

Do low corporate income tax rates attract FDI? – Evidence from Central- and East European Countries

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Postprint / Postprint

Zeitschriftenartikel / journal article

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Empfohlene Zitierung / Suggested Citation:

Bellak, C., & Leibrecht, M. (2009). Do low corporate income tax rates attract FDI? – Evidence from Central- and East European Countries. *Applied Economics*, 41(21), 2691-2703. <https://doi.org/10.1080/00036840701320217>

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Do low corporate income tax rates attract FDI? □ Evidence from Central- and East European Countries

Journal:	<i>Applied Economics</i>
Manuscript ID:	APE-06-0066.R1
Journal Selection:	Applied Economics
JEL Code:	F21 - International Investment Long-Term Capital Movements < F2 - International Factor Movements and International Business < F - International Economics, H25 - Business Taxes and Subsidies < H2 - Taxation, Subsidies, and Revenue < H - Public Economics
Keywords:	effective tax rates, Foreign Direct Investment, Central- and Eastern Europe



Do low corporate income tax rates attract FDI? – Evidence from Central- and East European Countries

1 Introduction

Foreign Direct Investment (FDI) is carried out by Multinational Enterprises (MNEs) in order to earn profits. The profitability of FDI is expected to decrease with increases in energy, taxes, labour costs etc.. Concerning taxation, the negative relationship between tax burden and FDI inflows is basically confirmed by the empirical evidence for OECD countries. (e.g. De Mooij and Ederveen 2003 and 2005) However, the empirical evidence concerning FDI and taxation in the Central- and East European Countries (CEECs) has consistently not found evidence that taxes matter for location decisions (see below).

We suggest that one possible reason for this somewhat unexpected evidence for the CEECs in the empirical FDI-taxation literature is due to the use of a flawed indicator of tax burden. These flaws, we argue, can be remedied.

The present paper differs from previous studies by including a theoretically well founded measure of the tax burden, namely forward-looking effective tax rates derived by Devereux and Griffith (1999), rather than the statutory tax rate, which has various shortcomings in explaining FDI.

In this paper we examine first of all whether there is any substance in the belief that corporate tax rates are an important location factor for FDI from 7 home countries to 8 CEECs.¹ Secondly, we investigate whether, and to what extent, the choice of measure of the tax burden affects the tax elasticity of FDI. This is mainly motivated by the fact that there has been a gap between the conceptually ideal measure of the tax burden and its operational counterpart in empirical models in earlier studies. Thirdly, we compare the role of the corporate tax burden to that of other location determinants.

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3 Our empirical results show that the semi-elasticity of FDI with respect to taxation ranges
4 between -3.3 and -4.6. This is above those of earlier studies in absolute terms and can partly
5 be attributed to using a superior measure of the corporate tax burden than the statutory tax
6 rate. The results indicate that tax-lowering strategies of CEEC governments seem to have an
7 important impact on foreign firms' location decisions.
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10
11 The remainder of the paper is structured as follows. Section 2 provides some conceptual
12 background and a review of previous studies. Section 3 describes our data set and the
13 variables used. Section 4 describes the empirical specification and methodology used in the
14 estimation. Section 5 presents the estimation results and discusses their significance in
15 relation to earlier studies. Section 6 provides a summary of our main findings.
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28 2. Some Conceptual Considerations and a Review of Previous Studies

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30 The question why a particular country succeeds in competing for inward FDI can be
31 answered by reference to the eclectic paradigm (Dunning 1988; Markusen 1995). Based on
32 various theories (e.g. Trade Theory, Theory of the Firm and Theory of Industrial
33 Organisation) the eclectic paradigm avers that FDI emerges if a firm has an Ownership-
34 advantage (e.g. a patent) combined with a Location-advantage (e.g. low production costs;
35 large market size) and an Internalisation-advantage (e.g. economies of interdependent
36 activities).
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47 The particular location factors considered by the firm in choosing between different *foreign*
48 markets have to be valid proxies for host-country Location-advantages. The eclectic
49 paradigm incorporates all possible location factors which attract FDI *conditional* on a firm's
50 decision to undertake FDI. This poses a problem as it neither attributes weights to single
51 location factors like taxation, nor does it assess their relative weights. Hence empirical
52 applications based upon the eclectic paradigm have to rely on more or less *ad hoc*
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¹ The home countries are Austria, France, Germany, Italy, the Netherlands, the United Kingdom and the United States. The host countries are Bulgaria, Croatia, the Czech Republic, Hungary, Poland, Romania, Slovakia and Slovenia.

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3 specifications. Recently, gravity-models have been successful in explaining bilateral trade-
4 flows and, more recently, bilateral FDI-flows as well (e.g. Frenkel et al. 2004, Brainard
5 1997). As these models can easily be combined with the eclectic paradigm, empirical models
6 explaining bilateral FDI-flows should be based on a Panel-gravity setting. It is then possible
7 to classify Location-advantages in terms of factors which are efficiency- or market-related,
8 supply and demand based (e.g. Mold 2003) or transition specific (Carstensen and Toubal
9 2004). Our variable of main interest, the corporate income tax burden, clearly falls into the
10 efficiency and supply related categories.

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21 As the tax burden is a factor which reduces profitability in the host-country, it should be
22 negatively related to the inflow of FDI. In general, few studies have dealt with taxes as
23 drivers of FDI to the CEECs. Recently, *anonymous* (2006) surveyed eight papers, which
24 dealt explicitly with FDI to the CEECs, in order to ascertain their tax-rate elasticities. The
25 outcome suggests a median tax-rate elasticity of around -1.45 (semi-elasticity). This result
26 implies that a 1 percentage point increase in the tax rate will reduce FDI inflows by 1.45
27 percent. As almost all of the studies surveyed used statutory tax rates as a measure of the
28 corporate tax burden, the result is in line with the tax-rate elasticities found by DeMooij and
29 Ederveen (2003 and 2005), i.e. -1.2 and -2.05, respectively.

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41 However, we question this low tax-rate elasticity. The statutory tax rate is not an appropriate
42 indicator of the tax burden, especially in the case of FDI, because it does not include all
43 relevant tax codes. From a conceptual and empirical point of view, bilateral forward-looking
44 effective average tax rates (beatrs) should be used (Devereux and Griffith 1999 and 2002).
45 Hence the estimated tax-rate elasticities from statutory tax-rates are probably flawed and
46 suffer from some measurement error bias. In our study, we follow Devereux and Griffith
47 (1999) and use beatrs. We expect a higher tax-rate elasticity than the one based on statutory
48 tax rates as the meta-analyses by DeMooij and Ederveen (2003 and 2005) show tax-rate
49 elasticities of -9.3 and -5.9 respectively, when effective average tax-rates are used..

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In addition, the low semi-elasticities derived by *anonymous* (2006) may also be explained by
the following facts, which are partly transition-specific. First, since relatively little FDI is

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3 efficiency-oriented but most is horizontal FDI,, other location factors are believed to be
4
5 important, too. In the case of the CEECs, location factors specific to the transition process
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7 such as hyper-inflation, privatisation, recession, exchange-rate fluctuations etc. may play an
8
9 important role. Second, the more varied the mix of location factors in competing host
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11 countries, the smaller should be the influence of a single factor such as taxation. It follows
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13 that the tax burden should be more important the more similar potential host countries are
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15 with respect to other location factors, *ceteris paribus*. Third, MNEs may avoid taxes via
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17 profit shifting. Fourth, insofar as FDI-flows contribute to expansionary investment in the
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19 existing capital stock, it may react less than in the case of new investment and Greenfield
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21 investment in particular.
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28 3. Data and Variables

29 *Dependent Variable*

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33 The bilateral net-FDI-outflow in millions of euro from home country (i) to host country (j)
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35 for the years 1995 to 2003 (t), is used as the dependent variable (*fdi*). Data are mainly taken
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37 from the ‘OECD International Direct Investment Statistics Yearbook’ and the ‘OECD
38
39 Foreign Direct Investment’ database. Missing values are substituted by information from
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41 Eurostat’s ‘New Cronos’ database and from National Statistical Offices.
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45 The fact that we use net-FDI-outflows in our study requires some explanation, as criticism
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47 has frequently been directed at this measure. In particular, some authors argue that FDI-
48
49 flows reflect financial flows only and not necessarily real-capital formation in the host
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51 country (see Devereux and Griffith 2002, p. 84f.). These authors conclude that there is a
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53 superior measure, namely plant, property and equipment (PPE), which reflects real capital
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55 (fixed assets).
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58 In our view net-FDI-outflows indeed represent the annual decisions of MNEs, either to
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60 invest Greenfield or to acquire a foreign firm directly or to expand an existing affiliate or to
divest in the CEECs. Net-FDI-outflows include (i) equity of the parent company in the

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3 subsidiary, (ii) net-loans between parent and affiliate, as well as (iii) reinvested earnings. In
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5 addition, local financing in the form of raising new capital, or taking loans, contributes to the
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7 affiliate's capital (vi). Empirically, using FDI-flows as the dependent variable may thus
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9 overestimate or underestimate "real investment". *Overestimation* may result from the fact
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11 that financial flows, which are unrelated to the activities of the affiliate, may enter the
12
13 components (i), (ii) or (iii). For example, transfer pricing (i.e. overvaluing services or goods
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15 by the parent) could have this effect as it inflates debt or overvalues services or goods by the
16
17 affiliate, which in turn, inflates reinvested earnings. Another source of overestimation is the
18
19 capital provided by the parent company to cover losses of the affiliate abroad.
20
21 *Underestimation* of real capital formation results from the fact that the local financing
22
23 (component iv) is excluded from FDI-flow figures.
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26
27 In the case of the CEECs, over- and under-estimation effects of real capital by FDI-flows
28
29 tend to exist but should be rather small. Profit shifting might play a certain role, as the
30
31 CEECs are low-tax countries in general, but underestimation due to local new equity
32
33 financing is probably of minor importance.²
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35

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37 Thus, we are left with 'local loans' as the most serious remaining source of under-estimating
38
39 real capital. Falcetti et al. (2003) reported that the ratio of total domestic credit to annual
40
41 GDP was only 43.2 per cent in Central and Eastern Europe and the Baltic States, while it was
42
43 108.8 per cent in the Euro Area on average. Still in 2005, the EBRD's Transition Report
44
45 concludes on "financial sector vulnerabilities in Hungary", one of the most advanced
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47 countries of the CEEC-8.
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51 In summary, we are convinced that, due to the minor importance of local financing, net-FDI-
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53 outflows to the CEECs are a reasonable proxy for the annual real capital formation of
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55 affiliates abroad.
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59 *Independent Variables*
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3 The independent variables have to be valid proxies for host-country related Location-
4 advantages. We base our choice of independent variables on the findings of some recent and
5 widely cited studies which, however, use a somewhat different operationalisation. We group
6 the location advantages as follows:
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- 10
11 ■ market-related variables: host market size, distance, common border,
- 12
13 ■ efficiency-oriented location factors: unit labour costs, effective tax rate,
- 14
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18 ■ transition-specific location factors: inflation, privatisation, political risk.
- 19

20 Moreover, as we use a gravity setting we also include home country size.

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25 The larger a home country, the greater the potential for FDI outflows *ceteris paribus*, which
26 suggests a positive coefficient on home country size (*gdphome*). With a larger market, there
27 is a greater likelihood that MNEs will be able to recoup the costs of their FDI (Navaretti and
28 Venables 2004). We therefore expect a positive sign of the estimated coefficient of host
29 market size (*gdphost*).
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36 While a larger distance (*dist*) between home and host country may encourage FDI due to an
37 Internalisation-advantage it may also discourage FDI due to the lack of market know-how,
38 higher communications and information costs and differences in culture and institutions
39 (Buch and Lipponer 2004). Hence, from a theoretical point of view the sign on the distance
40 coefficient is ambiguous *a priori* (see Markusen and Maskus 2002). Here, we expect a
41 negative sign as intra-firm trade flows between parent and affiliate tend to be high in the case
42 of vertical FDI (VFDI) where the costs of re-exporting are an important determinant of
43 overall cost. Secondly, even with horizontal FDI (HFDI), distance matters. If affiliates are
44 relatively new, as is often the case in the CEECs they typically depend on headquarter
45 services and intermediate inputs supplied by the parent. Thirdly, the negative impact of
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² Rather, in many cases it is the other way round, i.e. a listed acquired firm is de-listed from the stock exchange after the acquisition by a foreign MNE, in order to gain 100% ownership.

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3 distance on FDI has been shown by many empirical studies, notably by Markusen and
4
5 Maskus (2002), who discriminate between various theories of FDI.
6
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8 As explained above the average tax rate is the relevant measure of tax burden for *discrete*
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10 choices like the location decision of MNEs. Moreover, for international investment decisions
11
12 *beats* are the relevant location factor to reflect the tax component of the location decision of
13
14 MNEs. As taxes are a cost we expect a negative sign on the estimated coefficients.
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16

17 Privatisation revenues on an annual basis (*privrev*) are used to reflect progress in
18
19 privatisation. We expect a positive sign on the estimated coefficient, as a higher degree of
20
21 privatisation implies more investment opportunities for foreign investors arising from first-
22
23 mover advantage, competition effects etc. In our view this variable is a better measure of
24
25 privatisation progress than the index of the private-sector's share in the total economy, as
26
27 published by the EBRD, which is sometimes used. This index exhibits little variation over
28
29 time as it varies, if at all, only in steps of 5 percentage points, so that it may underestimate
30
31 the actual progress of privatisation.
32
33

34 Our labour cost variable is a measure of real unit labour costs in a common currency (*ulc*).
35
36 According to public opinion, low labour costs are among the most important determinants of
37
38 inward FDI in the CEEC-8. This reasoning is in line with evidence reported in Hunya (2004)
39
40 *inter alia*, who suggests that after the first wave of vertical FDI in the CEECs, FDI has
41
42 shifted "further East" within, and across, the CEECs due to increasing labour costs. In
43
44 general, high labour costs in the host country should exert a negative impact on FDI. Should
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46 the coefficient carry a positive sign, this could be an indication of an omitted variable
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48 problem, as in this case labour costs may capture effects of an increasing level of skill in the
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50 host country.
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54 In countries in transition, property rights may be insecure and political stability may be low.
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56 Hence, political *risk* may play a role as a determinant of FDI, too. As Navaretti and Venables
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58 (2004, p. 6) argue "political risk and instability seems to be an important deterrent to inward
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60 FDI". Political instability could seriously deteriorate the investment climate of a CEE host

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3 country and thus cause losses for foreign investors. We expect a negative relationship
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5 between political risk and FDI but a *positive* coefficient due to the measurement of political
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7 risk ranging from 0 (highest risk) to 25 (lowest risk).
8
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10 Inflation (*pp*) is included as a proxy for macroeconomic instability, which transition
11
12 countries may be confronted with (Buch and Lipponer 2004). We expect a negative sign on
13
14 the estimated coefficients.
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17 A common-border dummy-variable is considered in addition to *dist*, as centre-to-centre
18
19 distance may overstate the effective distance between home and host countries (Head 2003).
20
21 We expect a positive sign on the estimated coefficient.
22
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24 Tariffs (*tar*) are defined as the ratio of tariff revenues over imports of goods and services.
25
26 From a theoretical point of view the sign of the coefficient on this variable is ambiguous *a*
27
28 *priori* depending on the underlying motive for FDI. If the observed FDI is mainly HFDI, the
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30 market imperfection theory of FDI suggests a positive sign. In this case HFDI is observed
31
32 due to an Internalisation-advantage (“tariff-jumping” FDI). If, on the other hand, FDI is
33
34 mainly VFDI, theory suggests a negative sign (e.g. Frenkel et al. 2004; Navaretti and
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36 Venables 2004). In the case of VFDI high trade costs can be seen as a location disadvantage,
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38 which deters FDI.
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41 Table 1 summarises the discussion of individual location factors.
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47 [Table 1 here]
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52 *Descriptive data analysis*

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55 Our data set constitutes a balanced panel of bilateral net-FDI-outflows for seven home
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57 countries (i), eight host countries (j) and nine years (t), resulting in 504 observations.
58
59 However, as bilateral net-FDI-outflows can be negative, and the log of FDI is used as the
60
dependent variable, we are obliged to drop 45 observations (about 9 percent of our data set).

The search for unsystematic outliers³ in the dependent and independent variables via box-plots and added variable plots pinpoints four data points as potential outliers which are also dropped from the analysis. Table 2 shows the descriptive statistics for our dataset and reveals that the *between* variability is higher than the *within* variability. Our variable of interest, the *beatr*, has an overall mean of 34.8 percent and ranges between 16 percent (Austria – Bulgaria in 2002) and 56 percent (Italy – Czech Republic in 1995). The broad range is not only due to large differences in the statutory tax rates of the home and the host countries but also due to large differences in the withholding tax rates on dividends and interests as well as in allowances.

[Table 2 here]

4. Empirical Specification and Methodology

The basic panel-gravity-model includes the logarithm of home country and host market size, distance, country-pair specific effects as well as time dummies (Cheng and Wall 2004; Egger and Pfaffermayr 2003).⁴ The estimated model is a generalised panel-gravity model with various location factors added. It is shown in equation (1).

$$\ln FDI_{ijt} = b_1 \ln Y_{it} + b_2 \ln Y_{jt} + b_3 \ln DIST_{ij} + b_4 X_{ijt} + b_5 Z_{ij} + b_6 W_{jt} + \gamma_t + \alpha_{ij} + e_{ijt} \quad (1)$$

where:

$\ln FDI_{ijt}$ is the log of net-FDI-outflow from home country i to host country j at time t ($\ln fdi$);

$\ln Y_{it}$ is the log of GDP in country i at time t and the same for $\ln Y_{jt}$ for country j ($\ln gdp_{home}$ and $\ln gdp_{host}$);

$\ln DIST_{ij}$ is the log of the distance between countries i and j ($\ln dist$);

X_{ijt} are location factors which vary between country-pairs and over time (e.g. *beatr*);

Z_{ij} are location factors which vary over country-pairs only (i.e. *combord*);

W_{jt} are location factors which vary over time and over host countries (e.g. *pp*);

γ_t are time dummies (TD);

³ We define unsystematic outliers as data points which do not represent heterogeneity between the host countries. For example, using box plots the *ulc* for Slovenia are shown to be extreme values throughout the sample period. Hence, these data represent heterogeneity between the host countries which we exploit in our analysis.

⁴ These variables may be called “gravity-specific”.

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2
3 α_{ij} are country-pair-specific effects;
4 e_{ijt} is the remainder error term.
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6
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8 We regard the country-pair specific effects as random for two reasons. First, Hausman-tests⁵
9 on fixed versus random effects show that the random effects assumptions cannot be rejected.
10 Hence, using the random effects estimator results in more efficient estimates than the fixed
11 effects estimator, which can be inefficient as the cross-section dimension is large relative to
12 the time dimension (Pesaran et al. 1998). Using the random effects approach is in line with
13 several recent studies dealing with FDI, trade or capital flows to CEECs (e.g. Clausing and
14 Dorobantu 2005; Dawson and Hubbard 2004; Bevan and Estrin 2004; Gibson and
15 Tsakalotos 2004) and it allows estimating the impact of time fixed variables (i.e. *dist* and
16 *combord*) on FDI-flows. Second, from a more substantive point of view, the random effects
17 approach is relevant here as we are concerned with the decision of MNEs between various
18 host countries. In this decision, differences *between country-pairs* matter, which are
19 exploited by the random effects estimator. Concerning time effects we consider these to be
20 fixed. They account *inter alia* for the business cycle, for common shocks and common trends
21 (Egger and Pfaffermayr 2003).
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39 Our estimation strategy is based on two pillars. We first estimate equation (1) with the
40 gravity-specific variables only and include the *beatr*. Then we introduce additional location
41 factors stepwise to this basic specification (“pillar 1” strategy). Second, we apply a general
42 to specific strategy, starting with the most general model (1) and test down until a
43 specification is reached with all significant⁶ variables included (“pillar 2” strategy). This
44 procedure should reduce the probability of an omitted variable bias and it provides
45 information about the robustness of the tax-rate elasticity. An additional robustness and
46 stability analysis (see below) is carried out via the jackknife procedure with respect to host
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58 ⁵ We perform two types of Hausman-tests. First, if no serial correlation and heteroskedasticity seem to be present
59 and if the other requirements of the original Hausman-test are fulfilled (e.g. the difference between fixed effects
60 and random effects variance matrices is invertible) we use the original Hausman-test. Second, in case of non-
spherical errors or a non-positive definite difference in the fixed effects and random effects variance matrices we
follow Wooldridge (2002, p. 290ff.) and perform a regression based Hausman-test (with cluster robust standard
errors).

⁶ significantly different from zero at the 5% level

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2
3 countries included and via interacting the coefficient on *beatr*, *ulc* and *privrev* with a dummy
4
5 for the period 2000-2003. We always test for the presence of serial correlation in linear panel
6
7 data models (Wooldridge-test, Wooldridge 2002) and heteroskedasticity (LM-test, Verbeek
8
9 2004) in the residual error term. Furthermore, we inspect standard errors from different types
10
11 of robust covariance estimates (non-robust, White-robust; cluster-robust). In case statistical
12
13 tests do not show the presence of non-spherical residuals but the significance of our
14
15 estimates changes when more robust standard errors are used, we also present these results
16
17 for comparison reasons (cf. models 2b and 4b below).
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23 5. Results

24 *Tax-rate elasticities using effective tax rates*

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26
27 Table 3 shows the results of our “pillar 1” strategy. The coefficients on the *gravity-specific*
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29 *variables* are always significant with the expected signs, with the exception of home-country
30
31 size. The magnitude of the coefficients on distance and host-market size is reasonable as they
32
33 are in line with the theoretical prediction of the gravity model and with empirical evidence
34
35 for gravity models explaining international trade flows (Head 2003; Leamer and Levinsohn
36
37 1995). In some models, the relatively low and statistically insignificant coefficient on home-
38
39 country size is not unexpected as relatively small countries (Austria and The Netherlands)
40
41 are among the main source countries of FDI to CEECs.
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47 The coefficient on *beatr* is always statistically significant and negative, and falls in the range
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49 -3.3 and -4.6 (-5.7 excluding time dummies). Concerning other location factors considered,
50
51 only *privrev* and *ulc* have a statistically significant impact on net-FDI-outflows. All other
52
53 location factors carry the expected sign and the magnitude of their coefficients seems to be
54
55 economically meaningful, but they are statistically insignificant.⁷ The positive sign on *tar*
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57 does suggest the tariff jumping motive for FDI. But the insignificance of *tar* is plausible as
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7 For example, the coefficient on *combord* implies that sharing a border increases net-FDI-outflows by about 67%, a typical value for gravity models explaining international trade-flows (Head 2003).

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3 tariffs were brought down considerably during the first part of the 1990s and, hence, are of
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5 minor importance throughout our sample period.
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8 The insignificant coefficient on inflation points to the fact that inflation has decreased
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10 considerably in the CEEC-8 compared to earlier periods of transition. Studies including
11
12 earlier years and countries in macroeconomic turbulence (e.g. Edmiston et al. 2003) reveal
13
14 significant negative effects of inflation on FDI-flows. Political stability (*risk*) does not seem
15
16 to be a relevant location factor within the CEEC-8. This is in marked contrast to studies
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18 using data from the beginning of the transformation process till the end of the 1990ies (e.g.
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20 Carstensen and Toubal 2004; Frenkel et al. 2004). Furthermore, statistical tests show that
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22 time dummies are mostly jointly significant and that the random effects assumption can not
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24 be rejected.
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31 *[Table 3 here]*
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36 Turning to our “pillar 2” strategy, the results are reported in table 4. Model 8 is our most
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38 general model including all location factors as well as time dummies. The results are not
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40 very different from those of our „pillar 1“ strategy: *beatr*, *privrev* and *ulc* are statistically
41
42 significant with the expected signs, while all the other variables have the expected signs but
43
44 are statistically insignificant. Moreover the magnitude of the estimates is in line with those of
45
46 our „pillar 1“ strategy.
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48

49
50 Dropping insignificant variables step-by-step beginning with the most insignificant variable
51
52 and controlling for possible multi-collinearity effects we finally end up with model 9. This
53
54 includes the gravity-specific variables as well as *beatr*, *ulc* (both efficiency-related) and
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56 *privrev* (transition specific). Again, statistical tests show that the random effects specification
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58 is valid. Further tests suggest that model 9 has satisfactory properties from a statistical point
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60 of view. Studentised residuals do not show the presence of outliers using a cut off-level of
+/- 3.5 (Egger and Pfaffermayr 2003), the highest variance inflation factor of 3.95 implies

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3 that multi-collinearity should not be a problem in model 9 and a Reset-test suggests that our
4 linear specification is sufficient. Finally a regression based Hausman-test for endogeneity of
5 our privatisation variable in model 9, using the index of the private-sector share in the total
6 economy as well as dummies for the method of privatisation as instruments (see Carstensen
7 and Toubal 2004 and below) does not reject the null hypothesis of exogeneity (p-value =
8 0.38).
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24 The tax-rate elasticity in model 9 is -4.4^8 implying that a 1 percentage-point decrease in the
25 effective tax rate increases net-FDI-outflows, *ceteris paribus*, by about 4.4 per cent, which,
26 evaluated at the mean net-FDI-outflow of € 193.5 m., amounts to € 8.5 m. on average. Thus,
27 in the past, tax-lowering strategies of governments in the CEECs have had an important
28 effect on the allocation of FDI among the CEEC-8.
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34 The derived semi-elasticity is higher than the median value concerning CEECs reported
35 above and it is lower than those reported by DeMooij and Ederveen (2003 and 2005). As the
36 study by Carstensen and Toubal (2004) partly covers the same countries as well as a similar
37 time period, it is convenient to compare our results to those of their study. Their study is also
38 based on bilateral FDI data. The comparable median value of their semi-elasticities is -1.6
39 and is thus lower than ours in absolute value. It must be kept in mind, however, that besides
40 other differences to our study Carstensen and Toubal base their analysis on statutory tax
41 rates.
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53 To conclude the discussion on efficiency-related variables we take a closer look at the
54 impact of *ulc* on net-FDI-outflows. Model 9 shows that a one percentage-point increase in
55 *ulc* reduces net-FDI-outflows by about 3.1 percent. Comparing this estimate with those of
56 other studies is notoriously difficult, as almost every study uses an alternative definition of
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⁸ The mean value of all estimates is about -4.0.

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3 labour costs. Lansbury et al. (1994) use unit labour costs in a host country relative to other
4 potential hosts in Central Europe and find that it has a significant and negative impact on
5 FDI. Inclusion of relative wage and relative productivity measures as in Holland and Pain
6 (1998) appears to leave only the relative wage variable significant. Productivity differentials
7 across host countries do not appear significant. According to the authors this implies “that
8 considerations of comparative factor costs across countries influence some investment
9 decisions” (p. 16). Clausing and Dorobantu (2005) measure labour costs by the average
10 compensation rate in the host country and also find a negative effect throughout. Some
11 studies (e.g., Benassy-Quere et al., 2005, p. 590) even find a *positive* relationship between
12 FDI and labour costs, which is most likely attributable to an omitted variable problem. The
13 authors themselves state, that “unit labour costs are positively related to the quality of
14 labour.” (ibidem, p. 589) Hence labour costs include the impact different skill levels may
15 exert upon FDI-flows.
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32 Concerning the privatisation process, our analysis shows a significant and positive impact of
33 *privrev* throughout. At first sight, the coefficient on *privrev*, although significant and with
34 the correct sign, seems very low; *ceteris paribus*, net-FDI-outflows increase by about 0.03%
35 if privatisation revenues increase by one million euro. Yet, given that foreign MNEs have
36 been active in the CEEC-8 for some time now and that privatisation programmes are far
37 advanced, the share of FDI unrelated to privatisation processes *per se* should have increased.
38 This is what our result indicates.
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Other studies use the EBRD’s private-sector share in total economy (see Lansbury et al.
1996, Holland and Pain 1998; Carstensen and Toubal 2004) and/or the method of
privatisation (Holland and Pain 1998; Carstensen and Toubal 2004) to capture the effect of
the privatisation process on FDI. Using the private sector share often results in insignificant
coefficients, partly because the share variable does not vary much over time. In Carstensen
and Toubal (2004) and Holland and Pain (1998) the “method of privatisation” (i.e. vouchers
vs. other methods) turns out to have a significant effect on FDI inflows. Holland and Pain
conclude that “countries with a program of direct privatisation through cash sales have

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3 attracted relatively higher inward investment than those countries using voucher
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5 privatisation.” (p. 16) Clearly, the studies quoted here cover earlier time periods.
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10 *Relative importance of effective tax rates as a location factor*

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12 Table 5 shows the Beta coefficients corresponding to model 9.⁹ The gravity-specific
13 variables are the most important determinants of net-FDI-outflows. This result is in line with
14 many other studies (e.g. Mold 2003). Taxation and privatisation are equally important
15 location factors, while unit labour costs are slightly less important. These results imply that
16 the role of taxes should not be over-emphasised relative to that of other location
17 determinants.
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29 *An alternative measure of the corporate income tax burden*

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31 In order to check our argument that the appropriate tax rate is the effective tax rate we
32 replace the *beatr* by the statutory tax rate in model 9. Results for model 10 (reported in table
33 5) show the expected substantial drop of the semi-elasticity to about -2.4, although this
34 estimate falls short of statistical significance at the 5% level. This implies that the relatively
35 low value of the semi-elasticity derived in our meta-analysis is partly due to the use of
36 statutory tax rates in empirical studies. This result is also important with regard to evaluating
37 the effectiveness of governments’ tax cuts, which might have had a larger effect on inward
38 FDI than earlier studies have revealed.
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52 *[Table 5 here]*
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57 *Robustness and stability analysis*

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⁹ These are calculated by applying the usual formula for standardised coefficients on the random effects estimates using the overall standard deviations for the random effects transformed variables of model 9.

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3 We check the robustness of our preferred specification in model 9 against the impact of
4 possible cross-section outliers by dropping host countries stepwise (e.g. Winner 2005). Table
5 6 reports the resulting minimum and maximum values of the coefficient estimates and the
6 7 coefficient derived from our preferred specification (model 9) as well as the country
7 8 excluded. The results are robust with respect to dropping countries as no coefficient changes
8 9 sign and none becomes insignificant at the 10% level with the exception of the coefficient on
9 10 *ulc* when Slovenia is excluded (not shown). Hence, the relatively low FDI-flows to Slovenia
10 11 may be partly due to the high unit labour costs when compared to other host countries in our
11 12 sample.
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[Table 6 here]

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The stability of the coefficients on *beatr*, *ulc* and *privrev* is checked by combining these variables with a dummy variable for the years 2000-2003. The year 2000 has been chosen as some host countries (notably Romania and the Slovak Republic) started to reduce their *beatr* since 2000. Table 7 (models 11 to 13) shows that the semi-elasticities for *beatr* and *ulc* for the period 2000-2003 are not significantly different from that of previous years, but that the importance of privatisation as a driver of FDI is significantly lower from 2000 onwards. This last result seems to be plausible as the privatisation process levelled off in many CEECs around 2000 (EBRD transition report, various issues). In contrast, the sensitivity of FDI with respect to taxation and unit labour costs has not changed during this period.

[Table 7 here]

6. Summary

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3 The aim of this paper was to test the hypothesis that a high corporate tax burden acts as a
4 deterrent to FDI-flows, since it exerts a negative effect on the profitability of investments.
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6 We suggest that using the statutory tax rate in previous studies might blur the effects of the
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8 tax burden on FDI and lead to questionable results. Therefore, we use the bilateral effective
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10 average tax rates to explaining net-FDI-outflows from the 7 most important home countries
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12 to the CEEC-8. Referring to the eclectic paradigm as a conceptual basis, we find in a panel-
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14 gravity setting that FDI is positively related to both source country and host-market size as
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16 well as to progress in privatisation. Also, FDI is inversely related to the distance separating
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18 home and host countries, to the corporate tax burden and to unit labour costs. Concerning the
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20 role of taxes three points are worth noting:
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27 First, the derived tax-elasticity is robust across various specifications and is greater in
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29 absolute value than those reported in earlier studies on the CEECs, pointing to a greater
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31 importance of tax policy for company location decisions than previously acknowledged.
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35 Second, the differences in the absolute value of the semi-elasticities when compared to
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37 earlier studies are clearly partly due to the use of *beatrs*. The derived semi-elasticity after
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39 replacing the *beatr* by *statrate* in our study is, indeed, substantially lower.
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42 Third, the relative importance of the corporate tax rate as a determinant of FDI must not be
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44 over-emphasised as our results (Beta-coefficients) reveal that at least during the period 1995-
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46 2003 the tax burden had no exceptional influence on net-FDI-outflows to the CEEC-8 when
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48 compared to other determinants.
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51 While this study is a step towards a greater understanding of FDI-flows to the CEECs, there
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53 are several limitations to our analysis; in particular, we are conscious of the exclusion of
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55 location factors such as the size and quality of public infrastructure. This omission is due to
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57 the lack of meaningful data. Moreover, special investment incentives (e.g. regional, R&D)
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59 are not included, as many different incentives have been granted by CEEC governments
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throughout the sample period of nine years. The choice of incentives to be included in the
beatr would be arbitrary. Finally, many CEECs have reduced their special investment

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3 incentives to MNEs during our survey period in accordance with the aquis communautaire of
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5 the EU. For example, Boudier-Bensebaa (2005) reported that, in Hungary, special tax
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7 incentives for MNEs have increasingly been phased out, or that domestic and foreign firms
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9 are now treated equally. Further research should focus on a meaningful operationalisation of
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11 these factors.
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For Peer Review

Table 1: Country-level Location Factors related to Market- and Efficiency-oriented FDI

	Source	Variable	Expected Sign
<i>Market-specific</i>			
(a) $gdphome_{it}$ §	Eurostat: New Cronos database	Home country size measured as GDP home country in €m.	+
(b) $gdphost_{jt}$ §	Eurostat: New Cronos database	Host market size measured as GDP host country in €m.	+
<i>Efficiency-specific</i>			
(c) $dist_{ij}$ §	http://www.wcrl.ars.usda.gov/cec/java/lat-long.htm	Distance in kilometres	-
(i) $combord_{ij}$	Maps	Common border; Dummy variable: 1 if common border	+
(d) $beatr_{ijt}$	Our own calculations based on Devereux and Griffith 1999; assumptions follow Devereux and Griffith except that we give investment in inventory less and investment in buildings more weight, as data for the CEECs show that investment in inventories is of minor importance; tax data are taken from the European Tax Handbook and KPMG's Corporate Tax Rate Surveys	Bilateral effective average tax rate; measured in per cent	-
(e) ulc_{jt}	Own calculations based on van Ark and Monnikhof 2000; data are taken from the AMECO database and the WIIW database	Real unit labour costs in common currency (Euro); measured in per cent	-
<i>Transition-specific</i>			
(f) $privrev_{jt}$	Own calculations; EBRD: Transition Report	Annual privatisation revenues in €m.	+
(g) $risk_{jt}$	Euromoney	Political Risk; index ranging from 0 to 25	+
(h) pp_{jt}	EBRD: Transition Report	Inflation measured as the percentage increase in producer prices.	-
(i) tar_{jt}	Own calculations; ratio of taxes and duties on imports excluding VAT over imports of goods and services; Eurostat: New Cronos database	Percentage tariffs on imports.	?

§ these variables are the "core" gravity variables

Table 2: Descriptive Statistics

Variable		Mean	Std. Dev.	Min	Max	Observations
<i>lnfdi</i>	overall	4.02	1.75	-0.43	7.81	N = 449
	between		1.39	1.66	7.19	n = 56
	within		1.11	0.60	7.94	T = 8.02
<i>lngdphome</i>	overall	13.90	1.10	12.11	16.24	N = 449
	between		1.12	12.20	16.09	n = 56
	within		0.14	13.43	14.24	T = 8.02
<i>lngdphost</i>	overall	10.40	0.76	8.96	12.24	N = 449
	between		0.75	9.38	11.94	n = 56
	within		0.21	9.93	10.88	T = 8.02
<i>lnDIST</i>	overall	6.99	0.98	4.03	9.15	N = 449
	between		0.99	4.03	9.15	n = 56
	within		0.00	6.99	6.99	T = 8.02
<i>beatr</i>	overall	34.79	7.43	16.11	55.92	N = 449
	between		5.37	24.07	48.07	n = 56
	within		5.08	17.52	47.06	T = 8.02
<i>ulc</i>	overall	24.61	9.23	11.00	50.00	N = 449
	between		8.77	15.42	46.14	n = 56
	within		2.89	15.61	32.41	T = 8.02
<i>privrev</i>	overall	1223.80	1157.48	58.16	4570.03	N = 449
	between		908.25	93.03	2712.47	n = 56
	within		739.74	-19.38	4375.46	T = 8.02
<i>pp</i>	overall	28.08	112.81	-1.20	901.80	N = 449
	between		43.94	1.92	154.04	n = 56
	within		104.10	-122.55	803.66	T = 8.02
<i>risk</i>	overall	13.88	3.32	5.32	19.82	N = 449
	between		2.90	9.59	17.48	n = 56
	within		1.64	7.73	17.39	T = 8.02
<i>tar</i>	overall	4.34	3.83	0.50	18.45	N = 449
	between		3.07	0.95	11.71	n = 56
	within		2.28	-0.17	13.43	T = 8.02
<i>combord</i>	overall	0.31	0.33	0.00	1.00	N = 449
	between		0.33	0.00	1.00	n = 56
	within		0.00	0.13	0.13	T = 8.02

Table 3: „Pillar 1“ Results

Model 1		Model 2a		Model 2b	
<i>lngdphome</i>	0.29026 (1.78)		0.34597** (2.48)		0.46472*** (3.21)
<i>lngdphost</i>	1.27140*** (8.02)		1.34399*** (8.99)		1.44075*** (10.70)
<i>lndist</i>	-0.60524*** (-3.28)		-0.67522*** (-4.35)		-0.76821*** (-4.55)
<i>beatr</i>	-0.03476*** (-2.85)		-0.04636*** (-3.42)		-0.05685*** (-5.80)
		<i>ulc</i>	-0.03316*** (-2.88)	<i>ulc</i>	-0.03439*** (-2.99)
cons	-7.74253*** (-3.34)		-7.59421*** (-3.94)		-9.21078*** (-4.70)
N	449	N	449	N	449
R ²	within = 0.2960 between = 0.5913 overall = 0.4638	R ²	within = 0.2957 between = 0.6485 overall = 0.4981	R ²	within = 0.2516 between = 0.6493 overall = 0.4818
AR(1): χ^2_1	= 1.232	χ^2_1	= 1.207	χ^2_1	= 2.005
Het.: χ^2_{12}	= 18.39	χ^2_{13}	= 19.07	χ^2_5	= 8.966
TD: χ^2_8	= 24.01***	χ^2_8	= 13.45	<i>not included^a</i>	
Hausman: χ^2_3	= 5.88	χ^2_4	= 8.32	χ^2_4	= 7.69
BP: χ^2_1	= 226.88***	χ^2_1	= 162.35***	χ^2_1	= 153.38***

Model 3		Model 4a		Model 4b	
<i>lngdphome</i>	0.28124 (1.81)		0.27291 (1.65)		0.40092** (2.52)
<i>lngdphost</i>	0.98886*** (5.98)		1.23147*** (6.96)		1.32896*** (8.14)
<i>lndist</i>	-0.59529*** (-2.84)		-0.57739*** (-3.03)		-0.67614*** (-3.61)
<i>beatr</i>	-0.03379*** (-2.84)		-0.03512*** (-2.44)		-0.04482*** (-4.68)
<i>privrev</i>	0.00029*** (4.29)	<i>risk</i>	0.02111 (0.58)	<i>risk</i>	0.02252 (0.73)
cons	-5.03765** (-2.19)		-7.59143*** (-3.61)		-9.38413*** (-4.36)
N	449	N	449	N	449
R ²	within = 0.3205 between = 0.6248 overall = 0.4927	R ²	within = 0.2984 between = 0.5834 overall = 0.4601	R ²	within = 0.2549 between = 0.5813 overall = 0.4416
AR(1): χ^2_1	= 1.304	χ^2_1	= 0.935	χ^2_1	= 1.737
Het.: χ^2_{13}	= 20.78	χ^2_{13}	= 19.99	χ^2_5	= 7.480
TD: χ^2_8	= 29.21***	χ^2_8	= 15.43	<i>not included^a</i>	
Hausman: χ^2_4	= 5.4	χ^2_4	= 8.88	χ^2_4	= 7.38
BP: χ^2_1	= 213.27***	χ^2_1	= 210.83***	χ^2_1	= 196.99***

^a Model_2a and model_4a: cluster robust standard errors change significance of time dummies but not that of other variables. Model_2b and model_4b hence exclude time dummies.

Table 3: „Pillar 1“ Results (cont’)

	Model 5	Model 6	Model 7
<i>lngdphome</i>	0.28021	0.32341**	0.23844
	(1.70)	(2.04)	(1.40)
<i>lngdphost</i>	1.24630***	1.37563***	1.25056***
	(7.66)	(8.17)	(7.80)
<i>Indist</i>	-0.59275***	-0.65996***	-0.45979**
	(-3.16)	(-3.86)	(-2.01)
<i>beatr</i>	-0.03254**	-0.03440***	-0.03472***
	(-2.61)	(-2.76)	(-2.84)
<i>pp</i>	-0.00044	<i>tar</i> 0.04499	<i>combord</i> 0.51741
	(-0.86)	(1.43)	(1.08)
cons	-7.48229***	-9.04955***	-7.87836***
	(-3.17)	(-3.78)	(-3.37)
N	449	N 449	N 449
R ²	within: 0.2980 between: 0.5894 overall: 0.4633	R ² within = 0.3004 between = 0.5949 overall = 0.4671	R ² within = 0.2964 between = 0.5990 overall = 0.4677
AR(1): χ^2_1	= 1.193	χ^2_1 = 1.209	χ^2_1 = 1.232
Het.: χ^2_{13}	= 18.40	χ^2_{13} = 26.109**	χ^2_{13} = 19.259
TD: χ^2_8	= 24.52***	χ^2_8 = 28.33***	χ^2_8 = 24.59***
Hausman: χ^2_4	= 8.92	χ^2_4 = 7.36	χ^2_4 = 5.55
BP: χ^2_1	= 227.50***	χ^2_1 = 228.82***	χ^2_1 = 213.27***

*** p < 0.01; ** p < 0.05; t-values in parenthesis; Het: LM-test for heteroskedasticity in fixed effects model; TD: time dummies; BP: Breusch-Pagan-test for random individual effects; Hausman: Hausman-test or Hausman-Wooldridge-test for fixed vs. random effects; AR(1): Wooldridge-test for serial correlation in linear panel data models

Table 4: „Pillar 2“ Results

Model 8		Model 9	
<i>lngdphome</i>	0.24030 (1.61)	0.32967** (2.27)	
<i>lngdphost</i>	0.99097*** (5.58)	1.05707*** (6.63)	
<i>Indist</i>	-0.42646** (-2.18)	-0.65757*** (-4.35)	
<i>beatr</i>	-0.04360*** (-3.51)	-0.04370*** (-3.50)	
<i>privrev</i>	0.00028*** (3.54)	0.00029*** (3.79)	
<i>ulc</i>	-0.03739*** (-3.26)	-0.03076*** (-2.67)	
<i>combord</i>	0.73066 (1.81)		
<i>pp</i>	-0.00083 (-1.58)		
<i>risk</i>	0.03424 (1.10)		
<i>tar</i>	0.02148 (0.67)		
<i>cons</i>	-5.06197** (-2.27)	-4.898357** (-2.20)	
N	449	N	449
R ²	within = 0.3311 between = 0.6776 overall = 0.5280	R ²	within = 0.3235 between = 0.6603 overall = 0.5155
AR(1): $\chi^2_1 =$	0.960	$\chi^2_1 =$	1.276
Het.: $\chi^2_{18} =$	35.593***	$\chi^2_{14} =$	21.535
TD: $\chi^2_8 =$	29.66***	$\chi^2_8 =$	28.32***
Hausman: $\chi^2_8 =$	10.32	$\chi^2_{13} =$	13.35
BP: $\chi^2_1 =$	151.79***	$\chi^2_1 =$	175.14***
		Reset: $\chi^2_3 =$	5.04
		stud.res > 3.5 :	0
		Highest VIF:	3.95
Hausman-test for endogeneity		1 st stage F-value =	10.65
		2 nd stage p-value =	0.38

*** p < 0.01; ** p < 0.05; t-values in parenthesis; stud.res: studentized residuals; VIF: variance inflation factor; Het.: LM-test for heteroskedasticity in fixed effects model; TD: time dummies; BP: Breusch-Pagan-test for random individual effects; Hausman: Hausman-test or Hausman-Wooldridge-test for fixed vs. random effects; AR(1): Wooldridge-test for serial correlation in linear panel data models; Reset: Ramsey-functional-form-test

Table 5: Beta Coefficients and Statutory Tax Rate

Beta Coeff.		Model 10
<i>lngdphome</i>	0.173	0.26277 (1.69)
<i>lngdphost</i>	0.396	1.04806*** (6.15)
<i>lndist</i>	-0.261	-0.60497*** (-3.67)
<i>beatr</i>	-0.192	<i>statrate</i> -0.02360 (-1.78); p = 5.1
<i>privrev</i>	0.191	0.00027*** (3.57)
<i>ulc</i>	-0.115	-0.02546** (-2.09)
cons	—	-5.057145** (-2.12)
N	449	N 449

*** p < 0.01; ** p < 0.05; t-values in parenthesis; Overall standard deviations from random effects transformed variables are used to calculate beta coefficients. The values used are: 1.264 (*lnfdi*), 0.664 (*lngdphome*), 0.474 (*lngdphost*), 0.502 (*lndist*), 5.552 (*beatr*), 832.988 (*privrev*) and 4.716 (*ulc*).

Table 6: Jackknife Analysis

	Minimum (in absolute value)	Host country excluded	Estimate	Maximum (in absolute value)	Host country excluded
<i>beatr</i>	-3.17** (-2.45)	Czech Republic	-4.40***	-5.80*** (-4.38)	Croatia
<i>ulc</i>	-1.99* (-1.61)	Czech Republic	-3.10***	-4.40*** (-3.08)	Romania
<i>privrev</i>	0.02** (2.64)	Hungary	0.03***	0.04*** (3.63)	Czech Republic
*** p < 0.01; ** p < 0.05; * p < 0.1; t-values in parenthesis					

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Table 7: Stability Analysis

Model_11		Model_12		Model_13	
<i>lngdphome</i>	0.33443**		0.33157**		0.32780**
	(2.54)		(2.43)		(2.41)
<i>lngdphost</i>	1.06292***		1.01179***		1.05694***
	(5.97)		(5.82)		(5.95)
<i>lndist</i>	-0.66290***		-0.66850***		-0.65628***
	(-4.49)		(-4.34)		(-4.32)
<i>beatr</i>	-0.04666***		-0.03725***		-0.04277***
	(-2.93)		(-2.89)		(-3.14)
<i>dummybeatr</i>	0.00259	<i>privrev</i>	0.00044***		0.00029***
	(0.12)		(4.75)		(3.38)
<i>privrev</i>	0.00029***	<i>dummypriv</i>	-0.00031***	<i>ulc</i>	-0.03010**
	(3.39)		(-2.79)		(-2.36)
<i>ulc</i>	-0.03126***		-0.02565**	<i>dummyulc</i>	-0.00219
	(-2.71)		(-2.26)		(-0.16)
cons	-4.96785**		-4.50656**		-4.86455**
	(-2.28)		(-2.18)		(-2.32)
N	449	N	449	N	449

*** p < 0.01; ** p < 0.05; t-values in parenthesis

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1
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3 Acknowledgement
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5 We are grateful to the Austrian Science Fund for providing financial support by grant
6 F 2008.
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Do low corporate income tax rates attract FDI? – Evidence from Central- and East European Countries

1 Introduction

Foreign Direct Investment (FDI) is carried out by Multinational Enterprises (MNEs) in order to earn profits. The profitability of FDI is expected to decrease with increases in energy prices, taxes, labour costs etc. Concerning taxation, the negative relationship between tax burden and FDI inflows is basically confirmed by the empirical evidence for OECD countries. (e.g. De Mooij and Ederveen 2003 and 2005) However, the empirical evidence concerning FDI and taxation in the Central- and East European Countries (CEECs) has consistently not found evidence that taxes matter for location decisions (see below).

We suggest that one possible reason for this somewhat unexpected evidence for the CEECs in the empirical FDI-taxation literature is due to the use of a flawed indicator of tax burden. These flaws, we argue, can be remedied.

The present paper differs from previous studies by including a theoretically well founded measure of the tax burden, namely forward-looking effective tax rates derived by Devereux and Griffith (1999), rather than the statutory tax rate, which has various shortcomings in explaining FDI.

In this paper we examine first of all whether there is any substance in the belief that corporate tax rates are an important location factor for FDI from 7 home countries to 8 CEECs.¹ Secondly, we investigate whether, and to what extent, the choice of measure of the tax burden affects the tax elasticity of FDI. This is mainly motivated by the fact that there has been a gap between the conceptually ideal measure of the tax burden and its operational counterpart in empirical models in earlier studies. Thirdly, we compare the role of the corporate tax burden to that of other location determinants.

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3 Our empirical results show that the semi-elasticity of FDI with respect to taxation is about -
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5 4.3. This is above those of earlier studies in absolute terms and can partly be attributed to
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7 using a superior measure of the corporate tax burden than the statutory tax rate. The results
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9 indicate that tax-lowering strategies of CEEC governments seem to have an important
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11 impact on foreign firms' location decisions.
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15 The remainder of the paper is structured as follows. Section 2 provides some conceptual
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17 background and a review of previous studies. Section 3 describes our data set and the
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19 variables used. Section 4 describes the empirical specification and methodology used in the
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21 estimation. Section 5 presents the estimation results and discusses their significance in
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23 relation to earlier studies. Section 6 provides a summary of our main findings.
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26 27 28 2. Some Conceptual Considerations and a Review of Previous Studies 29 30

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32 The question why a particular country succeeds in competing for inward FDI can be
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34 answered by reference to the eclectic paradigm (Dunning 1988; Markusen 1995). With
35
36 reference to various theories (e.g. Trade Theory, Theory of the Firm and Theory of Industrial
37
38 Organisation) the eclectic paradigm avers that FDI emerges if a firm has an Ownership-
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40 advantage (e.g. a patent) combined with a Location-advantage (e.g. low production costs;
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42 large market size) and an Internalisation-advantage (e.g. economies of interdependent
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44 activities).
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48 The particular location factors considered by the firm in choosing between different *foreign*
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50 markets have to be valid proxies for host-country Location-advantages. The eclectic
51
52 paradigm incorporates all possible location factors which attract FDI *conditional* on a firm's
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54 decision to undertake FDI. This poses a problem as it neither attributes weights to single
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56 location factors like taxation, nor does it assess their relative weights. Hence empirical
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¹ The home countries are Austria, France, Germany, Italy, the Netherlands, the United Kingdom and the United States. The host countries are Bulgaria, Croatia, the Czech Republic, Hungary, Poland, Romania, Slovakia and Slovenia (CEEC-8).

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3 applications based upon the eclectic paradigm have to rely on more or less *ad hoc*
4 specifications.
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8 Recently gravity-models have been used to explain not only bilateral trade-flows but also
9 bilateral FDI-flows (e.g. Brainard 1997). These models can easily be combined with the
10 eclectic paradigm. Empirical models explaining bilateral FDI-flows should be based on a
11 Panel-gravity setting.
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17 Location-advantages can be classified in terms of factors which are efficiency-- or market-
18 related, supply and demand based (e.g. Mold 2003) or transition specific (Carstensen and
19 Toubal 2004). Our variable of main interest, the corporate income tax burden, clearly falls
20 into the efficiency and supply related categories.
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26 As the tax burden is a factor which reduces profitability in the host-country, it should be
27 negatively related to the inflow of FDI.² In general, few studies have dealt with taxes as
28 drivers of FDI to the CEECs. Recently, *anonymous* (2006a) surveyed eight papers, which
29 dealt explicitly with FDI to the CEECs, in order to ascertain their tax-rate elasticities. The
30 outcome suggests a median tax-rate elasticity of around -1.45 (semi-elasticity). This result
31 implies that a 1 percentage point decrease in the tax rate will increase FDI inflows by 1.45
32 percent. As almost all of the studies surveyed used statutory tax rates as a measure of the
33 corporate tax burden, the result is in line with the tax-rate elasticities found by DeMooij and
34 Ederveen (2003 and 2005), i.e. -1.2 and -2.05, respectively.
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46 However, we question this low tax-rate elasticity. The statutory tax rate is not an appropriate
47 indicator of the tax burden, especially in the case of FDI, because it does not include all
48 relevant tax codes. From a conceptual and empirical point of view, bilateral forward-looking
49 effective average tax rates (beatrs) should be used (Devereux and Griffith 1999 and 2002).
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56 ² Having described the general relationship between FDI and lower taxes, the story could, however, be
57 different on a more disaggregated level. We are grateful to the referee for raising this problem. First,
58 footloose manufacturing sectors may react differently to service sectors. Second, different tax
59 incentives etc. may apply on the sectoral level. Recently this issue was analysed empirically by
60 Stöwhase (2005). He shows that the tax sensitivity of FDI depends crucially on the sector receiving
the capital flow. This raises the possibility of an over- or underestimation of sectoral tax elasticities on
the aggregate level. Given the difficulties of obtaining appropriate data at a reasonable scale at

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3 Hence the estimated tax-rate elasticities from statutory tax-rates are probably flawed. In our
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5 study, we follow Devereux and Griffith (1999) and use beats. We expect a higher tax-rate
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7 elasticity than the one based on statutory tax rates as the meta-analyses by DeMooij and
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9 Ederveen (2003 and 2005) show tax-rate elasticities of -9.3 and -5.9 respectively, when
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11 effective average tax-rates are used.
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13
14 In addition, the negative but low median semi-elasticity derived by *anonymous* (2006a) may
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16 also be explained *inter alia* by the following facts, which are partly transition-specific. First,
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18 since relatively little FDI is efficiency-oriented but most is horizontal FDI other location
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20 factors are believed to be important, too. In the case of the CEECs, location factors specific
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22 to the transition process such as hyper-inflation, privatisation, recession, etc. may play an
23
24 important role. Second, the more varied the mix of location factors in competing host
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26 countries, the smaller should be the influence of a single factor such as taxation. It follows
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28 that the tax burden should be more important the more similar potential host countries are
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30 with respect to other location factors, *ceteris paribus*. Third, MNEs may avoid taxes via
31
32 profit shifting. Fourth, insofar as FDI-flows contribute to expansionary investment in the
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34 existing capital stock, it may react less than in the case of new investment and Greenfield
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36 investment in particular.
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43 44 3. Data and Variables

45 46 *Dependent Variable*

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48 The bilateral net-FDI-outflow in millions of euro from home country (i) to host country (j)
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50 for the years 1995 to 2003 (t), is used as the dependent variable (*fdi*). Data are mainly taken
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52 from the ‘OECD International Direct Investment Statistics Yearbook’ and the ‘OECD
53
54 Foreign Direct Investment’ database. Missing values are substituted by information from
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56 Eurostat’s ‘New Cronos’ database and from National Statistical Offices.
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present, we have not followed this strategy. As more data will become available in the future, sectoral analyses will show the size of the bias incurred.

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3 The fact that we use net-FDI-outflows in our study requires some explanation, as criticism
4 has frequently been directed at this measure. In particular, some authors argue that FDI-
5 flows reflect financial flows only and not necessarily real-capital formation in the host
6 country (see Devereux and Griffith 2002, p. 84f.). These authors conclude that there is a
7 superior measure, namely plant, property and equipment (PPE), which reflects real capital
8 (fixed assets).
9

10
11 In our view net-FDI-outflows indeed represent the annual decisions of MNEs, either to
12 invest Greenfield or to acquire a foreign firm directly or to expand an existing affiliate or to
13 divest in the CEECs. Net-FDI-outflows include (i) equity of the parent company in the
14 subsidiary, (ii) net-loans between parent and affiliate, as well as (iii) reinvested earnings. In
15 addition, local financing in the form of raising new capital, or taking loans, contributes to the
16 affiliate's capital (iv). Empirically, using FDI-flows as the dependent variable may thus
17 overestimate or underestimate "real investment". *Overestimation* may result from the fact
18 that financial flows, which are unrelated to investment activities of the affiliate, may enter
19 the components (i), (ii) or (iii). For example, transfer pricing via overvaluing services or
20 goods by the affiliate inflates reinvested earnings. Another source of overestimation is the
21 capital provided by the parent company to cover losses of the affiliate abroad.
22 *Underestimation* of real capital formation results from the fact that the local financing
23 (component iv) is excluded from FDI-flow figures.
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45 In the case of the CEECs, over- and under-estimation effects of real capital by FDI-flows
46 tend to exist but should be rather small. Profit shifting via transfer pricing might play a
47 certain role, as the CEECs are low-tax countries in general, but underestimation due to local
48 new equity financing is probably of minor importance.³
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54 Thus, we are left with 'local loans' as the most serious remaining source of under-estimating
55 real capital. Falcetti et al. (2003) reported that the ratio of total domestic credit to annual
56 GDP was only 43.2 per cent in Central and Eastern Europe and the Baltic States, while it was
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³ Rather, in many cases it is the other way round, i.e. a listed acquired firm is de-listed from the stock exchange after the acquisition by a foreign MNE, in order to gain 100% ownership.

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3 108.8 per cent in the Euro Area on average. Still in 2005, the EBRD's Transition Report
4 concludes on "financial sector vulnerabilities in Hungary", one of the most advanced
5 countries of the CEEC-8.
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10 In summary, we are convinced that, due to the minor importance of local financing, net-FDI-
11 outflow to the CEECs is a reasonable proxy for the annual real capital formation of affiliates
12 abroad.
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16 17 18 19 20 *Independent Variables*

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22 The independent variables have to be valid proxies for host-country related Location-
23 advantages. We base our choice of independent variables on the findings of some recent and
24 widely cited studies which, however, use a somewhat different operationalisation. We group
25 the Location-advantages as follows:
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30 ■ market-related location factor: host market size
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32 ■ efficiency-related location factors: unit labour costs, effective tax rate, distance,
33 common border
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35 ■ transition-specific location factors: inflation, privatisation, political risk.
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41 Moreover, as we use a gravity setting we also include home country size as another market-
42 related variable.
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49 The larger a home country, the greater the potential for FDI outflows *ceteris paribus*, which
50 suggests a positive coefficient on home country size (*gdphome*). With a larger market, there
51 is a greater likelihood that MNEs will be able to recoup the costs of their FDI (Barba
52 Navaretti and Venables 2004). We therefore expect a positive sign of the estimated
53 coefficient of host market size (*gdphost*).
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59 While a larger distance (*dist*) between home and host country may encourage FDI due to an
60 Internalisation-advantage it may also discourage FDI due to the lack of market know-how,

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3 higher communication and information costs and differences in culture and institutions
4 (Buch and Lipponer 2004). Hence, from a theoretical point of view the sign on the distance
5 coefficient is ambiguous *a priori* (see Markusen and Maskus 2002). Here, we expect a
6 negative sign as intra-firm trade flows between parent and affiliate tend to be high in the case
7 of vertical FDI (VFDI) where the costs of re-exporting are an important determinant of
8 overall cost. Secondly, large distance will impact negatively even on horizontal FDI (HFDI).
9
10 . If affiliates are relatively new, as is often the case in the CEECs they typically depend on
11 headquarter services and intermediate inputs supplied by the parent. Thirdly, the negative
12 impact of distance on FDI has been shown by many empirical studies, notably by Markusen
13 and Maskus (2002), who discriminate between various theories of FDI.
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18 As outlined above the average tax rate is the relevant measure of tax burden for *discrete*
19 choices like the location decision of MNEs. Moreover, for international investment decisions
20 *beats* are the relevant location factors. As taxes are a cost we expect a negative sign on the
21 estimated coefficients.
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26 Privatisation revenues on an annual basis (*privrev*) are used to reflect progress in
27 privatisation. We expect a positive sign on the estimated coefficient, as a higher degree of
28 privatisation implies more investment opportunities for foreign investors arising from first-
29 mover advantages, competition effects etc. In our view this variable is a better measure of
30 privatisation progress than the index of the private-sector's share in the total economy, as
31 published by the EBRD, which is sometimes used. This index exhibits little variation over
32 time as it varies, if at all, only in steps of 5 percentage points, so that it may underestimate
33 the actual progress of privatisation.
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38 Following *anonymous* (2006b) our labour cost variable is a measure of real unit labour costs
39 in a common currency (*ulc*). According to public opinion, low labour costs are among the
40 most important determinants of inward FDI in the CEEC-8. This reasoning is in line with
41 evidence reported in Hunya (2004), who suggests that after the first wave of VFDI in the
42 CEECs, FDI has shifted "further East" within and across the CEECs due to increasing labour
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3 costs. In general, high labour costs in the host country should exert a negative impact on
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5 FDI.⁴
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8 In countries in transition, property rights may be insecure and political stability may be low.
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10 Hence, political *risk* may play a role as a determinant of FDI. As Barba Navaretti and
11
12 Venables (2004, p. 6) argue “political risk and instability seems to be an important deterrent
13
14 to inward FDI”. Political instability could seriously deteriorate the investment climate of a
15
16 CEEC and thus cause losses for foreign investors. We expect a negative relationship between
17
18 political risk and FDI but a *positive* coefficient due to the measurement of political risk
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20 ranging from 0 (highest risk) to 25 (lowest risk).
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23 Inflation (*pp*) is included as a proxy for macroeconomic instability, which may occur
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25 especially in transition countries (Buch and Lipponer 2004). We expect a negative sign on
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27 the estimated coefficients.
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30 A common-border dummy-variable is considered in addition to *dist*, as centre-to-centre
31
32 distance may overstate the effective distance between home and host countries (Head 2003).
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34 We expect a positive sign on the estimated coefficient.
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37 Tariffs (*tar*) are defined as the ratio of tariff revenues over imports of goods and services.
38
39 From a theoretical point of view the sign of the coefficient on this variable is ambiguous *a*
40
41 *priori* depending on the underlying motive for FDI. If the observed FDI is mainly HFDI, the
42
43 market imperfection theory of FDI suggests a positive sign. In this case HFDI is observed
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45 due to an Internalisation-advantage (“tariff-jumping” FDI). If, on the other hand, FDI is
46
47 mainly VFDI, theory suggests a negative sign (e.g. Barba Navaretti and Venables 2004). In
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49 the case of VFDI high trade costs can be seen as a Location-disadvantage, which deters FDI.
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53 Table 1 summarises the discussion of individual location factors.
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58 [Table 1 here]
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⁴ Should the coefficient carry a positive sign, this could be an indication of an omitted variable problem, as in this case labour costs may capture effects of an increasing level of skill in the host country.

Descriptive data analysis

Our data set constitutes a balanced panel of bilateral net-FDI-outflows for seven home countries (i), eight host countries (CEEC-8) (j) and nine years (t), resulting in 504 observations. However, as bilateral net-FDI-outflows can be negative, and the log of FDI is used as the dependent variable, we are obliged to drop 45 observations (about 9 percent of our data set). The search for unsystematic outliers⁵ in the dependent and independent variables via box-plots and added variable plots pinpoints four data points as potential outliers which are also dropped from the analysis. Table 2 shows the descriptive statistics for our dataset and reveals that the *between* variability is higher than the *within* variability. Our variable of interest, the *beatr*, has an overall mean of 34.8 percent and ranges between 16 percent (Austria – Bulgaria in 2002) and 56 percent (Italy – Czech Republic in 1995). The broad range is not only due to large differences in the statutory tax rates of the home and the host countries but also due to large differences in the withholding tax rates on dividends and interests as well as in allowances. This again is a strong hint of the importance to exploit the considerable heterogeneity across host countries and in bilateral relationships to their home countries.

[Table 2 here]

Table 3 shows the correlation matrix of the various location factors used in the empirical study. No correlation coefficient is above 0.8 in absolute value, which is often used as a threshold value. As low pairwise correlation coefficients are not sufficient for concluding that the variables are not highly multicollinear we provide further evidence using variance inflation factors in the empirical analysis (e.g. Kennedy 2003).

⁵ We define unsystematic outliers as data points which do not represent heterogeneity between the host countries. For example, using box plots the *ulc* for Slovenia are shown to be extreme values throughout the sample period. Hence, these data represent heterogeneity between the host countries which we exploit in our analysis.

[Table 3 here]

4. Empirical Specification and Methodology

The basic panel-gravity-model includes the logarithm of home country and host market size, distance, country-pair specific effects as well as time dummies (Egger and Pfaffermayr 2003).⁶ The model applied is a generalised panel-gravity model with various location factors added. It is shown in equation (1).

$$\ln FDI_{ijt} = b_1 \ln Y_{it} + b_2 \ln Y_{jt} + b_3 \ln DIST_{ij} + b_4 X_{ijt} + b_5 Z_{ij} + b_6 W_{jt} + \gamma_t + \alpha_{ij} + e_{ijt} \quad (1)$$

where:

$\ln FDI_{ijt}$ is the log of net-FDI-outflow from home country i to host country j at time t ($\ln fdi$);

$\ln Y_{it}$ is the log of GDP in country i at time t and the same for $\ln Y_{jt}$ for country j ($\ln gdp_{home}$ and $\ln gdp_{host}$);

$\ln DIST_{ij}$ is the log of the distance between countries i and j ($\ln dist$);

X_{ijt} are location factors which vary between country-pairs and over time (e.g. *beatr*);

Z_{ij} are location factors which vary over country-pairs only (i.e. *combord*);

W_{jt} are location factors which vary over time and over host countries (e.g. *pp*);

γ_t are time dummies (*TD*);

α_{ij} are country-pair-specific effects;

e_{ijt} is the remainder error term.

We regard the country-pair specific effects as random for two reasons. First, Hausman-tests⁷ on fixed versus random effects show that the random effects assumptions cannot be rejected. Hence, using the random effects estimator results in more efficient estimates than the fixed effects estimator, which can be highly inefficient if the cross-section dimension is large relative to the time dimension (Pesaran et al. 1998). Using the random effects approach is in line with several recent studies dealing with FDI, trade or capital flows to CEECs (e.g. Clausing and Dorobantu 2005; Dawson and Hubbard 2004; Bevan and Estrin 2004; Gibson

⁶ These variables may be called “gravity-specific”.

⁷ We perform two types of Hausman-tests. First, if no serial correlation and heteroskedasticity seem to be present and if the other requirements of the original Hausman-test are fulfilled (e.g. the difference between fixed effects and random effects variance matrices is invertible) we use the original Hausman-test. Second, in case of non-spherical errors or a non-positive definite difference in the fixed effects and random effects variance matrices we perform a regression based Hausman-test with cluster robust standard errors (see Wooldridge, 2002).

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3 and Tsakalotos 2004) and it allows estimating the impact of time fixed variables (i.e. *dist* and
4
5 *combord*) on FDI-flows. Second, from a more substantive point of view, the random effects
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7 approach is relevant here as we are concerned with the decision of MNEs between various
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9 host countries. In this decision, differences *between country-pairs* matter, which are
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11 exploited by the random effects estimator. Concerning time effects we consider these to be
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13 fixed as they are likely to be correlated with *gdphome* and *gdphost* as time dummies account
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15 *inter alia* for the business cycle and for common shocks (Egger and Pfaffermayr 2003).
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19 Our estimation strategy is based on a general to specific approach. We start with the most
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21 general model (1) and test down until a specification is reached with only (at conventional
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23 levels) significant variables included. This procedure should reduce the probability of an
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25 omitted variable bias and it provides information about the robustness of the tax-rate
26
27 elasticity.⁸ An additional robustness and stability analysis (see below) is carried out via the
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29 jackknife procedure with respect to host countries included. Furthermore we explore the
30
31 stability of the coefficient on *beatr*, *ulc* and *privrev* over time. We always test for the
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33 presence of serial correlation in linear panel data models (“Wooldridge-test”, Wooldridge
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35 2002) and heteroskedasticity (LM-test, Verbeek 2004) in the remainder error term. In all
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37 cases the Wooldridge-test does not reject the null hypothesis. In cases heteroscedasticity is
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39 implied by the LM-test heteroscedasticity-robust standard-errors are used.
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45 46 5. Results

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48 Table 3 shows the results of our estimation strategy. Model 1 is our most general model
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50 including all location factors as well as time dummies. All coefficients carry the expected
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52 sign. The core gravity variables as well as *beatr*, *privrev* and *ulc* are highly statistically
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54 significant. *Combord* and *pp* are marginally insignificant at the 10 percent significance level
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56 (p-values of 0.102 and 0.11, respectively) using two-sided t-tests. Applying one-sided tests
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58 with the alternative hypothesis specified according to the expected sign of the coefficient (cf.
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3 table 1) these two variables are significant at the 10 percent level. *Risk* and *tar* are highly
4 insignificant even in the case of a one-sided test.
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8 Dropping these two highly insignificant variables step-by-step beginning with the most
9 insignificant variable (*tar*) we finally end up with model 2. This includes the gravity-specific
10 variables as well as *beatr*, *ulc*, *combord* (efficiency-related), *privrev* and *pp* (transition
11 specific). *Pp* is again marginally insignificant at the 10 percent significance level, but due to
12 its p-value of 0.102, which implies statistical significance in case of a one-sided test, we
13 decide to keep this variable in our preferred specification.⁹
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20 The Hausman-Wooldridge-test implies that the random effects specification cannot be
21 rejected. Further tests suggest that model 2 has satisfactory properties from a statistical point
22 of view. Studentised residuals do not show the presence of outliers using a cut-off level of
23 +/- 3.5 (Egger and Pfaffermayr 2003), the highest variance inflation factor (VIF) of 5.40
24 implies that multicollinearity should not be a problem in model 2 and a Reset-test suggests
25 that our linear specification is sufficient. Finally, a regression based Hausman-test for
26 endogeneity of *privrev* in model 2, using the EBRD's index of the private-sector share in the
27 total economy as well as dummies for the method of privatisation as instruments (see
28 Carstensen and Toubal 2004 and below) does not reject the null hypothesis of exogeneity.
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41 The magnitudes of the coefficients on distance and host-market size are reasonable as they
42 are in line with the theoretical prediction of the gravity model and with empirical evidence
43 for gravity models explaining international trade flows (Head 2003; Leamer and Levinsohn
44 1995). The comparably low coefficient on home-country size is not unexpected as relatively
45 small countries (Austria and The Netherlands) are among the main source countries of FDI
46 to CEECs. Moreover, the coefficient on *combord* of about 0.68 implies that sharing a border
47 increases net-FDI-outflows by about 97%, a value in line with those usually found for
48 gravity models explaining international trade-flows (see Head 2003).
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⁸ We also used a specific to general approach to assess the robustness of the tax-rate elasticity with respect to single location factors additionally included in the empirical model. The results show the robustness of our estimate in this respect but are not reported here. For details see anonymous (2005).

⁹ Dropping *pp* does not change the results of our analysis. Details can be found in anonymous (2005).

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3 The coefficient on *beatr* is statistically significant and negative. The estimate of -4.30 signals
4 a substantially larger impact of corporate income taxes on FDI than earlier studies imply. For
5 example, a median semi-elasticity of about -1.6 can be deduced from the study by
6 Carstensen and Toubal (2004), which partly covers the same countries as well as a similar
7 time period. This estimate is thus substantially lower than ours in absolute value. However, it
8 must be kept in mind, that besides other differences to our study Carstensen and Toubal base
9 their analysis on statutory tax rates.
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12 The tax-rate elasticity of -4.30 implies that a 1 percentage-point decrease in the effective tax
13 rate increases net-FDI-outflows *ceteris paribus* by about 4.30 per cent. Evaluated at the
14 mean net-FDI-outflow of 193.5 m. this amounts to 8.3 m. on average. Thus, in the past,
15 tax-lowering strategies of governments in the CEECs had an important effect on the
16 allocation of FDI among the CEEC-8.
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19 Model 2 shows that a one percentage-point increase in *ulc* reduces net-FDI-outflows by
20 about 3.30 percent. Comparing this estimate with other studies is notoriously difficult, as
21 almost every study uses an alternative definition of labour costs. Lansbury et al. (1994) use
22 unit labour costs in a host country relative to other potential hosts in Central Europe and find
23 that labour costs have a significant and negative impact on FDI. Inclusion of relative wage
24 and relative productivity measures as in Holland and Pain (1998) appears to leave only the
25 relative wage variable significant, while productivity differentials across host countries are
26 not significant. According to the authors this implies “that considerations of comparative
27 factor costs across countries influence some investment decisions” (p. 16). Clausing and
28 Dorobantu (2005) measure labour costs by the average compensation rate in the host country
29 and also find a negative effect throughout. Some studies (e.g. Bénassy-Quéré et al. 2005, p.
30 590) even find a *positive* relationship between FDI and labour costs, which is most likely
31 attributable to an omitted variable problem. The authors themselves state, that “unit labour
32 costs are positively related to the quality of labour.” (ibidem, p. 589) Hence, labour costs
33 may account for the impact of skill differentials across host countries.
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3 Concerning the privatisation process, our analysis shows a significant and positive impact of
4 *privrev*. At first sight, the coefficient on *privrev*, although significant and with the correct
5 sign seems very low: *ceteris paribus*, net-FDI-outflows increase by about 0.03% if
6 privatisation revenues increase by one million euro. Yet, given that foreign MNEs have been
7 active in the CEEC-8 for some time now and that privatisation programmes are far advanced,
8 the share of FDI unrelated to privatisation processes *per se* should have increased.
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11 Other studies including the privatisation process as a determinant of FDI use the EBRD's
12 private-sector share in total economy (see Lansbury et al. 1996, Holland and Pain 1998;
13 Carstensen and Toubal 2004) and/or the method of privatisation (Holland and Pain 1998;
14 Carstensen and Toubal 2004). Using the private sector share often results in insignificant
15 coefficients, partly because the share variable does not vary much over time. In Carstensen
16 and Toubal (2004) and Holland and Pain (1998) the "method of privatisation" (i.e. vouchers
17 vs. other methods) turns out to have a significant effect on FDI inflows. Holland and Pain
18 conclude that "countries with a program of direct privatisation through cash sales have
19 attracted relatively higher inward investment than those countries using voucher
20 privatisation" (p. 16). Clearly, the studies quoted here cover earlier time periods.
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24 The marginally insignificant coefficient on inflation points to the fact that inflation has
25 decreased considerably in the CEEC-8 compared to earlier periods of transition. Studies
26 including earlier years and countries in macroeconomic turbulence (e.g. Edmiston et al.
27 2003) reveal significant negative effects of inflation on FDI-flows.
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31 Finally, the analysis implies that political instability (*risk*) does not seem to be a relevant
32 location factor within the CEEC-8. This is in marked contrast to studies using data from the
33 beginning of the transformation process till the end of the 1990ies (e.g. Carstensen and
34 Toubal 2004). Finally, the insignificance of *tar* is plausible as tariffs were brought down
35 considerably during the 1990s and, hence, are of minor importance throughout our sample
36 period.
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8 *Relative importance of effective tax rates as a location factor*
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10 Table 5 shows the Beta coefficients corresponding to model 2. Host-market size and distance
11 are the most important determinants of net-FDI-outflows. This result is in line with many
12 other studies (e.g. Mold 2003). Taxation, privatisation and unit labour costs are almost
13 equally important as location factors. *Inter alia* these results imply that the role of taxes
14 should not be overemphasized relative to that of other location determinants.
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25 *An alternative measure of the corporate income tax burden*
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27 In order to show that using statutory tax rates instead of the conceptually superior effective
28 tax rates may lead to an underestimation of the tax-rate sensitivity of FDI we replace the
29 *beatr* by the statutory tax rate (*statrate*) in model 2. Results for model 3 (reported in table 5)
30 show the expected substantial drop of the semi-elasticity to about -1.9. This estimate also
31 falls marginally short of statistical significance at the 10 percent significance level (two-
32 sided test). This should be considered as an indication that the relatively low value of the
33 median semi-elasticity derived by *anonymous (2006a)* is partly due to the use of statutory tax
34 rates. This result is also important with regard to evaluating the effectiveness of
35 governments' tax cuts, which might have had a larger effect on inward FDI than earlier
36 studies have revealed.
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51 [Table 5 here]
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57 *Robustness and stability analysis*
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59 We check the robustness of our preferred specification in model 2 against the impact of
60 possible cross-section outliers by dropping host countries stepwise (e.g. Winner 2005).

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Thereby we focus on those variables which are relevant from a policy perspective (*beatr*, *ulc*, *privrev*). Table 6 reports the resulting minimum and maximum values of the coefficient estimates and the coefficient derived from model 2 as well as the country excluded. The results are robust with respect to dropping countries as no coefficient changes sign and all but one remain highly significant. The coefficient on *ulc* gets insignificant when Slovenia is excluded. This is plausible as Slovenia received low FDI and has comparably high unit labour costs when compared to other host countries in our sample.

[Table 6 here]

The stability of the coefficients on *beatr*, *ulc* and *privrev* is checked by combining these variables with a dummy variable for the years 2000-2003. The year 2000 has been chosen as some host countries (notably Romania and the Slovak Republic) started to reduce their *beatr* since 2000. Table 7 (models 4 to 6) shows that the semi-elasticities for *beatr* and *ulc* for the period 2000-2003 are not significantly different from that of previous years, but that the importance of privatisation as a driver of FDI is significantly lower from 2000 onwards. This last result seems to be plausible as the privatisation process leveled off in many CEECs around 2000 (EBRD transition report, various issues).

[Table 7 here]

6. Summary

The aim of this paper was to test the hypothesis that a high corporate tax burden acts as a deterrent to FDI-flows in the CEECs, since it exerts a negative effect on the profitability of investments. We suggest that using the statutory tax rate in previous studies might blur the effects of the tax burden on FDI and lead to questionable results. Therefore, we use the

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3 bilateral effective average tax rates to explaining net-FDI-outflows from the 7 most
4 important home countries to the CEEC-8. Referring to the eclectic paradigm as a conceptual
5 basis, we find in a panel-gravity setting that FDI is positively related to both source country
6 and host-market size as well as to progress in privatisation. Also, FDI is inversely related to
7 the distance between home and host countries, to the corporate tax burden and to unit labour
8 costs. We also find weak evidence for the negative impact of macroeconomic risk on FDI.

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11 Concerning the role of taxes three points are worth noting:

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14 First, the derived tax-elasticity is robust across various specifications and is greater in
15 absolute value than those reported in earlier studies on the CEECs, pointing to a greater
16 importance of tax policy for company location decisions than previously acknowledged.

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19 Second, the differences in the absolute value of the semi-elasticities when compared to
20 earlier studies are clearly partly due to the use of *beatrs*. The derived semi-elasticity after
21 replacing the *beatr* by *statrate* in our study is, indeed, substantially lower.

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24 Third, the relative importance of the corporate tax rate as a determinant of FDI must not be
25 overemphasized as our results (Beta-coefficients) reveal that at least during the period 1995-
26 2003 the tax burden had no exceptional influence on net-FDI-outflows to the CEEC-8 when
27 compared to other determinants.

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30 While this study is a step towards a better understanding of the determinants of FDI-flows to
31 the CEECs, there are several limitations to our analysis. In particular, we are conscious of
32 the exclusion of location factors such as the quantity and quality of production related
33 (public) infrastructure. This omission is due to the lack of meaningful data. Moreover,
34 special investment incentives (e.g. regional, R&D) are not included, as many different
35 incentives have been granted by CEEC governments throughout the sample period of nine
36 years. The choice of incentives to be included in the *beatr* would be arbitrary. Moreover,
37 many CEECs have reduced their special investment incentives to MNEs during our survey
38 period in accordance with the *aquis communautaire* of the EU. For example, Boudier-
39 Bensebaa (2005) reported that, in Hungary, special tax incentives for MNEs have
40 increasingly been phased out, or that domestic and foreign firms are now treated equally.

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3 Finally, as data on the sectoral level become available differences in tax-rate elasticities
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5 between sectors should provide a more detailed picture on the tax-rate sensitivity of FDI.
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For Peer Review

Table 1: Independent Variables

	Source	Variable	Expected Sign
<i>Market-related variables</i>			
(a) $gdphome_{it}$ §	Eurostat: New Cronos database	Home country size measured as GDP home country in m.	+
(b) $gdphost_{jt}$ §	Eurostat: New Cronos database	Host market size measured as GDP host country in m.	+
<i>Efficiency-related variables</i>			
(c) $dist_{ij}$ §	http://www.wcrl.ars.usda.gov/cec/java/lat-long.htm	Distance in kilometres	-
(i) $combord_{ij}$	Maps	Common border; Dummy variable: 1 if common border	+
(d) $beatr_{ijt}$	Our own calculations based on Devereux and Griffith 1999; assumptions follow Devereux and Griffith except that we give investment in inventory less (10%) and investment in buildings more weight, as data for the CEECs show that investment in inventories is of minor importance; a pre-tax financial return of 20% is assumed; only corporate income taxes are considered; raw tax data are taken from the European Tax Handbook and KPMG's Corporate Tax Rate Surveys	Bilateral effective average tax rate; measured in per cent	-
(e) ulc_{jt}	Own calculations based on van Ark and Monnikhof 2000; data are taken from the AMECO database and the WIIW database	Real unit labour costs in common currency (Euro); measured in per cent	-
<i>Transition-specific variables</i>			
(f) $privrev_{jt}$	Own calculations; EBRD: Transition Report	Annual privatisation revenues in m.	+
(g) $risk_{jt}$	Euromoney	Political Risk; index ranging from 0 to 25	+
(h) pp_{jt}	EBRD: Transition Report	Inflation measured as the percentage increase in producer prices.	-
(i) tar_{jt}	Own calculations; ratio of taxes and duties on imports excluding VAT over imports of goods and services; Eurostat: New Cronos database	Percentage tariffs on imports.	?

§ these variables are the "core" gravity variables

Table 2: Descriptive Statistics

Variable		Mean	Std. Dev.	Min	Max	Observations
<i>lnfdi</i>	overall	4.02	1.75	-0.43	7.81	N = 449
	between		1.39	1.66	7.19	n = 56
	within		1.11	0.60	7.94	T = 8.02
<i>lngdphome</i>	overall	13.90	1.10	12.11	16.24	N = 449
	between		1.12	12.20	16.09	n = 56
	within		0.14	13.43	14.24	T = 8.02
<i>lngdphost</i>	overall	10.40	0.76	8.96	12.24	N = 449
	between		0.75	9.38	11.94	n = 56
	within		0.21	9.93	10.88	T = 8.02
<i>lnDIST</i>	overall	6.99	0.98	4.03	9.15	N = 449
	between		0.99	4.03	9.15	n = 56
	within		0.00	6.99	6.99	T = 8.02
<i>beatr</i>	overall	34.79	7.43	16.11	55.92	N = 449
	between		5.37	24.07	48.07	n = 56
	within		5.08	17.52	47.06	T = 8.02
<i>ulc</i>	overall	25.42	9.23	11.00	50.00	N = 449
	between		8.77	15.43	46.14	n = 56
	within		2.89	15.42	33.22	T = 8.02
<i>privrev</i>	overall	1223.80	1157.48	58.16	4570.03	N = 449
	between		908.25	93.03	2712.47	n = 56
	within		739.74	-19.38	4375.46	T = 8.02
<i>pp</i>	overall	28.08	112.81	-1.20	901.80	N = 449
	between		43.94	1.92	154.04	n = 56
	within		104.10	-122.55	803.66	T = 8.02
<i>risk</i>	overall	13.88	3.32	5.32	19.82	N = 449
	between		2.90	9.59	17.48	n = 56
	within		1.64	7.73	17.39	T = 8.02
<i>tar</i>	overall	4.34	3.83	0.50	18.45	N = 449
	between		3.07	0.95	11.71	n = 56
	within		2.28	-0.17	13.43	T = 8.02
<i>combord</i>	overall	0.31	0.33	0.00	1.00	N = 449
	between		0.33	0.00	1.00	n = 56
	within		0.00	0.13	0.13	T = 8.02

Table 3: Correlation Matrix

	<i>lngdphome</i>	<i>lngdphost</i>	<i>lnDIST</i>	<i>combord</i>	<i>beatr</i>	<i>privrev</i>	<i>pp</i>	<i>risk</i>	<i>ulc</i>	<i>tar</i>
<i>lngdphome</i>	1.00									
<i>lngdphost</i>	0.03	1.00								
<i>lnDIST</i>	0.75	-0.02	1.00							
<i>combord</i>	-0.29	0.10	-0.59	1.00						
<i>beatr</i>	0.03	-0.01	0.01	0.04	1.00					
<i>privrev</i>	0.02	0.69	-0.03	0.06	-0.05	1.00				
<i>pp</i>	-0.02	-0.23	0.09	-0.07	0.14	-0.10	1.00			
<i>risk</i>	0.03	0.52	-0.18	0.27	-0.21	0.39	-0.27	1.00		
<i>ulc</i>	0.02	0.07	-0.10	0.18	-0.38	-0.10	-0.25	0.45	1.00	
<i>tar</i>	-0.05	-0.59	0.14	-0.18	0.09	-0.32	0.30	-0.67	-0.29	1.00

Table 4: Estimation Results

	Model 1	Model 2
<i>lngdphome</i>	0.25*	0.26*
	(1.70)	(1.76)
<i>lngdphost</i>	0.98***	0.96***
	(5.50)	(6.21)
<i>lndist</i>	-0.46**	-0.46**
	(-2.35)	(-2.39)
<i>combord</i>	0.66**	0.68*
	(1.63)	(1.72)
<i>beatr</i>	-4.29***	-4.27***
	(-3.42)	(-3.41)
<i>privrev</i>	0.028***	0.030***
	(3.51)	(3.93)
<i>pp</i>	-0.084**	-0.090**
	(-1.59)	(-1.61)
<i>ulc</i>	-3.40***	-3.30***
	(-2.95)	(-2.88)
<i>risk</i>	2.80	
	(0.91)	
<i>tar</i>	2.20	
	(0.68)	
<i>cons</i>	-4.86**	-4.29**
	(-2.16)	(-2.04)
N	449	449
R ² within	0.33	0.33
R ² between	0.66	0.67
R ² overall	0.52	0.52
AR(1): χ^2_1	0.97	1.21
Het.:	χ^2_{18} : 34.15**	χ^2_{16} : 23.78*
TD: χ^2_8	29.44***	28.34***
Hausman:	χ^2_8 : 11.48	χ^2_6 : 9.31
BP: χ^2_1	165.02***	171.20***
Wald:	χ^2_{18} : 325.04***	χ^2_{16} : 316.15***
sigma_u	0.70	0.70
sigma_e	0.98	0.99
Reset: χ^2_3		3.54
stud.res > 3.5 :		0.00
Highest VIF:		5.40
Hausman-test for endogeneity of privrev		
1 st stage F-value on joint significance of instruments:		10.95
2 nd stage p-value on statistical significance of 1 st stage residuals		0.31

*** p < 0.01; ** p < 0.05; * p < 0.10; ** significant at 10 percent level in case of one-sided test; t-values in parenthesis; stud.res: studentized residuals; VIF: variance inflation factor; Het: LM-test for heteroskedasticity in fixed effects model; TD: time dummies; BP: Breusch-Pagan-test for random individual effects; Hausman: Hausman-test or Hausman-Wooldridge-test for fixed vs. random effects; AR(1): Wooldridge-test for serial correlation in linear panel data models; Reset: Ramsey-functional-form-test; Wald: model-test; groups = number of cross-sections; sigma_u = standard deviation of cross-section specific residual; sigma_e = standard deviation of remainder error term; theta = weight on cross-section specific mean in random effects model

Table 5: Beta Coefficients and Statutory Tax Rate

Beta Coeff.		Model 3	
<i>lngdphome</i>	0.16		0.19 (1.15)
<i>lngdphost</i>	0.42		0.94*** (5.34)
<i>Indist</i>	-0.26		-0.41* (1.84)
<i>beatr</i>	-0.18	<i>statrate</i>	-1.90** (-1.59)
<i>privrev</i>	0.20		0.029*** (4.12)
<i>ulc</i>	-0.17		-2.70** (-2.30)
<i>pp</i>	-0.05		-0.094* (-1.84)
<i>combord</i>	–		0.66** (1.41)
<i>cons</i>	–		-4.36* (-1.83)
N	449		449
R ² within			0.33
R ² between			0.61
R ² overall			0.49
AR(1): χ^2_1			1.20
Het.: χ^2_{16}			22.87
TD: χ^2_8			36.32***
Hausman: χ^2_{14}			16.08
BP: χ^2_1			257.13***
Wald: χ^2_{16}			267.83***
<i>sigma_u</i>			0.81
<i>sigma_e</i>			0.99

*** p < 0.01; ** p < 0.05; * p < 0.10; “ significant at 10 percent level in case of one-sided test; t-values in parenthesis; Het: LM-test for heteroskedasticity in fixed effects model; TD: time dummies; BP: Breusch-Pagan-test for random individual effects; Hausman: Hausman-test or Hausman-Wooldridge-test for fixed vs. random effects; AR(1): Wooldridge-test for serial correlation in linear panel data models; Wald: model-test; groups = number of cross-sections; *sigma_u* = standard deviation of cross-section specific effects; *sigma_e* = standard deviation of remainder error term; theta = weight on cross-section specific mean in random effects model; standard deviations used to calculate Beta coefficients are taken from table 2; *combord* is a dichotomous variable; hence calculation of a Beta-coefficient is inadmissible

Table 6: Jackknife Analysis

	Minimum (in absolute value)	Host country excluded	Estimate	Maximum (in absolute value)	Host country excluded
<i>beatr</i>	-2.95** (-2.24)	Czech Republic	-4.30***	-5.91*** (-4.34)	Croatia
<i>ulc</i>	-1.23 (-0.59)	Slovenia	-3.30***	-4.28*** (-3.36)	Romania
<i>privrev</i>	0.023** (2.65)	Hungary	0.03***	0.032*** (3.63)	Poland
*** p < 0.01; ** p < 0.05; * p < 0.1; t-values in parenthesis					

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Table 7: Stability Analysis

	Model 4		Model 5		Model 6
<i>lngdphome</i>	0.26*		0.27*		0.26*
	(1.84)		(1.83)		(1.73)
<i>lngdphost</i>	0.97***		0.93***		0.96***
	(6.34)		(5.96)		(6.05)
<i>Indist</i>	-0.46**		-0.49**		-0.46**
	(-2.45)		(-2.49)		(-2.31)
<i>combord</i>	0.68*		0.63**		0.68*
	(1.73)		(1.55)		(1.65)
<i>pp</i>	-0.09*		-0.07**		-0.09*
	(-1.65)		(-1.36)		(-1.70)
<i>beatr</i>	-4.50***		-3.80***		-4.40***
	(-3.40)		(-3.08)		(-3.44)
<i>dummy_beatr</i>	0.22				
	(0.13)				
<i>privrev</i>	0.03***		0.044***		0.03***
	(4.24)		(5.39)		(4.37)
		<i>dummy_privrev</i>	-0.03***		
			(-3.12)		
<i>ulc</i>	-3.30***		-2.80**		-3.40***
	(-3.03)		(-2.52)		(-2.92)
				<i>dummy_ulc</i>	0.46
					(0.38)
<i>cons</i>	-4.35**		-4.03*		-4.34**
	(-2.10)		(-1.90)		(-2.01)
<i>N</i>	449		449		449

*** p < 0.01; ** p < 0.05; * p < 0.10; t-values in parenthesis; * significant at 10 percent level in case of one-sided test

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3 Acknowledgement
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5 We are grateful to the Austrian Science Fund for providing financial support by grant
6 F 2008.
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