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Tax competition and tax structure in open federal economies: Evidence from OECD countries with implications for the European Union

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Abstract

Tax competition arguments suggest that governments that operate in an open economy (such as local governments) should not and will not rely on non-benefit taxes, such as the income tax. Yet we observe reliance on income taxes by local governments in many countries, and such reliance changes over time. Evidence from a panel data set of 13 OECD countries over the period 1975–1984 suggests that competition between levels of government (resulting in a vertical fiscal externality) and between governments at the same level (resulting in a horizontal fiscal externality) provide some economic rationale for these changes. Moreover, the evidence indicates that the vertical and horizontal fiscal externalities interact. These results have some interesting implications for fiscal policy in the European Union, particularly as the EU continues to evolve. One implication for the EU is that enlargement that increases tax base disparities within the EU (and is not accompanied by an EU-level income tax) will tend to lower national income tax rates, although this must be qualified because it also depends on the mobility of the population. A second implication is that fiscal expansion of the EU to include an EU-level income tax may tend to lower the reliance of national governments on income taxes through the vertical externality, but may also tend to equalize tax bases across countries, and so

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increase reliance on national income taxes through the horizontal externality.

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1. Introduction

The degree to which local governments across the OECD countries rely on personal income taxes to finance their expenditures differs tremendously and changes over time. Tables 1 and 2 show that individual income tax revenue of local governments as a proportion of GNP (averaged over the 1975–1984 period) ranged from a low of zero or close to zero in countries such as the USA, the UK and the Netherlands to a high of 0.14 in Sweden and 0.12 in Denmark.[1] Moreover, reliance on local income taxes within these countries changes over time, sometimes increasing as in Sweden and sometimes decreasing as in Norway.

This is quite extraordinary because both normative and positive arguments suggest that governments that operate in an open economy environment, such as local governments, should not and will not rely on non-benefit taxes, such as the income tax. The well-known argument holds that a taxed factor can migrate to avoid the tax in an open economy; this produces an excess burden (the normative argument) and may lead to low or zero tax revenue in equilibrium (the positive argument). The traditional normative view can be found in Stigler (1957) and Oates (1972), for instance. The implications for redistributive tax policy in the European Union have been discussed in Sinn (1990), Persson and Tabellini (1992), and Cremer and Pestieau (1996).[2] Two notable surveys on redistribution and factor mobility are Cremer et al. (1995) and Wildasin (1998).

This paper attempts to explain empirically changes in local income taxes over time by appealing to vertical and horizontal fiscal externalities that exist in an open federal economy. A theory of horizontal externalities has seen its modern development in the tax competition literature such as Wildasin (1988, 1989) and

[1] A similar ranking results if local income tax revenue is taken as a proportion of total local government revenues. For 1975, for instance, this proportion for Sweden is 0.51, 0.42 for Denmark, and zero for the UK.

[2] Several papers in the recent special issue of the *European Economic Review* on The Domain of the State, such as Edwards and Keen (1996) and Picketty (1996), address related issues, as do several papers in a recent special issue of *International Tax and Public Finance*, summarized in Wildasin (1996). See also Bahl et al. (1996) for evidence on redistributive tax structure for US states.