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Economic versus political symmetry and the welfare concern with market integration and tax competition

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Abstract

The paper studies the implications of increased capital market integration and the associated increased tax competition for world welfare. We consider a population with heterogeneous endowments of capital in a model of redistributive politics. We show that if countries have the same average capital endowments but differ with respect to the endowments of their decisive majority, autarky may be socially preferred to integration under any aversion to inequality. We then reverse the conclusion by assuming that the decisive majority has the same endowment but countries differ in their average capital endowments. In proving these results we show that integration may decrease world output and increase the utility of the poorest members of the economy.

Keywords: Market integration; Globalization; Tax competition; Political economy; Welfare

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1. Introduction

Surely, a key feature of the world economy in the twentieth century has been increased economic integration of international markets. The mobility of factors and goods has been enhanced as new technologies have dramatically reduced

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transportation and communication costs and as institutional or political barriers to that mobility have fallen. It is then not surprising that one of the important themes in the media and the economics literature is about the consequences of a globalized economy on the economic structure of our societies.

For most economists integration of international markets is viewed as a desirable development. At its core, it is about individuals exploiting mutually beneficial gains from trade with the obvious potential for the enhancement of efficiency. But increased integration also implies increasingly mobile tax bases and, as pointed out by Edwards and Keen (1996), this in turn raises the prospect of increasingly fierce international tax competition as national authorities attempt to expand their tax base by offering more favourable tax treatment. It has been argued that as tax rates are reduced to avoid flight of the tax base, the ability of national governments to provide public services and to undertake redistribution at traditional levels is threatened.

The competition for mobile capital is considered by some authors as one of the greatest dangers to the survival of the welfare state. Sinn (1994), for example, predicts an European Union where ''. . . fiscal competition will wipe out redistributive taxes on mobile factors and reduce the tax system to mere benefit taxation''.[1] He argues that the losers will include immobile workers who will bear a larger share of taxation and the poor who will lose because governments will not be able to maintain their current scales of redistribution.

The theoretical literature on capital tax competition is voluminous and began with the ideas of Hamada (1966) and Oates (1972), and the works of Wilson (1987), Zodrow and Miezskowski (1986), and Wildasin (1988). This research largely supports the view that capital tax competition may lead to inefficiencies and reduce redistribution. The logic is simple. Imagine countries non-cooperatively choosing taxes on freely mobile locally employed capital to finance a uniform public service. As discussed in Wildasin (1988), when a government of one country considers increasing its tax rate in accounting for the capital flight it does not consider the benefit of increased tax base in the competing countries (a beneficial externality). Thus each country chooses a tax in equilibrium such that Pareto improvements are possible by a coordinated increase in tax rates and benefit levels.[2]

We consider a positive model of redistribution in the presence of fiscal competition. Capital and domestic labour are combined to produce a composite good. In each country, the redistributive policy consists of a tax on locally employed capital and a uniform benefit for redistribution and is democratically

[1] For antidotal evidence of tax competition, see Edwards and Keen (1996). The concern amongst policy practitioners that capital market integration intensifies tax competition is also evident in the policy coordination guidelines recently issued by the OECD and the EU (see OECD (1998) and European Commission (1998)).

[2] We refer the reader to a recent survey by Wilson (1999) which provides many references.