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Tax competition in imperfectly competitive markets

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Abstract

The literature on strategic trade policy has shown that in imperfectly competitive markets governments have an incentive to subsidize exports of their own firms. Yet the consequence of the departure from laissez-faire is a wasteful subsidy race. In contrast, this paper shows that even in imperfectly competitive markets there is a strong tendency for laissez-faire to prevail. The driving force is the firms' willingness to exploit tax or subsidy differentials by relocating production. A small tax differential induces firms to change their place of production. The change in market structure has a negligible effect on the oligopoly equilibrium, but a non-negligible impact on government revenues. When tax policy is non-discriminatory, governments gain (lose) by attracting all firms when production is taxed (subsidized). Hence, laissez-faire is the only equilibrium. Since, from the point of view of the two producing countries, laissez-faire (nondiscrimination) Pareto dominates the intervention equilibrium (discrimination), nondiscrimination is a simple device to result in a mutual beneficial outcome. © 1998 Elsevier Science B.V.

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1. Introduction

In an important branch of the international trade literature, known as strategic trade theory, it has been argued that there seems to be plausible reason why governments might intervene in markets characterized by increasing returns to

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scale and imperfect competition in the output market. According to a standard model, a few firms operate in different countries and produce goods which are sold in a third market. In that situation Brander and Spencer (1985), Eaton and Grossman (1986), Helpman and Krugman (1989) among others showed that governments may intervene in order to increase national welfare. Export subsidies can shift profits to the domestic economy at the expense of foreign firms. Since all governments have the same incentive, however, the result is a wasteful subsidy race. Reducing subsidies from their non-cooperative equilibrium level in both producing countries would improve the welfare of these economies at the expense of consumers.

This subsidy game is similar to the problem of excessively low tax rates in the literature on capital income tax competition. (See, for example, Bond and Samuelson (1989); Bucovetsky and Wilson (1991); Gordon (1992).) There it is usually assumed that firms respond to tax differentials and move to the country with lower taxes. The equilibrium of a game in which governments compete for mobile capital, however, is characterized by excessively low tax rates since governments do not internalize the fiscal externality. An increase in the own tax rate induces a capital outflow that is beneficial to other regions but which is not taken into account by the government that changes the tax.

The similarity in results, however, is derived from different assumptions. In the strategic trade theory literature it is usually assumed that firms produce in the country where their owners reside. The market is characterized by imperfect competition and increasing returns to scale, possibly because of high fixed costs of entry. This assumption is well supported by empirical evidence and it allows us to explain trade patterns between industrialized countries. In contrast, in the literature on (international) tax competition output markets are normally assumed to be perfectly competitive. Yet capital is mobile and firms exploit tax differentials. Since the key assumption in each literature—imperfect competition on the one hand and mobility of firms on the other hand—is well taken, an interesting question arises: Does competition for mobile firms in the presence of imperfectly competitive markets make the subsidy race even more wasteful?

In this paper I will provide an answer to the question. The paper therefore contributes both to the tax competition literature by adding imperfect competition and to the literature on strategic trade theory by allowing firms to choose their location of production. I will argue that the effects of imperfect competition and the mobility of firms do not reinforce each other. On the contrary, when governments do not discriminate against foreign firms there exist strong forces that lead to laissez-faire, hence to lower subsidies. With mobility alone, governments are tempted to subsidize their own firms while they tax foreign firms which leads to a wasteful subsidy race. Since governments are better off without discrimination, nondiscrimination may be seen as a simple device to overcome the inefficiency of the subsidy race between governments. The laissez-faire result is still only a second-best result, since the ineffìcency arising from imperfect