Economic Integration, Tax Erosion, and Decentralisation: An Empirical Analysis

Francesca Gastaldi [a]
Paolo Liberati [b]
Antonio Scialà [c]

Abstract

This paper addresses the issues of whether and how the degree of economic integration may affect central government tax revenues and the decentralisation of the public sector. To this purpose, we develop an econometric strategy in two steps using a sample of OECD countries. In the first stage, economic integration is directly used as a determinant of the size of taxation, measured by the implicit tax rates (ITR) on four tax basis (mobile capital, immobile capital, labour, and consumption. In the second stage, a measure of *erosion* of central tax revenues is derived (defined as the elasticity of *ITRs* with respect to economic integration) and used as a determinant of the decentralisation of the public sector. Our results first show that economic integration has a negative impact on the implicit tax rate on mobile capital, and that this negative impact may grow at increasing rates as far as economic integration increases. At the same time, the implicit tax rate on labour is positively affected by economic integration. Second, we show that a reduction of the elasticity (which means increasing difficulties of obtaining additional tax revenues from mobile capital) would be associated to an increase of the size of local public sectors.

Keywords: Tax erosion; implicit tax rates; economic integration; fiscal federalism; tax competition.

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[a] "Sapienza" Università di Roma, Dipartimento di Economia Pubblica, francesca.gastaldi@uniroma1.it, Via del Castro Laurenziano 9, 00161, Rome, Italy.

[b] Università Roma Tre, Dipartimento di Economia, paolo.liberati@uniroma3.it, Via Silvio D'Amico 77, 00145, Rome, Italy.

[c] Università Roma Tre, Dipartimento di Diritto dell'Economia e Analisi Economica delle Istituzioni, asciala@uniroma3.it , Via Ostiense 163, 00154, Rome, Italy.