Forthcoming, *Journal of Public Economic Theory.*

Fiscal Competition: An Introduction[†]

David E. Wildasin[‡]

Martin School of Public Policy

University of Kentucky

Lexington, KY 40506-0027

USA

November, 2002

[†]This essay has been prepared as an introduction to a special issue of the *Journal of Public Economic Theory* for which the author has served as a guest editor. The special issue is scheduled to appear in April, 2003 as Volume 5, No. 2 of *JPET*. Interested readers may wish to consult the table of contents for this forthcoming issue, which has been posted at http://tanstaafl.gws.uky.edu/∼wildasin/pub/pub.html.

[‡]The papers that appear below were submitted in response to an earlier announcement of plans for a special issue on this subject. All have been subjected to the usual *JPET* refereeing process, except for the introductory essay (which did, however, benefit from the comments of J. Conley and E. Janeba). I thank *JPET* editors J.P. Conley and M. Wooders for suggesting a special issue of *JPET* on this theme, to the authors for their contributions (and patience), and, certainly not least, to the many referees who assisted in the evaluation of the papers submitted for this special issue.

This special issue of the *Journal of Public Economic Theory* is devoted to the theme of "Fiscal Competition." As some (but perhaps not all) will be aware, this has been a very active area of research for the past fifteen years or so. By way of introduction, this essay will attempt to provide a brief overview of some of the important issues that have arisen in the literature of this subject. I will resist the temptation to provide a detailed "reader's guide" to the individual papers in this issue; the difficulty with doing so is that each paper – as indeed is true of the underlying subject matter itself – contains many facets, and one cannot do justice to these contributions in a short space. But I hope that a short presentation of a conceptual framework will help the reader to place these papers into a broader context, to appreciate their potential applications, and to suggest where there remains a need, as there certainly is, for additional research.[1] I should observe at the outset that "fiscal competition" can be (and sometimes is) narrowly defined to refer solely to very specific policy issues such as the often highly-publicized efforts of some governments to attract big companies. No doubt this is an important facet of the subject, and some of the papers in this issue can help to shed light on such matters. The papers range much more widely than this, however, and for good reason. Once one starts down the path of analyzing the fiscal implications of the mobility of productive resources among jurisdictions, the range of issues to be investigated broadens quickly, leading in perhaps surprising directions. I hope that the following remarks help to introduce the topic of fiscal competition in this wider sense, first by reminding the reader of intellectual traditions in public and international economics on which recent literature builds – and from which it departs. I then turn to a discussion of some of the diverse topics that have figured in recent developments in the literature and that, to varying degrees, are reflected in the papers published here.

1 Public Economics: Closed and Open-Economy Perspectives

State and Local Public Finance and Fiscal Federalism. It is not much of an exaggeration to say that public economics or public finance, during most of the past century, has evolved as a "closed economy" discipline. The evidence for this generalization lies in the standard textbooks on the subject. In fact, a fruitful division of labor has developed among public economics, international economics, and macro and monetary economics, especially during the period since, say, the publication of Musgrave's landmark *Theory of Public Finance.* While Musgrave incorporated a substantial discussion of aggregative public finance (or macro fiscal policy) in his book, macro and monetary economics largely diverged from public economics subsequent to Musgrave's book, with the latter relying heavily on modeling approaches thoroughly grounded in microeconomic theory,

[1] There have been several surveys of related literature which interested readers may wish to consult. See, for example, Cremer *et al.* (1996), Wellisch (2000), Wildasin (1986, 1998), Wilson (1999), and Wilson and Wildasin (forthcoming).

including general equilibrium theory in the Arrow-Debreu tradition. (As two examples, one may cite the public expenditure theory tradition grounded in Samuelson's classic work, and the general equilibrium tradition in tax analysis found in Harberger's study of corporation income tax incidence and in the Diamond-Mirrlees optimal tax analysis.) Macro and monetary economics developed in a rather different direction, driven at least partly by an emphasis on short-run stabilization policy issues that, as Keynes noted, simply do not arise (at least in obvious ways) in equilibrium micro-theory models. International economics was also characterized by a divergence between the real side – gains from trade, the analysis of tariffs, trade and the general-equilibrium structure of prices, including factor prices – and the macro/monetary side, dealing with exchange rates, short-run macro stabilization issues, and the like.[2]

The most notable exceptions to the general characterization of public economics as a closed-economy field, until relatively recently, were the development of what in the US used to be called "state and local public finance," with much emphasis on applications to the policy problems facing state and local governments in the US, along with research done by Canadian economists, especially relating to fiscal relations between the federal and provincial governments. The term "fiscal federalism," now very familiar thanks to Oates' classic work of that title, fairly characterizes this subfield within public economics as it evolved during much of the postwar period.

Many fundamental problems, including the advantages or disadvantages of decentralized provision of public goods and services (including the problems of preference revelation and benefit spillovers), tax competition and tax exporting (including general-equilibrium tax-incidence analysis in a multi-regional setting), and the efficiency and distributional implications of intergovernmental transfers were raised in famous studies by Tiebout, Buchanan, Oates, Mieszkowski, McLure, and numerous others in the 1950s, '60s, and '70s. Applied work in this field has tended to emphasize issues of importance within the two mature North American federations, including the financing of local public schools and their support by transfers from state governments, the related but somewhat distinct issue of equalizing intergovernmental transfers (of particular importance in Canadian context of federal-provincial fiscal relations), the equity and efficiency implications of local property taxation and of political fragmentation of metropolitan areas, the taxation of natural resource rents at the subnational level, and the division of responsibility between national and subnational governments for the implementation and financing of cash and in-kind redistributive policies. Much of the theoretical literature has been developed with these sorts of applications in mind. In all of these contexts, both horizontal and vertical relations among governments and among the local and regional economies within their jurisdiction are of crucial importance, and thus require some departure from pure closed economy modeling frameworks.

[2] These characterizations are somewhat simplistically overdrawn, of course. For instance, the study of the effects of public pensions and tax policy on capital accumulation and growth has blurred the boundary between public economics and macroeconomics.

Changes in the International Scene. Changes on the world scene in the past decade or so have given new impetus to the study of open-economy public economics. Perhaps most fundamentally, the end of the Cold War and the breakup of the Soviet Union has led to a relaxation of the unusual rigidity of political structures and institutions that had emerged in Europe at the end of World War II. The breakup of the former Czechoslovakia, the unification of the two Germanies, the ongoing political and economic restructuring of the Balkan region as well as the dissolution of the Soviet Union itself has made the organization of the public sector, starting with the definition of fundamental political units themselves, a matter of immediate importance. The process of economic and political integration in Western Europe through the institutions of the EU also raises basic questions about the role of the nation in the modern world. Outside of Europe, there has been considerable rethinking of the role of the state in the management and planning of the economy. Along with an increased emphasis on economic liberalization has come increased interest in fiscal decentralization. Indeed, fiscal reforms have been a practical necessity in economies where fiscal systems were thoroughly intertwined in the price and non-price incentive and reward structures embedded in state-owned and controlled enterprises.

The challenges that these developments present for theoretical and applied public economics are profound indeed. Certainly, the movement of goods and services across international boundaries, the traditional focal point of international trade theory, remains a matter of great importance in the evolution of the economies of Europe and elsewhere. However, when national boundaries are subject to change, when long-standing barriers to the movement of people and capital are broken down or deliberately dismantled, and when new government institutions are under construction or in the blueprint stage, the traditional distinctions between international and domestic policy or between central and local governments become less obviously useful or appropriate, as does the traditional division of tasks between international and public economics. The "nation" is no longer the natural geographic entity for economic and policy analysis that it once appeared to be.

2 Open-Economy Public Economics: Some Items on the Agenda

There are certain obvious parallels that emerge in the study of fiscal policy in open economies on different geographic scales. Towns and cities must compete in larger ambient capital markets for investment and for human resources; so must countries. Fiscal policies that impose heavy burdens or offer generous advantages to mobile resources are bound to affect economic development and performance not only in small jurisdictions or regions but in large ones. Surely the study of open-economy public economics at one geographic scale can provide useful lessons for the investigation of similar issues that arise on other geographic scales. Theorists naturally search for general frameworks that exploit such parallels and that can point toward general principles and insights.

But public economic theory is a branch of *applied* economic theory; the art of applied theoretical analysis often necessitates the adaptation of models to reflect the essential particularities that underlie some applied problem. The following examples will provide the reader with a sample of some of the questions that have arisen in different branches of the literature of open-economy public economics. Some of these questions have been examined in theoretical studies, others have been addressed in empirical or applied-policy contexts.

(i) The taxation of corporate income by states or provinces within the US or Canada raises issues that to some degree are quite analogous to those faced by EU member states. However, within the North American federations, accounting and legal standards are largely shared among all jurisdictions, tax enforcement and auditing responsibilities rest to a significant degree in the hands of national authorities, and well-developed systems exist through which the national authorities can transfer revenues to lower-level governments. The situation facing EU member states (or other nations) is quite different in this respect; indeed, whether EU countries can, should, or will build new institutional structures to facilitate corporation income taxation, and if so, how, is itself an important topic for theoretical analysis (see, e.g., Wildasin (2000, forthcoming,a) for further discussion and references). The "right" model of corporate income taxation in the open-economy setting, as well as the choice of issues for investigation, may well differ significantly depending on the intended application of the analysis.

(ii) Theoretical and empirical analyses both confirm that local government tax and expenditure policies affect the locational choices of households while, in democratic systems, the composition of the electorate affects political competition and policy choices, thus giving rise to simultaneous determination of political, demographic, and economic conditions. International migration, in principle, presents rather similar issues. Within countries, however, a change in location normally does not jeopardize a migrant's franchise, nor is freedom of movement normally subject to legal restraint (though internal passport controls continue to exist in a few countries). In the context of international migration, however, both the degree to which people are free to move across jurisdictional boundaries and the ease with which they become enfranchised – first, through the acquisition of legal residence status (a thorny problem for millions of illegal migrants throughout the world) and secondly through the granting of voting rights – are very much open policy questions. In Europe, migration is closely related to EU membership: accession of a new country implies a change in the legal standing of that country's citizens vis-à-vis existing member states. Fiscal considerations (the provision of public services, social benefits, and tax treatment) are presumably very important to international migrants (consider, for instance, the value of public safety for residents of regions experiencing political upheaval and violence) just as is the case within countries. But to what degree can we appropriately apply theoretical models to issues of local government finance within advanced economies, on the one hand, or to international migration issues, on the other?

(iii) In established federations, both vertical and horizontal fiscal interactions come into play simultaneously, although different branches of literature have often tended to emphasize one or the other of these forms of interaction. What light can these analyses shed on the allocative or distributional consequences of varying institutional arrangements (for example, the "co-habitation" of tax bases, different types of intergovernmental transfer programs, greater or lesser degrees of fiscal autonomy among governments at a given level, etc.)? Can they help us to explain the advantages or disadvantages of the organization of the public sector or the historical or prospective evolution of different forms of organization?

(iv) The integration of factor markets is a matter of degree within and among countries and over time. Some studies treat capital as a highly-mobile resource while others view labor as mobile while capital is fixed. Over what geographical scale does fiscal competition occurs: metropolitan areas, countries, or the whole world? To what degree is ownership of capital, natural resources, and other assets broadly shared among residents of different regions? Do the answers to these questions depend on the time horizon of the analysis? These are critical issues when analyzing the effects of factor market integration on factor prices and thus on the distribution of income, the propagation and pooling of income risk among regions, and, of course, for empirical analysis.[3]

(v) How best should one model the "degree of competition" among governments? Do they interact atomistically, like perfectly competitive firms, or do they interaction strategically, like oligopolists? Of the many ways to model strategic interactions among governments, especially as they play out over time, what will prove to be the most important?

(vi) A related question concerns the nature and type of competition that occurs in the private sector of the economy. What is the nature of fiscal competition among governments when taxed (or subsidized) industries are oligopolistically organized or monopolistically competitive? Well-known analyses of strategic trade policy in the literature of international economics have demonstrated that the benefits and costs of tariffs and other policies can be quite sensitive to industrial structure, and ongoing research in the area of fiscal competition shows that the same is true in this context, as well. How do unionization, social insurance policies, and labor-market regulations that limit the operation of competitive market forces interact with the fiscal treatment of capital investment and its impact on labor-market conditions?

[3] As examples, consider recent empirical analyses of fiscal competition among local governments in small regions in the US (Brueckner and Saavedra (2001)) and Germany (Buettner (2001)), and contrast these with studies of the movement of capital and labor between the Old and New Worlds in the 19th century (Hatton and Williamson (1994)) which, though they do not emphasize issues of fiscal competition, certainly indicate that there was active international competition for productive resources well before the era of high-speed internet access. Because of the vast differences in geographical and temporal scales over which competition can be analyzed, my personal view is that explicit analysis of the dynamics of factor mobility will ultimately play a crucial role in bridging the gap between theory and application (Wildasin (forthcoming, b)). There should be some interesting opportunities here to blend public economics with economic history and macroeconomic modeling methods.

(vii) Transfers by national to subnational governments are often used to assist poor regions, to help promote economic development, and to ease transitions in response to economic, demographic, and other shocks. Transfers by nations or by multilateral agencies such as the IMF or World Bank are also often targeted at similar objectives. Changes in fiscal policies by subnational governments can trigger capital flows within (or among) countries, while changes in fiscal policies by national governments can trigger capital flows among countries. The analysis of these issues lies at the intersection of macro- (and monetary) economics, open-economy public economics, and those parts of (international) development economics dealing with international development aid and international capital flows. Public-economic theorists can make important contributions to sorting out the incentive problems that arise in the structuring of intergovernmental relations, including relations that are intermediated by multilateral institutions.

3 Onward

This list could easily be extended. It will be apparent that there is a vast and diverse research agenda for students of open-economy public economics. It will no doubt also quickly be apparent to the readers of this journal that this diverse field not only invites but requires the development of useful theory. Theoretical analysis, such as that displayed in the current issue of *JPET*, can be especially valuable in distilling central principles that can be applied in the varied contexts described above. Furthermore, theoretical analysis can be informed and shaped by an appreciation of diverse institutions and policy contexts. We can learn a lot, in other words, by discovering essential commonalities in diverse areas of application, and we can also learn a lot by discovering essential differences. The papers presented here provide an excellent sample of the current range of theoretical research in a dynamic field full of deep intellectual and scientific challenges and full of opportunity for future research.

References

Brueckner, J.K. and L. Saavedra (2001), "Do Local Governments Engage in Strategic Property-Tax Competition?" *National Tax Journal 54*, 203–229.

Buettner, T. (2001) "Local Business Taxation and Competition for Capital: The Choice of the Tax Rate," *Regional Science and Urban Economics 31*, 215–245.

Cremer, H., V. Fourgeaud, M. Leite-Monteiro, M. Marchand, and P. Pestieau (1996), "Mobility and Redistribution: A Survey," *Public Finance 51*, 325–352.

Hatton, T.J. and J.G. Williamson (1994), "International migration 1850–1939; An economic survey," in T.J. Hatton and J.G. Williamson (eds.), *Migration and the International Labor Market 1850–1939*, Routledge, London, 1994, 3–54.

Musgrave, R.A. (1959) *Theory of Public Finance* (New York: McGraw-Hill).

Oates, W. E. (1972) *Fiscal Federalism* (New York: Harcourt Brace Jovanovich).

Wellisch, D. (2000), *Theory of Public Finance in a Federal State* (New York: Cambridge University Press).

Wildasin, D.E. (1986), *Urban Public Finance* (New York: Harwood Academic Publishers); reprinted (with minor updates) in Richard Arnott (ed.), *Regional and Urban Economics*, Part 2 (Amsterdam: Harwood Academic Publishers, 1996), 561–730.

Wildasin, D.E. (1998), "Factor Mobility and Redistributive Policy: Local and International Perspectives" in P.B. Sorensen (ed.), *Public Finance in a Changing World* (London: MacMillan), 151–192.

Wildasin, D.E. (2000), "State and Provincial Corporation Income Taxation: Current Practice and Policy Issues for the US and Canada," *Canadian Tax Journal 48*, 424–441.

Wildasin, D.E. (forthcoming, a), "Tax Coordination: The Importance of Institutions", *Swedish Economic Policy Review.*

Wildasin, D.E. (forthcoming, b), "Fiscal Competition in Space and Time," *Journal of Public Economics.*

Wilson, (1999), "Theories of Tax Competition," *National Tax Journal 52.*

Wilson, J.D. and D.E. Wildasin (forthcoming), "Capital Tax Competition: Bane or Boon?" *Journal of Public Economics.*