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Tax competition and Leviathan

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Abstract

Attitudes towards downward pressure on tax rates from international tax competition depend on attitudes towards government. This paper synthesises the two extremes which, as in other areas of public finance, have dominated the debate, typically being presented as stark alternatives: the view of government as a Leviathan (from which tax competition emerges as a useful constraint on policy-makers) and the view of government as a benevolent maximiser of their citizens' welfare (from which it emerges as a source of inefficiency). Conditions are derived under which, when policy-makers are neither entirely benevolent nor wholly self-serving, tax coordination benefits the representative citizen.

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1. Introduction

In enhancing the mobility of capital, goods and people, increasing international economic integration means, to a large extent, increasing the international mobility of tax bases. This, in turn, raises the prospect of increasingly fierce international tax competition, as national authorities attempt to expand their tax bases by offering more favourable tax treatment than is available elsewhere. [1] Taxes on capital income, in particular, look increasingly vulnerable to international tax

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competition. Indeed such competition may already be a reality, with the worldwide tax reforms of the 1980s leaving the average rate of corporate taxation in the OECD about 6 points lower at the end of the decade than at its start (a proportionate reduction of about 12 percent), and the average top rate on interest income 13 points lower (a proportionate reduction of about 25 percent). [2] The recent experience of tax reform in the Nordic countries is even more striking. [3] In 1991, Sweden moved to a schedular tax system with a 30% flat rate tax on capital income (far below the previous top marginal rate); in 1992, Norway introduced a similar system but at the lower rate of 28%; Finland followed suit in 1993, but at the still lower rate of 25%. The proper interpretation of these developments is not clear-cut. It is hard to believe, however, that international tax competition is not an important part of the story. The perception that international tax competition is likely to become increasingly cut-throat has, in any event, come to play a major role in tax policy discussions, the question then arising as to whether some form of international tax coordination is appropriate. In the European Union, in particular, such measures have already been adopted in relation to commodity taxation (the abolition, at the start of 1993, of restrictions on the importation for personal use of tax-paid goods being accompanied by the imposition of minimum rates of indirect taxation) and, even more controversially, are under consideration for capital income taxation (with the proposal for a minimum withholding tax on interest income).

This paper addresses the deceptively simple question at the heart of these policy issues: Is international tax competition – or, by the same token, tax competition between lower-level governments in a federal structure – a good thing or a bad thing? Or, to put the point more precisely (and in the form that it will be addressed): Starting from the non-cooperative equilibrium, would the representative citizen benefit from, or be harmed by, some degree of international tax coordination?

Two widely divergent views dominate both the academic literature and the policy debate. In one, tax competition is an essentially straightforward instance of the presumption that non-cooperative behaviour will lead to inefficient outcomes. [4] Thus Sinn (1994), for instance, foresees a future for the European Union in which

[1] In addition to this 'base-stealing' motive, pointing to excessively low tax rates, there may be a 'tax exportation' motive pointing towards excessively high rates (a point emphasised in the context of commodity taxation by Mintz and Tulkens (1986)). In practice, however, it is the former concern that typically dominates the policy debate (the latter arising only for countries that are, in the relevant sense, 'large').

[2] The figures, from Owens (1993), are for 18 OECD countries.

[3] See, for instance, Sørenson (1994) and Tikka (1993).

[4] This is again a sweeping generalisation. There are circumstances in which non-cooperative behaviour by national welfare-maximisers leads to a constrained efficient outcome: with mobile labour, for instance, the Tiebout mechanism can generate an efficient outcome (albeit only under restrictive conditions); another example is the result of Kehoe (1989) discussed in the text below.