

Preface

The causal relationship between growth and inequality is complex, and there have been many scholarly works to study this relationship since the seminal work of Kuznets (1955). Few recent studies in this field have shown that the nature of relationship is multifaceted and non-linear. In addition to the intrinsic non-linear nature of the relationship, government and institutions play a pivotal role in distributing the benefits of growth to reduce inequality. The responsiveness greatly depends upon a country's initial conditions in terms of inequality and the nature of democracy prevailing in that country. This book highlights the role of institutions in explaining the gulf between inequality and growth.

Our method for exploring the role of institutions uses a dynamic general equilibrium framework and econometric techniques. Econometrically, two important hypotheses are tested. First, holding fixed institutions, the growth rate increases as inequality decreases. Second, holding fixed inequality, improvement in the integrity of fiscal institutions results in higher economic growth.

This book examines the connections among taxation, growth, and fiscal institutions in an overlapping generations production economy. In this economy, agents with different productive abilities vote for a proportional tax rate on labor income to finance a lump sum welfare transfer. In equilibrium, the size of the transfer is inversely proportional to the median–mean ability ratio. Time–consistent fiscal policy yields a higher tax rate than that of a Ramsey equilibrium in which policy commitment is possible. Fiscal institutions are modeled as trigger mechanisms in a dynamic tax game, in order to support inter–generation cooperation. A simulation example quantifies the effectiveness of the fiscal institutions of 20 OECD countries. Cross-section growth regressions confirm the hypothesis that strong institutions are pro-growth.

This analysis will be useful to scholars and policymakers in the fields of economic growth and development, public policy and economic modeling.

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