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Federal tax autonomy and the limits of cooperation ☆

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Abstract

We consider the hold-up problem between a foreign direct investor and the government(s) in a host country with weak governmental structure and lack of power to commit. Using "Nash threats," we show that an efficient investment level can be sustained for a sufficiently high discount factor and ask whether a vertically disintegrated government structure makes collusion more or less sustainable. We show that collusion between the government and the investor is easier to sustain if the host country is vertically more integrated, or if the different vertical layers of government can commit to fixed tax-sharing rules.

JEL classification: H11; H71; H73; H77

Keywords: Tacit collusion; Foreign direct investment; Hold-up problem; Federalism; Vertical tax externality; Tax competition

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1. Introduction

Foreign direct investment (FDI) is notoriously prone to risk. Once the investment is made, a large share of it is sunk, and the expected returns from the investment may be diluted by changes in the host country's policy. This creates a hold-up problem, and some aspects of this problem have been carefully studied.[1] Federalism and decentralization are often regarded as important policy instruments for overcoming this obstacle to FDI. For example, in its latest World Development Report, which focusses on measures to foster investment, the World Bank highlights decentralization of policy decision-making as conducive to attracting FDI. For, as it is argued, decentralization 'permits a degree of institutional competition between centers of authority that can ... reduce the risk that governments will expropriate wealth' (World Bank [32, p. 53]). This view is rooted in the notion that competition between jurisdictions for mobile factors of production, coupled with joint accountability of the levels of governments, makes ex-post opportunistic behavior more difficult (Weingast [31], and Qian and Weingast [30]).[2] As Weingast [31, pp. 5–6], most vividly puts it:

> 'If a jurisdiction attempts to confiscate the wealth of an industry, the mobility of capital implies that firms will relocate. The mobility of resources thus raises the economic cost of those jurisdictions that might establish certain policies, and they will do so only if the political benefits are worth these and other costs. Federalism thus greatly diminishes the level of pervasiveness of economic rent-seeking and the formation of distributional coalitions.'

This argument is important, and certainly applies to many types of investment, particularly human capital investment that, with its owner, can easily relocate.

However, once an international investor has invested in a given country the hold-up problem is rooted in the immobility of capital. This casts doubt on the plausibility of the argument that federal structures per se will attenuate the hold-up problem. Does an increase in the number of competing government actors actually reduce the likelihood of a hold-up and increase investment levels? As emphasized by previous work, the main element that prevents governments from expropriation and confiscatory taxation is the prospect of future benefits from repeated investment (see, for instance, Eaton and Gersovitz [7], and Thomas and Worrall [25]).[3] Building upon this work this paper investigates, using a simple framework of repeated interaction between the foreign investor and the host country government(s), whether a multi-layer structure of government facilitates reaching efficient FDI levels. We show that federal countries, meaning countries with a higher number of fiscally independent government levels, are less likely to achieve efficient levels of FDI.

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[1] See, for instance, among others, Eaton and Gersovitz [7], Doyle and van Wijnbergen [6], Thomas and Worrall [25], Konrad and Lommerud [19], Janeba [12], and Schnitzer [20,21].

[2] This view can be traced back to Hayek [11], and Tiebout [23]. That inter-jurisdictional competition may serve as a welcome supplement to inadequate constitutional constraints and imperfect political institutions has also been emphasized by Brennan and Buchanan [3,4].

[3] Payments from the host country government to the investor that compensate the investor upfront for future confiscatory taxation, as discussed in King et al. [18], could potentially solve the hold-up problem. However, in reality, further problems such as moral hazard on the side of the investor, liquidity constraints on the side of the host country government, and free-riding incentives in the bidding process in the case of multi-layered government make such bids a rather imperfect solution.