Fiscal competition between decentralized jurisdictions, theoretical and empirical evidence

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Call for papers: Tax competition: how to meet the normative and political challenge

Abstract

This article provides theoretical and empirical evidence that local fiscal competition generates a bias toward low business tax rates. Furthermore, this bias is stronger for smaller jurisdictions, which means that tax competition may increase inequalities.

First, a theoretical model – close to the Zodrow & Mieszkowski (1986) model – is settled. This is a classical model with additional properties. The production function is a Cobb-Douglas, with private and public capital and a fixed factor. The public capital is financed through taxes on private capital. The fixed factor allows to consider differences between the jurisdictions. The point is not only to measure a bias toward low tax rate, but also to measure the dependency of this bias with respect to the fixed factor. The fixed factor may be interpreted as land – weighted with its accessibility –, population – in case of worker mobility limitations –, or the technological level of the jurisdiction.

The results show that there exists a bias toward low tax rates due to tax competition. This bias generates an underprovision of public capital, and therefore production is smaller with tax competition than with cooperation. Furthermore, the bias toward low tax rates is stronger for jurisdictions with less fixed factor. That means that tax competition generates a larger production decrease for smaller jurisdictions.

The empirical part aims at estimating the bias toward low tax rates and its dependency with respect to the fixed factor. The model is calibrated for French local jurisdictions. The fixed factor is the size of the local jurisdiction, measured by the number of inhabitants at the 1999 census time. Then panel regressions with temporal and individual fixed effects of the tax rates are implemented, using the creation of intercity communities. The point is to measure the difference of city tax rate variations before, after, and at the time of the inter city entry, controlling for global tax variations due to conjuncture effects.

The results indicate that the bias toward low local tax rates is strong: up to 23% decrease for the smaller cities. It is also significantly decreasing with respect to the city size: there is no tax rate decrease due to tax competition for the biggest cities.

Despite these negative effects of decentralization – a significant decrease of fiscal revenue – a majority of countries keeps a decentralized administrative organization. This is because local decisions may fit the local needs better, in term of inhabitants asking as in term of public investments. That for, it could be interesting to compare this two forces - decentralization force due to efficiency of decisions and centralization force due to fiscal competition - in an optimal decentralization level model.

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