

Public Capital and Optimal Taxes Without Commitment*

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Abstract

We consider a representative agent, infinite-horizon economy where production requires private and public capital. The supply of public capital is financed through distortionary taxation. The optimal (second best) tax policy of a benevolent government is time inconsistent. We therefore introduce explicitly the constraint that at no point in time the revision of the original tax plan is desirable. We completely characterize the (third best) tax plan that satisfies this constraint, and estimate the difference in tax rate between the second and third best policy for a wide range of parameters. For some of these the difference between the second and third best tax rates is large, and so are the associated rates of economic growth.

JEL Classification: H21, D9

Key Words: Public Capital, Optimal Taxation, Time Consistency

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