

# Taxes and Human Capital as Determinants of Foreign Direct Investment in EU: The Role of Most Favoured Nation Treatment

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# Summary

**Title:** Taxes and Human Capital as Determinants of Foreign Direct Investment in EU: The role of Most Favoured Nation treatment

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**Problem discussion and problem Formulation:** The recent year's rapid increase in foreign direct investment (FDI) is a clear indication of increasing globalisation. In order to stay competitive companies must take advantage of talented people, new technology and new markets around the world. Not only companies but also countries and regions, such as EU, need to take advantage of globalisation and the advantages that come with the increase in FDI around the world. Studies have shown that FDI does not only make companies more competitive but it also stimulates the economic growth of the region where the FDI takes place. There are many determinants of FDI such as, for example, the size of the local market and logistic costs. In recent years there has however been a lot of activity in EU that affects two factors, which according to theory, is determinants of FDI. One area where recent years activities have the potential to affect taxation in EU is the area of EC law and bilateral tax treaties. The activity has concerned the question whether there should be community most favoured nation (MFN) treatment in bilateral tax treaties. Taxes are according to theory a determinant of FDI which makes an analysis of these business law events topical and important. The other area is human resources where EU has made several attempts to raise the level of human capital in the EU region. Human capital is according to theory another determinant of FDI which makes it important to investigate whether EU's efforts to raise the level of human capital will affect the inflows of FDI into the EU region. Countries with a high level of human capital do in most cases also have a high tax level. This makes it more interesting to investigate how important taxes and human capital are as determinants of FDI inflows into the EU region.

The research question is thus if the level of Human Capital in EU is a determinant of FDI inflows into the region? Should there be MFN treatment in bilateral tax treaties according to EC law and is the potential tax effect of the MFN treatment also a determinant of FDI inflows into the EU region?

**Purpose:** One of the two purposes of this thesis is to find out whether the level of EU's human capital and taxes are determinants of FDI inflows into the region. The taxes in the EU

region are said to be affected if there would be MFN treatment in bilateral tax treaties which brings in the other purpose which is to find out whether MFN treatment in bilateral tax treaties is provided for according to EC law.

**Method:** A deductive research method was chosen in this thesis. The research consisted of books, articles, legal documents and case law analysed. The empirical research in the business law part was done by analysing the EC treaty and appropriate case law. The empirical research in the business part was done with the help of a number of small qualitative case studies.

**Conclusion:** According to the findings in this thesis is it very unclear whether MFN treatment in bilateral tax treaties is provided for according to EC law. The main argument for MFN treatment would be art 12 EC which forbids any type of discrimination that is based on nationality. Art 12 EC is applicable in all areas that are covered by “the four freedoms”. “The four freedoms” cover all forms of investment and cross-border activity which means that the scope of art 12 EC is rather broad and it should cover most of the possible MFN situations that might arise in bilateral tax treaties. The case law is however very vague and inconsistent when it comes to MFN treatment in bilateral tax treaties and it is not possible to conclude that MFN treatment is provided for according to case law.

If MFN treatment will be provided for according to case law, there will be some sort of impact on EU taxation. If companies were subjected to more favourable tax treatment it might have some effect on the inflows of FDI into EU. The results from the miniature case studies however indicates that taxes are not an important determinant when it comes to the type of FDI that is usually undertaken in the EU region. Taxes seem to be a determinant when the investing company is looking for the cheapest way to produce, the production is simple and a high level of human capital is not needed. Companies that are only looking for the cheapest way to produce do normally not invest in EU and hence is taxes not a determinant of FDI in EU. Human capital however seems to be a very important determinant of inflows of FDI into the EU region. The results from the miniature case studies indicate that human capital is important for all types of FDI except for when the investing company is only trying to produce at the lowest cost. These types of investments are however rare in EU which shows that the level of human capital in EU is very important if the EU region wants to continue to attract FDI.

# Abbreviations

MFN	Most Favoured Nation
ECJ	European Court of Justice
EC	European Community
GATT	The General Agreement on Tariffs and Trade
EU	European Union
OECD	Organisation for Economic Co-operation and Development
FDI	Foreign Direct Investment
R&D	Research and Development
MNC	Multinational Corporation
M&A	Mergers and Acquisitions
UN	United Nations
HRD	Human Resource Development
MNE	Multinational Enterprises
TNC	Transnational Corporation

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# 1 Introduction

## 1.1 Background

An apparent indicator of the increased globalisation in the world is the recent year's rapid increase in Foreign Direct Investments (FDI). FDI can shortly be explained as investments made by foreign companies into domestic organisations, structures or equipment. (about.com, 2006-06-15) There has been a constant increase in FDI during the last 20 years and sales coming from foreign affiliates grew twice as fast compared to exports during the 1990's (Davies, 2004). In 2002 12 percent of the total investments made in the developed countries came from FDI. On average was the value of FDI 19 percent of the GNP (Grönlund, 2004). If companies want to remain competitive these days, they need to gain access to talented people, new technology and new markets all over the world. (PPI, The new economy index, 2006-05-12) FDI however does not only increase the competitiveness of the investing companies but also increase the technology and knowledge as well as employment and productivity in the host country. (Grönlund, 2004) FDI is also said to stimulate the host countries economic growth more than other forms of capital inflows. The reason for this is for example the increase in managerial knowledge and new technologies. (Nunnenkamp, 2002) FDI is also considered to be especially beneficial in countries or regions with a high level of human capital like the EU. (Loungani et al, 2001)

If one counts the flow of FDI between the EU Member States 50 percent of the worlds inward FDI flows into EU. After the enlargement EU has over 450 million consumers which means that the Union is the world's largest internal market when looking at opportunities for trade. (<http://europa.eu>, 2006-05-15) However, in 2004 inflows of FDI into the EU area fell by more than 50 percent. In 2003 the inflows amounted to 125 billion euros compared to a mere 58 billion euros in year 2004. EU was also a net investor in 2004; the outflows were 41 billion euro higher than the inflows. (English People Daily Online, 2006-05-12) Since inflows of FDI are seen by many as positive for a country or a region's economic development these numbers are not positive for the EU area. There has been however, in

recent years some activity in EU which could have positive effects on the inward flows of FDI to the region.

The different reasons for why a region is chosen for direct investments are many. The determinants are for example the quality of the regions infrastructure and the size of the local market. Over the last years in EU there has been a lot of activity in two areas that are indirectly or directly considered to be determinants of inward FDI. The areas are business law, with regard to double taxation treaties, and the human resource area. The business law area is indirectly a determinant because of the effect the business law can have on the tax scene and human resources have been mentioned as a direct determinant of FDI.

## 1.2 Problem discussion

As mentioned in the background there are many factors that are said to make a region more attractive for direct investments. Examples are logistic costs, the human capital, availability of production factors, the geographical location and taxes. There are several of these factors that have become more attractive because of the creation of the common market. It is for example more attractive for companies to be located in the EU area because of the possibility to export all over EU without hindrance. This means that the companies have access to a market that is obviously a lot larger than the different national markets which create an advantage. Out of the earlier mentioned determinants there are however two that are particularly current in the EU. In recent years there has been much activity in these areas which could potentially affect the inflows of FDI into the EU area.

One of these is the human resource area where there has been several active efforts made in order to improve the level of EU's human capital. Traditionally a country or region's human capital is usually measured through the educational level in the country/region. It can also be measured on the availability of, for example, managers and technicians. (Noorbakhsh et al, 2001)

EU has worked hard to create the right conditions for the common market to build the world's highest level of human capital. In 1999 the Bologna agreement was concluded in order to create "a European Higher Education Area". (Hayward, Multi-lateral Agreements That Address International Quality Assurance, International Quality Review, p 1, 2000) The idea is



that the degrees in Europe should be comparable and that the quality of the education can be assured. The goal with the agreement is to create a higher education system in Europe that is globally competitive. (Hayward, 2000) Another effort by the EU to improve the human capital was made year 2000 at the summit meeting in Lisbon. At the summit the European Commission decided that in order to meet the competition from, in particular the US and Japan, the EU needed to be “the most competitive knowledge-based economy in the world”. (Zaragoza, The European Union: A Knowledge Based Economy, p 1, The FEBS Newspages) The goal was to reach this target by the year 2010.

Countries with a high level of human capital do in most cases also have a high tax level. Therefore it is also worthwhile to investigate how important taxes are as a determinant of FDI inflows into the EU region. Taxation and more precisely the area of bilateral tax treaties and EC law is also another area where there has been much activity in EU. This activity might have an impact on the future inflows of FDI because of its effect on the taxes. The national laws of the EU Member States are becoming more and more affected by EC law. This has made practically all areas of law related to cross border business activities applicable to EC law. In order to achieve the EC’s goal of creating an internal market Community law has to be superior to national laws. In areas concerning direct taxation there is only one convention and a few directives that provide harmonisation of certain national tax law aspects. This sparse harmonisation is due to the fact that Member States are still fiscally sovereign. This means that the Member States have to agree unanimously in the European Council in order to take away taxes that hinder cross border business activities. It is often the case that harmonisation at the EC level results in lower tax revenues at a national level. This has made the Member States hesitant to increase the harmonisation of direct taxation laws. (Durr Schmidt, 2006)

Because of this it has been ECJ that, via its rulings, has “pushed” the integration further in the field of direct taxation. This type of integration, that is called “negative integration”, is somewhat restricted since the ECJ only can rule on cases put before it. Hence ECJ cannot take the initiative and may also not, unless required, establish an extensive system of tax law. ECJ is also limited from harmonising the national laws completely because the court can only stop restrictions and discrimination. This however, has not stopped ECJ’s case law from having an important impact on the Member States tax laws. (Durr Schmidt, 2006)

The Mr “D” case exemplifies how the ECJ had the opportunity to “push” integration further in the field of direct taxation. A short explanation of the case would be that it concerns “Mr D” who is a German resident with property in the Netherlands. “Mr D” has to pay wealth tax on his property in the Netherlands but cannot make a deduction of the tax allowance on the wealth tax because he is not a Dutch resident. Belgian residents however, are entitled to the deduction thanks to a bilateral tax treaty between Belgium and the Netherlands.

“Mr D” off course wants to be able to make the deduction since another non-resident who is a resident of another Member State and in the same situation as “Mr D” is entitled to it. (The “D” case C-376/03)

This case was so interesting because it gave the ECJ a chance to answer the question whether the MFN principle could be applied in bilateral tax treaties according to EC law. The EC treaty does not contain a MFN clause which is unusual for a multilateral economic agreement. (Kofler, 2005) The MFN principle has been defined as “a treatment accorded by the granting State to the beneficiary State, or to person or things in a determined relationship with that state, not less favourable than treatment extended by the granting State or the third State or to persons or things in the same relationship with that third State” (Yearbook of the international Law Commission, 1978, vol 2, Part 2, p.21.)

ECJ did not accept the argument put forward by “Mr D” that the MFN principle should be applicable in his case. The reason for ECJ’s decision could be that the court is worried about the possible effects that the application of MFN treatment in bilateral tax treaties could have on international tax law. The courts judgement and the explanation of the judgement could be seen as both questionable and unclear which means that the question whether EC law provide for MFN treatment in bilateral tax treaties remain. (Van Thiel, 2005)

The application of MFN treatment in the area of bilateral tax treaties would definitely affect the EU tax scene, since there would automatically be a “Multilateralisation” of all the bilateral tax treaties that the Member States has concluded. (Kofler, 2005)

This means that it would be possible for companies and people to benefit from the most favourable bilateral tax agreements that are concluded between any of the Member States and between any of the Member States and third countries. The most favourable agreement likely means the one that will give the lowest tax. This means that companies and people can choose

among the most favourable tax treaties that have been concluded between the Member States and any other countries.

This situation would definitely affect the tax scene in EU with potential changes in the tax levels among the Member Nations. It would also promote the harmonisation of taxation within EU. (Kofler, 2005) The question is if this would also affect the inflows of FDI.

### 1.3 Research question

Is the level of Human Capital in EU a determinant of FDI inflows into the region? Should there be MFN treatment in bilateral tax treaties according to EC law and is the potential tax effect of the MFN treatment also a determinant of FDI inflows into the EU region?

### 1.4 Purpose

One of the two purposes of this thesis is to find out whether the level of the EU's human capital and taxes are determinants of FDI inflows into the EU region. The taxes in the EU region are said to be affected if there would be MFN treatment in bilateral tax treaties which brings in the other purpose which is to find out whether MFN treatment in bilateral tax treaties is provided for according to EC law.

### 1.5 Demarcation

The business part of the thesis is limited to investigating the effect of two possible determinants of FDI inflows, the level of the human capital and the tax level. The author acknowledge that there are many other possible determinants of FDI such as market size, availability of production factors and the cost of logistics. However, in order to make a deeper analyse possible, the area of research has to be limited. These two factors were chosen due to

recent year's events, which were mentioned in the problem discussion, have the potential to directly or indirectly affect these two determinants of FDI which make them highly topical.

The business law part of the thesis will be limited to investigating if there should be Community MFN treatment in the area of bilateral tax treaties according to EC law. This means that the specific effects on taxation that will come from giving bilateral taxation treaties MFN treatment in the EU will not be investigated. Because of the earlier mentioned "multilateralisation" of the tax treaties there will be an effect on the EU taxes but for the purposes of the thesis there is no need to know the exact effects. This is so because the effect on FDI inflows due to any type of change in the tax level will be investigated.

The MFN principle could be applied to practically all types of investment activities. In this thesis however the business law part of the thesis will be limited to investigating the issue of Community MFN treatment in the area of bilateral tax treaties. To cover the consequences of Community MFN treatment in all the different kinds of investment activities would not be possible due to the limited time and resources available.

If the MFN principle would be applicable in EU tax law the effect of this would be economy-wide and it would not give foreign direct investors any tax advantages over domestic enterprises. It would however ensure that they would get the same treatment as domestic companies. Because of this, the thesis will not investigate the effects of tax investment incentives given to foreign investors, like sales tax exemptions or corporate tax reductions, but rather how a general change in the tax level affects the propensity to invest.

## 2 Methodology

### 2.1 Research method

When doing research the researcher should relate theory and reality (empirical) to each other. The two most common ways of producing theory is the deductive and the inductive method. When working with the deductive method the researcher tries to find empirical proof for the existing theory. This mean that the researcher does not come up with new theories but uses already existing ones and tests this empirically.

When working according to the inductive method the researcher tries to discover something new. This means that the researcher conducts investigations that are not based on any accepted theories. The researcher collects empirical information and tries to come up with a theory with the help of the results. (Patel et al, 1994)

In this thesis a deductive research method is chosen. The author has tried to use existing theory and then find empirical evidence for this theory with the help of both primary and secondary data.

### 2.2 Research procedure

Research is done by collecting, analysing, interpreting and presenting of the data. There are two comprehensive ways of collecting the data. They are qualitative and quantitative methods.

When doing research with the qualitative method the researcher usually wants a lot of in depth information from a few sources. Often in depth interviews are conducted where all of the questions are not decided in advance. The questions are normally also unstructured and open. This makes the qualitative method informal and flexible.

If the research is quantitative the researcher wants information from many sources. This often means that a small amount of information is gained from many sources which make the investigation broad but shallow. (Holme et al, 1997)

Because of the quite complex nature of the research questions in depth information about the topic was needed. This means that the quantitative method of research could not be used since the information collected this way is too shallow. It is also very difficult for the author to establish contact with a sufficient number of people, whom have a position at the correct level within the companies that enables them to give reliable answers, in order to make for example a questionnaire useful. The author also felt that the information given would be more reliable if a few people with the right knowledge would be interviewed compared to interviewing a group of people that do not have the right position in the companies to give correct answers. Due to these reasons a qualitative research method was chosen. A small qualitative survey was done, consisting of five miniature case studies and a small “expert” panel. A qualitative survey was chosen because the researcher wanted a lot of information from the respondents. The survey is considered small because there are only 7 respondents that has either been interviewed or responded to a questionnaire. Information from both the interviews/surveys and other sources such as the annual report has been used when doing the miniature case studies. The case studies are small because there was no secondary data found that was relevant to the chosen companies and the topic. The chosen companies often choose who the researcher was allowed to interview and it was difficult to get more than one interview. This meant that no more than one person per company could be interviewed which made it hard to enlarge the study by interviewing more respondents. The respondents that were interviewed were chosen because of their positions in the companies. They all had a position which made them well informed about the companies’ strategic decisions.

## 2.3 Business Law Method

When doing the legal analysis the author mainly investigated EC law by analysing different EC articles and EC case law. In order to give the reader a better understanding about the legal situation MFN treatment in international tax law and in international trade law was also investigated. By studying the different articles the author could discover whether there were

any articles that covered MFN treatment and bilateral double taxation treaties. EC case law helped the author to interpret the different EC articles and for example show the coverage of the different articles. The case law does also not only show how legal issues regarding MFN treatment have been solved but also how the legal situation has changed over the years. This means that case law also show if there have been any changes in the way EC articles, directives and regulations should be interpreted. When studying case law the author chose the cases that were most relevant to MFN treatment and bilateral tax treaties. There were many cases that were relevant which meant that the author had to choose the most important one for the legal analysis. In the analysis the cases are shortly described and then analysed in order to show how they are important to the issue of Community MFN and bilateral double taxation treaties.

## 2.3 Collection of data

### 2.3.1 Primary data

The author was aiming at interviewing representatives from 10 different companies. The criterion for the companies chosen was that they should be among the largest in Sweden (when looking at turnover) and that they should have made FDI around the world and in the EU region. The companies chosen were; Volvo, Ericsson, Electrolux, SCA, SKF, Astra Zeneca, Atlas Copco, Assa Abloy, HM, and a 10<sup>th</sup> company that wanted to be anonymous. The author was able to get interviews from representatives from 5 of these companies. The companies were Ericsson, Astra Zeneca, Atlas Copco, Assa Abloy and the anonymous company. Some of the other companies did not want to answer questions concerning FDI decisions. Representatives from a few companies also promised to get back with information about whom to interview and then simply did not do so, even after being reminded several times. Since representatives from all of the original 10 companies could not be interviewed the research was complemented with interviews with representatives from the Swedish Trade Council. These representatives were chosen since they could be considered as being “experts” in the area of Swedish companies FDI decisions. The Swedish Trade Council is also likely to have the most information regarding Swedish companies FDI.

A case study is normally an intensive study of a few objects (Svenning, 1997). In this thesis the case studies are very small as only one interview per company was conducted along with an analysis of the annual reports. The interviews were done via telephone and the questionnaire was answered via e-mail. The advantage with primary data is that it is current and adjusted to the research. This is so because the data is collected specifically for the research. (Johansson et al, 1993)

### 2.3.2 Interview procedures

If interviews are the chosen way of conducting the research, the researcher has probably decided that in depth information from a few sources is the appropriate method for the research. In order to reach this decision the researcher need to ask himself two questions; Is the type of detailed information that is given in an interview necessary?

Does it make sense to rely on information that is collected from so few sources?

(Denscombe, 1998)

In this research the information received needed to be detailed since the answers to the questions could give the researcher new ideas and perspectives regarding the issue and then the researcher needed to ask more questions which would give more information etc. The respondents might also feel that the answers to the questions can reveal too much about the company's strategies. In that case it is possible to use some details from the interview and treat other details as "off the record". If the same type of questions were asked in a questionnaire the respondents would probably not give the same amount of information since they would be afraid of reviling too much.

In order to be able to rely on the few sources that were interviewed the researcher was thorough when finding respondents with the "right" position in the company. If the respondents had the "right" position they were likely to give the correct information about the issue.



Interviews can be structured in three ways; they can be structured, semi structured and unstructured.

In a structured interview the researcher has very strong control over the questions and the wording of the responses. The structured interview resembles a questionnaire as the researcher compiles in advance a list with questions and the respondents can chose from a limited amount of alternatives when answering. The advantage with this type of interview is that all the respondents get exactly the same questions in the same order which make the material easy to analyse.

In the semi structured interview the researcher still has a list of questions but they are not necessarily asked in the same order. More importantly the answers in this type of interview are open. The respondent has the possibility to develop his ideas and speak more freely about the subject.

In the unstructured interview the idea is that the researcher should interfere as little as possible. The researcher should introduce a theme or a subject and then let the respondent develop his ideas and thoughts about the subject. Often is an interview pending between being unstructured and semi structured. What separates them from the structured interview is that the respondents can chose their own words and develop their thoughts. This makes the unstructured and semi structured types of interviews more suitable for complex questions. (Denscombe, 1998)

In the research for this thesis a mix of a semi structured and unstructured type of interview was chosen. There were some basic questions that were asked in every interview but the follow up questions were different and depended on the answers given by the respondents. The answers were open and the respondents were completely free to come up with new ideas and thoughts that were related to the subject.

### 2.3.3 Choice of method

The reason for why telephone interviews and a mail survey were chosen is that it was the only possible option. The respondents that were interviewed are all very busy people and they do not have time to meet in person. It was also not possible to meet “face to face” since the offices of the respondents often were located far away. Representatives from the different

companies decided which people in the company that were the most suitable for answering the researcher's questions. The respondents that were chosen by the companies were all, with the exception of one, suitable candidate's for answering the questions according to the author. The one respondent that might not have been the ideal candidate was the representative from Astra Zeneca who was working with Student Relations Sourcing & Employer Branding. Because of the respondents position in the company he was not really involved in the company's strategic decisions. The respondent, however, got help from other departments when answering the questions and could answer most of the questions. The respondent was the only representative that was possible to interview in the company. The mix of a semi-structured and unstructured interview method was chosen when doing the interviews. This method was chosen as the author felt that this type of method would give the most information and might also give inspiration to look at the subject from a new angle.

The following questions were asked to all the respondents. These questions were also used in the e-mail questionnaire. In the interviews the researcher asked a number of follow up questions that depended on the answers given. The respondents also often elaborated on the questions and gave their opinion on matters related to the questions. The interviews were done in Swedish so the author has tried to translate as direct as possible.

1. *What is the number one reason for xxx to make FDI in EU countries?*

- This open question was asked with the intention of getting an idea of what the companies considered to be the most important factor, without influencing their answer by naming different factors.

2. *Is it for example to gain access to the local market, raw material, a skilled labour force, cheap labour, low taxes or a favourable geographic position etc.*

- If the respondent thought that the first question was unclear or wanted me to be more specific this question was asked. This was also asked when the respondent gave an answer that was rather vague.

3. *How much does the tax level, in the country where xxxx is planning to invest, affect the FDI decision?*

4. *Is it an important factor?*

5. *Is it a determining factor?*

- These questions were asked to see if and how much the tax level affects FDI decisions.

6. *How much does the level of the human capital, in the country where xxxx is planning to invest, affect the FDI decision?*

7. *Is for example the availability of highly skilled managers, technicians, researchers etc an important factor?*

8. *Is it a determining factor?*

- These questions were asked to see if and how much the level of human capital affects the FDI decisions.

9. *How often is xxxx FDI decisions affected or determined by the level of taxes in the country where you are planning to invest?*

10. *How often is xxxx FDI decisions affected or determined by the level of human capital in the country where you are planning to invest?*

- The questions 9 and 10 were asked in order to find out how many out of all the investment decisions that were affected by the tax level and the level of human capital.

11. *If xxxx, thanks to new EC legislation, gained access to trade agreements that gave you tax benefits such as the right to tax exemption, would it affect your investment decisions and possible make you invest more in the EU?*

- This question was asked in order to see what kind of effect a change in EC legislation has on the companies' investment decisions.

12. *What kind of taxes has the most influence over xxxx investment decisions?*

- This question was asked in order to see if there were some certain taxes that were especially important.

#### 2.3.4 Interviews

The following people have been interviewed during the course of this thesis:

Katrin Lindblom, Member of the Market information team, The Swedish trade council  
On the 3<sup>rd</sup> of May a telephone interview was conducted with Katrin. She works with informing Swedish companies about the market conditions in the countries where the Trade council is active. Her position gives her much insight into the strategic thinking of Swedish companies when it comes to exporting and making foreign investments. Katrin was very

helpful and did not only answer the questions but elaborated on them which gave the author more information than expected.

Mauro Gottsson, Manager of the economics team, The Swedish trade council

On the 5<sup>th</sup> of May a telephone interview was conducted with Mauro.

The interview with Mauro complemented the interview that was done with Katrin and also answered some new questions.

Henrik Israelsson, Student Relations Sourcing & Employer Branding, AstraZeneca

A “discussion” was made via telephone with Henrik the 8<sup>th</sup> of May. The conversation is called a discussion instead of an interview because it was quite informal and it was not possible for Henrik to answer all of my questions since he is no “expert” of the company’s strategies and strategic decisions when it comes to FDI decisions. His position in the company did not make him the ideal candidate for an interview but it was not possible to interview someone else.

Henrik was however very helpful and with the help of some colleagues, that were more informed about the subject area, he managed to answer some of my questions.

Susanne Andersson, Investor Relations Manager, Ericsson

A mail survey was sent to Susanne and she answered on the 2<sup>nd</sup> of May. As a Manager of Investor Relations Susanne is well informed about the company’s strategies decisions which make her a good candidate for the interview. Susanne tried to answer all of the questions but the interview was not as rewarding as the telephone interviews conducted with the other companies. This was probably due to the fact that interaction and hence a further explanation of the questions were not possible. Susanne however gave the Author information about where to look for more information which was helpful.

Xxxx, Senior Business Manager, xxxx

A telephone interview was made on the 10<sup>th</sup> of May with a Senior Business Manager for one of the, when looking at turnover, largest companies in Sweden. The respondent was willing to participate in the interview but wanted both his name and the company name to be anonymous. The respondent position in the company made him well suited for answering the questions. He had plenty of knowledge about the area and could answer all of the researcher’s questions.

Xxxx, Member of the finance department team, Atlas Copco

A team member in the finance department at Atlas Copco was interviewed on the 15<sup>th</sup> of May. The respondent was quite informed about Atlas Copco's FDI. During the interview he was also able to get help from other team members of the department when questions were complicated. The respondent answered all of the questions and was also very helpful by guiding the author through the company's annual report. The respondent wished to be anonymous.

Xxxx, Finance Manager, Assa Abloy

On the 15<sup>th</sup> of May a telephone interview was made with one of Assa Abloy's Finance Managers. The position as a Finance Manager in Assa Abloy made the respondent well informed about the company's FDI decisions. The respondent was also willing to answer all of the asked questions. The respondent wished to be anonymous.

### 2.3.5 Secondary data

Secondary data is information that is already collected by someone else for some other research. The closer the source is to the situation examined the more important it is. This means that primary data is to be preferred when doing research but since secondary data is both easier and cheaper to collect it is often used to a great extent during research. (Holme et al, 1997) (Eriksson et al, 1997) The researcher was not able to find any secondary data on the same topic involving the same companies. The researcher has instead used literature to give a theoretical background to the thesis.

### 2.3.6 Literature review

When choosing literature the author tried to find research papers written by authors that had made plenty of research in his field. When reading through working papers the author also discovered some researchers that often were used as references. Because these researchers seemed to be thought of as being leaders in their field the author of this thesis tried to use

much of their work. The author of this thesis read many articles and journals without including the information from these articles into this thesis. This was done because the same or similar information was often found in articles written by different authors. A lot of information was also not used because it was not relevant enough to be included in the thesis. When choosing literature the writer of this thesis first decided what to include in the thesis and then looked for information about the different parts that should be included. Some information was hard to find. There was for example not a lot of research done on the importance that human capital had for attracting FDI to developed countries. Because of this was the theory section complemented with literature that was focusing on developing countries. This was done because much of that information was also applicable to developed countries.

## 2.4 Credibility

### 2.4.1 Validity

Research has high validity if it manages to measure the things that were meant to be measured. There are two types of validity called internal and external validity. The internal validity is about how the researcher structures the research. For example that the right people are interviewed and that the right questions are asked. The external validity is about the possibility to draw generalisations from the research. In the research done in this thesis the author has put emphasis on finding people with a position in the company that has enabled them to give correct answers. The companies chosen also represent different types of industries which make generalisations about businesses in general more valid. (Svenning, 1997)

## 2.4.2 Reliability

Reliability is an expression of how trustworthy the research results are. A research study has reliability if two studies that use the same method and have the same purpose give the same result. (Svenning, 1997)

Because the interviews were semi or even unstructured, different questions were asked to different companies. This might have affected the respondents in different ways and made them give answers coming from a different angle compared to if the questions were asked in another way. The same basic questions were however always asked even if the follow up questions were different. There is also a risk that the author has interpreted the answers from the interview differently compared to another interviewer.

## 3 Background and Theory

### 3.1 The Most Favoured Nation principle

The MFN principle can be traced back all the way to the 17 of August in 1417 when the king of England, Henry V, signed a treaty with Duke John of Burgundy in Amiens where English vessels were given the right to in the same way as for example Dutch and French vessels use the Flander harbour. In the seventeenth century the MFN agreements concluded started to include any third state instead of limiting the principle to some named countries. The most classical unconditional MFN clause is found in article 1 in the GATT agreement that was signed in 1947. In the 1950s the MFN clause started to be common in international investment agreements. (UNCTAD series, 1999)

The MFN principle basically seeks to hinder nationality based discrimination towards foreign investors. It also set some limits on the host countries regarding their current and future investment policies by forbidding them from favouring investors from one foreign nation over another.

The MFN principle can potentially cover all types of activities relating to investment, for example the sale, use, operation or maintenance of the investment. This coverage that is very comprehensive ensures the protection of the investors even if the activities related to the investment would expand or change during their investments life time. The principle can also be invoked regarding any type of legislation that is related to investment.

In order for a treatment to fall under the MFN clause the treatment has to be *general* and *usually* provided to investors of foreign nations. This means that not all treatment is covered by the MFN principle. If for example there is a “one off” deal between an investor and the host country there are not any obligations under the MFN clause to give the same treatment to other foreign investors. This is so because host countries are not obliged to enter into contracts regarding an individual investment. The reason for this is that the MFN principle does not prevail over the freedom of contract. However, if in the host country an individual



behaviour such as this becomes the general practise the MFN principle would apply.  
(UNCTAD series, 1999)

If investors are not in the same objective situation the host country is allowed to treat them differently. This means that the MFN principle give the right to host countries to give different treatment to different sectors in their economy or to differentiate between companies that does not have the same size. This difference in treatment could however create *de facto* discrimination if the aim with the differentiation was to exclude investors from some countries from benefits. (UNCTAD series, 1999)

The MFN principle can be established in three different ways.

1. By an administrative act, this is, with help of a decree or a law.
2. By a diplomatic action that is embodied in an exchange of notes.
3. By convention or treaty, which is the most common way.

The MFN clause confers rights as well as imposes obligations. The obligations are divided into two groups, positive and negative. The positive one regards the obligation to extend any favours conceded to a third nation to the other contracting party. The negative one is the requirement to refrain from extending disadvantages to the other party if they are not also extended to third nations.

The MFN clause has four basic characteristics. It can be;

1. positive or negative
2. reciprocal or unilateral
3. unlimited or limited
4. conditional or unconditional

- 1) It was mentioned before that the clause imposes both an obligation to extend favours and one not to extend disadvantages. When the “to do” one is explicit the clause has a positive form. When the “not to do” is explicit the clause has a negative form.
- 2) Commercial treaties are normally mutual. The unilateral form has been used on surrendering nations after war but is uncommon.
- 3) The clause can limit the territories that it covers and the objects which it applies to. This is a very important factor in the MFN clause. If the form is unlimited the parties

have to grant each other all privileges and favours (regarding matters referred to in the clause) that are granted to the third nation.

- 4) The unconditional form, off course, lays down no conditions for concessions to be granted. The conditional form however implies that concessions shall be given only when equivalent compensation is given back.

Even if the MFN clauses are similar when looking at the substantive coverage and structure they are different in one area and that is whether they only apply at the post-entry stage or if they also apply at the pre-entry stage.

In the majority of trade agreements MFN is only obliged to be applied after the making of the investment. This is called the post entry-model. Some treaties also explicitly forbid the application of the MFN clause on pre-entry investment. There is however a possibility for the contracting parties to extend MFN so that it also includes the pre-establishment stage. This is done with the help of a supplementary treaty.

The pre-entry model is different because it requires that the MFN standard is applied both on the establishment and the following treatment of the investment. (UNCTAD series, 1999)

In many investment agreements there is an exception to the MFN principle that is based on reciprocity. Examples of such areas are intellectual property, regional economic integration, mutual recognition and other bilateral issues. The most important area for the purpose of this thesis is however the area of taxation where all agreements on investment contain an exception to MFN. Because of this the MFN clause do not impose an obligation on a contracting party to extend any privileges to its treaty partners that it has given to the investors of a third country under a bilateral agreement that regards double taxation avoidance. This is so because the contracting parties to a bilateral tax treaty has delimit their right to tax the other contracting party's investors which mean that they partly renounce the right they have to tax investors that are located in their country. This is something that is done on a mutual basis in order to avoid double taxation. This right is given up on the condition that the other party does the same thing which means that a unilateral extension to third countries with all the financial implications that comes with that is not accepted. (UNCTAD series, 1999)

MFN clauses have enhanced the economic liberalisation when it comes to for example trade and investments. The application of MFN in investment is more recent compared to

international trade but for investors it is one of the most important standards of treatment. The clauses also link agreements together by providing equal treatment to parties under different treaties in areas that are covered by the clause. The principle also helps avoiding economic distortion. The different MFN clauses in investment treaties are diverse and they can be anything between narrow and quite general. Some extend to the whole content of the treaty and other only cover some of the matters addressed by the treaty. The purpose and object of the treaties varies as well as the context of the clauses. In investment treaties the MFN clauses often contain exceptions and specific restrictions. These exclude certain areas, such as for example matters concerning regional economic integration, from the MFN clause.

There is a principle called the *ejusdem generis* that has been applied by national courts, international tribunals and by diplomatic practice. This principle states that “an MFN clause can attract the more favourable treatment available in other treaties only in regard to the same subject matter, the same category of matter or the same class of matter”. (Marie-France Houde et al, 2004, Most-Favoured-Nation treatment in international investment law, p 16)

The *ejusdem generis* principle can be used as a guideline when interpreting a MFN clause. The application and interpretation must however be extracted from the text of the provision and according to the Vienna Conventions general rules of interpretation. Art 31 and 32 of the Vienna Convention states the rules and means of interpretation of treaties. (Marie-France Houde et al, 2004)

## 3.2 Foreign Direct Investment

### 3.2.1 What is FDI?

Foreign investment is generally thought of as the acquisition of financial and real assets in other countries than your home country. Financial assets could be e.g. equity shares and bonds.

Real assets are fully owned or operationally controlled foreign means of production.

The company gets operational control over production by acquiring the sufficient number of shares. (Wang Liansheng, 1992) This means that FDI flows do not always constitute a real investment. It could be a merger or acquisition which means that it is a change in ownership but there is not real investment involved. The OECD argues that more than 60% of the FDI in developed countries are mergers and acquisitions. FDI could also be an equity increase or a joint venture. (de Mooij et al)

That wholly owned foreign firms are classified as FDI enterprises is not ambiguous. However, the criterion for classifying a direct investment enterprise involved in partial foreign ownership is more difficult. There are many different criteria depending on what country the company is located in. If the foreign ownership is concentrated it is usually enough with a 10 percentage ownership to be classified as a directly investing enterprise. The criterion is a bit more complicated when the foreign ownership is divided between un-associated investors. (Wang Liansheng, 1992)

Oxelheim and Gärtner state that when there is a permanent relationship between the object of investment and the investor it is a direct investment. “The aim is to acquire a lasting interest in an enterprise operating in an economy other than that of the investor, the investors purpose being to have an effective voice in the management of the enterprise”(Outsiders response to European Integration, eds. Hirsch et al, p 52)

FDI flows can be put into two wide categories. Either the parent company makes a direct net transfer to the foreign affiliate through debt or equity, or earnings can be reinvested by the foreign affiliate. If the investment is financed by for example local borrowing or some other way it is not registered as FDI which means that the total amount of investment done by foreign companies might be underestimated by FDI. (Hirsch et al, 1996)

Normally, FDI decisions are based on the decision to either buy or make the company grow internationally. As mentioned earlier this can be done by making a Greenfield investment, through organic growth or with the help of M&A (mergers and acquisitions). To buy international growth is usually riskier but faster than making the companies grow. To buy the company's growth through M&A's is also very expensive because large parts of the resources that are bought may not be wanted. Employee resistance is also likely and this decreases the unilateral control over the company. When companies are growing organically the employee resistance is usually low and the control over the company is high. The majority of regulatory barriers that EU and the US have on M&A's are also avoided when the company is growing organically. The disadvantage with organic growth is that it is often slow and costly. To form a strategic alliance is a third option that is becoming increasingly popular. An alliance can be everything from a formal joint venture to a network relationship that is long term. A strategic alliance is often quite inexpensive, flexible and fast. By working together, the companies can create synergies that would be too costly to acquire or grow internally. Employee resistance is also often low compared to M&A's because the company is not bought. The drawback with strategic alliances is that the control over the company has to be shared. This type of growth is also often inflexible because several companies have to agree on strategic decisions. (Larsson et al, 2003)

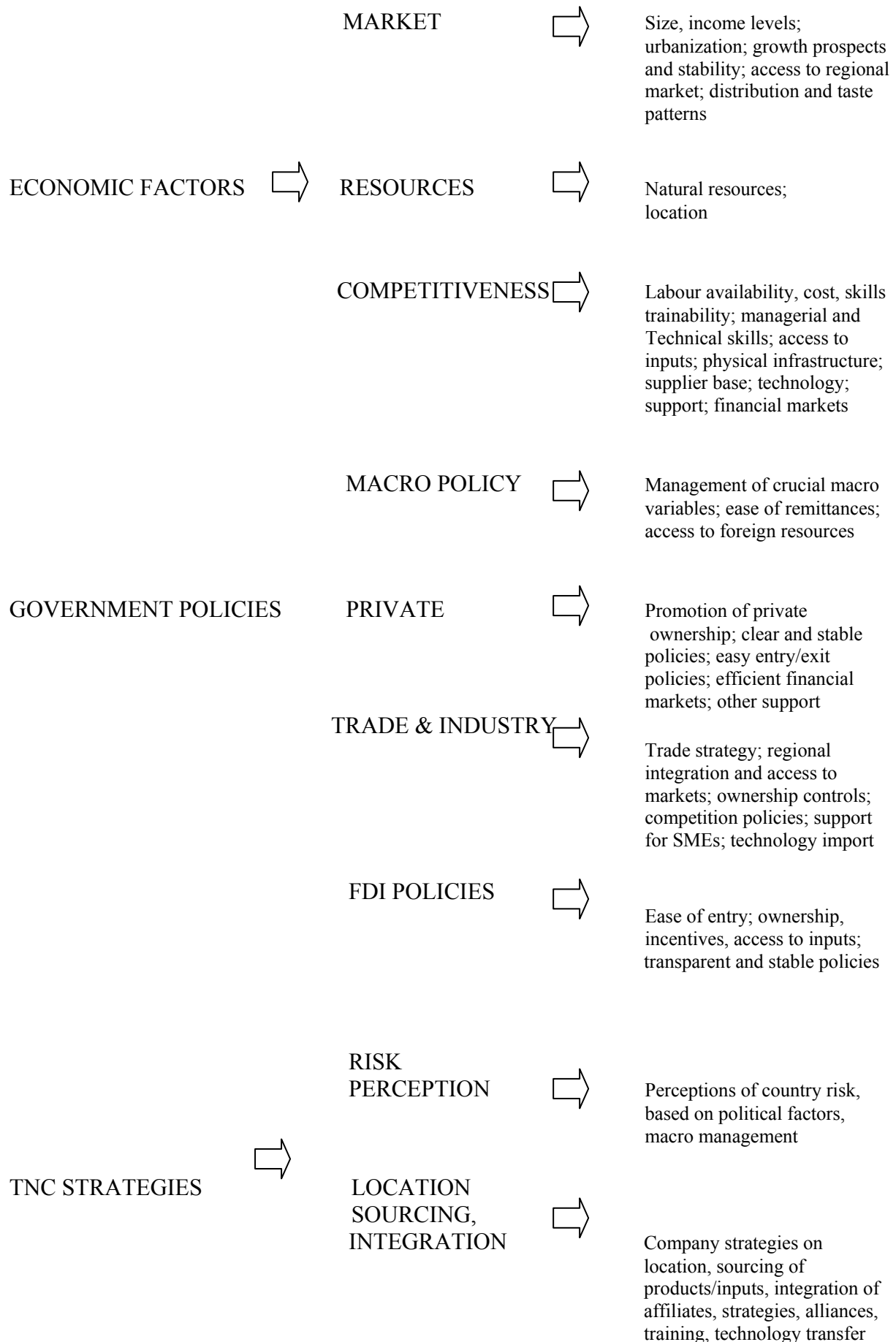
### 3.2.2 Location of FDI

The decision of where to locate a firm depends on a mixture of firm specific factors and more general institutional or country-based considerations. Differences in relative costs, the need to reach a competitive position in markets and global strategies are all factors that help determining where to set up production. One factor that is becoming increasingly important is the design of economic policy within countries and regions. The risk of a global race for investment has increased as policy-makers have started to realise the political pay-offs of attracting investments. Depending on how this race develops and how far it goes, latecomers might end up with a permanent lower growth. During the 1980s there was an institutional wedge created between outsiders and insiders by European integration. There was a massive inflow of FDI in EU in the late 1980s and early 1990s which indicates that companies were

expecting that insiders would mainly benefit from the internal market. There is also evidence showing that the fear of being excluded from the EU market with its potential growth was a major reason for European as well as Asian and American firms to invest in the common market. (Hirsch et al, 1996)

A protectionist trade policy is said to increase FDI. If the level of protection is high foreign investors want to jump the trade barrier through local production. (Tore Ellingsen et al) This “tariff-jumping” theory was the main view in the early theory on foreign investment where they usually regarded capital movements and trade as substitutable modes of serving foreign markets. The more recent literature, however, sees another major motive for FDI, the exploitation of intangible assets. Firm specific intangible assets as for example technological expertise gives the company a competitive advantage. To use these assets the firm sometimes need to “internalize” their international operations by establishing foreign affiliates since e.g. licensing of technology to foreign firms brings along quite high transaction costs. Therefore, some FDI is expected even when there are no formal trade barriers. Regional integration would not lead to a reduction of investment that were undertaken primarily to internalise the exploitation of intangible assets. The reduction of trade barriers might instead increase FDI flows by enabling the investing company to more efficiently operate across international borders. This goes particularly for vertically integrated FDI where the different affiliates of the MNC are specialised according to the host countries locational advantage. For an international division of labour a liberal and predictable trade environment is needed. The effect on FDI flows often depends on the motives and the structure of pre-existing investment. (Magnus Blomström et al)

Yussof et al, have in the Asia-Pacific Development Journal Vol 9 No 1, June 2002, P 92 created a model that shows the determinants of FDI in developing host countries. This model gives a good overview of the determinants and all though it’s designed for developing countries it’s still applicable on the EU market. According to this model there are three main categories of factors that influence FDI decisions. There are economic factors, government policies and TNC strategies. As can be seen by the model there are also many factors within these three categories that influence the flow of FDI. (Ishak Yussof et al, 2002)



### 3.2.3 FDI Theories

There are many different theories about the motives for FDI. Three of the major ones are the

1. Macroeconomic, which examines the national and international trends.
2. Mesoeconomic, which looks at the interaction between companies at an industry level.
3. Microeconomic, i.e. considering FDI from the individual firm's perspective.

The first one is often to a high degree based on theories of trade, exchange rate effects, balance of payments and location. The second focus on industrial economics, the theory of innovation and game theory. The third one relates to the theory of the firm. A fourth level called the sub-micro level has also been identified. This level focus on the companies processes when making investment decisions. There is no FDI theory that is unanimously accepted. (Korhonen, 2005)

The latest theories, where the eclectic theory is an example, have tried to mix past ones. They focus on the industries and firms instead of the countries. They reason as follows, if a foreign firm operates in a country they face some extra costs compared to the local competitors. There are cultural, institutional, linguistic and legal differences which makes it harder for them. Because of this, in order to be profitable, the foreign firm needs advantages that local competitors don't have. The advantages can be ownership, internalisation or locational advantages.

Some of these advantages are specific to the firm and can be transferred across distance. These ownership or firm-specific advantages are a necessary but not sufficient condition for FDI. These assets that competitors do not possess can be found in the firm's employees, trademarks, patents, technical knowledge or even in intangible assets such as management, marketing and even the reputation of the firm.

If a company has an internalisation advantage it would like to internalise the transactions that exist within their hierarchies instead of allowing transactions to be made in the market. The incentive to internalise the firm's advantages is higher the greater the ownership advantages are.

Whether a company want to supply the foreign market by producing locally or exporting is decided by the locational advantages. An advantage that is locational creates an incentive to



exploit its assets in the foreign market instead of serving the market via exports from the home country. (Korhonen, 2005)

Empirical findings show that R&D intensive or high tech firms are more likely to engage in FDI. The output of MNCs is characterized by for example product newness, high R&D and technical workers. Therefore, a high ratio of the intangible assets of the firm compared to its total market value is connected with multinationality. These types of companies tend to choose FDI as a way of operating in foreign markets. This is so because traditional trade arrangements such as for example exports or licensing can erode the exploitation of the company-specific assets. Hence, FDI is conducted in order to internalize production which ensures the control over the companies own specific advantages. This internalisation theory must often be taken into consideration together with the locational factors. Examples of those are trade barriers, costs of production and market characteristics.

Another way of classifying the different forms of investments is by structuring them according to the internal structure of the investor's. If the investments are classified this way there are vertical, horizontal, conglomerate and concentric investments. (Korhonen, 2005)

A vertical investment is when a company establishes a subsidiary to handle the next stage backward or forward, in the sale of its product or in the manufacturing.

The most common form of investment is the horizontal one where the company duplicates all the parts of the production process, except for the activities performed by the headquarter, in the host country subsidiaries. By producing locally it is possible for the investing companies to increase their reputation and penetrate the local market by adapting their products to suit the requirements of the local market. To manufacture the same products in foreign markets as in the home country involves the extension of the company's monopoly advantage into world markets.

The most important difference between a vertically integrated and horizontal firm used to lie in the country specific factors, e.g. raw materials or input prices. The vertically integrated company seeks to take advantage of this and it is now a phenomenon that is to a high degree associated with FDI conducted between developed and developing countries. Vertical FDI reduces the risks because of the decreased uncertainty surrounding the supply of the upstream

good and the downstream firm's need for information. Vertically integrated firms conduct FDI to create trade barriers to new arrivals and to avoid oligopolistic uncertainty.

When the investment is concentric the foreign units sell to the same customers as the investors but with other methods of production and R&D (research and development). It could also be the other way around where the foreign units use the same method to produce and conduct R&D but sell to different customers.

A conglomerate investment is when a company produces a range of products that are internationally diversified which means that the foreign unit's products are different to the investing firms when it comes to all greatest characteristics such as technology, customers, distribution channels and production. Because of this difference the conglomerate investments are usually done with the help of an acquisition.

Investments can simply be divided into two types, related and unrelated. Horizontal and vertical investments are part of the related category since their investments are related to the company's customers or industry. Conglomerate and concentric investments are driven by the company's risk dispersion and are hence unrelated. Investments of the unrelated type create a higher risk for the investing company because of the unfamiliar industry or market. This has made it more common among companies to focus on investments of the related type. Companies also tend to get involved in unrelated investment in market that are familiar and stay in the related types of investment when the market is more distant and unfamiliar. Depending on how the company grows the investment can be seen as either an internal or external process. A Greenfield investment is a type of internal growth where the company invest in a new company and new equipment. This builds the capability and knowledge within the company. The acquisition of a plant and equipment that already exist is an external investment. If a certain location has some important factors of production and there are no suitable partners a Greenfield strategy is normally adopted. In developing countries it is the most common type of FDI.

The fastest way of entering a new market is by purchasing an existing company or by cross border M&A. The advantage with this approach is for example that the company get a local distribution channel and a market share that is already built up. It is however often hard to integrate two different organisations. This form of FDI is the most common one in countries that are developed.

A company can also do a joint venture or set up a wholly owned subsidiary. To fully own the subsidiary gives complete control of production decisions, decision making, operations, management and technological assets, which obviously is an advantage. The disadvantages are mainly the capital needed and the shortage of internationally experienced management staff. Cultural differences as well as economic, legal and political aspects could also create problems for the wholly owned subsidiary.

A joint venture gives the investor access to for example market knowledge and specialised skills via the local partner. With a partner that is well connected and has government contacts a joint venture is many times the most rewarding way to invest. However, often the contributions made by the partners are not proportionate. In many cases the local partner only provides local facilities and labour while the company investing must provide with the technology, capital, training and equipment. The joint venture can be done with one or many partners. (Korhonen, 2005)

### 3.2.4 Firm specific strategic motives as incentives to FDI

Recently, some research have emphasised that strategic advantages alone can trigger FDI. These scholars argue that there are two types of narrowly linked locational advantages. The first one is the traditional locational advantages considering the costs of e.g. transaction and inputs. The other one is the strategic locational advantage, which is said to be more relevant. Here it is assumed that FDI is made in order to defend/increase their market power and this can be done by showing a commitment to be established in a geographical market.

Firm-specific strategic motives can be divided into five main types of not mutually exclusive considerations.

1. **Market seekers** are primarily looking for better opportunities to enter and expand within markets. They produce in foreign markets either to export to third markets or to satisfy local demand. Often is for example market size, competitive situation or the markets growth prospects the motivation for investment. This type of FDI is also common when access is restricted or the market is closed. Many studies have showed that these factors are the major motive for conducting FDI.

2. **Raw material seekers** are normally e.g. oil companies or mining industries. They extract raw materials wherever they can be found and then either export or process and sell them in the host country. Here the cost of inputs is usually the motive for the investment.
3. **Production efficiency seekers** produce in countries where some of the factors of production are under priced compared to their productivity. The cost of for example, energy, labour, transportation or the presence of a labour force that is very skilled, are the motives for investment.
4. **Knowledge seekers** try to access technology or managerial expertise by undertaking FDI. This type of investment usually has locational needs such as e.g. organisational competence, learning experience or technical knowledge. The majority of this kind of investment is found in industrial economies that are advanced. The role of this strategic asset seeking investment has increased which can be seen by the increase in mergers and acquisitions.
5. **Political safety seekers** tries to minimise the risk of expropriation by either investing in countries that are not likely to interfere with the company's operations or in the form of divestment from countries that are politically unsafe. (Korhonen, 2005)

### 3.3 The influence of tax rates on FDI

Differences in tax rates between countries affect the behaviour of firms in different ways. First, it provokes profit shifting with the help of for example debt contracts. Second, taxes determine how much dividend the subsidiaries send home to their parent companies. Thirdly, company taxes affect how the real investments of international companies will be allocated. The latter is the one that has received most attention because of its welfare-economic importance. (de Mooij et al, 2001) It's also the one that will be further investigated in this thesis.

In an investigation on the tax effect on FDI in the USA, it was found that state tax rates to a very high degree influence where the investment was located. A 1 percent difference in state tax rates lead to a difference of 9-11 percent in shares of manufacturing capital owned by investors. A difference of 1 percent state tax rate also change the willingness of investors to establish affiliates by 3 percent. It wouldn't be correct to say that a state tax increase from 6 to

8 percent would lead to 20 percent less investment, but the effects that are estimated are big and important when evaluating the impact of tax changes. The effect on investment that differences in tax lead to is most noticeable when tax rates are low. In the sample period, five of the 50 American states had corporate tax rates that was zero. The behaviour in these states affects the investment result of the observations so much that if they were removed from the observations the statistically estimated effect of taxation on capital ownership would have been indistinguishable from zero. However, removing these states from the sample observations wouldn't influence the estimated effect of the numbers of affiliates.

Research on state taxation that has been conducted earlier hasn't really found a link between business location and tax rates. The easiest explanation of this is that it's difficult to control important unobservable variables. California and New York can be seen as examples. Both states have high levels of investment as well as high tax rates. The high amount of investments are not due to the high tax rates but is a result of attractive locations such as Silicon Valley and Manhattan which encourages investment even though the taxes are high. If other considerations like these can be held constant, large differences in investments can be influenced by even small changes in tax rates. (Hines, 1996)

The EU has during the last decade reduced its average company tax rate from 38 percent in 1990 to 33 percent in 2000. The reductions in taxes are motivated by the increase in the mobility of capital and the increasing internationalisation of businesses. The aim with the tax reductions is to attract foreign companies. This behaviour might be reinforced by the EU code of conduct on business taxation which forbids the use of tailor-made tax measures to attract FDI. There are fears that these tax cuts in Europe will lead to a degradation of tax systems which would threaten its redistributive function. This has led to suggestions of harmonising the capital income tax rates among the EU members. These discussions about tax harmonisation arise from the belief that tax rates play an important role in how multinational firms behave. (de Mooij et al, 2001)

### 3.4 The influence of Human Resources on FDI

There are many things that determine how competitive a country is. For example, availability of resources, how open the economy is, technological advancement and the capacity of human capital. The economy is more likely to gain from participating in the market competition if it is more competitive. It is for example reported that the nations with the largest degree of world trade, and therefore most likely enjoying economies of scale, lost ground in industrial exports to challengers mainly from Asia because of a decrease in their competitiveness. To ensure inflows of FDI it is an essential prerequisite to have a competitive environment. (Yussof *et al*, 2002)

The most crucial element in human resource development is to have a high level of education. A country's attractiveness for inward FDI can be greatly improved by having educational policies that increase the quality and supply of the human resources. An education system that is efficient can possibly create a labour force that can use modern techniques and production facilities. Authors have argued that the most important labour requirement usually is to find people that has a secondary education and can be technicians, managers or administrators. (Noorbakhsh *et al*, 2001)

New technological improvements and the change of FDI toward industries that are more knowledge, skill and capital intensive have made MNEs more interested in the availability of highly educated labour compared to low labour costs. The globalisation has increased this change which has made MNEs interested in creating new strategies that will improve their competitiveness. Because of this companies organise their activities so that R&D, accounting, distribution, finance etc are performed by affiliates that are located in the areas that are most suitable for the different activities. By doing this the companies' use FDI as a way to rationalise their production by accessing factors of production internationally. (Noorbakhsh *et al*, 2001)

One thing that is found among all richer developed countries is the amount of highly skilled human capital among the workforce. It is debated whether this has been the driver of economic growth or if it is the other way around. Whatever the answer is it has been seen in empirical investigations that HRD and economic growth follow each other. This has also been

seen among some of the developing countries. The thing that set these countries apart from the other developing countries was their ability to gain financial benefits by attracting FDI. This means that they have attained a fast economic growth by attracting inward FDI. (Miyamoto, 2003)

In recent years the flows of FDI to the developing countries have increased dramatically. The major part of these investments however has gone to a small number of nations. Therefore it has been argued by authors that it might be possible for developing countries to increase their amount of FDI inflows by increasing the capabilities of their human resources and enhance their level of local skills. (Noorbakhsh et al, 2001)

As mentioned before there are many factors that influence companies about where to invest. Market size, cost of logistics and availability of production factors are all examples. However, it has also been showed when looking at countries that successfully have attracted FDI, that many of these factors are indispensable. One of these indispensable factors is the amount of human capital which has turned out to be a crucial factor that in particular the high value added MNEs were looking for when deciding where to invest. In recent times this has become even more important since the production of MNEs is getting more skill biased. There is an increasing number of MNEs that has manufacturing that is high tech or provide services and are looking for labour force that has knowledge in technology, business administration, organisational skills or engineering. (Miyamoto, 2003)

There are only a few empirical analyses that are cross-country and identify the inward FDI determinants. The reason for this can be that it is hard to construct qualitative variables that are explanatory. This is especially so for human capital indicators.

The analyses that have been made can be divided into two categories. The first one cover the time period between the 1960s and the 1980s and the second one covers the 1980s and half of the 1990s. In the first category an analyse made by Root and Ahmed examined 58 developing countries using human capital proxies such as school enrolment and availability of professional and technical workers. In this analysis no evidence was found that these proxies were determinants of FDI. Another analysis made by Schneider and Frey were investigating 54 developing countries. They looked at the amount of people with secondary education and found that this determinant was not significant compared to other influences such as political and economical ones. Another author named Narula showed that the amount of people with tertiary education in a country did not affect the amount of inward FDI in the 22 examined

developing countries. These studies and other that were made in the same time period showed that human capital is not an important factor for attracting FDI. However, these investigations were made in developing countries and in the 1960s and 1970s companies investing in these countries were looking for resources or lower end types of manufacturing which means that natural resources and cheap labour were more significant. This means that it should not be expected that higher educated labour was high in demand during this time period.

(Miyamoto, 2003)

The second category of analysis that covered the 1980s to mid 1990s showed a different result. In these analyses it was found that human capital has a positive effect on the inflows of FDI and that the effect became larger over time. The largest difference in these results, if compared with the first category of studies, comes from the fact that the authors used a data set that contained more high value added manufacturing companies. The data were also more recent. The largest part of the MNEs that operated in developing countries during the end of the 1980s and 1990s were subcontracting or looked for efficiency improvements which increases the demand for a labour force that is highly skilled.

Also among developed countries this effect was found. In an investigation made by UNCTAD a high correlation was found between proxies for human capital and inflows of FDI. The proxies were student ratios of engineering and science and tertiary gross enrolment ratio.

Another analysis used 28 developing countries and looked at the average years of education among the population that was over 15 years. They found that from the middle of the 1980s to the end of 1990s education became more and more important as a determinant of FDI.

(Miyamoto, 2003)

Other reports have shown that low labour costs are not always a determinant of FDI. If staff costs are a proxy for skills this could indicate that FDI goes to areas with high salaries because of the need for high skills. (Noorbakhsh et al, 2001)

These results indicate that, especially among MNEs that are efficiency seekers, human capital is an essential determinant of inward FDI. Among resource or market seeking MNEs human capital is not so important. This evidence is consistent with the fact that the FDI growth in Africa was made by MNEs that were market seekers or looking for natural resources which lead to the stagnation of the of human capital growth in this region. (Miyamoto, 2003)



By looking at this evidence one might think that nations, that want MNEs that are market or natural resource seekers, do not need to enhance their human capital while it is important for nations seeking value added MNEs to have a high level of human capital. This is not true because enhanced human capital reduces corruption and crime and also increases the health and political stability in the country. All these factors are considered to be crucial determinants of all types of FDI which mean that human capital can play an important role for all types of FDI. The reason for why the studies during the 1960s and 1970s did not find that human capital was an important determinant could be that some of the other control variables might have captured the effects that were created by the enhanced human capital. An example of this could be the political and social stability which is a determinant of FDI that could be enhanced thanks to an improvement of the human capital. It could also be that the effects of enhanced human capital take a while before it makes an impact on the political and social stability. (Miyamoto, 2003)

Nations that uses natural resources or low cost labour that is also low skilled as incitements for FDI must also consider that their economic growth probably will suffer because they do not attract high value added companies. The low cost of labour might also only matter in some low technology operations such as low end garments. This because semiconductors have turned into highly automated and capital intensive industries. (Noorbakhsh et al, 2001)

The minimum amount of education needed in order to attract FDI that is efficiency and high valued added seeking seem to be secondary school level. The evidence is however limited and it also does not tell what kind of human capital that is the most suitable for attracting inward FDI. The proxy for human capital used by the major part of the cross section studies is secondary or tertiary level of education. Not a single one of these studies tries to identify the type or level of human capital that is the most effective. There are also only a few studies made that show the minimal level of human capital that is needed for promoting inward FDI. (Miyamoto, 2003)

The last years there have been a couple of surveys made where direct questions have been asked regarding the companies motives for choosing certain locations over other. Analyses of these surveys have shown that the level of human capital is a crucial criterion for companies choosing where to invest. One of the crucial factors is the possibility to hire staff that is skilled and has technical and managerial knowledge. Another survey showed that the

possibility to hire plant and managerial staff that are superior is one of the crucial factors for Japanese companies when planning where to make their future investments.

(Miyamoto, 2003)

The empirical evidence and the literature on FDI and human capital suggest that human capital is a crucial determinant of inflows of FDI. This is especially the case among companies that are efficiency seeking and need a talented workforce as one of their key inputs. Even if market or resource seeking inflows of FDI do not seem to be affected by higher human capital it can still be affected indirectly thanks to for example an improved health and a lowering of the crime rates. After the 1980s the minimum level of education needed seems to be basic schooling. The last years the tendency has been that FDI move towards being more skill intensive, both in the service and production industry and that the manufacturing based on resources has declined. This means that for developing countries basic schooling must be the absolute lowest level of education. The EU countries, which are all developed, are mainly looking for higher value added MNEs which mean that they must be able to provide human capital that is way above basic schooling. (Miyamoto, 2003)

## 3.5 International tax systems and treaties

### 3.5.1 International tax systems and double taxation

One potential problem for companies making FDI is the threat of being taxed twice on their foreign investments. Since governments are aware of this there are different ways of avoiding the problem with double taxation. One way is to provide foreign tax credits for taxes that are paid to foreign governments. This system is used by many OECD countries. If the foreign tax credit system is used companies have to pay taxes on profits made in foreign countries but they are allowed to claim credits against home country tax liabilities for the taxes they have paid in the foreign country. As an example we can take a Japanese firm investing in USA, let's say they earn a profit of 100\$ and pays 35 percent in taxes to USA. In Japan the net corporate tax rate is about 52 percent. The firm can then claim a foreign tax credit of 35\$ which reduces

the obligation to the Japanese government to 17\$ (52\$ - 35\$). However, there are many complications associated with this tax credit system. Countries can for example limit the foreign tax credits. It is also common that home countries wait until the foreign profits are repatriated from the foreign country and then tax them. (Hines, 1996)

Another system that can be used and which is common among EU countries is the tax exemption system. This system exempts taxation in the parent country if the foreign income is already taxed in the host country. This means that the profit of the subsidiary is only taxed in the host country. Countries that use the exemption system have different conditions for these exemptions. Some demand that the company control a substantial part of the subsidiary and that a certain amount of foreign corporate income tax is paid. Other countries use less severe conditions of e.g. ownership shares.

There is a Parent-Subsidiary Directive in the EU that make sure that countries either use the exemption system or the credit system in order to avoid double taxation within the EU. (de Mooij et al, 2001)

### 3.5.2 Bilateral tax treaties

Bilateral tax treaties adjust the tax environment for investors resident in the treaty partner's countries. This is done by specifying what tax base that is applicable, as well as the applicable withholding taxes and other measures that affects FDI taxation. There are over 2000 tax treaties in the world that are in force and these treaties govern the majority of the taxation made on FDI. (Blonigen et al, 2002) A majority of the tax treaties loosely follow the OECD's (Organisation for Economic Cooperation and Development) or UN's (United Nations) recommendations. Even if these models have undergone many revisions they still normally form the basis for the majority of tax treaties. (Blonigen et al, 2004) As stated in the OECD's model tax treaty the goal of forming a treaty is to remove the obstacles that double taxation creates which will reduce the effects that are harmful on the exchange of services and goods and the movement of persons, technology and capital. (Blonigen et al, 2002)

Plenty of different incentives to investment can be found in the individual treaties but normally they all have two ways of reducing barriers to FDI. The double taxation of

investments can be reduced by harmonizing both the definitions of tax and the treaty partner's tax jurisdiction. Income is for example most often taxed in the host country in the cases where a permanent establishment has generated the income. If there is not any treaty every country can create its own definition of what a permanent establishment is and this difference in definition can cause double taxation of the foreign profits. This means that the difference in definition can create capital flows that are inefficient.

The second way of reducing the barriers is by affecting the rules that concern the multinationals actual statutory taxation. This is done by affecting the rules concerning the relief of double taxation and the withholding taxes that FDI repatriations are levied on. The majority of tax treaties specify, according to the guidelines in the OECD model, that profits that are foreign earned must be exempt from home country taxation or offered tax credits when the home country tax is calculated. As well as offering relief from double taxation, most treaties also reduce the maximum withholding tax that is allowed on three different types of income. These are interest payments, royalty payments and dividend payments. Normally it is specified in the treaties that both treaty partners must apply the same maximum rate. In certain treaties the withholding rates have been lowered all the way down to zero.

Bilateral tax treaties also improve the exchange of information between the governments that are partners in the treaty. This can in some cases lead to tax evasion being included in a treaty which leads to an increase in tax revenues for the governments. (Blonigen et al, 2002)

### 3.5.3 Conclusion

When doing the empirical research the author will mainly use the recent theory of firm specific strategic motives to FDI. This theory was described earlier in the theory section. This theory is easily applied to companies when doing the empirical research. The strategic reasoning behind FDI decisions is also the area that the respondents in the case studies are most familiar with which makes this theory the most suitable for the following case studies. In the business law part of the empirical findings mainly case law will be used. The treaty freedoms will also be used when analysing the possible application of MFN treatment in bilateral tax treaties according to EC law. To give a background to the legal issue, international law and international trade law will be described before EC law is analysed.

## 4 Empirical findings

### 4.1 Case studies of 5 Swedish companies

#### 4.1.1 Ericsson

Ericsson was founded in 1876 when Lars Magnus Ericsson opened a shop in Stockholm that repaired telegraph equipment. A few years later he delivered switchboards and telephones to the first telecom operator in Sweden and Stockholm was soon the city in the world with the greatest density of telephones.

Ericsson is today one of the world leaders in the telecom business and business related to fixed networks and mobiles. Over 140 countries and more than 1000 networks around the world uses Ericsson's network equipment.

The types of products that Ericsson develop and sell can be divided into three business segments.

Systems: This in turn can be divided into three parts consisting of Fixed Networks, Mobile Networks and finally Professional Services.

Phones, in this segment the company has a 50/50 joint venture together with SONY Corporation.

Other Operations, this segment has several businesses, all of them quite small. Examples are Mobile Platforms, Enterprise Systems and Network Technologies.

Ericsson has 14 major manufacturing and assembly facilities around the world. Out of these are 5 located outside of Sweden. The company also has, besides the joint venture with SONY, many other smaller joint ventures and cooperative arrangements around the world. (Annual report, 2005)

#### 4.1.2 The importance of human capital in the case of Ericsson

Ericsson invest heavily in R&D and have around 16 500 people working in R&D departments in 17 countries around the world. When Ericsson is making investments in a R&D centre the level of human capital in the country is considered to be a very important factor. Ericsson also cooperates a lot with universities and research institutes in the countries where the R&D centres are located which make a high educational standard crucial for achieving good results. This means that for Ericsson is the level of human capital a crucial determinant when it comes to direct investments in R&D centres. Other factors usually also affect the decision where to locate the R&D centres but they are normally not as important as the level of the human capital. (Survey, Susanne Andersson) (Annual Report, 2005)

Also when investing in factories that manufactures and assemblies, the level of human capital is considered to be important. In these types of investments however there are many factors that are important when deciding where to invest. Factors like the production costs, where the cost of labour is an example, are considered to be more important than the level of human capital when investing in production facilities. This is probably because Ericsson has full control over these factories which means that they easily can control the production and the quality of the output.

The same type of control might not be possible when Ericsson outsource its production which the company does with quite a large part of its production. When Ericsson chose to outsource there are two factors that are considered to be the most important. These are that the production facilities has the adequate capacity and more importantly that the right expertise is available. This can be interpreted as that the level of human capital is one of the two most important factors when choosing where to outsource the company's production. (Survey, Susanne Andersson) (Annual Report, 2005)

### 4.1.3 The importance of taxes in the case of Ericsson

In Ericsson's annual report a chapter is dedicated to Forward Looking Statements where different risk factors are highlighted. Among these risk factors the risk of changes in tax liabilities is found. This is considered to be one of the risks when investing abroad that the company wants to highlight which indicate the importance of taxes when investing.

In the answers from the survey it could also be seen that taxes are considered to be an important determinant for FDI decisions. The determinant that was most important for the FDI decisions differed between the different investments and generally there were many determinants that were important. Generally it could be said that taxes was important but not the determining factor. (Survey, Susanne Andersson) (Annual Report, 2005)

### 4.1.4 AstraZeneca

AstraZeneca is a pharmaceutical company with many leading products in areas such as cardiovascular, infection and inflammation. The company has over 65 000 employees in more than 100 countries around the world. The corporate office is located in London and the R&D headquarters are located in Sweden.

AstraZeneca has five main areas that the company has identified as strategic priorities. These are:

Products, where sales growth is maximised by for example expanding into emerging markets and by defending the company's intellectual property rights.

Pipeline that delivers a portfolio with many different medicines that take care of the patients needs. This is done by for example discovering new drugs either via in-house research or together with research partners.

Productive Use of Resources, which can be divided into three parts. Effective Leadership, that uses the available resources in best possible way. Best Practice, in all part of the business which is done by for example harmonising production processes and create cost effectiveness.

New Practice, which means develop business approaches that are new and meet customer needs by for example investing in new promising areas of healthcare.

People, are encouraged to perform at their best with the help of a company culture that is performance driven.

Reputation, by living up to high ethical standards the company aim to keep the customer, patients, employee's etc confidence and trust.

AstraZeneca has a very extensive global marketing and sales network. In the majority of cases, at least in the major markets, the company wholly own the local marketing/sales companies. The company also has 14 000 people that work in the 27 production sites. These manufacturing sites are spread out over 19 countries in the world. Many of these are found in the EU, for example in France, Sweden, UK and Germany. (Annual Report, 2005)

This means that AstraZeneca has plenty of experience in the area of FDI around the world and in the EU.

#### 4.1.5 The importance of human capital in the case of AstraZeneca

In the interview with a representative from AstraZeneca the first question asked was if the respondent could mention the most important factor for choosing a certain country when making FDI in the EU area. The answer was that it was the availability of competent personnel and availability of for example researcher and managers with the right expertise in the country. In other words the level of human capital in the country. Another important determinant was to get access to the local markets in EU but it was not seen as being as important as the human capital. This can also be seen if looking at where AstraZeneca has chosen to locate its FDI. Besides the earlier mentioned countries like Sweden and UK that are not exactly the low cost type of countries, AstraZeneca also invest in for example the US. All of these countries have access to highly educated personnel and a corporate culture that embraces R&D.

AstraZeneca thus mainly invest in countries with a high level of human capital but the company also moves personnel around the world in order to ensure that competent personnel is available in the different production sites around the world. It is mainly scientists and researchers that are moved to the countries where the investments take place but also other type of personnel is moved. (Interview, Henrik Israelsson)



#### 4.1.6 The importance of taxes in the case of AstraZeneca

No information about the importance of taxes when making investments was found in the company's annual report. Also the respondent in the interview was hesitant to talk about the importance of taxes. The respondent said that taxes were important but that it was hard to say how important compared to other determinants of FDI. The respondent did not have the knowledge about tax issues that were needed in order to give a correct answer so more information could not really be given. (Interview, Henrik Israelsson)

#### 4.1.7 Anonymous company

This company operates in a capital intensive and high technology industry where it focuses on three main business areas. The company is market leading in all these three areas. It operates in way over 100 countries around the world. (Annual Report, 2005)

#### 4.1.8 The importance of human capital

When interviewed the respondent gave many reasons for the company to make FDI in the EU area. Examples are a favourable geographical location, logistic advantages and low labour costs. The company is as mentioned earlier a capital intensive company. It is not labour intensive and the level of human capital is not seen as an especially important factor when choosing where to locate the FDI. The work done in the foreign affiliates is not so technically demanding for the majority of the personnel and it is more important for the company that the labour is cheap than that the labour is highly skilled.

The only time that the level of a country's human capital is important according to the respondent is when the company is investing in research centres around the world. In those cases it is a factor that is considered when choosing the appropriate location. The company has also chosen to locate its main R&D centres in countries well known for being in the

forefront when it comes to research, Finland, Sweden, USA and Austria. Sweden for example has the highest research share in the world with 4, 3 percent of GDP spent on research in 2003. Finland came second in the world with 3, 5 percent of GDP spent on research. (www.n24.se, 2006-05-15) The level of the human capital is however not the main determinant even when investing in R&D centres. This is partly so because of all the new technology such as for example internet which makes it possible to work across borders and to easily exchange information and knowledge without being in the same physical location. (Interview, Senior Business Manager)

#### 4.1.9 The importance of taxes

The respondent in the interview did not consider taxes to be an important factor for FDI decisions. This financial effect was not given much attention and there were many other factors that were considered far more important. The respondent meant that if there were two countries to choose from, and all other conditions in the countries besides the tax level were the same, the company would chose the one with the lowest tax. This type of situation is however quite rare. (Interview, Senior Business Manager) There is also not anything mentioned in the Annual report about any possible effects that taxes might have on the companies FDI decisions.

#### 4.1.10 Assa Abloy

Assa Abloy produces and supplies locking solutions. The company is the world leaders in this segment and has more than 150 companies in over 40 countries. Their global market share is around 10 percent and the company offers a range of products that is more complete than any of their competitors. Assa Abloy was formed in 1994 and has gone from being a regional company having 4 700 employees to being a global player having 29 500 employees. The Assa Abloy group is divided into 4 divisions.

**Americas**, which is made up of the North and South American companies. The division has 9 300 employees spread out in 24 production units and 8 sales companies. The most important markets in this region are Canada, USA and Mexico. Examples of companies in this division are Medeko and Emtek.

**EMEA**, is the division that comprise of Assa Abloy's companies in Africa, the Middle East and Europe. This is the largest division with 41 percent of Assa Abloy's total sales. The head office is in Stockholm and the main markets are France and Scandinavia. This division has 12 400 employees in 30 sales companies and 46 manufacturing facilities. Examples of the most important companies in this region are Tesa, Abloy and Assa.

**Global Technologies**, is Assa Abloy's global organisation for products and services that are sold worldwide. This division has 3 500 employees in 40 sales units and 15 manufacturing facilities. The division is divided into 4 business units.

- Assa Abloy HID, mainly produce and sell card readers and ID cards.
- Assa Abloy Identification Technology, examples of products in this unit are electronical passports and electronic tagging of for example livestock.
- Assa Abloy Entrance System, this unit is the global leader in selling electronic door solutions.
- Assa Abloy Hospitality, this unit sells security systems and hotel locks.

**Asia Pacific**, this division covers the companies in China, Australia, New Zealand and the rest of Asia. This division has 4 300 employees in 8 sales companies and 9 manufacturing facilities. The main markets are Australia, China and New Zealand and examples of the largest companies in Asia Pacific are Assa Abloy Australia and New Zealand. (Annual Report, 2005)

#### 4.1.11 The importance of Human Capital

The most important factor when Assa Abloy is making direct investment is to get access to the local market. Another important determinant is the lowering of the production costs. This is the reason for why Assa Abloy locates much of its production in low cost countries. The level of the country's human capital is seen as important but it is not a crucial determinant. Assa Abloy has a strategy where they often buy an existing company which gives them access to knowledge and competence within that area. They then expand the business that they have bought which make it possible to use the already existing human capital as a way of educating the new staff in the expanding business. In order for this strategy to work there need to be already existing companies with employees that are fairly qualified so that they can draw knowledge from these employees when expanding the business. Because of this does an attractive location for FDI need to have a certain level of human capital according to Assa Abloy.

(Interview, Senior Manager)

#### 4.1.12 The importance of taxes

The effect of taxes on the company's direct investment decision is not mentioned in the annual report which might indicate that it is not seen as really important. The representative from Assa Abloy that was interviewed however considered taxes to be an important determinant of FDI. Since one of the main goals for the company when making FDI is to save costs and to be able to produce as cheap as possible it is obviously an advantage with low taxes. The manufacturing facilities of the company are also often located in countries that not only have low production costs but also low taxes. (Interview, Senior Manager)

#### 4.1.13 Atlas Copco

Atlas Copco is a company with over 27 000 employees that has businesses in over 150 markets. The company headquarter is located in Stockholm. The company is operating in the field of industrial productivity solutions where it is the world leader. The company can be divided into four main business areas.

**Compressor Technique,** The companies in this area are working with for example electric power generators, coolers and air compressors. The different companies develop, produces, markets and distribute these products and many more. Most of the business is concentrated to Belgium but there are also units in for example China, Brazil and France.

**Construction and Mining Technique,** This area is developing, producing and manufacturing mainly drilling and construction tools. This area mainly develops and produces its products in USA and Sweden but also in for example Austria and Finland.

**Industrial technique,** This area develops, produces and markets for example assembly systems and power tools. The development and production in this area is done in for example China, Sweden, UK and India.

**Rental Service,** This area has 465 rental stores spread out in 38 states in the US and 5 provinces in both Canada and Mexico. This area rents out equipment and related services to companies working with for example industrial production and construction. The business is also supported by sales in used spare parts, equipment etc. (Annual Report, 2005)

#### 4.1.14 The importance of Human capital

Atlas Copco mainly chooses a certain location for FDI in order to penetrate the local market. They also invest in order to add their product and service range. This is normally done via acquisitions. The level of the human capital in the location is however also very important. In the business area, industrial technique, there were two new acquisitions made during the last year and the most important reason, after getting access to the market, for these acquisitions was to gain the technical knowledge that was found in the newly acquired businesses. The

importance of the human capital can also be seen when looking at where Atlas Copco chooses to invest. They have production in some low cost countries like China and India but they chose to locate a large part of their foreign investments in countries with a high level of human capital like the US, Austria, Finland and Belgium. Competence development is also an important part of the company's strategy. One example is the training of the staff members where every employee on average got 48 hours of training last year. (Interview, Finance department member) (Annual Report 2005)

#### 4.1.15 The importance of taxes

There were no special comments made in the annual report regarding taxes and direct investments. The respondent in the interview also said that he did not think that taxes were important for Atlas Copco's investment decisions. He said that it obviously was no disadvantage if there was a low tax level in the region where they were considering investing but it was not at all an important determinant.

#### 4.1.16 The Swedish Trade Council

The Swedish Trade Council is an organisation that is financed by the Swedish Government and Swedish Businesses. This organisation offers Swedish companies free advice and strategic consulting both in Sweden and in the country where the companies want to invest. 450 people are employed by the Swedish Trade Council and the organisation is represented in more than 40 countries. The organisation works together with the Swedish embassies and the chamber of commerce in the countries where it is not represented. Thanks to these networks the organisation is able to offer its services in over 100 countries around the world. The Swedish Trade Council's aim is to make it easier for Swedish companies to grow internationally. ([www.swedishtrade.se](http://www.swedishtrade.se), 2006-05-14)

The organisation was founded 34 years ago and is very experienced when it comes to helping Swedish companies with their FDI decisions. This makes them suitable to answer questions about what factors Swedish companies consider to be important when making FDI.

#### 4.1.17 The importance of human capital

Two people from the Swedish Trade Council were interviewed and both of them thought that the most important determinant for Swedish companies investing in EU was to gain access to the local market. EU was also seen as an important determinant since companies could move production to countries with cheaper production such as the Eastern Europe countries but still have easy access to the whole EU market. Geographical factors were also important which was considered to be one of the reasons for why many Swedish companies have moved to the Baltic States. These countries are conveniently located for Swedish companies at the same time as they have cheaper production compared to producing in Sweden. (Interview, Mauro Gottsson) (Interview, Katrin Lindblom)

The level of the country's human capital was considered by both respondents to be a very important determinant of FDI. It had even been noticed at the Trade Council that many Swedish companies were investing in the Baltic countries because of the high level of human capital that is found there. One of the respondents also said that Swedish companies experienced that the younger working generation in the Baltic countries was becoming more and more "market oriented" and had a more "professional" attitude towards making business which was seen as very positive by the Swedish companies. The Trade Council had also noticed that Swedish companies experienced that people in the Baltic countries had a high level of education which was a reason for why they chose to invest there. (Interview, Mauro Gottsson) (Interview, Katrin Lindblom)

Many companies also invest in certain countries because of the special skills that are available there. One of the respondent said that it has become more common that companies from different countries chose to make direct investment, in specialised areas, in some of the new EU Member States because of the high competence the human capital has in those countries. One example is Czech where companies from many countries have located their car manufacturing because the labour force in the country is very skilled in car manufacturing. This increase in the level of human capital in the new EU Member States make these countries very attractive for investments compared to the "old" EU Member States like for example Germany. This because these countries still have lower production costs but they are

quickly improving their human capital which make them very competitive. (Interview, Katrin Lindblom)

#### 4.1.18 The importance of taxes

Katrin was very hesitant to comment on how important the tax level is on FDI. Katrin did not consider her self to be an expert in the area and did not really want to give an opinion. Mauro was certain that taxes are a very important determinant for Swedish companies making FDI. It was however said that it is hard to say how important this factor is compared to other determinants. Mauro also did not think that taxes alone is a determinant of FDI or that taxes is the determinant factor in the decision even if it is important.



## 5 Legal Analysis

Throughout the thesis it has been shown that there are many determinants of FDI. There are also plenty of theories about the different motives that companies have to make FDI.

However, before analysing the results of the case studies it must be established whether the MFN principle should be applied in bilateral tax treaties according to EC law. Since MFN treatment would affect the EU tax scene and tax is one of the investigated determinants it is appropriate to first establish if there even should be MFN treatment.

### 5.1 Background

In tax treaties there are advantages for taxpayers that are residents in the states that are concluding the contract. Because these treaties are negotiated with regard to the special economic and occasionally political connection between the states signing the contract, the advantages many times change from one treaty to another. Because of this the question is if a resident of a third nation is able to claim from a contracting nation the advantages of a tax treaty that is more advantageous compared to the one signed by the third nation and the concerned contracting state. From the nation's viewpoint, the question is if a nation has to give a non resident an advantage that is part of a tax treaty signed by that nation and a nation other than the one where the taxpayer wanting the advantage is a resident. (Durr Schmidt, 2006)

In order to give a background to the issue of tax treaties and MFN treatment, international law and international trade law will be described and analysed briefly to see whether they create obligations for nations to give MFN treatment in the area of tax treaty advantages. After that EC law will be examined in order to see if an obligation for the Member States to give Community MFN treatment in tax treaties can be found.

## 5.2 MFN and tax treaties in international tax law

National tax laws are the main source of international tax law but apart from those are tax treaties the number one source. So, the answer to whether an MFN clause can be found in international tax law is found among the tax treaties. (Durr Schmidt, 2006) There are many international treaties, both bilateral and multilateral, where a MFN clause can be found. The most well known is probably Article 1 in the GATT where MFN treatment is provided for in connection with goods. (Cordewener et al, 2006) Plenty of the tax treaties are formed after the OECD Model Tax Convention on Income and on Capital. This model does not have a MFN clause which could be seen as a clear sign that there is no general rule of MFN treatment in international tax law. This was also stated in the OECD Model commentaries until 1992. This statement was removed in 1992 which might indicate that international tax law was changing and that a general MFN clause now existed. When looking at the actual practice of tax treaties however, it can be seen that the removal of the statement can't be interpreted like that. In many but not all tax treaties the MFN clause can be seen. In the majority of treaties, MFN clauses are limited to certain issues of international taxation. Because of this should MFN treatment be seen as an exception. The reason for this is that there would be no need for nations agreeing on MFN treatment in their contracts if it, according to customary international law, was a general principle. There is also a great diversity in the MFN clauses when it comes to the restrictions on the scope of the agreement. This makes it impossible to deduct a "habitual" content of MFN clauses.

There are also plenty of tax treaties with MFN clauses that were signed between two nations with a special type of relationship, for example a nation that is a former colony to the other nation. These special circumstances cannot be generalised which makes the existence of a general MFN clause impossible. (Durr Schmidt, 2006)

## 5.3 MFN treatment and international trade law

Tax treaties are affected by international trade law in a more intricate way and there are two reasons for this. The first reason is that international trade law has a large number of sources. International trade law entails plenty of bilateral treaties just like international tax law but also has many multilateral treaties.

The second reason is that it is not really for certain that trade agreements entail direct taxes and especially tax treaties.

There are many examples of multilateral trade agreements, for example NAFTA and GATT which are both important agreements. Both of them also entail a general MFN clause which obliges the contracting partners to give MFN treatment to residents of the other partners.

These clauses are unlimited which means that they cover every area that might hinder the international trade. This means that also taxes might be affected by the MFN clause.

However, it is not for sure that also direct taxes are covered since some of the agreements only cover taxes on goods which indicate that only indirect taxes are affected by the multilateral agreement when it comes to taxes. This together with the fact that taxation is a sensitive area because of its effect on the nation's revenue might indicate that direct taxes are in the majority of cases excluded from areas that might put the nation's revenue at risk.

(Durr Schmidt, 2006)

For the purpose of this thesis there is no need to further consider the applicability of multilateral trade agreements on direct taxes since it has practically no effect on tax treaties. The contracting parties to a multilateral trade agreement can reserve their rights when it comes to tax treaties. In NAFTA the applicability of MFN clauses in tax treaties is explicitly excluded. This is not the case in the GATT but there is still no doubt that the MFN principle in the GATT doesn't cover tax treaties signed by the GATT's contracting parties. Usually must exceptions to the coverage be part of the agreement. However, customary international law might also establish exceptions. This thesis does not cover whether the demands for establishing customary international law are fulfilled for not including tax treaties in the GATT. To not include tax treaties in the GATT goes together with the contracting parties' intention which was shown in the Uruguay Round. Concluding tax treaties is most often seen as a political decision which means that it shouldn't be affected by the GATT. Because of this

it can be said that tax treaty advantages are generally not covered by multilateral trade agreements. (Durr Schmidt, 2006)

As well as multilateral trade agreements there are many bilateral trade agreements which form the basis for international trade law. These bilateral agreements often have a MFN clause that is general. It is questionable if these clauses also can be applied in the area of taxation. However, because they are unlimited one could argue that taxes are covered automatically. There are also examples of bilateral trade agreements where direct taxation is expressly provided for in the MFN clause. There are also bilateral trade agreements where the MFN clause is limited and only applies to the area of taxation.

If direct taxation is covered by a bilateral trade agreement there are in the majority of cases reservations that concerns the right to for example protect revenues or give tax benefits that are based on reciprocity. These reservations are made because of the impact taxation has on the nations revenues. These reservations can be used in order to exclude tax treaty advantages that come from an MFN clause. (Durr Schmidt, 2006)

## 5.4 Community MFN and bilateral double taxation treaties.

In the text above it has been seen that the obligation to give MFN treatment in the area of tax treaty advantages cannot be found in general international tax law. Tax treaties in trade agreements are also not covered by any eventual MFN clause found in the agreement. The question is if there is an obligation to provide MFN treatment in regards to tax treaty advantages under EC law. (Durr Schmidt, 2006)

It has been questioned if the purpose and object of community law and especially the treaty freedoms make MFN treatment a community right. (Weber, 2005) It has for example been claimed that there is a legal basis for MFN treatment in Art. 10 in the EC treaty since it is stated there that Member States must cooperate with each other according to the general principle of Community loyalty. Art 10 EC however only has an auxiliary function which means that the article presupposes that more specific obligations exist and that the article

merely forces the Member States to follow these obligations. Because the clause is general and broad it is very hard to derive MFN treatment from it. Because of its unclear phrasing Art 10 EC does also not directly apply which means that it cannot be used by individuals in national courts. (Cordewener et al, 2006)

There is a sophisticated set of equal treatment rules that guarantees national treatment which is another standard of non-discrimination. The principle of national treatment guarantees that imported goods are not discriminated against in a way that favours domestic goods by imposition of a regulation or an internal tax. Hence does national treatment ensure the equal treatment between foreign and local companies/persons. MFN treatment on the other hand ensures that all foreign companies/persons that are covered by the MFN principle are treated the same way. (wto.org, 2006-06-19)

National treatment can be seen as embracing MFN treatment via its rules which would indicate that in the concept of a close community of states MFN could be generally inherent. A member state is not allowed to give nationals of another member state a treatment that is less favourable than the treatment given to another member state or a third country. Some authors however, argue that national treatment gives room for a more advanced stage of integration and thus that there isn't any need for MFN treatment. These authors argue that because discrimination is forbidden under EC law there cannot be a clause that assumes that it's possible to discriminate.

It however needs to be pointed out that when it's not possible to compare non-nationals with nationals there is no other mean than the MFN doctrine to solve the situation.

A multitude of different double taxation conventions, or as they are also called bilateral tax treaties, have been concluded between Member States and between Member States and third countries. The treaties gives mutual benefits for the residents of the contracting states by distributing taxing rights between the treaty partners. However, normally these benefits vary from treaty to treaty which could result in a situation where a member state grants tax benefits to one member state resident but not another. (Kofler, 2005)

It has been suggested that ECJ might be more willing to accept the idea of MFN treatment when it comes to tax treaties concluded between Member States and third countries rather than accepting it within the community. The potential effects of MFN treatment with non-Member States could however be more severe than the effects of intra community MFN. This is so because tax treaties between Member States and non Member States normally have tax benefits that are even further reaching than the ones concluded between the Member States. (Schuch, 2006)

There is no harmonization of direct taxation in EU. Due to this lack of political solutions, taxpayers have turned to the legal process in order to overcome discriminatory rules. This has created a large body of case law where ECJ has investigated the national tax rules compatibility with the EC treaty. This case law basically says that even if the Member States may keep their competence in direct tax matters, they have to use this power consistently with EC law and may therefore not discriminate, neither overt nor covert, on the grounds of nationality. (Kofler, 2005) This has for example been expressed in the following way: “It must be borne in mind that, according to settled case law, although direct taxation falls within this competence, Member States must none the less exercise that competence consistently with Community Law.” (Hinneken, The EJC and the new path in Community tax law, CFE Forum 27 April 2006, p 1). The principle is based on Article 5 paragraph 1 EG which is the Treaty that limits Community powers. It is also confirmed by Article 293 EC where it says that Member States resolve matters of double taxation. The principle is ambivalent because it contains, on one side the Member States competence in the area of direct taxation and, on the other side, a limitation of their competence due to Community Law principles that are higher ranking (Hinneken, 2006).

#### 5.4.1 “The Four Freedoms”

“The four freedoms”; the internal market, is an important part of the EC jurisprudence. This is the free movement of persons which includes the freedom of establishment, the freedom of movement of capital, the free movement of goods and the free movement of services. These four freedoms cover all forms of investment and cross-border activity and in conjunction with the principle of equal treatment they prohibit tax provisions that might create obstacles to economic activities across borders. However, the issue whether an EU Member State under EC law must treat a non resident taxpayer equally is unsolved. In other words that an EU taxpayer has a right to the benefits from a MFN tax treaty that is concluded by the Member State from where he gets his income. The ECJ has in several cases left this issue open. To give preferential tax treatment to businesses in some Member States and not to businesses in the other Member States seems unacceptable but if this wasn't the case there would be MFN treatment or synonymously “Community MFN”. MFN treatment would immediately

lead to a “multilateralization” of all the bilateral tax treaties that the Member States has concluded. ECJ is not impressed by a judgements fiscal consequence and hasn’t hesitated to revolutionize long standing principles of international tax policies or the internal tax systems. This creates a strong hesitation to recognise the existence of an implicit MFN clause because the impact would be far-reaching. The principle of reciprocity which is said to be a cornerstone in tax treaty law would be abolished if there would be Community MFN. However, “a judicial application of the MFN doctrine to tax treaties undoubtedly ensures full compatibility with EC Law and the idea of a single market.” (Georg W. Kofler, p 9, Most Favoured Nation treatment in direct taxation: Does EC law provide for community MFN in bilateral double taxation treaties?, 2005.) Thus would a judicial application of MFN treatment motivate the Member States and the Community to, on the EC level, harmonize international tax law. This mean that ECJ would, as it has done before, “push” further integration between the Member States. (Kofler, 2005)

#### 5.4.2 Article 12 EC

In article 12 EC there is a non discrimination provision that has a general character and states that any type of discrimination due to nationality is forbidden. This wide coverage could indicate that MFN is provided for. The article forbids both overt and covert forms of discrimination due to nationality. Case law has settled “that the principle of non-discrimination requires that comparable situations must not be treated differently and that different situations must not be treated in the same way. (Georg W. Kofler, p 9, Most Favoured Nation treatment in direct taxation: Does EC law provide for community MFN in bilateral double taxation treaties?, 2005.) Companies with office in the EU (EU company) should be treated the same as natural persons according to art 48 EC which clearly indicates that EU companies should be treated as nationals according to art 12 EC. It is also almost unquestioned that discrimination that is made between two non residents goes under art 12 EC. According to case law should art 12’s non discrimination principle be read together with the provisions that regard citizenship in the Union, art 17 EC, in order to see what areas the article covers. According to art 17 EC are areas that are covered by the fundamental freedoms covered by art 12 EC.

### 5.4.3 Pros and Cons of Community MFN

The pros and cons of Community MFN seem to be equally persuasive. The opponents to MFN treatment agree that the EC treaty forbids “any discrimination on grounds of nationality” but doesn’t think that MFN treatment is explicitly provided for in the treaty. They also want to avoid a “free-rider course” and argue that Member States have sovereignty in matters concerning direct tax. They also invoke the “reciprocity” of bilateral tax treaties and argue that MFN treatment could create chaos. The proponents of Community MFN turn to Article 14 EC which foresees that the internal market should function as a national market. They also argue with the earlier discussed Article 12 EC where “any discrimination on grounds of nationality” (Georg W. Kofler, p 11, Most Favoured Nation treatment in direct taxation: Does EC law provide for community MFN in bilateral double taxation treaties?, 2005.) is forbidden which include discrimination between two non residents. It is also argued that although there is sovereignty the powers must be exercised in compliance with EC Law and that the unconditional EC obligations don’t depend on “reciprocity”. (Kofler, 2005)

The Member States national courts are also hesitant when it comes to the question of MFN treatment under community law. The Bundesfinanzhof in Germany for example first considered MFN treatment to be applicable in a non-discrimination clause that was found in a bilateral tax treaty but then stepped back and refused MFN treatment without looking into the aspects of EC law that might apply to the case. There have also been two cases regarding tax benefits for individuals in Holland where the Dutch court refused MFN treatment without turning to the ECJ for a preliminary ruling. (Kofler, 2005)

Already in 1992 the Commission got a question where the Parliament asked whether MFN treatment applied to bilateral double taxation treaties concluded between either two Member States or between a Member State and a third country. The Commission denied MFN treatment and stated that “current community law does not oblige a Member State to grant automatically the withholding tax rate of its most favourable bilateral agreement to taxpayers of another Member State which is not covered by that agreement” (George W. Kofler, p 11, Most Favoured Nation treatment in direct taxation: Does EC law provide for community MFN in bilateral double taxation treaties?, 2005.)



This view was not shared by the Ruding Report that found it unacceptable that preferential tax treatment could be given to enterprises in some Member States but not in other. The Report stated that government rules should not be in conflict with EC's competition policies but this would be the case if a policy would allow a withholding tax that is preferential to some Member States but not the other. Another example is when governments only give certain incentives to taxpayers that reside in some of the Member States. (Kofler, 2005)

#### 5.4.4 When would it be possible to apply the MFN principle under EC law?

A number of questions need to be asked in order to find out if the MFN principle is applicable under EC law. One must start with asking if Member States A's domestic legislation deny the residents of Member States B a benefit that is given to its own residents.

If the question is answered with a yes, it is not relevant if Member States C's resident can claim the same advantage that is given to A's residents thanks to a tax treaty. This is so because the case can be solved by comparing Member State A's tax treatment of resident A and resident B. This means that there is no need to compare resident B and C in order to establish that Member State A is giving discriminatory tax treatment.

In the case that the answer to the above question is no, a second question should be asked. Are Member State C's residents getting the advantages that are refused Member States B's residents?

If the question is answered with a yes, one need to ask whether the granting of an advantage to Member State C's residents at the same time as Member State B's resident and the own residents of A are refused the advantage, should be considered to be forbidden state aid or tax competition that is harmful. In order to reply one need to find out if the giving of the advantage to State C's residents is justified by the difference between residents and a non residents in the framework of State A's tax system. An example being when State A does not impose a withholding tax on the own residents, since they are subjected to a tax liability that

is unlimited when the tax rates are ordinary. This at the same time as non residents get a reduced withholding tax, which means that the reduced withholding tax given to State C's residents is not considered as state aid or tax competition that is harmful because the residents of State A could be subjected to taxation that is unlimited on the same type of income but with a rate that is even higher than the WHT rate given to State C's residents. If this is the case, the giving of a WHT reduction by State A to State C's residents and the exclusion of the residents from State A from the advantage would give full justification for tax reasons according to the harmful tax competition and state aid tests.

However, if the giving of an advantage to State C's residents can't be based on the tax treatment differences by State A of non resident and resident tax payers, since the advantage would give a net benefit to a tax payer that is non resident whereas the residents from State A would be excluded from it, the provisions on harmful tax competition or state aid might become possible to apply and State B's residents would have small if any chances of succeeding when trying to claim the same advantages the ones given to State C's residents.

If no harmful tax competition or state aid can be found when looking at a scenario where State A gives a tax advantage to State C's residents at the same time as State A's own residents and State B's residents are excluded from this advantage a fourth question need to be asked. This is the question whether the giving of an advantage to State C's residents in a tax treaty concluded between State A and C is considered to be founded on the concept of reciprocity. In other words: Does State A's residents receive corresponding advantages from State C when they are taxed in State C. If this is the case, is it possible to see these corresponding advantages as in a relationship that is reciprocal to the advantages given by State A to State C's residents. The MFN principle can't be applied by State B's residents in order to get the same advantages from State A as the advantages given to State C's resident if the answer is yes.

The MFN principle would be possible to apply if the last question was answered with a no. Then it would be possible for State B's residents to claim equal treatment compared to State C's residents. (Thömmes)

## 5.5 Case law

### 5.5.1 Saint-Gobain, Case C-307/97

The 30<sup>th</sup> of June in 1997 the ECJ was asked by the Finanzgericht Köln to give a preliminary ruling under article 234 of the EC treaty on three questions regarding the interpretation of article 43EC and 48EC. Saint-Gobain ZN is the French company's Compagnie de Saint-Gobain's German branch. The seat and business management of the company is located in France. Because of this Saint-Gobain SA (Compagnie de Saint-Gobain) was subjected to limited tax liability in Germany. This limitation applies both to income earned in Germany via Saint-Gobain ZN and the assets held by Saint-Gobain ZN.

Saint-Gobain SA was refused some tax concessions that related to taxation of dividends that came from shares in foreign companies because these concessions were limited to companies that had an unlimited tax liability in Germany.

Saint-Gobain ZN had shares in two German companies and in one American company. One of the German companies owned shares in both an Austrian and Swiss company. The other one owned shares in an Italian company.

The Finanzamt refused to give Saint-Gobain ZN a tax exemption on the corporate tax that was paid for the dividends from the US and Swiss company. If Saint-Gobain ZN would have been a German company it would have gotten the exemption thanks to the double taxation agreement between Germany and USA and Switzerland. If Saint-Gobain would have been subjected to unlimited tax liability it would also have gotten the tax exemption.

Saint-Gobain ZN was also rejected a credit on the foreign corporation tax that was charged on the profits that were distributed by foreign subsidiaries. This credit would also been granted if Saint-Gobain ZN had been subject to unlimited tax liability.

The third problem was that the Finanzamt included the shares that Saint-Gobain ZN had in the American subsidiary into Saint-Gobain ZNs tax base for the purpose of capital tax in

Germany. There were no tax concessions for international groups available for Saint-Gobain ZN because that was limited to German companies limited by shares.

### 5.5.2 The court's judgement

The ECJ ruled that Article 43 EC and Article 48 EC precludes Germany from not giving the tax credit that Saint-Gobain ZN would have gotten if the company would have been subjected to a tax liability in Germany that was unlimited.

According to ECJ Saint-Gobain ZN should also have been given the wealth tax exemption that a German limited company would have received. This decision was also based on Article 43 EC and Article 48 EC.

Regarding the bilateral treaty with the US the German Government does not think that bilateral treaties that are concluded with third countries are within the Community's sphere of competence. The German government means that the ability for Member States to conclude bilateral double taxation agreements would become undermined if companies like Saint-Gobain ZN would benefit from the relief's that were agreed in the treaty. ECJ agrees that because no harmonising measures have been adopted in the EU, Member States have the right to decide how to tax in order to avoid double taxation by making international agreements. However, Member States must obey community rules and according to the national treatment principle non-resident establishments that are permanent should have the same conditions as the resident companies. These community law obligations does not in any way affect the obligations that Germany has with their double taxation treaty partners and it would also not create any new obligations for their treaty partners. This means that also the exemption from capital tax that was given German companies should be given to Saint-Gobain ZN.

### 5.5.3 Analysis of the case

In the judgement the ECJ refers explicitly to the balance and reciprocity of bilateral tax treaties which could be viewed as a statement favouring the opponents to MFN treatment in EU. This statement was however explained by mentioning that Germany unilaterally could decide whether to give Saint-Gobain ZN a tax advantage and that this decision would not affect in any way the rights of the non-member nation or create any new obligations on this nation.

This case is also interesting because it makes a clear distinction between MFN treatment and national treatment. This was done in order to avoid interfering with the case

**Metallgesellschaft and Hoechst** which was pending at the same time as Saint-Gobain.

As was mentioned in the Advocate General's opinion of the Saint-Gobain case, the two cases were different. This was so since the Saint-Gobain case concerned the difference in treatment between a non resident company and a resident company while in the Metallgesellschaft and Hoechst cases the difference in treatment was between companies that were non resident. The distinction made between the two cases and hence between MFN treatment and National treatment made the expectations on ECJ's judgement in the following cases high.

(Kofler, 2005)

### 5.5.4 The Metallgesellschaft and Hoechst cases C-397/98 – C-410/98

In October 1998 the high court of Justice of England and Wales asked ECJ for a preliminary ruling on five questions. The questions had been raised in the proceedings between Metallgesellschaft and Hoechst and the Commissioners of Inland Revenue. The five questions were related the obligation that companies resident in the UK had to pay corporation tax in advance when it came to dividends paid to the parent company. The companies in the two cases had subsidiaries in the UK and received dividends from these companies. UK law states that companies that are resident in the UK and pay out dividends has to pay an advanced corporation tax (ACT) on the dividends. However, if there are two UK resident companies

and one of them own at least 51 percent of the other, they can do a group income election. Thanks to this election subsidiaries does not have to pay ACT when paying dividends to the parent company. This also means that non-UK parent companies, in this case German, cannot make a group income election together with their subsidiaries in the UK. This off course creates a disadvantage for the German companies since their subsidiaries in the UK had to endure an extra cash flow cost compared to the UK companies' subsidiaries. In the case the German companies claimed that especially the articles concerning the free movement of capital and the freedom of establishment were violated. This is basically the main question one can extract from the case. EJC agreed with Metallgesellschaft and Hoechst and stated in the judgement that according to article 43(freedom of establishment) in the EC treaty this type of discrimination is forbidden.

However, the most interesting question put forward in this case is the third one which relates to the MFN principle. UK had some double taxation treaties with other Member States that gave the residents in those countries the right to get a refund of parts of the taxation credit. So in the third question it was basically asked whether it was right of Member States authorities to give a tax credit to companies resident in some Member States because of a double taxation treaty but not to companies resident in another Member State. The answer to this question could obviously answer the question if MFN treatment is provided for in bilateral tax treaties according to EC law. The ECJ however, did not think it was necessary to answer this question since they already had established that there was a breach of article 43. (C-397/98) (C-410/98)

### 5.5.5 Analysis of the case

Even if ECJ did not answer the question related to the MFN principle the case is still worth mentioning since the ECJ more or less got a direct question whether MFN treatment should apply to bilateral tax treaties according to EC law and refused to answer. In the two cases that follow the ECJ had the chance to solve this issue again and ECJ's judgement in these cases will be analysed more in depth.

### 5.5.6 The “D” Case, C-376/03

The 24<sup>th</sup> of July 2003 the national court Gerechtshof te `s-Hertogenbosh in the Netherlands asked the ECJ for a preliminary ruling on three questions regarding the potentially unequal treatment of a non-resident taxpayer.

Mr “D” is a German resident and national who own property in the Netherlands. The property in the Netherlands amount to 10% and the rest of his property was invested in Germany.

Because he own property in the Netherlands he has to pay wealth tax there as a non-resident taxpayer. Tax payers that are resident in the Netherlands always have the right to deduct a tax allowance on the wealth tax but this is not the case for non-residents who only can make the deduction if 90% or more of their investments are located in the Netherlands. This means that Mr “D” did not have the right to claim the allowance. Belgian residents however have this right under all circumstances thanks to a non-discrimination clause that can be found in the tax treaty between Belgium and the Netherlands. Although Germany did not have this type of tax treaty with the Netherlands and Mr “D” did not have 90% of his investments in the Netherlands Mr “D” applied for the tax-free allowance. Mr “D” did not receive the allowance and brought action against the decision before the Regional Court of Appeal, ‘s-Hertogenbosh relying on the EC treaty. Mr “D” argued that he was discriminated against, especially in the light of Articles 56 EC and 58 EC and the convention between Belgium and the Netherlands. (The “D” case, C-376/03)

The questions that were put forward for a preliminary ruling regarded the following;

1. Whether it is discriminatory, especially under Article 56 EC, to exclude non-residents with most of their assets in the State where they are resident, from the basic allowance that is given to Dutch residents.
2. Is the denying of this allowance to German residents compatible with the free movement of capital if Belgian residents under the same circumstances are, based on their tax treaty with the Netherlands, granted this advantage? (The MFN issue)
3. If any of the previously mentioned questions were answered in the affirmative, is it forbidden according to Community law to only contribute to some of the legal costs if the individual is successful in the proceedings that were brought to the national court

because of a Community law breach made by a Member State? (The “D” case C-376/03)

### 5.5.7 The court’s judgement

The investments that Mr “D” had in the Netherlands fell under article 56 of the EC treaty but did not pass the Schumacker test. According to the case law from Schumacker S-279/93 resident tax payers and non resident taxpayers are not comparable unless the non resident taxpayer receives at least 90 percent of his worldwide income from the state where he is considered to be a non resident. Since Mr “D” only has 10 percent of his investments in the Netherlands he is not in a comparable situation.

In the Schumacker case income tax was at issue and Mr “D” consider this tax to be different than wealth tax and that the earlier solutions based on income tax are not transposable to wealth tax. The court disagrees and again mentions that he is not in a comparable situation with a resident mainly because of his minor investments in the Netherlands.

Hence the court do not consider article 56 EC and article 58 EC to preclude legislation where a non resident is denied the allowance and reject Mr “D”’s first claim. (The “D” case C-376/03)

The second question deals with the MFN treatment issue since Mr “D” claim that he is in the same situation as non residents from Belgium but do not receive the same treatment. The ECJ do not think that Mr “D” can be compared with a Belgian non resident since the latter resides in a Member State with a bilateral tax treaty which only apply to the residents of the two contracting States. Hence, ECJ argues that a resident in Belgium is not in a comparable situation with a resident outside of Belgium because of the Belgium-Netherlands Convention and therefore Mr “D” cannot benefit from this bilateral tax agreement.

There was not any need to answer the third question since the two first ones were answered in the negative.



### 5.5.8 Analysis of the case

First of all it was surprising that ECJ rejected the MFN principle since Ruiz-Jarabo who was the Advocate-general of the case argued in favour of the principle in an implicit way by claiming that the application of a conventional rule could be an obstacle to the free movement of capital. The Advocate-general states that “in triangular situations such as that in the main proceedings, the position of the taxpayer in the taxing State can be defined on the basis not only of the most-favoured-nation clause but also of the fact that there is a restriction on free movement.” Opinion of Advocate-general Ruiz-Jarabo Colomer in case C-376/03, paragraph 97. Colomer also states that he is “aware of the dangers which the foregoing considerations imply for the equilibrium and reciprocity which prevail in the system of double-taxation treaties, but those difficulties must not become obstacles to the establishment of the single market. Opinion of Advocate-general Ruiz-Jarabo Colomer in case C-376/03, paragraph 101. The Advocate-general also states that mutual commitments do not take precedence over the equal treatment right.

According to the author these statements clearly indicates that the Advocate-general considers that MFN treatment could be applied in this case according to EC law, which means it could also be applied in other cases, and that community law must be followed no matter what the Member States feel about the possible effects of this decision. Because of these statements it was surprising to read the courts judgement since it has been common that the Advocates-general’s opinion has been followed. (Colomer, AG’s Opinion, C-376/03)

Both the ECJ’s decision and the motivation behind it could be seen as questionable. The first question that comes up is how the wider implications of this decision go together with the idea of an internal market that should function as a domestic market. A supreme court in a domestic market as for example Sweden would never except, both for economic and legal reasons, that an investor from Malmö that invest in Stockholm is taxed differently compared to an investor from Göteborg. To not give the same treatment to two taxpayers with an identical capital flow because they come from two different Member States is a potential distortion of the most suitable allocation of resources within EU and why this is accepted by the ECJ is not clear. The reasoning behind the decision is also said to be problematic. ECJ allows different treatment when it comes to wealth tax because the taxpayers in the case are

not in a similar situation. They both carry out the same activities and both have 10 percent of their investments in the Netherlands so the only difference is that the Netherlands treat them differently because of a tax treaty. This means that ECJ allows the Netherlands to use different treatment between taxpayers because there is a different treatment. It looks like the ECJ uses a circular reasoning and gets trapped in it.

The Belgian resident in the case received better treatment because of the Belgian-Dutch tax treaty. If the law had been a domestic Dutch one the ECJ would probably not have allowed the difference in treatment. It would probably be hard for the Dutch Supreme Court to apply national law differently to two taxpayers that are non residents. In that case ECJ would probably have felt the need to either allowing the tax allowance to both of the non residents or deny the allowance because both of them failed the Schumacker test. Discrimination, whether it is based on a bilateral treaty or national law, should be forbidden and Community law should have priority over them both. By allowing discrimination because it is based on a bilateral treaty the ECJ creates a problem with the basic principles of supremacy and direct effect.

The explanation that ECJ tries to give regarding its decision is that the reciprocity and obligations in a tax treaty only make it applicable to the two parties' residents. It is however settled case law that reciprocity does not make it right to not comply with Community law. (St Gobain, Gilly, Commission vs. France)

By looking at points 59 to 62 of ECJ's decision it can be seen that Member States are allowed to keep a differentiation that distorts the internal market if they pack it in to a bilateral treaty. This could have implications for other areas of law such as the ones where Member States still have the right to conclude bilateral treaties and legislate. The free movement of persons is an example of such an area. There the Member States would have the possibility to for example only allow doctors from other Member States to practice medicine if they have completed at least 7 years of studies, and then allow Belgian doctors to practice medicine in their country after only completing 5 years of studies. This would most likely not be accepted by the ECJ but it is basically the same thing as refusing a tax allowance to a German and then allows it to a Belgian only because the latter lives in a country with a tax treaty. (Van Thiel, 2005)

### 5.5.9 The Bujura case

The Bujura case was withdrawn by the Dutch court before a preliminary ruling was given.

The case is however worth mentioning since it was related to the MFN issue.

This case resembled the Mr “D” case if one looks at the facts and could potentially have given a new answer to the MFN issue. The case was another preliminary ruling brought to the ECJ by the Dutch court Gerechtshof Herzogenbusch. This time it was for the case of E. Bujura against Inspecteur van de Belastingdienst Limburg. The national court basically asks if a taxpayer that is a resident of Germany has the right, according to EC law, to claim a tax free allowance and a tax credit on his income tax from savings and investments in the Netherlands if another taxpayer resident in Belgium have this right even though Mr Bujura does not receive 90 percent of his income in the Netherlands. (Reference for a preliminary ruling, 2004, C-8/04)

### 5.5.10 Analysis of the case

This case was very similar to the Mr “D” case except for the fact that this case concerns income tax and the Mr “D” case concerned a wealth tax. It was mentioned before that the ECJ pointed out the similarities between wealth tax and income tax in the Mr “D” case which makes it very likely that the outcome in the Bujura case would have been the same as in the Mr “D” case.

The case was withdrawn but if the outcome would have been the same in this case it would be a clear indication that the ECJ has chosen to not allow MFN treatment within the EU for at least the nearest future.

## 5.6 Consequences of MFN treatment within the EU

The purpose of this thesis is not to find out exactly what areas, and how these areas, would be affected by EU MFN treatment in bilateral tax treaties. A comprehensive overview of the possible consequences of MFN treatment is however given in order to show how the tax scene for EU companies can be changed because of MFN treatment.

The two most probable possibilities when it comes to the States affected by the MFN clause in the EU are the following:

- 1) Tax treaties that two Member States has signed between them should be included in the clause. Thus a Member State should apply the most favourable of the treaties that it has signed with the other Member State to residents from any of the other Member States.
- 2) The MFN clause should also refer to signed double tax treaties between third States and Member States. This means that residents from any of the Member States would be able to apply the treaties that were signed between the Member States previously mentioned and the third State which could be any State that is not member of the EU. (Raventos-Calvo)

The next thing to analyze is the content of the treaty clauses. The interesting question is which regulations in the double tax treaties that are the most beneficial for a tax payer and if these could be applied by a tax payer in one Member State when that person deals with the other Member States authorities. (Raventos-Calvo)

If the OECD Treaty Model and the different provisions in that model are looked upon it can be concluded that the following articles could most commonly be invoked.

- Article 5 that deal with Permanent Establishments and the time period that is considered the limit for an assembly and construction work in order for it to be classified as a permanent establishment. The time period needed is different depending on what country the company come from. A German company in Spain for example need 12 months in order for the operation to be considered to be a permanent establishment whereas a Greek company only need a duration of 9 months and a

Hungarian company as many as 24 months. The Greek company in Spain could under a MFN clause seek treatment equal to the German and even the Hungarian one.

- Article 10 that regard dividends, Article 11 that regard interest and Article 12 that regard royalties. Here several things are important, for example the different limits on taxation at source.
- Article 13 that regard capital gains that come from shares that represent the ownership of real property and the issue of voting stock majority.
- Article 15 that regard dependent workers and the different methods that can be applied in order to calculate the 183-day clause.
- Article 17 that regard athletes and artists. In some cases the treaty makes it impossible to attribute income to an entity that is foreign.
- Article 23 could also be invoked in the situation where the exemption method could be applied. (Raventos-Calvo)

Some of the legal aspects regarding MFN treatment in bilateral tax treaties under EC law have now been examined. These empirical findings will be further discussed in the analysis section but first will the empirical results from the business case studies be presented.

## 5.7 Conclusion

The question whether MFN treatment in bilateral tax treaties is provided for according to EC law is obviously very complicated as the author has not found any clear answer in the case law or in the EC treaty. There is probably no clear answer as the bilateral tax treaties that are concluded by the Member States would be greatly affected by MFN treatment. The ECJ is obviously also hesitant to give a clear answer because the question is politically sensitive.

As mentioned earlier in the thesis are EU companies covered by art 12 EC. This article forbids discrimination that is based on nationality. The article together with “the four freedoms” makes it possible for an EU company to demand to be treated equal to any other company that is in a comparable situation. According to the author this does indicate that

MFN treatment is provided for under art 12 EC. The idea of a common market with equal opportunities for all European companies also suggests that there should be MFN treatment.

Member States could claim that because there are no harmonising measures made in the EU in the area of taxation the Member States have the right to conclude bilateral tax treaties. Member States could also claim that the reciprocity and balance of the bilateral tax treaties would be disturbed if MFN treatment was applied to these treaties. In the Saint-Gobain case it could however be seen that this does not justify discrimination. This indicates that Member States cannot use reciprocity as an argument for not giving MFN treatment. On the other hand did ECJ in the Mr “D” ruling decide that if two non-residents were under different tax jurisdictions because of a bilateral tax agreement they were not in a comparable situation. In the same case was the Advocate-general implicitly in favour of MFN treatment. This makes it hard to make an analysis whether case law provides for MFN treatment. The Advocate-generals statements in the “D” case however suggest that ECJ might be moving towards accepting the MFN treatment in bilateral tax treaties.

Even if there should be MFN treatment according to EC law it could be questioned if it is the right solution for the EU. MFN treatment would extend favourable tax provisions that are created via tax treaties to residents in the other Member States. The question is however, whether bilateral tax treaties still can be seen as the right way of creating the right conditions for a common market in EU. Another way of solving this would be to either sign a multilateral tax treaty among the EU Member States or by having a unilateral provision where all the Member States wish to extend favourable treatment to all of the residents in every Member State.

Bilateral tax treaties are mentioned in Art. 293 EC as an appropriate way of hindering double taxation in EU. However, having bilateral tax treaties as a way of hindering double taxation in EU might no longer be the right way of creating the right conditions for the common market. ECJ’s case law has developed in regards to the interpretation and application in the area of direct tax issue. This is so both in the area of personal freedoms of the treaty and the EJC’s establishment of a complete forbidding of restrictions that comes from the European Freedoms which makes it necessary to look at Art. 293 EC in a more critical way today compared to four decades ago which was when this article in the Treaty was drafted. The more appropriate way of creating conditions for a common market might be to conclude a Tax Treaty that is multilateral. If the MFN principle would be applied on the Member States

bilateral tax treaties it could be seen as a concept that is not even appropriate for the single market is being stretched by the ECJ. (Thömmes)

Even if MFN treatment was an appropriate way of creating the best conditions for the common market it is not sure whether EC law provides for MFN treatment in bilateral tax treaties. As mentioned earlier does art 12 EC suggest that MFN treatment might be provided for but the case law hasn't given a clear answer and the court seem to be very reluctant to accept the idea of MFN treatment in bilateral tax treaties. If the court should change its mind and allow MFN treatment in the future it would have wide ranging implications on the EU tax scene.

## 6 Analysis of the case studies

The theory that was chosen for analysing the different companies in the case study was the theory about Firm-specific strategic motives. The theory was described in the theory section but will be described shortly again at the same time as taxes and human capital will be put into the theory. The theory could be divided into five main types of not mutually exclusive considerations.

**Market seekers** that often are motivated by for example market size and growth prospects in the region where they invest.

**Raw material seekers** are mainly looking for cheap raw material.

**Production efficiency seekers** are mainly looking for lower costs when producing. This could be the cost of for example labour, energy or transportation but also a labour force that is very skilled since this could make the production more efficient and hence cheaper.

**Knowledge seekers** are mainly looking for skilled workers such as staff with a lot of technical knowledge or managerial expertise.

**Political safety seekers** try to invest in countries that are seen as “politically safe”.

If the level of a regions human capital would be an incentive for companies to make FDI the companies would according to this model be either or both production efficiency seekers or/and knowledge seekers. In the interviews the model was used in order to first find out what type of strategic motives the companies had for making FDI. If they belonged in one or both of the production efficiency seekers and knowledge seekers category the author tried to find out if the companies considered human capital and taxes to be important. If it was important the author used follow up questions in order to see if there was a special type of human capital or tax that was most important.

As can be seen in the case studies all of the companies except for Astra Zeneca were either market seekers or production efficiency seekers. In these categories the most common determinant of FDI according to the case study companies was to get access to the local market, which means that they were mainly market seekers. The theory also suggests that this type of incentive for making FDI is the most common. Astra Zeneca falls under the



knowledge seeking category because they consider the availability of highly skilled researchers and managers to be the most important factor when conducting FDI. The other determinants that were most common among the companies were production costs, the human capital, the geographical location and low labour costs.

## 6.1 Human capital as a determinant of FDI

In the case studies it was found that four out of the five companies thought that the level of the human capital was an important or very important determinant of FDI. One of the companies, Astra Zeneca, even considered the level of human capital to be the most important determinant of all. The different companies thought that different types of human capital were important. This is probably because the companies are not in the same type of industries.

Astra Zeneca is in the pharmaceutical industry where the companies need to be very innovative and emphasise R&D. Because of the conditions in this industry it is not surprising that Astra Zeneca also was the company that considered the human capital in a region to be the most important determinant. When saying human capital Astra Zeneca meant researchers and managers with the right expertise and also a high level of competent personnel.

Ericsson also operates in a R&D intensive industry and considers human capital to be a very important factor when investing in the company's R&D centres. Ericsson considers that especially a high level of education in the region is important and also cooperates with many universities. One thing that was interesting with the Ericsson case study was that it showed that competence was considered very important also when the company outsourced its production.

The only company that did not consider human capital to be an important determinant of FDI was the company that chose to be anonymous. Human capital was only seen as a determinant when investing in research centres but even then it was not considered to be especially important. The reason for this is probably that the company is very capital intensive and does not require a highly skilled labour force in the production. The most interesting thing that was discovered in the research of this company was that the new IT technology made the level of

human capital less and less important. This company only considered human capital important when investing in research centres but even then it was not so important and this was due to the possibilities that mainly the internet was creating. Researchers could get online and have conferences where they exchanged ideas and helped each others research without actually meeting. This might indicate that due to the progress made in IT technology the need for a high level of human capital when making FDI is not as important as it used to be, at least for some companies.

Assa Abloy mainly invests in order to get access to the local market which primarily makes them to a market seeking company. The company however also see FDI as a strategy to acquire for example a special type of technical knowledge or knowledge about a certain product segment. This means that they are also a knowledge seeking company which makes a high level of the human capital a crucial determinant in order to be able to supply the knowledge.

Atlas Copco is also a knowledge seeking type of company which acquires companies in order to get access to their technical knowledge. Atlas Copco and Assa Abloy are both industrial groups with businesses in many industries. A large part of the companies' growth is made by acquiring new companies that operates in various segments within their industry. The acquisitions are often a way to get into and learn to operate in a certain market segment which makes it important that the level of human capital is high in the acquired companies. These two companies are probably knowledge seeking companies because of this growth strategy. This can be compared to the other investigated companies where a high level of human capital was needed in order to make R&D and production more effective. That strategy goes under the production efficiency seeking type of strategy where an educated and skilled labour force is seen as a way of making the company more effective and their products more attractive.

All five of the investigated companies thought that the level of human capital was important when making FDI in R&D centres around the world. The two companies that emphasise R&D the most are also the two companies that found the level of human capital to be the most important. These two companies were Ericsson and Astra Zeneca. They did not only find human capital to be very important when investing in R&D centres but also when investing in their production facilities around the world. The similarity between these two companies is

that they are both at the forefront in their field when it comes to new techniques and ideas. They are also both in industries that constantly demand improved products and solutions. One difference between Ericsson and the other companies is that Ericsson chose to outsource a large part of their production. For Ericsson it is more important that the level of human capital is high when the production is outsourced. The reason for this might be that Ericsson has less control over the production when it is outsourced which makes it more important for them to know that the level of human capital is high because it ensures a higher quality of the output.

The anonymous company was the only company that did not consider human capital to be important when investing in production facilities. This separates them from the other companies and there might be several reasons for that. One reason could be, as mentioned before, that they are a capital intensive company and do not need a high level of human capital when producing. Another reason however, might be that they are the company with the strongest emphasis on organic growth. When studying their webpage one can see that organic growth has “top priority” among the strategic goals. This type of growth gives the company more control over the production compared to the strategies used by the other companies e.g. Ericsson - joint ventures and Atlas Copco - acquisitions. This control might reduce the need of a high level of human capital in the host country because the company can continuously ensure that new staff is trained properly and that personnel is moved to new locations when their expertise is needed.

Assa Abloy and Atlas Copco do in several ways have a similar growth strategy. Both of the companies focus on making acquisitions in order to penetrate local markets and add their product and service range. This separates their growth strategy from the other companies. When these two companies are making an acquisition the level of human capital in the acquired company is seen as very important. However, when the companies are growing organically and build new production facilities the level of human capital is not seen as equally important as when making an acquisition. This has similarities with the other companies. For example Ericsson, who consider the level of human capital crucial when making joint ventures but not as important when investing in production facilities.

## 6.2 Taxes as a determinant of FDI

Three out of the five companies in the case studies considered taxes to be a determinant of FDI. Only Ericsson mentioned anything specific about taxes with regard to the company's direct investment in the annual report. This shows that taxes are a factor that Ericsson consider when making direct investments. The respondent at Ericsson also considered taxes to be an important determinant even if it was not one of the most crucial factors when deciding where to invest. Also Assa Abloy and Astra Zeneca's respondents considered taxes to be an important determinant. The respondent at Assa Abloy meant that since one of the company goals when making FDI was to lower the cost, low taxes could be a way of achieving this goal. The anonymous company was also a company that mainly wanted to lower the production costs by making FDI. The respondent in this company however, did not consider taxes to be important and meant that there were more efficient ways of lowering the production costs than taking advantage of a favourable tax level. This was surprising since it would be logical if companies that are production efficiency seekers and mainly are interested in lowering their costs would be the ones most interested in a low tax level.

Atlas Copco did also not consider taxes to be important. The company has a mix of market and knowledge seeking type of strategy when making FDI which means that they do not only want to get access to the local market but also learn from this market. Because lowering of the production costs were not seen as a major determinant of FDI it was not surprising that taxes were not considered important in this case.

Generally it can be said about the companies that several of them considered taxes to be, at least to some extent, important. None of the companies could however explain exactly how it was important or in which cases it was most important except for the reason that it contributed to a lower production cost. They also found it hard to answer how much new EC legislation, that would give more beneficial tax treatment, would affect the willingness to invest in the EU area. The respondents found it hard to answer this because there were many factors that determined the willingness to invest and it is hard to say how much, for example, a tax exemption would affect the FDI decisions. Several of the respondents also considered taxes to be a sensitive issue and did not want to go into to many details about it.

### 6.3 Comparison between human capital and tax explanations

Ericsson is together with Astra Zeneca the company that finds the level of human capital most important. Ericsson also considers the tax level to be important when making FDI. Like the other companies that consider the tax level to be important Ericsson want to have a low tax level because it because it decreases the production costs. Changes in the tax level are considered to be a risk factor when making FDI according to Ericsson's annual report. When the international growth is not organic but done via e.g. joint ventures Ericsson finds it very important that the level of human capital is high. This can also be seen of a way of reducing the risk that for example the joint venture will be a failure. This indicates that risk factors are important for Ericsson when making FDI. If the tax legislation in EU is unclear and there is a risk that Ericsson might not get the same tax treatment, as companies that are resident in the country where Ericsson is planning to invest, it can be seen as a risk that comes with investing in EU. Because the level of human capital is relatively high in EU it is attractive for companies like Ericsson to invest there. However the taxes are also relatively high in the EU region which might be a disincentive for FDI. Because of this it is very important that the tax legislation in EU at least is clear and that companies like Ericsson can be sure of getting the same tax treatment as resident companies since this at least reduces the risk of not knowing what kind of financial results that can be expected from the investment.

The information regarding the importance of taxes was very vague in the case of Astra Zeneca. It was considered important but neither the respondent nor the annual report gave any information why it was important. As mentioned before is the level of human capital very important for Astra Zeneca. They have also chosen to locate much of their FDI in countries with a high level of human capital, e.g. in many EU countries. These countries also have a high tax level which of course increases the costs in these countries. These "extra costs" compared to investing in for example developing countries might be the reason for why taxes are considered to be important.

The anonymous company didn't find taxes or the level of human capital to be an important determinant. The company has located most of its production in undeveloped countries because they are mainly trying to cut their costs when investing abroad. In these countries the tax level generally low and hence hasn't the same impact on the company's result as it

would if they had invested in the EU region. This is probably why this company didn't find taxes to be important.

Assa Abloy's FDI can be divided into two main types. One kind of FDI is done in order to get access to knowledge and competence in a new area. This kind of FDI is done with the help of acquisitions and when acquiring new companies the level of human capital is seen as very important. The other kind of FDI is when the company invests abroad in order to lower their production costs. This kind of FDI is normally done in undeveloped countries because production there is not only cheaper but taxes are also lower. This means that when Assa Abloy is investing abroad with the main goal to lower costs, not acquire new competences, taxes are seen as a determining factor. This indicates that when a country competes with its low costs it is also important to have low taxes. When a country competes with its highly skilled labour force the tax level does not seem as important.

Atlas Copco has an investment strategy that is similar to Assa Abloy. Atlas Copco also makes FDI in order to get access to for example technical knowledge. They also find the level of human capital to be very important. Atlas Copco does not consider taxes to be an important factor when making FDI. They have invested in some low cost countries, for example china, but the main part of their FDI is located in countries with a high level of human capital like the US and Finland. This shows that the company finds access to a skilled labour force much more important than the countries tax levels.

If one look at all the companies and compare the results it can be seen that the companies' goals when making FDI affect whether human capital and taxes are determining factors for choosing a location. If the company's goal is to gain access to new competence and knowledge the level of human capital is, not surprisingly, very important. The level of human capital is also very important when investing in R&D centres. Taxes do not seem to be important when acquiring new knowledge or making R&D investments. When the company's goal is to make the production more effective and decrease the costs both the level of human capital and the tax level can be important. For Ericsson and Assa Abloy is the tax level an important determinant when investing in order to improve cost effectiveness. The other companies considered low taxes to be an advantage but probably not a determinant. This shows that the tax level is mainly important when the companies are trying to lower their costs. The increase in effectiveness that a high level of human capital gives is a more

important factor and is probably the reason for why a company like Ericsson chooses to locate much of its production in EU even if the taxes are higher there. Most of the companies want both a high level of human capital and a low tax level even if the level of human capital seems to be more important. Countries that have a high level of human capital do however also often have a high tax level. Because of this, companies seem to choose to locate their FDI in different parts of the world depending on what their main goal with the investment is. EU has, maybe thanks to its high taxes, managed to create a highly skilled labour force which attracts FDI that is mainly looking for effective and technical demanding production and a suitable environment for R&D. Third world countries do not have the human resources that is needed in order to attract companies to invest in for example R&D centres. Instead these countries try to attract FDI by offering the investing companies low costs by for example lowering their taxes. These low cost seeking companies are not investing in technically demanding production which means that the personnel in the third world countries do not learn new production skills from this production and their human capital is not improving so much. When the taxes are low it is also hard for third world governments to invest the money into education that is needed in order to improve the level of human capital. This leads to a downward spiral where these countries human capital is falling more and more behind the developed countries which mean that they have to lower their taxes even more in order to attract FDI which gives even less funds for improving their human capital. EU already has a relatively high level of human capital but constantly need to improve their human capital in order to stay competitive. If there is a “multilateralisation” of all bilateral tax treaties in EU the Member States tax incomes might decrease which would make it harder for EU to finance a world class education. This might in turn lower the level of human capital which would have a great effect on FDI inflows into the EU region. It also seems like taxes are not an important determinant for the type of FDI that is done in EU which means that EU would probably lose more than they would win if they would lower their taxes to much.

## 6.4 The Swedish Trade Council's viewpoint

The Swedish Trade Council every day helps Swedish companies with their FDI decisions. This has given them a great amount of knowledge about Swedish companies' incentives for making FDI. This experience makes the organisation ideal for providing information about FDI determinants among Swedish companies.

Both the respondents at the Trade Council considered Swedish companies to be mainly market seekers. This is consistent with the theory and the results from the case studies. Both of them also considered human capital to be a very important determinant of FDI. The type of human capital Swedish companies were looking for could be found both in the production efficiency seeking and the knowledge seeking strategic category. According to the Trade Council do some countries have specialised knowledge that is acquired by producing certain types of products or services for many years. The companies that have a knowledge seeking FDI strategy often locate its FDI in these countries. Countries that are specialised also attract production efficiency seeking company due to their human capital. The Trade Council mentioned the Czech Republic as an example of where many companies chose to locate their car manufacturing. The Czech Republic's level of human capital in the car manufacturing industry makes the production much more efficient and hence cheaper. One thing that is interesting is that the Trade Council is of the opinion that Swedish companies more and more chose to invest in the Baltic countries because of the high level of human capital there. The level of human capital is high compared to other low cost countries and this is according to the Trade Council the reason why so many companies chose to invest there. This indicates that it is very important for countries to not only improve for example infrastructure in order to attract FDI but also emphasis education and job training which seem to be more and more important.

Also the respondents at the Swedish Trade Council were hesitant to discuss the tax issue. One of the respondents did not consider herself to have enough information about the subject to be able to give an opinion. The other respondent definitely thought that taxes was important but could not really say if there was some special type of taxes that were important. The respondent also thinks that it was hard to say how important taxes are compared to other determinants of FDI. That tax alone could be the incentive for companies to choose one location over another was not considered as being realistic according to the respondent. It



could however together with other factors be the determinant that makes some companies chose to invest in a certain country.

## 7 Conclusion

According to the findings in this thesis it is very unclear whether MFN treatment in bilateral tax treaties is provided for according to EC law. The main argument for MFN treatment would be art 12 EC which forbids any type of discrimination that is based on nationality. Art 12 EC is applicable in all areas that are covered by “the four freedoms”. “The four freedoms” cover all forms of investment and cross-border activity which means that the scope of art 12 EC is rather broad and it should cover most of the possible MFN situations that might arise in bilateral tax treaties.

The case law is very vague and inconsistent when it comes to MFN treatment in bilateral tax treaties and it is not possible to conclude that MFN treatment is provided for according to case law. The comments made by the Advocate-general in the important Mr “D” case however indicates that ECJ is moving towards MFN treatment and it is not impossible that case law sooner or later will show that MFN treatment is provided for according to EC law.

If MFN treatment will be provided for according to case law, there will be some sort of impact on EU taxation. If companies were subjected to more favourable tax treatment it might have some effect on the inflows of FDI into EU. The results from the miniature case studies however indicates that taxes are not an important determinant when it comes to the type of FDI that is mainly done in the EU region.

Two out of the five investigated companies were confident that taxes are a determinant or an important determinant of FDI. One of the companies considered taxes important but could not specify how important and in what way it was important. The other two companies did not consider taxes to be a determinant of FDI even if a low tax level was seen as an advantage. One out of the two respondents from the Swedish Trade Council also considered taxes to be an important determinant of FDI.

The respondents were careful when making comments regarding taxes and many did not think that they had enough information in order to give a correct answer. Some conclusions could however be drawn from the results from the miniature case studies. It could for example be seen that different types of FDI were affected differently by the tax levels. Companies that are trying to cut their production costs seem to be affected by the tax levels. Companies that are trying to find more efficient ways of producing with the help of for example a skilled labour

force do not seem to be so affected by a high tax level. Knowledge seeking types of companies are also not affected by taxes according to the case study. EU is a region with a relative high level of human capital and the access to highly skilled labour is high. This means that companies that chose to invest in EU are mainly looking for effective production and a skilled labour force. These companies are not so affected by the tax level in a region which indicates that a change in the EU tax scene might not affect the inflows of FDI. If the EU could keep the same level of human capital and have lower taxes it would probably have a slightly positive effect on FDI inflows but taxes do not seem to be an important determinant of FDI inflows to the EU region. The MFN principle might however affect the FDI inflows in another way. Companies' want control over their results and if the MFN principle would be provided for under EC law EU companies could be more confident of getting the same tax treatment as all other EU companies get. This increases the control over for example the expected profits which is seen as positive.

The results from the research of human capital were much more conclusive. 80 percent of the investigated companies stated that human capital was an important or very important determinant of FDI. The different companies were also able to explain why human capital was important and in what kind of situations it was most important. The companies had different motives and strategies when making FDI and this affected what kind of human capital the companies found important when investing. Knowledge seeking companies for example wanted to invest in regions with a high level of knowledge about a certain type of industry or market. Production efficiency seeking companies were mainly looking for highly educated and skilled personnel in order to make the production more efficient.

The type of investment chosen when doing FDI also affected how important the level of human capital was. Companies, such as for example Ericsson, that choose strategies that decreases the control over the investment find the level of human capital to be more important then companies that use organic growth. This indicates that companies that use for example joint ventures find human capital more important because it gives them more control over the quality of the output. A company that chooses to grow organically abroad seems to be more confident that they can control the training and development of the staff. This seems to decrease the need of an already existing workforce that is highly skilled.

The only situation where human capital does *not* seem to be important is when the company is investing with the main goal to lower the costs and the production is not so advanced. This type of situation is also the one where companies find taxes to be the *most* important. Taxes and human capital can therefore be said to be determinants of opposite types of investments. Most EU countries have a highly skilled labour force and focus on having an industry that is fairly advanced. The new member states have more of the low cost type of production but these countries are improving their techniques and skills at a rapid pace and their industries will be more advanced in the future. This means that companies that are only looking for the cheapest way to produce, and hence low taxes, will probably turn to third world countries. This does not have to be a problem for EU because with its highly skilled labour force EU is competing for other types of investments. However in order to increase the investments EU has to continuously improve the level of human capital in the region in order to keep their competitive advantage.

EU's recent activities in the business law and human resource area will probably not have any immediate dramatic effects on the inflows of FDI into the EU region. Even if the MFN principle would be applied to bilateral tax treaties, which seems unlikely at least in the near future, it would not have a dramatic effect on the FDI inflows to the region. This is so because companies that are investing in EU are generally looking for a skilled labour force and a technically demanding type of production. When this is the goal with the investment, taxes is not an important determinant or even a determinant at all. Human capital on the other hand seems to be a very important determinant for FDI inflows to EU. It could be seen in the miniature case studies that there are different types of FDI and that the level of human capital is more or less important for the different investment types. The kind of FDI that is most likely to go to the EU region seems to be very dependent on a high level of human capital. Because of this is it crucial for EU to keep emphasising the importance of education and a skilled labour force in order to increase its competitiveness as a knowledge based economy. This means that the agreement at the summit meeting in Lisbon might be one of the most important decisions made when it comes to influencing the future inflows of FDI into EU.

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