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Journal of Urban Economics 55 (2004) 498–513
JOURNAL OF Urban Economics
www.elsevier.com/locate/jue

Tax competition in a fiscal union with decentralized leadership

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Received 30 April 2003; revised 6 November 2003

Abstract

This paper examines capital tax competition in the presence of an interstate transfer policy without federal commitment. Lack of commitment implies that local tax policy is chosen *prior* to federal transfers. The paper's main result is that ex-post federal policy *neutralizes* horizontal fiscal externalities, insulating tax policy from capital mobility. Federal policy, however, introduces a new source of inefficiency unrelated to tax competition. Specifically, ex-post transfer payments prove to be equivalent to an interstate *revenue-sharing system* which may render federal intervention in the presence of fiscal externalities welfare-deteriorating relative to tax competition.

JEL classification: H7; H3; H1

Keywords: Federalism; Capital tax competition; Commitment; State leadership

1. Introduction

Tax competition is a prevalent feature in the globalized economy, being of concern to policy-makers and academics alike. Though following Zodrow and Mieszkowski [37], a lot of attention is confined to tax competition among politically independent states, in many cases however competing states are members of the same fiscal union. For example in federal economies, such as Germany, USA and Canada, taxing powers are partially assigned to lower level governments, which allows them to compete for mobile capital (see Messere [23]). Tax competition in a fiscal union differs from inter-union competition in at least two respects. Lacking political and legal barriers, intra-union capital mobility tends

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0094-1190/$ – see front matter
doi:10.1016/j.jue.2003.11.002

to be higher, magnifying concerns of tax competition. More importantly, member states are linked by a common federal tax-transfer policy, which can be expected to significantly alter local incentives to engage in tax competition. However, the hierarchical structure of the public sector is generally neglected in models of tax competition, as pointed out in Oates [26], though it may yield efficiency effects different to those predicted by the standard Zodrow–Mieszkowski-type model and to those used in policy debate.

This paper analyzes tax competition in a two-layer fiscal union with decentralized leadership.[1] Member states engage in capital tax competition and receive lump-sum transfers from the federal budget. Implied by decentralized leadership, states choose tax policy, rationally anticipating how the federal layer will respond to policy changes. The federal government, however, takes states' policy choices as given when deciding on the level of transfers.

This sequence of policy determination, albeit with a slightly different set of instruments, is found to have significance in real-world federal politics. Federal governments are frequently argued to choose transfers after the level of public debt has been chosen by lower-level governments. Moving first, state governments rationally anticipate federal transfers (i.e. bailouts) in case of excessive indebtedness and strategically choose public debt levels at a too high level. Some indications of decentralized leadership, implying soft state budget constraints, are provided e.g. for the US in Poterba [29] and for Germany in Rodden [31].

Turning to the micro-foundation of state leadership, political competition or constitutional provisions are identified as two potential candidates for why member states can safely expect the federal government to react ex-post to their policy changes; see Rodden and Eskeland [32]. If fiscally troubled states contain voters that are politically decisive in federal elections, federal politicians will favor bailing out these states. Alternatively, a constitutionally anchored "grandfathering" role for the federal government forces the upper level to respond to unsound local fiscal policies by providing funds.[2]

Particularly in the European Union (EU), state leadership appears to be an appropriate representation of intergovernmental commitment, reflecting its historical evolution as a bottom-up federal system and, more importantly, its political structure. Via the council of ministers, the EU member states have a significant say in the formulation of EU policy. The council is comprised of ministers of national governments representing national interests at the EU level. Given their active role in EU legislation, national governments are unlikely to take EU policy parametrically. Instead, when designing national policies, they perceive how EU policy reacts to national legislation. The political structure may therefore be interpreted as assigning a Stackelberg leadership to member states and the role of a Stackelberg follower to Brussels.

Apart from constitutional and political factors, the sequence of moves may also inherently originate from the type of fiscal policies pursued by both layers of government.

[1] Throughout the paper the terms decentralized leadership and state leadership are used interchangeably.

[2] Such a "grandfathering" role is e.g. prescribed by the German constitution. Enforcing this principle, the German supreme court has repeatedly instructed the federal government to provide bailouts to needy states; see Rodden [31].