

Regional Transfers and Tax Effort: A Nash Equilibrium in Fiscal Federalism

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Abstract

This paper develops a general equilibrium model in which local governments (LGs) and a central government (CG) interact under a fiscal transfer rule combining a penalty for inefficient revenue collection, an income-equalization target, and an investment-tied share. Each LG chooses its tax collection effort; the CG chooses the share of each region's transfers earmarked for local investment. The Nash equilibrium is derived in closed form: the optimal earmarking share decomposes additively into an enforcement term and a preference-alignment term, and in any interior equilibrium the public—private expenditure mix equals the CG's preferred ratio, independently of local preferences. Under a benevolent-CG criterion this composition is welfare-optimal; a Stackelberg benchmark shows that commitment would trade the preferred composition for higher effort -- a time-inconsistent outcome. Calibration classifies the United States as a full-effort corner solution and China as an interior equilibrium.

Keywords

Fiscal Decentralization, Tax Effort, Transfer Rule, Earmarked Transfers