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**CORPORATE TAXATION AND THE
INVESTMENT LOCATION DECISIONS OF
MULTINATIONAL CORPORATIONS**

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CORPORATE TAXATION AND THE INVESTMENT LOCATION DECISIONS OF MULTINATIONAL CORPORATIONS

ABSTRACT

Recent reductions in barriers to the international flow of capital have meant that taxation of corporate profits may be more influential than before in investment location decisions. This article investigates the importance of corporate taxation in such decisions in this new global environment. It also investigates the comparative importance of the various corporate tax system attributes in potential investors' appraisals of these systems.

A survey of executives of multinational corporations was undertaken. Of the many factors involved in investment location decisions, corporate taxation was found to be one of the most important, although political stability, size of the local market, proximity to markets, and the local macro-economic environment were of greater importance. The most important corporate tax system attributes in investors' appraisals were found to be broad systemic ones such as its transparency and predictability, as well specific features such as the statutory tax rate.

PART 1 – INTRODUCTION

The past two decades have witnessed important developments in the restrictions imposed by nations on international investment. In that period, the vast majority of countries have either reduced or entirely eliminated controls on cross-border flows of capital and foreign exchange. This has led to an increase in the international mobility of capital, evidence for which has been provided by, amongst others, Frankel and McArthur (1987) and Popper (1990). A rapid expansion in the level of foreign direct investment (FDI) has consequently occurred. According to the World Trade Organisation, the world volume of FDI rose by over 700% between 1970 and 1996, a much faster rate of growth than that of world GDP and nearly double that of world trade. There has also been significant growth reported in the importance of such investment to the economies of individual countries. For Western Europe as a whole, FDI inflows in 1997 were equivalent to approximately 8.6% of total gross fixed capital formation; in individual countries, for example Ireland, the figure came to 19.0%.¹

One of the consequences of the dismantling of barriers to international investment is that in their absence corporate taxation is seen as assuming a greater role in determining the location of those funds, through its ability to influence the returns from investment. The role of corporate taxation has also been enhanced in recent years by reductions in non-tax costs of transferring capital.² The presence of international differentials in corporate taxation is now perceived as one of the few remaining government-induced distortions to the global free flow of capital.³

In such a climate, one might expect to observe the greater use of corporate tax policy by governments in encouraging investment from overseas. Indeed, this appears to have been the case; recent years have seen significant corporate tax reforms in many countries. These reforms, which first appeared in the U.K. and the U.S. in the early Eighties, were soon

¹Statistics from World Investment Report 1999, United Nations

²The rise in the influence of taxation is thus consistent with the theory that management trades off tax factors against non-tax costs (see Scholes and Wolfson, 1992).

³In the opinion of, for example, the OECD (1991)

followed in several other Western countries, and then more widely around the world. The reforms had, as their most significant common characteristics, a reduction in statutory tax rates together with a broadening of the tax base.⁴ Although the reforms had their origins in political developments and a desire to improve economic efficiency, their widespread adoption is thought to have been caused, at least in part, by the increased need for governments to compete in the new liberalised environment for investment from overseas (or, at least, by the need to protect their existing stock of investment from disappearing abroad). The consequent decline (and convergence) of corporate tax rates around the world has been widely seen as evidence of this modern phenomenon of “tax competition” (see, for example, York, 1993).

The above global developments raise two important questions. First, how important currently *is* the influence of corporate taxation on the flow of international investment? Taxation is likely to have *some* effect upon the investment location decisions of corporations, but it is the strength of that effect that is important to potential tax reformers in considering whether any changes in taxation to attract investment would be worthwhile. The question is therefore concerned with whether corporate tax policy is an appropriate instrument with which to attract FDI. If such investment is not responsive to changes in taxation in the potential host country, then encouraging investment through use of the tax system is not only pointless but also possibly harmful to the country’s economy in terms of the potential tax revenues foregone. The first objective of this study is to ascertain the importance of corporate taxation in investment location decisions, and is achieved through surveying the views of company executives involved in deciding whether to invest abroad.

The actions of governments mentioned above seem to indicate that, in their view, taxation *does* have a significant effect on FDI location decisions. On the assumption that they are right, this article addresses a second question of relevance in the new global environment: what form of corporate tax reforms is most effective in attracting international investors? Governments can use several policies to compete for FDI, such as tax rate reductions or the use of specific tax incentives. However, investors’ evaluations of the attractiveness of countries’ tax systems may be influenced more by some tax system

⁴As an illustration of these changes, Simmons (1997) showed that the mean statutory corporate tax rate amongst European Union Member States declined from 47.11% in 1980 to 36.37% in 1996.

characteristics, or attributes, than by others. An answer to the second question can be usefully approached through a comparison of the importance attached to the various attributes of a country's tax system by potential investors in assessing the overall attractiveness of a country's tax system. The second objective of this study is to estimate the relative importance of the various attributes.

A point should be made here concerning the research scope. This study focuses on direct investment (in particular, the forming of a new subsidiary overseas and the subsequent investment in that subsidiary's assets, or the purchase of a controlling interest in existing overseas corporations), as opposed to international portfolio investment (the purchase of securities issued in a foreign country). The justification for this restriction of the research scope is that the factors motivating indirect portfolio investment are likely to differ considerably from those motivating direct investment. An important purpose of portfolio investment is for international diversification in order to avoid overall levels of risk, and thus portfolio capital flows are largely determined by interest rate levels and the covariance of stock market movements between individual countries, rather than solely by expected returns to the investment. Thus the comparative effect of taxation can be expected to differ with respect to the two forms of investment.

Corporate taxation would intuitively appear to influence investment location decisions. Tax is often a significant cost to a company's operations, and a company would normally, *ceteris paribus*, be expected to locate its FDI in the least cost location. Thus the higher the tax burden imposed by a country on the profits of FDI the less competitive that country would likely become for the investment. One would therefore expect decreases in the tax burden imposed *by a host country* on income from FDI to increase the amount of such investment flowing into that country. However, this is not necessarily the case, because the overall size of the tax burden on income from a direct investment overseas is dependent on the tax system of both the home (or residence) country of the company making the investment, and that of the host country.

Corporate taxes are normally leviable on earnings from FDI in at least two countries, the host and the home country.⁵ In practice, however, double taxation is relieved by one of

⁵Taxes on capital income are also potentially leviable in the countries where the shareholders reside, when the profits are distributed as

two methods used by the home country. These are, first, the exemption method, whereby the income, having already been taxed in the host country, is exempted from tax in the home country, and, second, the credit method, whereby any tax payable in the host country is credited against the tax payable in the home country.⁶ This latter method is applied in many capital-exporting countries, including the three most important in recent decades, the U.S., Japan and the U.K. This may mean, for example, that tax differentials between two competing host countries may be irrelevant to the investment location decision if in both countries the tax burden is lower than in the home country. In such cases, the choice of one host country over the other will, from the point of view of the investor, only mean a different distribution of the tax burden between home and host tax authority; it will not affect the overall tax burden to the investor.

The effect of the above is lessened by two factors. First, most home countries tend to tax income from overseas subsidiaries only on a remittance basis (in other words, such income would only tend to be taxed in the home country if the income were repatriated there). Second, many countries have agreed to include “tax sparing” arrangements in their tax treaties with other nations, especially developing ones.⁷ Nonetheless, the ability of a host country government to influence the final tax burden of overseas investors alone is sometimes limited, and may depend largely on tax treaty provisions with other countries concerning double tax relief.

Evidence collected to date suggests a linkage between corporate taxation and FDI, although the strength of this relationship remains unclear. Taxation is, however, only one (and likely not the most important) of many possible factors which may influence the choice of location for overseas investment. Indeed, numerous potential factors influence the choice. Factors with respect to the host country can be divided into three broad categories: the

dividends.

⁶A third method, whereby the tax liability incurred in the host country is deductible against taxable income in the home country, is used much more rarely.

⁷These arrangements encourage investment between two nations by enabling investors from a home country using the credit system of double tax relief to benefit from any tax concessions offered by the host country. Tax sparing operates through adjustment of the deductible tax credit to include the notional host country tax which would have been paid in the absence of the concessions as well as the host country tax actually paid.

characteristics of the host economy itself (such as the availability of labour or the incidence of corruption); policy measures which affect the country's attractiveness for investment indirectly (exchange rate policy); and proactive measures which host countries adopt specifically to attract investment (government grants). Some factors, including taxation, may fall into more than one category. Also involved in the location choice would be the strategy of the investing company (such as the need for geographical diversification)

The importance of corporate taxation in these decisions can therefore be found not only by ascertaining its perceived importance *per se*, but also by comparing its importance with that of other potential factors involved. Although this paper focuses primarily on corporate taxation, this approach has the further advantage of adding to the growing body of literature on the comparative importance of the multitude of other factors that affect investment location decisions.

The second research objective concerns the comparative importance of the various tax system attributes to the location of FDI. The perceived importance of one of these, the statutory tax rate, has, as already mentioned, been demonstrated through the recent tax reforms of various nations. However, other attributes could be of equal, or greater, significance to investors. For example, broad systemic qualities of a country's tax system, such as its transparency, understandability and predictability, may be of great significance to investors, who seek these qualities in a tax system in order to confidently undertake effective long-term tax planning to minimise their tax burden (with respect either to their operations in that country alone or their operations world-wide).⁸ As another example, a country's withholding tax provisions might be of great concern to international investors, as they may wish to operate investment strategies that minimise taxes in the host jurisdiction through the use of, for example, management fees, royalties, or financing with head office debt.⁹

In conjunction with (and undoubtedly as a result of) the increase in the global mobility of capital mentioned above, the past two decades have seen a dramatic rise in the

⁸This view is consistent with the Coase theorem that if people are certain of the tax law, they can "plan around" them to nullify their intended effects. See Thornton (1997)

⁹These provisions will become less important when the host country tax rate is low, since then there is less incentive to minimise taxable income in the host country.

economic power of multinational corporations (MNCs¹⁰). In view of the central position of MNCs in undertaking FDI, this study surveys the views of executives of those corporations to attain the two research objectives. As well as directly obtaining the opinions of important decision-makers, this methodology also has the attraction of enabling both objectives to be fulfilled using the same research instrument.

Thus, as the research data is gathered from those directly responsible for investment location decisions, the answers to the two research questions should be of importance to policy makers, since they should take the optimal responses of tax planners into account when designing new tax rules or engaging in tax reform.

The remainder of this article is divided into four parts. Part 2 considers the results of previous studies on the research questions posed above. Part 3 outlines the methodology used, while Part 4 presents and analyses the results. Part 5 concludes and suggests fruitful avenues for further research.

PART 2 – PRIOR RESEARCH

The volume of research undertaken into the relationship between taxation and the level and direction of FDI is not unexpected, given its important economic ramifications. An extensive review of the literature on this issue was undertaken by the Ruding Committee (Ruding, 1992) as part of that committee's report into economic distortions caused by corporate taxation in the European Union. The committee cited several previous studies that used a variety of methodological approaches. Simulation studies by, for example, Horst (1977), and Damus, Hobson and Thirsk (1991) were reviewed. Econometric studies cited were those of, for example, Hartman (1984), Boskin and Gale (1987) and Slemrod (1990) (all related to FDI flows into the United States), and Jun (1990) (concerning outward FDI flows from that country).

¹⁰ Also known as Trans-National Companies (TNCs). Although several definitions of an MNC have been attempted elsewhere, in this article the term simply refers to a company which has significant direct investment overseas.

More recently, quantitative studies using economic modelling have investigated the responsiveness of firm-level FDI to changes in corporate taxation (Cummins and Hubbard, 1995), and the effect of taxation on the choice of investment location (Devereux and Freeman, 1995; Devereux and Griffith, 1996).

These quantitative studies have shed some light on the matter, in general giving qualified support to the expected direction of the relationship between corporate taxation and FDI. Nevertheless, these studies have their drawbacks, primarily related to the lack of reliable data and the choice of (and the assignment of quantifiable values to) model parameters. It is also difficult for such quantitative exercises to isolate the effects of changing tax rules from the effects of changes in all other factors affecting investment.

Researchers have therefore also used other methods of determining the measure of the importance of taxation in investment location decisions. One important method used has been to survey business people for their views and experience on the issue.

Surveys have taken different forms. One approach has been to ask business people how often taxation is either a relevant consideration or a major factor in deciding where to locate investment. Two such surveys were those of Devereux and Pearson (1989), who surveyed 173 large U.K. companies that conducted a large proportion of their investment overseas, and Ruding (1992) who surveyed managers of companies in all the (then) twelve Member States of the E.U. and five EFTA countries.¹¹ The results of both of these surveys indicated that indeed taxation is commonly influential in investment location decisions.

Surveys have also been used, as in this study, to ascertain the importance of taxation compared to that of other potential factors in the investment location choice. The Ruding Committee cited several surveys carried out with this objective in the 1960s and 1970s that are instructive, even though the changes to the world economy since then have reduced the applicability of their findings in today's environment.

¹¹ Germany, France, Ireland, the United Kingdom, Belgium, the Netherlands, Luxembourg, Portugal, Spain, Denmark, Greece and Italy of the E.U.; Austria, Finland, Iceland, Sweden and Switzerland from EFTA

In the early 1970s, Scholhammer¹² investigated the importance of taxation compared to nine other main categories of locational determinants amongst 140 multinationals and found that taxation was ranked third out of the nine, behind supply conditions (infrastructure, etc.) and perceptions of political risks.

In a survey of forty business executives in 1968 on location decision factors in North-West Europe, the Centre de Recherches Economiques et de Gestion in Lille¹³ concluded that although telecommunications, manpower qualifications and transport facilities were the most important determinants of investment location in general, the most significant determinant *which depended directly upon the nation state* was the fiscal one.

Three further surveys concerned FDI into or out of particular countries. In the first, in the early 1970s by the University of Ghent in Belgium¹⁴, the most important reasons given by foreign companies (owning 342 Belgian affiliates) for their choice of Belgium as host country were labour market situation, infrastructure, the fiscal system (the most important aspect of that system being the corporate tax system), state aids and credit facilities.

In Ireland, in 1968 the Irish Industrial Development Authority¹⁵ asked 81 foreign firms operating in Ireland to indicate on a list of seven factors, the most important and second most important factors for their choice of Ireland. Thirty-six percent replied that fiscal incentives were the most important, and sixty-three percent that they were the second most important.

¹²Unpublished thesis. Results reviewed in Dunning, J. and Yannopoulos, G. (1973), *The Fiscal factor in the Location of Affiliates of Multinational Enterprises*, in Centre de Recherches Interdisciplinaires Droit-economie, *Vers une Politique Fiscaleeuropeenne a l'egard des Societes Multinationales*. Louvain: Vande

¹³Results reported in Falise, M. and Lepas, A. (1970), *Les Motivations de Localisation des Investissements Internationaux dans L'Europe du Nord-Ouest*, *Review Economique*, Vol.21, pp 103-109

¹⁴Reported in Van Den Bulcke, D. (1971), *De Buitenlandse Ondernemingen in de Belgische Industria*. Ghent: Serug

¹⁵See Industrial Development Authority (1967), *Survey of Grant-aided Industry*. Dublin: Government Printing Office

Finally, in Scotland, a survey of 105 Scottish subsidiaries of U.S. multinationals¹⁶ found that one-third of respondents felt that financial inducements were the most important factor in their decision to invest in Scotland and that one-sixth mentioned financial inducements as the second most important factor.

In contrast to the above findings, however, the results of other research have stressed the importance of factors other than taxation in the investment location decision. Wilson (1991), who studied 68 such decisions made by nine U.S. multinationals between 1965 and 1990, concluded that although taxation is normally an important factor in locating manufacturing plant, it is only one of many factors involved in the decision (operating requirements, marketing considerations, and global strategic needs of the company being others), and is rarely the most important. He concluded that tax is a more important consideration in locating administration and distributive centres, which can be separated from the company's other activities.

Other studies have emphasised the importance of the size of the host country market (see, for example, Schneider and Frey, 1985; Haufler and Wooton, 1997), macro-economic factors such as GDP growth (Julius, 1990), labour costs (Riedel, 1975), exchange rate considerations (Frost and Stein, 1985) and the clustering of economic activity (Andretsch, 1998). There has also been considerable interest in the "New Economic Geography" developed by Krugman (1991), which emphasises both clustering and the size of the home market.

In a survey of the Global 1000 companies undertaken in 1994 concerning investment in emerging markets, Ernst and Young¹⁷ found that the most common of the principal reasons given for investing in emerging markets was the large potential market, with almost all respondents mentioning this factor. Tax incentives and government subsidies, low labour costs and access to raw materials were all considerably less commonly indicated as principal reasons. The study also found that political instability was the most frequently cited barrier

¹⁶ Forsyth, D. (1972), U.S. Investment in Scotland. New York: Praeger Publishers

¹⁷Ernst and Young (1995), Investment in Emerging Markets: Opportunity versus Risk. Hong Kong: Ernst and Young

to investing in emerging markets. Legal infrastructure, bureaucracy, exchange controls, commercial infrastructure, local inflation and the tax regime in the emerging market (in declining order of importance) were all seen as significant barriers. The report also mentioned a strong correlation between the level of interest of investors in any emerging market and the level of current and projected economic growth in that country. Finally, Van Raemdonck (1992) concluded from his study of investment incentives that the main drivers of FDI appear to be market size and labour costs, rather than financial incentives, such as fiscal ones.

In general, however, the above research tends to reinforce the intuitive supposition that international flows of investment are affected by corporate taxation. Indeed, the conclusion of the Ruding Committee's literature review in 1992 was that the studies, taken together, "seem to support the view that corporation tax does have some influence on the international location of investment". But prior research also tends to suggest that although taxation is often a relevant or even major factor in the choice of investment location, other factors are typically more important.

Given the rapid globalisation of business and the rise of the economic power of the MNCs in recent years, much of the above survey research on the comparative importance of taxation is now somewhat dated. Prior studies have also concerned only single countries or, in the case of the Ruding survey, trade areas. Further, the lists of factors chosen for comparison in earlier research have also not been comprehensive. This study aims to address these deficiencies by ascertaining the comparative importance of taxation to the investment decisions of MNCs in a worldwide context and by reference to a comprehensive list of potential factors.

Also addressed in this article is the relative importance of different attributes of a country's corporate tax system to the overall attractiveness of that system, as perceived by the international investor. To date, there have been few investigations into this area. One of these was in the study by Devereux and Pearson (1989) mentioned above, in which 173 large U.K. companies were also asked whether different attributes of the host country tax system were relevant considerations/major factors when deciding the location of an investment. The attributes considered were tax rates, withholding tax rates, depreciation provisions, tax loss provisions, automatic grants and discretionary grants. From the replies, all of these attributes

were considered to be influential; tax rates were considered the most important, followed by withholding tax rates, then depreciation provisions, and lastly, grants.

A similar comparative analysis was also undertaken by the Ruding Committee as part of its survey mentioned above. It was again found that tax rates were the most important, followed by withholding taxes on cross-border dividends and interest, and then special investment incentives. The tax base and costs of complying with tax rules were found to be of comparatively less importance.

While both of these surveys provided some evidence of the comparative importance of selected attributes of corporate tax systems, their coverage was not comprehensive. In particular, they both focused solely on those attributes of tax systems that directly affect the tax burden, such as the rates of tax and the level of depreciation allowances. However, broad systemic attributes such as consistency or transparency, and attributes concerning the administration of the system, such as the degree of enforcement, which were not included in the surveys, may well be of equal or greater importance to the investment location decisions of potential investors. By seeking to include all attributes of corporate taxation in the survey, this study hopes to provide a more complete analysis than attempted previously.

PART 3 – METHODOLOGY

In order to accomplish the two research objectives, the survey method was adopted. A questionnaire was drawn up in the English language, to be sent to executives of MNCs.

The target population consisted of all executives of MNCs throughout the world as at December 1998 who have had experience in considering international locations for investment. MNCs constituted the sampling unit because of their importance to global FDI and because these organisations were considered most likely to be currently employing executives who have had the experience necessary to answer the questions posed authoritatively.

The list of MNCs contained in the Directory of Multinationals, 1998 ("The Directory")¹⁸ was used as part of the sample frame. This list constitutes the 500 largest MNCs in the world in 1996, each with a consolidated turnover of US\$1 billion and overseas turnover of at least US\$500 million, excluding the banking and finance industry.¹⁹ Because of this exclusion, a further 100 multinationals from the banking, brokerage and insurance industries were also selected for the sample. The majority of these were taken from Forbes'²⁰ lists of the largest organisations in those industries.

One hundred percent of the 500 MNCs in the Directory, plus the selected 100 MNCs from the banking and finance industry plus two companies (one from the U.S. and one from Hong Kong) which were used in a limited pilot study formed the sample of 602 companies.

The first part of the questionnaire comprised six questions. Three questions requested data concerning the respondents; their position within the firm, number of years spent in managerial/executive positions, and main qualifications. These questions were asked in order to ascertain the reliability of the responses in terms of the respondent's ability to provide meaningful replies. Three further questions concerned the organisation for which the respondents worked: the main business of the organisation, the country of incorporation/residence, and the country of incorporation/residence of the parent company.

A seventh question required the respondent, on a scale of 1 to 10, to evaluate, based on his/her past experience, the importance of a list of factors potentially involved in the decision making process concerning the location of direct investment. A time frame of five years was chosen, on the basis of balancing the wish to maximise the potential response rate with the desire to receive up-to-date data.

¹⁸Directory of Multinationals 1998 (5th Ed.), edited by Martin C. Timbrell and Diana L. Tweedie, School of Business and Economics, University of Exeter, U.K.

¹⁹ According to the Directory, the multinationals listed represent a "concentration of wealth and control unparalleled in the development of the international economy" and "account for a significant proportion of foreign direct investment in the world".

²⁰ Forbes Top Companies: The Forbes Annual Review of Today's Leading Businesses (1997). New York: Wildy Press. Addresses for these firms were then found from Hoover's Handbook of World Business (1997). Austin: Reference Press

This comprehensive list of factors was compiled through a review of the literature. The review included standard texts on international investment, for example Madura (1995), and recently published articles (see the literature review above). To further ensure the completeness of the list of potential factors, two open spaces for other factors were included at the bottom of the list for the respondent to make additions if he/she so desired.

An eighth question asked the respondents, based again on their experience of the last five years, to evaluate, on the same scale, the importance of different attributes of a country's tax system to the overall attractiveness of that system with respect to making a direct investment. The list of attributes, which was again compiled through a review of the literature, included attributes directly affecting the tax burden, such as the statutory tax rate, broad systemic attributes such as transparency and predictability, and attributes concerning the administration of the system, such as the effectiveness of collection procedures. As in the previous question, an open attribute, for completion by the respondent if deemed important, was included at the bottom of the list of attributes.

At the end of the questionnaire, the respondent was asked if he/she would be willing to be interviewed or would wish to receive a summary of the results of the survey, and if so, to provide contact details. This was done in order to facilitate the collection of further information for this study if required at a later date. It was also done in order to increase the response rate, and possibly to facilitate administration of a second round of questionnaires if an unacceptably low response rate was achieved on the first round.

Letters were sent to the registered address of the multinationals, enclosing the questionnaire and a pre-addressed envelope for the reply. A covering letter was also included, requesting the information, explaining the purpose of the request, defining the term "direct investment", and assuring confidentiality for the replies.

Whenever possible, (which was in the vast majority of cases), the name of the relevant corporate executive (normally the Director of Operations or equivalent) was found through the Internet²¹ or, if not available through that means, through an appropriate directory

²¹ Data taken from Corporate Information Corp. (Website: <http://www.corporateinformation.com>). This means of collecting the information was preferred as it provides more up-to-date data.

of companies such as Forbes, Standard and Poors²², etc. The letters were addressed to named executives as this was felt to be likely to improve the response rate.

PART 4 - RESULTS

The questionnaires were posted to executives of the selected multinationals in February 1999. Ninety-two useable responses were received²³, representing a response rate of approximately 15.3%. A breakdown of the questionnaires sent and responses received according to country of residence/incorporation of the firm is as follows:

Table 1

Questionnaires Sent and Responses Received by Country

<u>Country</u>	<u>Questionnaires Sent</u>	<u>Responses Received</u>	<u>Response Rate(%)</u>
U.S.A.	219	23	10.5
Japan	124	15	12.1
U.K.	76	17	22.4
France	43	9	20.9
Germany	37	11	29.7
Switzerland	17	3	17.6
The Netherlands	13	2	15.4
Italy	11	1	9.1
Canada	11	-	-
Sweden	9	1	11.1
South Korea	8	1	12.5
Australia	7	2	28.6
Finland	5	2	40.0
Belgium	5	-	-
Norway	3	-	-
Spain	3	-	-
Hong Kong	2	1	50.0
South Africa	2	1	50.0
Ireland	2	2	100.0

²² Standard and Poor's Register of Corporations, Directors and Executives. New York: Standard and Poor's Corp.

²³ Two companies responded not with a completed questionnaire but with a short description of the main criteria used in the investment location decision. Unfortunately, it was impossible to incorporate this information in the data analysis.

Argentina	1	-	-
Austria	1	-	-
Singapore	1	-	-
P.R. China	1	-	-
Luxembourg	1	1	100.0
	---	--	
	602	92	15.3
	===	==	

Exactly one half of the responses were from executives of manufacturing businesses, while 17.4% were from the banking, finance and insurance industries. A further 19.6% came from other services, while 7.6% were from trading/distribution and 5.4% from agriculture/mining. However, in many cases, it was difficult to categorise the operations of the firms, since they covered a wide spectrum of activities.

Of the respondents who gave their position within the firm (91 out of the 92 replies), nearly all held high-level positions. 21 of these respondents (23.1% of the total) indicated that they were chairman, president or vice-president of their corporation. 26 respondents (28.5%) were members of the board of directors (managing director, finance director). In addition to finance director, a further 13 respondents (14.3%) held high-level posts in the accounting/finance function (controller, CFO, treasurer or company accountant). 11 respondents (12.1%) were managers (strategy, group analysis), 10 respondents (11.0%) were heads of department (corporate development, strategy, coordination), and there were 10 others (11.0%), including corporate officer, corporate planning officers, partner, and executive assistant.

Of the respondents who gave details of their main qualifications (76 out of the 92), all indicated that they held either an academic or a professional qualification. Over three-quarters (77.6%) of these respondents held an academic qualification, which was at least a bachelors degree. In many cases, a Masters degree (commonly an MBA) was indicated, while a few respondents held a Ph.D. Professional qualifications were held (in accounting, engineering, law and business) by over a third (34.2%) of those replying. 11.8% of those who replied held both academic and professional qualifications. It is likely that this last statistic is undervalued, as some respondents may have considered that only *one* qualification (i.e. either academic *or* professional) was requested.

From the 86 responses indicating the number of years' experience of the respondent in managerial/ executive positions, the mean value was 15 years, with a standard deviation of 9 years. The minimum value was 1 year, and the maximum 35 years.

The responses to question 7, concerning the importance of the listed factors to the investment location decision, are summarised in Table 2 below. The table shows the means and standard deviations of the responses in descending order of the mean values.

Table 2

Importance of Factors in the Investment Location Decision

[Question 7]

In your experience within the last five years, when you were considering the attractiveness of a country as a location for direct investment, in general how important were the following factors to your decision? (Please rate on a scale of 1 to 10, 1 = not at all important, 10 = extremely important)

<u>Ranking</u>	<u>Factor</u>	<u>Mean</u>	<u>σ</u>
1	Political stability of the country	7.73	1.79
2	Size of local market	7.47	2.31
3	Proximity to markets	7.37	2.61
4	Current and prospective macro-economic environment in that country	7.34	1.84
5	Transparency/predictability of legal & regulatory framework	7.16	2.05
6	Quality of infrastructure, communications, etc.	7.11	1.88
7	Availability and quality of labour	7.05	2.19
8	Taxation of profits (including withholding taxes)²⁴	6.66	2.28
9	Avoidance of obstacles to importing to that country (tariffs, quotas, other restrictions)	6.62	2.28
10	Other strategic aims (please identify) ²⁵	6.50	2.93
11	Incidence of corruption in that country	6.41	2.41
12	Availability and cost of other basic inputs	6.03	2.12
13	Need for geographical diversification	6.00	2.80
14	Cost of labour	5.95	2.27
15	Exchange rate considerations	5.50	1.94
16	Proximity to suppliers	5.28	2.39
17	Other taxes: taxes on sales, revenues, etc.	5.24	2.28
18	Presence of other firms in same industry in that country	5.10	2.32
19	Other taxes: personal taxes on employees' income	5.00	2.09
20	Improved access to latest relevant technology	4.88	2.40
21	Availability of government grants, loans, etc.	4.34	2.21
22	Need for business diversification	4.12	2.54

²⁴ Assumed here to represent corporate taxes. Withholding taxes are not normally considered part of a country's corporate tax system. However, they are included here because of their impact on repatriated corporate profits.

²⁵ Fourteen responses were made to the open item "Other strategic aims". However, only six responses identified those aims. They were, "growth markets", "government policy towards overseas investment", "vertical integration", "globalisation", "forex repatriation", and "capacity diversification". As would be expected, these items identified by the respondents themselves were, in general, given comparatively high evaluations. While it was possible in many of these cases to subsume these evaluations under the specific categories listed, no attempt to do so was made.

In addition to the above, three responses were made to the open item “Other factors, if any”. These other factors were “local currency financing, “connections with other markets“ and “availability of airline services”. Whilst the first two responses could possibly be subsumed under factors already listed (under exchange rate considerations and proximity to markets respectively), no attempt to do so was made, on the grounds that as the respondent chose not to do so him/herself, it would not be appropriate to make an assumption on their behalf.

Table 2 shows that a significant degree of importance was attached to most of the factors listed, with mean scores ranging from 4.12 to 7.73. The mean values of nineteen of the twenty-two factors were 5 or above. As most respondents gave ratings for all factors, this suggests that investment location decision making is normally a complex and multi-factorial process.

MNC executives appeared to put a high value on stability and predictability in making their judgements; political stability and legal and regulatory predictability took first and fifth place respectively. Qualities of the market were also highly valued; size of the local market and proximity to markets took second and third place respectively. Also ahead of corporate taxation were (as in prior studies mentioned) quality of the infrastructure, communications, etc. in sixth place and availability and quality of labour in seventh place.

Taxation of profits received a maximum score of 10 (from eleven respondents), and a minimum score of 1 (from two respondents). Its mean value of 6.66 was ranked in eighth place. Of note is that statistically only the four top-ranked factors are significantly higher at a confidence level of ninety-five percent. This result seems to add support to the conclusions of previous surveys mentioned above, that taxation is an important factor, but usually not the most important one, in the investment location decision.

Taxation of profits was ranked higher than some factors that have commonly received much attention for their perceived importance in attracting investment, such as lack of corruption, availability and cost of basic inputs, and cost of labour. It was also ranked higher than other factors that have received considerable attention in recent research, such as the presence of other firms in the industry, and improved access to latest relevant technology.

The diverse operations of many of the multinationals made it difficult to categorise them by type of business. Nevertheless, the findings for the individual sub-groups were analysed; one-way ANOVA was used to assess the significance of the differences between the means of the sub-groups. Significant differences were anticipated, in particular that the financial services sub-group would show a higher mean value for the importance of taxation, due to the nature of their operations, and because of the executives' expected greater awareness of the taxation implications of their decisions. (The results of the survey by Ruding, above, had given some support to this supposition). However, this was not the case. An analysis of the mean values for the importance of taxation of profits by industry sub-group showed no statistically significant differences at a confidence level of ninety-five percent. Further, the rankings (order of importance) for the listed factors showed no statistically significant differences by sub-group (Kendall's W statistic at 0.745).

The responses to question 8, concerning the importance of listed attributes of a country's corporate tax system to the attractiveness of that system are shown in Table 3 below. Table 3 shows the means and standard deviations of the responses for each attribute, in descending order of the mean values.

Table 3

Importance of Corporate Tax System Attributes to the Evaluation
of the Attractiveness of Corporate Tax Systems

[Question 8]

In your experience within the last five years, when evaluating the attractiveness of a country's corporate tax system as part of your decision whether to make a direct investment there, in general how important were the following factors in your evaluation? (Please rate on a scale of 1 to 10, 1 = not at all important, 10 = extremely important).

<u>Ranking</u>	<u>Attribute of Corporate Tax System</u>	<u>Mean</u>	<u>σ</u>
1	Transparency of the tax system (i.e. preciseness of law enabling confident interpretations)	7.64	1.86
2	Predictability of the tax system (in terms of future stability of rates, allowances, etc.)	7.61	1.68
3	Statutory corporate tax rate (include local taxes on profits, e.g. state tax, if applicable)	7.50	2.00
4	Availability and extent of relief for double taxation (through tax treaties or otherwise)	7.33	1.83
5	Predictability and consistency of tax judgements and interpretations by the courts	7.30	2.04
6	Rate of withholding tax on repatriated profit	7.27	1.94
7	Other benefits from existence of relevant tax treaties (e.g. provision of a framework for the resolution of disputes)	6.40	1.87
8	Availability and size of allowances, deductions, etc. e.g. depreciation allowances (ignore special tax incentive schemes for investment)	6.24	2.17
9	Special tax incentives for investment (e.g. tax holidays)	6.05	2.13
10	Ease and cost of complying with tax legislation	5.97	2.14
11	Availability and extent of loss relief	5.71	2.12
12	Effectiveness of tax collection	5.33	2.32
13	Comprehensiveness and effectiveness of anti-avoidance legislation	5.31	2.31

Additionally, two responses were received to the open item “other factors, if any”. One respondent referred to the tax rate on royalties and technical assistance fees, while another referred to the availability of tax exemptions for shipping. In both cases, these “other factors” were given a high evaluation by the respondent (10 and 9 respectively), expected results for an open item. However, because of the low response rate, they were not included in the analysis above.

All factors received a wide range of scores from the individual respondents. The results indicate that all attributes listed were considered important, with no attribute receiving a mean score of less than 5 out of 10.

There were similarities with the results of earlier research. The statutory tax rate was, not unexpectedly, given a high ranking of third, due to its “headline” quality. This attribute was, as in previous studies, seen as more important than withholding tax rates (in sixth place), which in turn was viewed as more important than the tax base (in eighth place). Also, as found in previous studies, was the comparatively low importance attached to special tax incentives (ninth place).

Of particular note, in view of the fact that they had not been included in any prior surveys of this nature, were the high rankings for certain broad systemic attributes, such as the transparency of the tax system (first place), the predictability of both the tax system (second place) and of tax judgements and interpretations (fifth place). It would appear that, in this context as well as in the results shown in Table 2, MNC investors valued stability highly in their decision making.

As in the results from the previous question, the results from question 8 somewhat surprisingly showed no statistically significant differences amongst the industry sub-groups in terms the ranking order of the various attributes (Kendall’s W statistic at 0.835)

PART 5 – CONCLUSIONS AND FURTHER RESEARCH

This study adds to the expanding literature on the determinants of FDI location by surveying the views of executives of MNCs with regard to the importance of a wide range of

factors, including corporate taxation, in investment location decisions. It also investigates the importance of individual attributes of the corporate tax system to the overall evaluation of the system in these decisions.

This study's findings are subject to the usual limitations of the survey approach, including the reliability of the responses. There is also the possibility of non-response bias and a demand effect, the latter having the potential to over-state the reported importance of taxation, although the questionnaire was phrased to minimise this effect. The survey's use of a numerical scale has the potential disadvantage of leading to different interpretations by respondents with identical opinions. Further, there is the possibility that respondents may reply with a score based on an *ex post facto* rationalisation of their actions, rather than one reflecting their original thought processes. Finally, as only executives of the largest multinationals were included in the sample, there is the possibility that this sample may not be representative of all MNC executives, although there are no *a priori* reasons for believing that this is the case.

The above limitations notwithstanding, some broad conclusions may be drawn. Taxation of profits was found to be more important than most other factors in the investment location decisions of MNCs. However, certain other factors, especially those relating to the stability and predictability of the investment environment, and those relating to the size and proximity of the market, were of greater significance.

Also, the quality of the infrastructure and the workforce were, as in some previous studies, found to be more important factors than taxation of profits, suggesting that government expenditure on public assets and education may be an effective means of encouraging funds from overseas.

The availability and quality of labour, in seventh place, was held to be slightly more important than taxation of profits, although the difference was not statistically significant. In view of the importance to corporate competitiveness currently attached to the quality of a firm's human resources, its showing might appear somewhat low. However, this may be due to the fact that that quality of the workforce may invite "raiding" and relocation of skilled staff by the MNC rather than investment in the host country.

The study therefore finds that corporate taxation currently remains a significant factor in the investment location choice, though only one of many important considerations in a multi-faceted decision. Unfortunately, a clear comparison of these results with those of previous surveys cannot be made, and so it is difficult to conclude whether the increasingly liberalised climate for international investment has led to the increased importance of corporate taxation. However, it seems likely at present that this liberalisation process will continue on its current trend, especially if the proposed and long-awaited international agreement on FDI along the lines of the GATT comes into being. If this turns out to be the case, a survey similar to this one undertaken some years in the future may provide the basis for a more appropriate comparison.

As to the second objective, the study finds that when considering the attributes of a country's corporate tax system, stability and predictability were also comparatively highly valued by the MNC investor. These results suggest that, in their quest to attract FDI through use of tax policy, governments would be well advised to adopt a long-term strategy, in order to improve certainty and consistency. Transparency and clarity of the tax system (which tend to lead to greater consistency of judgements in the courts) would also appear to be useful aims for tax reformers in this regard.

Also notable was the comparative importance attached to the statutory tax rate. A reduction in rates, which many countries have indeed undertaken in recent years, would appear to be an effective means of competing for mobile FDI, justifying the policies of those countries. However, it could be argued these reforms may have been motivated not so much by governments' awareness of the efficacy of such reforms in attracting overseas investment as by a desire to stabilise sources of revenue, reduce economic distortions and ease administration of the tax.

The survey results also emphasise the comparative importance of the availability of double tax relief in investors' evaluations and thus indicate the potential significance of related tax treaty provisions in establishing and clarifying such relief. Future research might aim at classifying the residence of respondents into high and low tax jurisdictions and thus establishing whether the level of home country taxation influences the importance attached by the investor to the host's tax rate and treaties for mitigating double taxation.

By contrast, a lower level of importance was attached to specific tax incentive schemes. Several countries in the OECD and in Eastern Europe have reported the ineffectiveness of these incentives in encouraging FDI (see OECD, 1995), and the apparent comparative lack of interest in such incentives by international investors shown here would appear to provide an explanation for this.

However, before coming to any conclusions about the comparative importance of tax incentives, two points need to be made. First, the ineffectiveness of tax incentives reported by the OECD may be due to the incentives being offered on relatively non-productive projects; thus it may be this non-productiveness that would disinterest investors, rather than the incentives themselves. Second, the findings of this study may be based on the respondents' intuitive reactions or perceptions, which tend to be formed at the early stage of the decision-making process when attributes such as the low tax rate attract the attention of the potential investor. It may only be at the latter stages of the decision-making process, when complex investment models may be used by sophisticated investors, that the importance of tax incentives is fully appreciated. The findings may thus understate the role of incentives in the final investment decision.

Nonetheless, the findings of this study tend to support the approach of those countries whose recent reforms have consisted of a reduction in statutory tax rates, often combined with an expansion of the tax base, as a comparatively effective means of attracting foreign investment. It also lends support to the policies of the Hong Kong SAR, which has consistently used overall low tax rates, the stability and, with some notable exceptions, the certainty of its system to attract capital from overseas, while offering a minimum of specific investment incentives.²⁶ Following such a policy also has the advantage of avoiding increased complexity which tax incentives normally bring to a tax system due to the need to counter abuse.

²⁶It has, however, been argued that the narrowness of Hong Kong's tax base (due to the exclusion of capital gains, dividends and offshore profit, together with generous depreciation allowances) constitutes in itself a special incentive for attracting investment.

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