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Regional Science and Urban Economics 31 (2001) 319–337

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# On the effects of capital mobility on local infrastructure policy and rent-seeking

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Received 27 January 1998; received in revised form 19 July 1999; accepted 5 January 2000

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## Abstract

This paper deals with the influence of capital mobility on local infrastructure policy and on rent-seeking activities of local interest groups. It employs a model where households differ with respect to their endowments with the immobile factor land. Local governments decide about the level of productive infrastructure in their jurisdiction. According to their land endowments, different households benefit to a different degree from infrastructure. This redistribution effect of local infrastructure gives households an incentive for rent-seeking. As this paper shows, capital mobility and fiscal competition between local governments have an influence on the equilibrium level of rent-seeking. Rent-seeking expenditures increase with the introduction of capital mobility in a broad class of cases. © 2001 Elsevier Science B.V. All rights reserved.

*Keywords:* Capital mobility; Fiscal competition; Rent-seeking

*JEL classification:* D72; H41; H72

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## 1. Introduction

In this paper a political economy model is set up to analyse the influence of capital mobility on local infrastructure policy and on rent-seeking of interest groups. Infrastructure is modelled as a local public intermediate input. Examples

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for this kind of infrastructure are local transport and communication facilities or public administration services. These inputs raise the productivity of private factors in the jurisdiction where they are supplied and thereby cause an increase in factor incomes. According to their factor endowments, different households benefit to a different degree from this increase in factor incomes. This paper deals with the case where households differ with respect to their endowments with the immobile factor land. Households owning much land then derive high benefits from an increase in the infrastructure level compared to households owning less land or no land at all in the jurisdiction.

In such a setting, households have an incentive for rent-seeking: Land-abundant households seek to influence the local government for an increase in the level of infrastructure; land-poor households seek to influence the government in the opposite direction. Rent-seeking is analysed in this paper in a simple model of political equilibrium. The government is assumed to maximise the weighted aggregate welfare of land-abundant and land-poor households. The respective weight of each household group is determined by its rent-seeking expenditures. If the interest groups of land-abundant and land-poor households are symmetric and both exert the same rent-seeking pressure, then the local government does not redistribute in favour of one group. Infrastructure is then provided on a level that maximises aggregate net factor income in the jurisdiction, and the marginal productivity of infrastructure is equal to its marginal costs. The equilibrium infrastructure level exceeds the income maximising level, if the group of land-abundant households exerts a higher political pressure than the group of land-poor households, whereas the infrastructure level is below the income maximising level, if land-poor households exert a relatively higher political pressure.

As this paper shows, capital mobility influences the distribution effects of local infrastructure policy and rent-seeking activities of local interest groups. With capital mobility, an improvement of local infrastructure attracts mobile capital from other jurisdictions. On the one hand, this capital influx raises the land rent. On the other hand, local infrastructure has a smaller influence on the capital income in an open jurisdiction compared to a closed jurisdiction. In other words, the incidence of local infrastructure policy is shifted from the mobile factor capital to the immobile factor land. With unequally distributed land, the redistribution effects of local infrastructure policy increase with the introduction of capital mobility, whereas the marginal influence on aggregate income remains unchanged. In the case of symmetric rent-seeking, the local government does not consider the redistribution effects, and infrastructure is supplied on the same level as in the closed jurisdiction. However, the marginal benefits of rent-seeking increase with the introduction of capital mobility. The interest groups therefore expand their rent-seeking activities to a new symmetric equilibrium with higher rent-seeking expenditures.

In addition to the case of symmetric rent-seeking, the paper also considers asymmetric rent-seeking with rent-seeking by only one of the interest groups and

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