How large are the welfare costs of tax competition?

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Abstract

Competition among regional governments may lead to suboptimal levels of capital taxation, as governments ignore the external benefits of capital flight to other regions. However, there have been few attempts to quantify the magnitude of the resulting efficiency losses. This paper presents extensive calculations of the efficiency costs over a wide range of parameter scenarios and assumptions about government behavior, using various generalizations of Wildasin [Journal of Urban Economics 25 (1989) 193–213]. The efficiency costs tend to be fairly moderate under most (though not all) scenarios, and particularly when allowance is made for the possibility of Leviathan and non-competitive government behavior.

1. Introduction

There is a large theoretical literature on the welfare implications of fiscal competition between governments of different regions, such as states within the United States, provinces within Canada, or countries within the European Union.[1] A key theme of this literature is that taxes on mobile factors such as capital, and hence overall public spending, may be inefficiently low due to a fiscal externality. When an individual government chooses its capital tax it does not take account of the efficiency gains to other regions within a bloc from the resulting capital flight from its own region; consequently, the local cost of higher taxes exceeds the social cost (Wildasin [37,38], Wilson [43], Zodrow and

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[1] See Wilson [40] for a comprehensive review.

Mieszkowski [44]). Put another way, to the extent that reducing capital taxes in one region attracts capital from neighboring regions, the local incentives for lower taxes are socially excessive.

In principle this externality may justify a system of subsidies from a central authority to regional governments, although when regions are heterogeneous the corrective measure is a complicated one that requires a different subsidy for each region (e.g., DePater and Myers [10], Wildasin [39]).[2] This approach may not be feasible in the European Union because the budget of the European Commission is only around 2% of GDP. Instead, the European Commission is considering imposing minimum rates of corporation income tax and other capital taxes across the European Union.[3]

However, several factors can dampen the severity of the fiscal externality. At the region bloc level, the supply elasticity of capital may be non-zero. Thus, as higher taxes across regions depress the net of tax return on capital at the bloc level, there might be a reduction in savings, or capital flight outside the bloc. These effects limit the socially optimal size of the public sector for regions in the bloc (e.g., Boadway and Wildasin [5], Kotlikoff [18]). Individual regions may be large enough to have some monopsony power in the capital market for the bloc. To the extent that an individual region faces an upward sloping, rather than flat, supply curve for capital, this will limit capital flight out of that region and reduce the fiscal externality. And regional governments may anticipate some reaction from neighboring regions in response to their own tax changes: the local incentives to reduce taxes are modified if a regional government anticipates other governments will cut taxes in response.[4]

Moreover, it is also possible that tax competition is desirable because it curbs excessive government spending and taxation, rather than undesirable because it results in an inefficiently small public sector. This can be the case if government behavior is in part driven by the revenue-maximizing behavior of bureaucrats, or by the interplay of interest groups, rather than by a desire to maximize social welfare or satisfy the median voter (Brennan and Buchanen [6], Edwards and Keen [11], McGuire [21], Rauscher [29], and Sinn [32]). In addition, decentralization allows (mobile) voters with different preferences to choose among jurisdictions providing different amounts of public goods, though this Tiebout [36] type of competition is beyond the focus of the present paper. Thus, the theoretical literature is ambiguous as to whether the public sector is actually too small or too large, and whether there is a case for policies to increase the size of government (e.g., subsidies from a central authority, minimum tax laws), or for policies to reduce the size of government (e.g., California's Proposition 13, which limits the rate and base of local property taxes).

Little quantitative work has been done on the magnitude of the welfare effects of fiscal competition. Indeed, Oates [24, p. 10] writes: "We are badly in need of empirical studies

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[2] In the United States, Canada, and Australia the central government does provide extensive subsidies for regional governments. See Rounds [30] for a detailed comparison of these countries.

[3] Currently, the European Union imposes a minimum rate of value-added tax (17.5%) and a minimum rate of gasoline tax (though the latter is currently too low to be binding). Tax harmonization is a second-best response to the fiscal externality as it imposes the same rate of taxation across regions. The optimum amount of government spending and taxation differs across regions when they are heterogeneous: for example, electorates may differ in their preferences for redistributive public spending programs.

[4] See, for example, Bucovetsky [9], Hoyt [14], Mintz and Tulkens [23], and Wildasin [38].