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# Can revenue equalisation mitigate tax competition? Ad valorem, residence-based taxation in a federation

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## Abstract

In this paper, fiscal externalities are analysed in a model of tax competition with three distinguishing features: (i) the tax base is shared by two levels of government; (ii) taxes are levied on an ad valorem basis; (iii) although the tax base is mobile across lower-level jurisdictions, these jurisdictions levy their taxes on a residence basis. We find that either under- or overtaxation occurs, under similar conditions as in Keen and Kotsogiannis (2002, 2004). However, the neat trade-off between positive horizontal externalities and negative vertical externalities breaks down entirely in our ad valorem setting. Precisely because of this ambiguity, decentralising the unitary outcome via revenue equalisation becomes far more complex than under unit taxation. Only when the marginal valuation of public provision is on par with private consumption, can we replicate the clear-cut, efficiency-enhancing equalisation formulas given by Kotsogiannis (2010) and Bucovetsky & Smart (2006).

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