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THE RELATIONSHIP BETWEEN TAX BURDEN AND FOREIGN DIRECT INVESTMENT INFLOWS: A REVIEW OF EMPIRICAL LITERATURE

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ABSTRACT: *This study reviews literature on the relationship between tax burden and foreign direct investments (FDI) inflows across the world. Various empirical research have found contradicting outcomes of the relationship between tax burden and FDI inflows. This study aims to establish the dominant relationship between tax burden and FDI inflows. Taxation components such as tax system, tax types, tax rates, tax base, tax structures affect the amount of tax revenues collected hence the tax burden. Therefore, in this study, tax burden was represented by itself and taxation components. The research found literature has two divergent relationships between tax burden and FDI inflows: negative and none. However, the relationships largely depended on the taxation components and country or economic region under study. The research findings demonstrate that world over there is no universal consensus on the relationship between tax burden and FDI inflows. Therefore, tax competition theory, which proposes that there is inverse relationship between tax burden and FDI inflows may not be applicable universally. The research implication is that the paper has demonstrated that inverse relationship between tax burden and FDI inflows is not universal. There is need to establish the relationship between tax burden and FDI inflows in any specific country or economic region. Countries that rely on the presumptive inverse relationship between tax burden and FDI inflows to shape their tax policy to attract FDI inflows should rely on empirical research findings undertaken in the country or economic region. The research recommends empirical studies on the relationships between tax burden and/or taxation components, and FDI inflows in specific countries and economic regions.*

KEY WORDS: Tax Burden, FDI Inflows, Taxation

INTRODUCTION

The relationship between tax burden and foreign direct investment (FDI) inflows has been debated widely across the world. For example, Zirgulis (2014) found that tax burden and FDI inflows have inverse relationships. Hence, in some countries, Government tax policies for attracting FDI inflows are based on the supposed relationship inverse between tax burden and FDI inflows. However, in countries such as in the European Union (EU), taxes are high yet there are high and consistent volumes of FDI inflows. Therefore, it is important to establish the relationship

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between tax burden and foreign direct investment worldwide. Thus, the objective of this paper is to review conceptual and empirical literature and determine whether there is a universal relationship between tax burden and FDI inflows from global perspectives.

OECD (1996) defines tax as the obligatory contribution to the government. Therefore, governments develop tax policies that ensure receipt of maximum tax revenues. Tax policies are implemented through taxation which comprises components such as tax types, tax rates, tax bases and tax structures. In every country, overall effects of taxation determine the amount of tax revenues contributed to the government in any financial year. Australian Treasury (2012) defined tax burden as the tax revenues in a financial year expressed as a ratio of Gross Domestic Product (GDP). Hence, taxation components are important determinants of tax burden in a country. Therefore, a study on taxation components is a study of tax burden since taxation components have a bearing on the ultimate tax burden. Any changes in taxation components may result in changes in tax revenues and tax burden.

Consequently, governments influence taxation components to raise adequate tax revenues for re-current and development expenditures during the fiscal year. This influence increases tax burden. Additionally, governments use taxation to reduce inequality and for redistributive purposes (Martinez-Vazquez et al., 2012). The level of government influence on taxation components determines the tax burden endured by the taxpayers thus influencing investments in the country including FDI inflows. For example, according to OECD (2008), tax burden creates entry barriers, internal operating barriers and exit barriers thus making doing business expensive, influences efficiency and reduces profits to shareholders. This is negative influence of tax burden on investments.

However, majority of international investors seek higher return on investments (ROI) that are mostly available in host countries. The high ROI is assured by such factors as availability of natural resources, market size, political stability and skilled labour. Moreover, the influence of tax burden may negatively impact the bottom line thus reducing ROI. Therefore, host governments and investors expect to have mutual benefits in any form of investment including FDI inflows. The aim of this paper is to explore empirical literature to determine the most dominant relationships between tax burden and FDI inflows. This is because there is widely held view that tax burden has inverse relationship with FDI inflows. This view has led some countries to formulate tax policies based on this presumption. This position is evidenced by the numerous tax incentives offered especially in third world countries to foreign investors.

Therefore, the argument in this paper is that there is no universal relationship between tax burden and FDI inflows. Hence, the objective of this research is to examine results of empirical research across the world to determine whether there is a universal relationship between tax burden and FDI inflows. This paper is arranged as follows: first part is introduction, second part discusses tax burden and third part explains FDI inflows. The fourth part comprises empirical and conceptual literature review and discussions on the relationship between tax burden and FDI inflows. The fifth part is

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the conclusions and also includes the conceptual framework. The sixth part includes recommendations for further research.

TAX BURDEN

Governments levy tax for various objectives such as financing of recurrent and development expenditures, protection of home industries and social equity (Moolman et al., 2015 and Hussain and Kimuli, 2012). Often times, tax revenues are not adequate to achieve the set objectives. However, governments have various options to increase tax revenues such as influencing taxation components. The taxation components that the government influences are tax systems (direct and indirect taxes), tax rates, tax bases (stock or flow), tax structures (regressive, proportional or progressive), source of tax (family units, companies, institutions or foreign bodies) and tax types (corporate tax, personal tax, Value-added tax, domestic excise taxes, custom taxes and duties etc.). The government influence results in increased tax revenues which translates into higher tax burden. The increased tax burden may have adverse effect on businesses including international investments.

Therefore, even though governments are in need of tax revenues, mobilisation of increased tax revenues should not be at the expense of investments since according to OECD (2008), tax burden has capacity to act as entry barriers, internal and exit barriers to investments. The barriers impact on efficiency and cost of doing business in the host countries. Accordingly, host governments should balance use of tax burden for purposes of domestic tax revenues mobilization and for attracting investments. According to Ghinamo et al., (2007), the need for this balancing results in governments influencing tax policies and ultimately the tax burden. Consequently, any changes in a country's tax policy will affect the tax burden which will influence international investment's profits realised in the host countries and profits repatriated to home countries. However, governments have strategies to lower tax burden aimed at several objectives such as attracting investments into the country, attracting skilled and qualified human capital, and attracting financial investments into the country (Nikula & Kotilainen, 2012).

Consequently, government strategies for attracting investments should result in creation of competitive advantage based on tax burden. However, tax competition proposition assumes that most countries use tax burden to advance their competitiveness internationally. Hence, tax burden is a major consideration in international investment decisions. Bretschger and Hettich, (2000) explained that international investors also consider social expenditure, labour costs, education levels and political stability in the host country. Moreover, host governments have various strategies at their disposal to use apart from tax burden to make the country internationally competitive to attract increased and consistent volumes of FDI inflows in the current and in the future.

FOREIGN DIRECT INVESTMENTS INFLOWS

FDI inflows are long-term foreign investments into a country. According to UNCTAD (1997), FDI flows in the initial transactions (green-fields investments,

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cross-border mergers and acquisitions and joint ventures) and in any subsequent transactions during the life of an investment. FDI inflows consist of equity capital, intra-company loans and non-equity investments (OECD, 2008). International investors seek safe investment destinations and high returns on investment (ROI). Hence, FDI inflows are attracted to a host country by factors that facilitate generation and repatriation of profits from host countries to home countries.

However, as explained by Kurtishi-Kastrati (2013), FDI inflows have many potential benefits. Consequently, host countries seek FDI inflows for the potential benefits. According to Moolman et al., (2015), Hussain & Kimuli (2012) and Muhammad (2010), FDI inflows into host countries result in increased economic development, employment creation, transfer of technology, increase in local investments and facilitate economic growth, Further, OECD (2008) explains that FDI inflows results in human capital development, increase in exports and reduction of imports. Moreover, FDI inflows have capacity to generate substantial amounts of tax revenues in host countries. Therefore, every year, world over governments are estimated to use over US dollars 50 billion for purposes of attracting FDI inflows (Leowendahl, 2016).

THEORETICAL FOUNDATION

The theoretical foundation of this literature review is tax competition theory. Tax competition theory was proposed by Oates in 1972 as explained by Wilson (1999). The theory proposes that governments lower economic burdens for justifications such as support for valuable resources inflows for example capital and to deter outflow of production resources. Therefore, tax competition theory may explain government strategies to lower economic burdens for purposes of attracting investment inflows, skilled and qualified human capital, and financial investments into the country. Lowering of tax burdens by government create tax burden based competitive advantage for foreign investments. Tax competition theory supports the proposition that there is an inverse relationship between tax burden and FDI inflows. Therefore, use of tax burden to attract FDI inflows by governments' world over is an act of tax competition. However, there is no universal consensus on the proposition or applicability of tax competition theory.

EVIDENCE FROM EMPIRICAL LITERATURE REVIEW

Investigations on the relationship between tax burden and FDI have been conducted in individual countries, economic regions, continents and specific industries. The studies have covered tax burden or taxation components and FDI inflows. However, universal conclusive evidence on the relationship between tax burden and FDI inflows is lacking. Therefore, this research examines results of previous empirical and conceptual studies to establish the dominant relationships between tax burden and FDI inflows worldwide.

Specific studies have demonstrated confirmation of the inverse relationship between tax burden and FDI inflow. For example, Zirgulis (2014) investigated the effects of productivity and capital tax on FDI inflows using panel data and Generalized Method of Moments (GMM) system on dynamic spatial models from 41 countries. The results

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indicated that increase in capital tax rates occasioned reduced FDI inflows. In addition, Cung and Hua (2013) used descriptive statistical method and empirical method to analyse determinants of FDI inflows into Vietnam utilising data from 1999 to 2011. The results demonstrated that tax burden had negative influence on FDI inflows into Vietnam. Further, the findings are supported by Kubicova (2013) who examined the role of corporate income tax in attracting FDI inflows into European Union member states using panel data for the period 2003 to 2011. The study used econometric analysis as the analytical method. The results established that effective tax rates and statutory corporate tax rates were insignificant but had adverse effects on FDI inflows in EU countries.

Additionally, Murthy & Bhasin (2013) shed light on the relationship between tax burden and FDI inflows by investigating the role of tax treaties as modelled in promoting FDI inflows using panel data from 1993 to 2007. Fixed effect models were used for policy and macroeconomic factors while the analytical models were Principal Component Analysis (PCA). The study found that FDI inflows were negatively influenced by policy and macroeconomic variables that included tax treaties. Moreover, FDI inflows to the Baltic countries using gravity approach from 2000 to 2008 with data from Eurostat were analysed by Raudonen and Freytag (2013). Corporate taxation was found to have statistically significant negative influence on FDI inflows in the Baltic countries. Further, evidence was provided by Sichei and Kinyondo (2012) using dynamic panel data estimation techniques on panel data from forty five (45) African countries for the period 1980 to 2009. The purpose of the study was to identify factors that determine FDI inflows into those African countries. Double taxation treaties (DTTs) which have the effect of reducing tax burden were found to attract FDI inflows.

Besides, evidence of the relationship between tax burden and FDI was provided by Nikula and Kotilainen (2012) using two econometric gravity (aggregate model of FDI and bilateral FDI inflows model). The study was on FDI inflows to 9 countries in the Baltic Sea region from 1995 to 2010. The study found that corporate tax had statistically significant adverse effects on FDI inflows to the Baltic Sea region. Also, Arbatli (2011) investigated determinants of FDI inflows to emerging market economies using data based on events of domestic conflicts on economic policies, political stability and the role of external push-factors. The data was from forty six countries from 1990 to 2009. The results demonstrated that minimising trade tariffs and rates of corporate tax are related to increased FDI inflows in emerging market economies.

Other studies demonstrate the negative relationship between tax burden and FDI inflows. Baldwin & Okubo (2009) studied international tax competition in presence of significant agglomeration of economies and firm heterogeneity. The research used Nash Equilibrium where big economies maintain higher taxes and vice versa. The results revealed that large companies are sensitive to tax differentials and are likely to relocate from large-high tax countries to small-low tax countries. Still, Bellak and Leibrecht (2009) provided evidence by exploring whether low corporate income tax attracts FDI inflows. Panel data from 56 bilateral country-relationships of 7 home and

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8 host countries from 1995-2003 in the EU was used in a panel gravity-model setting. The study found that corporate tax rates were negatively related to FDI inflows into the EU.

Solomon, Islam and Barker (2015) established the factors that determined FDI inflows into Malaysia during the period 1991 to 2010. FDI inflows were found to be negatively related to corporate tax. Additionally, Benassy-Quere, Fontagne and Lehreche-Revil (2003) used a panel of bilateral FDI inflows in 11 OECD countries from 1994 to 2000 and found that high corporate taxation discouraged FDI inflows in OECD countries. Further, Saidu (2015) examined the relationship between corporate taxation and foreign direct investments in Nigeria from 1970 to 1980 using descriptive statistics, correlation and regression models. The study found that there was negative relationship between corporate tax rates and FDI. Moreover, Eshghi et al., (2016) investigated the impact of corporate tax rate on foreign direct investments inflows from Germany into five Eastern European countries from 2000 to 2012 using statutory tax rates as a measure of tax burden. The study found that corporate tax rates had significant negative impact on FDI inflows in Central and Eastern European countries.

Furthermore, Sato (2012), examined effect of corporate income tax on foreign direct investments using panel of bilateral foreign direct investments from 30 OECD countries from 1985 to 2007 used System GMM. The research found that corporate tax impact on FDI is significantly negative. Additionally, Davies et al., (2016) examined the impact of corporate taxation and other factors on the attractiveness of Ireland and other EU countries from 2002 to 2013. The study found that on average attractiveness of countries to FDI is negatively linked to corporate tax rates. Other studies that support the inverse relationship are by Lejour (2014) who examined the impact of bilateral and multilateral tax rates on bilateral FDI stock using database of all OECD countries from 1985 onwards. The study used panel regression and found that tax treaties and lower withholding tax rates on dividends increased bilateral FDI significantly. Supports for the inverse relationship is also found in Reidle (2016). The study used large international firm level panel dataset and investigated the impact of corporate taxation on foreign direct investments. Withholding tax rates were found to have negative effects on investment decisions on foreign direct investments. Moreover, Ang (2008) studied tax burden and FDI inflows by examining annual time-series data from 1960 to 2005 to establish the determinants of FDI in Malaysia. The study found that corporate tax rates did not attract FDI inflows in Malaysia.

Therefore, the empirical literature reviewed in this section confirms the long held view that there is an inverse relationship between tax burden and FDI inflows into a host country. However, the studies used different taxation components. The taxation components used were tax system, tax types, tax rates, tax base and tax structures. The studies were undertaken in different countries. In addition the studies were conducted in different economic regions. However, the results demonstrate that tax burden had negative influence on FDI inflows.

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Other empirical studies have provided evidence that there is no relationship between tax burden and FDI inflows. For example, Kersan-Skabic (2015) researched the determinants of FDI inflows in South-East European (SEE) countries of Albania, Bosnia and Herzegovina, Croatia, former Yugoslav Republics of Macedonia, Montenegro and Serbia. The study emphasised corporate tax rates and used panel data from 2000 to 2011. The study used two models. One model used bilateral FDI between host and home corporate tax. The other model used aggregate FDI flows and host state nominal corporate tax rates. The results of the study indicated that corporate tax was not significant in attracting FDI inflows in SEE countries. In addition, Hunady & Orviska (2014) investigated the key determinants of FDI inflows into the European Union (EU) using panel data and regression models. The study focused on country statutory effective tax rates and the effects on FDI inflows using data from 27 EU countries for the period 2004 to 2011. The results demonstrated that corporate tax had no significant effect on FDI inflows in the 27 EU countries.

Further evidence of no relationship between tax burden and FDI inflows was provided by Mughal and Akram, (2011) who investigated the impact of market size, exchange rate and corporate tax rates on FDI inflows in a low income developing country (Pakistani). Time series data were used from 1984 to 2008. The study used Autoregressive Distributed Lag (ARDL) and error correction model based on ARDL to estimate the relationships among the variables. The results of the study showed that corporate tax rates had no influence on the FDI inflows into Pakistan during the study period. Additionally, the effects of agglomeration economies and corporate tax rates on FDI flows and stocks in the EU was analysed by Hansson and Olofsdotter (2010). The aim of the study was to determine the agglomeration forces that explain the differences in tax policies between the old and new EU member countries. The study used an implicit model on decisions on FDI inflows that determined whether to invest and how much to invest. Panel data were obtained from 27 EU countries from 1995 to 2006. The study found that tax rate differentials were not important in determining whether to invest and the amount of FDI inflows to invest in the old 15 EU member countries during the study period. Hence, tax burden had no effect on FDI inflows into the EU.

Therefore, the results of the literature reviewed demonstrate two dominant scenarios in different countries and economic regions. First, tax burden has negative relationship with FDI inflows as revealed by such studies as Zirgulis (2014), Cung and Hua (2013), and Kubicova (2013). Second, tax burden has no relationship with FDI inflows as demonstrated by such studies as Kersan-Skabic (2015), Hunady & Orviska (2014) and Hansson and Olofsdotter (2010). Therefore, the relationship between tax burden and FDI inflows is specific to the tax burden and taxation components being tested, the country and the region. Hence, to establish the relationship between tax burden and FDI in any country and/or economic region, specific studies should be undertaken. Results from studies conducted elsewhere should not be relied on to make decisions in any country and/or economic region.

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CONCLUSION

In this literature review, the relationship between tax burden and foreign direct investment (FDI) inflows was examined from existing empirical and conceptual studies. The results indicate that tax burden represented by tax burden and taxation components (tax system, tax types, tax rates, tax base, and tax structures) have either negative or no relationship with FDI inflows. However, the relationships depend on the taxation component, country or economic region under study. The research findings demonstrate that there is no universal consensus on the relationship between tax burden and FDI inflows but there is overwhelming evidence of negative and no relationship. Therefore, tax competition theory which proposes that there is inverse relationship between tax burden and FDI inflows is not applicable universally. The results of this literature review demonstrate the inconsistent relationships established between tax burden and FDI inflows worldwide.

Therefore, a conceptual framework on the relationship between tax burden and FDI inflows can be established. In the conceptual framework, it is assumed that there is a relationship between tax burden and FDI inflows. This is consistent with Asiedu (2002), Sannassee et al., (2007) and Demirhan and Masca (2008). The following univariate model is developed.

$$FDI_{it} = \alpha_{it} + \beta_{Tit} TAXB_{it} + \varepsilon_{it}$$

where:
α is the model constant. FDI is FDI inflows. TAXB is tax burden. βT_{it} is regression coefficients, *i* denotes country, *t* denotes time.

RESEARCH AND PRACTICE IMPLICATIONS

The implication of the research findings is that the negative and none relationships between tax burden and FDI inflows were confirmed as the most dominant relationships. However, the relationships are not universally applicable. Therefore, decisions pertaining to use of the relationship between tax burden and FDI inflows in any country or economic region should rely on studies conducted specifically for those countries or economic regions. The implication of the research findings on practice is that the use of the presumed inverse relationship between tax burden and FDI inflows for tax policy formulation as a strategy to attract FDI inflows to specific countries and/or economic regions should be refocused. The overwhelming evidence of negative or no relationship demonstrates that tax burden may not influence FDI inflows. Therefore, use of tax burden where governments offer tax incentives such as tax exemptions or tax holidays results in tax losses. Hence, governments should use other factors to attract FDI inflows into their countries or economic regions.

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RECOMMENDATIONS FOR FURTHER RESEARCH

The study recommends country or economic region empirical research on the relationship between tax burden and FDI inflows. In addition, the study also recommends country or economic region empirical research on the relationship between taxation components and FDI inflows. Further, the study recommends country and economic region research on the relationship between tax burden and FDI outflows.

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