Introduction: rethinking the role of the state

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“Rethinking the Role of the State: Responses to Recent Challenges” was the theme of the 67th Congress of the International Institute of Public Finance, held in Ann Arbor, Michigan, in August 2011. Highlighting the changing views in our profession on the appropriate role of government, it dealt with a number of lessons learned from the 2009 financial crisis and its aftermath. Moreover, “Rethinking the Role of the State” addressed key challenges in the public sector in light of ongoing long-term trends, such as the ageing of populations, the rising mobility of production factors, technological change, cultural developments, and altering political landscapes and processes. “Rethinking the Role of the State” therefore is a timely, relevant and fascinating theme. Five terrific keynote speeches at the Congress shaped the theme with a broad coverage of issues, ranging from the Eurozone crisis, policy challenges for resource-rich developing countries, and policy reforms to cope with ageing and pensions, the income distribution and factor mobility. This special issue contains a selection of six papers presented at the Congress, including two of the Keynote lectures, which have been developed into written contributions (the ones by Hans-Werner Sinn and Frederick van der Ploeg).

1 The Eurozone crisis

The special issue takes off with the article “Target loans, current account balances and capital flows: the ECB’s rescue facility” by Hans-Werner Sinn and Timo Wollmershauser. The paper offers an illuminating picture of what has happened with international financial flows in the Eurozone since 2009. As is well known, the Eurozone’s

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GIIPS countries (Greece, Ireland, Italy, Portugal and Spain) have had current account deficits for many years. Before the crisis, these were matched by private capital inflows. However, as Sinn and Wollmershauer show, during the crisis years the capital inflows were no longer of a private nature, nor were they from explicitly created rescue facilities. Instead, the main line of credit can be found hidden on the balance sheets of the National Central Banks (NCBs): the TARGET balances. The authors are the first to show that these 'loans' indeed match the trade balances and have effectively financed the deficits in the GIIPS. In particular, the NCB's of the GIIPS countries created money via private bank lending, thereby expanding their liabilities vis a vis the ECB. The interest charged on these liabilities has been the same that the ECB applies to other lending as there is no requirement for countries to hold capital for the money they borrow through TARGET loans. Thus, it offered a cheap source of finance for the GIIPS to cover their trade deficits. The authors warn that this process cannot be sustained and draw a parallel with the collapse of the Bretton Woods system four decades ago. They then discuss two remedies that could avoid such a scenario. The first is keeping the TARGET balances as they are and introduce Eurobonds. This provides an explicit insurance for investors and a form of redistribution to weaker countries by keeping interest rates low. Discipline should come from political pressure to keep borrowing within limits as the market will not price the individual countries' risk. The alternative is that the ECB redeems the TARGET balances once a year with marketable assets, as is the case in the US. By requiring private capital for borrowing, market forces are brought back into the system and interest rates for TARGET loans to the GIIPS countries will reflect the market price of risk. The authors state a preference for market discipline rather than peer pressure.

2 Natural resources in developing countries

In "Bottlenecks in ramping up public investment", Frederick van der Ploeg explores what is the optimal investment policy of a developing country that enjoys a temporary natural resource windfall, such as an oil discovery. This is particularly relevant in several African countries where resources have recently been discovered. As in his earlier papers, Van der Ploeg shows that a developing country should not optimally follow the permanent-income rule, which borrows first and saves later to obtain a permanent and smooth increase in consumption; nor should it follow the bird-in-hand rule, which saves and invests the windfall and consumes from the interest income earned. These rules of thumb might well be desirable in the developed world, but not in developing economies that are characterized by capital scarcity. For them, many domestic investment projects yield rates of return that are much higher than those prevailing on international capital markets. This makes it optimal to ramp up domestic investment. In his paper, Van der Ploeg assesses the optimal way of harnessing natural resource windfalls for economic growth and development in alternative versions of his model of a small open developing economy. For instance, one model accounts for the increasing inefficiency as investment gets ramped up due to absorption problems. The optimal strategy is then to have negative genuine saving in order to finance

public investment early on. The model is also extended with a non-traded sector to explore the consequences of absorption constraints resulting from Dutch disease, i.e. the increase in the price of non-tradables and appreciation of the real exchange rate. Van der Ploeg extends the model to allow for absorption constraints due to a sluggish adjustment of ‘home-grown’ public capital needs (the need to ‘invest to invest’), which leads to smaller optimal real consumption increments.

3 Remittances and immigration

Remittances form a sizable source of income for several developing countries. John Wilson in “Should remittances be taxed or subsidized?” analyzes the optimal nonlinear taxation of these remittances. It thus extends the analysis of taxes and migration, which has traditionally been studied in the context of brain drain effects. In particular, a developing country may fear the emigration of high skilled people to developed countries, where they earn higher incomes. This can be a considerable loss for the countries’ government budget and its welfare. To avoid this ‘brain drain’, developing countries may find it optimal impose a tax on emigrants to reduce the incentives to move. However, other studies have pointed to the positive effects of emigration of high skilled workers for the home country due to the remittances the emigrants transfer to their relatives in the home country. Thus there exists a trade-off in the optimal tax on emigrants between the benefits of subsequent remittances and the cost of the brain drain. Notwithstanding this trade-off, taxing emigrants might be a very hard to do in practice. Therefore, a more realistic account on the issue is to consider the optimal taxation of the incoming remittances themselves. Wilson takes up this question and derives conditions under which the home country should tax or subsidize remittances at the margin. Thereby, a new trade-off emerges. On the one hand, taxing the income from remittances might allow the government to achieve a more equitable distribution of this source of income, or might generate scarce public revenue to finance investment projects. The latter could be particularly productive if governments are restricted in the use of other taxes and face tight credit constraints. On the other hand, a tax on remittances might reduce the inflow of transfers, thus hurting aggregate consumption in the home country. By allowing for a nonlinear tax schedule, Wilson shows that relatively large amounts of income should face positive marginal taxes, but that small amounts of remittances should actually be subsidized at the margin.

4 Capital taxes under prospect theory

Khaneman and Tversiki’s prospect theory can shed new light on several traditional public finance results. In “Capital income taxation and risk taking under prospect theory”, Jaroslava Hlouskova and Panagiotis Tsigaris examine this in more detail for the impact of capital income taxation on risk taking. Rational agents driven by expected utility respond to capital income taxes in different ways: they might increase risk taking due to the Domar–Musgrave insurance aspect of taxes, as long as losses

can be fully offset; but agents might also reduce risk taking through negative income effects. The net effect depends on how risk aversion is captured by the utility function. The expected utility framework, while dominating the public finance literature, however, has failed to explain several stylized facts of how people actually choose risk, e.g. how they respond to profits versus losses, how they deal with large versus small risks, and how they use reference points in taking decisions. Behavioral economics has offered alternatives that can help explain this behavior. In their article, Hlouskova and Tsigaris explore how reference levels, relative to which people value changes in their level of wealth affect the impact of taxes on risk taking. The authors show that the impact of capital income taxes on risk taking of sufficiently loss averse investors depends critically on the reference level people use. For instance, if the reference level is the initial level of wealth, the tax has no effect on risk. Risk taking is encouraged by taxes if investors compare their reference level with others or if the loss is not perceived as a reduced benefit but as an increased tax loss, which happens if the reference level is set at the after-tax return on the safe asset. While tax effects could go in the same direction as in expected utility models, the interpretation is usually very different.

5 Cross-border shopping

Differences in sales taxes between states or countries give rise to cross-border shopping. In “Games within borders: are geographically differentiated taxes optimal?“, David Agrawal—winner of the Peggy and Richard Musgrave Prize 2011 for the best paper of young scholars—explores how different regions within a country or state should levy different commodity tax rates in light of this cross-border shopping. Intuitively, one might expect that a government aiming to maximize revenue from its sales tax will reduce the rate in the border region so as to expand the tax base through an inflow of cross-border shoppers. In Agrawal’s model, however, governments do not maximize public revenue but social welfare. In that case, the government needs to trade off revenue considerations with other aspects. For instance, it will also care about the geographical distribution of welfare. As people near the border with a country that has a lower tax rate have an opportunity to cross-border shop, they effectively face a lower sales tax. Hence, with the same income as someone in the core of the country, people near the border enjoy higher consumption. The government might want to impose higher taxes on consumers near the border to reduce this inequality, but it can only do so as long as the elasticity of cross-border shopping is not too large. Another consideration in maximizing welfare is tax exportation. If a country or state receives cross-border shoppers from its neighbor because it adopts a lower sales tax, this might be a reason for the government to set a higher tax rate in the border region than in the core. The reason is that foreign consumers bear this tax, which benefit public goods for domestic residents. However, again, this is only desirable if the cross-border response to a higher tax is not too large. Such results are not possible in models in which the government maximizes revenue. Agrawal’s model derives the exact conditions under which tax rates in border regions in either high or low tax countries will be set higher or lower than in the core.

6 Politics of tax reform

In “On the political economics of tax reforms: survey and empirical assessment”, Micael Castanheira, Gaetan Nicodeme and Paola Profeta, explore how political mechanisms help explain outcomes of personal income taxes in Europe. Economic theory offers alternative explanations for actual tax policy outcomes, including median voter theory, probabilistic voting and models based on Colonel Blotto games. To understand the political economy of tax changes, other aspects become relevant too, such as status quo bias, the distinction between gradual and comprehensive reform, and information asymmetries between the political elite and the electorate. Armed with these insights from political economy, the authors exploit a new database that identifies labor tax reforms in the European Union for the period 2000–2007. This allows them to test various political-economy aspects of tax reforms. It appears that political variables carry more weight than economic variables in explaining tax reforms. Political variables, such as the number of parties in a coalition or the concentration of the opposition, turn out to be important. There are no indications for a political cycle, whereby new governments implement reforms in the beginning or end of their term of office. The authors do find support for reform gradualism in the sense that the probability of tax reform is greater if there has been a reform in the previous year.

This completes the summary of papers in this special issue. It is inevitably selective and sometimes subjective. I hope it will encourage readers to study the papers more thoroughly themselves. I thank the authors, the discussants, the referees and all involved in the organization of the Congress for making this special issue possible.