Subsidy competition, imperfect labor markets, and the endogenous entry of firms

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Abstract

This paper constructs a model of subsidy competition for manufacturing firms under labor market imperfection. Because subsidies affect the distribution of firms, they influence unemployment rates, the number of firms, and welfare. In our model, governments always provide inefficiently high subsidy rates to manufacturing firms. When labor market friction is high, subsidy competition is beneficial, although subsidies under subsidy competition are inefficiently high. We show that an increase in labor market friction always lowers welfare, while trade liberalization always improves welfare. Finally, we find that a rise in labor market friction in a country raises the equilibrium subsidy rate, affects unemployment rates, and lowers welfare.