

Abstract

The conventional wisdom in the tax competition literature is that the optimal capital tax rate for local government is zero when head taxes on immobile residents are available. However, the zero tax-rate is incompatible with the phenomenon that we actually observe. In this paper, we depart from the full employment tax competition model and present a model of a tax competition with a regional trade union to explain the behavior of local government choosing a non-zero tax rate. Furthermore, it turns out that local governments are likely to overprovide public goods when the trade union's preferences are characterized by a high elasticity of substitution between wage and employment rates.