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Is it tax competition or tax exporting?

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Abstract

This paper extends the basic tax-competition model to a framework in which jurisdictions have market power over the price of the output produced within their borders. If firms within the jurisdiction are competitive, the jurisdiction can play the role of monopoly-rent collector by using taxes to restrict the level of output. It is shown that the basic tax competition model can be thought of as a special case of this more general framework. In this framework, the opportunity to export the tax burden can partially or fully offset the well-known effects identified by the tax competition model.

JEL classification: H2; H4; H7; R

Keywords: Tax-competition; Market-power

1. Introduction

In the basic tax competition model[2] independent governments set tax rates at inefficiently low levels when competing for a mobile tax base. The typical model usually depicts a system of independent jurisdictions, each of which uses a tax on mobile capital employed within the jurisdiction. The tax is used to finance a publicly provided good, which may or may not have the characteristics of a public good. The outflow of capital that accompanies a tax increase becomes part of the cost of providing the good, but the beneficial expansion of the tax base elsewhere is not taken into account. With all governments behaving in this same fashion, there occurs a general under-provision of local public goods throughout the economy.

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[1] I thank the editor and an anonymous referee for helpful comments. Remaining errors are my own.

[2] See Zodrow and Mieszkowski [16] and Wilson [12].

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A critical assumption of the basic model is that local governments only have access to a tax on mobile capital to finance local government goods. If jurisdictions had access to a head tax or other nondistortionary tax, the basic model indicates that there would be no tax on capital and local government goods would be provided at efficient levels. One criticism of this literature, therefore, is that the results are contrived and depend on the fact that the choice of tax instrument is exogenously determined.[3] If other reasonable tax instruments were available (e.g. a tax on land value), then governments would not tax mobile capital and would supply efficient levels of local government goods.[4]

A simple justification for studying the tax competition model is that, for whatever reason, independent governments at every level do tax mobile capital, and the tax competition model highlights some of the efficiency characteristics of that tax. On the other hand, it is interesting to try to develop reasonable scenarios in which the choice of tax instrument is endogenous and yet governments still choose to tax the mobile capital employed within their boundaries. If a particular motive for taxing capital is identified, such a variable may interact in important ways with the effect identified in the tax competition literature.

There are, of course, only two reasons why a welfare maximizing local government would tax a mobile tax base effectively chasing part of it out of the community. One is if the tax, although distortionary, is less distortionary at the margin than alternative tax instruments. The second is if the tax itself directly provides net benefits to the jurisdiction; for example because it helps to export part of the local tax burden to other communities.

This paper provides a straightforward example of the second case. It considers a system of independent governments each of which faces a perfectly elastic supply of capital, but each also has market power in a particular output market. In other words, each jurisdiction is assumed to contain a high concentration of a particular industry. The industry is nevertheless assumed to be competitive. In this case the jurisdiction can use a tax on mobile capital to capture monopoly rents. The tax burden is exported to outside households, providing a direct benefit to the community, and this benefit can conceivably outweigh the perceived cost associated with an outflow of capital.

Tax exporting is, of course, a well-known phenomenon about which there exists a large literature. Tax exporting is why resource-rich regions levy severance taxes and why resort towns levy hotel taxes. But tax exporting has not been considered within the context of the tax-competition model, and when tax exporting has been associated with the taxation of mobile capital it has usually been studied from the perspective of passing the tax burden on to absentee capital owners.[5]

It is obvious that a local government could achieve the same ends by directly taxing output to capture rents, but, as in the traditional tax-competition literature, the purpose here is to try to understand the allocative effects of taxes on mobile capital.[6] Whether it is

[3] See McClure [10] for an early criticism.

[4] Wilson [15] provides a comprehensive review of the literature.

[5] See, for example, Mutti and Morgan [9]. There has been some recognition of the relevance of tax exporting through output price effects in general equilibrium models of systems of governments (see, for example, Morgan et al. [8]).

[6] See Arnott and Grieson [1] for a general treatment of the tax exporting options of local and regional governments.