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Capital tax competition under a common currency

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Abstract

We re-examine the view that capital taxes are too low when capital is mobile across tax jurisdictions. We do so by emphasising a previously neglected implication of decentralised capital tax setting when jurisdictions share a common currency. Namely, capital taxes give rise to a vertical externality by affecting the revenues of the over-arching central bank from issuing the common currency. This externality may lead, ceteris paribus, to too high regional capital taxes, and may more than offset the usual effects of tax competition. In this case, and contrary to conventional wisdom, decentralised capital taxes will be too high.

JEL classification: E42; E62; H25; H77

Keywords: Tax competition; Currency unions

1. Introduction

Mobility of tax bases between tax jurisdictions gives rise to horizontal externalities that tend to leave regional/state/national taxes too low. This standard wisdom is expressed forcefully in the well-established models of Zodrow and Mieszkowski [46] and Wilson [43] (ZMW hereafter): competition for mobile capital leads to too low capital taxes.[1] The analysis in ZMW has

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[1] Low capital taxes may not be an exclusive characteristic of open economies, that compete for capital. As Chamley [7] and Judd [29] emphasise, even when a closed economy is considered, in the long-run the accumulated distortions on capital and labour, through the effect of capital taxes on interest rates and wages, dominate the distortions on labour, that arise from the effect of labour income taxes on labour supply. So, the optimal steady-state capital tax in a closed economy is zero.

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since been enriched in various directions to provide instances in which capital taxes might be too high.[2] These instances include[3]: trade in capital- and labour-intensive goods (Wilson [43]), large capital-importing countries (DePater and Myers [13]), large foreign ownership of immobile factors (Huizinga and Nielsen [27]), competition for amenities (Noiset [37] and Wooders et al. [45]), commonality of the capital tax base between states and federal governments (Keen and Kotsogiannis [30]), government failure (Edwards and Keen [19]), political economy considerations (Fuest and Huber [23], Kessler et al. [32], Grazzini and van Ypersele [25] and Lockwood and Makris [34]).

What[4] is strikingly absent in the received literature is that in many instances competing tax-regions share the same currency. This is true for member-nations of monetary unions like the European Monetary Union. It is also true, for member-states of federal economies like US and Canada. And, it is definitely true for jurisdiction and their local governments, which de facto share the use of the country's currency. The additional feature of currency unions is the coexistence of a centralised monetary policy and a decentralised fiscal, and, in particular, capital and property tax, policy.

This paper takes on board this feature and re-examines the view that capital taxes are too low when capital is mobile across tax jurisdictions. It does so, by emphasising a previously neglected implication of decentralised capital tax setting in a single-currency area. Regional governments compete with one another for mobile capital, as in standard models, but they are located within the jurisdiction of a central bank whose money is valued and used by all residents. Manipulation of inflation policy creates seignorage, i.e. revenue from issuing money, which is transferred to the regional governments.[5] Money demand depends on income and the cost of holding money.

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[2] For an excellent recent survey, see Wilson [44].

[3] On a related topic, Kehoe [31], by building on the capital levy problem discussed, for instance, in Fischer [22], has shown that an attempt to coordinate to higher taxes may not prove beneficial even if tax competition leads to a 'race to the bottom', as long as governments cannot pre-commit to their tax policies. In such an environment, an anticipation of coordination to higher taxes after savings have taken place will lead to low savings and hence low aggregate capital stock in the first place. On another related topic, Bucovetsky and Wilson [5] show that if tax authorities can deploy a savings, as well as a capital, tax then the resulting policy mix is efficient, and hence there is no scope for coordination.

[4] Nevertheless, the message of the basic ZMW model and anecdotal evidence of capital taxes in EU and OECD countries seem to drive many of the debates for tax coordination (for empirical work on whether countries are involved in tax competition, see Devereux et al. [14] and references therein). In particular, the Ruding [10], Monti [11] and, more recently, Primarolo [12] reports propose the introduction in European Union of a minimum level for some capital taxes, to combat tax competition (for a recent defence of proposals for a minimum level of capital taxes, see Sorensen [41]). Moreover, recent research on fiscal coordination in Economic and Monetary Union (EMU) seems to have accepted that in the absence of coordination taxes on mobile factors will be too low, and focuses, instead, on other aspects of fiscal policy (e.g. stabilisation, income taxation, debt accumulation). See, for instance, Sibert [40], Dixit and Lambertini [16,17], Dixit [15], Beetsma et al. [3], Engwerda et al. [20], and references therein.

[5] The transfer of seignorage to regional governments can take place in many ways. For instance, in the European Monetary Union, the income of the European Central Bank is distributed between the national central banks, with the national banks being ultimately under the (financial) control of national governments. For the rules and provisions of the allocation of income between the national central banks see the "Protocol on the Statute of the European System of Central Banks and of the European Central Bank", especially Articles 28–33 (http://www.ecb.int/ecb/legal/pdf/en_statute_2.pdf). Alternatively, in monetary unions like USA and Canada, the Central Bank transfers its revenue to the central government, with the latter facilitating a complex system of inter-regional grants according to the rules and provisions of the federal system. So, for instance, King and Plosser [33] report that for USA the real value of the transfers from the central bank to the Treasury amounted to 0.15–0.47%, depending on the measure, of real GNP during the 1952–1982. Also, the transfer in 2001 from the Federal Reserve Bank to the Treasury was $27 billion (see the 88th Annual