CAPITAL TAXATION AND GLOBALIZATION*

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1. INTRODUCTION

The increasing integration of capital markets that characterized the last two decades is seen as having implications on the individual governments' ability to tax capital income. Since the tax base is more and more mobile, tax revenues are more sensitive to changes in the tax rate, also. Therefore we have witnessed a growing consensus, namely in regions that share some supranational decision making, and where the intra-area mobility is higher, for the desirability of coordinated fiscal policies, in particular on capital taxation. In practice, however, very few steps have been taken to harmonize capital taxation. This lack of coordination would lead us to expect a "race to the bottom" as a result of fiscal competition, which would imply a negligible tax revenue from capital taxation. Although we can observe as a general trend a small decline of the share of tax revenues from capital over time, that decline is not the one that economic theory would anticipate. This fact is even more puzzling when we take into account that the tax on capital income, when compared either with the tax on labor income or the value-added tax, is much more inefficient. This is a well known and robust result in the literature.\(^1\) Taxing capital imposes a negative incentive on saving (that is, an intertemporal distortion since it taxes more heavily future than current consumption). This characteristic is worsened with the double, or sometimes triple, capital taxation that characterizes most fiscal codes. Social welfare is usually pointed out as the reason for the relatively high taxes on capital income, due to the undesirable effects on equity that a decline of those taxes could deliver, namely when compensated by an increase of labor taxation. Therefore, the existing situation can be seen as an implicit and partial coordination system, since different countries have different levels for capital taxes. This arrangement is supported by the argument that lower taxes would have a positive impact on efficiency, at the cost of penalizing the poorest of each economy. This equity loss is a cost that most countries would not want to pay.

In this article we want to test whether this thesis is supported by the economic theory and by the empirical characterization of different households, in developed economies as well as in emergent countries, which are entering in the international capital markets.

The background work of this article\(^2\) aims at reconciling the apparently conflicting results of two con-

\(^1\) Chamley (1986) and Judd (1985) are the seminal works on this subject.

\(^2\) See Correia (2010).

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tributions to the literature. The first is the quite well known result of Arnold Harberger (1995), that an increase of capital taxation would lead to a decline in wages, in a general equilibrium model of a small open economy. This article differs from Harberger (1995) since we consider that the change in capital taxes must be compensated by a change in an alternative tax. We assume that it is the tax on labor that is adjusted to guarantee that the total tax revenue is invariant. The second one is that of Garcia-Milá et al. (2001). These authors consider a closed economy model with heterogeneous households. Their conclusion is that the elimination of the capital income tax, when compensated by an increase of the tax on labor income, decreases the welfare of the households in the left side of the welfare distribution, that is the poorest of the economy. As the poorest households have labor income as the main source for financing of consumption, if wages would increase, as in Harberger (1995) with the elimination of capital taxation, it may not be the case that they would suffer in terms of welfare. This is the literature dilemma that this article tries to clarify.

2. THE MODEL

The model represents a small open economy with perfect capital mobility, that is an economy integrated in a global capital market. It is a real economy in the sense that we abstract from money as a facilitator of transactions. There is just one good produced in every period, this good is identical to the one produced in the rest of the world and there are no restrictions to the tradability of this good. The available technology uses as inputs capital, \( K \), and labor measured in units of efficiency, \( EN \), where \( N \) represents hours of work and \( E \) is an index of labor efficiency. We assume that markets are competitive. This assumption and the production function characteristics imply that real wages (in units of consumption), as well as the real cost of capital, depend only on the capital/labor ratio used in equilibrium by each firm. We can also say that the real wage depends positively on that ratio while the cost of capital (as its equilibrium rentability) depends negatively on the same ratio. The produced good can be used in the small open economy for private consumption, for investment or for government consumption or to export to the rest of the world. The government spends a constant flow of per capita expenditures, \( G \) and taxes labor and capital income, at the proportional tax rates \( \tau_n \) and \( \tau_k \) respectively. The assumption that the system of taxing capital income is the territorial system implies that the income of external assets held by domestic households, \( B^* \) is not subject to taxation. The real net return of these assets is the net international real interest rate, \( r^* \). By assuming that this rate is constant we are imposing that the rest of the world is stationary. We also assume that fundamentals in the rest of the world are identical to the ones of the small economy. These assumptions imply that, with no costs of adjustment of capital, the economy will converge immediately to the new stationary state, following the change of policy.

As the objective of this article is to understand the different effects that the change of policy can have on different households that live in the small open economy, it is important to characterize

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(3) This paper considers an increase of the tax rate on corporate taxation. The bulk of the paper contemplates a small open economy environment. It has a section were the results are extended to the US economy, that is to a closed economy.

(4) These properties derive from the production function being neoclassical and markets competitive.
the intrinsic heterogeneity of households, which leads them to suffer differently the effects of the change of policy. Then we will assume that households differ on labor efficiency and in the stock of non-human wealth that they hold at the time of the reform. Each household \( i \) has a labor efficiency level measured by \( E_i \) and holds wealth in physical capital, \( K_i \) domestic bonds, \( B_i \) and external assets \( B_i^\Delta \). Agents are identical in every other characteristic. To apply the method described in Correia (1999) we assume that preferences are such that it is possible to define a representative household.\(^5\) Moreover, and given cross section empirical evidence, we propose the type of preferences GHH,\(^6\) which are characterized by labor supply decisions in every period reacting just to the real wage of that period, and not reacting to the current or expect household’s wealth. These preferences imply that if rich households work more than poor one it is just because that have a higher labor efficiency index.

Then preferences of household \( i \) can be represented by\(^7\)

\[
U_i = \sum_{t=0}^{\infty} \beta^t \left( C_{it} - \chi N_{it}^\psi \right)^{1-\sigma} / (1 - \sigma), \quad \chi > 0, \varphi > 1
\]

where \( C_{it} \) and \( N_{it} \) represent the consumption and hours of work of agent \( i \) in period \( t \).

This household is constrained in its choices by the intertemporal budget constraint, which can be written as:

\[
\sum_{t=0}^{\infty} \frac{C_{it}}{(1 + r_0)(1 + r^*)^t} = \sum_{t=0}^{\infty} \frac{w_t E_i N_{it}}{(1 + r_0)(1 + r^*)^t} + A_{i0}
\]

where \( r_0 \) is the net rate of return in period zero, \( w_t \) is the net wage rate at period \( t \) and \( A_{i0} \) the initial wealth, is defined as \( K_{i0} + B_{i0} + B_{i0}^\Delta \). By solving the household problem it is straightforward to verify that the optimal choice of hours is given by the following expression:

\[
N_{it} = \left( \frac{E_i w_t}{\chi \varphi^t} \right)^{\frac{1}{\psi-1}}
\]

So it is clear that with GHH preferences the hours of work do not differ across agents when these have the same level of efficiency. Substituting this expression in the utility function (1) and in the budget constraint, (2), we can redefine the optimal choice of consumption as:

\[
\text{MAX } U_i = \sum_{t=0}^{\infty} \beta^t \left( C_{it} - \bar{C}_{it} \right)^{1-\sigma} / (1 - \sigma)
\]

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\(^5\) That is, that preferences are such that conditions for Gorman aggregation are satisfied.

\(^6\) These preferences are the ones used in Greenwood, Hercowitz and Huffman (1988).

\(^7\) The qualitative result on equity is maintained with different preference representations.
subject to:

\[
\sum_{t=0}^{\infty} \frac{C_{it} - \bar{C}_{it}}{(1 + r_0)(1 + r^*)^t} = \sum_{t=0}^{\infty} \frac{(E_i w_i)^{\frac{1}{\varphi}}}{(1 + r_0)(1 + r^*)^t} \left(1 - \frac{1}{\varphi}\right) (\chi \varphi)^{-\frac{1}{\varphi}} + A_{i0}
\]

(5)

where

\[
\bar{C}_{it} = \chi \left[ \frac{E_i w_i}{\chi \varphi} \right]^{\frac{1}{\varphi}}
\]

(6)

As \( \bar{C}_{it} = \bar{C}_i \), i.e. transformed consumption is constant over time.\(^8\) In this case the budget constraint for household \( i \), given by equation (5), allows for the determination of the optimal level of \( \bar{C}_i \) for every household \( i \) as a function of the net wages path, the international real interest rate, the interest rate at time zero and its level of labor efficiency and of initial wealth.

The value of that variable \( \bar{C}_i \) is given by the expression:

\[
\bar{C}_i = \frac{r^*}{1 + r^*} \left[ \sum_{t=0}^{\infty} \frac{(E_i w_i)^{\frac{1}{\varphi}}}{(1 + r^*)^t} \left(1 - \frac{1}{\varphi}\right) (\chi \varphi)^{-\frac{1}{\varphi}} + (1 + r_0)A_{i0} \right]
\]

(7)

The general equilibrium of this economy depends on the compatibility of the firm’s and of the different household’s decisions. Firms are very simple entities in this economy that, in each period, hire labor and rent capital goods to, given the technology, produce the unique good. Every firm uses the same technology and are price takers in every market where they operate.

We will define the status quo as the situation where public goods are financed uniquely by taxes on labor and capital income. We will compare this equilibrium with the one that would result from the elimination of capital taxation, increasing the tax on labor income such that the same flow of government consumption can be financed.

As said before we use the method developed in Correia (1999). That is a very simplified method when compared to the ones used in the literature with heterogeneous agents models. One of the hypothesis that allows for that simplification is the choice of preferences which, through households heterogeneity, allows for the existence of the so-called "representative household".\(^9\) The separability between aggregate and individual equilibrium is feasible given the described hypothesis: the type of preferences, households being price takers in the market and being anonymous to the government.

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\(^8\) Given the isoelastic preferences described in (4) and since the international real interest rate is at the steady state level, \( r^* = \frac{1}{\varphi} \), then \( \bar{C}_i = \bar{C}_i \), i.e., the transformed consumption is constant over time.

\(^9\) That is the aggregate equilibrium, namely equilibrium prices, can be computed independently of the distribution of initial wealth \( A_{i0} \) or the distribution of labor efficiency \( E_i \) as well as of the distribution that results from the equilibrium.
The effect of policy changes on equity is measured through the effects on welfare distribution. Using the optimum from households' problem the proposed utility function can be written as:

\[ U_{t}^{W} = \frac{r^{*}}{1 + r^{*}} \left[ \sum_{t=0}^{\infty} \frac{(E_{i}w_{t})^{\sigma}}{(1 + r^{*})^{\tau}} + (1 + n_{0})A_{i0} \right] \] (8)

Note that this utility is an expression linear in \( E_{i} \) and in \( A_{i0} \). This property is essential for the comparison of the welfare distribution's associated with each fiscal policy.

The interpersonal utility comparison has raised always questions due the cardinality that is necessary to proceed to that comparison. In this work we minimize that problem by using as a measure of the welfare of household \( i \) the index \( u_{i} = U_{i}^{W} \), which measures the consumption (transformed) of that household. In this case to compare the utility between two households \( i \) and \( j \) the ratio \( \frac{u_{i}}{u_{j}} \) is computed. This ratio has a clear interpretation since it can be read as the consumption ratio across households, transformed by the labor desutility. The value of this ratio is the answer to the question: how much should be the growth of households \( j \) consumption, such that household \( i \) would be indifferent between their position in the welfare distribution? The reason for defending that we are minimizing the cardinality problem in the interpersonal welfare comparison is that the units chosen allow to interpret this relative position as a consumption equivalent.

To order the different policy regimes by equity it is equivalent to compare vectors of utility across households. We compare those vectors using the concept of relative differentials. Then policy 1 dominates policy 2 if and only if the consumption increase (in percentage) of the poorer household, needed for the richer agent to change positions with him, is lower in policy 1 than in policy 2. In this way the choice of the household utility indicator and the criterion for comparing distributions complement each other.

### 3. ELIMINATION OF THE CAPITAL INCOME TAX

The objective of this article is to determine in which conditions the elimination of the tax on capital income, when compensated by an increase of the labor tax, improves equity in the small open economy. Then we should compare the welfare distribution of households in policy 1, where the economy is characterized by a constant positive tax rate on capital, with the alternative situation, policy 2, where the economy is characterized by a zero tax rate on capital. In Correia (1996) we prove that policy

\[ v^{1} \succ_{rd} v^{2} \iff \frac{v_{i}^{1}}{v_{i}^{2}} > \frac{v_{j}^{1}}{v_{j}^{2}} \]

for any household \( i \) with a smaller utility than household \( j \). This relative differential dominance is equivalent to the Lorenz dominance for any partition of the distribution support.

(10) Policy 1 is equity improving in relation to policy 2 if policy 1 dominates policy 2 in relative differential, \( v^{1} \succ_{rd} v^{2} \), iff:

\[ \frac{v_{i}^{1}}{v_{i}^{2}} > \frac{v_{j}^{1}}{v_{j}^{2}} \]

(11) In this case we maintain the tax on capital income in period zero, since this is a lump sum tax.
1 is the second best solution. Then, policy 2 is always more efficient than policy 1, i.e. the utility of the representative agent is higher in 2 than in 1. The effect on efficiency, or the effect on utility of the representative agent, \( i = i^* \) can be measured by comparing

\[
\hat{C}_{i^*} = \frac{r^*}{1 + r^*} \left[ \sum_{t=0}^{\infty} \left( \frac{w_i}{(1 + r^*)^t} \right) \left( 1 - \frac{1}{\varphi} \right) + (1 + r_0^i) A_{r^*0} \right]
\]

between the two policies. As we said efficiency is higher with policy 2, that is:

\[
\sum_{t=0}^{\infty} \left( \frac{w_2^i}{(1 + r^*)^t} \right) \left( 1 - \frac{1}{\varphi} \right) + (1 + r_0^2) A_{r^*0} > \sum_{t=0}^{\infty} \left( \frac{w_1^i}{(1 + r^*)^t} \right) \left( 1 - \frac{1}{\varphi} \right) + (1 + r_0^1) A_{r^*0}
\]

where \( x^1 \) and \( x^2 \) represent respectively the equilibrium values of variable \( x \) associated respectively to policy 1 and to policy 2.

As the tax on capital income is constant in both experiments for \( t \geq 1 \) the non-arbitrage condition and the neoclassical production function implies that \( \frac{K_{i^*}}{N_{i^*}} \), and therefore the marginal productivity of labor, is constant for \( t \geq 1 \). As the labor tax is also constant over time for every policy, we can guarantee that the net wage is constant over time, for policy 1 and for policy 2, for \( t \geq 1 \).

For \( t = 0 \) and using the optimum conditions of firms, that equate the wage paid (before taxes) to the marginal productivity of labor, we get that:12

\[
w_0 = (1 - \tau_n) F_2 (\frac{K_{i^*0}}{N_{i^*0}})
\]

\[
N_{i^*0} = \left( \frac{w_0}{\varphi} \right)^{\frac{1}{\alpha}}
\]

If we assume a Cobb-Douglas production function, where \( \alpha \) represents the capital share, we can write labor decisions as:

\[
\varphi N_{i^*0}^{\alpha - (1 - \alpha)} = (1 - \tau_n)(1 - \alpha) K_{i^*0}^\alpha
\]

As \( \varphi > 1 \), then \( \varphi - (1 - \alpha) > 0 \), and since \( \tau_{n0}^2 > \tau_{n0}^1 \), then \( N_{i^*0}^{\frac{2}{\alpha}} < N_{i^*0}^{\frac{1}{\alpha}} \) and \( w_0^2 < w_0^1 \frac{K_{i^*0}}{N_{i^*0}} \) increases with the higher tax on labor. By assumption \( \tau_{k0}^1 = \tau_{k0}^2 \). Therefore we can state that:13

Result 1: The elimination of the tax rate on capital income, accompanied by an increase of the labor tax, implies that the net real interest rate in period 0 declines, i.e. \( r_0^2 < r_0^1 \).

(12) \( F(K,N) \) represents the technology and \( F_i \) represents the partial derivative of \( F \) relative to the \( i \) argument. Then \( F_j \) represents the marginal productivity of labor.

(13) Note that the net return on capital is given by \( (1 - \tau_c) \left[ (\alpha K_{c} / N_{c})^{\alpha - 1} - \delta \right] \), where \( \delta \) represents the depreciation rate.
Using (10) result 1 implies:

**Result 2: The elimination of the tax rate on capital income implies that:**

\[
\sum_{t=0}^{\infty} \frac{(w_t^2)^{\phi-1}}{(1 + r^*)^t} > \sum_{t=0}^{\infty} \frac{(w_t^1)^{\phi-1}}{(1 + r^*)^t}
\]  

(11)

These two results explain that, for the representative agent, utility increases not due to the return on capital, which declines, but due to the net present value of human capital, which increases although being taxed at a higher rate.

To understand how different households are affected differently we order households by increasing transformed consumption, or utility. If \(i > j\), agent \(i\) is richer, that is it has a higher utility than agent \(j\). Then to compare policy 1 with policy 2 in terms of equity we use, as described before, the relative differential concept:14

**Definition:** Policy 2 is equity improving in relation to policy 1 if policy 2 dominates policy 1 in relative differential, that is:

\[
\frac{\tilde{C}_i^2}{\tilde{C}_j^2} < \frac{\tilde{C}_i^1}{\tilde{C}_j^1}, \text{ for } i > j
\]

(12)

To determine the effect on equity of the elimination of the tax on capital income let us consider two extreme cases: One where households differ just due to labor efficiency, i.e. \(A_{io} = A_{i'o'}\), and in the other households have identical efficiency levels \(E_i = E_{i'} = 1\), and heterogeneity comes from different initial levels of non-human wealth.

Note that the definition of \(\tilde{C}_i\), given in (7) depends on the sum of two items: one that is homogeneous across households and the other is heterogeneous.

Using (7), we check whether condition (12) is satisfied, after the results 1 and 2. When heterogeneity is in labor efficiency, condition (12) is equivalent to

\[
\frac{1 + r_{io}^2}{\sum_{t=0}^{\infty} \frac{(w_t^2)^{\phi-1}}{(1 + r^*)^t}} > \frac{1 + r_{i'o'}^1}{\sum_{t=0}^{\infty} \frac{(w_t^1)^{\phi-1}}{(1 + r^*)^t}}
\]

On the other side when heterogeneity is caused by different initial stocks of financial wealth, condition (12) implies the opposite condition, that is:

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(14) This concept was developed by Marshall and Olkin (1979). It is equivalent to a first-order stochastic dominance criteria, for any sub-groups of the population.
Therefore we can state that:

Result 3: The effect on equity of the elimination of the tax on capital depends crucially on the roots of heterogeneity across households: is equity worsening when agents differ on labor efficiency and, on the contrary, is equity improving when agents differ by the initial stock of financial wealth.

We can easily interpret result 3 in the following way. Individual welfare depends on two items: the present value of a function of net wages, which by result 2 increases with the elimination of capital taxation, and the initial wealth of every agent evaluated at \( (1 + r_0) \), which by result 1 declines with the change of policy. In the extreme cases described in result 3, depending on the characterization of households, either the first or the second parcel is homogeneous across households. So, in the case where agents differ by labor efficiency, the first parcel is heterogeneous across households and the second is homogeneous. The opposite occurs when agents are differentiated exclusively by the initial stock of financial wealth.

Therefore, in this environment, the effect of the elimination of capital taxation on equity depends completely on the roots of households heterogeneity. Then the question proposed is an empirical one: what is the root of the households heterogeneity observed in most industrialized or emerging countries? Cross section data tells us that both wealth and earnings are not equally distributed across households. We can show, using general characteristics of empirical evidence, that the joint distribution of those two household characteristics, labor efficiency and initial wealth, satisfy the necessary conditions for:

Result 4: The elimination of capital income in a small open economy, inhabited by households characterized by asymmetries compatible with empirical cross section evidence, leads to an improvement in equity. Any household with welfare lower than the one of the representative household of the economy increases welfare due to that policy change.

The last part of this result comes from using together the increase of efficiency and the improvement of equity. As the representative agent is better off and, for \( i < r \), \( \frac{C_i}{C_j} \) increases, then the utility of household \( i \) the poorer, increases necessarily more than the utility of the representative agent.

The question is now to understand how can these results and the opposite one described in Garcia-Mila et al. (2001) coexist.

\[
\sum_{t=0}^{\infty} \frac{(w_0^t)^{\alpha}}{1 + r_0^2} > \sum_{t=0}^{\infty} \frac{(w_1^t)^{\alpha}}{1 + r_0^4}
\]

\( \phi \phi \)
4. THE IMPORTANCE OF THE EXOGENOUS REAL INTEREST RATE

The environment in which the exercise of last section was developed was the one of a small open economy with perfect capital mobility, while Garcia-Mila et al. calibrate their model for the US, which is described as usual by a closed economy model. How does this change of environment revert the results on equity in a such a strong way? The fundamental difference is that in the environment described until now the real interest rate was exogenous to policy. That is it did not react to the elimination of capital taxation. While in Garcia-Mila et al. the real interest rate is a variable that reacts to policy, due to the changes in saving and investment associated to the change in taxation. The same would occur if, even when considering a small open economy, we would assume that the rest of the world, composed by a set of identical small open economies, was changing policy in a similar way and simultaneously to the specific small open economy under study.

In this section we question result 4. How should it change when the economy is represented by a closed economy, that is one economy where the path for the real interest rate would react to the change of policy. The environment is identical to the one developed in section 1.1, except for capital immobility and goods nontradability which implies that, in every period, market clearing imposes that the sum of private consumption, public consumption and investment has to be equal to the production realized in the economy. This change, which is equivalent to the real interest rate being endogenous to policy in this economy, implies that, contrary to the former model which was analyzed analytically, now we have to use a numerical solution method for the computation of the equilibrium. We use the calibration as in Correia (1999). That is, $\tau_k = .5^{16}$ and $\tau_n = .23$, which are consistent with $N = .25$ and $G / Y = .19$. Preferences are such the $\varphi = 1.8$, $\chi = 2.34$, $\sigma = 1.001$ and $\beta = .96$. The technology is Cobb Douglas, the share of capital is 0.4 and depreciation is 10%.

The following table summarizes the information that results from the computed equilibria, and which is necessary for the present analysis:

<table>
<thead>
<tr>
<th>Policy 1</th>
<th>$\lambda$</th>
<th>$\gamma$</th>
</tr>
</thead>
<tbody>
<tr>
<td>$\tau_k = .5$, $\tau_n = .23$</td>
<td>1</td>
<td>3.7</td>
</tr>
<tr>
<td>Policy 2</td>
<td>$\tau_k = 0^{17}$, $\tau_n = .35$</td>
<td>1.02</td>
</tr>
</tbody>
</table>

$\lambda$ is the welfare of the representative household relative to its welfare with policy 1. That is the efficiency gain of the elimination of capital taxation is positive and for the chosen calibration it represents an increase of 2% in the utility of the representative household. The effect on equity is still measured by the effect on the value of human wealth and on the value of non-human wealth. The ratio of these two values is given by $\gamma^{18}$.

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(16) Note that this tax is on capital income net of depreciation.
(17) Except for period zero, where is 50%.
(18) The value of $\gamma$ is given by $\sum_{t=0}^{\infty} \frac{(a_t)^{1/3}}{(1 + r_p)} \prod_{s=1}^{(1+r_s)}$. 
It is immediate to see that, contrary to what happens in the small open economy, the value of $\gamma$ declines with the elimination of capital taxation.\(^{19}\) The transition to the new steady state is now characterized by an increasing capital/labor ratio, therefore by an increasing path of wages and a decreasing path of interest rates. When compared with the case when there is no transition, the path of wages is now always lower and the path of interest rates always higher. Both contribute to a change of $\gamma$ of different sign from the change in the small open economy. The incentives to save and invest more are identical to the ones in the small open economy. But now to increase the capital stock it is necessary to sacrifice significantly consumption. This implies that capital accumulation is now realized at a much more gradual way over time. Therefore wages do not increase so much as before, the incentive to work more is lower and labor taxation has to increase more. On the other hand the slow increase of investment and the immediate elimination of capital taxation implies a higher return on capital than the one observed over time for the small open economy.

This result confirms, partially, the conclusions in Garcia-Milá et al. (2001):

**Result 5:** The elimination of capital taxation in a closed economy, inhabited by heterogeneous households whose distribution of characteristics is consistent with cross-section evidence, implies a more unequal economy.

The effect of the change of policy over the poorest depend now on the specific distribution of the economy under study. Namely we need to know the distance across those poorest and the representative household of the economy. As we know that the representative household increase welfare by 2% and that poorest families increase distance relatively to the representative household we cannot say what happens to welfare of poorest without knowing its distance or its idiosyncratic characteristics.

### 5. CONCLUDING REMARKS

We show in this article that the effect on equity of the elimination of the tax rate on capital income, when compensated by an increase of labor taxation, depends in a crucial way on the effect that the change of policy has on the path of the real interest rate. When we analyzed a small open economy where that rate is exogenous to policy the result is that the poorest households of the economy increase welfare as a result of the change of policy.

When this change of policy is also implemented by other economies that belong to the international capital market, the real interest rate reacts to the change of policy and the result is the one described for the closed economy. Here the effect on equity is reversed. This may explain why, contrary to what should be expected by fiscal competition, we have observed during the last two decades a slight decline of capital taxation. Maybe policy decision makers are benevolent, or maybe that the hypothesis that, though moved by different incentives, they reach the desirable goals is not so far from reality.

\(^{19}\) This decline is robust to different preferences, for example the same effect is obtained with preferences isoelastic in consumption and leisure.
REFERENCES


