Summary for non-specialists
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International taxation and multinational firm local decisions

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With globalization and the progressive removal of barriers to trade, an increasing number of companies develop international activities. To access foreign markets, firms face a choice between producing goods at home for exports and producing abroad. A host of tax and non-tax factors affect the decision whether to relocate production abroad. Studies of the effect of taxation on FDI location decisions generally examine host country taxation to the exclusion of parent country taxation. Logically, the goal of each corporation is to minimize its worldwide tax liability. As a first level of taxation, the host country may impose corporate income taxation on the income of local foreign subsidiaries. In addition, the host country could levy a non-resident dividend withholding tax on the subsidiary's earnings at the time they are repatriated to the parent firm. But taxation need not stop at the host country level. The parent country can further choose to levy a corporate income tax on the resident multinational's foreign-source income. The novelty of this paper is to jointly consider the impact of host and parent country taxation on multinational firm location decisions using a range of data from 33 European countries. Data on the international structures of European multinationals are obtained from the Amadeus database. This data set allows us to consider multinational companies resident in a broad set of countries, each potentially having foreign subsidiaries in many other countries. Thus, unlike earlier work, this paper considers multinational firm location choices in a setting of N by N countries. In addition to being an innovative approach, this multi-country framework is in fact necessary to obtain sufficient variation in parent-country corporate taxation (not highly correlated with host-country corporate taxation) to be able to separately estimate its impact on international location decisions.

The paper analyses the impact of three levels of taxation: corporate income tax imposed by the host country on local foreign subsidiaries; non-resident dividend withholding tax levied when the subsidiary's earnings are repatriated to the parent firm; and corporate income tax imposed by the parent country on the parent firm's foreign-source income. It also examines how these taxes and location choice affect the organizational structure of multinational corporations. We have collected detailed information on how parent-country tax systems interact bilaterally with corporate taxation and non-resident withholding taxation in the host country. Specifically, we collect information on whether or not countries tax the income of their multinationals on a worldwide basis, and whether foreign tax credits are provided for non-resident withholding taxes only or also for the underlying host country corporate tax (as, for instance, in the United States). As an alternative to worldwide taxes, parent countries may partially or fully exempt foreign source income from taxation. As an example, Germany exempts 95 percent of the foreign source income of German multinationals from taxation. In some cases sensitivity to parent-country taxes will prompt multinationals to invert their organizational structure, so that one of the foreign subsidiaries becomes the parent firm, and the previous parent firm becomes an international subsidiary.

We find that host-country and parent-country corporate income tax both tend to discourage multinational firms from locating their subsidiaries in a particular country, and that both taxes have a fairly equal impact on this decision. Specifically, we find that parent-country taxation has a strongly negative effect on location probability, despite the fact that in most cases these taxes can be deferred until funds are repatriated. These same taxes also affect the location of the parent firm. The evidence provided in this paper shows that a parent firm is less likely to be located in countries with relatively high foreign-source income. Additionally, the paper notes that the sensitivity to host and parent-country taxation is highest for companies that invest in an intermediate number of foreign countries. The main lesson drawn from these results is thus that parent-country taxation is instrumental in shaping the structure of multinational enterprise, and that this is potentially useful to the creation of tax policies at the national and international level.