



## Fiscal federalism and lobbying

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### ABSTRACT

Which government functions should be decentralized (resp. centralized) once lobbying behavior is taken into account? We find that the answer largely depends on how the interests of the regional lobbies are positioned with respect to the function to be decentralized (resp. centralized). When regional lobbies have conflicting interests, then lobbying is less damaging for social welfare under centralization than under decentralization. On the contrary, when regional lobbies have aligned interests, then lobbying is less damaging for social welfare under decentralization, provided that policy spillovers on the non-organized groups are not too strong.

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### 1. Introduction

One of the most fundamental questions in the theory of fiscal federalism concerns the correct allocation of functions to different levels of government. This question has not only theoretical appeal. Given the recent and widespread tendency towards decentralization within countries, and centralization (of some functions) across countries, it also has a deep policy content. Economists are not completely devoid of answers. According to Oates's (1972) celebrated 'decentralization theorem', we should centralize (decentralize) functions with more (less) spillover effects and less (more) heterogeneity of preferences across jurisdictions. In its simplicity, this is a recipe that can carry one some way (see, for instance, Alesina et al., 2005; Tabellini, 2003, on the European Union). However, an important limitation of Oates's analysis is that it assumes welfare maximizing governments, and it is not clear how far its insights could go in more realistic political environments.

As an example, consider the current debate on the role that the European Union (EU) should play on the supply side of the economy, in fields such as labor markets institutions, pension policy, infrastructures, competition and regulation policy. In these fields, currently largely under the control of national governments, many observers would agree that the most important policy distortions come from the pressure of powerful organized interest groups on governments (e.g. Tabellini and Wyplosz, 2006). The important policy question is then whether these pressures are likely to become more or less powerful once these functions were centralized at the EU level. But this is not the issue that has been considered in the attempts to extend Oates' analysis to a political economy framework (see Besley and Coate, 2003; Lockwood, 2002). Moreover, despite the large economic literature on lobbying (see Grossman and Helpman, 2001, for a comprehensive survey), very few studies have concentrated on the specific relationship between interest groups and (de)centralization. And when they have done so, they mostly focused on the higher heterogeneity of preferences under centralization as the main discriminating factor (e.g. De Melo et al., 1993, and Redoano, 2002). However, the differences in preferences among EU countries do not seem to play an important role in the cases discussed above (see again Alesina et al., 2005, for empirical evidence).

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A more extensive discussion of the relationship between decentralization and lobbying is offered by [Bardhan and Mookherjee \(2000, 2002\)](#). They consider a probabilistic model of voting, where rich voters may decide to form an interest group which offers campaign contributions to Downsian parties before the elections, in order to influence the voting behavior of poorer and less informed voters. Comparing national versus local elections, they find several arguments supporting the idea that interest groups are more powerful at the local level, and many others that pull in the opposite direction, so that the question rests on empirical grounds.<sup>1</sup> Other studies are also somewhat connected to the topic, although they do not explicitly focus on the relationship between decentralization and lobbying. For example, [Treisman \(2006\)](#) criticizes the usual argument in favor of assigning a large share of locally generated revenue to local authorities in tax sharing systems, by noting that the incentives given to local politicians for improving the local economy (that may take the form of bribes from local businesses) may be counterbalanced by the opposite incentives given to the central government. [Brou and Ruta \(2006\)](#) consider the effect of political integration when lobbies are asymmetrically distributed among integrating countries, arguing that the country with more organized groups should fare better in the ensuing political game. Endogeneizing lobbying formation, they then conclude that political integration (e.g. centralization) should promote more lobbying formation.

While we do not question the potential importance of all these factors, we argue that there is another important channel which has so far escaped attention. This has to do with the simple idea, widespread in the political debate, that local governments care more for local interests than for foreign ones, as supporting a local interest generates additional benefits for the local politicians than supporting a foreign one (e.g. [Prud'homme, 1994](#)). As an example, advocates of the EU traditionally argue for more power to be assigned to the Union to reduce each country's incentives to defend its own 'national champions'. Loosely, the argument is that national governments do not internalize the effects of their policies on foreign interests and, as a result of this failure, they make inefficient choices that a federal government would avoid. While interesting, this argument is however incomplete. It fails to recognize that interest groups would attempt to influence policy even under centralization, so that the true question to ask, as argued above, is whether these pressures are likely to become less important once those functions were centralized.

To address this issue, we build a simple model that encompasses several possible realistic interactions among national lobbies and national residents. We consider two identical regions and, in each region, one organized group which may lobby politicians to the detriment of non-organized interests. Organized groups may have either *conflicting* interests – when the successful lobbying activities of a regional lobby hurt the other regional organized group – or *aligned* interests – when the lobbying activities of a regional lobby benefit also the other. Similarly, non-organized groups may be damaged either only by the lobbying activities occurring in their region of residence, or by those occurring in the other region as well. Lobbying equilibria are studied under both *centralization*, in which a national policy maker is in charge of all decisions, and *decentralization*, in which local policy makers (simultaneously) set local policies. Following [Grossman and Helpman \(1994, 2001\)](#) and [Dixit et al. \(1997\)](#), we model lobbying by using the common agency approach of [Bernheim and Whinston \(1986a\)](#), extending it to multiple principals and multiple agents when considering the decentralized case (see [Prat and Rustichini, 2003](#)). In this approach, politicians maximize a weighted utility function which takes into account both social welfare and money contributions from the interest groups.<sup>2</sup> This is of course a 'reduced form' of political behavior that lacks many details emphasized by the more recent literature. However, in our view, this simpler approach has the advantage of maintaining a larger generality.

We get very sharp results. In our basic model, lobbying is more damaging for social welfare under decentralization than under centralization when the lobbies have conflicting interests; while it is more damaging for welfare under centralization when the interests of the lobbies are aligned, provided that policy spillovers on non-organized groups are not too large and that policy makers do not attach too much (or too little) weight on lobbies' contributions. The latter result is somehow surprising as in the benchmark allocations in the absence of lobbying decentralization is always worse than centralization in terms of social welfare. The intuition is very simple and rests on an externality argument. When the interests of the two lobbies are aligned, decentralization means that the local policy makers do not take into account the beneficial effect of their policy on the non-resident interest group. Thus, the resulting policy under-provision reduces the distortionary effect of lobbying. In the opposite case in which the interests of the two lobbies are conflicting, local policy makers do not internalize the interests of the group hurt by the policy, thus strengthening lobbying distortions under decentralization. Hence, our model offers one important insight. It suggests that the answer to the normative question of the allocation of functions to different levels of government under lobbying behavior may also depend on the specific function under consideration, and in particular on how the interests of the national lobbies are positioned with respect to that particular function.

Naturally, in order to keep the model tractable we do not explicitly model many other relevant features that could make a difference between centralization and decentralization. For example, we do not explicitly account for within groups heterogeneity of preferences, agents' mobility, intergovernmental transfers, tax competition, or differences in the preferences of local versus national politicians.<sup>3</sup> We consider however some extensions of the basic model in Section 7, showing that our results survive, with

<sup>1</sup> We are not aware of any specific empirical work studying the relationship between decentralization and lobbying. There are, however, empirical works discussing the relationship between corruption and decentralization, usually finding a negative correlation between the two. For recent examples, see [Treisman \(2000\)](#), and [Fisman and Gatti \(2002\)](#).

<sup>2</sup> We focus exclusively on lobbying activities aimed at buying influence by means of contributions offered to the policy maker. However, lobbying activities may be directed at a variety of other goals, such as providing information to policy makers. See [Grossman and Helpman \(2001\)](#) and [Spiller and Liao \(2006\)](#) for comprehensive surveys.

<sup>3</sup> These features have already been scrutinized by a large literature. For instance, see [Persson \(1998\)](#) and [Persson and Tabellini \(2000\)](#) for 'common pool' effects which may arise out of transfers from the central level to local ones, [Wilson \(1999\)](#) for 'fiscal competition' effects which may arise out of the mobility of the tax base, [Keen and Kotsogiannis \(2002\)](#) for 'spillover effects' in taxation, and [Seabright \(1996\)](#) for honesty effects induced by the larger accountability of local politicians.

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