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Decentralization and international tax competition

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Abstract

This paper models tax competition between two countries that are divided into regions. In the first stage of the game, the strategy variable for each country is the division of a continuum of public goods between central and regional government provision. In the second stage, the central and regional governments choose their tax rates on capital. A country's decentralization level serves as a strategic tool through its influence on the mix of horizontal and vertical externalities that exists under tax competition. In contrast to standard tax competition models, decentralizing the provision of public goods may improve welfare.

JEL classification: H40; H71; H77
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1. Introduction

The roles of central and lower-level governments in a federal system are imperfectly understood. Much of the local public economics literature treats these roles as exogenous. The different levels of government are each given control of various tax and expenditure instruments, and the central government can employ various policies to influence the behavior of lower-level governments. The theory developed by Tiebout (1956) justifies a

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large role for local governments by emphasizing the ability of mobile households to "vote with their feet." By doing so, these households effectively reveal their preferences for local public goods, and local governments use this information to efficiently provide these goods. In contrast, the central government encounters difficulties in inducing individuals to reveal their preferences for public goods. But only recently have researchers focused on formal models of informational asymmetries in a federal system.[2] A weakness of this literature is that these asymmetries are assumed rather than derived.

It is now well-understood that the behavior of independent governments is unlikely to be optimal in any reasonable sense, and a central government is needed to correct the various externalities and income distribution problems that arise in a system of independent governments. There exists a particularly large literature on tax competition, under which, governments compete for scarce capital, leading to inefficiently low levels of taxation and public good provision.[3] In contrast to Tiebout models, this literature emphasizes problems with the decentralized provision of public goods by independent governments. However, it seems to stack the deck in favor of centralized provision because it typically assumes away any inefficiencies at the central level.[4]

A more recent literature tries to come to grips with the inefficiencies that would exist under central provision of public goods. In Oates (1972), these inefficiencies consist of uniform provision of public goods across different jurisdictions, which must be traded off against the interjurisdictional externalities that might occur in a decentralized system (e.g., spillovers from public good provision). In contrast, Besley and Coate (2003) examine a model in which the behavior of the legislative system under centralization leads to an unequal (and inefficient) division of public good expenditures across localities. Panizza (1999) examines a model in which the provision of a single public good is subject to greater spatial decay at the central level, and the amount of decentralization is then determined at the central level by balancing the preferences of the median voter with central-government preferences for greater government size.[5] The political economy approach to fiscal federalism remains relatively unexplored.

Using a different approach, the current paper derives an active role for lower-level governments in public good provision. We consider a world economy in which the central governments of two countries provide public goods financed by taxes on mobile capital. Competition for this mobile capital leads to inefficiently low taxes and public good levels, as in the standard tax competition model (e.g., Wilson, 1986 and Zodrow and Mieszkowski, 1986). Unlike the standard model, however, there exists a continuum of public goods and, therefore, the possibility for the central governments to decentralize the provision of some, but not all, public goods. From a single country's viewpoint, both horizontal and vertical tax externalities are involved in the provision of public goods by "regional" governments (e.g., state, local, or provincial). When a single regional government lowers its tax rate, it not only attracts capital away from other regions (a domestic horizontal externality), but also expands the central government's tax base by

[2] See, for example, Raff and Wilson (1997) and Lockwood (1999), and the references therein.
[3] See Wilson (1999) for a review.
[4] An exception is Wilson (2003).
[5] See also Arzaghi and Henderson (2000), which builds on this framework.