

Fiscal spillovers and policy biases: Heterogeneous firms and industry structure.

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Abstract

This paper analyzes labour taxation in open economies by exploiting a two-country trade model with heterogeneous firms augmented to include endogenous labour supply and fiscal policy variables. First, it shows how fiscal variables affect industry structure, terms-of-trade, aggregate productivity and the real wage. Secondly, it documents an upward bias in labour taxation in the sense that non-cooperative tax rates exceed cooperative tax rates. The upward bias is partly driven by intra-industry reallocations where a higher tax rate leads to an increase in aggregate productivity in the country increasing the tax rate and a reduction abroad. The upward bias is shown likely to be strengthened with increased openness to trade. Hence further openness to trade may lead to a race to the top in labour taxation rather than a race to the bottom. These findings contribute to the literature on biases in fiscal policies by documenting new mechanisms running through intra-industry reallocations in a setting where trade/production structures, number of products available to consumers, and investments in firm entry are all endogenous and thus depend on fiscal policies.

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