

DG ECFIN Workshop in Brussels February 27th and 28th on:

Who will own Europe?

The Internationalisation of Asset Ownership in the EU Today and in the Future

Foreign Ownership, the Case of Finland

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Introduction and summary

Martti Nyberg and Pentti Vartia

Who will own the firms and industries in Finland? The question has become increasingly important as a result of the fundamental changes in the owner structure of Finnish companies. During the past decade, as a consequence of internationalisation, a large number of Finnish firms have been acquired by foreign owners or have been merged with foreign firms. The share of the foreign ownership in the Helsinki Stock Exchange has increased rapidly. At the same time Finnish companies have established subsidiaries abroad and their investments have increasingly been directed outside of Finland. This two way street process has attracted the rising interest of Finnish top executives, researchers, policy-makers as well as the public.

This paper is to be presented in the DG ECFIN workshop in Brussels February 27th and 28th 2003. It consists of a collection of papers. The authors of different chapters are as follows. Chapter 1 is written by Jyrki Ali-Yrkkö, Tuula Joronen and Pekka Ylä-Anttila from The Research Institute of the Finnish Economy (ETLA), Chapter 2 by Ari Hyytinen, Ilkka Kuosa and Tuomas Takalo and Chapter 3 by Hannu Piekkola, Harri Hietala, Seppo Kari and Tarmo Valkonen. Chapters from 4 to 6 are written by Jyrki Ali-Yrkkö and Pekka Yli-Anttila. The original papers have been edited (and a few of them also translated) by Martti Nyberg. Introduction and summary is written by the editors.

In the first section the development of the internationalisation of Finnish companies is summarized. Typical characteristics related to foreign investments in Finland are presented from the early 1800s to the present. Data on the foreign companies engaged in industrial production in Finland as well as on the number of Finnish subsidiaries in foreign countries is introduced. In addition, the significant increase in the number of employees in foreign operating units of the large Finnish corporations is discussed. In the end of the section the role of globalisation as a unifier of Finnish companies' objectives is considered. Furthermore, the internationalisation of companies increases the importance of cultural differences for the management of the companies. On the basis of recent case studies cultural characteristics related to the management of Finnish multinational companies is considered. The original paper *Finland in the World*

Economy – The Era of Liberalization was published in Sitra Reports Series No. 20: Immigration and Economy in the Globalisation Process, the Case of Finland (2002).

In the second section of this paper the changes in the Finnish financial system are described. A short historical review of the changes in the Finnish economy including an exceptionally severe depression in the early 1990's is also presented. It seems that the structure of the Finnish financial system has thoroughly changed during the period 1980–2000. The role of the relationship-based debt in the Finnish financial system has reduced, while the role of the stock market has grown in importance. The original paper *Law and Finance: Evidence from Finland*, was published as ETLA Discussion paper No. 775 (2002).

In section three the taxation of portfolio and direct investments in Finland is discussed. First, a brief look at the characteristics of the old and new tax system in Finland is taken. Then, central tax regulations are presented and the main effects of capital taxation on direct investments are considered. In addition, the taxation of pension, life insurance and investment funds is described. It can be said that the Finnish tax system discriminates foreign ownership. Also it can be concluded that Finnish corporation tax (29%) appears competitive. In addition, results suggested that taxing in Finland promotes investments in the home country compared with investments abroad. The original paper *Beskattning av Internationella Aktieplaceringar* was first published in Swedish in a Workshop held in Helsinki 30-31.10.2002 by the Nordic Council for Tax Research.

In the fourth section we consider the role of taxation in explaining foreign investments. The role of corporate taxes and taxes on labour in foreign direct investments is considered. The impact of corporate taxes and tax burden of labour is estimated by using regression analyses and data from a number of countries in the EU. The results for different countries vary considerably. The results suggest that corporate taxes and tax burden of labour seem to have some kind of role in allocation of foreign direct investments although one must be careful with any definitive interpretations.

In section five the location of corporate headquarters is discussed. In Finland relocations of headquarters have, in most cases, taken place as a consequence of a merger or an acquisition. However, there are few cases when the location decision has been made independently of merger or acquisition. In 2002 a survey was made regarding factors affecting the location of headquarters. The results show that decisions related to firms' location are an outcome of interaction and combination of several

factors. Taxation might have an important role as a location factor when two equal firms merge. The original paper Chapters 4 and 5 are based on was published as ETLA Discussion paper No. 831 in Finnish (2002).

Globalization has changed also ownership structures and corporate governance systems. In the last section of this paper the implications of these changes are investigated by examining the effects of ownership nationality on the goals and the performance of the companies in Finland. The largest Finnish companies have adopted the maximization of shareholder value as a major goal during the 1990s. On the other hand there seem to be significant differences between the objectives of foreign-owned and Finnish-owned companies. The change has coincided with increases in foreign ownership. It seems that foreign-owned companies perform better than Finnish-owned companies. The original paper Chapter 6 is based on was published as ETLA Discussion paper No. 779 (2002).

This paper is preliminary. There may be changes in the composition of this paper.

1. Finland in the World Economy – the Era of Liberalisation

Jyrki Ali-Yrkkö, Tuula Joronen and Pekka Ylä-Anttila

Introduction

Foreign entrepreneurs played an important role in the industrialization of Finland and also as importers of foreign know-how. In the late 1800s and early 1900s Europe, entrepreneurs and artisans were widely mobile, seeking opportunities to apply their skills. Some settled and established businesses in Finland. For example, the food and wood working industries and trade benefited greatly from foreign entrepreneurs and foreign know-how.

As a whole, however, the impact of foreign entrepreneurs and direct investments on the Finnish economy has been relatively minor compared to many other small industrial countries. In the decades following independence and the World Wars, investments made in Finland by foreign companies were fairly small. This had to do with reservations on the part of Finnish people, but also with Finland's small size and remote geographic location as a market area.

The situation changed in the 1990s – the circle became complete. The legislation that had restricted foreign ownership was repealed, and active measures were taken to attract foreign capital to Finland. Foreign companies and entrepreneurs have clearly helped make the economy more effective, and multinational corporations have opened up new marketing channels for Finnish technology and products.ⁱ

Attitudes toward foreign companies and ownership have changed very rapidly, even though questions and criticism have not entirely disappeared. Parliamentary discussions on repealing the law restricting foreign ownership, and on the merger between the Swedish and Finnish paper companies – Stora and Enso – are good examples of the rapidity of the change as well as of the critical attitudes that continue to exist.ⁱⁱ The 1939 law that restricted foreign ownership was overturned in 1992 as part of Finland's policy of integration and EEA membership, but there was strident criticism toward the development, particularly with regard to freeing up land ownership. According to a popular impression, foreigners were going to “rush to buy land at cut-rate prices”. Such talk died down quickly. At present, the discussion has broadened to encompass the theme of globalisation, which is in some ways rendered into concrete terms by the

creation of StoraEnso. Supranational mergers are an essential part of the ongoing wave of globalisation. They are resulting in entirely new management and administrative clashes between cultures, which the claims that represented the national viewpoint could not foresee in the early 1990s.

The national strategic significance associated with ownership has diminished in a fundamental way. Ownership has become more international, and international investors place only one demand on management: produce earnings. From the perspective of the national economy it is important where the companies are located, where they expand and increase employment – not who their owners are. For this reason, it matters whether Finland is seen as an attractive location for businesses and people alike.

Table 1.1 Summary of direct foreign investment in Finland

Time period	Typical characteristics connected to foreign investments
Industrialization (1800s-1917)	<ul style="list-style-type: none"> • Foreign entrepreneurs and businesses speed up pace of industrialization and bring know-how
First decades of independence (1917–1950)	<ul style="list-style-type: none"> • Majority of most prominent businesses are transferred to Finnish ownership during early days of independence • 1939 law restricts foreigners' ownership rights; law in effect over 50 years • Little foreign investment
Gradual growth of foreign Investments begins (1960s and early 1970s)	<ul style="list-style-type: none"> • Number of foreign-owned companies grows gradually • Investments into labour-intensive fields (textile and garment industry, metal industry assembly companies) • Motives: low labour costs, entry into markets
From assembly to higher skills (late 1970s–1980s)	<ul style="list-style-type: none"> • Number of foreign-owned companies grows slowly • Motives: acquiring special know-how of Finnish companies
Liberalization & globalisation of the economy (1990s–)	<ul style="list-style-type: none"> • Last restrictions on foreign investment are lifted in early 1990s ("forced" by EEA) • Era of protectionism of national industry ends • Foreign companies increasingly interested in buying Finnish businesses • Investments focus on industry and services • Foreign ownership has greater impact than before on business activity, mostly positive, for example from the perspective of economic efficiency

Technology, know-how and a high-quality infrastructure have made Finland a more powerful magnet for investors, and Finnish companies into interesting investment targets. A certain end of development has been reached when the capital investment

operations that were originally established to provide available capital for Finnish-owned companies – and in part, to bolster Finnish ownership – now has global owners. Investing and ownership now have a professional dimension, and ideologies and national borders are becoming less and less significant in the global world economy.

Foreign Assembly Factories and Garment Industry come to Finland

Direct foreign investment in Finland did not surge during the decade that followed World War II, even though elsewhere in the world enterprises were experiencing a strong internationalisation trend. After the war, foreigners saw Finland as politically unstable. The West saw Finland as part of the Soviet Union's sphere of interest, even though it had retained its independence. Strict currency and import regulations did not make investments any more attractive. In the late 1950s the level of foreign investment was at the same low level as two decades previously.ⁱⁱⁱ

Finnish attitudes toward foreign companies became more positive during the 1960s. Simultaneously, social conditions were stabilizing, as indicated by a decrease in risk premiums of foreign currency loans.^{iv} However, the law restricting foreign ownership remained in effect.

Direct investments in Finland by foreign companies continued to be modest. For example, in the 1960s inward direct investments were typically less than 0.2 percent of the gross national product (GNP). The modest volume of investment was connected to the fact that a majority of the foreign businesses established in Finland were marketing and sales companies that operated on small capital, and many companies indeed rented rather than owned their business offices.

It was typical of the newly established or acquired enterprises that a foreign, frequently multi-national parent company was the sole owner of the Finnish subsidiary. Joint ventures that also had Finnish partners were less common. They were established mostly when the law restricting foreign ownership posed limits on operating a business. The strategy of most businesses was to enter the growing Finnish market and compete there. It is true that some enterprises exported their products further to Soviet markets, among others. A large portion of the businesses that engaged in exporting imported the raw materials or semi-finished products they needed for production.

In the 1960s and 1970s, foreign companies were tempted by Finland's low labour costs relative to other Western competitor countries. Some of those investors included Swedish garment companies and metal and electronics industries' assembly factories.

But the companies that came to Finland merely for the sake of the low cost of labour left the country very quickly in late 1970s and early 1980s, when the relative cost of labour began to rise.

Direct foreign investments began to increase in the 1980s, but in relation to the GNP, the investments were still fairly small. The targets of investment began to be increasingly in buying and selling companies, especially small businesses with special know-how. The most significant direct foreign investment in Finland in the 1980s was the deal between what was then Kymi-Strömberg and the Swedish ASEA, in which ASEA purchased Kymi-Strömberg's entire electrical operations unit. This event was indicative of how Finnish attitudes toward foreign companies began to shift with the outward-directed internationalisation trend of Finnish industry itself.

Technology is Attractive to Businesses and Investors

Finland became much more attractive to foreign investors in the course of the 1990s (see also pages 28 and 52). One factor that influenced this development was that, like many other industrialized countries, Finland freed the remaining restrictions on capital movements and liberalized competition in business sectors that had heretofore been protected from open competition. EU and EMU memberships carried a valuable message: they signalled that Finland wanted to be part of the integration trend of the international economy. Transnational investments by companies had grown rapidly in the world economy starting in the mid-1980s. In addition to a liberalization trend in the flow of capital, this had to do with developments in information and transportation technologies and the services related to them. These developments made it possible for a geographically scattered company to operate more effectively than before. In many sectors, the competitive environment has become global over the last several decades. In order to succeed in this kind of competition, many companies have chosen to specialize and increase their size in areas of expertise. This has encouraged company structures to move across national borders, because domestic alternatives have not been sufficiently effective.

In part, the growth of direct investment has been the product of an international trend. An important factor in terms of the increase in direct investments into Finland has been the emergence of numerous technology-intensive companies, especially in the information and communications technology sectors. The sectors are characterized by specialized know-how considered valuable by foreign businesses. The motivation of

the foreign companies to relocate to Finland is no longer to benefit from their own area of specialization in the Finnish market, but rather, for a multinational company to benefit by making the know-how of Finnish companies an integral part of its own operations. Indeed, most of the Finnish companies that were thus acquired have benefited from the new ownership arrangement: as part of a multinational company, their technologies and products have found new, international marketing and distribution channels. Financial resources have also increased notably in many cases.

Table 1.2 Some of the largest foreign subsidiaries engaged in industrial production in Finland 1998

Foreign parent company	Finnish subsidiary	Sector of Industry	Em- ployees
ABB	ABB-Strömberg	Power and electrical industry	9625
Kvaerner	Kvaerner Masa-Yards	Metal and engineering industry	4225
Carlsberg	Sinebrychoff	Food industry	1830
Sandvik	Sandvik	Metal and engineering industry	1339
NKF	NKF	Metal and engineering industry	1221
Aker	Aker	Metal and engineering industry	1118
Borealis	Borealis	Chemical industry	1112
Schering	Leiras	Pharmaceutical industry	1042
Tellabs	Tellabs	Power and electronics industry	903
Foster-Wheeler	Foster-Wheeler	Metal and engineering industry	879

Source: ETLA's business database

Direct foreign investments into Finland have also increased because big Finnish corporations tend to focus on their specific area of specialization. Many operational units that had to be unloaded might not have found an appropriate or interested buyer in Finland at the time of sale. In the open economy, many operational units that were for sale were able to continue operating as part of a foreign company in the same field. The large proportion of mergers and acquisitions among foreign companies' direct investments in Finland is reflected in Table 1.2, which lists some of the largest subsidiaries that were operating and engaged in industrial production in Finland in 1998, and were owned by foreign parent companies. All were bought by foreign companies, and with a few exceptions, were, prior to being purchased, originally part of a larger Finnish group.

The internationalisation of Finnish companies - from exporting to foreign production

As late as the 1970s, Finnish companies' international activities consisted mostly of exporting from Finland. Since the early 1980s, internationalisation has primarily referred to production investments directed abroad. Companies have either purchased businesses abroad or set up new international units.

Before, Finnish companies became international in stages. Simple international operations gradually progressed to more complex operations. International operations were launched through exporting, which was usually targeted at Finland's traditional trading partners Sweden and Germany. Later there was an effort to expand operations to other parts of Europe and North America. Often after only several years of experience with exporting, companies moved on to more demanding forms of international operations, like overseas production.

The situation is different today. Many companies begin targeting the world market at a very early stage. Companies in the high-tech industry in particular view the entire world as a potential market from the very start. As a result, foreign subsidiaries are already established during a company's product development phase. Earlier, research and development abroad was carried out only after the company had acquired international experience through other operations.

A majority of investments of Finnish companies have gone to the EU region. Within Europe, the most important countries are Sweden and Germany, and they have also been Finland's traditional trading partners. On the heels of Europe is North America, where the United States is naturally the dominant investment target.

The issue can also be examined another way, by looking at the number of subsidiaries. For the most part, the conclusions remain the same. Most Finnish companies are located within the EU and in North America. Conversely, the impact of the former Eastern European nations is not visible in the figure. Following table 3.1 presents the most significant countries where Finnish companies are located outside of Western Europe and North America.

The table provides a sampling of the broad scope of international operations of Finnish companies. Estonia and Russia in particular are home to a high number of Finnish companies' subsidiaries. In addition to subsidiaries, many companies in Estonia and Russia are owned by Finnish individuals. They are not shown in the table, because the figures were compiled from data for the 900 largest concerns in Finland.

Table 1.3 Number of Finnish subsidiaries outside of Western Europe and North America – the most important countries by region (number of subsidiaries in parentheses)

Region	Countries with most subsidiaries		
Rest of Europe	Estonia (279)	Russia (238)	Poland (98)
Latin America	Brazil (31)	Chile (29)	Mexico (22)
Asia and Oceania	Australia (71)	Singapore (55)	Japan (51)
Africa	South Africa (15)	Egypt (6)	Kenya (4)
Other countries	Cayman Islands (18)	Bermuda (6)	Seychelles (3)

Source: Statistics Finland enterprise register, supplemented by data from the FIBO database of the Helsinki School of Economics

In South America, Brazil and Chile have been the primary targets. Finnish corporations also have operations in many other countries in the region. For example, Metra has operations in Venezuela, Peru and Argentina. Kone also has personnel in Venezuela and Argentina.

Foreign investments by Finnish corporations have grown most rapidly in Asia. For Nokia, for example, China is now the second-most important market. Trailing Nokia, a number of other Finnish companies have operations in China, where many of Nokia's cooperation partners, such as Perlos, Efore, Elcoteq, Ojala and Eimo, have invested. The group keeps growing, as many companies have plans for investing in China. In addition to China, Malaysia and Singapore are among countries with significant investments by Finnish companies. There are Finnish subsidiaries in 90 different companies at the moment.

In other words, in the course of the last 10–15 years, Finnish companies have internationalised into nearly all parts of the world. Africa may be the only exception; only a handful of companies operate there, and the same is true for other western companies. This means that Africa – excluding South Africa – has not been successful in attracting foreign companies.

The growing foreign investments by companies can also be seen in the location of personnel. A significant portion of many large Finnish corporations work outside of the country's national borders. The situation has changed drastically over the last fifteen years (Table 1.4).

Large Finnish corporations have changed in many ways. They have grown in size. The growth has mostly occurred abroad, as international operations have been expanding actively. Companies strive to operate close to their markets. For this reason, more and

more production takes place outside of our borders. In 1983 only slightly more than 15 percent of the ten largest corporations had operations abroad, when the proportion now is clearly more than half. All signs indicate that this proportion will continue to grow in the future. The growth focus of large corporations has shifted abroad. Companies want to operate in the vicinity of their customers. Because these markets are abroad, a growing share of investments too are directed outside of Finland.

Table 1.4 Number of employees in large Finnish corporations in 1983 and 1999

Company	1983		2000	
	Total number of employees	In foreign operating units (%)	Total number of employees	In foreign operating units (%)
Nokia	24 000	17,5	59 000	58
Stora-Enso	15 000	9,8	42 000	64
UPM-Kymmene	35 000	11,7	33 000	37
Metso	15 000	12,8	22 000	50
Kone	13 000	66,2	23 000	94
Metsäliitto	8 000	7,5	25 000	61
Fortum	7 000	21	15 000	37
Ahlström	12 000	14,4	9 000	78
Wärtsilä	22 000	9,5	11 000	69
Rautaruukki	8 000	1,6	13 000	39
Total	159 000	17.2	252 000	59

Source: Ali-Yrkkö & Ylä-Anttila (1997), updated in 2000

The degree of internationalisation increases even more, when we look at the role of international sales. Approximately 85 percent of sales derive from abroad. The ownership of corporations has become increasingly international as well. A significant portion of the shares of these companies is in the hands of foreigners.

Finnish companies operate in many different environments, and the international context is visible in all company operations. They constantly encounter rich varieties of national cultures to which they must adapt their own operations. In addition to national cultures, corporate culture itself varies between countries and regions. The following will provide a closer look at the culture of ownership.

Globalisation Unifies Corporate Objectives

When corporations work in a context that is more and more international, different management, ownership and corporate cultures have to meet. In particular, international buyouts and mergers present huge management challenges. Organizations that previously operated apart now must be streamlined to work in accordance with

common goals. One current theme in economics and political science concerns the relationship between management and stakeholders. Cross-border mergers and the internationalisation of ownership have elicited more discussion of this kind of *corporate governance*.

Corporate governance systems refer to all the means that groups of stakeholders of a corporation seek in order to influence the management so that the group's goals are met as successfully as possible. Central factors here are, first of all, what the role of owners, management and employees, and second, what kind of governance structures work best from the point of view of society and the economy.

Until recent years, Finland's corporate governance has been of the Euro-Japanese kind, where it is typical for the objectives of personnel, customers and other stakeholders to be reflected in the company's governance structure. The situation is now changing more toward an Anglo-Saxon system, in which the only objective of the corporation is to increase shareholder value. The following offers a look at how the goals of large Finnish corporations have changed over the last 10–15 years. The objectives were gathered from company annual reports.

The objectives reported by companies are rather varied. Profitability and improving it has been the most common goal in the course of all study years. Annual reports do not, however, discuss maximizing profits, but improving or maintaining them. It is important to note that profitability does not necessarily mean that the wealth of shareholders increases, because traditional measures of profitability do not always take into account the capital used to achieve the profits.

Increasing the wealth of owners is a newcomer among corporate objectives. The position of owners is being emphasized more than before. Since mid-1980s, a growing number of companies has included among its public objectives increasing profits for owners. By the late 1990s, half of the corporations that were studied stated that they sought to increase shareholder value.

Changes in corporate objectives are reflected in the company's operations in many ways. Company management spends more and more time maintaining investor relations and PR. Foreign owners demand increasingly open PR. To ensure equal status among shareholders, PR needs to be transparent and balanced. For example, much more detail is given about management salaries and bonuses than before (see also p. 59).

In addition, PR, wage and incentive systems have also changed. The share-based incentive programs that have become so common so quickly originally came from the United States. Nowadays, these arrangements are usually made with the help of stock options. Through stock options, shareholders want to ensure that management acts in accordance with the interests of the owners. A second reason for using stock options is to bind key persons to the company. There is a desire to retain key personnel in the company in the future as well.

New ownership structures, foreign ownership and a new way of thinking all mean changes for corporations. Globalisation acts as a unifier of companies' objectives. It is not clear which system is superior, the continental European or the Anglo-Saxon. It does seem that the continental European as well as Japanese systems are veering toward the Anglo-American one. A high rate of return on capital and amassing shareholders' wealth have become more emphasized and continue to be emphasized even more as the objective behind all the decisions that are made about a company's operations. National traits in the governance structures and management styles of companies are evened out, and at least to some extent, differences will disappear.

From Exports to International Corporate Acquisitions

Most large industrial corporations are already multinational, and a significant portion of the sales of small and medium-sized businesses comes from abroad. Service companies too are internationalising rapidly.

During the last fifteen years, the forms internationalisation takes have changed fundamentally. Direct investments and supranational alliances are the most important forms of internationalisation. Companies focus on their core operations, and a significant portion of their investments are directed abroad. Aside from production, also financing and R&D operations, for example, are already largely globalised. Two mechanisms have made globalisation more embedded: it encompasses all of the company's operations, and it occurs more and more frequently through corporate acquisitions or mergers. For this reason, people and cultures encounter each other at all levels of business organizations. A central factor that determines the success of international mergers seems to be the ability to manage cultural diversity.

- Corporate governance systems become uniform

As a result of globalisation, the organizations and objectives of companies operating in different countries become more uniform. The corporate governance systems of many companies edge toward Anglo-Saxon practices.

Moving toward ownership-oriented business that emphasizes efficient capital seems to result in conflicts and overemphasize the strengths of one's own culture and operating methods. A strong company culture provides an important competitive edge in the global market, where cross-border mergers and acquisitions are increasingly standard practices.

- With globalisation, companies encounter cultural diversity

Deepening globalisation easily leads to collisions between cultures. In a majority of international mergers and corporate restructuring, the problems are greater than anticipated. According to studies, as many as over half fail. The reason is often cited as undefined "cultural differences".

Although cultural differences are often a veil that conceals many other causes for the failure, there is no doubt that cultural differences play a very real role. Many empirical studies show that cultural differences may result in misunderstandings that in turn lead to conflict situations that are difficult to resolve. When dealing with people of different cultural backgrounds, the biggest challenge is to leave one's own value system at the door. In other words, there is no right or wrong way to act, there are only different ways of acting. Cultural differences are felt most acutely in situations where the parties lack international experience.

On the basis of the most recent case studies (see Ali-Yrkkö et al., 2001), it can be concluded that there are certain special cultural characteristics that are connected to managing multinational Finnish companies: working toward a flat hierarchy, direct and straight forward communication, and extensive delegation of decision making power. In some countries, this kind of corporate culture and management style were seen as too straightforward, even harsh. As a whole, Finnish corporate culture functions fairly well. Quick decision-making and a democratic management style are particularly useful when a company's operating environment undergoes dramatic changes.

The misunderstandings that arise between different nationalities can be minimized by using one common language. Hence, a number of international companies have adopted English as the company language. This has played a part in creating an

international business culture as companies have expanded operations to several continents. By using the same terminology and concepts in different countries, they are able to bypass an obstacle that would otherwise stand in the way of inter-cultural communication.

It is nearly certain that corporations will continue to become increasingly and more fundamentally international. Operating in a multicultural environment poses ever-greater challenges. Many small high-tech companies will become internationalised already in their first years of operation, and companies and their personnel will become accustomed to operating in a multicultural environment almost from the first days of the company's existence. Many companies are multicultural as soon as they are established.

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Endnotes

ⁱ Pajarinen – Ylä-Anttila 1999

ⁱⁱ See Väyrynen 1999, who records and analyses closely the rather heated debate surrounding the topic.

ⁱⁱⁱ Hjerppe & Ahvenainen 1986 s. 292

^{iv} Hjerppe & Ahvenainen 1986 s. 292

2. Finnish Financial System

Ari Hyytinen, Ilkka Kuosa and Tuomas Takalo

Introduction

The purpose of this section is to describe changes in Finnish financial systems that occurred in the 1980s and 1990s. In the past two decades Finland has experienced simultaneous financial and currency crises. In addition, its economy underwent the most serious cyclical downswing in the industrialised countries since the Great Depression of the 1930s (see, e.g., Kiander and Vartia 1996, and Honkapohja and Koskela 1999).

Integral to the economic distress was a typical twin crisis. A major banking crisis and a collapse of the fixed exchange rate regime in the early 1990s followed the financial liberalisation of the 1980s. Over the same period, the structure of Finnish industry shifted in emphasis from the heavy metal and paper industries to the ICT sector. An apt example of the shift is that Finnish firms filed domestically 2,579 patent applications in 2000 – nearly two times as many as in 1980 and the second highest number per capita in the European Union (EU). Finland is also currently considered as one of the most competitive countries in the world both by World Economic Forum (WEF 2000) and International Institute of Management Development (IMD 2000).

Finnish financial markets were reorganized at the same time. In early 1980s the Finnish financial system had a main-bank structure, like the financial systems in Japan and Germany. By the end of the millennium the financial system had moved from relationship-based debt towards increasing influence of the stock market.

Initial conditions

At the start of World War II, Finland was behind the other Nordic countries in terms of industrial development. Since the war, Finland's industrial structure has undergone rapid change continuing throughout the period of this study. In 1980 heavy metals, steel and forest-based industries formed the core of the Finnish economy. Since then, the electronics and telecommunications industries have expanded rapidly. The ICT sector currently accounts for 40% of GDP and over 60% of exports. Finland, which is ranked among the most competitive countries in the world, has a highly innovative business sector (WEF 2000, IMD 2000). An apt example of the change is Nokia, which is now

the best-known Finnish company and employs over 60,000 persons. In 1980 Nokia had only 2,500 employees involved in the electronics industry. Production of rubber products, forest-related goods and cable machines accounted for over 80% of total sales – mainly to customers in Finland, Sweden and the Soviet Union. In 2000 virtually all of Nokia’s sales came from ICT business. Over the period 1980–2000, Nokia's annual R&D investment grew from EUR 16 million to EUR 2,646 million (Ali-Yrkkö and Hermans 2002).

Table 2.1 shows some key indicators of the Finnish economy, which reflect structural changes and cyclical developments.ⁱ The growth of real GDP was rapid during the 1980s. After the growth period, Finland underwent an exceptionally deep depression. In many ways, it was more severe than the depression of the 1930s, as Kiander and Vartia (1996), and Honkapohja and Koskela (1999) point out. Real GDP had never declined during the post-war period until the economic crisis of the 1990s, when it dropped by about 14%. The recovery, however, was rapid, and economic growth was strong through the rest of the 1990s. Because of steady but slow population growth, the economic turbulence shows up also in the GDP per capita figures. The patterns of foreign trade illustrate both the structural change and the cyclical movements. In the 1980s the major trading partner was the Soviet Union. Exports as a percentage of GDP hit bottom in the early 1990s, when bilateral trade with the Soviet Union collapsed. Since then, export intensity has increased and Germany, Sweden, United Kingdom and United States have become the most important trade partners.

Table 2.1 Initial conditions

Average	Real GDP growth	GDP per capita *	Inflation
1980-1985	3.3%	9199	9.1%
1986-1990	3.3%	15061	4.9%
1991-1995	-0.6%	20263	2.2%
1996-2000	5.1%	26754	1.6%
Average	Export intensity **	Bankruptcies ***	TFP relative to USA ***
1980-1985	30.9%	120	73%
1986-1990	20.5%	235	75%
1991-1995	25.5%	509	85%
1996-2000	32.7%	284	95%

* EUR m, current prices, ** % of GDP

*** average number of bankruptcies per month

**** total factor productivity of Finnish manufacturing, USA = 100% (Maliranta 2001)

In summary, Finnish economic performance during the sample period is characterised by industrial change, wide-ranging deregulation, and turbulent economic conditions. The large-scale changes are closely related to reform of the Finnish financial system, which we document next.

Financial system

The Finnish financial system has traditionally been relationship-focused, debt-based, and dominated by deposit banks. The stock market has been small and illiquid (Hietala 1989, Kasanen et al. 1996). Now we describe developments in the financial system.

As in many other countries, financial market regulation was introduced in Finland in the aftermath of the crisis of the 1930s and has since then been gradually extended. At the start of the 1980s, the Finnish financial system was heavily regulated: cross-border capital flows controlled by the central bank, interest rate ceilings on bank loans and deposits, quantity limits on lending (Vihriälä 1997), etc. Besides the direct regulation, taxation shaped the financial system.ⁱⁱ Tax exemption of interest earnings was tied to a uniform deposit rate and terms set by the authorities, and interest expenses were often deductible in taxation. Equity financing, by contrast, was subjected to burdensome tax treatment.

Low nominal lending rates, tax deductibility, and high inflation resulted in negative real lending rates and hence in excess demand for loans in the early 1980s. The regulation and low lending rates created favourable selection by excluding risky borrowers from the market (Drees and Pazarbasioglu 1995; see also de Meza and Webb 2001). The tax exemption of deposit interest earnings subsidised banks and effectively discouraged the development of other financial intermediaries. The regulations in turn reduced banks' incentive to compete for market shares and encouraged the creation of close banking relationships. Against this mix of regulation, taxation, and monetary policy favouring bank finance, it is hardly surprising that at the start of the 1980s the Finnish financial system was built on a non-competitive and subsidised banking sector in which long-term relationships with borrowers were essential and the incentives for risk management and monitoring were weak.

It however became increasingly evident that the old financial system, which relied on long-term relationships, was outdated. The gradual change in the industrial structure described earlier generated a need to move funds from declining to emerging industries. For example, between 1981 and 1985 the average real growth of R&D expenditures in

the business sector was 13% while the corresponding growth rate for gross fixed capital formation was 3%. Demirgüç-Kunt and Maksimovic's (1998) analysis moreover suggests that, unlike in many other countries, firms in Finland used more long-term than short-term debt to fund their growth in the 1980s.

Faced with intermediation restrictions and accelerating inflation, the old system could not satisfy the financing needs of Finnish companies. Lenders, borrowers, and financial intermediaries began in the early 1980s to circumvent the regulation in a parallel (grey lending) market (Swoboda 1986, Drees and Pazarbasioglu 1995). The unregulated lending of commercial banks took place through their recently acquired finance companies. Measured as a ratio of total lending, it grew from 17% to 35% during the period January 1980 – December 1985 (Swoboda 1986).

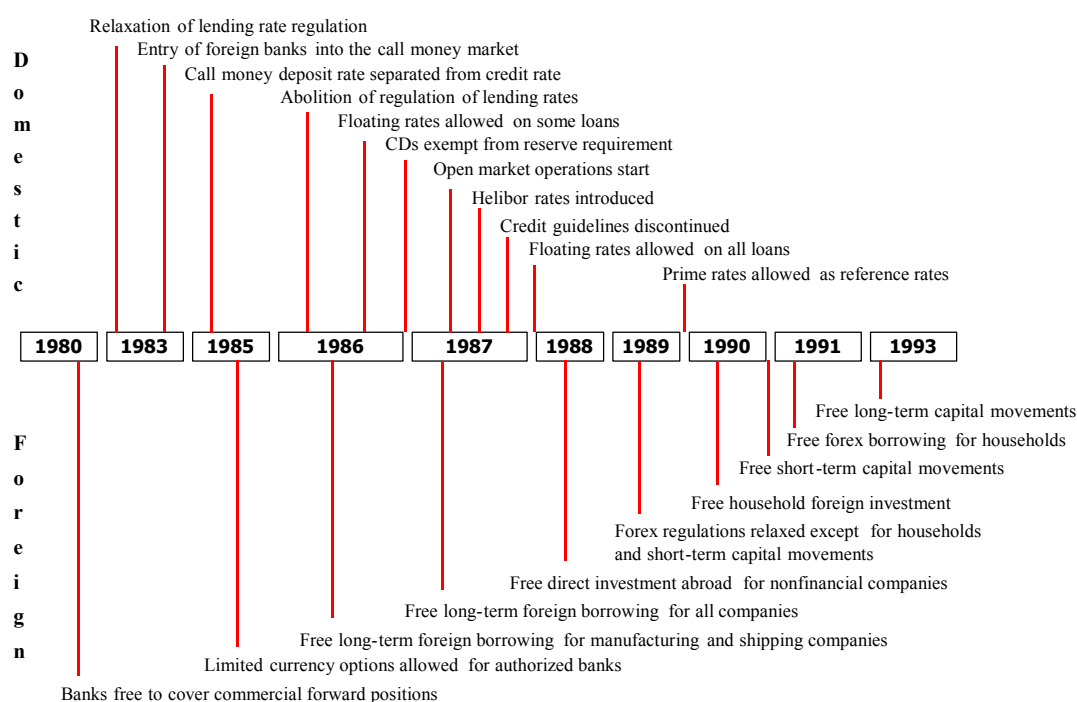
There were several other signs of financial system failure. For instance, another grey market emerged in the stock markets, where the demand for so-called unrestricted Finnish stocks by foreign investors steadily increased (Hietala 1989). In the early 1980s financial institutions also raised risk capital on the stock market, even more than the non-financial corporations. Moreover, the profitability of Finnish deposit banks, despite the regulation and subsidisation, was among the lowest in Europe. According to OECD Bank Profitability Statistics, Finnish banks' operating profit before credit losses amounted to 0.75% of balance sheet total for the period 1980–1984. In Europe only the Belgian banks had a lower ratio (0.54%).

The difficulties in the financial sector and the example of the United Kingdom and the other Nordic countries led to the gradual liberalisation of the financial market in the 1980s (Figure 2.1).ⁱⁱⁱ By 1988 the major restrictions, including foreign exchange movements and interest rate regulations, were removed. The financial market deregulation intensified competition between financial institutions and launched rapid lending growth. The annual growth rates were 25–30% in real terms. Borrowing in foreign currency also increased. As a result, the ratio of total credit to GDP grew sharply.

Financial market liberalisation initially increased the importance of intermediated debt finance and strengthened to the dominant position of the deposit banks. Nonetheless, an 'equitisation' process was also initiated. Initial public offerings increased in the late 1980s and peaked in 1989 when 43 companies were listed. Equity issuances by non-financial corporations also increased, and the liquidity of the stock market improved. In addition, 23 development or private equity companies were established during 1984–

1986. The role of the commercial banks in securities trading, in taking companies public and in the emergence of the private equity industry was nonetheless significant.

Figure 2.1 Financial liberalisation



Although equity investments grew, bank lending, money and public debt markets grew more rapidly, and the economy became increasingly indebted towards the end of the 1980s. The economy was thus vulnerable to the shocks that hit in the early 1990s. When borrowers' incomes and wealth declined dramatically in 1991, and bankruptcies (see Table 2.1) increased, the banks experienced severe problems. The currency crisis first raised short-term interest rates and then led to depreciation of the currency. This further weakened the borrowers' debt service capacities, especially since many had borrowed in foreign currencies.

Measured by loan losses and bankruptcies, the worst years of the banking crisis were 1992–1994. Bankruptcies for example reached their peak in 1993 when nearly 1.5 firms per thousand went bankrupt (see also Table 5.1). To prevent the banking sector from collapsing and to limit the adverse impact of financial sector problems on the real economy, the government intervened.^{iv} A part of the intervention was Parliament's resolution, published in February 1993, in which the Finnish state guaranteed the Finnish banks' contractual obligations.

The banking crisis led to a reorganisation of the banking sector (see Table 5.2). The savings bank group almost disappeared because of forced mergers by the authorities and eventual takeovers by other banking groups. The banks that were not forced to

consolidate, consolidated voluntarily. For instance, the two largest commercial banks (KOP and SYP) merged in 1995.

The banking crisis also changed corporate financing in Finland. In the short-term it caused a disruption in the supply of external finance to companies. Although the evidence on a general credit crunch is weak (Vihriälä 1997), Saarenheimo (1995) finds that adverse shocks to the credit supply reduced private investment by about EUR 3.3 billion annually in the early 1990s.^v

Perhaps the most important long-term consequence of both the deregulation and banking crisis concerns the availability of external finance to small firms. As Petersen and Rajan (1994) and Berger and Udell (1998) argue, this may crucially hinge on the supply of relationship-based credit, which we feel shrank considerably in Finland in the 1990s. First, the deregulation increased competition both within the banking sector and from outside the sector, which tended to undermine banks' long-term relationships with borrowers (Petersen and Rajan 1995 and Booth and Thakor 2000). Second, the banking crisis limited the scope for relationship-based debt finance. Kinnunen and Vihriälä (1999) report, e.g., that small and medium size firms that were the customers of the banks in the worst trouble were more likely to close in 1992 than other firms or the same such firms in other years. Finally, the consolidation of the banking sector reduced the number of small banks, which tend to devote larger proportions of their assets to small business lending than do large banks (see Berger and Udell 1998 and Berger, Miller, Petersen, Rajan and Stein 2002).

When the economic environment improved in the mid-1990s, the development of the stock market that had begun in the late 1980s continued. In the 1990s, equity issuance on the stock market by the non-financial firms increased, clearly outpacing that of financial institutions. IPO activity restarted immediately once economic conditions had improved. Six new companies were successfully listed on the Helsinki Stock Exchange in 1994, and the trend accelerated in subsequent years. In the period 1995–2000, 55 companies were listed. As Hyytinen and Pajarinen (2001) report the venture capital market also grew. The first venture-backed company was listed in 1994 and by end-2000, there had been 23 venture-backed listings.

In summary, it seems that the structure of the Finnish financial system has thoroughly revamped during the period 1980–2000. The role of relationship-based debt in the Finnish financial system has reduced, while that of the stock market grew in importance.

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Endnotes

ⁱ Besides the indicators shown in Table 5.1, the unemployment rate closely follows movements in the Finnish economy. The unemployment rate remained at low levels in the 1980s, but in the crisis of the early 1990s, the rate of unemployment exploded. After peaked above 20%, it has gradually declined during the rest of the 1990s.

ⁱⁱ See Hyytinen et al. (2002) for concise description of the Finnish tax system.

ⁱⁱⁱ See Drees and Pazarbasioglu (1995) and Vihriälä (1997) for comprehensive accounts of the liberalisation. Figure 2.1 is a modified version of Vihriälä's (1997) Figure 1.

^{iv} Vihriälä (1997) reports that confidence in the Finnish economy and financial system deteriorated in winter 1992/93 to the extent that the Finnish banks and large corporations encountered severe difficulties in borrowing from abroad.

^v The debt-equity ratios of non-financial enterprises rapidly declined in 1991–1993, to the level that had prevailed in the 1970s, i.e., prior to liberalisation. As Edey and Hviding report (1995), similar developments occurred in Denmark, Norway and Sweden.

3.Taxation of international portfolio investments

Hannu Piekkola, Harri Hietala, Seppo Kari and Tarmo Valkonen

In this section we briefly describe some details of the old and new tax systems before and after the Finnish corporate and capital income tax reform that took place in 1987. Then we investigate taxation of portfolio investments in Finland, taxations main effects on foreign investments. In addition, taxation of pension, life insurance and investments funds is considered.

The Finnish Tax System before and after the Capital Income Reform

The statutory corporate income tax rate was very high before the reform (on average 50 percent in 1987), but generous allowances like inventory and investment reserves and accelerated fiscal depreciation considerably reduced the corporate taxes collected. The double taxation of distributed profit was alleviated at the firm level also allowing a 40-100 per cent dividend deduction in state taxation. Another remarkable point is that the investments were supported by the strict regulation of financial markets, which was geared to keep the real interest rate low. The necessary saving for corporate investment was carried out by the firms themselves, the pension funds and by the central government, which kept its budget mostly in surplus.

At the household level the main principle was to tax capital income at the marginal rates of personal income taxation. The top marginal rate exceeded 70 percent. The statutory marginal rates were, however, seldom applied to capital income due to the substantial use of non-taxed assets. The tax-exempt ceiling in personal income taxation lowered average tax rates and abolished totally the tax burden from minor capital incomes.

The above mentioned tax system and the underdeveloped and strongly regulated financial markets generated strong implications for investment and the financial strategy of firms and the saving and portfolio allocation decisions of households. The regulated low interest rate maintained a high investment rate. Tax allowances and the endogenous adjustment of financial strategies eliminated largely the effects of the high statutory tax rates on the cost of capital, but created other distortions. Household wealth was invested mostly in owner-occupied housing and deposits. The share ownership of firms was institutionalised.

The ideal of neutrality and the aim to improve the international competitiveness of the tax system were the main driving forces in the tax reform.

The main reforms of the tax system were carried out during the years 1987-1993, i.e. there was no “big bang” but instead a gradual implementation. The elements of the reform are: the broadening of tax bases and lowering of the tax rates from 1987 onwards, the adoption of an avoir fiscal system in corporate income taxation (1990), the introduction of source taxation of interest income (1991), the separation of taxation of earned income and capital income and a major corporate income tax reform (1993). The tax rate is now 29 percent regardless of whether the tax base is rental income, interest income, dividend income, capital gains or corporate income. The withholding tax on interest incomes does not apply to foreign investors.

In the avoir fiscal system the corporate tax paid on distributed earnings can be deducted in the dividend taxation of domestic households. In the listed companies the corporate tax rate and the personal dividend tax rate are equal and there is full imputation. The effective rate is now close to the statutory rate because most allowances have been abolished and possibilities to use accelerated tax depreciation rates have been reduced. Therefore the tax neutrality between industries has also increased. The corporate tax rate is the same for both distributed and for retained earnings.

The following table 3.1 describes the tax rates used in the analysis before and after the tax reform.

Table 3. 1 Effective tax rates before and after the reform

	Before	Now
Corporate tax	25	29
Interest income tax	0	29
Dividend tax	13	0(29)
Capital gains tax	0	29

Taxation of portfolio investments in Finland

Introduction

In the recent years, the international mobility of capital has increased rapidly. For example, in 1998, portfolio investments from other countries to USA were 6 % of GNP, i.e. 400 % more than in 1991 (Board of Governors of the Federal Reserve System, 1999). At the same time portfolio investments rose up to 70 % of all investments (Slemrod et al., 1996).

>From the point of view of economic performance this kind of development can be seen attractive, but it does set certain demands for the national tax policy (Razin and Sadka, 1991, Zodrow and Mieszkowski, 1986). Portfolio investments usually follow the “residence” principle, which states that the tax treatment is the same regardless of in which country the investment is made. Therefore taxation has a neutral effect on the choice of the country in which the investment will take place (i.e. capital export neutrality is maintained). The double taxing of international portfolio investments has usually been prevented in the EU by low source tax.

Due to the problem in taxing capital income abroad, “source” principle, which states that tax burden varies depending on the place of investment, has however remained an attractive alternative (which is also suggested by the OECD). Without any kind of tax harmonizing between countries, taxing based on “source” principle acts as a positive incentive for tax competition. A reasonable reduction in individual country’s tax rate can cause a large inflow of portfolio investments into that country. Under Nash bargaining, when all the countries have the same incentive for reducing tax rates, the result is that portfolio investments can be taxed very moderately. Bucowetsky and Wilson (1991) show that at the same time taxation rates of labour income remain relatively high. Keen and Marchand (1997) argue that tax competition also leads to the concentration of investment in the infrastructure that is most useful for the firm. On the other hand portfolio diversification in investments has not gone so far that the reasonable reduction in tax rates would not cause an immediate mobility in capital (Schjelderup, 2001).

Taxation of international portfolio investments

Finland has an agreement on information transmission with all the countries that are under the tax agreement. For portfolio investments, usual agreement lowers source tax to 15%. If we consider dividend income, Finland belongs to the countries using imputation system. Imputation credit is usually limited to domestic shareholders only. Broadway and Bruce (1992) and Fuest and Huber (2000) suggest that avoir fiscal is not important for international investors. Devereux and Keen (2001) show that many countries have specifically stopped using avoir fiscal (or a single tax on dividend income) and taken the traditional system with double taxation (yet with more favourable tax treatment for domestic shareholders). In Finland, Liljebloom, Löflund and Hedwall (2000) find exceptionally high returns of profits during ex-dividend days in

the Helsinki Stock Market, especially among shares with high foreign ownership. There are signs of a possible dividend arbitrage based on the fact that credit imputation is not extended to foreign shareholders.

Table 3.2 Source tax for portfolio investments in 2000

	Finland	Sweden	Germany	Britain	Ireland	Holland	USA	Cayman
Finland	-	15	15	0	0	15	15	31
Sweden	15	-	15	0	0	15	15	15
Germany	15	15	-	0	0	15	15	15
Britain	0	5	15	-	0	15	-	15
USA	15	15	15	0	0	15	-	15
Cayman	29	30	26.4	0	0	25	30	-

The place of investment in column and home country in row.

Huizinga and Nicodème (2001) show that tax rates have fallen over the times.

Table 3.3. Tax rates 1985-2000

	1985	1990	1995	2000
Tax rate for domestic interest income	47	37	31	30
Property tax	0,6	0,51	0,47	0,36
Source tax for interest income		3,6	3,6	1,8

BIS-countries: Australia, Austria, Bahamas, Bahrain, Belgium, Canada, Cayman, Denmark, Finland, Greece, Hong Kong, Ireland, Italy, Japan, Luxemburg, Holland, Norway, Portugal, Spain, Sweden, Switzerland, Great Britain, USA.

Finnish capital income tax (29%) corresponds to the average of tax rates presented in table 3.3. Sorensen (2002) suggests that lowering in tax rates of internal financing has been bigger in small countries: from 1985 to 1999 the tax rates have declined 17 % in the 12 small countries (including all the Nordic countries) and 8 % in the bigger ones. It is clear that Finland is not an exception with its reduction of corporate tax rate from 50% in 1989 to the present 29%. This shows that the small open economies like Finland are faced with higher capital mobility and are more sensitive to tax competition. Baldwin and Krugman (2000) argue also, that countries act asymmetrically. Large countries do not have such a big incentive to follow tax reductions. Table 3.3 also shows that the source tax for interest income (for example capital gains) is very low, whereas the source tax is usually higher for dividend income. For example, in Finland many firms feel that source tax paid abroad on dividend income lowers the interest in investing in Finland. Especially, foreign funds (for example pension funds) are many times not taxable at all and cannot deduct source tax in their final taxation. Avoir fiscal on the contrary is not seen as such a big problem.

Huizinga and Nicodeme (2001) show that one percent rise in tax rate leads to 4,3 percent increase in portfolio investments abroad. This result is based on portfolio investments (other than banks) between 1983 and 1999 in BIS countries. Property tax has even stronger effect. The Finns (others than banks) had one milliard euros deposited abroad in 1998, which is about 2% of all deposits. Table 3.4 shows portfolio investments abroad:

Table 3.4 Portfolio investments of Finnish investors abroad, 1992-1997

	Interest	Capital (milliards of Euros)	Capital costs
1992	13,75	4,65	21,15
1993	9,73	3,75	13,51
1994	7,35	3,53	10,21
1995	7,46	3,08	10,36
1996	5,43	9,56	7,54
1997	4,81	10,26	6,68

Source: Punakallio (1998)

Investments abroad have more than doubled under the 1990's. At the same time interest rates and capital costs have declined. This means that the elasticity of capital to interest rates has not necessarily become any bigger. In any case, it is clear that with increasing large portfolio investments abroad, a change in tax treatment (and a change in profits after tax), has a potential large effect on international investors.

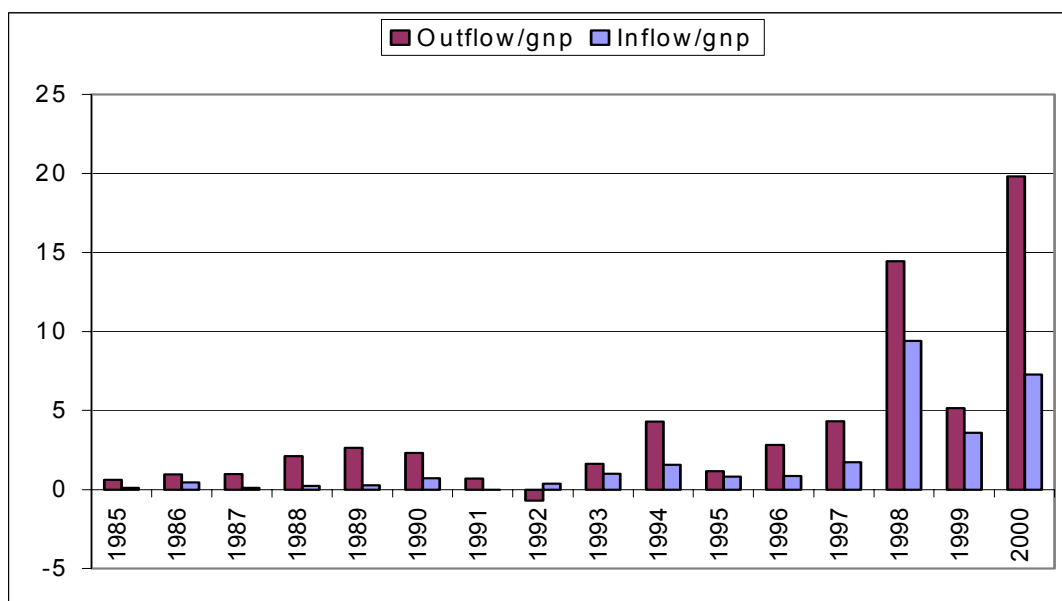
Taxation of portfolio investments in EU

Traditionally "residence" principle has been used in debt financing and "source" principle in stock financing. In EU a source tax has been proposed in the 1990's on interest income that follows "source" principle. Investors outside of EU should have been released from source tax. This means that profits remain untouched. In any case the proposal intended a change in debt financing that follows the "residence" principle. This major change has not been discussed thoroughly. It is clear that different regulations on debt and self-financing will be difficult to maintain since new finance instruments often include both of the elements. Just recently EU countries have decided that information transmission between countries, which will come into effect in 2010, aims at the situation where portfolio investments abroad will be taxed in the home country within the EU region.

Direct Investments

Figure 3.1 shows that direct investments have grown considerably in Finland. Important reasons behind this development are the internationalisation of Finnish firms (in the beginning of 1980's only few Finnish firms had considerable manufacturing abroad, among them was for example Kone Corporation) and the ongoing liberalisation of Finnish capital markets from the mid 1980's.

Figure 3.1 Direct investments to and from Finland



Central tax regulations

Usually a Finnish firm pays corporation tax for its worldwide profits. International double taxing is lightened mainly through credit method. Double tax on dividends is eased by exemption method if certain assumptions about the size of the ownership in the foreign firm are fulfilled (10%/25%, tax free portion of dividends).

Finland taxes dividends from Finnish firms to their foreign owners by source tax. Source tax is in general 29% but is almost always lower depending on the bilateral tax agreements, usually from 0 to 15% for portfolio investments. Tax on dividends from direct investments is on average lower. The portion of these dividends that is paid to a firm within the EU region is freed from tax. In the Finnish system also the interests which have been paid to foreign investors are usually freed from the source tax.

Important rules concerning the flow of dividends over borders are also included in the Finnish imputation system. Imputation credit is given to taxpayers liable to pay taxes and only in special occasions to foreign shareholders. Therefore it can be said that the

Finnish system discriminates foreign ownership. Another important element of the system is the equalization tax, which prevents credit being given when any corporate tax is not paid. If the parent company tries to pay dividends from repatriated profits from abroad can equalization tax lead to double or triple taxation of profits. These take effect when parent company tries to pay dividends from repatriated profits to foreign owners.

An example of equalization taxing:

Assumption:

Parent company's profit	100
-from domestic operations	50
-repatriated dividends from abroad	50
-distribution to shareholders in Finland	71

Taxing:

Finnish corporate tax	14,5
Complement tax	14,5

Comments:

Taxable profits are 50. The ones repatriated from abroad are freed from tax in special cases only. According to Finnish imputation system tax must be at least $0,29/(1-0,29)*71=29$ for the firms (minimum tax). Complement tax is the positive difference between minimum tax and the corporate tax.

Capital taxation's main effects on direct investments

According to economic theory taxing of dividends should have little effect on the direct investments of an international firm. The effect depends on how the investment is financed. Neither source tax nor taxing of the parent company have any influence on the investments that are financed from the profits of a subsidiary, since tax on dividends reduces investments net income. There are two opposite effects that lead to a situation where taxes on dividends do not influence investments. Theory also suggests that taxes on dividends do not influence dividends from subsidiary to the parent company. On the other hand, if direct investments are financed by new issued capital from the parent company to subsidiary, dividend tax reduces investments impulse.

The usual way of describing ideas focuses on marginal international investments through emphasising the meaning of effective marginal tax rate (EMTR). A new theory, based on Devereux-Griffith (1998), suggests that even the average tax rate can be important, especially when multinational firms decide allocation of investments between different countries. Theory presents that international firms often operate in monopolistic markets where profitability is better than in normal markets. So when taxation affects multinational firm's location decisions, it is therefore necessary to consider the taxation of the part of profits that exceeds investments normal market determined profits. The effective average tax rate (EATR) developed by Devereux-

Griffith (1998) notices this. One result of this model is that the influence of dividend tax can be more important than the older theory suggested. Dividend tax can also affect investments that have been financed with loan and parent company's profits.

In economic discussion it has many times been stated that the imputation system in global environment leads to two kinds of asymmetry.¹ Because firm's home country seldom wants to extend the imputation credit to foreign shareholders, domestic and foreign owners are treated differently ("shareholder asymmetry"). The other kind of asymmetry is that the profit originating from the home country is treated differently from the one originating from abroad. In almost all countries using credit imputation, there exists some kind of equalization tax.² This tax can, as described earlier, lead to complementary taxing if one pays dividends at home from the profits earned abroad. This asymmetry in "distribution of profits" can also occur if, as was the case earlier in Germany, crediting depends on where the distributed profits originate from. Crediting was complete for the distribution of profits at home but with dividends from repatriated profits, which were not taxed at home, shareholders were not given any crediting. Weichenrieder (1995, 1998) studied the economic effects related to these asymmetries. By using a dynamic model he showed that the large German corporation's decisions related to profit distribution and investments were in many ways influenced by the old German system.

There exists no thorough analysis of the functioning of the Finnish equalization tax system³, but it is likely that the effects of same kind as in Germany have also occurred in Finland: the cost of distribution of profits grows and profits are locked inside firms. This can also motivate firms to repatriate profits home, and on the other hand, if it increases the average tax rate, it may lower the competitiveness of the Finnish tax system.

Capital import-export neutrality

In the following section we examine how capital import-export neutrality is maintained in the Finnish tax system and how competitive is the Finnish corporate taxation

¹ Credit method has been considered in economic analysis for example in Boadway-Bruce (1992), Deveraux-Freeman (1993), Weichenrieder (1998), Fuest-Huber (2000) and Kari – Ylä-Liedenpoja (2002).

² In Finland complementary tax, in Norway correction tax. In Britain the corresponding advance corporation tax was abandoned in 1999.

³ See Kari – Ylä-Liedenpoja (2002)

globally. In popular discussions it is common that the evaluation of the economic effects of taxation are based on nominal tax rates. It is also important to calculate the effective tax rates, since impulse effect can depend on many factors, for example on tax base regulations and on the vast amount of different taxes. In this section the effective tax rates of international investments are calculated based on Devereux-Griffith method, which has been used in many research papers during the last years (for example EU Commission 2001). It resembles the well-known King-Fullerton method but applies better to observing international investments. In this context one can measure the effective tax burden in two different ways: by using the effective marginal tax rate (EMTR) or the effective average tax rate (EATR). The first one tries to investigate the effects of taxing domestic investments in a certain country whereas the other concentrates on how taxes influence the allocation of international corporate investments between countries. More information about the calculations is presented in appendix.

Figure 3.2 shows an overview of the competitiveness of the Finnish corporate taxation. The figure presents the corporate tax rate and the effective average tax rate (EATR) in some industrial countries. EATR in figure 3.2 illustrates an effective tax burden of investment in a subsidiary of an American corporation. (Subsidiary must be a limited company.)

Finland's nominal tax rate 29% is lower than in most of the other countries as seen in Figure 3.2, but clearly higher than in Ireland, which has the lowest rate of 10%. Norway and Sweden have little lower nominal tax rates than Finland. In the same way is EATR lower in Finland than in most of the other countries. Only Ireland and Sweden have lower EATR and Denmark and Britain are about on the same level. Difference in EATR between Finland, Ireland and Sweden is very small. This examination shows that Finnish corporate tax appeals competitive.

In figure 3.2 calculations are shown how Finnish taxation influences capital export neutrality. Figure compares effective tax burden between domestic investments and investments from Finland abroad. Foreign investments are arithmetic average of effective tax rates for investments in 16 OECD countries. The same assumption has been made in calculations which figures 3.4 and 3.5 are based on.

Figure 3.2 Corporate tax rates and EATR in Finland and some other industrial countries

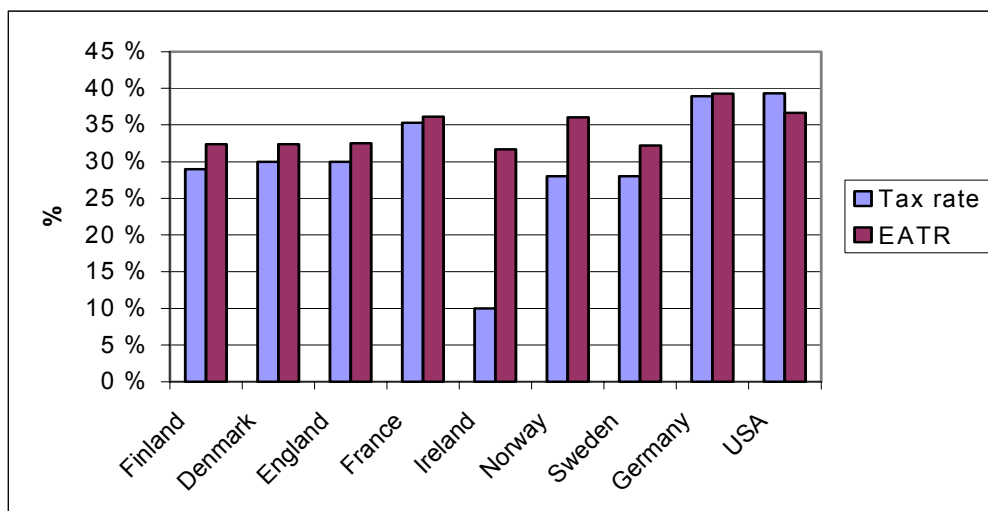
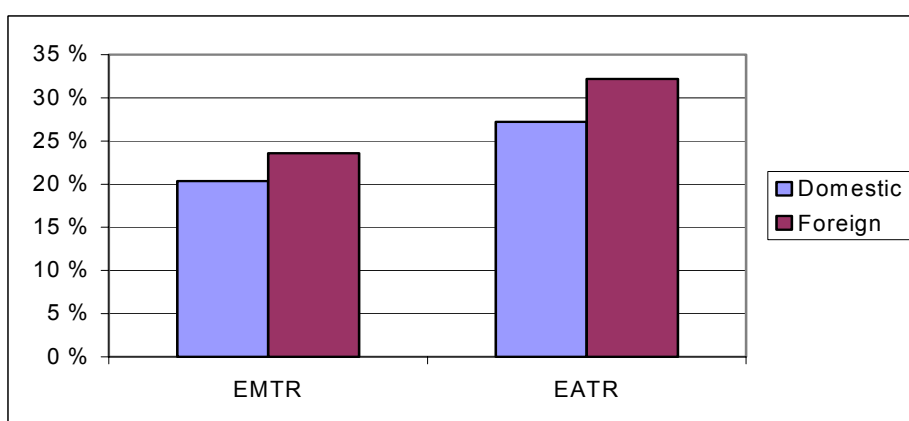


Figure 3.3 shows that taxation promotes investments in the home country compared with investments abroad. Difference in the effective tax rate is about 5%. Nevertheless Finland is no exception in this case. Also in other Nordic countries as well as all over Europe investments abroad are discriminated by taxation (see Appendix, EU Commission 2001).⁴ This can result from the fact that source tax and corporate tax are higher abroad than in Finland.

Figure 3.3 Capital export neutrality, EMTR and EATR for domestic investments and foreign investments from Finland



The picture of discrimination of foreign investments becomes even more convincing if we consider a few effects that usually are not taken into account. Finnish imputation system includes, as mentioned above, the so called equalization tax, which can increase especially the tax burden on Finnish corporations operating abroad through

⁴ Figure A1 in appendix shows that the discrimination is a bit larger in Norway than in Finland.

subsidiaries. Figure 3.4 presents calculations suggesting that the difference between the effective tax rates of domestic and foreign investments can be as high as 10-20%, if equalization tax is taken into account. Calculations in figure 3.4 give the maximal effect, when the complementary tax is supposed to have been paid for the parents company's whole distribution and no complementary tax reductions are given.

Figure 3.4 Capital export neutrality, EMTR and EATR, complementary tax

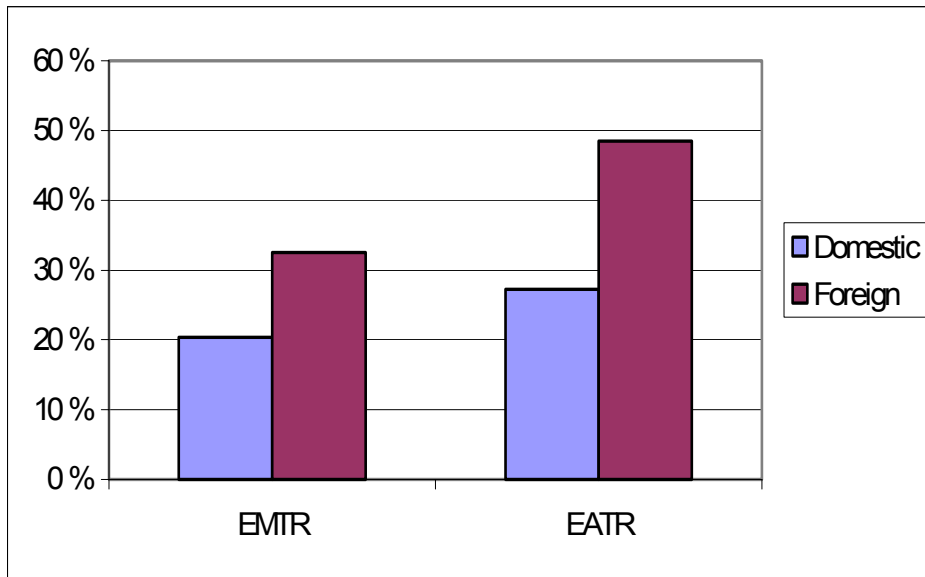
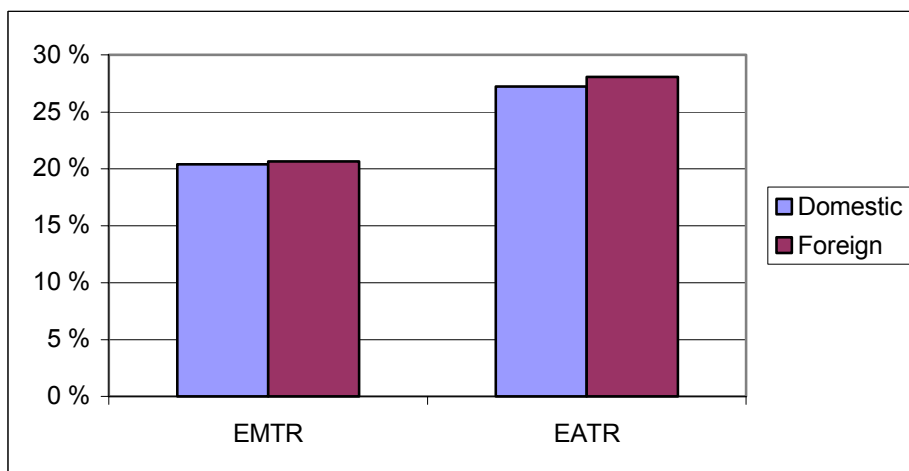


Figure 3.5 sheds light on the question how capital import neutrality is maintained in Finland. The figure shows that tax burden on domestic investments is little lower than the burden of Finnish investments abroad. This means that the capital import neutrality

Figure 3.5 Capital import neutrality in Finland, EMTR and EATR for domestic and foreign investments



in the Finnish tax system has been realized on average quite well. Tax rate differences between domestic and foreign investments mainly originate from the source taxes and high corporate taxes in some other countries, for example USA. The fact that the capital import neutrality is realised on average better than the capital export neutrality depends on two things: the corporate tax in Finland is relatively low and exemption method is practiced fairly often.

Taxation of pension funds, life insurance companies and investment funds in Finland

Introduction

Gaining of household's wealth and its distribution between different investment possibilities is largely based on the institutional structure of financial markets as well as on taxing. Characteristic of Finnish financial markets is stock ownership through institutions. The amount of international investments in funds has increased rapidly during the last five years. Especially the improved solidity of pension institutions and the fixing of currency in Euro region have accelerated portfolio diversification.

Table 3.5 Pension funds, life insurance companies and investment fund's investments 30.12.2001

	Domestic		Foreign		All
	Mrd. Euro	%	Mrd. Euro	%	Mrd. Euro
Statutory earnings-related pension insurance	34,1	49,3	35,1	50,7	69,2
Collective supplementary pensions	1,2*	24,0	2,3*	76,0	5,0
Other life and pension insurance	9,7	46,4	11,3	53,6	21,0
Domestic investment funds	3,3	22,5	11,2	77,5	14,5
Total	48,3	44,0	59,9	54,6	109,7

*The estimated share of foreign investments in supplementary pensions is based on the distribution of pension funds other investments.

Source: The Finnish Pension Alliance, Survey 31.12.2001, Federation of Finnish Insurance Companies, Survey 2001, Fintra, Survey, 2001, 2002.

The statutory earnings-related pension insurance system has the largest share of investments in stocks. Little more than half of its total equity portfolio 20 milliard Euros, is invested in foreign stocks. Earnings-related pension scheme is partly funding, but follows the so called defined benefit principle, which states that the profits from funds are not related to the pensions being paid, but to pension contributions when funds are being demounted. Collective supplementary pension is an insurance form complementing the compulsory employment pensions. It can be used by those, who

have been insured for too short of a period under compulsory pensions to be able to receive the full pension. Its conditions are the same as in the compulsory one.

The group called other life and pension insurance in table 3.5 includes many kinds of different insurances. The traditional life insurance policies constitute about half of the investments. The rest are mostly private or group pension insurances. The firms that offer these forms of insurance have one third of their investments in stocks. One fifth of the private individuals insurance savings are bound directly to the profits from investments, whereas almost all of the firms' insurances are bound to base rate.

Investment funds have about 400 000 owners consisting of private citizens and institutional investors. From their total capital 36% was in bonds, 41% in stocks and the rest in combined and hedge funds. There are no exact data on the amount of investments in foreign investment funds but estimations are around a few milliards of Euros. We do not consider here the kind of firm's wealth, which is related to profits from investments that are generated by enhancements in the value of firms' own stock or through distribution of dividends. This could be the case in property investment companies and other investment companies.

Taxation of funds

Private individuals

Both the compulsory and voluntary pension contributions are deductible in income taxation (voluntary ones with some restrictions). When pensions are received they are taxed by income tax, which is progressive. The capital of voluntary pensions is not wealth taxed during their saving time and after that they are partly taxable (EET-principle). With life insurances there are no tax deductions and the profits are taxed by capital tax, which is 29%. Life insurance savings are freed from wealth tax.

Profits from investment funds are received as enhancements in value of the share of the fund, which is taxed by a capital gains tax. The capital is taxed by wealth tax.

If we compare direct investments with investing through funds in financial markets it can be concluded that investing through funds is less attractive because of the wealth tax. Equity funds are discriminated by taxing in such a way, that investors do not receive crediting in corporate taxation. Investments in international or domestic investment funds are treated equally in private individuals taxation.

Institutions

Investment funds are not liable to pay taxes and in practice the firms dealing with compulsory employment pensions are taxed lightly. This means that these funds cannot receive tax crediting provided by the domestic corporate tax system in the same way as private investors. International diversification of investments has reduced the significance of this feature.

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Appendix

Calculations related to international investments' effective tax rates are based on Devereux and Griffith (1998). A good summary of the method is in EU Commission (2001). In Figure 3.2 the effective average tax rate (EATR) is the relative tax burden of investment from an American parent company to its affiliates abroad. Figure also includes the domestic investments to USA. In Figures 3.3-3.5 the relative tax burden (EMTR and EATR) of domestic and international investment over Finnish borders is compared. Values for international investments are the arithmetic average of investments between Finland and other 16 countries. For simplicity only corporate taxation and not wealth taxation is considered in calculations in Figures 3.2-3.5.

In calculations following parameter values have been used:

- Investment project: 50% machines, 28% buildings and 22% inventory.
 - Amortization: 17,5% for machines, 3,1% for buildings and 0% for inventory.
 - Financing of subsidiary: 1/3 self-financing, 1/3 debt financing and 1/3 by share issue.
 - Nominal interest is 7%, inflation 2% and profit demand before taxes 30% (EATR).
- Countries in calculations are the 15 EU-countries and Norway and USA.

Figure A1. Capital export neutrality in the Nordic countries, EATR

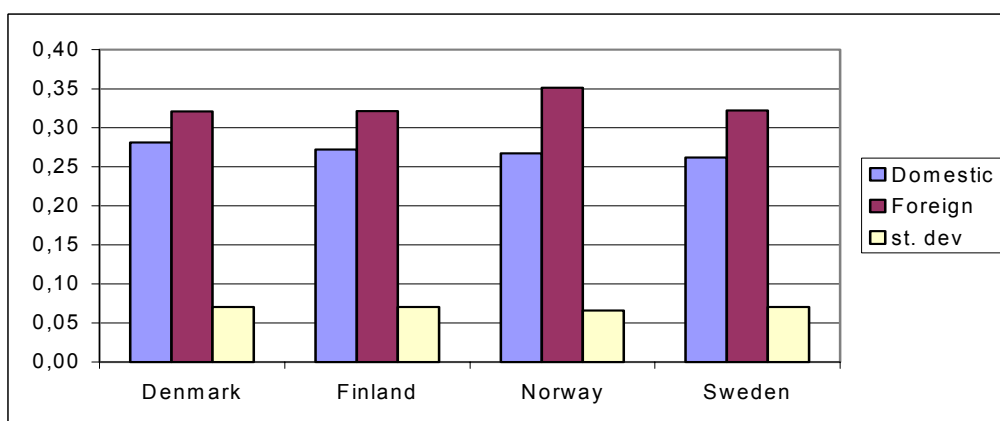
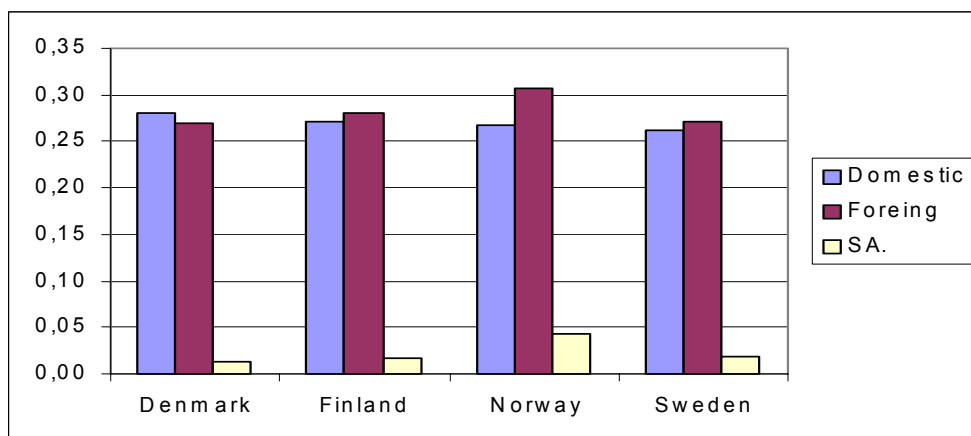


Figure A2. Capital import neutrality in the Nordic countries, EATR



4. The Role of Taxation in Explaining Foreign Investments

Jyrki Ali-Yrkkö and Pekka Ylä-Anttila

The role of taxes in foreign investment

Many research papers investigating the possible interaction between corporate taxes and foreign investments have been published during the past few years. The impact has been estimated by explaining the role of corporate taxes in foreign direct investments.

De Mooij & Ederveen (2001) reviewed empirical literature on impact of company taxes on the allocation of foreign direct investment. There exists a substantial variation across studies however. Also the number of semi-elasticities derived from each study differs. The interpretation of semi-elasticities is as follows: they measure the percentage change in FDI in response to a 1%-point change in tax rate, e.g. a decline from 35% to 34%. Hence the level of the tax is irrelevant for the size of the semi-elasticity.

The entire meta-sample was 371 semi-elasticities. More than 80 % had the expected negative sign. When extreme observations were left out sample size dropped to 351. Slightly less than half of the semi-elasticities were statistically significant (166). In this case result was that 1%-point increase in the host country tax rate decreases foreign direct investment in that country by 6.6 percent.

Devereux & Griffith (2002) criticised previous literature concerning foreign direct investment and taxation. They argued that based on them no serious economic policy suggestions can be made. They also argued that by examining the impact of company taxes on foreign direct investments, the most important affects of company taxes would not taken into account. They suggested that it would be important to investigate the impact of company taxes on country's whole capital stock and its ownership. In addition, they suggested that by using foreign direct investments the impact of company taxes on foreign investments cannot be fully explained.

Karolina Ekholm (2002) pointed out that there might be 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.

We think that the critique made by Devereux and Griffith does not entirely extinguish the possibilities of examining the interaction by using data based on foreign direct investments. Even though the effects of company taxes cannot be explained entirely, at

least preliminary conclusions on the impact of company taxes on the allocation of foreign direct investment can be drawn.

The model

In this study we try to investigate what factors influence the allocation of foreign investments between different countries. Under special interest is the impact of company taxes and taxing of labour on the allocation. The model proposed by Gorter and Parikh (2000) is estimated (see appendix 1).

Key results from estimations are presented in Table 4.1. The results obtained by Gorter and Parikh (2000) are also presented. The estimated model in this work is the same as the one used by Gorter and Parikh. The countries are also the same except that in our work we replaced Denmark with Sweden. In both of the studies the model was estimated by using the ordinary least squares as well as SURE. The UK is the only country allowing crediting of taxes paid on foreign source profits against home tax liabilities and therefore is used as a benchmark against which the behaviour of non-UK investors is measured. In SURE estimation the UK tax elasticity is constrained to zero because of its tax credit status.

Table 4.1 shows that the results vary between countries. There are clear differences in the coefficients of the dependent variables as well as in their statistical significance. Most of the results are in accordance with the results obtained by Gorter and Parikh (2000). The sizes of the coefficients obtained from OLS are similar to ones of Gorter and Parikh. In addition some countries get statistically significant coefficients in both of the studies. Also the results from the SURE-estimations are similar. Bigger difference exists only in results obtained for Finland and Austria. In this study the coefficient of corporate tax in case of Finland is positive and is not statistically significant where as in Gorter's and Parikh's paper it was negative and clearly statistically significant. Furthermore, in case of Austria the coefficient of corporate tax in is positive (3.04) and statistically significant where as in Gorter's and Parikh's paper it was negative.

One reason for variation in impact of corporate taxation can be found from different forms of investments or from different branches of industry. According to Swenson (2001) corporate taxation has a negative effect on setting up foreign plants as well as on expanding them. Corporate taxation on the other hand has a positive effect on acquisitions. Stöwhasen (2002) suggests that the impact of corporate taxes on foreign direct investments varies between the sectors of production. According to his empirical

results corporate taxes do not influence foreign direct investments in primary production and mining industry but instead they do have an impact on other industries as well as services.

Table 4. 1 Impact of taxes on foreign direct investments *

Maa	Semi-elasticity** Ali-Yrkkö & Ylä-Anttila, Period 1997-98		Semi-elasticity** Gorter & Parikh (2000), Period 1995-96	
	OLS	SURE	OLS	SURE
Portugal	-8.89 (-3.29)	-10.35 (-4.4)	-11.00 (4.01)	-14.3 (8.2)
Holland	-5.94 (-2.93)	-6.93 (-11.7)	-4.65 (2.41)	-6.6 (3.8)
France	-6.52 (-3.93)	-5.92 (-12.63)	-5.47 (2.78)	-4.6 (3.7)
Finland	-1.69 (0.48)	0.75 (0.52)	-2.41 (1.12)	-4.3 (3.4)
Germany	-4.17 (-2.61)	-3.89 (-6.6)	-3.96 (2.33)	-2.3 (2.2)
Austria	1.94 (0.83)	3.04 (1.65)	4.28 (1.57)	-1.0 (2.4)
Denmark			-5.09 (1.98)	-1.5 (1.4)
UK	-6.75 (-1.36)	zero	-5.51 (1.22)	zero
Sweden		1.67 (2.37)		
All countries (sep. regression)	-4.52 (-4.57)			

* Complete regression results in Appendix 2.

** Semi-elasticities measure the percentage change in FDI in response to a 1%-point change in tax rate
Statistically significant coefficients boldfaced, t-values in parentheses.

In addition to corporate taxes also taxes on labour may have an impact on foreign direct investments. In model, which explain the impact of total tax wedge of labour on foreign direct investments, the variable describing corporate taxes is replaced by tax wedge of labour is estimated. (see appendix 1).

Key results are presented in table 4.2 and the complete estimation results in appendix 3. According to table 4.2 the impact of tax burden of labour on foreign direct investments vary between countries. Both the signs of the coefficients and their statistical significance vary. Tax burden of labour gets negative and statistically significant coefficient in France, Germany and Holland. Negative and statistically significant coefficient for tax burden of labour is also obtained from the regression analysis

including all of the countries. The results from regressions of different countries are far from unambiguous and therefore any decisive conclusions are difficult to be drawn.

Table 4.2 Impact of tax burden of labour on foreign direct investments

	Coefficient	t-value
Portugal	-5.14	-1.61
Holland	-3.74*	-1.70
France	-5.87***	-2.80
Finland	1.18	0.34
Germany	-2.98*	-1.86
Austria	0.014	0.01
UK	-8.39	-1.12
Sweden	-2.98	-1.55
All countries (sep.regression)	-3.24***	3.12

Statistically significant at 10 % confidence level, ** Statistically significant at 5 % confidence level,

*** Statistically significant at 1 % confidence level.

Statistically significant coefficients boldfaced, t-values in parentheses

Conclusions

The impact of taxes on foreign direct investments has been considered in previous literature. The results are far from unambiguous. The results obtained in this study also vary considerably. Negative statistically significant coefficients for the impact of corporate taxes on foreign direct investments were obtained for Portugal, Holland, France and Germany where as the coefficient for Finland was not statistically significant and the ones for Austria and Sweden were positive against the assumption. This would implicate that higher corporate tax rates would increase foreign direct investments.

In addition to corporate taxes also the impact of total tax wedge of labour on foreign direct investments was examined. The results varied considerably between countries. Negative statistically significant coefficients for the impact of tax burden of labour on foreign direct investments were obtained for Holland, France and Germany, where as the coefficients for Portugal, Finland, Austria, UK and Sweden were not statistically significant.

As a conclusion we can say that corporate taxes and tax burden of labour seem to have some kind of role in allocation of foreign direct investments although one must be careful in the interpretation of the estimation results. When other factors affecting the allocation of foreign investments are equal, taxations role is more evident.

Appendix 1

The following model proposed by Gorter and Parikh (2002) is estimated:

$$\frac{FDI_{ij}}{FDI_j} = \alpha_j + \beta_j s_i (t_i - \bar{t}) + \gamma_j \ln P_i + \delta_j \ln \frac{GDP_i}{P_i} + u_{ij}, \quad i = 1, \dots, 14, j = 1, \dots, 8, \quad (1)$$

where FDI_{ij} denotes the foreign direct investments in country i of country j and FDI_j corresponding total for EU. α_j is a country specific constant, β_j is the parameter to be estimated and, s_i is population share of country i , t_i is statutory corporate income tax rate of country i and \bar{t} is mean corporate income tax rate in EU. In addition γ_j is parameter to be estimated for P_i which denotes the population of country i , and GDP_i is the gross domestic product of country i corrected by purchasing power parity. δ_j is parameter to be estimated for $\frac{GDP_i}{P_i}$, the stage of development of country i .

The parameter we are interested in is β_j . It can be interpreted as a semi-elasticity of FDI with respect to corporate taxation i.e. the percentage change in FDI in response to a 1%-point change in corporate tax rate of country i compared to EU average.

Data

The FDI data is from the EUROSTAT statistical office. It has been harmonized by EUROSTAT in order to make international comparisons possible since national collection methods and classifications vary. Data covers years 1997 and 1998. Population data and the data of gross domestic product corrected by purchasing power parity are based on Main Science and Technology Indicators published by OECD. Some characteristics of data are presented in table 4.3. Corporate tax rates of different countries are based on the Worldscope database, which has information about financial accounts of 6000 firms. Tax rates are calculated by dividing the corporate income tax paid by the pre-tax corporate income for each firm individually and the median tax rate is obtained. In this work the tax rates are taken directly from Gorter and Parikh (2000).

Table 4. 3 Characteristics of data

	Mean	Median	Std. dev	Min	Max	obs.
$\frac{(FDI)_{ij}}{(FDI)_j} * 100$	7.692	3.693	9.977	-0.003	54.053	208
s_i *Corporate tax difference	0.313	-0.036	0.835	-0.428	2.227	208
s_i *Labour tax difference	-0.065	0.074	0.645	-1.975	0.980	208
Population (1000)	26401.85	10559	25534	3661	82052	208
GDP per capita	540.99	218.26	543.88	78.08	1820.75	208

The indicator of total tax wedge of labour is obtained from the article written by Martinez-Mongayn (2002). It has been calculated by adding up social security contributions and taxes on income and consumption. Same variable has also been used by De Santis, Mercuri and Vicarelli (2001) in their study concerning the impact of taxes on foreign direct investments.

The model to be estimated is

$$\frac{FDI_{ij}}{FDI_j} = \alpha_j + \beta_j s_i (tw_i - \bar{tw}) + \gamma_j \ln P_i + \delta_j \ln \frac{GDP_i}{P_i} + u_{ij}, \quad i = 1, \dots, 14, j = 1, \dots, 8. \quad (2)$$

The variables are as in Model 1 except that impact of tax burden of labour on foreign direct investments is under investigation instead of corporate taxes. Tax wedge of labour that measure tax burden of labour in country i is denoted by tw_i and average the of EU countries by \bar{tw} .

Appendix 2

Complete OLS results

	Austria	Finland	France	Germany	UK	Holland	Portugal	Sweden	All counties
Coefficient	16.15 (36.6)	73.08 (53.0)	17.74 (24.75)	44.46** (21.1)	65.75 (62.16)	42.6 (30.47)	-84.62* (53.83)	62.11* (30.21)	32.06** (14.74)
Corporate taxes	1.94 (2.33)	-1.69 (3.49)	-6.52*** (1.66)	-4.17** (1.60)	-6.75 (4.96)	-5.94*** (2.03)	-8.89*** (3.09)	-2.31 (2.01)	-4.52*** (0.99)
Population	5.24*** (1.87)	1.29 (2.93)	8.48*** (1.37)	5.60*** (1.14)	7.11 (4.22)	7.10*** (1.62)	6.03 (2.48)	3.17* (1.62)	5.69*** (0.81)
GDP per capita	15.41* (9.01)	19.84 (13.31)	23.0*** (6.37)	23.0*** (5.40)	31.77* (16.04)	26.01*** (7.89)	-9.21 (12.53)	21.66*** (7.69)	20.01*** (3.79)
R ²	0.51	0.09	0.66	0.61	0.19	0.52	0.29	0.31	0.24
Observations	26	26	26	26	26	26	26	26	208

Statistically significant at 10 % confidence level, ** Statistically significant at 5 % confidence level, *** Statistically significant at 1 % confidence level. Standard deviations in parentheses.

Complete SURE results

	Austria	Finland	France	Germany	UK	Holland	Portugal	Sweden
Coefficient	65.70*** (30.38)	315.42*** (28.94)	53.58*** (18.44)	38.02** (15.80)	273.41*** (41.22)	50.14** (22.04)	-168.15*** (44.62)	245.24*** (12.27)
Corporate taxes	3.04* (1.85)	0.75 (1.44)	-5.92*** (0.47)	-3.89*** (0.59)	--	-6.93*** (0.59)	-10.35*** (2.37)	1.67** (0.70)
Population	3.78*** (1.36)	-3.03 (1.35)	7.55*** (0.73)	5.15*** (0.63)	1.10 (1.94)	6.35*** (0.77)	8.94*** (1.93)	-2.39*** (0.70)
GDP per capita	24.54*** (7.81)	71.32*** (7.10)	29.93*** (5.39)	20.20*** (4.58)	70.88*** (9.90)	26.01*** (6.79)	-23.64** (10.29)	55.07*** (2.70)

Statistically significant at 10 % confidence level, ** Statistically significant at 5 % confidence level, *** Statistically significant at 1 % confidence level. Standard deviations in parentheses.

Appendix 3 Complete OLS results

	Austria	Finland	France	Germany	UK	Holland	Portugal	Sweden	All counties
Coefficient	16.00 (38.56)	67.6 (56.57)	54.11* (30.21)	63.15** (24.26)	110.28 (69.77)	64.00* (36.27)	-14.30 (56.07)	79.24** (31.51)	52.12*** (16.21)
Tax burden of labour	0.01 (2.33)	1.18 (3.46)	-5.87*** (2.09)	-2.98* (1.60)	-8.39 (7.52)	-3.74* (2.20)	-5.14 (3.19)	-2.98 (1.97)	-3.24*** (1.04)
Population	6.27*** (1.43)	0.39 (2.18)	4.16*** (1.23)	3.47*** (1.04)	3.81 (2.86)	3.71*** (1.32)	0.91 (1.99)	1.84 (1.19)	3.11*** (0.62)
GDP per capita	17.76* (9.27)	16.31 (13.59)	22.31*** (7.22)	22.80*** (5.85)	35.52* (18.4)	23.66*** (8.83)	-2.98 (13.96)	23.0*** (7.66)	19.16*** (3.95)
R ²	0.51	0.09	0.57	0.56	0.17	0.41	0.12	0.34	0.20
Observations	26	26	26	26	26	26	26	26	208

Statistically significant at 10 % confidence level, ** Statistically significant at 5 % confidence level, *** Statistically significant at 1 % confidence level.
Standard deviations in parentheses.

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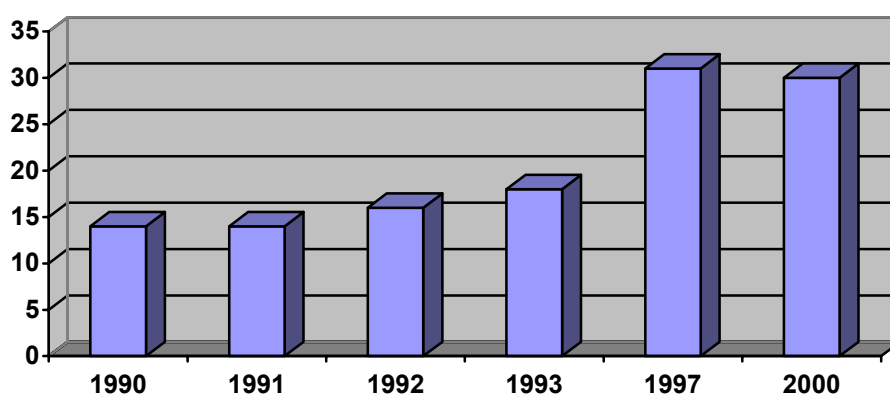
5. Location of corporate headquarters?

Jyrki Ali-Yrkkö and Pekka Ylä-Anttila

Introduction

In this section we discuss the factors affecting the location of corporate headquarters of Finnish firms. The relocation of headquarters has recently become a popular subject on different forums, since it is not a strategic decision only for firms but also for policymakers. May the relocation of headquarters have any impact on economic growth in Finland or may it affect government tax income are among the questions under general consideration. Figure 5.1 shows how the proportion of relocations of corporate headquarters has grown throughout the 1990's.

Figure 5.1 Proportion of Finland's largest 250 firms that have relocated corporate headquarters abroad



Source: Calculated by the authors

In Finland the relocation of headquarters has, in most cases, taken place as a consequence of a merger or an acquisition, as in all of the cases in Table 5.2. Thus a foreign company has bought a Finnish firm and its existing headquarters has determined the location. However, there are few cases in which the relocation decision has been made independently of M&A. In these cases firms have been small or medium-sized in the high tech industry. For example software manufacturer Solid as well as MoreMagic, which is specialising in mobile paying have relocated their headquarters to United States. In 2002 Microcell specialising in contract designing of mobile phones changed its headquarters to Switzerland. Also biotechnology firm Bionx Implants' headquarters are now located in United States.

Table 5.2 Examples of Finnish firms that have relocated their corporate headquarters abroad

Firm	Where to	Firm	Where to
Ahlströmin leijukerroskattilat	USA	Servi Systems	Denmark
Nokian Paperi	USA	Sinebrychoff	Denmark
Kyrel	USA	Cultor	Denmark
Metsä-Serla Chemicals	USA	Nokian Kaapeli	Holland
Ojala-yhtiöt	USA	Leaf	Holland
Timberjack	USA	Ahlström Pumps	Switzerland
Martis	USA	Nokia-Maillefer	Switzerland
Enviset	Sweden, USA	Arctia (hotellit)	Great Britain
Salcomp	Sweden	LK Products	Great Britain
Tamrock	Sweden	Asko Kodinkone	Italy
Assa-Abloy	Sweden	Andritz-Ahlström	Austria
STV	Sweden	Aker Finnyards	Norway
Leiras	Germany	Polarkesti	France
Marli	Germany	Transtech	Spain
Huolintakeskus	Germany	Lohja Rudus	Ireland

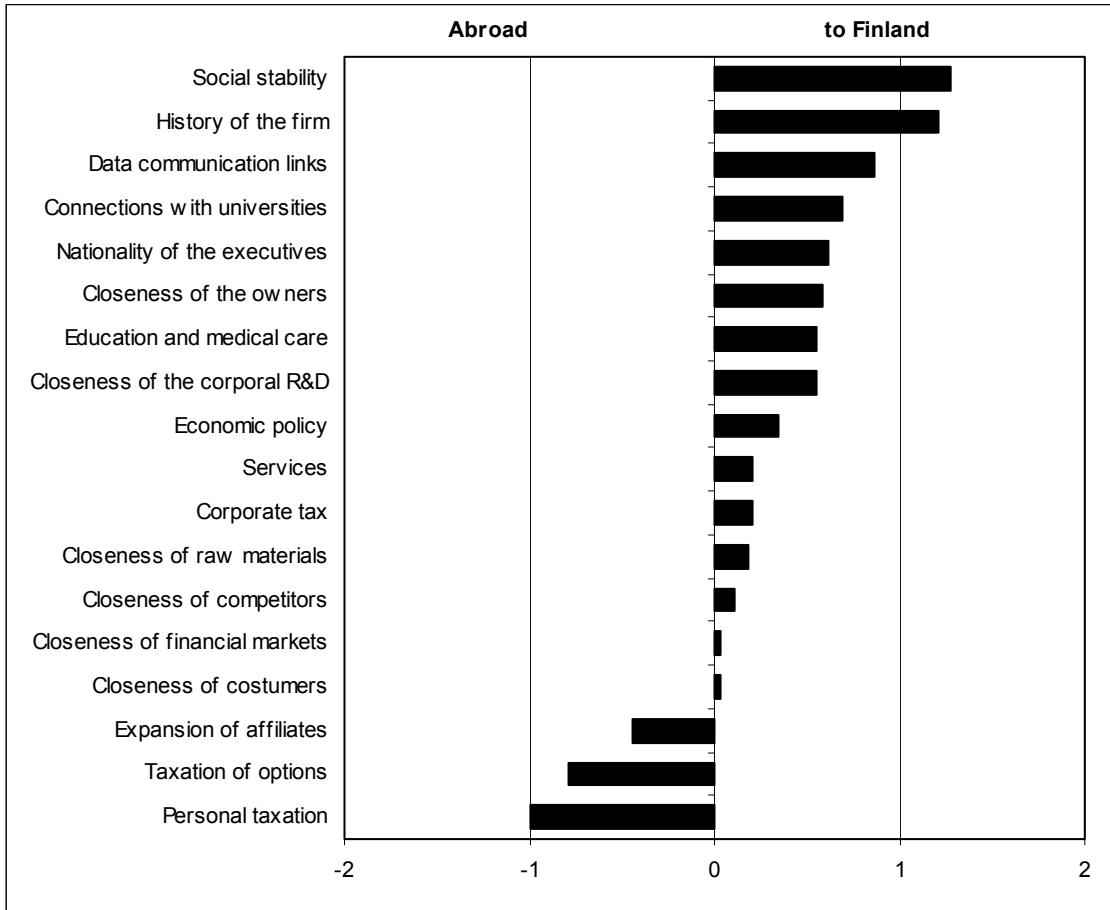
Factors affecting the location of corporate headquarters

In 2002 the Confederation of Finnish Industry and Employers made a survey regarding factors affecting the location of headquarters. Results in Figure 5.3 indicate that history, social stability and data communication links favoured locating headquarters in Finland. High income tax rate and heavy taxation of personal options as well as the growth of subsidiaries favoured relocation of headquarters abroad. There were clear differences in responses regarding how globalised the firm in question was. More globalised firms saw more advantages in locating their headquarters abroad than less globalised ones.

In addition, factors affecting the location of the headquarters vary among different fields of industry. Especially branches of businesses in need of new capital may want to be located near main financial markets (see Braunerhjelm et. al. 1999, p. 128). In such areas, as in New York and London, operate large amount of analysts, investment banks and other financial institutions. Being located near these financial centres may help them in becoming better known among investors and therefore increase their possibilities of getting new capital. On the other hand as Anglo-Saxon corporate governance is further adopted in Finland also large firms in more traditional fields of industry may want to be located near main financial markets.

Problems in recruiting personnel may also have an effect on the location of corporate headquarters. Especially large multinational firms operating in a small country may find it difficult to persuade personnel to move into remote peripheral areas.

Figure 5.3 Factors favouring the location of headquarters in Finland and abroad



Source: Confederation of Finnish Industry and Employers. Values scaled between -2 and 2. 2 is strongly in favour of locating in Finland, 1 is somewhat in favour of locating in Finland, 0 is neutral, -1 is somewhat in favour of locating abroad and -2 is strongly in favour of locating abroad.

Internationalisation of headquarters operations

Even if the headquarters of large Finnish firms are in Finland, some headquarters operations are located elsewhere. For example actions related to finance and R&D are commonly undertaken at home as well as in their foreign affiliates. During the last five years the internationalisation of R&D has increased rapidly. In 2001 about 40% of R&D of the Finnish industrial firms were undertaken abroad.

Importance of location of corporate headquarters

Internationalisation of headquarters and their possible relocation to another country brings up the question of what effects does this have on the Finnish economy. Because

the definition of headquarters is not unambiguous the consequences of relocation are on the one hand considered from the viewpoint of the parent company's actual physical location and on the other hand from the viewpoint of the locations of headquarters operations and top executives.

The location of the parent company of a group of companies (concern) decides where firm pays its corporate tax. If the parent company of such a group moves to another country, country of departure will lose firm's corporate taxes in the future. Relocation of the company headquarters may also have an impact on firm's image. Especially in a case of a small country a large multinational corporation may help country being better known. For example Nokia's success has increased Finland's reputation as a high-tech country.

Parent company's moving abroad may generate multiplicative effects in the long run. If many parent companies move abroad it may serve as a signal of competitiveness of the country to other firms. This may lead to relocations of headquarters of some other firms. Moving abroad of many firms may also have a negative impact on the possible foreign investing to the country in the future.

Future visions of locations of headquarters

As mentioned earlier the relocation of corporate headquarters abroad, has in Finland almost exclusively taken place as a consequence of a merger or an acquisition. It is probable that this development continues also in the future. Location of corporate headquarters and parent company is especially interesting when two equal firms merge. In this case corporation taxation might be the decisive factor.

It is possible that in the next five years some of the largest firms in Finland relocate their headquarters abroad without a merger or an acquisition. (This is based on an idea related to the internationalisation of large firms.) Already now the globalisation of large firms extends to sales, production, R&D and ownership. As a part of this globalisation and the decreasing importance of Finland some parent companies and top executives may relocate themselves abroad. Most probable locations are for example Great Britain and Holland. Relocation of corporate headquarters abroad may also be relevant to some small or medium-sized firms in the high-tech industry.

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6. Globalisation of Business in a Small Country - Does Ownership Matter?

Jyrki Ali-Yrkkö and Pekka Ylä-Anttila

Introduction

In this section we take a look at the effects of globalisation of business, ownership and corporate governance on firms' goals and performance. By globalization we refer to the international integration of markets for goods, technology, labor and capital. None of these components of globalization is really new, but the intensity of the current globalization process is different from what it has been in the past.

Globalisation is, to a large extent, an economic phenomenon driven by multinational enterprises. The central and increasing role of corporations in allocating resources in the economy has stimulated a debate among economists and politicians about how to govern corporations to enhance the efficiency of businesses and the welfare of national economies. The subject of corporate governance has proved to be of huge practical importance for economic performance (see, e.g., Jonung 2002).

The issue has become topical, especially in Europe, as a consequence of major cross-border mergers and acquisitions (often of firms with different governance structures), and the growing presence of large American institutional investors. The globalisation of capital markets and ownership has triggered major changes in corporate governance towards the US model in most European countries (see, e.g., Berglöf, 1997).

Empirical evidence on the effects of ownership structure and the nationality of ownership on firm's goals and performance is in harmony with the view that ownership matters (see for example Thomsen and Pedersen (2000), Griffith (1999), Chibber and Majumdar (1999) and Strandell 1997).

There is very little empirical evidence on the effects of foreign ownership on firm performance in Finland. In this section we examine the effects of foreign ownership on the performance and goals of Finnish firms. We ask whether the internationalisation of ownership matters: Do foreign-owned companies perform better than Finnish-owned ones? Are there differences in goals and governance? Are the announced goals and actual financial performance in line with each other?

Ownership Nationality – Why Might it Matter?

There are essentially two types of corporate governance or capital market models in modern market economies: the *outsider system* (or the US/UK system) and the *insider system* (or the German/Continental European system).ⁱ The former is characterized by a large number of listed firms, dispersed ownership, strong minority protection, and maximization of *shareholder value*. In this system, so it has been argued, there is also an efficient market for corporate control, and management failure is corrected by the take-over mechanism. The latter system – also known as a *stakeholder model* – is characterized by concentrated ownership, a small number of listed companies, domination of banks in the financial market, and weak minority protection. The management is controlled and disciplined by a small group of the largest shareholders.ⁱⁱ Table 6.1 illustrates these differences. The message of the table is clear. In the US and UK the shareholder perspective strongly dominates, whilst in Germany and Japan the stakeholder view seems to be prevalent.

Table 6.1. Differences in corporate governance

	Whose company is it?		Job security or dividends?	
	All interest groups'	Shareholders'	Job security	Dividends
Japan	97.1%	2.9%	97.1%	2.9%
USA	24.4%	75.6%	10.3%	89.7%
UK	29.5%	70.5%	10.7%	89.3%
German	82.7%	17.3%	59.1%	40.9%
France	78.0%	22.0%	50.4%	49.6%

Note: The data are based on a survey made among business executives, reported originally in Institute of Fiscal and Monetary Policy (1996).

The Nordic governance model has traditionally been akin to that in Germany/Continental Europe (and to some extent Japan). However, as a consequence of the rapid globalisation of capital markets and changes in corporate ownership, firms (and also the governments) are facing a “governance dilemma”: Whether to promote the adoption of the Anglo-Saxon model or to keep some of the features of the Continental European model? (see, e.g., Holmström and Kaplan, 2001). Because the Anglo-Saxon corporate governance system emphasizes return on capital and equity more than the Nordic and Continental European systems do, this difference in goal setting may have an effect of firm performance.

Differences in operating environment may cause differences in firm performance. Perhaps the most obvious sources of differences are the degree of competition and firms’ exposure to international markets, which may vary a lot across countries and

industries. Differences in competitive environment are highlighted when restrictions on competition are removed in previously protected industries. The reason is, of course, that the restrictions have often been in place to protect domestic companies from foreign competition.

Lichtenberg (1992) has proposed that ownership change is caused by lapses in firms' efficiency. These lapses may be due to the incompatibility (or "bad matching") between a plant (an asset) and the characteristics of an owner (i.e. a parent firm). This argument, which is the key hypothesis of Lichtenberg's (1992) "matching theory", is based on three primary assumptions: i) Some owners have a comparative advantage in owning certain plants; ii) The quality of the match is a decisive factor in the decision to maintain the ownership of the plant; and iii) The quality of the match can be measured by productivity performance.

Globalisation of Finnish Capital Markets

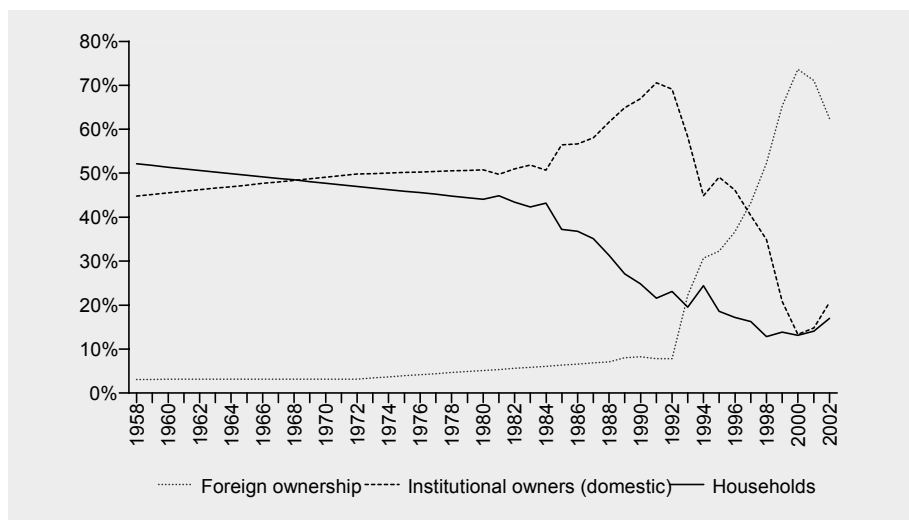
In the Nordic countries, notably Finland, there has been a fast and dramatic change in ownership policies and structures.ⁱⁱⁱ The trend has during the 1990s been that a large number of Finnish firms have been merged with foreign firms or acquired by foreign buyers. Figure 6.1 provides an illustrative example of this trend by showing how rapidly foreign ownership has increased in the Finnish listed firms. The data on inward foreign direct investment in Finland presented in Figure 6.2 provide further support for the trend.

Until recently, the Finnish corporate governance system has been more akin to the German/Japanese system than the Anglo-Saxon system. In line with this, the ownership of major Finnish companies was for long concentrated. Founding families, banks, other companies or the state, typically wielded control.^{iv} In the 1990s, companies, their governance and operations changed remarkably. Cross-ownership diminished when banks and large industrial companies sold their shares of other companies. The privatisation of state-owned companies also proceeded fast during the past decade: in many cases, the buyer was a foreign firm or investor.

As a consequence of the globalisation of Finnish capital markets a number of changes have taken place. First, the supervisory board, which used to be quite common in large Finnish companies, is a rare bird today. Second, the board of directors no longer consists only of operating management as it used to. Third, a number of diversified companies have focused on their core competencies and businesses by selling off less

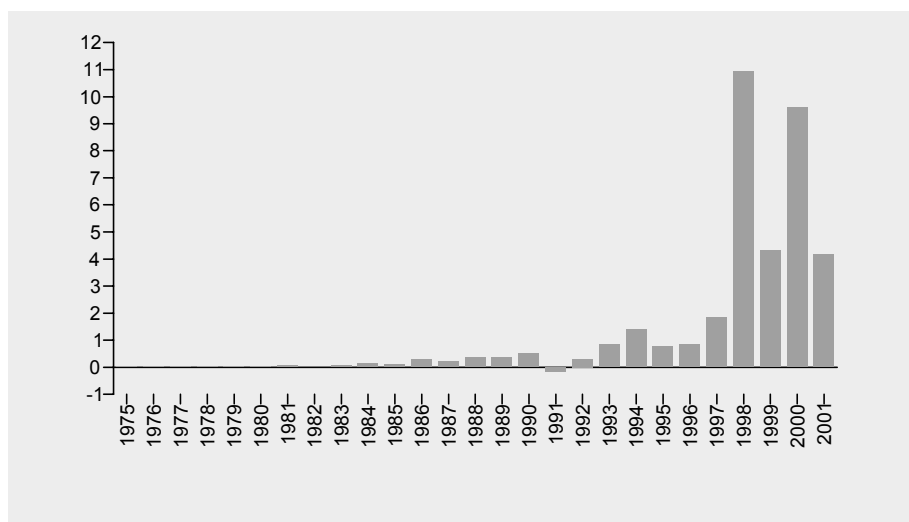
strategic businesses. Fourth, as we will show below, companies have changed their targets. Shareholder value has become one of the key targets in most large companies. All these changes are consistent with the view that the nationality of ownership matters. How the increasing foreign ownership has affected the behaviour and performance of Finnish firms is considered in more detail in what next follows.

Figure 6.1. Ownership in Finnish listed firms, percent of market capitalization (1958-2002)



Note: The data are based on the authors' estimates and derived from Grandell (1959) Laakso (1979), Airaksinen and Kallinen (1987) and HEX.

Figure 6.2. Inward foreign direct investment in Finland, billions of euros (1975-2001)



Note: The source of data is Bank of Finland. The bars depict net inward capital flows.

Empirical Analysis

Differences in corporate governance, degree of competition, and lapses in the matching of resources suggest that the nationality of ownership might cause differences in firms' goal setting and performance. The casual observations that we made in the previous

section seemed to support this view. In this section we examine whether also firm-level data supports the existence of such differences. We examine, in particular, whether there are differences between foreign and Finnish-owned firms in terms of their goal setting, investment rate, and financial performance.^v

Data

We use two data sets on Finnish companies. The first data set (“*Top 100*”) is derived from a database on the 100 largest Finnish corporations (ranked according to sales). The database covers the period from 1986 to 1998. However, due to mergers and restructuring we have comparable data over the whole period on only 50 corporations. The database includes information on firms’ financial performance and corporate governance, such as ownership structure, organization, and what kinds of goals (shareholder value, growth, etc.) the companies have pursued.

The second data set (“*Top 500*”) consists of financial statement data on the 500 largest companies in Finland for the period from 1986 to 1998. The data allows us to make financial performance analyses, but does not include information concerning firms’ goal setting, nor other measures of governance structures. As far as the ownership structure is concerned, only the distinction between foreign controlled (majority owned firm) and domestically owned firms can be made. Approximately one third of these companies were in 1998 foreign-owned, i.e., subsidiaries of foreign firms. There is no data on the amount of the foreign portfolio investment in this data set.

Foreign vs. Domestic ownership: Does it Matter?

We start by examining whether the financial performance of Finnish firms differs from that of foreign-owned firms. To this end, we use the *Top 100* data and divide firms into two groups on the basis of whether the foreign ownership in a firm is above or below 20%. As shown in

Many of the indicators of financial performance differ significantly between Finnish and foreign-owned companies. The biggest difference relates to EVA, which is on average much higher in foreign-owned firms. Even if we exclude the largest Finnish multinational firm Nokia Corporation from the sample, the difference remains double. Although the larger size of foreign-owned firms may explain the difference, this finding is not inconsistent with the view that foreign-owned companies yield more value added to their owners. The ratio of EVA to capital invested describes the

efficiency of capital use. It too indicates that the foreign owned firms outperform the Finnish ones. Moreover, it seems that foreign-owned firms have invested less and have a lower equity ratio than domestic-owned companies. Due to the small sample size, these differences should be considered tentative.

Table 6.2 we use several measures of financial performance, including the Economic Value Added (EVA). Unlike traditional measures of corporate profitability, EVA also takes into account the opportunity cost of equity capital.

Many of the indicators of financial performance differ significantly between Finnish and foreign-owned companies. The biggest difference relates to EVA, which is on average much higher in foreign-owned firms. Even if we exclude the largest Finnish multinational firm Nokia Corporation from the sample, the difference remains double. Although the larger size of foreign-owned firms may explain the difference, this finding is not inconsistent with the view that foreign-owned companies yield more value added to their owners. The ratio of EVA to capital invested describes the efficiency of capital use. It too indicates that the foreign owned firms outperform the Finnish ones. Moreover, it seems that foreign-owned firms have invested less and have a lower equity ratio than domestic-owned companies. Due to the small sample size, these differences should be considered tentative.

Table 6.2. Performance by ownership (using Top 100 data, N = 199)

	Foreign ownership <20%, (n=121)	Foreign ownership ≥20%, (n=78)	t-statistics	p-value
Return on investment	14%	17%	-1.687	0.09
Capital turnover rate	3%	3%	0.057	0.96
Equity share	47%	42%	2.389	0.02
Investments/Net sales	13%	8%	2.132	0.03
Operating income/Net sales	7%	7%	0.501	0.62
EVA, FIM mill.	79	447	-2.092	0.04
EVA/Capital invested	6.0%	9.0%	-1.647	0.10

Note: The data refer to 1997 and 1998. Capital turnover rate = the ratio of net sales to capital invested. The number of observations is 199, since the sample is based on the Top 100 in 1997, but the merger of IVO and Neste reduces the number to 99 in 1998. t-statistics is a test for a population mean (t-test, variance unknown) testing H0: Mean (Domestic-owned) = Mean (Foreign-owned). EVA without Nokia Ltd is 221 million FIM.

In order to solve the small sample problem, we turn to the *Top 500* data. Table 6.3 is displays the results. Because we lack data on foreign portfolio investments in these companies, the definition of foreign ownership changes from what we used above. As indicators of firm performance, we use only EVA, the ratio of EVA to capital invested, and the conventional rate of return on investment.

Table 6.3. Performance by ownership (using Top 500 data, N=5121)

Year	Finnish-owned			Foreign subsidiaries		
	EVA, FIM mill.	EVA / Capital invested	Return on investment	EVA, FIM mill.	EVA / Capital invested	Return on investment
1986	-27	-1%	8%	2	1%	11%
1987	10	2%	10%	16	7%	15%
1988	24	3%	11%	18	8%	17%
1989	11	1%	10%	12	6%	16%
1990	-24	-1%	8%	-1	0%	11%
1991	-71	-4%	6%	-3	-4%	8%
1992	-70	-3%	8%	-2	-3%	9%
1993	-32	0%	9%	1	2%	12%
1994	13	3%	12%	11	10%	20%
1995	36	4%	16%	23	12%	27%
1996	14	4%	17%	19	9%	24%
1997	37	5%	18%	24	11%	26%
1998	54	5%	17%	23	10%	24%
Total average	-4	1%	12%	12	6%	18%

The message is clear. Foreign-owned companies have performed much better than domestic ones. Foreign companies created slightly negative value added during the recession (1991-1993), but at the same time, the average EVA of Finnish-owned companies was strongly negative. The ratio of EVA to capital invested, which is not as much driven by differences in firm size, has averaged to 1% in Finnish companies, while the same figure for foreign-owned companies is 6%. The rate of return on capital invested in foreign companies is also higher than in Finnish-owned companies.

Table 6.4 reports the capital turnover rate, the ratio of investment to net sales, and the number of companies. It seems that Finnish-owned companies need far more capital to generate the same sales or value added than foreign-owned companies.

Table 6.4. Investment by ownership (using Top 500 data, N=5121)

Year	Finnish-owned			Foreign subsidiaries		
	Capital turnover rate	Investment/ Net sales	Number of companies	Capital turnover rate	Investment/ Net sales	Number of companies
1986	2.5	11%	190	2.8	7%	39
1987	2.5	10%	249	2.8	5%	50
1988	2.4	13%	292	3.1	5%	58
1989	2.5	11%	318	3.2	6%	74
1990	2.6	12%	360	4.3	6%	88
1991	2.8	8%	399	3.6	6%	91
1992	3.5	10%	339	3.1	5%	77
1993	3.6	8%	334	4.9	4%	88
1994	4.1	7%	299	7.9	4%	93
1995	3.5	8%	289	6.7	3%	110
1996	5.5	8%	297	7.2	4%	115
1997	3.8	9%	286	6.3	4%	117
1998	5.2	10%	333	7.1	5%	136
Total average	3.4	10%	3985	5.3	5%	1136

Table 6.5 reports statistical tests for the performance differences. As can be seen from the table, the hypothesis that there are no performance differences between domestic and foreign-owned companies is rejected. Furthermore, the investment ratio of foreign-

owned companies is lower than domestic-owned companies. Finnish companies are also on average more capital-intensive than foreign-owned companies are. This finding does not change significantly even if the capital-intensive forest industry is eliminated from the data. In a previous study on the financial performance of Finnish companies (Ali-Yrkkö and Ylä-Anttila 1997), the industry differences between domestic and foreign companies were carefully controlled. The result was that the industry differences did not explain the performance differences. It is worth emphasising that the findings in Table 6.5 are consistent with our earlier results using the *Top 100* data and the different criterion for foreign ownership. Thus, to sum up, these results support our hypotheses that investment ratio and financial performance differ between domestic and foreign-owned firms. It seems that foreign-owned companies outperform domestic companies in Finland.

Table 6.5. Statistical tests (using Top 500 data, N=5121)

	Variable			
	EVA	Return on investment	Investment/Net sales	Capital turnover rate
t-statistic	-4.258	-10.376	14.350	-5.075
p-value	< 0.01	< 0.01	< 0.01	< 0.01

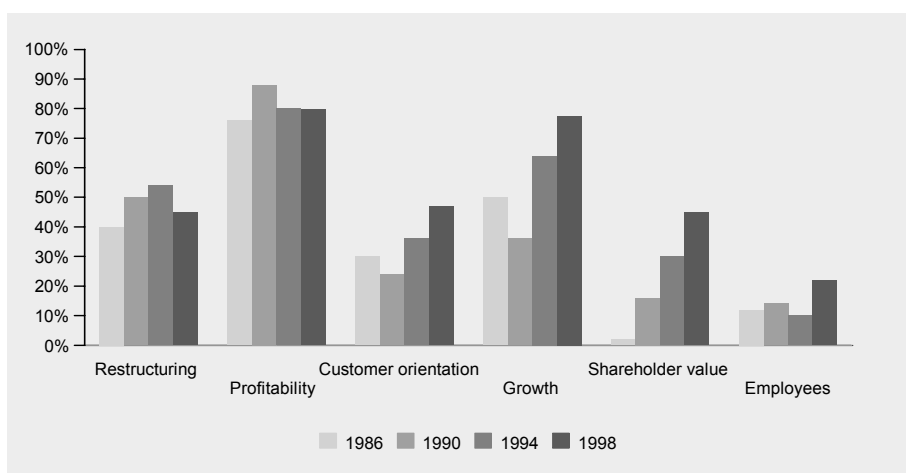
Note: t-test, variance unknown, H0: Mean (Domestic-owned) = Mean (Foreign subsidiary)

Why do the differences arise? Are Finns poor managers? Anecdotal evidence is not consistent with poor management. Case studies of firms that have been taken over by foreign firms show that the old management has often been allowed to keep its position after the takeover. However, the performance of these firms has improved. These findings are consistent with the view that foreigners are more demanding owners than Finns, i.e., that more is squeezed out of the firm.

Goals and Ownership

The annual reports of Finnish companies usually include a section describing their goals and targets. All companies state several goals. Figure 6.3 shows that profitability and its improvement were the main goals throughout the 1990s. Companies announced either that they would maintain profit performance at the same level as before, or that they would try to improve it. Another goal, not shown in the figure, is improving the debt/equity ratio. Since the sample is small, the conclusions based on it should be regarded tentative.

Figure 6.3. Goals of the largest Finnish companies, percent of companies



Note: The data are from the Top 100 data set and consist only of firms that mentioned their goals.

It is of interest to note that during the recession in the 1990s, the desire of companies to grow diminished. This finding is not very surprising, because growth was not a very realistic goal in the depth of the recession. In fact, most companies tried to keep their sales at the same level as before. It is interesting that the goal of customer orientation declined during the economic slowdown. It may be that many companies were forced to concentrate on improving their financial position, such as debt/equity ratios, at the expense of other goals.

Stressing the owners' role increased rapidly during the 1990s. Since 1990, more and more companies have announced that they seek value added for shareholders. By the end of the 1990s, almost half of the large companies stated shareholder value as one of their key goals. Shareholder value is, of course, closely related to other targets, like profitability and growth. However, stating it explicitly as one of the key goals includes a specific signal to current and potential owners and is, at least, an indication how shareholder value became an increasingly common goal of Finnish firms in the 1990s.

Table 6.6 shows how goals differ between Finnish and foreign-owned companies. The results in the table suggest that foreign-owned companies are more customer, growth

Table 6.6. Comparison of firms' goals (using Top 100 data, N=199)

	Foreign ownership <20%	Foreign ownership >20%	t-statistic	p-value
Restructuring	38	38	-0.353	0.72
Profitability	76	67	0.406	0.68
Customer orientation	49	63	-2.721	0.00
Growth	63	73	-2.313	0.01
Shareholder Value	28	52	-3.990	0.00
Employees	38	29	-1.474	0.14

Note: See the earlier tables.

and shareholder-value-oriented than domestic companies. To summarize, these results support our hypothesis that the goals of foreign and domestic-owned companies are not similar.

As shareholder value has become an important goal during recent years, an interesting question is whether those who put emphasis on shareholder value have really created more value added for their owners than other companies have. In Table 6.7 the firms have been divided into two groups, i.e. into firms that are “Aspirants to shareholder value” and “Others”. Unexpectedly, the performance of the firms that are aspirants to shareholder value does not deviate significantly from the other firms. The only difference is in EVA, which is probably explained by the larger size of the aspirants to shareholder value. Announcing shareholder value as a key goal is not necessary associated with higher than average performance. One obvious explanation in light of our earlier results is that foreign ownership is driving the both (and thus an omitted variable here). However, as we are looking at only two years, we cannot be conclusive on this matter.

Table 6.7. Performance by goals (using Top 100 data, N = 199)

	Others (N=127)	Aspirants to shareholder value (N=72)	t-statistic	p-value
EVA, FIM mill.	87.7	468.2	-1.977	0.05
EVA/Capital invested	7.0%	8.1%	-0.633	0.53
Return on investment	15.0%	16.4%	-0.763	0.45
Investment/Net sales	9.6%	13.9%	-1.454	0.15
Equity ratio	45.0%	45.8%	-0.337	0.74

Note: See the earlier tables.

Conclusions

As a consequence of globalization, capital flows – both FDI and portfolio investment – have increased significantly. The role of foreign capital and foreign ownership has increased rapidly in many countries. In this study, we have focused on financial performance and differences in governance structures between domestic and foreign-owned companies, using data on Finnish companies.

Our data show that maximizing shareholder value has been increasingly adopted as a major goal in most large Finnish companies since the early 1990s. The increase coincided with increasing foreign ownership in the Finnish business sector. Our empirical results suggest that ownership matters in goal setting. There are significant

differences between foreign-owned and domestic-owned firms in terms of their announced objectives (see also p.12).

Furthermore, our comparisons suggest that foreign-owned companies have not invested as much as domestic companies. This partly explains why foreign-owned companies produce a higher rate of return on capital than domestically-owned companies. The difference applies not only to companies that are majority-owned and controlled by foreigners (subsidiaries of foreign firms) but also to companies with lower (but still significant) foreign ownership. Consistent with earlier empirical evidence, our analysis also shows that foreign companies perform better than Finnish-owned companies.

Taken together, our evidence suggests that increases in foreign ownership have improved the efficiency of capital use. The results also imply that in less integrated and partly protected markets it was possible to pursue other goals at the expense of the rate of return on capital. In the future, the nationality of ownership (domestic vs. foreign) in determining firm performance will probably diminish. Owners will pursue high rates of return irrespective of their nationality.

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Appendix

Unlike traditional measures of corporate profitability, such as net operating profit after tax, and net income, EVA looks at a firm's "residual profitability," net of both the cost of debt capital and the cost of equity capital (Grant, 1997). It can be computed as follows: $EVA = \text{Net result} \textit{ minus} (\text{Riskless rate of interest} \textit{ plus} \textit{ Beta times Risk premium}) \textit{ times} \textit{ Equity share}$, where the riskless rate of interest is measured using the treasury bond (5 years) yield in Finland (Source: Bank of Finland), Beta is measured using betas by industries (Source: Finnish Economic Weekly (Talouselämä, 20/1997)) and risk premium is assumed to be 4.5 %.

Endnotes

ⁱ See, e.g., Shleifer and Vishny (1997).

ⁱⁱ An often cited statement of the CEO of Volkswagen AG some 30 years ago is still thought to be an illustration of the German (Continental Europe) system: "Why should I care about the shareholders, whom I see once a year at the general meeting. It is much more important that I care about the employees; I see them every day."

ⁱⁱⁱ See Ali-Yrkkö and Ylä-Anttila (1999) and Ylä-Anttila (2000).

^{iv} The number of listed companies has been rather small, and banks have served as a major source of finance to Finnish companies. These basic characteristics of the traditional system are described in more detail, e.g., in Kasanen et al. (1996). Changes in institutional and legal settings in the 1990s are described by Hyytinen et al. (2002).

^v The causality might, of course, run also to the other direction, i.e., companies with high financial performance are attractive investment targets for foreign companies and investors. Indeed, a previous study with Finnish data shows that foreign companies tend to acquire firms with higher than average rate of return. It is of interest to note that the difference in the rate of return between domestic-owned and foreign-owned companies seems to grow after the acquisition (see, Ali-Yrkkö and Ylä-Anttila 1997 and Ali-Yrkkö et al. 1997).