

Foreign direct investment in the enlarged EU: do taxes matter and to what extent?

Guntram B. Wolff



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Abstract:

Foreign direct investment is of increasing importance in the European Union. This paper estimates the effect of taxes on foreign direct investment (FDI) flows and on three sub-components of these flows for the countries of the enlarged European Union. The model in the spirit of gravity equations robustly explains FDI flows between the 25 member states. Sample selection needs to be addressed in the estimation. We show that the different subcomponents of FDI should and indeed do react differently to taxes. After controlling for unobserved country characteristics and common time effects, the top statutory corporate tax rate of both, source and host country, turn insignificant for total FDI and investment into equity. However, high source country taxes clearly increase the probability of firms to re-invest profits abroad and lower the percentage of debt financed FDI. This might reflect profit re-allocation to avoid taxes. Market size factors have the expected signs for total FDI. Non-productivity adjusted wages as determinants of FDI are less robust.

Keywords:

Foreign direct investment, FDI, corporate taxes, sample selection model, profit re-allocation

JEL-Classification:

F3, F2, F4, E6, H2, H8

Non Technical Summary

Foreign direct investment (FDI) is of increasing importance in the European Union. FDI flows among the old EU 15 have substantially increased, but also investments into the now 10 new member states (NMS) have significantly increased. Recently, the 10 NMS have also started to invest abroad. FDI flows are sub-divided into three sub-components by Eurostat: investment into equity, re-invested profits, and other (mostly credits) investments.

We discuss the relevance of corporate taxes for the different parts of FDI. While in principle high corporate taxes should deter FDI, the reaction of the sub-components of FDI might differ. In particular, we argue that equity FDI reflects fundamental decisions on where to locate production, while credit extensions and re-invested profits are also tools to allocate profits. Accordingly, we expect credits and re-invested profits to depend more strongly on corporate tax rates.

The paper then estimates the effect of taxes on FDI flows and on these three sub-components for the countries of the enlarged European Union. The model in the spirit of gravity equations robustly explains FDI flows between the 25 member states. Statistical tests show that sample selection needs to be addressed in the estimation. We show that the different sub-components of FDI indeed react differently to taxes.

In the regressions without country and time dummies, we find the standard results confirmed: High host country tax rates deter investment flows while high source country tax rates increase the probability of observing FDI flows. After controlling for unobserved country characteristics and common time effects, the top statutory corporate tax rates of both, source and host country, turn insignificant for total FDI and investment into equity. Market size factors have the expected signs for total FDI. Non-productivity adjusted wages as determinants of FDI are less robust. The insignificant tax coefficient does not allow to confirm that tax rates were a relevant variable for total FDI flows in the enlarged EU. The insignificance might however result from the relatively weak variation of the tax rate after controlling for the country mean or from measurement problems regarding the true tax burden.

High source country taxes clearly increase the probability of firms to reinvest profits abroad after controlling for time and country dummies. They also lower the percentage of debt financed FDI. This might reflect profit reallocation to avoid taxes.

Nicht technische Zusammenfassung

Direktinvestitionen gewinnen in der Europäischen Union zunehmend an Bedeutung. Die Direktinvestitionsströme zwischen den alten EU-15-Ländern haben beträchtlich zugenommen, aber auch die Investitionen in die zehn neuen Mitgliedstaaten sind deutlich gestiegen. Seit kurzem sind auch Direktinvestitionen der zehn neuen Mitgliedstaaten im Ausland zu verzeichnen. Die Direktinvestitionen werden von Eurostat in drei Teilkomponenten unterteilt: Investitionen in Form von Beteiligungskapital, reinvestierte Gewinne und sonstige Anlagen (vor allem Kredite).

Zunächst wird auf die Bedeutung der Körperschaftsteuer für die verschiedenen Teilbereiche der Direktinvestitionen eingegangen. Während hohe Körperschaftsteuern prinzipiell der Direktinvestitionstätigkeit entgegenstehen sollten, könnte die Reaktion der Teilkomponenten unterschiedlich sein. Im Einzelnen wird hier argumentiert, dass Direktinvestitionen in Form von Beteiligungskapital Grundsatzentscheidungen über den Produktionsstandort widerspiegeln, während Kreditausreichungen und reinvestierte Gewinne auch als Instrumente der Gewinnverteilung dienen. Dementsprechend wird erwartet, dass Kredite und reinvestierte Gewinne stärker von den Körperschaftsteuersätzen abhängen.

Anschließend wird im vorliegenden Beitrag der Effekt von Steuern auf die Direktinvestitionen und deren drei Teilkomponenten für die Länder der erweiterten Europäischen Union geschätzt. Das Modell, das sich an die Gravitätsmodelle anlehnt, liefert eine fundierte Erklärung für die Direktinvestitionsströme zwischen den 25 Mitgliedstaaten. Statistische Tests zeigen, dass die Stichprobenauswahl in der Schätzung berücksichtigt werden muss. Es wird gezeigt, dass die verschiedenen Teilkomponenten der Direktinvestitionen tatsächlich unterschiedlich auf Steuern reagieren.

In den Regressionen ohne Länder- und Zeitdummies werden die üblichen Ergebnisse bestätigt: Hohe Steuersätze im Empfängerland wirken investitionshemmend, während hohe Steuersätze im Herkunftsland die Wahrscheinlichkeit von Direktinvestitionen im Ausland erhöhen. Nach Ausschaltung unbeobachteter Ländermerkmale und allgemeiner zeitspezifischer Effekte wird der gesetzliche Körperschaftsteuer-Spitzensatz sowohl im Herkunfts- als auch im Empfängerland für die Direktinvestitionen insgesamt und für Direktinvestitionen in Form von Beteiligungskapital insignifikant. Die Faktoren der

Marktgröße weisen die erwarteten Vorzeichen für die Direktinvestitionen insgesamt auf. Nicht produktivitätsbereinigte Löhne sind als Bestimmungsgröße von Direktinvestitionen weniger robust. Aufgrund des insignifikanten Steuerkoeffizienten kann nicht bestätigt werden, dass die Steuersätze eine relevante Größe für die gesamten Direktinvestitionsströme in der erweiterten EU sind. Es ist allerdings nicht ausgeschlossen, daß dieses Ergebnis auf Beschränkungen in den verfügbaren Daten zurückzuführen ist, etwa bezüglich der Messung der echten Steuerbelastung. Die Insignifikanz könnte auch aus der relativ geringen Schwankung des Steuersatzes nach Bereinigung mit dem Ländermittelwert resultieren.

Unter Berücksichtigung von Zeit- und Länderdummies erhöhen hohe Steuern im Herkunftsland jedoch eindeutig die Wahrscheinlichkeit, dass Unternehmen ihre Gewinne im Ausland reinvestieren. Zudem verringern sie den Anteil fremdfinanzierter Direktinvestitionen. Darin könnte sich eine Gewinnumverteilung zur Steuervermeidung widerspiegeln.

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Foreign direct investment in the enlarged EU: do taxes matter and to what extent?¹

1 Introduction

In the last 15 years, the structure of the European economies changed substantially. An important tendency was the increased integration of those economies that were once separated by an "iron curtain". After the fall of the Iron curtain, in particular the 10 new member states of the European Union underwent profound changes of their economies. While GDP levels significantly dropped in most countries until the mid 1990s, the economic performance was quite dynamic in the second half of the 1990s. This dynamic evolution together with the prospective EU membership also attracted significant foreign direct investment (FDI) inflows. Against the background of relatively low tax rates in the new EU member states, the political debate in Europe focusses especially on the effect of taxes on FDI flows.

Increased FDI flows are a global trend and are extensively investigated in the economic literature. Blonigen (2005) provides a survey of the two main motives of FDI. Vertical FDI serves to allocate different steps of the production to those countries, where the corresponding production costs are lowest. Horizontal FDI represents just a duplication of the entire production process to a second country in order to be closer to the foreign market. Empirical studies therefore explain FDI by firm level factors and external factors such as the market size to capture horizontal FDI motives and labor costs and taxation to capture vertical FDI motives. The empirical literature on tax effects is surveyed by de Mooij and Ederveen (2003), who report a median semi-elasticity of FDI to taxes of -3 and document a wide range of empirical estimates. Important recent contributions include Bénassy-Quéré, Fontagné, and Lahrèche-Révil (2005), Desai, Foley, and Hines Jr. (2004), and Devereux and Griffith (1998, 2003).

So far, almost all studies on the empirical effects of taxes on FDI either focus

¹Author: Guntram B. Wolff; Deutsche Bundesbank, ZEI-University of Bonn, UCIS-University of Pittsburgh, email: guntram.wolff@bundesbank.de ; I thank Jörg Breitung, Heinz Herrmann, Anna Iara, Wolfgang Lemke, Alexander Lipponer, Robert Lipsey and participants of the first Villa Kleist workshop in Potsdam, and workshop participants at the HWWA for very helpful comments, remaining errors are mine. The opinions expressed in this paper do not necessarily reflect the opinions of the Deutsche Bundesbank or its staff.

on the discrete decision to invest, or on the amount of investment. Buettner and Ruf (2004), for example, study in how far discrete location decisions are affected by taxes with a panel of German multinationals. The statutory tax rate significantly influences the probability to locate in a country. Bénassy-Quéré, Fontagné, and Lahrèche-Révil (2005), on the other hand, estimate the reaction of FDI flows to corporate taxation in a gravity model of 11 OECD countries abstracting from the discrete location decision problem. The authors find that tax differences negatively affect FDI flows.

Devereux and Griffith (1998) show that factors determining the discrete location decisions of multinational firms can differ from the factors relevant for the size of the investment. Similarly, Razin, Rubinstein, and Sadka (2004) argue that a representative firm takes two sequential decision, first whether to invest and second, how much to invest. Razin, Rubinstein, and Sadka (2005) apply this idea to macroeconomic FDI data and corporate tax rates. To our knowledge, they are the first to simultaneously estimate the determinants of the discrete investment choice and the amount of FDI. With OECD data, they show that failure to address this sample selection problem leads to biased results. Furthermore, high source country taxes increase the probability of observing FDI, while high host country taxes lower the amount of FDI to that particular country.

Only few papers study FDI in transition countries. Carstensen and Toubal (2004) examine the determinants of FDI into the Central and East European countries (CEECs). Traditional determinants of FDI such as market potential, low relative unit labor costs, and relative factor endowments have plausible effects. Buch, Kokta, and Piazzolo (2003) do not find significant evidence for the relocation of FDI to Eastern Europe. Bevan and Estrin (2000) present evidence that country risk, unit labor costs, host market size and gravity factors determine FDI. Frenkel, Funke, and Stadtmann (2004) find that FDI flows from developed countries to emerging economies depend on market size, distance and host country risk and economic growth. Kinoshita and Campos (2003) focus more narrowly on transition countries and show that the main determinants of FDI inflows are institutions, agglomeration and trade openness.

We contribute to the literature in several ways. To our knowledge we are the first to simultaneously estimate the determinants of the flow size and the decision to invest with EU 25 data. To do so, we employ a sample selection

gravity framework. Addressing sample selection is of particular relevance in the enlarged EU, as many source-host country pairs (still) report zero FDI flows. Four different bilateral FDI measures are used (total FDI flows, equity capital flows, reinvested earnings, and other FDI), which are usually lumped together in empirical studies. With the data provided by Eurostat, we are able to show, that these different components of FDI react differently to taxes and basic macroeconomic determinants, reflecting investment decisions and allocation of profit operations. Furthermore, we are among the first to separate the differential effects of host and source country taxes on FDI.

The remainder of the paper is organized as follows. The next section presents theoretical considerations on the effects of taxes on the different FDI components. Section 3.1 discusses the structure of FDI relationships in the EU of 25 countries, and its evolution. It also provides summary information on the tax data. Section 3.2 discusses the empirical strategy, while Section 4 presents the empirical results and interprets the findings. The final section concludes.

2 Theoretical framework

Economic theory points at numerous factors, that influence the amount of FDI and the decision to undertake FDI. In our empirical part, we follow very closely the specification of Razin, Rubinstein, and Sadka (2005), which is similar to the standard way of modelling FDI proposed by Markusen, Venables, Kohan, and Zhang (1996). In this section, we therefore focus the discussion on the effect of host and source country taxes on total FDI, equity FDI, retained earnings and other FDI. Especially the different impact of taxes on equity and retained earnings investment has not been discussed so far.

Our theoretical framework extends the framework by Razin, Rubinstein, and Sadka (2004, 2005). The second paper looks specifically at the the role of source and host corporate tax rates on FDI. In this model, two decisions are taken: First whether to engage in FDI, second, how much to invest. Razin et al (2005) assume that fixed set-up costs of new FDI projects accrue in the source country of FDI. If fixed set-up costs should arise in the host country, the representative firm² can use transfer pricing to transfer the fixed set-up costs

²Razin, Sadka, and Tong (2005) discuss the relevance of firm level heterogeneity. They show that firm level heterogeneity can explain, why FDI flows in both directions. Helpman,

in the source country. In most cases, large parts of the fixed cost in terms of assembly line planning, R&D and similar activities occur in the source country of FDI anyway. This implies that the investment is only undertaken if the present discounted profits in the host country, which depend negatively on the host country tax rate, is larger than the fixed set-up cost, which is tax deductible in the source country, i.e.,

$$c(1 - \tau_s) \leq v(\tau_h) \tag{1}$$

Larger source country tax rates τ_s reduce the fix cost c , thereby lowering the threshold at which an investment will be undertaken and increasing the probability to invest. Larger host country tax rates τ_h , on the other hand, reduce the marginal return on investment and thereby the net present value of the investment v . This reduces the amount of FDI. Source country taxes on the other hand should matter little for the amount, as any investment project, whether abroad or at home, is subject to the same source country tax rate upon repatriation of the profit. In this sense, source country corporate tax rates can be expected to impact on the investment decision as fixed costs are source country tax deductible, but not on the amount of FDI in particular.

Following Razin, Rubinstein, and Sadka (2005), host country tax rates should negatively affect the amount of FDI as they reduce the marginal return of an investment project and thereby the present value of income streams from abroad. The validity of this hypothesis, however, largely depends on the precise tax system. The majority of world's countries exempt from tax most of the income earned by foreign affiliates of domestic multinational corporations (Hines 2001).³ In this case, host country taxes should matter strongly for FDI quantities while source country taxes matter only to the extent that foreign source income is taxed. Several major countries permit tax credits. If a tax credit is given on taxes paid abroad, host country taxes should matter little since they reduce the tax payment in the source country accordingly.⁴ However, many source countries only grant partial tax credit. Thereby the relevance of

Melitz, and Yeaple (2004) show that productivity differences across firms determine whether firms choose to serve only the domestic market, export or engage in FDI.

³Also see McLure (2005) for a short description of the current European rules and the European Commission's proposals for reform.

⁴If the tax rate in the host country is larger than in the source country, the difference in tax rates times the profit has to be paid. However, if firms make other profits in the home country, accounting might enable companies to reduce even the tax payment resulting from higher host country taxes.

host country taxes increases. On the other hand, many countries in Europe, especially the 10 NMS, attract foreign investment by granting tax breaks for some initial period. In such a case, host country corporate tax **rates** probably matter only little for the amount of investment, because the profits earned are exempted from tax payments. Source country taxes should still play a role for the discrete investment decision because of set-up costs.

The discussion so far has made no distinction between different components of FDI. Razin, Rubinstein, and Sadka (2005) use total FDI flows to test their empirical hypothesis. In the following, we will argue, that the different parts of FDI should depend differently on tax rates. We will also show that the empirical predictions concerning total FDI can be distorted by the different reactions of sub-components of total FDI.

Investment into new equity constitutes the largest part of FDI. It also approximates best the part of FDI flow, to which Razin et al (2005) refer. Set-up costs relate to new investment projects, which are contained in equity FDI, but, by definition, not in retained earnings or inter-company credits. The effects of source and host country taxes on equity, as pointed out, crucially depend on the tax system in place. Deductibility of taxes already paid in the host country against the source country tax payments reduces the relevance of host country tax rates. Also, granted tax breaks probably reduce the importance of host tax rates for FDI flows. On the other hand, exemption of foreign source income from source country taxes increases the relevance of host country taxes and reduces the importance of source country taxes. The empirical predictions concerning the relevance of host country tax rates for equity FDI flows are thus unclear.

Reinvested earnings (RE) help to clarify the importance of taxes for FDI. RE can only happen, after a profitable FDI has been effectuated. Profits that are re-distributed to the source country of FDI are most likely to be taxed somehow in the source country. We therefore predict, that the likelihood of re-investing profits abroad should increase with the source country corporate tax rate, holding constant the host country tax rate. In addition, transfer pricing can be used to shift profits abroad. These increased profits can be recorded as RE and are a direct reaction to source country taxes. RE might be depressed by high host country taxes, which can lower the profits that can be reinvested. We also expect RE to most robustly depend on taxes as they presuppose a profitable investment. Overall, RE are probably much

more guided by tax considerations than equity investments, which strongly depend on other economic factors, such as market acquisition, production cost advantages and the like.

Concerning the FDI category, "other", which mostly covers credit FDI⁵, empirical predictions are difficult. Probably, companies will extend less funds to countries, where taxes are higher, as investments in the country are less profitable. They might also want to use debt instruments instead of equity to a larger extent if host country taxes are high, since interest payments resulting from financial credits are not taxed in the host country, but in the source country.⁶ In other words, financial credits and the like are probably also extended to shift costs from the source to the host country and profits from the host to the source country. Overall, the effects go in opposite directions and the predictions for other FDI are unclear. To get a better view on the cost shifting aspect, we later extend our empirical analysis with a regression of inter-company debt-FDI in percent of equity FDI on source and host country tax, more formally: $\log(OC/equity) = \alpha_1 tax_{jt} + \alpha_2 tax_{it} + \epsilon_{ijt}$. We expect that high source country taxes will lower the percent of credit financing of FDI.

We summarize the predictions of source and host taxation of the different components of FDI in the following table. The table shows that the effects of

Table 1: The effect of corporate tax rates on different FDI categories in the flow and selection equation.

	flow		select		
	host	source	host	source	reason
equity	-	0	-	+	fixed cost (Razin et al)
	0	0	0	0	other "fundamental" determinants
	0	?	0	+	tax breaks
re-invested earnings	0	+	0	+	avoid high source tax
	-	0	0	0	profits lower
	0	+	0	+	profit shifting
other	-	0	-	0	investment less profitable
	-	?	-	?	standard
	+	-	+	-	cost shifting
total FDI	-?	+??	-??	+	

taxes on FDI flows are not always unambiguous. We expect the results for tax effects to be most explicit for retained earnings because they should be independent of more fundamental investment considerations and ultimately reflect

⁵Other consists of inter company debt transactions: covering the borrowing and lending of funds, including debt securities and trade credits and land acquisitions. More details are given in the appendix.

⁶See Hines (2001) for a description of increased debt financing because of corporate taxation.

decisions on where to allocate profits. Furthermore, source country tax rates might matter more than host country tax rates because tax payments abroad are partially deductible and because tax breaks exist to attract FDI. Finally, the results show that empirical studies need to look at the three subcomponents of FDI, since they may react differently to taxes.

3 Data summary and empirical strategy

3.1 Data

Foreign direct investment has increased worldwide and this trend is also prevalent in Europe. In our analysis, we focus on the years 1994-2003, as data before and after that period are not yet available. We include data for the EU 25 and Bulgaria, no data for Belgium and Luxembourg are included.⁷ We rely on Eurostat data as they provide a comprehensive and comparable data set. The details of the data sources are given in the appendix B.

Total FDI flows consist of equity, reinvested earnings, and other direct investment capital. Equity investment comprises equity in branches, all shares in subsidiaries and associates and other capital contributions such as provisions of machinery, etc. Reinvested earnings consist of the direct investors' share in proportion to direct equity participation of earnings not distributed. Other FDI is inter-company debt transactions such as covering the borrowing and lending of funds, including debt securities, trade credits, and land acquisition.

Figures 1 to 4 provide information on the evolution of FDI flows in the period 1994-2003. As Figure 1 shows, gross FDI flows among the EU 15 countries has evolved dynamically, amounting to 80 billion Euros in 2001 after a peak in 2000 of 350 billions.⁸ FDI flows from the EU 15 countries to the 10 NMS have steadily increased in this period to reach almost 14 billion Euros in 2001 (Figure 2). The share of these FDI flows in percent of intra EU 15 FDI has considerably increased from virtually zero to almost 16 percent in 2001. It is interesting to note that FDI flows from the 10 new member states to the old

⁷Eurostat reports FDI data for Belgium and Luxembourg as investing country jointly, making their inclusion difficult. Separate data for Luxembourg and Belgium are only available as of 2002 for equity FDI. Furthermore, Luxembourg is known to be a very large conduit of indirect flows of FDI.

⁸The peak in 2000 is a world-wide phenomenon. Global FDI flows according to UNCTAD data peaked at almost 1500 billion US\$ in 2000, falling back to less than 800 in 2001. The peak reflects an M&A wave also prevailing in Europe (Pagano and Thadden 2004).

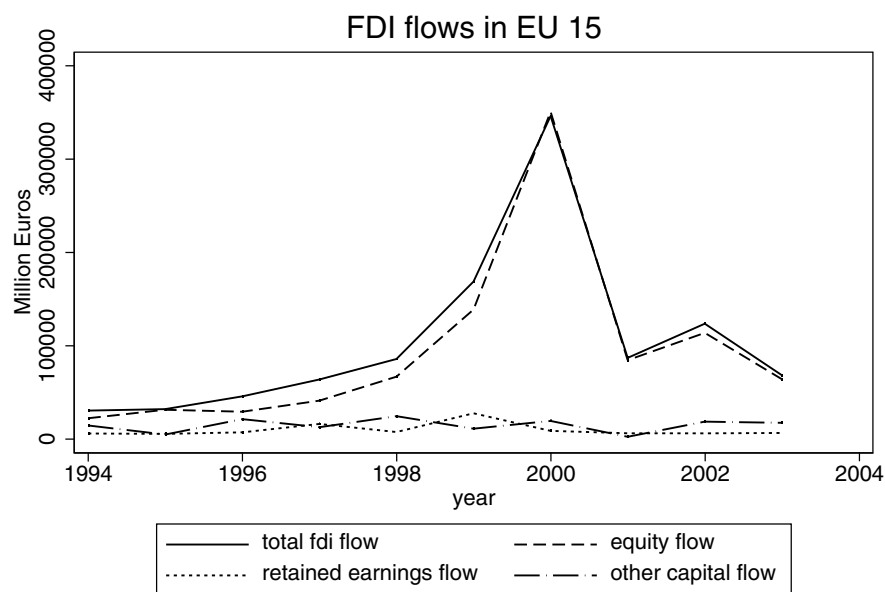


Figure 1: Evolution of intra-EU 15 FDI flows, Million Euros, *Source:* Eurostat, authors' calculations from the data set.

15 are still quantitatively small. However, in recent years they have increased in importance (Figure 3). Also, bilateral FDI flows among the 10 new member states have picked up (Figure 4). As regards the different kinds of FDI, we see that the predominant share of FDI comes from investment into equity capital. Reinvested earnings and "other FDI capital flow" are also relevant, especially for the aggregate flows to the 10 new member states. A separate investigation into the determinants of these different FDI flows therefore appears justified.

An important characteristic of bilateral FDI data in general and especially in the present sample concerns zero FDI flows between countries. Table 12 in the appendix gives information on the frequency of positive FDI flows in the investigated countries. The data indicate that smaller countries invest less frequently abroad.⁹ Also, the 10 NMS are relatively rarely a source of FDI. Table 2 below shows that more than 33 percent of the bilateral relations, for which data are available, report that the FDI flow was zero.¹⁰ In the earlier years, few East European countries were recipients of FDI, while the number and the amounts of investment to them strongly increased in time. But also in the EU 15, there are numerous country pairs without an FDI flow. Recently, East European countries have also started to invest in other EU countries.

⁹On a yearly basis, this feature of the data becomes even more important.

¹⁰Eurostat does properly differentiate between zero and missing observations.

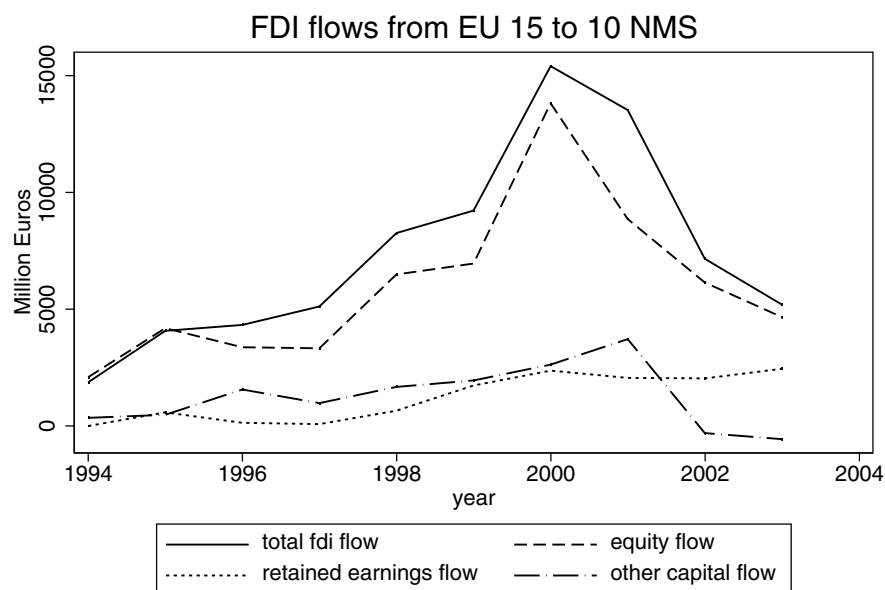


Figure 2: Evolution of FDI from the EU 15 countries to the 10 NMS, Million Euros, *Source:* Eurostat, authors' calculations from the data set.

Table 2: Structure of the data for the EU25, 1994-2003

	Total FDI		Equity		Reinvested		Other	
		%		%		%		%
#	1996		2724		1772		2314	
equal zero	661	33.1	991	36.4	991	55.9	1073	46.4
greater 0	1335	66.9	1733	63.6	781	44.1	1241	53.6
mean	637.19		402.74		111.16		163.23	
std. dev.	4763.98		3978.91		471.69		629.41	

Source: Author's calculations from Eurostat data.

FDI flows have not only increased in amount, but more country pairs have established positive FDI relationships. The mean annual FDI flow from one to another country, where observations are available, amounts to 637 million Euros. An empirical analysis of FDI flows in Europe should therefore take into account the structure of the bilateral FDI flows and especially the information contained in the zero bilateral FDI flows.

Concerning our main explanatory variable, the tax burden, the literature has seen different approaches towards its measurement. One can distinguish between backward and forward looking measures and between effective tax rates, tax quotas and legal tax rates. All measures have advantages and disadvantages. The most widely used measure is the statutory tax rate, which is given by law. Devereux and Griffith (1998, 1999, 2003) and Devereux, Griffith,

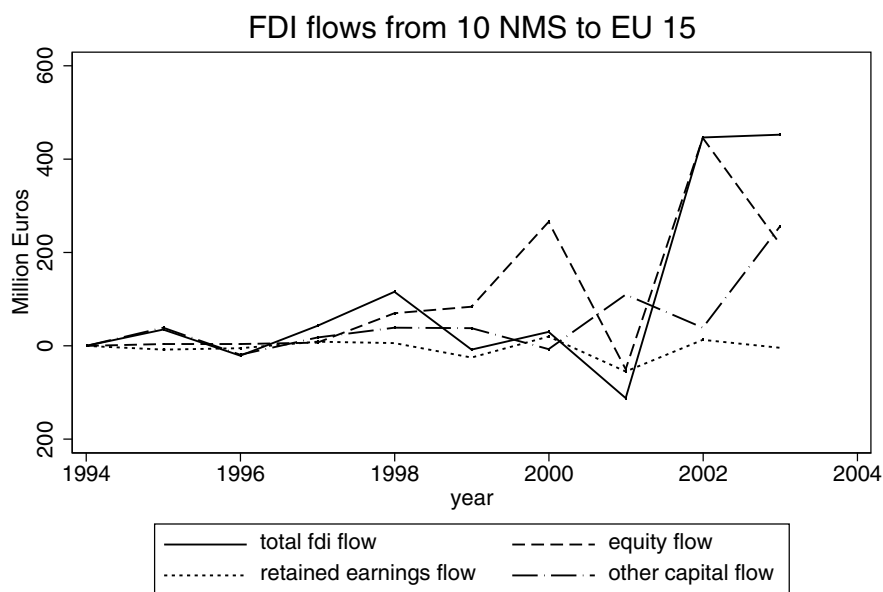


Figure 3: Evolution of FDI from the EU 15 countries to the 10 NMS, Million Euros, *Source:* Eurostat, authors' calculations from the data set.

and Klemm (2002) argue in favor of rather complex measures of forward looking effective tax rates and distinguish between average and marginal concepts. This measure is not available for the enlarged EU in one coherent definition. Furthermore, it presupposes an asset and financing structure of an investment project. However, firms adjust their asset portfolios and their way of financing investments to tax burdens. Due to this endogeneity problem, Razin, Rubinstein, and Sadka (2005) suggest to instrument it by the corporate tax rate. While Bellak, Leibrecht, and Römisch (2005) argue in favor of the theoretical superiority of the Devereux et al. measures, they also show that the cross sectional information contained in statutory tax rates is close to the more complex measures. Moreover, it is well known, that the more complex effective measures converge to the statutory rates as profits increase. We therefore believe that the top statutory tax rate is a good proxy for forward looking measures of Devereux et al. Effective ex-post tax rates for most countries in the EU 25 are computed by Wolff (2005) following a methodology developed in Mendoza, Razin, and Tesar (1994). This measure gives a very rough prices wedge for capital income, which takes into account all possible tax exemptions and base reductions. However, it is measured for all capital income in a country and is therefore not well suited for FDI flow determinants. In this study, we follow Razin, Rubinstein, and Sadka (2005) and restrict our analysis to the

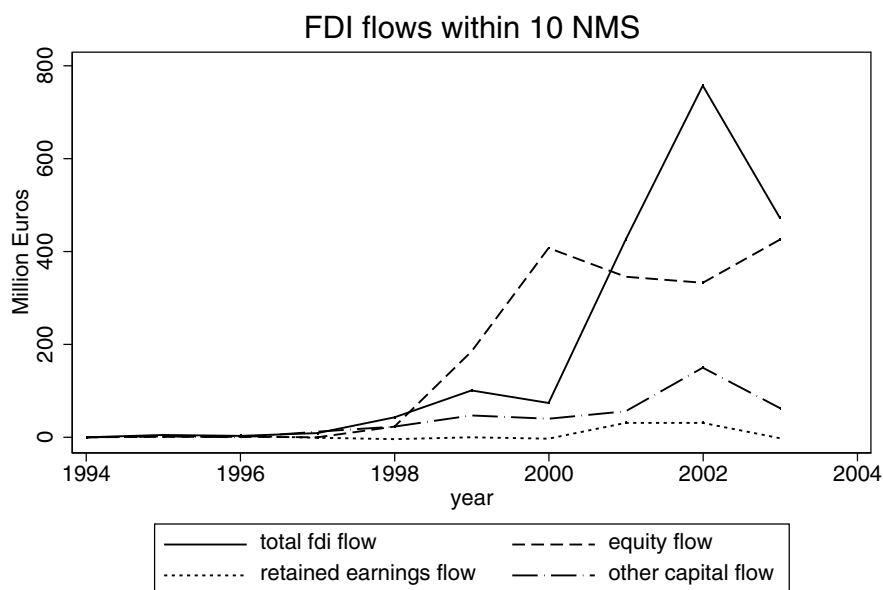


Figure 4: Evolution of FDI from the EU 15 countries to the 10 NMS, Million Euros, *Source:* Eurostat, authors' calculations from the data set.

top statutory tax rate taken from European Commission - DG Taxation and Customs Union (2004).

The corporate tax rates of corporations in Europe differ substantially. Especially the new member states can be characterized by relatively low levels of taxation. Figure 5 shows the top statutory tax rates in the EU countries in 1995 and 2004. Most countries have experienced a reduction in the tax rate, the average tax rates are lower in the 10 new member states compared to the older members of the EU. The time variation of this tax reduction is, however, relatively small with only a few tax reforms per country in the investigated period.

3.2 Methodology

In the theory part, we have given reasons, why the decision to engage in FDI might depend differently on explanatory variables than the amount of FDI. The data description of the FDI flows in the 25 EU countries further confirms that some country pairs do not choose to engage in FDI. We show that about one third of the observations have zero FDI flows.¹¹ When estimating the

¹¹It is possible to have a positive FDI flow, which is exactly offset by an equal negative FDI flow, resulting in a zero aggregate FDI flow. The probability of this to happen is however very low.

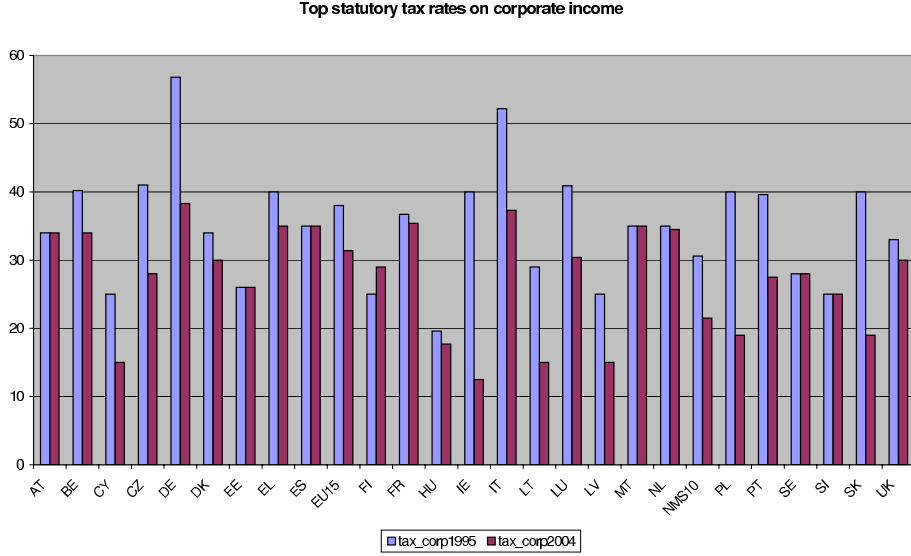


Figure 5: Comparison of the top statutory tax rate on corporate income, *Source: Eurostat*

effect of taxes and other variables on FDI flows, these "zeros" have to be taken into account. Standard OLS estimation will yield biased results for the effect of the independent variable on the actual flow.

A standard procedure in the international trade and FDI literature is to treat all zero observations as resulting from a censored process. The appropriate econometric model is then Tobit estimation. The Tobit estimator assumes that the effect of the independent variable x on $E(y)$ is the same as the effect of x on $P(y>0)$. If this assumption is violated, the Tobit estimator is inappropriate. In terms of our theoretical part, the Tobit model is too restrictive. Tobit requires host and source country tax rates to matter equally for the amount and the probability of FDI.

A more flexible estimation approach, which allows for the possibility of endogenous selection, is the sample selection model (Heckman 1979, Kyriazidou 1997). In this model, the probability of being selected, i.e., of observing a positive FDI flow depends differently on the same explanatory variables than the amount of FDI. In particular, it is possible, that taxes matter for selection, but not for the amount. The model is thus more flexible than Tobit and suited for estimating differential effects of taxes. More specifically, in a sample selection approach the following empirical model is estimated (see, e.g., Verbeek (2000, p 209)).

$$FDI_{ijt}^* = X_{1ijt}\beta_1 + \varepsilon_{1ijt} \quad (2)$$

$$h_{ijt}^* = X_{2ijt}\beta_2 + \varepsilon_{2ijt} \quad (3)$$

$$FDI_{ijt} = FDI_{ijt}^*, h_{ijt} = 1 \quad \text{if } h_{ijt}^* > 0 \quad (4)$$

$$FDI_{ijt} = 0, h_{ijt} = 0 \quad \text{if } h_{ijt}^* \leq 0 \quad (5)$$

where h_{ijt} is one in case of a positive FDI flow from country i to country j , while it is zero if no FDI is observed. The two error terms are assumed to be normally distributed with a covariance σ_{12} and correlation coefficient ρ . Equation 3 determines the probability of investing, while equation 2 measures the impact of the x_1 variables on the amount of FDI. Note that β_1 measures the impact of X_1 on the latent variable. The marginal effect of the common regressors X_1 in the observed sample consists of two components. There is a direct effect on the mean given by β_1 . In addition, the respective variable will influence FDI through its presence in the inverse Mills ratio $\lambda = \frac{\phi(X_2\beta_2)}{\Phi(X_2\beta_2)}$ (Greene 2000, p.929), since the variables in X_1 are included in X_2 . If ρ is positive, an OLS estimate of equation 2 will understate the effect of X on FDI flows. Note that the selection equation is a non-linear Probit estimator. The probability of investment is thus a non-linear function of the source country tax rate and given by

$$P(\tau_s) = \int_{-\infty}^{c+\beta_2*\tau_{it}} (2\pi)^{-1/2} \exp(-y^2/2) dy \quad (6)$$

where c is the effect of all other variables at their averages.

Even though our theoretical model predicts that Tobit has too restrictive assumptions, we want to test empirically, whether this is the case. Furthermore, the Tobit estimator is more efficient than the sample selection model given that its restrictions are valid. We therefore test its restrictions with a likelihood ratio test developed by Fin and Schmidt (1984) and described in Greene (2000, p.915). The likelihood ratio statistic can be computed as

$$\lambda = -2[\log L_T - (\log L_P + \log L_{TR})] \quad (7)$$

where L_T is the likelihood given by the Tobit model, L_P is the likelihood of the Probit model and L_{TR} is the likelihood for the truncated regression model. The test results clearly reject the null hypothesis that the restrictions are valid. The test thus shows that the independent variables have different effects on the probability to observe FDI and the amount of FDI. A sample selection approach is thus justified.

A further important issue when estimating a sample selection model concerns identification. If X_1 and X_2 are identical, the model is only identified

through the fact that the inverse Mills ratio depends on the same variables in a non-linear fashion. Some authors therefore suggest, that X_2 should at least include one additional variable. However, this variable is always subject to criticism, since the variable might also be relevant for the flow equation. In addition, even if a variable was known, that clearly influences only the probability and has no effect on the amount of FDI, we still have to rely on the functional form assumption underlying the Heckman regression model. Using an additional variable thus appears dispensable. We rely on the functional form for identification and present our empirical results with the same variables for both, selection and flow equation. We also present robustness checks where we include one additional identifying variable, a dummy for previous FDI flows, suggested by Razin, Rubinstein, and Sadka (2005). However, we doubt that it influences only the probability.

When estimating a gravity model, the role of country and time fixed effects needs to be discussed. In a first step, we present estimation results without fixed effects. These estimates give information on the effects of the main explanatory variables. It is, however, possible that unobserved country characteristics determine the results. Note that the estimation of fixed effects (within estimator) is not possible if one wants to identify the importance of distance and other time invariant country pair characteristics. Also, the sample selection estimation procedure involves non-linearities making the computation of a within estimator impossible. Therefore, Matyas (1997, 1998) argues that a proper specification of the gravity model should include source and host country and time dummies. In general, we expect these dummies to significantly weaken the impact of the other explanatory variables. This holds especially, as FDI flows react to long term characteristics of countries. The macroeconomic control variables capture well the long term characteristics. However, at the same time, they change relatively little in the short time period investigated. Also, top statutory corporate tax rates are changed only irregularly. Therefore identification of the effects of macroeconomic aggregates on FDI flows, when country dummies are included, will be more difficult. Time dummies also appear necessary, as the flows reveal common time effects.

Our empirical specification is in the tradition of the gravity model. Besides the standard gravity factors like distance, we include variables for X_{1ijt} to capture cost advantages, market access and agglomeration effects identified by economic theory. The following Equation specifies the set-up of the estimation

Equation 2 in greater detail:

$$\begin{aligned} \log(FDI)_{ijt} &= \gamma_1 TAX_{jt} + \gamma_2 TAX_{it} + \gamma_3 \log(L)_{jt} + \gamma_4 \log(L)_{it} + \gamma_5 \log(Y/L)_{jt} \\ &+ \gamma_6 \log(Y/L)_{it} + \gamma_7 Z_{ij}^1 + \dots + \epsilon_{ijt} \end{aligned} \quad (8)$$

where L is population size, and Y is nominal GDP measured in million Euros. The tax variables is the top statutory tax rate in the recipient country and in the investing country. γ_3 gives the effect of population size holding constant the degree of development of a country. The total effect of the population size can be tested with an F-test on the coefficient difference $\gamma_3 - \gamma_5$ for the recipient country, while the effect of income levels is given by γ_5 . The same holds - mutatis mutandis - for the investing country. Z_{ij}^1 is a vector of variables varying across country pairs, but not in time, such as distance, common language, and border dummies.

As discussed, we use four different measures of FDI as dependent variable: total FDI, equity capital FDI, retained earnings and other capital. Equity capital FDI constitutes the largest part of total FDI in our sample, even though other and retained earnings also play a significant role (see Table 2). Data coverage is greatest for the equity measure. For retained/reinvested earnings, the least data are available.

Population size and GDP should both positively affect FDI flows as they capture factors determining horizontal FDI. GDP in the host country is a measure of market potential and should be positively associated with FDI. A high level of GDP in the investing country measures the ability to engage in significant amounts of FDI. We therefore expect the coefficient on GDP per capita to be positive in both, the host and the source country. GDP per capita is a measure of economic development. Net FDI should therefore flow to countries with lower GDP per capita as the return to capital is probably larger. Differences in magnitude of the coefficient size of GDP per capita in host and source country reflect the impact of relative GDP per capita values on the **net** FDI flows. If the coefficient is larger for source country GDP per capita than for host country GDP per capita, net FDI will flow from the richer to the poorer country.

We include the monthly wage rate, measured as monthly labor cost in total industry and construction.¹² The wage rate measures vertical FDI motives, as

¹²For the precise definition of this wage rate see the appendix. We also used the hourly wage rate as an alternative measure without any substantial change in the results.

it captures an important part of production costs. As an additional control variable, we include total government expenditure in percent of GDP for both, the host and investing country. We expect a larger (and unproductive) government sector in the host country to reduce investment opportunities and expect a negative coefficient, while a large government in the source country might encourage firms to invest abroad. Alternatively, productive government expenditure should positively influence FDI.¹³

Finally, we include the distance between two countries as a standard gravity measure. A negative coefficient reflects increasing transaction costs (e.g., longer travel times for executive personnel, greater cultural differences). However, a positive coefficient might be explained by the fact that trade costs become too high so that investment is chosen instead. A dummy for a common language should be positively related to FDI flows as transaction costs are significantly reduced. However, in the present data set of 25 EU countries only few such common language matches exist (Germany and Austria, Ireland and UK), and the coefficient is therefore insignificant and not reported. A dummy for bordering countries should have a positive effect on FDI as transaction costs are significantly lower.

4 Results

4.1 Baseline results

The basic empirical results are presented in Tables 4 to 7. We present three sets of regressions, one without country and time fixed effects, one with country fixed effects, and one with country and time fixed effects. For each set of dummy control variables, we present three different specification. Besides the baseline regression, we show the results after controlling for government expenditure and the results for an additional variable to improve the identification of the Mills ratio. The three different specifications broadly yield the same results. Finally, in Tables 8 and 9, we present the results for an additional control variable often used in the FDI literature, the wage rate.

The first important result relates to the sample selection term. Our test results indicate that in most regressions a failure to address sample selection will bias the empirical result. The null hypothesis of no correlation of the

¹³Buettner (2002) argues that government expenditure might be productive and thereby even offset the negative impact of higher taxes.

errors of the two regression can be rejected in most regressions. Analyzing the effect of taxes on FDI in Europe with this data set thus requires a sample selection estimation approach.

In the regression excluding country and time effects, the control variables have the expected signs. Distance is detrimental to FDI flows and probability, while bordering countries have more FDI. GDP in host and home country increases FDI flow and probability. The coefficient on the home country GDP per capita is roughly three times the size of the host country GDP coefficient. This implies that, on average, net FDI flows from rich to poor countries. Countries with larger GDP size invest more in small sized countries than small sized countries in large ones. The coefficient for population is significant and of similar size for both, source and host country after controlling for GDP per capita. Large government expenditure to GDP values in the host country lower the amount and the likelihood of FDI flows, while source country government expenditure affects the probability of FDI flows positively. Regarding the effects of wages, the results are less clear cut. Wage differences, a factor very often cited as a prime determinant of FDI, are significantly negative only in some specifications. The insignificance might be explained by the fact, that GDP per capita is a variable closely related to wages. Also, the wage data are not adjusted for productivity.

For total FDI and equity FDI, we can confirm the empirical results for OECD countries by Razin, Rubinstein, and Sadka (2005). Higher host country taxes are associated with lower FDI flows. Higher source country taxes are insignificant in the flow equation, but significantly increase the likelihood of observing a positive FDI flow in a country pair.

For retained earnings and other FDI, the estimated coefficients give a different picture. While for the control variables the results are essentially the same as for equity FDI, the coefficients on source and host country taxes are less intuitive. In particular, source and host country tax rates reduce the amount of retained earnings. For other capital, host country taxes appear to lower the amount and the probability of the intercompany credits.

These empirical results are, however, based on regressions without country and time dummies. The coefficients might therefore reflect other unobserved country characteristics. In the following, we present the estimation results of the sample selection model specified with the necessary dummies. An F-test on the dummies confirms, that they have to be included. The dummies

dramatically reduce the significance of the other variables.

The most robust variables across all specifications is the distance measure and the border dummy. More distant countries have less FDI flows and are less likely to engage in FDI.

For total FDI, the only control variable besides distance and border dummy staying significant is GDP in the host country. An F-test on the difference between the population and GDP per capita coefficient cannot reject the null hypothesis that population in the host country significantly matters for FDI after controlling for GDP. For the selection equation, we find that source country taxes increase the probability of FDI flows at a 10 percent level. However, for the flow equation, host corporate tax rates are insignificant.

Equity FDI represents the largest part of FDI. Also, any firm intending to start production abroad has to start by acquiring equity. We therefore expect equity FDI to most strongly depend on market size and cost factors. This holds for both, the selection and the flow equation. This view is confirmed by our regression results. We find that especially source country GDP per capita and population size matter for the amount of FDI. Population and GDP in the host country, on the other hand, are not significant. For the selection equation, population in the source country and GDP per capita in the host country are significant at a seven percent significance level. Larger government expenditure in percent of GDP in the source country increases the amount of FDI, but does not operate on the selection process. Higher wages in the source country lower the amount and the probability of equity FDI, after one has controlled for GDP per capita. The wage difference is statistically insignificant. For equity FDI, source and host country statutory tax rates do not matter significantly. These results indicate that equity FDI seems to be mostly determined by fundamental source country characteristics and unobserved country characteristics, while statutory tax rates do not matter.

Retained earnings are driven by different factors than equity FDI. Here, the regression results indicate that GDP and population as well as wages are insignificant, while source country taxes very significantly increase the probability of observing re-investments of profits abroad. Finally, for other FDI we do not find significant tax effects after controlling for country and time fixed effects.

4.2 Robustness checks

To check the robustness of the results, we perform two further sets of regressions. First, to check that the difference in the effects of source country taxes on equity respectively retained earnings is not driven by the sample, we re-estimated the model with equity FDI as the dependent variable for the sample, for which retained earnings observations were available. The coefficients for source and host country taxes stayed insignificant. We also estimated the regressions with retained earnings as the dependent variable for only those observations, for which equity flows are available. The source country tax rate stays significant in the selection process.

Since the 10 new member states have arguably a different history, and different characteristics than the old EU members and since they probably have less funds for investment, we present in Table 10 the estimates for EU 15 source countries only. The estimation results broadly confirm the picture obtained with the data for the EU 25. In particular, only for retained earnings, the source country tax increases the probability to re-invest abroad significantly. Also, for equity FDI, the macroeconomic fundamentals are significant in explaining amount and decision of FDI. The basic empirical results are also not driven by the fact, that the 10 new member states do not invest in the other new member states, as is evident from Table 11.

4.3 Interpretation

Our empirical results give a more differentiated picture of the effects of taxes and market size on FDI flows. In the specification without country and time dummies, we find that host country corporate taxes reduce the amount of FDI, in particular equity FDI. Source country taxes, on the other hand, very robustly and strongly significant operate on the selection. Thus, higher source country taxes increase the probability of observing FDI. These results might be explained by a fixed set-up cost argument as put forward in Razin, Rubinstein, and Sadka (2005). Higher source country taxes reduce the cost of set-up costs if they are incurred at home and thereby increase the probability of FDI flows. However, the results have to be taken with great caution, as they might be driven by unexplained country characteristics.

After controlling for source and host unobserved country characteristics and common time effects, the significance of the tax measure disappears in

this EU data set for equity FDI. Equity FDI, the largest part of total FDI, is however still determined by source country characteristics such as GDP per capita and population size. For the decision to establish an FDI flow, host country GDP matters significantly. We do, however, observe very significantly positive source country tax effects for the probability of observing re-invested earnings. On the other hand, for re-invested earnings, population size and GDP are insignificant.

The results must be interpreted cautiously. The insignificant coefficient might reveal, that taxes do not matter for total and equity FDI flows in the EU during the period 1994-2003. This interpretation is also supported by a recent survey study of German manufacturing firms, in which tax considerations are mentioned by a relatively small percentage of firms as decision variable for shifting production abroad (Kinkel, Lay, and Maloca 2004). The main determinants in this study are cost factors and market acquisition arguments. Our empirical results confirm this view as macroeconomic fundamentals remain significant for the main FDI category, investment into equity.

The insignificance of the top statutory tax rate might also result from an identification problem. In the regressions without country and time controls, we find the expected signs for host and source statutory tax rates. An insignificant tax coefficient after controlling for country and time fixed effects can be explained by the fact that tax incentives cannot empirically be distinguished from the additional unobserved country and time characteristics. Indeed, identification is only due to the time variation of the tax rate. As we have seen, this variation is relatively minor. This view is further supported by auxiliary regressions of the host country dummies' coefficients on the host country tax rates. In this regression, the tax rate significantly negatively explains the value of the host country dummies, even after controlling for GDP per capita and population. However, this auxiliary regression does not establish a proof that tax rates matter.

The insignificant coefficient might also mean, that company taxation is met by an equivalent provision of public goods improving location advantages. However, Buettner (2002) does not find evidence in support of significant public spending effects for FDI flows. Our admittedly very broad measure of government expenditure also contradicts this hypothesis as it indicates that public spending deters FDI and encourages FDI in other countries. Finally, it is unlikely, that a direct equivalence between company taxation and public

goods relevant for FDI exists, as revenue from corporate taxes constitutes only a minor share of public revenue.

Corporate tax rates might be a bad measure of actual tax burdens on FDI. In particular, tax exemptions, credits and the like cannot be captured well by any measure of tax burdens. Many countries indeed grant generous tax breaks to attract FDI, anecdotal evidence for the 10 new member states points at that. Real tax burdens are however difficult to measure. The existing effective measures each suffer from various drawbacks and are not available for all countries. We are nevertheless confident, that top statutory tax rates should be positively connected to actual tax burdens and therefore we believe that our empirical results are not an artefact of the precise tax measure.

Finally, our empirical evidence shows that top statutory corporate tax rates in the enlarged EU have very strong and significant effects on the probability of firms to retain profits abroad, even after controlling for country dummies. Evidence for increased financial transactions of US companies to reduce dividend repatriation and avoid source country taxes is also presented in Hines and Hubbard (1990). Previous research (Ramb and Weichenrieder 2005) also indicates that inter-company loans are used as an instrument to avoid taxes, even though the estimated effects are small. Our study complements this result by showing a significant effect of taxes on re-investment of profits. To gather further evidence on the effect of taxes on the financing structure, we regress other capital FDI in percent of equity FDI on host and source country tax rates. Since interest on debt represents a cost in the host country, which

Table 3: Estimation results for the effect of taxes on debt financing of FDI

	tax_{jt}	tax_{it}	obs	R^2
$\log(oc/equity)$	-0.66	-1.53	899	0.01
	-0.95	-2.14		

Notes: t-values below the coefficient.

is not taxed, but a revenue, which increases profits in the source country, we expect high source country taxes to lower the amount of debt as an instrument of investment. High source country taxes indeed significantly reduce inter-company debt in percent of equity investment (Table 3). These results are consistent with the effect measured in Ramb and Weichenrieder (2005). Top statutory tax rates therefore do not appear to matter for the more fundamental decisions of where and how much to invest. They, however, prevent firms from re-distributing their profits and increase the amount of debt FDI.

Overall, with the present data set, it is difficult to confirm the hypothesis

of significant tax effects on (equity and total) FDI flows. We do find evidence, however, that taxes matter for the allocation of profits in the European Union.

5 Conclusion

The empirical determinants of FDI are a hotly debated issue. In the public debate, high corporate tax rates are often mentioned as one of the key reasons for low investment rates from abroad, while low tax rates abroad are claimed to constitute unfair competition attracting FDI. The available empirical evidence, however, shows a rather wide range of estimates of tax elasticities of FDI.

The empirical results presented in this paper indicate that the importance often attributed in policy circles to the top statutory corporate tax rate for FDI is difficult to confirm. After controlling for unobserved country characteristics and common time effects, the tax rates of both, source and host country, turn insignificant for equity FDI. Equity FDI, however, is influenced significantly by market size factors. High source country taxes clearly increase the probability of firms to re-invest profits abroad, while market size factors play less of a role. We also find some evidence that source country taxes lower the use of debt to finance FDI. Further research could investigate in greater depth, in how far taxation determines the financing structure of foreign investments. Our results provide some evidence that taxes influence the allocation of profits, while possibly leaving total FDI flows unaffected.

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A Estimation results

Table 4: Estimation results for the effect of taxes on total FDI.

tax _{jt}	-1.80	-0.94	-1.79	-0.65	-0.55	-0.62
	-2.27	-1.1	-2.29	-0.48	-0.39	-0.46
tax _{it}	0.29	0.30	0.16	2.14	3.35	2.06
	0.35	0.35	0.2	1.34	1.98	1.29
log(population) _{jt}	0.74	0.69	0.71	3.18	1.77	3.26
	13.18	12.07	12.74	0.73	0.4	0.75
log(population) _{it}	0.61	0.55	0.59	-0.49	-7.16	-0.56
	9.35	8.29	9.07	-0.05	-0.69	-0.06
log(GDP/population) _{jt}	0.71	0.80	0.70	0.92	0.93	0.94
	10.45	10.94	10.45	1.85	1.86	1.87
log(GDP/population) _{it}	2.54	2.37	2.30	1.13	0.71	1.19
	12.84	14.19	13.42	1.35	0.82	1.42
dist	-1.97	-1.91	-1.82	-2.43	-2.34	-2.35
	-10.28	-10.79	-10.47	-13.53	-12.79	-13.28
border	0.32	0.28	0.31	0.64	0.64	0.63
	2.09	1.79	2.06	4.61	4.44	4.57
G/Y _{jt}		-0.02			-0.01	
		-2.85			-0.5	
G/Y _{it}		-0.01			0.01	
		-0.81			1.22	
cons	-2.86	-0.17	-2.97	-35.30	86.04	-35.37
	-2.06	-0.1	-2.14	-0.24	0.57	-0.24
selection equation						
tax _{jt}	-0.51	0.42	0.21	-0.09	-1.80	0.02
	-0.63	0.45	0.23	-0.05	-0.8	0.01
tax _{it}	2.96	3.65	2.71	6.19	6.74	6.50
	2.66	3.34	2.49	1.65	1.63	1.77
log(population) _{jt}	0.47	0.41	0.38	1.90	-5.99	1.00
	7.74	6.47	5.96	0.35	-0.88	0.19
log(population) _{it}	0.27	0.16	0.24	2.73	-1.84	5.20
	4.34	2.4	3.85	0.28	-0.18	0.52
log(GDP/population) _{jt}	0.28	0.32	0.21	-0.23	-1.32	-0.46
	4.28	4.42	3.05	-0.31	-1.42	-0.63
log(GDP/population) _{it}	1.66	1.55	1.45	-0.67	-1.27	-0.97
	16.12	15.56	13.91	-0.49	-0.91	-0.71
dist	-1.55	-1.54	-1.41	-2.69	-2.63	-2.37
	-10.29	-9.9	-9.08	-6.52	-6.23	-6.07
border	0.84	0.97	0.88	0.95	1.04	0.97
	3.18	3.53	3.64	4	4.24	4.27
G/Y _{jt}		-0.02			0.01	
		-2.02			0.71	
G/Y _{it}		0.01			0.00	
		2.14			0.12	
previousfdi			0.66			0.63
			5.11			4.21
cons	-1.78	0.10	-1.85	-69.57	0.27	-95.81
	-1.35	0.07	-1.37	-0.47	10.35	-0.66
dummies	no	no	no	c+t	c+t	c+t
N	1552	1436	1552	1552	1436	1552
censored	461	409	461	461	409	461
χ ²	7.99	7.24	4.30	4.21	3.52	1.29
p	0.005	0.007	0.038	0.040	0.061	0.256

Notes: t-values below the coefficient. c+t dummies means that source and host country and time dummies are included in the regression.

Table 5: Estimation results for the effect of taxes on equity FDI.

tax _{jt}	-2.73	-1.58	-2.74	-0.27	0.74	-0.26
	-4.03	-2.13	-4.11	-0.23	0.59	-0.21
tax _{it}	-0.77	-0.74	-0.89	1.71	2.08	1.69
	-0.98	-0.92	-1.14	1.11	1.33	1.1
log(population) _{jt}	0.84	0.79	0.79	0.35	-1.50	0.66
	15.99	15.19	15.65	0.1	-0.41	0.18
log(population) _{it}	0.73	0.63	0.66	13.63	12.29	13.07
	10.56	8.73	10.3	2.07	1.75	1.98
log(GDP/population) _{jt}	0.71	0.75	0.70	0.59	0.81	0.56
	11.95	11.67	11.97	1.35	1.86	1.29
log(GDP/population) _{it}	2.37	2.31	2.05	2.36	2.11	2.38
	12.49	15.65	14.09	3.23	2.8	3.26
dist	-2.14	-2.11	-1.96	-2.66	-2.65	-2.57
	-12.69	-13.36	-12.51	-14.55	-14.71	-14.39
border	0.41	0.38	0.39	0.58	0.55	0.58
	2.8	2.53	2.72	4.55	4.14	4.54
G/Y _{jt}		-0.02			-0.01	
		-2.26			-0.81	
G/Y _{it}		-0.02			0.02	
		-1.73			2.05	
cons	-6.97	-2.92	-6.29	-178.66	-171.24	-176.08
	-5.46	-1.55	-5.03	-1.73	-1.32	-1.71
selection equation						
tax _{jt}	-0.68	0.25	-0.35	0.66	0.55	0.19
	-1.11	0.36	-0.51	0.47	0.35	0.13
tax _{it}	1.99	2.43	1.73	1.60	-0.61	2.62
	2.29	2.85	2.08	0.56	-0.2	0.89
log(population) _{jt}	0.44	0.38	0.34	0.71	-0.54	0.69
	9.58	8.22	7.22	0.15	-0.11	0.14
log(population) _{it}	0.41	0.33	0.37	11.61	14.83	16.66
	8.33	6.62	7.29	1.87	2.21	2.58
log(GDP/population) _{jt}	0.19	0.25	0.14	1.05	1.71	0.70
	3.72	4.57	2.83	1.81	2.74	1.17
log(GDP/population) _{it}	1.41	1.36	1.15	1.24	1.34	1.20
	19.2	16.98	14.83	1.5	1.55	1.44
dist	-1.28	-1.29	-1.18	-2.46	-2.49	-2.19
	-12.68	-12.13	-10.94	-8.15	-7.7	-7.52
border	0.54	0.74	0.43	0.70	0.85	0.62
	3.19	3.76	2.45	3.9	4.46	3.46
G/Y _{jt}		-0.01			0.01	
		-1.8			0.7	
G/Y _{it}		0.01			0.01	
		2.05			1.68	
previousseq y			0.80			0.56
			7.94			4.69
cons	-5.45	-3.75	-5.09	-202.06	-183.58	-292.18
	-5.31	-3.26	-4.75	-1.43	-1.38	-2.05
dummies	no	no	no	c+t	c+t	c+t
N	2057	1915	2057	2057	1915	2057
censored	676	594	676	676	594	676
χ ²	9.34	12.74	3.73	9.54	10.73	6.75
p	0.002	0.00	0.054	0.002	0.001	0.009

Notes: t-values below the coefficient. c+t dummies means that source and host country and time dummies are included in the regression.

Table 6: Estimation results for the effect of taxes on retained earnings FDI.

tax _{jt}	-2.46	-1.16	-2.16	-1.29	-0.92	-1.19
	-2.44	-1.07	-2.17	-0.74	-0.5	-0.68
tax _{it}	-2.42	-2.10	-1.78	-2.01	-2.11	-2.55
	-2.04	-1.72	-1.49	-1.06	-0.99	-1.32
log(population) _{jt}	0.54	0.43	0.43	-8.09	-7.59	-7.72
	7.07	4.95	5.62	-1.69	-1.51	-1.63
log(population) _{it}	0.62	0.54	0.56	1.44	-0.34	2.05
	7.88	6	6.78	0.12	-0.03	0.17
log(GDP/population) _{jt}	0.66	0.68	0.58	0.85	0.76	0.86
	7.47	6.77	6.52	1.3	1.09	1.31
log(GDP/population) _{it}	2.12	2.15	1.52	0.69	0.28	0.74
	9.11	7.02	6.6	0.81	0.32	0.87
dist	-1.41	-1.24	-1.16	-2.32	-2.15	-2.14
	-6.78	-5.48	-5.79	-9.34	-8.33	-8.44
border	0.42	0.45	0.35	0.49	0.49	0.48
	2.47	2.64	2.04	2.93	2.86	2.83
G/Y _{jt}		-0.01			-0.02	
		-1.36			-1.3	
G/Y _{it}		-0.06			-0.01	
		-3.18			-0.32	
cons	-1.97	4.60	-1.90	84.32	108.03	70.42
	-1.27	1.81	-1.18	0.42	0.51	0.35
selection equation						
tax _{jt}	-0.81	0.62	0.18	-1.58	-0.04	-2.27
	-1.15	0.81	0.24	-0.89	-0.02	-1.24
tax _{it}	-1.56	-1.42	-1.10	7.11	6.25	6.05
	-1.93	-1.8	-1.29	3.21	2.54	2.67
log(population) _{jt}	0.39	0.39	0.33	-7.14	-10.66	-7.62
	8.53	8.22	6.87	-1.42	-1.99	-1.49
log(population) _{it}	0.18	0.10	0.09	-22.75	-24.29	-14.68
	3.3	1.64	1.65	-2.14	-1.99	-1.36
log(GDP/population) _{jt}	0.26	0.34	0.24	-0.35	-0.38	-0.71
	4.44	5.14	3.93	-0.52	-0.53	-1.03
log(GDP/population) _{it}	1.52	1.39	1.27	-1.27	-1.84	-1.01
	16.5	15.28	13.3	-1.22	-1.53	-0.93
dist	-0.89	-0.99	-0.70	-1.96	-1.97	-1.80
	-7.12	-7.64	-5.35	-7.07	-7.14	-6.22
border	0.31	0.33	0.38	0.39	0.44	0.45
	1.69	1.59	1.99	1.96	2.02	2.18
G/Y _{jt}		-0.02			-0.04	
		-3.6			-2.64	
G/Y _{it}		0.03			0.09	
		4.76			2.39	
previousre			1.24			0.96
			11.67			6.42
cons	-0.20	0.10	0.14	401.25	462.96	293.66
	-0.16	0.07	0.11	2.48	2.54	1.79
dummies	no	no	no	c+t	c+t	c+t
N	1379	1269	1379	1379	1269	1379
censored	754	674	754	754	674	754
χ ²	1.48	0.004	7.81	6.03	2.40	0.04
p	0.224	0.95	0.005	0.014	0.121	0.833

Notes: t-values below the coefficient. c+t dummies means that source and host country and time dummies are included in the regression.

Table 7: Estimation results for the effect of taxes on other capital FDI.

tax _{jt}	-2.40	-1.73	-1.96	0.79	0.45	0.83
	-3.19	-2.16	-2.71	0.62	0.34	0.66
tax _{it}	-0.94	-0.55	-0.89	2.48	3.17	2.39
	-1.08	-0.63	-1.05	1.46	1.79	1.41
log(population) _{jt}	0.69	0.67	0.58	5.17	3.64	5.23
	11.25	11.07	9.68	1.26	0.87	1.28
log(population) _{it}	0.53	0.47	0.44	3.77	0.54	3.89
	7.85	6.52	6.59	0.48	0.06	0.5
log(GDP/population) _{jt}	0.98	1.07	0.93	1.45	1.43	1.45
	14.9	15.62	14.54	3.09	2.99	3.1
log(GDP/population) _{it}	2.50	2.54	2.04	0.34	0.51	0.38
	13.62	14.19	12.51	0.4	0.58	0.46
dist	-1.69	-1.64	-1.41	-1.82	-1.71	-1.76
	-10.33	-10.42	-9.16	-10.6	-10.06	-10.42
border	0.01	0.03	0.00	0.39	0.40	0.39
	0.07	0.17	-0.02	2.64	2.59	2.63
G/Y _{jt}		-0.04			0.00	
		-4.59			0.05	
G/Y _{it}		-0.02			0.00	
		-2.09			-0.07	
cons	-0.31	3.95	0.88	-111.04	-60.84	-113.08
	-0.23	2.29	0.66	-0.97	-0.38	-0.99
selection equation						
tax _{jt}	-1.93	-2.00	-1.21	0.31	-1.76	0.41
	-3.08	-2.9	-1.82	0.2	-1.05	0.26
tax _{it}	0.08	-0.36	-0.28	1.90	3.28	1.81
	0.11	-0.48	-0.38	0.57	1	0.58
log(population) _{jt}	0.41	0.38	0.31	7.09	5.98	6.69
	9.78	8.57	6.99	1.32	1.02	1.29
log(population) _{it}	0.32	0.37	0.25	-4.66	-9.67	-2.10
	7.02	7.43	5.17	-0.7	-1.4	-0.32
log(GDP/population) _{jt}	0.24	0.25	0.15	1.02	0.44	0.90
	4.6	4.69	3.01	1.6	0.63	1.42
log(GDP/population) _{it}	1.13	1.23	0.99	-1.86	-1.72	-1.91
	16.65	15.96	13.57	-2.21	-1.96	-2.34
dist	-0.94	-0.94	-0.78	-2.11	-2.07	-1.95
	-9.68	-9.37	-7.32	-6.82	-6.47	-6.63
border	0.13	0.23	0.22	1.02	1.00	0.97
	0.9	1.5	1.42	5.4	5.04	5.16
G/Y _{jt}		0.00			0.00	
		-0.67			-0.02	
G/Y _{it}		-0.01			-0.01	
		-2.8			-1.08	
previousoc			1.08			0.53
			11.84			4.49
cons	-4.12	-3.17	-3.25	-18.98	24.22	-58.88
	-4.2	-2.92	-3.06	-0.14	0.16	-0.43
dummies	no	no	no	c+t	c+t	c+t
N	1766	1639	1766	1766	1639	1766
censored	749	675	749	749	675	749
χ ²	22.44	26.55	1.85	11.26	7.84	8.63
p	0.000	0.000	0.174	0.001	0.0051	0.003

Notes: t-values below the coefficient. c+t dummies means that source and host country and time dummies are included in the regression.

Table 8: Estimation results for the effect of taxes on total FDI and equity FDI, control for wage effects.

	Total FDI				Equity FDI			
tax _{jt}	-1.92	-2.09	-2.65	-2.82	-2.73	-2.76	-2.34	-2.38
	-1.84	-2.03	-1.45	-1.56	-2.84	-3.25	-1.39	-1.43
tax _{it}	0.12	0.16	1.76	2.03	-0.88	-0.58	2.05	2.21
	0.11	0.15	0.95	1.11	-0.83	-0.61	1.1	1.19
log(pop) _{jt}	0.85	0.88	11.38	10.80	0.93	0.89	4.00	3.59
	10.84	13	1.53	1.57	12.09	13.58	0.57	0.52
log(pop) _{it}	0.70	0.60	0.48	1.95	0.82	0.75	5.63	12.22
	9.33	8.43	0.04	0.18	9.58	8.09	0.69	1.67
log(gdp/pop) _{jt}	0.19	0.88	1.47	1.72	0.43	0.67	1.11	0.80
	0.36	4.2	1.33	2.12	0.89	3.65	0.99	1.01
log(gdp/pop) _{it}	4.27	2.50	2.71	1.47	2.82	2.45	3.53	1.95
	7.07	8.34	1.64	1.32	5.26	7.33	2.89	2.24
dist	-2.31	-2.18	-2.48	-2.48	-2.37	-2.17	-2.78	-2.80
	-11.59	-10.98	-12.72	-12.69	-12.62	-9.61	-14.05	-14.1
border	0.48	0.47	0.80	0.80	0.60	0.60	0.66	0.67
	2.73	2.68	5.12	5.11	3.56	3.44	4.43	4.45
log(wage) _{jt}	0.35		0.33		0.22		-0.33	
	0.73		0.3		0.5		-0.32	
log(wage) _{it}	-1.25		-1.40		-0.09		-2.20	
	-2.35		-0.99		-0.19		-1.92	
wage diff		0.00		0.00		0.00		0.00
		-1.51		0.19		-0.14		1.3
cons	5.83	-4.40	-174.25	-202.15	-10.34	-8.01	-127.16	-259.27
	0.76	-2.81	-0.76	-0.9	-1.55	-5.3	-0.66	-1.5
selection equation								
tax _{jt}	-1.03	-1.18	-0.75	-0.01	0.03	-0.34	1.16	0.60
	-0.93	-1.07	-0.29	0	0.04	-0.46	0.56	0.29
tax _{it}	3.38	3.76	6.01	6.01	1.16	1.11	3.71	4.48
	2.5	2.84	1.32	1.33	1.09	0.94	1.12	1.34
log(pop) _{jt}	0.46	0.50	-0.24	0.09	0.42	0.49	-3.95	-6.95
	6.3	7.77	-0.02	0.01	7.79	8.77	-0.42	-0.75
log(pop) _{it}	0.18	0.17	5.26	3.42	0.44	0.43	0.49	9.37
	2.54	2.64	0.43	0.28	7.27	6.67	0.05	1.13
log(gdp/pop) _{jt}	-0.30	0.39	-1.28	-1.21	0.18	0.41	0.11	0.39
	-0.59	2.01	-0.69	-0.9	0.44	3.16	0.08	0.38
log(gdp/pop) _{it}	1.46	1.48	-4.47	-0.82	1.95	1.19	3.93	0.81
	3.03	7.58	-1.46	-0.51	5.12	6.77	2.23	0.75
dist	-1.60	-1.61	-3.50	-3.51	-1.31	-1.31	-3.22	-3.20
	-9.88	-10.18	-7.45	-7.42	-11.15	-12.15	-9.74	-9.79
border	1.04	1.05	1.04	1.02	0.74	0.67	0.69	0.70
	4.6	4.64	3.94	3.93	4.57	3.62	3.62	3.68
log(wage) _{jt}	0.44		0.02		-0.09		0.39	
	0.93		0.02		-0.24		0.32	
log(wage) _{it}	0.21		3.61		-0.50		-3.79	
	0.5		1.35		-1.5		-2.33	
wage diff		0.00		0.00		0.00		0.00
		-1.3		-0.47		-2.03		1.93
cons	-8.36	-1.03	-118.98	-60.64	0.97	-6.25	76.67	-46.60
	-1.27	-0.68	-0.43	-0.22	0.19	-5.25	.	.
mills-lambda	1.57	1.43			1.64		0.83	0.87
	6.02	5.22			5.91		3.83	4.05
dummies	no	no	c+t	c+t	no	no	c+t	c+t
N	1243	1243	1243	1243	1625	1625	1625	1625
censored	374	374	374	374	552	552	552	552
χ ²			2.19	1.96		3.61		
p			0.14	0.16		0.06		

Notes: t-values below the coefficient. c+t dummies means that source and host country and time dummies are included in the regression.

Table 9: Estimation results for the effect of taxes on retained earnings and other FDI, control for wages.

	RE				OC			
tax _{jt}	-2.81	-2.29	0.21	-0.24	-1.26	-1.41	0.78	0.97
	-2.25	-1.91	0.08	-0.1	-1.31	-1.49	0.43	0.55
tax _{it}	-3.11	-3.48	-2.63	-2.89	0.16	0.46	3.82	3.84
	-2.16	-2.49	-1.2	-1.31	0.16	0.44	1.87	1.9
log(pop) _{jt}	0.79	0.69	-12.18	-14.75	0.69	0.78	4.89	6.81
	8.55	8.48	-1.23	-1.6	7.91	10	0.56	0.81
log(pop) _{it}	0.59	0.54	-5.34	-8.54	0.46	0.43	3.82	3.67
	5.93	5.94	-0.36	-0.58	5.34	5.16	0.38	0.39
log(gdp/pop) _{jt}	2.03	1.19	-0.57	0.50	0.25	0.98	1.39	1.10
	3.41	4.6	-0.38	0.46	0.5	4.52	1.17	1.27
log(gdp/pop) _{it}	2.52	1.65	-2.93	-1.22	2.66	2.37	0.87	0.87
	3.25	4.85	-1.32	-0.96	4.07	6.01	0.59	0.79
dist	-1.42	-1.42	-2.28	-2.30	-1.74	-1.79	-1.94	-1.93
	-6.59	-6.68	-8.47	-8.68	-8.61	-8.57	-8.54	-8.66
border	0.65	0.59	0.67	0.67	0.21	0.20	0.58	0.58
	3.53	3.22	3.64	3.67	1.09	0.96	3.27	3.28
log(wage) _{jt}	-1.34		1.37		0.49		-0.45	
	-2.47		0.97		1.06		-0.39	
log(wage) _{it}	-0.09		1.99		-0.14		0.22	
	-0.13		1.06		-0.24		0.2	
wage diff		0.00		0.00		0.00		0.00
		-2.49		-0.44		-0.94		-1.5
cons	12.76	-2.75	193.76	308.13	-5.06	-1.58	-140.65	-174.53
	1.31	-1.64	0.85	1.43	-0.66	-1.02	-0.65	-0.86
selection equation								
tax _{jt}	-1.52	-1.56	-2.83	-3.49	-1.36	-1.48	3.83	4.19
	-1.61	-1.69	-1.11	-1.39	-1.7	-1.89	1.7	1.86
tax _{it}	-2.82	-2.64	8.30	9.45	0.10	-0.12	5.74	5.35
	-2.78	-2.66	3.22	3.88	0.12	-0.15	1.63	1.49
log(pop) _{jt}	0.44	0.47	-3.44	-8.11	0.43	0.43	-9.43	-7.06
	6.84	8.57	-0.42	-1.04	7.4	8.28	-0.87	-0.66
log(pop) _{it}	0.22	0.18	-45.60	-40.30	0.30	0.30	-6.57	-7.57
	3.41	2.85	-3.56	-3.08	5.03	5.28	-0.7	-0.94
log(gdp/pop) _{jt}	0.00	0.73	-1.87	-0.47	0.07	-0.14	0.77	-0.01
	-0.01	4.29	-1.3	-0.45	0.18	-1.09	0.54	-0.01
log(gdp/pop) _{it}	1.34	1.03	-0.24	-3.88	1.62	1.56	-1.85	-1.55
	2.66	5.79	-0.1	-2.97	4.64	9.35	-1.13	-1.51
dist	-0.88	-0.88	-2.32	-2.31	-0.96	-0.99	-2.23	-2.22
	-6.07	-6.3	-6.82	-7	-8.88	-8.88	-5.5	-5.47
border	0.47	0.45	0.47	0.47	0.27	0.26	1.10	1.10
	2.15	2.11	2.14	2.14	1.56	1.54	5.41	5.39
log(wage) _{jt}	0.19		1.95		0.08		-1.07	
	0.46		1.4		0.22		-0.91	
log(wage) _{it}	0.27		-4.09		-0.39		0.41	
	0.61		-1.87		-1.21		0.25	
wage diff		0.00		0.00		0.00		0.00
		-3.67		1.37		2.56		-0.73
cons	-6.26	-1.04	859.74	779.87	-0.74	-4.05	236.03	216.30
	-0.91	-0.73	3.1	3.08	-0.15	-3.42	1.02	1
dummies	no	no	c+t	c+t	no	no	c+t	c+t
N	1096	1096	1096	1096	1372	1372	1372	1372
censored	602	602	602	602	603	603	603	603
χ ²	4.9	5.2	9.4	12.6	9.6	8.1	5.3	5.8
p	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0

Notes: t-values below the coefficient. c+t dummies means that source and host country and time dummies are included in the regression.

Table 10: Estimation results for the effect of taxes on different FDI components, only EU 15 as source countries. Country and time dummies included.

	total FDI	Equity	RE	OC
tax _{jt}	-0.31	0.50	-1.64	1.58
	-0.23	0.4	-0.96	1.2
tax _{it}	1.77	1.14	-2.52	2.74
	1.04	0.7	-1.26	1.52
log (pop) _{jt}	1.64	3.07	-7.00	4.62
	0.41	0.83	-1.41	1.15
log (pop) _{it}	-16.18	13.63	-21.12	-11.31
	-1.32	1.58	-1.29	-1.21
log (gdp/pop) _{it}	0.49	0.65	0.96	1.25
	0.95	1.39	1.4	2.49
log (gdp/pop) _{it}	2.42	2.77	2.06	1.86
	2.38	2.81	1.88	1.72
dist	-2.13	-2.41	-1.98	-1.80
	-11.67	-13.3	-7.47	-9.9
border	0.48	0.50	0.40	0.11
	3.28	3.41	2.17	0.71
cons	235.62	-276.68	485.71	112.52
	1.25	-1.69	1.66	0.72
selection equation				
tax _{jt}	-4.42	-2.88	0.31	0.32
	-0.7	-1.13	0.12	0.13
tax _{it}	-16.10	-2.86	5.51	6.91
	-0.78	-0.56	1.97	1.38
log (pop) _{jt}	3.76	-3.25	3.58	-1.91
	0.12	-0.36	0.47	-0.25
log (pop) _{it}	-78.49	52.58	-64.51	2.09
	-0.8	2.96	-2.35	0.12
log (gdp/pop) _{it}	-2.55	-0.05	-0.95	-0.35
	-0.83	-0.04	-1.02	-0.36
log (gdp/pop) _{it}	-6.08	-0.35	3.15	-4.06
	-0.77	-0.14	1.42	-1.72
dist	-8.82	-3.04	-1.54	-1.98
	-1.07	-8.07	-4.45	-6.25
border	0.45	4.72	0.03	1.39
			0.09	3.33
cons	1351.15	-898.64	1102.53	-29.48
	0.78	-2.52	2.2	-0.08
mills-lambda	-0.64	0.08	-0.47	0.36
	-2.18	0.34	-1.52	1.77
dummies	c+t	c+t	c+t	c+t
N	1019	1416	832	1185
censored	112	210	269	304

Notes: t-values below the coefficient. c+t dummies means that source and host country and time dummies are included in the regression.

Table 11: Estimation results for the effect of taxes on different FDI components, data for (non-)investment of the 10 NMS in other 10 NMS excluded.

Country and time dummies included.

	Tot FDI	equity	RE	other
tax_{jt}	-0.10	0.22	-0.67	1.43
	-0.08	0.19	-0.4	1.13
tax_{it}	2.00	1.02	-2.08	3.12
	1.22	0.66	-1.06	1.78
$\log(\text{pop})_{jt}$	3.22	2.24	-7.39	5.28
	0.83	0.62	-1.51	1.31
$\log(\text{pop})_{it}$	-6.43	17.85	-3.43	-3.03
	-0.75	2.65	-0.26	-0.38
$\log(\text{gdp}/\text{pop})_{jt}$	0.69	0.44	0.92	1.38
	1.4	1.02	1.37	2.93
$\log(\text{gdp}/\text{pop})_{it}$	1.63	2.15	0.99	0.61
	1.96	3	1.04	0.7
dist	-2.25	-2.61	-2.23	-1.79
	-12.84	-11.87	-8.61	-10.18
border	0.51	0.46	0.40	0.24
	3.61	3.43	2.22	1.57
cons	50.11	-277.46	194.38	-2.73
	0.36	-2.59	0.97	-0.02
selection equation				
tax_{jt}	-2.59	-0.41	0.12	-0.11
	-0.94	-0.22	0.06	-0.06
tax_{it}	6.54	-0.47	6.17	4.68
	1.27	-0.13	2.47	1.06
$\log(\text{pop})_{jt}$	-0.09	7.05	-0.78	7.96
	-0.01	1.17	-0.12	1.33
$\log(\text{pop})_{it}$	2.59	25.32	-17.68	1.60
	0.19	2.94	-1.26	0.2
$\log(\text{gdp}/\text{pop})_{jt}$	-1.19	0.53	-1.75	0.73
	-1.15	0.69	-2.12	0.99
$\log(\text{gdp}/\text{pop})_{it}$	-2.43	1.59	-1.76	-2.78
	-1.24	1.49	-1.31	-2.77
dist	-2.03	-2.63	-1.60	-1.86
	-5.69	-9.98	-5.32	-7.96
border	1.28	1.20	0.17	1.08
	2.04	3.34	0.68	3.78
cons	-63.58	-550.40	229.80	-142.21
	-0.23	-2.91	.	-1.02
dummies	c+t	c+t	c+t	c+t
N	1332	1796	1158	1525
censored	323	504	564	567

Notes: t-values below the coefficient. c+t dummies means that source and host country and time dummies are included in the regression.

B Data

Table 12: Frequency of source-host interactions by countries

	host	source
Austria	0.28	0.67
Bulgaria	0.09	0.00
Cyprus	0.10	0.07
Czech Republic	0.27	0.09
Germany	0.35	0.78
Denmark	0.27	0.18
Estonia	0.17	0.10
Spain	0.31	
Finland	0.21	0.52
France	0.32	0.56
Greece	0.22	
Hungary	0.30	0.14
Ireland	0.25	0.03
Italy	0.31	0.40
Lithuania	0.21	0.07
Latvia	0.17	0.03
Malta	0.05	
Netherlands	0.32	0.69
Poland	0.33	0.15
Portugal	0.21	0.39
Sweden	0.31	0.07
Slovenia	0.18	0.29
Slovakia	0.23	
UK	0.35	0.56

Notes: Values calculated as number of total FDI flow observations larger than zero divided by number of possible observations in the entire period.

B.1 On FDI

The data on foreign direct investment (FDI) stem from Eurostat. They cover the years 1995 – 2003. The data follow the benchmark definition of FDI as given by the IMF Balance of Payments Manual and being fully consistent with the OECD guide.¹⁴ According to the IMF and OECD definitions, direct investment reflects the aim of obtaining a lasting interest by a resident entity of one economy (direct investor) in an enterprise that is resident in another economy (the direct investment enterprise). The lasting interest implies the existence of a long-term relationship between the direct investor and the direct investment enterprise and a significant degree of influence on the management of the latter. Direct investment involves both the initial transaction establishing the relationship between the investor and the enterprise and all subsequent capital transactions between them and among affiliated enterprises, both in-

¹⁴IMF (1993) and OECD (1996).

corporated and unincorporated. Despite the consensus among all countries on this definition there may exist bilateral discrepancies in country specific FDI statistics, that is between inward and outward data of two partner countries: A country's recorded FDI inflow does not necessarily correspond to the partner country's statistics on FDI outflow to this country. Main reasons for such differences are found in country specific registration practices.¹⁵ We employ FDI inflow data.

The fifth Edition of the IMF's Balance of Payment Manual defines the owner of 10% or more of a company's capital as a direct investor. Even though this definition is somewhat arbitrary, the IMF recommends using this percentage as the basic dividing line between direct investment and portfolio investment in the form of share holdings.

As for the instruments, direct investment capital comprises the capital provided (either directly or through other related enterprises) by a direct investor to a direct investment enterprise and the capital received by a direct investor from a direct investment enterprise. Direct investment capital transactions are made up of three basic components: (i) **Equity capital**: comprising equity in branches, all shares in subsidiaries and associates (except non-participating, preferred shares that are treated as debt securities and are included under other direct investment capital) and other capital contributions such as provisions of machinery, etc. (ii) **Reinvested earnings**: consisting of the direct investor's share (in proportion to direct equity participation) of earnings not distributed, as dividends by subsidiaries or associates and earnings of branches not remitted to the direct investor. If such earnings are not identified, all branches earnings are considered, by convention, to be distributed. (iii) **Other direct investment capital** (or inter company debt transactions): covering the borrowing and lending of funds, including debt securities and trade credits, between direct investors and direct investment enterprises and between two direct investment enterprises that share the same direct investor.

B.2 On taxation

The data on the top statutory tax rate on corporate income are taken from European Commission - DG Taxation and Customs Union (2004, p.116). The

¹⁵For a detailed discussion on reasons for discrepancies in FDI statistics with special focus on Germany see for example Jost (1997).

tax rates taken from the European Commission's publication cover the period 1995 – 2003. The data include local taxes and surcharges.

B.3 The other data

Distance data are measured in 1000 miles (Rose's data are divided by 1000).

Table 13: Sources of main data

data	source
GDP	Eurostat
wage	Eurostat
population	Nace sectors varying across country and year
distance	Eurostat
	Andrew Rose's data set
	http://faculty.haas.berkeley.edu/aroze/
border dummy	Andrew Rose's data set
	http://faculty.haas.berkeley.edu/aroze/
common language dummy	Andrew Rose's data set
	http://faculty.haas.berkeley.edu/aroze/

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