The University of Nottingham

Leverhulme Centre for Research on Globalisation and Economic Policy

Research paper media briefing

Foreign Direct Investment

Tax Competition and Social Expenditure

by Holger Görg, Hassan Molana and Catia Montagna

Key Findings:

- Countries which attract the highest levels of FDI often have higher taxes
- Multi-nationals prefer countries with better social welfare policies even if this means taxes are higher
- Countries are not competing to cut taxes

New research which challenges the widespread assumption that countries need to cut corporate taxes to attract investment from multi-national firms.

Some of the findings in detail:

Higher taxes may boost investment:

Countries with higher taxes and higher social welfare spending are actually more successful in attracting overseas investment.

Holger Görg from GEP and Hassan Molana and Catia Montagna, both from the University of Dundee, analysed data from 18 OECD countries over a 14 year period. They found that the countries which attracted the highest levels of foreign investment – a key economic target of most Governments - were actually the ones with higher taxes (and higher public social expenditure as a proportion of GDP).

GEP's Holger Görg, said: "The results may be startling and appear to be counterintuitive. Most economists have always argued that globalisation leads to a 'race-to-the-bottom' as countries compete to cut tax rates in the hope of attracting multinational investment and the jobs that come with it. The traditional theory is that this then leads to a shrinking of tax revenues and undermines the welfare state.

"But evidence shows that overall effective corporate tax burdens do not appear to have fallen in response to capital and trade liberalisation, that countries aren't competing to cut taxes and actually, when investing abroad, firms find countries with higher taxes attractive because they associate them with a happy, stable workforce."

The fear that globalisation will force countries to compete in cutting taxes and therefore welfare spending to attract investment is behind much of the recent drive to harmonise tax policies within the EU and OECD.

But evidence shows that tax revenues as a percentage of GDP are on the rise in many OECD countries. Whilst many governments have reduced statutory corporate income tax rates, most have simultaneously broadened the tax base and closed various loopholes so total revenue from capital taxation has not declined. And differences in corporate tax treatments between OECD countries remain very large.

Dr Görg said: "This research suggests that commentators and economists have overstated the degree to which international investment decisions are driven by relative tax-treatment considerations."

Amongst the reasons suggested by the researchers for their lack of sensitivity to taxation is the fact that multinationals have the ability to shift profits to lower-tax locations – for example by transfer pricing or intra-firm debt contracting.

Dr Görg said: "Perceptions about the host country's economic and social environment are key to the choice of location for many multinationals. It seems that investment decisions depend on the combination of taxation and the provision of public goods and services that host countries can offer because of taxation. So an 'unfavourable' tax differential may lead to more and not less investment flowing into a country."

The research data covered the period 1984-1998 for the following 18 OECD countries: Australia, Belgium, Canada, Finland, France, Germany, Greece, Ireland, Italy, Japan, Netherlands, New Zealand, Portugal, Spain, Sweden, Switzerland, UK and USA.

The researchers found differences in the overall effects of taxation and social expenditure on foreign direct investment (FDI) across OECD countries. For the UK, a country with an already moderately low tax rate and above average level of social expenditure, a marginal cut in the tax rate is not likely to affect inward investment at all – presuming that it does not lead to a cut in the level of social expenditure. A cut in tax rates may be more beneficial for countries with comparatively high tax rates, such as Germany or the US, although the estimated effects are likely to be small. For the US, the researchers calculate that a two percent reduction in the rate of corporate tax could increase inward FDI by about one percent – but an increase in the level of social expenditure, instead of cutting taxes, may have an even larger effect.

GEP – the Globalisation and Economic Policy Centre - is the major centre in Europe studying the impacts of globalisation and economic policy, and one of the biggest of its kind in the world. The centre has an impressive international reputation; its academics have advised the Treasury, the OECD, the World Bank and WTO.

GEP is keen to promote its research work and is committed to communicating its expertise through the media and to assisting journalists whenever able.

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Website: www.gep.org.uk

Research paper authors:

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Associate Professor and Reader in International Economics, GEP.

Holger Görg focuses primarily on the impact of globalisation at a firm level.

Recent GEP work includes exploring the effects of exporting and offshoring on a firm's productivity and the impact on wages when foreign multinationals buy UK firms. He has also produced interesting work showing how countries with higher corporate taxes are often actually more successful in attracting foreign investment.

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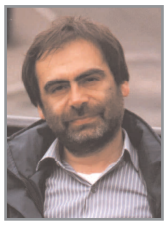

Hassan Molana is a macroeconomist. His recent research focuses primarily on the effectiveness of macroeconomic policies in the presence of market imperfections and the impact of globalisation on the sustainability of welfare state policies.

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