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Climate Policy under Factor Mobility: A (Differentiated) Case for Capital Taxation

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Abstract: In a general equilibrium model with two periods and a finite fossil resource, I analyze the non-cooperative climate policies of symmetric countries that are in competition for mobile factors of production (capital and fossil energy). The paper shows that countries that want to slow down climate change but are also concerned about tax revenues from mobile tax bases have a rationale to supplement environmental taxes on fossil fuels with source-based capital taxes (or subsidies). More specifically, countries find it beneficial to subsidize capital in period one and tax it in period two. The first-period subsidy on capital facilitates a higher environmental tax by counteracting its adverse effects, and increases national and global welfare in equilibrium. By contrast, the capital tax in period two induces inter- and intratemporal distortions that lead to lower welfare. The rate of resource extraction is inefficiently high in equilibrium, no matter which tax portfolio is at the governments' disposal. Furthermore, unintended ('Green Paradox') effects of demand-side policies are shown to arise even in general equilibrium with factor mobility. Finally, factor mobility does not necessarily lead to a higher rate of extraction and lower welfare compared to autarky.

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