

Abstract

In the problem of optimal taxation in an economy with labor and capital, the optimal solution when the government can commit to a sequence of tax rates entails the tax on capital to tend to zero in the limit, with all the tax burden on labor. It is well known, however, that this solution is time inconsistent; so if the commitment power is not perfect, this second best tax plan will not be sustainable.

We model explicitly the trade-off between the cost of revising the tax plan, and the benefit of the revision. As a result, when commitment is not possible, both the limit tax rate and the steady state capital are different from their levels in the second best solution. Limit taxes on capital may be strictly positive, but it may also be the case that the only sustainable plan has subsidies to capital. The subsidies induce an overaccumulation of capital, which becomes a commitment device against revisions of the tax plan. Journal of Economic Literature Classification numbers: H 21, C73.

Keywords: Optimal Taxes, Commitment, Incentive Compatibility.