Discussion of

Productivity and Taxes as Drivers of FDI
by Assaf Razin and Efraim Sadka

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Overview:

1. Note Razin and Sadka’s contributions
2. Discuss the economic interpretation of the results from their FDI flow estimates.
3. Discuss this work in light of empirical findings of others.
4. Policy implications.

<u>New Appreciation of the Trader in Trade</u>

- Fixed Costs of investment.

- Incorporation of firm heterogeneity.

  → Razin and Sadka re-evaluate the effects of productivity and taxes on foreign investment, focusing on the potential for responses on both the extensive and intensive margins.

Claim: Foreign Investment responds at the *extensive* margin and the *intensive* margin.

- Selection equation is identified by OECD country pairs with 0 investment. No Firm wanted in invest in the year.
  - [Greece/Korea], [Portugal/Mexico], [Finland = Nokia]
- Flow Equation includes both extensive margin and intensive margin responses.
  - US has positive investment in most OECD countries year after year. However, the number of investing firms changes over time.

→It is not possible to draw inferences about firm decisions from *country-level* FDI Data.

→Results discussion focus on FDI flows.

Key FDI Flow Results

1. Source country labor productivity is *negatively* correlated with the level of foreign investment. No association with host labor productivity.

    - Does variation in labor productivity actually reflect business cycle effects?
    - Analysis combines M&A and greenfield FDI.
        - 18.8% of FDI Value in 2005 was due to M&A.
    - To what extent does national productivity - Host or Source - carry over to firms? [Ex: Lenovo acquisition of IBM Thinkpad]

Key FDI Flow Results

2. Host country taxes are *negatively* correlated with the level of foreign investment flows.

Is this effect large or small?

- Do infrastructure and amenities counteract tax effects?
- Is the effect relatively large due to nature of neighbor effects in the OECD sample?

  Ex: Neighbor effects (Market Potential, FDI) influence EU FDI [Blonigen, Davies, Naughton, Waddel] or Neighbor Tax effects [Swenson] as in 1)FDI in US states and 2) Overseas 9802 assembly locations

Is the extensive margin relevant?

– Firm-level studies suggest the answer is yes.

Entry Decisions:

[Devereux and Griffith (98), Mutti and Grubert (2004), DFH]

Extensive and *intensive* margin:

[Muendler and Becker (07)]

– However, extensive margin is only a first step. Biggest additions to multinational activity are expansions of existing operations, which suggest a dynamic process in firm operations.

Do taxes influence the level of foreign investment?

- Less than they did before:
  - Increased sensitivity with time. [Mutti and Grubert]
  - Financial alternatives reduce repatriation taxes.

    [Altshuler and Grubert]
  - Increased use of Holding Companies. 30% of US foreign affiliate activity in 2005, as compared with 9% in 1982. [BEA]
- Still an influence:
  - Jobs Creation Act of 2004 → smallest increase in US FDI in 2005. Firms repatriated earnings at the low, *temporary* tax rate, rather than investing abroad. [BEA]

Policy Questions:

1. Should tax structure design reflect firm decision process?

→ No uniform prescription due to diversity of entry and operation modes.

– Horizontal, Vertical [Mutti and Grubert 2004]
  – Smaller effect of taxes in high-income countries.
  – Tax effects and openness.
– Export vs FDI [Devereux and Griffiths]
– Invest at home or FDI [Razin and Sadka]
– Merger vs Greenfield FDI [Scholes and Wolfson, Swenson]
  – Clientele effects.

→ However, in the aggregate policy-makers should be cognizant of the potential effects of tax policy on national productivity stemming from selection effects.

2. If taxes matter for real investment, are governments locked into a race to the bottom?

The incentive: MNCs represent a large contribution to host country economic activity.

- The value-added of U.S. foreign affiliates generated 2.8% of host country GDP in 2004 [BEA]
- Ongoing declines in corporate tax rates.

Increased opportunities for offshore tax planning may help preserve positive rates of taxation.

[Altshuler and Grubert]