

Abstract

In a dynamic optimising model with costly tax collection, a tax cut by one nation creates positive externalities for the rest of the world if initial public debt stocks are positive. By reducing tax collection costs, current tax cuts boost the resources available for current private consumption, lowering the global interest rate. This pecuniary externality benefits other countries because it reduces the tax collection costs for foreign governments of current and future debt service. In the non-cooperative equilibrium, nationalistic governments do not allow for the effect of lower domestic taxes on debt service costs abroad. Taxes are too high and government budget deficits too low compared to the global cooperative equilibrium. Even in the cooperative equilibrium complete tax smoothing is not optimal: current taxes will be lower than future taxes.