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Tax competition, tax exporting and higher-government choice of tax instruments for local governments

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Abstract

This paper presents a theoretical model with tax exporting due to external ownership of a fraction θ of the land in each local jurisdiction. There are n local jurisdictions in a metropolitan area ($n \geq 1$) and many metropolitan areas in a world economy. The paper examines the usage of business property taxes and source-based wage taxes by local jurisdictions, first in the presence of and then in the absence of residence-based lump-sum taxes, and how this depends on θ and n. The paper then examines the choice of a world, national or state government as to whether to allow local (metropolitan or sub-metropolitan) governments to use business property taxes, wage taxes or both, assuming that the local governments choose the actual tax rates.

JEL classification: H71; H73
Keywords: Tax competition; Tax exporting; Property tax; Local wage tax; Local income tax

1. Introduction

In this paper, I present a theoretical model with tax exporting due to nonresident landownership, which can be used to examine the tax-rate choices of metropolitan or sub-metropolitan governments, and the choices of state, provincial, national or world governments as to which tax instruments lower-level governments are allowed to use.

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It is useful to start by discussing the real world. In various countries, local governments (counties, cities, suburbs and school districts) use different types of taxes.[1] In most countries, the national (or provincial or state) governments limit the tax instruments that local governments can use, sometimes limiting them to a single type of tax. Property taxes are 100% of local tax revenue in Australia and Ireland, 99% in the United Kingdom, 93% in Canada and 72% in the United States. Income taxes make up 100% of local tax revenue in Sweden, 94% in Denmark and 79% in Germany. In some countries, there is more balance between different taxes.[2]

Local taxation varies among states in the United States. Property taxes (residential and business) are the most important source of local government tax revenue. Local sales taxes are used in 31 states. Only 16 of the 50 states allow local governments to use wage or income taxes and they are actually used in 14 states, though some allow only one or two large cities to use them.[3] Local wage or income taxes are widely used and make up a substantial percentage of overall local tax revenues in Maryland (28%), Kentucky (25%), Ohio (22%) and Pennsylvania (18%). In 9 of the other 10 states, they make up less than 10% of local tax revenue. Pure source-based local wage taxes, the kind considered in this paper, are used in Kentucky and four other states.

One branch of the theoretical literature that is relevant to local government tax choices consists of "traditional business tax competition models".[4] A (large or finite) number of spatially separated metropolitan areas, each with a fixed population of resident-workers, produce output using labor and business capital. Metropolitan areas compete for business capital, which is freely mobile throughout the world (or national) economy.[5] If a residence-based lump-sum tax and a source-based business capital tax can both be used (by each metropolitan area), then only the lump-sum tax is used and a local public good is provided at the efficient level. If only a business capital tax can be used, then it is underused and the local public good is underprovided.[6] A business capital tax is the same as a business property tax in these models (since land is typically absent).

[1] Also, in most countries, a significant fraction of local government revenue comes from intergovernmental grants from regional governments or from the central government.

[2] Percentages of local government tax revenues that come from income taxes, property taxes, sales taxes and other taxes are (for selected countries, based on International Monetary Fund, 2002): Austria (60, 0, 40, 0), Belgium (38, 0, 62, 6), France (16, 37, 11, 36), Germany (79, 15, 6, 0), Japan (63, 23, 13, 1), Spain (19, 29, 47, 5) and the United States (6, 72, 22, 0).

[3] See Volumes 1 and 2 of United States Advisory Commission on Intergovernmental Relations (1994) for much of the information in this paragraph.

[4] See Beck (1983), Brueckner (2000), Bucovetsky (1991), Bucovetsky et al. (1998), Hoyt (1991a), Oates and Schwab (1988), Wildasin (1988, 1989), Wilson (1986, 1991), Zodrow and Mieszkowski (1986) and the references in footnote 6. See Wilson (1999) for a survey. Sometimes, "tax competition" refers to situations in which a local public good is underprovided.

[5] See Gordon and Bovenberg (1996) concerning whether business capital is freely mobile throughout a world economy, or just throughout a national economy.

[6] See the references in footnote 4. Bucovetsky and Wilson (1991), Gordon (1986), Razin and Sadka (1991) and part of Wilson (1991) have a source-based business capital tax, and a residence-based wage tax that is distortionary because of labor-leisure choice. If there are many metropolitan areas, only the wage tax is used and the local public good is underprovided. If there are finitely many metropolitan areas, both taxes are used. Wilson (1995) assumes workers can freely *migrate* between metropolitan areas (in Braid, 1996, and this paper, they freely *commute* between local jurisdictions within a metropolitan area). See also Bucovetsky (1993, 1995).