

The role of local currency pricing in the international transmission effects of corporate tax reduction in an economy with vertical production linkage and foreign direct investment

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Abstract

By constructing a two-country model with asymmetry in price-setting behavior between home and foreign intermediate goods firms, vertical production and trade, and endogenous entry of three types of final goods firms, we examine the effects of a reduction in the corporate tax rate of the home country. In particular, we focus on the role of asymmetry in price-setting behavior between home and foreign intermediate goods firms. We show that a reduction in home corporate tax rate yields the entry of foreign multinational firms, the exit of home multinational firms, the improvement in home welfare, and the deterioration in foreign welfare. In addition, when the ratio of home and/or foreign intermediate goods firms that set their export prices in the local currency rises, we show that the above effects are weakened.

Keywords: Local currency pricing, Vertical production and trade, Firm entry, Foreign direct investment, Corporate tax reduction