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Sharing budgetary austerity under free mobility and asymmetric information: An optimal regulation approach to fiscal federalism ☆

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Abstract

In the present article, Tiebout meets Laffont and Tirole in the land of fiscal federalism. A non-trivial Principal–Multi-Agent model is used to characterize the optimal intergovernmental grant schedule, when the cost of local public goods depends on hidden characteristics and actions of local governments, and under citizen free mobility. We show how informational rents, landlords' interests, and citizen mobility interact to produce distortions at both ends of the type space: in particular the most efficient jurisdictions should overproduce and overtax in second-best optimum. Informational asymmetries decrease the average production of public goods and increase the inter-jurisdictional variance of taxes and public-good production.
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1. Introduction

Since Tiebout's (1956) seminal work, the extent to which citizens' free mobility helps mitigating inefficiencies in the allocation of local public goods has been studied in various contexts. In the present article, Tiebout meets Laffont and Tirole in the land of fiscal federalism.[1] We study a non-trivial Principal–Multi-Agent problem in which the Principal is a central government, the Agents are local governments, and in which citizens are free to move from one jurisdiction to the other. In each jurisdiction, there is a land market, the local government chooses a local tax, and the production level of a local public good. Local governments have incentives to increase their share of central government money, and to run excessive deficits. At the same time, improvements in local public policies may trigger population movements, increase local tax revenues, and therefore decrease local deficits. The central government's policy objective is to maximize a weighted sum of the local jurisdictions utilities, minus the social cost of transfers to local governments – i.e., the total sum of grants – including any financial costs or interest charges associated with public deficits, and subject to the constraints of a free-mobility equilibrium. Our central government has no aversion for inequality, and thus no redistribution motive: we therefore isolate a pure efficiency problem. We study this problem under asymmetric information: the center cannot disentangle the impact of unobserved local conditions and unobservable cost-reduction efforts of the local government on the cost of local public goods. A higher type corresponds to a higher marginal cost of production, *ceteris paribus*. There is a continuum of possible types, described by a given probability distribution. We analyze the second-best optimal contract in this Principal–Multi-Agent setting. The solution yields an optimal grant function, as well as local public-good production levels and local tax rates.

Our results can be summarized as follows. The first-order conditions for maximization of the central government's objective under self-selection constraints and citizen mobility yield a complex system of integral equations. We focus on the linear-quadratic case, in which the optimal contract can be fully derived. Second-best optimal local public-good productions, taxes, cost-reduction efforts, and land prices are decreasing functions of the jurisdiction's marginal cost type. Because of incentive compatibility, the optimal grant schedule is a cost-reimbursement rule requiring the payment of an informational rent, which is decreasing with type, to all local governments, except the least efficient one. If citizens are made more mobile, the inter-jurisdictional variances of taxes and public productions are increased.

We compare second-best and first-best optima, that is, asymmetric and complete information allocations. The effect of informational asymmetries is to reduce average production, and to increase the inter-jurisdictional variance of both local productions and taxes. The citizen's average utility is smaller under asymmetric information, as compared to the complete information benchmark. The results obtained are very different from the case of immobile consumers, in which the model would boil down to a standard Principal–Agent model. In the free-mobility case, there are distortions at both ends of the type space. There are distortions "at the top": i.e., the most efficient jurisdiction should overproduce and overtax as compared to first-best optimum. There are distortions at the bottom: inefficient jurisdictions should produce less and tax less than required by the first-best optimum. Upward distortions (including distortions "at the top") are unambiguously driven by citizen mobility, and by the weight of landlords' interests in the objective of local governments. Downward distortions are due to informational asymmetries, and

[1] For a recent survey of the literature on local public goods, see Scotchmer (2002). On optimal regulation, see Laffont and Tirole (1986, 1993). On fiscal federalism, see the recent surveys of Inman and Rubinfeld (1997) and Oates (2004).

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