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A note on unemployment and capital tax competition

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Abstract

We introduce a labor market imperfection into the capital tax competition literature to study the equilibrium tax formulae and their efficiency in the presence of unemployment. Since we allow for labor market imperfection, the standard conclusions of the tax competition literature would be generalized in the case of non-full employment. Our first result shows that even when head taxes on immobile residents are available, the optimal capital tax rate for jurisdictional governments is not zero. Our second finding is that decentralized equilibrium might be characterized by the overprovision of local public goods when the labor market is imperfect.
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1. Introduction

There is an extensive literature on the efficiency properties of a system of competing local jurisdictions. One element of this literature is capital tax competition.[1] The simplest models involve perfectly mobile capital, a local fixed factor, and the provision of a local public good by jurisdictional governments with revenue raised by a source-based tax on locally employed

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[1] There is a large body of research on capital tax competition. A partial list includes Zodrow and Mieszkowski [20], Wilson [16], and Wildasin [14]. See Wilson [17], Zodrow [18], and Wildasin and Wilson [15] for a general review of the tax competition model.

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capital. The major conclusions of the literature are: (i) when head taxes on immobile residents are available, the optimal capital tax rate for jurisdictional governments is zero, and (ii) when restrictions are imposed on head taxes, the capital tax rate set by jurisdictional governments is low compared with the efficient level. We can easily detect the intuition behind the first result in Zodrow and Mieszkowski [19]. In a standard small-open economy, each jurisdiction perceives that it faces a perfectly elastic supply of capital, and that any tax on mobile capital will be shifted to immobile residents, as will the excess burden attributed to the tax-induced outflow of capital. The logic behind the second result is given by Wildasin [14]. He identifies the source of inefficiency in the tax competition model as a fiscal externality; although a tax increase in any jurisdiction affects other jurisdictions' fiscal budgets, jurisdictional governments do not take that into account.

Much of this literature has assumed a perfect regional labor market. This is somewhat surprising since jurisdictions have a strong interest in the issue of attracting investment to boost regional employment. More specifically, jurisdictions often compete for mobile capital to create jobs in their region. Recent studies that address these issues within a particular unemployment model have departed from the assumption of full employment in their fiscal competition analysis (see Lejour and Verbon [7], Fuest and Huber [4], Richter and Schneider [11], Boadway et al. [3], Koskela and Schöb [5], Lozachmeur [8], and Leite-Monteiro et al. [6]). In contrast to these existing studies, this paper retains the original setting of a seminal work of Zodrow and Mieszkowski [20], leaving aside such factors as a wage tax, profit tax, and unemployment benefit. The important feature that differentiates our model from those in the literature is that we consider unemployment within a basic model of Zodrow and Mieszkowski [20], putting emphasis on the complementarities between capital and labor in production, which has not been covered in previous studies.

One may expect that unemployment would be of special importance to most countries. In such countries it would be reasonable to assume that the labor market is imperfect, and that residents face a fear of unemployment originating from different causes. Not surprisingly, labor economists have developed a variety of theories of non-competitive wage determination.[2] In the present study, we focus on the consequences of labor market imperfection based on the fixed wage model underlying the central questions dealt with in the literature, i.e., (i) whether jurisdictional governments choose a non-zero tax rate on mobile capital when they are allowed to use a head tax on immobile residents, and (ii) whether they undersupply public goods when they rely only on a taxation of mobile capital. Our result shows that, given labor market imperfections, since a head tax on both employed and unemployed residents will distort the resource allocation, jurisdictional governments will choose a non-zero tax rate for mobile capital even when allowed to use a head tax. A second set of results concerns the efficiency of providing local public goods when a head tax is not available. As the level of labor market imperfections becomes significant, a jurisdiction may induce negative externality by exporting unemployment. It is at this point that the positive and negative externalities associated with the use of capital taxes can be compared. Throughout this paper, using the notions of fiscal (positive) and unemployment-exporting (negative) externalities, we are able to provide an intuitive basis for our results.

The organization of this paper is as follows. In the next section, we depart from the full-employment model developed by Zodrow and Mieszkowski [20] in their seminal work. Section 3 offers some conclusions.

[2] See reviews of the unemployment literature by Nickell [9] and Bean [2], among others.

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