Tax Reform and Foreign Direct Investment

James R. Hines Jr.

University of Michigan and NBER

How does tax policy affect FDI?

- There are two channels of influence:
  - (i) the obvious, and
  - (ii) the less obvious.
  - – Both are important, just one is more obvious than the other.
- First, the obvious: lower tax rates improve after-tax returns, thereby encouraging greater levels of FDI.

Belaboring the obvious…

- This point carries implications for effects of both foreign and domestic taxation:
  - Low domestic tax rates encourage inflows of direct investment from elsewhere.
  - Heavy taxation of income earned abroad discourages outbound FDI.
- Lower foreign tax rates have stronger attractive effects for investors whose home governments tax on a territorial basis than on investors from countries taxing on a worldwide basis, but both are affected.

What is the evidence?

- There is considerably more FDI in low-tax places, and correspondingly less FDI in high-tax places, than one would predict based only on underlying economic fundamentals.
- Example: in 1999, small tax havens accounted for just 0.8% of world population and 2.3% of world GDP (outside the USA)…
- But these same tax havens were home to 8.4% of the property, plant and equipment owned by American firms abroad, and 6.1% of foreign wages paid by American firms.

Is there more evidence?

- Oh yes. Statistical studies consistently find that the location of American FDI abroad is highly sensitive to tax rate differences: 10% differences in foreign tax rates are associated with 10-30% differences in amounts of FDI.
- There is ample evidence as well of the impact of home country taxation: investors from territorial countries are more sensitive to foreign tax rate differences than are investors from countries that tax on a worldwide basis. Treaty provisions such as “tax sparing” appear to encourage greater FDI as well.

So, what isn't obvious?

- Tax rate differences encourage tax avoidance of various kinds, such as the use of debt to finance investments in high-tax foreign countries, and the greater use of equity to finance investments in low-tax foreign countries.
- The tax avoidance associated with tax rate differences itself can affect FDI patterns.

How does this work?

- One benefit of locating in a low-tax jurisdiction is that it becomes possible to use financial or other transactions to report taxable income that might otherwise have been attributed to high-tax jurisdictions.
- This is part of the reason why low-tax jurisdictions are so popular.

What is the evidence?

- The foreign affiliates of American firms use considerably more debt in higher-tax environments: 10% higher local tax rates are associated with 2.8% higher debt/asset ratios.
- Studies consistently find that after-tax profit rates of American firms are lower in high-tax foreign locations.

Implications for tax reform.

- First, there is every reason to expect fundamental U.S. tax reform to be associated with significant changes in inbound and outbound FDI.
- Second, U.S. tax rate reductions are likely to stimulate greater foreign investment in the United States.
- Third, reduced U.S. taxation of foreign income would have significant effects.

Effects of reducing U.S. taxation of foreign income…

- American investment abroad would become even more sensitive to foreign tax rate differences, as the creditability of foreign taxes pales to insignificance (depending on the reform).
- Such reforms would encourage greater U.S. investment abroad and greater foreign investment in the United States.
- Such reforms would improve the efficiency of capital ownership by aligning U.S. tax incentives with those of most of the rest of the world.