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# Corporate Tax and Location Choice for Multinational Firms

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## **Corporate Tax and Location Choice for Multinational Firms**

**Abstract:** This paper examines the effects of corporate tax on these location decisions of newly established multinational subsidiaries across 26 European countries over an eight year period. We contribute to the existing literature by examining the effects of a non-linear response of firm location decisions to changes in the tax rate. We also show that there are large variations in the sensitivity to tax rates across sectors and firm size groups. In particular, financial sector firms are more than twice as sensitive to changes in corporation tax rates relative to other sectors. Our baseline result is a finding that a one percent increase in the statutory or policy rate of corporation tax would lead to a reduction in the conditional location probability of 0.68 percent. Using the effective average tax rate (EATR), the marginal effect implies a reduction in the location probability of 1.15 percent following a 1 percent increase in the tax rate. Although overall tax has the expected negative effect on location probability, the marginal effect of an increase is lower at higher rates of tax.

**JEL Code:** F23, H25, C25

**Key Words:** Corporation Tax, Location Choice, Multinational firms, FDI.

**Word Count:** 7875

## 1. Introduction

Firms that operate in a global marketplace are faced with a variety of decisions on how to manage their international activities, including whether to services a foreign market from a domestic base or to establish a foreign affiliate to service this market. Once a firm has decided to set up a base abroad, it then is faced with the decision of where to locate. A wide range of factors are likely to impact on this decision by the firm. Particular attention has been paid to the role of corporate tax rates as a potential way to increase the attractiveness of a country to businesses seeking a location for a new investment.

The effect of corporation tax differences on foreign capital has been analysed (Devereux and Griffith, 2002, 2003; Devereux and Freeman, 1995; Billington, 1999; Young, 1999) and the location decisions of FDI firms more generally have also been examined in the literature (Basile et al. 2009; Chen and Moore, 2010; Davies et al. 2009). These papers tend to find an inhibiting effect of tax on multinational entry and investment. A recent paper by Barrios et al. (2012) considers the effect of host and parent country taxation on the location decisions of European firms and finds a significant and negative effect of the effective rate as well as the host country corporation taxation on the probability of choosing a location. Additionally, they find an independent and strongly negative effect of parent country taxation on foreign subsidiary location decisions, suggesting both host and home country taxation are important determinants of firm operational choices on affiliate locations.

This paper extends the existing literature on the effect of corporate taxation on location choices of multinationals in a number of ways. Firstly, in contrast to the existing literature which assumes a linear response of firm location decisions to differences in the tax rate, we test for a non-linear response, which implies that changes in tax rates at higher levels of taxes have less effect<sup>1</sup>. This might arise if other location factors dominate the location decision of a firm such that they are insensitive even to high corporate tax rates. For example firms might be seeking market access in a particular country or might also be attracted by a higher level of public goods provision that is financed by higher tax rates (see Bénassy-Quéré et al., 2007).

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<sup>1</sup> An exception is Bénassy-Quéré et al, (2015a) who included a squared tax variable in their gravity model of foreign direct investment flows.

Secondly, the model is estimated with an extensive database on newly established firms locating across 26 European countries and with ownership information identifying them as coming from a potential 48 source countries over the period from 2005 to 2012. This allows us to examine the impact of a considerably wider range of characteristics from the source and potential host countries than has generally been the case in the literature. The size of our dataset allows us to examine differences in the effect of corporate tax rates across sub-groups of firms and sectors.

We find that accounting for potential non-linearity in the tax effect improves the performance of the model for all of the alternative measures of the tax rate. All specifications show a significantly negative effect of taxation on the probability of location choice but a positive squared term indicates that the strength of this negative effect moderates as the tax rate increases. Thus, for countries with low corporate tax rates, any tax-rate increase has greater relative effect on location probabilities. Given that a countries' corporate tax rate tends to be correlated with GDP, moves towards tax convergence might disproportionately impact smaller countries in their ability to attract new investment.

Our baseline result is a finding that a one percent increase in the statutory or policy rate of corporation tax would lead to a reduction in the conditional location probability of 0.68 percent. Using the effective average tax rate (EATR), the marginal effect implies a reduction in the location probability of 1.15 percent following a 1 percent increase in the tax rate. These results combine the direct and non-linear elements of the estimated effects.

We find large variations in the sensitivity to tax rates across sectors. For manufacturing firms, we find a significant negative coefficient combined with a smaller positive squared term, with the sizes of the effects being fairly close to those observed in the overall results. For services firms the size of the effect is noticeably smaller than that for manufacturing, suggesting that services firms are more likely to be driven in their location decisions by the need to be close to their identified customer base and this reduces their sensitivity to tax rates. In contrast financial sector firms appear to be the most sensitive to changes in corporation tax rates with an estimated marginal effect more than double those of the other sectors. This is likely to be a reflection of the more footloose nature of these firms. In terms of firm size, we find that the size of the tax elasticity increases across firm asset size groups showing that higher tax rates are regarded as a greater disincentive to choosing a location by larger firms.

The paper is structured as follows: Section 2 describes the data used, including a discussion of the alternative measures available for corporate tax rates. Section 3 describes the methodology used. Section 4 presents the empirical results and Section 5 concludes.

## 2. Data

The data on the number of newly established subsidiaries used in our analysis comes from the Bureau Van Dijk Amadeus database, supplemented with FAME data for Ireland and the United Kingdom. Our sample includes information on 3,238 new foreign affiliates across 26 countries for the period 2005-2012. In order to focus on firms with direct ownership control, we restrict our sample to firms we can identify as foreign owned in which the owner has an ownership percentage of 50% or more.

A wide range of European countries is included in our analysis as can be seen from Table 1. We aggregate up NACE 2 digit sectors into the following broad categories: manufacturing, services, financial, and other (construction and utilities) as well as high-tech and low-tech<sup>2</sup>. The number of firms in each of these sectors is broken down in Tables 2.

<Table 1 about here>

<Table 2 about here>

Amadeus contains Profit and Loss and Balance Sheet information on each firm in the database. However, this is not always very well reported and due to patchy coverage of other variables we can only include data on each firm's total assets. For a set of regressions we group firms by size: Small, Medium and Large. This split is outlined in Table 3 below.

<Table 3 about here>

Table 4 provides information on the location of the parent company. This distribution is broadly as one would expect with OECD countries making up the majority of origin countries. We could only

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<sup>2</sup> The initial sector aggregation in table 4 is a Eurostat aggregation based on NACE Rev 1.1 codes. For further details see [http://epp.eurostat.ec.europa.eu/cache/ITY\\_SDDS/Annexes/htec\\_esms\\_an2.pdf](http://epp.eurostat.ec.europa.eu/cache/ITY_SDDS/Annexes/htec_esms_an2.pdf)

include firms in which the home country was known and could be traced by Bureau van Dijk in their ownership database.

<Table 4 about here>

Our year coverage is from 2005-2012 as presented in Table 5. One might have expected a significant drop in the number of new affiliates being opened as a result of the financial crisis and subsequent recession in Europe in 2008. We can see this in the 2009 data, however this trend does not continue as we have a higher number of new affiliates opened in 2010 than any other year.

<Table 5 about here>

## **2.1 Tax variables**

We use a number of alternate tax variables; the Policy Rate, the Mean Effective Average Tax Rate (Mean EATR) and the Total Tax Rate. We also use the EATR Crossborder as a robustness check.

- **Policy Rate:** The statutory rate charged by the host country government on corporate profits earned by the subsidiary.
- **Mean EATR:** This is calculated by comparing the cash-flows from a hypothetical, forward-looking investment project in the presence and absence of taxation. It is a weighted average of the effective marginal tax rate and the policy rate, converging towards the policy rate for a highly profitable investment. We use the mean EATR as this also accounts for the implications of using different financing sources to fund the investment project, applying a weighting of 0.55 on projects financed by retained earnings, 0.1 on equity and 0.35 on debt. In order to accurately calculate the NPV of the investment, this measure also explicitly considers each country's real interest rate, inflation rate, true economic depreciation rate, and the NPV of capital allowances on different asset types; industrial buildings, intangibles, machinery, financial, inventory<sup>3</sup>.
- **Total Tax Rate:** This includes all taxes and mandatory contributions payable by businesses after accounting for allowable deductions and exemptions.
- **EATR Crossborder:** This is calculated in a similar manner to the mean EATR except in an international setting. The approach considers a parent firm located and owned by shareholders in a home country which undertakes an investment in a host country through a wholly-owned subsidiary. It considers taxes levied by the host country government on income earned by the subsidiary and corporate taxes levied by the home country government on the same income and personal taxes levied by the home country government on the shareholders.

Table 6 below displays the descriptive statistics and sources for each tax variable used. As can be seen the Policy Rate and Mean EATR are highly correlated. The EATR Crossborder has a wider range

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<sup>3</sup> For a detailed example of these calculations for both measures of EATR please see "Section B – Worked Examples" of Spengel et al (2012) report for the EU Commission.



as this measure takes home country taxation into account. The main difference between the EATR Crossborder and the first two measures is the presence of some outliers in the distribution, e.g. the EATR Crossborder for an investment from France into Bulgaria was 52.9% in 2005.

<Table 6 about here>

## ***2.2 Country-level Control Variables***

We use a wide range of country controls in our regressions, reflecting the variables commonly used in the literature on firm location decision. To capture information on host country market potential and growth we use inverse distance-weighted GDP and GDP growth respectively. The cost and quality of the labour force is commonly found to be a significant determinant of location choice. We include information on both relative labour cost and the share of the host country labour force with third level education.

Other relative measures included are distance in km between home and host country capital cities, relative GDP per capita and relative population. In our baseline we include only the log of GDP to capture country size. However, in our main extended model, we replace this with the log of relative GDP between the home and host economies. We also conduct a robustness check to control for a non-linear impact of country size by including a squared term with  $\ln\text{GDP}$ .

The lag of FDI stock as a proportion of GDP within each potential host country is used to capture agglomeration as well as potential crowding out by existing FDI firms. As this measure is broad it may also capture potential displacement effects of similar firms. By including the proportion of motorways as a percentage of total land area we have a broad proxy for the level of infrastructure in the host country.

A range of other explanatory variables we include are dummy variables to indicate whether the host and home country share a common language, if they shared a colonial relationship at some stage in the past and if they share a border. We also include a dummy for EU15 membership. Detailed information on variable definitions and source data is contained in Annex 1. Table 7 contains summary statistics for all variables used in our analysis.

<Table 7 about here>

### 3. Methodological approach

To explore the relationship between the location choice of multinationals and corporate tax rates, we draw on the existing literature and use a conditional logit model as in McFadden (1974). This model has been applied empirically in the recent literature both on the wider determinants of location choices of multinationals (Head and Mayer, 2004; Siedschlag et al., 2013a,b) and more specifically on research focusing on the effect of corporation tax on MNE location decisions (Devereux and Griffith, 1998; Barrios et al., 2012). While alternative approaches such as the nested logit model and Poisson models can be used, the conditional logit is the most widely applied in the extant literature. Schmidheiny et al (2011) and Guimaraes et al. (2003; 2004) provide a useful discussion on the relative merits of each when modelling the firm location decision problem.

To model the locational choice facing the enterprise, the firm's problem can be outlined as follows. The profits earned from locating in a particular country,  $\Pi_{ic}$ , are:

$$\Pi_{ic} = \beta' X_{ic} + \varepsilon_{ic} \quad (1)$$

Where  $X$  is a vector of location specific control variables. The firm therefore faces a choice across destinations which yield different potential returns, and chooses the location,  $c$ , across  $J$  alternatives, which maximises profit:

$$\Pi_{ic} > \Pi_{ij} \forall j = 1, \dots, J \text{ with } j \neq c \quad (2)$$

That is  $\Pi_{ic}$  yields the highest profit across all groups. The firm therefore makes the following decision:

$$Y = \begin{cases} 1 & \text{if } \Pi_{ic} > \Pi_{ij} \forall j \neq c \\ 0 & \end{cases} \quad (3)$$

In this case  $Y$ , the dependent variable, is an indicator of the location choice of Multinational Enterprise (MNE)  $i$ , over a set of all possible locations  $J$ . It is a function of the location specific characteristics  $X_{ic}$ . Assuming that the error term  $\varepsilon_{ic}$  is modelled as a type 1 extreme value distribution, IID across all firms and countries, the probability of choosing country  $c$  can be expressed as follows:

$$P(Y = c | 1, \dots, J, X_{ic}) = \frac{e^{X_{ic}\beta}}{\sum_{j=1}^J e^{X_{ij}\beta}} \quad (4)$$

The coefficient vector  $\beta$  can be estimated using maximum likelihood methods<sup>4</sup>. An important consideration is the selection of control variables in  $X$ . Following the existing literature, we include the following controls in our baseline model: market potential (distance weighted GDP),  $\ln$  GDP to capture market size, GDP growth, host economy labour cost, the share of the population with tertiary education (% of labour force) to capture labour quality, the existing stock of FDI (to capture agglomeration and network effects), the density of motorways to capture the quality of infrastructure and the distance between host and home country capital cities.

An extended, more global model includes controls for countries that share a common language, a common border or shared a past colonial link. A dummy for EU15 is also included while a control for the share of natural resources is also included. We also include relative GDP, population and labour costs. Standard errors are robust to heteroscedasticity and clustered at the firm level.

Importantly, we not only include the tax variables but also their squares to account for potential non-linearity in the relationship between location decisions and tax rates. We expect the tax rates to have a negative impact on location decisions but that the squared term has a small positive effect such that tax rates have a decreasing effect on location decisions at higher rates of corporation tax. Firms may still consider locations with very high tax rates if other factors dominate their decision. For example to get access to a market firms might be willing to pay higher taxes.

When applying non-linear discrete choice models such as the conditional logit, a number of issues arise in calculating the magnitude of effects from the coefficients. Firstly, while the sign on the coefficient is always interpretable as the direction of the effect, the magnitude is not easily interpreted as the model is non-linear and the effect is dependent on the functional form.

Secondly, developing a single magnitude from a coefficient is non-trivial as there are a number of available methodologies including estimated marginal effects and probability elasticities. Greene (2012) notes that the selection decision between marginal effects and elasticities, is mainly a matter of choice, as the sign and significance does not change between the effects. In essence both apply a

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<sup>4</sup> Estimation of the conditional logit model entails maximising the conditional log-likelihood, and was carried out using STATA 14.

different positive scaling to the estimated coefficient so no changes occur in relation to the sign of the effect.

Thirdly, there is no consensus in the literature as to which effect is the “industry standard” with some papers reporting marginal effects (Devereux and Griffith, 1998; Barrios et al., 2012) and others reporting probability elasticities (Head and Mayer, 2004). Given our paper is closer to Devereux and Griffith (1998), we report estimated marginal effects. These are calculated as follows:

$$\frac{\partial P(y=c)}{\partial X} = P_c(1 - P_c)\beta_X \quad (5)$$

Where  $P_{c^5}$  simplifies to  $1/J$  when evaluated at the means of all covariates. In our case,  $J = 26$  representing the number of countries in our choice set. The marginal effects can be interpreted as an increase in variable  $X$  by 1 percent changes the conditional probability of locating in particular country by the estimated value (in percent). In section 4, we provide both the coefficients and tables of estimated marginal effects for our tax rates of interest.

In estimating the marginal effects for corporate taxation, consideration must be given to the fact that the variable enters the estimation equation in a non-linear fashion. To estimate an overall marginal effect for corporation taxation, which includes both linear and non-linear terms, we follow Davies et al. (2001) and apply the following calculation:

$$\frac{\partial P(y=c)}{\partial X} = P_c(1 - P_c)(\beta_{T1} + 2\beta_{T2} \hat{T}) \quad (6)$$

Where  $\beta_{T1}$  is the estimated coefficient on the linear term,  $\beta_{T2}$  is the estimated coefficient on the non-linear term and  $\hat{T}$  is the mean tax rate from the sample data.

#### 4. Empirical results

Our first results look at the effects on multinational location decisions for the entire sample of firms, focusing on the effects of various estimates of the corporate tax rate faced by the firm in each potential country. We then look deeper into the sensitivity of firms in different broad sectors to the location characteristics and to different elements of the tax structure.

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<sup>5</sup> Where  $P_c = P(Y=c)$  probability the location is chosen amongst the alternatives.

#### ***4.1 Baseline results***

We begin with the baseline results presented in Column 1 of Table 8, where we include the statutory policy rate as our measure of corporate tax. Looking at the other country characteristics first, we find the expected positive effect of GDP on the probability of locating in a particular country, picking up the attractiveness of access to larger and higher-income markets. In the initial specification, we also find a positive and significant effect of market potential. This is in line with expectations and captures the attractiveness of larger, closer proximity markets.

GDP growth is insignificant in this initial specification but, as we shall see in the next table, this is not the case when we take into account the non-linearity of the effect of the tax rate. We find the expected negative and significant effect of labour cost on the location decision: in our sample, firms are attracted towards lower labour cost destinations. We find some evidence that labour quality is positively associated with location choice but the effect is weak.

Given that labour cost and GDP per capita are quite strongly correlated ( $\rho = 0.96$ ), we do not include GDP per capita in the specification. We include the lag of the stock of FDI in the economy to capture both agglomeration as well as potential crowding out by existing FDI firms. The literature on agglomeration effects has found evidence that there are benefits to firms to locating in the same regions as other similar firms in order to take advantage of potential spillovers and other externalities such as supplier and labour pools, but we do not find such an effect. This may perhaps indicate that there is also a competitive effect that offsets the agglomeration benefits, or, perhaps equally likely, that agglomeration externalities are better measured using firm counts at a regional level which we do not have access to. Lagged motorway density is included as a proxy for public infrastructure and has a positive and significant effect on the probability of location choice.

The first tax measure we include in this baseline specification is the country's headline policy rate for corporate profits, which is found to have a significant negative effect on the probability of choosing a location. The other columns in Table 8 examine how this result is affected by using different measures of the tax rate. Column 2 uses the effective average tax rate (EATR) and column 3 shows the results for the total tax rate. The other country characteristics have the same pattern as before, apart from labour

quality which becomes statistically significant. In contrast to the policy rate both the EATR and the total tax rate are not found to be statistically significant.

<Table 8 about here>

While the first results showed a negative relationship between the probability of location choice and corporate tax rates for only one specification, our next set of results (Table 9), which include a squared term for each of the tax rates, show that this was almost certainly due to not taking account of non-linearity in the reaction of firms to the tax rate. All three columns show a significantly negative effect of taxation on the probability of location choice, and the positive squared terms indicate that the marginal effect of an increase in the tax rate is lower at higher rates of tax.

<Table 9 about here>

Interpretation of the coefficients of a conditional logit model can be somewhat difficult so Table 10 makes an adjustment following Davies et al. (2001) to convert the coefficients on the tax variables into marginal effects. Comparing these results to others in the literature such as Devereux and Griffith (1998) our baseline elasticity of 1.15 on the EATR is in line with their finding of 1.26.

<Table 10 about here>

## ***4.2 Sensitivity Analysis***

In this section we provide a further robustness checks<sup>6</sup>. For two of our tax variables, the policy rate and the mean EATR, we apply Extreme Bounds Analysis that was first proposed by Leamer (1983). Extreme Bounds Analysis tests the robustness of the parameter estimates of the key variable, in our case the corporation tax rate, by estimating the model under alternative exclusion restrictions on the set of other explanatory variables. In doing so we follow Sala-i-Martin (1997), who considers the distribution of all resulting estimates rather than just the upper and lower extreme bounds, and McAleer et al. (1985) who argue that selecting a subset of variables to be included in all models, as is sometimes

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<sup>6</sup> In addition to the robustness checks reported here we also conducted extensive robustness checks by including both the EATR cross border and the mean EATR, limiting the sample to home country firms that are in the OECD, home country firms that are in the EU 28, removing the US firms, removing investment option pairs (home-host) that are never chosen by firms, as well as adding additional and re-specified control variables. Across all robustness checks, the effects of the new variables and sample splits are qualitatively the same and in all cases the signs and significance of the tax rate and its squared term remain unchanged although the magnitudes are slightly reduced in some of the specifications.

practiced, is arbitrary. Considering the entire distribution of results on the basis of all possible combinations of other explanatory variables provides a strong test of the robustness of our results.

In total we ran the model with 16,383 combinations of the other explanatory variables. The resulting distribution of the estimated coefficients for the tax variables follows a normal distribution with a mean coefficient on the policy rate of -7.285, and -13.478 for the Mean EATR (see Table 11). The 95% confidence interval around the mean of the estimates is relatively small and only encompasses negative values. Furthermore, over 97% of the estimated parameters for EATR and 93% of the parameters for the policy rate are negative, with the remaining parameters coming from models with only one or two additional variables that are disregarded in the Sala-i-Martin paper. This sensitivity analysis therefore provides overwhelming evidence of the robustness of our results.

<Table 11 about here>

One concern regarding our estimation is the potential for an endogenous relationship to exist between the statutory tax rate, or the EATR, and the location choice of firms. If countries compete over tax rates, as demonstrated by Devereux et al. (2008) for both the statutory and effective average tax rate, perhaps countries might lower their rates in an effort to attract more firms? If this were the case, this reverse causality would bias our tax rate coefficients.

This is more of a concern when considering backward-looking tax rates. As highlighted by Devereux and Maffini (2007), backward-looking average rates, which may depend on the level of investment and the capital stock, could introduce endogeneity into the regressions as high levels of investment could generate high allowances, reducing the tax liability in that period. We do not consider this an issue in our analysis as we are using forward-looking tax rates and we examine the extensive margin, not the intensive margin<sup>7</sup>.

### ***4.3 Sectoral and skill variation in tax response***

The results discussed so far have pooled all firms in the sample. However, firms in different sectors may have different reaction functions to differences across many country level characteristics, including

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<sup>7</sup> As a robustness check we also estimate our model with the tax variables lagged by one period to further reduce the potential for reverse causality. While the effect of the tax rates using this specification are slightly smaller in absolute size, the sign and significance of tax coefficients remains unchanged.

those relating to taxation. The results are presented in Table 12 with the estimated marginal effects calculated in Table 13.

We divide firms into four subgroups – manufacturing, services, financial firms and other sectors (primarily utilities and construction) – in order to examine if there are any differences in their sensitivity to the tax measures estimated above. We also separately look at the effects of a high and low technology split in the non-financial sectors as well as at low-tech and high-tech manufacturing and services separately.

The results are quite striking, with large variation in the size of the coefficients across the broad sectors. For manufacturing firms, we find a pattern very similar to that of the total sample, with each of the tax measures having a significant negative coefficient combined with a smaller positive squared term.

The estimated coefficients for services firms have the expected negative sign and are statistically significant but the size of the effect is smaller than that for manufacturing. We interpret this as suggesting that services firms are more likely to be driven in their location decisions by the need to be close to their identified customer base and this reduces their sensitivity to tax rates. A similar explanation would also apply to the generally insignificant response to tax rates for the group of other sectors as utilities and construction would be particularly market access driven and immobile.

In contrast to other services firms, financial firms have a much greater sensitivity to taxation. This is likely to be a reflection of the more footloose nature of these firms, given limited fixed assets relative to other sectors and less of a requirement to locate close to their market (particularly for more “back-office” type operations). This could allow these firms greater freedom to choose lower tax locations than is the case for manufacturing and other services firms.

As well as splitting the sample by strict economy sector, we use EC definitions for high-tech and low-tech industries and recalculate the effects for these groupings (excluding the financial sector). We also split the skill categories by manufacturing and services to explore whether there is further heterogeneity beneath the broad aggregation. Interestingly we find that low-skill firms are more sensitive to tax rates and this result holds for firms in both the manufacturing and services sectors. It is unclear a-priori whether to expect low-tech or high-tech firms to be more or less sensitive to corporation tax. In



line with our findings, high-tech firms may be more inclined to prioritise labour quality or the R&D environment with low-tech firms taking “off-the-shelf” capital structures to the lowest cost (in terms of operating costs and tax considerations) destination. However, it is not necessarily the case that this logic applies across both services and manufacturing firms.

<Table 12 about here>

<Table 13 about here>

#### **4.4 Firm size**

As discussed in the data section, the information on firm characteristics in their year of entry is more limited than our information on entry and reduces the sample size by approximately one-fifth. However, this still leaves a large enough number of firms to allow us to do an interesting comparison of the sensitivity to tax rates of different sized firms, which would be an important consideration for policy makers. The firms are divided into three groups according to the assets of the newly established subsidiary (as discussed in the data section) and the location decision specification run separately for each group. The results are shown in Table 14 with the associated marginal effects presented in Table 15.

We find that across all of our measures of the tax rate there is an increase in the absolute value of the coefficients, showing that higher tax rates are regarded as a greater disincentive to choosing a location by larger firms. In addition, the countervailing positive squared term does not change much across the firm size group.

<Table 14 about here>

<Table 15 about here>

## **5 Conclusions**

When companies internationalise their operations, they face many decisions. These include whether or not to export or to locate a plant abroad, where to locate an affiliate if FDI is the chosen method of globalisation, and then the volume of investment once the destination is chosen.

This paper is narrowly focused on evaluating the role of corporation taxation on the location decision of foreign affiliates. It assumes that the firm has chosen FDI as its preferred internationalisation

strategy and does not model investment flows. Our focus is therefore on identifying the degree to which corporation tax affects the location decision of foreign multinationals while controlling for a range of other important factors such as infrastructure, market potential, labour market cost and quality and geographic factors.

A number of results emerge. We find a strong negative, but non-linear, effect of taxation on the likelihood of a destination being chosen. The result holds using a range of tax measures including the statutory policy rate, an estimated effective average tax rate, and a total tax rate. The findings are robust to the inclusion of a range of additional control variables and sub-sample splits.

Splitting the sample by sector and by skill type, we find that the financial sector is the most sensitive to changes in the corporation tax rate, following by the manufacturing and services sectors. The utilities and construction sectors appear the least sensitive to corporation tax changes. Across both non-financial services and manufacturing, the location decisions of foreign affiliates in high-tech sectors are less sensitive to corporation taxation changes than firms in low-tech sectors. These heterogeneous impacts across industrial groupings are important to understand the impact of policy changes to corporation taxation across countries.

The analysis in this paper focused on location choices within Europe. A natural extension of this analysis is to extend the set of potential destination countries. Furthermore, our analysis only considered the location choice but not investment volumes. Corporation tax rates and in particular the nature of capital allowances might impact on investment volumes.

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## Annex: Variable Sources and Definitions

| Variable             | Definition                                                                                                                                                                                                                                                                                                                                                                   | Source        |
|----------------------|------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------|---------------|
| Location             | Dummy variable equal to 1 if subsidiary is located in a country and 0 otherwise                                                                                                                                                                                                                                                                                              | AMADEUS       |
| GDP per capita       | Real GDP per capita                                                                                                                                                                                                                                                                                                                                                          | WDI           |
| Market potential     | The sum of inverse distance-weighted real GDP of all regions other than the host region. Distance is measured as km between host and home country capital cities                                                                                                                                                                                                             | WDI, CEPII    |
| GDP growth           | Annual GDP growth, percent                                                                                                                                                                                                                                                                                                                                                   | WDI           |
| Relative Labour cost | Total compensation of employees divided by total number of persons employed                                                                                                                                                                                                                                                                                                  | AMECO         |
| Labour education     | Proportion of the labour force with a tertiary education, percent                                                                                                                                                                                                                                                                                                            | WDI           |
| Distance             | Distance is measured as km between host and home country capital cities                                                                                                                                                                                                                                                                                                      |               |
| Agglomeration        | Lag of the stock of FDI as a percentage of GDP, percent                                                                                                                                                                                                                                                                                                                      | WDI           |
| Infrastructure       | Surface area of paved motorways as a proportion of total land area in km squared, percent                                                                                                                                                                                                                                                                                    | Eurostat, IRF |
| Infrastructure 2     | Fixed broadband Internet subscribers (per 100 people)                                                                                                                                                                                                                                                                                                                        | WDI           |
| Common language      | Common official primary language                                                                                                                                                                                                                                                                                                                                             | CEPII         |
| Share border         | Dummy variable equal to 1 if home and host country share a border and 0 otherwise                                                                                                                                                                                                                                                                                            | CEPII         |
| Former colony        | Dummy variable equal to 1 if home and host ever shared a colonial relationship and 0 otherwise                                                                                                                                                                                                                                                                               | CEPII         |
| Natural resources    | Total natural resources rents as a percentage of GDP, percent                                                                                                                                                                                                                                                                                                                | WDI           |
| EU15 membership      | Dummy variable equal to 1 if host country is a member of EU15 and 0 otherwise                                                                                                                                                                                                                                                                                                | -             |
| Relative Population  | Home country population divided by host country population                                                                                                                                                                                                                                                                                                                   | WDI           |
| Relative GDP PC      | Home country GDP per capita divided by host country GDP per capita                                                                                                                                                                                                                                                                                                           | WDI           |
| Policy rate          | High-level policy rate                                                                                                                                                                                                                                                                                                                                                       | KPMG, EY      |
| Mean EATR            | Griffith and Devereux (2003) methodology. This is a forward looking approach which calculates the reduction in the value of the profit stream for a model company as a result of the application of corporate income tax                                                                                                                                                     | EU Commission |
| EATR cross-border    | Similar to the above except in an international setting. This also takes into account corporate taxes and personal taxes levied on the shareholders by the home country government                                                                                                                                                                                           | EU Commission |
| Total tax rate       | <i>"Total tax rate measures the amount of taxes and mandatory contributions payable by businesses after accounting for allowable deductions and exemptions as a share of commercial profits. Taxes withheld (such as personal income tax) or collected and remitted to tax authorities (such as value added taxes, sales taxes or goods and service taxes) are excluded"</i> | WDI           |

Table 1: Number of Firms by Host Country

| <b>Country</b>    | <b>No of Firms</b> | <b>Country</b> | <b>No of Firms</b> |
|-------------------|--------------------|----------------|--------------------|
| Austria           | 101                | Ireland        | 130                |
| Belgium           | 27                 | Italy          | 421                |
| Bulgaria          | 121                | Lithuania      | 36                 |
| Czech Republic    | 214                | Latvia         | 42                 |
| Germany           | 316                | Netherlands    | 249                |
| Denmark           | 30                 | Norway         | 104                |
| Estonia           | 66                 | Poland         | 142                |
| Spain             | 320                | Portugal       | 109                |
| Finland           | 40                 | Sweden         | 34                 |
| France            | 213                | Slovenia       | 23                 |
| Greece            | 6                  | Slovakia       | 48                 |
| Croatia           | 90                 | United Kingdom | 342                |
| Hungary           | 14                 |                |                    |
| <b>Total 3238</b> |                    |                |                    |

Table 2: Number of Firms by Sector Type and Sector Skill

| <i>Sector Type</i> | <i>Number</i> | <i>Percentage</i> | <i>Sector Skill</i> | <i>Number</i> | <i>Percentage</i> |
|--------------------|---------------|-------------------|---------------------|---------------|-------------------|
| Manufacturing      | 400           | 12%               | Hi-tech             | 896           | 28%               |
| Services           | 2,020         | 62%               | Low-tech            | 1,703         | 53%               |
| Financial          | 639           | 20%               | Financial           | 639           | 20%               |
| Other              | 179           | 6%                |                     |               |                   |

Table 3: Number of Firms by Asset Size

| <i>Size</i> | <i>Definition</i>                                 | <i>Number</i> | <i>Percentage</i> |
|-------------|---------------------------------------------------|---------------|-------------------|
| Small       | Total Assets less than €250k                      | 950           | 29%               |
| Medium      | Total Assets greater than €250k and less than €3m | 804           | 25%               |
| Large       | Total Assets greater than €3m                     | 853           | 26%               |
| Unknown     | No Asset data                                     | 631           | 19%               |

Table 4: Number of Firms by Location of Parent Company

| Country                  | Number of Firms | Country         | Number of Firms |
|--------------------------|-----------------|-----------------|-----------------|
| United States of America | 478             | Australia       | 30              |
| Germany                  | 319             | Korea, Republic | 30              |
| Luxembourg               | 273             | Ireland         | 29              |
| United Kingdom           | 249             | Poland          | 27              |
| Netherlands              | 210             | Slovakia        | 27              |
| Switzerland              | 194             | Portugal        | 26              |
| France                   | 167             | Romania         | 26              |
| Sweden                   | 146             | Malta           | 23              |
| Spain                    | 123             | Czech Republic  | 19              |
| Italy                    | 117             | Turkey          | 19              |
| Cyprus                   | 105             | Hungary         | 18              |
| Belgium                  | 93              | Estonia         | 16              |
| Austria                  | 92              | Slovenia        | 16              |
| Denmark                  | 84              | Lithuania       | 15              |
| Finland                  | 70              | Latvia          | 15              |
| Japan                    | 54              | Croatia         | 14              |
| Canada                   | 50              | Greece          | 11              |
| Norway                   | 40              | Others          | 13              |
| Total 3238               |                 |                 |                 |

Table 5: Number of Firms by Year of Entry

| Year of Entry | No of Firms |
|---------------|-------------|
| 2005          | 389         |
| 2006          | 444         |
| 2007          | 423         |
| 2008          | 439         |
| 2009          | 217         |
| 2010          | 634         |
| 2011          | 486         |
| 2012          | 206         |
| Total         | 3,238       |

Table 6: Summary Statistics of Tax Variables

| Variable         | Source        | N     | Mean  | Std. Dev. | Min   | Max   |
|------------------|---------------|-------|-------|-----------|-------|-------|
| Policy Rate      | KPMG          | 82224 | 0.237 | 0.067     | 0.100 | 0.384 |
| Mean EATR        | EU Commission | 82224 | 0.218 | 0.064     | 0.088 | 0.365 |
| EATR Crossborder | EU Commission | 80430 | 0.247 | 0.068     | 0.075 | 0.532 |
| Total Tax Rate   | WDI           | 82224 | 0.457 | 0.116     | 0.214 | 0.768 |



Table 7: Summary Statistics for Control Variables

| Variable              | Source     | N     | Mean   | Std. Dev. | Min    | Max    |
|-----------------------|------------|-------|--------|-----------|--------|--------|
| Location              | AMADEUS    | 82224 | 0.039  | 0.194     | 0      | 1      |
| Market potential*     | WDI, CEPII | 82224 | 23.058 | 0.895     | 20.402 | 24.133 |
| GDP growth            | WDI        | 82224 | 0.022  | 0.039     | -0.180 | 0.122  |
| Labour education      | WDI        | 82224 | 0.266  | 0.075     | 0.115  | 0.415  |
| Relative Labour cost* | AMECO      | 82224 | -0.401 | 2.470     | -6.995 | 3.421  |
| Agglomeration         | WDI        | 82224 | 0.513  | 0.331     | 0.098  | 2.044  |
| Distance*             | CEPII      | 82224 | 7.396  | 0.943     | 4.088  | 9.802  |
| Infrastructure        |            | 82224 | 0.016  | 0.016     | 0      | 0.064  |
| Common language       | CEPII      | 82224 | 0.068  | 0.252     | 0      | 1      |
| Share border          | CEPII      | 82224 | 0.096  | 0.295     | 0      | 1      |
| Former colony         | CEPII      | 82224 | 0.044  | 0.205     | 0      | 1      |
| Natural resources     | WDI        | 82224 | 0.016  | 0.032     | 0      | 0.219  |
| EU15 membership       | -          | 82224 | 0.530  | 0.499     | 0      | 1      |
| Relative Population*  | WDI        | 82224 | 0.691  | 2.246     | -5.627 | 5.464  |
| Relative GDP PC*      | WDI        | 82224 | 0.579  | 0.863     | -3.134 | 3.076  |

\* Variable in natural logarithm

Table 8: Estimates of Conditional Logit Model for Multinational Location Choice – Baseline – Linear Tax Rates

|                               | (1)                  | (2)                  | (3)                  |
|-------------------------------|----------------------|----------------------|----------------------|
|                               | b/se                 | b/se                 | b/se                 |
| Market Potential              | 3.114***<br>(0.334)  | 3.221***<br>(0.337)  | 3.170***<br>(0.330)  |
| Ln GDP                        | 0.684***<br>(0.030)  | 0.614***<br>(0.030)  | 0.634***<br>(0.026)  |
| GDP Growth                    | -0.628<br>(0.886)    | -0.268<br>(0.890)    | -0.365<br>(0.890)    |
| Ln Labour Cost                | -0.271***<br>(0.049) | -0.364***<br>(0.049) | -0.341***<br>(0.044) |
| Labour Quality                | 0.510<br>(0.416)     | 0.664*<br>(0.403)    | 0.720*<br>(0.434)    |
| FDI Stock (% of GDP)<br>$t-1$ | -0.895***<br>(0.080) | -0.855***<br>(0.078) | -0.876***<br>(0.084) |
| Motorway Density              | 4.743***<br>(1.455)  | 3.277**<br>(1.504)   | 3.533**<br>(1.513)   |
| Ln Distance                   | -1.283***<br>(0.042) | -1.289***<br>(0.041) | -1.285***<br>(0.041) |
| Policy rate                   | -2.092***<br>(0.603) |                      |                      |
| Mean EATR                     |                      | 0.840<br>(0.701)     |                      |
| Total Tax Rate                |                      |                      | 0.008<br>(0.188)     |
| N                             | 82224                | 82224                | 82224                |
| Pseudo R <sup>2</sup>         | 0.121                | 0.120                | 0.120                |

Standard errors in parentheses \*\*\* p<0.01, \*\* p<0.05, \* p<0.1

Table 9: Estimates of Conditional Logit Model for Multinational Location Choice – Baseline Quadratic Tax Rates Tax Rates

|                             | (1)                   | (2)                   | (3)                   |
|-----------------------------|-----------------------|-----------------------|-----------------------|
|                             | b/se                  | b/se                  | b/se                  |
| Ln GDP                      | 0.704***<br>(0.029)   | 0.732***<br>(0.033)   | 0.643***<br>(0.025)   |
| Market Potential            | 3.932***<br>(0.364)   | 4.674***<br>(0.390)   | 3.489***<br>(0.331)   |
| GDP Growth                  | 0.986<br>(0.890)      | 1.478<br>(0.916)      | 3.246***<br>(1.005)   |
| Ln Labour Cost              | -0.182***<br>(0.047)  | -0.038<br>(0.053)     | -0.533***<br>(0.051)  |
| Labour Quality              | 0.598<br>(0.414)      | -0.428<br>(0.411)     | 2.763***<br>(0.502)   |
| FDI Stock (% of GDP)<br>t-1 | -1.154***<br>(0.083)  | -1.032***<br>(0.081)  | -1.082***<br>(0.085)  |
| Ln Distance                 | -1.369***<br>(0.043)  | -1.414***<br>(0.044)  | -1.350***<br>(0.042)  |
| Motorway Density            | 6.623***<br>(1.508)   | 5.887***<br>(1.526)   | 7.891***<br>(1.553)   |
| Policy rate                 | -21.917***<br>(2.241) |                       |                       |
| Policy rate <sup>2</sup>    | 0.382***<br>(0.041)   |                       |                       |
| Mean EATR                   |                       | -34.530***<br>(2.879) |                       |
| Mean EATR <sup>2</sup>      |                       | 0.665***<br>(0.052)   |                       |
| Total Tax Rate              |                       |                       | -14.519***<br>(0.942) |
| Total Tax Rate <sup>2</sup> |                       |                       | 0.148***<br>(0.010)   |
| N                           | 82,224                | 82,224                | 82,224                |
| Pseudo R <sup>2</sup>       | 0.125                 | 0.129                 | 0.132                 |

Standard errors in parentheses. \*\*\* p<0.01, \*\* p<0.05, \* p<0.1

Table 10: Marginal Effects – Baseline and Extended Models

|                      | Policy rate | Mean EATR | Total Tax Rate |
|----------------------|-------------|-----------|----------------|
| Baseline (Linear)    |             |           |                |
| Marginal Effect      | -0.07       |           |                |
| Baseline (Quadratic) |             |           |                |
| Marginal Effect      | -0.80       | -1.26     | -0.53          |

Notes: Marginal effects are calculated as Davies et al. (2001).



Table 11: Descriptive Statistics for Distribution of Tax-rate Coefficients

| Variable   | Model runs | Mean    | Std. Dev. | 95% CI for mean  |
|------------|------------|---------|-----------|------------------|
| Polycyrate | 16,383     | -7.285  | 5.199     | [-7.365, -7.205] |
| Mean       |            |         |           | [-13.592, -      |
| EATR       | 16,383     | -13.478 | 7.470     | 13.363]          |

Table 12: Coefficients – By Sector

|                                    | Policy rate | Mean EATR  | Total Tax Rate | Obs    |
|------------------------------------|-------------|------------|----------------|--------|
| Manufacturing                      |             |            |                |        |
| Coeff Tax                          | -17.123***  | -25.630*** | -13.061***     | 10,123 |
| Coeff Tax Rate ^ 2                 | 0.356***    | 0.526***   | 0.140***       |        |
| Services                           |             |            |                |        |
| Coeff Tax                          | -8.489***   | -20.527*** | -12.346***     | 51,235 |
| Coeff Tax Rate ^ 2                 | 0.211***    | 0.510***   | 0.130***       |        |
| Financial sector                   |             |            |                |        |
| Coeff Tax                          | -36.832***  | -70.170*** | -18.188***     | 16,339 |
| Coeff Tax Rate ^ 2                 | 0.327**     | 1.086***   | 0.176***       |        |
| Other (Utilities and construction) |             |            |                |        |
| Coeff Tax                          | -13.177     | -18.240    | -19.896***     | 4,527  |
| Coeff Tax Rate ^ 2                 | 0.276       | 0.352      | 0.226***       |        |
| High-tech non-financial            |             |            |                |        |
| Coeff Tax                          | -4.562      | -12.740**  | -13.647***     | 22,791 |
| Coeff Tax Rate ^ 2                 | 0.078       | 0.275***   | 0.136***       |        |
| Low-tech non-financial             |             |            |                |        |
| Coeff Tax                          | -12.361***  | -24.990*** | -12.377***     | 43,094 |
| Coeff Tax Rate ^ 2                 | 0.316***    | 0.614***   | 0.137***       |        |
| High-tech Manufacturing            |             |            |                |        |
| Coeff Tax                          | -5.377      | -17.878    | -11.016***     | 4,468  |
| Coeff Tax Rate ^ 2                 | 0.127       | 0.381*     | 0.112***       |        |
| Low-tech Manufacturing             |             |            |                |        |
| Coeff Tax                          | -25.511***  | -32.439*** | -14.649***     | 5,655  |
| Coeff Tax Rate ^ 2                 | 0.528***    | 0.665***   | 0.164***       |        |
| High-tech Services                 |             |            |                |        |
| Coeff Tax                          | -5.6        | -13.637**  | -15.052***     | 18,323 |
| Coeff Tax Rate ^ 2                 | 0.079       | 0.276**    | 0.149***       |        |
| Low-tech Services                  |             |            |                |        |
| Coeff Tax                          | -10.204***  | -25.572*** | -11.141***     | 32,912 |
| Coeff Tax Rate ^ 2                 | 0.289***    | 0.663***   | 0.123***       |        |

\*\*\* p&lt;0.01, \*\* p&lt;0.05, \* p&lt;0.1

Table 13: Marginal Effects – By Sector

|                                    | Policy rate | Mean EATR | Total Tax Rate |
|------------------------------------|-------------|-----------|----------------|
| Split by Sector Type               |             |           |                |
| Manufacturing                      | -0.63       | -0.94     | -0.48          |
| Services                           | -0.31       | -0.75     | -0.45          |
| Financial sector                   | -1.36       | -2.58     | -0.67          |
| Other (Utilities and construction) |             |           | -0.73          |
| Split by Sector Skill              |             |           |                |
| High-tech non-financial            |             | -0.47     | -0.50          |
| Low-tech non-financial             | -0.45       | -0.91     | -0.46          |
| Split by Sector Type & Skill       |             |           |                |
| High-tech Manufacturing            |             |           | -0.41          |
| Low-tech Manufacturing             | -0.93       | -1.19     | -0.54          |
| High-tech Services                 |             | -0.50     | -0.55          |
| Low-tech Services                  | -0.37       | -0.93     | -0.41          |

Table 14: Coefficient Estimates by Firm Size

|                    | Policy rate           | Mean EATR             | Total Tax Rate        |
|--------------------|-----------------------|-----------------------|-----------------------|
| Size 1 - Small     |                       |                       |                       |
| Coeff Tax          | 5.501<br>(5.985)      | -20.149***<br>(5.394) | -11.449***<br>(1.754) |
| Coeff Tax Rate ^ 2 | 0.043<br>(0.102)      | 0.596***<br>(0.100)   | 0.136***<br>(0.017)   |
| Size 2 - Medium    |                       |                       |                       |
| Coeff Tax          | -13.807***<br>(4.897) | -28.864***<br>(5.296) | -14.001***<br>(1.782) |
| Coeff Tax Rate ^ 2 | 0.359***<br>(0.084)   | 0.689***<br>(0.098)   | 0.157***<br>(0.017)   |
| Size 3 - Large     |                       |                       |                       |
| Coeff Tax          | -26.834***<br>(4.358) | -36.680***<br>(5.329) | -12.432***<br>(1.933) |
| Coeff Tax Rate ^ 2 | 0.414***<br>(0.081)   | 0.654***<br>(0.100)   | 0.121***<br>(0.020)   |

Standard errors in parentheses

\*\*\* p<0.01, \*\* p<0.05, \* p<0.1

Note: Model estimated using all controls as in main extended model.

Table 15: Marginal Effects by Size

|                 | Policy rate | Mean EATR | Total Tax Rate | N      |
|-----------------|-------------|-----------|----------------|--------|
| Size 1 – Small  |             | -0.74     | -0.42          | 24,056 |
| Size 2 – Medium | -0.50       | -1.06     | -0.52          | 20,350 |
| Size 3 – Large  | -0.99       | -1.35     | -0.46          | 21,714 |