Corporate Tax and Foreign Direct Investment in Developing Countries

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Abstract

Using data on US multinational enterprises (MNEs) outward foreign direct investment (FDI) between 2000 and 2009, this paper aims to investigate the relationship between corporate tax rate and FDI in developing countries, and contrast the differences in regional corporate tax rates in order to reveal an asymmetry between developed and developing countries. This paper identifies the nature and the relationship between the four independent variables (GDP, trade openness, statutory corporate tax and distance) and U.S. outwards FDI in developing countries. The results indicate that (i) FDI is strongly and positively correlated to market size as well as to trade openness in both types of host countries - developing and developed countries. Also, FDI is inversely correlated to the distance between home and host developed countries, but no significant relationship between home and host developing countries. (ii) US MNEs are negatively influenced by the level of statutory corporate tax rates in host developing countries.

Keywords: Taxation, foreign Direct Investment, Developed and Developing Countries.

INTRODUCTION

Globalization, a tendency towards interaction and integration of world-wide economies bringing to the varying of the multinational enterprises (MNEs) ' strategies and the technique countries compete for foreign direct investments (FDI). In this globalize world economy with liberalisation investments; attracting FDI gradually more depends on the ability to provide a favourable government regime such as lower taxation rate, especially to the developing countries who lack of well-establish markets if compared to the developed countries. The corporate tax burden obviously affects the MNEs decision to locate FDI for the simple reason that it would reduces profits after tax from investment. MNEs have the capacity to shift their location and/or taxable income across borders. So what drives inward FDI and what is the role of taxation rates in this process? FDI is not determined by a single driver but many factors intervene, such as market size, market growth, trade openness, human capital, the quality of the physical infrastructure and others. Taxation is but one of many influences on inward FDI but how important is it in attracting FDI? These are the issues to which this paper is going to examine by using data of outwards FDI of U.S. MNEs to developing countries between 2000 and 2009.

Problem Statements

The choice of target countries for FDI has changed over time. Some countries may become more attractive targets while other countries become less attractive. Developed countries now receive a smaller global FDI proportion than in the past, due to the financial crisis in 2007. In contrary, FDI flow to developing countries has been less affected by the global financial crisis. FDI recovery in developing countries has been earlier and stronger. Even so, not much studies concern on the determinants of FDI inflows into developing countries, since most studies focus on developed countries such as U.S., European Union, Canada, Japan, Central and East European host countries (CEECs). The study on determinants of FDI for developing countries is largely been disregardful.

In the other hand, according to the previous literatures, the determinants of FDI vary considerably with the condition of host country such as market size, economy growth, trade openness, inflation, taxation, human capital, and the physical infrastructure. However, have not much study indeed concern on the taxation as a determinant for FDI if compared to the other determinants, since researchers preferred to investigate the major determinants.

Other than that, understanding the taxation effects on inwards FDI may be important in developing countries, because it is theoretically vague whether low corporate tax rate is observed by MNEs as a determinant of FDI, or if on the contrary, it is observed as a prospect to compensate for weak economic

conditions. This paper proposes to trail these issues, by investigate the taxation influence on FDI in developing countries between 2000 and 2009.

Research Question

Is taxation an important determinant of FDI in developing countries?

Research Objectives

- 1. To investigate the taxation influence on FDI in developing countries and to what extent the tax influence is.
- 2. To compare the level of taxation influence on FDI between developing countries and developed countries.

Significance of Study

This study attempts to shed light on how important of taxation do affect the inward FDI to developing countries instead of developed countries. This paper would suggest corporate tax-lowering strategies of governments seem to have an important impact on MNEs FDI location decisions. Thus presents the government of developing countries some ideas in planning their taxation policy by now consider the effects on FDI and provide framework for government to develop a successful long run taxation policy. This paper also expects to provide MNEs a new perspective towards taxation influence on FDI in developing countries. Thus contribute to the decision making of MNEs toward FDI location.

LITERATURE REVIEW

Determinants of FDI

The possible determinants of FDI flows have widely studied by researchers and economists, such as Coughlin, 1992; Friedman, 1994; Hood, 1999; Dunning, 2001; Barrell, 2002; Blonigen and Wang, 2002. These studies found that FDI flows influenced by factors like market size, physical infrastructure, government policy, costs of labour, trade openness and risk factors. Nunencamp and Spaz (2003) explained significant Spearman correlations between flows of FDI and market size, years of schooling, international trading flexibility, corporate governance, distance between home and countries, and cost factors which included tax burden. Finding by Holland (2000) presented that the market size and trade openness as major factors of FDI flows into Eastern and Central Europe.

A country market size typically proxy by its level of gross domestic products (GDP) that represents the total value of all goods and services produced over a specific period. With a larger size of market, there is a bigger possibility to recover the costs of the MNEs direct investment (Markusen and Venable, 1999; Blonigen and Wang, 2002). Therefore previous studies estimated a positive relationship between host countries market size and the home country FDI flows.

Trade openness refers to the degrees to which countries trading with other countries. According to previous studies by Islam and Montenegro, 2002; Gwartney, 2003; Pugel, 2007, a country with greater openness in trade normally provides better marketplace opportunities; as the trade openness demonstrated a country quality and effectiveness of institution. These studies suggested a positive relationship between home country FDI flows and host country trade openness.

A larger distance between home and host country may increase the transaction costs (Boch, 2004). However, it may occur in opposite effects, when the costs of cross country trading are higher than implantation costs in host country with larger distance, MNEs would reduce international trading volume and substitute by increases FDI. Hence, from a theoretical outlook the estimates coefficient between distance and FDI is indefinite (Mayerr, 1996; Head and Young, 2000; Markus and Markusen 2002).

Empirical Relationship between Taxation and FDI

Hines (1999) found that the tax rate elasticity is approximately in between -.5 and -.6 with single-linear approach. However, Mooij and Ederveen (2001) used the provisional logit approach; result showed that tax elasticity is -3.4. Bellak et al., (2007) study's finding of tax elasticity of FDI is semi-elasticity which is around -1.45.

Hines and Ride (1999) and Grubert and Mutti (2003) studies have included the developing countries in their regional coverage but the impact of taxes on FDI has not investigated particularly in the case of developing countries. Their studies report negative tax rates elasticity of U.S. MNEs yet they did not distinguish developing countries from developed countries. Thus, data sample of both sets of countries pooled into the same model might be inappropriate to test the tax elasticity estimates on FDI; data sample is forced to be the equivalent for countries-specific variable. (Young, 2000).

Azemar and Delios (2006) is the other one study that makes obvious a significant statistical negative correlation of -2.4 between statutory corporate tax rate and FDI in the case of developing countries. This study offers an estimation that exclude developed countries from the methodology data set. Thus this paper was contributed a more significant finding than the previous two studies regarding the developing countries.

MNEs prefer to place themselves in larger economies that have larger market, better product and infrastructure, even if the statutory corporate tax rates are higher (Hatler and Moot, 2002). Imperfect

competition encourages relatively small economies to choose lower statutory corporate tax rates to compensate for their unappealing small market size (Raff and Srinivas, 1998 and Hatler and Moot, 2002). Accordingly, the influences of corporate taxes should be greater in determining MNEs decision for FDI location in small economies than in large economies (Zucovetsky, 1992; and Wilson, 1999). Low corporate taxes rates would thus compensate for weak economic fundamental which are not in favour to attract FDI.

Overview of the Historical Trend of Global Inwards FDI Figure 1: Global Inwards FDI Flows



Source: UNCTAD — Inwards FDI flows, annually, 1990-2009

The 2007 financial crisis has changed the global FDI flows landscape: surged the direct investment flows into developing economies, increasing their share in global inwards FDI flows to 46% in 2009. This was partly due to a contemporaneous huge decline in global FDI flows to developed countries. According to the Figure 2.1 above, shows the large fluctuation trend of global FDI flows to developed countries, particularly during the period of

year 1997 to 2009. This implies that the FDI flows to developed countries were unstable with high volatility, largely been affected by financial crisis. As what reported in the UNCTAD's World Investment Reports, a burly rebound in FDI flows to developing countries, offsetting a further FDI fall in developed countries. Increased profits of foreign affiliates, especially in developing countries, boosted reinvested earnings. Overall policies trends of developing countries for both nationwide and worldwide, during the financial crisis have been mostly encourage FDI inflows. (UNCTAD - World Investment Reports, 1990 to 2009).

Research Variables

Dependent Variable – U.S. Outwards Direct Investment

To investigate the relationship between taxation and FDI inflows into developing countries, this paper focus on U.S. MNEs implantations in twenty sample host countries including ten developing countries and ten developed countries between year 2000 and 2009.

The fact that U.S. has been chosen as the home country is because of it has the largest stock of FDI abroad in the world which reach up to US\$3,597 billion (CIA World Factbook, 2009). The data of U.S. direct foreign investment inflows into both selected sample developing and developed countries are collected from Bureau of Economy Analysis (BEA) through U.S. Department of Commerce Website. The data collected is reliable because of BEA is one of the world's leading agencies of statistics. It produces the most closely watched economic statistics to its major users: White House and Congress, the Federal Reserve, the Wall Street. Furthermore, BEA is protects under Section 207(f)(2) of the E-Government Act of 2002 and the U.S. Department of Commerce No FEAR Act.

Independent Variable

(i) Tax Variable

Statutory corporate tax rate has been used in this paper as it has the benefit of being more simply taken into account in analysis compared to other tax measurements which consist of complexity measures. Besides, it is applicable and available for all nations, especially to less developed countries with poor system.

This paper expects a negative coefficient between host countries statutory corporate tax rate and the home country FDI flows as taxes are a cost to MNEs; high tax burden will reduce their capital income. The data of statutory corporate tax rates is collected from the WDI (World Bank development indicators).

(ii) Control Variables

Besides tax variable, some other independent variables may also affect the analysis outcome such as host market size, host trade openness, and distance are included in the analysis model. A country

market size typically proxy by its level of GDP (gross domestic products) that represent the total value of all goods and services produced over a specific period. The host countries' GDP data are collected from WEO (world economic outlook) databases from IMF (International Monetary Fund) website. In order to standardize the data, data chosen is current price of GDP in term of U.S. Dollar.

Trade openness refers to the degrees to which countries trading with other countries. It is measured by the sum of exports and imports of goods and services divided by GDP. The export and import values are collected from WTO (World Trade Organization) databases.

The distance data between U.S. and the host countries obtained from the American Airlines company website. It was award-winner of globally <u>AA.com</u> website (good grade website) shows the information from its website is informative and trustable.

Regression Model

The multiple regression model is applied in this paper in order to estimate the taxation influence on FDI. Multiple regression model does not just include one method, but a family of method that can be employed to investigate the relationship between a dependent variable and numerous of independent variables. Multiple regression model is using correlation (beta value) as foundation, but allows a more complicated investigation of the inter-relationship between a set of variables. This makes it ideal for the investigation of multifaceted real life, rather than laboratory based research questions. Applied into the estimation of this paper, the linear form is shown in Equation 1:

InFDIijt = αijt + $β1^{1}$ InGDPjt + $β2^{T}$ RADEjt + $β3^{C}$ CORTaxjt + $β4^{1}$ InDISTij + εijt (1) Where.

- InFDlijt is the log of outwards FDI from home country i to host country j over time t.
- αijt is the intercept point of country-pair effects
- β is coefficient of regression
- **InGDPjt** is the log of GDP in host country j at time t
- **TRADEjt** is the degree of trade openness for host country j at time t
- CORTaxjt is the statutory corporate tax rate of host country j at time t
- InDISTij is the log of the distance between home country i and host country j
- εijt is an error term or disturbance term

** The figures obtained for U.S. outward FDI, and twenty host countries' GDP are in millions of U.S. Dollar, distance in kilometres, to reduce wide-ranging amount to smaller scopes, logarithms scale used to simplify the analysis.

[Cummins and Hubbard (1994); Hines (1999); Newlon (1997); Murthy (1999); Mooij and Ederveen (2001); Desai (2002); Mutti and Grubert (2004)

FINDINGS

Data Estimates Table 1: Correlation Matrix

	GDP	TRADE	CORTAX	DIST
Pearson Correlation InGDP	1.000			
TRADE	294	1.000		
CORTax	.416	405	1.000	
InDIST	.375	.295	026	1.000

Tabachnick and Fidell, (1996) suggested that two variables should not has a bivariate correlation of .7 or more in the same model analysis. If in this situation, need to consider omit one of the variables or forming a composite variable from the scores of the two highly correlated variables. In this paper, as presented in the Table 1, the correlation scores are lower than .7 between each of the four independent variables. Thus, there is no variable need to be taken out from the model.

Table 2: Model Summaryb

Model	R	R Square	Adjusted R Square	Std. Error of the Estimate
1	.772*	.597	.588	.45727

** a. Predictors: (Constant), lnDIST, CORTax, TRADE, lnGDP

** b. Dependent Variable: FDI

The other important way to evaluate the model is by checking the R square. This value tells how much of variance in the dependent variable is explained by the model. In this paper, the R square value is .597 as shown in the Table 2. Expressed as a percentage, this implies that 59.7% of the variance in the dependent variable is explained by the model. This value considered as a quite respectable result.

Figure 2: Histogram



Figure 2, shows the model in normal probability plot with mean 4.16. This would suggest no major deviations from the normality. Simultaneously, no outlier is being detected. Thus, no variable needs to be omitting from the model. The descriptive statistics as followings:

Table 3: Descriptive Statistics

	N	Range	Minimum	Maximum	Mean	Std Deviation
InI(D)	200	3 41	2.26	5.67	4 1638	71260
InGDP	200	2.85	3.85	6 71	5 3640	69622
TRADE	200	3.47	.04	3.52	. <mark>807</mark> 9	.66400
CORTax	200	36.60	15.00	51.60	30.7250	6.52173
InDIST	200	.77	3.42	4.18	3.9119	.20798
Valid N (listwise)	200					

The Table 3 reveals that the variable of statutory corporate tax rate (CORTax) has an overall mean of 30.725%, and ranges of 36.6% between the lowest 15% of Chile in 2000 and the highest 52.6% of Germany in 2000. The wide range again a strong hint of the importance to investigate the taxation influences on FDI in developing countries, without mixture with developed countries as what majority of previous studies done.

Result and Discussion

Table 4: Result includes Data Set of Both Developed and Developing Countries Coefficients²

		Unstandardized Coefficients		Standardized Coefficients			Collinearity	Statistics
Мо	del	В	Std. Error	Beta	t	Sig.	Tolerance	VIF
1	(Constant)	546	646		845	399		
	InGDP	.876	.060	.856	14.620	.000	.601	1.655
	TRADE	.428	.060	.399	7.188	.000	.673	1.486
	CORTAX	013	.006	117	-2.203	.029	.734	1.362
	InDIST	- 264	190	- 077	-1 391	166	675	1 482

a Dependent Variable: InFDI

Table 4 shows the result estimation with combination of both developed and developing countries set. All coefficients carry the expected sign, and are statistically significant at the 5% significant level, except the distance. It is marginally insignificant with Sig. value more than .05. According to the previous studies, this can be explained by the distance factor which may occur in two opposite effects, depend on the shipping costs and implantation costs incurring. (Mayerr, 1996; Head and Young, 2000; Markus and Markusen 2002). While the GDP has the highest influence level with positive coefficient of .856 to the U.S outwards FDI among the four independent variables tested. This result estimate is matched with the empirical results which suggested that the host market size (GDP) is the major factor of FDI (Holland, 2000; Dunning, 2001; Nunencamp and Spaz, 2003; Kapo and Ginoshita, 2005). For statutory corporate tax rate, the core independent variable of this paper, shows the expected negative sign (-.117) of coefficient between U.S. and host countries. This result estimate of tax elasticity are much lesser than the findings of previous studies such as Hines (1999) with coefficient of -.5; Mooij and Ederveen (2001) with coefficient of -3.4; and Bellak (2007) with coefficient of -1.45.

In the Table 4 above, variable is first tested for combination data set of developing and developed countries, as considered that this pooled coefficient may misrepresent the real relationship between taxation and FDI in both types of countries. So, the next result estimates is done by separating the data set for developing countries and developed countries, as shown in the Table 5 and Table 6.

Coefficients*

		Unstandardized Coefficients		Standardized Coefficients			Collinearity	/ Statistics
Mo	del	В	Std. Error	Beta	t	Sig.	Tolerance	VIF
1	(Constant)	.112	.297		.376	.708		
	InGDP	.723	.090	.819	8.032	.000	.242	4.129
	TRADE	.194	.054	.233	3.607	.000	.603	1.658
	CORTAX	.018	.003	.266	5.271	.000	.986	1.011
	InDIST	.081	.144	.056	.559	.578	.251	3.982

Table 5: Result of Developing Countries only

a. Dependent Variable: InFDI

Table 5 shows the result for developing countries only. All variables are statistically significant at the 5% significant level, except the distance with Sig. value more than .05. This implies that there is no relationship between distance and FDI flows. The GDP which represents the host market size stills the largest influences on the dependent variable contributed .819% changes to U.S. outwards FDI if 1% changes of GDP in the same direction. The host countries' trade openness and U.S. outwards FDI have a positive relationship with coefficient of .233. While the statutory corporate tax rate, also in the expected negative sign of coefficient. However, the negative coefficient with value of -.266 is larger than the first result estimate with value of -.117. Imply that 1% decreases in the statutory corporate tax rate in host developing countries will increase the U.S. FDI inflows by .266%. This result same as the previous study of Azemar and Delios (2006) which excluded the developed countries data from the model analysis. The finding presented a more obvious larger negative coefficient value for developing countries.

Table 6: Result of Developed Countries	s only
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		Unstandardized Coefficients		Standardized Coefficients			Collinearity	Statistics
м	odel	в	Std. Error	Beta	t	Sig	lolerance	VI⊦
1	(Constant)	12 609	3 281		3 843	000		
	InGDP	.469	.100	.592	4.703	.000	.511	1.958
	IRADE	.587	.137	.917	4.280	.000	.176	5.678
	CORTAX	.002	.009	.026	.209	.835	.512	1.955
	InDIST	2.844	.934	.516	3.047	.003	.282	3.547

Coofficientes

a. Dependent Variable: InFDI

As shown in the Table 6, the results estimations for developed countries only are being different from the first and second results estimations (Table 5 and Table 6). All coefficients are significant at 5% level

of significant including the distance variable yet with expected negative sign. Except the statutory corporate tax rate, is highly insignificant at the 5% level. The trade openness contributed the largest beta of .917, has highest impact on U.S. outwards FDI. Whereas, the host GDP is being less influence on FDI than the trade openness is. These results are totally different from the earlier studies. As what can explain here is, the data with different period range chosen will create different results. As presented in the study of Nunencamp and Spaz (2003), different years of schooling lead to the different findings.

Comparison of Taxation Influence on FDI between Developing Countries and Developed Countries

In the case of statutory corporate tax rate, obviously, the results generated from the above three model tests (Table 4, 5, and 6) are dissimilar. As comparison, the developing countries result provides the highest negative coefficient of -.266 between statutory corporate tax rate and U.S. outwards FDI. This implies that, the impacts of statutory corporate tax rates on FDI are stronger in the developing countries relatively to the developed countries. By distinguishing the data of developing countries from the developed countries a more noticeable result to interpret the relationship between statutory corporate tax rate and FDI flows. Moreover, what most surprising here is, the statutory corporate tax rate is insignificant at 5% level for developed countries analysis; indicates that there is no relationship between host developed countries' statutory corporate tax rate and U.S. outwards FDI flows. This result is absolutely contrary to the previous studies which point up highly impact of corporate tax rate on FDI in developed countries.

Again, substantiate that the important to investigate the taxation influence on FDI for developing countries, instead of for developed countries only or combination of both types of countries. This is because of the different views of the taxation as important determinant of FDI flows between the developing and developed countries government. Thus, they may implement different tax policies due to their different objective or purpose. Developing countries' economies are relatively small than those developed countries. They have less ability in provision of large market size, well-established market, high quality of infrastructure and institution to compete with developed countries to absorb FDI inflows. Thereby, developing countries to revise their taxation policy to reduce the tax burden for MNEs or foreign investors, in order to attract FDI inflows. This is supported by several empirical studies which have demonstrated that a country's weaknesses in market-related variables such as size of market and market potential can be compensated by government monetary policies, such as lower corporate tax rates (Zucovetsky, 1992; Wilson, 1999; Benassy-Quere, 2005).

Meanwhile, through the results, they explain that the developed countries do not think highly of the statutory corporate tax rate influences on FDI; instead of taxation variable, they are attach more importance to the other major determinants of FDI such as market size and trade openness. In other words, the changes of statutory corporate tax rates in developed countries do not affect U.S. MNEs' decisions to place FDI or locate plants and facilities in their countries. Taxation is not an influential determinant of FDI for developed countries, but it is an important determinant of FDI for developing countries.

CONCLUSION

Summary of Findings

The purpose of this paper is to shed light on the relationship between taxation and FDI in developing countries by using data on outwards FDI of U.S. MNEs over the 2000 to 2009 period. The multiple regression model allows a more sophisticated investigation of the interrelationship between one dependent variable and a set of independent variables, which ideal for this paper. This paper identifies the nature and the relationship between the four independent variables and U.S. outwards FDI in developing countries, which derives a number of implications.

First, FDI is strongly and positively correlated to market size as same as to trade openness in both types of host countries - developing and developed countries. Also, FDI is inversely correlated to the distance between home and host developed countries, but no significant relationship between home and host developing countries.

Second, U.S. MNEs operations are negatively influenced by the level of statutory corporate tax rates in host developing countries. Whereas, the level of statutory corporate tax rates has no impact on the FDI location decisions of U.S. MNEs in the host developed countries. With this, this paper observes an asymmetry between the impact of statutory corporate taxes on FDI in developing countries and in developed countries. This finding has pointing to a greater importance of tax policy in developing countries for MNEs FDI location decisions than previously acknowledged.

Limitations

While this study is a step towards a better understanding of the determinants of FDI flows to the developing countries, there are several limitations to this paper analysis. In particular, according to the R square value of .597, this paper is conscious of the leaving out of approximately 40% of possible variables that would be affects the analysis outcome. For example, this paper has been excluded the

location factors such as the quality of physical infrastructure, the cost of labour, and inflation. This omission is due to the lack of meaningful data and unavailability of data collection.

Recommendations for Future Study

Finally, greater possible determinants coverage of FDI such as market growth, quality of physical infrastructure, inflation, exchange rate, tax regimes, unit of labour cost should be includes in the future study, in order to provide a more obvious and accurate result. Furthermore, as data on the regional level becomes available differences in tax-rate elasticity between regions, should provide a more detailed picture on the tax rate sensitivity of FDI in the future study. By the way, the data range of developing countries sample should be expanding in future study.

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