On the Efficiency of Decentralized Commodity Taxation in the Presence of International Spillovers

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March 2, 2018

Abstract

We examine the efficiency of decentralized commodity taxation in the context of an international trade model, where consumption tax revenue finances public sector activities related to international spillovers. We consider two cases; tax revenue finances (i) public pollution abatement in the presence of consumption generated transboundary pollution, and (ii) the provision of an international public consumption good, in the absence of pollution. The key result of our study is that in either case, non-cooperative equilibrium origin-based consumption taxes are efficient, while destination-based taxes are not. When in the presence of international spillovers, consumption tax revenue is lump-sum distributed, neither type of consumption taxes is efficient.

JEL classification: H21, H23.

Keywords: Origin and destination consumption taxes, consumption cross-border externalities, efficiency of non-cooperative international commodity taxation.

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1 Introduction

In December 2015, 195 countries signed the Paris climate agreement (COP21), the first-ever universal, legally binding global climate accord. However, recent political developments unveil the difficulties regarding the implementation of this agreement. Since cooperative policies for resolving international issues are hard to achieve, it is of vital importance to explore possible ways to target the cooperative outcomes when the governments act independently, i.e., non-cooperatively, in pursuing their own national interest.

Motivated by the above recent developments, we examine the efficiency of decentralized commodity taxation in the context of an international trade model, where consumption tax revenue finances public sector activities related to international spillovers. We consider two cases; tax revenue finances (i) public pollution abatement in the presence of consumption generated transboundary pollution, and (ii) the provision of an international public consumption good, in the absence of pollution. The key result of our study is that in either case, non-cooperative equilibrium origin-based consumption taxes are efficient, while destination-based taxes are not. In the presence of international spillovers, when consumption tax revenue is lump-sum distributed, neither type of consumption taxes is efficient.

The novelty of these results rests on two pillars. First, it holds regardless of whether countries are symmetric or not, provided, however, that individuals in each country have the same income and preferences, or alternatively they have identical and homothetic preferences. Second, contrary to related studies, it does not require other mechanisms such as income transfers either between countries or different levels of government, e.g., union and country level governments, in order to ensure the efficiency of the decentralized commodity tax setting. The rationale of our main result is the following. A higher origin-based consumption tax by one country, affects the other country's welfare negatively due to the reduction in consumption of the taxed commodity, and positively due to either the mitigation of the adverse pollution effect, or the favorable effect on consumption of the international public good. Evaluated at the Nash equilibrium, these two externalities cancel each other out. Contrary to it, the non-cooperative equilibrium destination-based consumption taxes are inefficient in both cases.

Despite the fact that our model can accommodate different versions of the same question regarding the optimality of decentralized commodity taxation we adapt it to the timely issue of transboudary pollution and the arising difficulties regarding the mitigation of climate change. In this regard, our study is founded on three important features which are strongly supported by real world practice. The *first* feature is consumption generated pollution. The *second* is the principle of commodity taxation, and the *third* is the existence of public pollution abatement. Regarding the consumption generated pollution, it is well known that a significant part of greenhouse emissions, e.g., CO_2 emissions, are attributed to consumption or residential activity. Hu and McKitrick (2016) report that "*....According to the US Environmental Protection Agency (EPA 2012), nearly one half of the emissions of smog-forming volatile organic compounds (VOCs), more than half of the nitrogen oxides (NOx) emissions, and about half of the toxic air pollutant emissions in US are generated from motor vehicles. .... For OECD countries, up to 90% of the total carbon monoxide (CO_2) is from the source "road" (OECD Statistics 2012).... The emissions related to consumption of energy in US are accountable for about 71% of US carbon dioxide emissions....*". Also, in 2014, EPA reports that in the US, about 40 percent of greenhouse gases are attributed to residential activity.[1]

In regards to our second feature, we argue that when pollution is generated from consumption, policies such as those implemented to combat production generated pollution, e.g., emissions taxes and emissions permits, are not the most appropriate ones to contain consumption emissions. On these grounds, consumption taxes and general goods and services taxes ($GSTs$) may serve as more appropriate instruments to control consumption generated pollution.[2] Indeed, recently many governments have used general consumption taxes or excise taxes on specific goods and services either to discourage “harmful” behaviors or to encourage “responsible” ones towards the environment in order to improve welfare. Such have been taxes on energy-consuming products, mineral oils and transport fuels, and taxes on products which produce environmentally harmful emissions, e.g., vehicles.[3] The introduction of feed-in tariffs or premiums in the consumption of electricity is also

[1] CO_2 emissions related to residential activity are attributed to, e.g., fossil fuels burned for heat, electricity, the use of products containing greenhouse gases, the handling of waste, and to recreational transportation such as use of passenger cars, sport utility vehicles, pickup trucks, and minivans. A smaller fraction of CO_2 emissions comes from other modes of transportation, e.g., freight trucks, commercial aircraft, ships, boats, and trains, pipelines and lubricants.

[2] When pollution is a function of consumption then a consumption and an emission (Pigouvian) tax may be equivalent in terms of policy effectiveness.

[3] For example, OECD (2014) pp. 135-160, reports: Per litre total taxation (VAT + excise) on premium unleaded gasoline: Australia 0.51, Austria 0.95, Canada 0.39, Germany 1.20, Greece 1.29, Japan 0.65, Norway 1.47, Sweden

a widely used policy instrument of this type.

These revenue yielding tax policies gain an advantage relative to other environmental policies that do not generate revenues such as environmental standards, since they can also allow for the funding of public sector activities to protect the environment, which brings us to the third analytical feature of our framework, i.e., public pollution abatement. Related to this issue of public pollution abatement, ample evidence shows that governments spend a considerable portion of their tax revenues for pollution and abatement control (PAC) activities. During 1990-2004 most countries public expenditures accounted for about $40 - 60\%$ of total PAC expenditures (see Linster and Zegel 2007).[4] In a similar fashion, more than 60 countries world wide use feed-in tariffs, including the US, Canada, the European countries, Japan, and even China to finance renewable energy projects which contribute to climate mitigation (see IEA 2014; Antoniou and Strausz 2017). Recent studies, e.g., Welsch (2006), Ng (2008), Ong and Quah (2014), Vella *et al.* (2015), conclude that in developed countries higher marginal welfare gains occur for their residents with increased public expenditures on environmental improvements relative to other public sector expenditures.

The complexity of the various national tax systems, the recorded difficulties in many countries to monitor and collect tax revenue, the rapid growth of cross-border electronic trade, and sales of services, have put severe restraints on the enforceability of the destination-based (DP) commodity taxation, which levies commodity taxes in the jurisdiction of final consumption and relies on border tax adjustments. Because of the above, quite often destination-based taxes are held accountable for various administrative complexities such as double taxation, and uncertainty for businesses and fiscal authorities, e.g., see OECD (2014) pp. 25-28. Instead, an alternative system of levying commodity taxes in the jurisdiction of production, the so-called origin principle (OP) has been discussed in public policy debates.[5] The choice of the most appropriate principle of commod-

1.26, Switzerland 0.93, the U.K. 1.25, the U.S. 0.14. Per litre total taxation (VAT + excise) on light fuel oil for households: Austria 0.35, Denmark 0.95, Germany 0.25, Hungary 0.88, Israel 1.1, Korea 0.21, the Netherlands 0.81, Norway 0.63, Sweden 1.01, the U.K. 0.37. Taxes on sales and registration of motor vehicles: Austria VAT 20% + New Registration Tax (fuel efficiency, CO_2 emissions, polluting emissions), Belgium VAT 21% + Entry into Service Tax (age, engine power, CO_2 emissions, type of fuel gas), Germany VAT 19%, Iceland VAT 25.5% + Vehicle registration Fee (CO_2 emissions, electric propulsion), the Netherlands VAT 21% + Registration Tax (CO_2 emissions, motor fuel, value, electric propulsion), Norway VAT 25% + Registration Tax (engine performance, CO_2 emissions, NOx emissions, type of fuel, electric propulsion), Spain VAT 21% + Vehicle Registration Tax (CO_2 emissions), the US gas guzzler tax (fuel efficiency).

[4] They also report that public PAC expenditures as a percentage of total PAC expenditures averaged 55% in Canada, Finland, France and Korea, 77% in Germany, 35% in Japan, and 40% in the US.

[5] As noted in OECD (2014), p. 24, "*...The key economic difference between the two principles is that the destination principle places all firms competing in a jurisdiction on an even footing whereas the origin principle places consumers*

ity taxation is part of an ongoing debate especially within the European Union which constitutes an economic union trading with the rest of the world and thus adopting a common principle of commodity taxation is of vital importance (COM 2011). In light of the real world considerations and of the two systems of international commodity taxation discussed above, the following policy dilemmas, puzzling policymakers and theorists alike, arise naturally, "*should commodity taxes be levied in the source location, i.e., origin-based taxes, or in the location of final consumption, destination-based taxes*?", "*can governments achieve the cooperative outcomes when they act independently, i.e., non-cooperatively, in the pursuit of their national interest?*". Our study advocates that origin-based consumption taxes are those leading to the cooperative solution. This policy recommendation may have important implications for policymakers as it does not require any form of international cooperation on behalf of the participants.

1.1 Related literature

The long standing literature on international tax competition examines various aspects of the DP and OP taxation principles, e.g., welfare dominance of the one over the other, efficiency of decentralized tax setting under each regime, employment and revenue implications in the presence of production generated pollution, without, however, considering consumption externalities and public pollution abatement as we do in the current study. Cremer and Gahvari (2006), in a perfectly competitive model of two identical small open economies set conditions under which either the DP or the OP taxation regime can Pareto-dominate the other in the presence of such an externality. A limited literature considers the environmental and welfare implications of consumption or emission taxes in the presence of local or cross-border consumption generated pollution, e.g., Krutilla (1991), Beghin *et al.* (1997), McAusland (2005), Gulati and Roy (2008), Chao *et al.* (2012). Chao and Yu (2015) in the context of a small open economy examine the environmental implications of tariff and consumption tax reforms under destination and origin-based tax principles.

In the context of models of perfect competition, a general result is that under the DP, and when countries are small in world commodity markets, non-cooperatively chosen commodity taxes are set efficiently. Under the OP, the non-cooperatively chosen commodity taxes are set inefficiently low due to a fundamental tax base externality (one region's higher tax increases the tax base of

in different jurisdictions on even footing...".

the other), e.g., see Mintz and Tulkens (1986).[6] Lockwood (2001) shows, among other things, that (i) destination-based Nash equilibrium taxes are second-best efficient, and (ii) under the origin principle the tax base (fiscal) externality can be of any sign depending on the relationship between the private goods in consumption (i.e., complements or substitutes).

Other studies examining the welfare ranking of the two taxation principles, include Keen and Wildasin (2004), who conclude that Pareto efficient international taxation may require production inefficiencies in the allocation of world resources. As a result, OP consumption taxes may be superior to DP taxes, source-based taxation of capital income may be superior to residence-based taxation, and tariff on trade flows may dominate free-trade. Moriconi and Sato (2009) in a model of two symmetric small open economies examine the impact of commodity tax competition on welfare and employment under DP and OP, in the presence of unemployment due to a rigid nominal wage. Among their results, under DP the non-cooperative equilibrium taxes are higher than the optimal level, while under OP the results are ambiguous.

Regarding the efficiency in decentralized policy making, the literature with pollution externalities is relatively thin. Silva and Caplan (1997) show under the presence of transboundary consumption pollution externality that the federal policy may be socially efficient when regional governments are leaders with the presence of appropriate income transfers between regions selected by the central government. Hoel and Shapiro (2003) demonstrate that when there is perfect population mobility the efficient outcome consists an equilibrium and there exists only a coordination problem. Hoel (2004) argues that if decisions about migration take a longer time to make than the corresponding decisions of policy changes the result regarding the efficiency does no longer hold. Silva and Yamaguchi (2010) show that when there is imperfect household mobility and pollution from production is transboundary then the efficient outcome can be obtained provided the existence of transfers. Finally, Ogawa and Wildasin (2009), in a framework of inelastic supply of capital, capital related cross-border pollution and capital tax competition, show that capital taxes are set efficiently by the distinct jurisdictions.

[6] Kanbur and Keen (1993) in a single commodity partial equilibrium model of (DP) tax-competition between two countries, conclude that differences in their size (population) exacerbate the inefficiencies of non-cooperative behavior, harming them both. In the framework of imperfectly competitive open economy models, the issue of efficiency of the destination vs. origin-based commodity taxation has been examined, among others, by Lockwood (2001), Keen *et al.* (2002), Haufler and Pflüger (2007), and Behrens *et al.* (2009).

2 The Model

We consider a world of three open economies, Home, Foreign, and the Rest of the World (*ROW*) whose role is implicit in the analysis. Hence, variables related to *ROW* are not explicitly defined. Variables of Foreign are denoted by an asterisk ($*$). Home and Foreign constitute an economic union vis-a-vis *ROW*.[7] A representative household resides in each country consuming three internationally traded commodities. A numeraire commodity 0 is produced by all three countries, and is exported by *ROW* to Home and Foreign. By assumption, the numeraire commodity is not traded between Home and Foreign. Commodity 1, is produced by Home and *ROW*, and Home exports this good to Foreign and the *ROW*. Commodity 2 is produced by Foreign and *ROW*, and Foreign exports this good to Home and the *ROW*.[8] Consumption of the numeraire commodity 0 is a clean activity in all countries, but one unit of consumption of commodities 1 and 2 generates one unit of pollution (see footnote 2). Consumption generated pollution is transboundary affecting negatively the utility of households in Home and Foreign. Incoming pollution from the *ROW* to the two union countries is simply a fixed additive term into their overall pollution functions, to be defined later on, and thus we opt to neglect it. The representative household in a country derives utility from the consumption of goods and from clean environment.

Throughout the analysis it is assumed that Home and Foreign are small open economies relative to the *ROW*, in the sense that their tax policies do not affect the world prices of the three goods. Moreover, trade of Home and Foreign, respectively, with *ROW* is free. That is, neither country levies any tax on its exports to the *ROW*, or a tariff on imports of the numeraire commodity 0 from it. As a result, producers prices in Home and Foreign are constant and without loss of generality, for the rest of the analysis, are set equal to one.[9] Production of goods in all countries is assumed

[7] Following examples such as the EU, the US, and Canada, Home and Foreign can be viewed either as two countries constituting an economic union vis-a-vis the *ROW*, or as two states of a federal country vis-a-vis other states of the federation or the *ROW*.

[8] This pattern of production specialization implies that the economic union is a net exporter of goods "1" and "2" to *ROW* and a net importer of the numeraire, and is commonly used in the the relevant literature of international commodity taxation. For example, in Haufler (1994), this pattern of production and trade ensures that (i) no country can simultaneously export and import the same commodity, and (ii) a country's multilateral trade must be balanced. Other studies in this literature, e.g., Haufler and Pflüger (2007), and Moriconi and Sato (2009) also consider a three tradable good, two country model, each country producing two goods, i.e., the numeraire and one of the other two.

[9] The assumption of fixed producer prices is commonly used in the literature of international commodity taxation. For example, in Lockwood (2001, p.285), producers prices are constant and set equal to one, due to perfect international labor mobility (assumption A1, p.284), and due to same wages in the two countries, which are set equal to one. In Moriconi and Sato (2009) due to the fixed factor prices, producers prices are also fixed. Finally, Haufler and Pflüger (2007) by choice of units, fix to one the wage rate and producer prices in the two countries. Here we consider

a non-polluting and untaxed activity, and is represented by the Gross Domestic Product (GDP) function. The GDP function depends on producer prices and supplies of factors of production. Given our assumptions of constant producers prices and fixed factor supplies, Home and Foreign's GDP functions are denoted by $R(.)$ and $R^*(.)$, respectively.

Let $e(1, q_1, q_2, r, u)$ be the minimum expenditure function for Home's representative household capturing the minimum expenditure required to attain a level of utility u at given consumer prices q_1 and q_2, and level of overall pollution r. With $e_{q_i} (= \partial e/\partial q_i)$ we denote the i^{th} commodity's compensated demand function, where $i = 1, 2$, e_u is the reciprocal of the marginal utility of income, and e_r denotes the *marginal willingness to pay* for pollution reduction (or alternatively the marginal damage from pollution) and is positive since pollution affects negatively the utility. The $e(.)$ function is strictly concave in consumer prices, i.e., $e_{q_1q_1}$ and $e_{q_2q_2}$ are negative, and commodities 1 and 2 can be substitutes (complements) in consumption, i.e., $e_{q_1q_2} = e_{q_2q_1} > 0\,(< 0)$.[10] It is assumed that all income effects fall on the numeraire commodity, thus, $e_{q_1u} = e_{q_2u} = 0$ and that the level of pollution does not affect consumption, i.e., $e_{q_ir} = 0$.[11] Equivalently, the minimum expenditure function for Foreign's household is given by $e^*(1, q_1^*, q_2^*, r^*, u^*)$, with similar properties applying.[12]

An active government in Home and Foreign taxes the consumption of polluting commodities at a specific rate t in Home and t^* in Foreign according to the origin, i.e., t_o and t_o^*, or destination, i.e., t_d and t_d^*, principle of commodity taxation. We further assume that ROW follows only the destination principle of taxation regarding commodities 1 and 2, while the numeraire commodity 0 is untaxed in all three countries.[13] For simplicity we also assume uniform destination or origin-based consumption taxes in Home and Foreign on all commodities instead of commodity-specific taxes on each commodity in each country. In Section 3, revenue from commodity taxation in Home and Foreign is used to finance public pollution abatement.[14] In order to ascertain the validity

fixed, and equal to unity, producer prices due to the small country assumption and the structure of international trade.

[10] All subscripts denote partial derivatives, e.g., $e_{q_1q_1} = \partial e_{q_1}/\partial q_1$.

[11] Assuming $e_{q_ir} = 0$ implies that the polluting good and pollution (clean environment) are independent in consumption, e.g., see Keen and Kotsogiannis (2014).

[12] For the properties of the expenditure and GDP functions see, e.g., Kreickemeier (2005), Keen and Kotsogiannis (2014), and Chao and Yu (2015).

[13] The assumption of an untaxed numeraire commodity is common in the international commodity taxation literature, since all tax systems exempt from taxation a share of national product, e.g., see Moriconi and Sato (2009).

[14] In a theoretical level, public pollution abatement has been considered by several studies within the trade and environment literature. See, among others, Silva and Caplan (1997), Chao and Yu (1999), Hadjiyiannis *et al.* (2013), Vlassis (2013), Fell and Kaffine (2014).

of the results under other assumptions, in Section 4 we assume that consumption tax revenue is lump-sum distributed, and in Section 5, in the absence of consumption pollution, consumption tax revenue finances the provision of an international public consumption good, e.g., measures for the prevention of infectious diseases, world peace and international security.

3 Commodity tax competition with consumption cross-border pollution and public pollution abatement

Consider the case where the two governments abate consumption generated pollution via the use of a traded good, purchased at quantities g and g^*, at a constant world price p_g.[15] The purchases of g and g^* are financed by levying origin or destination-based consumption taxes.[16] Assuming also that both governments maintain balanced budgets, their budget constraints are:

$$p_g g = t_o \left(e_{q_1} + e^*_{q^*_1} \right) \quad \text{and} \qquad p_g g^* = t^*_o \left(e_{q_2} + e^*_{q^*_2} \right) \tag{1}$$

under origin-based consumption taxes, and

$$p_g g = t_d \left(e_{q_1} + e_{q_2} \right) \qquad \text{and} \qquad p_g g^* = t^*_d \left(e^*_{q^*_1} + e^*_{q^*_2} \right) \tag{2}$$

under destination-based consumption taxes.[17] With public pollution abatement, overall pollution in the two countries is defined as follows:

$$r = r^* = \left(e_{q_1}(.) + e_{q_2}(.) - g \right) + \left(e^*_{q^*_1}(.) + e^*_{q^*_2}(.) - g^* \right). \tag{3}$$

[15] The underlying assumption behind a fixed price of public pollution abatement is that one unit of g is purchased with units of the numeraire good.

[16] In our context, public pollution abatement entails the role of an international public good, e.g., environmental clean-up activities or adaptation measures in the context of climate change, in the sense that a higher (lower) level of g or g^* by one country results to lower (higher) cross-border pollution.

[17] Alternative specifications of the government budget constraints can be easily introduced with the present analytical apparatus, e.g., the tax revenue partly finances the purchases of g and g^* and partly is either lump-sum distributed or it finances the purchases of other, international or local, public consumption goods. These specifications only raise additional algebraic complexities without contributing to the importance and clarity of the results.

We consider the case of perfect cross-border pollution.[18] Note that since tax policies by Home and Foreign do not affect world commodity prices, consumption in *ROW* is unaffected by changes in t_j and t_j^*, $j = d, o$. Consumption tax policies in Home and Foreign affect only the levels of consumption of commodities 1 and 2 in these two countries.

The two countries income-expenditure identities require that total private spending on commodities must equal income from production. That is:

$$e\left(1, q_1, q_2, r, u\right) = R(.) \qquad \text{and} \qquad e^*\left(1, q_1^*, q_2^*, r^*, u^*\right) = R^*(.). \tag{4}$$

We examine the welfare effects and the efficiency of decentralized setting of origin and destination-based consumption taxes in the presence of consumption generated cross-border pollution and public pollution abatement.

3.1 Origin-based consumption taxes

Home and Foreign tax only the production which is used for consumption in Home and Foreign. That is, Home taxes the production of good 1, while Foreign taxes the production of good 2 which are used for consumption in Home and Foreign. Their exports to *ROW* are completely untaxed. Following the relevant literature, e.g., Haufler (1994), we refer to this principle of commodity taxation as "*restricted origin principle*".[19] With origin-based consumption taxes, prices are $q_1 = 1 + t_o$ and $q_2 = 1 + t_o^*$ in Home, and $q_1^* = 1 + t_o$ and $q_2^* = 1 + t_o^*$ in Foreign. That is, $q_1 = q_1^*$ and $q_2 = q_2^*$. Consumption tax revenue in Home and Foreign, respectively, are given by the right -hand side terms in equations (1). Equations (4) along with equations (1) and (3) constitute a system of five equations in u, u^*, g, g^* and r, in terms of the policy parameters t_o and t_o^*.

Totally differentiating equations (1) and (3) we obtain the effects of changes in t_o and t_o^* on

[18] The assumption of perfectly transboundary pollution emissions is relevant for the case of emissions such as *GHG*, e.g, CO_2 pollutants.

[19] In Haufler (1994), the two union countries apply the origin principle of commodity taxation for their mutual trade, and the destination principle for the trade between each of them and the *ROW*.

aggregate pollution as follows:

$$dr = dr^* = \left[-E_{q_1} + (p_g - t_o)\, E_{q_1 q_1} + (p_g - t_o^*) E_{q_2 q_1}\right] p_g^{-1} dt_o$$
$$+ \left[-E_{q_2} + (p_g - t_o)\, E_{q_1 q_2} + (p_g - t_o^*) E_{q_2 q_2}\right] p_g^{-1} dt_o^*, \tag{5}$$

where $E_{q_1} = e_{q_1} + e^*_{q_1^*}$ and $E_{q_2} = e_{q_2} + e^*_{q_2^*}$ are, respectively, the aggregate consumption for commodity 1 and 2 by the two countries, and $E_{q_1 q_1} = e_{q_1 q_1} + e^*_{q_1^* q_1^*} < 0$, and $E_{q_1 q_2} = e_{q_1 q_2} + e^*_{q_1^* q_2^*} \gtrless 0$.

Totally differentiating equations (4), changes in Home and Foreign's welfare are given as:

$$e_u du = -e_r dr - e_{q_1} dt_o - e_{q_2} dt_o^* \quad \text{and} \quad e^*_{u^*} du^* = -e^*_{r^*} dr^* - e^*_{q_1^*} dt_o - e^*_{q_2^*} dt_o^*. \tag{6}$$

Equations (6) show that an increase in Home's origin-based consumption tax affects Foreign's welfare directly by reducing its consumption and indirectly by affecting its pollution. Using equation (5) in equations (6) we obtain analytically the welfare effects of changes in origin-based consumption taxes as follows:

$$e_r^{-1} p_g e_u du = \left[e_r^{-1} (e_r - p_g)\, e_{q_1} + e^*_{q_1^*} - (p_g - t_o)\, E_{q_1 q_1} - (p_g - t_o^*)\, E_{q_2 q_1}\right] dt_o$$
$$+ \left[e_r^{-1} (e_r - p_g)\, e_{q_2} + e^*_{q_2^*} - (p_g - t_o)\, E_{q_1 q_2} - (p_g - t_o^*)\, E_{q_2 q_2}\right] dt_o^*, \text{ and} \tag{7}$$

$$e^{*\,-1}_{r^*} p_g e^*_{u^*} du^* = \left[e^{*\,-1}_{r^*} (e^*_r - p_g)\, e^*_{q_1^*} + e_{q_1} - (p_g - t_o)\, E_{q_1 q_1} - (p_g - t_o^*)\, E_{q_2 q_1}\right] dt_o$$
$$+ \left[e^{*\,-1}_{r^*} (e^*_r - p_g)\, e^*_{q_2^*} + e_{q_2} - (p_g - t_o)\, E_{q_1 q_2} - (p_g - t_o^*)\, E_{q_2 q_2}\right] dt_o^*. \tag{8}$$

Equations (7) and (8) indicate that a higher origin-based consumption tax improves a country's welfare if (i) the price of the public abatement commodity is lower than the marginal willingness to pay for pollution abatement, i.e., $e_r - p_g > 0$ and $e^*_r - p_g > 0$, and higher than the tax level, i.e., $p_g - t_o > 0$ and $p_g - t_o^* > 0$, and (ii) commodities 1 and 2 are complements in consumption, i.e., $E_{q_2 q_1} = E_{q_1 q_2} < 0$.

3.1.1 Efficiency of the Nash equilibrium

Setting $e_u\left(du/dt_o\right)=0$ and $e^*_{u^*}\left(du^*/dt^*_o\right)=0$, in equations (7) and (8) and solving them simultaneously, the Nash equilibrium origin-based consumption taxes, with cross-border pollution and public pollution abatement, are given as follows:

$$t_o^N=p_g+\bar{E}_{q_1q_1}\left[e_r^{-1}e_{q_1}\left(p_g-e_r\right)-e^*_{q_1^*}-E^{-1}_{q_2q_2}E_{q_2q_1}\left({e^*_{r^*}}^{-1}e^*_{q_2^*}\left(p_g-e^*_{r^*}\right)-e_{q_2}\right)\right],\text{ and}$$

$${t_o^*}^N=p_g+\bar{E}_{q_2q_2}\left[{e^*_{r^*}}^{-1}e^*_{q_2^*}\left(p_g-e^*_{r^*}\right)-e_{q_2}-E^{-1}_{q_1q_1}E_{q_1q_2}\left(e_r^{-1}e_{q_1}\left(p_g-e_r\right)-e^*_{q_1^*}\right)\right]. \tag{9}$$

where $\bar{E}_{q_1q_1}=E_{q_1q_1}-E_{q_1q_2}E^{-1}_{q_2q_2}E_{q_2q_1}<0$ and similarly $\bar{E}_{q_2q_2}<0$.

We evaluate whether in the presence of cross-border pollution and public pollution abatement, the Nash origin-based consumption taxes are equally efficient as the corresponding cooperative taxes. The cooperative equilibrium origin-based consumption taxes are determined by simultaneously setting $e_u\left(du/dt_o\right)+e^*_{u^*}\left(du^*/dt_o\right)=0$ and $e_u\left(du/dt^*_o\right)+e^*_{u^*}\left(du^*/t^*_o\right)=0$. Evaluating the sign of the slope of the joint welfare functions at the Nash equilibrium, it suffices to determine the signs of $e^*_u\left(du^*/dt_o\right)$ and $e_u\left(du/dt^*_o\right)$ respectively, since at the Nash equilibrium $e_u\left(du/dt_o\right)=e^*_u\left(du^*/dt^*_o\right)=0$. The impact on u^* of changes in t_o, after some algebraic manipulation is given by:[20]

$$e^*_{u^*}\frac{du^*}{dt_o}\mid_N=\underbrace{-e^*_{q_1^*}}_{\textit{private consumption externality}}\quad\underbrace{-e^*_{r^*}(dr^*/dt_o)}_{\textit{environmental externality}}=e_{q_1}\left(\frac{e^*_{r^*}}{e_r}-\frac{e^*_{q_1^*}}{e_{q_1}}\right). \tag{10}$$

The intuition for the result in equation (10) is as follows. When Home increases its origin-based consumption tax, first it affects Foreign's welfare negatively due to the reduction of the consumption of good 1. This is what we call, *private consumption externality*, is captured by the term $-e^*_{q_1^*}$ and is negative Second, it exerts an ambiguous impact on Foreign's welfare through its impact on the country's level of pollution. This we call *environmental externality*, captured by the term

[20] From equation (7), $e_r^{-1}p_ge_u\frac{du}{dt_o}\mid_N=0\Longrightarrow-\left(p_g-t_o\right)E_{q_1q_1}-\left(p_g-t^*_o\right)E_{q_2q_1}=-e_r^{-1}\left(e_r-p_g\right)e_{q_1}-e^*_{q_1^*}$. Substituting this expression into the expression for ${e^*_{r^*}}^{-1}p_ge^*_u\frac{du^*}{dt_o}$, after some algebra, we arrive to the result in equation (10).

$-e_r^*(dr^*/dt_o)$. At the Nash equilibrium this externality is positive since $(dr^*/dt_o) = -e_{q_1}/e_r < 0$.[21] Therefore, at Nash equilibrium the two externalities are of opposite sign, and thus the total effect on welfare is ambiguous. Elaborating further, equation (10), shows that the overall impact of Home's higher consumption tax on Foreign's welfare can be written as $e_{q_1}\left(\frac{e^*_{r^*}}{e_r} - \frac{e^*_{q_1^*}}{e_{q_1}}\right)$. This expression allows us to identify clear conditions under which the decentralized setting of the origin-based consumption taxes coincides with their cooperative setting. Specifically, if $\frac{e^*_{r^*}}{e_r} = \frac{e^*_{q_1^*}}{e_{q_1}}$, then the negative *private consumption externality* is exactly equal to the positive *environmental externality*, and thus, the Nash and cooperative equilibrium origin-based consumption taxes are equally efficient. Based on the above we state the following Proposition.

Proposition 1 *Consider two small open economies where there is consumption generated cross-border pollution, origin-based consumption taxes are levied on the polluting goods, and the consumption tax revenue finances public pollution abatement. The decentralized (Nash) equilibrium and the cooperative equilibrium origin-based consumption taxes coincide if,* $\frac{e^*_{r^*}}{e_r} = \frac{e^*_{q_1^*}}{e_{q_1}}$.

The novelty of the result of the above Proposition rests on two pillars. First, it holds regardless of whether countries are symmetric or not, provided, however, that individuals in each country have the same income and preferences, or alternatively they have identical and homothetic preferences.[22] Second, contrary to related studies, e.g., Silva and Caplan (1997), it does not require other mechanisms such as income transfers either between countries or different levels of government, e.g., union and country level governments, in order to ensure the efficiency of the decentralized commodity tax setting.

Corollary 1 *Consider two open economies where there is consumption generated cross-border pollution, origin-based consumption taxes are levied on the polluting goods, and the consumption tax revenue is used to finance public pollution abatement. The Nash equilibrium and the cooperative equilibrium origin-based consumption taxes coincide if the individuals in the two countries have identical incomes and preferences, or have identical and homothetic preferences.*

[21] From equation (5) and using that at the Nash equilibrium $e_r^{-1} p_g e_u \frac{du}{dt_o} \mid_N = 0$ and $e_{r^*}^{*^{-1}} p_g e_u^* \frac{du^*}{dt_o^*} \mid_N = 0$, we get that at Nash $(dr^*/dt_o) = (-e_{q_1}/e_r) < 0$.

[22] The literature on the efficiency of the origin and destination principle usually employs models where the two countries are symmetric or identical, e.g., see Moriconi and Sato (2009), Haufler and Pflüger (2007).

3.2 Destination-based consumption taxes

Next, we consider the case of the destination-based consumption taxes. Consumer prices now are $q_1 = 1 + t_d$, $q_2 = 1 + t_d$, $q_1^* = 1 + t_d^*$ and $q_2^* = 1 + t_d^*$. Equations (4) along with equations (2) and (3) constitute a system of five equations in u, u^*, g, g^* and r, in terms of the policy parameters t_d and t_d^*. Totally differentiating equations(3) and (2) we obtain the effects of changes in consumption taxes on aggregate pollution as follows:

$$dr = dr^* = [(p_g - t_d)(Z_{q_1} + Z_{q_2}) - (e_{q_1} + e_{q_2})]\, p_g^{-1} dt_d \\ + \left[(p_g - t_d^*)(Z^*_{q_1^*} + Z^*_{q_2^*}) - \left(e^*_{q_1^*} + e^*_{q_2^*}\right)\right] p_g^{-1} dt_d^*, \tag{11}$$

where $Z = e_{q_1} + e_{q_2}$, $Z_{q_1} = e_{q_1 q_1} + e_{q_2 q_1}$ and $Z_{q_2} = e_{q_1 q_2} + e_{q_2 q_2}$. For example, Z_{q_1} captures the changes in Home's consumption of commodities 1 and 2 due to changes in the consumer price of good 1 as a result of changes in t_d. By the properties of the expenditure function $(Z_{q_1} + Z_{q_2})$ is negative.[23] Similarly, we define $Z^* = e^*_{q_1^*} + e^*_{q_2^*}$, $Z^*_{q_1^*} = e^*_{q_1^* q_1^*} + e^*_{q_2^* q_1^*}$, $Z^*_{q_2^*} = e^*_{q_1^* q_2^*} + e^*_{q_2^* q_1^*}$, and $(Z^*_{q_1^*} + Z^*_{q_2^*})$ is also negative.

Totally differentiating equations (4), changes in Home and Foreign's national welfare are given as:

$$e_u du = -e_r dr - (e_{q_1} + e_{q_2}) dt_d, \quad \text{and} \qquad e^*_{u^*} du^* = -e^*_{r^*} dr^* - (e^*_{q_1^*} + e^*_{q_2^*}) dt_d^* \ . \tag{12}$$

Equation (12) shows, for example, that an increase in the destination tax of one country affects its own welfare directly by reducing its consumption and indirectly by affecting its pollution. The effect on the other country's welfare is only indirect through changes in its level of pollution. Using equation (11) in equations (12) we obtain the welfare effects of changes in taxes t_d and t_d^*, on the two countries welfare as follows:

[23] From the properties of the expenditure function we know that $q_0 e_{q_1 q_0} + q_1 e_{q_1 q_1} + q_2 e_{q_1 q_2} = 0$, and $e_{q_i q_j} = e_{q_j q_i}$. Since producer prices of both goods equal 1 and consumption taxes are the same, we have $q_1 = q_2 = q$. Thus $q_0 e_{q_1 q_0} + q(e_{q_1 q_1} + e_{q_1 q_2}) = q_0 e_{q_1 q_0} + q Z_{q_1} = 0$. Similarly, $q_0 e_{q_2 q_0} + q Z_{q_2} = 0$. Thus, $q(Z_{q_1} + Z_{q_2}) = -q_0(e_{q_0 q_1} + e_{q_0 q_2})$, which can be written as $q(Z_{q_1} + Z_{q_2}) = \frac{q_0}{q}(q_0 e_{q_0 q_0}) < 0$.

$$
\begin{aligned}
e_r^{-1} p_g e_u du = &- \left[(p_g - t_d) (Z_{q_1} + Z_{q_2}) - e_r^{-1} (e_{q_1} + e_{q_2}) (-p_g + e_r) \right] dt_d \\
&- \left[(p_g - t_d^*) \left(Z_{q_1^*}^* + Z_{q_2^*}^* \right) - \left(e_{q_1^*}^* + e_{q_2^*}^* \right) \right] dt_d^* \ , \qquad (13)
\end{aligned}
$$

$$
\begin{aligned}
e_{r^*}^{*^{-1}} p_g e_{u^*}^* du^* = &- \left[(p_g - t_d^*) \left(Z_{q_1^*}^* + Z_{q_2^*}^* \right) - e_{r^*}^{*^{-1}} \left(e_{q_1^*}^* + e_{q_2^*}^* \right) (-p_g + e_{r^*}^*) \right] dt_d^* \\
&- \left[(p_g - t_d) (Z_{q_1} + Z_{q_2}) - (e_{q_1} + e_{q_2}) \right] dt_d, \qquad (14)
\end{aligned}
$$

Equations (13) and (14) indicate that a higher own destination-based consumption tax improves a country's welfare if the price of the public abatement commodity is (i) higher than the tax level, i.e., $p_g > t_d$ and $p_g > t_d^*$, and (ii) lower than the marginal willingness to pay for pollution abatement, i.e., $-p_g + e_r$ and $-p_g + e_{r^*}^* > 0$. A higher destination-based consumption tax by one country improves the other's welfare if $p_g > t_d$ and $p_g > t_d^*$.

3.2.1 Efficiency of the Nash equilibrium

Setting $e_u (du/dt_d) = 0$ and $e_{u^*}^* (du^*/dt_d^*) = 0$, in equations (13) and (14), the Nash equilibrium destination-based consumption taxes with consumption generated cross-border pollution and public pollution abatement are given as follows:

$$
\begin{aligned}
t_d^N &= p_g - e_r^{-1} (Z_{q_1} + Z_{q_2})^{-1} (e_{q_1} + e_{q_2}) (-p_g + e_r) \, , \\
t_d^{*N} &= p_g - e_{r^*}^{*^{-1}} \left(Z_{q_1^*}^* + Z_{q_2^*}^* \right)^{-1} \left(e_{q_1^*}^* + e_{q_2^*}^* \right) \left(-p_g^* + e_r^* \right) . \qquad (15)
\end{aligned}
$$

Equations (15) indicate that the Nash equilibrium destination-based consumption taxes are positive, provided that $(-p_g + e_r) \geqslant 0$ and $(-p_g + e_{r^*}^*) \geqslant 0$. Furthermore, if $(-p_g + e_r) = (<)0$ and $(-p_g + e_{r^*}^*) = (<)0$, then, the Nash equilibrium destination-based consumption taxes equal (exceed) the fixed price of the public abatement commodity.

To assess whether Nash destination-based consumption taxes are equally efficient as the corresponding cooperative taxes, we follow the same procedure as in the case of origin-based consumption taxes. The cooperative equilibrium destination-based consumption taxes t_d^C and t_d^{*C} are determined by simultaneously setting $e_u\left(du/dt_d\right)+e_{u^*}^*\left(du^*/dt_d\right)=0$ and $e_u\left(du/dt_d^*\right)+e_{u^*}^*\left(du^*/t_d^*\right)=0$. Evaluating the sign of the slopes of these joint welfare functions at Nash equilibrium, it suffices to determine the signs of $e_{u^*}^*\left(du^*/dt_d\right)$ and $e_u\left(du/dt_d^*\right)$ respectively, since at Nash equilibrium $e_u\left(du/dt_d\right) = e_{u^*}^*\left(du^*/t_d^*\right) = 0$. Consider, for example, the joint welfare function when Home changes its destination-based consumption tax. Evaluating its slope at Nash equilibrium gives:[24]

$$e_{u^*}^*\frac{du^*}{dt_d}\mid_N=\underbrace{e_{r^*}^*e_r^{-1}\left(e_{q1}+e_{q2}\right)}_{environmental\ externality}. \tag{16}$$

The expression in equation (16) is positive, indicating that the Nash equilibrium tax rate t_d^{*N} is lower than the corresponding cooperative equilibrium destination-based consumption tax, i.e., $t_d^N < t_d^C$. It is only in the absence of such an externality that Nash and cooperatively set destination-based consumption taxes are equally efficient, e.g., Lockwood (2001), Haufler and Pflüger (2007). Intuitively, an increase e.g., in t_d affects Foreign's welfare only through the changes in pollution. This effect is the *environmental externality*. That is, when Home acts non-cooperatively, an increase in t_d decreases consumption of both commodities 1 and 2. Then, overall consumption generated pollution in Home and Foreign falls. This positive *environmental externality* of the higher t_d on Foreign's welfare is not accounted for by Home, when the latter country acts Nash (non-cooperatively). Thus, its Nash equilibrium destination-based consumption tax is smaller than the corresponding cooperative tax. On the basis of these results we state the following proposition.

Proposition 2 *Consider two small open economies where there is consumption generated cross-border pollution, destination-based consumption taxes are levied on the polluting goods, and the consumption tax revenue finances public pollution abatement. The Nash equilibrium destination-based consumption taxes are lower than the corresponding cooperative taxes.*

[24] From equation (12) we have $e_u\frac{du}{dt_d}\mid_N=0 \Rightarrow \frac{dr}{dt_d}=-e_r^{-1}\left(e_{q_1}+e_{q_2}\right)$, and $e_{u^*}^*\frac{du^*}{dt_d}=-e_{r^*}^*\frac{dr^*}{dt_d}$. Since by equation (11) $\frac{dr}{dt_d}=\frac{dr^*}{dt_d}$, then at Nash equilibrium we obtain equation (16).

4 Commodity tax competition with consumption cross-border pollution but without public pollution abatement

Now, we examine the welfare effects and the efficiency of decentralized setting of consumption taxes under the two tax principles in the presence of consumption cross-border pollution, but without public pollution abatement. Consumption tax revenues are lump-sum redistributed to the countries representative households. Overall pollution in Home and Foreign equals total consumption of the two polluting goods in both countries plus the fixed amount of pollution transmitted from ROW, which is omitted as it is constant. Then, equation (3) reduces to:

$$r = r^* = e_{q_1}(.) + e_{q_2}(.) + e^*_{q_1^*}(.) + e^*_{q_2^*}(.) . \tag{17}$$

4.1 Origin-based consumption taxes

Combining equations (1) and (4), the countries income-expenditure identities in this case are:

$$\begin{aligned} e(1, q_1, q_2, r, u) &= R(.) + t_o E_{q_1}(q_1, q_2, r, r^*, u, u^*) , \\ e^*(1, q_1^*, q_2^*, r^*, u^*) &= R^*(.) + t_o^* E_{q_2}(q_1, q_2, r, r^*, u, u^*) , \end{aligned} \tag{18}$$

recall that $E_{q_1} = e_{q_1} + e^*_{q_1^*}$ and $E_{q_2} = e_{q_2} + e^*_{q_2^*}$. Equations (17) and (18) constitute a system of three equations in u, u^*, and r, in terms of the policy parameters t_o and t_o^*. Totally differentiating equations (17) and (18), after some algebra, yields the overall changes in the levels of welfare in Home and Foreign due to changes in t_o and t_o^*. The results are presented by equations (A.1) and (A.2) in the Appendix.

4.1.1 Efficiency of the Nash equilibrium

To ascertain the efficiency of the decentralized setting of origin-based consumption taxes, we evaluate the signs of the slopes of the joint welfare functions at Nash equilibrium.[25] Doing so, it

[25] Using equations (A.1) and (A.2) in the presence of consumption generated cross-border pollution the cooperative consumption taxes under the origin principle of taxation are given by equation (A.8). The cooperative taxes under the origin-based taxation principle are the same as those under the destination-based principle, since the two regimes are equivalent under cooperative taxation.

suffices to determine the sign of the terms $e^*_{u^*}\,(du^*/dt_o)$ and $e_u\,(du/dt^*_o)$, since at Nash equilibrium $e_u\,(du/dt_o) = e^*_{u^*}\,(du^*/t^*_o) = 0$. Consider the case where Home rises t_o. Substituting t^{*N}_o from equations (A.3) into the expression for $e^*_{u^*}\,(du^*/dt_o)$ in equation (A.2), we obtain:

$$
\begin{aligned}
e^*_{u^*}\frac{du^*}{dt_o} \quad |\quad_N = & \quad \underbrace{-e^*_{q^*_1}}_{\text{private consumption externality}} \quad \underbrace{-t^{*N}_o E_{q_2q_1}}_{\text{public revenue externality}} \quad \underbrace{-e^*_{r^*}(dr^*/dt_o)}_{\text{environmental externality}} \quad = \\
= & \quad -e^*_{q^*_1} \quad - E^{-1}_{q_2q_2}E_{q_2q_1}e_{q_2} \quad - e^*_{r^*}\bar{E}_{q_1q_1},
\end{aligned}
\tag{19}
$$

where $\bar{E}_{q_1q_1} = E_{q_1q_1} - E_{q_1q_2}E^{-1}_{q_2q_2}E_{q_2q_1} < 0$.[26] Equation (19) indicates that the impact of a higher t_o on Foreign's welfare (u^*) is through three effects. First, through the negative *private consumption externality* (i.e., $-e^*_{q^*_1} < 0$), second through a *public revenue externality, i.e.,*$-t^*_oE_{q_2q_1}$, whose sign is ambiguous, depending on whether commodities 1 and 2 are complements or substitutes in consumption.[27] Haufler and Pflüger (2007), without consumption pollution, demonstrate that the sum $-e^*_{q^*_1} - E^{-1}_{q_2q_2}E_{q_2q_1}e_{q_2}$, is negative. Third, through the positive *environmental externality, i.e.,* $-e^*_{r^*}(dr/dt_o) = -e^*_{r^*}\bar{E}_{q_1q_1} > 0$. Thus, the sum of the three terms is ambiguous, without, however, excluding the possibility that it can also be equal to zero.

At this point, it is important to compare the results in equations (10) and (19). That is, the efficiency of the decentralized setting of origin-based consumption taxes, when tax revenue finances public pollution abatement vis-a-vis to when it is lump-sum distributed. The impact of a higher t_o on Foreign's welfare is decomposed as follows. First, in both cases there is (i) a negative *private consumption externality*, i.e., $-e^*_{q^*_1}$, due to lower consumption of good 1 in Foreign as Home raises its origin-based consumption tax on this commodity, and (ii) an *environmental externality*, i.e., $-e^*_{r^*}(dr^*/dt_o)$, which as shown by our analysis, exerts a positive impact on Foreign's welfare at Nash equilibrium. When consumption tax revenue is lump-sum distributed, an additional effect arises. This effect we call *public revenue externality*, which captures the change in Foreign's consumption tax revenue, at the given t^{*N}_o, as a result of changes in consumption of good 2 in both

[26] The analytical result for $e^*_{u^*}\frac{du^*}{dt_o} \mid_N$ emerges after some algebra, by substituting the Nash equilibirum value of t^{*N}_o given in equation (A.3), and the expression $(dr/dt_o) = E_{q_1q_1} + E_{q_2q_1}$ into the first right-hand-side expression of equation (19).

[27] For example, if commodities 1 and 2 are complements, i.e., $E_{q_2q_1} < 0$, a higher t_o by Home also reduces aggregate consumption of commodity 2, thus Foreign's consumption tax revenue and welfare.

countries, resulting from the higher consumption tax t_o on good 1. This *public revenue externality,* in the case of public pollution abatement is "*embedded*" into the positive *environmental externality.* The discussion of equation (19) established sufficient conditions under which the negative private consumption externality and the positive environmental externality cancel each other out, resulting in $e^*_{u^*} \frac{du^*}{dt_o} \mid_N = 0$, thus, rendering efficient the decentralized setting of origin-based consumption taxes when consumption tax revenue finances public pollution abatement. These clear-cut conditions, however, cease to hold when consumption tax revenue is lump-sum distributed, i.e., equation (10), and in this case, the efficient setting of decentralized origin-based consumption taxes could occur, more likely than not, out of sheer coincidence.

4.2 Destination-based consumption taxes

Combining equations (2) and (4), with destination-based consumption taxes and consumption tax revenues being lump-sum distributed to the local households, the countries income-expenditure identities are:

$$
\begin{aligned}
e\left(1, q_1, q_2, r, u\right) &= R(.) + t_d\left(e_{q_1} + e_{q_2}\right), \\
e^*\left(1, q_1^*, q_2^*, r^*, u^*\right) &= R^*(.) + t_d^*\left(e^*_{q_1^*} + e^*_{q_2^*}\right).
\end{aligned}
\tag{20}
$$

Equations (17) and (20) constitute a system of three equations in u, u^*, and r, in terms of the policy parameters (t_d, t_d^*). We examine the effects of changes in t_d and t_d^* on Home's welfare. Totally differentiating equations (17) and (20), after some algebra, yields the overall changes in the levels of welfare in Home and Foreign due to changes in t_d and t_d^*. The results are presented by equations (A.4)-(A.6) in the Appendix.

4.2.1 Efficiency of the Nash equilibrium

To ascertain whether the decentralized setting of destination-based consumption taxes is efficient, again we evaluate $sign\left[e^*_{u^*}\left(du^*/dt_d\right)\right]$ and $sign\left[e_u\left(du/dt_d^*\right)\right]$ at Nash equilibrium, since $e_u\left(du/dt_d\right) = e^*_{u^*}\left(du^*/t_d^*\right) = 0$. Doing so, we obtain:

$$e^*_{u^*}\frac{du^*}{dt_d}\mid_N = \underbrace{-e^*_{r^*}\left(Z_{q_1}+Z_{q_2}\right)}_{environmental\ externality}, \tag{21}$$

where $e^*_{u^*}\frac{du^*}{dt_d}\mid_N > 0$, since $(Z_{q_1}+Z_{q_2}) < 0$. Equivalently,[28] $e_u\frac{du}{dt^*_d}\mid_N = -e_r\left(Z^*_{q^*_1}+Z^*_{q^*_2}\right) > 0$. This is to say that the slopes of the joint welfare functions at Nash equilibrium are positive. Thus, the Nash equilibrium destination-based consumption taxes are lower than the corresponding cooperative equilibrium taxes. The intuition of this result follows along the lines of the case of destination-based consumption taxes when consumption tax revenue finances public pollution abatement, i.e., see equation (16).

Proposition 3 *Consider two small open economies where there is consumption generated cross-border pollution, destination or origin-based consumption taxes are levied on the polluting goods, and the consumption tax revenue is lump-sum distributed to the countries' households. Then,*

(i) The Nash equilibrium destination-based consumption taxes are inefficient, leading to lower Nash tax rates relative to the cooperative tax levels.

(ii) The Nash equilibrium origin-based consumption taxes, in general, are inefficient, and only incidentally can be equally efficient as the corresponding cooperative equilibrium taxes.

5 Commodity tax competition and international public consumption goods

In this section we consider the case where there is no consumption pollution and no public pollution abatement. Instead, consumption tax revenue finances the provision of an international public consumption good, e.g., measures for the prevention of infectious diseases, or world peace and international security.

The relevant literature has examined the efficiency of decentralized commodity taxation on grounds of destination or origin-based tax competition only in the presence of local public consumption goods, e.g., Haufler and Pflüger (2007), and Moriconi and Sato (2009). However, the efficiency of decentralized commodity taxation in the presence of international public goods is yet

[28] Combining equations (A.4) and (A.6) we get that $e^*_{u^*}(du^*/dt_d) = -e^*_r(dr/dt_d)$, where $(dr/dt_d) = (Z_{q_1}+Z_{q_2})$.

to be examined.[29]

On the basis of the above, our interpretation of consumption tax revenue financing g and g^* is along the lines of a more pragmatic view that consumption tax revenue finances the provision of an international public consumption good, rather than that it is fully earmarked for the provision of public pollution abatement. Letting g and g^* be the quantities of the international public consumption good purchased by Home and Foreign, its overall consumption in the two countries is:[30]

$$G = g + g^*, \tag{22}$$

and the two countries income-expenditure identities are given by:

$$e\left(1, q_1, q_2, G, u\right) = R(.) \qquad \text{and} \qquad e^*\left(1, q_1^*, q_2^*, G, u^*\right) = R^*(.). \tag{23}$$

5.1 International public consumption goods and the efficiency of decentralized origin-based consumption taxes

Totally differentiating equations (1), (22) and (23), after some algebra we obtain the welfare effects of changes in t_o and t_o^* as follows:

$$\begin{aligned} e_G^{-1} p_g e_u du = & \left[-\left(e_G + p_g\right) e_{q_1} e_G^{-1} - e^*_{q_1^*} - t_o E_{q_1 q_1} - t_o^* E_{q_2 q_1}\right] dt_o \\ & + \left[-\left(e_G + p_g\right) e_{q_2} e_G^{-1} - e^*_{q_2^*} - t_o E_{q_1 q_2} - t_o^* E_{q_2 q_2}\right] dt_o^*. \end{aligned} \tag{24}$$

$$\begin{aligned} e_G^{*-1} p_g e^*_{u^*} du^* = & \left[-\left(e_G^* + p_g\right) e^*_{q_1^*} e_G^{*-1} - e_{q_1} - t_o E_{q_1 q_1} - t_o^* E_{q_2 q_1}\right] dt_o \\ & + \left[-\left(e_G^* + p_g\right) e^*_{q_2^*} e_G^{*-1} - e_{q_2} - t_o E_{q_1 q_2} - t_o^* E_{q_2 q_2}\right] dt_o^*. \end{aligned} \tag{25}$$

[29] Relating the provision of international public goods and destination and origin-based commodity taxes has been examined in models of international tax harmonization, e.g., see Karakosta *et al.* (2014). This, however, is a distinct literature not related to the present study.

[30] This is an assumption for analytical simplicity, quite prevelant in the relevant literature, e.g., Bjorvatn and Schjelderup (2002). Alternatively, it is easy to model the case where each country finances the provision of a different international public good, enjoyed, however, by consumers in both countries.

where $e_G < 0$ and $e_G^* < 0$ respectively denote the marginal willingness to pay for the provision of the public consumption good in Home and Foreign.[31] Equations (A.9) and (A.10) in the Appendix provide algebraic details of these results.

Ascertaining the efficiency of the decentralized setting of origin-based consumption taxes, it suffices to evaluate the signs of $e_{u^*}^* (du^*/dt_o)$ and $e_u (du/dt_o^*)$ respectively at Nash equilibrium. Following some algebra we obtain:

$$e_{u^*}^* \frac{du^*}{dt_o} |_N = \underbrace{-e_{q_1^*}^*}_{private\ consumption\ externality} \underbrace{-e_G^*(dG/dt_o)}_{int'l\ public\ good\ externality} = e_{q_1} \left(\frac{e_G^*}{e_G} - \frac{e_{q_1^*}^*}{e_{q_1}} \right). \tag{26}$$

Equation (26) is similar to equation (10). A discussion comparing the results in equations (26) and (19), follows along the lines of that comparing the results in equations (10) and (19).

5.2 International public consumption goods and the efficiency of decentralized destination-based commodity taxes

Totally differentiating equation (22) and (2), and (23), after some algebra, we obtain the welfare effects of changes in t_d and t_d^* as follows:

$$\begin{aligned} p_g e_u du = & -e_G \left[t_d \left(Z_{q_1} + Z_{q_2} \right) + e_G^{-1} \left(e_{q_1} + e_{q_2} \right) \left(p_g + e_G \right) \right] dt_d \\ & - e_G \left[t_d^* \left(Z_{q_1^*}^* + Z_{q_2^*}^* \right) + \left(e_{q_1^*}^* + e_{q_2^*}^* \right) \right] dt_d^* \ , \end{aligned} \tag{27}$$

$$\begin{aligned} p_g e_{u^*}^* du^* = & -e_G^* \left[t_d^* \left(Z_{q_1^*}^* + Z_{q_2^*}^* \right) + e_G^{*^{-1}} \left(e_{q_1^*}^* + e_{q_2^*}^* \right) \left(p_g + e_G^* \right) \right] dt_d^* \\ & - e_G^* \left[t_d \left(Z_{q_1} + Z_{q_2} \right) + \left(e_{q_1} + e_{q_2} \right) \right] dt_d, \end{aligned} \tag{28}$$

Equations (A.11) and (A.12) in the Appendix provide some algebraic details of these results.

As shown thus far, to examine the efficiency of the decentralized setting of destination-based

[31] Contrary to e_r and $e_{r^*}^*$ which are positive, e_G and e_G^* are negative. This is because, on the one hand, higher levels of r and r^* reduce welfare, thus requiring higher level of expenditure on private consumption goods to maitain a constant level of utility. On the other hand, higher levels of G increase welfare, thus requiring lower level of expenditure on private consumption goods to maintain a constant level of utility.

consumption taxes, it suffices to evaluate the signs of $e^*_{u^*}\left(du^*/dt_d\right)$ and $e_u\left(du/dt^*_d\right)$ respectively at Nash equilibrium. Following some algebra we obtain:

$$e^*_{u^*}\frac{du^*}{dt_d}\mid_N = \underbrace{e^*_G e_G^{-1}\left(e_{q_1}+e_{q_2}\right)}_{int'l\ public\ good\ externality} > 0. \tag{29}$$

This is to say that under any form of international public consumption goods, the decentralized setting of destination-based consumption taxes is inefficient. Employing the equations (26) and (29) we state the following Proposition:

Proposition 4 *Consider two open economies without consumption generated pollution and where origin or destination-based consumption taxes are used to finance an international public consumption good. Then i) the Nash and the cooperative equilibrium origin-based consumption taxes are equally efficient if the individuals in the two countries have identical incomes and preferences, or have identical and homothetic preferences and ii) the Nash destination-based consumption taxes are lower than their corresponding cooperative rates.*

The literature on international commodity taxation, has shown that in the presence of local public consumption goods, the Nash destination-based consumption taxes are set at the efficient (cooperative) level, e.g., see Haufler and Pflüger (2007). The Nash origin-based consumption taxes may be higher or lower than their corresponding cooperative rates. Here it is shown that in the context of international public consumption goods and under certain conditions, the decentralized setting of origin-based consumption taxes is efficient, while the decentralized setting of destination-based consumption taxes is inefficient.

6 Concluding remarks

A key issue in international commodity taxation is whether taxes should be levied in the jurisdictions of destination or origin. Based on the fundamental characteristics and differences of the two tax principles, OECD (2014), p. 24, reports ".... the destination principle is the international norm and is sanctioned by the OECD International VAT/GST Guidelines and by the World Trade Organisation rules ...". Without disputing the proclaimed advantages or disadvantages that international organizations and policy makers attribute to one tax system over the other, this paper shows that, under certain conditions, in the presence of international spillovers the Nash equilibrium origin-based consumption taxes are efficient, while destination-based taxes in all these cases are inefficient. In particular, we show that the origin-based consumption taxes are efficient (i) in the presence of consumption generated cross-border pollution and where revenue from taxation finances public pollution abatement, and (ii) in the absence of pollution, the revenue from taxation finances the provision of an international public consumption good. These results hold not only in the context of symmetric countries, but also in the case of non-symmetric countries with unequal population, provided that households have identical incomes and preferences or have identical and homothetic preferences. However, the Nash equilibrium destination-based commodity taxes are inefficient. In the presence of international spillovers, when consumption tax revenue is lump-sum distributed, the efficient setting of decentralized origin-based consumption taxes could occur, more likely than not, out of sheer coincidence. We do believe that these results contribute to the theoretical literature of international tax competition, but more importantly that they enrich the arguments favouring the implementation of origin-based taxation in the corresponding policy debates.

Acknowledgements

We thank participants in Asian Meetings of the Econometrics Society (AMES) 2016, Kyoto-Japan. 22nd Annual Conference, EAERE, Zurich-Switzerland for constructive comments and suggestions. The authors remain responsible for any shortcomings of the paper.

Appendix

Consumption cross-border pollution and no public pollution abatement: Origin-based consumption taxes

Totally differentiating equations (18) and (17), yields:[32]

[32] The total differentiation of these two equations yields $e_u du = -e_r dr + \left(e^*_{q^*_1} + t_o E_{q_1 q_1}\right) dt_o + \left(-e_{q_2} + t_o E_{q_1 q_2}\right) dt^*_o$, and $dr = \left(E_{q_1 q_1} + E_{q_2 q_1}\right) dt_o + \left(E_{q_2 q_2} + E_{q_1 q_2}\right) dt^*_o$. Substituting the expression for dr into that for du yields equation (A.1).

$$
\begin{aligned}
e_u du = & [(-e_r + t_o) E_{q_1 q_1} - e_r E_{q_2 q_1} + e^*_{q^*_1}] dt_o \\
& + [(-e_r + t_o) E_{q_1 q_2} - e_r E_{q_2 q_2} - e_{q_2}] dt^*_o .
\end{aligned} \tag{A.1}
$$

$$
\begin{aligned}
e^*_{u^*} du^* = & \left[(-e^*_{r^*} + t^*_o) E_{q_2 q_1} - e^*_{r^*} E_{q_1 q_1} - e^*_{q^*_1}\right] dt_o \\
& + [(-e^*_{r^*} + t^*_o) E_{q_2 q_2} - e^*_{r^*} E_{q_1 q_2} + e_{q_2}] dt^*_o .
\end{aligned} \tag{A.2}
$$

Sufficient, but not necessary conditions, for a higher origin-based consumption tax to improve a country's own welfare are that: (i) the consumption tax is smaller than the marginal environmental damage of pollution in the country, i.e., $(-e_r + t_o) < 0$ and $(-e^*_{r^*} + t^*_o) < 0$, and (ii) commodities 1 and 2 are complements in consumption, i.e., $E_{q_1 q_2} = E_{q_2 q_1} < 0$. However, a higher tax by one country still exerts an ambiguous impact on the other's welfare.

Setting $e_u (du/dt_0) = 0$ and $e^*_{u^*} (du^*/dt^*_o) = 0$, in equations (A.1) and (A.2), the Nash equilibrium origin-based consumption taxes are given as follows:

$$
t^N_o = E^{-1}_{q_1 q_1} \left[e_r (E_{q_1 q_1} + E_{q_2 q_1}) - e^*_{q^*_1}\right], \quad t^{*N}_o = E^{-1}_{q_2 q_2} \left[e^*_r (E_{q_2 q_2} + E_{q_1 q_2}) - e_{q_2}\right]. \tag{A.3}
$$

Consumption cross-border pollution and no public pollution abatement: Destination-based consumption taxes

Totally differentiating equation (17) we obtain:

$$
dr = (Z_{q_1} + Z_{q_2}) dt_d + \left(Z^*_{q^*_1} + Z^*_{q^*_2}\right) dt^*_d . \tag{A.4}
$$

Totally differentiating equations (20) and (17), after some algebra, yields:

$$
e_u du = (Z_{q_1} + Z_{q_2}) (-e_r + t_d) dt_d - \left(Z^*_{q^*_1} + Z^*_{q^*_2}\right) e_r dt^*_d \quad \text{, and} \tag{A.5}
$$

$$e^*_{u^*} du^* = \left(Z^*_{q^*_1} + Z^*_{q^*_2} \right) (-e^*_{r^*} + t^*_d) dt^*_d - (Z_{q_1} + Z_{q_2}) e^*_{r^*} dt_d \quad , \tag{A.6}$$

An increase in the own destination-based consumption tax improves (worsens) Home's welfare if it is lower (higher) than the household's marginal willingness to pay for pollution abatement, e.g., $(-e_r + t_d) < 0 (> 0)$. A higher destination-based tax by Foreign, improves Home's welfare. Similar results are derived for changes in t_d and t^*_d on Foreign's welfare.

Setting $e_u (du/dt_d) = 0$ and $e^*_{u^*} (du^*/dt^*_d) = 0$, in equations (A.5) and (A.6), the Nash equilibrium destination-based consumption taxes are given as follows:

$$t^N_d = e_r \qquad \text{and} \qquad t^{*N}_d = e^*_{r^*}. \tag{A.7}$$

Using equations (A.5) and (A.6) and setting $e_u (du/dt_d) + e^*_{u^*} (du^*/dt_d) = 0$ and $e_u (du/dt^*_d) + e^*_{u^*} (du^*/t^*_d) = 0$, gives the cooperative destination-based consumption taxes:

$$t^C_d = t^{*C}_d = e_r + e^*_{r^*}. \tag{A.8}$$

Clearly, $t^C_d > t^N_d$, ${t^*_d}^C > {t^*_d}^N$.

International public consumption goods and the efficiency of decentralized origin-based consumption taxes

Totally differentiating equations (1) and (22) we obtain the effects of changes in t_o and t^*_o on G as follows:

$$\begin{aligned} dG = {} & [E_{q_1} + t_o E_{q_1 q_1} + t^*_o E_{q_2 q_1}] \, p_g^{-1} dt_o \\ & + [E_{q_2} + t_o E_{q_1 q_2} + t^*_o E_{q_2 q_2}] \, p_g^{-1} dt^*_o. \end{aligned} \tag{A.9}$$

Totally differentiating equations (23), changes in Home and Foreign's welfare are given as:

$$e_u du = -e_G dG - e_{q_1} dt_o - e_{q_2} dt^*_o \quad \text{and} \quad e^*_{u^*} du^* = -e^*_G dG - e^*_{q^*_1} dt_o - e^*_{q^*_2} dt^*_o \tag{A.10}$$

Using equation (A.9) in equations (A.10) we obtain equations (24) and (25) in the text.

International public consumption goods and the efficiency of decentralized destination-based consumption taxes

Totally differentiating equation (22) and (2), we obtain the effects of changes in t_d and t_d^* on aggregate G as follows:

$$\begin{aligned} dG = &\left[t_d(Z_{q_1} + Z_{q_2}) + (e_{q_1} + e_{q_2})\right] p_g^{-1} dt_d \\ &+ \left[t_d^*(Z_{q_1^*}^* + Z_{q_2^*}^*) + \left(e_{q_1^*}^* + e_{q_2^*}^*\right)\right] p_g^{-1} dt_d^*. \end{aligned} \tag{A.11}$$

Totally differentiating equations (23), changes in Home and Foreign's national welfare are given as:

$$e_u du = -e_G dG - (e_{q_1} + e_{q_2}) dt_d, \quad \text{and} \qquad e_{u^*}^* du^* = -e_G^* dG^* - (e_{q_1^*}^* + e_{q_2^*}^*) dt_d^* \ , \tag{A.12}$$

where using equation (A.11) in equations (A.12) we obtain equations (27) and (28) in the text.

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