COMMENTS ON SESSION III:
TAX COMPETITION AND TAX HARMONISATION

Ranjana Madhusudhan[*]

The six papers included in this session span over a wide array of interesting topics and I found them very stimulating. I will focus on issues relating to tax competition and tax harmonization using the New Jersey example.

In 1997, the Federal Reserve Bank of Boston had organized a Symposium to examine the impact of inter jurisdictional competition and tax harmonization on economic development. The first question addressed dealt with the definition of inter jurisdictional competition (IJC). One of the definitions provided by the U.S. Advisory Commission on Intergovernmental Relations (ACIR) was that "IJC is the manner in which the free movement of goods, services, people and capital constraints the actions of independent governments in a federal system" (ACIR 1991). The consensus was that regardless of whether IJC was good or bad, there should be no attempt to constrain it (in US by the Congress or the Supreme Court).

Kastrop's paper presents a good outline of the German federal evolution and highlights unique features in the German federal system such as the clause "for all time", which is unique among modern democratic constitutions. An interesting feature is that even though there are three levels of government, including the communes, the Federal Republic of Germany is a two-tier federal state comprising the Federation and the Lander. The big taxes are federal while state and local governments have a limited but exclusive revenue base.

In the United States the degree of fiscal decentralization is quite apparent. States can levy personal income and corporation business taxes that are levied by the federal government. They also have state level taxes such as sales and use taxes. Although, the property tax constitutes the primary local revenue source, local governments have the power to utilize income taxation. New York City is a case in point.

New Jersey is very decentralized with a strong tradition of home rule. There are close to 1,600 units of local government, including 21 counties, 566 municipalities, 611 school districts, 400+ local authorities, fire districts and special purpose districts.[1] In 2000, local governments raised $14.2 billion through property taxes, which was greater than the sum of revenues from the Big three state taxes: personal income tax ($6.5B), sales tax ($5.3B) and corporation business tax

* New Jersey Department of Treasury.
The views expressed are those of the author and do not represent the views of the New Jersey Department of Treasury.

1 See Coleman *et al.* (2001), pp. 18-9.

($1.6B).[2] In contrast to Germany where local taxes are shared with the federal and Lander governments, New Jersey does not get directly involved with the local government budgeting process and revenues from property tax is not shared with the State.

Kastrop points to the serious efficiency issues that arise with the relatively high degree of expenditure side autonomy on the one hand and the diminished revenue side autonomy on the other hand. The current system is also suffering from other problems accentuated by stagnating economic conditions, coined the “German disease”. The paper lays out and evaluates major reform proposals to promote efficient and effective economic and fiscal policies.

State Tax Study Commissions have made similar recommendations to improve the fiscal imbalance situation facing local governments in New Jersey, including measures to improve local government structure through greater cooperation among jurisdictions and employing diverse funding sources, particularly non property tax sources to increase revenue independence for local governments. The Regional Efficiency Aid Program and Regional Efficiency Development Incentive are two measures that illustrate the promotion of inter jurisdictional cooperation and efficiency in New Jersey.

Kastrop recommends the promotion of healthy inter jurisdictional competition, which is good when regional preferences are satisfied in line with the Tiebout model. A good competition has the potential to generate creative legislations, which in turn lead to inter jurisdictional cooperation. This is illustrated by the development of interstate banking legislations in the U.S.

There are some ambiguities in the paper on financial equalization measures and in the distribution of tax revenue by source and level of government. In particular, the percent distribution is unclear. It would be useful, for instance, to clarify the >100 per cent rule and explain the 72.5 per cent cap in greater detail. The paper reflects that constitutional changes would be needed to legislate serious reforms in Germany. The policy implications that are expected when the German federal system is fully modernized are somewhat speculative (see p. 304). The paper concludes by extending the analysis in the EU context. It would be helpful to have more specific recommendations and details on what type of tax is being considered for the EU and indicate if is it going to be a revenue neutral tax change?

The paper by Boothe focuses on a recent natural experiment to examine the issue of tax competition in the Canadian context. It attempts to measure and assess the impact of change from the TOFT to TONI on the degree and nature of inter provincial tax competition. Economic efficiency in the Tiebout context is discussed and it is suggested that political efficiency may be gained by pooling tax collection systems when regions use similar tax systems. This is supported by U.S. experience with interstate cooperative compacts. The present “CITE” (cooperative interstate tax enforcement) program between two neighboring states, New Jersey and New York,

2 New Jersey State budgets.

which was signed into law in 1986 is a good example. Under this agreement, businesses located in bordering jurisdictions agree to collect/remit sales tax from non-residents. As of early March 2003, there were 7,689 active vendors under CITE, including 3,521 vendors from New Jersey and the remaining 4,168 from New York. During fiscal year 2002, New Jersey collected close to $52 million for New York while New York collected over $22 million for New Jersey.[3] Boothe notes that tax structures got simplified with no increases in compliance/administration costs since provinces adopted federal definitions. Again this is similar to the experience in the United States where states have adopted uniform definitions under the Uniform Definition for Income Tax Purposes Act (UDITPA) to improve administrative efficiency. Currently, states are working on a 'Streamline' project, developing uniform definitions of tax base and situs rules to deal with the challenges posed by electronic commerce, particularly to state sales tax systems.

It may be too early to generalize and draw policy conclusions from the new Canadian experiment. The policy implications may be tentative and the results may be different if provinces move away from the federal definition, which may be limiting the degree of regional diversity. It would be helpful to explain in detail why over the period under consideration, taxes over $10,000 to $100,000 range became more progressive in the maritime provinces (Nova Scotia, New Brunswick and Prince Edward Island) and somewhat less progressive in other provinces? It would also be useful to know what happened in Quebec during all these changes that took place in the rest of Canada?

The third paper by Ederveen and Mooij is an interesting application of Meta analysis to empirical literature examining the impact of company taxes on the allocation of FDI. The analysis embodied in this paper is very detailed and includes 25 empirical studies; the primary finding is that the elasticities derived from studies using forward-looking concepts are significantly higher as compared to backward looking approaches. A typical elasticity based on marginal effective tax rate is shown to be –4.2 per cent. The paper then reports that on average the tax rate elasticity of foreign capital is around –3.3 per cent. This opens up the question as to which value should be used for benchmarking? The paper is insightful but suffers from certain limitations as some observations in the Meta sample are dependent and there are other problems noted by the authors. As such some of the methodological issues remain unresolved under Meta analysis.

An extension of the analysis to track countries that have experienced an increase in FDI after changing tax rate on their company taxes would be helpful to policy makers. The U.S. has been experiencing different trends in the level of FDI, particularly, a slowdown in recent years, independent of changes in company tax rates. Other factors that have affected the level of FDI include the general health of the economy (U.S. and global), the relative strength of the dollar, regional distribution of corporate profit margins, and the level of productivity. The application of Meta analysis should be extended to understand the role of other

---

[3] Information obtained from the New Jersey Division of Taxation.

significant factors such as the interest rate environment, which has a bearing on the flow of FDI via the rate of return on investment.

The paper by Catenaro and Vidal demonstrates in the context of a stylized game theoretic framework of capital tax competition that when repeated policy interactions are associated to a systematic punishment of the deviating policymaker, a coordinated outcome can be the solution to the non cooperative tax game. The methodology moves beyond the static tax competition model to examine the issue of tax competition/ harmonization in a dynamic world setting with a repeated interaction framework. An interesting reflection in the paper is that the Nash equilibrium outcome of the static tax competition models may not necessarily coincide with the outcome of the tax game in a repeated interaction framework. The paper indicates that governments may secure a cooperative or coordinated outcome by threatening to retaliate if one of them deviates from the coordinated tax rates. In the U.S. we can find examples – the use of retaliatory taxes to discourage negative tax competition (insurance industry taxation) on the one hand and the use of inter-state tax compacts (such as inter state fuel tax agreement or IFTA) to encourage tax harmonization.

The methodology employed in the paper uses a two-country model. An extension to a multi-country structure would be more useful in understanding policy issues relating to tax competition/harmonization in the EU. Other useful extensions would include examining implications when the assumptions regarding factor mobility change? What happens when labor is also mobile, as may be possible within the EU region? Other questions worth examining include: What happens when countries under consideration are more symmetric in size and what are the effects specific to bordering regions?

The paper by Haughwout is an insightful application of intra regional trade model to examine fiscal policy issues. The paper examines an equilibrium model of a single region, whose separate political jurisdictions are linked by trade in intermediate goods. I found the paper very thought provoking and stimulating. From a practitioner's perspective I am interested in understanding the implications of relaxing certain assumptions made in the model. What happens, for instance, when the elasticity assumptions are changed or when non intermediate goods/final goods are introduced in the model? That is, exploring the linkages via final goods? What are the implications of assuming agglomeration externality in the secondary region as well? The production function is assumed to be linear and homogenous but in the complex real world context it may be useful to look at a non-linear function since inter regional variations are expected to be significant in some parts of the EU.

It would be useful to extend the analysis to explore multi-dimensional linkages and to more than one jurisdiction to examine issues with the open EU economies and inter-regional dependence. For the policy maker it would be useful to know the implications when several countries are involved, particularly, in the EU context? Consider the case when Country A takes advantage of production in Country B but exports to Country C due to other trade advantages? In Jersey City, New Jersey, lot of relocation is taking place of major businesses from New York

City but the underlying dynamics may be different from those being examined in this paper.

Finally, Weale's paper examines the nature of capital income taxation in the UK and raises the issue of short term vs. long term dynamic inconsistencies. The paper indicates that even when distributional effects are taken into account there would be a majority among rational electorate for setting the tax rate on income from capital at zero because of the change in demographic dynamics. In the Weale's model, younger population favor taxation of income from capital while older people do not due to the wealth constraint facing the former group.

The question that remains open is what is an optimal tax rate that would satisfy both the young and the old? Another question of interest relates to the IT age which made lot of the young people rich (before the financial bubble) and this could change the inter temporal dynamics. For instance, it would be useful to know if the results change when rich young folks from the era of new technology are introduced in Weale's analysis?

REFERENCES

Coleman, H.C., J.W. Hughes and D. Kehler (2001), "Fiscal Reponsibility", New Brunswick, NJ, The Fund For New Jersey.

Federal Reserve Bank of Boston (1997), "Proceedings of a Symposium on The effects of State and Local Public Policies on Economic Development", *New England Economic Review*, March/April issue.

New Jersey Division of Taxation (2003), *CITE* Info (internal data).

New Jersey State, *Budgets*, various issues.

U.S. Advisory Commission on Intergovernmental Relations (ACIR) (1991), *Interjurisdictional Tax and Policy Competition: Good or Bad for the Federal System?*, M-177, Washington, D.C., April.