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Competing for capital when labor is heterogeneous

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Abstract

This paper investigates the impacts of capital mobility and tax competition in a setting with imperfect matching between firms and workers. The small country attracts less firms than the large one but accommodates a share of the industry that exceeds its capital share—a reverse home market effect. This allows the small country to be more aggressive and to set a higher tax rate than the large one, thus implying that tax competition reduces international inequalities. However, the large country always attains a higher utility than does the small country. Our model thus encapsulates both the ‘‘importance of being small’’ and the ‘‘importance of being large’’. Last, tax harmonization benefits to the small country but is detrimental to the large one.
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1. Introduction

During the last two decades, OECD countries have experienced very high increases in foreign direct investments (OECD, 2003). As economic integration gets deeper, these investments are likely to become more responsive to differentials in corporate tax rates. The empirical evidence collected by Mooij and Ederveen (2003) confirms the idea that

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governments vastly use such an instrument to influence firms' locational choices. Building on that observation, the literature on fiscal competition studies how governments choose their tax rates in order to attract firms (Wilson, 1999). Because the outcome of fiscal competition crucially hinges on the international mobility of capital, it seems promising and reasonable to build on the microeconomic underpinnings of firms' locational choices. New economic geography (NEG) aims precisely at explaining how firms do interact to form clusters within a few regions (Fujita et al., 1999; Baldwin et al., 2003). It is, therefore, natural to tackle the process of fiscal competition by using the main ingredients of NEG, namely increasing returns, market size, and imperfect competition.

This is the road taken recently in various papers (Baldwin and Krugman, 2004; Ottaviano and van Ypersele, 2005; Borck and Pflüger, 2006). However, very much like in NEG, they all have chosen to focus on the product market. Yet, recent empirical contributions suggest that labor-market pooling is one of the main explanations for the existence of firms' clusters (Dumais et al., 2002; Rosenthal and Strange, 2004). The specificity of human capital being itself the main reason for imperfect matching between firms and workers, we find it natural to study how skill mismatch affects the spatial distribution of firms through both firms' locational choices and the working of local labor markets. When the labor force is heterogeneous in the skill space, firms are able to set wages below the marginal productivity of labor by differentiating technologies. Hence, they operate on imperfectly competitive labor markets. As firms also exhibit scale economies at the plant level, it appears that our setting blends the main ingredients of NEG. However, we obtain results that are very different from existing ones.

First, we show that the large country's residents enjoy a higher utility level than do those of the small country. Yet, though the large country has more firms than does the small one, competition on local labor markets hinders the large country to have a more than proportionate share of firms. We thus get a reverse home market effect: *the share of firms in the larger region is less than the share of consumers in that region*. Put together, the last two results mean that our model encapsulates both the "importance of being small" and the "importance of being large", two aspects that have been emphasized in distinct papers.

Second, the few existing studies focussing on tax competition between asymmetric countries predict that the large country sets a higher corporate tax rate than does the small one (Bucovetsky, 1991; Wilson, 1991; Haufler and Wooton, 1999; Ottaviano and van Ypersele, 2005). This prediction does not necessarily fit well the real world, however. In their analysis of the effective corporate tax rates set in several OECD countries, Devereux et al. (2002) report much more mixed results. For example, their Fig. 7 reveals that, if the effective average tax rates in Germany, Japan, and the United States are higher than those set in Austria, Finland and Sweden, those prevailing in Belgium and Greece are higher than those in France and the United Kingdom. There is, therefore, a need for a different approach.

This is what we accomplish in this paper where we show that *the small country levies higher corporate tax rate than does the large country*, the reason being that the small country enjoys a reverse home market effect that allows it to follow a more aggressive tax policy. Hence, by focussing on the microeconomic underpinnings of local labor markets, we are able to establish that the main implication of the above-mentioned studies is reversed. Such a prediction seems to fit well what we observe in the European Union. To see it, consider the six founding EU-members (Belgium, France, Germany, Italy, Luxembourg, and the Netherlands), the economies of which are fairly well integrated.

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