

Intergovernmental Tax Competition

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I. ECONOMIC EXTERNALITIES: THE NEED FOR HARMONIZATION

A. Public goods and redistribution enter

In the presence of externalities between countries, or spillovers from one state to another, there is an inefficient allocation of resources; all countries concerned experience an efficiency loss. This outcome of external effects, and in the extreme, of public goods and of taxes, has been argued in verbal terms by Musgrave (e.g. 1983): The flow of trade and factors of production is distorted compared to an efficient allocation as in a perfect market, taxes are non-neutral, and world welfare is reduced. The same result has also been shown in a mathematical way by the theory of optimal taxation applied to federal structures (e.g. Gordon 1983): Each state is assumed to maximize the weighted sum of the utilities of its own residents, subject to a budget constraint and the public production function. The value of national public services to non-residents is thereby disregarded, as well as the utility loss of non-residents from paying taxes.¹

Compared to benefit spillovers, taxation spillovers have until recently been neglected, but they are of considerable importance in the context of intergovernmental relations. Take the example of a factor in fixed supply, like capital, which is perfectly mobile between countries. It will flow to the state with the lowest tax rate. In equilibrium, the tax rate on capital in each state will be driven to zero because each one will compete for that tax base. With coordinated decision making on the other hand, a uniform tax on capital in all countries would be non-distortionary (as capital is in fixed supply), and the optimal tax rate on capital would be very high. In general, the elasticities of supply of a mobile factor will be quite different within one state than for the aggregate of all states. It follows

1. Indeed, more precisely seven types of externalities resulting from a given community's decision may be distinguished (Gordon 1983, pp.35/36):

- (1) Non-residents may pay some of the taxes.
- (2) Non-residents may receive some of the benefits from public services.
- (3) Congestion costs faced by non-residents may change.
- (4) Tax revenues received in other communities may change due to the spillover of economic activity.
- (5) Resource costs for public services in other communities may change.
- (6) Output and factor price changes may favour residents over non-residents.
- (7) Distributional effects among non-residents would be ignored.

that the tax rates in a decentralized setting will bear little relation to those chosen in a coordinated setting.

In the light of these costs arising from a lack of coordination - i.e. the utility losses due to distortions - both the proponents of a literary and a mathematical analysis clearly advocate a harmonization of taxation. Coordination being designed to overcome the disregard of the effects of one state's activity on the other states, a policy improvement is an obvious result.

Redistribution of income between states is faced with the same problems if governments act independently. Those factors of production which are burdened by taxes tend to exit, and those benefited by redistribution tend to enter a particular country. With mobility of factors, income redistribution is not possible in the long run because the tax base is eroded, and the number of recipients grows.

B. Public goods and redistribution are driven out

The discussion so far has essentially summarized the state of knowledge obtaining in the 1960s to the mid 1970s. It has, of course, been (mathematically) refined, and is considered by many economists to represent adequately the essential elements of inter-governmental fiscal relationships. However, since the mid 1970s, and particularly in the 1980s, a new kind of approach has entered economic thinking which looks in quite different ways at inter-governmental relationships.

1. Public goods

When Samuelson (1954) introduced the precise notion of a public good into economics, and Musgrave (1959) into public finance, it was taken for granted that it is not just a relevant theoretical concept, but that it is also of great practical importance. Public goods, and elements of public goods (i.e. externalities) were explicitly or implicitly taken to be pervasive in modern economics. Moreover, no difference tended to be made between public goods and publicly supplied goods (though thoughtful scholars were always aware of the difference).

This view has changed much in recent years. Today, it is common to emphasize the *private* elements in public goods, and especially in publicly supplied goods. It has become normal to argue that in many cases it is possible to assign private property rights in such a way that what used to be a 'public good' can be handled as a private one. In particular, it has been shown that the price system or market can be applied, and brings about an efficient allocation. Even the lighthouse as a cherished example of a perfect public good has been dismantled, and it has been shown that its supply can be, and historically has been, privately arranged (Coase 1974). It follows, that 'publicness' is not a sufficient reason for harmonization between countries, but that instead an effort should be made to find ways and means to establish private property rights so that harmonization becomes superfluous.

The view that fiscal coordination should be undertaken to effect a *redistribution of income* has also drastically changed. Many scholars today stress a particular private element in redistribution, namely that individuals and interest groups

use it to raise their income at the cost of others. Due to rent seeking (Tullock 1967; Buchanan, Tollison and Tullock 1980; Tollison 1982) overall welfare is moreover reduced because resources are employed to influence distribution instead of to raise income. Not rarely the net effect of an attempted redistributive policy by the state leads to the opposite of what was intended because the well organized groups tend to benefit while the unorganized - and the poor typically belong to this group - tend to lose. For these reasons, today governmental income redistribution is not considered to be desirable by many scholars, or it is even rejected outright. Empirical observation at least partly supports this view. Examples are aid to third world countries or the agricultural and regional redistribution programs undertaken by the European Community.

The mode of thinking about the presumed 'need' for fiscal harmonization between states has thus much changed. The arguments based on public goods and redistribution now sound old-fashioned; 'private' solutions where a cooperation between states is either unnecessary or even damaging are favoured.

II. POLITICAL EXTERNALITIES: THE NEED FOR TAX COMPETITION

A. Responsive government

It has so far been taken for granted that the government cares about the preferences of its citizens. This line of thought may be based on either of two views: *a. Belief in 'good government'*. There is an old tradition in economics and other social sciences, as well as in law, to assume either explicitly or implicitly that politicians in power are benevolent and care about the wishes of the population. As has been seen above, the (mathematical) theory of optimal taxation takes government to maximize the utility of its residents.

b. Government is forced to be responsive. While the first view is simply based on an assumption, this second view offers an argument of why politicians (which are people like everyone else, and certainly not more altruistic) would be induced to take their citizens' preferences into account. In a perfectly functioning 'ideal' democracy, politicians do indeed have no discretionary power; only politicians that meet the voters' wishes are reelected and may stay in power.

With government being responsive to the citizens' desires, harmonization between states can be undertaken to the benefit of the citizens concerned.

B. Exploitive government

Over the last decennium, the idea of a benevolent government has come under heavy attack by a particular group of Public Choice scholars, led by Brennan and Buchanan (e.g. 1980). Politicians are taken to be purely selfish and to have considerable discretionary room as the democratic institutions are not capable of bringing about an efficient outcome. This may, e.g. be shown with the simple majority rule where the median voter's wishes are fulfilled but where the outcome is efficient only by chance. It has also and quite rightly been argued (in particular by Tullock 1987) that most states in the world are authoritarian or dictator-

ships, and that democracies are a very small, and perhaps even dwindling, minority. Whenever democracy is not perfect, the rulers tend to behave in their own interest, actively exploiting the tax payers.

Based on this view, a harmonization of fiscal (and other) policies between states will involve costs in terms of violations of individuals' preferences (*see, e.g. Grewal 1983*). Looking, for instance, at harmonization among EC-countries, one may well argue that many such policies are obviously more in the interest of politicians in power, and strongly benefit the European bureaucrats (eurocrats) while it is difficult to see what the exact benefits for the citizens are.

To take governments to be completely responsive to the population's wishes with respect to harmonization is certainly not realistic. Rather, the fact that inter-governmental harmonization is costly, and may mainly serve the interests of politicians and bureaucrats, should be taken seriously.

III. INTEGRATING ECONOMICS AND POLITICS

The discussion has so far considered economic and political externalities in an isolated way. This corresponds to what has been done in the literature on harmonization and competition between nations. The 'harmonization' camp has concentrated on the existence of economic externalities and has paid little or no attention to whether governments are responsive to the citizens' wishes; the 'competitive' camp has played down economic externalities and has concentrated on how to force governments to fulfill individuals' preferences.

The *table* presents an overview of these points of view.

		Economic externalities	
		<i>pure public good and re-distribution</i>	<i>private good without re-distribution</i>
	<i>completely responsive government</i>	harmonization	no harmonization required
Political externality	<i>non-responsive government</i>	conflict between harmonization and tax competition	tax competition

It may immediately be seen that each camp makes those assumptions which support their case:

- The upper left-hand corner exhibits those conditions which make harmonization desirable: economic spillovers are strong, and the respective policies are achieved at no cost in the citizens' interest.

- The lower right-hand corner exhibits those conditions which serve to make tax competition appear desirable: there are few or no economic externalities, but government must by tax competition be forced to care about the population's wishes.
- The situation portrayed in the upper right-hand corner of the table does not present any problem: it describes the conditions necessary for markets: the economic relationships between countries are efficiently guided by the price system, and there is no need for any government intervention or harmonization between states.
- It is the conditions described in the *lower left-hand corner* which create grave problems: On the one hand harmonization is needed because of public goods and redistribution, but at the same time competition among states is needed in order to make governments responsive to the citizens' wishes. There is thus a *conflict* between the two policies, and the question arises which of the two should be relinquished. There is the danger that if harmonization is given up, the tax on mobile factors is driven to a sub-optimal level (or in equilibrium to zero); if tax competition is given up the outcome may be 'technically' efficient but may disregard the individuals' preferences, politicians and bureaucrats forming an (implicit) cartel to exploit the tax payers by way of harmonization.

IV. TOWARDS A MORE ELABORATE THEORY

The conflict identified is quite general and does not apply only to the relationships among states but arises whenever public goods (and redistribution) and non-responsive governments are taken to exist. It may be argued that many of the politico-economic problems in the real world pertain to the conditions obtaining in the lower left-hand corner, and that the 'nice' solutions offered by either the 'harmonization' or the 'competition' camp are rather unimportant cases.

However, a more sophisticated view of the issues involved allows one to take a more optimistic stance. The perception of both economic and political externalities to be found in the literature should be overcome by developing a richer theory.

A. Economic spillovers

In the authors's opinion, public goods cannot realistically be defined away by postulating that it is always possible to assign adequate property rights. Global public goods and especially bads do exist, and Chernobyl may well be just one example of such international environmental disasters which we have to expect in the future. To argue that such problems are due to ineffectively defined and monitored property rights, while formally correct, overlooks the basic issue, namely, that to establish effective property rights intergovernmental cooperation is necessary.

Property rights theory has, nevertheless, taught us an important lesson. It is not sufficient to claim that there exist technological international externalities, and thereupon suggest fiscal harmonization as the solution. We are now able to per-

ceive much better that there exists no public good as such. Externalities are not technologically given but are the result of social forces, in particular of the assignment of property rights. An important policy task is to find out under what conditions internationally respected private (national) property rights can be defined and effectively monitored. This study falls into the province of Political (Constitutional) Economics, and stresses that harmonization must be achieved with respect to international rules and not outcomes. The establishment of international rules also extends to how far intergovernmental *regulations* are able to deal with international spillovers.

Public Choice theory has taught us to be aware of the ineffectiveness and waste of much of what is claimed to be *income redistribution*. Again, the view should shift from fixing 'justice' of outcome to establishing institutional conditions at the international level which give poorer nations a chance to become more competitive and to therewith raise per capita income. Rules such as assigning private property rights are again important, but it must be recognized that these 'private' elements in almost all cases must be established and monitored by the state. There can be little doubt that the successful economic development of Japan and the 'Four Little Tigers' (Hongkong, Singapore, South Korea and Taiwan) has not been the result of redistributing income between nations, but to the setting of favourable institutional conditions for growth. International coordination or even harmonization (i.e. establishing the *same* institutions) is likely to play a minor role. A country such as Taiwan has even been excluded from the international (diplomatic) community (especially since the United States formally recognized the People's Republic of China) but has nevertheless been able to dramatically raise its national income (also per capita) and to engage in international trade. Competition between nations has not precluded that per capita income has narrowed between these nations and the developed world.

B. Political responsiveness

1. A more refined behavioural model

The analysis of intergovernmental competition has been based on a concept of 'homo oeconomicus' which should be considered anew in two respects:

a. Is man completely selfish? Do politicians and bureaucrats really seek to maximize only their *own* utility even to the extent of actively exploiting the citizens and tax payers as suggested by (one variant of) Public Choice? There are presently fascinating new developments in the analysis of human behaviour which reject this view. They adopt a less cynical view by postulating that selfish behaviour is not in a person's own best interest because it destroys confidence and reputation (e.g. Frank 1989).

b. Is man rational? Much of economic theory has an extremely narrow view of human behaviour, assuming that an individual acts in every instance and at every moment like a perfectly functioning automaton. Such a conception is no longer tenable. It has been shown already some time ago by Allais (1953), and has recently been reiterated, especially by cognitive scientists (best known are Kahneman and Tversky 1979) and economists (e.g. Grether and Plott 1979), that in many (experimentally controlled as well as real life) situations individuals syste-

matic and strongly violate the von Neumann/Morgenstern axioms of rationality on which economic theory (in particular formal theory such as optimal taxation) is founded.

A more realistic model of man acknowledges that individuals under specified conditions do not act in a fully rational way but that they are able to overcome certain weaknesses by either resorting to self-commitment or to institutions (see more extensively Frey and Eichenberger 1989a,b). The economic approach need not be given up but may rather be taken as the basis for a truly general social science approach to human behaviour which includes psychological and sociological features. Applied to the politico-economic sphere (Frey and Eichenberger 1989c) it follows that politicians and bureaucrats have little incentive to use their discretionary room to actively exploit other people.

Both aspects of the more refined view of man suggest that the absence of intensive competition between states does not lead politicians and bureaucrats to deviate willingly and strongly from what they perceive to be the wishes of the population. This statement is, however, still a far cry from simply assuming fully responsible governments.

2. Additional constraints on government behaviour

It is a rather surprising feature of the tax competition literature that it considers only one constraint on government behaviour, i.e. the possibility for citizens to exit to another jurisdiction, to therewith reduce the tax base and to induce the rulers to take their preferences into account (see, explicitly, Brennan and Buchanan 1983). In reality, various mechanisms exist which give governments an incentive to follow the citizens' wishes:

a. *Internal exit to the shadow economy.* This mechanism works in a quite similar way as the exit to another jurisdiction (nation). In both cases the rulers lose part of their power because the tax base and the area in which their regulations are followed shrinks. This exit option of the population affects not only politicians but also public bureaucracy.

b. *Democratic institutions.* Voting in elections and on referenda are the classical mechanisms to force the government to be responsive to the citizens' wishes and need not be further discussed here.

c. *Voice.* The population may also induce or force the rulers to take its preferences into account by resorting to various forms of protest, ranging from complaints by individual persons to a violent uprising (see Hirschman 1970).

It is not argued here that these mechanisms can fully substitute for intergovernmental competition. Indeed, (tax) competition between nations and the three other constraints just mentioned affect politicians and bureaucrats in quite different ways. For instance, democratic voting rules have an indirect effect on public bureaucracy, only by constraining elected politicians. As is well known, this does not necessarily mean that the discretionary behaviour of bureaucrats can be effectively checked. The growth of a strong, large and rather independent bureaucracy arising within a harmonizing effort of democratic states shows that this constitutes a real problem. What is argued here is that the various mechanisms serv-

ing to make governments responsible should be considered when discussing the possible advantages and disadvantages of harmonization and competition between states.

V. CONCLUSIONS

Intergovernmental harmonization and competition have been looked at in a too narrow framework. Economic externalities (public goods spillovers and redistribution of income) between countries have either been stressed, while political externalities (responsiveness of the government to the people's desires) neglected, so that harmonization was the conclusion; or economic externalities have been defined away by considering them to be insufficiently defined and monitored property rights, while political externalities have been stressed, so that competition between jurisdictions was the conclusion.

Both views do not adequately deal with those conditions which in the author's opinion are relevant in today's international setting: Public good problems cannot be dismissed, not least because of recent experiences with environmental problems, *and* politicians and public officials do have a tendency to disregard the citizen's preferences.

A broader view based on a more elaborate analysis helps us to see aspects so far largely disregarded. Some of the issues on which the relative merits of international harmonization and/or competition have to focus are:

- i. To concentrate on taxes is seriously misleading. It has long been argued that the benefit side must be considered simultaneously (*see, e.g.* the recent discussion in McLure 1986). Regulations (which can for some purposes be looked at as an implicit tax) must also be taken into account.
- ii. Economic externalities (public good spillovers between nations) are not given by nature or technology but are the result of social interactions. The extent to which (private) property rights can be defined and monitored determines the extent of international spillovers.
- iii. Harmonization between countries is not an activity without price; in actual fact it may entail significant cost in terms of economic resources, time and political attention.
- iv. Proposals and efforts to harmonize policy between countries should not concentrate on outcomes but should also concern rules.
- v. Government activities deviating from citizens' wishes constitute a serious issue but should be seen in the light of a realistic model of human behaviour in political and administrative affairs. In particular, politicians and bureaucrats are neither so self-seeking nor rational to consistently exploit the taxpayers.
- vi. Competition between countries is not the only way to bring about a responsive government. Politicians and bureaucrats may also be induced to follow more closely the citizens' wishes by easing exit into the shadow economy, by establishing democratic institutions of voting, and by allowing protest.

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