The Impact of Non-Profit Taxes on Foreign Direct Investment

Paper prepared for the European Tax Policy Forum conference "The Impact of Corporation Taxes Across Borders", London, April 24th. 2006

by Thiess Buettner and Georg Wamser (Ifo Institute and Ludwig Maximilian University Munich)

Executive Summary:

While numerous studies have shown that international differences in the taxation of corporate income exert an impact on location and investment decisions of multinational corporations, little is known about the consequences of taxes other than income taxes on those decisions. This study provides empirical evidence using a large panel of German multinationals. Given the heterogeneity between the various types of potentially relevant taxes other than corporate income taxes the analysis uses a variety of tax indicators capturing sales, property, and excise taxes, import duties, as well as taxes on skilled labor.

The panel data analysis of the level of capital invested in property, plant, and equipment by German multinationals in 18 other OECD countries supports a role of corporate income taxes via the cost of capital and, in fact, indicates some further adverse effects of sales taxes, possibly related to demand effects. Another tax variable which proves significant is the tax on skilled labor. This conforms with theoretical predictions if we assume that skilled labor is mobile internationally and if there is some capital-skill complementarity. Some further significance of other tax variables is detected only in single specifications and proves not to be robust across specifications. In contrast to the analysis of the level of FDI, the analysis of location decisions reveals no significance of taxes other than corporate income taxes. Location decisions are only found to be affected by import duties, which, however, exert a positive impact. This is consistent with the view that multinationals show a higher propensity to place production in markets which are protected from imports.

Taken together the results suggest that policies devoted to attract investments of multinationals which already have an affiliate in the country should care for low cost of capital, low sales taxes, as well as low taxation of skilled labor. Policies aiming at an attraction of subsidiaries of foreign multinationals should reduce corporate income tax rates. Abolition of import duties, however, might exert adverse effects on the location propensity.