International Coordination of Tax Policies
Comment to A. Lans Bovenberg

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COMMENTS ON: L. BOVENBERG, "INTERNATIONAL COORDINATION OF TAX POLICIES"

Hans-Werner Sinn

Competition of economic systems sounds good to the liberal or libertarian economist. The word "competition" arouses positive connotations, and indeed there are good practical examples for the beneficial role of competition among governments.

However, a closer look reveals that the beneficial role of competition among economic systems in general, and tax systems in particular, is ambiguous, to say the least. Lans Bovenberg presents many good examples for this. The harmful effects of tax competition which he describes make a strong case for a coordination of government policies.

While I fully agree with what he says, I would have preferred a more theoretical categorisation of the arguments and placed the emphasis on somewhat different points. I see four fundamental reasons for "market failure" in the competitive selection of tax systems. They are very similar to the conventional reasons for the possibility of failure of private markets, but although these reasons are more than exception than the rule for the private sectors, they seem typical for the "market" of tax systems.

(1) Monopoly power. It has long been recognised in the foreign trade literature that a large country can act like a monopolistic price setter in the world commodity and factor markets. It can capture welfare gains at the expense of its trading partners by imposing taxes which affect its inhabitants' demands and supplies in a way which changes the world-wide terms of trade in its favour. More pointedly, a country which is not afraid of retaliatory action by its trading partners may well introduce protectionist beggar-thy-neighbour policies. Bovenberg mentions the American policy of massively subsidising domestic investment after 1981. This policy boosted the world interest rate and helped the U.S. lend its capital to the rest of the world under more favourable conditions. Although there is evidence that the policy went too far to be really beneficial for the United States, it definitely hurts the rest of the world. It was a major reason for the world debt crisis. There is broad agreement within the economics discipline that tax competition does not result in desirable equilibria when countries try to exploit their

monopoly power in protectionism games. This is so notwithstanding the fact that some scholars seem to reserve the word "competition" for those fiscal games which result in "good" equilibria.

(2) Externalities. The externality problem is nearly as important for competition between tax systems as it is for competition in the private sector: Bovenberg is right to emphasise the need for a coordination of environmental taxes. It is true, of course, that a competition between tax systems might work where Pigovian taxes are imposed on those kinds of pollution which fall exclusively on domestic residents. A government that seeks to maximise national welfare then has an incentive to choose a tax rate equal to the marginal social cost of pollution to ensure that the relative prices of its traded commodities correctly reflect the domestic scarcity of environmental factors. However, some, if not most, pollution spills over to other countries, examples here being air and water pollution. A single country has no incentive to internalise these external costs in its domestic producers' output prices. Only collectively determined tax agreements can lead to an efficient amount of environmental protection.

(3) Income redistribution. Fiscal competition in a world of integrated factor markets severely reduces the scope for the government's redistributional activities. With fully mobile factors which can freely choose among competing fiscal systems only benefit taxes are feasible. Benefit taxes can be seen as prices of those public goods and services that a country can offer a factor it wants to attract. No country can afford to impose a net burden on a mobile factor, for if it did, other countries could capture a rent by undercutting this country's tax and attracting all the available supply of the factor. Similarly, a country could not afford to pay out a net transfer to a mobile factor since this factor would be attracted from everywhere and the country would soon run into severe deficit problems (New York City effect). Superficial observers may consider this an efficiency enhancing change for the better. However, in an uncertain world, income redistribution by the government may itself be efficiency enhancing since it acts as insurance against the risks of lifetime careers. If, due to adverse selection and monitoring problems, such insurance cannot be offered by private markets, it should not be sacrificed in a process of tax competition. Policy coordination is needed because if all countries agreed to take from the rich (the lucky) and give to the poor (the unlucky) no country need fear offsetting factor migrations. Without policy coordination, the likely migration of factors would wipe out a large class of binding redistribution contracts which risk-averse individuals like to "buy" before they know how the dice of destiny will be cast. Voting with one's feet after the dice have been thrown is counter productive when there is fiscal

competition. It is like an insurance market where the customers can choose between high and low coverage contracts after they know where a loss has occurred. If we do not want to limit immigration we must reduce the degree of fiscal competition. This is the only way that the increased international factor mobility now characteristic of Europe and other parts of the world can be prevented from extinguishing the insurance state.

(4) Increasing returns to scale and public goods. The reasoning given the emergence of benefit taxes in a process of tax competition, to be precise, explains marginal benefit taxes. If there is to be a fiscal equilibrium it must be one in which the tax that a marginal unit of a factor has to pay equals the cost of the additional benefit this unit creates. This is a trivial fact, but its important consequence is that, with increasing returns to scale in the production of benefits, the tax revenue does not cover the production cost when, for technical reasons or because of constitutional equity requirements, it is impossible to impose discriminatory taxes on immobile factors or intramarginal factor supplies. Unfortunately, however, increasing returns to scale is the rule for public production for, with constant or decreasing returns, the production could easily be privately organised. In the extreme case of pure (local!) public goods the revenue generated by benefit taxes would even be zero since there is no rivalry in consumption and hence no marginal cost of providing the benefits. Thus even a fiscal equilibrium with benefit taxes could hardly exist in a world of highly integrated factor markets. The reason for non-existence of a private market equilibrium carries over to the case of fiscal competition. Those who want unlimited fiscal competition implicitly support the abolition of public goods production. Again, only policy coordination will prevent this outcome. If the fiscalities agree to uniformly raise more than marginal benefit taxes they will have the funds needed to finance the production of public goods and other increasing returns to scale operations.

In my opinion, the public goods problem and the potential death of the insurance state are the most severe obstacles to an unrestricted competition of tax systems. I would have preferred the author to mention these issues and to elaborate upon them since they would have made an even stronger case for policy coordination. Nevertheless I fully agree with the points he makes and share his conclusions. Undoubtedly, the article is a useful contribution to the policy debate that goes far beyond the superficial praise of tax competition that enjoys so much popularity in our discipline.