SOME REFLECTIONS ON TAX COMPETITION

on the occasion of
Hans-Werner Sinn's 60th birthday

by

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TAX COMPETITION: THE CURRENT MAINSTREAM VIEW

- If competition in the private marketplace is good, fiscal competition between governments must be good too

- Fiscal competition to attract mobile factors and activities keeps governments on their toes and helps to weed out public sector inefficiencies

- Europe must embrace tax competition as an integrated part of the Lisbon agenda

AN ALTERNATIVE VIEW: THE SINN SELECTION PRINCIPLE

- The selection principle: governments should (and mostly do) step in only where markets fail

- If governments stepped in where markets failed, reintroducing markets through the backdoor of systems competition will again result in market failure

ILLUSTRATING THE SELECTION PRINCIPLE (I): COMPETITION FOR MOBILE CAPITAL (Sinn, JPubE 1997)

Setting:

- Perfectly mobile capital and immobile labour
- A source-based capital tax and a labour tax are levied to finance public infrastructure
- Increased domestic investment increases the congestion of infrastructure
- Increased provision of infrastructure reduces congestion costs
- The average cost of infrastructure provision is declining (increasing returns to scale)

ILLUSTRATING THE SELECTION PRINCIPLE (II): COMPETITION FOR MOBILE CAPITAL (Sinn, JPubE 1997)

Outcome under fiscal competition:

- The source tax on capital will equal the marginal external congestion cost arising from additional investment
- Infrastructure will be provided up to the point where the marginal reduction of total congestion cost equals the marginal cost of expanding the infrastructure (Samuelson)
- If the government only provides infrastructure that the private sector cannot profitably provide, the capital tax will not yield sufficient revenue to cover the cost of the optimal level of infrastructure, due to increasing returns. The remaining cost must be covered by taxes on labour.

TAX COMPETITION VERSUS TAX HARMONISATION UNDER THE SINN SELECTION PRINCIPLE

- The trouble with tax competition: No efficiency problem, but a *distributional* problem, since labour is subsidising capital

- Harmonising the capital tax at the supra-national level would not be a satisfactory solution, since national governments would then compete to attract capital by offering excessive levels of infrastructure

- Sinn’s solution: Impose a self-financing constraint requiring national governments to levy a capital tax sufficient to cover the cost of infrastructure provision.

  Outcome: same (efficient) allocation of resources but no redistribution from labour to capital

BEYOND THE SELECTION PRINCIPLE: FROM PUBLIC FINANCE TO PUBLIC CHOICE

The Michael Parkin Folk Theorem:

”Public Finance deals with benevolent governments optimally correcting market failures, but since there are neither benevolent governments nor market failures, Public Finance is irrelevant!”

Brennan and Buchanan (1980): Tax competition is an efficiency-enhancing constraint on rent-seeking politicians and bureaucrats whose goal is to maximise tax revenue

MARRYING PUBLIC FINANCE AND PUBLIC CHOICE: EDWARDS AND KEEN (EER, 1996)

- Perfectly mobile capital and immobile labour; source tax on capital finances a publicly provided private good plus rents to politicians

- Politicians trade off rents to themselves against the welfare of the representative citizen

- Tax competition reduces rents (welfare-increasing) but also causes underprovision of public goods (welfare-reducing)

- Tax competition has a positive net effect on welfare if the elasticity of the tax base exceeds the politicians' marginal propensity to spend public funds on 'waste', and vice versa

SOME PROBLEMS WITH THE LEVIATHAN LITERATURE

- Break with methodological individualism: the utility of politicians and bureaucrats does not count in the social welfare function

- In Leviathan models, an increase in government rents always reduces the probability that the government will be reelected. But in Western democracies, the rents appropriated by policy makers are probably quantitatively unimportant. It seems more likely that rents are created and dissipated to voters in order to obtain political support

BEYOND LEVIATHAN: POLITICAL EQUILIBRIUM WITH TAX COMPETITION

Eggert and Sørensen (JPubE, 2008): Probabilistic voting model where politicians create rents to public sector employees as part of a political strategy to maximise the expected number of votes (synthesis of Persson-Tabellini (2000) and Edwards-Keen (1996))

Model features:

- Explicit modelling of the political process that generates rents
- Consistent welfare analysis: the welfare of all agents is accounted for in the evaluation of the welfare effects of tax competition and tax coordination
- The model ’stacks the deck’ in favour of tax competition by assuming that voters employed in the public sector are better organised than voters in the private sector

TRADE UNION DENSITIES IN THE PRIVATE AND PUBLIC SECTORS[1]

Country[2]	Union density		Ratio of public to private sector union density (1./2.)
	1. Public sector	2. Private sector	
Australia (2004)	46.4	17.4	2.7
Austria (1998)	68.5	29.8	2.3
Canada (2004)	72.3	17.8	4.1
Denmark (2003)[3]	85.0	63.0	1.3
Finland (2001)	86.3	55.3	1.6
France (2003)	15.3	5.2	2.9
Germany (1997)	56.3	21.9	2.6
Ireland (2003)	68.0	30.4	2.2
Japan (2003)	58.1	17.9	3.2
Netherlands (2001)	38.8	22.4	1.7
Norway (1998)	83.0	43.0	1.9
Spain (1997)	32.0	14.5	2.2
Sweden (1997)	93.0	77.0	1.2
United Kingdom (2004)	58.8	17.2	3.4
United States (2004)	36.4	7.9	4.6

1. Trade union members in percent of total sectoral work force, excluding members outside the labour force.
2. Year of observation indicated in brackets.
3. Data provided by the Confederation of Danish Trade Unions (LO).

Source: Visser (2006, Table 4).

THE MODEL SET-UP

Structure of the world economy:

- *n* symmetric countries
- Perfect capital mobility, no labour mobility
- Public goods provision financed by a source-based capital tax

Policy formation and policy evaluation:

- Probabilistic voting; politicians set fiscal policy with the purpose of maximising the expected number of votes
- Policy outcomes are evaluated by means of a utilitarian social welfare function

VOTERS AND PARTIES

Two groups of voters:

● ”Insiders” are all employed in the public sector and belong to a lobby

● ”Outsiders” do not belong to the lobby and may be employed in the public or in the private sector

Political system:

● Two competing political parties (A and B) maximising the expected number of votes through the choice of public goods provision, the public sector wage rate and the capital tax rate

● The lobby maximises the expected economic welfare of a lobby member, net of the cost of campaign contributions

POLITICAL INCENTIVES FOR EXCESS PUBLIC SPENDING

- The existence of a public sector lobby provides an incentive for politicians to offer rents to public sector workers

- Given the existence of such rents, a political candidate has an incentive to create more public sector jobs, since this will increase an outsider's expected economic gain from voting for him (by increasing an outsider's chance of obtaining a high-paying public sector job)

MAIN FINDINGS (I)

- Under probabilistic voting with a lobby for (some) public sector employees, the political equilibrium under autarky will involve rents to public sector workers, implying a deviation from the first best

- Tax competition has the potential to wipe out all rents, but at the same time it will cause an underprovision of public goods

MAIN FINDINGS (II)

- Tax competition is welfare-improving up to a point, but excessive tax base mobility reduces welfare. Hence there is an optimal intensity of tax competition (measured by the elasticity of the tax base)

- Starting from a tax competition equilibrium where all rents have been destroyed, some amount of tax coordination will always increase social welfare

- It may even be welfare-improving to carry tax coordination beyond the point where rents to public sector workers start to emerge

CONCLUSION

- Even in a political economy framework that 'stacks the deck' in favour of tax competition (by assuming that voters receiving their income from the public sector have greater political influence than other voters), tax competition is beneficial only up to a certain point, and unfettered tax competition among small jurisdictions is almost surely welfare-reducing

- Bottom line: Hans-Werner Sinn is right in warning against unfettered systems competition!

SOME IMPORTANT WORKS ON SYSTEMS COMPETITION BY HANS-WERNER SINN

"Tax Harmonization and Tax Competition in Europe". *European Economic Review* 34 (1990), 489-504.

"The Selection Principle and Market Failure in Systems Competition". *Journal of Public Economics* 66 (1997), 247-274.

The New Systems Competition. Yrjö Jahnsson Lectures, Basil Blackwell: Oxford 2003.