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Commodity tax harmonization and the location of industry

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Abstract

We study the positive implications of commodity taxation and tax harmonization under the destination and origin principles when firms are monopolistic competitors facing variable demand elasticity and segmented markets. Our emphasis is on the international location of firms in the presence of market size asymmetries and trade costs. Under the destination principle, an increase in the tax rate of a country always causes some firms to relocate to the other. This effect may be reversed under the origin principle when economic integration is deep enough. Under tax harmonization the choice of a common tax principle is irrelevant for the market outcomes and for the global tax revenues. It affects, however, the distribution of revenues between small and large countries.
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1. Introduction

The issue of VAT harmonization within the European Union (henceforth, EU) has attracted considerable attention and generated heated debates in the political arena (European Commission, 2000). Commodity taxation has raised similar passion in the United States, where e-commerce has created significant pressures on existing cross-border tax systems (Goolsbee, 2001). Central to the debates are two key questions on designing indirect taxation in the international context (Keen et al., 2002). The first question asks where taxes should be levied. Two alternative regimes are traditionally considered, depending on the founding principle. Under the 'destination or consumption-based principle' (DP) tax is paid in the country where goods are consumed at the rate applied there, while under the 'origin or production-based principle' (OP) tax is paid in the country where goods are produced at that country's rate. Accordingly, local consumption is taxed and exports are exempted under DP while local production is taxed and imports are exempted under OP. The second question asks whether tax rates should be set independently by national governments or rather harmonized across countries.

As recently acknowledged by economists at the IMF, those questions are becoming increasingly important as global economic integration steadily proceeds:

> "Some of the deepest design issues for the VAT in the coming years are likely to be those arising from intensifying international economic integration and continued pressure to decentralize tax powers." (Ebrill et al., 2001, p. 176).

Nonetheless, they have proved difficult to resolve in practice. For example, VAT in the EU relies on a hybrid principle according to which taxes on firms' transactions are levied under OP whereas taxes on consumers' transactions are levied under DP. Since the latter rule is increasingly perceived as inflating the administrative costs of tax collection, thus favoring tax evasion, policy makers are now considering a full switch to OP (Nam et al., 2001). Furthermore, as attested by the large variation in EU VAT rates and the recent political tensions in renegotiating reduced rates in labor intensive sectors, countries are still lukewarm about harmonizing their tax rates and giving up control over domestic fiscal instruments:

> "Members States have shown little enthusiasm for the proposals in Council meetings and […] have been reluctant to accept the greater harmonization of VAT rates and tax structures." (European Commission, 2000, p. 18).

Our aim is to highlight the effects of tax competition and harmonization on firms' location decisions in an increasingly integrated world. We consider a two-country, two-factor model featuring many firms, imperfect competition, and variable markups. Capital is mobile whereas labor is immobile, which seems to fit the EU quite well, since labor mobility remains low despite the absence of formal barriers (Braunerhjelm et al., 2000). Furthermore, since our analysis focuses on federations such as the EU and the US, we assume that countries (or regions) share a common currency, thus disregarding the potential impacts of taxes on exchange rates. We adopt a quasi-linear utility function to abstract from the way the proceeds of taxation are used. With quasi-linearity, transfers have no impact on the demand of the taxed goods, so they do not influence the market outcome. While this is a handicap, it allows us to introduce variable markups by integrating commodity taxation into the monopolistically competitive model with linear demand developed by Ottaviano and Thisse (2004).

By allowing for variable markups, our framework addresses the criticism put forward by Keen et al. (2002) according to whom neglecting price discrimination, as existing models of commodity

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