Strategic Production Subsidy/Tax under Mutual Endogenous Entry of Foreign Firms

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Abstract

Considering the subsidy/tax on domestic production, this paper examines the tax competition between two symmetric countries in the presence of the mutual endogenous entry of foreign firms into each country's market through exports and foreign direct investment (FDI). In the absence of FDI, we find that whether the equilibrium tax rate is positive or negative depends on the export intensity of the domestic firms and thus, the tax rate is always negative (subsidy) in the symmetric interior case. However, in the presence of FDI, we demonstrate that the condition for the sign of the equilibrium tax rate is weighed toward FDI and as a result, the tax rate can plausibly be positive (tax). We also show that from the perspective of the world welfare, the equilibrium tax rate is excessively low (high) if and only if it is a subsidy (tax).

Keywords: Cournot competition, strategic trade policy, import/export, foreign direct investment, endogenous market structure, free entry, free trade agreement.

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