International Review of Economics and Finance 35 (2015) 110–121

Contents lists available at ScienceDirect

International Review of Economics and Finance

journal homepage: www.elsevier.com/locate/iref

# The role of firm ownership in policy competition for foreign direct investment between asymmetric countries

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A R T I C L E I N F O

*Article history:*
Received 10 April 2014
Received in revised form 12 September 2014
Accepted 15 September 2014
Available online 22 September 2014

*JEL classification:*
F12
F23
H25
L13

*Keywords:*
Foreign direct investment
Policy competition
Role of firm ownership
Location choice

A B S T R A C T

This study develops a two-country policy competition model for foreign direct investment between asymmetric countries. It analyzes how firm ownership via foreign capital affects the investment location choice of the foreign firm, and policy competition between the potential host countries. The findings show that the inflow of foreign capital changes the investment location choice of the foreign firm, as does policy competition between the host countries. Further, an increase in the inflow of foreign capital to a domestic firm in the host country heightens the country's attractiveness as an investment location.

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## 1. Introduction

In recent decades, with the globalization of the world economy, foreign investment in firms has become common. Indeed, we often observe many firms in developed countries engaging in foreign direct investment (FDI) and moving their production bases from their home countries to foreign countries in search of cheap labor and huge markets—for example, to the Southeast Asian countries (e.g., Indonesia, Vietnam, Bangladesh, Thailand, and Myanmar). Such enterprise activity has attracted considerable attention from economics researchers. Many theoretical studies on FDI use typical two-country models to examine factors such as the investment location choice of foreign enterprises, the policy competition between host countries—including tax competition—welfare levels, and unemployment (e.g., Barros & Cabral, 2000; Bjorvatn & Eckel, 2006; Fumagalli, 2003; Hao & Lahiri, 2009; Haufler & Wooton, 1999; Sanjo, 2012, 2013).[1]

In a pioneering contribution to the literature, Haufler and Wooton (1999)—as well as Haufler (2001)—analyze the tax competition between host countries for FDI by using a two-country model and assuming different market sizes and a foreign monopolist. Their main finding is that when the market size is significantly large, the foreign monopolist is willing to invest in the host country having the largest domestic market even if that country imposes a higher tax rate on the monopolist. Bjorvatn and Eckel (2006) examine policy competition for FDI between asymmetric countries in terms of market structure. In their model, a domestic incumbent firm exists in the larger country but not in the smaller country. They show that the difference in market structure affects both the location

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[1] See Dembour (2008) for a review of tax competition relating to FDI. Faeth (2009) provides a review of FDI theoretical models.

http://dx.doi.org/10.1016/j.iref.2014.09.009
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choice of a foreign firm and the welfare implications of policy competition and that policy competition gives the impression that the smaller country is a more attractive investment location. Sanjo (2012) investigates the location choice of a foreign firm by introducing a two-country tax competition model for FDI based on the concept of "country risk"; he shows that the relationship between country size and country risk, representing locational advantage and disadvantage, respectively, affects such choice. With the advent of globalization, we observe the economic situation in which domestic firms are possessed by foreign capital; however, these studies do not consider the role of firm ownership played by foreign capital.

On the other hand, in addition to FDI, globalization has recently created a situation wherein foreign capitalists own the domestic firms of many countries either partially or fully; following this circumstance, several studies have examined the interaction between firm ownership and taxation policy in the global economy (e.g., Ferrett & Hoefele, 2014; Ferrett & Wooton, 2010; Fuest, 2005; Haufler & Schulte, 2011; Mittermaier, 2009).

For instance, Fuest (2005) investigates the impact of economic integration on tax policy by using an open economy model in which the number of foreign-owned firms is endogenous. Fuest shows that foreign firm ownership may not succeed in preventing profit taxes from declining as economic integration progresses and that retrenchment of tariffs through international free trade agreements may lead to more aggressive corporate tax competition. Mittermaier (2009) examines how firm ownership influences both policy competition of host countries and investment location choice of a foreign firm by incorporating the role of firm ownership into a two-country tax competition model for FDI. In an analogous fashion to the approach by Haufler and Wooton (1999) and Bjorvatn and Eckel (2006), these studies analyze the relationship between FDI and tax policies of the potential host countries by using a model that specifies the profits of the foreign and domestic firms and the social welfare of individual countries.

By contrast, unlike the above theoretical studies, Ferrett and Wooton (2010) and Ferrett and Hoefele (2014) develop a simpler and more general modeling framework and analyze fiscal policy (including taxation policy) and the role of firm ownership. Ferrett and Wooton (2010) investigate how the international distribution of the foreign monopoly firm affects tax competition for FDI between the two potential host countries and the investment location choice of the foreign firm. They show that the international distribution of foreign firm ownership does not influence fiscal competition between the two potential host countries. Ferrett and Hoefele (2014) develop a theoretical model in which the incumbent firms in the two host countries are owned by both the host countries and the rest of the world. They show that when the incumbent firms in the host countries are partially owned by other countries, the investment location choice for FDI will be inefficient, whereas the location choice will be efficient when the incumbent firms are entirely owned by the host countries. Therefore, they conclude that incumbent firm ownership affects the efficiency of fiscal competition for FDI, a conclusion different from that reached by Ferrett and Wooton (2010).

As implied by the results of these studies, since foreign markets are believed to be important to the capitalists who make profits from investments as well as the enterprises who aim to expand their profits, it can be said that the importance of firm ownership by foreign capitalists will increase further on account of globalization. Therefore, in the literature concerning firm ownership, there is a need for more research on the tax policies for FDI between the potential host countries and also the investment location choice by the foreign firm.

Unlike Ferrett and Wooton (2010) and Ferrett and Hoefele (2014), this study adopts the approach of Bjorvatn and Eckel (2006) and analyzes how the ownership of a firm by foreign capitalists affects the investment location choice of a foreign firm, and the policy competition between the two potential host countries. We show that under an exogenous policy scenario wherein two countries have the same tax policy, the possibility of the larger country benefiting from hosting the foreign firm increases with the increase in inflow of foreign capital, whereas under an endogenous policy scenario wherein the potential host countries have different tax policies, the possibility of the foreign firm investing in the larger country increases with the increase in the inflow of foreign capital. Therefore, our study shows that firm ownership significantly affects the investment location choice of the foreign firm.

The remainder of this paper is organized as follows: Section 2 outlines our model. Section 3 analyzes the exogenous policy scenario in which the governments of two countries follow the same tax policy, as well as the endogenous policy scenario in which these governments have different tax policies. Section 4 examines the equilibrium investment policy by the two potential host countries. Section 5 concludes the paper.

## 2. The model

Consider an economic region with two countries, $A$ and $B$. While country $A$ has one domestic firm, firm $a$, country $B$ has no domestic firms. Firm $a$ is partially owned by foreign capitalists. We assume that both the countries compete for the investment of a foreign multinational; we refer to the multinational as "the foreign firm", and denote it as firm $f$. In this model, we assume that firm $f$ faces increasing returns to scale; therefore, firm $f$ is not able to divide its production facilities between countries $A$ and $B$.[2] The transaction costs for exporting from firm $f$'s home country (home base) to both the host countries $A$ and $B$ are assumed to be extremely high, and firm $f$ therefore does not export from its home base (see Barros & Cabral, 2000; Bjorvatn & Eckel, 2006; Haufler & Wooton, 1999; Mittermaier, 2009; Sanjo, 2012). Hence, in the case in which firm $f$ invests in country $A$, it incurs transportation costs (trade costs) when exporting from country $A$ to country $B$ and vice versa. The export of products entails a per-unit trade cost denoted by $t > 0$.

Assume that the demand of country $i(=A, B)$ can be given as

$$Q_i = n_i(\alpha - p_i), \tag{1}$$

[2] For a two-plant model for FDI, see Bjorvatn and Eckel (2005).

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