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Country size and tax competition for foreign direct investment

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Abstract

We analyse tax competition between two countries of unequal size trying to attract a foreign-owned monopolist. When national governments have only a lump-sum profit tax (subsidy) at their disposal, but face exogenous and identical transport costs for imports, then both countries will be willing to offer a subsidy to the firm. At the same time, the firm prefers to locate in the larger market where it will be able to charge a higher producer price. In equilibrium the large country receives the investment and may even be able to charge a positive tax, if the difference in the sizes of the national markets is sufficiently great. The profit tax paid in equilibrium rises further if countries are given an additional instrument of either a tariff or a consumption tax.

Keywords: Tax competition; Foreign direct investment; Regional location

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1. Introduction

When a firm chooses to become a multinational enterprise and establish a foreign production plant, it seldom builds a factory to service only the domestic

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market of the country in which it is investing. Instead, it establishes a base from which it supplies consumers in surrounding countries. This foreign direct investment (FDI) may have been triggered by efforts at increasing the level of integration between countries in the region, as have recently been taken by regional economic groupings such as the European Union (EU), NAFTA and the ASEAN countries.

Thus, for example, the EU's Single Market Initiative has reduced the remaining barriers to trade between member states and has raised the level of competition within the region (see Smith and Venables, 1988). Even if external trade barriers are unchanged, these policies of reducing intra-regional trade costs put suppliers from outside the region at a disadvantage (for example, transforming the EU into ''Fortress Europe''). The foreign firms may respond by setting up production within the region in order to avoid the external trade barriers and avail themselves of access to the single market. Consequently the tariff-jumping incentive to build a branch plant is increased when trade barriers within the region are lowered (Norman and Motta, 1993).

In this paper, we investigate what influences a foreign-owned firm in its choice of country in which to invest, once it has opted for foreign direct investment rather than exporting from its home base. In particular, we focus on foreign direct investment in a region in which the population is asymmetrically distributed between countries and there are some remaining barriers to intra-regional trade (though these are lower than on trade with countries outside the region).

The existence of trade costs creates a ''home market bias'' familiar from the new trade theory (e.g. Krugman, 1980), which interacts with tax policy as governments attempt to attract the foreign firm by offering investment incentives. Recent empirical work has shown that both market size and the effective tax rate on capital are important factors in influencing multinational firms' choices of countries in which to invest (Devereux and Freeman, 1995; Devereux and Griffith, 1998; Grubert and Mutti, 1996).

These empirically relevant determinants of FDI lead us to draw on two fields which have traditionally been largely separated in the literature—the new trade theory on the one hand and the public finance related literature on international tax competition on the other.

Recent work in the trade literature has focused on imperfectly competitive markets and has introduced transport costs as a model element that plays an important role either as an agglomerating force (Krugman, 1991), or for the equilibrium market structure and the production decision of multinational firms (Horstmann and Markusen, 1992).

In the last few years, several papers have also incorporated tax competition in a framework of imperfectly competitive markets. Thus Ludema and Wooton (1998) introduce tax competition for mobile workers to the Krugman model. Markusen et al. (1995) study a model where governments compete through environmental taxes when production activity causes local pollution and a multinational firm may