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Capital tax competition: bane or boon

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Abstract

This paper reviews potential advantages and disadvantages of capital tax competition. Tax competition may introduce, mitigate, or exacerbate inefficiencies in both the private sector and the public sector. In different models, tax competition may either limit or increase public expenditures and taxes on mobile factors, with differing welfare consequences. We also discuss the implications of tax competition for redistributive policies and for policies dealing with risk, and we identify some of the possible empirical implications of tax competition.

JEL classification: H0; F0
Keywords: Tax competition; Tax structure; Public expenditure; Redistribution

1. Introduction

Early contributions to the theory of tax competition emphasized the possibility that competition for capital leads to inefficiently low tax rates and public expenditure levels[1]. This view is articulated by Oates (1972) and formally modeled by Zodrow and Mieszkowski (1986) and Wilson (1986). If regions differ in the extent to which they compete for capital, tax competition also leads to the misallocation of capital. Numerous subsequent writers have extended and refined the view that tax competition lowers

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[1] Although issues of fiscal competition arise in other contexts (commodity taxation and the fiscal treatment of labor and population), our discussion in this paper focuses primarily on the tax treatment of capital. For surveys that address some of these other forms of fiscal competition, see Cremer et al. (1996), Wildasin (1998), Lockwood (1998), Keen (1998) and Wilson (1999).

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welfare[2]. More recently, researchers have begun to investigate the possibility that tax competition can have desirable effects. Actually, this possibility dates back to Brennan and Buchanan (1980) model of government as a Leviathan that needs to be "tamed", and it has already been the subject of extensive empirical testing by Oates (1985, 1989) and others. In contrast, the "standard model" (i.e. Zodrow–Mieszkowski and its variations) assumes welfare-maximizing governments and models an economy that would be fully efficient if capital were not interregionally mobile. This seems to stack the deck against tax competition.

This paper describes some approaches to modeling the potential benefits of tax competition, including both existing approaches and some new approaches, and how they contrast with models of welfare-worsening tax competition. We discuss issues associated with how tax competition handles inefficiencies in both the private sector and the public sector. One theme that emerges is that tax competition can lead to higher public expenditures and taxes on mobile factors, and that such effects can be a sign of efficiency-enhancing tax competition. These possibilities seem to be consistent with the difficulties researchers have encountered in documenting a negative relation between total tax revenue and various indicators of tax competition, although there are certainly competing explanations.

The plan of this paper is as follows. We begin by providing a definition of tax competition that is then used throughout the paper. In Section 3, we discuss the efficiency effects of tax competition on the location of firms, beginning with the Tiebout Hypothesis (Tiebout, 1956), which implies that firm location is efficient. We stress, however, that the assumptions of Tiebout models are quite stringent. Section 4 examines the implications of tax competition for the size of government, and Section 5 looks at the impact of tax competition on the mix and levels of taxes used to finance government expenditures. In both cases, we focus on the efficiency effects of tax competition, and whether these effects can be distinguished empirically. Sections 6 and 7 then examine models that generate variations in tax policies across the competing regions, including the role of international goods trade in creating such differences. The special considerations associated with the government's role in redistributing income and allocating risk are dealt with in Section 8. Section 9 briefly reviews some of the key empirical approaches to testing for tax competition, including the difficult task of distinguishing between good and bad types of tax competition. Section 10 concludes.

2. Defining tax competition

To investigate the empirical evidence on tax competition, we first need a definition of tax competition. The literature on tax competition has devoted surprisingly little attention to defining this phenomenon. In some cases, tax competition seems to be defined very broadly as any form of noncooperative tax setting by independent governments.

2 See Wilson (1999) for a review.