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EU regional policy and tax competition

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A B S T R A C T

The European Union (EU) provides coordination and financing of trans-European transport infrastructures, i.e. roads and railways, which link the EU member states and reduce the cost of transport and mobility. This raises the question of whether EU involvement in this area is justified by inefficiencies of national infrastructure policies. Moreover, an often expressed concern is that policies enhancing mobility may boost tax competition. We analyze these questions using a model where countries compete for the location of profitable firms. We show that a coordination of investment in transport cost reducing infrastructures within union countries enhances welfare and mitigates tax competition. In contrast, with regard to union-periphery infrastructure, the union has an interest in a coordinated reduction of investment expenditures. Here, the effects on tax competition are ambiguous. Our results provide a rationale for EU-level regional policy that supports the development of intra-union infrastructure.

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1. Introduction

The European Union (EU) invests substantial resources in transport infrastructures, i.e. in roads and railways which link the EU member countries to each other. The intended effect is to reduce mobility costs of workers and transport costs for goods and factors of production. This reduction of mobility costs is in line with the objective of fostering economic integration in the common market. However, from an economic perspective, these policies also raise various concerns. Firstly, the question arises whether EU involvement is necessary, given that member states themselves also have an interest in improving their infrastructure. Secondly, increasing mobility across borders has implications for other policy areas as well, in particular tax policy. As some member states are concerned about tax competition, the question of how EU infrastructure policies affect tax competition may be of crucial importance.[1] A widespread view is that increased international mobility leads to more intensive tax competition.

In this paper, we analyze the interaction between regional policies, i.e. public investment in regional infrastructure, and tax competition. We develop a model of open economies competing for foreign direct investment through tax and infrastructure policies. Infrastructure investment leads to the reduction of transport costs of goods across borders. We assume that some countries form a union and are able to coordinate their infrastructure policies but not their tax policies. This reflects the current situation within the European Union, where large infrastructure policies are (co-)financed by the supranational EU-level, while business taxes remain uncoordinated. We ask whether national infrastructure policies are

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[1] For instance, on a visit in Poland after its accession to the EU, on May 26th 2004, the German chancellor Gerhard Schröder argued, with reference to EU regional policies: “It is certainly unreasonable that we finance an unbridled tax competition among each other via the EU budget”, cited after Jan Stoyaspal: *Want Lower Taxes? Go East*, TIME Magazine of 11th July 2004.

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efficient for the union as a whole and how coordination of infrastructure policies affects tax competition, given that the member states retain autonomy in corporate taxation.

Our results show that national governments will invest in infrastructure in order to attract firms and to reduce import prices faced by domestic consumers. However, uncoordinated national infrastructure policies do not lead to efficient outcomes for the union as a whole. There is a potential for welfare enhancing coordination of infrastructure policies. These welfare gains arise not only because national infrastructure investment gives rise to spillovers, but also because more infrastructure investment may mitigate tax competition. This is surprising because policies which enhance mobility are usually considered as intensifying tax competition. In our model, this is not the case because more infrastructure reduces transport costs and thus reduces the difference between the prices of imported compared to domestically produced goods faced by consumers. Attracting firms to make them produce close to the consumers becomes less important, so that governments are less willing to cut taxes. We also consider investment in infrastructure which reduces the transport costs to non-union countries. In this case, uncoordinated expenditures are too high from the perspective of the union, and the effect of infrastructure spending on tax competition within the union is ambiguous.

In the empirical literature on international taxation, the idea that decreasing mobility costs intensifies tax competition is taken for granted.[2] Tax competition is predicted to be strongest between neighboring countries. Indeed, proximity is a strong determinant for the location of investment by multinational investors, see e.g. Markusen (2002) or Buch et al. (2005). In contrast, the literature dealing with tax competition between countries is somewhat inconclusive. There are only very few papers which set out to measure tax competition directly and, more specifically, there is no unanimous approach towards geographical distance. Whereas Devereux et al. (2008) do not account for the impact of distance and find significant evidence for tax competition, Overesch and Rincke (2008) show that the evidence becomes weak when distance is omitted from the regression equation.[3]

Apart from this, our paper is related to several distinct strands of literature. Firstly, there is a theoretical literature dealing with the regional policies of central governments in federal systems. Fuest and Huber (2006) analyze regional policy from a public finance point of view. They argue that a coordination of regional policies helps internalizing positive externalities of national policies. However, in their model, regional policies do not affect transport costs. Ulltveit-Moe (2007) explores whether redistributive goals can be achieved by more efficient instruments than those used by the EU. Behrens et al. (2007) analyze transport cost reducing regional policies in a 'new economic geography' model. Their focus is on intra-versus interregional agglomeration, though.

Secondly, there is a literature on intergovernmental competition over public spending on infrastructure, see in particular Keen and Marchand (1997). They consider a model where the government provides infrastructure and a public consumption good and show that there is too much infrastructure spending in the uncoordinated equilibrium. Thirdly, several papers analyze partial coordination in the sense that policy coordination agreements cover only a subset of the available policy instruments. This literature shows that partial coordination agreements may fail to be effective because governments react by adjusting other instruments, see Fuest (1995) and Cremer and Gahvari (2000). Fourthly, there is a literature which analyzes interjurisdictional competition for profitable firms.[4] These contributions assume that a potential reason why it may be desirable for a country to attract investment is the existence of transport costs. If production takes place close to consumers, consumer prices are lower compared to the case where goods have to imported. Seen from the firm's perspective, it is desirable to locate where consumers are in order to charge higher prices net of transport costs.[5] A final related strand of literature analyzes the effects of policy coordination in a subset of competing countries.[6] Basically, these papers show that policy coordination may yield welfare gains even if only a subset of countries participates.

The remainder of the paper is organized as follows. Section 2 gives a quick overview on infrastructure expenditures of the European Union. In Section 3, the model is presented. Section 4 analyzes competition and coordination of tax policies and regional infrastructure expenditures. Section 5 concludes.

2. Infrastructure expenditure and tax competition within the European Union

According to the EU, transport infrastructure investments contribute to achieving sustainable growth, which is one of the core objectives of EU policies. The Fourth Report on Economic and Social Cohesion by the European Commission (2007a) states: "An efficient transport system is a key factor underlying regional competitiveness and growth. Accordingly, it is one of the main areas of investment of cohesion policy." (p. 100) In the 2008 budget of the European Union, 44.9% of total expenditures are spent for this purpose. This budget share corresponds to 58 billion € of which 46.9 billion € are planned for cohesion policies and 11.1 billion € for the purpose of supporting competitiveness.

Since the actual level of transport infrastructure expenditures depends on the projects the member states apply for, it is helpful to take a look at the pattern of expenditures in the past. Financing is mainly provided via the European Regional

[2] See the surveys by Devereux (2007) and Hines (1999).

[3] Further evidence for tax competition is provided in Winner (2005) and Lahrèche-Révil (2006).

[4] See e.g. Black and Hoyt (1989), Haaparanta (1996), Haufler and Wooton (1999, 2006) and Fuest (2005).

[5] In so far, this literature builds on the New Trade Theory or New Economic Geography, see Baldwin and Krugman (2004).

[6] Apart from Haufler and Wooton (2006), who analyze the coordination of tax or subsidy policies within a union of countries, important contributions to this literature are Konrad and Schjelderup (1999) and Sørensen (2004).

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