



ELSEVIER

Journal of Public Economics 88 (2004) 2745–2763

JOURNAL OF
PUBLIC
ECONOMICS

www.elsevier.com/locate/econbase

Preferential trade agreements and tax competition for foreign direct investment

Horst Raff*

Department of Economics, University of Kiel, Wilhelm-Seelig-Platz 1, 24098 Kiel, Germany

Received 27 January 2000; received in revised form 9 March 2004; accepted 11 March 2004
Available online 20 May 2004

Abstract

This paper examines how free-trade agreements and customs unions affect the location of foreign direct investment (FDI) and social welfare, taking into account that governments may adjust taxes and external tariffs to compete for FDI. Conditions are identified under which a free-trade agreement leads to FDI and under which this improves welfare. The welfare effect is shown to depend on the relative size of efficiency gains in production and government revenue losses due to tax competition. A free-trade agreement may fail to induce welfare-improving FDI, creating a role for a customs union.

© 2004 Elsevier B.V. All rights reserved.

JEL classification: H25; F23

Keywords: Preferential trade agreements; Tax competition; Multinational enterprises

1. Introduction

This paper examines the effect of preferential trade agreements on the location of foreign direct investment (FDI) and social welfare, taking into account that governments may adjust their tax policy to compete for FDI. There is considerable empirical evidence that preferential trade agreements, such as free-trade areas (FTAs) and customs unions (CUs), affect FDI flows. For instance, the creation of the European customs union in 1968 and especially the Single European Act of 1986/1987 were associated with significant inflows of US and Japanese FDI (see, for instance, [Motta and Norman, 1996](#); [Pain, 1997](#)). Inflows were particularly strong in relatively low-cost locations, such as Ireland. Similar

* Tel.: +49-431-880-1582; fax: +49-431-880-3150.

E-mail address: raff@econ-theory.uni-kiel.de (H. Raff).

effects were observed in the case of the North American Free Trade Agreement (NAFTA), which particularly boosted FDI into Mexico. Some authors, including Ethier (1998), have argued that attracting FDI was in fact one of the main reasons why some countries have pursued such agreements. Many preferential trade agreements, including NAFTA, explicitly stipulate the removal of FDI review procedures and other barriers to direct investment. Another possible effect of the removal of internal trade barriers is that companies may rationalize and concentrate production in low-cost locations within the preferential trade area. This was pointed out, for instance, by the Royal Commission (1985) and Pain (1997). Empirical evidence of this effect for NAFTA is found by Niosi (1994).

Given the potential of preferential trade agreements to affect the location choices of foreign investors, governments may find it tempting to intervene to try to attract new firms or to prevent existing firms from leaving. Competition for FDI especially on an intra-regional basis is well documented, and there is some evidence that it has increased in line with regional integration (Bond and Guisinger, 1985). Benassy-Quere et al. (2000) find that nominal and effective corporate tax rates in the EU have decreased in the process of European integration. According to UNCTAD (1996, Table III.1), the use of fiscal incentives, such as tax holidays, to attract FDI has increased in Europe between the mid-1980s and early 1990s.¹ The study reports a similar trend in the United States and Canada. The main objectives pursued with these incentives appear to have changed as well during this period. UNCTAD (1996, Table III.4) argues that in the EU as well as in the United States and Canada more incentives were given to stimulate FDI and exports and fewer were given for sectoral development and restructuring, priority industries, and research and development.

Examples of incentive-based competition in Europe are listed in Table 1. These examples suggest that multinational firms, after identifying possible locations for a project, shop around for the most attractive combination of location-specific fundamentals and incentives (see also Oman, 2000). In the UNCTAD survey, Samsung offered as key factors influencing its decision to invest in England (i) access to the European single market; (ii) high labor productivity and competitive wage rates; (iii) an attractive incentive package; and (iv) good transport infrastructure to markets. Mercedes-Benz and Swatch gave almost exactly the same reasons for their choice of locating in France, as did Ford and Volkswagen for their decision to locate in Spain. The desire to supply the European market from a single low-cost location within the EU providing significant incentives also appears in many of the other examples listed in the UNCTAD survey (UNCTAD, 1996, Boxes III.4 to III.5).

Many observers have noted that competition for FDI may resemble a prisoner's dilemma with countries setting taxes too low or offering excessive incentives (see Hines, 1996; Wilson, 1999; Gordon and Hines, 2002 for surveys). Both the EU and the OECD have developed standards for good behavior in international taxation that would require

¹ Of the 20 European countries surveyed, 16 provided reductions of standard income-tax rates, seven provided tax holidays, 10 offered accelerated depreciation, five gave investment and reinvestment allowances, five offered deductions from social security contributions, nine granted specific deductions on gross earnings for income tax purposes or reductions in other taxes, seven provided exemptions from import duties and 6 offered duty drawbacks. The only instrument that appears to have been used less was accelerated depreciation.

متن کامل مقاله

دریافت فوری ←

ISIArticles

مرجع مقالات تخصصی ایران

- ✓ امکان دانلود نسخه تمام متن مقالات انگلیسی
- ✓ امکان دانلود نسخه ترجمه شده مقالات
- ✓ پذیرش سفارش ترجمه تخصصی
- ✓ امکان جستجو در آرشیو جامعی از صدها موضوع و هزاران مقاله
- ✓ امکان دانلود رایگان ۲ صفحه اول هر مقاله
- ✓ امکان پرداخت اینترنتی با کلیه کارت های عضو شتاب
- ✓ دانلود فوری مقاله پس از پرداخت آنلاین
- ✓ پشتیبانی کامل خرید با بهره مندی از سیستم هوشمند رهگیری سفارشات