Abstract

The existence of fixed setup cost of new investments introduces two margins of FDI decisions. There is an intensive margin of determining the magnitude of the flows of FDI, according to standard marginal productivity conditions, and also an extensive margin of determining whether at all to make a new investment. In such a setup, there are conflicting effects of productivity shock in the host country in a way that allows an econometric application. Elsewhere we investigated the role played by the host and source corporate tax rates on the abovementioned intensive and extensive margins. We find that the host country tax rate has a negative effect primarily on the intensive margin, whereas the source tax rate has a positive effect mostly on the extensive margin. In this paper we discuss key policy implications. Specifically, we formulate an international tax competition model to explain the co-existence of a "rich" source country with high capital-income (business and individuals) taxes and public expenditures and a "poor" host country with low capital-income taxes and public expenditures. This phenomenon may be common in the enlarged EU with the new accession countries which, are predominant recipients of FDI from the old member countries. We also analyze the welfare gains from a tax coordination.