

# Capital Flows, Tax Competition and the Welfare State

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## Expenditures, Revenue, Debt, 17 OECD countries 1972-1995

	Total Expenditures	Total Tax Revenue	Social Security Contributions as a % of GDP
USA 1972-1995	33.1 - 35.6	27.7 – 28.7	5.7 – 7.8
Canada 1972-1995	37.2 - 48.1	33.1 – 40.4	3.0 – 6.3
UK 1972-1995	39.2 - 44.2	33.6 – 35.5	5.2 – 6.3
Netherlands 1972-1995	44.9 – 54.2	40.3 – 43.9	14.1 – 18.4
Belgium 1972-1995	39.6 – 54.6	37.0 – 46.5	11.7 – 15.4
Italy 1972-1995	37.0 – 51.8	28.5 – 41.3	11.2 – 13.1
Finland 1972-1995	32.4 – 59.1	33.9 – 46.5	4.4 – 12.9
Sweden 1972-1995	45.5 – 67.0	44.2 – 49.7	8.5 – 14.5
Norway 1972-1995	45.0 – 48.9	48.2 – 41.5	12.7 – 9.8
Denmark 1972-1995	40.4 – 61.6	42.9 – 51.5	1.7 – 1.6
Australia 1972-1995	26.5 – 37.3	24.9 – 30.6	0 – 0
France 1972-1995	37.3 – 54.1	35.6 – 44.5	14.7 – 19.3
Switzerland 1972-1995	27.2 – 36.6	23.9 – 33.7	5.6 – 12.6
Spain 1972-1995	22.5 – 45.3	18.5 – 33.9	7.5 – 12.3
Portugal 1972-1995	22.5 – 45.3	22.5 – 34.9	6.4 – 9.4
Germany 1972-1995	38.8 – 49.2	37.3 – 41.2	12.1 – 15.4
Austria 1972-1995	35.6 – 51.5	37.2 – 44.0	9.3 – 15.4
Minimum – maximum 1972	22.5 – 44.5	18.5 – 48.2	0 – 14.7
Minimum – maximum 1995	35.6 – 67.0	28.7 – 51.5	0 – 19.3

Source: IMF OECD

## Once again: Compensation Hypothesis, Efficiency Hypothesis and the Welfare State

### **Efficiency hypothesis**

The more open to the global economy countries are, the less they spend on social transfers.

Social transfers increase production costs of corporations, who prefer to invest abroad, in countries with lower levels of social transfers.

### **Compensation hypothesis**

Global economic openness produces losers which need to be compensated by the winners in order to avoid social tensions.

## Why are some States Welfare States?

- governments want to reduce poverty  
→ redistribution to the lowest income quintile
- governments want to achieve an optimal level of income inequality
- the mean income exceeds the income of the median voter → redistribution to the mean voters
- governments seek to attract swing voters  
→ redistribution to the better informed parts of the population
- governments provide benefits for their clientele  
→ redistribution along partisan lines
- candidates provide benefits to their districts  
(Majoritarian Systems)
- else?

Countries with majoritarian electoral systems are less likely to be welfare states. Why?

## How and why are Welfare States Different?

### Social Security Systems

(Tax financed versus contribution financed)

### Unemployment Insurance

(Generosity, Durability, ...)

### Health Insurance

## Financing the Expansion of the Welfare State:

Contributions

Taxes

Debt

## Financing Social Security Spending

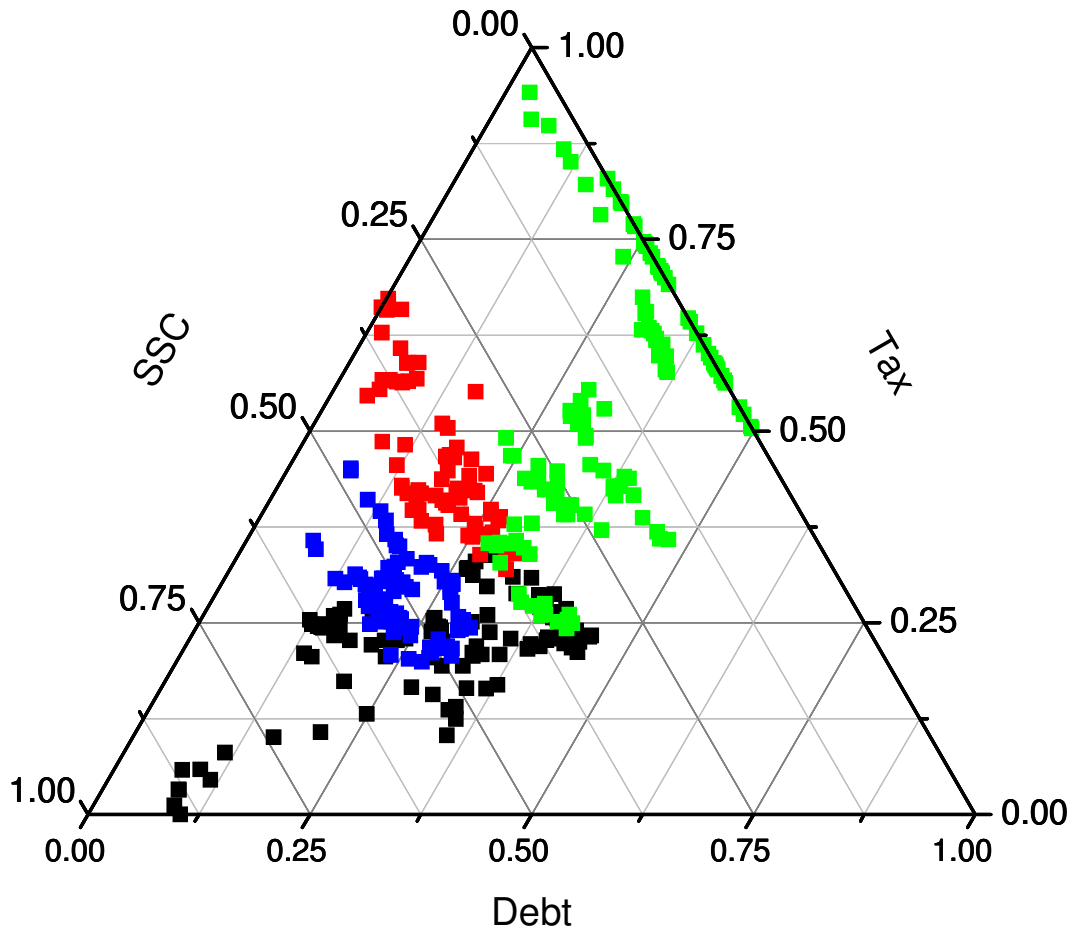


Figure 1: Ternary of relative importance of policy instruments

green: Anglo-Saxon countries, Denmark (tax based, indep. CBI)  
red: Scandinavian countries (tax based, dependent CB)  
blue: continental European countries (transfer based)  
black: South European countries (debt-intense)

Is being a Welfare State more costly since governments have abandoned capital controls?

Discuss!

## Alternative Explanations of Welfare State Expansion

- Aging of Society
- Welfare States create the problems for which they ought to provide a social solution, i.e. unemployment.
- partisan preference (left parties)
- union's power
- reaction to exogenous shocks (oil crises)
- else?

## The Logic of Tax Competition

In technical terms:

“A striking feature of international tax competition is that independent jurisdictions fully or partially share a mobile tax base. As a consequence, if one country reduces its tax rate strategically to attract mobile capital it provokes an immediate inflow of capital, and this, in turn, creates a fiscal externality (i.e., a shrinking tax base) in other countries (see Wildasin 1989). In the (Nash-)equilibrium, governments are left in a situation where tax rates (on capital and labor) are set at comparably low levels.”

Hence: the logic of tax competition depends on capital mobility.

Which tax bases are mobile?

- savings
- corporate profits
- corporations? (holdings)

hence:

governments should remove

withholding taxes (capital earnings taxes)

and

corporate profit taxes

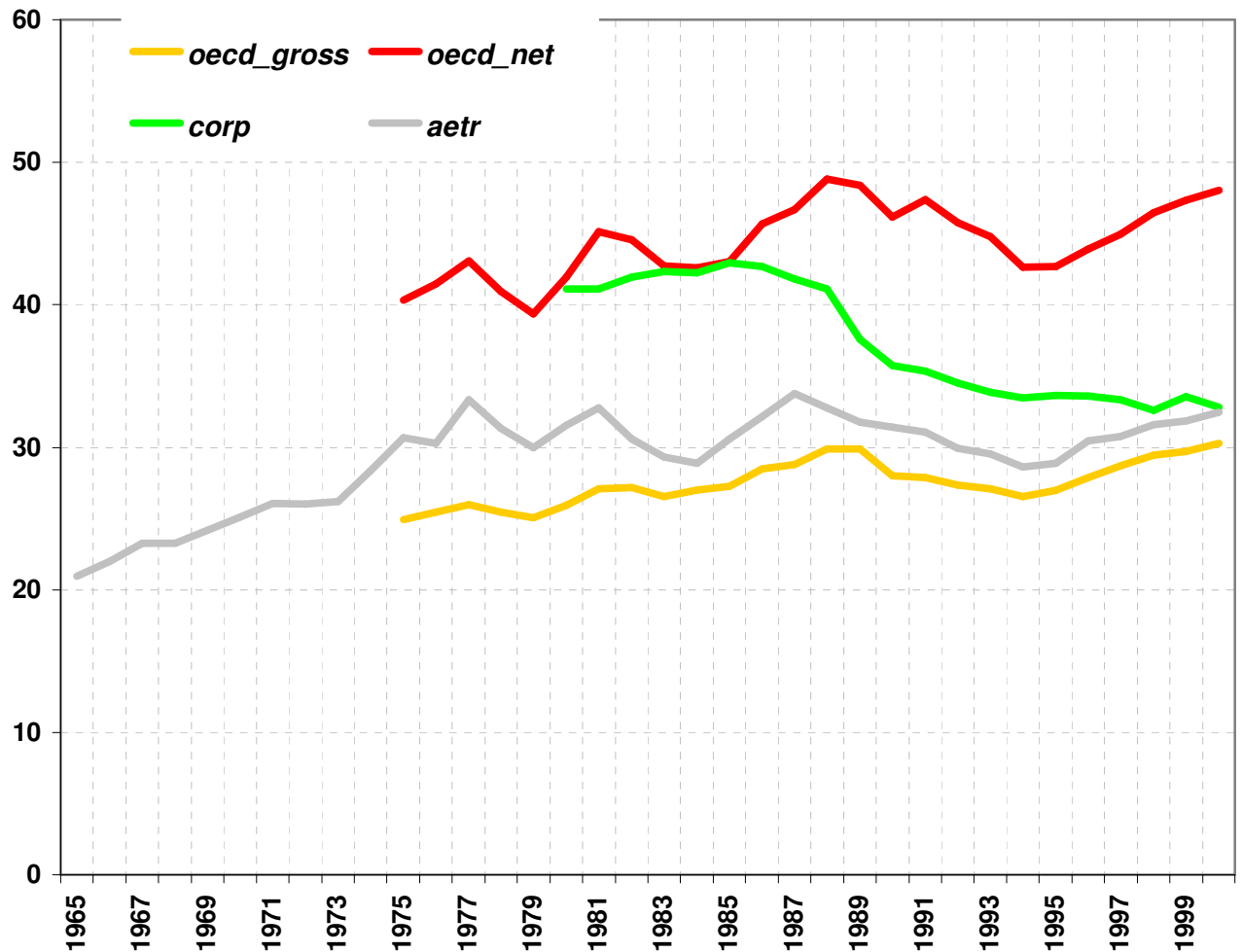
The codes used in the formulas correspond to the OECD classification in the OECD Revenue Statistics:

1100 ... Taxes on income, profits, and capital gains of individuals;

1200 ... Corporate taxes on income, profits, and capital gains;

Is tax competition 'good' or 'bad'? Discuss!

## A view on Tax rates on Mobile Capital (Various Sources)



Has 'globalization' removed taxes on mobile capital bases?

Why not?

## **The Effect of Country Size**

Small countries should act more aggressively in tax competition, because for them the tax base effect is more important than the tax rate effect. In large countries, the tax rate effect is more important than the tax base effect.

## **The Effect of Veto-Players**

Hallerberg and Basinger argue that the extent of tax cuts depends on the number of veto-players (actors that can veto reforms). The more veto-players, the lower tax cuts.

## **The Effect of Budget Constraints**

Governments in countries with budget deficits are less likely to reduce tax rates (Plümper, Winner, Troeger).

1. *Estimation Results*

<i>independent variable</i> <sup>a)</sup>	<i>CTAX<sub>i</sub></i>	<i>LCTAX</i>	<i>CTAX/LCTAX</i>
CTAX <sub>i</sub>	0.604** (0.312)	-0.923*** (0.236)	1.434*** (0.399)
RIGID	0.344*** (0.085)	0.321*** (0.039)	0.118# (0.083)
EQUITY	0.147*** (0.052)	0.036*** (0.010)	0.053** (0.027)
SIZE	0.430*** (0.039)	0.069*** (0.015)	0.356*** (0.032)
GDPPC	0.368*** (0.047)	0.336*** (0.021)	-0.007 (0.043)
Observations	467	467	467
Cross sections	21	21	21
R <sup>2</sup>	0.944	0.954	0.951
Country effects: $\chi^2(20)$	3846.70***	1330.20***	3391.17***
Excluded instruments: <sup>b)</sup> F( <i>DF1</i> , <i>DF2</i> )	37.88*** (4,338)	13.23*** (2,440)	32.88*** (2,440)
Wu-Hausman test: <sup>c)</sup> F( <i>DF1</i> , <i>DF2</i> )	2.00# (1,440)	27.44*** (1,440)	7.14*** (1,440)
Sargan test: <sup>d)</sup> $\chi^2$ ( <i>DF</i> )	4.16 (3)	0.00 (1)	0.36 (1)

*Notes:* Standard errors in parentheses. \*\*\* significant at 1%; \*\* significant at 5%; \* significant at 10%; # significant at 15%. <sup>a)</sup>Constant and country effects not reported. <sup>b)</sup>F-Test for excluded instruments. <sup>c)</sup>Wu-Hausman F-statistic ( $H_0$ : regressor is exogenous (i.e., OLS is consistent and efficient)). <sup>d)</sup>Sargan-Test for overidentifying restrictions.

## **Is tax competition good or bad?**

Bad, if we believe that governments are social welfare maximizers, they provide the optimal amount of public and private goods.

Good, if we believe that governments tend to overtax the society, provide useless benefits to a small minority of important voters and influential individuals.