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Journal of Urban Economics 54 (2003) 173–180

JOURNAL OF Urban Economics

www.elsevier.com/locate/jue

Tax competition and the choice of tax structure in a majority voting model

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Received 17 September 2002; revised 17 February 2003

Abstract

This note studies the choice of tax structure in a majority voting model with tax competition. Regions may tax mobile capital or immobile labor. Individuals differ with respect to their relative endowments of labor and capital. Even though a lump sum tax is available, the equilibrium capital tax in a jurisdiction may be positive. In a symmetric equilibrium, this will be true if the median capital endowment is smaller than average.
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JEL classification: H77; D72

Keywords: Tax competition; Voting

1. Introduction

In the standard tax competition model of Zodrow and Mieszkowski [10], it is assumed that jurisdictions tax capital which is mobile among them. Tax revenue is used to provide public goods to immobile consumers. In equilibrium, capital is undertaxed and public goods are underprovided. The reason is that taxing capital produces a fiscal externality: A jurisdiction which taxes capital ignores the positive externality on other jurisdictions caused by the outmigration of capital. Given that capital is fixed for the economy as a whole, the capital tax is lump sum from the viewpoint of the economy; hence, the decentralized equilibrium is inefficient.

However, the model assumes that capital is taxed even though immobile labor is in perfectly inelastic supply and a tax on labor therefore equivalent to a lump sum tax. Indeed,

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doi:10.1016/S0094-1190(03)00037-8

the fiscal externality would disappear if labor were taxed instead of capital. Therefore, a welfare maximizing government should not tax capital. In extensions of the Zodrow–Mieszkowski model, it may be optimal to tax both capital and labor, for instance, if regions are large and labor supply endogenous (Bucovetsky and Wilson [2]). In the simple model, however, it is usually assumed that lump sum taxes (or alternatively, efficient residence based capital taxes) are not feasible for political reasons (see, e.g., Wilson [9]). For instance, Margaret Thatcher's introduction of the poll tax in Britain is usually seen as one of the reasons that removed her from office.

But if lump sum taxes are politically disadvantageous, this should be modeled explicitly. If the political gain of supplementing a lump sum tax with a tax on mobile capital outweighs the political cost, then in equilibrium capital taxes may prevail despite their deadweight costs. Wilson [9] argues that political economy explanations should be used to explain the choice of tax structure in tax competition models. Fuest and Huber [3] analyze a voting model of tax competition where regions are small, and may tax capital or labor. In this model, the optimal capital tax rate is zero, as in Bucovetsky and Wilson [2] when regions may use residence based capital taxes.

This note explores the effect of introducing heterogeneity among individuals in a model of large regions. I use a standard tax competition model where individuals differ with respect to their capital and labor endowments. Labor supply is exogenous. Individuals vote on the tax rates on labor and capital income. In the voting equilibrium, the capital tax rate may be positive even though labor supply is completely inelastic. The reason is that the tax mix has redistributive consequences. Persson and Tabellini [5] present a similar model which analyzes the choice of labor versus capital taxes in a closed economy.

The model is introduced in the next section. Section 3 analyzes the properties of the voting equilibrium. The last section concludes the paper.

2. The model

I use the standard tax competition model originally developed by Zodrow and Mieszkowski [10], with the distinction that regions are large enough to affect the interest rate.[1] There are $N \geqslant 2$ regions, indexed by $i = 1, \dots, N$, each inhabited by an identical number of immobile residents with mass one who each supply one unit of labor. The capital stock in region i is given at $\bar{k}_i$. A region may attract capital through the use of taxes. There are two taxes in the model: a unit wage tax at rate τ and a unit tax on capital at rate t (the capital tax may be negative). Since labor is immobile, the wage tax is effectively an efficient lump sum tax while the capital tax is distortionary from the viewpoint of a single jurisdiction. In the standard model with identical individuals, this would imply that each region is better off using only wage taxes.

Output is produced using capital and labor. The production function is written in intensive form, $f(k_i)$, with $f' > 0$, $f'' < 0$, where k_i is the region's capital stock per

[1] See Wildasin [6,7] for a model with large regions, and Bucovetsky [1] and Wilson [8] for models of asymmetric tax competition. Wilson [9] surveys the theoretical literature on tax competition.

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