

Contents lists available at [ScienceDirect](#)

European Journal of Political Economy

journal homepage: www.elsevier.com/locate/ejpoleco

Symmetric tax competition and lobbying within federations

Simon Winter

University of Münster, Institute of Economic Education, Scharnhorststr. 100, 48155, Münster, Germany

ARTICLE INFO

*JEL classification:*D72
H22
H23
H71*Keywords:*Fiscal federalism
Interest groups
Political economy
Fiscal externalities
Tax competition

ABSTRACT

The present paper deals with the question of whether tax harmonization and federal taxation increase welfare in a symmetric tax competition framework with heterogeneous individuals and lobbying. A model closely related to the approach of Lai (2010) is linked to externalities that are familiar from conventional public finance. The observed deviations from efficient taxation are derived from the interplay of four externalities, which can be divided into two groups: externalities occurring due to tax competition and externalities which are caused by lobbying. Whether or not the centralization of tax competences is useful depends mainly on the relative sizes of the competition-induced and lobbying-induced externalities.

1. Introduction

Over the last few decades, a harmonization of corporate income taxes has repeatedly been proposed for the European Union. In general, the convergence of effective corporate tax rates in all member countries has been considered as desirable (Neumark Committee, 1962). The imposition of common minimum and/or maximum tax rates has been debated (European Commission, 1975; Ruding Committee, 1992), as well as the harmonization of the tax base (CCCTB=common consolidated corporate tax base; European Commission, 1971; Nyborg Committee, 1979; European Commission, 2001, 2011, 2015). Value added tax rates have already been harmonized in the European Union by defining certain minimum tax rates.¹ Additionally, a growing number of interest groups can be observed in Brussels. According to the European Transparency Register which was founded by the European Parliament and the European Commission in 2011, there are over 9,800 interest groups at present – thereof over 1,800 companies and nearly 2,200 trade and business associations.² This increasingly raises the question of the extent to which and with what welfare implications these interest groups would influence a harmonized EU-wide tax policy, compared to decentralized taxation, and whether tax harmonization could still be welfare-enhancing.

The issue of tax harmonization is closely associated with the theory of tax competition and tax coordination. For the sake of convenience, I focus on capital taxation rather than profit taxation. The recent literature about tax competition yields ambiguous results on the welfare effects of tax harmonization and essentially states that they depend on basic assumptions about government behavior. On the one hand, the benchmark model of symmetric tax competition (Zodrow and Mieszkowski, 1986; Wilson, 1986) assumes government to be a benevolent planner and to set tax rates optimally in terms of welfare. A coordinated tax policy is therefore per definition optimal, whereas the regional taxation of mobile tax bases induces a detrimental race to the bottom concerning effective tax rates. On the other hand, there are models which adapt the Leviathan concept of Brennan and Buchanan

E-mail address: simon.winter@uni-muenster.de.

¹ See Council Directive 2006/112/EC of 28 November 2006 on the common system of value added tax [2006] OJ L347/1.

² See URL <http://ec.europa.eu/transparencyregister/public/homePage.do?locale=en> (retrieved on September 21, 2016).

<http://dx.doi.org/10.1016/j.ejpoleco.2017.02.002>

Received 17 May 2016 Received in revised form 23 January 2017 Accepted 8 February 2017

0176-2680/© 2017 Elsevier B.V. All rights reserved.

(1980), assuming government to set tax rates inefficiently high in order to maximize tax revenue rather than welfare (Sinn, 1992). Tax competition combined with tax base mobility, can therefore produce welfare-enhancing downward pressure on tax rates, whilst centralized taxation increases the potential for government to exploit the tax base and to levy excessive tax rates.³

This paper adds lobbying to a symmetric capital taxation framework with mobile capital and immobile labor, following the approach of Lai (2010), and using the concept of a political contribution function (Grossman and Helpman, 1994, 1995). Accordingly, capitalist lobbying leads to an overemphasis of capitalist welfare in the governmental objective function. In the case of regional taxation, the impact of capitalist lobbying is ambiguous: while it exerts downward pressure in scenarios with relatively few regions (which might appear intuitively plausible), it even exerts an upward pressure on capital tax rates in scenarios with a multitude of regions. Capitalists then lobby for higher tax rates because the tax burden is increasingly shifted to the immobile factor (labor) with an increasing number of regions. By introducing a federal level of government, it offers the opportunity to harmonize taxation by imposing minimum or maximum tax rates (which is equivalent to federal taxation in a symmetric scenario) and this effect disappears: there is no longer any possibility for the capitalists to avoid bearing the tax. As a consequence, capitalist lobbying always leads to a downward pressure on capital tax rates in the case of federal taxation.

Going beyond of Lai (2010), the present paper links the results of the model to a set of externalities already familiar from conventional public finance: I argue that the results of Lai (2010) lead back to the interplay of two types of externalities, namely competition- and lobbying-induced externalities, leading to both negative and positive biases of capital tax rates. This asks the question which effects prevail under which conditions. I find that especially the wage externality which describes the consequences of capital taxation for workers' wages and causes a shift of the tax burden plays a crucial role for the welfare consequences of tax harmonization. Although this conclusion might seem intuitively plausible, it has not been mentioned by Lai (2010). In a second step, I compare the dynamics of externalities in different regimes, i.e. regional taxation under competition and federal taxation. Eventually, tax harmonization is welfare-enhancing in the presence of weak capitalist lobbying since there is a relatively weak lobbying-induced distortion in taxing capital on the federal level, but a relatively strong competition-induced distortion on the regional level. However, federal taxation appears to be detrimental with strong lobbying because the large influence of the lobby causes major distortions on the federal level even outweighing the competition-induced inefficiencies on the regional level. Thus, the present paper makes a further contribution to the extensive debate on the allocation of tax competence within federations beginning with the famous decentralization theorem of Oates (1972).

The structure of this paper is as follows. Section 2 presents the model for regional (Section 2.1) and federal (Section 2.2) taxation, Section 3 discusses the results and the relevant externalities (Section 3.1), expands the model for scenarios with two lobbies (Section 3.2) and discusses the effects of endogenous lobby formation within federations (Section 3.3). Section 4 concludes.

2. The model

Consider a federation with $n \in \mathbb{N} \setminus \{1\}$ symmetric regions each having N_i inhabitants – M_i capitalists and L_i workers (with index $i \in [1, n]$ denoting the respective region). The capitalist share in the population is defined by $\alpha = \frac{M_i}{N_i} \in (0, 0.5)$, meaning that in every region, there are more workers than capitalists and that the capitalist share is constant over regions. People are assumed to be immobile and therefore have to reside in their home region. Additionally, workers can only supply their labor in their home region, whereas each capitalist is endowed with the same amount of capital \bar{K} which she can also supply to workers in other regions – in other words, the factor capital is assumed to be mobile across regions. Labor supply per worker is fixed and normalized to unity.

Each worker produces a homogeneous numeraire according to the production function $f(k_i)$ with $k_i = \frac{K_i}{L_i}$ denoting capital used by the respective worker and K_i denoting capital demand in region i . In this framework, workers can be interpreted as profit-maximizing entrepreneurs.

The production function has diminishing returns to capital, implying that $f'(k_i) > 0$ and $f''(k_i) < 0$. All markets are assumed to be perfectly competitive. Workers in region i receive a wage w_i and capitalists in each region obtain a net rate of return r . Thus, wages are simply the residual claim of the entrepreneurial worker, i.e. what is left after capital costs have been paid.

Furthermore, there is a public good z_i which is provided by the regional government and which is financed by a source-based capital tax t_i . Foreigners can be effectively excluded from public good consumption, i.e., the public good in one region is only provided to its respective citizens. There are no spillover effects concerning public good consumption.

Capitalists as well as workers have quasilinear utility, which is $u_i^k = r\bar{K} + v(z_i)$ for capitalists and $u_i^l = w_i + v(z_i)$ for workers, respectively. The first summand is the utility derived from private consumption (x_i^k and x_i^l , respectively) and equals – as all commodity prices are normalized to unity – the respective labor or capital income. $v(z_i)$ is a concave function ($v'(z_i) > 0$ and $v''(z_i) < 0$) with $\lim_{z_i \rightarrow 0} v'(z_i) = \infty$, which transforms the amount of public good consumed to a utility level. An additive social welfare function is assumed, such that $W_i = M_i u_i^k + L_i u_i^l = W_i^k + W_i^l$, with W_i^k denoting capitalist and W_i^l worker welfare.

Last but not least, the capitalists form an interest group and their influence is implemented into the governmental objective function by using a political contribution schedule $c_i(\mathbf{t})$ with $\mathbf{t} = (t_1, \dots, t_n)$ as the vector of regional tax rates.⁴

³ For an integrated model, see Edwards and Keen (1996).

⁴ The concept of a political contribution schedule was originally outlined by Grossman and Helpman (1994) in the context of foreign trade policy and was first applied to capital tax competition by Lai (2010).

Download English Version:

<https://daneshyari.com/en/article/5067792>

Download Persian Version:

<https://daneshyari.com/article/5067792>

[Daneshyari.com](https://daneshyari.com)