

3: Free factor mobility and fiscal competition: Can the national welfare state survive in a “United Europe”?

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3.1 INTRODUCTION

Providing social protection is an important task and ambition for many European governments. In 2003, for example, the 15 old member states spent on average over 28 percent of their GDP on social protection (Eurostat, 2006). Even though the variation within member states is wide, the government’s role as a provider of social protection is generally greater than in other parts of the world. In the US and Japan, for instance, the governments spend about half as much (as a share of GDP) and in Korea only a fifth (OECD, 2001a). That the government should provide generous social protection is well rooted among the European citizens, who in general are positive to current levels of welfare spending and negative to cutbacks (Boeri et al., 2001).

Another important goal in Europe, integration, has been a priority dating back at least to the end of the Second World War. While the motivation for European integration was initially primarily political, including the desire to avoid future warfare in Europe, contemporary discussion often centres on the economic benefits of free factor mobility. Indeed, the Lisbon Strategy aims to make Europe the most competitive and dynamic knowledge-based economy in the world by 2010. To meet the challenges of the Lisbon strategy, however, many believe that the mobility within EU must increase considerably, and 2006 was, in fact, designated the “European year of workers’ mobility”. Unfettered mobility has been credited, for instance, with increasing efficiency (lowering costs) by removing barriers to the realisation of scale economics and with increasing competition, thus increasing the range of products offered to consumers while lowering prices (Emerson et al., 1988).

It has become increasingly apparent that these two goals -- generous social protection and free mobility -- may be hard to combine. Free factor mobility permits economic actors, both labour and capital, to locate where their economic welfare is maximised and, consequently, member

states may find it increasingly difficult to levy taxes exceeding those of other member states without losing capital and the most productive workers or to offer generous transfers without attracting less productive individuals. Over time, the competition for mobile production factors threatens to lead toward a downward spiral in tax rates (Zodrow and Mieszkowski, 1986). In short, not only may generous welfare states struggle to survive as net contributors leave and net beneficiaries enter, but the provision of public services may decline generally across even the initially low-tax countries. As a consequence, many argue for the need to harmonise or coordinate tax and transfer policies within the EU in order to maintain acceptable levels of social protection (Sinn, 2002, and Tanzi, 2002).¹

It is not obvious that coordination within EU is feasible or even desirable, however. First of all, regional coordination may be fruitless in a world where capital is globally mobile and labour increasingly so. A large threat to the national welfare states in Europe is competition from outside the EU, for instance, firms outsourcing to Asia. Second, there are important efficiency arguments favouring competition (Wilson, 2005). Coordination may also require that nations give up yet another tool available for guiding their economies. Clearly, any gains from coordination must outweigh the gains from competition to justify coordination. As the globalisation process increases the cost of the welfare state the benefits from the welfare state, must increase accordingly.

This chapter discusses the consequences of increased integration on the ability of member states to conduct independent fiscal policy with a focus on redistribution and the survival of the national welfare state. The chapter begins with a short description of the “welfare state” in Europe. The next section discusses how free factor mobility may threaten the national welfare state both by providing downward pressure on tax rates and, thus, the means to finance social spending and by forcing government to spend strategically in ways attractive to desirable production factors. The chapter then moves on to examine possible countervailing factors which may ensure at least some ability for conducting independent fiscal policies. For instance, labour mobility is so far limited enabling member countries to still conduct some independent

¹ I use the same distinction between harmonisation and coordination as in the chapter 2 by Bellak and Leibrecht in this book. That is, harmonisation involves attempts to equalise tax parameters while coordination involves measures that do not lead to equalisation.

fiscal policy. In addition, the need for a welfare state may be reduced as the benefits from integration in terms of increasing market size and efficiency gains are utilised, which may compensate for some of the lost fiscal autonomy. Finally, the chapter discusses the trade-off between coordination and competition where the positive effects of competition are set against the negative externalities of fiscal competition.

3.2 THE WELFARE STATE IN EUROPE

Europeans generally agree on the value of extensive social protection. Indeed, relative to other continents, welfare transfers are considerably larger in Europe. In 1998, for example, public expenditures on social protection constituted almost 25 percent of GDP in EU15 compared to less than 21 percent for the whole OECD and on average 17 percent for the US, Canada, Australia, New Zealand, and Japan (OECD, 2001a). In Korea and Mexico, corresponding numbers were only 5.9 and 8.2 percent, respectively. The wide range in public social protection suggests that social protection in other continents is to a larger extent provided by the family or the market.

There are several economic arguments for providing this social protection collectively rather than through private markets. First, moral hazard is a critical problem for insurance against such risks as becoming poor, and private markets are unlikely to operate at efficient levels or to arise altogether. Similarly, adverse selection may also discourage the creation of private social protection markets. Finally, the problem of free riders may limit voluntary redistribution even when most people care about the welfare of others (at least to some extent). Compulsory redistribution may, indeed, result in Pareto improvements.

At the same time, publicly financed social protection has an economic cost. One obvious cost of social protection is that associated with collecting the revenues required to finance social protection. To a large extent this is done through taxes on labour (see chapter 4 by Schneider and Österle in this book). Obtaining the required revenues involves not only redistribution from those working to those receiving the benefit but also a welfare cost (excess burden) due to taxes' distortionary effects. In addition to tax-related distortions, transfer recipients may also change their behaviour creating an additional distortion. The optimal level of social protection

is thus when the marginal benefit of social protection equals the marginal cost. To determine this level, however, requires information on both the marginal benefit and the marginal cost of social protection, something that is not easily done in reality.

Though there is no universally accepted definition, the term “welfare state” has loosely come to mean a regime where the state accepts responsibility for the provision of social protection for its citizens in the form of risk insurance and equality. This risk insurance involves public transfers designed to protect against income uncertainty (e.g., due to unemployment or sickness) and to assist the elderly and the poor (e.g., via intergenerational and inter-class transfers).

Even within Europe, however, there is great variation in the ambition, preferences and means for achieving equality and reducing risk and hence in the provision of social protection. In chapter 4 in this book, for instance, Schneider and Österle present numbers showing that expenditures on social protection as a share of GDP range from 14.3 percent in Latvia to 32.5 percent in Sweden. Even within “old Europe”, the range is wide: 16 percent in Ireland compared to 32.5 percent in Sweden. Esping-Andersen (1990) identified three different distinct styles of welfare states in Europe: the universal welfare regime predominant in northern Europe, the corporate welfare regime in, for instance, Germany and Austria and the liberal welfare regime in Ireland and the UK (see chapter 4 for a further description of these welfare regimes).

More recently, Ferrera (1998) and Bertola et al. (2001) suggested a new dichotomy that includes four different categories of welfare states in “old Europe” distinguished by level of social protection provided and target beneficiaries. The wage structure also varies considerably between these welfare states affecting the income distribution. The four models are Nordic, Continental, Mediterranean, and Anglo-Saxon. The welfare state in the Nordic countries, including Denmark, Finland, Sweden, and the Netherlands, is characterised by a high level of social protection, universal welfare benefits based on the citizenship principle, relatively extensive interventions in labour markets and strong labour unions that ensure a relatively compressed wage structure.

In contrast, the Anglo-Saxon countries, including Ireland and the UK, have a less extensive welfare state where social assistance is seen as a last resort and primarily oriented to people in working-age. Weak unions and comparatively wide and increasing wage dispersion and a high incidence of low-pay employment characterise the labour market.

The Continental countries, including Austria, Belgium, Germany, France, and Luxembourg, employ extensive insurance-based non-employment benefits and old-age pensions that rely on contributions on employment income, and while labour unions are on decline they still exercise a strong influence.

Finally, the Mediterranean countries, including Greece, Italy, Portugal, and Spain, focus their welfare spending on old-age pensions and typically concentrate on employment protection and early retirement to exempt groups of the working age population from participating in the labour market. Strong labour unions in the formal sectors have compressed the wage structure.

3.3 THE THREAT TO THE NATIONAL WELFARE STATE IN EUROPE FROM FREE FACTOR MOBILITY

In Europe, there are currently no institutions at the EU level capable of collecting taxes or social contributions to finance welfare transfers so social welfare is provided at the national level. There is widespread concern among politicians and economists alike that increased globalisation, and in particular increased factor mobility related not only to the “internal market” but to the global market as well, will introduce harmful inter-country competition which will threaten the very survival of the welfare state (Sinn, 2002, and Tanzi, 2002).

Two hypotheses are central to these fears. First, countries may be pressured to lower their tax rates, hence reducing tax collections and their means to redistribute, in the competition for increasingly mobile capital and labour. Second, the competition for mobile productive factors may put pressure on nations to adopt fiscal policies strategically favourable to capital and workers rather than providing socially desirable levels of public goods and redistribution (henceforth referred to as fiscal competition).

Tax competition

An extensive literature suggests that tax competition may lead to inefficiently low tax rates and sub-optimal levels of public spending (e.g., Zodrow and Mieszkowski, 1986, Wilson, 1986, 1991). The resulting underprovision arises because changes in tax rates in one jurisdiction affect tax bases in other jurisdictions, an externality which is not internalised when decisions about tax rates changes are made in the first jurisdiction. That is, when a country chooses its tax rate it ignores the impact on capital and labour location decisions occurring in other countries (positive or negative). Tax rate decreases, thus, may be larger than what is globally optimal had the externality been internalised. Consequently, it becomes increasingly costly to deviate from the tax rates in competing countries, and tax rates, therefore, tend to converge. Furthermore, this competition makes it difficult for countries to maintain desired tax rate levels without losing dynamic firms and able workers, and lead to a “race to the bottom”.

The standard model of tax competition rests on the assumption that there exist a large number of homogeneous jurisdictions. Wilson (1991) and Bucovetsky (1991) relax this assumption to allow for “asymmetric” tax competition between large and small jurisdictions. If the larger jurisdictions are large enough to affect after-tax return on capital, they tend to have higher equilibrium tax rates than smaller jurisdictions because they are less concerned about tax-induced capital outflows since they face lower capital supply elasticities. Thus, in contrast to the standard tax competition, asymmetric tax competition allows different tax rates in small and large countries, respectively, and a tax-induced capital flow from smaller to larger countries.

To make the model more compatible with conditions within the EU, researchers have developed models of tax competition whereby a limited number of countries interact strategically. These models also predict downward pressure on redistribution due to free factor mobility but less drastic than that predicted by the traditional tax competition models. For instance, the equilibrium redistribution levels will depend negatively on the number of countries competing as well as on the mobility of the production factors. When the number of

regions and production factor mobility are limited, some measure of redistribution will still be possible.

Proponents of tax coordination or harmonisation have used these results to argue that global welfare would increase if tax reform decisions were taken at a supra-national level in order to internalise external effects affecting other countries' tax bases (e.g., Sinn, 1990, and Tanzi and Bovenberg, 1990). Moreover, the proponents of harmonisation fear that a downward spiral in tax rates will endanger desired government spending. Even if an individual country can gain from tax competition (by winning the race) the losses to the global economy as a whole may be larger.

Nevertheless, views differ widely across economists and it is not clear that tax competition is unambiguously harmful and needs to be tamed. Indeed, economists historically have even considered tax competition as healthy and vital for efficiency. The seminal examination of tax competition, Tiebout (1956), for instance, postulates a general equilibrium in which independent jurisdictions compete to attract mobile households by supplying different mixes of taxes and public expenditures, resulting in an efficient provision of public services in all jurisdictions, and household relocation ensures that each household finds a jurisdiction satisfying their preferences. Individuals, "voting with their feet", enforce strict discipline on government leading to efficient outcomes.

Tiebout's Hypothesis, originally designed for household mobility, applies equally well to firm mobility (White, 1975, Fischel, 1975, and Wellisch, 2000). Jurisdictions compete to attract firms by providing favourable tax rates and useful public services. In equilibrium, firms locate efficiently across the regions and the tax rates they face reflect the cost of providing "public inputs".

The model is less well-suited for personal capital gains taxation, however, where investors can often avoid taxation by residing in regions/countries where personal income is taxed relatively hard but place their capital in low-tax jurisdictions because of incomplete international control. Where income and capital gains taxation follows the residence principle, that is taxation takes

place in the country where the taxpayer resides rather than where the income or gain was made, the model functions better.

In the EU context, the Tiebout hypothesis implies that tax competition will lead the different member states to supply public goods and services efficiently, that equilibrium tax rates and public goods and service levels will generally differ, and that each EU resident will relocate to where her/his preferences are best satisfied. Tax competition within the EU, thus, should lead to efficient provision of public resources and the EU should consequently encourage fiscal competition and avoid coordination.

To realise the positive effects of tax competition predicted by the model, however, a large number of quite unrealistic assumptions must be met. In particular, a large number of jurisdictions must exist permitting each household or firm to find its optimal mix of taxes and expenditures and individuals and firms must be fully mobile,² so it is debatable whether the model is applicable for competition between countries. Moreover, the model disregards economies of scale in public production, which can make it inefficient to have many independent jurisdictions each independently supplying public goods and services.

More recently, however, economists have started to question again whether tax competition is harmful and needs to be tamed. The reasons for this are several. First, the result that tax competition leads to a suboptimal small government rests on the assumption that the initial size of government is optimal. If the government is driven by revenue-maximising behaviour of bureaucrats or by the interplay of interest groups rather than a desire to maximise social welfare or satisfy the median voter the resulting government size can be excessive (Brennen and Buchanan, 1980, and Edwards and Keen, 1996). If this is the case, tax competition could have a disciplinary effect on wasteful government. Second, tax competition may force countries to adopt more efficient tax systems. It is well known, for instance, that taxing mobile tax bases is associated with larger efficiency losses than taxing less mobile tax bases and the welfare gains from efficient taxation can be substantial (Mendoza and Tesar, 2005).

² For firms the number of competing regions can be limited as the bidding process result in efficient firm location (see Black and Hoyt, 1989, and King et al., 1993).

Empirical evidence of tax competition and alternative explanations

Whether or not tax competition poses a threat to the welfare state hinges on whether tax competition theory correctly describes reality. Time series of corporate tax rates, for instance, suggest a downward trend. Average OECD corporate tax rates declined by 12 percentage points between 1986 and 2003 (OECD, 2001b, and, 2004) and average EU15 corporate tax rates declined by 3.4 percentage points between 2000 and 2003 (OECD, 2004). The expected reductions in corporate tax revenues have not followed, however. Indeed, despite declining tax rates, they actually increased in the 1990's, though perhaps in part because of favourable business conditions and corresponding increases in the tax base.

Whether this decline in corporate tax rates is caused by tax competition or something else cannot be determined exclusively from these numbers. A vast and growing empirical literature, however, has tried to determine whether tax rates have declined due to tax competition. Briefly, earlier studies generally failed to reach a consensus that increased integration led to lower tax rates on corporate income. Indeed, many studies actually found a positive relationship between corporate tax rates and integration (e.g., Garratt, 1995, Quinn, 1997, and Swank, 2001). This somewhat counterintuitive result has been explained by the compensation hypothesis: increased integration increases the demand for social protection and hence tax rates. More recent studies, using more sophisticated techniques, have generally found relatively robust evidence of a negative relation between integration and tax rates on corporate income (see Griffith and Klemm, 2004) for a recent survey and Winner, 2006), however, even though exceptions exist (e.g., Dreher, 2006). The result is somewhat sensitive to the choice of tax burden studied. Dreher (2006), for example, found that the overall influence of globalisation – including economic, political as well as social integration – on corporate tax rates is positive when using average effective tax rates based on tax revenues while negative when using statutory tax rates. Similarly, Slemrod (2004) obtained a positive relationship between integration and average corporate tax rates (based on revenues collected) but a negative relationship when statutory tax rates were used. The use of tax measures based on historical tax revenues collected can be questioned as they are backward-looking and the investment and location decisions that drive tax competition depend on current and expected future tax rates.

A related literature highlights the interdependence of governments by estimating a reaction function that captures how jurisdictions adjust tax rates depending on the tax policy of its neighbouring jurisdictions, providing further support for the standard tax competition literature (see for instance Besley and Case, 1995, Devereux et al., 2002, and Brueckner, 2003).

The effects of increased integration on other tax bases, in particular labour and capital gains income, have been less well studied, though several papers (e.g., Razin et al., 2002) find that increased labour mobility negatively affects labour tax rates. Even though data point to a downward pressure on labour tax rates, the data are not yet robust and integration is typically not blamed for the downward trend as it took place before labour mobility increased and was primarily driven by tax reforms in the late 1980's and early 1990's aimed at increasing efficiency.

The evidence suggestive of tax competition in the EU has so far been limited primarily to corporate tax rates, which are still far from zero, and the worst fears of a race to the bottom as projected by many have not been realised. This absence of a race to the bottom has sparked a search for alternative explanations. One obvious candidate may be that production factors are not as freely mobile as assumed in theoretical models, especially labour which may be constrained by language and cultural barriers in addition to pecuniary relocation costs. Moreover, even capital does not move seamlessly. Evidence of "home-bias", whereby investors prefer investing financial capital at home abounds (French and Poterba, 1991, and Tesar and Werner, 1995). For corporate capital, there are still means for "home countries" to tax companies located in low-tax countries, for example Controlled Foreign Company taxation, that reduces the gains from relocating. Moreover, attracting firms requires more than low tax rates. For example, it is also important to provide a business friendly climate in general, including working infrastructure and an educated labour force.

Recently, researchers have begun to question whether the relationship between increased integration and taxation must unambiguously be negative. For instance, one consequence of increased globalisation has been an increasing share of foreign ownership, providing

governments the ability to increase tax rates and, hence, shift the tax burden from domestic to foreign tax payers, i.e., tax exporting. An empirical study by Huizinga and Nicodemes (2003), for example, found that each one percentage point increase in the share of foreign ownership was associated with an increase in the corporate tax rate of between one-half and one percent.

Burbidge et al. (2006) expand this line of thought and introduce heterogeneous firms earning profits that can be taxed. They argue that tax competition can result in higher taxes and even in overprovision of publicly provided goods with a large share of foreign ownership and a high degree of heterogeneity because governments view the profit accruing to the foreigners as “free money” and are tempted to annex a share through taxation.

Researchers in the field of economic geography offer a perhaps more important explanation of the absence of a race to the bottom (Baldwin and Krugman, 2000). By relaxing the assumptions of constant returns to scale and perfect competition, these models predict that firms tend to concentrate in specific regions, the “core”, where production is located close to other producers and consumers in order to realise advantages from linkages in production and consumption. Increased integration, with lower trade and transportation costs, tends to increase the importance of these linkages and strengthen the agglomeration forces to certain regions or countries where industries “lock in”, hence limiting factor mobility. As a consequence, the regions where industries and labour choose to locate experienced increased tax bases and may be able (at least to some degree) to raise tax rates. At least theoretically, thus, it is possible for at least some countries (the core) to conduct independent fiscal policy in spite of increased integration.

Whether these agglomeration forces are country-specific and strong enough to affect national tax policy is questionable, however. They are more likely to be local phenomena with little impact on national tax policy, and the few empirical studies that test the insights from economic geography have generally failed to find support for a positive relation between agglomeration forces and tax rates (e.g., Krugstrop, 2004, and Hansson and Olofsdotter, 2005a) and although some support for this conjecture was found by Dreher (2006).

In summary, even though there is no convincing evidence of a race to the bottom there seems to be robust evidence of a downward pressure on corporate tax rates. It is unlikely however, that we have seen the end of the downward trend and the pressure will likely intensify as labour becomes increasingly mobile.

Fiscal competition

The scope for government

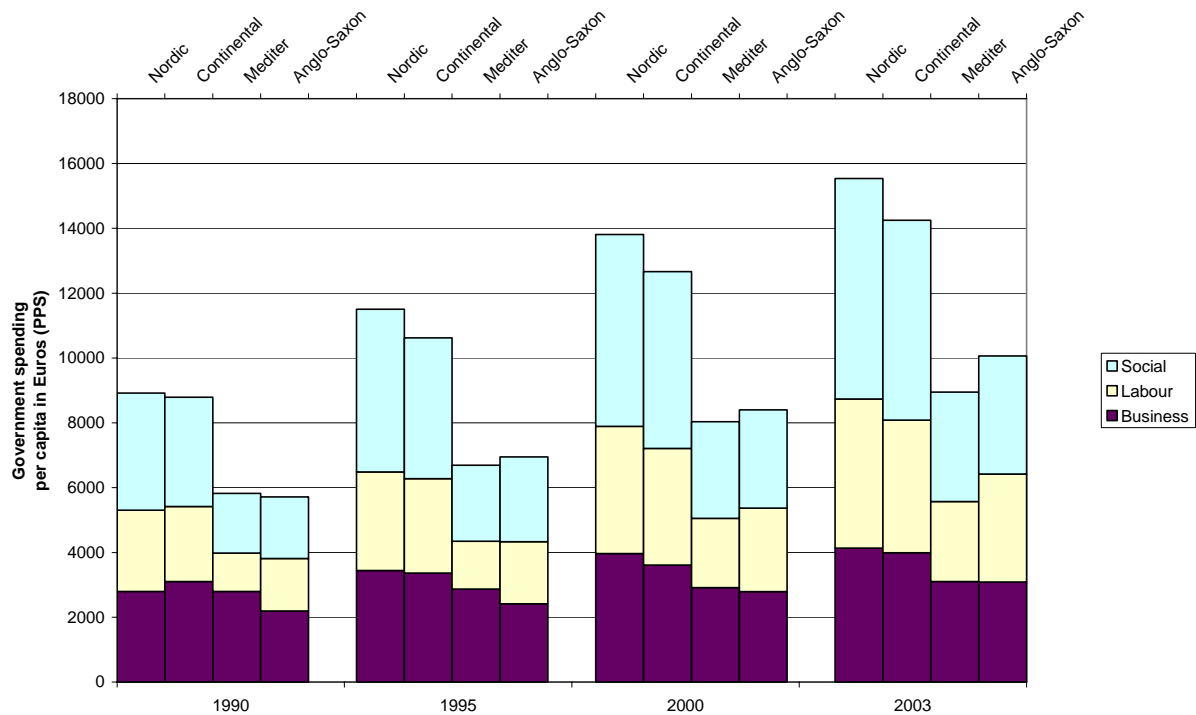
In addition to implications for tax rates and tax revenue collections, increasing integration and the corresponding competition among governments to attract and retain mobile production factors may also have important implications for the composition of public expenditures. Because different types of government spending are valued differentially by the various production factors, nations may be pressured to use their resources in ways favourable to desired factors at the expense of independent fiscal policy. In particular, redistribution may become increasingly costly.

A growing body of literature has delved into this fiscal competition among states. The majority focus on the distinction between expenditures financing public consumption (items like infrastructure and research that primarily benefit firms and items like education, health care and culture that foremost benefit household productivity) and those financing income and wealth redistribution (items like transfers). To the extent that capital is more mobile than labour, it has been postulated that increases in integration lead to a shift in expenditures toward those more likely to attract capital at the expense of those benefiting individuals (e.g., Keen and Marchand, 1997). As labour becomes more mobile, however, this effect will diminish as expenditures that benefit residents may also attract productive labour (Bénassy-Quéré et al., 2005). Indeed, the importance that public spending not directly benefiting businesses plays for firm location has increasingly been realised. For example, Gabe and Bell (2004), found that a rise in educational spending increased the number of firms locating in Maine, a state in the Northeast United States.

Diagram 1 illustrates how government expenditures benefiting business, labour and primarily welfare recipients, respectively, in constant purchasing Euros per capita have developed over

time for the four different welfare state regimes in “old Europe” (Nordic, Continental, Mediterranean and Anglo-Saxon).³ Specifically, spending on economic affairs, general public services, public order and safety, and defence are categorised as spending benefiting businesses, while spending on education, health, recreation, and environmental protection are assumed to mainly benefit productive labour, and finally government spending on housing and social protection as spending benefiting “welfare shoppers”.

Diagram 1. Government spending benefiting business, labour and “welfare shoppers” in constant purchasing power Euros per capita in the Nordic, Continental, Mediterranean and Anglo-Saxon welfare states



Source: Eurostat

Not surprisingly, the different welfare state regimes spend different amounts on the three categories. The Nordic welfare states generally spend the most in per capital terms on all three categories. The Continental welfare states generally mimic the Nordic spending pattern closely, while Mediterranean and Anglo-Saxon countries spend considerably less with a relative emphasis on expenditures primarily benefiting businesses.

³ Data on government expenditures are classified by function (COFOG) and come from Eurostat.

The Nordic and Continental countries increased their expenditures on labour and social welfare between 1990 and 2003 the most (around 80 percent), while they increased their expenditures on businesses by 48 and 29 percent, respectively. The Mediterranean and Anglo-Saxon welfare states, on the other hand, increased their spending on labour the most (approximately 110 percent) but social spending rose considerably as well (around 83 and 91 percent, respectively). Contrary to fiscal competition, thus, the countries in each of the four regimes increased business spending the least and there seem to be no evidence of convergence between the different welfare state blocks. On the contrary, if anything, they appear to have diverged. Moreover, there is no indication that the integration process has so far pressured the Nordic model as would be expected if “welfare shopping” was widespread.

The existing empirical literature aiming at determining how government spending is affected by increased integration is generally consistent with this picture (e.g., Dreher, 2006, and Hansson and Olofsdotter, 2005b). Hansson and Olofsdotter (2005b), for instance, find no empirical evidence that integration affects public transfers. Public consumption and investment, on the other hand, seems to be negatively associated with integration perhaps because cuts in public consumption and investments are politically easier to undertake than cuts in public transfers.

The scope of the welfare state

I now turn to the effects of integration on redistribution, the fastest growing component of government expenditure in most countries and by far the largest component of the welfare state.

The effects of integration on redistribution are hard to predict accurately, and likely vary by type of transfer. The mobility of labour, and in particular the relative mobility of high-skilled versus low-skilled labour, plays a large role. To date, labour mobility in Europe has generally lagged far behind capital mobility, though this is anticipated by many to change as the integration process proceeds. While most theoretical models have assumed that high-skilled labour is more mobile than low-skilled labour, this may not be the case. Indeed, Wildasin

(2000), for example, presents data that show that immigration from poorer regions of the world has become an important determinant of today's population and labour force trends in Europe. Some even suggest that the generous welfare programs act as magnet to low-income individuals and attract potential "welfare shoppers" (Razin and Sadka, 2000, 2001 and Borjas, 1999).

It is often assumed in the literature that the threat to the welfare state will arise first when labour becomes more mobile. This is misleading, however, as it is enough for capital to be mobile to threaten the welfare state even if its activities are primarily financed by taxes and social security contributions levied on labour income. This would be the case if jobs are driven out of high-tax countries to low-tax countries when firms relocate, with higher unemployment and soaring dependency ratios in the high-tax country as a consequence.

Increased labour mobility may, nevertheless, threaten the survival of the welfare state as redistribution itself provides an incentive for net contributors to relocate elsewhere and potential net beneficiaries to move in (Wilson and Wildasin, 2004). Moreover, even if the welfare states survive redistribution may become ineffective as those supposed to benefit may actually be harmed. To illustrate, consider the following simple example of a small country with three factors of production: high-skilled labour, low-skilled labour and land. Both types of labour are mobile and land is immobile. High-skilled labour is taxed to finance a subsidy to the low-skilled labour. In an integrated world, this tax and transfer policy drives high-skilled labour out of the local economy until the local before-tax return rises to offset the local tax and the net return equals the net return in the rest of the world. Low-skilled labour, on the other hand, is attracted by the subsidy, which drives down the net-of-subsidy return until it equals the net return to low-skilled labour in the rest of the world. Since the real distribution of incomes is unaffected, the tax and transfer policy is inefficient. Nevertheless, the policy alters the returns to high-skilled and low-skilled labour, respectively, thus distorting the equilibrium amount of taxed and subsidised resources consumed in the local economy and harming the welfare of the owners of the immobile resource -- immobile land -- despite it being neither taxed nor subsidised. Moreover, if low-skilled labourers own the immobile land, it is quite

possible that the tax and transfer policy perversely reduces their gross income by an amount greater than the transfer given.

While it may be hard for countries to conduct independent fiscal policies that redistribute between existing cohorts, it may be even harder to do so for policies that redistribute across generations, for example, pensions. Consider, for example, the difficulties in choosing whether to employ a pay-as-you-go or a funded system. First, the two systems have different implications for capital accumulation. In autarchy, for instance, pay-as-you-go systems will generally have higher interest rates. In an integrated world, however, with a given rate of return, capital will flow from countries with funded systems to countries with pay-as-you-go systems, leading to higher welfare in countries employing pay-as-you-go systems. Pemberton (1999) shows that an individual country should not switch unilaterally to a funded system even though it would be Pareto improving if all countries switched to a funded system simultaneously. Second, young workers have economic incentives to locate in countries with funded systems while older workers benefit from pay-as-you-go systems. Wildasin (1999), for instance, showed that an individual can gain an additional 15 percent or more of his/her lifetime wealth by moving from one public pension program to another, given that the benefits are not contribution based. To overcome this problem, many countries employing the pay-as-you-go system have a contribution based system where pension size depends on how much is contributed and permits amounts to carry over between countries.

With mobile labour, thus, there will be no incentives to institute a pay-as-you-go system as that will attract individuals close to or already retired and drive out younger workers, hence, forcing countries to switch over to funded systems (which none wants to do voluntarily), or all countries have to employ pay-as-you-go systems with equal contributions and benefits. Several researchers (e.g., Homburg and Ritcher, 1993, and Breyer and Kolmar, 2002) have pointed this out and call for harmonisation to increase efficiency. Fiscal independence regarding intergenerational redistribution in the EU will become increasingly limited, whether with or without harmonisation.

Local redistribution, thus, may be doomed to fail, implying that redistributive policies should be carried out by central governments in order to internalise fiscal externalities (e.g., Stigler, 1957, and Oats, 1972). Indeed, redistributive taxes and transfers are typically the responsibility of national rather than local governments. In the EU context, this may argue for coordination of redistributive taxes and policies at a supra-national level.

In addition to economic mechanisms threatening the welfare state several political mechanisms in the face of mobile production factors may threaten the welfare state as well. For instance, Razin et al. (2002) describe a phenomena referred to as the “fiscal leakage effect”. In the face of an influx of low-skilled labour, the median voter will be a native tax payer favouring lower taxes and less redistribution so long as the number of medium- to high-skilled native labourers remains larger than the block of pro-transfer voters bolstered by low-skilled immigrants joining at the bottom of the income distribution. Empirically, Razin et al. (2002) found that an increase in low-skilled migration indeed leads to lower taxes and per capita transfers, while the opposite is true for an increase in immigration of medium- and high-skilled labour. Countries may, thus, engage in a “race to the bottom” in which they reduce the generosity of the welfare payments to avoid attracting low-income taxpayers or discouraging high-income taxpayers (Hindriks, 1999).

Moreover, increased factor mobility may also decrease spending if it increases the heterogeneity of the population. Specifically, migration that causes the population to be more heterogeneous may have an anti-social effect (Böheim and Mayr, 2005) and several authors have documented a negative empirical relationship between ethnic heterogeneity and the level of public spending (e.g., Orr, 1976, Ribar and Wilhelm, 1996, Poterba, 1997, Alesina et al., 1999). In practice, ethnic heterogeneity may decrease the utility the median voter derives from public spending because the distance between her/his and the net recipients’ preferred types of public spending may increase.

A consequence of increased factor mobility is that the cost of financing the welfare state will increase. The marginal cost associated with financing the welfare state will increase as it gets harder to generate required tax revenues. Provided that current levels of publicly financed

social protection is optimal, to justify the status quo the marginal benefit of social protecting must rise accordingly. This may very well happen if increased integration makes us more vulnerable and therefore increase the demand and benefits from social protection. If the increase in marginal costs exceeds the increase in marginal benefits, however, the optimal size of the welfare state from society's point of view naturally shrink.

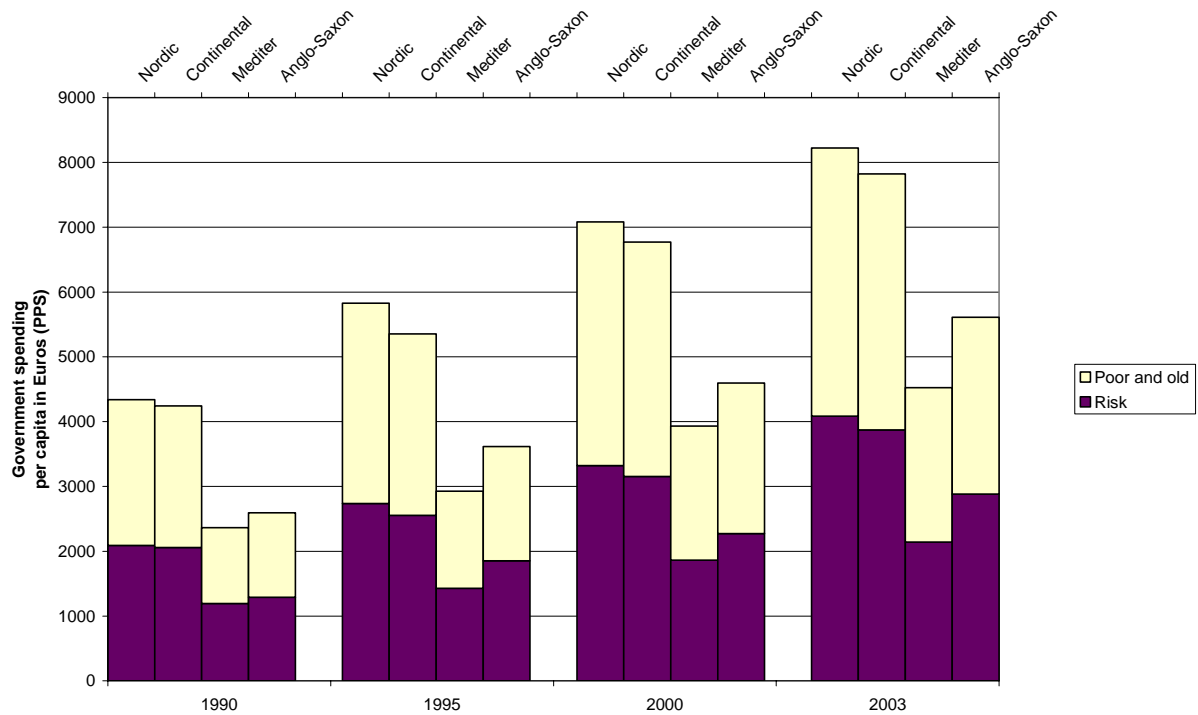
The development of the four welfare states in Europe since 1990

Free factor mobility appears likely to impact the size and the scope for the welfare state and the effect may well be increasing. To determine whether integration has so far affected the welfare state, it is useful to sub-divide social protection expenditures to two categories. The first category consists of redistribution designed to provide public insurance against such risks as unemployment and sickness where private markets function poorly because of adverse selection and moral hazard. The second category consists primarily of intergenerational and inter-class transfers designed to assist the elderly and poor. While these can also be viewed as insurance against risk -- for example, longevity and being born to a poor family -- they are more commonly viewed as an outcome of the political process in which competing groups attempt to transfer resources toward themselves (Wilson and Wildasin, 2004).

Diagram 2 shows how these two categories have developed over time for the four different welfare states.⁴ Again, the Nordic and Continental welfare states spend considerably more in per capita terms both on redistribution designed to reduce risk and on redistribution directed towards the poor and elderly than the Mediterranean and Anglo-Saxon welfare states. As a share of total social protection expenditures, the welfare states spend a fairly even share on redistribution designed to reduce risk and poverty, however. The increases over time in per capita terms have been substantial, and slightly larger for the risk component for all but the Mediterranean welfare state. There is no suggestive evidence of any systematic differences between the two components or any downward trends or convergence between the different welfare state regimes.

⁴ Redistribution designed to reduce risk includes social protection spending on unemployment, sickness and health, invalidity and disability and survivor expenditures, while redistribution towards poverty reduction and the elderly includes social spending expenditures on old age, family and child, housing and social exclusion not elsewhere classified. All data come from Eurostats's ESSPROS database.

Diagram 2. Public insurance against risk and redistribution towards the poor and elderly in constant purchasing power Euros per capita



Source: Eurostat

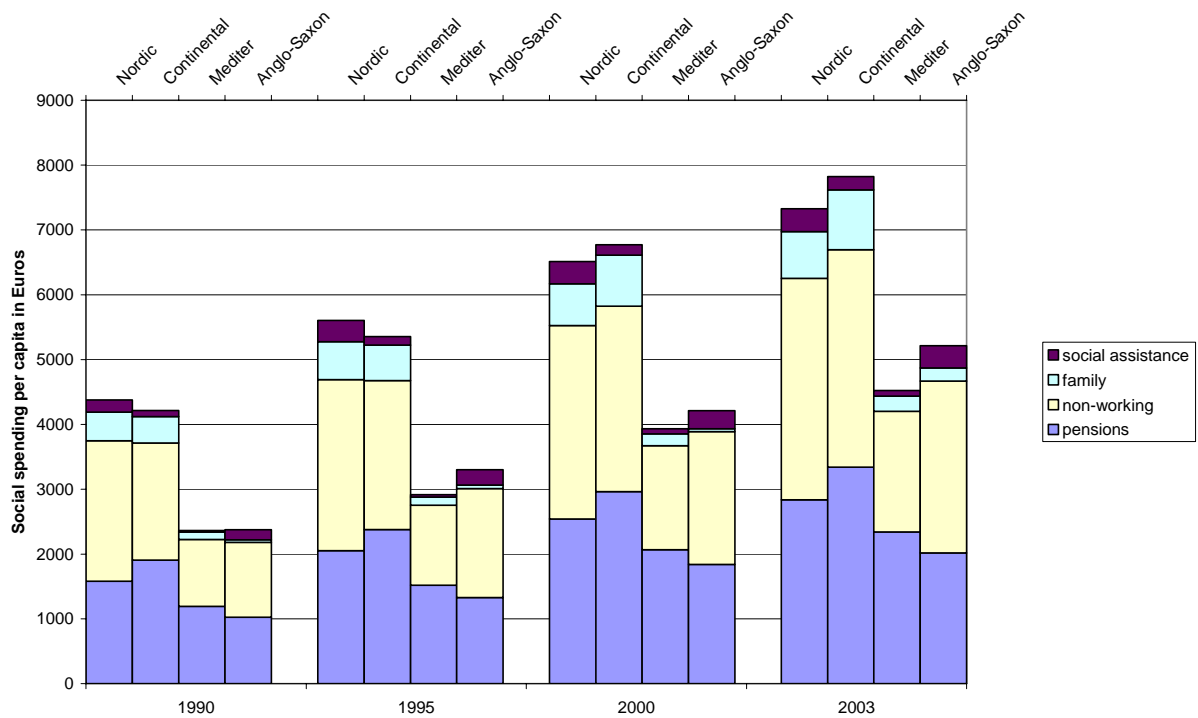
To further illuminate whether increased globalisation has affected the welfare states within “old Europe”, the development over time of the different social spending categories benefiting different groups is studied. The four social spending categories are spending primarily benefiting the aged (spending on old age and survivors), spending directed towards working age individuals that are not working (including expenditures on unemployment, sickness and healthcare and invalidity), social spending directed towards families and children and spending on social assistance (including expenditures on housing and social exclusion).⁵

Diagram 3 illustrates how these different components differ between the various welfare states and have changed over time. The Continental welfare states spend the most in Euros per capita on pensions followed by the Nordic, Mediterranean and the Anglo-Saxon welfare states. When it comes to expenditures benefiting those not working the Nordic and the Continental welfare

⁵ Data come from Eurostats’s ESSPROS database.

states spend about twice as much in per capita terms compared to the Anglo-Saxon and Mediterranean countries. Expenditures on family and social assistance are much lower in per capita terms in all welfare states. As shares of total social protection expenditures the Nordic and Anglo-Saxon welfare states direct the most towards those not-working while the Continental and Mediterranean welfare states direct relatively more towards the elderly. Over time, the Anglo-Saxon welfare states more than doubled their expenditures (total expenditures per capita grew with 119 percent), followed by the Mediterranean, the Continental and the Nordic welfare states who grew with 91, 86 and 67 percent, respectively. Within the different components spending on social assistance and family/child grow the most in percentage terms - partly because of low initial values.

Diagram 3. Social spending expenditures on pensions, non-working, family and social assistance in constant purchasing power Euros per capita



Source: Eurostat

Again, the picture provides no indication that the welfare state is currently threatened. If anything, there seems to be a tendency for increased social protection in per capita terms and the standard deviation between the different welfare states provides no support of convergence. This picture is consistent with a number of empirical studies investigating the effect of

integration on social spending. Boeri (2002), for example, finds no evidence for any convergence in social spending between welfare systems but some within groups. He did find a very mild convergence in the size of the welfare state across OECD countries, however, but the EU integration process did not seem to have played a role in this process. Moreover, several studies find social spending to be positively correlated with integration (e.g., Hicks and Swank, 1992, Garrett and Mitchell, 1997, Rodrik, 1998, while others find no correlation (e.g., Castles, 2001, and Dreher, 2006).

3.4 WHAT CAN AND SHOULD BE DONE TO PROTECT THE NATIONAL WELFARE STATE?

How can the national welfare state survive?

The actual development of social protection expenditures in the EU over the last 15 years shows no indication of the welfare state being threatened by increased integration. This is not a reason to conclude that the national welfare state is unthreatened, however. On the contrary, the theoretical discussion gave a generally pessimistic prognosis for the prospects of EU member states to conduct independent redistribution policies in the future, which should be taken seriously.

While it is clear that all member states will need to adapt to a more integrated environment, there are a number of factors that may preserve some degree of sovereign autonomy. First, there are important barriers to labour mobility. For example, it is not costless to move, there are cultural and language barriers that must be overcome, many individuals have strong local ties, and individuals must adapt to new legal and commercial environments. Information barriers and productivity differences due to, for example, language and cultural barriers, make the economic returns uncertain. It is therefore not surprising that mobility is much lower in Europe than in the US. Less than 0.5 percentage point of the European labour force change their residence region each year compared to 2.5 percent of the US labour force (Boeri, 2002). It is important to keep in mind, however, as mentioned before, that it is enough for capital to be mobile for the welfare state to be threatened if firms relocate to low-tax countries and jobs are lost resulting in increasing dependency ratios.

While labour is likely to become increasingly mobile as the integration process proceeds. Economic history suggests that differences in labour returns may persist for some time. For instance, returns to labour and capital narrowed while the returns to immobile land fell in Europe and increased in North America following the movement of labour and capital from Europe to North America in the last half of the 19th and beginning of the 20th century (see e.g., Hatton and Williamson, 1994), but the adjustment process took decades and in some respect continues today. While the costs of moving are less today, given better communication and transportation, they are still substantial.

Moreover, even if labour ultimately becomes quite mobile, the welfare state may still survive if redistribution has the nature of a local public good as suggested by Pauly (1973). He argues that redistribution may have the characteristic of a local public good -- that is the welfare of the poor is an increasing function of the rich's utility and the rich care more about the poor that live in close proximity than those that live further away. If this is the case, local redistribution is not only possible but also preferred if regions differ in their taste and income, and, hence, in the amount of redistribution. Nevertheless, the argument for decentralisation is strongest when labour mobility is limited, taste for redistribution is heterogeneous, and there are large potential Pareto gains from redistribution, which may have limited applicability but describe EU better than other regions.

Glazer et al. (2005) argue that redistribution can actually increase because of migration. Because taxes are partially capitalized in property values and rents, a central tenet of urban economics, increased mobility can lead to higher tax rates on the rich in a model where land is heterogeneous and only the rich mobile because emigration by the rich reduces the competition for desirable locations at home and, hence, reduce rents while increasing the competition for desirable location in the new country and the price. Their results suggest that accounting for the responses in housing markets can alter the common view that mobility hampers redistribution.

Increased integration, by increasing economic efficiency and better employing production factors, may also reduce the scope of some of the governments' activities naturally. For

example, while increased labour mobility may limit government's ability to insure against reduced earnings, greater market efficiency will better employ resources and hence reduce the levels of redistribution needed (Wilson and Wildasin, 2004). In addition, individuals, companies, and governments can each benefit from increased diversification possible in the wider economy. For instance, local risks can be pooled and bundled (for instance, by multinational firms) to achieve better protection against local shocks. In addition, world-wide equity markets make it easier for private investors as well as the public sector to reach preferred exposure to and diversification of local risks and shocks (Asdrubali et al., 1996). Moreover, cross-ownership of immobile resources can achieve gains of diversification of local risks to immobile factors (even though, this may encourage tax exporting, since the tax burden can be shifted to non-residents). This may be especially important as factor mobility may shift the distribution of risks away from mobile resources toward immobile resources. Increased factor mobility may, hence, reduce the need for some types of social insurances while raising overall productivity. It is of great importance that these benefits of globalisation are utilized as the need for other forms of protection due to globalisation may increase.

Even though the demand for some government activities will decline due to increased integration, however, the opposite will be true for others. For instance, individual job losses will likely occur in the short run as the economy adjusts to increased world competition. If fiscal competition constrains local governments from insuring against important risks where the market fails to do so, the social costs of failing to coordinate may be large. As noted already by Domar and Murgave (1944), social policies that pool otherwise uninsurable risks through the public sector may improve the allocation of resources between more and less risky activities. Failing to coordinate, hence, may undermine important social-insurance mechanisms that help offset market failures. As increased integration may lead to increased vulnerability the need for efficient redistribution and social insurance programs must be met.

Clearly, thus, the EU (perhaps even the OECD) will have to play a major role in designing tax and transfer policies at a supra-national level if public consumption and redistribution are sure to survive (see Schneider and Österle in chapter 4 for possible ways to do this). The EU is in some respects better prepared than many other regions in the world as the institutional

framework is in place and redistribution programs like CAP and the structural funds that redistribute at a supra-national level already exist. Nevertheless, designing tax and transfer policies at an EU level will be a great challenge. Even if some redistribution programs exist already, the EU is not a federation and reforms come about only through negotiation and cooperation. Even if centralised reforms may be Pareto improving, gains and losses are likely to be unevenly distributed and give rise to compensation demands and logrolling. It is unlikely, thus, that centralised tax and transfer policies will continue to be as high as they currently are in many high-tax EU member states. The fact that countries with generous welfare states may actually have incentives to redistribute outside their borders argues that there may be political will to coordinate transfer programs to increase overall efficiency, however.⁶

Reasons not to coordinate or the trade-off between competition and coordination

Even if the EU were to succeed in achieving some level of coordination of tax and transfer policies, the gains from that may be limited by external factors. First, the benefits from regional coordination as opposed to global are obviously limited. As capital is mobile not only within the EU but globally, coordination within the EU has limited influence on capital mobility. Several researchers have studied the gains from regional integration and found that the gains from regional as opposed to global coordination are small. Sørensen (2004), for example, shows using a general equilibrium framework that the gains from regional as opposed to global coordination are small if capital is perfectly mobile. If capital is not perfectly mobile between the coordination region and the rest of the world, however, the gains from regional coordination can be greater, though simulations indicate that the gains will not exceed one percent of GDP, the welfare gains are higher in countries with high initial capital income tax rates, and some countries may even lose (an obstacle to agreement on coordination). Several observers have argued that the problems associated with increased globalisation require global institutions as a “World Tax Organization” (Tanzi, 1998) or a “GATT for Taxes” (McLure, 1997) for coordination to be effective.

⁶ Indeed, Wildasin (1994) demonstrated that a country may gain by making transfer payments to potential immigrants in order for them to stay home.

Second, there is clearly a trade-off between tax policy coordination on EU level and decentralised national tax policy. It may be costly to give up tax policy, one of the few measures left for national governments to influence their own economies in dealing with asymmetric shocks, national externalities and differences in preferences. In addition, competition among national system may enhance efficiency. The benefits from coordination (that is to internalise the external effect) must, hence, outweigh the benefits of competition. Put differently, how bad is tax competition and how advantageous is tax coordination? Several studies have tried to estimate the harm from tax competition. Parry (2003), for example, tried to determine the welfare cost of fiscal competition and find that the welfare costs may be significant under some plausible parameter values, but it can easily be small under others. The size of the welfare cost depends on capital tax elasticity and the capital supply elasticity and for the welfare cost to be sizable the former needs to be substantial and the latter not too large. If governments are assumed to behave in a Leviathan way or if national governments can influence the net return to capital the welfare costs are reduced considerably. Parry finds estimates to be consistent with those from Sørensen (2004), and well below one percent of GDP which cast some doubt on the economic case for harmonisation of capital taxes in the EU.

Similarly, Brueckner (2004) tries to determine whether the “good side” of fiscal competition, as emphasised by the Tiebout literature dominates the “bad side”, as studied in the tax competition literature. He finds that a key factor for the outcome is the dispersion of consumer preferences for public goods and the sensitivity of capital to tax rate changes. With identical preferences fiscal competition is undesirable because Tiebout benefits are absent. In many of his scenarios the overall welfare losses of tax competition are less than 1 percent of GDP, and sometimes even negative, though they can be substantial when capital is highly sensitive to tax changes in which case tax competition has significant costs that may offset its benefits.

Mendoza and Tesar (2005) find similar results using a game-theoretical model with two countries. More specifically, they find that the gains to coordination, that is incorporate international externalities, are small and speculates that the lack of tax policy coordination within the EU could reflect that the costs of coordination exceeds the small benefits.

Moreover, Boeri (2002) argues that increasing competition among the European welfare systems may result in better outcomes as it can increase the efficiencies in social spending and suggests that the EU should restrain itself from imposing one particular model over the others and instead let the mobility of the European workforce drive the political and social policy convergence. He also investigate the effectiveness of the different welfare states and find that the Nordic and Anglo-Saxon models perform better than the Continental and Mediterranean when it comes to reducing poverty and protection against uninsurable labour market risks while at the same time provide reasonable rewards to working.

Centralisation of all tax instruments within the EU is, thus, not only undesirable but also unrealistic. A piece-meal approach, where one or a few taxes are harmonised to help finance supra-national transfer programs, is a more likely alternative. The choice of tax rates to harmonise is not irrelevant, however. Harmonisation of one tax rate, for instance a minimum tax rate on capital income, is likely to lead to fiercer tax competition for other tax instruments as well as slacker enforcement policies in order to re-introduce tax competition through the back-door (see Cremer and Gahvari, 2000, for a discussion of this).

The effects of partial tax harmonisation can even be perverse as countries compete with other tax instruments. Consider a situation with two tax rates: a capital tax that is harmonised at a minimum rate and a tax on low-skilled labour that is free to vary. The tax rate on low-skilled labour is now conditional on the capital income tax and can be used indirectly to attract capital. If the two production factors are complements, a decrease in taxation (a subsidisation) of low-skilled labour will increase the net return to capital and, hence, have the same effect as lowering the capital tax rate. If the two factors are instead substitutes, the net return to capital can be increased if taxation of low-skilled labour is increased, which will perversely reduce the welfare of the poor (Cremer and Pestieau, 2004).

In addition to perverse effects, partial harmonisation may also harm efficiency as it forces countries to raise more distortive taxes to balance the budget (Mendoza and Tesar, 2005). In general, countries with inefficient tax systems competing with countries with relatively efficient tax systems can experience significant welfare losses if forced to raise distortive taxes

to remain fiscally solvent. For this reason, Mendoza and Tesar (2005) suggest that it is preferable to harmonise labour taxation over other taxes. Cnossen (2003), on the other hand, strongly disagree with this view as he believes that any “EU-wide coordination of taxes on labor, benefit schemes and labor market regulations would most likely exacerbate the impact of existing distortions and structural rigidities in the labor market” (Cnossen, 2003, p. 634). It is, hence, not straightforward, thus, how to harmonise taxes even with the political will.

Coordination should only be undertaken when redistributive tax and transfer policies fail because of fiscal competition, however. Other government activities, with a more public good nature or where private insurance markets against risks function, may benefit from fiscal competition, leading to a better use of public resources. In addition, it is important to increase the link between what residents pay and what they receive wherever possible, for instance by increasing individual unemployment and pensions programs. It is important, however, that these are made mandatory to avoid adverse selection. Local governments should then be allowed to vary in what they provide and permit residents to locate where the mix of taxes and public expenditures reflect their preferences. This will force governments to use its resources efficiently and, in addition, have a disciplinary effect on government waste. Wilson (2005), for example, shows that competition for mobile capital makes government behaviour more efficient. Specifically, he finds that welfare is improved if local governments make the expenditure decisions, even when taxation is conducted centrally.

The European welfare state may in the future be left to provide a basic right of a minimum acceptable level of social assistance, and income and welfare security beyond the basic level may be left for individuals to voluntarily obtain from the market and other non-governmental welfare providers. It is of great importance, however, that individuals can carry with them these social security rights between employers and regions.

3.5 CONCLUSIONS

Currently, the threat from globalisation to the European welfare state is still hypothetical. The empirical evidence linking integration process within Europe or world wide globalisation to decreased social spending is inclusive. Nevertheless, the theoretical discussion focusing on the

prospects of EU member states' ability to conduct independent redistribution policies in the future is pessimistic and should be taken serious. Politicians within the EU face a great challenge as the need to coordinate tax and transfer policies in order to maintain welfare states at current levels likely will become more acute in the future. Not only will it be hard to reach agreement as the gains and costs of coordination will be unequally distributed, but the gains from coordination within the EU are limited. The greatest threat to the national welfare state may very well stem from competition outside EU -- for instance, firm outsourcing -- that EU authorities have few means to tame.

Without coordination of some tax and transfer policies public social protection expenditures that redistribute from richer to poorer households as well as from one generation to another are likely to diminish both for economic and political reasons. Even with coordination, publicly financed social protection will likely diminish, however. One possible future outcome is that EU will provide a basic level of social protection in the form of a minimum guarantee income scheme and that anything above that will be voluntarily and provided by private markets, local governments or through employers and be transferable between regions. This type of arrangement would minimise "welfare shopping" and stimulate migration from countries with inefficient welfare states to more efficient welfare states and "arbitrage away" part of the regional labour market asymmetries.

Other forms of redistribution designed to insure against risk, for example, have a larger chance to survive because they are less income dependent (hence the gains of relocation may be less pronounced.) These insurances need to be transferable between regions, however, in order to stimulate mobility. In addition, the demand for redistribution designed to insure against some risks will likely decrease if the gains from integration are redeemed. It is of great important that full advantage is taken of the possibility for individuals to find preferred exposure to and diversification of risks and that gains from pooling and bundle risks is utilised by multinational firms as well as by governments as the demand for other forms of risk insurances may increase.

Even if coordination will be necessary, among other things to guarantee an acceptable safety-net for the most vulnerable, coordination should be avoided where unnecessary to facilitate

better use of public resources that fiscal competition will ensure. It has been shown that fiscal and political competition is important for efficient resource allocation and economic performance and that gains from region coordination are small.

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