Labour policy and multinational firms: the "race to the bottom" revisited

Anindya Bhattacharya[*]   Debapriya Sen[†]

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Abstract

This paper revisits the "race to the bottom" phenomenon in a simple game the-oretic framework. We consider two countries and one multinational firm, which requires two inputs that are imperfect substitutes. In the benchmark model the labour of each country specializes in a distinct input. Seeking to maximize their labour incomes, countries simultaneously announce wages following which the firm chooses its labour employment in each country. We show that "race to the bottom" (countries setting minimum possible wages) is never an equilibrium. Moreover there are equilibria with "race to the top", that is, countries set max-imum possible wages. This result is robust in an extended model where prior to competing in wages, each country can make input-specific investments to make its labour available for one or both inputs. Provided the production function of the firm is not asymmetrically intensive in either one of the two inputs, there are equilibria of the extended game with specialization (that is, countries invest in distinct inputs) as well as "race to the top".

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[*]Department of Economics, University of York, York, UK.

[†]Corresponding author. Department of Economics, Ryerson University, Toronto, ON, Canada.

1   Introduction

The phenomenon of competitive dilution of labour standards—"race to the bottom"—
by the governments of developing countries[1] for attracting multinational corporate
economic activities to one's country, especially for direct investment, is a crucial current
issue in the political economy of such countries. An editorial piece in the Economic
and Political Weekly (2014) provides a succinct description of the phenomenon:

> "The strategy is basically one of global labour arbitrage, which is a means
> whereby transnational business earns a higher rate of profit by shifting
> production to businesses in countries of the global South to take advantage
> of the significant wage difference...In the process, the countries of the South
> are driven to engage in a "race to the bottom" in order to emerge globally
> competitive as far as unit labour cost is concerned."

In this paper we revisit the phenomenon of "race to the bottom" in a simple game
theoretic framework to explore whether drastic strategic undercutting of labour's bar-
gaining power, as reflected in the expected wage labourers can get, is an *inevitable*
outcome of strategic competition between policymakers of different countries.

While anecdotal descriptions of "race to the bottom" in labour standards or wages
are quite common (see, again, EPW, 2014), concrete identification of the phenomenon
often proved elusive (see Singh and Zammit, 2004; Potrafke, 2013). Recently Davies
and Vadlamannati (2013) and Olney (2013) have provided empirical evidence in favour
of such phenomena.

There has been consideration of whether "race to the bottom" is inevitable and some
channels through which this can be endogenously counteracted have been identified.
Of course, generating externality of increased demand through increased wages is one
well-known channel. This prevalent theme of development economics has been studied
again by Caraballo Cueto (2017) in the context of labour standards. In the context
of tax competition, Baldwin and Krugman (2004) analyze how agglomeration effect
can counteract "race to the bottom". Dorsch et al. (2014) see how pressure of getting
re-elected in a democracy may induce a government to adopt ways to woo foreign
investments other than lowering labour standards. Our research is along this line: that
of identifying factors which can endogenously counteract this phenomenon.

Toward this end, we consider two countries and one multinational firm, which
requires two labour inputs. We model the strategic behaviour of two countries as a
two-player game with simultaneous moves where the action of each country is to choose
a wage for its labourers (or a labour policy that might generate such a price as the

expected wage). The payoffs to the players are determined by the production decision of the multinational firm that is a monopsonist availing the labour inputs provided by these countries which may be substitutes but not *perfect* substitutes. Using the properties of supermodular games (see Milgrom and Roberts, 1990), we show that this game has a unique Nash equilibrium in pure strategies. Exploring the properties of this equilibrium, we find that "race to the bottom" (countries setting minimum possible wages) never emerges as an equilibrium outcome while the complete opposite—"race to the top" (countries setting maximum possible wages)—is possible for a range of relevant parameters of our model.

We extend this benchmark model to incorporate the feature that at the very first stage, both countries have to decide simultaneously whether to make an input-specific fixed investment with the assumption that if such an investment is undertaken for a specific input, only then the country gets that input available for selling to the monopsonist. We show that provided the production function of the firm is not asymmetrically intensive in either one of the two inputs, in this augmented multi-stage game there are subgame perfect equilibria at which there is specialization as well as "race to the top", that is, each country specializes in getting an input different from the other and then sets the maximum possible wage for that labour-input.

Our work is motivated by the following simple observations. Race to the bottom in labour markets is akin to Bertrand competition: competitive undercutting of prices to increase demand for one's product. However, the possibility of relaxing such competition in presence of product differentiation is well-known (from onwards at least Shaked and Sutton, 1982). A multinational corporation (MNC) often organizes production in more than one country for intermediate products to create its final product which is sold all over the world. This implies that for such an MNC, inputs obtainable in different countries may not be *perfect* substitutes although near-perfect substitution is still possible. As an example one might think of a car manufacturer obtaining mineral ore or processed metal from one country and having the assembly line in another country; in the first country it may obtain labour experienced in mining activities and in the second the labour skilled in works related to a modern automobile industry. We explore the implication of such production processes involving imperfectly substitutable labour inputs.

To model the imperfect substitutability of the inputs in the MNC's production process, we adopt one usual approach of taking its production function to be of the constant elasticity of substitution (CES) type. Then we analyze the policy-setting game played by the two countries (as outlined above and described in detail in the

next section). We look at the properties of pure strategy Nash equilibria as parameters in this benchmark model—especially the elasticity of substitution—change. However, our focus is on ascertaining whether "race to the bottom" is feasible (and we find the answer to be negative) and on identifying situations for which the completely opposite phenomenon, "race to the top", rather, is possible. Next we study the extended model focusing on the possibility of "race to the top" when countries first decide about making specific labour inputs being available in the country.

There have been discussions on the channels through which foreign direct investment may *better* rights of the labourers in developing countries (see Mosley and Uno, 2007, especially pp.925-926 for a review they made on this issue). However, the channels identified were rather non-central and exogenous to the central choice problems of the firms and the governments. In contrast, the channel through which "race to the top" emerges in our model is through the core strategic choices in presence of imperfect substitutability of the factors of production. Moreover, while analyses of MNC's decisions of input choices are profuse (see the survey by Antras and Yeaple, 2014; also see Sly and Soderbery, 2014, whose work is close to the theme of this paper), our finding of the possibility of "race to the top" even when inputs are substitutes seems novel. We would like to mention here that in a recent paper Fukumura and Yamagishi (2020) have explored the possibility of "race to the top" in a model of minimum wage competition. However, our set-up is quite different, in fact somewhat opposite: in their model labour is partially mobile whereas in our model, as is natural in our context, labour is confined to its own country or geographical location.

The main ingredients of our setup and the benchmark model is described and analyzed in the following section. Section 3 gives the analysis of the extended model. Section 4 provides some concluding remarks. Most proofs are collected in the Appendix.

2   The benchmark model

There are two countries a, b. There is a multinational firm that requires two different labour inputs $1, 2$ to carry out production of a final commodity which we take as the numeraire. The two inputs are imperfect substitutes. Let x_1, x_2 be the amount of inputs $1, 2$. The firm has a constant elasticity of substitution (CES) production function (Arrow et al., 1961) given by

$$F(x_1, x_2) = \left[\alpha x_1^{-\rho} + (1 - \alpha)x_2^{-\rho}\right]^{-1/\rho} \tag{1}$$

where $0 < \alpha < 1$ and $\rho \in (-1, 0) \cup (0, \infty)$, i.e., $\rho > -1$ and $\rho \neq 0$. As we assume that the product is the numeraire which is sold in the rest of the world, the function F is called the firm's profit function.[2]

Let w_1, w_2 represent the wages for inputs $1, 2$ which the firm has to pay. For any input i, the firm can purchase any quantity of that input from either of the countries, at the wages available in that country if the input is indeed available in the country. However, for both the inputs, the firm has an outside option for getting the input. For any input, the outside option has a unit wage $\overline{w}$. This outside option could be to use labour input from a location that has a high prevailing wage. For instance, such a location can be an industrialized country that is the origin of the multinational firm.

Assume that the firm has a fixed amount of capital $K > 0$ that it uses to pay for the inputs. The budget constraint of the firm is given by

$$w_1 x_1 + w_2 x_2 = K \tag{2}$$

For any $w_1, w_2 > 0$, the firm's constrained profit maximization problem (to maximize (1) subject to (2)) has a unique solution $(x_1^*(w_1, w_2), x_2^*(w_1, w_2))$. Let $\pi(w_1, w_2, K) = F(x_1^*, x_2^*)$ be the maximized value of the profit of the firm.

The total labour population in country $j \in \{a, b\}$ is denoted by $\overline{x}^j$. It is assumed that $\overline{x}^a, \overline{x}^b$ are sufficiently large so that for the firm's problem, the labour constraint is never binding. If the labour of a country is available as an input for the firm, then the government or the policymaker of that country sets a fixed wage for that input. At that wage, the firm may employ any labour for that input. Any labour that is not employed by the firm gets the reservation wage prevailing in that country.

Notice that it is not necessary that the government in each country has to *actually* administer a fixed wage. Think of a more realistic scenario that the labourers in each country and the management of the firm get into a bilateral conflict over the wages to be paid and where the probability of either of these conflicting entities winning depends on the labour policy adopted by the government. Then the wage set up by the government can be thought of as the expected price to be paid to the labourers of that country in the face of this possible conflict. However, in what follows, we shall adopt the simple convention as if the government in each country administers its wage for each labour input that the firm can employ in that country and then offers this wage to the firm.

2.1 The benchmark model: further ingredients

In the benchmark model we consider the case where each country specializes in *one* (and only one) of the inputs. Specifically we assume country a specializes in input 1 and country b in input 2. Therefore, for the remainder of this section, we simply denote $x_a = x_1$ and $x_b = x_2$. Likewise, the wages for the inputs are denoted simply by w_a, w_b.

The strategic interaction is modeled as a simultaneous-move game G where two countries simultaneously set wages (or, as we remarked above, equivalently, set policies resulting in effective wages) w_a, w_b. Note that if w_i exceeds $\overline{w}$ (wage at firm's outside option), the firm will not employ any labour from country i. So there is no loss of generality in restricting $w_a, w_b \leq \overline{w}$. Given any such wage pair (w_a, w_b), the firm employs $x_i^*(w_a, w_b)$ units of labour from[3] country i. Let $\psi_i^M(w_a, w_b, K) = w_i x_i^*$ be the labour income accruing from the firm in country i. Any labour unit that is not employed by the firm earns the reservation wage $\underline{w}^i$ of country i (for example, by working in a traditional sector). So the income for the labour that is not employed by the firm is $\psi_i^T(w_a, w_b, K) = \underline{w}^i(\overline{x}^i - x_i^*)$. Consequently the total labour income in country i is

$$\psi_i(w_a, w_b, K) = \psi_i^M(w_a, w_b, K) + \psi_i^T(w_a, w_b, K) = (w_i - \underline{w}^i)x_i^* + \underline{w}^i\overline{x}^i \tag{3}$$

For any (w_a, w_b), the payoff of the policymaker in each country is its total labour income given by (3).

Certain specific features of the set-up are notable. First, we focus on the labour policy and extract away from other general equilibrium features of international trade: e.g., in our model the firm presumably sells its output in a third country. Next, we endow the firm with maximum market power. Also, we allow substitutability of inputs for the firm apart from the single-point of *perfect* substitutability.

Note that the two distinct types of reservation wages are relevant to two distinct entities: while $\overline{w}$ is relevant as the outside option for the multinational firm, $\underline{w}^i$ is relevant for the policymaker of country i. We asssume that the reservation wage in each country is lower than the outside option wage of the multinational:

$$0 < \underline{w}^i < \overline{w} \text{ for } i \in \{a, b\}. \tag{4}$$

So there is no loss of generality in taking $w_i \in [\underline{w}^i, \overline{w}]$.

Lemma 1 *The following hold for $i, j \in \{a, b\}$ and $i \neq j$.*

(i) x_i^* *is decreasing in w_i.*

(ii) x_i^* *is increasing in w_j if $\rho \in (-1, 0)$ and decreasing in w_j if $\rho \in (0, \infty)$.*

(iii) π *is decreasing in* w_i.

(iv) ψ_i^M *is decreasing in* w_i *if* $\rho \in (-1, 0)$ *and increasing in* w_i *if* $\rho \in (0, \infty)$.

Proof See the Appendix. ∎

We look for *Nash Equilibria in pure strategies* (abbreviated simply as NE) for the game G. In particular, we are interested in whether the equilibria show strategic undercutting or otherwise. Therefore, we introduce the following definitions.

Definitions An NE of G has

(i) *race to the bottom* property if $w_i = \underline{w}^i$ for some $i \in \{a, b\}$;

(ii) *complete race to the bottom* property if $w_i = \underline{w}^i$ for both $i \in \{a, b\}$;

(iii) *race to the top* property if $w_i = \overline{w}$ for some $i \in \{a, b\}$;

(iv) *complete race to the top* property if $w_i = \overline{w}$ for both $i \in \{a, b\}$.

2.2 The equilibria in the benchmark model

Proposition 1 below characterizes best responses of the players in G and shows that G has a unique NE. It also identifies some initial properties of the NE.

Proposition 1 (I) *The best responses of countries in the game G have the following properties where* $i, j \in \{a, b\}$ *and* $i \neq j$.

   (i) *If* $\rho \in (-1, 0)$, *then for any* $w_j \in [\underline{w}^j, \overline{w}]$, *country i has a unique best response* $B_i(w_j)$. *The best response function B_i is non-decreasing in w_j and* $B_i(w_j) > \underline{w}^i$ *for any* $w_j \in [\underline{w}^j, \overline{w}]$.

   (ii) *If* $\rho \in (0, \infty)$, *then for any* $w_j \in [\underline{w}, \overline{w}]$, *country i has a unique best response* $\overline{w}$.

(II) *The game G has a unique NE. The NE has the following properties.*

   (i) *If* $\rho \in (-1, 0)$, *then at the NE,* $w_i > \underline{w}^i$ *for* $i \in \{a, b\}$, *i.e., the NE does not have the race to the bottom property.*

   (ii) *If* $\rho \in (0, \infty)$, *then the NE has the complete race to the top property.*

(III) *The NE value of w_i is non-decreasing in* $\underline{w}^i$ *for* $i \in \{a, b\}$.

Proof See the Appendix. ∎

Since the case where $\rho \in (0, \infty)$ is immediately clear, next we get on to the case where $\rho \in (-1, 0)$ and identify the property of the equilibrium as the parameters affecting demands vary.

Proposition 2 *Consider the game G. Let $\rho \in (-1, 0)$ and $\delta \equiv -\rho \in (0, 1)$. Let $\tau_a \equiv \alpha$, $\tau_b \equiv 1 - \alpha$ and for $i, j \in \{a, b\}$, $i \neq j$, define*

$$\widetilde{\delta_i} \equiv \delta/[1 + (1 - \delta)(\tau_i/\tau_j)^{1/(1-\delta)}] \in (0, \delta) \tag{5}$$

(i) (**not race to the top**) *If $\underline{w}^i < \widetilde{\delta_i}\overline{w}$ for both $i \in \{a, b\}$, then at the NE, $w_i < \overline{w}$ for both i.*

(ii) (**complete race to the top**) *If $\underline{w}^i \geq \widetilde{\delta_i}\overline{w}$ for both $i \in \{a, b\}$, then the NE has complete race to the top property.*

(iii) (**partial race to the top**) *If $\underline{w}^i < \widetilde{\delta_i}\overline{w}$ and $\underline{w}^j \geq \delta\overline{w}$ for $i, j \in \{a, b\}$, $i \neq j$, then at the NE, $w_i < \overline{w}$ and $w_j = \overline{w}$.*

(iv) *If $\underline{w}^i < \widetilde{\delta_i}\overline{w}$ and $\widetilde{\delta_j}\overline{w} \leq \underline{w}^j < \delta\overline{w}$ for $i, j \in \{a, b\}$, $i \neq j$, then the NE either has not race to the top or shows partial race to the top.*

Proof See the Appendix. ∎

The economics behind Proposition 2 seems as follows. At an equilibrium $(\overline{w}, \overline{w})$ if a country reduces wage, then indeed the demand for its labour goes up. However, if the substitution of labour in its favour, driven by the parameters controlling the firm's demand for labour is low enough in magnitude, then the total labour income resulting from such a unilateral lowering of wage, may, however, go down owing to the lowering of the wage. Moreover, as the reservation wage in the country goes up, the volume of incremental labour income of the labour units shifting from the reservation sector to the monopsonist would also be low enough. Therefore, as $\underline{w}^i$ increases or as the degree of plausible substitution of labour goes down, the propensity of "race to the top" being an equilibrium phenomenon goes up.

The most interesting aspect of our results is the possibility of having an equilibrium with "race to the top"—opposite to "race to the bottom"—even when $\rho \in (-1, 0)$, that is, even when the labour inputs can be said to be substitutes in production. To better understand this aspect in a simpler but useful setting, we consider the case where the two countries have the same reservation wages[4] and explore whether we can provide a bound on ρ for which the equilibrium possesses this property.

Let $\underline{w}^a = \underline{w}^b = \underline{w} < \overline{w}$, $\theta \equiv \underline{w}/\overline{w} \in (0,1)$, $m \equiv \min\{\alpha/(1-\alpha), (1-\alpha)/\alpha\} \in (0,1]$ and $\delta \equiv -\rho \in (0,1)$. Denote

$$\gamma_m(\delta) := \delta/[1 + (1-\delta)m^{1/(1-\delta)}] \tag{6}$$

By (5), $\gamma_m(\delta) = \max\{\widetilde{\delta}_a, \widetilde{\delta}_b\}$. Taking $\underline{w}^a = \underline{w}^b = \underline{w}$ in Proposition 2, it follows that the NE of G has complete race to the top property if and only if $\underline{w} \geq \gamma_m(\delta)\overline{w}$ (that is, $\gamma_m(\delta) \leq \theta$). Since $\gamma_m(\delta) < \delta$, in particular if $\delta \leq \theta$, then there is complete race to the top. The next proposition identifies the values of δ for which there is race to the top.

Proposition 3 *Suppose $\underline{w}^a = \underline{w}^b = \underline{w} < \overline{w}$ and $\rho \in (-1,0)$. Let $\delta \equiv -\rho$, $\theta \equiv \underline{w}/\overline{w}$ and $m \equiv min\{\alpha/(1-\alpha), (1-\alpha)/\alpha\}$.*

(i) *There is $\delta^*(m,\theta) \in (\theta, 1)$ (which is increasing in both m, θ) such that the NE of G has complete race to the top property if and only if $\delta \leq \delta^*(m,\theta)$.*

(ii) *For any $0 < m < 1$, there is $\hat{\delta}(m,\theta) > \delta^*(m,\theta)$ (where $\hat{\delta}(m,\theta) = (m+1)\theta/(m+\theta)$) such that if $\delta^*(m,\theta) < \delta \leq \hat{\delta}(m,\theta)$, then the NE of G has partial race to the top property.*

Proof See the Appendix. ∎

Proposition 3 shows when the two countries have the same reservation wage and $\rho \in (-1,0)$ (so $\delta = -\rho \in (0,1)$), there is an upper bound δ^* such that the necessary and sufficient condition to have complete race to the top in wages is that δ must not exceed that bound. If δ exceeds that bound but not by much, race to the top does not disappear; there is partial instead of complete race to the top. Also note that the threshold δ^* is increasing in $\theta = \underline{w}/\overline{w}$. This means given the outside option $\overline{w}$ of the multinational, as the common reservation wage $\underline{w}$ increases, there are more values of δ that can sustain complete race to the top. A similar conclusion holds with some qualification when the countries are not symmetric in terms of their reservation wages. If both countries have relatively high reservation wages, there is complete race to the top (Proposition 2(ii)). If one country has a relatively low reservation wage, the other country can still have the maximum wage in equilibrium, but for that to happen its reservation wage has to be even higher than the previous case ($\underline{w}^j \geq \delta\overline{w} > \widetilde{\delta}_j\overline{w}$, Proposition 2(iii)).

2.3 Some remarks

We conclude this section with some remarks on the benchmark model.

Remark 1 Taking the two labour inputs to be two goods that are imperfect substitutes, the multinational can be viewed as a representative consumer with a CES utility function (1) and budget constraint (2). The game G can then be viewed as a duopoly in which countries a, b compete in prices w_1, w_2 and obtain profits given by (3) (where $\underline{w}^a, \underline{w}^b$ are effectively their constant marginal costs). With this interpretation, our model is equivalent to a variant of a Bertrand duopoly with differentiated products. Therefore, this exercise can also be seen as a contribution to the literature on oligopoly pricing without invoking any connection to the economics of developing countries. Analyses of price-setting duopoly with differentiated products (with consumer utility function being of linear-quadratic form) are available (see, e.g., Zanchettin, 2006). However, we consider our framing of the model to be helpful in throwing light in analyzing inter-country competition for getting multinational investments. Moreover, the feature of "race to the top" in equilibrium choice seems novel.

Remark 2 Our specification of payoff for the countries—consisting of labour income only—is crucial for our result. Generally, the payoff of the policymaker in each country can be a weighted sum of the firm's profit and its total labour income as follows:

$$\Pi_a(w_a, w_b) = \lambda_a \pi(w_a, w_b, K) + (1 - \lambda_a)\psi_a(w_a, w_b, K)$$

$$\Pi_b(w_a, w_b) = \lambda_b \pi(w_a, w_b, K) + (1 - \lambda_b)\psi_b(w_a, w_b, K) \tag{7}$$

where $\lambda_a, \lambda_b \in [0, 1]$ and $\lambda_a + \lambda_b < 1$. The interpretation of this general payoff function would be that a country's policymaker, a priori, may have two kinds of incentives. It can get a share of the firm's profit which may be thought of a pecuniary gain of it or bribe paid to it by the firm. However, the policymaker may also have some incentive for increasing the labourers' income (perhaps so that it does not get too unpopular). Note that for each country, the payoff function (7) is a welfare-weighted sum and it is distinct from its national income (which might, within this framework, be considered as a sum of the total labour income, any profit taxed, any externality generated by the operation of the firm within the country etc.).

By Lemma 1, π is decreasing in w_i. It follows from (7) that in the general case if λ_i (the weight put by the policymaker of country i to the profit of the firm) can be made large enough, then it would be optimal for the policymaker of country i to push the effective wages down and thus, "race to the bottom" may re-appear as an equilibrium outcome. Looking at the case $\lambda_a = \lambda_b = 0$ enables us to concentrate on the issue of endogenous counteracting of "race to the bottom" and to explore the rather counter-intuitive possibility of the "race to the top".

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3 An extension: endogenous specialization

The benchmark model assumed that each of the two countries is endowed with one distinct country-specific labour input. In this section we drop this assumption and extend the model by making the choices of specialization endogenous. In the extended model, to make a specific labour input available in a country the government or the policymaker of that country has to carry out an initial input-specific investment. This investment can be conceptualized as a training program which enriches the input-specific human capital of the labour force or it can correspond to the fixed cost associated with building an infrastructure. Specifically, we assume that a country has to make investment $c > 0$ for every input, so that it has to invest $2c$ if it wishes that both kinds of labour inputs are available within the country.

Note that thematically the analysis following our assumption of input-specific investment is quite close to analyzing price competition in a differentiated duopoly following a quantity precommitment. There is a literature that has looked at this problem with quadratic utility functions (e.g., Yin and Ng, 1997; 2000). However, our focus is a little different. First, we do not concentrate on the precise quantity of capacity creation: we assume that once the specific investment for an input is made in a country, any labour unit of that country can be used for that input. Further, our goal is to verify whether the equilibrium behaviours of wage-setting as observed in the benchmark model—especially the "race to the top" behaviour—continue even when the countries make the decision to generate the inputs at a prior stage.

The strategic interaction in this extended framework is modeled as the extensive-form game Γ. In stage 1 of Γ, the two countries simultaneously decide to make one of the following investment choices: (i) invest only for input 1 by incurring cost c (choice 1), (ii) invest only for input 2 by incurring cost c (choice 2), (iii) make investment for both inputs by incurring cost $2c$ (choice 12) and (iv) invest for none of the inputs (choice 0). The investment choices become commonly known at the end of stage 1. In stage 2, countries simultaneously announce wages for inputs in which they have made investment. For $j \in \{a, b\}$ and $i \in \{1, 2\}$, if country j has invested in only input i, it announces $w_i^j > 0$ (wage of input i); if it has invested in both inputs, it announces wage pair (w_1^j, w_2^j) such that $w_i^j > 0$ for both $i \in \{1, 2\}$; if it has not invested at all, there is no wage announcement. In stage 3, the firm chooses how much of each input to buy and use from each country. We continue to assume that the policymaker of each country seeks to maximize its total labour income. We restrict to pure strategies to determine subgame perfect Nash equilibria (SPNE) of Γ.

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Recall that there is an external source—the outside option of the firm—at which the firm can obtain any input at wage $\overline{w}$. So the firm will not purchase an input in a country that sets a wage higher than $\overline{w}$ for that input. Since the profit of the firm is decreasing in the wage of any input, for each input it is optimal for the firm to employ labour from a location that offers the lowest wage. We retain the tie-breaking assumption (see endnote 3) that if the lowest wage for an input offered by the countries is $\overline{w}$, then the firm does not use its outside option. Furthermore, for ease of presentation we carry out the analysis of the extended game Γ under the assumption that the countries are symmetric with respect to reservation wages, that is, $\underline{w}^a = \underline{w}^b = \underline{w} < \overline{w}$.

For $t_a, t_b \in \{1, 2, 12, 0\}$, let $\Gamma(t_a, t_b)$ be the subgame of Γ that follows the investment choice t_j by country j. Observe that the cost of investment of any country is incurred prior to this subgame. So this is a sunk cost that can be ignored to determine NE outcomes of the subgames $\Gamma(t_a, t_b)$. If for $i = 1, 2$, the firm employs x_i^j units of input i at wage w_i from country j, then given the assumption $\underline{w}^a = \underline{w}^b = \underline{w}$, the total labour income of country j is

$$w_1 x_1^j + w_2 x_2^j + \underline{w}(\overline{x}^j - x_1^j - x_2^j) = (w_1 - \underline{w})x_1^j + (w_2 - \underline{w})x_2^j + \underline{w}\overline{x}^j \qquad (8)$$

Note if $x_1^j > 0$ and $x_2^j = 0$, then the labour income in (8) is $(w_1 - \underline{w})x_1^j + \underline{w}\overline{x}^j$ whereas if $x_1^j = 0$ and $x_2^j > 0$, it is $(w_2 - \underline{w})x_2^j + \underline{w}\overline{x}^j$. If $x_1^j = x_2^j = 0$, the labour income is $\underline{w}\overline{x}^j$. Noting that the constant term $\underline{w}\overline{x}^j$ is common in the labour income of country j for any w_i, x_i^j, we can consider the payoff of country j in $\Gamma(t_a, t_b)$ to be simply the "incremental labour income" above the reservation labour income $\underline{w}\overline{x}^j$.

Denote by $\phi_i^j(w_1, w_2)$ the incremental labour income of country j when (i) the only labour input that the firm employs from country j is input i and (ii) the firm employs $x_i^*(w_1, w_2)$ units of input i (its optimal amount of input i at (w_1, w_2)) at wage w_i from country j, that is,

$$\phi_i^j(w_1, w_2) := (w_i - \underline{w})x_i^*(w_1, w_2) \qquad (9)$$

Denote by $\phi_{12}^j(w_1, w_2)$ the incremental labour income of country j when for both $i = 1, 2$, the firm employs $x_i^*(w_1, w_2)$ units of input i at wage w_i from country j. That is,

$$\phi_{12}^j(w_1, w_2) := (w_1 - \underline{w})x_1^*(w_1, w_2) + (w_2 - \underline{w})x_2^*(w_1, w_2) = \phi_1^j(w_1, w_2) + \phi_2^j(w_1, w_2)$$

Since $w_1 x_1^*(w_1, w_2) + w_2 x_2^*(w_1, w_2) = K$, we have

$$\phi_{12}^j(w_1, w_2) = K - \underline{w}(x_1^*(w_1, w_2) + x_2^*(w_1, w_2)) \qquad (10)$$

Note from (9) and (10) that $\phi_i^a(w_1, w_2) = \phi_i^b(w_1, w_2)$ and $\phi_{12}^a(w_1, w_2) = \phi_{12}^b(w_1, w_2)$. Henceforth we denote the expressions in (9) and (10) simply by $\phi_i(w_1, w_2)$ and $\phi_{12}(w_1, w_2)$

dropping the superscript j. Also observe that

$$\phi_{12}(w_1, w_2) = \phi_1(w_1, w_2) + \phi_2(w_1, w_2) \tag{11}$$

Lemma 2 (i) *If $w_1 \leq w_2$, then $\phi_{12}(w_1, w_2)$ is increasing in w_1 and if $w_2 \leq w_1$, then $\phi_{12}(w_1, w_2)$ is increasing in w_2.*

(ii) *For $w_1, w_2 \in (0, \overline{w}]$, the unique maximum of $\phi_{12}(w_1, w_2)$ is attained at $w_1 = w_2 = \overline{w}$ and $\phi_{12}(\overline{w}, \overline{w}) = (\overline{w} - \underline{w})K/\overline{w}$.*

Proof See the Appendix. ∎

3.1 SPNE of Γ

Recall that for $\rho \in (-1, 0)$, we denote $\delta \equiv -\rho$ so that $\delta \in (0, 1)$. Also we denote $m \equiv \min\{\alpha/(1-\alpha), (1-\alpha)/\alpha\}$ where $\alpha \in (0, 1)$ is the *distribution parameter* of the CES function (1). Also recall that for the case $\underline{w}^a = \underline{w}^b = \underline{w} < \overline{w}$, we denote $\theta \equiv \underline{w}/\overline{w}$. We have shown in Proposition 3 that in this case there is $\delta^*(m, \theta)$ such that if $\delta \leq \delta^*(m, \theta)$, then the unique NE of the game G has complete race to the top property.

The next proposition shows this result is robust under endogenous choices of specialization when the production function of the firm is not asymmetrically intensive in either one of the two inputs. Specifically, when α is close to $1/2$, there is always an interval of magnitudes of c for which the extended game Γ has an SPNE that has specialization as well as complete race to the top.

Proposition 4 *Suppose $\underline{w}^a = \underline{w}^b = \underline{w} < \overline{w}$, $\delta \equiv -\rho \in (0, 1)$ and let $\delta \leq \delta^*(m, \theta)$. Then $\exists \, \varepsilon \in (0, 1/2)$ such that for any $\alpha \in (1/2 - \varepsilon, 1/2 + \varepsilon)$:*

$\exists \, 0 \leq \underline{c}(\alpha) < \overline{c}(\alpha)$ such that if $c \in (\underline{c}(\alpha), \overline{c}(\alpha))$, then Γ has an SPNE that has specialization in inputs as well as complete race to the top. Specifically, for $i, j \in \{1, 2\}$ and $i \neq j$, the following outcome is an SPNE: country a invests only in input i, country b invests only in input j and the wage set for each input is $\overline{w}$. Furthermore there is no other SPNE where at least one of the countries invests in only one input.

Proof To determine SPNE of Γ we note that for any $t_a, t_b \in \{0, 1, 2, 12\}$, either (a) the subgame $\Gamma(t_a, t_b)$ has a unique NE (see Observations 1-3 and 5-6, Section 5.2, Appendix) or (b) it has a continuum of NE, but every NE gives the same input wages and payoffs (see Observation 4). Using these results, the interaction between countries a, b in stage 1 of Γ can be presented as the "reduced form" game of investment choices

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in Table 1 where the payoff of a country in the cell (t_a, t_b) is its NE payoff at $\Gamma(t_a, t_b)$ net of its cost of investment. For $i \in \{1, 2\}$, $\widetilde{w}_i(\alpha)$ is a function of α ($\underline{w} < \widetilde{w}_i(\alpha) \leq \overline{w}$). We write a payoff $\phi_i(.\,,\,.|\alpha)$ to indicate that ϕ_i is a function of α. Using the budget constraint (2) in (10), we have $\phi_{12}(w, w) = (\overline{w} - \underline{w})K/\overline{w}$, which does not depend on α.

Table 1: The reduced form game Γ_α^* of investment choices

	0	1	2	12
0	$0, 0$	$0,$ $\phi_1(\overline{w}, \overline{w}|\alpha) - c$	$0,$ $\phi_2(\overline{w}, \overline{w}|\alpha) - c$	$0,$ $\phi_{12}(\overline{w}, \overline{w}) - 2c$
1	$\phi_1(\overline{w}, \overline{w}|\alpha) - c,$ 0	$-c, -c$	$\phi_1(\overline{w}, \overline{w}|\alpha) - c,$ $\phi_2(\overline{w}, \overline{w}|\alpha) - c$	$-c,$ $\phi_2(\underline{w}, \widetilde{w}_2(\alpha)|\alpha) - 2c$
2	$\phi_2(\overline{w}, \overline{w}|\alpha) - c,$ 0	$\phi_2(\overline{w}, \overline{w}|\alpha) - c,$ $\phi_1(\overline{w}, \overline{w}|\alpha) - c$	$-c, -c$	$-c,$ $\phi_1(\widetilde{w}_1(\alpha), \underline{w}|\alpha) - 2c$
12	$\phi_{12}(\overline{w}, \overline{w}) - 2c,$ 0	$\phi_2(\underline{w}, \widetilde{w}_2(\alpha)|\alpha) - 2c,$ $-c$	$\phi_1(\widetilde{w}_1(\alpha), \underline{w}|\alpha) - 2c,$ $-c$	$-2c, -2c$

Observe that for any $\alpha \in (0, 1)$, a pair of investment choices (t_a, t_b) constitutes an SPNE of Γ if and only if (t_a, t_b) is an NE of the reduced form game Γ_α^*.

By (10), $\phi_{12}(w_1, w_2|\alpha) = \phi_1(w_1, w_2|\alpha) + \phi_2(w_1, w_2|\alpha)$. Since $\phi_1(\underline{w}, w_2|\alpha) = 0$ and $\phi_2(w_1, \underline{w}|\alpha) = 0$, we have $\phi_2(\underline{w}, w_2|\alpha) = \phi_{12}(\underline{w}, w_2|\alpha)$ and $\phi_1(w_1, \underline{w}|\alpha) = \phi_{12}(w_1, \underline{w}|\alpha)$. Then by Lemma 2(ii) it follows that

$$\phi_1(w_1, \underline{w}|\alpha) < \phi_{12}(\overline{w}, \overline{w}) \text{ and } \phi_2(\underline{w}, w_2|\alpha) < \phi_{12}(\overline{w}, \overline{w}) \tag{12}$$

Consider $\alpha = 0.5$. Note that $\phi_1(\overline{w}, \overline{w}|0.5) = \phi_2(\overline{w}, \overline{w}|0.5) = (1/2)\phi_{12}(\overline{w}, \overline{w})$. By (12), we have $\phi_1(w_1, \underline{w}|0.5) < 2\phi_1(\overline{w}, \overline{w}|0.5)$ and $\phi_2(\underline{w}, w_2|0.5) < 2\phi_2(\overline{w}, \overline{w}|0.5)$. Hence

$$\phi_1(w_1, \underline{w}|0.5) - \phi_1(\overline{w}, \overline{w}|0.5) < \phi_1(\overline{w}, \overline{w}|0.5) = \phi_2(\overline{w}, \overline{w}|0.5) \text{ and}$$

$$\phi_2(\underline{w}, w_2|0.5) - \phi_2(\overline{w}, \overline{w}|0.5) < \phi_2(\overline{w}, \overline{w}|0.5) = \phi_1(\overline{w}, \overline{w}|0.5).$$

Taking $w_i = \widetilde{w}_i(0.5)$, these inequalities imply

$$\phi_1(\widetilde{w}_1(0.5), \underline{w}|0.5) - \phi_1(\overline{w}, \overline{w}|0.5) < \phi_i(\overline{w}, \overline{w}|0.5) \text{ and}$$

$$\phi_2(\underline{w}, \widetilde{w}_2(0.5)|0.5) - \phi_2(\overline{w}, \overline{w}|0.5) < \phi_i(\overline{w}, \overline{w}|0.5) \text{ for } i = 1, 2 \tag{13}$$

Since the functions ϕ_1, ϕ_2 are continuous in α, from (13) we conclude that $\exists\, \varepsilon \in (0, 0.5)$ such that for all $\alpha \in [0.5 - \varepsilon, 0.5 + \varepsilon]$:

$$\phi_1(\widetilde{w}_1(\alpha), \underline{w}|\alpha) - \phi_1(\overline{w}, \overline{w}|\alpha) < \phi_i(\overline{w}, \overline{w}|\alpha) \text{ and}$$

$$\phi_2(\underline{w}, \widetilde{w}_2(\alpha)|\alpha) - \phi_2(\overline{w}, \overline{w}|\alpha) < \phi_i(\overline{w}, \overline{w}|\alpha) \text{ for } i = 1, 2 \tag{14}$$

For $\alpha \in [0.5 - \varepsilon, 0.5 + \varepsilon]$, denote $\overline{c}(\alpha) := \min\{\phi_1(\overline{w}, \overline{w}|\alpha), \phi_2(\overline{w}, \overline{w}|\alpha)\}$ and

$$\underline{c}(\alpha) := \max\{\phi_1(\widetilde{w}_1(\alpha), \underline{w}|\alpha) - \phi_1(\overline{w}, \overline{w}|\alpha), \phi_2(\underline{w}, \widetilde{w}_2(\alpha)|\alpha) - \phi_2(\overline{w}, \overline{w}|\alpha), 0\}.$$

Then by (14), $0 \le \underline{c}(\alpha) < \overline{c}(\alpha)$.

Let $c \in (\underline{c}(\alpha), \overline{c}(\alpha))$. In what follows we show that in this case both $(1, 2)$ and $(2, 1)$ are NE of the game Γ_α^*. Since $c > \underline{c}(\alpha)$, we have $\phi_1(\overline{w}, \overline{w}|\alpha) - c > \phi_1(\widetilde{w}_1(\alpha), \underline{w}|\alpha) - 2c$ and since $c < \overline{c}(\alpha)$, we have $\phi_1(\overline{w}, \overline{w}|\alpha) - c > 0 > -c$. Then by Table 1, for $i, j \in \{a, b\}$, $i \ne j$, investment choice 1 is the unique best response of country j to country i's investment choice 2.

Similarly, since $c > \underline{c}(\alpha)$, we have $\phi_2(\overline{w}, \overline{w}|\alpha) - c > \phi_2(\underline{w}, \widetilde{w}_2(\alpha)|\alpha) - 2c$ and since $c < \overline{c}(\alpha)$, we have $\phi_2(\overline{w}, \overline{w}|\alpha) - c > 0 > -c$, which shows for $i, j \in \{a, b\}$, $i \ne j$, investment choice 2 is the unique best response of country j to country i's investment choice 1. This shows that both $(1, 2)$ and $(2, 1)$ are NE of Γ_α^*.

Noting that for any country, 2 is the unique best response when the other country chooses 1 and 1 is the unique best response when the other country chooses 2, we conclude that $(1, 2)$ and $(2, 1)$ are the only SPNE where at least one country invests in only one input. ∎

4 Concluding remarks

In this paper we considered a simple game theoretic framework with two countries and one multinational corporation (MNC) to show that drastic strategic undercutting of labour's bargaining power is not an inevitable outcome of strategic competition between policymakers of different countries. Notice that our setup is not meant to provide a comprehensive model of MNCs' competition and input choice decisions involving all its multifarious complexities. We focussed on *one* aspect of an MNC's organization of production and looked into the possibility of this feature generating a counteracting effect to the "race to the bottom". We find that indeed this feature of imperfect substitutability of labour inputs can act as a possible counteracting factor to the "race to the bottom".

Our analysis suggests that facing the problem of attracting multinational investment and consequent possible necessity of undercutting labour standards, a way-out for the developing countries could be to specialize on different types of labour-skills. We provide some modellings to illustrate this possibility analytically. In fact, in our setup we have rather deliberately left out some additional factors such as any demand

externality for producers from increased wage of labourers or any agglomeration effects, which can act as additional countervailing factors to "race to the bottom".

As we noted in Remark 2 earlier, our specification of payoffs in which the policymaker of each country maximizes its labour income, is crucial for our result. What emerges for the labourers in richer environments (e.g., when the payoff of policymaker in a country is a weighted sum of labour income and the firms's profit in a dynamic situation) is a matter for future research.

5 Appendix

5.1 Proofs of results

Proof of Lemma 1 (i)-(ii) Solving the firm's problem, optimal labour inputs for the firm are given by

$$x_a^* = \frac{K}{w_a + [(1-\alpha)w_a/\alpha w_b]^{1/(1+\rho)}w_b}, x_b^* = \frac{K}{w_b + [\alpha w_b/(1-\alpha)w_a]^{1/(1+\rho)}w_a} \qquad (15)$$

Using the expressions above, standard reasoning proves (i)-(ii).

(iii) Recall that $\pi(w_a, w_b, K)$ is the maximized value of the profit of the firm, i.e., $\pi(w_a, w_b, K) = F(x_a^*, x_b^*)$. Invoking Roy's identity (see, e.g., Kreps, 1990, p.57) we have

$$\partial \pi(w_a, w_b, K)/\partial w_i = -x_i^*[\partial \pi(w_a, w_b, K)/\partial K] \text{ for } i \in \{a, b\} \qquad (16)$$

By (15), both x_a^*, x_b^* are increasing in K. Since F is increasing in both x_a, x_b, we conclude that $\pi(w_a, w_b, K)$ is increasing in K. As $x_i^* > 0$, from (16) it follows that $\pi(w_a, w_b, K)$ is decreasing in w_i for $i \in \{a, b\}$.

(iii) The labour income in the monopoly sector for countries a, b, are given by

$$\psi_a^M(w_a, w_b, K) = w_a x_a^* = \frac{K}{1 + [(1-\alpha)/\alpha]^{1/(1+\rho)}(w_b/w_a)^{\rho/(1+\rho)}}$$

$$\psi_b^M(w_a, w_b, K) = w_b x_b^* = \frac{K}{1 + [\alpha/(1-\alpha)]^{1/(1+\rho)}(w_a/w_b)^{\rho/(1+\rho)}} \qquad (17)$$

If $\rho \in (-1, 0)$, we have $\rho/(1+\rho) < 0$ and hence $w_a^{\rho/(1+\rho)}$ is decreasing in w_a. Consequently the denominator of ψ_a^M is increasing in w_a and hence ψ_a^M is decreasing in w_a for any $w_b > 0$. By the same reasoning, ψ_b^M is decreasing in w_b for any $w_a > 0$.

If $\rho \in (0, \infty)$, we have $\rho/(1+\rho) > 0$ and hence $w_a^{\rho/(1+\rho)}$ is increasing in w_a. Consequently the denominator of ψ_a^M is decreasing in w_a and hence ψ_a^M is increasing in w_a for any $w_b > 0$. By the same reasoning, ψ_b^M is increasing in w_b for any $w_a > 0$. ∎

Proof of Proposition 1 Throughout let $i, j \in \{a, b\}$ and $i \neq j$. First we prove parts (I)(ii) and (II)(ii), then parts (I)(i) and (II)(i).

(I)(ii), (II)(ii): Let $\rho \in (0, \infty)$. Then ψ_i^M is increasing in w_i (Lemma 1(iv)). As x_i^* is decreasing in w_i (Lemma 1(i)), ψ_i^T is increasing in w_i. Then by (3) it follows that ψ_i is increasing in w_i for any w_j, so the unique best response of country i to any w_j is to choose $w_i = \overline{w}$ which proves (I)(ii). It is immediate from (I)(ii) that the unique NE of G is $(\overline{w}, \overline{w})$, proving (II)(ii).

(I)(i), (II)(i): Let $\rho \in (-1, 0)$. As before, ψ_i^T is increasing in w_i. However, in this case ψ_i^M is decreasing in w_i (Lemma 1(iv)), so unlike the previous case we cannot conclude that ψ_i is increasing in w_i.

Let $\delta \equiv -\rho \in (0, 1)$. For $\tau \in (0, 1)$ and $w \geq 0$, let $s_\tau(w) := \tau^{1/(1-\delta)} w^{\delta/(1-\delta)}$. Denote $\tau_a \equiv \alpha$ and $\tau_b \equiv 1 - \alpha$. For $i, j \in \{a, b\}$, $i \neq j$, define

$$g_i(w_i) := (\delta w_i - \underline{w}^i) s_{\tau_j}(w_i) \text{ and } h_i(w_j) := (1 - \delta)\underline{w}^i s_{\tau_i}(w_j) \tag{18}$$

Using (15) and (17) in (3) we have

$$\frac{\partial \psi_i}{\partial w_i} = \frac{K s_{\tau_i}(w_j)[h_i(w_j) - g_i(w_i)]}{(1 - \delta)w_i^2 [s_{\tau_b}(w_a) + s_{\tau_a}(w_b)]^2}$$

Note that $\partial \psi_i / \partial w_i \gtreqqless 0 \Leftrightarrow g_i(w_i) \lesseqqgtr h_i(w_j)$. Observe that[5] $g_i(w_i)$ is increasing in w_i, $h_i(w_j)$ is increasing in w_j and $\lim_{w_i \to \infty} g_i(w_i) = \lim_{w_j \to \infty} h_i(w_j) = \infty$. To prove (I)(i), we consider the following two cases.

Case 1 $\underline{w}^i \geq \delta \overline{w}$: Then for any w_j, we have $g_i(w_i) \leq 0 < h_i(w_j)$ and hence $\partial \psi_i / \partial w_i > 0$ for all $w_i \in [\underline{w}^i, \overline{w}]$. So the unique best response of country i to any w_j is to choose $w_i = \overline{w}$.

Case 2 $\underline{w}^i < \delta \overline{w}$: Then for $w_i \in [\underline{w}^i, \underline{w}^i/\delta]$, we have $g_i(w_i) \leq 0 < h_i(w_j)$ and hence ψ_i is increasing in w_i in this interval. So for any w_j, best response of country i is to choose $w_i \in [\underline{w}^i/\delta, \overline{w}]$. As $g_i(\underline{w}^i/\delta) = 0 < h_i(w_j) < \lim_{w_i \to \infty} g_i(w_i) = \infty$, by the monotonicity of g_i, $\exists$ a unique $w_i = b_i(w_j) \in (\underline{w}^i/\delta, \infty)$ such that $g_i(w_i) \lesseqqgtr h_i(w_j) \Leftrightarrow \partial \psi_i / \partial w_i \gtreqqless 0 \Leftrightarrow w_i \lesseqqgtr b_i(w_j)$. Therefore the unique best response of country i to any $w_j \in [\underline{w}^j, \overline{w}]$ is $B_i(w_j) = \min\{b_i(w_j), \overline{w}\}$. As h_i is increasing in w_j, it follows that $b_i(w_j)$ is increasing and $B_i(w_j)$ is non-decreasing in w_j. This completes the proof of (I)(i).

To prove (II)(i), first we show that G has a unique NE for $\rho \in (-1, 0)$. Note from the proof of (I)(i) that for $i \in \{a, b\}$, $\exists\, 0 < \varepsilon_i < \overline{w} - \underline{w}^i$ such that $B_i(w_j) \in [\underline{w}^i + \varepsilon_i, \overline{w}]$ for any w_j (take $\varepsilon_i = (\overline{w} - \underline{w}^i)/2$ in Case 1 and $\varepsilon_i = (1 - \delta)\underline{w}^i/\delta$ in Case 2). Also observe that the constant term $\underline{w}^i \overline{x}^i$ in (3) does not play any role in determining NE outcomes of G. Consider the two-person "transformed" game H in which countries a, b

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choose w_a, w_b, where the strategy set of country i is $[\underline{w}^i + \varepsilon_i, \overline{w}]$ and its payoff is

$$\Phi_i(w_a, w_b) = \log((w_i - \underline{w}^i)x_i^*(w_a, w_b)) = \log(w_i - \underline{w}^i) + \log(x_i^*(w_a, w_b)) \qquad (19)$$

The log function is well defined for the game H. Note that the set of NE of G coincides with the set of NE of H.

Lemma A1 *The log labour demand $\log(x_i^*(w_a, w_b))$ of any country $i \in \{a, b\}$ has increasing differences in (w_a, w_b), i.e., the following hold for $w_a' > w_a$, $w_b' > w_b$.*

$$[\log(x_i^*(w_a', w_b')) - \log(x_i^*(w_a, w_b'))] - [\log(x_i^*(w_a', w_b)) - \log(x_i^*(w_a, w_b))] > 0$$

Consequently the game H is a supermodular game.

Proof We prove the increasing difference result for $i = a$ (the proof is similar for $i = b$). Let $t_\alpha(w) := \alpha^{1/(1+\rho)} w^{\rho/(1+\rho)}$. By (15), $x_a^*(w_a, w_b) = K t_\alpha(w_a)/w_a[t_\alpha(w_a) + t_{1-\alpha}(w_b)]$ and

$$\log(x_a^*(w_a, w_b)) = \log K + \frac{1}{1+\rho}\log\alpha - \frac{1}{1+\rho}\log w_a - \log[t_\alpha(w_a) + t_{1-\alpha}(w_b)] \quad (20)$$

Using (20) and simplifying, we have

$$[\log(x_a^*(w_a', w_b')) - \log(x_a^*(w_a, w_b'))] - [\log(x_a^*(w_a', w_b)) - \log(x_a^*(w_a, w_b))]$$

$$= \log \frac{[t_\alpha(w_a') + t_{1-\alpha}(w_b)][t_\alpha(w_a) + t_{1-\alpha}(w_b')]}{[t_\alpha(w_a') + t_{1-\alpha}(w_b')][t_\alpha(w_a) + t_{1-\alpha}(w_b)]} > 0$$

Using the increasing difference result and the conclusions of Milgrom and Roberts (1990) (see page 1271, the paragraph before equation (5)), it follows that the game H is supermodular. ∎

Lemma A2 *For $i \in \{a, b\}$, let $y_i = \log(w_i)$. The payoff of i in the game H has the property $\partial^2\Phi_i/\partial y_a\partial y_b + \partial^2\Phi_i/(\partial y_a)^2 < 0$. Consequently H has a unique NE.*

Proof We prove the inequality for $i = a$ (similar reasoning applies for $i = b$). Denote $\widetilde{\alpha} \equiv [(1-\alpha)/\alpha]^{1/(1+\rho)}$. By (19) and (20), we have

$$\Phi_a = \log[\exp(y_a) - \underline{w}^a] + \log K + \frac{1}{1+\rho}\log\alpha - \frac{y_a}{1+\rho} - \log(\nu(y_a, y_b))$$

where $\nu(y_a, y_b) := \alpha^{1/(1+\rho)}\exp[\rho y_a/(1+\rho)] + (1-\alpha)^{1/(1+\rho)}\exp[\rho y_b/(1+\rho)]$. For $i, j \in \{a, b\}$, let $\nu_i = \partial\nu/\partial y_i$ and $\nu_{ij} = \partial^2\nu/\partial y_i\partial y_j$. Note that $\nu_{ab} = 0$ and $\nu\nu_{aa} - \nu_a^2 - \nu_a\nu_b = 0$. Hence $\partial^2\log(\nu)/\partial y_a\partial y_b + \partial^2\log(\nu)/(\partial y_a)^2 = [-\nu_a\nu_b - \nu_a^2 + \nu\nu_{aa}]/\nu^2 = 0$ implying that $\partial^2\Phi_a/\partial y_a\partial y_b + \partial^2\Phi_a/(\partial y_a)^2 = -w_a\underline{w}^a/(w_a - \underline{w}^a)^2 < 0$.

Since H is a supermodular game, the inequalities above imply that H has a unique NE (see equation (6), page 1271 of Milgrom and Roberts, 1990). ∎

Since H has a unique NE, so does G. Having shown that G has a unique NE, observe from part (I)(i) that for any country i, the unique best response $B_i(w_j)$ to any w_j has either $B_i(w_j) = \overline{w} > \underline{w}^i$, or $B_i(w_j) > \underline{w}^i/\delta > \underline{w}^i$. So the unique NE of G does not have $w_i = \underline{w}^i$ for any i. This completes the proof of part (II)(i).

Finally part (III) of Proposition 1 is immediate from the facts that for any w_j, best response of i is increasing in $\underline{w}^i$ and that G possesses a unique NE. ∎

Proof of Proposition 2 Let $\rho \in (-1, 0)$. Note from the proof of Proposition 1 ((I)(i), (II)(i)) that if $\underline{w}^i \geq \delta\overline{w}$ for both $i \in \{a, b\}$, then the unique NE is $(w_a = \overline{w}, w_b = \overline{w})$. To characterize NE for other cases, let $\underline{w}^i < \delta\overline{w}$ for some i. Then the best response function of i is $B_i(w_j) = \min\{b_i(w_j), \overline{w}\}$. By the monotonicity of g_i (see (18)), $b_i(\overline{w}) \gtreqqless \overline{w} \Leftrightarrow g_i(b_i(\overline{w})) = h_i(\overline{w}) \gtreqqless g_i(\overline{w})$. Using the expressions of g_i and h_i from (18), we conclude that $\exists \, \widetilde{\delta}_i \in (0, \delta)$ (given by (5)) such that

$$b_i(\overline{w}) \gtreqqless \overline{w} \Leftrightarrow \underline{w}^i \gtreqqless \widetilde{\delta}_i \overline{w} \tag{21}$$

(i) If $\underline{w}^i < \widetilde{\delta}_i \overline{w}$, then $b_i(\overline{w}) < \overline{w}$ and hence $b_i(w_j) < \overline{w}$ for all $w_j \in [\underline{w}^j, \overline{w}]$. So $B_i(w_j) = b_i(w_j) < \overline{w}$ for all $w_j \in [\underline{w}^j, \overline{w}]$. Therefore if $\underline{w}^i < \widetilde{\delta}_i \overline{w}$ for both $i \in \{a, b\}$, then the (unique) NE has $w_i < \overline{w}$ for both i.

(ii) If $\underline{w}^i \geq \widetilde{\delta}_i \overline{w}$ for both $i \in \{a, b\}$, then $b_i(\overline{w}) \geq \overline{w}$ and hence $B_i(\overline{w}) = \overline{w}$ for both i. Thus $(w_a = w_b = \overline{w})$ is an NE and so it must be the only NE (as by Proposition 1, G has a unique NE).

(iii) Let $\underline{w}^i < \widetilde{\delta}_i \overline{w}$ and $\underline{w}^j \geq \delta\overline{w}$. Then $B_j(w_i) = \overline{w}$ for all $w_i \in [\underline{w}^i, \overline{w}]$ and $B_i(\overline{w}) = b_i(\overline{w}) < \overline{w}$. So the NE has $w_j = \overline{w}$ and $w_i = B_i(\overline{w}) < \overline{w}$.

(iv) Let $\underline{w}^i < \widetilde{\delta}_i \overline{w}$ and $\widetilde{\delta}_i \overline{w} \leq \underline{w}^j < \delta\overline{w}$. In this case $B_i(w_j) = b_i(w_j) < \overline{w}$ for all $w_j \in [\underline{w}^j, \overline{w}]$ and $B_j(\overline{w}) = \overline{w}$, but for $w_i < \overline{w}$, $B_j(w_i)$ can be either strictly lower than $\overline{w}$ or equal to $\overline{w}$. So the NE must have $w_i < \overline{w}$ and either $w_j < \overline{w}$ (not race to the top) or $w_j = \overline{w}$ (partial race to the top). ∎

The following lemma will be useful for the proof of Proposition 3.

Lemma A3 Let $\rho \in (-1, 0)$ and $\underline{w}^a = \underline{w}^b = \underline{w} < \overline{w}$. Denote $\delta \equiv -\rho$, $\theta \equiv \underline{w}/\overline{w}$ and let $\delta > \theta$. Denote $m_a \equiv \alpha/(1-\alpha)$, $m_b \equiv (1-\alpha)/\alpha$ and for $t > 0$,

$$\ell^{t,\delta}(w) := t^{1/\delta}[(\delta w - \underline{w})/(1-\delta)\underline{w}]^{(1-\delta)/\delta}w, \, r^\delta(w) := \underline{w}/\delta + (1-\delta)^2\underline{w}^2/\delta(\delta w - \underline{w}) \tag{22}$$

(i) $\ell^{t,\delta}(w)$ is increasing and $r^\delta(w)$ is decreasing in w.

(ii) If G has an NE where $w_i < \overline{w}$ for both $i \in \{a, b\}$, then $\ell^{m_a,\delta}(w_a) = r^\delta(w_a)$ and $\ell^{m_b,\delta}(w_b) = r^\delta(w_b)$.

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(iii) *Let $m = min\{m_a, m_b\}$. If $r^\delta(\overline{w}) > \ell^{m,\delta}(\overline{w})$, then G cannot have an NE where $w_i < \overline{w}$ for both $i \in \{a, b\}$.*

Proof Part (i) is immediate. For part (ii), let $\delta > \theta$, so that $\underline{w} < \delta\overline{w}$. From the proof of Proposition 1, it follows that if G has an NE with $w_i < \overline{w}$ for both $i \in \{a, b\}$, then $g_a(w_a) = h_a(w_b)$ and $g_b(w_b) = h_b(w_a)$ where the functions g_i, h_i are given in (18). Taking $\underline{w}^a = \underline{w}^b = \underline{w}$, we obtain $w_b = \ell^{m_b,\delta}(w_a)$ from the first and $w_a = \ell^{m_a,\delta}(w_b)$ from the second equation. Since $m_a m_b = 1$, from these two equations, $(\delta w_a - \underline{w})(\delta w_b - \underline{w}) = (1 - \delta)^2 \underline{w}^2$ which implies that $w_b = r^\delta(w_a)$ and $w_a = r^\delta(w_b)$, proving (ii).

(iii) If $r^\delta(\overline{w}) > \ell^{m,\delta}(\overline{w})$, there is at least one $i \in \{a, b\}$ such that $r^\delta(\overline{w}) > \ell^{m_i,\delta}(\overline{w})$. Then by (i), $r^\delta(w_i) > \ell^{m_i,\delta}(w_i)$ for all $w_i \in [\underline{w}, \overline{w}]$ and by part (ii), the result follows. ∎

Proof of Proposition 3 (i) Observe from (6) that since $0 < m \leq 1$, the denominator of $\gamma_m(\delta)$ is decreasing in δ. As the numerator is increasing, $\gamma_m(\delta)$ is increasing in δ. Also note that $\gamma_m(0) = 0$ and since $m^{1/(1-\delta)}$ is bounded above by m, we have $\lim_{\delta\uparrow 1}(1 - \delta)m^{1/(1-\delta)} = 0$, so $\lim_{\delta\uparrow 1}\gamma_m(\delta) = 1$. This shows there is a unique $\delta^*(m, \theta) \in (0, 1)$ such that $\gamma_m(\delta^*(m, \theta)) = \theta$. Thus $\gamma_m(\delta) \leq \theta$ if and only if $\delta \leq \delta^*(m, \theta)$, so there is complete race to the top if and only if $\delta \leq \delta^*(m, \theta)$. As $\gamma_m(\delta) < \theta$ for $\delta \leq \theta$, we have $\delta^*(m, \theta) > \theta$. Finally as $\gamma_m(\delta)$ is decreasing in m and increasing in δ, it follows that $\delta^*(m, \theta)$ is increasing in both m, θ.

(ii) Let $0 < m < 1$. First we show that[6] $\hat{\delta}(m, \theta) \equiv (m + 1)\theta/(m + \theta) > \delta^*(m, \theta)$. From (6) it can be seen that

$$\gamma_m(\hat{\delta}(m, \theta)) - \theta = \frac{(1 - \theta)\theta[1 - \kappa(m, \theta)]}{m + \theta + (1 - \theta)\kappa(m, \theta)} \text{ where } \kappa(m, \theta) := m^{[m(2-\theta)+\theta]/[m(1-\theta)]}$$

Noting that $0 < \kappa(m, \theta) < 1$ for $0 < m < 1$, it follows that $\gamma_m(\hat{\delta}(m, \theta)) > \theta$. Using the proof of part (i), the monotonicity of $\gamma_m(\delta)$ implies $\hat{\delta}(m, \theta) > \delta^*(m, \theta)$.

Consider $\delta^*(m, \theta) < \delta \leq \hat{\delta}(m, \theta)$. Note that $\delta > \theta$ in this case. Consider $\ell^{m,\delta}(\overline{w})$ (take $t = m$ and $w = \overline{w}$ in (22)). We show that if $\delta \leq \hat{\delta}(m, \theta)$, then $\ell^{m,\delta}(\overline{w})$ is increasing in δ. By (22),

$$\frac{\partial \ell^{m,\delta}(\overline{w})}{\partial \delta} = \frac{\ell^{m,\delta}(\overline{w})}{\delta^2}\left[\frac{\delta(\overline{w} - \underline{w})}{\delta\overline{w} - \underline{w}} + \log\frac{(1 - \delta)\underline{w}}{m(\delta\overline{w} - \underline{w})}\right] \tag{23}$$

As $\delta > \theta$, we have $\delta\overline{w} > \underline{w}$ and so $\ell^{m,\delta}(\overline{w}) > 0$. The inequality $\delta \leq \hat{\delta}(m, \theta)$ is the same as $(1 - \delta)\underline{w} \geq m(\delta\overline{w} - \underline{w})$. By (23), this implies that $\ell^{m,\delta}(\overline{w})$ is increasing in δ.

Next observe that since $0 < m < 1$, we have $r^{\hat{\delta}}(\overline{w}) = m\overline{w} + (1 - m)\underline{w} > m\overline{w} = \ell^{m,\hat{\delta}}(\overline{w})$. As $\ell^{m,\delta}(\overline{w})$ is increasing and $r^\delta(\overline{w})$ is decreasing in δ, we have $r^\delta(\overline{w}) > \ell^{m,\delta}(\overline{w})$ for all $\delta \leq \hat{\delta}$. Then by Lemma A3(iii), when $\delta^*(m, \theta) < \delta \leq \hat{\delta}(m, \theta)$, there is no NE of

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G where $w_i < \overline{w}$ for both $i \in \{a, b\}$. By part (i) we also know in this case there is no NE with complete race to the top. So we conclude that in this case the NE must have partial race to the top (that is, $w_i = \overline{w}$ and $w_j < \overline{w}$ for some $i, j \in \{a, b\}$, $i \neq j$). ∎

Proof of Lemma 2 (i) Using the budget constraint (2) in (10) we have

$$\phi_{12}^j(w_1, w_2) = K - \underline{w}^j(1 - w_1/w_2)x_1^*(w_1, w_2) - K\underline{w}^j/w_2$$

Hence $\partial\phi_{12}^j/\partial w_1 = -\underline{w}^j(1 - w_1/w_2)\partial x_1^*/\partial w_1 + \underline{w}^j x_1^*/w_2$. Since $\partial x_1^*/\partial w_1 < 0$, it follows that $\partial\phi_{12}^j/\partial w_1 > 0$ if $w_1 \leq w_2$. Similar reasoning shows $\partial\phi_{12}^j/\partial w_2 > 0$ if $w_2 \leq w_1$.

  (ii) Let $w, w_1, w_2 \in (0, \overline{w}]$. By part (i), $\phi_{12}^j(w, w) > \phi_{12}^j(w_1, w)$ for $w_1 < w$ and $\phi_{12}^j(w, w) > \phi_{12}^j(w, w_2)$ for $w_2 < w$. Consequently, a necessary condition for $\phi_{12}^j(w_1, w_2)$ to be maximized is that $w_1 = w_2$. When $w_1 = w_2 = w$, by the budget constraint (2), $x_1^*(w, w) + x_2^*(w, w) = K/w$. Using this in (10), we have $\phi_{12}(w, w) = (w - \underline{w})K/w$. This shows that $\phi_{12}(w, w)$ is increasing in w, so its unique maximum over $w \in (0, \overline{w}]$ is attained at $w = \overline{w}$. ∎

5.2   Subgames of Γ

In what follows we determine NE outcomes of subgames $\Gamma(t_a, t_b)$ by classifying these subgames into different classes.

5.2.1   Each country invested in only one input, each invested in different inputs

Consider the game $\Gamma(1, 2)$ (the analysis is similar for $\Gamma(2, 1)$). This is the game in which country a has invested in input 1 and country b has invested in input 2, so the subsequent strategic interaction is same as the game G of Section 2.1. In the game $\Gamma(1, 2)$, country a announces wage w_1^a and country b announces wage w_1^b. Let $w_1 = \min\{w_1^a, \overline{w}\}$ and $w_2 = \min\{w_1^b, \overline{w}\}$. The firm employs $x_i^*(w_1, w_2)$ units of input i. The firm employs an input from a country if the country offers a wage for the input that does not exceed $\overline{w}$; otherwise the firm employs from the external source. Since it is assumed $\delta \leq \delta^*(m, \theta)$, by Proposition 3, we conclude the following.

Observation 1 $\Gamma(1, 2)$ *has a unique NE:* $w_1^a = w_2^b = \overline{w}$. *At the NE, country a obtains* $\phi_1(\overline{w}, \overline{w})$ *and country b obtains* $\phi_2(\overline{w}, \overline{w})$.

5.2.2 Each country invested in only one input, each invested in the same input

Consider the game $\Gamma(1,1)$. This is the game in which both countries have invested in the same input 1 (the analysis is similar for the game $\Gamma(2,2)$). In the game $\Gamma(1,1)$, country $j \in \{a,b\}$ announces wage w_1^j. Let $w_1 = \min\{w_1^a, w_1^b, \overline{w}\}$. The firm employs $x_i^*(w_1, \overline{w})$ units of input i. The firm employs input 2 from the external source at wage $\overline{w}$. If $\min\{w_1^a, w_1^b\} > \overline{w}$, the firm employs input 1 from the external source; otherwise it employs input 1 from countries that offer the lowest wage for input i.

Observation 2 $\Gamma(1,1)$ *has a unique NE:* $w_1^a = w_1^b = \underline{w}$. *At the NE, each country obtains zero payoff.*

Proof Denote $w_1 = \min\{w_1^a, w_1^b, \overline{w}\}$. We prove the result in following steps.

Step 1: We cannot have an NE where $w_1 < \underline{w}$. To see this, consider a strategy profile such that $w_1 < \underline{w}$. Then $\exists$ a country $j \in \{a,b\}$ such that $x_1^j = \lambda x_1^*(w_1, \overline{w})$ for some $\lambda \in (0,1]$ and j obtains $\lambda \phi_1(w_1, \overline{w}) < 0$. By unilaterally deviating to $w_1^j = \underline{w}$, country j obtains zero payoff, so such a deviation is gainful.

Step 2: We cannot have an NE where $w_1 > \underline{w}$. To see this, consider a strategy profile such that $w_1 > \underline{w}$. Then $\exists j \in \{a,b\}$ such that $x_1^j = \lambda x_1^*(w_1, \overline{w})$ for some $\lambda \in [0,1)$ and j obtains $\lambda \phi_1(w_1, \overline{w})$. Let j unilaterally deviate to $w_1 - \varepsilon$ where $\varepsilon > 0$ and $w_1 - \varepsilon > \underline{w}$. Following this deviation, j obtains $\phi_1(w_1 - \varepsilon, \overline{w})$. Since $w_1 > \underline{w}$ and $\lambda < 1$, we have $(1 - \lambda)\phi_1(w_1, \overline{w}) > 0$. Let $0 < \delta < (1-\lambda)\phi_1(w_1, \overline{w})$. Since $\phi_1(w_1, \overline{w})$ is continuous in w_1, for sufficiently small $\varepsilon > 0$ we have $\phi_1(w_1 - \varepsilon, \overline{w}) > \phi_1(w_1, \overline{w}) - \delta > \lambda \phi_1(w_1, \overline{w})$, showing gainful deviation for j.

Step 3: By Steps 1-2, at any NE, we must have $\min\{w_1^a, w_1^b\} = \underline{w}$. Now we show that at any NE, we must also have $\max\{w_1^a, w_1^b\} = \underline{w}$. Consider a strategy profile such that $\min\{w_1^a, w_1^b\} = \underline{w} < \max\{w_1^a, w_1^b\}$. Without loss of generality, let $w_1^a = \underline{w} < w_1^b$. Since $\min\{w_1^a, w_1^b\} = \underline{w}$, each country obtains zero payoff. Let country a unilaterally deviate to $\tilde{w}_1^a$ such that $\underline{w} < \tilde{w}_1^a < \min\{w_1^b, \overline{w}\}$. Following this deviation, a would obtain $\phi_1(\tilde{w}_1^a, \overline{w}) > 0$, so the deviation is gainful. This shows that at any NE, we must have $w_1^a = w_1^b = \underline{w}$.

Step 4: Finally observe that the strategy profile (w_1^a, w_1^b) where $w_1^a = w_1^b = \underline{w}$ is indeed an NE. At this strategy profile, each country gets zero. There is no unilateral deviation that gives positive payoff to a country. ∎

5.2.3 One country invested in only one input, another country invested in no input

Consider the game $\Gamma(1,0)$. This is the game in which country a invested in only input 1 and country b invested in no input (the analysis is similar for the games $\Gamma(2,0)$, $\Gamma(0,1)$ and $\Gamma(0,2)$). In the game $\Gamma(1,0)$, country b always obtains zero payoff. In this game country a announces wage w_1^a. Let $w_1 = \min\{w_1^a, \overline{w}\}$. The firm employs $x_i^*(w_1, \overline{w})$ units of input i. It employs input 2 from the external source at wage $\overline{w}$. If $w_1^a = w_1$, the firm employs input 1 from country a; otherwise it employs input 1 from the external source at wage $\overline{w}$.

Observation 3 $\Gamma(1,0)$ *has a unique NE. At the NE:* $w_1^a = \overline{w}$, *country a obtains* $\phi_1(\overline{w}, \overline{w})$ *and country b obtains zero payoff.*

Proof Country a obtains at most zero by setting $w_1^a \leq \underline{w}$, zero payoff by setting $w_1^a > \overline{w}$ and positive payoff by setting $\underline{w} < w_1^a \leq \overline{w}$. So at any NE we must have $w_1^a \in (\underline{w}, \overline{w}]$. Since it is assumed $\delta \leq \delta^*(m, \theta)$, by Proposition 3(i), the unique maximizer of $\phi_1(w_1^a, \overline{w})$ over $w_1^a \in (\underline{w}, \overline{w}]$ is attained at $w_1^a = \overline{w}$. This proves the result. ∎

5.2.4 One country invested in both inputs, another country invested in only one input

Consider the game $\Gamma(12,1)$. In this game country a invested in both inputs $1, 2$ and country b invested in only input 1 (the analysis is similar for games $\Gamma(12,2)$, $\Gamma(1,12)$ and $\Gamma(2,12)$).

In the game $\Gamma(12,1)$, country a announces wage pair (w_1^a, w_2^a) and country b announces w_1^b (its wage for input 1). Let $w_1 = \min\{w_1^a, w_1^b, \overline{w}\}$ and $w_2 = \min\{w_2^a, \overline{w}\}$. The firm employs $x_i^*(w_1, w_2)$ units of input i. If $\min\{w_1^a, w_1^b\} > \overline{w}$, the firm employs input 1 from the external source; otherwise it employs input 1 from countries that offer the lowest wage for input 1. If $w_2^a > \overline{w}$, the firm employs input 2 from the external source; otherwise it employs input 2 from country a. The next observation shows that $\Gamma(12,1)$ has multiple NE, but all of them have the same input wages and payoffs. At every NE, both countris a, b set the same wage $\underline{w}$ for input 1. This makes the firm indifferent between the two countries in regard to employing input 1, resulting in multiple optimal choices that give rise to multiple NE.

Observation 4 $\Gamma(12,1)$ *has a continuum of NE, all of which have the same input wages and payoffs. Specifically* $\exists \, \widetilde{w}_2 \in (\underline{w}, \overline{w}]$ *such that at every NE:* $(w_1^a, w_2^a) = (\underline{w}, \widetilde{w}_2)$, $w_1^b = \underline{w}$, *country a obtains* $\phi_2(\underline{w}, \widetilde{w}_2)$ *and country b obtains zero payoff. An NE is*

indexed by $\lambda \in [0,1]$, in which the firm employs $\lambda x_1^*(\underline{w}, \widetilde{w}_2)$ units of input 1 from a and $(1-\lambda)x_1^*(\underline{w}, \widetilde{w}_2)$ units of input 1 from b.

Proof Denote $w_1 = \min\{w_1^a, w_1^b, \overline{w}\}$. We prove the result in the following steps.

Step 1: At any NE of $\Gamma(12,1)$, we must have $w_2^a \leq \overline{w}$. To see this, consider (w_1^a, w_2^a) such that $w_a^2 > \overline{w}$. Then $x_2^a = 0$ and $x_1^a \leq x_1^*(w_1, \overline{w})$, so the payoff of country a is at most $\phi_1(w_1, \overline{w})$. If $w_1 \leq \underline{w}$, country a obtains at most zero. Let it unilaterally deviate to $(\underline{w}, \overline{w})$; then x_2^a would be positive and a would obtain positive payoff. If $w_1 > \underline{w}$, let a deviate to $(w_1 - \varepsilon, \overline{w})$ such that $\varepsilon > 0$ and $w_1 - \varepsilon > \underline{w}$. Following this deviation, country a would obtain

$$\phi_{12}(w_1 - \varepsilon, \overline{w}) = \phi_1(w_1 - \varepsilon, \overline{w}) + \phi_2(w_1 - \varepsilon, \overline{w}).$$

Note $\phi_2(w_1, \overline{w}) > 0$. Let $0 < \delta < \phi_2(w_1, \overline{w})/2$. Since for $i = 1,2$, $\phi_i(w_1, \overline{w})$ is continuous in w_1, for sufficiently small $\varepsilon > 0$, we have $\phi_i(w_1 - \varepsilon, \overline{w}) > \phi_i(w_1, \overline{w}) - \delta$. Hence

$$\phi_1(w_1 - \varepsilon, \overline{w}) + \phi_2(w_1 - \varepsilon, \overline{w}) > \phi_1(w_1, \overline{w}) + \phi_2(w_1, \overline{w}) - 2\delta > \phi_1(w_1, \overline{w})$$

showing that the deviation is gainful for country a.

Step 2: At any NE, we must have $w_1^a = w_1^b = \underline{w}$. To see this, first note by Step 1, at any NE we have $w_2^a \leq \overline{w}$. So $w_2 = w_2^a$ and $x_2^a = x_2^*(w_1, w_2^a)$. In what follows, we show that we cannot have $w_1 < \underline{w}$ or $w_1 > \underline{w}$ at any NE (recall $w_1 = \min\{w_1^a, w_1^b, \overline{w}\}$).

If $w_1 < \underline{w}$, then $\exists\, j \in \{a,b\}$ such that $w_1^j < \underline{w}$ and $x_1^j = \lambda x_1^*(w_1, w_2)$ for some $\lambda \in (0,1]$. If $j = b$, then b obtains $\lambda\phi_1(w_1, w_2) < 0$ (since $w_1 < \underline{w}$ and $\lambda > 0$) and b is better off unilaterally deviating to $\tilde{w}_1^b = \underline{w}$ to obtain zero payoff. If $j = a$, then a obtains $\lambda\phi_1(w_1, w_2) + \phi_2(w_1, w_2) < \phi_2(w_1, w_2)$. By unilaterally deviating to $(\underline{w}, w_2)$, country a would obtain $\phi_2(w_1, w_2)$, so the deviation is gainful.

If $w_1 > \underline{w}$, then $\exists\, j \in \{a,b\}$ such that $w_1^j > \underline{w}$ and $x_1^j = \lambda x_1^*(w_1, w_2)$ for some $\lambda \in [0,1)$. There are two possibilities: either $j = b$ or $j = a$.

If $j = b$, then b obtains $\lambda\phi_1(w_1, w_2)$. Let b unilaterally deviate to $\tilde{w}_1^b = w_1 - \varepsilon$ such that $\varepsilon > 0$ and $w_1 - \varepsilon > \underline{w}$. Following this deviation, b obtains $\phi_1(w_1 - \varepsilon, w_2)$. As $w_1 > \underline{w}$ and $\lambda < 1$, we have $(1-\lambda)\phi_1(w_1, w_2) > 0$. Let $0 < \delta < (1-\lambda)\phi_1(w_1, w_2)$. Since $\phi_1(w_1, w_2)$ is continuous in w_1, for sufficiently small $\varepsilon > 0$, we have $\phi_1(w_1 - \varepsilon, w_2) > \phi_1(w_1, w_2) - \delta > \lambda\phi_1(w_1, w_2)$ showing that the deviation is gainful for b.

If $j = a$, then a obtains $\lambda\phi_1(w_1, w_2) + \phi_2(w_1, w_2)$. Let a unilaterally deviate to $(w_1 - \varepsilon, w_2)$ such that $\varepsilon > 0$ and $w_1 - \varepsilon > \underline{w}$. Following this deviation, a obtains

$$\phi_{12}(w_1 - \varepsilon, w_2) = \phi_1(w_1 - \varepsilon, w_2) + \phi_2(w_1 - \varepsilon, w_2).$$

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As $w_1 > \underline{w}$ and $\lambda < 1$, we have $(1-\lambda)\phi_1(w_1, w_2) > 0$. Let $0 < \delta < (1-\lambda)\phi_1(w_1, w_2)/2$. Since for $i = 1, 2$, $\phi_i(w_1, w_2)$ is continuous in w_1, for sufficiently small $\varepsilon > 0$ we have $\phi_i(w_1 - \varepsilon, w_2) > \phi_i(w_1, w_2) - \delta$. Hence

$$\phi_{12}(w_1 - \varepsilon, w_2) > \phi_1(w_1, w_2) + \phi_2(w_1, w_2) - 2\delta > \lambda\phi_1(w_1, w_2) + \phi_2(w_1, w_2)$$

showing that the deviation is gainful for a.

Thus, at any NE we must have $w_1 = \underline{w}$ so that $\min\{w_1^a, w_1^b\} = \underline{w}$. If $\max\{w_1^a, w_1^b\} > \underline{w}$, then $\exists\, j \in \{a, b\}$ such that $w_1^j = \underline{w}$ and $x_1^j = x_1^*(\underline{w}, w_2)$. If $j = b$, then b obtains $\phi_1(\underline{w}, w_2) = 0$ and b is better off unilaterally deviating to $\tilde{w}_1^b$ such that $\underline{w} < \tilde{w}_1^b < \min\{w_1^a, \overline{w}\}$ to obtain positive payoff. If $j = a$, then a obtains $\phi_{12}(\underline{w}, w_2)$, which by (11) equals $\phi_1(\underline{w}, w_2) + \phi_2(\underline{w}, w_2) = \phi_2(\underline{w}, w_2)$. If $w_2 \leq \underline{w}$, this payoff is at most zero and a is better off unilaterally deviating to $(\underline{w}, \underline{w} + \varepsilon)$ for a sufficiently small positive ε. If $w_2 > \underline{w}$, then by Lemma 2(i), a is better off unilaterally deviating to $(\underline{w} + \varepsilon, w_2)$ for a sufficiently small positive ε. So we must have $w_1^a = w_1^b = \underline{w}$ at any NE.

Step 3: To complete the proof, consider a strategy profile $((w_1^a, w_2^a), w_1^b)$ such that $w_1^a = w_1^b = \underline{w}$. Let $w_2 = \min\{w_2^a, \overline{w}\}$. At this strategy profile, choosing $x_1^a = \lambda x_1^*(\underline{w}, w_2)$, $x_1^b = (1-\lambda)x_1^*(\underline{w}, w_2)$ is optimal for the firm for any $\lambda \in [0, 1]$. Since $\phi_1(\underline{w}, w_2) = 0$, at this strategy profile the payoff of country b is $(1-\lambda)\phi_1(\underline{w}, w_2) = 0$. The payoff of country a is $\lambda\phi_1(\underline{w}, \overline{w}) = 0$ if $w_2^a > \overline{w}$ and $\lambda\phi_1(\underline{w}, w_2^a) + \phi_2(\underline{w}, w_2^a) = \phi_2(\underline{w}, w_2^a)$ if $w_2^a \leq \overline{w}$. Since $\phi_2(\underline{w}, w_2^a)$ is at most zero for $w_2^a \leq \underline{w}$ and positive for $\underline{w} < w_2^a \leq \overline{w}$, by Proposition 1(I)(i), $\phi_2(\underline{w}, w_2^a)$ has a unique maximizer $\widetilde{w}_2$ over $w_2^a \in [0, \overline{w}]$ and $\widetilde{w}_2 > \underline{w}$. Thus at any NE, we must have $w_1^a = w_1^b = \underline{w}$ and $w_2^a = \widetilde{w}_2$.

Finally we show that the profile $((\underline{w}, \widetilde{w}_2), \underline{w})$ indeed constitutes an NE. To see this first observe that at this strategy profile, for input 1 the firm is indifferent between the two countries. For any $\lambda \in [0, 1]$, choosing $x_1^a = \lambda x_1^*(\underline{w}, \widetilde{w}_2)$ and $x_1^b = (1-\lambda)x_1^*(\underline{w}, \widetilde{w}_2)$ is optimal for the firm. For any choice of λ by the firm, b obtains $(1-\lambda)\phi_1(\underline{w}, \widetilde{w}_2) = 0$. If b unilaterally deviates to $w_1^b \neq \underline{w}$, it would obtain negative payoff if $w_1^b < \underline{w}$ and zero if $w_1^b > \underline{w}$, so no such deviation is gainful.

For any choice of λ by the firm, a obtains $\lambda\phi_1(\underline{w}, \widetilde{w}_2) + \phi_2(\underline{w}, \widetilde{w}_2) = \phi_2(\underline{w}, \widetilde{w}_2) > 0$. Suppose a unilaterally deviates to (w_1^a, w_2^a). If $w_2^a > \overline{w}$, then a would obtain at most zero. If $w_1^a \geq \underline{w}$ and $w_a^2 \leq \overline{w}$, then a would obtain $\phi_2(\underline{w}, w_2^a)$, which cannot exceed $\phi_2(\underline{w}, \widetilde{w}_2)$. If $w_1^a < \underline{w}$ and $w_2^a \leq \underline{w}$, then a would obtain at most zero. If $w_1^a < \underline{w} < w_2^a \leq \overline{w}$, then a would obtain $\phi_{12}(w_1^a, w_2^a)$, which is lower than $\phi_{12}(\underline{w}, w_2^a)$ (by Lemma 2(i)). Since $\phi_{12}(\underline{w}, w_2^a) = \phi_1(\underline{w}, w_2^a) + \phi_2(\underline{w}, w_2^a) = \phi_2(\underline{w}, w_2^a) \leq \phi_2(\underline{w}, \widetilde{w}_2)$, this deviation is also not gainful for country a. Thus, the strategy profile $((\underline{w}, \tilde{w}_2^a), \underline{w})$ constitutes an NE.

This shows that the game $\Gamma(12, 1)$ has a continuum of NE. Any NE has $(w_1^a, w_2^a) = (\underline{w}, \widetilde{w}_2)$ and $w_b^1 = \underline{w}$. Since both countries offer the same wage $\underline{w}$ for input 1, the firm is indifferent between the two countries for this input. This results in a continuum of NE, but all them have the same input wages and payoffs. ∎

5.2.5 One country invested in both inputs, another country invested in no input

Consider the game $\Gamma(12, 0)$. This is the game in which country a invested in both inputs $1, 2$ and country b invested in no input (the analysis is similar for the game $\Gamma(0, 12)$). In the game $\Gamma(12, 0)$, country b always obtains zero payoff. In this game country a announces wage pair (w_1^a, w_2^a). Let $w_i = \min\{w_i^a, \overline{w}\}$ for $i = 1, 2$. The firm employs $x_i^*(w_1, w_2)$ units of input i. If $w_i^a = w_i$, the firm employs input i from country a; otherwise it employs input i from the external source at wage $\overline{w}$.

Observation 5 $\Gamma(12, 0)$ *has a unique NE:* $w_1^a = w_1^b = \overline{w}$. *At the NE country* a *obtains* $\phi_{12}(\overline{w}, \overline{w}) = (\overline{w} - \underline{w})K/\overline{w} > 0$ *and country* b *obtains zero payoff.*

Proof First observe that at any NE of $\Gamma(12, 0)$, we must have $w_i^a \leq \overline{w}$ for both $i = 1, 2$. If $w_i^a > \overline{w}$ for both $i = 1, 2$, then country a obtains zero payoff; by unilaterally deviating to $(\overline{w}, w_2^a)$, it obtains $\phi_1(\overline{w}, \overline{w}) > 0$, so the deviation is gainful. If $w_i^a > \overline{w}$ for only one i, without loss of generality let $w_1^a \leq \overline{w} < w_2^a$. Then country a obtains $\phi_1(w_1^a, \overline{w})$. By unilaterally deviating to $(w_1^a, \overline{w})$, it would obtain $\phi_{12}(w_1^a, \overline{w}) = \phi_1(w_1^a, \overline{w}) + \phi_2(w_1^a, \overline{w}) > \phi_1(w_1^a, \overline{w})$ so the deviation is gainful.

Consider (w_1^a, w_2^a) such that $w_i^a \leq \overline{w}$ for both $i = 1, 2$. Then a obtains $\phi_{12}(w_1^a, w_2^a)$ and the result is immediate from Lemma 2(ii). ∎

5.2.6 Both countries invested in both inputs

Consider the game $\Gamma(12, 12)$ (the game in which both countries have invested in both inputs $1, 2$). In this game, country $j \in \{a, b\}$ announces wage pair (w_1^j, w_2^j). Let $w_i = \min\{w_i^a, w_i^b, \overline{w}\}$ for $i = 1, 2$. The firm employs $x_i^*(w_1, w_2)$ units of input i. If $\min\{w_i^a, w_i^b\} > \overline{w}$, the firm employs input i from the external source; otherwise it employs input i from countries that offer the lowest wage for input i.

Observation 6 $\Gamma(12, 12)$ *has a unique NE:* $w_i^a = w_i^b = \underline{w}$ *for both* $i = 1, 2$. *At the NE, each country obtains zero payoff.*

Proof For $i = 1, 2$, denote $w_i = \min\{w_i^a, w_i^b, \overline{w}\}$. We prove the result in following steps.

Step 1: We cannot have an NE where $w_i < \underline{w}$ for some $i = 1, 2$. To see this, take $i = 1$ (same reasoning applies for $i = 2$) and consider a strategy profile in which $w_1 < \underline{w}$.

Case 1 $w_1 < \underline{w}$ and $w_2 \leq \underline{w}$. In this case $\exists$ a country $j \in \{a, b\}$ such that $x_1^j = \lambda x_1^*(w_1, w_2)$ for some $\lambda \in (0, 1]$. As $w_2 \leq \underline{w}$, country j obtains at most $\lambda \phi_1(w_1, w_2) < 0$. By unilaterally deviating to $(\underline{w}, \underline{w})$, country j would obtain zero payoff, so such a deviation is gainful.

Case 2 $w_1 < \underline{w}$ and $w_2 > \underline{w}$. In this case $\exists$ a country $j \in \{a, b\}$ such that $x_2^j = \lambda x_2^*(w_1, w_2)$ for some $\lambda \in [0, 1)$. Let $j = a$ (same reasoning applies if $j = b$). There are two possibilities: (i) $w_1 = w_1^a < w_1^b$ and (ii) $w_1 = w_1^b \leq w_1^a$.

Subcase 2(i) $w_1 = w_1^a < w_1^b$. Then a obtains $\phi_1(w_1, w_2) + \lambda \phi_2(w_1, w_2)$. Let a unilaterally deviate to $(w_1, w_2 - \varepsilon)$ where $\varepsilon > 0$ and $w_2 - \varepsilon > \underline{w}$. Following this deviation, a would obtain $\phi_1(w_1, w_2 - \varepsilon) + \phi_2(w_1, w_2 - \varepsilon)$. Since $w_2 > \underline{w}$ and $\lambda < 1$, we have $(1 - \lambda)\phi_2(w_1, w_2) > 0$. Let $0 < \delta < (1 - \lambda)\phi_2(w_1, w_2)/2$. Since $\phi_i(w_1, w_2)$ is continuous in w_2, for sufficiently small $\varepsilon > 0$ we have

$$\phi_1(w_1, w_2 - \varepsilon) + \phi_2(w_1, w_2 - \varepsilon) > \phi_1(w_1, w_2) + \phi_2(w_1, w_2) - 2\delta > \phi_1(w_1, w_2) + \lambda \phi_2(w_1, w_2)$$

showing that the deviation is gainful for a.

Subcase 2(ii) $w_1 = w_1^b \leq w_1^a$. Since $w_1 < \underline{w}$, in this case a obtains at most $\lambda \phi_2(w_1, w_2)$. Let a unilaterally deviate to $(\underline{w}, w_2 - \varepsilon)$ where $\varepsilon > 0$ and $w_2 - \varepsilon > \underline{w}$. Following this deviation, a would obtain $\phi_2(w_1, w_2 - \varepsilon)$. Since $w_2 > \underline{w}$ and $\lambda < 1$, we have $(1 - \lambda)\phi_2(w_1, w_2) > 0$. Let $0 < \delta < (1 - \lambda)\phi_2(w_1, w_2)$. Since $\phi_2(w_1, w_2)$ is continuous in w_2, for sufficiently small $\varepsilon > 0$ we have $\phi_2(w_1, w_2 - \varepsilon) > \phi_2(w_1, w_2) - \delta > \lambda \phi_2(w_1, w_2)$ showing that the deviation is gainful for a.

Step 2: We cannot have an NE where $w_i > \underline{w}$ for some $i = 1, 2$. To see this, take $i = 1$ (same reasoning applies for $i = 2$) and consider a strategy profile in which $w_1 > \underline{w}$. Then $\exists j \in \{a, b\}$ such that $x_1^j = \lambda x_1^*(w_1, w_2)$ for some $\lambda \in [0, 1)$. Let $j = a$ (same reasoning applies for $j = b$). There are two possibilities: (i) $w_2 = w_2^a \leq w_2^b$ and (ii) $w_2 = w_2^b < w_2^a$.

Case (i) $w_2 = w_2^a \leq w_2^b$. Since $w_2 \geq \underline{w}$ (by Step 1), in this case a obtains at most $\lambda \phi_1(w_1, w_2) + \phi_2(w_1, w_2)$. Let a unilaterally deviate to $(w_1 - \varepsilon, w_2 - \varepsilon)$ where $\varepsilon > 0$ and $w_1 - \varepsilon > \underline{w}$. Following this deviation, a would obtain $\phi_1(w_1 - \varepsilon, w_2 - \varepsilon) + \phi_2(w_1 - \varepsilon, w_2 - \varepsilon)$. Since $w_1 > \underline{w}$ and $\lambda < 1$, we have $(1 - \lambda)\phi_1(w_1, w_2) > 0$. Let $0 < \delta < (1 - \lambda)\phi_1(w_1, w_2)/2$. Since $\phi_1(w_1, w_2)$ is continuous in w_1, w_2, for sufficiently small $\varepsilon > 0$ we have

$$\phi_1(w_1 - \varepsilon, w_2 - \varepsilon) + \phi_2(w_1 - \varepsilon, w_2 - \varepsilon)$$

$$> \phi_1(w_1, w_2) + \phi_2(w_1, w_2) - 2\delta > \lambda\phi_1(w_1, w_2) + \phi_2(w_1, w_2)$$

showing gainful deviation for a.

Case (ii) $w_2 = w_2^b < w_2^a$. In this case a obtains $\lambda\phi_1(w_1, w_2)$. Let a unilaterally deviate to $(w_1 - \varepsilon, w_2^a)$ where $\varepsilon > 0$ and $w_1 - \varepsilon > \underline{w}$. Following this deviation, a would obtain $\phi_1(w_1 - \varepsilon, w_2)$. Since $w_1 > \underline{w}$ and $\lambda < 1$, we have $(1 - \lambda)\phi_1(w_1, w_2) > 0$. Let $0 < \delta < (1 - \lambda)\phi_1(w_1, w_2)$. Since $\phi_1(w_1, w_2)$ is continuous in w_2, for sufficiently small $\varepsilon > 0$ we have $\phi_1(w_1 - \varepsilon, w_2) > \phi_1(w_1, w_2) - \delta > \lambda\phi_1(w_1, w_2)$ showing gainful deviation for a.

Step 3: By Steps 1-2, at any NE, for both $i = 1, 2$, we must have $\min\{w_i^a, w_i^b\} = \underline{w}$. Now we show that at any NE, we must also have $\max\{w_i^a, w_i^b\} = \underline{w}$ for both i. Consider a strategy profile such that $\min\{w_i^a, w_i^b\} = \underline{w}$ for both $i = 1, 2$ and there is some i (say $i = 1$) for which $\min\{w_1^a, w_1^b\} = \underline{w} < \max\{w_1^a, w_1^b\}$. Without loss of generality, let $w_1^a = \underline{w} < w_1^b$. Since $\min\{w_i^a, w_i^b\} = \underline{w}$ for both inputs $i = 1, 2$, each country obtains zero payoff. Let country a unilaterally deviate to $(\tilde{w}_1^a, w_2^a)$ such that $\underline{w} < \tilde{w}_1^a < \min\{w_1^b, \overline{w}\}$. Following this deviation, the firm would employ $x_1^*(\tilde{w}_1^a, \underline{w})$ units of input 1 from country a. So a would obtain $\phi_1(\tilde{w}_1^a, \underline{w}) > 0$, making the deviation gainful. This shows that at any NE, for both $i = 1, 2$, we must have $w_i^a = w_i^b = \underline{w}$.

Finally observe that the strategy profile $((w_1^a, w_2^a), (w_1^b, w_2^b))$ such that $w_i^a = w_i^b = \underline{w}$ for both $i = 1, 2$ is indeed an NE. This is because at this strategy profile each country gets zero payoff and there is no unilateral deviation that gives positive payoff to a country. ∎

Endnotes

1. In a recent paper, Caraballo Cueto (2017) provides a convenient list of the dimensions along which such dilution has been noted.

2. Strictly speaking, the function F is the revenue of the firm, but revenue and profit are operationally equivalent in our model. Calling F the profit function enables us to better interpret our results.

3. We make the tie-breaking assumption that if a country sets a wage exactly equal to $\overline{w}$, the firm employs labour from that country rather than using its outside option.

4. Apart from the purely analytical angle, one could also put an empirical content to the assumption that reservation wages are the same in the two countries: this

competition is between the poorest two countries, both with reservation wages at the bottom. Similar assumption is made in Chau and Kanbur (2006) and Caraballo Cueto (2017). We are indebted to an anonymous reviewer for pointing this out.

5. The functions g_i and h_j determine whether a country has to increase or decrease its wage to raise its labour income. Specifically, given w_j (and consequently a certain value of $h_i(w_j)$), increasing w_i will raise ψ_i as long as $g_i(w_i)$ does not exceed the given $h_i(w_j)$. By the monotoncity of g_i it follows that it is best for country i to set the maximum feasible w_i with $g_i(w_i) \leq h_i(w_j)$. Further, as h_i is increasing in w_j, it also follows that the best response function of country i is non decreasing in w_j, which indicates supermodularity of the strategic interaction (see Lemma A1 for a formal statement of this obsevation).

6. When $m = 1$ (which holds if and only if $\alpha = 1/2$), $\delta^*(1, \theta) = \hat{\delta}(1, \theta) = 2\theta/(2+\theta)$.

Acknowledgements

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