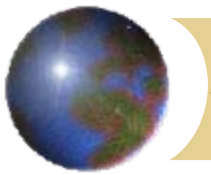


Discussion of Razin and Sadka

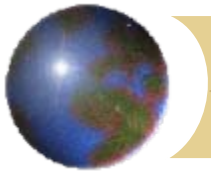
Mihir Desai
Harvard & NBER

Brookings Trade Forum
May 2007



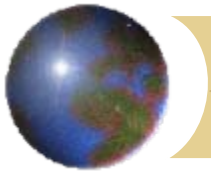
Three major points

- FDI consists of whether to invest and how much to invest - fixed startup costs are important to FDI
- How much to invest is a function of marginal profit conditions but whether to invest is a function of total profit conditions.
- Productivity shocks and taxation can give rise to different marginal and total effects, and therefore can influence the “whether” and “how much” differentially (and counterintuitively) – Observed 0’s reflect this.



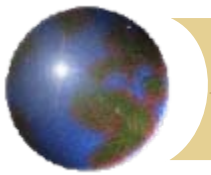
Anticipated effects (1)

- A positive productivity shock in host country:
 - Leads to more FDI flows because marginal profits increase (typically)
 - Can lead to lower initial investments because total profits can be lower
- How could this be? The setup cost is partly in host country wages – rising wages change the initial cost
- A source country productivity shock may also limit new outbound FDI as domestic opportunities become more attractive. (no setup cost?)
- Evidence on source country but not on host country



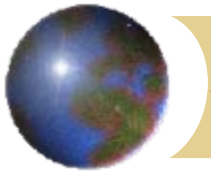
Anticipated effects (2)

- Tax rates have distinctive effects:
 - Host country tax rates influence “how much” and “whether” decisions (as you might expect)
 - Source rates don’t influence how much but increases in source rates make new investments in host more attractive
- How could this be? The setup cost is partly deductible at home so value of deduction changes
- Evidence provided on both



Theory Questions

- What are these fixed costs? More motivation...
- Are they country specific or one time for globalizing firms?
- How *relatively* important are they? How do they interact with market size? Eg. China
- How important are host wages to these set up costs? Eg. Consultants and I-bankers vs. investments or control
- What are “deductible” home costs?
- What are assumptions about constrained financing?
- Why don't source tax changes influence alternative investments?



Empirical Questions

- Could results on source taxation reflect other effects, including profit relocation opportunities?
- Could results on productivity domestically reflect a simpler mechanism?
- Treatment of Europe is odd...
- Are zeros really that important for OECD? Particularly for countries analyzed?



Policy Implications

- Implications for tax sparing policies – irrelevant for promoting FDI, both new and continued
- Only effect of increase in U.S. statutory rate - increased new outflows of FDI because of deductibility of upfront costs
- What would transition to exemption do? Irrelevant for new and continued FDI
- Incorporating transfer pricing – real activity abroad facilitates transfer pricing so new investments create new transfer pricing opportunities
- What about *interaction* of taxes and productivity?