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Tax Cuts in Open Economies

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Abstract

A reduction in income tax rates generates substantial dynamic responses within the framework of the standard neoclassical growth model. The short-run revenue loss after an income tax cut is partly – or, depending on parameter values, even completely – offset by growth in the long-run, due to the resulting incentives to further accumulate capital. We study how the dynamic response of government revenue to a tax cut changes if we allow a Ramsey economy to engage in international trade: the open economy's ability to reallocate resources between labor-intensive and capital-intensive industries reduces the negative effect of factor accumulation on factor returns, thus encouraging the economy to accumulate more than it would do under autarky. We explore the quantitative implications of this intuition for the US in terms of two issues recently treated in the literature: *dynamic scoring* and the *Laffer curve*. Our results demonstrate that international trade enhances the response of government revenue to tax cuts by a relevant amount. In our benchmark calibration, a reduction in the capital-income tax rate has virtually no effect on government revenue in steady state.

Keywords: international trade; Heckscher-Ohlin; dynamic macroeconomics, taxation, revenue estimation; Laffer curve

JEL Classification: E13, E60, F11, F43, H20

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1 Introduction

This paper studies the dynamic response of government revenues to income tax cuts in an environment in which countries can trade and specialize according to their comparative advantages. In particular, we construct a model in which two Ramsey economies specialize according to their factor abundance. We show that the long-run negative effect of a reduction in a country's capital-income tax rate on government revenues is much smaller than in the standard closed-economy Ramsey model.

The different behavior of the closed and open economies can be understood in terms of the different ways their sectorial factor allocation mechanisms work. A reduction in the capital-income tax rate raises the after-tax return to capital, thus creating an incentive to accumulate capital. Under autarky, an increase in the aggregate capital-labor ratio implies higher sectorial capital intensities; the diminishing marginal productivity of capital therefore reduces the return to capital and thereby the incentive to accumulate. In the open economy, instead, capital-labor intensities do not respond to increases in the aggregate capital-labor ratio that much, as resources are reallocated from labor-intensive to capital-intensive industries. This enables the open economy to accumulate capital without affecting the gross return to capital as much as under autarky. Obviously, this generates a stronger reaction of capital income to the initial tax cut, and therefore reduces the negative impact of the tax cut on government revenues.

To assess the quantitative relevance of this intuition, we calibrate our dynamic two-country model with the US and the rest of the world in mind, and compute the short-run and long-run responses of government revenue to tax cuts. We relate our results to two issues, dynamic scoring and the Laffer curve, that have been treated recently in the literature:

First, Mankiw and Weinzierl (2006) criticize the way the Congressional Budget Office and the Joint Committee on Taxation score the proposed legislation each time the US Congress considers tax policy changes: the way the revenue impact of tax changes is calculated is usually referred to as *static scoring*, because it ignores the feedback effect from tax changes to any macroeconomic variable.¹ Mankiw and Weinzierl (2006) take a firm stand in favor of *dynamic scoring*: they use a closed-economy Ramsey model to show that the short-run response of government revenues to tax-rate changes is always stronger than the long-run response.²

Second, in a more recent reference, Trabandt and Uhlig (2006) use the neoclassical growth model to characterize the shape of the Laffer curve in the US and Europe. They find that both the US and Europe are on the upward sloping side of the Laffer curve; however, they point out that Europe is quite close to the Laffer curve's 'slippery slope,' that is, its downward sloping side.

Regarding dynamic scoring, we find that our dynamic trade model generates a much larger response on the factor accumulation side to a tax cut than in the autarky model, as we discussed above.³ In our benchmark calibration, for example, a capital tax cut is able to finance itself in the long run, whereas the dynamic response to the tax cut in the autarky economy only compensates for 50% of the short-run revenue loss. As for the

¹It is static from a macroeconomic point of view only, because feedback effects from microdynamic behaviour are incorporated into the forecast. For details, see Auerbach (1996).

²Leeper and Yang (2006) point out that the results of Mankiw and Weinzierl (2006) are sensitive to their assumption on how government deficits are financed.

³In fairness to Mankiw and Weinzierl (2006), we should point out that they are aware of the open-economy model yielding a stronger dynamic effect. See section 3.6 in their paper.

Laffer curve, we find that the US reaches the “slippery side:” the actual average US tax rate on capital income is 27.3%, while the revenue-maximizing tax rate in our model, the peak of the Laffer curve, equals 26.7%. In contrast, under autarky, the peak of the Laffer curve occurs at a tax rate of 50.7%.

The main intuition of our paper is based on Ventura (1997), who shows, in the context of the neoclassical growth model, that the negative effect of capital accumulation on the return to capital is reduced by free trade. Although insightful and elegant, the Ventura model turns out not to be a very useful workhorse for performing a quantitative exercise of the kind we have in mind, since it yields international factor price equalization. First of all, this is obviously not a very realistic feature when contrasted with the data; secondly, the treatment of steady states in the presence of taxation becomes somewhat tricky, as the equalization of before-tax interest rates implies different after-tax interest rates if capital-income taxation differs across countries. Therefore, for our calibration exercise we produce a model based on Cuñat and Maffezzoli (2007), which is a dynamic generalization of Dornbusch et al. (1980). This set-up enables us to model Heckscher-Ohlin trade with trade frictions and therefore no factor price equalization (both important features in reality) in a rather straightforward way.⁴

The link between taxation and international trade is obviously not new. Whalley (1980) is a good example of a ‘Computable General Equilibrium’ model of taxation and international trade, which compares the welfare implications of tax policies under autarky and trade,⁵ while Epifani and Gancia (2007) studies the empirical relationship between international trade and the size of the government. In the realm of macroeconomics, Baxter (1992) shows that changes in taxation can affect cross-country specialization patterns within a dynamic model of Ricardian comparative advantage.⁶

The rest of the paper is structured as follows: section 2 lays out a rather general dynamic trade model; in section 3 we develop some intuition by working out a very particular case, while in section 4 we simulate a more realistic version of the model; section 5 checks the sensitivity and robustness of our results; finally, section 6 presents our concluding remarks.

2 The Model

This and the next two sections present the dynamic Heckscher-Ohlin model with which we study the dynamic effects of tax cuts. We first sketch out the main ingredients of the model economy; then solve for a particular case analytically; finally, we calibrate a more realistic, albeit less tractable, case.

⁴See Romalis (2004) for empirical evidence supporting this model’s predictions.

⁵See Shoven and Whalley (1984) for a survey of CGE models of taxation and international trade.

⁶The closed-economy literature on taxation in a dynamic set-up is obviously vast. We just mention here a couple of examples based on the endogenous-growth literature: (i) Bruce and Turnovsky (1999) present a dynamic scoring exercise with the main focus on the sustainability of the fiscal balance of the government. (ii) Novales and Ruiz (2002) use a numerically simulated endogenous growth model to compare the feasible pairs of tax rates on capital and labour from a welfare point of view, where feasibility is constrained by a minimal level of government consumption. It is worth mentioning also Backus et al. (2007), who study the empirical relationship between different measures of effective tax rates on capital and the cross-country dispersion of capital-labor ratios for a group of OECD countries.

2.1 The Representative Household's Problem

Countries, indexed by j , are populated each by a *continuum* of identical households that can be aggregated into a single representative household. The representative household owns the capital stock and supplies capital and labor services inelastically; and either consumes or invests a final good. Governments collect taxes on factors of production (with possibly different rates applied to capital K and labour L); government revenues are paid back to households via lump-sum transfers. The representative households' preferences over consumption streams can be summarized by the following intertemporal utility function:

$$U_j = \sum_{t=0}^T \beta^t \frac{C_{jt}^{1-\frac{1}{\mu}} - 1}{1 - \frac{1}{\mu}}, \quad (1)$$

where β is the subjective intertemporal discount factor, and μ the elasticity of intertemporal substitution. T denotes the representative household's time horizon; C denotes consumption of the final good. The representative households maximize equation (1) subject to the following intratemporal budget constraint

$$P_{jt} (C_{jt} + I_{jt}) = (1 - \tau_j^L) w_{jt} L_{jt} + (1 - \tau_j^K) r_{jt} K_{jt} + R_{jt}, \quad (2)$$

where P is the price of the final good; I denotes investment; r and w are factor prices; τ^L and τ^K are the tax rates on labor and capital, respectively; and

$$R_{jt} = \tau_j^L w_{jt} L_{jt} + \tau_j^K r_{jt} K_{jt} \quad (3)$$

denotes government transfers (we simplify by assuming a balanced government budget). Factor prices are taken as given by the representative household. The capital stocks evolve according to the following accumulation equation:

$$K_{jt+1} = (1 - \delta) K_{jt} + I_{jt}, \quad (4)$$

where $\delta \in [0, 1]$ is the depreciation rate.⁷ L_j is assumed constant. The first-order conditions

$$\beta C_{jt+1}^{-\frac{1}{\mu}} \left[(1 - \tau_j^K) \frac{r_{jt+1}}{P_{jt+1}} + 1 - \delta \right] = C_{jt}^{-\frac{1}{\mu}}, \quad (5)$$

$$K_{jt+1} = (1 - \tau_j^L) \frac{w_{jt}}{P_{jt}} L_{jt} + \left[(1 - \tau_j^K) \frac{r_{jt}}{P_{jt}} + 1 - \delta \right] K_{jt} + \frac{R_{jt}}{P_{jt}} - C_{jt}, \quad (6)$$

and the corresponding transversality condition are necessary and sufficient for the representative household's problem. A recursive competitive equilibrium for this economy is characterized by equations (5)-(6) together with the equations that determine prices in the "static" equilibrium, to be discussed below.

2.2 Equilibrium Prices

Capital and labor are assumed to be internationally immobile. In each period, prices are determined in a "static" equilibrium, where we consider both autarky and trade.⁸

⁷For the sake of notational simplicity, we ignore exogenous technical progress. This does not affect our results significantly.

⁸For convenience, in this section we avoid time subscripts on variables, which might vary over time.

2.2.1 The Final Good

The final good, which is assumed to be nontradable, is produced under perfect competition with a *continuum* of intermediate goods. The representative firm operating in the final good sector maximizes profits subject to a Cobb-Douglas production function, taking all prices as given:

$$\max_{\{x_j(z)\}} P_j Y_j - \int_0^1 p_j(z) x_j(z) dz \quad (7)$$

$$\text{s.t. } Y_j = \exp \left[\int_0^1 \ln x_j(z) dz \right], \quad (8)$$

where $x(z)$ denotes the quantity of intermediate good z used, and $p(z)$ the corresponding price. The demand for intermediate good z is given by

$$x_j(z) = \frac{P_j Y_j}{p_j(z)}, \quad (9)$$

where

$$P_j = \exp \left[\int_0^1 \ln p_j(z) dz \right]. \quad (10)$$

2.2.2 Intermediate Goods

Intermediate goods are produced also under perfect competition. The representative intermediate producer in industry z maximizes profits subject to a Cobb-Douglas production function taking all prices as given:

$$\max_{\{k_j(z), l_j(z)\}} p_j(z) y_j(z) - r_j k_j(z) - w_j l_j(z) \quad (11)$$

$$\text{s.t. } y_j(z) = \phi_j k_j(z)^{\alpha(z)} l_j(z)^{1-\alpha(z)}, \quad (12)$$

where $\alpha(z) \in [0, 1]$ denotes the capital share in industry z , $k(z)$ and $l(z)$ the capital and labor allocated to the production of intermediate good z , respectively, and ϕ_j is a time-invariant country-specific technology parameter. Capital-labor intensities are assumed to be increasing in z , *i.e.* $\alpha'(z) > 0$. Technologies are identical across countries, but for the exogenous factor-augmenting coefficients ϕ_j .

The unit-cost function associated to the dual of (11)-(12) is given by

$$b(z, \phi_j, r_j, w_j) = \frac{r_j^{\alpha(z)} w_j^{1-\alpha(z)}}{\phi_j a(z)}, \quad (13)$$

where $a(z) \equiv \alpha(z)^{\alpha(z)} [1 - \alpha(z)]^{1-\alpha(z)}$ is an industry-specific constant.

Intermediate goods can be traded. We model trade frictions as iceberg-type transport costs: $\nu \geq 1$ units of a good must be shipped from the country of origin for one unit to arrive to the country of destination. $\nu = 1$ therefore corresponds to free trade. A high enough ν yields autarky instead.

2.2.3 Autarky Equilibrium Prices

Assume that ν is such that intermediate goods are not traded. Choosing the final good as the numeraire, the autarky static equilibrium conditions (discussed in the appendix) yield the following equilibrium factor prices (before tax):

$$r_j = \phi_j A \left(\frac{1 - \tilde{\alpha}}{\tilde{\alpha}} \right)^{\tilde{\alpha}-1} \left(\frac{K_j}{L_j} \right)^{\tilde{\alpha}-1}, \quad (14)$$

$$w_j = \phi_j A \left(\frac{1 - \tilde{\alpha}}{\tilde{\alpha}} \right)^{\tilde{\alpha}} \left(\frac{K_j}{L_j} \right)^{\tilde{\alpha}}, \quad (15)$$

where $A \equiv \exp \left[\int_0^1 \ln a(z) dz \right]$, and

$$\tilde{\alpha} = \int_0^1 \alpha(z) dz \quad (16)$$

is the autarky economy's aggregate capital share.⁹

It is also easy to show that the allocation of labor to each sector is a constant fraction of the economy's total amount of labor:

$$l_j(z) = \frac{1 - \alpha(z)}{1 - \tilde{\alpha}} L_j. \quad (17)$$

Finally, sectorial capital-labor intensities move one-to-one with the economy's aggregate capital-labor ratio:

$$\frac{k_j(z)}{l_j(z)} = \frac{\alpha(z)}{1 - \alpha(z)} \frac{w_j}{r_j} = \frac{\alpha(z)}{1 - \alpha(z)} \frac{1 - \tilde{\alpha}}{\tilde{\alpha}} \frac{K_j}{L_j}. \quad (18)$$

2.2.4 Trade Equilibrium Prices

We consider two cases here: a free-trade scenario, in which factor prices are equalized across countries; and a more realistic scenario, in which trade frictions prevent the Law of One Price from holding. Below we use the free-trade case to produce an analytically solvable example providing some intuition; the case with trade frictions is used in the quantitative section of the paper.

Free Trade Assume $\nu = 1$. For simplicity, consider a worldwide factor price equalization (FPE) equilibrium, in which the world as a whole (the integrated equilibrium) works as the autarky economy described above. Provided that countries do not have capital-labor ratios that are “too different” from the world's aggregate capital-labor ratio, then they will not be completely specialized, and will have the integrated equilibrium's factor prices.¹⁰ This implies factor prices are independent of the country's own factor endowments. A direct implication of this is the independence of sectorial capital-labor intensities from the country's own capital-labor ratio.

⁹The autarky version of the model is equivalent to a one-sector Ramsey model with a Cobb-Douglas production technology of the form $Y_j = \phi_j A K_j^{\tilde{\alpha}} L_j^{1-\tilde{\alpha}}$; our closed-economy framework is thus comparable to similar papers in the literature.

¹⁰Below we make sure that the small open economy is in the FPE set.

Trade Frictions Assume there are two countries, North and South, indexed by $j = N, S$, respectively. We assume that the North is capital abundant, *i.e.* $K_N/L_N > K_S/L_S$, and therefore has a comparative advantage in the production of capital-intensive goods. Intermediate goods can be traded, but not freely: $\nu > 1$.¹¹ A trading equilibrium is characterized by two cut-off values $0 \leq z_N < z_S \leq 1$, that divide the range of intermediate goods into three subregions:

1. The intermediate goods $z \in [0, z_N)$ are exclusively produced in the South and shipped to the North.
2. The intermediate goods $z \in [z_N, z_S]$ are produced in both countries and nontraded. These commodities are not worth shipping from one country to another despite comparative advantage. This is due to the price wedge the trade cost introduces between countries.
3. The intermediate goods $z \in (z_S, 1]$ are exclusively produced in the North and shipped to the South.

The corresponding equilibrium conditions are discussed in the appendix. For further details, see Cuñat and Maffezzoli (2007).

3 A Simple Free-trade Case

Let us first address the free-trade case, which we can solve analytically. Assume $K_{j0} > 0$, $T = 1$, $\mu = 1$ (log-utility), $\delta = 0$, $\nu = 1$ (free trade), $\tau_j^L = 0$ and $\phi_j = 1$. We will use the final good as the numeraire: $P = 1$. Furthermore, for the sake of notational simplicity, we will drop time and country indexes, since they turn out to be redundant under the assumptions imposed in this Section. The Euler equation (5) can then be rewritten as:

$$\beta(Y_0 - I_0) [1 + (1 - \tau^K) r_1] = Y_1 + K_1, \quad (19)$$

where:

$$Y_0 = r_0 K_0 + w_0 L, \quad (20)$$

$$I_0 = K_1 - K_0. \quad (21)$$

The transversality condition associated to the representative household's maximization problem is simply $K_2 = 0$.

¹¹For the autarky equilibrium to be sustainable, *at autarky prices* transport costs must make it pointless to ship goods across countries. In other words, it has to be the case that

$$\begin{aligned} b(0, \phi_N, r_N, w_N) &\leq \nu b(0, \phi_S, r_S, w_S), \\ b(1, \phi_S, r_S, w_S) &\leq \nu b(1, \phi_N, r_N, w_N), \end{aligned}$$

where r_j and w_j are the autarky prices described above. This implies that, if $(w_N/r_N)/(w_S/r_S) = (K_N/L_N)/(K_S/L_S) \leq \nu^{\frac{2}{\alpha(1)-\alpha(0)}}$, autarky will take place. If, on the other hand, $(K_N/L_N)/(K_S/L_S) > \nu^{\frac{2}{\alpha(1)-\alpha(0)}}$, autarky will not be sustainable and countries will trade.

3.1 Autarky Economy

The Euler equation (19) implicitly solves for K_1 . We can now study the dynamic implications of changes in taxation (around this equilibrium). By the Implicit Function Theorem, we can compute the effect of changes in τ^K on capital accumulation:

$$\left. \frac{dK_1}{d\tau^K} \right|_A = \frac{-\beta r_1 (Y_0 - I_0)}{1 + r_1 + \beta \left\{ 1 + (1 - \tau^K) r_1 \left[\tilde{\alpha} + (1 - \tilde{\alpha}) \frac{Y_0 + K_0}{K_1} \right] \right\}} < 0, \quad (22)$$

as $Y_0 - I_0 > 0$. A fall in τ^K raises the after-tax return to capital, thus encouraging further capital accumulation.

The effect of τ^K on period-1 gross interest rate is also easy to compute:

$$\left. \frac{dr_1}{d\tau^K} \right|_A = \frac{dr_1}{dK_1} \left. \frac{dK_1}{d\tau^K} \right|_A = (\tilde{\alpha} - 1) A \left(\frac{1 - \tilde{\alpha}}{\tilde{\alpha}} \right)^{\tilde{\alpha}-1} \left(\frac{K_1}{L} \right)^{\tilde{\alpha}-2} \left. \frac{dK_1}{d\tau^K} \right|_A > 0. \quad (23)$$

For future reference, it will be useful to also compute

$$\left. \frac{dr_1/d\tau^K}{r_1} \right|_A = (\tilde{\alpha} - 1) \left. \frac{dK_1/d\tau^K}{K_1} \right|_A > 0. \quad (24)$$

The gross return to capital falls with the aggregate capital-labor ratio due to the diminishing marginal productivity of capital: from (18), it is easy to see that sectorial capital intensities rise with the economy's aggregate capital-labor ratio. Thus, the effect of a reduction in τ^K on government revenue has two opposing components: an increase in the capital stock, and a reduction in its gross return.

3.2 Small Open Economy

For simplicity, consider a factor price equalization (FPE) equilibrium, in which the world (the integrated equilibrium) has got a capital-labor ratio with a time path identical to that of the autarky economy above. Consider a small open economy that has got the same initial condition K_0 and parameter values as in the autarky equilibrium. Since this economy faces the same factor prices of the autarky economy, the Euler equation (19) must yield the same solution for K_1 as under autarky.¹²

Once again, by the Implicit Function Theorem, we can compute the effect of changes in τ^K on capital accumulation (around this equilibrium):

$$\left. \frac{dK_1}{d\tau^K} \right|_O = \frac{-\beta r_1 (Y_0 - I_0)}{1 + r_1 + \beta [1 + (1 - \tau^K) r_1]} < 0. \quad (25)$$

Comparing (22) and (25), it is easy to see that the effect of a tax cut on K_1 is larger under free trade than under autarky, as $Y_0 + K_0 > K_1$.¹³

$$\left| \left. \frac{dK_1}{d\tau^K} \right|_O \right| > \left| \left. \frac{dK_1}{d\tau^K} \right|_A \right|. \quad (26)$$

Since commodity prices are given for the small open economy,

$$\left. \frac{dr_1}{d\tau^K} \right|_O = 0. \quad (27)$$

¹²In the FPE jargon, our open economy is on the diagonal of the FPE set in both periods.

¹³The rest of variables and parameters in equations (22) and (25) are identical.

The different behavior of the closed and open economies can be understood as due to the different ways their factor allocation mechanisms work. A reduction in τ raises the after-tax return to capital in both economies, creating an incentive to raise K_1 . Under autarky, an increase in K_1 implies higher sectorial capital-labor intensities; the diminishing marginal productivity of capital thereby reduces the return to capital and, therefore, the incentive to accumulate. In the open economy, instead, capital-labor intensities do not respond to increases in the aggregate capital-labor ratio, and the marginal productivity of capital therefore does not fall: full employment of resources is achieved by a reallocation of resources from labor-intensive to capital-intensive industries. Openness to trade allows this reshuffling of the economy's production structure. This enables the open economy to accumulate capital without affecting the gross return to capital.¹⁴

3.3 Tax Revenues

Let us now compare the effect of a tax cut on government revenues, $R = \tau^K r K$, in the closed and open economy. Recall that the autarky and open economies have got the same R before the tax cut. Differentiating R_1 with respect to τ^K :

$$\frac{dR_1}{d\tau^K} = r_1 K_1 \left(1 + \tau^K \frac{dr_1/d\tau^K}{r_1} + \tau^K \frac{dK_1/d\tau^K}{K_1} \right), \quad (28)$$

or, in growth rates,

$$\frac{dR_1/d\tau^K}{R_1} = \frac{1}{\tau^K} + \frac{dr_1/d\tau^K}{r_1} + \frac{dK_1/d\tau^K}{K_1}. \quad (29)$$

Our results above on the responses of K_1 and r_1 to changes in τ^K imply that under free trade the tax cut is less costly for the government in terms of period-2 revenue than under autarky:

$$\begin{aligned} & \left. \frac{dR_1/d\tau^K}{R_1} \right|_A - \left. \frac{dR_1/d\tau^K}{R_1} \right|_O = \\ & = \tilde{\alpha} \left. \frac{dK_1/d\tau^K}{K_1} \right|_A - \left. \frac{dK_1/d\tau^K}{K_1} \right|_O > (\tilde{\alpha} - 1) \left. \frac{dK_1/d\tau^K}{K_1} \right|_A > 0. \end{aligned} \quad (30)$$

This example suggests that openness and autarky display non-trivial quantitative differences in the effects of taxation.

4 Trade with Frictions

Although intuitive, the simple case above is based on a quite unrealistic scenario: free trade, and therefore FPE, are hampered by trade frictions. One other “technical” problem of the dynamic FPE model is that its infinite-horizon case is not that straightforward: the steady-state condition equalizing the after-tax return to capital and the rate of time preference may not hold for all countries if they have got different tax rates, or if their tax rates change. This is due to the before-tax return to capital being equal across countries. This makes steady-state comparisons of the kind Mankiw and Weinzierl (2006) and Trabandt and Uhlig (2006) perform impossible, unless the rate of time preference is assumed endogenous. To study the quantitative aspects of the issue more in detail,

¹⁴See Ventura (1997).

therefore, we turn to the trade-frictions scenario we discussed in section 2. Below we discuss that the intuitions of both models, with and without frictions, are similar.

Assume $\nu > 1$ and $T = \infty$. It turns out to be convenient to choose a different numeraire this time: $p_S(0) = 1$. In the appendix we show that in order to remain in a steady state with trading equilibrium in which $K_N/L_N > K_S/L_S$, we need to impose that $(1 - \tau_N^K) \phi_N > (1 - \tau_S^K) \phi_S$.¹⁵ This assumption, together with the condition that equalizes the steady-state after-tax real rates of return across countries,

$$(1 - \tau_N^K) \frac{r_N}{P_N} = (1 - \tau_S^K) \frac{r_S}{P_S}, \quad (31)$$

enables us to solve the equilibrium conditions for the steady state of the model numerically. We characterize both the autarky and trading equilibrium in order to compare the dynamic feedback for the two different regimes.

4.1 Calibration

To perform our quantitative exercise, we calibrate our trade model in terms of the US (the capital-abundant North) vs. the Rest of the World (the labor-abundant South). The basic parametrization is taken from Cuñat and Maffezzoli (2007): we set $\mu = 1$, $\beta = 0.96$, and $\delta = 0.048$. We normalize the size of the world labor endowment setting $L_W \equiv L_N + L_S = 2$; according to data from Heston et al. (2006), roughly 5% of the global labor force is employed in the US economy: therefore, we set $L_N = 0.05L_W$.

Anderson and van Wincoop (2004) show that trade costs represent a 170% *ad-valorem*-tax-equivalent trade barrier for a representative rich country. This number breaks down into a 55% of local trade costs and a 74% of international trade costs. Abstracting away from local distribution costs, we assign the value of ν to represent the *ad valorem* equivalent of international trade costs, *i.e.* we set $\nu = 1.74$.

The capital intensity function $\alpha(z)$ is a key ingredient in our model; to parametrize it, we start by noting that, given the Cobb-Douglas production functions for intermediate goods, the capital intensity should be directly related to the capital shares in value added at the sectorial level. Taking advantage of the *Gross Domestic Product by Industry* published by the US Bureau of Economic Analysis, we collect data on Value Added (VA), Compensation of Employees (COMP), Proprietors' Income (PROINC), Proprietors' Income Inventory Valuation Adjustment (PROIVA), Full-time Equivalent Employees (FTE), and Persons Engaged in Production (PEP), for 56 US sectors, defined according to the SIC87 classification, over the 1987-97 period.¹⁶ These data allow us to compute

¹⁵We are simply imposing the condition that, for identical capital-labor ratios in both countries, the after-tax marginal productivity of capital be larger in country N . If, for example, $\beta_N = \beta_S$, $\phi_N = \phi_S$, and $\tau_N^K = \tau_S^K$, both countries would have the same capital-labor ratio in steady state, and there would be no trade. Note that we introduce cross-country differences in TFP levels only to guarantee the existence of international trade in steady state: the actual trade flows are generated by the induced differences in relative factor endowments. Hence, if TFP levels were equal across countries, trade could nonetheless emerge during converge towards the steady state. A large literature on cross-country comparison of TFP levels, summarized in Caselli Caselli (2005), provides empirical evidence that supporting the existence of international differences in TFP levels.

¹⁶We drop the government sector and the housing sector, because by construction they include respectively only labor and capital income. See Gomme and Rupert (2004) for a discussion. Furthermore, and for similar reasons, we drop Educational services, Social services, Private households, and Membership organizations. See the appendix for a full list of the sectors included.

the labor share in value added at the sectorial level. We follow the two most common approaches in the literature to account for the labor income of self employed workers.¹⁷ The first approach assigns the average wage perceived by employees to self-employed workers, and therefore our first estimate of the labor share is computed as

$$s_N = \frac{\frac{COMP}{FTE} PEP}{VA}. \quad (32)$$

The second approach recognizes that the main problem is the apportionment of proprietors' income, which has components of both labor and capital income, since it mainly represents income of self-employed individuals. We assume that proprietors income, net of inventory valuation adjustment, should be allocated to labor and capital in the same proportions they represent in the remainder of the economy. In other words, our second estimate of the labor share is computed as

$$s_N = \frac{COMP}{VA - PROINC - PROIVA}. \quad (33)$$

These two estimates turn out to be highly positively correlated (with a coefficient around 0.96); however, some relevant differences, in particular for labor-intensive sectors, remain. Since both are rough approximations of the true labor share, and both probably capture some distinct aspects of reality, we take the average of these two alternative estimates as our benchmark distribution. The capital share in value added is simply computed as one minus the labor share. Finally, we order the sectors according to their capital share and get the desired monotonically increasing cross-sector distribution of capital intensity. We approximate the latter with an algebraic polynomial of order 6, fitted using ordinary least squares.

In a closed-economy environment, this would be the end of the story; however, under trade, there is still a further important step. In our numerical experiment, the North, *i.e.* the US economy, is assumed to be the capital-abundant country. Hence, the distribution of capital shares actually observed in the US should correspond to the right-hand tail of the true distribution, *i.e.* the $[z_N, 1]$ interval in our notation. In other words, by focusing on the US sectorial data, we may get an estimate of the highest capital intensity, but not, under trade, an estimate of the lowest one. To bypass this problem, we use the previously fitted polynomial to extrapolate on the left-hand side of the distribution until we hit the horizontal axis, assuming implicitly that the lowest possible capital share is zero. Finally, the domain of this “extended” distribution is mapped into the $[0, 1]$ interval. Figure 1 plots the actual US distribution and the fitted polynomial.¹⁸ The fitted polynomial is then used in our simulations.

Carey and Rabesona (2002) compute average effective tax rates on factors of production and consumption for 25 OECD countries, extending the Mendoza et al. (1994) methodology: from their Table A2, p. 172, we take the tax rates on capital (based on

¹⁷See Gomme and Rupert (2004) for a recent discussion of the issues at stake, and Cooley and Prescott (1995) for a classical reference.

¹⁸In autarky, these values imply an aggregate capital share equal to 0.34, which is close to the 0.33 used in Mankiw and Weinzierl (2006) and the 0.36 used in Trabandt and Uhlig (2006). In the trading equilibrium, these values—together with the calibrated values of the productivity parameters—imply a capital share of 0.37 in the North and 0.33 in the South. Furthermore, the steady-state value of z_N in our model economy reaches 0.037, a value almost identical to its empirical counterpart, as obtained in our calibration procedure, equal to 0.034.

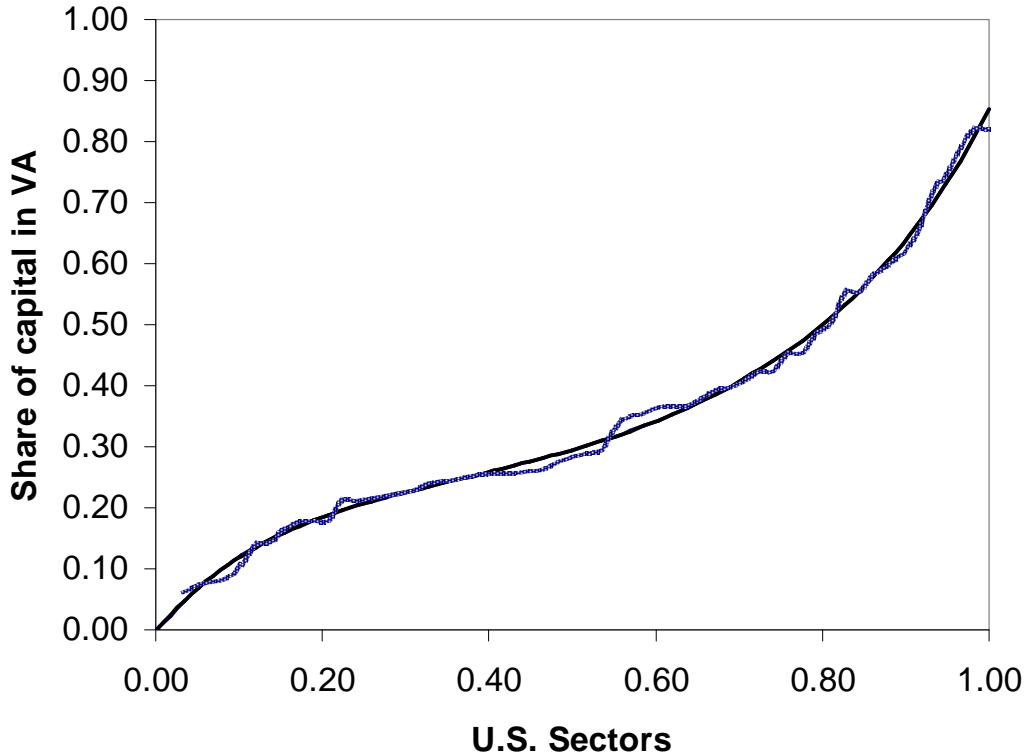


Figure 1: The sectorial distribution of capital shares in VA in the US (1987-1997).

gross operating surplus) and labor for the 1990-2000 period.¹⁹ We set the tax rates in the North to reproduce the observed US rates, *i.e.* $\tau_N^K = 27.3\%$ and $\tau_N^L = 23.4\%$; to pin down the tax rates in the South, instead, we compute weighted averages of the tax rates on capital and labor for the remaining countries, using the real GDP-PPP levels reported by Heston et al. (2006) for the 1990-2000 period as weights: the resulting values are $\tau_S^K = 28.0\%$ and $\tau_S^L = 30.5\%$.²⁰

We are left with the country-specific productivity parameters, ϕ_j ; to pin their values down, we (*i*) normalize the world capital stock setting $K_W \equiv K_N + K_S = 2$, and (*ii*) calibrate the model to reproduce the observed ratio between the capital-labor ratio in the US and the capital-labor ratio in a Rest-of-the-World aggregate, averaged over the 1990-2000 period, equal to 4.9.²¹ The implied values are $\phi_N = 0.778$ and $\phi_S = 0.306$.

¹⁹As Carey and Rabesona (2002) point out, the fiscal treatment of depreciation allowances is different across countries, making tax rates based on net operating surplus difficult to compare across countries.

²⁰We found no reliable data source for tax rates outside the OECD. Note that our results do not stem from differences in fiscal policy across countries: they do not change qualitatively - and even quantitatively only slightly - if we use the same tax structure in both countries for our model.

²¹We collect data from Heston et al. (2006) for 140 countries over the 1950-2003 period on population (pop), real GDP per capita (rgdpl and rgdpc9), real GDP per worker (rgdpwok), and real investment as a share of GDP (ki). Following Caselli (2005), we construct estimates for the net physical capital stock using the Perpetual Inventory Method; we assume infinite service lives and a constant geometric depreciation rate equal to 6% for all countries. The capital-labor ratio is computed as the ratio between our estimate of the capital stock and the labor force. Finally, the RoW aggregate is just computed as the total capital stock in the world, but for the US, over the total labor force, again excluding the US. To check the robustness of these results, we produced alternative estimates assuming fixed expected service

As already noted before, $(1 - \tau_N^K) \phi_N > (1 - \tau_N^K) \phi_S$ implies $K_N/L_N > K_S/L_S$, so that trade may arise in steady state. The trade share in income (imports plus exports over GDP) generated by our benchmark calibration reaches 7.3%, which is far below the actual overall trade share of the US (21% on average over the 1990-2000 period), but near the US share in income of trade with developing countries (8.7%),²² a group of countries for which US trade is likely to be explained to a great extent by differences in relative factor endowments. The fact that our model generates less trade than the observed is not so surprising, as we ignore Ricardian comparative advantage and “New-Trade Theory” features such as product differentiation and scale economies.

The recursive structure of our problem guarantees that the solution can be represented as a couple of time-invariant policy functions expressing the optimal level of consumption in each country as a function of the two state variables, K_N and K_S . These policy functions have to satisfy the following functional equations:

$$\beta C_j (K'_N, K'_S)^{-\frac{1}{\mu}} [(1 - \tau_j^K) r'_j/P'_j + 1 - \delta] = C_j (K_N, K_S)^{-\frac{1}{\mu}}, \quad (34)$$

where:

$$K'_j = (1 - \tau_j^L) \frac{w_j}{P_j} L_j + \left[(1 - \tau_j^K) \frac{r_j}{P_j} + 1 - \delta \right] K_j + \frac{R_j}{P_j} - C_j (K_N, K_S) \quad (35)$$

The real prices w_j/P_j and r_j/P_j are obtained by numerically solving the appropriate equilibrium conditions. To solve equations (34) numerically, we apply the Orthogonal Collocation projection method described in Judd (1992).

4.2 Results

4.2.1 Dynamic Scoring

This section studies the dynamic effects of an unexpected and permanent one-percentage-point reduction in the tax rate on capital income in the North, which in our experiment has been calibrated to reproduce the US economy. Figure 2 summarizes the impulse response of the main macroeconomic variables to such a tax cut. We plot income, capital, consumption, together with the trade share in income, under both trade and autarky for comparison purposes. All variables are expressed in real terms and as percent deviations from their initial steady-state value. The left-hand panels report results for the North, while the right-hand panels report the corresponding results for the South.

A capital-income tax cut in the North seems beneficial in terms of higher income and consumption in steady state, under both autarky and trade. Notice, however, that from a quantitative point of view the long-run effect under trade is more than twice larger than under autarky. As already noted, this is due to the different ways the factor allocation mechanisms work under the two regimes. A reduction in τ_N^K raises the after-tax return to capital in the North, creating an incentive to accumulate capital. Under autarky, capital accumulation implies higher sectorial capital-labor intensities: given diminishing marginal returns, this reduces the return to capital and the incentive to accumulate. In

lives (20 years), simultaneous exit mortality patterns, and linear depreciation, as in Maffezzoli (2006): the outcomes are almost identical.

²²We collect data from the UNCTAD Handbook of Statistics - *International merchandise trade by region* on US trade with developing countries over the 1990-2000 time period. A detailed list of the countries involved can be found on www.unctad.org.

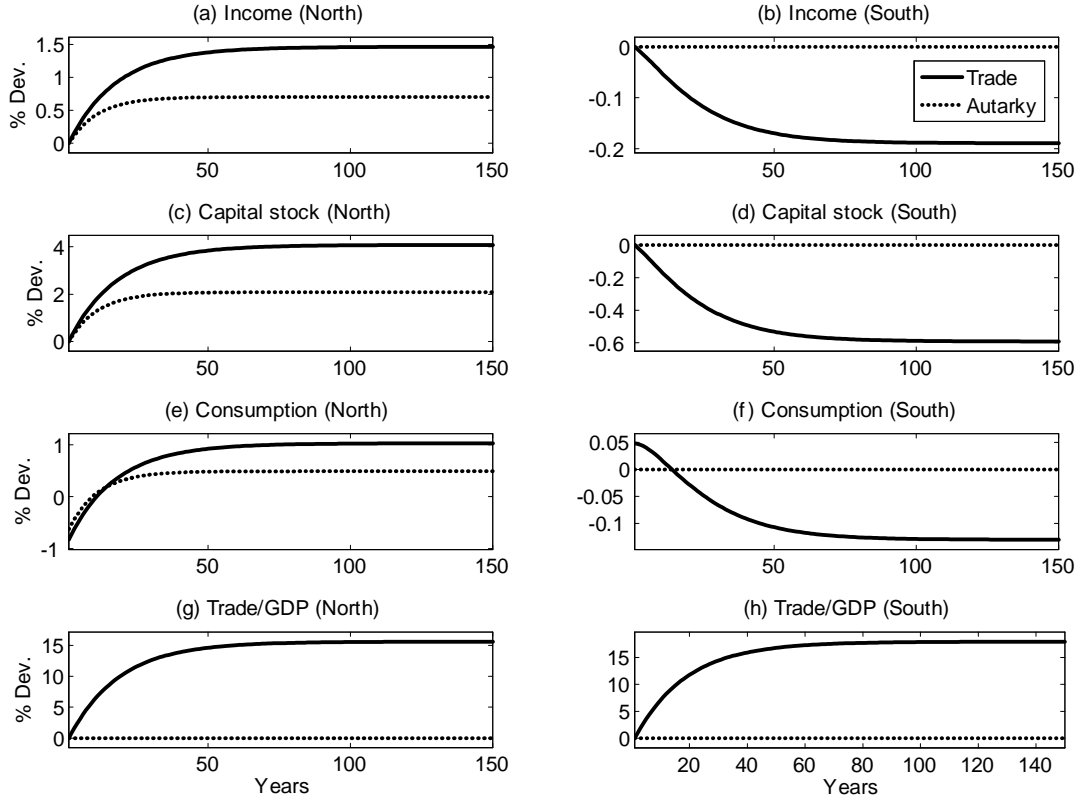


Figure 2: The effects of a capital tax cut in the North: main aggregate variables.

the trade model with transport costs, instead, an increase in K_N/L_N leads to an increase in z_N .²³ This enables the North to accommodate part of the increase in its aggregate capital-labor ratio not through a rise in sectorial capital-labor intensities, $k(z)/l(z)$, but by reshuffling resources from industries with low relative demand for capital (over labor) towards industries with high relative demand for capital. This enables the open economy to accumulate more capital, since the effect of capital accumulation on the gross return to capital is much smaller than under autarky.

In autarky, the South remains completely unaffected by tax cuts in the North. Under trade, however, factor prices in the South are influenced by the North's tax cut: the resulting increase in K_N/L_N not only raises z_N , but also reduces z_S . The South therefore reallocates factors from its most capital intensive industries to more labor intensive industries. This brings about a reduction in the South's return to capital: while the North accumulates capital, the opposite takes place in the South. The latter starts to eat up its capital stock, and ends up in steady state with lower capital, output, and consumption. This process further enhances its comparative advantage in labor intensive goods, and spurs an increase in international trade. These results suggest that fiscal policy decisions may have some spillover effects via international trade, and that the ongoing integration process may further enhance these effects in the future.

²³The change in z_N is proportional to the change in the North's trade share: the value of North's imports is

$$\int_0^{z_N} p_N(z) x_N(z) dz = z_N P_N Y_N.$$

Thus, the North's trade share is $2z_N$.

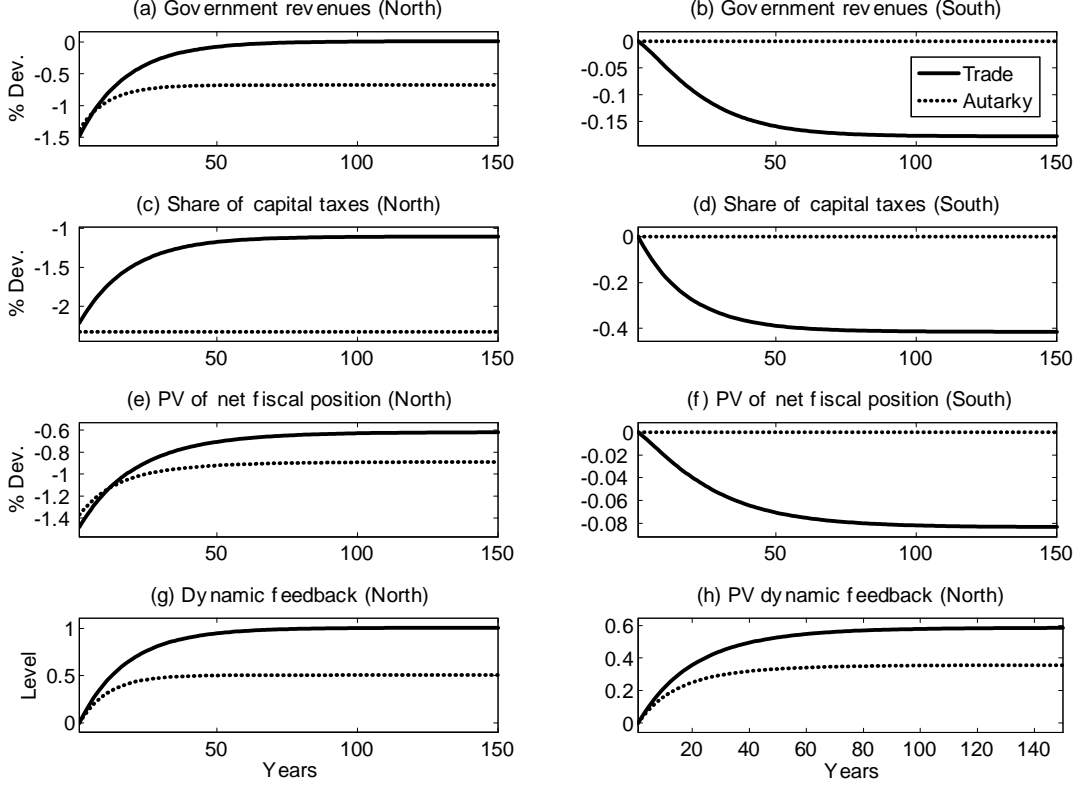


Figure 3: The effects of a capital tax cut in the North: government balances.

Figure 3 summarizes the dynamic response of government balances along the transitional path. Panels (a) and (b) (as before, North on the left-hand side and South on the right-hand side) plot the adjustment path for government revenues, while panels (c) and (d) report the share of capital taxes in government revenues; both variables are expressed in percentage deviation from their initial steady-state value. Panels (e) and (f) show the present-value *net fiscal position* of the government at different time horizons, defined as

$$\frac{\sum_{s=0}^t \rho_{js} \Delta R_{js}}{\sum_{s=0}^t \rho_{js} R_{j,-1}}$$

where ρ_{jt} is the discount factor along the transitional path. This variable shows the amount of resources the government should borrow or lend, in terms of the present discounted value of its initial revenue plan $R_{j,-1}$, to keep the level of its revenues at the same level as before the tax-cut. If its value is positive, then the tax cut pays for itself as the government could lend some of its revenues and still keep its ‘expenditure’ at their original level.²⁴

Panel (g) plots the *dynamic feedback*, which measures over time the extent to which a tax cut is self-financing in levels. Let us define the *static effect* of a tax cut as the revenue loss induced by the tax cut under the assumption that none of the variables adjust: hence, the static loss always equals to the change in the tax rate times the initial tax base. The share of the static effect which is dynamically offset by factor accumulation can be calculated as $(\Delta R_{jt} - \Delta \bar{R}_j) / |\Delta \bar{R}_j|$, where $\Delta \bar{R}_j$ denotes the static effect. If the tax cut is more than self-financing, then the change in government revenues is positive

²⁴The discount rate corresponds to the rental rate on capital net of taxes and depreciation.

Time	Gov. revenues			Net fiscal position		
	Autarky	Trade		Autarky	Trade	
	Both	North	South	Both	North	South
	<i>Elasticities</i>					
Impact	-0.37	-0.40	0.00	-0.37	-0.40	0.00
5	-0.31	-0.32	-0.00	-0.34	-0.36	-0.00
10	-0.26	-0.24	-0.01	-0.31	-0.32	-0.01
25	-0.20	-0.10	-0.03	-0.27	-0.24	-0.01
∞	-0.18	0.00	-0.05	-0.24	-0.17	-0.02
	<i>Dynamic feedbacks</i>					
Impact	0.00	0.00		0.00	0.00	
5	0.17	0.21		0.09	0.11	
10	0.30	0.42		0.16	0.21	
25	0.46	0.76		0.28	0.40	
∞	0.51	1.01		0.36	0.59	

Table 1: Dynamic feedbacks after a capital tax cut in the North

and the dynamic feedback is larger than one; if the tax cut is only partially self-financing, then the change in government revenues is negative but larger (smaller in absolute value) than the static effect and the dynamic feedback lies between zero and one. Panel (h) plots the present-value dynamic feedback, which shows the extent to which a tax cut is self financing in present discounted values and is computed as

$$\frac{\sum_{s=0}^t \rho_{js} \Delta R_{js} - \sum_{s=0}^t \rho_{j0} \Delta \bar{R}_j}{\sum_{s=0}^t \rho_{j0} |\Delta \bar{R}_j|}, \quad (36)$$

where ρ_{j0} is the discount factor at the initial steady-state. The value of the present value feedback has the same interpretation as the dynamic feedback: if the tax cut is self-financing, then it is more than one; if the tax cut is partially self-financing, then it is between zero and one.

Table 1 summarizes the dynamic response of government revenues and the net fiscal position, for the North and the South, and under autarky and trade. The upper part of the table reports the elasticities of both variables with respect to changes in τ_N^K , while the lower part reports the dynamic feedbacks, as defined above.

In the North, the tax cut impacts negatively government revenues under both autarky and trade. Actually, this negative impact turns out to be slightly larger under trade, since the elasticity on impact equals -0.37 under autarky and -0.40 under trade: this is a direct consequence of the North's higher steady-state capital-labor ratio in the trading equilibrium. In the South, the tax cut that took place in the other country has no effect on impact, but under trade has a significantly negative and permanent effect on government revenues in the long run. In both countries, these effects stem from the different adjustment paths for capital: enhanced capital accumulation in the North, the reverse process in the South. Note that this mechanism explains why in the North the actual decrease in government revenues in the long run is definitively smaller under trade than under autarky: in the former case, government revenues almost converge back to the initial steady-state value.

The role of capital accumulation is clearly reflected in Figure 3, panels (c) and (d): the share of capital taxes in total tax revenues increases steadily in the North and decreases

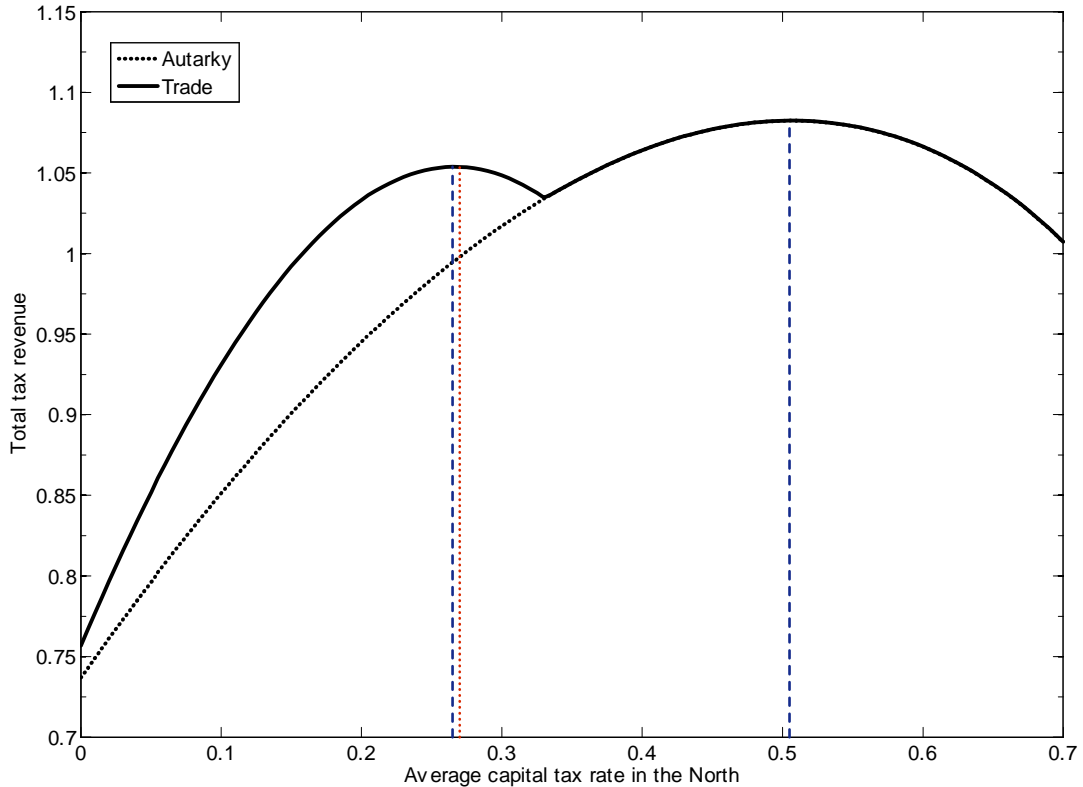


Figure 4: The Laffer curve in the North.

in the South. Panels (e) and (f) show that, if we focus on the net financial position, the government in the North is clearly better off under trade, while exactly the opposite happens in the South. Finally, panels (g) and (h), and the lower part of Table 1, effectively summarize these results in terms of dynamic feedbacks: under autarky, the dynamic feedback in the North converges in the long run to 51%, a value comparable to the findings of Mankiw and Weinzierl (2006); under trade, the long-run value of the corresponding dynamic feedback converges to 101%. This implies that, in the (very) long run, a capital tax cut does not decrease government revenues in the North; on the contrary, it actually improves them slightly. Of course, given that this effect relies on capital accumulation and therefore needs time to build up, the results are less dramatic, but still relevant, if we turn our attention to the present-value dynamic feedback.

4.2.2 The Laffer Curve

Dynamic scoring studies how tax cuts affect government revenues in the long run and along the transitional path to the new steady state. A closely related approach studies the relationship between steady-state total tax revenues and different tax rates on capital and labor, typically represented by the Laffer curve. Figure 4 plots the Laffer curve in the North resulting from our model: it plots steady-state total tax revenues as a function of the average tax rate on capital, *ceteris paribus*.

There are two features of the Laffer curve that are worth mentioning. First of all, note that the Laffer curve under trade lies always above, or at least corresponds to, the Laffer curve under autarky. This is of course a direct consequence of specialization: the North will specialize in the production of capital-intensive goods, and this will induce further

Parameter value	Trade share	Dynamic feedback in steady state		Revenue max. tax rate
		Gov. rev.	Net. fiscal pos.	
<i>Distribution of capital shares, $\alpha(z)$</i>				
No extrapolation	5.5%	1.02	0.59	26.4%
Benchmark	7.3%	1.01	0.59	26.7%
Two-sided extrap.	11.6%	1.10	0.60	25.5%
<i>Trade cost, ν</i>				
1.70	10.7%	0.98	0.57	27.2%
1.74	7.3%	1.01	0.59	26.7%
1.79	3.3%	1.05	0.61	26.1%

Table 2: Sensitivity analysis: capital intensities and trade costs.

capital accumulation and therefore generate a higher capital stock in steady state. The return has to be the same, in steady state, under both trade regimes, and therefore the overall revenues from capital taxes will be higher. Furthermore, even tax returns from labor taxes will be higher: the labor supply is fixed, but wages will be higher due to the higher capital stock and openness. Hence, total tax revenues have to be higher under trade.

Secondly, if the tax rate on capital is higher than 33.1%, then - *ceteris paribus* again - the trade equilibrium “collapses” into autarky. As the North’s tax rate on capital income rises, the North’s steady-state capital-labor ratio decreases relative to the that of the South. Thus, for a high enough τ_N^K (above 33.1%), transport costs make trade not profitable. Hence, for higher tax rates the Laffer curves under autarky and trade coincide. As a result, the Laffer curve becomes twin-peaked: the slope is positive initially, becomes negative, turns suddenly positive again and then finally turns negative.

The three dotted vertical lines denote - from the left to the right - the revenue maximizing tax rate under trade (26.7%), the benchmark tax rate used for calibration (27.3%), and the revenue maximizing tax rate under autarky (50.7%). Note that taking the consequences of trade into account has strong implications as far as fiscal policy is concerned: under trade, the actual marginal tax rate in the US, as measured by Carey and Rabesona (2002), turns out to be slightly larger than the revenue-maximizing rate, and therefore reaches the “slippery side” of the curve. In autarky, instead, the actual tax rate remains quite far from the peak.

5 Sensitivity Analysis

5.1 The Distribution of Capital Shares

Our calibration procedure parameterizes the $\alpha(z)$ distribution using empirical evidence on the US sectorial structure and taking the implications of our theoretical trade model literally. Two alternative procedures, based on the same data, may seem natural. The first one consists in fitting our polynomial on the actual US distribution of capital intensities without extrapolating the left-hand tail. This is more conservative from an empirical perspective, but not so faithful to our theory, as we attribute the sectorial shares of the interval $(z_N, 1]$ to the whole interval $[0, 1]$. Our second alternative takes our argument to the extreme, and extrapolates the capital intensity distribution not only on the left-hand

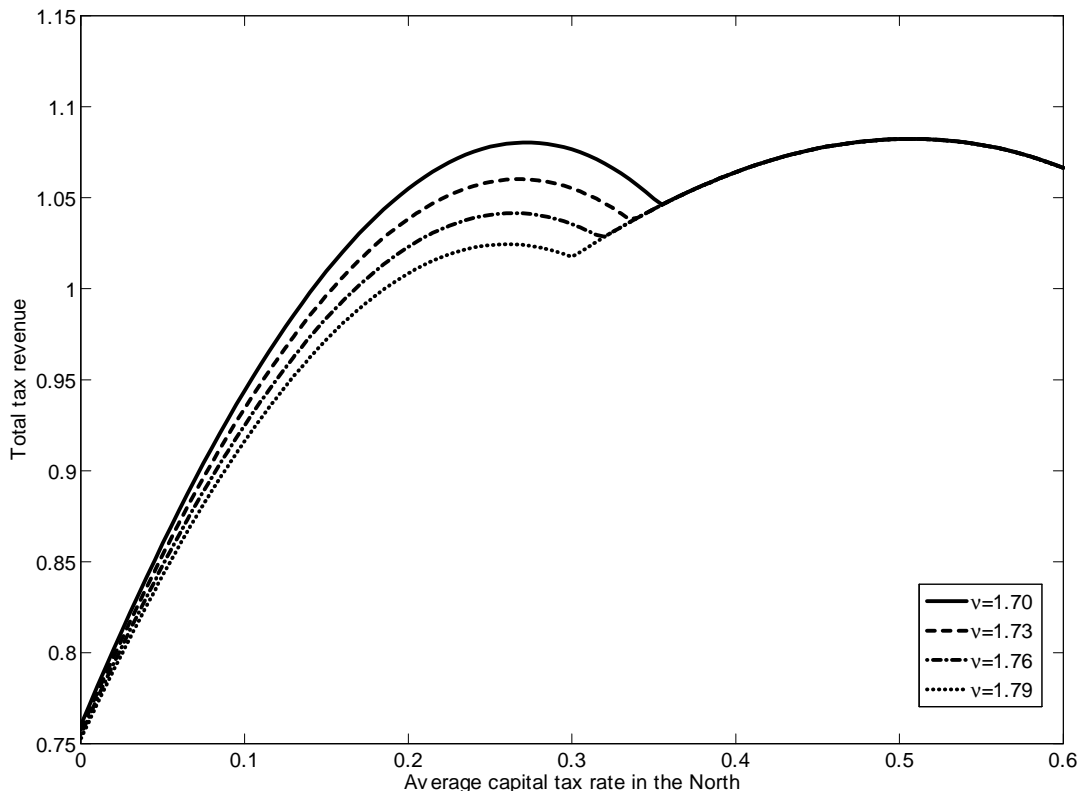


Figure 5: The Northern Laffer curve for different degrees of trade integration.

side, but also on the right-hand one, in order to span the full range of possible capital intensities $[0, 1]$. This second approach could be justified by noting that the level of disaggregation of the available sectorial data is quite coarse, and some of the highest (and lowest) capital shares could have simply been hidden by the aggregation process.

The first panel of Table 2 summarizes the main results for the three parameterizations discussed above. Notice that the cross-sector dispersion of capital intensities has an obvious effect on trade: the more disperse the distribution, the more room for taking advantage of comparative advantage and therefore more trade. More importantly, both alternative procedures generate results that are in line with the outcome of the benchmark parametrization. We do not graph the corresponding Laffer curves, as they are all very similar.

5.2 Trade Costs

The degree of openness, summarized by the trade cost ν , is another key feature in our framework. Figure 5 plots the Laffer curve in the North for four different values of the trade cost (*ceteris paribus*). These generate trade shares in GDP ranging from 50% to 150% of our benchmark's trade share. A lower trade cost boosts trade and specialization and therefore capital accumulation in the North. This makes the Laffer curve expand upwards and to the right, shifting the revenue-maximizing tax rate to the right.

The implications for our results, as summarized in the second panel of Table 2, are straightforward: for the given actual US tax rate, equal to 27.3%, an increase in the degree of openness will reduce the steady-state feedback effect under trade, for both government revenues and the net fiscal position. Furthermore, it will reduce the distance between the

Elast. inter. substitution	Dynamic feedback in steady state	Dynamic feedback Half life	
		<i>Gov. rev.</i>	<i>Net fiscal pos.</i>
μ	<i>Net fiscal position</i>		
0.80	0.55	14	16
1.00	0.59	12	14
1.20	0.62	11	14

Table 3: Alternative elasticities of intertemporal substitution.

actual tax rate and the revenue maximizing tax rate, bringing the North possibly back to the upward sloping side of the Laffer curve.²⁵

5.3 The Elasticity of Intertemporal Substitution

The elasticity of intertemporal substitution is key in determining the speed of capital accumulation, and therefore the speed of convergence towards the steady state. Table 3 summarizes our main results for some alternative values of μ that lie symmetrically around our benchmark value. Almost all variables of interest remain unaltered, except for the dynamic feedback for the net fiscal position. The speed of convergence as measured by the half life - the number of periods needed to cover half their way to the new steady state - increases slightly with μ , as expected.

6 Concluding Remarks

Opening the neoclassical growth model to trade changes its quantitative implications regarding the effects of taxation in a rather stark way. Given the shrinking size of the US economy relative to the world, and its relatively high degree of openness, our set-up seems to be a better workhorse for understanding the effects of tax policies than the standard closed-economy Ramsey model. At the same time, ours is still an incomplete model, as we ignore sources of comparative advantage other than capital abundance and, perhaps more importantly, “new-trade” theory features explaining intraindustry trade. This is left for future work.

For simplicity, we have assumed away international capital mobility, which is an important issue in the area of taxation. Notice, however, that allowing for capital mobility would not change the model’s steady-state results. If anything, it would make the model’s results stronger over the transition to the steady state, as the country reducing the capital-income tax rate would attract capital inflows from the rest of the world: this would yield even stronger dynamic feedback measures.

An issue that usually arises in connection with international capital mobility is that of international tax competition. The effects on the South of a tax cut in the North are not dramatic in our benchmark calibration, but suggest that the South might have an incentive to “retaliate.” We also leave this topic for future work, as our model is not well equipped to address the behavior of welfare-optimizing governments: one would need a

²⁵Note that, for $\nu = 1.7$, the actual and the revenue-maximizing tax rates reported in Table 2 almost coincide, and therefore the one-percentage-point tax cut we are examining takes the economy to the upward sloping side of the Laffer curve, since the dynamic feedback is less than unity. If the tax rate is reduced by a marginal amount, and therefore the economy remains on the “slippery” side, the dynamic feedback would remain (marginally) larger than one.

less simplistic government side, in which government expenditure raises the representative consumer's utility (or enhances productivity in the production function) and there is thus a trade-off to an income tax cut between the utility loss from lower government expenditure and the efficiency gain from lower taxation.

Another issue regarding government behavior that we have ignored is the treatment of government deficits. Since we were mainly interested in a comparison between autarky and trade, we do not think our balanced budget assumption is that misleading, and leave this issue as well as part of our research agenda.

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A Appendix: Equilibrium Conditions

A.1 Autarky Equilibrium Conditions

1. Commodity prices:

$$P_j = \exp \left[\int_0^1 \ln p_j(z) dz \right] = 1, \quad (37)$$

$$p_j(z) = b(z, \phi_j, r_j, w_j) = [\phi_j a(z)]^{-1} r_j^{\alpha(z)} w_j^{1-\alpha(z)}. \quad (38)$$

2. Goods market clearing:

$$y_j(z) = x_j(z) = \frac{P_j Y_j}{p_j(z)}, \quad (39)$$

where $P_j Y_j = r_j K_j + w_j L_j$.

3. Factor market clearing:

$$\int_0^1 \frac{\partial b(z, \phi_j, r_j, w_j)}{\partial r} y_j(z) dz = K_j, \quad (40)$$

$$\int_0^1 \frac{\partial b(z, \phi_j, r_j, w_j)}{\partial w} y_j(z) dz = L_j. \quad (41)$$

A.2 Trade Equilibrium in the Presence of Frictions

A.2.1 Equilibrium Conditions

1. Commodity prices: For $z \in [0, z_N)$,

$$p_N(z) = \nu p_S(z) = \nu b(z, \phi_S, r_S, w_S). \quad (42)$$

For $z \in [z_N, z_S]$,

$$p_j(z) = b(z, \phi_j, r_j, w_j). \quad (43)$$

For $z \in (z_S, 1]$,

$$p_S(z) = \nu p_N(z) = \nu b(z, \phi_N, r_N, w_N). \quad (44)$$

2. Goods market clearing: For $z \in [0, z_N)$,

$$y_N(z) = 0 \quad y_S(z) = x_S(z) + \nu x_N(z). \quad (45)$$

For $z \in [z_N, z_S]$,

$$y_j(z) = x_j(z). \quad (46)$$

For $z \in (z_S, 1]$,

$$y_S(z) = 0 \quad y_N(z) = \nu x_S(z) + x_N(z). \quad (47)$$

3. Factor market clearing:

$$\int_{z_N}^1 \frac{\partial b(z, \phi_N, r_N, w_N)}{\partial r} y_N(z) dz = K_N, \quad (48)$$

$$\int_{z_N}^1 \frac{\partial b(z, \phi_N, r_N, w_N)}{\partial w} y_N(z) dz = L_N, \quad (49)$$

$$\int_0^{z_S} \frac{\partial b(z, \phi_S, r_S, w_S)}{\partial r} y_S(z) dz = K_S, \quad (50)$$

$$\int_0^{z_S} \frac{\partial b(z, \phi_S, r_S, w_S)}{\partial w} y_S(z) dz = L_S, \quad (51)$$

4. Marginal commodity conditions:

$$b(z_j, \phi_j, r_j, w_j) = \nu b(z_j, \phi_{-j}, r_{-j}, w_{-j}). \quad (52)$$

5. The numeraire:

$$p_S(0) = 1. \quad (53)$$

B Appendix: Steady State with Trade

This appendix establishes the condition under which we can have a steady state with trade in which countries N and S produce ranges $[z_N, 1]$ and $[0, z_S]$, respectively. Given that the two countries have got the same discount factor and depreciation rate, in steady state,

$$(1 - \tau_N^K) \frac{r_N}{P_N} = (1 - \tau_N^K) \frac{r_S}{P_S}. \quad (54)$$

We need to make this equation compatible with the equilibrium conditions discussed above.

The price indices P_N and P_S can be expressed as

$$\begin{aligned} P_N &= \exp \left[\int_0^{z_N} \ln [\nu b_S(z)] dz + \int_{z_N}^1 \ln [b_N(z)] dz \right] = \\ &= \nu^{z_N} \exp \left[- \int_0^1 \ln [a(z)] dz - z_N \ln \phi_S - (1 - z_N) \ln \phi_N + \right. \\ &+ \int_0^{z_N} \alpha(z) dz \ln r_S + \int_0^{z_N} [1 - \alpha(z)] dz \ln w_S + \\ &\left. + \int_{z_N}^1 \alpha(z) dz \ln r_N + \int_{z_N}^1 [1 - \alpha(z)] dz \ln w_N \right], \end{aligned} \quad (55)$$

$$\begin{aligned} P_S &= \exp \left[\int_0^{z_S} \ln [b_S(z)] dz + \int_{z_S}^1 \ln [\nu b_N(z)] dz \right] = \\ &= \nu^{1-z_S} \exp \left[- \int_0^1 \ln [a(z)] dz - z_S \ln \phi_S - (1 - z_S) \ln \phi_N + \right. \\ &+ \int_0^{z_S} \alpha(z) dz \ln r_S + \int_0^{z_S} [1 - \alpha(z)] dz \ln w_S + \\ &\left. + \int_{z_S}^1 \alpha(z) dz \ln r_N + \int_{z_S}^1 [1 - \alpha(z)] dz \ln w_N \right]. \end{aligned} \quad (56)$$

From (52), the marginal commodities z_S and z_N must satisfy

$$b_S(z_S) = \nu b_N(z_S), \quad (57)$$

$$\nu b_S(z_N) = b_N(z_N), \quad (58)$$

respectively. From (57) and (58),

$$\frac{w_N}{w_S} = \nu^{\frac{2}{\alpha(z_S) - \alpha(z_N)}} \left(\frac{r_N}{r_S} \right). \quad (59)$$

From (57),

$$\frac{r_N}{r_S} = \left[\nu^{-1} \frac{\phi_N}{\phi_S} \left(\frac{w_N}{w_S} \right)^{\alpha(z_S) - 1} \right]^{\frac{1}{\alpha(z_S)}}. \quad (60)$$

From (59) and (60),

$$\frac{r_N}{r_S} = \nu^{\frac{2[\alpha(z_S) - 1]}{\alpha(z_S) - \alpha(z_N)} - 1} \frac{\phi_N}{\phi_S}. \quad (61)$$

From (54), (55), (56), (59), and (61),

$$\frac{\phi_N (1 - \tau_N^K)}{\phi_S (1 - \tau_S^K)} = \nu^x > 1, \quad (62)$$

where

$$\chi = 2 \left[z_N + \frac{(z_S - z_N) \alpha(z_S) - \int_{z_N}^{z_S} \alpha(z) dz + 1 - \alpha(z_S)}{\alpha(z_S) - \alpha(z_N)} \right] > 0. \quad (63)$$

Thus, we need $\phi_N (1 - \tau_N^K) > \phi_S (1 - \tau_S^K)$.

C Appendix: List of Sectors

Farms; Agricultural services, forestry, and fishing; Metal mining; Coal mining; Oil and gas extraction; Nonmetallic minerals, except fuels; Construction; Lumber and wood products; Furniture and fixtures; Stone, clay, and glass products; Primary metal industries; Fabricated metal products; Machinery, except electrical; Electric and electronic equipment; Motor vehicles and equipment; Other transportation equipment; Instruments and related products; Miscellaneous manufacturing industries; Food and kindred products; Tobacco products; Textile mill products; Apparel and other textile products; Paper and allied products; Printing and publishing; Chemicals and allied products; Petroleum and coal products; Rubber and miscellaneous plastics products; Leather and leather products; Railroad transportation; Local and interurban passenger transit; Trucking and warehousing; Water transportation; Transportation by air; Pipelines, except natural gas; Transportation services; Telephone and telegraph; Radio and television; Electric, gas, and sanitary services; Wholesale trade; Retail trade; Banking; Credit agencies other than banks; Security and commodity brokers; Insurance carriers; Insurance agents, brokers, and service; Other real estate; Holding and other investment offices; Hotels and other lodging places; Personal services; Business services; Auto repair, services, and parking; Miscellaneous repair services; Motion pictures; Amusement and recreation services; Health services; Legal services; Miscellaneous professional services.

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