

The Spatial Effects of Wage or Property Tax Differentials, and Local Government Choice between Tax Instruments¹

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This paper considers the spatial effects (on wages, employment, and business capital as functions of location) of a localized differential in source-based wage tax rates or business property tax rates between (for example) a central city and the surrounding suburbs. A simple model is used in which business production uses only labor and capital inputs. Consumers have fixed residential locations but may commute to work. Wage and property tax differentials have effects that are similar in some ways but different in other ways. If given a choice, a local government would choose to set its business property tax rate equal to zero and use only a wage tax. © 2002 Elsevier Science (USA)

Key Words: spatial model; tax differential; tax competition; wage tax; property tax.

1. INTRODUCTION

Taxes on business capital and labor can influence their distribution across metropolitan areas, or across local jurisdictions within metropolitan areas. For example, an increase in the tax rate on business capital (or business property) by a metropolitan area leads to capital outflow, but to capital inflow in other metropolitan areas (see for example Mieszkowski [18]).² The tax competition literature (see Wilson [30] for a survey) builds upon this to show, in models with mobile capital and immobile labor, that under certain conditions, metropolitan areas will set business capital tax rates “too low” and “underprovide” local

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²See the surveys of Mieszkowski and Zodrow [19] and Wildasin [25, particularly pp. 98–115] for some general strands of literature related to Mieszkowski [18]. These authors also consider residential property taxes, which have analogous effects on housing capital.

public goods.³ As another example, an increase in a wage tax or business property tax by one local jurisdiction in a metropolitan area can affect the employment of labor and business capital in all local jurisdictions in the metropolitan area.⁴ For example, Braid [5] uses a three-factor model (with immobile business land, mobile business capital, and labor which is mobile within a metropolitan area) to examine tax competition with wage taxes and business property taxes.

In this paper, I am concerned about the spatial effects (the changes in net wages and the employment of labor and business capital as functions of location) of a localized increase (or decrease) in wage tax rates, or business property tax rates, within a metropolitan area. This could represent a differential in tax rates between a central city and the surrounding suburbs, or between a suburban jurisdiction and its neighbors. I am also concerned with the consequences of the model for the choice of a central city (or other local government) between wage taxation and business property taxation.

Like most business tax competition papers, I consider only two factors of production, business capital and labor (Wilson [29] and Braid [5] also have land as an input). However, unlike almost all of the related literature, I present a model of the intrametropolitan location of employment and business capital in which space and location are explicit.⁵ Consumers have fixed residential locations but may commute to work at a constant cost per mile. Braid [5] considers local jurisdictions within metropolitan areas, but his costless commuting means that his model does not explicitly consider space or location. Braid [6] presents a spatial model of tax competition, but all employment is constrained to locate in one of two employment centers.

³ Models of this sort include Brueckner [8], Bucovetsky [9, 10], Bucovetsky *et al.* [11], Wildasin [26, 27], Wilson [28], and Zodrow and Mieszkowski [31]. In these models, and in most tax competition papers, there are two factors of production, mobile capital and immobile labor (or land), and a business capital tax is the only possible tax that is not equivalent to a lump-sum tax (and the latter is typically ignored; otherwise it usually dominates the business capital tax). Gordon [14] and Bucovetsky and Wilson [12] consider taxation of both capital and immobile labor and Wilson [29] considers taxation of both capital and mobile labor, when there is labor-leisure choice (so that a labor tax is no longer equivalent to a lump-sum tax).

⁴ See pp. 36–44 and Appendix 2.2 (pp. 216–247) of Bartik [2] for a survey of empirical studies regarding the effects of taxes on employment and business activity within states, metropolitan areas, and submetropolitan jurisdictions.

⁵ See Kanbur and Keen [17] for an explicit location model of retail sales, with retail sales concentrations on the low-sales-tax side of a boundary, just as there are employment concentrations on the low-wage-tax or low-property-tax side of a boundary in my Sections 3 and 4. Gordon [13] has both shopping and commuting trips and uses discrete rather than continuous space (jurisdictions are points, with discrete travel costs between them). Mintz and Tulkens [20], Braid [3, 4], and Trandel [23] present spatial models of retail taxation, the last three with continuous space. Arnott and Grieson [1] is also related, but not explicitly spatial.

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