

# Rethinking Competitiveness

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# Competitiveness in History

Adam Smith, in *The Wealth of Nations*, disposed of mercantilism

- Just as countries with no grapes can buy wine, countries with no mines can buy gold or silver

David Ricardo, in *On the Principles of Political Economy and Taxation*, described comparative advantage

- Even if one country can produce all goods more efficiently than another, they should still trade if the relative difference in efficiency is not the same for each good.

Paul Krugman, in *Competitiveness: A Dangerous Obsession*, condemned defining national competitiveness by productivity or output

- The prosperity of one country will often stimulate additional prosperity for others.

# The Current Paradigm

Popular reports relate national competitiveness to factors that enable firm competitiveness

- *The Global Competitiveness Report* - World Economic Forum
  - Competitiveness is “the set of institutions, policies, and factors that determine the level of productivity of a country”
- *World Competitiveness Yearbook* - International Institute for Management Development
  - Four primary factors of competitiveness:
    1. Economic performance
    2. Government efficiency
    3. Business efficiency
    4. Infrastructure

# Why the Current Paradigm is (Mostly) Useless

The scope of these competitiveness reports is too broad

- Sanjaya Lall (2001) writes of *The Global Competitiveness Report*, “all such efforts should be more limited in coverage...They should also be more modest in claiming to quantify competitiveness: the phenomenon is too multifaceted and complex to permit easy measurement.”

Recent studies find no relationship between competitiveness rankings and economic growth prospects (Berger and Bristow, 2009; Ochel and Rohn, 2006)

- Berger and Bristow write, “The value of such indices is therefore questionable beyond their purpose in reminding us of the continued success of particular nations and the continued paucity of others and thus encouraging policy-makers to indulge in place promotion”

# Aspiration for a New Paradigm

A definition for competitiveness should

1. Focus on areas over which nations actually compete
2. Reflect that world is becoming “flatter”, and the competition between international jurisdictions is becoming analogous to the competition between municipalities—a highly researched area
3. Focus on how countries depend on the actions of others when setting policy, not just on zero-sum games

# The Tiebout Model

- The Tiebout model from local public finance lends itself to international extension in a flat world
- Households “vote with their feet” by moving to communities that satisfy their preferences for taxes and public services
  - Foot-voting also applies to firms
- Taxes and services are capitalized into property prices
- Communities compete for mobile households and firms, particularly for those that offer local benefits

These observations are empirically supported in the metropolitan setting

# Tiebout's Motivation

- Non-collective consumption goods are optimally allocated by buyers based on decisions over costs and benefits
  - Competition among enterprises optimally allocates factors of production
- Public services could also be optimally allocated if users would respond truthfully to a poll question about their benefit
  - Then a benefits tax would be assessed
  - Users will under-report their benefit to avoid this tax and free-ride
- Voting is a second-best option for signaling desired public expenditure levels and ability to pay is a second-best method for determining tax levels
- Inter-municipal competition for foot-voting households can contribute to an optimal allocation of public goods under certain assumptions

# Externalities Contribute to the Prize

Positive “social effects” accompany rich neighbors

- The poverty rate affects the cost of police and fire services (Ladd and Yinger, 1991)
- Socioeconomically-advantaged peers have been linked to improved education outcomes (Betts and Morrell, 1999)
- Entrepreneurial neighborhoods influence residents to become entrepreneurs and invest more into their own businesses (Giannetti and Simonov, 2009)
- Communities will sub-optimally over allocate public goods to attract the rich
- Communities will become more homogenous, and the poor will suffer more from having poor neighbors
- This increases the prize from competition

# Competition Improves the Efficiency of Services

- Competition between localities can improve the efficiency of public services
  - Bayer, Ferreira, and McMillan (2005) show this for educational outcomes
- Specific services, taxes, or regulations can attract specific kinds of households
  - Regulation limiting ozone levels in the suburbs of Los Angeles attracted migrants who chose not to live there in the past (Kahn, 2000)

# The Tiebout Model and the Firm

- Firms also respond to differentials in the tax/service package
  - Empirical research indicates that firms mostly move in response to tax differentials and ignore public good differentials

# Tiebout and a New View of Competition

- Can we extend these results to the international setting?
  - One cannot assume the extension follows immediately
  - Tiebout competition assumes that households and firms are completely mobile and that individuals can work and live in different localities
  - As the world flattens, these assumptions and others will be more applicable to the international setting and may already be important in areas, such as the EU, that have adopted policies to significantly increase mobility

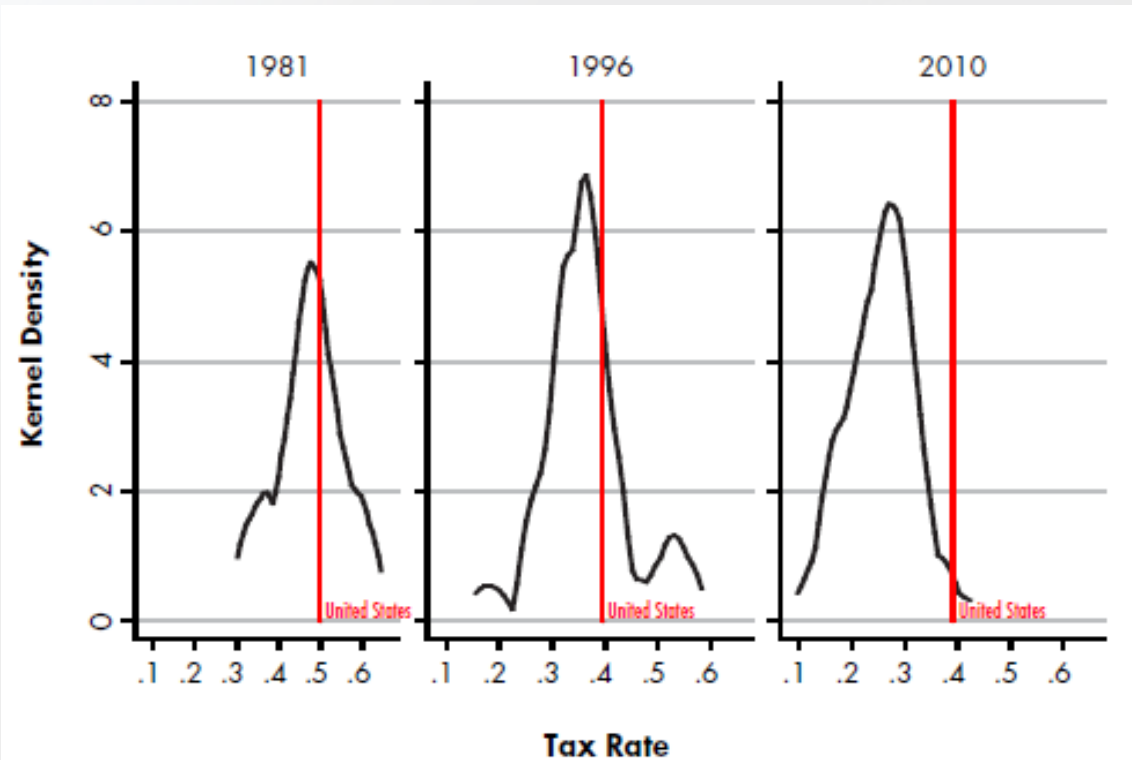
# Case 1: International Migration

- International foot-voting can be very beneficial. Ilya Somin (2008) notes that
  - “There are so many more options for international migrants than domestic ones”
  - “There are very large policy divergences between countries”
- International Tiebout competition is already happening
  - The service/tax package attracts skilled international-immigrants according to a 2002 OECD report
- More freedom of movement would stimulate more interjurisdictional competition

# Case 2: Tax Competition

## Why does it occur?

- Foreign Direct Investment responds strongly to corporate tax differentials as does plant location, just as in the municipal setting
- Governments compete with taxes, but maybe with public goods as well
- Increasing capital interaction has led to falling corporate tax rates



Distribution of Top Statutory Corporate Tax Rates in the OECD

*Source: Hassett and Mathur (2011)*

# Case 2: Tax Competition

## What does it mean for policy?

- Tax havens may help high tax countries compete
  - High tax countries remain attractive because their firms can use tax-efficient financing structures in tax havens as a release valve
  - This should be considered when the OECD is considering tax harmonization schemes
- Even though the game ends with all rates at or near zero, there is much to be gained by getting their first
- Countries should seek fundamental tax reform that leave them with non-distortionary taxes to replace lost revenue
- After capital tax rates reach zero, the standard Tiebout model will apply more closely

## Case 3: The EU

- The emergence of new federal regions designed to enhance mobility will increase Tiebout forces and may drive governments toward efficient policies
- Countries outside of these new regions may find that their relative attractiveness changes drastically because their own governments are immune to these forces. The U.S. corporate tax is an interesting case in point

# Conclusion

- The Tiebout model and empirical observation tell us that municipalities compete for households and firms
- Households and firms are able to satisfy their fiscal preferences by foot-voting
- As the world flattens, nations are beginning to compete in the same way over the location of individuals and firms and their assets
- The extension of the Tiebout literature to the international setting is a fertile area for future research