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Comment on Michael P. Devereux and Rachel Griffith: The impact of corporate taxation on the location of capital: A review

Karolina Ekholm*

This paper reviews the literature on the impact of taxes on the location of capital, an issue of considerable interest for policy makers in today's globalized economy. More specifically, the literature reviewed deals with two issues: (i) how tax rates affect the location of capital; and (ii) how tax rates affect ownership and control of capital by foreigners. Whereas the former issue may be the one of main interest from a policy perspective, it is primarily the second that has been dealt with in the literature.

The motivation for dealing with the former issue is the risk that even small positive tax differentials relative to other countries have *large* negative effects on a country's capital stock. According to traditional analysis, an increase in the tax on capital in one country would not lead to large decreases in its capital stock. Capital would move until the real return to capital net of taxes was equalized and, since there would be diminishing returns to capital, a new equilibrium would be established at a reduced level of the capital stock, but not dramatically so. However, the more recent literature on industry location has emphasized that the existence of agglomeration economies may lead to much more dramatic effects on the capital stock of deviations in the tax treatment of firms from that adopted by other countries. If the real return to investment is positively affected by the presence of other firms, small changes in policies, such as corporate taxes, may have no effect at all but, at the same time, there may be threshold values beyond which a whole industry essentially relocates.

The motivation for dealing with the issue of how tax rates affect ownership and control of capital by foreigners is the notion that multinationals generate net positive welfare effects. Standard theory would tell us that there are both positive and negative welfare effects from foreign direct investment. As is explained in the paper, there are

* *Karolina Ekholm is Associate Professor at the Department of Economics at the Stockholm School of Economics.*

potential positive effects stemming from the transfer of technology within firms, spillovers affecting the productivity of domestic firms and increased competition. However, there are also potential negative effects on welfare, which stem from a possible crowding-out of domestic firms. If multinationals operate in sectors generating rents and their presence leads domestic firms to go out of business, rents will be shifted from the domestic economy to abroad.

Whereas there is substantial evidence suggesting that productivity is usually higher in multinational than in domestic firms, thereby indicating that technology transfer within firms may indeed be important, recent studies using micro-level data suggest no positive productivity spillovers for domestic firms. The authors mention that it is unclear whether there are any externalities associated with the operations of multinationals and also point out that even if there are, there is no reason to believe that they should only be associated with foreign multinationals; they are just as likely to be associated with domestic multinationals. In view of this, one might make the observation that the present literature has the wrong focus, i.e. on how tax rates affect the location of capital operated by foreign-owned firms, whereas it should focus on their effect on the location of capital *per se* or, possibly, the location of capital operated by multinationals.

While there seems to be no strong evidence of overall multinational activity generating net welfare gains to the economy, there is a case to be made for the hypothesis that certain activities generate such gains. Several studies find that R&D activities generate knowledge spillovers that are geographically limited in scope, which means that the geographical location of R&D activities is of importance for national welfare. Therefore, a strong emphasis on the issue of how taxes affect the location of R&D activities seems to be warranted. The authors mention two studies that reach very different conclusions about the effect of tax treatment of R&D on the location of R&D activities. Again, the paper points to the important fact that the most relevant issues from a policy perspective, are largely unexplored in the literature.

The paper makes an important contribution in terms of bringing out this lack of relevant focus of the existing literature, but also in explaining the methodological difficulties encountered when doing research in this area. The main conclusion reached in the paper is that taxes do influence the location and investment decisions of firms, but it is impossible to say how much. Virtually all studies in this area suffer from methodological shortcomings, but it is thus not known to what extent that is the case. These shortcomings fall into one or several of the following areas:

- Difficulties in measuring the dependent variable: Foreign direct investment flows have an unclear relation to investment in real activity by multinational firms and may therefore be a poor measure of the variable of policy interest. On the other hand, real activity data are only available for a few countries and therefore, it may be difficult to generalize the results from studies based on these data.
- Inherent difficulties in measuring tax rates.
- Insufficient control for other variables influencing the location of capital.
- Insufficient care being taken when distinguishing the effects on decisions taken at different levels.

According to the authors, these shortcomings are so severe that it is impossible to summarize the literature in a quantitative measure of the effect of corporate taxation on the location of capital. This is a very discouraging conclusion, insofar as it would be desirable to get some idea of the quantitative impact of tax rates. Based on the authors' discussion of the methodological problems encountered in this literature, one would draw the conclusion that a carefully designed study of the effect of tax rates on the location of capital should (i) use data on real investment or activity, (ii) use forward-looking measures of tax rates, and (iii) take into account that there are several decision levels involved in the process whereby a firm headquartered in one country ends up investing in capacity in another. Out of the many studies reviewed in the paper, at least one has been designed in such a way. Perhaps modesty prevents the authors from basing their quantitative measure on this study, since it has, in fact, been carried out by themselves. In any case, the paper makes a strong argument for pursuing research in this area from a methodological point of view, in the very careful way that is a trademark of these authors.