with the geographical effect of revenue sharing and national budget, reinforcing progressivity in net-receiving groups, and creating a trade-off between progressivity and (negative) regional transfer in net-financing ones. Finally, provincial budgets have more impact than the national budget but they are both compatible in pursuing the redistributive goal.

These results contribute to the debate on the design and assessment of public policy in Argentina. The 1994 National Constitution gave constitutional hierarchy to the revenue sharing – *coparticipation* – regime. However, a Coparticipation Law has not been passed yet because of political and economic reasons, including the lack of research contemplating the overall effect of revenue sharing and its interaction with the rest of fiscal policy, on income distribution.

The paper contributes to international debate in several respects. First, the provision of public goods at different levels of government follows an evolutionary process, in which some countries are moving towards decentralization while others are returning to re-centralization.[1] One of the dimensions to understand the expected effects of decentralization or centralization of specific taxes or expenditures is the identification of the impact on redistribution and the interactions between different levels of public budget and dimensions of income distribution. Second, provincial expenditure is a strong income-redistribution tool, but in federal countries provincial budgets may strongly rely on national transfers, which create soft budget constraint and incentives for fiscal irresponsibility. The international literature that studies the case of Argentina concentrates on the second effect, but omits the first.[2]

The paper is organized as follows: Section 2 situates the paper in context; Section 3 provides a brief description of the institutional framework in Argentina; Section 4 provides the basic definitions and the methodological framework; Section 5 presents the main results; and, finally, Section 6 concludes.

2. Context

Income distribution has been, from both a theoretical and historical perspective, one of the most intense research areas in economics. Research has been tackled from two different approaches: a normative approach, i.e., the study of the instruments to modify such distribution following some value judgment; and a positive approach, i.e., the study of the laws of income distribution in a capitalist economy.[3]

In the normative approach, the relevance of income distribution evolved along two variants (Musgrave, 1996).[4] The "service state" establishes that the main role of the state is to allow the proper functioning of the market economy by providing a legal system, protection to society from foreign aggressions, basic education to the poor, and public works that, because of their size, cannot be provided by the private sector. Within this perspective, the tax principles, according to benefits and the ability to pay, were assumed to coincide, so that the distributional impact of fiscal policy would be neutral. Under the "welfare state" perspective, the correction of income distribution which results from market forces is one of the functions of the government.[5]

A first question considers the level of government responsible for the income distribution task in a federal (multilevel) public sector: national, provincial, or local, or all of them, in which case a second question would be how to share this responsibility. An early answer to both questions was firstly provided by Musgrave (1959), who concluded that the central theme of fiscal federalism is found in the proposition that the provision of services should be assigned among the different levels of government, but the stabilization and distribution branches should be concentrated at the national level. The literature that followed recognized the existence of constraints for decentralized redistributive policies, because of mobility of goods and factors across regions (Brown & Oates, 1987; King, 1984; Oates, 1972) and countries (Wildasin, 1992). However, some opposite viewpoints emerged. Pauly (1973) justified the sub-national government interventions under the assumption of altruistic rich households. Bird (1995) raised another point concerning the functions of the different levels of government by stating that "A government, whether local or central, that is not concerned with distribution is less a government than simply one of the many alternative organizational structures that may be used to deliver certain services". Recently, Tresch (2002, p. 851) argued for personal redistribution at the local level of government and grants-in-aid at higher levels under the assumption of a hierarchically nested structure of welfare functions. This author also sheds light on the potential problem of incompatibility of policies at different levels of governments. As an example, "...Suppose local government L wants to effect a redistribution from citizens in group A to citizens in group B, but the national government prefers a net redistribution from group B to group A. One can imagine an endless chain of redistributions as each government tries to have its way. Of course, this sort of game must be ruled out, and the most obvious way is to deny one government the right to redistribute" Tresch (2002, p. 842).

A third question considers the relevant dimension of distribution. Should the aim of the public policy be the regional distribution of income, the personal distribution, or both? The answer in this case is that personal distribution of income should be a matter of concern, because the arguments included in the welfare function are individuals' utilities (Atkinson & Stiglitz, 1980). Moreover, a line of research anticipated a potential risk of failure in the regional distribution principle since regional redistribution could result in rich people from poor regions being subsidized by poor people from rich regions (Oates, 1972). Empirical research followed these guidelines (see references below). The leading focus was the impact of national or consolidated government policies on personal income distribution, while the regional dimension was relegated to a supporting

[1] Some references, within a long list, are Ahmad (1997), Bird and Vaillancourt (1998), Schwartz and Ter-Minassian (2000), Martinez-Vazquez and Alm (2003), and Smoke et al. (2006).

[2] See de Figueiredo and Weingast (2005); Goodspeed (2002); Inman (2003); Oates (2005, 2008, 2009); Prud'homme (1995); Rodden et al. (2003); Webb (2003); and Weingast (2009). This literature analyzes the effect of revenue-sharing schemes on state or local (over) expenditure and/or (under) taxation. Argentina is a recurrent example of irresponsible behavior of sub-national governments induced by these schemes.

[3] Rigorous analysis of the second approach dates from the beginning of the nineteenth century with Ricardo (1817), for whom "the principal problem of political economy was the determination of the laws governing the distribution of national income among the classes of society" (p. 5). The Ricardian theory gave birth to two principles of income distribution: the "marginal principle" and the "surplus principle". The first principle is adopted by the Neoclassic School (see Hicks, 1964), and the second is adopted by the Marxist School (see Dobb, 1972).

[4] There is a third approach, that goes back to positive theory and considers a "flawed state", which pursues the objective of bureaucrats and/or politicians that capture the fiscal apparatus fulfilling own goals rather than general interest (Brennan and Buchanan, 1977, 1978).

[5] See Dasgupta (1986); Helm (1986); Musgrave (1996); Boadway and Shah (2009).

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