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Economic integration and tax policy with endogenous foreign firm ownership

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Abstract

This paper analyses the impact of economic integration on tax policy in a model where corporate taxation is motivated by the desire to tax profits accruing to foreigners and the number of foreign owned firms is endogenous. Increasing economic integration is modeled as a decline in trade costs or tariffs. It turns out that declining trade costs lead to increasing profit taxes if the government may use import tariffs. If tariffs are not available, declining trade costs induce profit taxes to decline as well. A mandatory reduction in tariffs also triggers profit tax reductions. We conclude that the existence of foreign firm ownership may fail to prevent profit taxes from declining as economic integration proceeds.
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1. Introduction

In the debate on the impact of globalization on national tax policies, a key issue is whether taxes on internationally mobile firms will survive. While most contributions to this debate emphasize the downward pressures on taxes implied by tax competition, some factors have been identified which may act as a break on tax reductions. One of those factors is foreign firm ownership. If firms are owned by foreigners, governments have

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incentives to tax these firms because the tax burden is at least partly borne by the residents of other jurisdictions, i.e. part of the tax burden is "exported" (Richter and Wellisch (1996); Huizinga and Nielsen (1997), (2002)).

While the idea that tax exportation may be a reason to levy corporate taxes in open economies is certainly plausible, a limitation of the literature in this field is that the existence of foreign firm ownership is taken as given. This neglects that the very decision of investors to set up firms in foreign countries is influenced by the process of economic integration. Moreover, the magnitude of foreign firm ownership is likely to depend on the tax burden on foreign owned firms. This paper develops a model where the number of foreign owned firms is endogenous and reacts to increasing economic integration as well as taxation. We consider a model of an open economy, where firms and goods are internationally mobile and households are immobile. Imperfect competition in goods markets gives rise to profits and intra-industrial trade. Firms from the rest of the world may serve the domestic market either via exports or by setting up a production facility in the country. Exports face a transport cost and setting up an additional production facility gives rise to a fixed cost which differs across industries. The government may levy profit taxes and tariffs. Our model thus combines elements of new economic geography models, in particular the trade-off between transport costs and fixed costs of production (see, e.g. Krugman, 1991), with elements of tax competition models and the concept of tariff-jumping foreign direct investment.[1]

In this setup, we ask how increasing economic integration affects profit taxes and foreign direct investment. We interpret increasing economic integration as (i) a decline in transport cost or (ii) a decline in tariffs which is imposed exogenously (for instance, as a result of free trade agreements). The analysis leads to the following results. In the absence of tariffs, a reduction in transport costs leads to a decline in corporate taxes. Investment by foreign firms is hump shaped in transport costs. In contrast, if the government of the host country may levy import tariffs, a decline in transport costs leads to higher corporate taxes and foreign investment unambiguously declines. Finally, a mandatory reduction in tariffs leads to a reduction in corporate taxes and an increase in foreign investment. These results suggest that foreign firm ownership may not prevent profit taxes from declining as economic integration proceeds. A decline in profit taxes is even compatible with increasing foreign firm ownership. Moreover, our results imply that the reduction of tariffs through international free trade agreements may give rise to more aggressive corporate tax competition. Of course, these findings are derived in a model based on a set of common but nevertheless restrictive assumptions like, for instance, linear cost and demand functions. The paper includes a section which explores the relevance of these assumptions for the results.

In the literature, the contributions which are most closely related to this paper are Richter and Wellisch (1996); Huizinga and Nielsen (1997, 2002); Wildasin and Wilson (1998); Kind et al. (2003).Richter and Wellisch (1996) analyse a model with household and firm mobility and show, among other things, that foreign ownership of land gives rise to an underprovision of productive local public goods and inefficiently high taxes on firms and

[1] For recent surveys on tax competition, see Haufler (2001) or Fuest et al. (2003). On tariff jumping foreign investment, see, e.g. Bhagwati and Srinivasan (1983).

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