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Discussion paper

Agglomeration, tax competition and local public goods supply

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This series consists of papers with limited circulation, intended to stimulate discussion.

Agglomeration, tax competition and local public goods supply¹

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Abstract: In this paper we develop a framework for studying tax competition and local public goods supply in a setting where real and fiscal externalities interact with local democracy. We use the framework (a) to analyse if there is any reason to believe that local autonomy generally will give a tax race to the bottom (there is not), and (b) to look more closely at possible sources of oversupply or undersupply of publicly provided goods in a setting where local democracies compete for people. We identify two potential sources – the relationship between individual mobility and willingness to pay for publicly provided goods, and the mobility distribution of individuals (i.e. the distribution of individuals over residential preferences). The two could reinforce each other in a local democracy if the majority of the residents in a community are relatively mobile (the “American” case), while they would pull in opposite directions if the majority of residents are relatively immobile (the “European” case).

JEL classification: F12, H21, H73, J61

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Introduction

The purpose of this paper is to provide a framework for studying local public goods supply and tax competition between jurisdictions in a context where there are gains from geographic agglomeration and where labour is imperfectly mobile. Thus, the paper brings together the literature on local public finance (Tiebout (1956)), Wilson (1986) and the so-called new economic geography literature (Krugman (1991), Krugman and Venables (1995), Venables (1996)), and it does so in a “European” context in which there are strong preferences for place of residence, and correspondingly limited mobility of individuals (Faini et. al. (2000)).

Much of the traditional literature on tax competition focuses on taxation of capital income, and a central result is that local or regional tax autonomy will lead to a tax “race to the bottom” (see Wilson (1999) for a survey). A number of papers in the new-economic-geography tradition have challenged this result, arguing that industrial agglomeration, by generating rents that can be taxed and hysteresis that reduces the effective mobility of capital, could just as easily generate a “race to the top” (e.g. Kind, Midelfart-Knarvik and Schjelderup (2000), Baldwin and Krugman (2003)).

There is a similar, traditional presumption that tax competition will give lower taxes on labour income if individuals are mobile (Sinn (2003), Honkapohja and Turunen-Red (2004)). Again, this could be reversed in the presence of agglomerations. Andersson and Forslid (2003) use a model with immobile and mobile workers to show that there will not be a tax race to the bottom for mobile workers and that taxes on immobile workers will actually be biased upwards.

Our paper brings together the insights from the traditional approach, with its focus on fiscal externalities, and the insights from the agglomeration externalities of the new-economic-geography literature. Combining the two, we show that local autonomy with respect to taxation and public provision of goods will give too high or too low taxes (compared to a global optimum) depending on whether the willingness to pay for the average publicly provided good increases or decreases with the mobility of the individual, and we show that this result holds even if there are no economies of scale in the publicly provided goods (and thus no fiscal externality); i.e. even if local authorities provide purely private goods produced with constant returns to scale. As most goods provided by local authorities are of that kind, we feel that our model provides a more meaningful framework for understanding the nature of competition between communities than models that focus on purely fiscal externalities.

At the same time, we also assume that local decisions are based on majority voting, so that it is the interests of the median local voter which determines taxes and the supply of publicly provided goods. This adds another source of possible bias. We show that if the willingness to pay for publicly provided goods varies systematically with the mobility of the individual, the public-choice bias will reinforce the tax-competition bias if mobility is relatively high (what we call the “American” case), while the public-choice bias will counteract the tax-competition bias if mobility is relatively low (the “European” case). To the extent that the total distortion is smaller if the two pull in opposite directions than if they pull in the same direction, therefore, there should be less reason for concern about possible distortions in the European than in the American case.

We model agglomeration gains in the simplest possible manner, by assuming that individuals consume a bundle of locally produced, differentiated products, produced by monopolistically competitive firms and modelled along Spence-Dixit-Stiglitz lines (Spence (1976), Dixit and Stiglitz (1977)). Because consumers value variety, and the range of products available will be larger the larger the local market, this creates agglomeration gains. These will be reinforced if there are economies of scale in the supply of goods provided by local authorities - i.e. if local authorities provide pure public goods or private goods with scale economies.

The agglomeration forces are counteracted by residential preferences. We assume that individuals differ both as to where they prefer to work and live, and in the degree to which they prefer one place to another. We capture this by an index measuring how highly a consumer values a particular choice. All individuals are assumed to have the same utility function defined over this index, the supply of public goods, and consumption of private, differentiated goods.

In the paper, we use this framework to look at a two-community equilibrium. Labour is the only factor of production in the model, and individuals have to make a joint decision on where to work and live. Equilibrium obtains when the marginal resident has nothing to gain from moving to the other community. There are clearly two possible outcomes. One is agglomeration in one community. That will happen if the agglomeration gains are sufficiently strong relative to the dispersion and intensity of residential preferences. The other possibility, on which we focus, is that the loss in residential surplus that the marginal individual would incur by moving is greater than the marginal gain from agglomeration. In that case, there will be a stable, interior equilibrium - i.e. geographical dispersion.

In an interior equilibrium, each community will gain from attracting new residents. Thus, the framework lends itself to the study of competition for residents between communities. The instruments available are publicly provided goods and local tax rates. We assume that no discrimination is possible, so all publicly provided goods are provided in equal quantities to all residents and everyone pays the same tax. If so, a community can only make itself more attractive to new residents if marginal residents differ from non-marginal ones in their willingness to pay for public goods. If potential immigrants are more tax-averse than current residents, a community can attract new residents by reducing the supply of public goods and lowering tax rates; if they value public goods more highly than the natives, immigration will be stimulated by raising taxes and increasing the public goods supply.

The resulting game between the communities will, therefore, be systematically biased towards overprovision of publicly provided goods that the most mobile individuals value more highly than the less mobile ones, and towards underprovision of publicly provided goods with the opposite characteristic.

The general model

The model has L individuals, each endowed with one unit of labour, which is the only factor of production. Individuals are mobile between communities, and move to the community where their total utility will be highest.

Preferences and consumer choice

The utility of an individual depends on three factors: The place of residence, the consumption of publicly provided local goods, and the consumption of private goods.

The utility person h gets when living in community i is

$$(1) \quad U_i^h = U(\alpha_i^h, g_i, c_i),$$

where α_i^h measures the intensity of his preference for living in community i (assumed to differ between individuals); and where g_i and c_i denote his consumption of publicly provided and private goods, respectively.

We take g_i to be a single good provided in equal quantities to all residents by the local authority in community i . It could be a pure public good or a private good with or without economies of scale in production. Publicly provided goods are financed by local taxes, levied in a non-discriminatory fashion on local residents.

Private goods are not traded, which means that consumers are limited to the range of locally produced goods. Consumption of private goods, c_i , is an aggregate of differentiated products. It will be the same for all individuals living at i , since they all supply the same amount of labour, pay the same amount of taxes, and face the same prices and product range.

We model product differentiation in the original Spence-Dixit-Stiglitz fashion. Let e_{ki} be per capita consumption of variety k in community i , and let $\varphi(e_{ki})$ be the sub-utility from consuming this amount. We make the usual assumptions about $\varphi(e_{ki})$; it is an increasing and concave function ($\varphi' > 0$; $\varphi'' < 0$). The consumption aggregate c_i , which may be thought of as a quantity index, is defined as

$$(2) \quad c_i \equiv \sum_{k=1}^{n_i} \varphi(e_{ki})$$

where n_i is the number of different varieties produced in community i .

Let x_{ki} denote total production of variety k in community i . As private goods are not traded, and everyone within the community consumes equal amounts of private goods, per capita consumption of variety k must be

$$(3) \quad e_{ki} = \frac{x_{ki}}{L_i},$$

where L_i is the number of consumers in community i . Inserting (3) into (2) gives per capita consumption of private differentiated goods as

$$(4) \quad c_i = \sum_{k=1}^{n_i} \varphi\left(\frac{x_{ki}}{L_i}\right).$$

The private sector

In the private sector a number of identical firms produce differentiated consumption goods. There are increasing returns to scale in the production of each variety, and these are sufficiently high to ensure that each firm produces only one variety and that each variety is produced by one firm only. The number of firms thus equals the number of different varieties.

Utility maximisation gives the first order conditions for optimal choice of e_{ki} as

$$(5) \quad U_c \varphi'(e_{ki}) = \lambda p_{ki},$$

where p_{ki} is the price of variety k , and λ the marginal utility of income.

Inserting (3) into (5) and rewriting gives the inverse demand functions

$$(6) \quad p_{ki} = \frac{U_c}{\lambda} \varphi'\left(\frac{x_{ki}}{L_i}\right),$$

where x_{ki} is the output of firm k .

Let $b(x_{ki})$ be the cost function of firm k . The profits are then

$$(7) \quad \pi_{ki} = p_{ki} x_{ki} - b(x_{ki}).$$

We make Chamberlain's large-group assumption that the number of firms is so large that each firm takes the aggregate c_i as given. From the point of view of an individual firm, the term U_c / λ in equation (6) is then a constant. Inserting (6) into (7) gives the profits of firm k as

$$(8) \quad \pi_{ki} = \frac{U_c}{\lambda} \varphi'\left(\frac{x_{ki}}{L_i}\right) x_{ki} - b(x_{ki}).$$

The first order condition for profit maximisation, marginal revenue equals marginal cost, becomes

$$(9) \quad p_{ki} + \frac{U_c}{\lambda} \varphi'' \frac{1}{L_i} x_{ki} = b',$$

or, rewriting,

$$(10) \quad p_{ki} \left(1 + \frac{\varphi'' e_{ki}}{\varphi'} \right) = b'.$$

There is free entry and exit in the private sector. New firms will enter until the marginal firm earns zero profits. As firms are identical, the zero-profit condition must hold for all firms in equilibrium,

$$(11) \quad \pi_{ki} = p_{ki} x_{ki} - b(x_{ki}) = 0,$$

which implies

$$(12) \quad p_{ki} = \frac{b(x_{ki})}{x_{ki}}.$$

In equilibrium, both the marginal-revenue-equal-marginal-cost (equation (10)) and the zero-profit condition (equation (12)) must hold, which gives the following equilibrium condition:

$$(13) \quad \frac{b'}{1 + \frac{\varphi'' e_{ki}}{\varphi'}} = \frac{b}{x_{ki}}.$$

Here, $-\frac{\varphi'}{\varphi'' e_{ki}}$ is the elasticity of substitution between any two varieties of private goods.

Assume that the elasticity of substitution between any two varieties is constant and equal to σ . Assume also that there are increasing returns to scale in the production of each variety, as represented by the linear labour-requirement function

$$(14) \quad A + Bx_{ki}.$$

Total costs are nominal wages times labour input,

$$(15) \quad b(x_{ki}) = w_i(A + Bx_{ki}).$$

Inserting (14) and (15) into (13) gives the following equilibrium condition:

$$(16) \quad x_{ki} = \frac{A}{B}(\sigma - 1).$$

We are free to choose units such that

$$(17) \quad A \equiv \frac{1}{\sigma}, \quad B \equiv \frac{\sigma-1}{\sigma}.$$

The supply of each firm is then

$$(18) \quad x_{ki} = 1,$$

and the price of each variety

$$(19) \quad p_{ki} = w_i.$$

Each firm supplies one unit of its exclusive variety, and the price of each variety is equal to the nominal wage rate in the community.

Note that the labour requirement of each firm is (inserting (17) and (18) into (14))

$$(20) \quad A + Bx_{ki} = 1.$$

One unit of labour is needed to produce one unit of each variety. As each firm produces one unit of its exclusive variety, the number of private firms/different varieties equals the number of workers in the private sector; i.e. n_i denotes both the number of firms and the number of workers in the private sector.

The public sector

The residents of each community are provided with some local public goods; pure public goods or publicly provided private goods. Everyone living in a community consumes the same amount, g_i , of these goods. The production of local public goods is financed by local taxation of the residents of the community. Everyone living in a community pays the same amount of taxes.

Labour is the only factor of production. Let $h(L_i)g_i$ be the labour requirement function of the public sector. The nature of local public goods, whether they are pure public goods or publicly provided private goods, is reflected in the term $h(L_i)$.

If $h'(L_i) = 0$, then g_i is a pure public good, i.e. a good for which there is no rivalry in consumption. If $h'(L_i) > 0$, g_i is a publicly provided private good in the sense that if one more person is to consume the good, others must reduce their consumption, everything else equal. One reason for the government to supply private goods is that there are increasing returns to scale in the production of these goods. That will be the case when $h(L_i)/L_i$ is decreasing in L_i .

Population and real income

There are L_i inhabitants in community i , of which $h(L_i)g_i$ work in the public sector. The number of workers in the private sector is therefore $L_i - h(L_i)g_i$. The number of private firms equals the number of workers in the private sector, so the number of private firms must also be $n_i = L_i - h(L_i)g_i$.

Inserting for n_i and x_{ki} in equation (4), we see that per capita consumption of private goods is

$$(21) \quad c_i = [L_i - h(L_i)g_i] \varphi\left(\frac{1}{L_i}\right) \equiv c^i(g_i, L_i).$$

Note that

$$(22) \quad \frac{\partial c^i}{\partial g_i} = -h(L_i) \varphi\left(\frac{1}{L_i}\right) < 0.$$

The effect of increasing the provision of public goods per capita, everything else equal, is that the consumption of differentiated goods per capita is reduced. The production of local public goods is financed by an equal tax on the residents of the community. As the production of public goods increase, so do the costs of public goods production. This leads to increased taxes per capita as long as the number of inhabitants remains unchanged. After-tax income is therefore reduced, leading to reduced consumption of private differentiated goods. The tax effect is equivalent to $h(L_i)$ units of labour. Because output per firm is given, the entire reduction in private consumption takes the form of a reduction in the number of product varieties available. Increased public

employment gives a one-to-one reduction in the number of private firms, and thus in the number of product varieties. This is reflected in the term $\varphi(1/L_i)$ in (22). Note that this means that the social marginal cost of publicly provided goods is higher than the private marginal cost, which is simply $h(L_i)$.

From (21) we also find the relationship between private consumption and the size of the community:

$$\frac{\partial c^i}{\partial L_i} = (L_i - hg_i) \left(-\varphi' \frac{1}{L_i} \right) + \varphi(1 - h'g_i)$$

i.e.

$$(23) \quad \frac{\partial c^i}{\partial L_i} = \frac{c_i}{L_i} \left[(1 - \beta) + \left(\frac{g_i [(h/L_i) - h']}{1 - g_i(h/L_i)} \right) \right] \text{ with } \beta \equiv \frac{\varphi' e_i}{\varphi}$$

This has an instructive interpretation. The term $(1 - \beta)$ captures the real, positive externality - i.e. gain from agglomeration: More residents means a larger local market, and thus a wider selection of products. It also means that consumption of each variety is reduced, but the net effect is positive. The second term in brackets captures the fiscal externality. If there are economies of scale in publicly provided goods, the marginal labour requirement will be lower than the average requirement, so the second term will be positive. The economic reason is simply that more people in that case means lower taxes per capita.

Inserting (21) into (1) gives the utility of individual h in community i as

$$(24) \quad U_i^h = U(\alpha_i^h, g_i, c^i(g_i, L_i)).$$

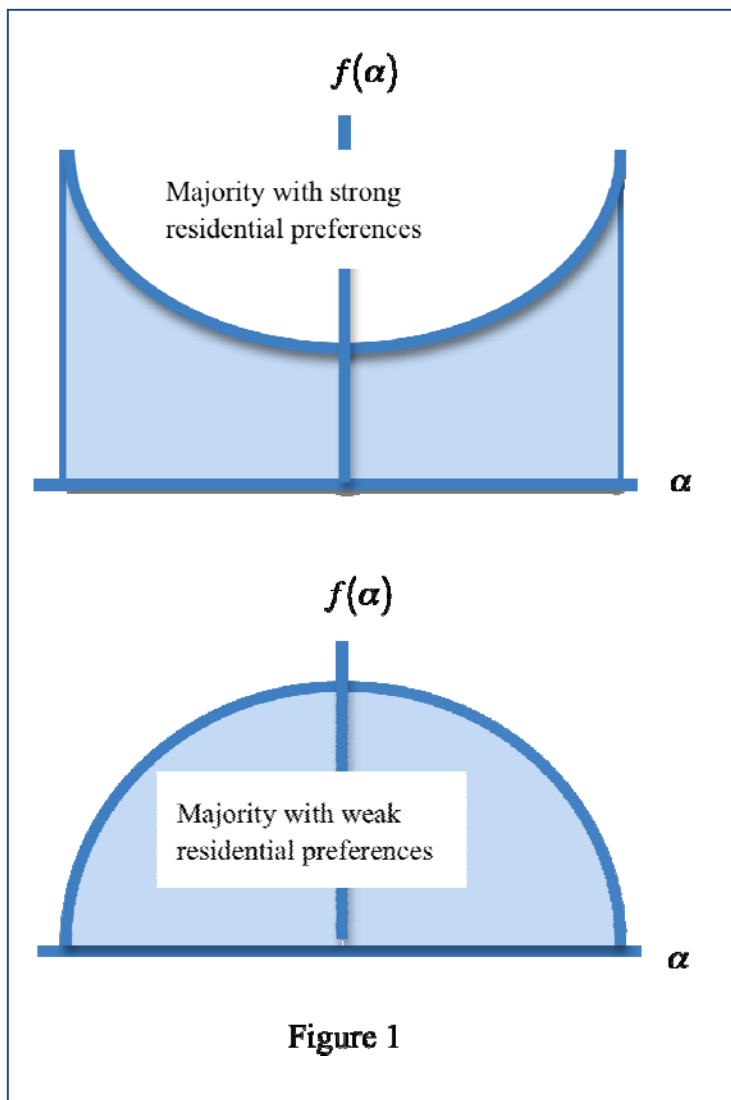
Migration and geographic equilibrium

Now, consider a country consisting of two communities. Each local community is formally like the one described in the previous section. In each community there are two sectors, a private and a public, producing goods consumed locally. Publicly provided goods are financed by local taxation, whereas the after-tax wage is used for consumption of private differentiated goods. People are mobile between communities,

and settle in the community where their total utility will be highest. Total utility depends on consumption and on the place of living per se. To proceed with the analysis we need to specify these locational preferences in some more detail.

Assume that the utility from living in community 1, α_1 , is distributed on the interval $[-(1/2), (1/2)]$, and that $\alpha_2 = -\alpha_1$. A person who very highly values living in community 1 (α_1 is close to $1/2$), has an equally strong dislike of living in community 2 (α_2 is close to $-1/2$). The distribution of α_1 is illustrated in figure 1. α_1 is measured along the horizontal axis, and increases as we move from left to right. (As $\alpha_2 = -\alpha_1$, α_2 is also measured along the horizontal axis, but increases as we move from right to left.) The total number of people in the country, L , is given by the total area under the curve $f(\alpha_1)$; i.e.

$$L = \int_{-\frac{1}{2}}^{\frac{1}{2}} f(\alpha_1) d\alpha_1.$$



We shall be concerned with symmetric equilibria only, so we assume that the distribution is symmetric. We distinguish between two cases – one where there are more people with strong residential preferences than the number of people with weak preferences, in which case the distribution is u-shaped; and one where most people have weak residential preferences, in which case the distribution is bell-shaped. The two are illustrated in figure 1.

A person settles in community 1 if (and only if) $U_1^h > U_2^h$. This can give rise either to an interior equi-

brium in which there are residents in both communities, or to complete agglomeration in one community. We focus on the former.

In an interior equilibrium, the utility of the marginal individual must be the same in both communities, so we must have

$$(25) \quad U(\alpha_1^M, g_1, c_1) = U(-\alpha_1^M, g_2, c_2).$$

where M denotes the marginal inhabitant. Let $F(\alpha_1^M)$ be the number of people for whom $\alpha_1 \geq \alpha_1^M$; i.e. $F(\alpha_1^M)$ is the number of inhabitants in community 1. Then

$$L_1 = F(\alpha_1^M) = L - \int_{-\frac{1}{2}}^{\alpha_1^M} f(\alpha_1) d\alpha_1$$

To find the critical value of α_1 , invert $F(\alpha_1^M)$:

$$\alpha_1^M = G(L_1) \equiv F^{-1}(L_1)$$

Inserting for α_1^M in (25), the equilibrium condition becomes

$$(26) \quad U(G(L_1), g_1, c_1) = U(-G(L_1), g_2, c_2).$$

The interior equilibrium is not necessarily stable. If the utility difference $U_1^M - U_2^M$ increases with L_1 , the equilibrium implied by (26) is unstable in the sense that a small deviation will induce massive immigration or emigration.

Thus, the condition for an interior equilibrium to be stable is that

$$(27) \quad \frac{d[U(G(L_1), g_1, c^1(g_1, L_1)) - U(-G(L_1), g_2, c^2(g_2, L_2))]}{dL_1} < 0,$$

Carrying out the differentiation in (27) gives

$$(28) \quad (U_\alpha^1 G_L + U_\alpha^2 G_L) + \left(U_c^1 \frac{\partial c^1}{\partial L_1} + U_c^2 \frac{\partial c^2}{\partial L_2} \right) < 0.$$

Consider a symmetric equilibrium, so $U_\alpha^1 = U_\alpha^2 \equiv U_\alpha$ and $U_c^1 = U_c^2 \equiv U_c$. Equation (29) then reduces to

$$(29) \quad 2U_\alpha G_L + 2U_c \frac{\partial c^i}{\partial L_i} < 0.$$

i.e.

$$(30) \quad \frac{\partial c^i}{\partial L_i} < \frac{U_\alpha}{U_c} G_L.$$

The term on the left-hand side is the marginal gain from agglomeration (which by (23) is the sum of the real and fiscal externalities). To interpret the right-hand side, note that in the symmetric equilibrium, everyone lives in the community for which they have a residential preference (i.e. $\alpha_1^M = 0$), so if one community is to grow, someone must move from the place they prefer to the place in which they would rather not live. The first term is the compensation necessary to induce one person to move from their preferred location to the other. The stability condition, therefore, is that the necessary compensation must be greater than the marginal gain from agglomeration.

Whether or not a symmetric equilibrium will be stable clearly depends on the size of the agglomeration gains. It also depends on the intensity of residential preferences (U_α/U_c) and on the preference distribution of individuals. With an “American” distribution, where most people have weak residential preferences, there are many people with preferences close those of the marginal resident, so $G_L (= d\alpha_1/dL_1)$ is small; with a “European” distribution, it is large. Thus, we are more likely to have a stable, symmetric equilibrium in the latter case.

Local public finance and tax competition

We now have the framework needed to discuss whether there will be over-, under-, or optimal supply of local public goods in a federal system of competing local communities, and whether the distribution of residents will be optimal.

National optimum

Consider first the national optimum. We shall not be concerned with distributional issues, so let us assume an additive national welfare function

$$(31) \quad W = \int_{\alpha_1^M}^{\frac{1}{2}} U(\alpha_1, g_1, c_1) f(\alpha_1) d\alpha_1 + \int_{\frac{1}{2}}^{\alpha_1^M} U(-\alpha_1, g_2, c_2) f(\alpha_1) d\alpha_1$$

The national optimum is found by maximising (31) with respect to α_1 , g_1 and g_2 , taking into account the effects on private consumption in each region.

Consider first the optimum condition with respect to α_1 - i.e. the optimum size of each community. If the size of the community did not matter for consumption per capita – i.e. if there were no real or fiscal externalities – the first-order condition with respect to α_1 would be

$$(32) \quad \frac{\partial W}{\partial \alpha_1} = -U(\alpha_1, g_1, c_1) f(\alpha_1) + U(-\alpha_1, g_2, c_2) f(\alpha_1) = 0$$

i.e. that the utility of the marginal inhabitant should be the same in both communities. With a symmetric distribution this means that each community will have the same number of inhabitants. But if so, a small deviation from (32) will have exactly offsetting effects on welfare in the two communities – per capita consumption in the community which gets an extra individual will rise by exactly the same amount as per capita consumption will fall in the community which loses an individual – so (32) must be the first-order condition for the optimum population distribution with externalities as well.

It is also seen from (32) that the second-order condition for a geographic optimum – and thus the condition for an interior solution – is that the utility differential between the two communities, taking into account the effects on consumption, is declining in α_1 . That is the same condition as the stability condition for a symmetric market equilibrium (condition (30) above). We assume that this condition is satisfied.

The first-order conditions for public goods supplies are

$$(33) \quad \frac{\partial W}{\partial g_1} = \int_{\alpha_1^M}^{\frac{1}{2}} \left[U_g + U_c \frac{\partial c_1}{\partial g_1} \right] f(\alpha_1) d\alpha_1 = 0$$

$$(34) \quad \frac{\partial W}{\partial g_2} = \int_{\frac{1}{2}}^{\alpha_1^M} \left[U_g + U_c \frac{\partial c_2}{\partial g_2} \right] f(\alpha_1) d\alpha_1 = 0$$

These are the usual first order conditions regarding optimal supply of public goods: The sum of the marginal rates of substitution equals the marginal rate of transformation. Another way of writing (33) and (34) is

$$(33') \quad \frac{U_g^A}{U_c^A} = -\frac{\partial c^1}{\partial g_1},$$

$$(34') \quad \frac{U_g^A}{U_c^A} = -\frac{\partial c^2}{\partial g_2},$$

where A refers to the average inhabitant. (The sum of the marginal rates of substitution ($MRS_{g,c}$) equals the number of inhabitants times $MRS_{g,c}$ of the average inhabitant.)

A decentralised equilibrium

In a decentralised equilibrium we assume that the residents of a community decide on taxes and supply of goods from the public sector, and that they do so by majority voting. With single-peaked preferences (which in our case follows from our assumptions about the utility functions and the distribution of individuals over residential preferences), this ensures a unique voting equilibrium, where the amount of local public goods supply is the amount preferred by the median voter.

The maximisation problem that determines taxes and public goods supply in community 1 is therefore

$$\max_{g_1} U(\alpha_1^m, g_1, c_1),$$

with m denoting the median voter. The first order condition for optimal choice of g_1 is

$$(35) \quad U_g^m + U_c^m \frac{dc_1}{dg_1} = 0$$

Total change in per capita consumption of private differentiated goods due to increased provision of local public goods is

$$(36) \quad \frac{dc_1}{dg_1} = \frac{\partial c^1}{\partial g_1} + \frac{\partial c^1}{\partial L_1} \frac{dL_1}{dg_1}.$$

The effect on private consumption of an increase in public goods supply may be split in two: The first is the direct effect, as given by equation (22). This is clearly negative. The second is the migration effect. If an increase in g_1 leads to a change in $U_1^M - U_2^M$, there will be emigration or immigration. A change in the number of residents leads to a change in per capita consumption of differentiated goods, as given by equation (23). If L_1 increases with increased g_1 , the second term of (36) is positive. If, however, L_1 decreases as g_1 increases, the second term of (36) is negative.

Inserting (36) into (35) gives the first order condition for optimal supply of local public goods in community 1 as

$$(37) \quad U_g^m + U_c^m \frac{\partial c_1}{\partial g_1} + U_c^m \frac{\partial c_1}{\partial L_1} \frac{dL_1}{dg_1} = 0.$$

The migration effect depends on the direct effect on U_1^M of an increase in per capita supply of public goods in community 1. Specifically, we must have

$$(38) \quad \frac{d(U_1^M - U_2^M)}{dg_1} = \frac{\partial(U_1^M - U_2^M)}{\partial L_1} \frac{dL_1}{dg_1} + U_g^M + U_c^M \frac{\partial c_1}{\partial g_1} = 0.$$

Define

$$(39) \quad S \equiv - \frac{\partial(U_1^M - U_2^M)}{\partial L_1},$$

which is positive by the stability condition (equation (28)).

Solving (38), we get

$$(40) \quad \frac{dL_1}{dg_1} = \frac{1}{S} \left(U_g^M + U_c^M \frac{\partial c_1}{\partial g_1} \right)$$

Inserting (40) into (37) gives

$$(41) \quad U_g^m + U_c^m \frac{\partial c_1}{\partial g_1} + U_c^m \frac{\partial c_1}{\partial L_1} \frac{1}{S} \left(U_g^M + U_c^M \frac{\partial c_1}{\partial g_1} \right) = 0,$$

Define

$$(42) \quad b \equiv \frac{\partial c^1}{\partial \mathcal{L}_1} \frac{1}{S},$$

which is positive.

Manipulating (41) then gives the following first order condition for the local choice of g_1

$$(43) \quad \left(\frac{U_g^m}{U_c^m} + \frac{\partial c_1}{\partial g_1} \right) + \frac{b}{1+b} \left(\frac{U_g^M}{U_c^M} - \frac{U_g^m}{U_c^m} \right) = 0.$$

(U_g^h/U_c^h) is the marginal rate of substitution between consumption of publicly provided and private goods of person h , i.e. the marginal willingness to pay for an extra unit of the publicly provided good. Call it $MRS_{g,c}$. If $MRS_{g,c}$ is increasing in α_1 , the median resident has a higher $MRS_{g,c}$ than the marginal inhabitant. The second term of (44) is then negative, and the first term must be positive for the equality to hold. Conversely, if $MRS_{g,c}$ is decreasing in α_1 , the second term is positive and the first term must be negative.

Tax competition or competition in public services?

To interpret (43), consider first what it implies about the nature of competition between communities. Suppose first that $MRS_{g,c}$ is increasing in α_1 ; i.e. that the marginal resident has a lower willingness to pay for publicly provided goods than the median voter. What will the tax/public-goods reactions functions look like in the two-community equilibrium? The answer is straightforward: If community 2 raises taxes and increases its supply of public goods, marginal residents will move to community 1. That will lower the $MRS_{g,c}$ of the marginal resident in community 1. It will also lower the $MRS_{g,c}$ of the median voter in community 1, as the new voters have a lower willingness to pay for public goods than the old ones. Taxes and local supply of public goods in community 1 will therefore unambiguously decrease. Thus, the reactions functions for public goods supply in the two communities must be downward-sloping.

It is equally clear that there will be undersupply of public goods in both communities relative to the preferences of the median voters in equilibrium. To see this, note that the

utility of the median voter in one community is increasing in the supply of public goods in the other community, as higher taxes there will induce people to move away. Thus, the iso-utility curves for the median voters must be as shown in figure 2. It follows that a cooperative solution between the median voters would entail higher taxes and greater supply of public goods in both communities, as indicated by the area I in figure 2. Thus, if $MRS_{g,c}$ is increasing in α_1 , we shall see tax competition between the communities.

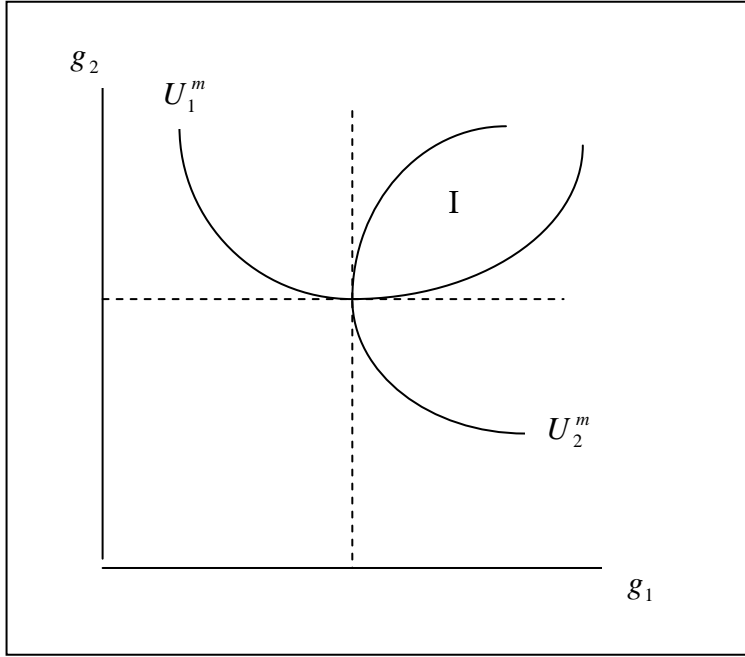


Figure 2

If $MRS_{g,c}$ is decreasing in α_1 , we get the opposite result; i.e. competition in public services and overprovision of public goods relative to the preferences of the median voters. The verification of this is left to the reader.

Efficiency

To see how the decentralised equilibrium deviates from the efficient solution, it is instructive to rewrite (43) as

$$(44) \quad \left(\frac{U_g^A}{U_c^A} + \frac{\partial c_1}{\partial g_1} \right) + \left(\frac{U_g^m}{U_c^m} - \frac{U_g^A}{U_c^A} \right) + \frac{b}{1+b} \left(\frac{U_g^M}{U_c^M} - \frac{U_g^m}{U_c^m} \right) = 0$$

Recall that the first order condition for efficient supply of local public goods in community 1 is

$$(33') \quad \frac{U_g^A}{U_c^A} = -\frac{\hat{\alpha}^1}{\hat{g}_1}.$$

Thus, there are two sources of possible inefficiency. The first is the cost-of-democracy wedge between the willingness to pay for public services of the median and the average voter. The second is the distortion arising because of competition for residents between local authorities. Both wedges could have either sign; so there is no a priori reason to believe that a democratic, decentralized solution will give systematic overprovision or underprovision of publicly provided goods. Nor is there any reason to believe that the two have the same sign. Thus, it could well be that decentralisation counteracts the democratic distortion; but it could equally well be that it magnifies it.

The “European” vs the “American” case

Whether the two sources of inefficiency reinforce or counteract each other depends on the distribution of residential preferences – specifically on whether the majority have strong residential preferences (the “European” case) or weak ones (the “American” case). In the latter case, of course, it is more likely that we will have geographic concentration, in which case local tax competition is no longer an issue at all. Barring that outcome, however, it follows from (44) that it is more likely that local autonomy creates serious distortions in the “American” than in the “European” case.

To see that, note from figure 1 (p.11) above that in a symmetric equilibrium, the distribution of people in each community over residential preference will be skewed. In the “American” case there will be overrepresentation in each community of people with α close to zero; in the “European” case there will be overrepresentation of people with a relatively strong preference for living in the community, i.e. with α quite different from zero. Thus, in the “American” case, the median voter will have preferences somewhere between those of the marginal resident and the mean preferences, i.e.

$$(45) \quad \alpha_1^M < \alpha_1^m < \alpha_1^A \quad \text{The “American” case}$$

while in the “European” case, the mean preferences will be somewhere between those of the marginal resident and the median voter:

$$(46) \quad \alpha_1^M < \alpha_1^A < \alpha_1^m \quad \text{The "European" case}$$

If, as many argue, tax aversion increases with mobility, therefore, tax competition to attract more people will be counteracted by the democratic bias in favour of the median voter in the “European” case, while it will be reinforced by the democratic bias in the “American” case. Generally, the two wedges in (44) pull in opposite directions in the “European” case and the same direction in the “American case”.

Conclusions

In this paper we have developed a framework to study tax competition and local public goods supply in a setting where real and fiscal externalities interact with local democracy, and we have used the framework (a) to analyse if there is any reason to believe that local autonomy generally will give a tax race to the bottom (there is not), and (b) to look more closely at possible sources of oversupply or undersupply of publicly provided goods in a setting where local democracies compete in order to attract more people to the area. We have identified two potential sources – the relationship between individual mobility and willingness to pay for publicly provided goods, and the mobility distribution of individuals (i.e. the distribution of individuals over residential preferences). The two could reinforce each other in a local democracy if the majority of the residents in a community are relatively mobile (the “American” case), while they would pull in opposite directions if the majority of residents are relatively immobile (the “European” case).

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