TAX INCENTIVES FOR FOREIGN DIRECT INVESTMENT

*Niti Bhasin**

ABSTRACT

With business operations becoming increasingly international in scope, policy makers are reconsidering whether the existing system of taxing international income is compatible with enhanced capital market integration and growing international competition. In their efforts to remove impediments to FDI, governments in developing countries are offering liberal tax incentives to foreign investors so as to make their tax systems internationally competitive. This paper examines the potential benefits and costs of offering tax incentives and the recent trends in tax competition to attract FDI. It also evaluates the various forms of incentives employed by economies to lure foreign investors. The trends indicate that although tax incentives are of doubtful efficiency, the fear of potential investment going to competitors often leads countries to offer such incentives to foreign investors.

Encouragement of FDI is an integral part of the economic reforms process of many developing countries because it is seen as an instrument of technology transfer, managerial skills, augmentation of foreign exchange reserves and globalisation of the economy. Conventionally, tax incentives have been considered ineffective to promote or direct economic activity. A major portion of the studies undertaken prior to 1990 concluded that taxation was a relatively minor consideration in most FDI decisions. More recent studies, however, suggest that tax considerations have become an increasingly important factor in investment decisions and that special tax incentives have become substantially more effective as instruments for attracting FDI than they were 10 or 20 years ago. W.S. Clark (2000, p.1176) has reviewed the recent evidence and he concludes, "Empirical work using improved data measuring FDI offers convincing evidence that host country taxation does indeed affect investment flows. Moreover, recent work finds host country taxation to be an increasingly important factor in location decisions."

RATIONALE FOR OFFERING TAX INCENTIVES

The following reasons have been cited by policymakers for offering tax incentives.

1. As other barriers to FDI are eliminated:

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* Lecturer, Department of Commerce, Shri Ram College of Commerce, University of Delhi. The author is indebted to Dr. A.K. Seth, Department of Commerce, Delhi School of Economics, University of Delhi for his guidance in the preparation of this paper.

the remaining obstacles assume an increasing importance. Professor Easson (1998, p.192) observes, "The process of globalisation and the integration of markets through the creation of free trade areas and customs unions has greatly increased the importance of taxation in investment decisions." With most world economies being liberalised in a big way, the prime considerations have become more or less equal for these economies. Consequently, tax considerations have become significant. Governments in all parts of the world now feel it necessary to offer tax incentives to attract FDI.

2. Tax considerations do not always figure prominently in the initial decision to invest abroad, but once the decision is made to invest in a particular region of the world, the tax differences between the countries in that region tend to have a major impact on the precise location of investment. In recent years, there has been new empirical evidence that tax rates and incentives influence the location decisions of companies within regional economic groupings, such as the European Union, NAFTA, or ASEAN. Devereux and Griffith (1998) found that the average effective tax rate plays a significant role in the choice of U.S. companies to locate within Europe.

Holland and Owens (1996, p. 66) observe, "Experience with tax incentives, particularly in Asia, suggests that so-called footloose manufacturing plants for export may be influenced by tax incentives when choosing the location for a new plant when they are comparing sites in different countries that are otherwise similar. This situation may also occur when a firm targets a region for strategic investment, but is indifferent as to which country it operates from."

3. Another explanation given by policymakers for offering tax incentives is that they are necessary in order to maintain their country's competitive position vis-à-vis neighbouring countries. They may consider that another country has a natural advantage, such as location or raw materials that makes it more attractive as a destination for FDI.

Costs and Benefits of Tax Incentives

While offering tax incentives, it becomes important to evaluate their efficiency, i.e., whether incentives are justified considering their costs relative to their assumed benefits. Though incentives may be effective in attracting FDI, they may be inefficient in that their costs exceed the value of the benefits of the new investment to the host country.

Costs: The most apparent cost of a tax incentive is the resulting loss of tax revenue for the host government. The analysis in this case is complicated by the fact that incentives are not always targeted to incremental investment, i.e., investment that would not have occurred without the incentive. To the extent an investment is incremental, there is no cost in terms of revenue foregone. The tax incentive has a cost when it benefits investments that would have been made in any event without the inducement of incentive, or where the incentives are more generous than was necessary to attract incremental investment (Easson, 2001, p.272).

Incentives often introduce complexity into the tax system in a number of ways. Incentives require definitions of the eligible activities which itself complicate the tax legislation. Moreover, rules are often required to deal with special situations, such as loss years or corporate reorganisations, in order for firms undertaking desired activities to be able to make use of the

incentives earned (Holland and Owens, 1996, p.53). Further, incentive regimes generally impose a significant administrative burden.

Benefits: The benefits derived from an investment are difficult to measure due to multiplicity of possible parameters. Prof. Easson (2001, p. 273). suggests that increased tax revenues from new investment (non-incremental) can be set against the revenue foregone as a result of the incentive. Alternatively, a broader concept of "social" benefit could be adopted, taking into account factors such as employment creation, regional development and technology transfer. However, the monetary value of these types of social benefits may be more difficult to estimate.

It has been observed that despite the costs, governments, particularly in developing economies are under immense pressure to offer tax incentives as they have come to be expected by the investors. The fear of potential investment going to competitors often leads countries to offer liberal tax incentives to foreign investors, even if such incentives are of doubtful efficiency.

Types of Tax Incentives

Governments seeking to attract FDI through tax inducements have a number of available options to make their economies as fiscally attractive as their competitors. Some of the commonly employed forms of tax incentives are examined below.

1. Tax Holidays

Tax holidays have been the most popular form of tax incentives used by countries, especially developing economies. With a tax holiday, firms are allowed a period of time free from the burden of income taxation. Further, this initial period is sometimes extended to a subsequent period of taxation at a reduced rate of tax. Tax holidays have been popular in emerging economies where authorities have favoured a discretionary approach. For example, several African Investment Codes have included tax holidays, with differentiated rebates and periods of abatement, depending on the government's objectives.

Tax holidays have the advantage of simplicity from the point of view of both the enterprise and the tax authorities. If no tax is payable during the holiday period, there is no need to calculate taxes in the early years of operation and there should be no compliance or administration costs. However, this argument is not very valid for long-term investors. The tax treatment of the initial capital expenditures made before and during the holiday period must be determined so that appropriate records will be available for the calculation of depreciation when the holiday ends. Similarly, where losses are allowed to be carried forward, the enterprise will need to file returns and maintain the required records.

Another advantage of tax holidays is that they provide large benefits as soon as a company begins earning income and are consequently more valuable than an incentive such as a low corporate tax rate that accrues more slowly over a longer time. However, they primarily benefit short-term investments, which are often undertaken in the so-called footloose industries characterised by companies that can quickly disappear from one jurisdiction to reappear in another. Short tax holidays, therefore, are quite effective in attracting investment in export-oriented activities such as textile production since that sector is highly mobile. Consequently, from the point of view of benefit to the host country, longer holidays

are likely to be more effective inducements, but they increase the cost to the host country in terms of the amount of tax foregone. Further, tax holidays are targeted at new firms rather than investment in existing companies. Therefore, they tend to discriminate against investments that rely on long-lived depreciable capital.

Further, as observed by Tanzi and Zee (2000), tax holidays provide a strong incentive for tax avoidance, as taxed enterprises can enter into economic relations with exempt ones to shift their profits through transfer pricing.

2. Investment Allowances andTax Credits

Many countries, especially in the industrial world, provide investment allowances or tax credits, which are forms of tax relief based upon the value of expenditures on qualifying investments. These tax benefits are over and above the depreciation allowed for the asset, with the result that the investor is effectively able to write off an amount greater than the cost of the investment. This form of tax incentive can take the following two forms: (i) an investment expenditure allowance that lets companies write off a percentage of qualifying investment expenditures from their taxable income, and (ii) an investment tax credit that allows companies to reduce taxes paid by a percentage of investment expenditures. While a tax allowance is used to reduce the taxable income of the firm, a tax credit is used to directly reduce the amount of taxes to be paid.

Investment allowances have a distinct advantage in that the incentive is correctly targeted at the desired activity since a company receives the benefit of lower corporate taxes only if it makes capital investments. It encourages companies to take a long-term view while planning investments. By targeting current capital spending, the allowance causes less revenue loss to the government than would a tax holiday. Further, it promotes new investment instead of giving a windfall gain to owners of old capital, as does a reduction in corporate tax rates.

However, investment allowances and credits as forms of tax incentives are not free from drawbacks. Where investment allowances are not allowed to be carried forward, existing companies reap the full benefits such as supporting expansion, while start-up companies must first earn enough income before they can avail the allowance. Besides, projects with long gestation periods suffer as compared to those that begin earning income quickly. Companies in high-inflation countries will benefit more if they borrow to finance capital, because tax deductions for capital expenditure are more valuable.

3. General Tax Rate Reductions/Exemptions

Reduced rates of corporate income tax or profits tax can be granted to income from certain sources or to firms satisfying certain criteria. These reductions differ form tax holidays in that the tax liability of firms is not entirely eliminated. The benefit is extended beyond new enterprises to include income from existing operations and the benefit is not time-limited. Some countries provide a reduced rate of tax for manufacturing, agriculture or other activities. For instance, Ireland till recently taxed manufacturing at 10% compared to a standard 36% rate for other activities. Reduced rates are also provided for investment in particular locations or regions. The standard corporate income tax rate of 30% in China is reduced to 15% or 24% in special economic zones and other designated regions.

An extreme approach has been to simply eliminate taxes to all or specific investors. Complete exemption from profits tax is relatively unusual, except in tax havens. Tax havens are countries with nil or nominal taxes on foreigners' income, e.g., Hong Kong, British Virgin Islands and Switzerland. They generally chose to suppress all direct income taxes and rely on indirect consumption and employment taxes. Other countries have limited those benefits to specific areas and Export Processing Zones (EPZs). In virtually all these zones, there is a tax holiday for a substantial period of time coupled with a reduction or elimination of import taxes on machinery and production inputs.

Tax havens are used in a number of ways to avoid/evade high taxes of non-tax haven countries. The most common device is to use a tax haven only as a conduit for transactions, the real economic impact of which is located elsewhere. Thus, international transactions between two high tax rate countries may be channelled through a tax haven company so that any resulting profit is realised in the tax haven with a consequent minimisation of tax.

Tax haven countries have been successful in encouraging FDI, but they have primarily attracted mobile companies or activities that are relatively global such as banking and insurance. For instance, the Cayman Islands claims that it is the fifth largest financial centre, as it is home to the subsidiaries of 45 of the world's largest banks. Exemption, in many cases, is usually restricted to enterprises engaged in conducting activities such as international finance centres and co-ordination centres. Generally, profits from such activities are taxed at very low rates as, for example, in Barbados, Cyprus, Ireland, Mauritius, and Singapore. Collins and Shackelfold (1995) have noted that tax havens have been much less successful in convincing multinational firms to relocate their corporate home rather than establishing new subsidiaries, partly reflecting the tax and regulatory costs of doing so from the home countries.

4. Accelerated Depreciation

The most common form of accelerated deduction is accelerated depreciation where the cost of an asset acquired may be written off at a rate greater than the economic rate of depreciation. This can either be in the form of a shorter period of depreciation or a special deduction in the first year. This has an impact similar to that of an investment allowance in the first year, but differs since the amount written off reduces the depreciation base for future years and so the total amount written off does not exceed the actual cost of the investment. It only allows the deduction to occur sooner than otherwise. The cost of accelerated depreciation to the host country, in terms of tax revenue foregone, is consequently quite small since it is only the timing of tax payable, and not the amount, that is affected. In the case of most initial investments, however, where there may be no profits for several years, accelerated depreciation will be of no benefit and may actually result in an enhanced tax burden, unless losses are allowed to be carried forward in full.

5. Reinvestment Incentives

Some countries such as China, Malaysia, and Vietnam provide incentives for the reinvestment of profits. One way of doing so is by allowing deduction of the amount reinvested, or a proportion thereof, from the profits otherwise taxable. An alternative approach is to give the parent company a

refund of the tax paid by the local enterprise up to a stated proportion of the amount reinvested.

The effectiveness of reinvestment incentives is, however, doubtful. Once an enterprise has made its initial investment, it will normally base its additional investment decisions on actual business needs, so that the incentive may reward the enterprise for doing what it would have done in any event. Further, the international tax system provides built-in incentives to reinvest profits where they are made, by allowing freedom from withholding tax in the host country.

6. Indirect Tax Incentives

Indirect tax incentives such as exemptions of raw materials and capital goods from VAT are sometimes provided as an inducement to foreign investors. Generally, such incentives are of doubtful validity as indirect taxes are of little concern to investors since these are borne by the consumers rather than businesses. In the case of market-oriented FDI, the same taxes are borne by competitors.

Exempting raw materials and capital goods used to produce exports from import tariffs is a more justifiable approach. In developing countries, customs duties are often one of the most important sources of government revenue and are imposed at relatively high rates. While taxes on raw materials will be passed on to domestic consumers, or remitted on export, the taxes on capital goods may be less easily recovered and can add substantially to the initial cost of an investment. Thus, exemption from customs duties and import taxes can be an important factor in investment decisions. The difficulty with this exemption lies in ensuring that the exempted purchases will, in fact, be used as intended by the incentive. Further, there is a risk that goods imported free of duty will subsequently be sold in the domestic market. Thus, it may be prudent to exclude such readily saleable articles (e.g. automobiles) from the exemption.

TAX COMPETITION TO ATTRACT FDI: RECENT TRENDS

Tax incentives for FDI have been around for a long time but as an UNCTAD (1996, p.28) study points out, such incentives have increased substantially in range and in scope since the 1980s. The general trend observable in recent years is towards more and larger tax incentives by countries to attract FDI. According to the above UNCTAD study (1996, p. 21), in 1994, at least 103 countries offered various forms of incentives for FDI. Some examples of tax competition by countries to attract FDI are presented below.

In the European continent, the EU Member States offer generous tax incentives to attract FDI and within those countries, different regions compete with each other. Hungary has been the most successful of the Central European countries to attract FDI. The basically liberal environment proved to be attractive to foreign companies. Capital flowing in through privatization proved to be sensitive to policy changes. In the case of greenfield investments, investors were able to take advantage of tax allowances and special regulations such as the customs-free zone status. These zones are export-oriented subsidiaries and play a decisive role in the Hungarian economy. Major investors and large-scale projects (especially in the automotive industry) were able to negotiate special incentive packages. Currently, major policy objectives include promotion of greenfield investment by firms with foreign participation. Two new

tax allowance schemes with effect from 1998 are good examples of these objectives. While one is for investment in underdeveloped regions, the other promotes the creation of R&D laboratories. The Hungarian corporate tax system is especially favourable to foreign investors. The nominal tax rate of 18 per cent is one of the lowest in the world and the effective rate may be further reduced by general incentives such as accelerated depreciation, etc. Furthermore, since the additional tax on distributed profits is structured as a withholding tax, it is usually reduced to 5 per cent (or is eliminated entirely) by tax treaty.

Inspired by the success of Hungary, Poland introduced, in 1995-97, special economic zones to develop economic activity, create employment and promote new technology and exports. In most cases, special economic zones have been established for a 20-year period in which investors enjoy tax holidays of ten years, with a further period of up to ten years at half the normal corporate income tax rate. Additionally, certain investments may be expensed immediately and accelerated depreciation of fixed assets is allowed.

In Latin America, tax competition among the various States has reached considerably high levels. For instance, to attract investment in automobile production, Argentina and Brazil have waged an incentive war by providing various tax subsidies.

Several countries in Asia have introduced a variety of tax incentives aimed at the alleviation of tax burden of foreign investors. In January 1999, Indonesia announced the introduction of tax holidays for up to eight years for approved new investments. Within a few months, Philippines and Thailand both announced enhanced investment incentives. In Asia, China continues to be the single largest recipient of FDI, followed by Hong Kong, Korea and Singapore (UNCTAD, 2000). In 1999, FDI flows to China were to the tune of US$ 40.4 billion and the country's share in developing Asia's total FDI was 42 per cent. Faced with a number of adverse factors during 1998, including the negative consequences of Asian financial crisis and the slowdown of growth, China intensified its investment promotion efforts. In the beginning of 1998, the Government restored all major incentives for foreign investors abolished earlier. These included exemption of import duties and value-added tax on import of equipment, particularly for high priority industries. Since then, China has been announcing new tax incentives with fair regularity. Foreign Investment Enterprises (FIEs) in China get the following tax benefits:

- A reduced rate of 15% (as against normal rate of 30%) for FIEs engaged in production and manufacturing activities in Special Economic Zones (SEZs)
- Tax holidays for FIEs engaged in production and manufacturing activities with an operating period of 10 years or more.

Singapore, which experienced a reduction in FDI inflows by 15 per cent (to US$ 7.3 billion) in 1998, adopted stimulatory measures such as tax concessions to reduce business costs and encourage investment. For example, approved operational headquarters for multinational group of companies are now taxed at a concessional rate of 10%, or nil in limited circumstances, on their service income for up to 10 years, with provision for renewal. Korea offers tax incentives to foreign companies that invest in high-technology companies, projects in foreign investment zones, etc.

The various types of incentives offered by different regional groupings of the world are presented in Table 1.

While African and Asian countries rely primarily on tax holidays and import duty exemptions, the Latin American countries mostly offer investment allowances and duty drawback. Similarly, the industrial Western European countries rely more on accelerated depreciation and tax holidays.

TAX INCENTIVES: THE INDIAN SCENARIO

To stimulate economic growth and encourage investment for industrial development, the Indian Government has offered several tax concessions to foreign investors from time to time. The various fiscal incentives and concessions have reduced the tax burden on foreign companies substantially. The effective rate of taxation for the companies availing these incentives is much lower than the normal rates. Some of the important incentives provided by the Government since liberalisation have been considered below.

1. Tax Holiday in respect of Newly Established Industrial Undertakings in Free Trade Zones

To encourage investments in technology, export-oriented industries and remote areas, several tax holidays have been offered by the Government over the years. With a view to encourage establishment of export-oriented industries in the Free Trade Zones, the Finance Act, 1981 provides, with effect from the assessment year 1981-82, for complete tax exemption in respect of profits derived from industrial undertakings set up in these zones. This tax concession is available to all tax-payers including foreign companies. Initially, the exemption was allowed for a period of five consecutive years within eight years from the year of commencement of production. In 1994, the tax holiday for Export Oriented Units/ Export Processing Zones was extended to Software and Electronics Hardware Technology Parks. The 100 per cent tax exemption for export of software was also extended for one more year. At present (i.e., up to assessment year 2002-03), the 100 per cent exemption is allowed for first ten consecutive assessment years

Table 1: Types of Tax Incentives Used by Different Regional Groupings

Region/ Major Incentives	*Africa (23)*	*Asia (17)*	*Latin and Caribbean (12)*	*Central and Eastern Europe (25)*	*Western Europe (20)*	*Other Countries (6)*	*Total (103)*
1. Tax holidays	16	13	8	19	7	4	67
2. Accelerated depreciation	12	8	6	6	10	5	47
3. Investment allowances	4	5	9	3	5	–	26
4. Import duty exemption	15	13	11	13	7	4	63
5. Duty drawback	10	8	10	12	6	3	49

Source: UNCTAD, Incentives and Foreign Direct Investment, Background Report, April 1995.

under Section 10A of the Income Tax Act, 1961.

2. Tax Holiday for Newly Established 100 per cent Export-Oriented Undertakings

Under Section 10B of the Act, a ten-year tax holiday is allowed for new 100 per cent export-oriented units. Any profits or gains derived by a 100 per cent export-oriented undertaking, manufacturing or producing any article or thing, or computer software, shall not be included in his income for ten consecutive assessment years beginning from the first year of production.

Deductions under Sections 10A and 10 B are subject to fulfillment of certain conditions. For instance, it is necessary that the undertaking should not be formed by the splitting up or reconstruction of a business already in existence, and it should not be formed by transfer of old plant and machinery. Units availing complete tax holidays under these sections are not entitled to other tax concessions such as unabsorbed depreciation allowance, unabsorbed investment allowance, set off and carry forward of losses, deductions under Section 80 HH, 80 HHA, 80-I, 80-IA, 80-IB, etc.

The 2001-2002 Budget further rationalised and enlarged existing tax incentives in the form of tax holidays for development of infrastructure. These include a ten-year tax holiday for roads, highways, rails, sanitation, airport, port, waterways, industrial park, and power generation and distribution. A 5 year tax holiday and 30 per cent deduction for the next five years (out of initial 15 years) for telecommunication sector which was earlier available up to March 31, 2000 was reintroduced retrospectively for units commencing operations on or before March 31, 2003. Similar concessions were also extended to internet service providers and broadband networks. Tax holiday for five years and 30 per cent deduction of profits for the next five years were introduced for undertakings engaged in the integrated handling, storage and transportation of foodgrains under Section 80 IB (GOI, 2001-02, p. 56).

3. Tax Concessions in Backward Areas

With a view to promote investment in backward areas, Section 80HH of the Act provides tax concession to newly established industrial undertakings or hotels in notified backward areas. The Section allows a deduction of 20 per cent of profits for a period of ten assessment years beginning from the year of commercial production or starting of hotel. Under Section 80-IB of the Act, a tax deduction is allowed in respect of profits and gains of hotels located in a hilly or rural area, or a place of pilgrimage. The deduction allowed is 50 per cent of the profits and gains for a period of 10 assessment years.

Under provisions of Section 10C, profits and gains derived by an industrial undertaking which began/begins to manufacture or produce on or after 1.4.1998 in any notified integrated Infrastructure Development Centre or Industrial Growth Centre located in the North-eastern region are not included in the total income provided certain specified conditions are fulfilled. Exemption is available in respect of ten consecutive assessment years beginning with the initial year in which the undertaking begins to manufacture or produce articles or things. Units availing tax holiday under this scheme are not entitled to other tax concessions available in the income tax Act. However, an assessee has the option not to avail of the tax holiday in which case he shall be eligible for all other concessions under the Act.

4. Tax Concessions Relating to Research and Development

To boost research and development activities, the Finance (Number 2) Act, 1996 enacted provisions whereby a 5-year tax holiday was provided to companies engaged in scientific and industrial research. In May 2000, the Government announced a 10-year tax holiday for biotechnology and pharmaceutical companies on their earnings from research and development.

With a view to promote scientific research, all revenue expenditure incurred on scientific research related to business is allowed full deduction while computing the taxable business profits. Further, capital expenditure on scientific research is also allowed as a deduction in the year in which it is incurred (Section 35 of the Act).

TAX COMPETITION VERSUS TAX HARMONISATION

Tax competition is a phenomenon whereby independent governments engage in wasteful competition for scarce capital through reductions in tax rates and public expenditure levels. Countries eager to attract FDI have entered into a potentially harmful tax competition, making it difficult for national fiscal authorities to tax the capital of multinational firms. Further, harmful tax practices distort trade and investment flows. In the words of Oates (1972, p.143), "The result of tax competition may well be a tendency toward less than efficient levels of output of local services. In an attempt to keep taxes low to attract business investment, local officials may hold spending below those levels for which marginal benefits equal marginal costs, particularly for those programs that do not offer direct benefits to local business."

POTENTIAL PITFALLS OF TAX COMPETITION

Tax competition can have the following adverse implications.

1. As taxes on business are progressively reduced, national revenues fall, with a corresponding reduction in public services. As observed by Gropp and Kostial (2001, p. 10), "these effects may have already become evident in the sharp decline in corporate tax revenue in some member countries of the Organisation for Economic Co-operation and Development (OECD)."

2. Alternatively, in order to maintain public services, it can also lead to a redistribution of the tax burden from mobile capital onto less mobile factors, particularly labour, or from large multinational to small national firms. If governments are largely unable to tax capital, the tax burden will ultimately fall on labour, and personal income taxes, sales taxes, etc. may have to offset the revenue shortfall.

3. From the perspective of many countries, some of their rivals for investment are perceived to be engaging in unfair tax competition by subsidising their own enterprises and by assisting international investors to avoid or evade tax in their home country.

Thus, tax incentives, allowing large multinational firms to considerably reduce their tax liability, have significant implications for countries' fiscal structure, larger budget deficits, or a cut in public services.

ATTEMPTS TOWARDS TAX HARMONISATION

The competitive process of tax reduction by various countries in order to secure investment has prompted fears of a "race to the

bottom". Although the optimum solution for all countries would be to restrict the use of tax incentives within certain agreed limits, few countries are prepared to take the risk of unilaterally withdrawing from the competition in the absence of such agreements. In view of the above, policymakers are currently debating whether corporate tax regimes should be allowed to compete for FDI or whether taxes should be harmonised. Recent efforts have been launched to harmonise tax systems both in the industrial and developing world. The main efforts in this direction are presented below.

OECD

In the face of the increased globalisation of the national economies, the OECD ministers, in May 1996, called upon the organisation to develop measures to counter the distorting effects of harmful tax competition on investment and financing decisions and the consequences for national tax bases. The OECD Council of Ministers released a report titled "Harmful Tax Competition: An Emerging Global Issue", on April 29, 1998. The Report identifies factors that characterise tax havens and harmful preferential tax regimes and recommends numerous measures in the areas of domestic legislation, tax treaties, and international co-operation, that countries may pursue to counter harmful tax competition.

The Report draws an important distinction between jurisdictions that tax income at a relatively low rate but are not engaged in harmful tax competition, and those where the low tax rate, combined with special features, constitute harmful tax competition. The former includes countries where the generally applicable effective tax rate is lower than that levied in other countries; however, they collect significant revenues from income tax. Jurisdictions, in the second situation, are primarily tax havens that generally impose no or nominal tax rate on income, and thus collect little revenue from income tax. In the case of these tax havens, there are significant undesirable spill over effects on other countries which may be categorised as harmful.

Identifying factors that may characterise tax havens is one of the primary objectives of the Report. Tax havens are defined as jurisdictions that have no or only nominal taxation and less regulatory or administrative constraints, and that refuse to share information with tax authorities, all of which reduce the effective taxation of income located in the jurisdiction. As with tax havens, the Report discusses factors that may help identify harmful preferential tax regimes that provide favourable tax treatment in the context of a general income tax system.

Having identified the phenomenon of harmful tax competition, the Report recommend measures to counteract the same. The Guidelines endorse the "3 R's": to refrain, to review, and to remove, i.e., countries will refrain from adopting new or strengthening existing measures; will review existing measures; and will remove the harmful features of their preferential tax regimes.

In June 2000, another Report was published by OECD, which identified about 47 "preferential tax regimes" among the OECD Member countries. These Member countries were required to eliminate factors causing preferential tax treatment by 2003.

EUROPEAN UNION

Harmonisation of tax systems has been one of the major objectives of the European Union, where Member countries are discussing more stable, predictable and transparent tax rules for investors and govern-

ments alike. The movement to limit tax competition has probably progressed further within the European Union than elsewhere. Gropp and Kostial (2001, p. 12-13) maintain, "The issue of tax harmonisation versus tax competition is of particular relevance in the European Union, where trade is liberalised and standards are largely harmonised. Consequently, competition for the location of investment within the European Union is particularly intense and has further deepened in response to the introduction of euro.......Some European governments fear that without harmonisation, taxes could fall to levels that could jeopardise the fiscal goals set out in the Stability and Growth Pact adopted by EU countries in July 1997."

On December 1, 1997, the European Union Finance Ministers, under the presidency of Luxembourg, agreed to a package of measures to tackle harmful tax competition. A "Code of Conduct" on business taxation was adopted under which the Member States agreed to refrain from certain types of tax competition, and committed to remove harmful tax regimes as soon as possible.

The existing rules of the EC Treaty on state aids are also of great significance. Article 92 of the Treaty prohibits the granting of any state aid which distorts or threatens to distort competition by favouring certain undertakings or the production of certain goods, insofar as trade between Member States is affected. Tax incentives such as tax holidays, reduced tax rates, and investment tax credits, that are aimed at a particular region or economic sector are considered to be specific and therefore open to investigation by the EU Commission. The Treaty goes on to provide that certain types of aid may be permitted by the Commission, in particular, the aid to promote the economic development of areas with low standards of living or serious unemployment.

The Code of Conduct and state aid rules apply only to the EU Member States and to the associated overseas territories of Member States. Thus, although the Code of Conduct and state aid rules have no direct impact on other countries, their indirect impact may be substantial. According to Prof. Easson (1998, p.197), "It is clear that the tax systems of potential members will be subject to scrutiny to determine whether they are consistent with the EC Treaty and with the Code of Conduct, although some of the existing incentives will probably be allowed to remain in effect, at least temporarily."

WORLD TRADE ORGANIZATION

The WTO has also taken a number of steps having far-reaching implications for the use of special tax concessions. For instance, China's admission to the WTO was contingent upon certain changes in China's existing tax system in order to make it compatible with the WTO rules. In particular, changes need to be made in the profits tax reductions linked to export performance, and tax preferences for using Chinese-made inputs. Similarly, the American FSC (Foreign Sales Corporation) regime, allowing profits from export sales made through offshore companies to be repatriated to the U.S. tax-free, was ruled by the dispute settlement panel as a prohibited export subsidy.

In addition to the above international forums, the IMF and the World Bank have also taken measures to persuade their Member countries to eliminate or reduce special tax incentives. For example, the IMF

has been able to exert substantial pressure on Philippines to remove discriminatory incentives; on Romania to remove concessions for investment in oil refineries; and on Tanzania to remove tax holidays for foreign investors. Similarly, several West African countries have been undertaking a joint effort to harmonise their tax incentives for FDI in one unified Investment Code within the Monetary Union of West African States.

CONCLUSION

To secure the benefits of FDI, countries now actively compete with each other to attract FDI which, in many cases, is done by offering tax incentives such as tax holidays, investment allowances etc. In view of the extensive use of tax incentives by governments all over the world, many economists have evaluated both their potential effects and costs. The general conclusion of this research seems to be that tax incentives are a very costly instrument for attracting FDI and that there are limits to their effectiveness. However, despite the costs, governments particularly in developing countries, are under immense pressure to offer tax incentives due to the fear of potential investment going to the competitors.

As a result of the growing tax competition, recent efforts have been launched by many international forums to harmonise tax systems both in the industrial and the developing world. The widespread use of tax incentives by economies world-wide has resulted in a counter-movement against them, which may impose some constraints in the future on the ability of both developed and developing countries to adopt fiscal measures designed to compete for investment. International forums such as the European Union and OECD have declared tax competition as harmful to countries. However, this view has to be contrasted with the argument that variations in tax regimes give taxpayers more choice and thus more chance of being satisfied. In addition, they push governments to compete by offering different combinations of public services and taxes.

Gropp and Kostial (2001, p. 13) conclude, "At this stage, it is unclear whether letting tax competition run its course would result in inefficiently low corporate tax rates or whether there would be some convergence towards a *reasonable* rate. However, if governments are largely unable to tax capital, the tax burden will ultimately fall on labour, and personal income taxes and sales or value-added, or both may have to offset the revenue shortfall.....Thus, the challenge for policymakers will be to balance what are, in many ways, contradictory demands and to find a package that appeals to international investors and firms while keeping an eye on the sustainability of the fiscal position. "

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