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Tax competition and FDI: The special case of developing countries

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According to the foreign direct investment (FDI) literature, the elasticities between FDI and its determinants vary considerably with the level of host country development. This may be a major concern when dealing with the influence of corporate tax rates on FDI in developing countries, since most studies concentrate on developed countries. Using data on Japanese firm location choices between 1990 and 2000, we contrast differences in regional tax rates in order to reveal an asymmetry between developed and developing countries. By looking at the interaction effects between Japan and host developing countries' tax systems, we also put forward the idea that special tax sparing provisions signed with Japan can alter the effect of host country taxes on Japanese firms' location choices. Finally, we find that even though tax competition can be strong in developing countries, this competition should not lead to an effective rate of zero taxation for these countries in their competition for FDI inflows. *J. Japanese Int. Economies* **22** (1) (2008) 85–108. CES—University of Paris I Panthéon Sorbonne—CNRS, France; NUS Business School, National University of Singapore, Republic of Singapore.

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1. Introduction

The impact of corporate tax rates on foreign direct investment (FDI) has seldom been investigated in the case of developing countries. All countries, however, compete against each other over corporate taxes to attract FDI. Statutory rates of corporation taxes have fallen considerably over the last decade, leading to substantially lower tax rates in developing countries than in developed countries. Nevertheless, the impact of taxes on FDI in developing countries has largely been neglected by the tax literature. Understanding the influence of tax rates on FDI inflows may be crucial in developing countries, because it is empirically unclear whether low taxation is seen by investors as a second rank determinant for FDI with a marginal effect, or if on the contrary, it is seen as an opportunity to compensate for weak economic fundamentals. Indeed, the literature points out that when foreign investment flows to developing countries are considered, market-related variables are the strongest determinants of FDI.[1] More recently, however, theoretical and empirical studies have demonstrated that a country's disadvantages in market-related variables such as market size and market potential can be compensated by direct fiscal incentives, such as lower corporate tax rates (Bucovetsky, 1991; Wilson, 1991; Bénassy-Quéré et al., 2005).

One explanation for the lack of empirical evidence regarding the link between foreign investment and corporate tax rates in developing countries is the difficulty in calculating appropriate measures of taxation. The only available measure of taxation for developing countries is the top statutory tax rate which may not correspond to the effective tax rate paid. The former has nevertheless been found to play a role in the determination of firm locations[2] (Devereux and Griffith, 1998). In this paper we investigate the sensitivity of Japanese firm location choices to statutory corporate tax rates across developing countries. The consideration of this relationship in these particular countries is interesting for at least four reasons.

First, estimates of the tax elasticity of FDI vary across empirical studies, depending on the econometric methodology, the measure of tax rates, the period studied, and the geographic area selected.[3] Hartman (1984), Boskin and Gale (1987), Newlon (1987), Young (1988) and Murthy (1989) each consider the influence of the after tax rates of return on FDI inflows into the USA. These studies report a positive correlation between levels of foreign investments and after-tax rates of returns. Other studies extend this literature with a better control of macroeconomic events, with a more appropriate measure of taxation, by distinguishing investments coming from a tax credit system and a tax exemption system, or by distinguishing investment financed by retained earnings or transfers of parent funds (Slemrod, 1990; Auerbach and Hassett, 1993; Swenson, 1994; Devereux and Freeman, 1995; Bénassy-Quéré et al., 2005). In these studies, the implied elasticity of FDI with respect to corporate tax rates in the USA or in a sample of OECD countries is always negative, suggesting the obvious capacity of tax policies to affect the location and volume of FDI.[4]

Among the empirical work dealing with the influence of international tax rates on foreign capital, the following three studies have included developing countries in their geographical

[1] Schneider and Frey (1985), Wheeler and Mody (1992), Tsai (1994), and Taylor (2000).

[2] Average effective tax rate data can be found for some developing countries but only for US multinationals (US Treasury Controlled Foreign Corporations files compiled by the Internal Revenue Service).

[3] The empirical literature of the impact of corporate tax rates on FDI location has been reviewed by Hines (1999).

[4] See Hines (1999), Devereux and Griffith (2002) and Mooij and Ederveen (2003) for a comprehensive survey of the literature dealing with the impact of taxation on FDI.