Regional Science and Urban Economics 31 (2001) 181–213
regional SCIENCE & urban ECONOMICS
www.elsevier.nl/locate/econbase

Income tax competition at the State and Local Level in Switzerland

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Received 22 November 1999; received in revised form 25 September 2000; accepted 4 December 2000

Abstract

Tax competition is supposed to lead to inefficiencies in the provision of public goods and difficulties for decentralized redistribution. A necessary condition for these effects to occur is that residence and location decisions are determined by fiscal considerations. In this paper, the impact of personal income taxes and transfer payments on residence decisions of taxpayers is analyzed using cross sectional data on the distribution of different groups of taxpayers in different income groups among the 26 Swiss cantons and the 137 largest Swiss cities. We find that tax competition with respect to personal income taxes is relatively strong in Switzerland.

Keywords: Tax competition; Fiscal federalism; Personal income taxes; Transfer payments

JEL classification: H73; H71

1. Introduction

Since Tiebout's (1956) seminal paper, the impact of fiscal competition on the efficiency of public goods' provision and the effectiveness of decentralized income redistribution is widely discussed in the literature. Following Tiebout's arguments, fiscal autonomy may be categorized as a precondition for achieving a Pareto-

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0166-0462/01/$ – see front matter
PII: S0166-0462(00)00084-3

efficient allocation of local public goods. By 'voting with their feet' citizens choose their residence in a community with the optimal combination of fiscal burden and of public goods according to their preferences. This migration process forces the other communities to realize that they are in a competitive framework. Yet, in equilibrium, different levels in the provision of public goods will persist to the extent that there are differences in citizens' preferences while people sort themselves in relatively homogeneous jurisdictions with respect to their incomes and preferences. In this context, sorting is supposed to be a necessary condition of an efficient allocation of public goods. Hence, an empirical test of fiscally induced sorting is provided in this paper.

However, it has to be noted that homogeneity of jurisdictions is not sufficient for envisioning an efficient supply of public goods as a result of competition because quite a number of restrictive and idealized assumptions between local communities or regions have to be met. For instance, if the assumption of constant (as it is employed by Tiebout) or increasing marginal costs is dropped, because public goods are characterized by increasing returns to scale with respect to the number of users, then competition does not really work. The main reason is that public goods, if produced at all, would be provided at marginal cost prices, which do not cover the higher inframarginal production costs. Thus, as Sinn (1990, 1997) points out, the community would incur a loss if a competitive marginal tax price was set. As a consequence, no public goods would be provided, especially no pure public goods, which are costless *in use* due to the non-rivalness in consumption. In the latter case, if such goods have been provided, communities will compete with each other until the tax price approaches zero. If this outcome is expected, no community will engage in the provision of a pure public good or immobile factors have to bear the tax burden fully, which implies a considerable distributive problem. Thus, given goods like these, a pessimistic assessment of the efficiency and the distributive impact of tax competition seems inevitable.[1]

As Schwab and Oates (1991) show, peer group effects may lead to inefficiencies as well, in particular because of the jurisdictional homogeneity induced by the Tiebout mechanism.[2] If a person with a low crime probability resides in a neighborhood with low crime rates, average costs of the provision of public safety decrease in that neighborhood. Consequently, residents in neighborhoods with a low level of public safety bear external costs since they have to pay higher taxes in

[1]Fiscal externalities and spillovers are other mechanisms that may lead to an inefficiently low provision of public goods in a setting of fiscal competition. See Gordon (1983); Inman and Rubinfeld (1996) and Wellisch (1996) for a comprehensive analysis of different externalities in a Tiebout-framework. Similar arguments hold with respect to capital income taxation. See Wilson (1986); Zodrow and Mieszkowski (1986); Oates and Schwab (1988); Wildasin (1988); Bucovetsky (1991); Bucovetsky and Wilson (1991); Braid (1996) and Janeba (1997) as well as Feld (2000a) for a survey.

[2]See Oates (1981); Arnott and Rowse (1987); Brueckner and Lee (1989) and De Bartolome (1990).