The Impact of Corporate Taxation on Foreign Direct Investment: a Survey

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Abstract

This paper reviews the literature on factors influencing the allocation of foreign direct investments, with respect to the significant role of corporate taxation policy. The review includes Bucovetsky’s tax competition model where countries are assumed to be asymmetric. Empirical studies of Sørensen (2000), Root and Ahmed (1978), Mooij and Ederveen (2003) are touched upon in the survey. The paper helps to understand the importance of tax policy in attracting foreign investments to the country. The survey assumes effective enforcement to highlight the impact of taxation on foreign investment.

Journal of Economic Literature Classification numbers: E2, F2, H2

Keywords: impact of tax policy, foreign direct investments, determinants of foreign direct investments, tax competition

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1. Introduction

World economy has been changing year by year, influencing monetary policy of governments across countries. Companies become increasingly mobile; the economies need more qualified labour and more technological solutions that need quite large investments. These conditions are very efficient in the process of economic globalization and give a push to fiscal policy changes. In particular, there is a huge pressure on national fiscal policies across the European Union (EU) countries where
much influence has been exerted by free movement of capital, goods and labour. On the one hand, EU countries protect the economy of the region. On the other hand, there are the pressure of common revenue policy and the wish to standardise the tax systems across the EU Member States.

After the 2004 enlargement of the European Union, tax policy has become a key issue of attracting resources and capital and working out the strategies. On the one hand, we have land resources in the allocation of which it is not possible to choose the location. On the other hand, we have mobile resources such as qualified labour force, cheap storage and work space in the manufacturing process or the service sector. When looking for a location for the latter, an entrepreneur would behave rationally. In that case one of the criteria will be the national tax policy. By reducing tax rates the state will force its neighbouring countries to make the same decisions in order to preserve their position in the global economy and make budget revenue. The described process is called tax competition. Tax competition reduces tax rates or implements partial deduction schemes in order to increase the tax base, attract capital and improve the business environment. Benassy-Query, Fontagne and Lareche-Revil (2000) explain how the tax harmonization influences inward and outward foreign investment and what will be the effect of adopting a common income tax system in EU.

Opposite to tax competition is harmonization of tax systems. For example, EU Member States may agree to limit tax competition and apply minimum tax rates and standardise the tax base. The asymmetric tax competition model (Krogstrup 2002) clarifies the reasons why Member States have not achieved consensus in this question. Companies then will not look at the country from the point of the most acceptable tax policy but from the point of location of land and other resources available. In the abovementioned case a situation in EU will arise where the poor (from the point of land resources) states will become even poorer, because the flow of capital and budget revenue, including tax revenue, will decrease, and there will be no state funds for development of business environment and infrastructure. And rich states will become richer.

The scope of discussions is broader than the description of empirical models of the relations between inflow of foreign direct investment and tax rates and thus the aspects of location decisions influenced by tax base differences and tax incentives of host countries will be discussed. Smith and Florida (1994), Coughlin, Terza and Arrondee (1991), Benassy-Quesry, Fontagne and Lareche-Revil (2005) have examined the role of credit and exemption schemes applicable for profit taxation in investor’s location decisions.

UNCTAD (2006) has reported that inflow of foreign direct investments increased in 2005 by 29%. In absolute terms, the largest recipient in 2005 was the United Kingdom; the second largest recipient was the United States, followed by China, Hong-Kong, Singapore, Mexico and Brazil. EU was an important destination for FDI, the amount of FDI inflow was $ 422 billion, which is almost half of the world total. The 10 new EU members together attracted $ 34 billion, i.e. growth 19% over 2004 and another new record. It was estimated that 77,000 multinational parent companies own over 770,000 foreign affiliates. At the same time, outflows from the United States have fallen mainly due to changes in law concerning the repatriation of earnings of US foreign affiliates that are taxed at a lower tax rate in case of additional jobs creation.

Sustained competition for foreign direct investment is anticipated by UNCTAD (2005), with incentives and targeting viewed as key tools for investment promotion. Many countries have introduced a large number of changes in their investment regimes during the last 10 years. Big growth in the number of changes is
visible since 2001 when the number of changes had increased twice in comparison with 1995. It was stressed that among the national regulatory changes the changes in corporate taxation policy have become more relevant. More than 20 countries have lowered their corporate income taxes with the purpose of making their investment environments more attractive. Out of 271 such changes introduced in 2004, 235 involved steps to open up new areas to foreign direct investment with new promotional measures.

One of the most important indicators of the contribution of country’s openness to foreign direct investment is the number of international agreements concerning investment. UNCTAD (2006) reports that the number of double taxation treaties all over the world reached 2599 in 2004, and the number of bilateral investment treaties 2392. In 2005, the tendency was still to increase, the number of bilateral investment treaties had reached 2495 and the number of double taxation treaties 2758.

The survey shows that asymmetric tax competition model is applicable in the European Union where smaller countries have a smaller tax rate and large countries have a higher tax rate (Krongstrup 2002).

Our paper provides a survey of literature on the research conducted in the field of effects of corporate taxation on foreign investment. The paper consists of 5 sections. The first section describes the concept of foreign direct investment and the situation in the world economy and particularly in the European Union concerning foreign investment. The second section is based on comparative analysis of corporate tax rates of EU countries and the situation of EU tax competition. It contains views of different scientists and raises the question of choice between tax competition and tax harmonization in the European Union. The third section gives an overview of different factors that influence the allocation decision and describes opinions of different researchers. The fourth section offers a short overview of the results of various empirical studies based on statistical analysis, stimulation models, and interviewing managers about the importance of taxation for business investment decisions. My concluding remarks call for more works on the important topics of the effects of corporate taxation on foreign direct investment in the European Union.

2. Recent Trends in International Capital Flows

Different definitions of foreign direct investment are available in literature. It is very important to mention that there are different types of foreign investment. International capital flows can be divided into two: international direct investments, which are directly connected with controlling interests of the investor in the company, and international portfolio investments, which are not connected with controlling interests in the investing company.

Portfolio investments are usually in the form of shares in the investment fund where the share does not exceed 10 or 25% of total capital of the fund. An important difference of direct investments from portfolio investments is that the investor loses mobility of the invested capital, the fact that makes the investment rather long-run (Schultze and Freytag 2007). An increase in tax rate on interests will tend to decrease the amount of portfolio investment, because the repatriation of profit of such investment is usually conducted in the form of interests.

According to the IMF and OECD definitions, direct investments reflect the goal of obtaining a stable, long-term interest by a resident entity of one economy (direct investor) in an enterprise that is a resident in another economy with a significant degree of influence on the management of the latter (Duwe 2003).
Discrepancies in statistics appear because of different approaches used by UNISTAD and IMF to classify some countries as “developed” or “developing.” Differences in definitions used by IMF and UNCTAD are not substantial. FDI flows consist of the net sales of shares and loans (including non-cash acquisitions made against equipment, manufacturing rights etc.) to the parent company plus the parent firm’s share of the affiliate’s reinvested earnings plus total net intra/company loans (short- and long-term) provided by the parent company (UNCTAD 2006). For branches, FDI flows consist of increase in reinvested earnings plus net increase in funds received from foreign direct investor. FDI flows with negative sign (reverse flows) indicate that at least one of the components in the above definitions is negative and not offset by positive amounts of the remaining components.

FDI stock is the value of the share of the capital and reserves (including retained profits) attributable to the parent enterprise (that is equal to total assets minus total liabilities), plus the net indebtedness of the subsidiary to the parent firm. For branches, it is the value of fixed assets and the value of current assets and investments, excluding amounts due from the parent, less liabilities to third parties.

Figure 1. FDI Outflow from EU Old Member States, 2002-2004

Source: UNCTAD

The global FDI inflow reached in 2006 $1,306 billion, i.e. growth 38% in comparison with 2005 (UNCTAD 2007). The rise in global FDI was partly driven by increase in corporate profit, as reinvested profits became an important part of inward FDI. According to UNCTAD estimations, it is 30% of total worldwide inflows. The largest recipient in 2005 was the United Kingdom; the second largest recipient was the
United States. In 2006, the United States reclaimed its position and achieved the leading position as a host country, the United Kingdom and France followed. Among developing countries, the largest recipients are China, Hong Kong (China) and Singapore. Among transition economies the leading position has been achieved by Russia. Almost half of the world outflows originate from the European Union countries. Service sector and infrastructure related services reached in 2006 the first place, the second largest sector is manufacturing, which declined from 41% in 1990 to 30% in 2005.

The situation in the European Union is quite interesting. The inward investments into the European Union increased 9% from 2005 to 2006, and reached $531 billion. FDI inflow decreased in Ireland, Spain and the United Kingdom and increased in Belgium, Luxembourg, Italy and in 10 new Member States where the FDI achieved $39 billion. Special attention should be given to the outward FDI from developed countries of the European Union. France became the second largest investor worldwide over the last 2 years. Spanish and Dutch companies continued to invest abroad.

Accession of new members was connected with their effort to enhance attractiveness to investors and several new Member States have lowered their corporate tax rates to levels comparable to those of Ireland. According to UNCTAD, the combination of relatively low wages, low corporate tax rates and access to EU subsidies makes the accession countries an attractive location for FDI, both from other EU countries and from third countries.

3. Tax Competition in the European Union

As it was mentioned before, the main aim of foreign investment is to establish operation in a foreign country. Cross-border operations’ dependence on taxation must be expected. The expected profit repatriated from a subsidiary by parent company depends, first, on the method used in the host country for applying double taxation rules. Countries usually apply the credit or exemption method recommended by OECD. The impact of the method used may be different. There is no clear evidence that it will impact foreign direct investment.

There is a free movement of capital resources in the European Union; the whole world has the tendency for high capital mobility. Many experts support the idea of harmonization of taxation and tax base. Let’s see how harmonization of tax rates will impact Member States. In EU there is a common opinion that the harmonization of taxes will reduce restraints between countries and simplify doing business in different EU countries.

Harmonization is connected with fixed tax rates. Countries with high tax rate will reduce their rate to harmonized one, as result it will be realized in increasing of investments. Countries with low tax rates will lose because investment outflow will increase. Generally speaking, if tax rates are harmonized at a high level, capital will be driven out. If tax rates are harmonized at a low level, capital will be attracted to Europe, and the Community as a whole would gain at the expense of the rest of the world. The distribution of effects of harmonization among Member States depends on the current situation in the particular Member State.

The European Commission has studied various possibilities to co-ordinate taxes in the European Union. Co-ordination would focus on unification of the tax base (i.e. taxes), emphasising that maintenance of the existing system is very costly, international companies must deal with many different definitions given in tax laws
when calculating the tax base of different countries. As a result, a conclusion was reached that such co-ordination as a simplified solution would bring significant benefits to companies and would give an opportunity to consolidate the tax base for business activity in the European Union.

Opinions of scientists and experts about this topic are different. Sinn (1997) stressed that the existing system gives an opportunity to re-distribute budget revenues with the help of tax competition. Absence of capital resources in some areas of the EU may be solved as follows: differentiate income tax rates in different regions by signing multilateral agreements between governments of Member States. Similar to that, Tanzi and Bovenberg (1990) paid attention to differences in income tax rates as an influence on allocation of capital. They advised to unify the tax base, if possible, by establishing the minimum tax rate, further strengthening of the coordination systems, including harmonization of the tax rate. Cnossen (1996) advised a harmonized system, on the basis of which the EU Member States should follow the Scandinavian (Nordic) model with two types of income tax. With such system, a progressive tax rate will be imposed on labour force and a low common rate (flat rate) will be imposed on capital. Frey and Eichenberg (1996) claimed that economists, politicians and other groups generally have prejudices in regard to tax coordination and in their opinion "international tax policy which has been specifically infection-proof" towards tax competition idea would help to decrease "political deformations".

Sørensen (2000) simulated in different variations the effects of tax coordination in the European Union. He modelled different tax coordination plans, including the complete harmonization of the corporate income tax rate and establishment of the common minimum capital tax rate. According to his calculations, implementation of such a plan would result in a small positive outcome. It would comprise 0.16–0.35% of the GDP. Thus, Sørensen’s result is that a potential use of tax harmonization in the EU may actually be quite moderate. In his works Sørensen looks at internal differences between the states, modelling three different regions: Scandinavian (Nordic) countries, continental Europe and UK. He showed that differences in demand for re-allocation in productivity and share of foreign owners are influencing re-allocation of prosperity. Therefore harmonization of taxes is obstructed from a political point of view, which is even more the case for the poor states.

Opposite to the previous research, Grubert (2001) has researched 60 states and concluded that in 1984-1992 the effective income tax rate decreased by ten percentage points. In his opinion, there is no tax competition because income tax rate did not decrease.

Government policies for attracting foreign investments can be divided into two categories: indirect and direct. One of them is to promote faster economic growth and the other creates a situation that does not discriminate between foreign and domestic investors via taxation and other regulation. Globerman and Shapiro (1999) evaluate different variables like GDP in Canada and abroad, exchange rate, investment climate, imports, exports etc. They concluded that managers should pay close attention to the public policy.

It is known that the countries of the European Union are in a sense competing with each other. This is also revealed in their tax policy behaviour. Statutory corporate tax rates have declined over the last 25 years in most of the EU countries (see Table 1). An important question is whether the decrease of corporate tax rate has been a result of tax competition and whether we see a “race-to-bottom”. An example here is Ireland, which being the leader in the mentioned “race” has lowered the corporate tax rate from 43% in 1990 to 12.5% in 2005.
### Table 1. Statutory Corporate Tax Rates in EU

<table>
<thead>
<tr>
<th></th>
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<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>Austria</td>
<td>55</td>
<td>39</td>
<td>34</td>
<td>34</td>
<td>25</td>
</tr>
<tr>
<td>Belgium</td>
<td>48</td>
<td>41</td>
<td>40.17</td>
<td>40.17</td>
<td>33.99</td>
</tr>
<tr>
<td>Cyprus</td>
<td>n.a.</td>
<td>n.a.</td>
<td>25</td>
<td>29</td>
<td>10</td>
</tr>
<tr>
<td>Denmark</td>
<td>n.a.</td>
<td>40</td>
<td>34</td>
<td>32</td>
<td>30</td>
</tr>
<tr>
<td>Estonia</td>
<td>n.a.</td>
<td>n.a.</td>
<td>26</td>
<td>26</td>
<td>24</td>
</tr>
<tr>
<td>Finland</td>
<td>59</td>
<td>41</td>
<td>25</td>
<td>29</td>
<td>26</td>
</tr>
<tr>
<td>France</td>
<td>50</td>
<td>37</td>
<td>36.67</td>
<td>36.67</td>
<td>34.93</td>
</tr>
<tr>
<td>Germany</td>
<td>52.8</td>
<td>57.7</td>
<td>56.8</td>
<td>51.63</td>
<td>38.29</td>
</tr>
<tr>
<td>Greece</td>
<td>43.4</td>
<td>46</td>
<td>40</td>
<td>40</td>
<td>35</td>
</tr>
<tr>
<td>Hungary</td>
<td>n.a.</td>
<td>50</td>
<td>19.64</td>
<td>19.64</td>
<td>17.68</td>
</tr>
<tr>
<td>Ireland</td>
<td>45</td>
<td>43</td>
<td>40</td>
<td>24</td>
<td>12.5</td>
</tr>
<tr>
<td>Italy</td>
<td>36.3</td>
<td>41.8</td>
<td>52.2</td>
<td>41.25</td>
<td>37.25</td>
</tr>
<tr>
<td>Latvia</td>
<td>n.a.</td>
<td>n.a.</td>
<td>25</td>
<td>25</td>
<td>15</td>
</tr>
<tr>
<td>Lithuania</td>
<td>n.a.</td>
<td>35</td>
<td>29</td>
<td>24</td>
<td>15</td>
</tr>
<tr>
<td>Luxembourg</td>
<td>n.a.</td>
<td>39.4</td>
<td>40.9</td>
<td>37.45</td>
<td>30.38</td>
</tr>
<tr>
<td>Malta</td>
<td>n.a.</td>
<td>32.5</td>
<td>35</td>
<td>35</td>
<td>35</td>
</tr>
<tr>
<td>Netherlands</td>
<td>48</td>
<td>35</td>
<td>35</td>
<td>35</td>
<td>31.5</td>
</tr>
<tr>
<td>Poland</td>
<td>n.a.</td>
<td>40</td>
<td>40</td>
<td>30</td>
<td>19</td>
</tr>
<tr>
<td>Portugal</td>
<td>n.a.</td>
<td>36.5</td>
<td>39.6</td>
<td>35.2</td>
<td>27.5</td>
</tr>
<tr>
<td>Slovak rep.</td>
<td>n.a.</td>
<td>n.a.</td>
<td>40</td>
<td>29</td>
<td>19</td>
</tr>
<tr>
<td>Slovenia</td>
<td>n.a.</td>
<td>n.a.</td>
<td>25</td>
<td>25</td>
<td>25</td>
</tr>
<tr>
<td>Spain</td>
<td>33</td>
<td>35</td>
<td>35</td>
<td>35</td>
<td>35</td>
</tr>
<tr>
<td>Sweden</td>
<td>n.a.</td>
<td>40</td>
<td>28</td>
<td>28</td>
<td>28</td>
</tr>
<tr>
<td>United Kingdom</td>
<td>52</td>
<td>34</td>
<td>33</td>
<td>30</td>
<td>30</td>
</tr>
<tr>
<td>EU-15 average</td>
<td>n.a.</td>
<td>40.4</td>
<td>38</td>
<td>35.3</td>
<td>30.4</td>
</tr>
<tr>
<td>New Member States-10 average</td>
<td>n.a.</td>
<td>n.a.</td>
<td>30.6</td>
<td>24.8</td>
<td>18.2</td>
</tr>
</tbody>
</table>

Source: Nicodeme 2006.

The tax competition model of asymmetric countries explains the behaviour of EU countries according to what the differences between tax rates of larger Member States and smaller Member States have increased during the last 25 years. Different authors have offered the asymmetric tax competition model. The conclusion of all of them is similar. Krongstrup (2002) pointed out that a larger country faces a lower elasticity of capital to the tax rate, and hence a lower marginal cost of public funds, and therefore chooses a higher tax rate than the smaller country. Let’s see Bucovetsky’s tax competition model for tax competition countries, which are different in size. Bucovetsky’s model reviews two countries, one of them is large and the other is relatively small by population.

\[ \delta_1 \text{ is the population of country 1,} \]
\[ \delta_2 \text{ is the population of country 2 and} \]
\[ \delta_1 > \delta_2 \]

So the tax elasticity of capital is smaller in country 1 and equal to\(^1\):

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\(^1\) Due to the limitations of this paper the author does not bring the whole model here. Please find Krongstrup(2002) for details.
In Bucovetsky’s model all per capita variables are identical. The asymmetry described by Krogstrup (2002) implies as follows: when a large country changes its tax rate, more capital will move out from the country than when a small country increases its tax rate by the same amount; this explains unavailability of EU countries to agree with tax coordination. Bucovetsky reached an important conclusion about the advantage of “smallness”, according to what a small country has lower cost of capital and will employ a greater amount of capital per fixed factor in equilibrium, with the consequence that the returns to these fixed factors is higher compared to the larger country (Krogstrup 2002).

Krogstrup (2002) examined and brought out the key message of tax competition model where larger countries have higher tax rates on capital compared to smaller countries when capital is mobile across countries.

The comparative statistics concerning the evaluation of corporate tax rates and revenues as percentage of GDP depicted in Figure 2 shows that there is no obvious relationship between the cuts in corporate statutory rate and the situation with revenues collected. The Figure suggests that new Member States which have decreased their rates have lost corporate tax revenues as percentage of GDP, while the opposite holds for most of the EU-15 countries (Nicodeme 2006).

A different research shows that investors are sensitive both to changes in tax rates and to possible charge-offs. For example, look at the neighbouring countries Lithuania and Poland, which have almost the same geographical advantages. From the economic geography point of view, their position is very good: Russian Federation is on one side and old Europe is on the other side. This enhances economic development in both states. At the same time, Poland has more natural resources and cheaper labour.
force. The Republic of Lithuania has more qualified specialists, and from the perspective of tax policy, allocation of capital into Lithuanian companies is more beneficial, because the income tax rate is lower. Hence, the Lithuanian government competes with Poland by offering lower tax rates instead of natural resources. Table 2 gives an overview of differences in corporate income tax systems in the new Member States of the European Union. The information on the tax base, main and specific rates, allowed period for deducting losses are presented in the table.

**Table 2. Main Aspects of Corporate Taxation in EU10, 2004**

<table>
<thead>
<tr>
<th>State</th>
<th>Tax base</th>
<th>Main rate</th>
<th>Specific rate</th>
<th>Period for deducting losses</th>
</tr>
</thead>
<tbody>
<tr>
<td>Cyprus</td>
<td>adjusted accounting profit</td>
<td>Up to 1 M CYP: 10%; over 1 M CYP: 15%</td>
<td>For companies: up to 1 M CYP: 25%; over 1 M CYP: 30%</td>
<td>Indefinite time</td>
</tr>
<tr>
<td>Czech Republic</td>
<td>adjusted accounting profit</td>
<td>2004 - 28%; 2005 – 26%; 2006 – 24%</td>
<td>Pension funds: 15%; investment funds: 5%</td>
<td>5 years</td>
</tr>
<tr>
<td>Estonia</td>
<td>distribution of net profit</td>
<td>26.74 (ca 35.14%)</td>
<td>-</td>
<td>-</td>
</tr>
<tr>
<td>Hungary</td>
<td>adjusted accounting profit</td>
<td>16%</td>
<td>4% to offshore companies till 31.12.2005</td>
<td>Indefinite time, restrictions apply after 3y of activity</td>
</tr>
<tr>
<td>Republic of Latvia</td>
<td>adjusted accounting profit</td>
<td>15%</td>
<td>-</td>
<td>5 years</td>
</tr>
<tr>
<td>Republic of Lithuania</td>
<td>adjusted accounting profit</td>
<td>15%</td>
<td>Small companies: 13%</td>
<td>5 years</td>
</tr>
<tr>
<td>Malta</td>
<td>adjusted accounting profit</td>
<td>35%</td>
<td>-</td>
<td>Indefinite time</td>
</tr>
<tr>
<td>Poland</td>
<td>adjusted accounting profit</td>
<td>19%</td>
<td>-</td>
<td>5 years, maximum 50% per year</td>
</tr>
<tr>
<td>Republic of Slovakia</td>
<td>adjusted accounting profit</td>
<td>19%</td>
<td>-</td>
<td>5 years</td>
</tr>
<tr>
<td>Slovenia</td>
<td>adjusted accounting profit</td>
<td>25%</td>
<td>Companies in special economic zones: 10%</td>
<td>5 years</td>
</tr>
</tbody>
</table>

*Source: Gyongui 2004*

Agnes Benassy-Quere, Lionel Fontagne, Amina Lahrecherevil (2000) conducted an empirical research on the basis of EU old Member States (12 minus Portugal and Greece due to the unavailability of data). The research showed that the size of the country has a major impact on the share of investments, because larger states have bigger economic potential.

In the research a problem of tax coordination was underlined. As financial policy is to a great extent connected to tax coordination, a question arises how big are the costs of implementing such a policy. A problem of capital mobility is visible through the fact that tax budgets start to suffer and someone has to compensate for losses in these budgets. A consequence of coordination is a reduced normal competition, which is conflicting with the general policy of the European Union. It is a well-known fact that euro was introduced to increase capital mobility and to improve “pure” competition at the same time avoiding currency risks.

In conclusion, it is important to mention Zodrow (2003) who has stated that tax competition causes ineffective underproduction of public goods, therefore redistribution of income to the poor via public goods under tax competition becomes problematic.
4. Determinants of International Capital Flows

Foreign investments are in most cases subject to corporate income tax in the host country. It is important to understand the issue of taxation of the gains from investment. Foreign investments may be subject to international double taxation, subject to corporate tax in the host country, subject to dividend tax in the home country. All these facts have been analysed by Mooij and Ederveen (2003) in a meta-analysis and its results will be presented below. Gains from investment may be an object of taxation in both, host and home country, and therefore it is important to adopt either a credit system or an exemption system to avoid double taxation. Many countries have adopted an international convention for the avoidance of double taxation, according to what they share the tax revenue based on the place of taxation.

FDI inflow depends first on stable political and economic environment, including availability of educated and skilled workers, low wages, open economy and stable currency (UNCTAD 1997). This means that first of all macro-economic conditions are significant for attracting foreign direct investment. Second, multinational firms evaluate micro-perspective issues such as tax breaks, restrictions on investment, majority control and profit repatriation. It is important to evaluate whether the host country is investment friendly or not. Many researchers, mostly in the U.S. where economic reforms in taxation were during many years considered important, have examined these aspects.

Tax base and tax rate are not the only factors that firms take into consideration while making investment location decisions. According to Forbes, tax policy conditions are more important in the fields of activity where competition is high. Forbes (2005) shows that the lowest effective tax rate is in Saudi Arabia and Hong-Kong, and the highest rate is in France.

Many scientists have investigated the determinants that influence the flows of investment. Considerable are the results of an empirical research by Root and Ahmed (1978) where 44 different economic, social, political and policy determinants of foreign direct investment are pointed out. In Table 3 the above-mentioned variables are grouped into categories. The economic factors include economic growth, stability variables and also infrastructure determinants. Political stability and social environment are irrefutably important factors for attracting foreign investors. Taxation issues are categorized into the policy group of factors that influence foreign investment allocation decisions. Hereby most essential are corporate taxation conditions, availability of tax incentives and their value, and the general complexity of taxation system. From among the political factors similar importance is attached to governmental policy in issues concerning foreign employees and legislative restrictions on foreign investors.

A comprehensive research by Moore, Steece and Swenson (1987) on determinants investigated the impact of tax rates and bases on foreign investment and concluded that corporate income tax has a small impact on foreign investment. The empirical analysis proved that investment incentives have a very important role in attracting foreign investment. The analysis was restricted to foreign investment in manufacturing. Similarly to Root and Ahmed (1978), the authors assessed the different scope of independent variables. These are availability of essential resources like level of electricity prices and natural gas prices, economic determinants such as unemployment rate, manufacturing wage rate, corporate tax rate and business climate variable. Significant variables are infrastructure development factors like number of airports, length of railway lines, port facilities, roadways. Size of the country evaluated with the
Table 3. Potential Determinants of Direct Foreign Manufacturing Investment

<table>
<thead>
<tr>
<th>Category</th>
<th>Variable</th>
</tr>
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<tbody>
<tr>
<td>Economic</td>
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Source: Root and Ahmed 1978

help of population number, average number of sunshine days, average number of heating days were also among the significant determinants. The authors used three tax variables: statutory marginal tax rate, average effective corporate income tax rate and unitary tax rates. On the basis of regression analysis it was concluded that the corporate income tax rate was not significant in the manufacturing sector for any of the five years. Results of the research are as follows: business climate, presence or absence of unitary tax structures (tax burden and tax compliance burden) are important determinants of foreign manufacturers’ investment decisions. The above-mentioned effect is more important for new firms.

Altshule, Grubert and Newlon (1997) examined the effect of tax rate on location decisions of US multinational companies and received a different result. They estimated that foreign investment by manufacturing firms is sensitive to differences in host country tax rates.

The Canadian economic research institute, CD Howe Institute, concluded in its report on tax competitiveness that “lowering taxes on capital investments holds the key to growth”. Mintz, Chen, Guillemeth and Doschmann (2005) sustained the impact of
taxation on FDI during the study of 36 countries in which effective tax rates on capital were evaluated. The impact of taxes on investment was evaluated beside the corporate income tax rate that applies to profits. For example, this was 35 percent in the United States and 12.5 percent in Ireland. According to this study, the most favourable tax regimes are in Hong Kong, Ireland, Iceland, Singapore, Slovakia and Sweden. A very important index is the ratio of foreign direct investment to GDP. For example, it is relatively high in Ireland (18.2 percent), Singapore (14.1 percent), Hong Kong (15.2 percent) and Sweden (8.2 percent). In Germany it is 2.7 percent. The study showed that countries who want to grow more attractive for investors must reform their income tax systems by decreasing levies on investment income. 

A research by Wilson (1999) using an interview methodology identified several examples of corporate investment location decisions that were largely driven by tax factors. Most of the EU countries use the world-wide income approach as the basis of multinational resident company taxation. This is in contrast to the territorial approach of some countries such as France and the Netherlands that normally exempt dividends received from a foreign subsidiary of a domestic corporation from home-country taxes. 

As it was mentioned before, 44 determinants of FDI were analysed in different developing countries by Root and Ahmed (1978). The period under examination was 1966-1970 and the number of companies was 41. The model used in this research evaluates certain factors determining the attractiveness of a country to foreign direct investment. 

Multiple discriminant analysis of data was used because the number of determinants was large. For analysis the variables were singled out into one group until no variance could be found that contributed to the variance among groups at the 5% level of significance. Six variables (per capita GDP variable; corporate tax level; ratio of exports to imports; extent of urbanization; commerce, transport and communication; regular executive transfer variable) were selected as essential discriminators at the 5 percent level of significance. The corporate tax level determinant being only one of the six variables is a significant determinant of FDI in manufacturing. This supports the hypothesis that taxes are an important factor for investor’s choice of a country; nonetheless it will also be important in the future for increasing the mobility of factors connected with international activities of companies. The findings verify that competitive tax incentives are necessary but not sufficient to attract foreign investment. 

Dutch scientists have used efficient techniques for obtaining numerical estimates for the tax variables. For example, for evaluation of liberality of tax incentives the number of tax exemptions, length of exemption period, number of years in loss carry-forward provisions were taken into account. Two or more exemptions were graded A; if there was only one exemption, then B, if none then C. These letters were converted into numbers. The other determinants were evaluated in a similar way. 

The main conclusion is that governmental policy is not a decisive factor of foreign investment climate, but it is an important factor for attracting investors to developing counties and it is necessary to take these determinants into consideration while changing and developing the respective policy. 

It is necessary to mention Loree and Guisinger (1995) who have also examined the effects of policy and non-policy determinants on the location of investments on the basis of 1977 and 1982 data on the US direct investments abroad. Part of the data came from results of questioning where the respondents were asked five questions about the performance requirements applied and four questions about the investment incentives offered to each of the firm’s foreign affiliates. Regarding the questions about investment incentives the respondents were asked whether in the host country the affiliate was
provided with tax concessions, incl. tax concessions on corporate income, export profits, capital expenditure, sales, exports, licence fees etc. The variable of tax rates was also added into the model, it is an effective tax rate for host countries derived as actual taxes paid divided by net income of majority-owned affiliates. The investment environment variable, cultural distance, various market characteristics and wage level determinants were also used in the empirical analysis by Loree and Guisinger. Results of the research showed that cultural distance, infrastructure, economic stability coefficients were significant in one period but insignificant in the other period under examination. The effective tax rate policy variable was strongly significant in both cases with the positive sign. The authors examined the determinants of US investment abroad and concluded that statistical analysis alone cannot provide a satisfactory answer to which, policy or non-policy, variables play a bigger role in influencing investors in their location decision-making. It was concluded that changes in tax policy stimulate a change in investment, both domestic and foreign, within one or two years.

5. Importance of Corporate Taxation in Allocation Decisions – Empirical Evidence

Determinants of Regional Investment Decisions: an Econometric Model

Empirical results of research into determinants of regional investment decisions in China suggest that tax rates and incentives are important determinants. It was found that regions with lower tax rates and more tax incentives attract greater amount of foreign direct investment (Tung and Cho 2001). Let us see how the empirical research reached such results. Two issues were examined: the impact of tax incentives on inflow of FDI into China and on location choices. The Chinese Income Tax Act makes tax incentives and tax refunds on reinvested profits available for foreign investments. In China there are tax differences in different zones and cities. In 1991, the Chinese government introduced a new unified Income Tax Act to remove the tax incentives created by previous tax law and to provide a better investment environment to solicit more foreign investments into China.

In the regression analysis FDI is a dependent variable and independent variables are infrastructure, tax incentives, wage rates, unemployment rate and population. The period under examination is 1988-1994. The sample consists of 3 investment incentive zones, which are made up of 43 zones and cities. It was found that wage effect and unemployment effects are insignificant. The focus was on tax and infrastructure variables. Non-infrastructure variables like total annual electricity supply, total annual water supply, size of harbour, passenger transport capacity, harbour cargo handling capacity, capital construction investment of state-owned units, number of phones and number of post offices were extracted from the correlation matrix under control of multiple correlation. According to the results of regression analysis, zones and cities with lower tax rates and greater tax incentives attract more foreign direct investments than other areas. After 1991 tax reforms foreign direct investments increased during 1992-1994, compared with 1988-1991.

Harmonization of Corporate Taxation in EU

A lot of research has been done to evaluate the impact of taxation on foreign investment. A substantive research conducted by the committee of independent experts examined the main points and necessity of harmonization of business taxation in the
European Union (Ruding Committee 1992). It suggested that withholding taxes levied by source countries on cross-border divided payments between related companies are the main reason for bias against inward and outward direct investment. The objective of the researchers was to evaluate whether differences in business taxation in different Member States have an impact on investment flows.

The Committee examined the international capital flows in two ways: direct investment and portfolio investment that involves the buying of securities on foreign market. Foreign direct investment may influence communication costs between the parent and daughter company, language knowledge problem and cultural differences, lack of familiarity with local business environment, risk of exchange rate changes etc. Taxation has effects on both the above-mentioned types of investment. The current paper examines FDI because this is more long-term strategic investment where FDI is less sensitive to tax considerations.

The experts’ argument is presented below in order to show how high taxes could influence the level of investment. Changes in taxation may have a significant role in influencing portfolio capital flows through the impact on domestic savings via taxes on interests. Savings are also dependent on the level of consumption. High level of private consumption is directly connected with decrease in private savings. The savings in the country and capital investments have to be large enough to achieve the necessary level of capital imports for the country. A rise in corporate income tax will reduce the expected amount of dividends in case of corporate direct investment. A higher personal tax on dividends will also tend to cut corporate investment. A higher personal tax on capital gains reduces the capital investments.

Importance of Taxation Aspects in Reallocation Decisions

Benassy-Query, Fontangne and Lahreche-Revil (2000) measured in their research the importance of taxation aspects for relocation decisions. The data were collected from the statistics of OECD countries. In addition to econometric research a simulation study was conducted in order to evaluate the impact of tax harmonization. In this empirical regression the dependent variable is bilateral FDI inward flows. Data are available for different periods such as the years 1985, 1990, 1992, 1995. Independent variables include effective tax rates, nominal tax rates, different types of taxation schemes (exemption and credit), cost of capital and different macroeconomic determinants like transportation costs and policy related determinants. Here the size of the country and distance between the host and investor country were also taken into consideration.

The impact of investment abroad was measured. According to the research results, the size of the investing country has a positive impact on foreign direct investments; bilateral exchange rate volatility reduces the FDI flow in both directions. The coefficient of tax rate discrepancies is negative. The coefficient of nominal tax rate is less significant and verifies the adverse taxation effect on inward FDI.

According to the simulation, adoption of a common tax scheme in the EU will reduce inward FDI by 3% per year, 3 billion USD. The simulations allowed concluding that harmonization of tax rates will lead to a situation where the EU countries become more attractive than Japan and the United States, although it will be connected with a decline in revenue with the exception of Ireland. Finally it was concluded that tax competition would be harmful and tax harmonization less harmful.

In addition to Smith and Florida (1994), Coughlin, Terza and Arromdee (1991) evaluated that the impact of corporate tax differentials on foreign direct investment is negative. They measured the importance of taxes in the decision-making process of the
firm to relocate its activities abroad. The authors claim that there is no consensus regarding the impact of taxation on the location of firms. According to the EU study (Ruding Committee 1992) of corporate taxes, employers’ contributions must be taken into account while making the choice of relocating firms’ activities. This study revealed the following conclusions. First, FDI from Japan and the United States into EU countries is indifferent to the level of corporate taxes in Europe, because there is a credit scheme to the benefit of foreign subsidiaries. Japan and the US as the host countries are sensitive to corporate taxes in Europe. Second, EU as a whole would benefit from tax competition in FDI inflows. Ireland would suffer from competition or harmonization in nominal rates, whereas Spain and Germany would suffer from competition or harmonization in effective rates. A greater impact on FDI inside the EU would be exerted by harmonized tax schemes rather than the harmonisation of tax rates. The adoption of a common credit scheme would reduce inward FDI in the EU by USD 3 billion due to that all tax incentives disappear. The adoption of a common exemption scheme would increase FDI in the EU because UK investors get an incentive to invest abroad.

Empirical Evidence for Tax Competition Theory

Sajal Laliri and Yoshiyasu Ono (1998) wrote that there is a real competition for foreign investments where host countries are using tax instruments to attract foreign investments. Winner (2005) has examined the tax competition theory using a sample of 23 OECD countries. In accordance with the theory of tax competition, Winner finds that capital mobility exerts a negative impact on capital tax burden, and a positive on a labour tax burden. The empirical research concerning competition is inconclusive. Winner in his research assessed the compensation hypothesis by estimating the impact of two important components of tax competition – capital mobility and country size – on the taxation of factor incomes on the basis of the survey period 1965-2000. He observed a significant relationship between tax burden and capital mobility, a significant positive impact of capital mobility on labour tax burden and significant effects of country size on capital and labour tax burdens.

On the basis of the above, Winner hypothesised: “Higher capital mobility leads to a lower tax burden on capital” and “labour is taxed more heavily than capital as capital mobility increased”. He brought out the idea that a large country is faced with a lower elasticity of capital supply and concluded that the tax rate in a large country is bigger than in a small country. This hypothesis had to explain why the countries like Luxembourg and Ireland have established low statutory tax rates on capital. The regression was composed for the evaluation of relationships between the exogenous variables and the AETR vector (average effective tax rates), incl. tax rates on capital income, labour income. In the empirical research the author evaluates the following endogenous variables: mobility of capital; size of the country; inflation; unemployment; GDP; public debt. According to the regression equation and statistical evaluation, the impact of capital mobility on capital tax burden is significantly negative. The statistical equation shows that increase of capital mobility by one percentage point is associated with decrease of capital tax burden by 0.18 percentage points. Positive effect of capital mobility on capital taxation, in case the country size is identified, has the expected sign for capital taxes.

Graham (2003) from Duke University analysed in his research and brought a theory how taxes can affect corporate decision-making and firm value. He argues that capital structure choice of a multinational company is based on taxes affecting the tax
advantage of debt. He concentrates on effects of multinational tax incentives like imputation or integrated tax system, residence or place of incorporation, degree of interest allocation, specificity of foreign subsidiary.

The Questioning Results of Business Executives

The Ruding Committee (1992) has conducted its own research asking the respondents from different countries about their views concerning the steps that should be taken towards the convergence of corporate taxes in the European Community. The survey investigates three issues of the impact of taxation on activities and costs of multinational companies: does the location choice for activities depend on tax treatment in different countries; are the legal and financial structures of international companies influenced by taxation; how large are tax planning and compliance costs in respect of international taxation as opposed to domestic.

The respondents were from all European Union countries (in 1992 12 Member States) as well as from Austria, Finland, Iceland, Sweden, Switzerland. 965 replies were received from companies of 17 countries, 585 were the parent companies that owned a branch or subsidiary. The response rate was 9%. 584 responses were from companies which answered positively to the question concerning the existence of a branch or subsidiary abroad. 213 responses were received from UK, 144 from Netherlands, 109 from Germany; there were only 17 responses from France, 36 from Portugal, 11 from Finland. 70 percent of the respondents operated in industrial market; at the same time responses show that companies tend to produce more domestically and export abroad. The answers were from individuals who had different responsibilities in the company; more individuals were responsible for taxation and finance and fewer for strategy. This fact could have had quite a significant effect on the survey result.

The structure of the questions was designed as follows: the respondents were asked to choose one answer from among: always, usually, sometimes, never. The questions were asked for five separate types of activity: production plant, sales outlet, coordination centre and financial service centre.

First, the respondents were asked “how often taxes are faced by your firm in alternative location a relevant consideration and a major factor in your decision?” Considering the production plan, almost 72% of the respondents answered that taxation is always or usually a relevant consideration and 47.6% of the respondents replied that it was always or usually a major factor. For other fields of activity the response percentages to the same question were slightly smaller: sales outlet – 57.9% and 37.8%; coordination centre – 69.9% and 56.6%; R&D centre – 58.7% and 40.9%. The taxation has the biggest effect in the field of financial services. In total 85 percent of the respondents replied that taxes are always or usually a relevant consideration in the strategic decision-making, and 78% of the respondents answered that it is always or usually a major factor. This result gives additional proof that taxation has an important effect on strategic decision-making concerning location of business in the future.

The second question was connected with determining the specific fields of taxation that are more important for location decisions. 78.1% of the respondents replied that tax rates on business profit are usually or always a relevant consideration in deciding in which country to locate a business activity, 57.6% of the respondents replied that it is always or usually a major factor. Withholding tax rates on cross-border dividends and interest are always or usually a relevant consideration for 74.5% of the respondents. At the same time, it is always or usually a major factor for 54.2% of the respondents. Special investment incentives were also regarded as an important factor.
Less important appear to be the tax base (64% and 47% respectively) and surplus advance corporation tax (59.2% and 43.5% respectively).

The third important question was about financial and legal structure of business. The question was formulated as follows: “The financial and legal structure of your international operations may be more or less influenced by tax considerations. Please indicate how often tax considerations are a relevant consideration and a major factor in the following decisions.”

The responses as to the organization of foreign operations through a subsidiary or a branch, financing of foreign operations locally or through parent company received similar results. 80% of the respondents replied that it is usually or always a relevant consideration and almost 70% of the respondents answered that in this case taxation is always or usually a major factor. It is quite clear that financial and legal structure decisions are highly influenced by taxation.

The results of the above-mentioned survey are quite interesting and support the general opinion about the role of taxation. Let me summarise the results of questioning. First, it was recognised that during the choice of legal structure and determining the location choice the companies take into consideration the taxation aspects. 47% of the respondents answered that taxes are always or usually a major factor in the location choice-making for a production plant. In other fields of activity this percentage is smaller: 28% in sales outlet, 57% for coordination centre and 48% for R&D. As it was mentioned before, the taxation has a significant impact on the financial and legal structure of companies. 78% of the respondents answered that taxation has always or usually been a major factor in determining the location of financial centre. 70% of the respondents answered that taxes are always or usually a major factor in financial decision-making. Taxation is an important factor in determining in which form profit will be repatriated to the parent company. It is important to underline that according to the survey taxation is an important aspect in the profit repatriation decision-making.

**Impact of Corporate Tax Variables**

A paper by French researchers, Benassy-Query, Fontangne and Lahreche-Revil (2005) also evaluated the influence of taxation on FDI, with a special focus on the impact of corporate tax variables, by taking into account tax schemes for avoiding double taxation. The analysis was conducted on the basis of bilateral FDI data of 11 OECD countries over 1984-2000. The French scientists examined the efficiency of the statutory tax rate used in empirical analysis of corporate tax differentials between host country and investing country. They calculated the tax differentials of average effective tax rates, marginal effective tax rates and apparent effective tax rates. OECD data were used for the calculations. For the assessment of the impact of tax policies on FDI additional variables such as distance between the investor country and the host country (transformed into log) and size of the investing country measured by the (log of) GDP were used. The choice of the latter variable is explained by the bigger potential of large countries to invest abroad compared with smaller countries, so this variable is assumed to have an impact on FDI. During the measurement of the variables some additional variables were added such as bilateral relative unit labour cost and bilateral real exchange rates.

According to the results, large market potential increases inward FDI and larger countries tend to export more FDI. The coefficient of investor-to-host distance is negative but non-significant. The coefficient of tax differentials is negative and highly significant. Benassy-Query, Fontangne and Lahreche-Revil proved with the help of
empirical analysis that tax differentials play a significant role in the location decisions of multinational companies. At the same time, tax differentials can also compensate for differences in market potential; for example, a host country suffering a 10% disadvantage in terms of market potential can offset the handicap by a 5 percentage-points lower statutory tax rate. It was confirmed that a higher provision of public goods increases the attractiveness of the country for FDI, and the authors suggested that higher taxes can be partly compensated for by an increase in the building up of public infrastructure. The influence of third country taxation on multinational companies was tested, and the result is quite clear: higher taxes in the host country relative to the investor defeat FDI, higher taxes in third countries tend to significantly increase FDI in the host country.

Benassy-Query, Fontangne and Lahreche-Revil investigated how firms react to the system of exemption, credit system, how they are affected by double taxation problems. The results of the investigation are similar to the findings by Hines and Rice (1994): the semi-elasticities to tax differential are significant for both credit and exemption countries. FDI flowing from countries operating under a credit scheme is more sensitive to taxes than FDI flowing from exemption scheme countries. The result suggests that higher tax rates are harmful to inward FDI.

Hines (1996) in his work described the influence of tax changes on the amount of foreign direct investments in the United States in 1960-1991. He focused his attention to the fact that in 1981 and 1986 there were the largest jumps in the FDI of the United States where at the same time took place an important change in tax policy. The result reported by Hines is as follows: high state tax rates have a significantly negative effect on local investment. Investors who cannot claim credits for state tax payments appear to reduce their investment shares, relative to foreign-tax-credit investor, by 9-11 percent per every 1 percent of the tax rate. In other words, this means that if a state were to lower its corporate tax rate by 1 percent, it would attract 10 percent more investment.

Results of Meta-analysis

As it was mentioned before, Dutch researchers, Ruud A. De Mooij and Sjef Ederveen (2003) explain the variation between different studies on the impact of company taxes on the allocation of foreign direct investments. The researchers conducted a so-called meta-analysis, it was a research for comparing different studies on the above-mentioned topic, their characteristics, especially for finding the elasticities. There were 25 different studies under investigation. According to the theory that was described by Dutch authors, FDI is attractive if OLI (ownership, location and internationalization) conditions are met. According to the OLI theory the person has to decide whether owning or leasing is more beneficial, export or not, domestic or international etc. In the above-mentioned study it was pointed out that many other researchers have used in their research the distinction between the above-mentioned systems for the evaluation of tax rate elasticity. Authors have taken into consideration that there are different approaches to the definition of tax rates used in different studies. These are average tax rate computed from data, marginal effective tax rate and average effective tax rate computed from tax codes. To make the outcomes of different studies comparable, the authors transformed the coefficients of each of the studies into a uniformly defined elasticity, semi-elasticity. Finally, there were 371 semi-elasticities that formed a meta-sample. Meta-regressions suggest that both average tax rates and effective tax rates engage a larger effect on FDI than country legitimate rates do.
De Mooij and Ederveen (2003) do not find support to the theoretical aspects that investors from tax exemption countries are more likely to respond to changes in host country taxes than investors from tax credit countries. Most of the regressions suggest no systematic differences between the two types of systems. The paper by De Mooij and Ederveen finds a median tax rate elasticity of foreign capital being –3.3.

In the 1980s, Hartman and others concluded on the basis of the example of the US market that domestic tax policy does influence foreign investment. Boskin and Gale (1987) have evaluated the tax effects on the international location of investment. Their results were very close to Hartman’s, especially as regards retained earnings equations. The results show a decline in the elasticity with respect to foreign net return in the US, from 1.2 to 0.9 in the coefficient of FDI financed by retained earnings and divided by GNP and from 1.0 to 0.8 in the retention ratio equation. The empirical research affirmed that domestic tax policy may have a significant impact on DIA and FDI. As it was mentioned before, the findings by Boskin and Gale are similar to those of Hartman for 1965-79, the elasticity estimates are a little smaller for the response of DIA and FDI to changes in the return on FDI. They estimate that a tax policy which raises the after-tax rate of return enough to lead to a one-dollar increase in domestic investment in the U.S. brings with it from eight to twenty seven cents of FDI. According to the research, the effective corporate tax rate was reduced from 35% to 20%. It was calculated that the mentioned reduction would bring a rise in FDI from 11% to 20%. The authors conclude that the welfare effects of tax policy depend on the responsiveness of FDI to net-of-tax returns.

6. Conclusions

Successful economic growth in a country depends on many factors: one of them is the level of FDI inflow into the country. Investors in the decision-making process take into consideration many different aspects including the country size, infrastructure, employment, economic stability and taxation. These determinants can be divided into four categories: economic, social, political and policy aspects. The importance and influence of these determinants on the attracting of foreign direct investments has been analysed by a huge number of scientists. The general opinion is that taxation has a negative effect on foreign direct investment. Regions with lower taxes and greater tax incentives attract more foreign investments than other areas.

It is necessary to underline how firms react to the system of exemption, credit system, how they are affected by double taxation problems. The research results show that semi-elasticities to tax differentials are significant for both credit and exemption countries. FDI flows from countries operating under a credit scheme are more sensitive to taxes than FDI flowing from the exemption scheme countries. The higher tax rates are harmful to inward FDI (Benassy-Query, Fontangne and Lahreche-Reville 2005).

This paper analysed the impact of corporate taxation on foreign investment, and the role of corporate taxation in investment location decisions. The results suggest one possible reason why income tax in smaller Member States of EU is lower than in bigger Member States. Krongstrup (2002) pointed out that a larger country faces lower elasticity of capital to tax rate, and hence lower marginal cost of public funds, and therefore chooses a higher tax rate than the smaller country.

The results suggest that both average tax rates and effective tax rates engage a larger effect on FDI than the country legitimate rates do (Mooij and Ederveen 2003). Coughlin, Terza and Arromee (1991) do not find support for the theoretical aspects that
investors from tax exemption countries are more likely to respond to changes in host
country taxes than are investors from tax credit countries.

The open economy of the European Union offers to investors great opportunities. Free movement of capital, labour, goods does not limit the expansion of activities over the whole territory of the European Union where at the moment 27
countries belong. Different economic conditions, incl. qualification of labour, land
resources and other aspects exert pressure on investors in the allocation decision-
making process. For this reason, the tax policy aspects often play a significant role in
this process.

Many experts support the idea that corporate taxes and tax base should be
harmonized in the European Union to decrease the restraints between countries and
simplify doing business in different EU countries.

Harmonization involves fixation of tax rates. The countries with high tax rates
will lower their rates to the harmonized one, which will involve growth of investment.
The countries with low tax rates will lose because the investment outflow will increase.
Generally speaking, when tax rates are harmonized at a high level, capital will be driven
out, when tax rates are harmonized at a low level, capital will be attracted to Europe,
and the Community as a whole could gain at the expense of the rest of the world. The
distribution of effects of harmonization among the Member States depends on the
current situation in the particular Member State. The country with low tax rates would
in fact suffer a loss.

The comparison of statutory corporate tax rates shows that in 2005 EU-15 (i.e.
old member states) average rate was 30.4% and EU-10 average was 18.2%. The
harmonization of the tax rates in the EU will increase attractiveness of the European
Union for third country investors and EU countries will become more attractive than
Japan and the United States. If the corporate tax rate will be fixed on the level of EU-15
average, cross-country investments inside the European Union will reflow from EU-10
to EU-15. As a result, the harmonization of corporate taxation in the European Union
will be surely adverse to new Member States.

In conclusion, it must be stressed that the effect of corporate taxation on
foreign direct investment is significant. In the policy decision making experts have to
take into consideration that average tax rates, effective tax rates as well as double
taxation aspects engage a larger effect on FDI than the country legitimate rates do. My
analysis can be applied to the recent policy moves in the European Union and
particularly in Estonia.

The evidence indicates that corporate taxation factors have generally been very
important in investors’ decision-making process among different political, economic,
social and policy determinants. However, the increasing pressure for harmonization of
corporate taxation in the European Union will be harmful to inward foreign direct
investment. Further studies are needed to analyse the factors influencing foreign direct
investment to increase and the effects of corporate taxation on foreign direct investment
in the European Union.

References

Sensitive to Tax Rates?


