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Can partial fiscal coordination be welfare worsening? A model of tax competition

Maurice Marchand,[a,b] Pierre Pestieau,[a,c,d] and Motohiro Sato[e,*]

[a] *CORE, Belgium*
[b] *Université catholique de Louvain, Voie du Roman Pays 34, B-1348 Louvain-la-Neuve, Belgium*
[c] *CREPP, Belgium*
[d] *Université de Liège—Sart Tilman, Boulevard du Rectorat 7, Bâtiment 31, B-4000 Liège, Belgium*
[e] *Graduate School of Economics, Kunitachi, 186-8601 Tokyo, Japan*

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Abstract

Most work on tax competition argues that mobile factors tend to be undertaxed except if there is coordination of tax policies. Full coordination is not however always feasible, and as a consequence some measures of partial coordination have been proposed such as minimal withholding taxes on interest income. We show that partial coordination can be in some instances welfare worsening and that then no coordination is to be preferred.

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1. Introduction

The last few decades have seen growing integration of economic activities of different countries that has facilitated mobility of production factors such as capital and labor. While economic integration is beneficial in certain aspects, there has been an increasing

* Corresponding author.
E-mail addresses: p.pestieau@ulg.ac.be (P. Pestieau), satom@econ.hit-u.ac.jp (M. Sato).

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concern that it may lead to fiscal competition among governments over mobile tax bases, constraining their ability to raise revenue for allocative and redistributive purposes. Fiscal competition results in the tax burden being shifted away from mobile tax bases into immobile ones and leads to the so-called race to the bottom. Such an unwanted outcome calls for fiscal coordination among governments.[1] In some cases coordination is enough to restore efficiency.

However, for political reasons it is not always possible to agree on full tax coordination and one could be forced to resort to partial coordination. Suppose for example that both capital and unskilled labor are mobile and that a tax is imposed on both of these factors as well as on some immobile factors. Suppose further that in autarky social optimality implies taxing capital income and subsidizing income of unskilled labor. In a setting with a large number of identical countries we have no tax at all and thus no redistribution. Ideally, one would like to impose the first-best tax/subsidy structure to all countries. But if this is not possible and if the only feasible policy is to adopt a minimum tax on capital income, should we implement it? We show in this paper that such a partial coordination policy can only be socially desirable if the technology is such that the competition for the mobile factor left alone does not have so perverse effects that national social welfare decreases.

Paradoxically, there has been little work on this issue of partial coordination. Fuest [3] analyzes a model where national governments react to coordinated capital tax increases by providing more public inputs in order to attract mobile capital and thus reduce the effectiveness of coordination. Cremer and Gahvari [2] analyze a model with tax evasion and endogenous tax auditing. They show that governments react to tax coordination by cutting effective tax rates via reduced auditing. Finally, Fuest and Huber [4] argue that partial coordination is unlikely to be effective if the interaction between different parts of the tax system is not taken into account. The reason is that coordination agreements covering only one tax will induce governments to adjust their tax policy using the other tax instruments; the inefficiencies associated with tax competition will then persist. Our paper is related to these works, but differ in that we focus on income redistribution and derive a condition for partial fiscal coordination to be welfare worsening/enhancing in an explicit and simple form.

The plan of the paper is as follows. In Section 2 the basic model is presented and the closed-economy situation leading to full redistribution of income between workers and rentiers/capitalists is discussed. The next section analyzes the consequences of integrating small countries whose governments feel unable to influence the world prices of the mobile factors through their fiscal policies. In the absence of policy coordination all taxes are set equal to zero, which means that there is no redistribution at all. In Section 4 containing the main result of the paper, the welfare effect of some partial coordination of fiscal coordination is studied. The last section presents some concluding remarks.

[1] For surveys see Wilson [8], Cremer et al. [1], Wellich [7], or Haufler [5].