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European Economic Review 49 (2005) 1927–1951

EUROPEAN ECONOMIC REVIEW

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Policy commitment and the welfare gains from capital market liberalization

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Received 6 December 2001; accepted 27 September 2004

Available online 23 November 2004

Abstract

This paper evaluates the quantitative impact of capital liberalization on the taxation structure and welfare of the liberalizing countries when governments conduct fiscal policy optimally but without commitment (time-consistent policies). The transition from a regime of capital autarky to a regime of free mobility leads to a decrease in the long-term tax rate on capital of 13 percent and an increase in the tax rate on labor of 2 percent. As a consequence of this taxation shift, welfare increases by about 1 percent. The reduction in capital taxation induced by capital market liberalization is welfare improving because, in the absence of capital mobility, the time-consistent policies over-tax capital.

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JEL classification: F2; F4; F42

Keywords: Capital mobility; International tax competition; Macroallocation

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doi:10.1016/j.euroecorev.2004.10.001

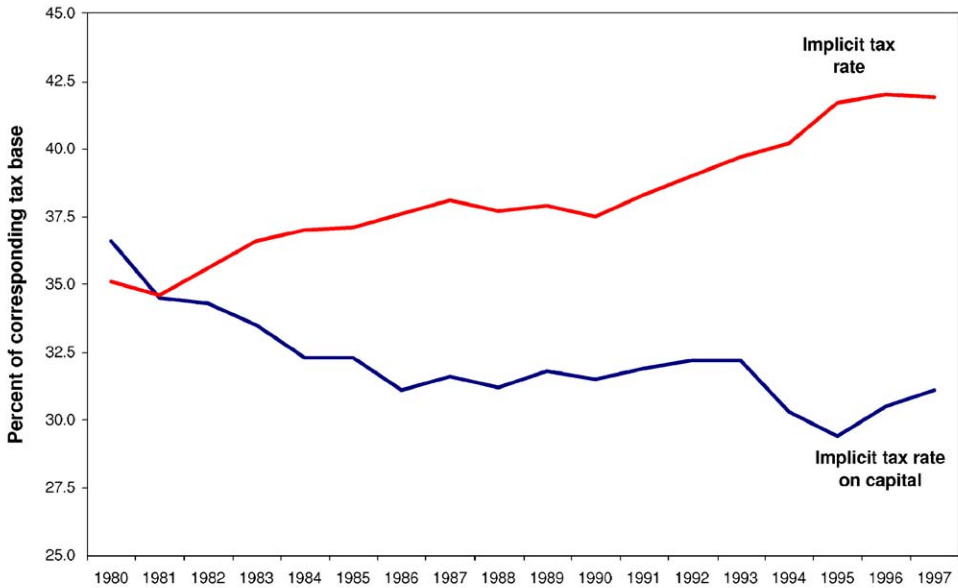

Fig. 1. Implicit tax rates on capital and labor in the European Union.
Source: Eurostat, Structure of the taxation systems in the European Union 1970–1997, 2000 edition.

1. Introduction

One of the heated debates in international economics concerns the liberalization of capital markets. A central theme within this debate is the issue of tax policy coordination. It has been argued that, given the fiscal policy autonomy of countries and the increase in the international mobility of capital, policy competition may lead to distortionary tax policies. Indeed, the incentive to attract foreign capital and prevent capital outflow may induce countries to shift the taxation burden from the highly mobile capital to the less mobile labor force. For instance, a shift in the taxation structure is observed in the integration experience of the European countries. As shown in Fig. 1, during the 1980s and the 1990s the implicit tax rate on capital has been decreasing while the implicit tax rate on labor has been increasing.[1]

There are reasons to believe that this taxation shift is, at least in part, the consequence of the increasing tax competition among European countries following the gradual removal of barriers to the mobility of capital. This shift in the tax structure is a major concern among European authorities. For example, in the October 1997 communication from the European Commission to the European Council, the Commission concludes: "...*This trend in tax structure should be reversed*". Concerns about harmful tax competition, given the globalization of capital markets, are also expressed by the Organization for Economic Cooperation and Development (see OECD, 1998). These concerns are consistent with the

[1]The implicit tax rate is defined as the ratio between the tax revenue and the tax base.

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