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Capital mobility, tax competition, and lobbying for redistributive capital taxation

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Abstract

This paper analyses the effects of international capital mobility on redistributive capital taxation and on lobbying activities by interest groups. A model is set up where unequally distributed endowments lead to a conflict between households concerning their most preferred capital tax rate. In a symmetric equilibrium, lobbying activities of all interest groups decline with the introduction of international capital mobility, and the welfare of all households increases. © 1998 Elsevier Science B.V. All rights reserved.

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1. Introduction

This paper analyses capital tax competition in a model with endogenous policy formation and interest groups. In an open economy with internationally mobile capital, investors have the possibility to transfer their capital to the country with the most favourable investment conditions. This opportunity changes the environment for national tax policy: [1] capital that is taxed heavily in the country where it

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[1] Competition between governments or other national institutions may also arise in other fields than capital taxation. For a general description of institutional competition caused by capital mobility, see, e.g., Siebert and Koop (1990).

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is invested may escape to other countries with a lower tax burden. Governments then have to compete for this internationally mobile capital as a tax base.

An extensive theoretical literature on interjurisdictional tax competition has emerged in the last years. The majority of this literature deals with capital taxes raised entirely for allocative reasons. [2] In these models, governments have to rely on source-based capital taxes to finance public goods or public infrastructure. Tax competition between symmetric countries leads to declining capital taxes in such a setting. [3] Since governments are predominantly assumed to maximise the welfare of their respective representative citizen, tax competition is viewed as inefficient: governments could increase the welfare of the representative citizen in their countries, if they raised the capital tax rate cooperatively. [4]

In contrast to the literature on tax competition with allocative capital taxes, this paper focuses on capital taxes raised to redistribute income. The better a household is endowed with capital, the more the household is hit by a rising capital tax rate. Different capital endowments therefore cause a conflict between households concerning the desired tax rate: households with a low capital endowment prefer a high capital tax rate compared to households with a higher capital endowment who prefer a lower capital tax rate or even a capital subsidy. The effects of capital taxes on the distribution of incomes give households an incentive to influence policy through lobbying of interest groups.

Two normative issues arise concerning the influence of interest groups on political decision-making. First, lobbying might influence tax policy. Governments then might raise a capital tax or subsidy where they would have raised none without lobbying. This kind of lobbying influence is not necessarily desirable from a normative viewpoint as the political power of interest groups determines which group of households benefits and which group suffers from a redistribution of incomes. Second, resources are dissipated in the process of lobbying and are then lost for production or consumption (Tullock, 1967, 1971). This dissipation of rents in the political process might depress the welfare of all households. To the degree to which tax competition affects redistributive capital taxation and lobbying of interest groups, it has welfare consequences which have not been treated so far in the existing literature.

This paper explicitly considers lobbying as a determinant of equilibrium tax policy. It derives the lobbying equilibrium for a closed and for an open economy. It is shown that lobbying of all interest groups declines with the introduction of

[2] Examples are the works of Zodrow and Mieszkowski (1986), Wilson (1986), Bucovetsky and Wilson (1991), Wildasin (1989), Oates and Schwab (1988, 1991) and Razin and Sadka (1991a,b).

[3] As Bucovetsky and Wilson (1991) and Razin and Sadka (1991a) show, this result holds as long as residence-based capital taxes cannot be raised adequately in addition to source-based capital taxes.

[4] In contrast to the assumption of purely welfare maximising governments, Edwards and Keen (1996) and Rauscher (1996) treat tax competition in a 'Leviathan' model of the government (see also Sinn, 1992). They reach ambiguous conclusions concerning the welfare effects of tax competition.