



# The political economy of capital market integration and tax competition

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## ABSTRACT

This paper investigates the effect of capital market integration (CMI) on capital taxes in a political economy framework in which policy is influenced by lobbying of interest groups. CMI increases the efficiency cost of the capital tax, which introduces incentives to reduce the tax rate, but also reduces lobbying by owners of capitalists, which introduces countering incentives to increase the tax rate. CMI can therefore result in a higher capital tax rate. When the market share of each country is small, CMI may increase government supply of public goods and enhance efficiency, which implies that, in the presence of policy endogeneity through lobbying, decentralized policymaking can be more efficient than centralized policymaking.

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## 1. Introduction

The effect of globalization on public policy has been the focus of much attention and debate. Theoretical models predict that integration of capital markets intensifies tax competition among jurisdictions and reduce capital tax rates (Hillman, 2009, chapter 9). The empirical evidence, on the other hand, is not conclusive. Some empirical studies indicate that globalization indeed has a significantly negative impact on capital taxes (e.g., Bretschger and Hettich, 2002; Devereux et al., 2008). Other studies find that the negative effect of increased capital mobility on tax rates is insignificant or even that the capital tax rates increase with capital mobility (see, e.g., Garrett (1995), Quinn (1997), Garrett and Mitchell (2001), Swank and Steinmo (2002), and Dreher (2006)).

The standard tax-competition model is capable of predicting only a decline in capital tax rates as a consequence of capital market integration (henceforth CMI). A satisfactory model should be able to explain the mixed results. Researchers have therefore modified the standard tax competition model. Wilson (1987) demonstrated that the presence of trade leads to multiple equilibrium tax rates, and one of which is higher than the tax rate in the closed economy. By introducing asymmetric tax competition, DePater and Myers (1994) showed that a capital-importing country has an incentive to set a higher capital tax rate in order to depress the net rate of return on capital. Noiset (1995) showed that, when spending provides local benefits, tax competition can increase the local capital tax. Huizinga and Nielsen (1997) pointed out that higher foreign ownership share of domestic firms leads to a rise in the capital tax rate if profits are not fully taxed.

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I investigate the effect of CMI on the capital taxes in a political economy framework.<sup>1</sup> Persson and Tabellini (1992), Lockwood and Makris (2006), and Haufler et al. (2008) have looked at the effect of CMI through voting. It seems unlikely that decisions about tax rates are made by voting. Rather we should investigate the role of interest groups. Haufler (1997) and Lorz (1998) have considered the influence of interest groups but in settings that differ from mine. Differences between these latter papers and the present paper are described in Section 3.3.

My endogenous policy model builds on Zodrow and Mieszkowski (1986), who described several identical countries. Each government imposes a tax on capital according to the source principle and uses tax revenue to finance a public consumption good. There are two types of residents, capitalists and workers, in a country. CMI increases capital mobility, which increases the efficiency cost of capital taxes and leads policymakers to lower capital tax rates. When policymakers are subject to political influence, CMI can either increase or reduce capital tax rates. When the economy is closed, capitalists bear the entire capital tax burden. Capitalists have an incentive to lobby for a lower capital tax rate. They gain from an increase in private consumption, which outweighs their loss from a decline in the public consumption. When the economy is open, a part of the tax burden is shifted to the workers. Since the capitalists do not bear the entire tax burden, their gains from lobbying to reduce the capital tax rate are reduced as a result of CMI. If tax competition among governments is sufficiently intense, most of the capital tax burden is shifted to the workers, and thus capitalists may even lobby for a higher tax rate. This effect through political endogenous policy has not been considered. I show how the political effect can reverse conventional conclusions.

A well-known conclusion is that tax competition results in sub-optimal supply of public goods. I show that interest groups can either enhance or reduce efficiency, depending on the extent of the tax competition. If tax competition is intense, capitalists bear a small proportion of the capital tax burden, and so they will lobby for a higher capital tax rate to benefit from a larger supply of the public good. Lobbying thus mitigates the under-provision of public goods, or even leads to overprovision. If tax competition is mild, capitalists' lobbying results in a lower tax rate, and thus aggravates the problem of under-provision of public goods.

The above conclusion is related to another result of the standard tax competition model, that is, that an increase in intensity of tax competition lowers supply of public goods and increases the inefficiency of tax competition (Hoyt, 1991). I show that, in the presence of lobbying, the opposite may occur, again because of capitalists' lobbying incentives.

A centralized government eliminates capital mobility. The equilibrium policy in the closed economy can be interpreted as that under centralized policymaking. Similarly, the equilibrium policy in the open economy can be interpreted as that under decentralized policymaking. It has been argued that the inefficiency of tax competition stems from decentralized policymaking and that a remedy for the inefficiency of tax competition is to centralize policymaking or to coordinate policy among countries. The findings of this paper, however, show that in the presence of lobbying, centralized policymaking is not necessarily more efficient than decentralized policymaking.<sup>2</sup>

Section 2 introduces the model underlying the analysis. Section 3 discusses the political effect of CMI and explains why CMI may increase capital tax rates. I turn to the effect of lobbying on tax competition in Section 4 and show how lobbying can reverse conclusions of the standard tax competition model. Section 5 extends the basic model to incorporate lobbying by workers and endogenous labor supply. Concluding remarks are in Section 6.

## 2. The model

In this section we construct a simple model close to the setting of Zodrow and Mieszkowski (1986). There are  $M$  identical countries. Given symmetry, subscripts denoting countries are omitted. Each country has two types of residents: capitalists and workers. Residents of the same type are homogeneous. Workers are endowed with 1 unit of labor time and inelastically supply labor to firms as an input and receive the wage  $w$ . To demonstrate this point as clearly as possible, we assume that workers do not have to pay taxes on labor income in the basic model.<sup>3</sup> Each capitalist is endowed with  $\bar{k}$  units of capital. Each country contains a perfectly competitive industry, which is composed of a large number of identical firms. The firms transform labor and capital into a consumption good by a constant-returns technology. The labor input is internationally immobile, whereas the capital input may or may not be internationally mobile.

There are  $n^k$  capitalists in each country. The utility function of a representative capitalist is<sup>4</sup>

$$u^k = y^k + \gamma^k H(z) \quad (1)$$

where  $y^k$  is the level of the private consumption good,  $z$  denotes supply of a public good, and  $\gamma^k$  measures the capitalists' relative preference for  $z$ . The function  $H$  has the properties that  $H' > 0$  and  $H'' < 0$  for all non-negative  $z$  and also  $\lim_{z \rightarrow 0} H'(z) = \infty$ . The public good is financed by capital-tax revenue. An individual capitalist's private budget constraint is given by  $y^k = r\bar{k}$ , where  $r$  is the rate of return on capital.

<sup>1</sup> The paper is therefore part of the literature on the political endogeneity of policy. For early studies, see for example Hillman (1982, 1989), Hillman and Ursprung (1988), Grossman and Helpman (2002).

<sup>2</sup> Several papers have demonstrated situations in which centralized policymaking may be less efficient than the decentralized policymaking, including Brennan and Buchanan (1980), Kehoe (1989), Edwards and Keen (1996), and Bordignon et al. (2008). Their settings and reasoning are different from those in this paper.

<sup>3</sup> We consider endogenous labor supply and a tax on labor income in Section 5.

<sup>4</sup> A similar specification can be found in Lockwood and Makris (2006).

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