Fiscal competition and European Union: contrasting perspectives

Wallace E. Oates*

Department of Economics, University of Maryland, College Park, MD 20742, USA

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Abstract

This paper has two objectives. First, it provides an overview of the vast literature on fiscal competition. A major theme is that the desirability of such competition depends in important ways on one's view of how the public sector works. This is a complex issue with some intriguing twists. Second, the paper explores the emerging structure of the public sector in the European Union in the presence of growing fiscal competition. From the perspective of traditional fiscal federalism, this structure may be ill-suited to performing two of the traditional tasks of public finance: support for the poor and macroeconomic stabilization. © 2001 Elsevier Science B.V. All rights reserved.

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1. Introduction

Economic competition, as economists are quick to point out, often has efficiency-enhancing consequences for the pattern of economic activity. But, as we know, this is not always true. And the case of economic competition among...
governments is especially complex in this respect. In a setting of private markets with individual profit-maximizing agents, we can characterize outcomes (or at least certain classes of outcomes) with reasonable clarity. But when we turn to public-sector behavior, including both fiscal and regulatory decisions, things are less clear. Outcomes depend, for example, on the precise objectives of public-sector decision-making. And these objectives are often quite murky. The literature on collective choice suggests a range of possibilities encompassing everything from benevolent planners who seek to maximize ‘the well-being of society’ (somehow defined), to bureaucrats with their own objective functions, or some amalgam resulting from the interplay of various interest groups.

My basic point here is that one’s view of the properties of fiscal competition — whether or not it is a good thing — depends in important ways on how one sees the general operation of the public sector. If one takes a more neoclassical approach with public decision-makers who seek to promote social welfare, then we find that fiscal competition leads to efficient outcomes only for a class of relatively special cases where jurisdictions are small with respect to the relevant capital markets, where strategic elements are relatively unimportant, and where the public sector has access to the right sorts of fiscal instruments. Otherwise, as the literature has shown, various kinds of distortions are likely to result. Public programs, for example, may often tend to be suboptimal. Even here though (as I shall discuss), the general magnitude of these distortions and their quantitative impact on social welfare are far from clear. In sharp contrast, if one views the public sector as inherently overly expansive and inefficient (as suggested by a Leviathan view or one that sees public-sector outcomes as essentially dictated by the interplay of powerful interest groups), then fiscal competition can take on a much more appealing character: it becomes a disciplinary mechanism that serves to constrain unwanted expansion of the public sector. But here again the message is not entirely unmixed: fiscal competition in a Leviathan setting can give rise to systematic and predictable sorts of allocative distortions.

The purpose of this paper is two-fold. First, it explores the ways in which such differing views of the public sector influence one’s position on the issue of public-sector competition. This is obviously a matter of some importance, for it has basic implications for whether or not certain classes of spending, tax, and regulatory policies should be harmonized across political boundaries or whether they should be left to public-sector decision-makers in the individual jurisdictions. There are, moreover, some subtle (and even rather ironical) twists in the way in which all this plays out. In subsequent sections of this paper, I shall try to develop (as best I understand them) the various approaches to this issue and their policy implications.

Second, with this discussion of fiscal competition as background, I want to offer

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1This general point is not a new one; see, for example, Edwards and Keen (1996) and Frey and Eichenberger (1996).
some reflections on the ongoing evolution of the European Union. My sense (like that of some others) is that the emerging vertical structure of the public sector in Europe may not be very well suited to performing two of its basic tasks: redistribution to the poor and macroeconomic stabilization.

2. Interjurisdictional competition with ‘local’ welfare-maximizing policies

In this section, I take up the now vast literature that explores the efficiency implications of so-called horizontal competition among governments in a framework in which policy design seeks to maximize the welfare of the residents of the jurisdiction. This can encompass a number of different settings including those in which a benevolent planner maximizes a social welfare function or, alternatively, a median-voter model in which the jurisdiction has either identical residents or a symmetric distribution of preferences (Bergstrom, 1979). The basic framework here is one in which policy decisions are made so as promote the economic welfare of the individuals who comprise the jurisdiction.

In such a general setting, it is not difficult to describe a world in which competition among governments is beneficial in the sense of leading to Pareto-efficient outcomes. In a series of papers, my colleague Robert Schwab and I have set forth a collection of such models.\(^2\) These are models in which jurisdictions compete for mobile firms in order both to increase levels of wage income in the jurisdiction and to enlarge the local tax base. The models produce a series of ‘invisible-hand theorems’ in which interjurisdictional competition leads to Pareto-efficient outcomes. In one sense, this should not be too surprising. So long as local residents care about public outputs as well as their levels of private consumption, they will not wish to extend invitations to new business for which the costs exceed the benefits. The results are in the spirit of Stigler’s (1957) contention that “Competition among communities offers not obstacles but opportunities to various communities to choose the type and scale of government functions they wish” (p. 216).

The models, however, have some essential ingredients that are required for efficient outcomes: governments are small in the sense that they are price-takers in the capital market; they are also small in the sense that they do not engage in strategic interaction in response to the policies of neighboring jurisdictions; they have access to the policy instruments needed for efficient fiscal and regulatory decisions; and public outputs do not have spillover effects on neighboring jurisdictions. Given these conditions, it is straightforward to characterize a quite rich model in terms of public-sector activities, all of which will be pursued at

efficient levels. Oates (1996; The invisible hand in the public sector: interjurisdictional competition in theory and Practice, unpublished paper), for example, presents a model in which governments provide public services for their residents, publicly provided inputs for local firms, in which they limit the polluting waste emissions of local firms, and in which they levy taxes on both residents and firms. In this model, jurisdictions compete through tax, expenditure, and regulatory policies for mobile firms: they try to attract firms both for the wage income they create and the tax revenues they provide. And in the model, we find that expenditure, tax, and environmental measures are all set at levels that satisfy the first-order conditions for Pareto-efficiency. Competition among governments in this framework is efficiency-enhancing; there are no tendencies toward suboptimal levels of public outputs or taxes.

The models provide what are basically analogues to the purely competitive model for private-sector activities. In them, ‘small’ governments that are price-takers in large capital markets compete for mobile capital using marginal-cost pricing policies. Firms face ‘tax-prices’ in each jurisdiction for publicly provided inputs into production that accurately reflect the marginal cost of extending the services to the marginal firm. Likewise if households are mobile, they too face tax-prices (a la Tiebout) that mirror the marginal cost of providing public services to residents. In such a world, taxes guide location decisions of economic agents, both residents and firms, in an efficient manner. And jurisdictions are led to select efficient levels of public activities, encompassing public outputs for both residents and firms. Such models can provide a kind of benchmark for the analysis of fiscal competition.

Not surprisingly, when the conditions that characterize these ‘competitive’ models are amended (often in quite realistic ways), the efficiency properties of their outcomes are compromised. And there is now an enormous and quite sophisticated literature that explores a wide range of such cases. I shall try here simply to provide the flavor of this large literature.

A key condition for efficient competition is the access to tax instruments that allow competing governments to engage in benefit taxation of mobile economic units. But governments in the context of horizontal fiscal competition may often have to resort to non-benefit taxes. And such taxes can be the source of a variety of forms of distortions, both in the allocation of capital (and other mobile units) across jurisdictions and in the determination of levels of local public outputs (e.g., Gordon, 1983; Inman and Rubinfeld, 1996; Wellisch and Hulshorst, 2000; Wellisch, 2000). In the tax-competition literature, important insights have emerged from a relatively simple framework in which jurisdictions have only a single tax instrument, a tax on mobile capital, which they must use to finance public-sector outlays for local public goods. As shown in seminal papers by Zodrow and Mieszkowski (1986), Wilson (1986), and Wildasin (1989), such non-benefit taxation of capital not only leads to a regional misallocation of capital itself. It also introduces a ‘fiscal externality’ into local public decisions. The cost of providing
local public services now involves not only the resource cost of these services, but a loss of local tax base that accrues to other jurisdictions. From the perspective of the locality, this loss of tax base is a cost of local programs and leads typically to suboptimal outputs of local services. As Wildasin (1989) suggests, this can, in principle, be corrected by a set of central subsidies to the jurisdictions to induce the needed increase in local outputs. The corrective measure is, in general, a fairly complicated one that requires a different subsidy rate for each jurisdiction. This strand of the fiscal-competition literature thus addresses the kinds of distortions that arise when jurisdictions do not have access to efficient tax instruments.

A second source of distortions can arise where jurisdictions are not ‘small’ — where their policy choices exert some influence on the equilibrium return after taxes to mobile capital. In such a setting, Wildasin (1988) and others have derived Nash equilibria to explore the ways in which jurisdictions can compete for mobile capital with both expenditure and tax measures. Here again, we find fiscal externalities associated with policy-induced capital flows. For certain cases such market power may actually reduce the extent of the distortions from fiscal competition (Hoyt, 1991).

I have not begun to do justice to the rich and extended literature that explores a wide variety of cases where realistic fiscal institutions produce distorted outcomes in the presence of fiscal competition. This literature has encompassed cases of multiple tax instruments, expenditure competition, and the explicit bidding for mobile firms. For a systematic and more comprehensive treatment of this literature, I strongly recommend two excellent surveys by one of its leading contributors, John Wilson (1996, 1999).

But I would like to offer two observations. First, some have informally characterized the thrust of this literature as describing a so-called ‘race to the bottom’. While this term may serve certain rhetorical purposes, I find it uncomfortably misleading. The term presents us with an image of one jurisdiction cutting its taxes on capital and, perhaps, its environmental standards to gain a competitive advantage over its neighbors, with the neighboring jurisdictions responding in kind. The suggested result is some kind of downward spiral in public sector activities taking us to the ‘bottom’ — a seemingly quite unhappy outcome. Yet this is not an accurate representation of the literature. The models, for example, of Nash equilibria do not describe a dynamic downward spiral ‘to the bottom’: they characterize what are simply suboptimal equilibria.

And this brings me to my second observation. The important issue here is really one of magnitude. How large are the distortions that this literature describes? If they, in fact, represent only minor deviations from efficient outcomes, they may not be of much consequence. But we have precious little evidence on this. It turns out that the measurement of the welfare losses from fiscal competition is a

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3Mintz and Tulkens (1986) show that Nash equilibria in a setting of commodity tax competition also exhibit a form of fiscal externality with a resulting tendency toward suboptimal public budgets.
formidable empirical problem. There is a substantial literature that both describes a wide range of competitive behavior by governments for mobile capital and that even provides some estimates of its effects on industrial location. But this really does not address the issue. As we have seen, the presence of fiscal competition need not imply distorted outcomes; such competition may, in the main, be quite healthy. So the discovery that public policies influence industrial location does not tell us much about the magnitude of any associated misallocative effects (Courant, 1994; Oates, 1996, The invisible hand in the public sector: interjurisdictional competition in theory and Practice, unpublished paper). Fiscal decentralization certainly seems to work tolerably well in many places. Kirchgassner and Pommerehne (1996), for example, have argued that tax competition among the cantons in Switzerland, while having some impact on location decisions, has not seriously impeded the efforts of fiscal authorities in the provision of public services. But, more generally, we are badly in need of empirical studies that can provide some estimates of the likely magnitude of the welfare losses resulting from fiscal competition.

3. Interjurisdictional competition in a world of Leviathans

If the public sector is under the control of agents who pursue their own objectives at the expense of the general welfare, then fiscal competition can serve the constructive social purpose of constraining the excessively expansionary tendencies of public programs. As Brennan and Buchanan (1980) have argued, fiscal competition serves to limit the scope of Leviathan in extracting resources from the private economy. A setting in which capital is highly mobile and in which households can move readily across jurisdictional boundaries places real constraints on the capacity of the public sector to extract tax revenues from the economy. As Brennan and Buchanan put it, competition among governments in the context of the ‘interjurisdictional mobility of persons in pursuit of ‘fiscal gains’ can offer partial or possibly complete substitutes for explicit constraints on the taxing power’ (1980, p. 184). From this perspective, ‘...tax competition among separate units is an objective to be sought in its own right’ (p. 186).

Harmonization of policies is, in general, an ally of Leviathan. Such a coordination of fiscal measures can create a kind of cartel that allows, among other things, an increase in tax rates in all jurisdictions. Frey and Eichenberger (1996), for example, cite the case of a preliminary agreement in 1991 of the EC Council of Ministers that proposed from 1993 onward a rate of VAT no less than 15% in all

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4 For the US, Bartik (1991) provides a useful and comprehensive survey of fiscal competition among states.
5 Wildasin (1989) provides some suggestive simulation results that indicate potentially sizeable distortions. But I am not familiar with much other evidence on this.
member countries. Competition, in contrast, can prevent such unified efforts to increase public budgets. This favorable view of competition has gained considerable currency. As Edwards and Keen (1996) note, the British government opposed the initial proposals of the European Commission for indirect tax coordination with the contention that, in the absence of such coordination, “the pressure on tax rates would in general be downwards, providing an essential antidote to the built-in pressures for increased public expenditure and taxation” (UK Treasury, 1988).

But things are a bit more complex than this. Fiscal competition in a Leviathan setting can introduce its own systematic sources of distortions. Oates and Schwab (1988), for example, show that a Leviathan regime will tend to set suboptimal environmental standards in order to attract mobile capital which can then be taxed. Excessively lenient environmental measures for polluting firms thus become a competitive instrument for enlargement of the public sector. Moreover, as Edwards and Keen (1996) find in their imaginative analysis, the effect of a tax-harmonization policy that raises taxes in all jurisdictions on mobile capital can, under certain conditions, raise the welfare of the representative citizen (if Leviathan is not too greedy).

The general presumption, however, must be that fiscal competition is likely to be a beneficent, anti-Leviathan force in a world of overly expansive government. Rauscher (1998) shows that (at least for the case of benefit taxes), increased interjurisdictional competition leads to lower tax rates and a reduction in Leviathan exploitation. Rauscher summarizes, “In my model, tax competition ties the hands of a bad government; it is forced to redistribute resources from its own members to the rest of society” (p. 66). Likewise, Sinn (1992) finds in his model that competition among governments in a world of mobile capital can ‘tame’ Leviathan tendencies.

It is interesting in this context that European Monetary Union has also been defended as a peculiar kind of anti-Leviathan measure. McKinnon (1997b) argues that national politicians have historically been unable to resist the political pressures of a variety of interest groups that have forced them into large spending programs financed by budgetary deficits. In his view, individual nations in Europe have been “trapped in a suboptimal political equilibrium” (p. 227). McKinnon suggests that EMU can be seen as a mechanism for ‘collective fiscal retrenchment’. By foregoing their individual monetary powers, governments have effectively constrained themselves in such a way that they can escape from the pressures for continued excessively large and debt-financed budgets.

More generally, Weingast (1995), McKinnon (1997a), and their colleagues contend that fiscal decentralization in the context of what they call ‘market-preserving federalism’ provides a framework that can support an efficient system of markets. Such a system is characterized by a public sector in which decentralized governments have the primary regulatory responsibility and where public officials face ‘hard budget constraints’ in a setting with free movement of
goods and economic units across jurisdictional boundaries. It can constrain government and create an environment conducive to sustained economic growth. From this perspective (much like that of the closely related Leviathan literature), fiscal competition is clearly a beneficent force: it keeps government in check and reduces its capacity for unwanted interference in the economy.

In a somewhat similar spirit, Frey and Eichenberger (1999) have recently proposed an innovative alternative for the structuring of the public sector in the EU. They contend that the advantages, both economic and political, from decentralization and competition could be captured in a system of “functional, overlapping, and competing jurisdictions (FOJC)”. Their approach involves the creation of separate jurisdictions for the provision of specific public services. Individuals would thus have membership in a multiplicity of jurisdictions, each with the responsibility for providing a particular public service. Competition among jurisdictions (operating both through potential mobility and political channels) would lead to levels of public services that are responsive to ‘local’ demands and that are provided in a cost-effective fashion. The Frey-Eichenberger vision is a provocative one. While the proposal is still in embryonic form with the precise character of these jurisdictions needing further exploration, it provides an intriguing general approach that merits careful consideration. Competition, properly channeled, may well improve the performance of the public sector.

4. On public redistributive programs

One of Musgrave’s three functions of the public sector is the redistribution of income with particular attention to providing assistance to low-income households. In the fiscal federalism literature, a number of us (e.g., Musgrave, 1959; Oates, 1972) have contended that the central government must play a primary role in poor relief. The familiar argument here is that sub-central governments are likely to be significantly constrained in their capacity to provide needed transfers by the potential mobility of the poor and of the tax base. A jurisdiction, for example, that introduces a generous program of income support runs the risk of attracting an inflow of low-income persons, while at the same time encouraging an outflow of those who must pay the taxes. It is, in fact, straightforward to show that there is a basic fiscal externality here that results in suboptimal levels of support under a purely decentralized system of poor relief (Brown and Oates, 1987; Wildasin, 1991).

From this perspective, several observers have noted that the public sector in the emerging European Union may not be able to carry out this function effectively. The central government at the community level will not be in a position to provide broad-based poor relief throughout Europe. No one seriously envisions this. The proposed central budget is simply too small. The Commission Report on ‘Stable Money — Sound Finances’ (1993), for example, envisions an EC budget on the
order perhaps of 2% of Community GDP. While this might allow for some very limited assistance to certain poor regions, the basic vision is certainly one in which the individual nation-states will have primary responsibility for support of their low-income populations.\footnote{This view, incidentally, echoes that of the earlier MacDougall Report on ‘The Role of Public Finance in European Integration’ (see Commission of the European Communities, 1977, Vol. 1).}

But as Sinn (1994, 1997), and several others have argued with considerable force, growing fiscal competition will seriously constrain redistributive programs in the individual nations. In a Europe of mobile capital and labor, substantial taxes to finance assistance to the poor may come (or at least be perceived to come) at a significant cost in terms of economic growth. In the limiting case, as Sinn (1994) points out, fiscal competition will result in ‘... an equilibrium where only benefit taxes are charged, and no redistribution policies are carried out’ (p. 100). This is admittedly a limiting case. In practice, we find in the US, for example, that the individual states place some reliance on non-benefit taxes. Moreover, as Kirchgas- snerr and Pommerehne (1996) have argued, Switzerland has managed to function reasonably well in a setting with individual income taxes at the canton level.

Nevertheless, the constraints are real. There is supporting evidence for the case that mobility makes subcentral redistribution costly. Helms (1985), for example, in a careful econometric study of states in the US, has found that state and local tax increases used to finance transfer payments result in reduced economic growth. And, in their survey of the empirical work, Brown and Oates (1987) find evidence suggesting that the perception that poor households are mobile has led in the US to a reluctance in the individual states to provide assistance to the poor. My sense is that Sinn and others are basically correct in their contention that the emerging E.U. will find itself in real difficulty in providing support for low-income households.\footnote{Sinn’s (1997) more general and interesting point (what he calls the ‘selection principle’) is that government is typically called upon to perform functions where markets have failed. For a series of cases, he shows that reintroducing competition where markets have failed is unlikely to resolve the problem.}

It may seem peculiar and even ironical in the light of this discussion to find that the US has recently undertaken a major devolution of poor relief. In 1996 the US replaced the longstanding federal entitlement programs with a new system under which the states have broad scope both to determine the form and levels of their programs to assist the poor. My reading of this reform, however, is not that it fails to recognize the risks inherent in a more decentralized welfare system, but rather that it is a response to the major disappointment and dissatisfaction with the operation and results under the traditional federal welfare programs (Oates, 1999). Without a clear sense of how to restructure these programs to make them more effective, legislators decided to transfer responsibility for them back to the states in the hope that some innovative new approaches will be developed. The idea here is
that the states can serve as ‘laboratories’ for designing and experimenting with new measures for poor relief. And some early results seem encouraging. But I emphasize that the federal government continues to provide extensive financial support to the states for poor relief in the form of substantial block grants with few strings attached to them.

5. Some further thoughts on fiscal federalism and European Union

A second Musgravian function of the public sector is macroeconomic stabilization. Here again, the fiscal federalism literature has argued for a predominant role for the central government (e.g., Musgrave, 1959; Oates, 1972). In the absence of monetary prerogatives and in a setting of highly open economies, decentralized levels of government simply have very limited capacity to influence levels of output and employment in their respective jurisdictions. The central government, in contrast, with a central bank and with access to debt finance where needed for counter-cyclical purposes, is in a position to influence overall levels of aggregate demand. Moreover, the central budget typically has built into it a significant amount of automatic stabilization, as tax revenues and transfer payments respond quickly and spontaneously to changes in the state of the macro-economy.

I will not even try to summarize the enormous literature on European macrostabilization issues that has accompanied the debate over monetary integration. Suffice it here simply to restate the obvious point that the individual nations have given up much of their capacity for macroeconomic policy. No longer with monetary powers or exchange-rate prerogatives, the individual nations are limited largely to fiscal measures for stabilization purposes. And, even here, they are likely to be much more constrained in their access to debt finance where needed to cushion adverse shocks to the national economy. Indeed, one of the major concerns among policy makers in Europe is how the individual nations will address asymmetric, country-specific shocks. For example, in its report on ‘Stable Money — Sound Finances,’ the Commission of the European Communities (1993) acknowledges this problem explicitly and investigates some alternatives for Community instruments to assist with regional stabilization. A major problem here is that unlike ‘mature’ federations where the central budget provides major forms of automatic stabilizers, the central budget in the EU is simply too small to provide any significant built-in stabilization. This role will continue to rest with the member states. It remains to be seen to what extent the more difficult access to debt finance will impair this capacity. If the US experience is any guide here (and perhaps it is not), the member states will find themselves quite constrained in their ability to perform the stabilization function (Inman and Rubinfeld, 1992).

The sense that emerges from a traditional fiscal-federalism perspective on the emerging public sector in Europe is thus an uneasy one. It suggests that the central government is not well equipped to take a leading role in addressing Musgrave’s...
redistribution and stabilization functions. Moreover, the individual nations find themselves with a much diminished capacity to do these jobs. Thus, the emerging European public sector may find its structure rather ill-suited to performing two of the traditional tasks of public finance.

What are the options? While this goes beyond the scope of my paper, let me simply conclude with a couple of observations. One response to the concerns raised here is to enlarge the scope and size of the central government to give it the budgetary capacity to undertake Community redistributive and stabilization programs. There is, I think, very little support for this alternative. This would most certainly entail a substantial expansion of the overall public sector in Europe, an outcome that few would welcome.

The more appealing option is some kind of selective coordination of policies. But this too is a tricky matter. There is a strong case for fiscal decentralization and the allocative gains that it brings. The tailoring of programs to the specific circumstances of the member states is surely something worth preserving. The hard problem will be one of determining the precise forms of coordination that promise to alleviate some of the worst distortions in the EU without foregoing the significant gains from decentralized decision-making.

On the other hand, if one really sees the basic problem as that of constraining Leviathan, then Europe should largely eschew measures to coordinate expenditure, tax, and regulatory policies. From this perspective, the structure of the European system should be one that actively promotes interjurisdictional competition as a means to limiting the encroachment of the public sector on private markets. As put recently by Becker (1998), “Competition among nations tends to produce a race to the top rather than to the bottom by limiting the ability of powerful and voracious groups and politicians in each nation to impose their will at the expense of the interests of the vast majority of their populations” (p. 22).

References


