

# Fiscal Federalism and the Welfare State

*Discussion*

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# Traditional model of fiscal federalism

- Local governments provide local public goods efficiently, due to Tiebout competition
- Higher levels of government
  - Correct remaining externalities
  - Provide national public goods
  - Provide social insurance and aid to poor

# Observe a declining role of national governments

- Shift of responsibilities downward
  - Privatization
  - Outsourcing
  - Fiscal devolution
- Shift of responsibilities upwards to international organizations

# Forecasts growth in use of international organizations

- Global agreements on environmental issues
- International coordination on migration
- World tax organization?
- Global redistribution?

# Key questions

- What specifically is driving these changes?
- Given these pressures, what institutions will result?
- Should we realistically expect a greater role for international organizations?
  - Greater role for EU?
  - Other more global organizations?

# Mobility of firms

- Essence of globalization that mobility of firms has increased
- Corporate tax rates drop, as countries compete for multinationals
- Could explain many of the privatizations
  - Trade undercuts monopoly power
  - With private ownership, smaller loss from tax distortions

# With full mobility of firms, forecast

- No source-based taxation of capital
- But other fiscal decisions largely unaffected

# Mobility of individuals

- Differences in timing of benefits and taxes becomes more costly
- Undermines redistribution, e.g.
  - Rich move to jurisdictions with less progressive taxes
  - Poor move to jurisdictions with generous benefits
- But competitive pressures to provide social insurance, since insurance makes a location more attractive

# Mobility and Insurance

- But mobility undermines social insurance due to adverse selection, undermining welfare state
- Possible responses
  - Eligibility depends on prior participation in program
  - Could impose fees to exit from program

# Why is the E.U. so anemic relative to U.S. government?

- The answer helps us understand the challenges faced by international organizations
- Many similarities in two jurisdictions
  - Similar size, population, and per capita incomes
  - 27 vs. 50 member states
- Possible answers
  - Lack of mobility across countries in E.U.
  - Unanimity requirement, de facto if not de jure

# Role of mobility

- With mobility, aid to a group in one region aids group members in all regions
- With common factor markets, common economic interests
- Avoid costly location distortions by delegating decisions to a central government

# Role of mobility

- Mobility across E.U. countries very low compared to across U.S. states
- International mobility
  - even lower
  - restricted by immigration rules
- Without mobility, no shared interests at least through factor markets

# Unanimity requirement

- Certainly required ex ante, so agreements
  - Must be Pareto improving ex ante
  - Hindered by bargaining over surplus
- Required to maintain an agreement unless have credible means of preventing secession.
- If not, agreements must be Pareto improving ex post, leading to paralysis
- Secession inhibited if all international agreements tied together, as happened during WTO negotiations

# Summary

- International interdependence clear, e.g. global warming
- Nonetheless, international coordination will be very difficult
  - Must be Pareto improving ex post as well as ante
  - Recipe for paralysis