

Capital tax competition with socially wasteful government consumption

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Abstract

Models of international tax competition typically suppose a benevolent government. This paper considers a government with self-interested consumption objectives in the presence of distorting taxes on capital investment, savings and labor income. In such a model, the effects of international tax coordination on the welfare of residents are ambiguous when a residence-based capital tax is not available. In contrast, government use of taxes is inefficient from the viewpoint of residents in the presence of residence-based capital taxation. © 2001 Elsevier Science B.V. All rights reserved.

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1. Introduction

Models of international capital tax competition, in general, assume a benevolent government that maximizes the welfare of residents subject to a public budget constraint for the set of taxes available. A core result of the early models is that, in response to tax competition, each government lowers source-based capital taxes in the Nash equilibrium to attract internationally mobile capital. The outcome is inefficient, in the sense that public goods are not provided according to the Samuelson rule (cf. Zodrow and Mieszkowski, 1986).

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A counterexample to this result is provided by Razin and Sadka (1991). In a small country model with endogenous labor and capital supply, they conclude that symmetric Nash equilibria are (second best) efficient if residence-based capital taxes and wage taxes are available. Interestingly, as Bucovetsky and Wilson (1991) prove, the Nash equilibrium with positive source-based and residence-based capital taxes continues to be efficient. As a consequence, the Nash equilibrium with residence-based capital taxes is efficient. This conclusion can be related to the production efficiency theorem (cf. Eggert and Haufler, 1999).

This above approach, which focuses on the potentially detrimental impacts of decentralization, contrasts with arguments found both in the policy debate (cf. Commission of the European Communities, 1998) and in economics literature, that tax competition may be beneficial, since decentralization of tax discretion may reduce the monopoly power of institutions relative to centralization. The Leviathan argument of a self-interested consuming government (see Brennan and Buchanan, 1977), stresses the potential gains from limits on the growth of the public sector. This view is related to the public choice perspective (cf. Eichenberger and Frey, 1996). In this perception of governments, international competition is welcome as a device to limit government discretion.

Both perspectives are noted by Persson and Tabellini (1992). They set out a model where tax competition does not necessarily reduce the size of government. In their model, voters delegate decisions to a government with a preference for higher budgets that will compensate them for the perceived negative effects of tax competition. Tax competition then, is not a problem.¹ If, however, the preferred policy program is not available, tax competition can again be beneficial or harmful for residents. Different kinds of distortions must then be considered to determine whether international tax coordination or a reduction in the size of institutions by means of tax competition is desirable.

Perhaps the most cited paper concerned with both the inefficiency of government and capital tax competition issue is Edwards and Keen (1996). As a guideline for constitutional recommendations, they derive rules for an optimal tax system from the viewpoint of residents.² Their main result is that, starting from the Nash equilibrium, a tax increase followed by international tax coordination is beneficial for residents, if the welfare loss due to tax competition is greater than wasteful government consumption at the margin. However, the analysis is based on the model of Zodrow and Mieszkowski (1986), in which factor supply is exogenous and, hence, taxes on wages and interest income are lump sum.

In this paper, I introduce endogenous factor supply in an adaptation of Edwards and Keen (1996). This allows us to contrast the view of government as a source of

¹ Schulze and Ursprung (1999) survey the tax competition and political literature and conclude that tax competition may not generally be undesirable, partly due to the compensation effect.

² Fuest (2000) extends the framework by taking account of the bargaining between bureaucrats and politicians.

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