



JÖNKÖPING INTERNATIONAL BUSINESS SCHOOL  
JÖNKÖPING UNIVERSITY

# **The Impact of Corporate Taxes on Foreign Direct Investment**

Paper within International Economics

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Jönköping March 2010-04-12

## **Bachelor Thesis in International Economics**

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**Date:** 2010- 06- 01

**Subject terms:** Foreign Direct Investment, Corporate Taxes, Developed Countries

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### **Abstract**

This thesis investigates the impact that the corporate income tax rate has on inflows of foreign direct investment (FDI) in high-income OECD countries during the periods 1998-2006. The thesis has a small focus on Sweden and how this country's policies can affect inward FDI. Moreover, the determinants of FDI are analyzed in order to build a model that allows to see the influence that the statutory corporate income tax rate has on these countries. OLS regressions are used to find the degree to which certain variables, specifically the corporate tax rate, have an impact of the dependent variable (i.e. aggregate inflows of FDI). The independent variables are: GDP, skilled labour, labour costs, economic freedom as a proxy for trade openness and property rights, infrastructure, the corporate income tax rate, dummy variables to account for time effects and three dummy variables for continental location targeting whether geographical location is of relevance or not.

It is concluded that the corporate income tax rate does have a significant impact on FDI inflows in OECD members for the specified period. Additionally, economic freedom, gdp and geographical location are also found to be important variables that determine the inflows of FDI. Other variables are found insignificant in almost all regressions.

# Table of Contents

Table of Contents .....	ii
<b>1 Introduction.....</b>	<b>1</b>
<b>2 Background .....</b>	<b>3</b>
2.1 Previous Studies .....	3
2.2 Inward FDI and taxes in Sweden .....	4
2.3 Benefits of FDI.....	6
<b>3 Theoretical Framework .....</b>	<b>7</b>
3.1 The Eclectic Theory of International Production.....	7
3.2 Deveroux's Decision Tree .....	7
3.3 The relationship between taxes and FDI .....	8
3.3.1 <u>Host Country Taxation</u> .....	9
3.3.2. <u>Home Country Taxation</u> .....	10
3.3.3 Transfer Pricing .....	11
3.4 The Determinants .....	11
<b>4 Empirical Framework.....</b>	<b>14</b>
4.1 Data.....	14
4.2 Dummy Variables .....	15
4.3 Model.....	15
4.4. Regression & Analysis .....	16
<b>5 Conclusions .....</b>	<b>19</b>
<b>6 Appendix .....</b>	<b>20</b>
Table A - List of High-Income OECD countries .....	20
Table B Corporate Income Tax Rate by country .....	2
Table C Fiscal Freedom Index 2009.....	2
Table D- Bivariate Correlations .....	3
6.1 Graph: Predicted Value .....	4
<b>7 References .....</b>	<b>5</b>
7.1 Internet Sources .....	7

# 1 Introduction

*Foreign Direct Investment* (FDI) has been a highly discussed subject in the past years and still is today. Most recently, it has been regarded as a key factor for economic growth and productivity for most countries. For this reason, competition has arisen between nations to become more attractive to investors as governments are constantly developing new policies that will favor this phenomenon (Easson 1999).

FDI is defined as capital movements in the form of “*investments made to acquire lasting interest in enterprises operating outside of the economy of the investor*” <sup>1</sup>(UNCTAD, 2002). The Swedish Central Bank (Sveriges Riksbank, 2005), describes the arousal of FDI as “*when someone, usually a company, directly or indirectly owns 10 percent or more in a company or commercial property located in another country.*” Moreover, a country can have outflows or inflows of FDI, which refer for example, for a given country A, to the outward movement of capital to be invested in another country outside A or, the inward movement of capital from other countries invested into A, respectively (Easson 1999). In this thesis we focus on the latter.

FDI inflows are subject to different factors of the economy. Firms will only invest in another country if they possess “additional ownership-advantages” other than the resources of the countries of origin, which can outweigh the costs of operating in a new market (Dunning 1980).

But which factors do firms consider when deciding to invest in another country other than theirs? We find a good answer in Easson (1999) who states that: economic and political stability, ample infrastructure, good communications system, skilled labor, and possibility to send home profits freely; are all relevant determinants. Although, he argues, these may differ depending on the type of investment made (e.g. market-oriented or resource-oriented). Other studies have shown very similar factors. In their studies: Dunning (1993); DeMooij and Ederveen (2003); Bellak and Leibrecht (2005, 9); Buettner and Ruf (2007); among others, also include tax regulations as a location determinant.

From all the general and relevant factors that are mentioned by different researchers, this thesis focuses mainly on one, taxes. Studies suggest that taxes are an important variable to consider when deciding on the location of new investment. Given the direct relationship between taxation and profits, investors will be attracted by lower levels of taxation. Although one could argue that the overall tax burden in a country can affect FDI location decisions, the most widely discussed and researched type of tax has been the Corporate Income Tax Rate (CIT) due to its direct relationship to corporate profit taxation (Easson 1999).

Moreover, as trade barriers disappear and competition between countries arises to become more attractive, fiscal policies are continuously being shaped in a way that is favourable to foreign investors. Ireland, although today is suffering from the recent financial crisis, managed to attract extensive amounts of foreign investment from early 1990's to late 2000's (Capell, 2007). Ireland's CIT was the lowest in the entire European Union, only 12% compared to the average 27% in 2007 (Mitchell, 2007). Sweden too, recently dropped its CIT from 28% to 26.3% in early 2009 (Invest Sweden, 2010) Although it might be too soon to see any long-run effect of

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<sup>1</sup>Citation from: UNCTAD (2002) <http://www.unctad.org/Templates/Page.asp?intItemID=3146&lang=1>

this change, expectations can always be made about future economic behaviour and the impact of fiscal policies.

This leads to the main purpose of this thesis. With observations from twenty five high-income countries (see Appendix for detail) the main objective is to test on the relationship between the CIT and FDI inflows. Additionally, the thesis aims to judge the possible impact that the recent cut in the CIT in Sweden could have on FDI inflows. Data from high-income economies is used due to their similarity to the country of interest and thus, enabling the possibility to make credible and coherent conclusions about the possible impact, either negative or positive, the recent change in the corporate tax rate will have in foreign investment in Sweden.

Aggregate data is used on inflows of FDI into OECD countries. Although, aggregate FDI flows data does not necessarily reflect only “new capital” or “new physical capital” (i.e. Greenfield Investment) being invested in another country, it is still a good proxy variable that accounts for all important capital flows between parent companies and subsidiaries (Deveroux, 2006).

The null hypothesis of the thesis is the Corporate Income Tax Rate (CIT) has no significant impact on FDI inflows, thus, if rejected, we can conclude that the CIT does affect inward FDI. A regression is conducted including other possible explanatory variables in order to capture all other determinants of FDI. The objective is to find the relationship between the CIT and FDI inflows.

Ho:  $\beta_6 = 0$  (If rejected, CIT has a significant impact on FDI)

H1:  $\beta_6 \neq 0$

The contribution of this thesis is for the field of International Economics. Different from other studies this thesis only analyzes the correlation between the corporate tax rate and inflows of FDI specifically in developed economies.

The first part of the thesis gives background information on general FDI determinants, Swedish inflows of FDI and the tax system. The second part is constituted by different theories on the subject of FDI and The role of Taxes on FDI. The third part explains the data and states our hypothesis, followed by the analysis and results of the regression. The last part (fourth) states our conclusions.

## 2 Background

### 2.1 Previous Studies

Since the 1970's and 1980's, economists such as John Dunning (1970) and David Hartman (1983), have been investigating: the behavior of Multinational Enterprises (MNE), the movement of capital across countries and the relationship of taxes to it. In this section, more recent studies are presented on the subject.

The study by Avik Chakrabarti (2001) on the determinants of FDI, shows that different variables are statistically correlated to FDI. Chakrabarti (2001) develops an econometric model where all variables are separated into three groups. The author uses: market size, which is represented by GDP; labor cost, growth rate, openness, trade deficit, exchange rate, and tax. All of which have a different type of correlation, either negative or positive. Less powerful variables which he calls "doubtful variables"; are also included these are: inflation, budget deficit, domestic investment, external debt, government consumption and political stability. The sample size on this cross-sectional regression is of 135 countries. The author concludes that market size is indeed the variable with the highest explanatory power while all other variables don't seem to be highly significant as stated by literature on the subject. He also concludes that the variables that seem to be more relevant after market size are openness to trade, wages, net exports, growth rate and tax. (Chakrabarti 2001)

Further on, Faeth (2008) uses an extensive amount of literature on FDI to develop one single model that can define FDI. The author bases the research on neoclassical trade theory and "new FDI theory", among others, in order to derive the model. Faeth (2008) concludes that there is not only one single theory that can explain FDI since factors vary across countries. Market size, skilled labour, transport costs and many others are all relevant factors that can affect FDI flows depending on the country or industry. However, the author argues, policy variables such as tax rates and tariffs have shown to be significant in numerous amounts of studies and thus these variables should be, in general, considered an important determinant of FDI. Market size, growth, infrastructure, political stability and production costs also showed to be the most widely accepted determinants.

Billington (1999) uses a statutory CIT rate for a model with multiple countries and for a regional model (in the UK) and finds a significant negative impact of taxes on FDI. The author also finds that, at the regional level, labor costs and unemployment are factors that influence location. The unemployment is a proxy for labour availability and hence the positive impact on FDI.

Moreover, studies focusing on Taxes and FDI, specifically on the CIT, have been made. Leibrecht and Bellak (2009) use a bilateral effective average tax rate measure (beatr) to determine a relationship of FDI to taxes. They find a -4.3 semi-elasticity (i.e. the percentage change in FDI when the corporate tax rate changes by one unit). With the use of bilateral relationships (i.e. inflows and outflows from home to host country) between 7 home countries and 8 Central and Eastern European host Countries they concluded that in CEEC countries, strategies taken by governments to lower tax rates impact significantly on FDI inflows.

Another study, by Devereux, Lockwood & Redoano (2007) focusing on corporate tax rates, analyzes the possibility of tax competition amongst OECD countries. The authors show evidence

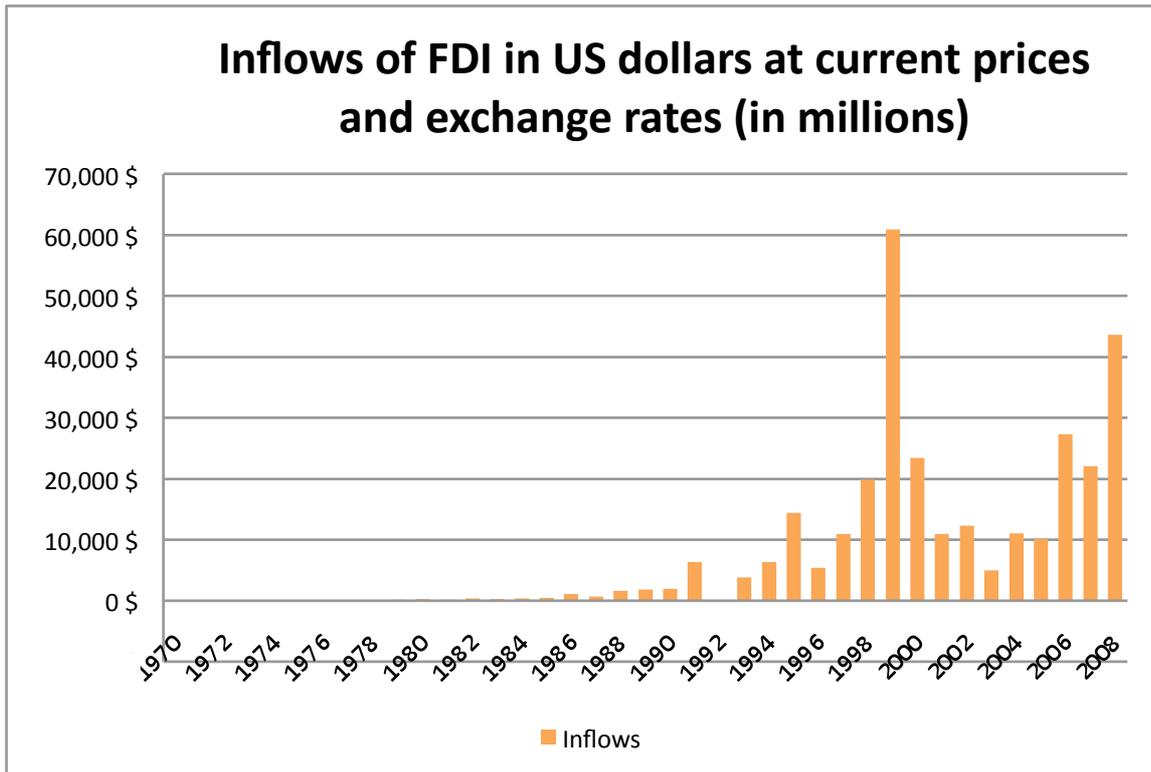
that countries do compete over tax rates by testing with effective marginal tax rates (EMTR) and statutory CIT rates. By analyzing the behavior of MNEs and governmental tax policies they conclude that both of these measures, EMTR and statutory rates, are taken into account by both parties, either when making location decisions or creating new tax policies, respectively. Moreover, studies by the OECD (2008b) on cross-border flows show evidence of a 3.7% decrease on FDI for every 1% point increase in the tax rate. However, this measure can vary depending on the type of industry or the country. Studies also show that market size and ample infrastructure are as well important determinants of FDI (OECD, 2008b).

## 2.2 Inward FDI and taxes in Sweden

Europe has been recognized as one of the most popular locations for investment because its area offers an optimal mix of classical determinants of FDI. During the 1980's US Multinationals (MNEs) attempted to look for other areas that had the same advantages as Europe but that offered lower wages too, however, MNEs found it hard to find other locations that would come across the advantages offered in Europe. Any low wage advantage would be dampened by other factors that would not meet the criteria such as: political and economic instability, restrictive trade, and investment policies and/or poor infrastructure. (Sethi, Guisinger, Phelan & Berg, 2003).

Moreover, in the specific case of Sweden, as international trade took a different course during the last decade, so did the Swedish policies. Since the early 1990's, Sweden's fiscal policies were redirected moving from a strict and closed regime to a more relaxed and open to foreign investment economy (Agell, Englund & Södersten, 1996).

FDI flows grew substantially as trade barriers continued to drop and ever since, the country has maintained certain levels of incoming FDI every year. **Graph 2.2** shows the volume of Inward FDI over the last decades into Sweden (UNCTAD, 2009). As seen in the graph, in the early 1990's Sweden was experiencing higher levels of FDI. Apart from relaxing its tax system, Sweden also became part of the European Union in 1995. Similar to other countries, this cohesion allowed for more capital mobility across the European members and thus stimulated FDI investment. (Essen, 2001)



*Author's own construction based on: [stats.unctad.org/FDI/](http://stats.unctad.org/FDI/)*

## 2.2 Graph. Inward FDI flows: Sweden<sup>2</sup>

Overall, we can say that Sweden has been an attractive country throughout the years, its openness to trade, political stability, ample infrastructure and impressive record make it a country easy to invest in. However, even though it ranks high among different indices such as the Inward FDI Potential Index by the UNCTAD (ranked between 6<sup>th</sup>-12<sup>th</sup> in the last two decades) and the 2010 Economic Freedom Index (EFI)<sup>3</sup> (ranked 21<sup>st</sup> with a 72.4% score), Sweden continues to be criticized for its high taxation system. The same index, EFI, gives Sweden only a 36.7% fiscal freedom<sup>4</sup> score (i.e. a tax burden measurement exerted by the government. It includes different tax rates, not only corporate), amongst the lowest figures in the index (see Appendix for detail on fiscal freedom score).

<sup>2</sup> All data on graph was collected from UNCTAD FDI statistics website: [http://stats.unctad.org/FDI/ReportFolders/reportFolders.aspx?sCS\\_referer=&sCS\\_ChosenLang=en](http://stats.unctad.org/FDI/ReportFolders/reportFolders.aspx?sCS_referer=&sCS_ChosenLang=en)

<sup>3</sup> The Economic Freedom index was developed by The Heritage Foundation and The Wall Street Journal, it can be found at: <http://www.heritage.org/index/Country/Sweden>

<sup>4</sup> The Fiscal Freedom Index is part of the Economic Freedom Index and a more detailed description can be found at: <http://www.heritage.org/Index/Fiscal-Freedom.aspx>

Sweden is the second highest taxed OECD country. In 2007, the tax-to-GDP ratio was 48.2%; this figure is amongst the largest numbers in the world together with Denmark which had a 48.9% (OECD). Nevertheless, although the overall tax burden seems to be relatively high, Sweden's corporate income tax rate alone is between the lowest rates within OECD countries, see Appendix for detail. Other taxes have also been abolished such as the wealth taxes. (OECD, 2008a)

Despite the burdensome taxes in Sweden, the economy has kept higher levels of inward FDI relative to those of the previous decades (1970's and 1980's). It seems like the government has been able maintain the important tax rate on the low, that is, the CIT. The question is if whether this rate is relevant or not. Would Sweden be enjoying same levels of investment if its Corporate Income Tax rate (CIT) was larger? And, is there any room for Sweden to improve its fiscal environment offered to foreign investors?

## **2.3 Benefits of FDI**

The attempt of governments to attract FDI by using fiscal strategies and offering financial incentives lies behind the idea that FDI has a positive impact on a country's economy. However, the exact impact of FDI on host countries is quite inconclusive and rather important in view of the fact that it is here where we find the reasons for exploring FDI. While some argue that there is none (Alfaro, Chanda, Kalemli-Ozcan & Sayek, 2009); (Carkovic & Levine, 2005) or even negative spillovers over domestic firms (Aitken and Harrison, 1999) others claim evidence of a positive increase in productivity and wages of the host country (Girma, Greenaway & Wakelin, 2001). Moreover, it has also been argued that positive technological spillovers on domestic firms can occur depending on the host country (developed, transition, or developing country), the industry or the amount of human capital (Blomström, Globerman & Kokko, 1999). Nevertheless, despite the mixed results, it is quite clear that FDI does have an impact; however, it all depends on the degree of foreign-owned companies in any given country. A too high degree of foreign-owned companies (or capital) can be harmful for the hosting economy (Deveroux, 2006).

On the other hand, Easson (2004) states that, "FDI is not a zero-sum game" (Easson, 2004, p. 12). By this he means that someone must necessarily benefit from FDI, either the investor, the home country or, as in most cases, both, otherwise investments wouldn't take place abroad nor the host countries would allow for new incoming capital. For investors, higher returns on capital are the main objective of undertaking ventures abroad. For the host countries, although highly disputed, larger amounts of capital available for investment, technological spillovers, higher employment and larger tax revenues for the government, among others, are factors that can lead to faster economic growth (Easson, 2004).

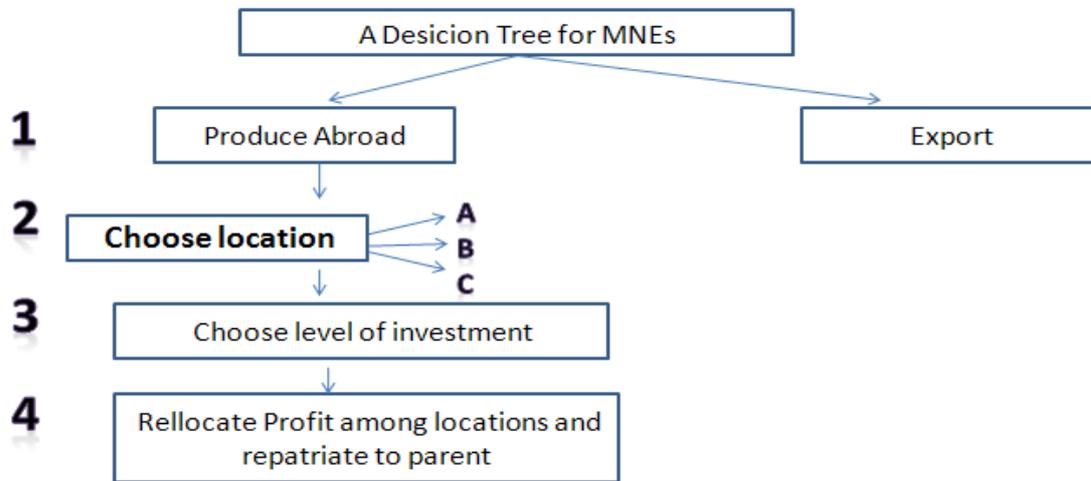
## 3 Theoretical Framework

### 3.1 The Eclectic Theory of International Production

John Dunning first presented the eclectic paradigm theory in 1976. At its first stages, Dunning explained that there are three main determinants representing the tendency for enterprises to produce internationally: ownership-specific advantages, the desire to internalize these advantages, and the amount of profits that could be made by combining these assets with location-specific resources. Ownership-specific assets refer to the competitive advantages that firms have over other firms. Location-specific advantages refer to a country's benefits (e.g. natural resources and technology availability). Dunning (1976) argued that the greater the ownership-advantages of a firm were and the wider the location-specific attractions of a country, the bigger the inclination towards internalizing the firm's advantages in the country with these attractive resources. The theory later became to be known as the *OLI paradigm*, the initials representing the words Ownership, Location and Internationalization which, he argued, are the variables that shape a firm's international activities (Dunning, 1980, 1988).

### 3.2 Deveroux's Decision Tree

In the literature review by Michael P. Deveroux (2006), the author presents a simple model describing different decisions faced by multinationals when deciding on a new investment. The decision tree consists of four stages in which different types of decisions are made. Step one is the decision to invest at home and export the product or invest abroad. This decision can be influenced, among other factors, by the home country taxation system. If the company chooses to invest abroad, the second decision to be taken is the optimal location of the investment. It is in this stage (2<sup>nd</sup>) that host country taxes play an important role given that any MNEs would prefer to locate where production costs are lowest or productivity is highest. It is at this stage where MNEs face the decision of location and thus the stage at which the tax rate plays an important role. The fourth and fifth decisions are the level of investment to be done and the reallocation of profit among locations, respectively and are dependent on the tax rate conditional upon the chosen location. Stage two is the decision we try to analyze in this thesis, through the question of: Where will MNEs locate? And will the CIT influence their decision? **Figure 3.2** shows the decision tree and the stages (Deveroux, 2006).



Author's own construction based on: Deveroux (2006)

### 3.2 Figure: Deveroux's Decision Tree

### 3.3 The relationship between taxes and FDI

Taxation can affect FDI inflows in different ways. According to Easson (1999), studies suggest that taxes are very important considering their direct impact on production costs and profits. Most research however, has been quite inconclusive on the exact relationship between FDI and changes in taxation; this could be due to the many other factors that affect FDI inflows into a country. Easson (1999) emphasizes on the importance of tax considerations while deciding where to locate, rather than decisions of whether to invest abroad or at home. Additionally, the type of investment may have an impact on the degree of the effect that taxes have on FDI. First of all, there are big differences between *market-oriented* and *export-oriented* investment, where the former is affected little by taxes compared to the latter. Moreover, according to Easson (2004), there is proof that the relevance of taxation varies depending on the type industry. In a study by Wilson (1993), the author finds that tax relevance varies significantly across industries. In the research, marketing and distribution centers and pharmaceutical and software companies were between medium and highly sensitive to taxes. While in the chemical industry taxes seemed to have no importance at all. *"These differences seem to reflect the relative mobility of the investment and the range of choice of possible locations"* Easson (2004).

Taxation is important for more export-oriented investment. Export-oriented FDI can be more sensitive to the host country tax burden than market-oriented FDI. It is also called "resource-oriented FDI" since the main reason for the investment is to have access to resources (natural or human). This type of FDI is more sensitive to taxes because the main factor that drives this type

of investment is the cost of labour, raw materials, and other costs of operations, which in turn, are directly affected by taxes. In addition, the price of the products or services to be exported are also affected, the higher the taxes, the higher the prices (Easson 1999). A MNE seeking to locate on a place where there is big supply of skilled labour will consider labour costs which can be affected by taxes on labour.

Nevertheless, home and host country taxation are both relevant to FDI flows, we develop each of them below.

### **3.3.1 Host Country Taxation**

Foreign companies can be, and in most cases, subject to the national tax system where they locate. The Corporate Income Tax (CIT), which varies from country to country, has been regarded as the most relevant and influential tax rate due to its direct relationship to profits. Company profits are directly taxed by the corporate tax rate and therefore any MNE looking to invest abroad will prefer a country where the CIT is lower. However, the CIT is not the only tax that can affect profits or production costs. Personal income taxes, payroll taxes and social security contributions, are other taxes that MNEs might be interested in knowing, before deciding where to carry on investment.

These taxes can have a substantial effect on labour costs. In many cases, foreign companies want to bring expatriates<sup>5</sup> when coming into a new market in order to train local managers and employees. The cost of hiring these expatriates will differ if the country in which the investment is carried out has a higher tax rate on income and on employer payable taxes (social security contributions, payroll taxes, etc.). Thus, to some extent, these type of taxes can have an impact on the location decisions of MNEs.

Other host country taxes that could also influence, but about which less evidence has been shown, are: consumption taxes, custom duties and import taxes. These taxes could influence to the extent to which these are passed on to consumers (e.g. Value Added Tax). Custom duties and import taxes, however, would affect the consumer's behavior on buying imported products which in turn might influence the decision of investing at home and exporting or producing abroad.

Foreign investors can be interested on the withholding taxes on dividends and interest. This could be the case of either home or host country taxation. Moreover, individual income tax and social security contributions are also important to consider, although they tend to have a minor effect, these type of taxes can have a large impact on labor costs, so is the case of Sweden.

Import taxes and custom duties can affect in two ways. If these are too high, it may perhaps create an incentive for MNEs to produce in a country rather than export to it. It could, however, also create a disincentive given that the initial cost of investment might be higher (Easson 2004). These are all taxes from the perspective of host countries, we now turn to the perspective of home countries.

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<sup>5</sup> expatriate – One who takes residence in a foreign country.

### **3.3.2. Home Country Taxation**

When we talk about home country taxation, we lie on the first stage of the decision tree presented earlier. Home country taxation comes into relevance when a company has to decide to either invest abroad or at home. The simplest of capital flows and taxation model suggests, “The tax rate in an open economy will cause a net capital outflow, and a lower aggregate capital stock. The lower capital stock may well have a negative impact on economic welfare of the residents of the country. It may therefore be natural to investigate the impact of capital taxes on the aggregate capital stock” (Deveroux, 2006, p. 7). Thus, it is important to investigate the impact of home country taxation in order to avoid capital flight, which in turn has a negative impact on the welfare.

Normally, governments tax their residents on their worldwide income. Any individual or company carrying out business in a different country, other than theirs, is subject to taxation in its home country. Consequently this has given rise to the problem of double taxation. Foreign companies are taxed by the host country and by the home country. This double taxation problem creates disincentives to invest and thus has influenced the creation of double taxation treaties. Double taxation is usually used in order to restrict companies from paying too little taxes, if the tax rates in the foreign country are too low it is only fair that foreign-sourced income is taxed and thus keeping capital export neutrality in the home country. (Easson, 2004) In some countries for example, such as Hong Kong, chaste territorial tax system is offered. Residents of Hong Kong are exempted from taxation of foreign-sourced income. This in turn, creates more transparency and less illegal or unfair transfer pricing amongst Hong Kong Multinationals, and consequently benefits their economy. In Sweden on the other hand, a crisis during early 1990’s caused a steep fall of the kroner. The crisis erupted primarily due to capital outflows from the country as citizens searched for tax havens to alleviate the high tax levels in Sweden (Banking Introductions, 2004). Additionally, although little evidence is presented about Swedish companies moving headquarters abroad due to high taxes in Sweden, it is inappropriate to disregard the possible influence that high taxation had on the decisions of these MNEs (e.g. Securitas, Autoliv and Esselte). Not to mention the relocation of Swedish richest man Ingvar Kampard to Switzerland (ITPS, 2008)<sup>4</sup>.

By contrast, the ability of MNEs to shift profits freely across countries and control prices, through the exercise of transfer pricing, could have an influence on the extent to which home country taxation affects FDI flows (Deveroux, 2006).

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<sup>4</sup> Article can be found at address:

[http://www.itps.se/Archive/Documents/Swedish/Publikationer/Rapporter/Arbetsrapporter%20\(R\)/R2008/R2008\\_001.pdf](http://www.itps.se/Archive/Documents/Swedish/Publikationer/Rapporter/Arbetsrapporter%20(R)/R2008/R2008_001.pdf)

### 3.3.3 Transfer Pricing

It is defined by Easson (1999) as “transactions in goods and services between related enterprises and, more specifically, the price charged in such transactions” (Easson 2004).

Transfer pricing can distort the results from research seeking to explain the impact of taxation on location decisions of capital. The ability of organizations to control prices, and therefore reduce the payable taxes, will provoke a weakening of the tax considerations taken by MNEs when deciding where to locate new investment. However, in a study by Bernard and Weiner (1990) on US firm-level data of oil imports seeking for a relationship between taxation and arm’s length and transfer prices, the authors find that there is no significant relationship between the controlling of prices and the tax liabilities (Deveroux 2006). Although, Deveroux argues, host country taxation may induce lower taxable income as companies try to find a way to shift profits to lower-taxed jurisdictions.

### 3.4 The Determinants

Since the 1950’s Western Europe has been an attractive area for US MNEs. Its lucrative market, technological advancements, skilled labour, efficient government policies and cultural proximity have been the main determinants of FDI inflows (Sethi et. al., 2003).

It is not appropriate to state that taxes are the only determinant behind foreign investment flows. If one wants to recognize the impact of taxation on FDI, it is necessary for all other possible factors to be included. For example, disregarding the infrastructure of a country, which is directly linked to government expenditure and taxes, might create a biased or misleading results on the true results (Deveroux 2006).

Based on the OLI framework, the most common variables used on other studies made on the impact of taxation on FDI were selected. Most developed economies share similar variables which are considered to be traditional determinants of FDI, for this reason, we have selected the variables that could differ more across these countries and thus influence the location decisions:

#### GDP

This variable is a proxy for market size. Market access has proven to be one of the main, if not the most important, determinant of FDI. The size of the market will determine the degree of possible profits hence, the relevance of the variable (Easson, 2004).

#### Skilled Labour

MNEs will be attracted to invest where human capital is larger given the higher productivity per labour cost unit. Moreover, technology intensive investment might require more advanced knowledge and thus the need for skilled labour. This however, may vary depending on the type of industry (Easson, 2004).

### Labour costs:

For export-oriented investment, costs of production and low-cost qualified labour are of high importance (Lankes & Venables, 1997). Therefore, other things equal, MNEs will prefer to invest in a country where production costs are lower rather than higher because of effect on profits. Given this, the location decisions of an Enterprise will be influenced by the long-run production costs associated with investing in a certain country (Easson, 2004).

### Economic Freedom

The Economic Freedom Index by The Heritage Foundation measures the degree of exertion of different factors that are rather important determinants of FDI. It measures the overall economic freedom in a given country. Higher values of the index mean better practice of all measurements and thus better possibilities for profitable investment.

The following are the targeted variables included in the index:

- *Trade Openness*: countries offering lower barriers and easiness to move capital freely will be more attractive for foreign investors given that costs such as tariffs and duties will be lower (OECD, 2000).
- *Property Rights*: Expropriation is a threat to any entrepreneur. The strength of the legal system over protection of new ideas is of high importance and of major concern to any investor. Weakness in this legal factor will have a negative impact on new investment and thus on FDI (Easson, 2004).

### The role of infrastructure

A country with very good roads, water supply, power grids, telecommunications, etc. contribute to efficiency and higher labour productivity and thereby lower costs of production. (Bellak, Leibrecht, Damijan 2009). All this constitute part of a country's infrastructure. Both taxes and infrastructure can have an impact of location decisions, one being negative and the latter being positive since it contributes to higher productivity.

It can be a confusing topic given that on one side an increase in taxes, all else equal, gives a lower post-tax net present value of any given investment. While on the other side, an increase in infrastructure contributes to labour productivity. Thus lower taxes or higher infrastructure can attract higher levels of FDI.

Bellak et. al. (2009) found that, infrastructure was a relevant factor or determinant of FDI location. Moreover, the authors also found that tax-rate elasticity of FDI was a diminishing

function of infrastructure endowment. Thus one can be dampened by the other. In general, both of these variables have an inverse relationship to inflows on investment (Bellak et. al. 2009).

## 4 Empirical Framework

In this section the model is introduced and data is used for the regression. First, data was collected from 25 high-income OECD countries for the years 1998-2006. A model was then constructed based on the theoretical framework and with the use of pooled data. In order to know if that all variables had some degree of correlation to FDI, all bivariate correlations are depicted in Table D (shown in Appendix). As shown in this table, all variables are correlated to the  $\ln\_FDI$  variable except for Skilled Labour variables.

Some variables required logarithmic transformation due to the type of relation they showed to have with FDI inflows; we found this by plotting scatter plots for every variable against FDI.

### 4.1 Data

Aggregate FDI inflows are used as the dependent variable. The independent variables are described in the table 7.1. A total of eight explanatory variables are used and eleven dummy variables are included to capture the effect of time and three for geographical location (4 continents). Data was acquired from OECD, UNCTAD and Eurostat amongst others.

Variable	Explanation	Expected Sign
$FDI_j$	FDI inflows per capita into country $j$	
$GDP_j$	GDP per capita in each country $j$	+
$EC_j$	Index of Economic Freedom using a scale from 1-100 where 1 is low economic freedom and 100 is high	+
$LC_j$	Total labour cost divided by nominal GDP Measure for productivity	-
$Infra_j$	Proxy variable for infrastructure. Total number of telephone lines per capita	+
$Skilled_j$	Total amount of skilled labour per capita. Population With <i>tertiary education of type A</i> .	+
$CIT_j$	Statutory Corporate Tax Rate	-
$D_j$	8 dummy variables 1998-2005 having 2006 as base year. Values: 1 if obs. is from year 1998-2005. 0 otherwise	
$D2_j$	3 dummy variables for location. Values: 1 if obs. is from Oceania, EU, North America. Value: 0 if otherwise. Asia works as the reference value.	

#### 4.1.1 Table: Variable Description

## 4.2 Dummy Variables

### For Time

“We can allow for time effect in the sense because of factors such as technological changes, changes in government regulatory and/or tax policies, and external effects such as wars or other conflicts” (Gujarati, 2004 p.645). Such time effects can be accounted for if we introduce time dummies, one for each year. Since we have data for 9 years, from 1998 to 2006, we can introduce 8 time dummies.

If the dummy variables show statistical significance, this could suggest that perhaps the investment function has changed much over time.

### For Location

Dummy variables for location were used in order to control for the effects of geography. If the variables are significant it means that part of the variability in FDI inflows is explained by the geographical location of the country. Four different regressions were carried out: no dummy, exclude year dummies, exclude location dummies, no excluded dummies.

	Minimum	Maximum	Mean	Std. Deviation
<i>FDI</i>	-7568295	60662918	1584265.84	4836512.193
<i>GDP per capita</i>	4576	90714	29475.64	13625.121
<i>LC</i>	.44747072	.66658723	.575582	....
<i>EF</i>	45.779003	82.328250	69.7587	6.6332581
<i>Infra</i>	2.813	7.466	5.29247	1.015587
<i>Skilled Labour</i>	.00000	.059936	.03631251	.012229039
<i>CIT</i>	13.000	56.00	31.9140	7.08243

### 4.1.2 Table: Descriptive Statistics

## 4.3 Model

$$\ln\_FDI_j = \beta_0 + \beta_1 \text{GDP} + \beta_2 \ln\_LC + \beta_3 \ln\_EF + \beta_4 \text{Skilled} + \beta_5 \ln\_Infra + \beta_6 \ln\_CIT + \beta_7 D_j + \beta_8 D_{2j}$$

The model is a log- log model given the use of logs on both sides of the equation. The variable of main interest is  $\beta_6 \ln\_CIT$  which is the one representing the corporate tax rate.

#### 4.4. Regression & Analysis

Coefficient	Reg 1 (No dummies)	Reg 2 (Exclude location dummies)	Reg 3 (Exclude time dummies)	Reg 4 (All dummies)
Constant (Std. Error) t-stat	8.595 (4.392) 1.957	8.000 (4.376) 1.837	.716 (4.908) .146	5.536 (4.896) (.145)
GDP per capita (Std. error) t-stat	***3.067E-5 (.000) 4.223	***3.669E-5 (.000) 4.239	***3.555E-5 (.000) 4.963	***5.177E-5 6.101 5.007
LC (Std. error) t-stat	-1.779 (1.286) -1.383	-1.295 (1.249) -1.041	-1.047 (1.296) -.808	-.457 (-.029) -.366
EF (Std. error) t-stat	1.533 (.938) 1.635	**2.030 (.934) 2.187	***2.571 (.998) 2.602	***2.968 (.982) 3.021
Infra (Std. error) t-stat	**1.039 (.490) 2.121	.714 (.542) 1.304	.4 (.474) 1.017	.024 (.521) .046
Skilled Labour (Std. error) t-stat	9.071 (8.131) 1.116	10.233 (8.058) 1.298	4.204 (7.782) .540	6.110 (7.581) .802
CIT (Std. error) t-stat	***-1.618 (.381) -4.251	***-1.808 (.371) -4.878	**-.862 .388 -2.223	***-1,088 (.375) -2.904
D_EU			***2.419 (.390) 6.194	***2.446 (.372) 6.657
D_NA			***1.929 (.467) 4.128	***2.012 (.455) 4.426
D_Oceania			***1.949 (.519) 3.753	***2.055 (.509) 4.035
Adj.R Squared	.291	.350	** .401	.465
F-Value	***14.960	***8.206	***16.159	***11.427

\*\*\*sig. at 1%

\*\*sig. at 5%

\*sig at 10%

Results are shown for all regressions. The regression with the strongest results is the fourth, that is, the model including all dummy variables (for years and for location). This model has an Adj. R Squared value of 0.465, meaning that 46.5% of the variation in FDI inflows is explained by the model.

The first regression, which excludes all dummy variables, has an adj. R squared value of only 0,291(29,1 % goodness fit). This number differs substantially to that of the fourth regression (46.5%); the value almost doubles when we incorporate the dummy variables. This means that the dummies contribute to the model significantly and thus should be included. The dummies (see Appendix for complete table) contribute to the model by controlling for other external factors (time effect and geographical location) that are not included in the model. However, this increase in adj. R sq. could also be explained by the simple fact that an increase in the variables of the right hand side of the model will tend increase the R sq. coefficient (Guajarati, 2004).

Most of the outward FDI in the world comes from the US and some European countries (UK and Netherlands). MNEs have a tendency to invest in countries that have some cultural proximity to theirs since this can reduce costs (language barriers, culture associated with advertisement, etc.) (Sethi et. al., 2003). Thus by adding dummy variables for the geographical location this type of differences are isolated giving more power to the model. In the third and fourth regressions the dummy variables for location are highly statistically significant. This means that continental location is an important variable that determines the flows of FDI. This is can be due to; physical distance, cultural proximity and/or natural resources, among other things. For example, the US (as a major exporter of FDI), will tend to choose countries that share cultural similarities (such as language). Moreover, natural resources and market size are also important factors that can be included in any location explanation. Investing in a European country allows for market entry into other economies given the close location to (e.g. Sweden to Norway), the same goes for a country located in Asia or in Latin America (although not included in this study) (Easson, 2004).

Further on, the CIT rate is highly significant in all regressions, with a p-value no greater than (0,008). We can thus reject the null hypothesis  $B = 0$  at the 5% sig. level proving that the CIT does have a negative impact on inward FDI in OECD countries.

These are very strong statistical results and translate into the clear impact that taxation has on inward FDI across OECD members. The results are according to the theory presented earlier and some previous studies such as Leibrecht and Bellak (2009) who also find a negative relationship between the corporate tax rate and FDI flows. Moreover, these results also concur with the study by Piteli (2010) where the author uses OECD countries and test for gdp, tax, productivity, and labour costs. Piteli's results are also negative for the CIT variable. The elasticity between FDI inflows and the CIT, however, is different. My results show a -1.33% elasticity, thus, a 1% decrease in the CIT will increase, on average, inward FDI by 1.33%. This is different to Piteli's results that show a -12.29%, a much greater impact. However, Piteli's model is different from the model used in this thesis. In addition, the results are also in line with another number of studies (Hartman, 1984; Chakrabati 2001; Bénassy-Quéré, Fontagné & Lahréche-Révil, 2005).

Moreover, throughout all four regressions most of variables keep the same significance or they only vary a little. For example, the variable for Economic Freedom has a very low p-value in

regressions 2- 4 and in regressions 3 and 4 there is almost no change in this variable's significance. The Economic Freedom variable was a proxy for trade openness and property rights. This variable is significant in all regressions except for the regression excluding the dummies. As expected this variables shows a positive relationship implying that the more the country is open to trade and foreign investment and the stronger are the laws on property rights imposed, the more attractive a country will be for any overseas investor ( OECD, 2000 ) .

For the rest of the variables, even though insignificant, the signs are all as expected, implying a negative relationship to FDI. For example, for labour costs, the beta coefficient is negative, implying a damaging effect on FDI inflows. The findings are the same as Piteli's (2010), however, in her study, labour costs appear significant.

Further on, the most significant variables are the proxy for market size (GDP per capita). These results are also in line with a number of studies where the measurement used for the size of the market shows to be the highest correlated variable to FDI inflows in any given country. (Chakrabati, 2001; Faeth, 2008; Piteli, 2010).

Other insignificant variables are skilled labour and infrastructure. Infrastructure shows signs it is significant in the first regression with a (.035) sig. value, however as the time and location dummies are included, this variable drops and loses it significance. This could mean that the variable is relevant but only to some extent. Once the differences in location are accounted for and the effects of time (Grunfeld investment) infrastructure is perhaps not that important given that the countries we are using are all developed economies which share, to some degree, a similar level of physical infrastructure (Easson, 2004). Another explanation for the insignificance of this variable is the inverse relationship it has to taxes (i.e. high infrastructure is funded with higher taxes which in turn lowers FDI, however high infrastructure induces higher levels of FDI). This is proved in the study by Bellak et. Al (2009), where the authors find that FDI is an important location factor for FDI and that "the tax-rate elasticity of FDI is a decreasing function of infrastructure endowment" in CEEC countries.

Moreover, skilled labour shows no significance whatsoever in any of the regressions, although, the coefficient is positive as expected. This could be due to multicollinearity. Although it is not shown in the bivariate correlations table in the appendix, the logged versions of gdp and skilled labour were tested. It was found that both variables are highly correlated and thus damaging the regression results. Therefore, it is not appropriate to fully disregard the possibility that this variable (skilled labour) has no impact whatsoever on FDI inflows.

Moreover, other variables that could also appear to be insignificant due to multicollinearity issues are labour costs and infrastructure. These two variables became highly significant when GDP was dropped from the model. Therefore, these variables might not be completely irrelevant to the dependent variable.

As for the predicted values given by the model. Sweden is very well overperforming with FDI inflows of up to 10 million dollars in the last year 2009. The model predicts a mean of 674,414.

## 5 Conclusions

Theory states that inward FDI into a country can, among others things; stimulate growth by creating new jobs and causing technological spillovers. For that reason, governments have embarked in aggressive fiscal policies in order to attract capital from foreign investors. Correspondingly, an instrument being used lately is the Corporate Income Tax rate. It's been claimed that the CIT is a major influent component of the location decisions of MNEs. Therefore, by offering lower tax rates, governments are expecting to attract higher volumes of investment.

Further on, based on the regression results of the model, it can be concluded that the hypothesis is consistent with theory. The Corporate Income Tax is an important variable that influences the location of new investment by MNEs thus, supporting the behavior of governments towards fiscal policies. Therefore, it is crucial that governments offer an investment-friendly environment through competitive tax rates that will encourage more foreign investment.

Additionally, the exertion of a good legal system that protects investors and entrepreneurs against expropriation and enabling the ability to send profits back to the home country through lower trade barriers will also influence the degree of investment a country will receive. This means that, not only a country should focus on setting a good CIT but also strictly implementing protections laws and shaping trade polices accordingly.

In the case of Sweden, it can also be expected that, together with the high openness to trade and good property rights protection, the recent decrease of CIT rate from 28% to 26% should, according to our results, produce a higher volume of incoming FDI into the country.

## 6 Appendix

**Table A - List of High-Income OECD countries**

<b>1) Australia</b>	<b>9) Greece</b>	<b>17) New Zealand</b>
<b>2) Australia</b>	<b>10) Hungary</b>	<b>18) Norway</b>
<b>3) Canada</b>	<b>11) Iceland</b>	<b>19) Portugal</b>
<b>4) Czech Republic</b>	<b>12) Ireland</b>	<b>20) Spain</b>
<b>5) Denmark</b>	<b>13) Italy</b>	<b>21) Sweden</b>
<b>6) Finland</b>	<b>14) Japan</b>	<b>22) Switzerland</b>
<b>7) France</b>	<b>15) Luxembourg</b>	<b>23) United Kingdom</b>
<b>8) Germany</b>	<b>16) Netherlands</b>	<b>24) United States</b>

**Table B Corporate Income Tax Rate by country**

Data extracted from:

<http://stats.oecd.org/index.aspx>

Ireland	13%
Hungary	16%
Iceland	18%
Switzerland	21%
Austria	25%
Finland	26%
Czech Republic	26%
Denmark	28%
Norway	28%
Portugal	28%
Sweden	28%
United Kingdom	30%
Luxembourg	30%
Australia	30%
Greece	32%
Netherlands	32%
New Zealand	33%
Italy	33%
Belgium	34%
Canada	35%
Spain	35%
France	35%
United States	39%
Germany	39%
Japan	40%

**Table B** shows the CIT for 25 high-income OECD countries for the year 2005 (all figures are rounded). Japan had the highest rate at 40% followed by the United States; both countries are big exporters of FDI. This is in line with home country taxation theory. The lowest rate is Ireland's at 13%, a big importer of FDI.

**Table C Fiscal Freedom Index 2009**

*(Sorted largest to smallest)*

Data extracted from: <http://www.heritage.org/Index/Explore.aspx?view=by-region-country-year>

Czech Republic	80,2%
Canada	76,6%
Iceland	76,2%
Hungary	70,6%
Ireland	69,2%
United States	67,5%
Japan	67,5%
Switzerland	67,5%
Greece	66,5%
Luxembourg	66,3%
Finland	64,3%
New Zealand	62,5%
Portugal	61,6%
Australia	61,4%
United Kingdom	61,0%
Spain	58,6%
Germany	58,5%
Italy	55,8%
France	50,9%
Netherlands	50,9%
Norway	50,3%
Austria	49,9%
Belgium	41,5%
Denmark	35,4%
Sweden	35,0%

**Table C** shows Sweden's position (last) on the fiscal freedom against other high-income OECD. The index includes the top tax rate on individual income, corporate income tax rate and total tax revenue as percentage of GDP (The Heritage Foundation, 2010).

**Table D- Bivariate Correlations**

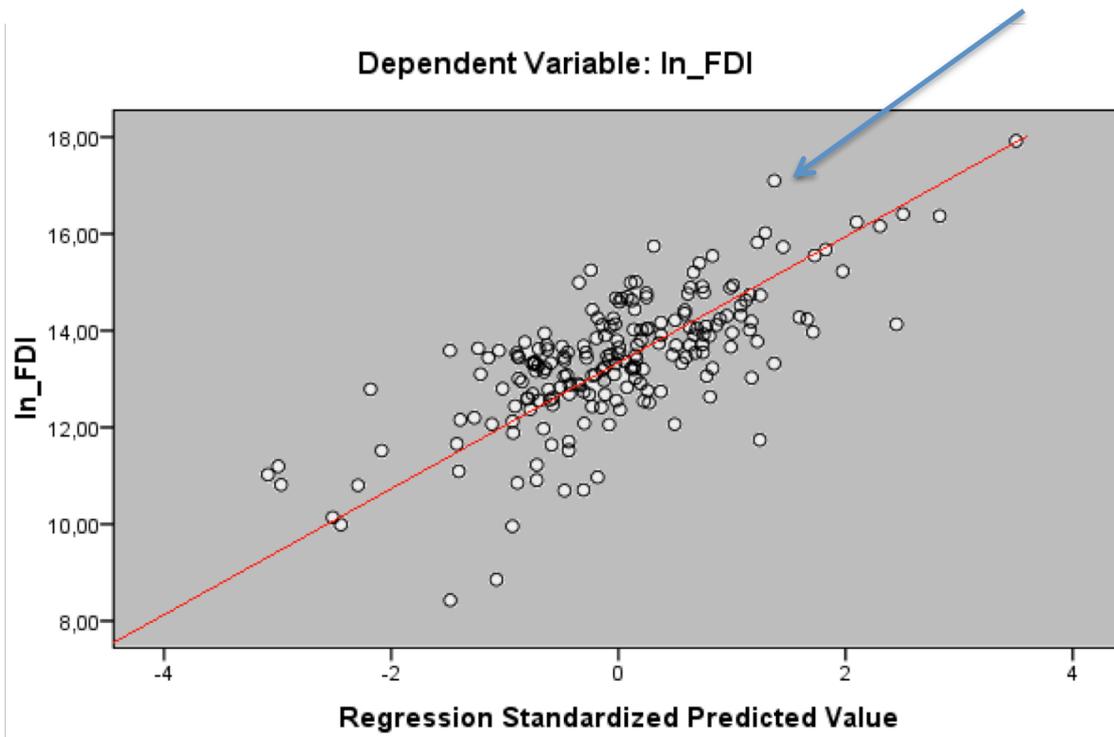
		In_FDI	GDP per capita	In_Labour Cost	In_Eco Free	In_Infra	Skilled Labour	In_CIT
In_FDI	Pearson Correlation	1						
GDP per capita	Pearson Correlation	.445**	1					
		.000						
In_Labour Cost	Pearson Correlation	(-.173)*	(-.116)	1				
		.013	.082					
In_Economic Freedom	Pearson Correlation	.270**	.368**	(.279)**	1			
		.000	.000	.000				
In_Infra	Pearson Correlation	.221**	.239**	.239**	.200**	1		
		.001	.000	.000	.003			
Skilled Labour	Pearson Correlation	.038	.126	.515**	(.234)**	.082	1	
		.590	.059	.000	.000	.221		
In_CIT	Pearson Correlation	(-318)**	(-.136)*	.386**	(-.170)*	.162*	.020	1
		.000	.043	.000	.012	.016	.770	

\*\*Correlation significant at 0.01 level (2-tailed)

\*Correlation significant at 0.05 level (2-tailed)

**Table D** : All variables are correlated to FDI inflows except for skilled labour which has a very low p-value.

## 6.1 Graph: Predicted Value



Predicted Value	Mean ln_FDI	Std. Deviation
	13.4157	.95731

**Graph 6.1:** The predicted value has a mean of  $e^{13.4216} = 674,414.37$  (thousands of FDI inflows). Sweden, for the last years, has been performing above this value with FDI inflows per capita of over 10 million US. If  $\ln(10000000) = 16.1180$ . Sweden should lie somewhere above the line. (shown with an arrow).

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