

Optimal Tariff with Heterogeneous Firms, Variable Markups and Tariff-jumping FDI*

Ziran Ding[†]

University of Washington

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Abstract

Variable markups and multinational production have gathered considerable attention in the trade literature, both because of their empirical prevalence and their welfare implication. In this paper, I study the optimal tariff in the presence of variable markups and foreign direct investment. I then identify conditions under which protectionist trade policy, by changing the distribution of markups, and by inducing tariff-jumping FDI, may affect welfare. Three policy implications stand out from the analysis. First, if the initial protection level is sufficiently high, an increase in home's tariff will increase the number of tariff-jumping foreign multinationals and decrease the number of foreign exporters, driving down the average markup in the home market, and creating a pro-competitive effect. Second, whether zero tariff is socially optimal depends on consumer's preference. Third, the promotion of FDI can reduce the non-cooperative tariff through a novel channel: reducing the misallocation in the economy.

Keywords: Optimal tariff, Firm heterogeneity, Misallocation, Variable markup, Foreign direct investment

JEL Codes: F12, F13, F23, F60, R13

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[†]Address: Department of Economics, University of Washington, Savery Hall, Box 353330, Seattle, WA 98195-3330. Email: econjosh@uw.edu.