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**A NOTE ON KANBUR AND KEEN: TRANSFERS
TO SUSTAIN FISCAL COOPERATION**

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Abstract

We analyze the two-country model of fiscal competition of Kanbur and Keen (1993) where countries differ in size and use a commodity tax to reach their objective of revenue maximization. Due to fiscal externalities, the non-cooperative outcome is inefficient. Besides, the international optimum could be individually irrational for the smaller country compared to the non-cooperative equilibrium.

The purpose of this paper is to examine whether the international optimum can be reached and sustained by means of financial transfers between the countries as suggested in another context by Chander and Tulkens (1995, 1997).

We show that with transfers of a specific form internationally optimal fiscal cooperation is indeed individually rational for both countries and, in that sense, sustainable. Furthermore, we show that these transfers can be such that the optimal outcome is, under some conditions, a dominant strategy for both countries.

Keywords: Indirect Taxation, Asymmetric Countries, Tax Competition, Transfers, Cooperation, Nash Equilibrium.

JEL Classification: H23, H26, H3, H73.

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