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Tariff jumping foreign investment and capital taxation

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Abstract

This paper reconsiders the welfare effects of 'tariff jumping' direct investment if mobile capital is subjected to taxation. In contrast to the conventional wisdom, the receiving country may in this case gain from the incremental inflow of capital, as this diverts tax revenues from the rest of the world. In the case of perfect capital mobility, this possibility becomes a certainty. Our argument provides one rationale for a small country to levy a distorting tariff in a second best world in which capital taxes already exist. © 2001 Elsevier Science B.V. All rights reserved.

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1. The received opinion on tariff jumping

There is a sizeable empirical literature which interprets the high levels of foreign direct investment (FDI) in a number of economies to be the result of 'tariff jumping': since tariffs increase the cost of exporting, foreign firms prefer to jump the tariff and take up production within the protected market. For example, economic historians interpret the expansion, during the nineteenth and early twentieth centuries, of German FDI in the United States, Russia, and a number of other European countries, British FDI in Europe and the US, and American FDI in

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Canada and Europe, to be, at least in part, the result of tariff jumping[1]. More recently, an UNCTAD report (1996, ch. IV), summarizing the evidence on incentives for FDI, points to high tariff levels in receiving countries as one determinant out of a host of economic and non-economic factors. Econometric studies of recent experience come to mixed conclusions, but it is difficult to reject the tariff jumping motive for FDI[2]. Likewise, the theory of multinational enterprises (MNEs) stresses the importance of tariff jumping possibilities when a firm produces in both its home country and an export market[3].

From the point of view of neoclassical economic theory, it is often argued that such 'tariff jumping' FDI is likely to be harmful to a small receiving country[4]. Intuitively, the inflow of capital is producing a good whose local price, because of the tariff, is higher than on world markets. Therefore, the marginal productivity of capital, evaluated at the socially optimal world price, falls short of the interest rate that must be paid to foreign capital owners. More recently, theorizing in the political economy mode has revisited the tariff jumping question, and rationalized the existence of tariff-defusing FDI, or 'quid pro quo FDI', which is intended to defuse the potential threat of future tariffs in the recipient country, when the level of protection is endogenous[5].

We believe that the literature on tariff jumping has failed to emphasize what is an obvious and important reason why countries may want to induce capital flows, viz., capital taxation[6]. There is a large literature in public finance which argues that, in a world where capital is taxed in all countries, each country has an incentive to reduce the net outflow (increase the net inflow) of capital[7]. The reason is that taxation drives a wedge between the objective of an investor and the national interest. While an investor will invest up to the point where net of tax returns across countries are equalized, the government would like to equate the gross return at home with the return net of foreign taxes abroad. As we show, in

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[1]Cf. Kenwood and Lougheed (1983, 49) as a typical example.

[2]UNCTAD (1996, 47) reviews the evidence and finds support for the tariff jumping motive for the US and (perhaps paradoxically, given the widely-held belief to the contrary), not for Canada, in the literature reviewed. However, it is also pointed out that some of the studies suffer from the defect that they use current tariff rates, rather than those in place at the time that the FDI took place.

[3]Dunning (1993) is a recent reference from the business literature. Caves (1996, ch. 2) demonstrates the relevance of tariff jumping in the context of the theory of the MNE.

[4]The classic reference is Brecher and Diaz-Alejandro (1978). The literature, both preceding and following this paper, is surveyed in Bhagwati and Srinivasan (1983, ch. 28) and Ruffin (1984).

[5]For a recent survey of the pertinent political economy literature, see Bhagwati et al. (1992).

[6]It should be noted that Brecher and Diaz-Alejandro allude briefly to the effect that capital taxation has on their results, and this is also implicit in the literature surveyed in Ruffin. In this literature, however, the problem studied is how to manipulate factor movements (which in turn change the terms of trade). In our approach, taxes create the possibility to benefit from a fiscal externality, which is quite a different argument. To our knowledge, the argument has never been articulated in this fashion nor related directly to the relevant public finance literature.

[7]Cf. MacDougall (1960, 16–17), Richman (1963), Musgrave (1969) and Alworth (1988, 233).

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