Do EU15 Countries Compete over Labour Taxes ?

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Because of the high international mobility of firms, empirical research on international tax competition has mainly considered corporate taxation. Competition in labour taxation tends to be overlooked, Altschuler and Godspeed (2003) being the exception. We see three arguments why this may be unjustified. First, the tax base in labour taxation is the wage mass, which depends on employment. While labour is largely internationally immobile, jobs are not, because of the international mobility of goods or firms (capital). Second, corporate taxation represents a much smaller share of total taxation compared to labour. Hence, labour tax competition could have more important consequences for the provision of public goods or income redistribution than corporate tax competition. Third, ongoing economic integration raises the concern that, on the one hand, the demand for income redistribution or social spending would increase (as a compensation for the increased risk of unemployment or income inequality that trade liberalisation may imply) but, on the other hand, the ability of the government to raise taxes to this aim may be constrained because of the increased mobility of the tax base. Increased taxation of immobile production factors is then considered as the “synthesis” of this dilemma. This may be obstructed if in addition, trade liberalisation implies strategic tax setting in labour taxation.

We model the possibility of labour tax competition using a standard Dixit-Stiglitz two-country model with transportation costs in exporting goods, to which we add the assumption of non-clearing labour markets and income redistribution by the government, financed by a tax on labour income. Based on this model, we derive an empirical specification of the labour tax reaction function, which is subsequently estimated for the EU15 member states. For the labour tax rates, we use two sources of data. First the Taxing Wages database of the OECD, which provides data on effective tax wedges for the period 1979-2004 and second, the Taxation Trends in the EU 2009 by Eurostat, from which we obtain implicit labour tax rates for 1995-2007. The tax reaction function is specified as a spatial lag panel and is estimated using an instrumental variable approach, in which the one and two period spatially lagged explanatory variables are used as instruments. We define four different weight matrices of the spatially lagged dependent variable of which the elements are a combination of the inverse of the distance between major cities and the number of years of common EU membership.

Using the implicit tax rates as the empirical proxy of the dependent variable, the spatial lag coefficient is not significant. However, the estimation results are in contradiction with the theoretical expectations for almost all the control variables and the common findings in the literature, which questions the adequacy of the use of implicit tax rates as empirical proxy. In the estimations using the effective tax wedges, we obtain a significant positive effect of the spatially lagged dependent variable for all the considered weight matrices and with correct signs of the control variables. In order to verify the identification of the tax interaction effect, we re-estimate a model with a weight matrix composed of uniform elements, i.e. a specification consistent with yardstick competition or common intellectual trends as explanation of the spatial interaction effect. However, in this specification, the coefficient of the spatially lagged dependent variable is not significant. Our results point to the presence of competition over labour taxes within the EU15 countries. In absolute value, the reaction effect remains small, though.