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Fiscal equalization and willingness-to-tax of sub-national authorities

In a federation, regions may know their regional tax bases better than the central government. For a given redistribution rule for smoothing the fiscal differences across regions, the information asymmetry may lead to a moral hazard problem on local tax enforcement. Particularly, the information asymmetry may induce provinces' governments to align their effort to raise tax revenues with state-specific marginal rates of loss. The marginal rate of loss is the fraction of an additional tax Euro raised in a province that is redistributed, as a result of fiscal equalization, to other jurisdictions. Building on a stylized model where province jurisdictions are benevolent and equalization grants hinge upon the provinces' fiscal capacities, we show that a province's willingness-to-tax is inversely related with marginal rate of loss. We empirically test the model using income-tax micro data from Germany. Regression estimates comply with the model presumption of an inverse relationship between marginal rate of loss and willingness-to-tax.