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A note on tax competition, attachment to home, and underprovision of public goods

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Abstract

This paper analyzes efficiency in the provision of public goods when there is tax competition, but investors have attachment to home, i.e., a biased preference for investing in the region where they live. Investors are assumed to be heterogeneous in the costs to invest outside the home region. As a result, in comparison with the no attachment case, the capital outflow response to an increase in the tax rate is reduced because only investors facing small mobility costs will move capital out. In a symmetric equilibrium, tax rates are increased and the extent of the underprovision of public goods caused by tax competition is lessened.

JEL classification: H71; H73

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1. Introduction

The tax competition literature analyzes the distortions created by the reliance of public finance on a mobile tax base. In the case of capital taxation, jurisdictions' fear of loss of capital invest-

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[1] The author is grateful to Jan Brueckner for advice and suggestions, and to Marco Polamartschuk, seminar participants at the University of Illinois at Urbana-Champaign, and anonymous referees for helpful comments. After the first version of this paper was completed, the author became aware of the work by Leite-Monteiro and Sato [M. Leite-Monteiro, M. Sato, Economic integration and fiscal devolution, Journal of Public Economics 87 (2003) 2507–2525] that also considers heterogeneity of capital regarding mobility costs. Their paper, however, does not discuss the efficiency in the provision of public goods.

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ment induces inefficiently low tax rates, resulting in underprovision of public goods relative to the social optimum (see Wilson [13] for a survey of the literature).

However, the usual assumption of perfect capital mobility can be contested by empirical evidence that indicates the persistence of significant home bias in investment decisions, despite the increasing openness of the economy. This home bias was first demonstrated by Feldstein and Horioka [3], who showed that investment rates were highly correlated with domestic saving rates across a sample of OECD countries.[2] In terms of subnational regions, Helliwell and McKitrick [6] did not find the same correlation across Canadian provinces, but Figueiredo et al. [4] noted a significant advantage of the home region (the "prior locality of economic activity") in the location choice of new industrial investments in Portugal. Regarding the causes of such home bias, most of the theoretical explanations focus on frictions in asset markets like transaction and information costs (see Obstfeld and Rogoff [9], Gordon and Bovenberg [2], and Coakley et al. [1]).

The objective of the present paper is to analyze tax competition in the presence of home bias in capital investment, with the population of investors assumed to be heterogeneous in the degree of home bias. Heterogeneity in home attachment was first considered in the fiscal competition literature by Mansoorian and Myers [8], in a model of population migration control, where they assumed that individuals differ in their preferences for residing in a given region. This bias, called "attachment to home," was justified by a nonpecuniary benefit derived from living in the home region.[3] Their paper shows that, with attached individuals, governments would have less incentive to make interregional transfers to control population migration. In the present paper, home attachment in investment decisions is assumed to come from higher costs related to obtaining information and managing resources when investing outside the home region. It is plausible that such costs are different for each investor because people differ in the ability to invest. Hence, some investors are more attached to home than others. As a result, the capital outflow response to an increase in the tax rate is reduced compared to the no attachment case. Intuitively, only the less attached investors move capital out when the net-of-tax returns on capital become higher abroad. Further capital flight would require an increasingly larger difference in returns between regions because the remaining capital stock is owned by more attached individuals. The choice of tax rates is affected. The analysis shows that, in a symmetric equilibrium, governments choose higher tax rates than in the absence of home bias, lessening the extent of the underprovision of public goods caused by tax competition.

Regarding the effects of capital mobility costs on tax rates, Persson and Tabellini [10] obtain similar results in a simplified setting, but their paper analyzes the political determination of fiscal redistribution rather than the efficiency issue. Moreover, the authors did not justify one of the key assumptions of their model (that mobility costs are increasing in the amount of capital exported).[4]

This paper is organized as follows. The next section presents the setup of the model. The choice of tax rates in a symmetric equilibrium is analyzed in Section 3. Section 4 presents remarks on a more general approach. Section 5 concludes.

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[2] More recent evidence confirmed the persistence of the bias across countries (see Coakley et al. [1]). There is also evidence of home bias in international portfolio diversification, first noticed by French and Poterba [5].

[3] The authors suggested that the consideration of attachment to home addresses the case of culturally diverse regions, such as the European Economic Community or Canada.

[4] Other related papers are Westerhout [11], which studies the case where capital mobility is restrained by information asymmetry between domestic and foreign investors, and Lee [7], which considers mobility costs that arise after capital is first installed.