CORPORATION TAX: MYTH OR MIRACLE MAKER?

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Ireland has come under increased scrutiny in recent years over its leniency in taxing big business. Mark Finn gives a comprehensive overview of corporation tax and foreign direct investment. While the prevailing consensus is that corporation tax is the best way of attracting firms from abroad, this essay explores other important factors and presents a more nuanced analysis of the relationship between corporation tax and foreign direct investment.

Introduction

In 1997 *The Economist* published an article entitled 'Ireland Shines' examining the causes of Ireland's 'astonishing economic success' (The Economist 1997). It cited the same reason that has so often been cited as the primary cause of Ireland's economic boom: Foreign Direct Investment (FDI). The economic benefits of FDI for Ireland are often used to justify Ireland's low rate of corporation tax, which has been criticised by other EU Member States. (Carswell, 2016) . The logic underlying these low tax rates follows conventional economic thought: low tax rates incentivise firms to do business in a given country and any raise in this rate will cause a decline in FDI. Interestingly however, Ireland is not cited as a European Leader for FDI. Ireland is not regarded as the best country for companies to establish their European Operations, with Germany being the most popular followed by the UK and France. Furthermore, the number of FDI projects in Ireland occurring in 2013 was 111; in the UK it was 799, in Germany it was 701 and in France it was 504 (Ernst & Young, 2014). It should be noted that these three countries all had (and continue to have) higher rates of corporation tax than Ireland's 12.5%, with Germany at 29.58%, the UK at 21% and France at 33.33% (KPMG, 2017). These findings challenge the narrative that low corporation tax is the sole or dominant factor in attracting FDI. This essay will analyse the role of corporation tax in attracting FDI, which will be followed by an examination of the other factors that influence the FDI level. Finally, a number of policy recommendations will be presented.

Explaining FDI

According to economic theory, the corporation tax rate is the primary determinant of the level of FDI in a country (Mudenda, 2015). Whilst other factors are acknowledged across the literature, corporate taxation rates are frequently hailed as the most significant; indeed it has been argued that the rate of corporation tax is the single determining factor for companies deciding where to set up operations (Root and Ahmed, 1978)[1]. It follows that the OECD has also cited the reduction of corporate tax rates as a primary means of attracting FDI.

This assumption, however, is flawed. Conventional economic theory assumes that corporations are profit motivated, yet it can be argued that there exists an upward limit on their desire for profit or that there are certain internal limitations which affect profit maximisation. An interesting example of this is the US textile industry. The US textile industry has suffered massively from the relocation of labour to low-wage economies. The fact that this industry that still exists and is now growing within the US, despite the fact that labour can be sourced cheaper elsewhere, is a testament to the fact that profit, and a desire to accumulate it, may be limited by certain factors; in this case anything from anti-global sentiment, to concern of workers' welfare by customers or governmental policy. In the case of other industries however, which are in this context assumed to be solely influenced by profit, an argument can be made that this profit need not come from savings made by corporation tax. A company could equally increase its profits by investing in countries that have specific trade deals (for example EU Member States), or lower wage costs. For instance, India, a large receiver of FDI inflows, has a minimum wage roughly equivalent to 5 USD per day (Worstall, 2016).

There exists data to back up the idea that corporate taxation is not the sole determinant of FDI. For example, in 2014, the top five countries in terms of FDI recipients were China, Hong Kong, the US, the UK and Singapore (United Nations Conference on Trade and Development, 2015). Although the report does factor out 'Caribbean offshore financial centres', the fact remains that there are a large number of other countries with lower rates of taxation; indeed, China and the US both had corporation tax rate significantly higher than the global average for 2014 (KPMG, 2017). Research conducted in 2013 shows that, while reductions in corporation tax often do attract FDI, there are other factors at play; it also warns of an overgeneralisation of the effectiveness of a tax cut, as they are often region specific (Baccini, Li and Mirkina, 2014). Baccini et al. also note that while policy makers believe that a favourable tax rate is the primary factor that incentivises FDI, managers of multinational enterprises (MNEs) will usually state that it is not 'very important for investment decisions'.

Beyond Corporation Tax

There is a large amount of literature concerning the other factors which influence foreign direct investment. These factors can be divided into four categories: economic, social, political and policy (Root and Ahmed, 1978). 'Economic' refers to general macroeconomic indicators such as GDP, GDP per capita, balance of payments and currency purchasing power. Social factors include education rates, urbanisation rates and the power of the labour movement while political factors refer to government efficiency, the levels of international aid it may receive, its attitude towards and interference in the economy and the level of peace and stability in an area. Finally, policy factors refer to taxation rates, taxation simplicity, as well as attitudes towards foreign nationals. This above list is by no means exhaustive, but provides a broad insight into the additional factors at play when it comes to foreign investment decisions.

Primarily, it can be argued that there are certain prerequisites for a country to possess before an MNE will consider investing there. These include obvious factors such as peace and stability; Lebanon has a corporation tax rate of 15%, nearly 10% below the global average, but FDI rates dropped by 24% in 2015 as tensions and political instability escalated in the region (Investment Development Authority of Lebanon, 2017). Additionally, workers who are suitably trained for the firm in question must be present within that country. This is why tech companies invest in developed, highly-educated and skilled countries as opposed to those with low education rates. In a model where Company X will engage in FDI, they can choose Country A or Country B. If we assume that both countries fulfil the basic, benchmark requirements (i.e. are peaceful and open to foreign nationals setting up industries there) as well the more specialised requirements (suitably trained workforce, access to raw materials necessary for production of a good and so on) then the deciding factor could very well be the rate of corporation tax. It should be noted that all of the factors affecting a firm's investment decision bear profit in mind. A better workforce leads to increased productivity, while consumers in wealthier countries have higher disposable incomes. Thus, from a profit perspective, an educated workforce and a prosperous economy are attractive for FDI. While low corporation taxes may reduce the costs of a firm, there may be other more effective ways for firms to do so. Indeed, one such factor could be the effective rate of corporation tax as supposed to the prescribed rate; France has an effective rate of roughly 8% for very large firms despite a prescribed rate of 33.33%. Thus, the effective tax rate may prove a deciding factor for certain firms, most likely larger ones that can afford to devote resources to identifying tax loopholes.

Perhaps one of the greatest concerns when it comes to increasing the rate of corporation tax is the fear that companies will leave, in search of a more favourable tax rate. It has been noted that companies will often either operate overseas or channel their profits through overseas offices (Genschel and Schwarz, 2011). However, the elasticity of

MNE's responsiveness to a tax change must be questioned. Elasticities are firm-specific. For instance, manufacturing firms are likely to be less elastic than service-based ones, due to intensive and specialised labour and capital requirements. Research from the OECD has shown that tax rises tend not to lead major changes in the current levels of FDI that exist within a country. They could, however, deter new FDI inflows (Bénassy-Quéré, Fontagné and Lahrèche-Révil, 2005). This could be due to the fact that relocation is often quite costly and time consuming. Furthermore, taxation rates vary from year to year meaning firms have a chance to lobby governments which is less time consuming than relocation. Kazman has also indicated that, within the US, the Laffer Curve theory, which shows the relationship between tax changes and government revenue, doesn't hold for individuals or corporations; suggesting that money doesn't always move abroad in response to tax rate changes.

Conclusion and Policy Implications

This essay has explored the role of corporation tax in attracting FDI. Increasing corporation tax rates must not necessarily result in a decline in FDI levels. Additional factors, such as political stability or the availability of an educated workforce, play a part in FDI decisions. These findings have important policy implications. Countries seeking to attract FDI should recognise that, while corporation tax is an important factor, it is not the only factor that influences a company's FDI decision. Engaging in education schemes in order to ensure a skilled workforce is a necessity. Furthermore, economic conditions, such as a high-income population, trade agreements and so on, reassure companies that there is potential for their firms to grow. For instance, HSBC threatening to relocate to Dublin following the British exit of the European Union suggests that EU access is the deciding factor for them, not the rate of corporation tax. Countries need to fulfil the baseline requirements for companies to be able to thrive; only after that will tax competition prevail.

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Notes

1- For the purposes of Root and Ahmed’s work, the other policy factors affecting FDI were tax incentive laws: complexity vs. simplicity; tax incentives: liberality; attitude toward joint ventures; local content requirement and limitations on foreign personnel.