Journal of Public Economics 81 (2001) 253–277
JOURNAL OF PUBLIC ECONOMICS
www.elsevier.nl/locate/econbase

Strategic tax competition; implications of national ownership

Trond E. Olsen[a,*], Petter Osmundsen[b]

[a]*LOS center, Bergen, and Department of Finance and Management Science, Norwegian School of Economics and Business Administration, Helleveien 30, N-5045 Bergen, Norway*

[b]*Stavanger University College/Norwegian School of Economics and Business Administration, Stavanger University College, Section of Petroleum Economics, P.O. Box 2557 Ullandhaug, 4004 Stavanger, Norway*

Received 1 August 1998; received in revised form 1 December 1999; accepted 1 April 2000

Abstract

Two jurisdictions compete to capture the rents of a large multinational enterprise (MNE) which invests locally and which is partly owned by local investors. The MNE contributes to local welfare by tax payments and dividends, and it has private information about the efficiency of the operations in the two localisations. It is shown that the distortions in the MNE's real investment portfolio are determined by a trade-off between fiscal externalities and equity externalities, and that investments in the case of strategic tax competition may be lower than in the co-operative case. Ownership matters, and we show how the firm may reduce its overall tax payments by influencing the distribution of owner shares between investors in the two countries.

Keywords: Tax competition, Mobility, Common agency

JEL classification: D82; H21; L51

1. Introduction

With enhanced international mobility of the corporate tax base, tax competition

*Corresponding author.
E-mail addresses: trond.olsen@nhh.no (T.E. Olsen), petter.osmundsen@tn.his.no (P. Osmundsen).

0047-2727/01/$ – see front matter
PII: S0047-2727(00)00114-6

is reinforced and national governments experience more problems in raising revenue. Foreign direct investments have been rapidly increasing[1], and recent empirical research shows that effective tax rates are important factors for determining the location and investment decisions of multinational enterprises (MNEs).[2] These enterprises tend to be important in industries that are characterized by high levels of R&D relative to sales, a large share of professional and technical workers in their work force, products that are new or technically complex, and high levels of product differentiation and advertising (Markusen, 1995). Given these characteristics there is every reason to believe that such a firm is better informed about its operations than are any of the national governments that it relates to. Countries that try to attract investments from such a firm, must then take informational asymmetries into account in their policy design.

In this paper we focus on a case where an MNE has private information about its efficiency and operating profits in two jurisdictions. The international nature of an MNE and the high number of interfirm transactions make it hard for the tax authorities to observe its true income and costs. Complex technology also implies obstacles for the authorities to ascertain the firm's efficiency, and thereby derive its true operating profits. Many of the inputs are not standard commodities with established market prices, making it further difficult to monitor costs or impose effective transfer pricing regulation. The inherent flexibility of multinationals not only helps these firms to minimise the costs of taxes and regulations in a given jurisdiction, but it also aids the multinational in pitting one government against the other as countries compete for foreign direct investments; see Gresik (1998).

We analyse this kind of strategic tax competition, where countries try to attract new corporate investments from an MNE. This is modelled as multiple-principal regulation of a firm that divides its real investment portfolio between two jurisdictions, and has an option of redirecting parts of the investments from one of the jurisdictions to the other. As part of a strategy to minimize its tax payments, the firm may have an incentive to behave so as to not completely reveal its earning potential in each individual country. Also, having investment opportunities in two countries, the MNE may try to reduce tax payments in each country by an implicit threat of directing a larger fraction of its investment to the other country.

Apart from its tax payments, the MNE contributes to local welfare by dividend payments to local shareholders. In our context any profits accruing to the MNE are then part of the national welfare to the extent that the country has an equity share in the firm. This assignment of positive welfare weights to profits significantly affects the qualitative results in our (common agency) model, since it implies equity externalities. These externalities arise because each country designs its

[1] See Markusen (1995).

[2] See, e.g. Devereux and Freeman (1995), Desai and Hines (1999).