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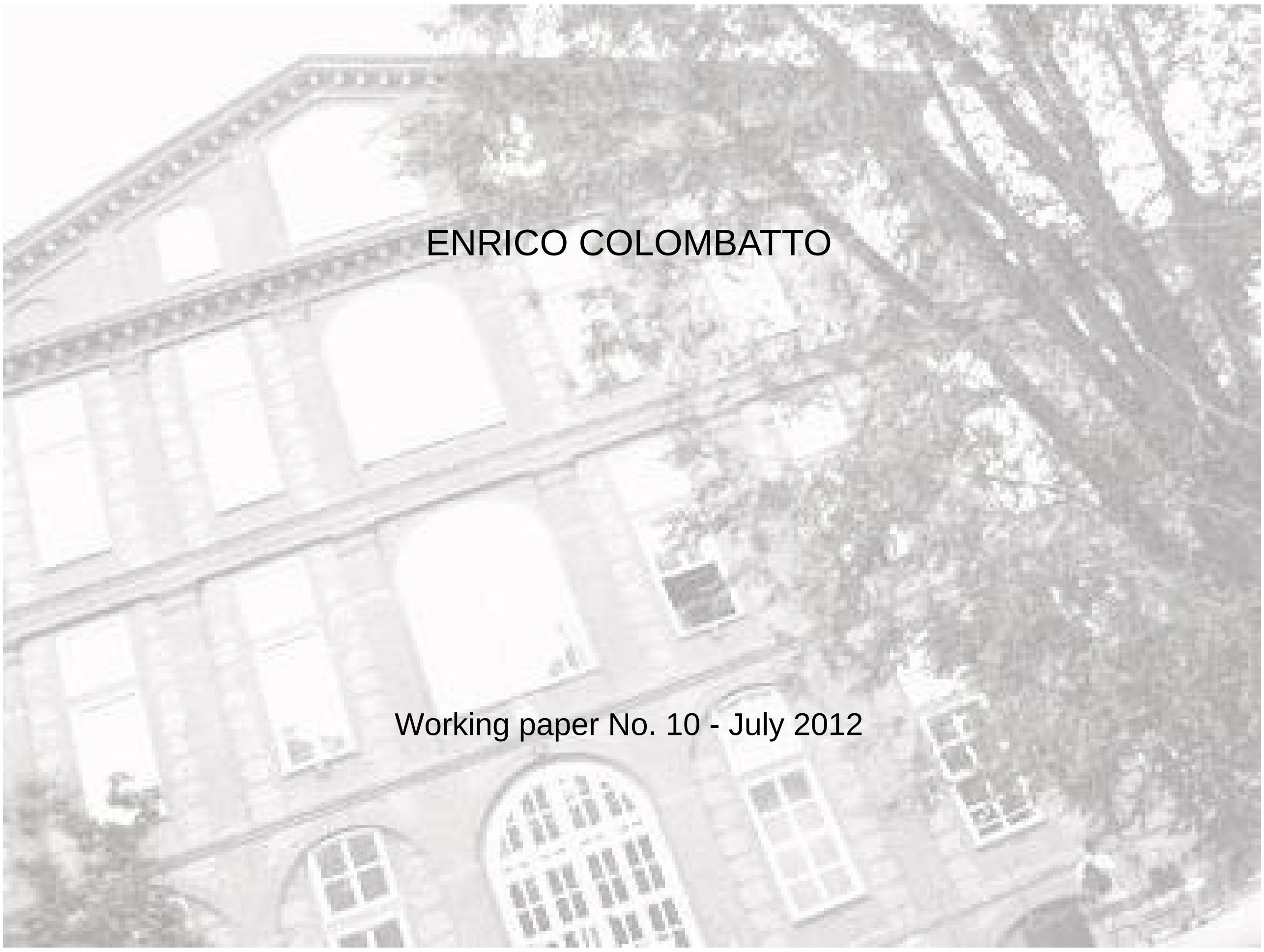
FISCAL HARMONIZATION: CREDIBLE GOAL OR TROJAN HORSE?



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Fiscal harmonization:

credible goal or Trojan horse?

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June 2012

Abstract

The supply-side literature underscores two main concepts. Taxation usually harms growth and fiscal competition provides effective protection against excessive fiscal pressure. Understandably, governments tend to dislike fiscal competition, and strive to create fiscal cartels justified by the general principle of fiscal harmonization.

This paper argues that, from the policymakers' standpoint, fiscal harmonization is inferior to automatic exchange of information among fiscal authorities and also to schemes of anonymous withholding taxes. By contrast, fiscal harmonization could be a useful instrument that international bureaucrats resort to in order to obtain fiscal centralization. We conclude that their chances to succeed largely depend on the rent-seeking strategies pursued by the national decision-makers and on the perceived legitimacy of the federal authorities

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Keywords: Laffer curve, taxation, fiscal harmonization, legitimacy, consensus, rent-seeking.

JEL Classification: H3, H7, H8

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Fiscal harmonization: credible goal or Trojan horse?

1 An introduction to the economics of the Laffer-curve and harmonization

The literature on taxation belongs to two fields. The mainstream view believes in well-meaning policymakers who operate for the common good, whatever this term means. In particular, taxation is the price residents pay either for a just cause (redistribution in the name of social justice), or to finance the production of public goods citizen are supposed to need. Two consequences follow. First, the role of the policymaker consists in giving substance to the generic principles of social justice and desirable cooperation, and transforming these principles into operational criteria for policies. Second, tax evasion and tax avoidance are unfair or worse, since they reveal free-riding or exploitation and violate the principle of justice as agreed upon by society.[1]

Libertarians put forward a different picture. In their view, policymakers are essentially rent-seekers. Although they are legitimized to act only to protect the individual's fundamental rights – freedom from violence and private property acquired through homesteading or voluntary exchange – politicians and bureaucrats are seen as taking advantage of their discretionary power and porous accountability with the express purpose of promoting their self-interest. In other words, they operate in order to accumulate wealth, to expand their influence and to satisfy their vanity. To pursue their goals, they resort to two sets of instruments – regulation and taxation. Regulation creates privileges for selected interest groups, as well as demand for a large number of bureaucrats. Taxation generates the means to feed these bureaucrats and, more broadly,

[1] To be fair, the allegedly illicit nature of free riding is questionable, since the free rider is not encroaching upon anybody's property right. Thus, there are no aggressors and no victims. Yet, the traditional literature considers free riding an offence because it maintains that consuming what somebody else produces without contributing to the cost, and without his consent, is unfair; and therefore socially unjust.

to engage in the redistribution schemes ultimately designed to win votes and galvanize consensus.

These pages side with the libertarian camp. We believe that the mechanisms that characterize modern democracies are designed to select representatives who are neither particularly altruistic, nor overly concerned about the moral perimeter of their power. Consistent with this view, we are convinced that they can hardly resist the temptation to legislate, regulate and increase expenditure; that they are inclined to conceal the weight of taxation (possibly through populism and public indebtedness),[2] rather than limit its burden; and that most of their actions focus on managing redistribution and social insurance,[3] rather than on producing eventual public goods.

These preliminary remarks help illustrate the structure of this paper, which regards fiscal harmonization as the outcome of a process through which governments try to identify – and agree upon − the tax pressure they consider "optimal" or sustainable in a context characterized by at least some degrees of institutional competition. In particular, the remaining part of this section is devoted to illustrating our starting points: the fiscal choices of the typical decision-maker and the concept of fiscal competition. Section 2 develops the idea that fiscal competition and harmonization are in fact the open-economy versions of the Laffer-curve economics of taxation. It suggests, however, that from the policymakers' vantage point, fiscal harmonization is not necessarily the best

[2] See for instance Puviani (1903) and, more generally, Buchanan (1967: chapter 10).

[3] Viewed from the socialist vantage point, however, the privileges generated by public expenditure are not necessarily immoral. The resources mobilized for redistributive purposes are usually considered "just" because they originate from the legislative process, are consistent with the current constitutional straitjacket (procedural legitimacy), and conform to the human-dignity, save-jobs and help-the-poor elements of social justice (substantive legitimacy).

The libertarian approach differs, in that it maintains that the state production of private goods and services involves the violation of property rights and is actually a means of redistributing income and alleviating individual responsibilities. For example, loss-making companies are kept in operation in order to benefit workers who otherwise would have to accept lower salaries; and state-managed deposit-insurance schemes are a way of meeting the depositors' unwillingness to examine the trustworthiness of their counterparts and accept the consequences of their negligence or bad luck.

choice, since it requires all but unanimous agreement and must ultimately rely on international agencies that often times feature their own ambitions. As will be pointed out, from their vantage point other solutions are preferable. Following from this, section 3 concludes by underscoring two major points. First, the agents really interested in fiscal harmonization are the decision-makers operating in international bodies, according to whom fiscal harmonization is merely an intermediate step towards fiscal centralization. Second, the chances to track down mobile taxpayers and deny them the right to choose tax jurisdiction ultimately depend on the absence of a large enough number of societies in which the role of the state is limited and private property and freedom of contract effectively protected.

1.1 The legacy of the Laffer curve

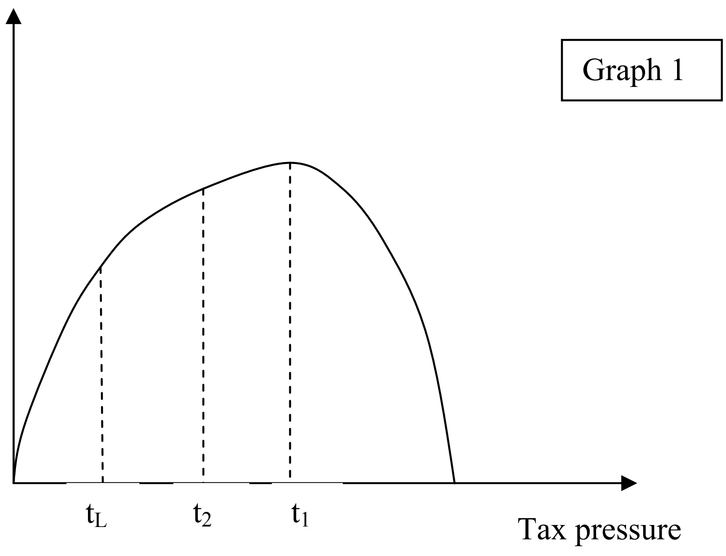
From the libertarian standpoint, taxation should generate the resources necessary to keep the minimal state working. When observing the real world, however, it is pretty clear that in modern democracies the minimal state is out of the question. Rather, the decision-makers seem to work hard in order to find the tax rate that maximizes revenue over time, so as to finance large amounts of public expenditure. It is generally accepted that such "optimal" tax rate – i.e. the tax rate that maximizes revenue over time[4] -- depends on three variables and is subject to one constraint. The variables are the short-run elasticity of tax revenues, the elasticity of economic growth[5] and the time horizon of the policy-maker. The two elasticities shape what has been known as the "Laffer curve".[6] The constraint is represented by the taxpayers' tolerance toward taxation.

[4] As the text makes clear, we deviate from the mainstream definition of optimality. According to Mankiw et al. (2009: 148), for example, "the standard theory of optimal taxation posits that a tax system should be chosen to maximize a social welfare function subject to a set of constraints".

[5] Both elasticities are calculated with respect to the marginal tax rate.

[6] The so-called "Laffer curve" was publicized by Canto, Joines and Laffer (1978) and Wanniski (1978: 97-98) and later popularized by the supply-side economics literature. In truth, the presence of a bell-shaped curve describing tax revenues as a function of tax pressure had already been aired by Smith (1981/1776: V.ii.k.33), it was clearly spelled out in Dupuit (1969/1844) and was normally used in political debates as early as 1848. See however Théret and Uri (1988) for a survey of the critiques against the theoretical foundations of this literature.

Graph 1 below refers to the traditional, static, Dupuit-Laffer causal relationship between fiscal pressure and tax revenues[7] and illustrates the choices that governments are likely to confront when assessing the desirable tax pressure in a given year. By and large, the intuition is that the (negative) elasticity of economic activity with respect to tax pressure is fairly modest when the tax rate t_i is low, and tends to increase as tax pressure rises. Thus, when this elasticity is less than one, an increase in tax pressure provokes a short-run increase in tax revenues: this is what happens along upward-sloping section of the curve. The opposite applies in the so-called "prohibitive range" (the downward-sloping section), where the elasticity is greater than one. Understandably, in order to pursue the goals defined in the introductory paragraphs, the rational policymaker will not operate in the prohibitive range: as the graph shows, for each degree of tax pressure in the prohibitive range, there exists a lower level of *t* in the feasible range that yields the same revenues and leaves the citizen with a higher disposable income.



[7] The static Laffer curve describes the relation between tax revenues and tax pressure in the short run – say a year. A large body of empirical literature underscores that the prohibitive range is actually attained for rather high marginal tax rates (see for instance Mirowski 1982 and, more recently, the survey in Bartlett 2012). By contrast, the dynamic version considers revenues over the long period. It includes the effect of tax pressure on growth, which can be substantial even when tax pressure is low (Ireland 1994, Stokey and Rebelo 1995, Cassou and Lansing 1996, Ventura 1999). See however Diamond and Saez (2012) for a different opinion.

Of course, the shapes of the Laffer curves vary across countries, since revenues can react differently, according to income, fiscal systems, socio-political factors and possibly the quality of government expenditure.

Now, if the policy-maker's time horizon is short (for example, one year), the optimal tax rate for that year is of course t_1, the rate that maximizes revenues over the next twelve months. Yet, in a closed environment, there are two reasons why in many countries the actual marginal pressure on most taxpayers is lower than t_1. As mentioned earlier, the taxpayers' tolerance toward tax pressure could induce the policymaker to moderate his greed, lest his actions are perceived as an infringement of the social contract and entail a loss of support.[8] Furthermore, if the policymaker's horizon spans – say – two years, he will try to maximize revenues over that period. Thus, since income/production is a negative function of tax pressure,[9] it will be desirable to have lower tax rates during the first period, enhance growth and obtain a larger taxable income in the second period. Let us call this lower tax pressure t_2.[10] The exercise could of course be extended over L periods and thus define a long-run tax strategy: in this case the revenue-maximizing tax rate is t_L, which is likely to approximate the top of the dynamic Laffer curve, subject to the tolerance constraint.

This line of reasoning has two implications. These are illustrated in graph 2, in which the shape of the optimal-tax curve refers to a situation in which changes in tax pressure

[8] Tolerable pressure depends on shared ideas (for example, respect for property rights and individual responsibility), on the income level of the taxpayers and on the features of government expenditure. For instance, low-income residents might tolerate or even welcome higher tax rates if they believe that they are likely to benefit from the redistributive game that it allows (i.e. if they are the net winners and the "rich" the net losers), or if they believe that revenues are used for a good purpose, e.g. helping the poor. Smith (1981/1776: V.ii.f.10) observed that tax compliance is higher "where the people have entire confidence in their magistrates, are convinced of the necessity of the tax for the support of the state, and believe that it will be faithfully applied to that purpose".

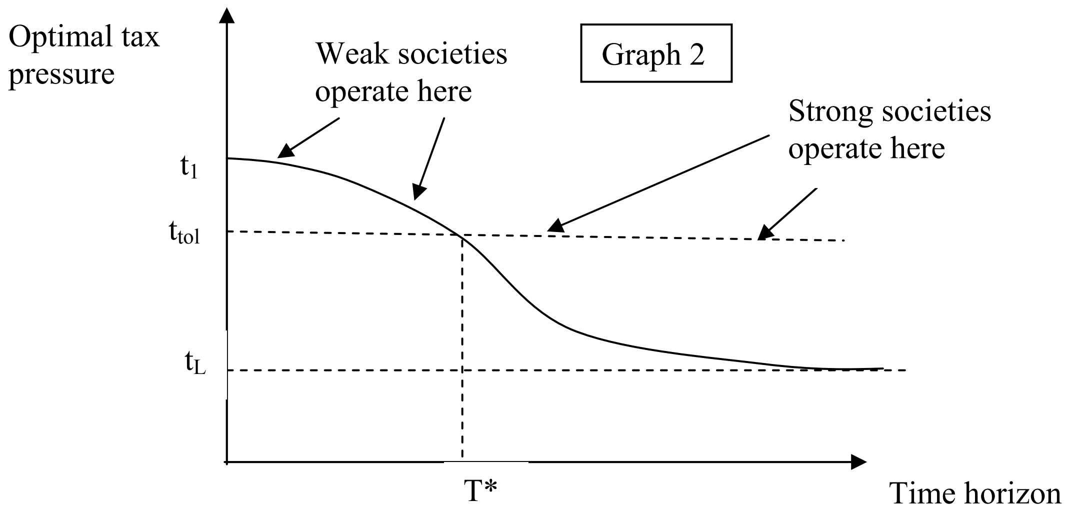
[9] Feige and McGee (1983) and Buchanan and Lee (1984) were perhaps the best known contributions at the time when supply-side economics dawned anew in the literature. Their contribution should also be complemented with Olson (1982), who emphasized that taxation not only reduces growth because it discourages investment; but also because it feeds a correspondingly large public expenditure that frequently translates into the creation of privileges and inefficiencies. These end up killing productive entrepreneurship and thus growth.

[10] Of course, if at the end of period 1 the decision-maker decides to update and renew his 2-year time horizon, at the beginning of time 2 his strategy will reproduce his choices of the previous year.

are more appealing in the middle t range, whereas a small decrease in tax pressure generates modest additional revenues when taxation is very heavy or very light and income earners have already decided to produce as little as necessary to survive or consider that tax pressure is too light to affect their decisions. The first implication is that unless the decision-maker operates within a relatively long time horizon, or unless tolerance to tax pressure is very low and effectively constrains the politician's behaviour, the actual tax rate is going to be greater than t_L. This means that by pursuing short-run revenue maximization, the decision maker is in fact operating on the wrong (downward-sloping) side of the dynamic Laffer curve. On the other hand, *ceteris paribus*, the longer the policy-maker's time horizon, the smaller the positive gap between the optimal t_i and the tolerable tax rate t_{tol}. In turn, the smaller the gap, the greater the probability that politicians are perceived as compliant with the social contract, the less are the tensions between the political class and the population, and the stronger is the legitimacy for the decision makers. For example, in graph 2, a political class that operates with a time horizon $T \geq T^*$, and thus chooses a tax pressure $t \leq t_{tol}$, is likely to enjoy more legitimacy than one that has a shorter vision ($T < T^*$), is tempted to give priority to consensus, and applies a fiscal pressure greater than t_{tol} in order to expand rent-seeking and create hopes for easily-accessible privileges.

In this light, the notions of – and the difference between − legitimacy and consensus play a crucial role. When this term has a meaning, legitimacy refers to the politicians' compliance with the social contract, i.e. with the implicit agreement that the members of a community have agreed upon. Hence, legitimacy applies both to the short and to the long run and, of course, it is also affected by the difference between t_i and t_{tol}. However, legitimacy might not be sufficient to win a democratic contest, since sections of the electorate could be tempted by the promise of privileges at the expense of the other members of the community. These promises and expectations are the source of consensus, which allows a candidate to win the next electoral game. Thus, when they look for consensus, a synonym for electoral support, policymakers engage in a short-run effort to gather a majority, possibly by distributing or maintaining privileges to parts of the electorate, even if these imply a violation of the t_{tol} constraint and, more generally, of the social contract. Sometimes, there is no alternative to the search for consensus.

When the notion of the state is weak, an appeal to legitimacy has little traction, whereas long-term policies might be undermined by opportunism, especially in countries with a relatively old population. The downside is that consensus is not a guarantee for success. On the one hand, the incumbent politician can be defeated by rivals with more generous promises. On the other hand, he can be defeated by accidents that prevent him from keeping his word (if he ever meant to do so). For example, if the expectations of significant segments of the electorate about economic growth decline, expected privileges from higher expenditure might not be enough to offset the discontent provoked by lower disposable incomes.



A detailed analysis of the connection between legitimacy, consensus, vulnerability to economic shocks and electoral competition would take us far away from the focus of these pages. Furthermore, generalizations are treacherous and often lead to gross misrepresentations. Nonetheless, the line of reasoning we have articulated in the previous paragraphs suggests two broad scenarios that might help us to better understand some aspects of fiscal harmonization.

One scenario characterizes what we would define as strong societies, i.e. environments in which legitimacy matters. In these countries, the perception of the role of the state has deeply rooted moral connotations and the concept of the common good is fairly well identified: typical examples are Sweden and the US in the last decades of the 20th century. In this context, the elected politician is considered a servant to the community, differences across parties with regard to economic policy-making are moderate and the representatives tend to be elected according to their expected commitment to the shared, prevailing principles.[11] Under these circumstances, the search for consensus and legitimacy almost coincide and the actual tax pressure is necessarily close to t_{tol}, since politicians are aware that pressure above t_{tol} would be considered a breach of faith/contract and thus expose them to electoral punishment.

Strong societies can be communitarian or individualistic. In both cases, the notion of individual responsibility is firmly in place. Yet, in the former case, residents advocate substantial state intervention present relatively high levels of tax tolerance tax morale[12] and individual responsibility is translated into the citizen's duty to monitor the integrity of the civil servants who are managing resources on his behalf. By contrast, an individualistic (free-market) society is in favour of limited state intervention and thus low expenditure and low taxation. In strong countries, compliance with the "social contract" is important and high growth is unlikely to play a significant role, as long as it remains positive. Unless one anticipates changes in people's attitudes towards GDP performance, therefore, lowering the tax rate below the tolerable level – and reducing expenditure accordingly -- does not guarantee reelection. Certainly, lower spending would not be considered a failure, but it would make any political competitor vulnerable to rivals promising more public goods and/or more equitable redistribution.[13] As showed in graph 2, this explains why the rational politician's behaviour in a strong

[11] Consistent with the libertarian view, we do not claim that in strong societies the political class is immune to corruption and self-interest. Yet, we posit that people's tolerance toward improper behaviour is low and that sanctions are relatively effective.

[12] See Torgler and Schneider (2006) who survey the literature on tax compliance and providence on the positive correlation between tax morale/compliance and trust in the judiciary and the political class.

[13] As a matter of fact, we conjecture that in these environments, political performance tends to be evaluated according to the quality of expenditure, given a broad consensus on tax pressure and thus on the size of expenditure.

country characterized by a high tolerance to fiscal pressure might well fail to maximize fiscal revenues and growth in the long run.[14]

The other scenario refers to countries in which the moral features of the state are flimsy or rapidly weakening, and in which the government is regarded as a source of rents and a distributor of wealth with considerable discretionary power. We call this environment a "weak society". In a weak society, the population is likely to take growth for granted, legitimacy does not mean much, and the political game is about the distribution of privileges and guarantees to selected groups in order to obtain consensus.[15] Put differently, there is a critical difference between the communitarian spirit typical of strong societies and the welfare-state ideology characterizing weak societies. In the former case, the principles of individual responsibility and active participation in the *res publica* are prominent, as mentioned in the text. By contrast, in the latter environment the individual considers the state as an oppressor or as a hostage in the hands of powerful pressure groups, an all but unaccountable institution over which monitoring by the periphery remains evanescent. Thus, in weak societies the political winner is likely to be accountable to privileged or would-be privileged clienteles and warnings against the long-term effects of high expenditure are not heeded. In fact, the notion of tolerable tax pressure is not an effective anchor. Policymakers are evaluated according to the substance and the credibility of their promises. In order to finance an ever increasing expenditure, therefore, tax pressure keeps creeping up towards t_1, the only constraint being that disposable income do not decrease. As mentioned earlier, this system meets crisis when growth is disappointing and the majority of the taxpayers are eventually won over to the idea that expenditure *cum* taxation is a losing game, despite their hopes of winning a rent.

[14] However, if t_{tol} drops, the positive gap between t_{tol} and t_L narrows and the politician's behaviour ends up meeting all targets: tax revenue maximization, growth and self-interest.

[15] Of course, a particular kind of privileges might benefit only one interest group. Yet, since the number of selected groups tends to be large, so are the number of privileges offered and the costs for which the population carries the burden – in terms of purchasing power and growth.

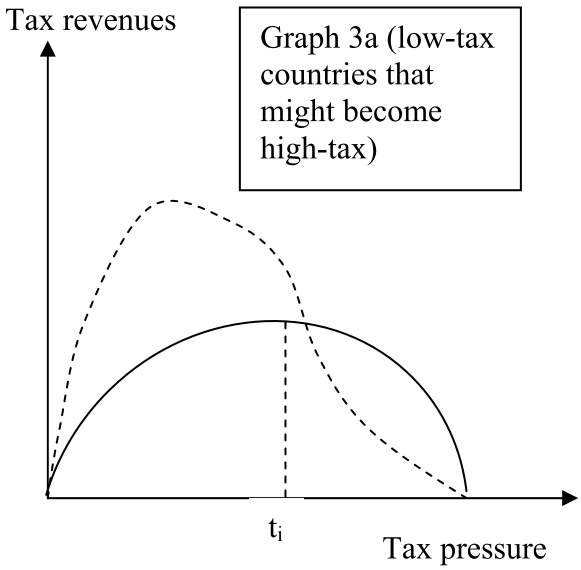
To summarize, although actual tax pressure is unlikely to reach t_1 (see graph 2), it can be close to that level in all weak countries and in those strong countries in which the communitarian spirit is deeply rooted and the tolerable tax pressure is high. In general, and unless affected by a deep crisis, growth is not an issue in these situations and that contributes to shortening the politicians' time horizon. On the other hand, in critical times growth (or the lack of) is indeed a major concern, t_{tol} drops and the decision-makers are caught between the need to reduce taxation and the unwillingness to downsize expenditure.

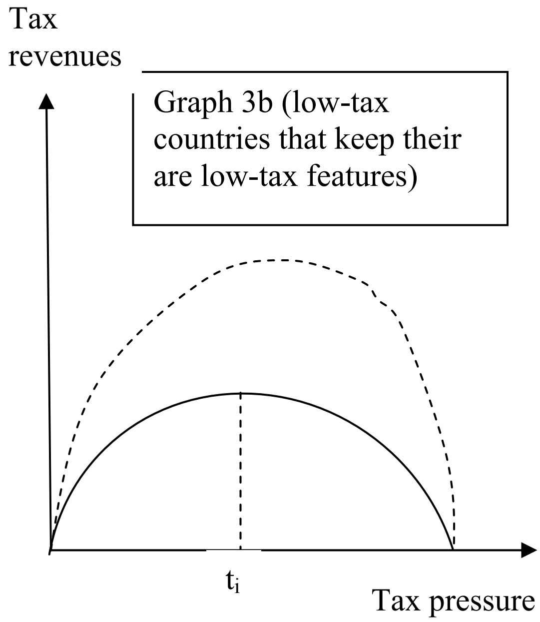
1.2 On fiscal competition

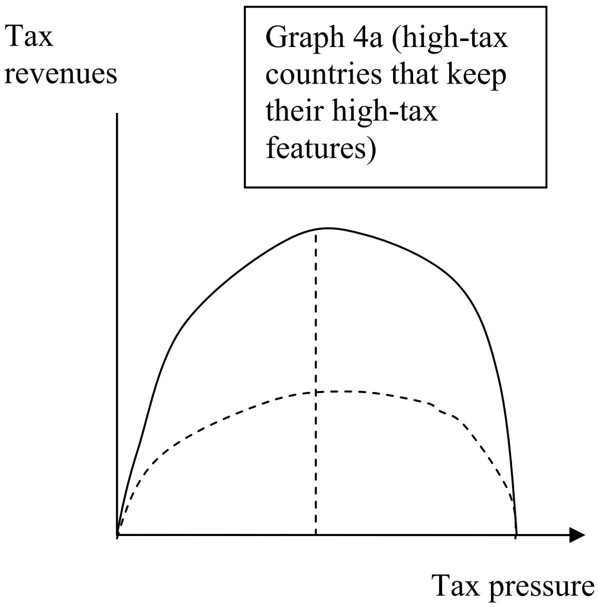
Once an economy opens up to tax competition and taxable assets move around, the short- and long-run shapes and positions of the Laffer curves are altered and the various countries might find it necessary to reassess their optimal and their feasible tax strategies. Following from this, graphs 3a and 3b below show how the closed-country, static Laffer curves (straight lines) are modified as a consequence of openness (dotted curves).

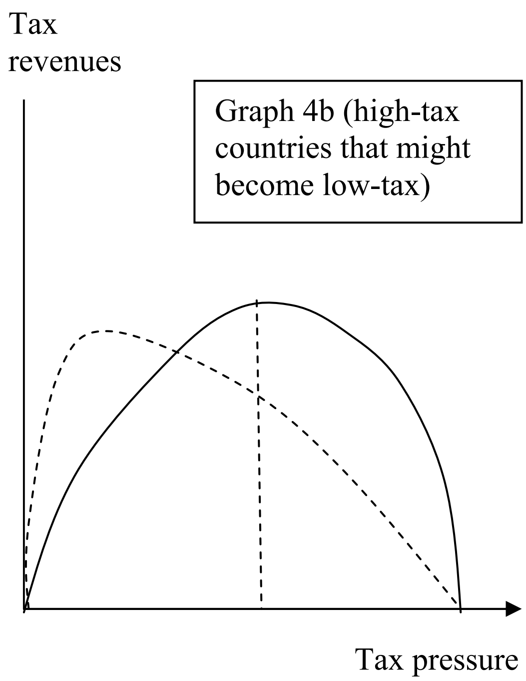
The intuition is simple. Consider a country in which tax pressure is relatively low. When it opens up, some foreign residents will take advantage of the possibility of paying a lighter tax bill and relocate their assets accordingly. In correspondence of each tax rate applied by this fiscally attractive economy, therefore, tax revenues increase. Hence, its Laffer curve moves upwards (higher revenues) and the slopes become steeper: since the amount of the taxable assets involved is now greater, the elasticity of tax revenues increases. In particular, if by increasing tax pressure the country eventually loses its low-tax features, then revenues will drop much more quickly than in a closed environment (see graph 3a). By contrast, if its tax structure remains more favourable compared with its rivals, then its fiscal revenues are always higher than in a closed environment (see graph 3b). The sign of the variation in the optimal tax rate remains ambiguous, though: it is negative if the elasticity of the assets inflow at t_i is high (as in graph 3a), it is positive in the opposite situation (as in graph 3b).

Mutatis mutandis, the same comments apply to countries in which tax pressure is relatively high (see Graphs 4a and 4b), the difference between these two graphs being dependent on whether the country loses its high-tax connotation by approaching the vertical axis.









2 On fiscal harmonization

The concept of fiscal harmonization identifies a process according to which different tax systems tend towards a more or less homogenous fiscal structure and, for each source of tax revenue, towards the same tax pressure. The mechanism is simple. As long as the costs of transition out of/into a tax system are not prohibitive, convergence takes place spontaneously: individuals evaluate the various fiscal systems and move their taxable assets towards the most favourable jurisdictions. If the costs of transition and the quality of expenditure remain about constant, the countries that lose taxable sources are bound to respond by lowering their tax pressure and thus partially or fully adjusting to the tax conditions offered by their competitors.[16] In the end, agents cease to migrate when transition cost are too high relative to the differential benefits obtained in the country of destination, these differential benefits being perceived and measured in terms of infrastructure, informal rules, security, judicial effectiveness and all the components generally labeled as "quality of life".

As a matter of fact, and rather understandably, most governments are reluctant to let the process of competitive harmonization described above unfold, since for each winner (the low tax country) there are going to be many potential losers (all the others). One can thus conjecture that the first movers in fiscal competition are going to be small countries featuring strong, individualistic societies. Small economies are more inclined to engage in fiscal competition, since a tax advantage that attracts even a modest amount of taxable assets can produce large benefits for their treasury.[17] Individualistic countries are in an ideal position to attract taxable assets, since they present a low degree of fiscal pressure, regardless of their intention to start a fiscal war. By contrast,

[16] This justifies the fast decrease in corporate income taxation between 1982 and 2005 (Riedl and Rocha-Axis, 2012).

[17] See Riedl and Rocha-Axis (2012) for some empirical evidence.

the large, high-tax economies will have to choose how to react to the competitive challenge, bearing mind that a tax war – a race to the bottom – would bring about lower tax revenues, undermine the rent-seeking game in weak countries, involve deeper institutional changes and possibly provoke the loss of power for the incumbent political class. In particular, they will be facing the following options:

- Stay put: this strategy is attractive if the loss of taxable assets is modest and if a competitive response could elicit a second round of moves by the low-tax countries (LTs) and eventually a tax war in which everybody would lose (except the taxpayers);
- Respond: fighting back is reasonable if the high-tax country (HT) believes that the LT bloc has little room for maneuvering (for making further reductions in tax pressure) – for example if the LT competitor has inherited a heavy debt that must be serviced through taxation;
- Respond selectively: such an option materializes when tax discrimination is feasible, i.e. when the HT fiscal authorities can lower tax pressure on some sensitive assets, and keep it roughly constant on less sensitive sources of revenues (Winner, 2005);
- Change the quality and structure of expenditure, so as to reduce the benefits of transition for those who physically migrate abroad;
- Complain about harmful fiscal competition[18] and reduce the effects of competition by raising the normative transition costs;
- Collude: this is the essence of forced harmonization, the perverse version of fiscal federalism.[19] In this context, one or more HTs force or persuade the

[18] The term "harmful competition" is usually employed to describe the behaviour of those low-tax countries that fail to disclose full information about their taxpayers, and therefore stifle high-tax countries that plan to go after their residents that decide to move their wealth abroad. See for instance Lampreave (2011), who provides plenty of references to official documents issued by international organizations in this regard. According to the traditional, neoclassical view, in the presence of harmful competition, the government "should put severe restrictions on capital exports and bring the marginal product of domestic capital to a level which is even below the world rate of interest" (Razin and Sadka, 1990: 7).

[19] Of course, the traditional, virtuous version of fiscal federalism regards a situation characterized by the principle of subsidiarity, which prescribes that the resources required to finance activities to the prevalent benefit of the local residents be raised locally, while interstate/interregional public-good projects

relevant LTs to agree on a common fiscal strategy. The result is the introduction of rules that weaken the role of fiscal competition and/or the establishment of a cartel enforcing a more or less uniform tax structure.

2.1 Who plays the game?

We can now try to put together the various elements presented in the previous pages. The key issue is that history matters: countries are not "born" with an HT or LT nature. Rather, their fiscal traits originate from their past, a term that includes culture, ideology, deeply-rooted habits and traditions that explain the prevailing views about the role of the state and the political class, expectations and attitudes toward social interaction. In particular, the past defines the strength/weakness of a society, the level of fiscal pressure that residents deem tolerable, and the politicians' willingness to sacrifice the long-term perspectives typical of legitimacy to the short-term vision that characterizes consensus.

As noted earlier, tax pressure is going to be lower in individualistic strong economies, in which the free-market ideology figures prominently and policymakers behave as if they had a long-term horizon. Opening up to a global environment generates inflows of resources from abroad. As a result, growth and fiscal revenues increase, especially if the size of the economy is small. This group of countries is unlikely to change preferences, since a deeply-rooted, free-market stance won't be shaken by globalization. In a strong, free-market country, the tolerable tax rate is related to what is needed to feed the minimal state, rather than to finance relativist ideals like social justice or equality.[20]

(redistribution) should be financed through a centralized authority. By contrast, the perverse notion of fiscal federalism refers to a context in which different tax authorities delegate the power to define the fiscal rules of a community to a central body. The central authority can be permanent, like a directorate for fiscal and budgetary affairs in Brussels; or virtual but binding, like a multilateral OECD agreement that aims at equalizing taxation on capital income.

[20] By definition, an increase in demand does not generate a scarcity of public goods. It is further assumed that the needy are hardly attracted by a favourable fiscal legislation, although they definitely appreciate the options offered by a growing economy with a flexible labour market.

Two consequences follow. First, as resources flow in from the rest of the world, higher fiscal revenues lead to a drop in t_{tol}, fiscal pressure eases, and another wave of taxable assets reaches the country. Second, the actual tax rate is effectively restrained by the tolerable tax rate, since the search for consensus at the expense of legitimacy would be vain and possibly counterproductive.

This bloc of LT economies is juxtaposed to two sets of fiscal contexts characterized by relatively heavy taxation. The first group of HT countries consists of strong communitarian societies, in which tax tolerance is high, the quality of expenditure is strictly monitored, and rent-seeking is modest. Under these circumstances, fiscal competition is not really an issue, especially when economic growth is satisfactory and the burden of taxation falls on personal incomes (human capital), rather than on financial wealth. By definition, in these countries taxation is perceived as the price the individual pays for goods and services that he is happy to buy from the state. In addition, this individual might indeed welcome redistribution fed by a fiscal system focusing on labour income, as long as this is considered the appropriate index of contributive capacity and progressive taxation is regarded as the instrument through which redistribution in the name of social justice is obtained.[21] The temptation to move toward more favourable fiscal environments, therefore, is far from irresistible. By migrating, the typical HT resident of a communitarian country would lose a sought-after supplier of appreciated services (the public sector) and would be excluded from a community of which he likes to feel a member and which he hesitates to betray (reputation matters).[22] To conclude, loyalty to a strong, HT, communitarian regime will be undermined only if taxation hit wealth. But if taxation on wealth and on corporate

[21] In this context, wealth would be considered the result of savings and virtuous behavior (moderate consumption), rather than deep pockets. Once again, ideology and history play an important role. In contrast with other cultural environments, in a communitarian country affluence is less likely to be considered the result of privileges, undeserved luck or borderline activities. Thus, the major drive behind deep pockets – envy – is not enough to legitimize a wealth tax.

[22] Clearly, this last element might be less present among young people who decide to migrate before they enter the labour force.

income is moderate or the alternatives are not credible,[23] these countries are all but immune to fiscal competition. In fact, and despite a severe tax burden, their credible and stable rules of the game funded on shared legitimacy principles might well attract significant inflows of wealth (fixed and financial capital).

Not unexpectedly, weak societies are more problematic. In these economies, legitimacy plays a marginal role and policymakers are driven by the search for consensus. Tax rates are high in order to raise significant revenues, create consensus and nourish a heavy rent-seeking system with a necessarily short-run temporal horizon. In contrast with the strong environment, the tolerated tax level in a weak framework does not depend on ideology, but rather on people's hopes to have non-negative growth, as well as on their expectations about the rent-seeking prospects. In particular, two mechanisms are operating. One regards growth: the faster the economy grows, the greater the credibility of the rent-seeking game (there are more rents to distribute and less opposition); and the greater the credibility of the rent-seeking game, the higher the level of fiscal tolerance. The second mechanism regards the policymakers, who are likely to maximize tax pressure and expand the rent-seeking, redistributive game in order to compensate for the unrest provoked (consensus is lost and credibility is dented when the t_{tol} limit is violated). They know that this approach undermines their grip on power. But they are happy to run the risk and pocket the benefits matured in the meantime. This short-run game may well extend beyond the short run, especially in the economic texture of the country is resilient and aggregate expenditure can stay ahead of taxation thanks to indebtedness.

The real source of trouble is in fact growth. As aired at the beginning of this paper, regulation is an important and tempting way of creating and distributing privileges in

[23] One may note that in 2011 the combined corporate income tax rate in the OECD ranged from 12% (Ireland) to 25% (Austria and Denmark), 30% (Germany) and 39% (USA and Japan) – source: http://www.oecd.org/document/60/0,3746,en_2649_34533_1942460_1_1_1_1,00.html#A_RevenueStatistics consulted on the April 29, 2012. These data should b treated with caution, though. As Pike (2012) has recently pointed out, VAT also hits corporate income. When VAT is taken into account, the only OECD countries with corporate income tax significantly below 40% are Switzerland, Canada, Korea and Ireland.

weak societies. Yet, regulation thwarts growth and is difficult to repeal.[24] When growth falters, consensus declines and policymakers meet trouble. To repeat our previous point, crisis can be averted only by resorting to financial markets. If financial markets allow, the political elite can ignore the dim picture, carry the rent-seeking game to extremes, increase taxation further and thus sustain a boom in expenditure through indebtedness.

Certainly, these countries can also be affected by fiscal competition, since in an open environment weak societies are going to lose both taxable labour incomes and taxable wealth to the rest of the world. Yet, given the short-time horizon of the authorities, the loss of labour incomes is not a major worry. Although entrepreneurs and high-productivity workers might and do eventually leave, the effects of this kind of migration on growth and revenues will be perceptible only in the medium-long run. The effects of fiscal competition on financial wealth can actually be more substantial, since these taxable assets are highly mobile and the deep-pocket ideology frequently prevailing in weak countries ensures that a tax war against wealth meets populist approval and thus strengthens short-run consensus. Hence, these weak countries do have an incentive to raise transition costs for wealth and/or to reach an agreement on a common tax policy with the strong countries. The former response is technically easy to enforce whenever wealth migrates, but its owner stays. The ideal way of raising transition costs and nullifying the effects of wealth mobility consists in asking the LT counterparts to provide the list of their non-resident wealth owners. Once this list is obtained, the HT weak country can simply tax them according to the domestic, "optimal" rules of the game (and possibly fine them, too). This course of action is feasible if the LT countries involved are large, strong and communitarian. From a communitarian perspective, each citizen has obligations towards governmental authorities, secrecy would not be justified and state supervision of the local financial institutions would make sure that reluctant board members be replaced with equally qualified individuals endowed with greater

[24] See Olson (1982) on regulation, rent-seeking and growth. More recently, Salotti and Trecroci (2012) analyze 20 OECD countries from 1970 to 2009 and show that high debt leads to low capital accumulation and low productivity growth. See also Bergh and Henrekson (2011), who document the negative correlation between government size and growth and discuss the exceptions that, according to our terminology, would identify the communitarian groups of countries.

"civic virtues". If so, the list will be provided without too much hassle. Yet, if the LT counterparts are small and/or individualistic, the request advanced by the HT could be rejected. As pointed out earlier, small countries have a strong interest in attracting taxable assets from abroad and could be less than willing to cooperate in stopping the flow. Furthermore, in individualistic countries, the government is not supposed to pry into people's private property, and financial intermediaries cannot be ordered to play the role of the police on behalf of somebody else.[25] As a result, when transition costs cannot be increased effectively, HTs must settle for some kind of agreement with their counterparts. This brings us to the issue of collusion.

2.2 Preliminary conclusions: When does collusion pay?

The main argument we have tried to articulate in the previous subsection is relatively simple. We have identified three sets of countries: (1) strong, free market countries, in which tax pressure is low and politicians are constrained by legitimacy; (2) strong, communitarian countries, in which tax pressure is high and politicians' behaviour is effectively monitored; (3) weak countries, in which taxation is high and politicians gather consensus by engaging in rent-seeking activities. Fiscal competition is not a problem for strong, free-market economies, which in fact are going to benefit in terms of revenues, growth and possibly lower tax rates. By contrast, heavy taxation on wealth in communitarian contexts could definitely provoke financial outflows. These can be counteracted in two different ways. The authorities can move the burden of taxation from (financial) wealth to personal income, a move that is unlikely to meet strong opposition if wealth is perceived as a residual (what is left after labour incomes have been taxed and partially spent on consumption goods) and if capital income is regarded as the just remuneration for the loss of purchasing power (inflation), risk and time preference.

[25] Of course, in a free-market society, any actor can decide to cooperate with a foreign government and regularly exchange all sort of information, as long as this exchange is not explicitly forbidden by a contractual agreement previously signed with a third party. Yet, in a free-market society, any potential financial intermediary has a right to offer its future customers a commitment to secrecy and no-cooperation with any kind of authority.

By contrast, when taxation on wealth plays an important role, the solution consists in joining the weak countries and reaching an agreement according to which the LT jurisdictions accept to force their financial intermediaries to hand over the list of the wealth owners and/or act as tax collectors on behalf of the HTs.[26] This will lead to nothing if such financial intermediaries are located in strong, free-market countries. In a free-market environment, no government can encroach upon contractual agreements between a financial institution and its clients, unless this agreement violates somebody else's freedom from coercion or of (private) property. Thus, all the attempts to promote international cooperation in these domains would be moot and run against the social contract that legitimizes a strong, individualistic society.

These simple observations allow us to draw the following preliminary conclusions:

- The existence of a significant number of strong, free-market economies weakens the effects of collusion and also reduces the possibilities of thwarting the migration of wealth by raising normative transition costs;
- Absent free-market counterparts, the game is restricted to communitarian and weak countries. Staying put will be the chosen strategy by the former bloc of societies. The legitimate traits of their institutional structures ensure that human capital will not flow out in substantial quantities, while the lack of rent-seeking and the credibility of their institutional structure are likely to offset the costs of relatively high taxes on capital incomes. Of course, these countries will not disregard the possibility of benefitting from extra revenues and subscribing to international agreements that force financial intermediaries to act as tax collectors. Yet, they will be unlikely to take the initiative. After all, the state is

[26] As documented extensively in Grinsberg (2012), given a choice between obtaining a list of wealth owners and being credited a sum proportional to the wealth the HT residents hold abroad, HT countries prefer the former. From their point of view, the introduction of a substitute anonymous withholding tax is less satisfactory on two accounts. First, it ultimately leaves the LT country with the power to define the withholding tax rate, which may not suit the preferences of the HT countries or follow changes in their legislation. Second, the principles of anonymity and withholding rule out the possibility of taxing the stock of wealth and require cooperation from all LT jurisdictions, lest wealth moves to less hostile environments.

built on the notion of cooperation in these societies. Absent the need to develop and finance consensus, there is little need to tax the stock of wealth in the name of deep-pocket populism. This would be perceived as a retroactive form of taxation on incomes and savings – and a probably a breach of the social contract.

- Competitive responses are feasible, but not sustainable. Given the rules of the game prevailing in a weak society – consensus obtained through high public expenditure and extensive regulation – its policymakers can engage in a tax war only if they can finance the budget deficit with debt and only if the new regime is perceived as sustainable. In most countries, these conditions are not fulfilled.
- Raising transaction costs is actually the most popular strategy. As mentioned earlier, this can take two forms. It can lead to exchanging information on the assets of non- resident wealth owners and/or to levying a withholding tax on capital incomes. The latter strategy is obviously easier to pursue from the political standpoint and it is likely to be accepted by those LT counterparts in which the free market is a matter of expedience, rather than of principle. Under such circumstances, a withholding tax turns up to be acceptable if it helps to alleviate international pressure, if the financial intermediaries are a powerful lobby,[27] and if the LT country succeeds in keeping part of its tax advantages. Put differently, the veil of harmful competition turns out to be a pretext to share the benefits created by fiscal competition.[28]
- Collusion (fiscal harmonization), therefore, makes little sense for the rational policymaker operating in a weak society, while his communitarian colleague would simply ignore the issue. In other words, by accepting harmonization, the fiscal authorities of an HT country would become dependent on some

[27] The major instrument through which weak countries succeed in coercing foreign financial intermediaries to acquiesce to their requests is by denying them access to their financial markets and possibly seizing their assets. As a result, it is hardly surprising that financial intermediaries located in LTs put pressure on their own governments in order to reduce their potential losses, and also lobby for regulation aiming at forestalling entry by new actors less inclined to compromise.

[28] To repeat, the benefits of fiscal competition include higher growth for the economy as a whole, higher living standards for the former victims of high taxation, higher tax revenues for the LT country. By raising the case of harmful competition, HTs strive to appropriate part of the LT revenues and transfer "back home" parts of the benefits accrued to the migrants.

> international body in charge of defining the optimal tax rates for the whole harmonized area and of policing compliance. Thus, the country might gain a modest amount of revenues, but it would still be vulnerable to those economies that do not join the cartel, and it would both lose sovereignty and flexibility. There is little doubt that automatic exchanges of information and withholding taxes are superior.

The upshot is that the debate on collusion and fiscal harmonization is not really about fiscal policy and revenues. As mentioned above, there are more effective ways of achieving these goals. Rather, we posit that the driving forces behind fiscal harmonization are international organizations aiming at extending their power. For these actors, harmonization is actually just a step towards fiscal unification/centralization.[29] By and large, such international organizations belong to two groups. Some have no policymaking responsibilities, but aspire to extend their monitoring powers (e.g. the OECD). Others have policymaking powers and long to extend their authority to new areas (e.g. the European Union). In the former cases, fiscal harmonization serves the purpose of justifying their existence, which is often limited to the production of statistics, reports, and to creating an alleged neutral table for multilateral negotiations. In such cases, fiscal harmonization would generate the demand for an international agency responsible for evaluating the "optimal" tax rates, taking care of monitoring potential loopholes and putting forward proposals for periodical revisions. By contrast, potential transnational policymakers would consider fiscal harmonization as an intermediate step towards fiscal centralization, i.e. towards a new fiscal architecture that might reserve spending powers to national governments, but would keep more and more taxing powers under federal (transnational) jurisdiction. The privileged targets would be taxation of wealth and capital incomes. Put differently, we believe that under these circumstances, tax harmonization *per se* is not a credible goal. Either the harmonization agreements are porous and with weak normative power, so that national sovereignty and

[29] Fiscal harmonization differs from tax unification. The former relates to the existence of different tax systems that remain subject to different and sovereign jurisdictions. In contrast with a harmonized system, unification implies centralized control on taxation and expenditure and makes opting out by dissenting jurisdictions more difficult.

flexibility are preserved and the cartel comes to nothing; or it is acknowledged that their effectiveness can only be guaranteed by an "independent" central authority that reduces the risk of cheating, unifies the rent-seeking game and ultimately changes the identity of the players involved.[30]

3 Concluding remarks

The main idea developed in this paper is rather simple. We have examined the economics of the Laffer curve and observed that the interesting question consists in why rational, self-interested policymakers restrain from introducing the "optimal" tax.

The essence of our answer relates to the notions of legitimacy and consensus. The former characterizes strong societies, while the latter is typical of weak societies. In a strong society, legitimacy induces the policymakers to adopt a long-run fiscal strategy that ultimately reins in the rent-seeking game and promotes growth. By contrast, consensus in a weak society encourages politicians and bureaucrats to look for populism, which is obtained through the creation and distribution of privileges, high taxation, generous expenditure and ultimately massive indebtedness.

We have observed that fiscal competition is a source of concern for myopic but rational policymakers when financial wealth is mobile. Under such circumstances, fiscal revenues are in jeopardy and the rent-seeking features needed to acquire or maintain consensus become less credible. Within this context, the political elite of the weak country strives to control significant taxable assets and wants to see quick results. Thus, relocation of fixed capital does not matter much, nor does the migration of human capital. Capital income and financial wealth are a different matter, though, since the potential immediate revenues they might generate are attractive.

[30] In a national game, the players are the electorate, the policymakers and selected interest groups. In a supranational centralized game, the main players would be the technocrats at the centre and the interest groups with privileged access to those technocrats. Local politicians and voters would be all but marginalized.

In order to appropriate those resources, fiscal harmonization is a worse solution than the acquisition of information about non-resident wealth owners and the introduction of an anonymous withholding tax. Put differently, fiscal harmonization is a moot issue, unless it serves other purposes, like the creation of an additional layer of bureaucrats and/or the process of centralization of the tax regime within an economic area in which the authorities aspire to expand their power. Following from this, therefore, we posit that fiscal collusion is likely to fail; but that this very failure could be instrumental in bringing about fiscal unification on a regional scale.

In this vein, therefore, the debate on fiscal collusion should focus on the interaction between the national élites and the federal/central bureaucracies. Not surprisingly, peripheral politicians have mixed feelings. The benefits associated with the loss of fiscal sovereignty are known as the shield effect: the further away the tax authorities, the less accountable they are with regard to the electorate, and the less "guilty" the local politicians become when the taxpayer is squeezed. Yet, there is a downside. As a matter of fact, local politicians rightly fear that once the federal bureaucrats act as tax collectors, they will soon develop an appetite for spending and thus trump national policymakers. Moreover, they realize that the balance between consensus and legitimacy at the federal level might be different than at the local level. As a result, strong communitarian countries will abstain from joining the fiscal union (they don't need it), while weak countries risk a political earthquake, since these societies would eventually be held together neither by legitimacy, nor by consensus. Put differently, by giving in to fiscal centralization, their political elites would lose their only source of power and authority.

It is clear that this paper has no normative implications. As we pointed out at the beginning, we side with the libertarian camp, which believes in the moral superiority of an economic system based on freedom from coercion, individual responsibility and private property. In this light, freedom to choose is a natural right and fiscal competition is a powerful instrument to ensure that the state does not encroach upon individual freedom. By contrast, if one sides with the socialist ideology – which often takes advantage of democratic populism in order to search for deep pockets – competition is necessarily "harmful," and the best way of containing its damages consists in forcing financial institutions to operate as informers and tax collectors. Certainly, there is no need for harmonization.

The explanatory consequences of our analysis are more articulated. During the past three decades, regulation has not been able to avert crisis, but has definitely contributed to slow down growth in many developed countries. As we know, the response has been mixed in terms of tax pressure, while rising expenditure has been financed by resorting to debt. At present, fiscal centralization is unlikely to elicit much support. For example, in the EU context, this process would require either legitimacy or the ability to galvanize consensus around renewed rent-seeking structures. These requirements are far from being met: it is widely accepted that the central authorities enjoy neither legitimacy, nor consensus. That explains why the current situation is conducive to renewed efforts to coerce LT governments to introduce significant withholding taxes in the short run and to postpone to the future the moment when the veil of anonymity will drop, full information exchanged and wealth taxes introduced beyond borders.

It is hard to predict how far away that future is. But one should not omit to mention that the current financial crisis could also enhance the prospects for centralization, no matter how individuals are wary of those very central authorities. In particular, the surrender of fiscal sovereignty can actually be the price that troubled countries are going to be asked to pay the federal bureaucracies in order to be bailed out.

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