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Tax competition, rent-seeking and fiscal decentralization

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Abstract

The present paper provides a basis for evaluating fiscal decentralization of expenditure and tax responsibilities, by encompassing the literature on tax competition and rent seeking. Both tax and rent seeking competitions are conceived of as being wasteful and self-defeating. We find that rent-seeking activities account for political distortions which may be mitigated in the process of fiscal decentralization, while tax competition results in economic distortions associated with decentralization. Welfare evaluation should be based on the balance of the political gain and the economic cost. © 2001 Elsevier Science B.V. All rights reserved.

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1. Introduction

A common phenomenon in both industrialized and developing economies has been the devolution of the fiscal system within countries. Fiscal devolution has occurred simultaneously with increased economic integration. These movements have raised concern and interest among economists about the effectiveness of government policies. While decentralization of expenditure responsibilities may enhance the flexibility of public good/service provision at the local level to suit the preferences of residents, devolving functions of

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tax and transfer limits the ability of the public sector to fulfill these tasks because lower levels of government are more vulnerable to factor and residential mobility across borders than is the central authority. Views on the latter prospect have been divergent, however. On the one hand, more intensive tax competition – led by the devolution of the tax system – is seen as wasteful or self-defeating, resulting in the under-provision of public expenditures. This view is widely accepted among normative public economists (Musgrave, 1997; Zodrow and Mieszkowski, 1986). These authors tend to advocate a re-construction of the centralized system or policy harmonization among different governmental units. On the other hand, the public choice perspective provides a different evaluation of tax competition. It argues that intergovernmental competition in a decentralized fiscal system will serve as a device to discipline governments (Brennan and Buchanan, 1980; Frey and Eichenberger, 1996).

These opposing views stem from different perceptions of government. The tradition of normative public economics presumes a benevolent government (a social welfare maximizer), while the public choice school regards government as a self-serving agent or a revenue maximizer (Leviathan). The literature on rent seeking, developed by Krueger (1974) and Buchanan et al. (1980) provides a view, closely related to, but different from, Leviathan government. Rent seeking is expenditure by competing interest groups in the form of lobbying and/or bribery, to acquire favorable treatment through public policies (e.g. regulation, tax/subsidy). In this literature, government serves the winning (most successful) interest groups by awarding them 'artificially created transfers' (Tollison, 1982).[1] In the present paper, we aim to synthesize the approaches of normative public economics and public choice. We examine the welfare implications of fiscal decentralization within a nation, in the presence of rent-seeking activities as well as capital tax competition. In this context, fiscal decentralization includes the devolution of both revenue and expenditure powers.[2]

Capital tax competition among local jurisdictions motivated by an attempt to attract mobile factors is wasteful in nature and contributes to economic distortions. For this reason, normative public economists have called for tax harmonization and/or central authority intervention to correct this inefficiency (Wildasin, 1989). The present model departs from this traditional argument

[1] This approach does not necessarily mean that the government is always the agent of the winning rent seeker. Appelbaum and Katz (1987) examine the situation where the government (regulator) designs a rent seeking game to maximize its own interests.

[2] The present paper considers political rents that can be decentralized. Examples include transfers to targeted households or/and specific industries (or occupations). Obviously, tariffs are not our focus.