Effect of Corporate Tax on FDI Inflows and Stock

Neha
Assistant professor,
Department of Commerce,
Maitreyi College, University of Delhi
Email : neha.dse13@gmail.com

Jyotsna
Assistant professor,
Department of Commerce,
Maitreyi College, University Of Delhi
Email : jyootsnasingh@gmail.com

ABSTRACT

The Foreign Direct Investment means "cross border investment made by a resident in one economy in an enterprise in another economy, with the objective of establishing a lasting interest in the investee economy. FDI is also described as "investment into the business of a country by a company in another country". Mostly the investment is into production by either buying a company in the target country or by expanding operations of an existing business in that country". Such investments can take place for many reasons, including to take advantage of cheaper wages, special investment privileges (e.g. tax exemptions) offered by the country. An objective of the study is, to empirically examine the impact of corporatetax on the FDI inflows and stock into countries with high income levels for the period from 2004 to 2016. Study has used panel regression equation through software Eviews 8 and Stat 13. For high income countries in model 1, study found that corporate tax rates have no effect on FDI inflows. .GDP, GDP per capita and FDI openness have positive impact on FDI inflows. For the model 2 of high income countries, study found that corporate tax rates do affect FDI stock. FDI stock displays positive relationship with FDI openness and GDP per capita.

Keywords- Corporate Tax Rate, GDP, Panel regressionand FDI

1. Introduction

Over the past few decades emerging countries have become the major recipients of Foreign Direct Investment (FDI) as MNCs have started expanding their business operations beyond their national borders to the countries offering various advantages which they seek to exploit to gain. Foreign Direct Investment (FDI) has appeared to be the most important source of external flow of resources to the developing countries and has become an integral part of capital formation despite of their small share in global distribution of FDI (Kumar and Pardhan2002).

Countries are competing with each other to attract FDI as it is seen as an instrument for development. FDI is the need of every country, whether it is high, middle or low income country as it provides a variety of benefits for example, technology upgradation, foreign exchange reserve, mobilizes domestic savings etc. which is very much essential for an economy. Most of the economies in the world compete to attract FDI but the motives to attract FDI may differ among high, middle and low income countries.

High income countries also strive to attract FDI but their needs are not similar to middle and low income countries. In most of the high income countries, people tend to save less which creates imbalances in saving and investment which in turn necessitates the need to get funds for investment through FDI. In

addition, FDI is also important to maintain the pace of growth in economy. Level of technological development, managerial ability, management of finance and labour are not same   in every country therefore high income countries struggle to catch attention of MNCs from other developed nation where these things are better in comparison to their own country. Every country has its own specialization for instance, Japanese and German companies are specialized in electronics and US firm are specialized in financial services. So, one high income country (U.S) may attract FDI from other high income country (Germany). FDI is needed to activate domestic savings. In this paperwe tests and found that corporate tax rates do affect FDI stock.

2. Rationale of the study

Countries are trying to attract MNCs by offering different tax incentives, but it is also creating adverse tax competition among them. Countries should analyze both the positive & the negative aspects of tax incentives before their implementation.It is important to study the role of taxation in attracting FDI in economies with high income level, as very few studies have dealt with a high income country, but too focused on single year like Djankov, Ganser, McLiesh, Ramalho, & Shleifer (2010) have taken data for the year 2004 only. Thus we will try to address this gap. Results of exiting studies have been found to be mixed.

Sample sizes of previous studies were small therefore they were not possible to generalize on all the high income countries. By considering high income countries as sample, study is attempted to arrive at a broader conclusion specifically for high income countries.

3. Objective

Objective of study is to examine the impact of tax environment on the FDI inflows and stock into high income level.

4. Literature Review

Previous studies can be divided into firm level, country level and firm and country level with sector specific studies For country level literature we have a variety of studies like Hartman (1984) and Boskin & Gale (1986) stated that FDI from retained earnings were more sensitive ,negatively and significantly related to corporate tax rates, but contrary to this Slemrod (1990) and Shah & Slemrod (1991)estimated that FDI from the transfer of funds are more sensitive and negative and significantly related to corporate tax rates. Wijeweera & Clark (2006), Egger et al. (2006),Cassou (2006), Bellak & Leibrecht (2009), Klemm & Parys (2011) andArbatli (2011) found that there was negative and significant relationship between tax related variable and FDI. Bezic & Pavlovic (2007) and Jensen (2011) concluded that there was a negative and insignificant relationship between corporate tax rate and FDI. Obeng (2014) stated that corporate tax rates, interest rate and inflation have a negative and significant impact on FDI inflows in all the sectors (mining, manufacturing and service) in Ghana. Gastanaga et al. (1998), Jun (1994), Chakrabrati (2001), Mateev & Tsekov (2012) and Talpos (2012) stated that there was a positive and significant relationship between corporate tax rates and FDI. Under firm level data P.Devereux & Griffith (1999), Grubert & Mutti (2000), L.swenson (2000), Mihiret al. (2004), Buettner & Ruf (2007) and Djankov et al. (2010) found that corporate rates were negatively related to FDI but study didn't find any evidence stating that there was a positive relationship between tax rates and FDI. L.Swenson (2000) analyzed that plant expansion and new plants were negatively related to statutory tax rates but merger and acquisitions were positively related. Plant expansion was less sensitive to tax rates over new plants and taxes effects were not significant when applied on aggregated data. In case of the firm and country level study division, Stowhase (2005) stated that primary sector was insensitive to tax incentives and both

tertiary and secondary sectors were affected by it. The tertiary sector was highly sensitive to tax incentives. Silva & Lagoa (2011) found out that out of three tax rates, effective average tax rates have strongest impact on FDI, services were less responsive to statutory tax rates in comparison to industries and industries were most sensitive to effective average tax rates over other sectors. As study has observed, results of the exiting literature have been mixed so paper will try to come on broader conclusion for high income countries.

5. Research Methodology

Sample period of the study is 13 years from 2004 to 2016 and sample size of the study is all the high income countries in the world but due non availability of data study has taken only 54 countries. World Bank categorizes the countries every year on the basis of GNI and paper has taken the list for the year 2016 from World Bank site. To segregate the countries World Bankuses GNI per capita in U.S dollar. After considering the data for all the variables, study got 54 countries as high income countries. Tax related variable was taken from e & y worldwide corporate tax guide ranging from 2004-2016. FDI inflows and FDI stock were taken from UNCTAD database and GDP, GDP per capita, were gathered from WDI of World bank for the period of 2004-2016.FDI openness is calculated, using data collected from above stated variables. Under the study 2 models were formed; in the first model, FDI inflow is dependent variable whereas FDI stock is dependent variable in the second model. Functional forms of models are as following:

MODEL 1
FDI =f (FCT, GDP, PCAP, FDIOP)
AND
MODEL 2
FSTK =f (FCT, GDP, PCAP, FDIOP)

5.1 Dependent Variable

FDI (Foreign Direct Investment) Inflows (For specification 1)

Our dependent variable for specification 1 is FDI inflows. FDI is the sum total of equity capital, intra company loan and reinvested earnings. It is the amount received from foreign direct investors. Equity capital shows total purchases done by foreign direct investors, excluding residents of the country. Reinvested earnings are undistributed part of profit which was to be distributed to foreign direct investors but reinvested in the enterprise. Borrowing and lending transactions between parent and associate enterprises are known as intra debt transactions, which can be for long or short term. FDI inflows are taken on the net basis. FDI inflows can be negative, if gross out flows exceeds gross inflows. This data is used in US million dollars at current prices.

FDI Stock (For specification 2)

The dependent variable for specification 2 is inward FDI stock. As per UNCTAD (United Nations Conference on Trade and Development), FDI stock is "the value of the share of their capital and reserves (including retained profits) attributable to the parent enterprise, plus the net indebtedness of affiliates to the parent enterprises". This data is also used in US million dollars at current prices.

5.2 Independent Variable

(1) GDP

According to the World Bank, GDP (constant 2005 US$) is defined as "sum of gross value added by all resident producers in the economy plus any product taxes and minus any subsidies not included in the

value of the products." It is calculated without making deductions for depreciation on fabricated assets or for depletion and degradation of natural resources. The data is in constant year 2005 U.S. dollars. Dollar figures for GDP are converted from domestic currencies using 2000 official exchange rates. GDP was taken as independent variable by Chakrabrati (2001) ,Stowhase (2002), Wijeweera & Clark (2006) , Silva & Lagoa (2011) and Matheson, Perry, & Veung (2013).

Expected relationship - FDI inflows are expected to be positively related to GDP, as GDP shows the market size of the economy. If market size is large then, larger FDI inflows/stock is expected. Multinational companies generally try to invest in those countries which have a large market size.

H_0:- GDP has no impact on FDI inflows/ stock.

H_1:- GDP has a positive impact on FDI inflows/ stock.

(2) GDP Per Capita

According to the World Bank, GDP per capita (constant 2005 US$) is defined as "gross domestic product divided by midyear population. GDP is the sum of gross value added by all resident producers in the economy plus any product taxes and minus any subsidies not included in the value of the products." It is calculated without making deductions for depreciation of fabricated assets or for depletion and degradation of natural resources. Data are in constant year 2005 U.S. dollars. Chakrabrati (2001), Jensen (2011), Mateev& Tsekov (2012) and Klemm & Parys (2012) have taken GDP per capita as independent variable.

Expected relationship - FDI inflows should be positively related to GDP per capita, as GDP per capita shows the quality of market size of the economy. If quality of market size is high, then larger FDI inflows/stock is expected. Multinational companies generally also try to invest in those countries which have high quality market size.

H_0:- GDP per capita has no impact on FDI inflows/stock.

H_1:- GDP per capita has a positive impact on FDI inflows/stock.

(3) FDI Openness

Meaning- FDI openness implies the reduction of barriers to foreign investment thereby creating a conducive climate for FDI. FDI openness is FDI stock divided by GDP at base year multiplied by 100. The meanings of GDP and FDI stock have already been explained above.

Expected Relationship – FDI openness is expected to have a positive relationship with FDI inflows/stock. As FDI openness increases it will also increase FDI inflows/stock in the country.

H_0 :- FDI openness has no impact on FDI inflows/stock.

H_1 :- FDI openness has a positive impact on FDI inflows/stock.

(4) Corporate Tax rates

In this study, focus is on foreign corporate tax rates as FDI is believed to be majorly affected due to foreign corporate tax rates. For our study corporate tax rates and foreign corporate tax rates are one and the same thing. Gastanaga, Nugent, & Pashamova (1998), Gropp & Kastial (2001),Bezic & Pavlovic (2007), Jensen (2011),Talpos (2012) and Mateev & Tsekov (2012) have taken corportae tax rate as independent variable.

Expected Relationship - Foreign corporate tax rate and FDI inflows are expected to have a negative relationship. When corporate tax rate increases, such locations are generally ignored by foreign companies for new FDI. They try to shift the existing plant and machinery from high corporate tax location to lower corporate tax location.

H_0:- Corporate tax rate has no impact on FDI inflows/stock.

H_1:- Corporate tax rate has negative impact on FDI inflows/stock

Paper tried to find a relationship between foreign direct investment inflows (FDI) OR Foreign direct investment stock (FSTK) and tax related variable.

In panel data, regression analysis is used to establish the relationship among the FDI inflows or FDI stock and other tax related variables. On the basis of the correlation matrix among the variable, multicollinearity can be identified and removed, if required. In case of panel data, to apply regression, two methods are available –one is fixed effect model and other one is random effect model. To identify which method is better, hausman test is used and after using Hausman test study found that fixed effect model was better, fixed effect model is used to find the relationship among dependent and independent variables. To check autocorrelation, Wooldridge test of autocorrelation is used and to detect heteroscedasticity, likelihood ratio test is applied by using Stata 13.Robust standard error fixed effects model using white period or white diagonalis used to eliminate the problem of autocorrelation and heteroscedasticity in dataset.

6. Results and Discussion

This section discusses, the empirical results for the factors affecting FDI in high income countries. Study has taken corporate tax rate (FCT), gross domestic product (GDP), GDP per capita (PCAP) and FDI openness of 54 countries. Two models are formed. In first model FDI inflows is the dependent model and in second one FDI stock is dependent variable, as they are completely different. FDI flows show foreign investment at a particular point of time. FDI stock shows foreign investment over a period of time.

Problem of Multicollinearity

To check the problem of multicollinearity, pairwise correlation matrix among explanatory variables is formed which is shown in table 6.1

Table 6.1 Correlation Matrix of High Income Countries

	GDP	PCAP	FCT	FDIOP
GDP	1			
PCAP	-0.129	1		
FCT	-0.01232	-0.06909	1	
FDIOP	-0.02746	0.016814	-0.26205	1

In table 6.1, it can be observed that all value is less than 0.8 therefore it can conclude that there is no problem of multicollinearity among variables.

Model 1

When FDI inflows is dependent variable

6.2 Likelihood Ration Test for FDI Inflows

To check the problem of heteroscedasticity, likelihood- ratio testis applied and results of the test are shown in the table 6.2

Likelihood-ratio test	LR chi2(53) = 2508.93
(Assumption: homosk nested in hetero)	Prob > chi2 = 0.0000

In table 6.2, p value is more than chi square statistic at 1% level of significance therefore there is the problem of heteroscedasticity in the dataset.

6.3 Wooldridge Test for FDI Inflows

To check the problem of autocorrelation in the data set, Wooldridge test for autocorrelation is used.

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Table 6.3 Estimates for Wooldridge test for Autocorrelation for FDI flows

Wooldridge test for autocorrelation in panel data

H0: no first-order autocorrelation

F(1,   53) =   0.044

Prob > F =   0.8354

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P value is more than F statistic at 5% level of significance in the table 6.3. Therefore there is no problem of autocorrelation in the dataset.

6.4 Hausman Test for FDI inflows

To find out which model is better, Hausman test is appliedand results are given in table 6.4

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Table 6.4 Results of the Hausman Test
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Correlated Random Effects - Hausman Test
Equation: Untitled
Test cross-section random effects

Test Summary	Chi-Sq. Statistic	Chi-Sq. d.f.	Prob.
Cross-section random	7.817622	4	0.0985

Table 6.4 displays that p value is less than 10 % (level of significance) hence we decide to apply the fixed effects model.

6.5 Regression Analysis for FDI Inflows

Fixed effect model:

$$FDIi = \beta_{1i} + \beta_2 FCTi + \beta_3 GDPi + \beta_4 PCAPi + \beta_5 FDIOP \ldots\ldots\ldots\ldots\ldots\ldots\ldots\ldots\ldots\ldots\text{Equation (1)}$$

μi= combine error component of time series and cross section.

FDI=Foreign direct investment inflows

GDP=Gross Domestic Product

PCAP=GDP Per Capita

FDIOP= Foreign direct investment openness.

FCT= Corporate tax rate

To resolve the problem of heteroscedasticity, white diagonal is used while estimating fixed effects model and robust standard error results were received in regression.

Table 6.5 Robust Standard Error Estimates for FDI Flows

Dependent Variable: FLOWS
Method: Panel Least Squares
Sample: 2004 2016
Periods included: 13
Cross-sections included: 54
Total panel (balanced) observations: 702
White diagonal standard errors & covariance (no d.f. correction)

Variable	Coefficient	Std. Error	t-Statistic	Prob.
C	-21893.70	15518.47	-1.410816	0.1588
GDP	2.53E-07	8.41E-08	-3.010399	0.0027***
PCAP	1.369759	0.528690	2.590855	0.0098***
FDIOP	0.909664	0.331893	2.740836	0.0063***
FCT	-80.02903	131.6971	-0.607675	0.5436

	Effects Specification			

Cross-section fixed (dummy variables)

R-squared	0.732075	Mean dependent var	18928.47
Adjusted R-squared	0.708361	S.D. dependent var	40323.29
S.E. of regression	21776.03	Akaike info criterion	22.89401
Sum squared resid	3.05E+11	Schwarz criterion	23.27027
Log likelihood	-7977.799	Hannan-Quinn criter.	23.03944
F-statistic	30.87118	Durbin-Watson stat	1.800205
Prob(F-statistic)	0.000000		

Note: ***Significant at the 1% level

Table 6.5 exhibits that GDP, PCAP and FDI openness are positiveand significant at 1% level of significance and foreign corporate tax rate is revealing negative and insignificant relationship with the FDI inflows. GDP shows the market size of the economy and results displayed that if market size is large then FDI inflows will be higher. Our results are in harmony with Chakrabrati (2001),Stowhase (2002),Wijeweera & Clark (2006), Silva & Lagoa (2011) andMatheson, Perry, & Veung (2013). GDP per capita depicts the purchasing power of the people. If a country has higher purchasing power then higher FDI inflows are expected and our results are consistent toChakrabrati (2001), Jensen (2011), Mateev & Tsekov (2012) and Klemm & Parys (2012).Adjusted R square is .708361 which depicts that 70.83% is explained variation which is explained by the explanatory variables in the given model. As p value of f statistic is zero, model fit is model.

MODEL 2

When FDI stock is dependent variable

6.6 Likelihood- Ratio Test for FDI Stock

To check the presence of heteroscedasticity, likelihood- ratio test is used and the results are shown in table 6.6.

Table 6.6 Estimates for Likelihood –Ratio test for FDI stock as Dependent Variable

Likelihood-ratio test	LR chi2(53) = 2990.65
(Assumption: homosk nested in hetero)	Prob > chi2 = 0.0000

Table 6.6 exhibits that likelihood- ratio test is significant at 1% level of significant therefore heteroscedasticity is present in the given dataset.

6.7 Wooldridge Test for FDI Stock

To confirm the existence of autocorrelation in the given data set, Wooldridge test for autocorrelation is applied and results are shown in table 6.7.

Table 6.7 Estimates for Wooldridge test for Autocorrelation for FDI stock as Dependent Variable

Wooldridge test for autocorrelation in panel data

H0: no first-order autocorrelation

$F(1, 53) = 39.878$

$Prob > F = 0.0000$

Table 6.7 illustrates that results are significant at 1% level of significance so the problem of autocorrelation is present in the dataset.

6.8 Hausman Test for FDI stock

To find out which model (fixed or random effects) is better for present dataset, Hausman test is used and the results are presented in table6.8.

Table 6.8 Results of the Hausman Test

Correlated Random Effects - Hausman Test Equation: Untitled Test cross-section random effects			
Test Summary	Chi-Sq. Statistic	Chi-Sq. d.f.	Prob.
Cross-section random	8.156769	3	0.0429

In table 6.8, it can be observed that p value is significant at 5% level of significance therefore fixed effects model is appropriate for the given model 2.

6.9 Regression Analysis for FDI Stock as Dependent Variable

Fixed effects model

$$FSTKi = \beta_{1i} + \beta_2 FCTi + \beta_3 GDPi + \beta_4 PCAPi + \beta_5 FDIOPi + \mu i \ldots\ldots\ldots\ldots\ldots\ldots\ldots\ldots\ldots Equation\ (2)$$

β values and μ are symbolizing similar values as they were showing in fixed effects model of FDI inflows of high income countries.

FSTK= FDI Stock

The entire notation used in the equation 2 of model 2 of high income countries have already been discussed in equation 1 of model 1 of this paper. To put an end to the problem of autocorrelation and heteroscedasticity, white period is applied while estimating fixed effects model. We got robust standard error results of regression.

Table 6.9   Robust Standard Error Estimates for FDI Stock

Dependent Variable: STOCK
Method: Panel Least Squares
Sample: 2004 2016
Periods included: 13
Cross-sections included: 54
Total panel (balanced) observations: 702
White period standard errors & covariance (no d.f. correction)

Variable	Coefficient	Std. Error	t-Statistic	Prob.
C	-200089.4	251367.0	-0.796005	0.4263
GDP	1.39E-06	1.16E-06	-1.200202	0.2305
PCAP	18.17327	8.498760	2.138344	0.0329
FDIOP	11.58359	1.631525	7.099858	0.0000
FCT	-3896.663	1280.852	-3.042244	0.0024

Effects Specification

Cross-section fixed (dummy variables)

R-squared	0.904557	Mean dependent var	290947.3
Adjusted R-squared	0.896109	S.D. dependent var	609031.6
S.E. of regression	196303.4	Akaike info criterion	27.29172
Sum squared resid	2.48E+13	Schwarz criterion	27.66797
Log likelihood	-9521.393	Hannan-Quinn criter.	27.43714
F-statistic	107.0787	Durbin-Watson stat	0.608655
Prob(F-statistic)	0.000000		

Table 6.9 shows that adjusted R square is 0.896109 which means 89.61% is explained variation which is explained by the explanatory variable given in the model.GDP per capita, FDI openness and foreign corporate tax rate are significant. FDI openness is positive and significant at 1% level of significance. GDP per capita is displaying positive and significant relationship with FDI stock at 5% level of significance. Results are similar to Chakrabrati (2001), Jensen (2011), Mateev & Tsekov (2012) and Klemm & Parys (2012). Foreign corporate tax rate shows negative and significant relationship with FDI stock at 1% level of significance which means high foreign corporate rate means low FDI stock in the country. Results of foreign corporate tax rate are consistent with Wijeweera & Clark (2006) , Egger et al. (2006) , Cassou (2006) , Bellak & Leibrecht (2009), Klemm & Parys (2011) and Arbatli (2011)

CONCLUSION

This paper gives a wide range of literature on FDI. This paper has covered literature from 1984 and our results are in conformity with most of the previous studies. We conclude that at particular point of time,

GDP, GDP per capita and FDI openness are significant means in case of FDI inflows and over a period(in case of FDI stock), GDP per capita, FDI openness and foreign corporate tax are significant.

Policy implication for government is that high income countries should charge low tax rate from multinationals to increase FDI in the country. They should also focus on increasing GDP, GDP per capita and FDI openness to attract more FDI in the countries.

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