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European Journal of Political Economy
Vol. 18 (2002) 695–716

European Journal of POLITICAL ECONOMY

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Globalisation, capital mobility and tax competition: theory and evidence for OECD countries

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Received 1 September 2000; received in revised form 1 August 2001; accepted 1 September 2001

Abstract

Are the predictions of tax competition theory wrong? While the tax competition literature predicts that taxes on income from capital decrease with increasing globalisation, past empirical studies on various data find contradicting evidence. By using different data and additional elements of economic theory, this paper aims to challenge the empirical contributions. For a panel of 14 OECD countries and for the period 1967–1996, we find that globalisation has indeed a negative and significant impact on corporate taxes. Furthermore, globalisation tends to raise labour taxes and social expenditures. As a consequence, the so-called "efficiency" and "compensation" hypotheses of globalisation are not competing, but rather, both appear to apply at the same time. Efficiency has an impact on the tax-mix, whereas compensation is provided through increased social expenditures.
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JEL classification: H7; H87; C23
Keywords: Tax competition; Empirical evidence; Panel data; OECD countries

1. Introduction

Following the basic results of tax competition literature, capital taxation is negatively related to the degree of international capital mobility, whereas labour taxation relative to capital taxation is positively related to international integration of national economies. The theory also suggests that larger countries levy higher capital tax rates than smaller countries because the erosion of their tax base is smaller in per capita terms (cf. Bucovetsky, 1991;

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0176-2680/02/$ - see front matter © 2002 Elsevier Science B.V. All rights reserved.
PII: S0176-2680(02)00115-5

Wilson, 1991). These predictions are derived from general equilibrium models in full accordance with microeconomic principles. It is thus surprising that most recent empirical studies obtain almost reverse results. For instance, in a panel regression of 15 OECD countries for the period 1976–1990, Garrett (1995) finds that a rising exposure to international trade, which is used as a proxy for financial liberalisation, leads to an increase in capital taxation. Referring to cross-country studies of economic growth, Quinn (1997) considers a broader range of 64 countries with annual data averaged over the years 1974–1989 and concludes that levels of corporate taxation are positively associated with financial liberalisation under a wide variety of different model specifications. These findings are supported by Swank (1998). In a panel regression for 17 industrialized countries (mainly OECD countries) for the period 1966–1993, he finds that three different measures of capital mobility are positively related to the proxy of corporate taxation.

A closer look at these empirical results reveals possible sources of problems and deficiencies. For instance, the creation of a proxy for the dependent variable—the tax policy—is a major problem. Proxies commonly used in cross-country studies are the revenues from corporate taxation as a percentage of the GDP. This method is inadequate in several respects. We set out the reasons in Section 3. In addition, specifications of estimated equations can be enriched through economic theory.

Rodrik (1997) avoids the data problem by using effective average capital and labour tax rates. In a panel approach of 19 OECD countries for the period 1965–1991, he finds that a proxy for openness has a significantly negative effect on capital taxes and a significantly positive effect on labour taxes. However, his results are not robust when one adds a qualitative dummy variable for international exchange rate restrictions and an interaction term of this dummy as a proxy for openness.

A change in capital taxation is one of the main features in the more general discussion on the consequences of globalisation for the nation state. In their broad survey, Schulze and Ursprung (1999) consider the different links between the reduction in international arbitrage costs and fiscal policy. Their contribution covers topics such as the size of the public sector, the structure of public expenditures, the structure of taxes and the scope of redistribution policies. The survey comments on the reviewed literature as follows: "...many of these studies find no negative relationship between globalisation and the nation's ability to conduct independent fiscal policies."[1] The authors also suggest that the different hypotheses on the effects of globalisation are not mutually exclusive. They argue that some effects apply especially to tax policy, which should be distinguished from the effects on government expenditures.

The plan of this paper is to focus on the following issues. First, we show that the proxy variables for corporate taxation used by Garrett (1995) and Quinn (1997) have conceptional difficulties and are responsible for certain counterintuitive results. Consequently, we use effective average tax rates on corporate capital with the methodology proposed by Mendoza et al. (1994). In this way, tax policy is better depicted, as we additionally control for tax base effects. Furthermore, we distinguish precisely between the measure of globalisation and country size.

[1] Schulze and Ursprung (1999, p. 345).

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