

An empiric approach of the FDI-taxation relationship in Romania

Ioan TALPOȘ

West University of Timisoara
ioan.talpos@gmail.com

Bianca Maria LUDOȘEAN (STOICIU)

West University of Timisoara
bianca.stoiciu@gmail.com

Abstract. *In the heart of the debate on the appropriate level of the profit tax burden on host countries lies a challenging question: How does FDI respond to tax rates? Studies analyzing inter-state fluctuation show that, on average, FDI decreases by 3.7% when corporate tax rates increase by one percentage point, other studies show that the FDI decline varies between 0 and 5%. Such variations reflect differences between nations and industries studied, as well as differences between time periods which have been considered. More recent studies show that FDI becomes increasingly sensitive to tax reflecting a growing mobility of capital as non-tax barriers, previously in the way of FDI, are eliminated (OCDE, 2008).*

The present article aims to study the effects of tax upon foreign direct investment in Romania. The period studied prolongs on ten years, from 1999 to 2009, with the aim to observe the effects of modifications upon tax revenues, direct tax and indirect tax on foreign investment in Romania. To study the relationship between the variables, econometric modelling has been used thanks to the software package Eviews 5.0. This paper's main conclusion is that foreign direct investment are not discouraged by the level of tax in Romania, on the contrary, they are stimulated by an eventual increase in tax revenue.

Keywords: foreign direct investment; tax; simple regression; correlation.

JEL Codes: H21, H32.

REL Codes: 8K, 10F.

1. Literature

Theoretically, each Government should be interested in attracting foreign direct investments. These can create new jobs, bring new technologies and can overall encourage economic growth and employment. The registered benefits in internal income are shared between the public sector, labor taxation and profits generated by multinational enterprises (MNE) and other taxable items (tax on properties for example). FDI can affect positively internal income through “spillover effects” that is to say through the introduction of new technologies and qualified labor. Given these potential benefits, policy-makers continuously re-examine fiscal rules, to make them attractive for investors.

At the same time, the Government needs permanently to balance the desire to provide a competitive financial environment for FDIs with the need to assure they can collect an appropriate level of taxes from MNEs. Although it is recognized that taxes represent an important factor concerning investing decisions, it does not remain the most principal determinant. FDIs are also attracted by countries that offer: access to market opportunities and profit, a predictable and undiscriminating legal environment, macroeconomic stability, a qualified and responsible labor market, a developed infrastructure. All these elements will contribute to the long term profitability of a project.

The majority of studies on the effects of fiscal reforms upon FDI ignore the strategies post-tax used by investors to reduce the tax burden. However, tax planning appears to be a significant activity which is expanding, in addition, recent works of the OCDE encourage analysts to take into consideration the effects of such activities when studying the impact of taxes on FDI. Future research in this domain could provide improved estimations of FDI’s sensitivity related to tax burden.

The traditional theory on fiscal competition shows that in an open economy, with perfectly mobile capital, taxes on capital should tend towards zero since it is dominated by taxes on immobile factors that cannot avoid tax through relocation (Diamond, Mirrlees, 1971, Gordon, 1986, Razin, Sadka, 1991, Wilson, 1999). Liberalization of capital flows made this theory the more relevant for profit tax since foreign direct investment (FDI) allows companies to choose where to locate their business for tax reasons. According to Gordon and Hines (2002), “fiscal policies are capable, in an evident way, to affect the volume and location of FDIs; since higher tax rates decrease income after tax, therefore discouraging reinvesting initiative”.

This view according to which FDI should react to taxes on profit is widely accepted in the academic field, as well as operational, even though empiric and theoretic studies show that the real impact is insignificant, maybe even inexistent. First of all, the practice of pricing transfer and according credits between companies allows enterprises to transfer profits where taxes are the lowest therefore breaking the link between the location of the profit and where production is located (Bénassy-Quéré et al., 2004).

Secondly, decisions concerning business location depend on a combination of taxes – public assets existing in the host country (Tiebout, 1956), which weakens the connection between tax burden and FDI in respective countries. In the same perspective, the impact of tax differentials upon the decision regarding FDI's location can be insignificant vis-à-vis of structural determinants such as: proximity to end market the characteristic of competition in the labor and products market etc. (Markusen, 1995).

Thirdly, a higher tax rate can generate greater income before tax, in a general equilibrium model (due to reduced capital stock), but with no measurable effect on income after tax (Scholes, Wolfson, 1990). Eventually, tax differences can represent the result of equilibrium, in conditions of imperfect competition, combining economy of scale with trade costs and/or agglomeration forces (Haufler, Wooton, 1999, Andersson, Forslid, 1999, Baldwin, Krugman, 2004, Ludema, Wooton, 2000). Then, tax difference compensates for differences in income due to geographical position.

Despite these arguments, empirical evidence shows that multinational enterprises (MNE) respond to tax incentives, whether they are contained in tax laws (to avoid international double taxation) or in tax rates. An extensive review of literature is provided by Hines (1999) and Gordon and Hines (2002). According to the meta-analysis conducted by Mooij and Ederveen (2003), semi-elasticity of FDI to tax rate varies from -2.7 to $+13.2$ with an average of -3.3 or -4.0 , depending to the inclusion in the sample of insignificant estimations. Regarding the elasticity of FDI to tax rates, it varies between 0.6 and -2.8 , depending on the estimation method (Desai, Hines, 2001).

Some studies refine these investigations and concentrate on the sensitivity of some categories of FDI to tax: reinvested earnings versus prices of transfer (Hartman, 1984, Slemrod, 1990) or merger and acquisitions versus new factories and expansion of facilities (Swenson, 2001). Desai and Hines (2001) show that FDI in the United States of America are sensitive not only on tax profit but equally to indirect taxes.

A series of works emphasizes the impact of rules to avoid double taxation in accordance with theoretic studies initiated by Hamada (1966) and Musgrave (1969). Concretely, exemption schemes are expected to stimulate the FDI flow towards countries with a lower tax burden as repatriated profits will be exempt from taxation. Inversely, FDI flows from countries that apply methods based on credits should be less sensitive to tax incentives since repatriated profit will be subject to taxation in the country of residence, income tax expenses paid abroad being considered deductible expenses. Empiric results in this regard are not conclusive, probably because the majority of studies concentrate on incoming and outgoing flows from the USA, which do not allow to differentiate the impact of taxes from the impact of other omitted variables (Bénassy-Quéré et al., 2004).

In the framework of a more recent study, Bénassy-Quéré et al. (2004) show that companies' profit should not be exempt from tax (as an effect of fiscal competition) since geographically attractive countries could exploit this advantage, keeping a high level of taxes on immobile factors. Using panel data on bilateral flows of FDI for the period 1984-2000, for 11 countries from the OECD, authors demonstrate that a high corporate tax discourages FDI flows, even when they are considered as control variables for the provision of public assets or severity factors (market's potentials, transport costs, dimension of the investing country, common language – dummy variables). Thus, although the potential of markets matters, it is important and a tax differential concerning companies' profit. In this respect, an asymmetry exists in the impact of tax differentials on FDI flows: while lower tax rates in recipient countries than in the country of origin don't attract in a significant way foreign investment; higher tax rates discourage new FDIs.

As a conclusion, we stress the fact that governments try make their tax administration friendlier, through increasing transparency and the predictability of tax treatment. In January 2008, at its fourth meeting, the OCDE Forum of Fiscal Administration to which tax commissioners from over 40 OECD and non OCDE countries, discussions focused on cultivating and ameliorating relationships between tax authorities and taxpayers. Many countries have introduced procedures under which tax authorities can answer in advance to questions about the tax status of a particular type of investment. Fiscal treaties and mutual understandings are also perceived as key factors in ensuring certainty and stability in inter-state investments (OECD, 2008).

2. Analysis of the impact of tax revenue upon FDIs

The analysis of the impact of tax revenue upon Foreign Direct Investments targets the period 1991-2009, following the effects of tax revenue upon the volume of Foreign Direct Investments in Romania. The method used for the analysis is the econometric modelling obtained using the software package EViews 5.0. Thereupon, I have developed a pattern single factor regressive model.

$$Y_t = \alpha + \beta \times X_t + \varepsilon_t \quad (1)$$

where:

- Y_t represents the dependent variable (FDI);
- α is the free time coefficient;
- β is the coefficient of independent variable;
- X_t is independent variable (tax revenues);
- ε_t is random variable;
- t is the time period (interval 1991-2009).

Specifically, it will seek to quantify the relationship that exists between, on one hand, the volume of foreign direct investments, and, on another hand, revenue from central taxes constituted of tax on profit, income tax, tax on profit from illicit activities, tax on dividend, economic contribution to social fund, other direct taxes, tax on added value, custom duties, excise duties and other indirect taxes (all considered independent variables), related to a physical person as well as legal entity.

The model of the impact of tax revenue upon foreign direct investment is based on a single factor regression model of the form:

$$Y_t = \alpha + \beta \times X_t + \varepsilon_t \quad (2)$$

where Y_t represents a dependent variable – FDI (foreign direct investment), α the free time coefficient, β the free time coefficient, X_t independent variable- TAX_REV (tax revenue), ε_t random variable and t time period (interval 1991-2009).

More precisely, the econometric model will have the following formula:

$$FDI = \alpha + \beta \times VEN_FISC + \varepsilon_t \quad (3)$$

The results obtained by modelling the 19 series are (table 1):

Table 1

**Statistical tests modelling the impact of tax revenue
upon foreign direct investment**

ISD=C(1)+C(2) × VEN_FISC				
Variable	Coefficient	Std. Error	t-Statistic	Prob.
C	-1410.579	551.3008	-2.558638	0.0203
VEN_FISC	0.427325	0.055902	7.644166	0.0000
R-squared	0.774635	Mean dependent var		2227.026
Adjusted R-squared	0.761379	S.D. dependent var		2483.854
S.E. of regression	1213.335	Akaike info criterion		17.13943
Sum squared resid	25027094.4616	Schwarz criterion		17.23885
Log likelihood	-160.8246	F - Statistic		58.43328
Durbin-Watson stat	1.316918	Prob (F - Statistic)		0.00001

Source: own processing with the help of the program EViews 5.0.

Analysing the figures presented in table, the following conclusions are reached:

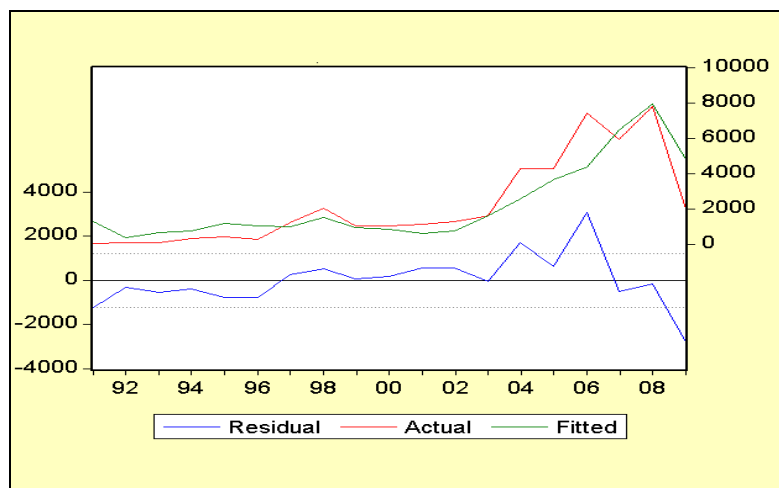
- The value of the standard error of the coefficient of the regression function is inferior to the value of the coefficient, which enhances the reliability of its estimation, conclusion sustained by the low value of the probability;
- The adjusted correlation coefficient, with a value of 76.13%, shows that the statistical relationship between the dependent variable – FDI and endogenous – TAX_REV is strong, modifications on the tax burden corresponding to tax revenue being found in a considerable proportion in modifications of the volume of foreign direct investments;
- The Durbin-Watson test, with a value below the critical limit 2, indicates that residual variables are easily correlated. A possible explanation would be the fact that, on the studied period, the Durbin-Watson test is not significant and cannot be interpreted;
- The F-statistic test, with a rather large value (58.43328), value exceeding the critical limit of 4.41 and Prob (F-statistic) with a very small value of 0.00001 indicates that the regression model is very good. Therefore, it can be said that the model built can be considered representative for describing, on the macroeconomic level, the relationship between tax revenue and the volume of foreign direct investment.

As a result, the model can be written as follows:

$$\text{FDI} = -1410.57897 + 0.4273251437 \times \text{TAX_REV} \quad (4)$$

From this model emerges the fact that, in the case of Romania, taxation generates an extension of foreign direct investment and, more precisely, the fact that *tax influence has an effect of increasing foreign direct investment*. Thereby, it can be observed that a growth of 1u.m. of the tax revenue determines a growth of 0.4273 m.u. of foreign direct investment.

From Figure 1 a tendency of growth for both lines can be observed: the historical foreign direct investment, represented by the red one, and the one of estimated foreign direct investment, represented by the green line. Both valuations follow a similar evolution. The blue line represents the difference between the historical values of the variable Y (foreign direct investment in this case) and the estimated values of the variable Y in the model used. The fact that the blue line is rather close to the axe OX shows that the estimation is very relevant.



Source: own processing with the help of the program EViews 5.0.

Figure 1. Evolution of historical value of foreign direct investment compared to estimated value of foreign direct investment

In the next part of the present study we will test the stability of the equation and of the estimated coefficients with the help of the *CUSUM* test, which is based on the cumulative sum of recursive errors together with a 5% critical lines. The equation parametres are not considered as stable if the cumulative sum of recursive errors goes outside the two critical lines.

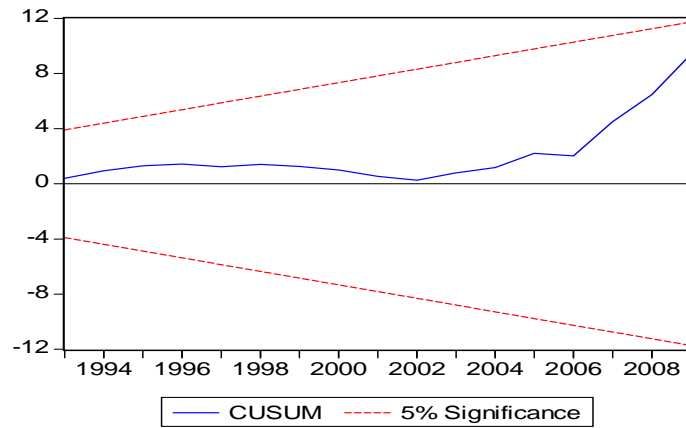


Figure 2. *Test of the coefficient's stability with the help of the CUSUM system*

In the above figure, we can observe that the cumulative sum of recursive errors does not go outside the two critical lines, the parameters are therefore stable.

3. Analysis of the impact of direct taxes upon FDI

The formula for the impact of direct taxes on foreign direct investments is also based on a single factor regression model:

$$Y_t = \alpha + \beta \times X_t + \varepsilon_t \quad (5)$$

where Y_t represents a dependent variable – FDI (foreign direct investment), α the free time coefficient, β the free time coefficient, X_t independent variable – DIR_TAX (direct taxes), ε_t random variable and t time period (interval 1991-2009).

The model has the following formula:

$$FDI = \alpha + \beta \times DIR_TAX + \varepsilon_t \quad (6)$$

The results obtained by modelling the 19 series are (Table 2):

Table 2

**Statistical tests modelling the impact of direct taxes
upon foreign direct investment**

ISD=C(1)+C(2) × IMP_DIR				
Variable	Coefficient	Std. Error	t-Statistic	Prob.
C	-987.3924	945.3236	-1.044502	0.3109
IMP_DIR	1.056207	0.276591	3.818661	0.0014
R-squared	0.461722	Mean dependent var		2227.026
Adjusted R-squared	0.430058	S.D. dependent var		2483.854
S.E. of regression	1875.172	Akaike info criterion		18.01009
Sum squared resid	59776621	Schwarz criterion		18.10950
Log likelihood	-169.0959	F - Statistic		14.58217
Durbin-Watson stat	0.569008	Prob (F - Statistic)		0.001374

Source: own processing with the help of the program EViews 5.0.

Analysing the figures obtained in the table, the following conclusions can be reached:

- The value of the standard error of the coefficient of the regression function is inferior to the value of the coefficient, which enhances the reliability of its estimation, conclusion sustained by the low value of the probability;
- The adjusted correlation coefficient, with a value of 43%, shows that the statistical relationship between the dependent variable – FDI and endogenous – DIR_TAX is weak; modifications on the tax burden corresponding to direct taxes are found in a smaller extent in modifications of the volume of foreign direct investments;
- The Durbin-Watson test, with a value below the critical limit 2, indicates that residual variables are correlated. A possible explanation would be the fact that, on the studied period, the Durbin-Watson test is not significant and cannot be interpreted;
- The F-statistic test, with a value of 14.58217, exceeds the critical limit of 4.41 and Prob (F-statistic) with a value inferior to 0.001374 indicates that the regression model is good.

Given the difficulty of estimating the constant term coefficient, we disposed of the regression and reviewed it.

As a result, the reviewed formula can be written as:

$$FDI = \beta \times DIR_TAX + \varepsilon_t \quad (7)$$

The results obtained by modelling the 19 series are (Table 3):

Table 3

**Statistical tests modelling the impact of direct taxes
upon foreign direct investment- reviewed model**

ISD=C(2) × IMP_DIR				
Variable	Coefficient	Std. Error	t-Statistic	Prob.
IMP_DIR	0.798956	0.126188	6.331490	0.0000
R-squared	0.427177	Mean dependent var		2227.026
Adjusted R-squared	0.427177	S.D. dependent var		2483.854
S.E. of regression	1879.906	Akaike info criterion		17.96703
Sum squared resid	63612820	Schwarz criterion		18.01673
Log likelihood	-169.6868	Durbin-Watson stat		0.575545

Source: own processing with the help of the program EViews 5.0.

Analysing the figures obtained in Table 3, the following conclusions can be reached:

- The value of the standard error of the coefficient of the regression function is inferior to the value of the coefficient, which enhances the reliability of its estimation, conclusion sustained by the low value of the probability;
- The adjusted correlation coefficient, with a value of 42.71%, shows that the statistical relationship between the dependent variable – FDI and endogenous – DIR_TAX is weak; modifications on the tax burden corresponding to direct taxes are found in a smaller extent in modifications of the volume of foreign direct investments;
- The Durbin-Watson test, with a value below the critical limit 2, indicates that residual variables are correlated.

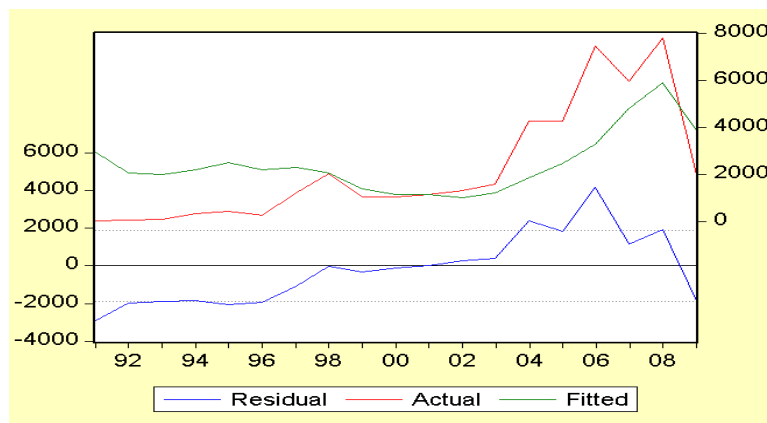
Under this limit, the model can be written as:

$$\text{FDI}=0.7989556028 \times \text{DIR_TAX} \quad (8)$$

From this model emerges the fact that, in the case of Romania, direct taxes generate an extension of the volume of foreign direct investment, and more precisely that direct taxes have the effect of increasing foreign direct investment. Therefore, it can be observed that a growth of 1u.m. of direct taxes induces a growth of 0.7989 m.u. of foreign direct investment.

Explanations that lie at the basis of this model are reflected in the fact that it is possible that other factors are much more important in influencing foreign direct investments than taxes, such as, cost of labor force. It is also possible that the environment enables tax evasion given that the tax rate is low.

From Figure 3 one can notice a tendency of growth for both lines: the one of historical foreign direct investments, represented by the red line, and the one of estimated foreign direct investment, represented by the green line. Both valuations follow a similar evolution and the fact that the blue line is rather close to the axe OX shows that the estimation is correct.



Source: own processing with the help of the program EViews 5.0.

Figure 3. Evolution of historical value of foreign direct investment compared to estimated value of foreign direct investment

To continue, we will test the stability of the equation and of the estimated coefficients, with the help of specific tests. In the figure below, we can notice that the cumulative sum of recursive errors exceeds the two critic lines towards the end of the studied period, the parametres of the equation becoming unstable.

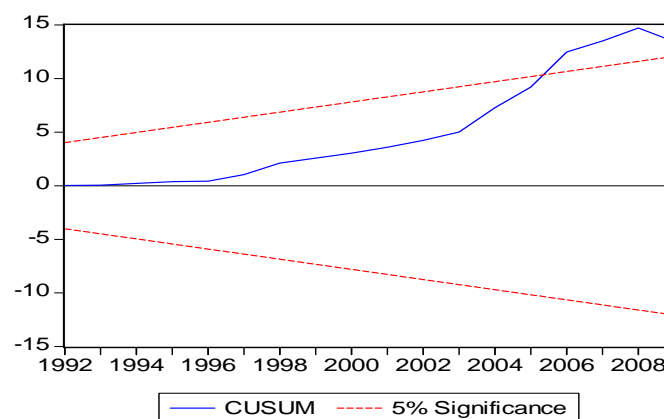


Figure 4. Test of the coefficient's stability with the help of the CUSUM system

4. Analysis of the impact of indirect taxes upon FDI

The formula for the impact of indirect taxes on foreign direct investments is also based on a single factor regression model:

$$Y_t = \alpha + \beta \times X_t + \varepsilon_t \quad (9)$$

where Y_t represents a dependent variable – FDI (foreign direct investment), α the free time coefficient, β the free time coefficient, X_t independent variable – IDIR_TAX (indirect taxes), ε_t random variable and t time period (interval 1991-2009).

The model has the following formula:

$$FDI = \alpha + \beta \times IDIR_TAX + \varepsilon_t \quad (10)$$

The results obtained by modelling the 19 series are (Table 4):

Statistical tests modelling the impact of indirect taxes upon foreign direct investment

ISD=C(1)+C(2) × IMP_IDIR				
Variable	Coefficient	Std. Error	t-Statistic	Prob.
C	-1098.148	472.9586	-2.321868	0.0329
IMP_IDIR	0.619691	0.073814	8.395269	0.0000
R-squared	0.805671	Mean dependent var	2227.026	
Adjusted R-squared	0.794240	S.D. dependent var	2483.854	
S.E. of regression	1126.695	Akaike info criterion	16.99127	
Sum squared resid	21580521	Schwarz criterion	17.09068	
Log likelihood	-159.4170	F - Statistic	70.48054	
Durbin-Watson stat	1.910222	Prob (F - Statistic)	0.000000	

Source: own processing with the help of the program EViews 5.0.

Analysing the figures obtained in Table 4, the following conclusions can be reached:

- The value of the standard error of the coefficient of the regression function is inferior to the value of the coefficient, which enhances the reliability of its estimation, conclusion sustained by the low value of the probability;
- The adjusted correlation coefficient, with a value of 79.42%, shows that the statistical relationship between the dependent variable – FDI and endogenous – IDIR_TAX is strong; modifications on the tax

burden corresponding to direct taxes are found in a considerable proportion in modifications of the volume of foreign direct investments;

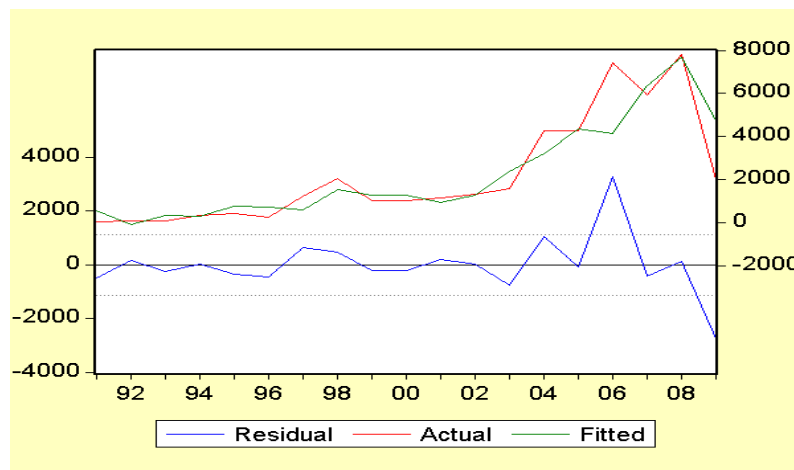
- The Durbin-Watson test, with a value slightly below the critical limit 2, indicates that residual variables are not auto-correlated;
- The F-statistic test, with a rather large value of (70.48054), exceeds the critical limit of 4.41 and Prob (F-statistic) with a value inferior to 0 indicates that the regression model is very good.

Therefore, we can say that the model built can be used to describe, on the macroeconomic level, the relationship between indirect taxes and foreign direct investments. As a result, the model can be written as:

$$\text{FDI} = -1098.147593 + 0.6196905865 \times \text{IDIR_TAX} \quad (11)$$

From this model emerges the fact that, in the case of Romania, indirect taxes generate an extension of the volume of foreign direct investment, and more precisely that indirect taxes have the effect of increasing foreign direct investment. Therefore, it can be observed that a growth of 1 m.u. of direct taxes induces a growth of 0.61969 m.u. of foreign direct investment.

Figure 5 shows us that the estimations are very good:



Source: own processing with the help of the program EViews 5.0.

Figure 5. evolution of historical value of foreign direct investment compared to estimated value of foreign investments

To continue, we will test the stability of the equation and of the estimated coefficients, with the help of specific tests. In the graph below, we can notice that the cumulative sum of recursive errors does not exceed the two critic lines, the parameters of the equation being stable.

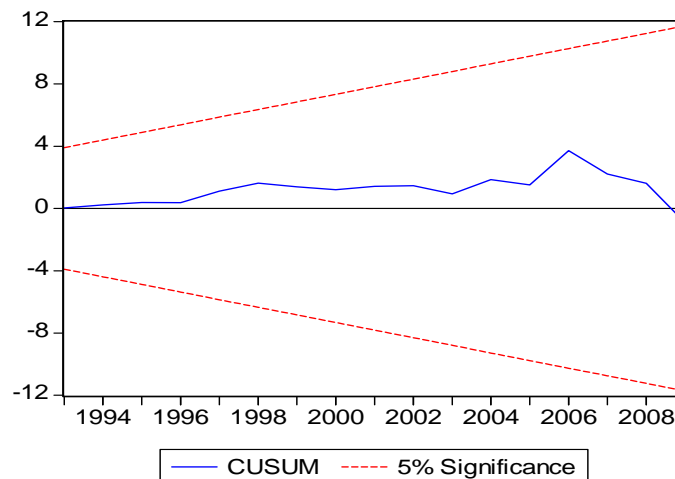


Figure 6. Test of the coefficient's stability with the help of the CUSUM system

Conclusions

Foreign direct investments are important for Romania, because of the „import of know how” and modern technologies which investors bring from their country of origin. Foreign direct investments generate additional collateral benefices for the receiving countries, and not only related to the production of goods and services. They bring technologies from abroad, including equipment and plants themselves, as well as modern production processes, new capital and jobs in countries that desperately need them.

In attracting foreign direct investment, taxation plays an essential role in terms of actual tax rates, multinationals' comportment being modelled by tax issues. In the actual economic situation, in which governments compete to attract multinational companies, ensuring proper tax treatment has become a global phenomenon. "A corporate tax system with reasonable fees, suitable deduction rules and discounts for depreciation is not only attractive for foreign investors, but also stimulates economic growth" (Halmi, 2009, p. 237).

Fiscal policy should aim to maintain budget balance, channelling resources towards the private sector, production, avoiding the accumulation of domestic public debt, broadening and strengthening the tax base, while reducing the level of taxation which leads to a stimulation of foreign direct investment.

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