

TAX SYSTEMS AND TAX REFORMS IN SOUTH AND EAST ASIA:
FEATURES AND EFFECTS OF CORPORATE TAXATION ON FDI

FRANCESCO D'AMURI, ANNA MARENZI

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TAX SYSTEMS AND TAX REFORMS IN SOUTH AND EAST ASIA: FEATURES AND EFFECTS OF CORPORATE TAXATION ON FDI

by

Francesco D'Amuri - University of Pavia



and

Anna Marenzi - University of Insubria



Abstract

This paper is part of a wider research on South and East Asia countries' taxation, carried on at this Department, under the direction of L. Bernardi, A. Frascini and P. Shome, and the supervision of V. Tanzi. The scope of the article is to give an overall picture of the existing interactions between the economic structure, the corporate tax system and the attractiveness of FDI inflows in a selected sample of South and East Asian countries. The sample comprises the two biggest developing countries (China and India) at the rushing stage of their catching up; two countries in a middle stage of development (Malaysia and Thailand) and, finally, two industrialized countries (Japan and South Korea). The six countries are characterized by a different degree of economic development and by a different level of maturity in their corporate tax systems. Also the role played by FDI in the economic performance of these countries has been different: Malaysia, Thailand, and Korea have experienced high levels of foreign capital inflows for a long time. For different reasons, India and Japan have had a poor performance in the attraction of FDIs. China, instead, has opened up its markets in the last two decades, experiencing a huge inflow of foreign investment. The structure of corporate income taxation and of tax incentives reflects the different level of economic development of the six countries analyzed. The paper discusses the characteristics of CIT and the effectiveness of tax incentives in the six countries in attracting FDIs. Finally, some broader considerations on the design of tax incentives policy will be drawn.

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E-mail address: francesco.damuri@unipv.it; amarenzi@eco.uninsubria .it.

Department of Public and Environmental Economics
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1. Introduction

This paper aims at giving an overall picture of the existing interactions between the economic structure, the corporate tax system and the attractiveness of FDI inflows in a selected sample of Asian countries. The economic structure of a country can explain much of the features of its tax system. Following economic growth, social and institutional changes, fiscal systems change. New tax handles substitute the old ones. The systems become more complex and tax administration and compliance more demanding. Furthermore, both the level and the structure of taxation affect the level of private saving and thus the volume of resources available for capital formation.

Corporate income taxation (CIT) plays a strategic role in this respect. In particular, differences in corporate taxation across countries can affect the allocation of foreign direct investment (FDI) by driving the wedge between the post and pre-tax rates of return. In a world where an increasing number of countries compete hard to attract FDIs, tax authorities try to encourage capital inflows by offering generous investment tax incentives. Consequently, the fiscal incentives have become a relevant aspect in the design of national tax policy. Generally, developing and transition economies rely mainly on profit-based incentives, including tax holidays and partial profit exemptions, which are particularly prone to aggressive tax planning (Owens 2004), while industrialized countries use more often capital based incentives which are intended to reduce the cost of qualified capital.

The sample of countries analyzed in this paper comprises the two biggest developing countries (China and India) at the rushing stage of their catching up; two countries in a middle stage of development (Malaysia and Thailand) and, finally, two industrialized countries (Japan and South Korea). The six countries are characterized by a different degree of economic development and by a different level of maturity in their corporate tax systems. Also the role played by FDI in the economic performance of these countries has been different: Malaysia, Thailand, and Korea have experienced high levels of foreign capital inflows for a long time. For different reasons, India and Japan have had a poor performance in the attraction of FDIs. Finally China has opened up its markets in the last two decades, experiencing a huge inflow of foreign investment.

The paper is organized as follows. We start with an analysis of the degree of economic development of the countries considered in the sample, the openness of their markets, the level of industrialization and their capacity to attract FDI. Then we review the main ideas in the literature about the effects of the systems of corporate income taxation and tax incentives on economic development and capital inflows. We then move to analyze in detail the corporate tax structures in the selected countries, distinguishing between the main features of the basic tax regimes and the complex systems of tax incentives. In the conclusion we bring the various themes together, evidencing how the different stages of economic development of the various countries are reflected in their respective corporate tax systems. Moreover some critical aspects of the design of a tax incentive policy, namely the risks of tax competition and the need of a comprehensive cost benefit analysis, are stressed.

2. External trade and FDI inflows in the countries of our selected sample

The economies of the six South and Eastern Asian countries whose fiscal systems are analyzed in this book differ dramatically (see Figure 1). One of them, Japan, can be considered one of the most industrialized countries in the world, characterized by a mature economy and a level of GDP per capita not comparable with those of the other countries, excepted Korea, that has experienced a strong and stable economic growth in the last 20 years. In the period 1975-2003 Malaysia and Thailand show economic performances similar in levels and growth rates and can be considered two countries at a medium stage of economic development. Finally China and India differ substantially from the others for their dimensions (respectively 1.3 and 1 billion inhabitants) and for their low but rapidly increasing level of economic development. In 1975 China had the lowest level of income per capita among the six countries, but, thanks to a strong growth, reached India in the early 1990s and it is in 2003 the greatest of the six economies in absolute terms.

The six economies are characterized by a relevant level of economic openness.

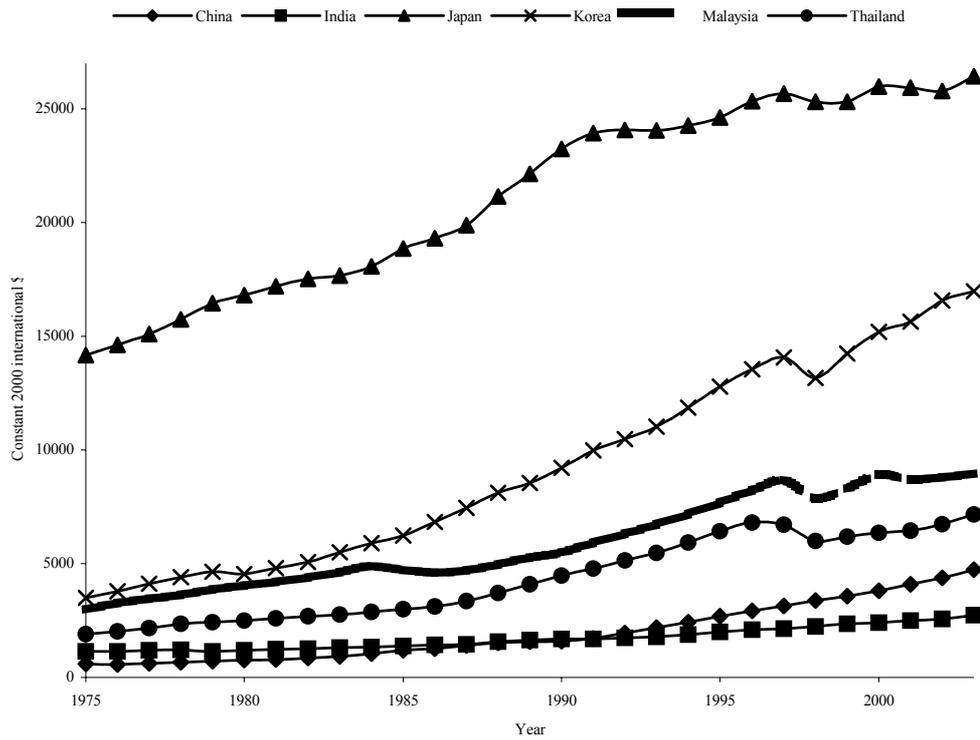


Figure 1 GDP per capita, PPP, 1975-2003
Source: World Development Indicators, World Bank

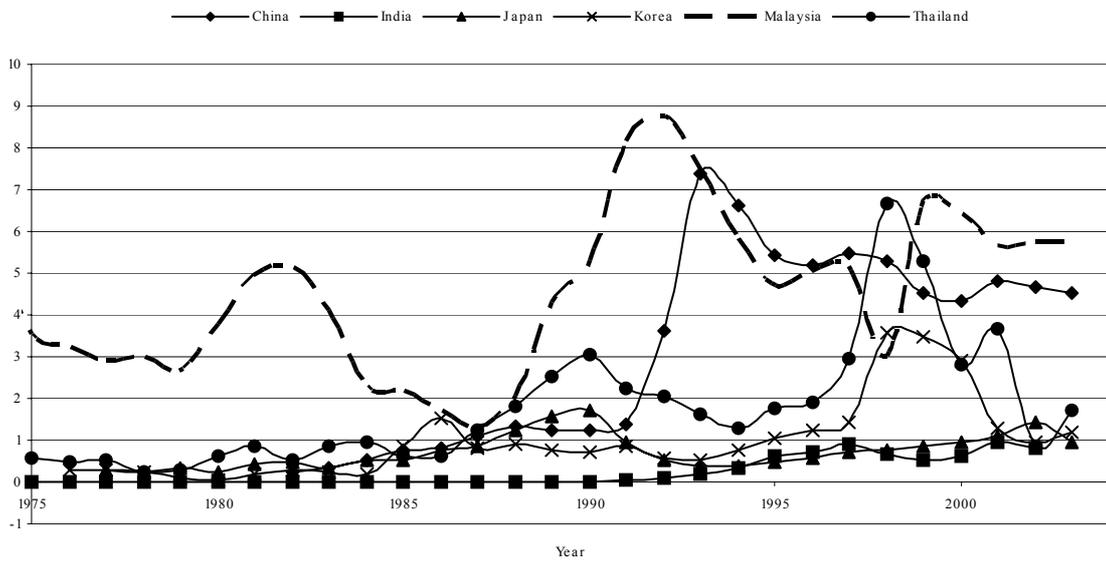


Figure 2 Gross FDI inflows as percentage of GDP 1975-2003
Source: World Development Indicators, World Bank

Japan is an exporter of high tech goods and cars, with a trade/GDP ratio around 20 percent. Gross FDI inflows are high in absolute terms (53 billion \$ in 2004), but low if compared with the size of the economy (0.97 percent on GDP in 2004, Figure 2). Many elements could have prevented Multi National Enterprises (MNEs) to invest massively in Japan. Lawrence (1991-1993) assumes that the prevalence of corporate groups or *keiretsu* could constitute an impediment to FDI, since they usually discriminate against foreign firms. Also the particular conditions of the Japanese labor market could partially explain the low level of FDIs: high-skilled Japanese workers prefer to work in domestic enterprises since they offer them long-term employment and better training opportunities.

Korea can be considered an export-led growth economy. At the beginning of its long period of economic development (early 1960s), the country was characterized by heavy protection, with high levels of tariffs and quotas on imported goods. This did not prevent the country from engaging in international trade: instead of removing the anti-export bias due to the high level of internal market protection, the government started a policy of export promotion. In particular, firms fulfilling the export objectives were subsidized with cheap credit by the financial system. In this stage exports were constituted primarily by labor intensive goods such as clothing and footwear, with FDIs playing almost no role in the economy. As the economy grew, the country had to shift its trade policy towards more openness, removing tariff and non-tariff trade barriers. Moreover, the production moved progressively from labor intensive goods towards higher levels of quality and style. Thanks to the increasing liberalization, FDIs have been playing an increasing role since the second half of the 1980s, with a clear boom ten years later (gross FDIs inflows were equal to 3.8 percent of GDP in 1998, see Figure 2), interrupted only by the financial crises.

Also Malaysia has industrialized rapidly in the last 30 years, with an economic structure initially based on the production of mineral and agricultural export commodities, now relying primarily on electronics. Malaysia has a sincere orientation to trade: the trade/GDP ratio has been increasing steadily during the past 30 years, reaching quota 220 percent in 2004. During this period the Malaysian economy has been characterized by a high level of gross fixed investment (43.1 percent of nominal GDP in 1997), decreased dramatically after the financial crises (22.1 percent in 2003),

due to a severe contraction of domestic and foreign investment. Reaching the old levels of private investment is a primary target for the government economic policy, but the increasing competition for FDIs makes this goal difficult to achieve. FDIs have had an important role in the Malaysian economic development, attracted by good infrastructures and highly educated workforce (expense in education is the largest item of the federal budget). FDIs are concentrated in manufacturing and in the service sector, with many MNEs reinvesting profits in the domestic market. Efforts have been made in the last years to attract more foreign investment, as underlined for example by the abandonment of the policy of reserving quotas of corporate equity on ethnic basis, which scared some foreign investment in the past. Notwithstanding this, the control operated by the Malaysian Industrial Development Agency (MIDA) remains strong. This agency has the task to approve inward investments on the basis of equity stakes, products and processes concerned, financing. In the last years FDIs in low productivity industries have been discouraged, while stronger incentives and reduced restrictions on investment inflows have been offset by the increasing Chinese competition in this field.

Thailand, as many of the other economies analyzed in this paper, has progressively lifted restrictions on trade in the last 40 years. During the late 1950s, the government started its effort of raising the level of domestic and foreign investment, without renouncing to a high level of protectionism and a strong commitment on import substitution. Since then Thai trade policy has progressively approached a more free market view, partially criticized by the last government, in charge since 2001. Above all, Thailand remains a very open economy, with a trade/GDP ratio steadily increasing and equal to 123 percent in 2003. Also FDIs have increased steadily in the last 20 years, reaching a maximum in 1998 (6.6 percent on GDP) and decreasing sharply afterwards because of the financial crises. The competitive advantage of the Thai economy has been traditionally on labor intensive goods, such as textiles and shoes, but since the mid-1990s these sectors are suffering from the competition of lower-cost producers such as China, India and Vietnam. Export performances remain high thanks to an increasing role of the high tech and automotive industries.

China is experiencing a different path of economic development and market liberalization, started in 1979 with the first stage of transition from a planning to a market economy. Before 1979 no FDIs were allowed to enter the country, while the

trade regime was characterized by the presence of a small number of foreign trade corporations with monopolies in the import-export of selected goods. The planned level of imports was determined in order to cover the difference between domestic demand and supply for certain goods, while exports were set at the level strictly necessary to finance imports (Ianchovichina and Martin 2001). In 1979, together with the introduction of the first reforms oriented to trade liberalization,¹ the establishment of four Special Economic Zones (SEZs) was approved. Foreign companies investing in these coastal areas were allowed to exploit tax holidays, physical infrastructures and low labor costs, together with the possibility of importing intermediate and capital goods duty free. Foreign investments started to arrive in China, concentrated in small sized export oriented businesses. In 1986 restrictions on FDIs were relaxed² and tax incentives augmented, while local governments were recognized as playing a role in the attraction of foreign investments. Foreign companies' activities started to concentrate in manufactures, while their importance was rapidly increasing till the Tiananmen Square incident. But in the early 1990s new successful provisions were approved in order to attract foreign investments, which reached double-digit growth. In 2004 China was the third largest exporter in the world, with Foreign Invested Enterprises (FIEs) accounting for 58 percent of export, according to Chinese customs data. FDIs reached in the same year the maximum of 70 billion \$, while exports were concentrated in textiles (15 percent total exports in 2004) and machinery and electrical appliances (41.8 percent of total exports).

Finally India, with its low record in FDIs attraction. The country was one of the first in the world to establish an Export Processing Zone in 1965, but many elements have prevented it from becoming an attractive destination for foreign investments. Acharya (2001) ascribes the not particularly high industrial performances of this country to the anti-export bias of foreign trade policies, strict labor laws, poor infrastructure and bureaucracy. Henley (2004) attributes the low attraction of FDI to causes such as the ineffectiveness of local government policies, the low level of public investment in infrastructure and lobbying activities against liberalization undertaken by domestic

¹ In 1979 the number of enterprises allowed to trade increased, indirect trade policy instruments (such as quotas and tariffs) were introduced, and restrictions on prices and exchange rates were removed.

² According to Sun *et al.* (2002), in 1986 were '*relaxed the restrictions regarding expatriation of profits and dividends, and allowed foreign nationals to be the chairman of the board of directors in Foreign Invested Enterprises.*'

enterprises. First comprehensive pro trade reforms were approved in the late 1980s, slowly abandoning the import substitution policies of the 1960s and 1970s. The 1991 “New Industrial Policy” removed public sector monopoly in many sectors and relaxed many restrictions posed up to that time on foreign investment. In particular, the threshold of 40 percent on foreign equity share was removed, while the automatic approval of foreign investments was progressively introduced in many sectors. The introduction of liberal policies did not have a strong impact on FDIs, that are still very low if compared with the size of the economy (less than 1 percent the gross FDI/GDP ratio in 2004). FDIs are concentrated in power generation, mobile telecommunications and software industries, while they are low in labor-intensive manufacturing sectors, due to the well-established policy of reserving some sectors for small-scale domestic industries.

3. Interactions between corporate taxes and FDIs: a remind of literature

Host country tax policy may have a relevant role in attracting foreign direct investments. As long as location decisions made by Multi National Enterprises (MNEs) are driven by after tax profit maximization, the structure of the corporate income tax and tax incentives offered by the host country can influence the inflow of investments, determining the wedge between before and after tax profits. If investments in different locations are characterized by the same expected rate of return, a reduction of the tax burden borne by MNEs in a particular country could determine the final investment location decision. However tax policy alone cannot be very effective in influencing FDIs location choice in the absence of other elements that determine the expected rate of return of a company, such as good infrastructure, proximity to final markets, stable social and political environment, good labor market conditions and many other economic fundamentals that could influence the desirability of an investment location.

Economic theory suggests that tax incentives designed to encourage FDIs are justified by the presence of positive spillover effects of foreign investment on the host country economy. FDIs are in fact expected to raise the competitiveness of the host

country economy increasing the level of capital, transferring knowledge and enhancing productivity. Moreover, regional specific incentives can be a tool of regional development, attracting investments into less developed areas. All these positive spillovers are not included in the objective function of MNEs when choosing the optimal level of investment. This therefore brings a sub-optimal level of FDI. To prevent this market failure, host country governments are then interested in offering tax incentives in order to subsidize the inflow of foreign investments. It is not often underlined in the literature the fact that special tax incentives and corporate tax reductions targeted on foreign investments are justified, on this ground, only if foreign enterprises differ significantly from domestic ones (Blomstrom and Kokko 2003). In fact, foreign enterprises cause positive spillovers on the host economy as long as they can improve the economic specialization of the host country producing new products or being characterized by elements such as higher productivity, better management, greater international orientation, more advanced technology. In absence of these elements, preferential tax treatment for foreign enterprises would only distort competition and put local companies in disadvantage. In this case, investment subsidizing policies are still justified by the aim of improving economic performance, but they should not differentiate between foreign and local investors.

Host countries aiming at a reduction of the tax burden borne by income generated by FDIs have several options. The first possibility is a reduction in the statutory corporate tax rate level. It enables the government to increase the after tax rate of return, stimulating investment but letting the market define the most profitable investments without governmental influence. The reduction could be targeted on a particular source of income (foreign or domestic) or on a particular sector of activity. In this case administrative and compliance difficulties arise together with the possibility of tax avoidance. Another shortcoming of a reduction in corporate rates relies on the fact that the incentive favors indiscriminately all investments, even those made before its introduction. Such revenue loss has no effect in raising the investment level.

Tax holiday is another instrument widely used to attract investments. Under a corporate tax holiday, newly-established, qualifying firms are exempt from paying corporate income tax for a specified period; usually, once the basic tax holiday has expired, companies pay a reduced tax rate for additional years. Tax holidays have some

advantages that make this form of incentive particularly attractive for developing and transitional countries; however, as it is well known, their costs might well outweigh their benefits as a means of attracting foreign investment (see, among others, Chalk 2001; Mintz 1990; Owens 2004; Zee *et al.* 2002).

Tax holidays provide, with respect to other types of tax incentives, a simple regime both for foreign investors and for tax authorities. They allow qualified investors, in the first years of operation, to avoid interactions with the tax authorities, while, on the other hand, they relieve tax authorities from the burden of administering them. In addition, they are neutral in their impact on the use of productive factors (Wells and Allen 2001).

However, CIT holidays provide large benefits if the company makes profits in the early years of operation. In this respect, they primarily favor short-term investments, which are often undertaken in so-called footloose industries characterized by companies that quickly disappear from one jurisdiction to reappear in another, and tend to penalize long-term projects with large start-up costs in the initial production years.

Furthermore, tax holidays create competitive distortions between old and new firms, pushing them to redesign existing investments as new investments or to form a new company after the holiday expires. They are also likely to have a direct negative effect on fiscal revenues and create significant opportunities for aggressive tax planning (OECD 2003).

The impact of tax holiday on the return of investment is quite difficult to evaluate since it depends on technical aspects of its design, that is, the starting period of the holiday, the tax treatment of losses incurred during the holiday period, and the duration of the incentive (for a rigorous demonstration of this result, see Mintz 1990).

Other forms of incentives, such as investment allowances and tax credits aim at lowering the corporate tax burden by a reduction in net costs of investment. These kinds of incentives should be preferred since they are targeted just on increases of the capital stock, and thus do not provide windfall gains to existing capital holders as in the case of a reduction in the corporate tax rate. Besides, they offer less possibility of tax avoidance. As with tax holidays, also investment allowances and tax credits are more attractive for those companies that are incurring profits when the incentive is introduced. Start-up businesses or newly-established long run activities (that should be

the main target of an investment incentive policy) are likely to incur losses in the first years of activity. For them investment incentives would then be irrelevant.

Finally it has to be noted that the effectiveness of tax incentives in lowering effective tax rates borne by foreign enterprises depends on the interactions between the host and the home country tax systems. In the case of full exception for corporate income earned abroad, tax incentives will be effective in lowering the total tax burden borne by MNEs. They could instead be ineffectual in the presence of tax credit schemes, in which a decrease in corporate taxes paid by a MNE abroad would be offset by an equal increase in the home country tax liability. In order to prevent this, many governments provide “tax sparing” credits for investments in developing countries. Under “tax sparing” agreements, companies investing abroad are allowed to claim tax credits computed as if no tax incentives existed in the foreign country. In this way tax breaks offered by capital importing countries can enhance the after-tax profitability of foreign investors (Hines 1998).

Several empirical works have tried to assess quantitatively the impact of taxation on FDI inflows (for recent surveys of empirical findings: De Mooij and Ederveen 2003; Hines 1999). Most of the empirical work has been focused on the US, for reasons of data availability. In particular, investment decisions made by US companies investing abroad or by foreign enterprises investing in one of the fifty US states (corporate tax legislation differs among US states) are taken into consideration in the attempt to estimate quantitatively the impact of taxation on FDI inflows. As noted earlier, tax policy effectiveness in attracting FDIs depends on the interaction between home and host country tax legislation. Then, empirical findings obtained analyzing only US data, should not be generalized.

Empirical analyses have been using time series and cross sectional estimation of FDI response to changes of after tax rates of return. In both cases the main limitation relies on the fact that the variation in effective tax rates could be correlated with other important omitted variables, difficult to control for (Hines 1999). This makes difficult the interpretation of tax/FDI elasticities. Notwithstanding these limitations, evidence does support the hypothesis of a negative tax elasticity³ of investment even if a consensus on its value is far from being reached. De Mooij and Everdeen (2003),

³ Studies reporting a positive tax elasticity of investment are not absent. See Scholes and Wolfson (1990) and Swenson (1994).

construct a meta sample including the estimates of different empirical works on the effect of tax burden on FDIs. They homogenize different definitions of tax elasticity of investment across the 25 studies analyzed. It is equal to $\partial \ln(FDI)/\partial t$ and measures the percentage change in FDI induced by a percentage change in the tax rate. The majority of the observations rank between -5 and 0 , giving support to the hypothesis of a positive effect of corporate tax cuts on FDIs. Moreover a certain consensus has been reached on the fact that FDI financed by retained earnings of foreign affiliates is more responsive to changes in the host country tax rate than FDI financed by transfers of parent company funds (Hines 1999). Another result common to many empirical studies is that the responsiveness of FDI flows to tax changes is increasing over time, consistent with the global reduction in non-tax barriers to FDI, including the suppression of investment and currency controls (OECD 2001).

However, given the uncertainty on the quantitative impact of tax incentives on foreign investment, elasticity estimates should still be used with caution when trying to carry out cost-effectiveness analysis of a given tax policy in attracting FDI. Moreover, until now, all the empirical works have concentrated on the effect of overall corporate tax policy (i.e. average or marginal effective tax rates borne by companies) on FDI. Given that a tax cut may have a beneficial impact on foreign investment, there is no evidence on how host countries should reduce taxes in order to obtain the maximum beneficial impact in terms of real capital inflows. As noted earlier, in fact, a decrease in effective tax rates can be obtained by means of different options.

4. Corporate taxation and tax incentives in South and East Asia

4.1 The systems of corporate taxation

The current corporate tax systems of the selected countries are the result of several successive fiscal reforms mainly started in the beginning of the 1990s and, for certain countries, still under way. Generally, most countries have realized a consistent reduction in statutory tax rates in the last decade, while only partial efforts of broadening tax bases, have been made.

Table 1 The main features of the corporate tax systems

	China	India	Malaysia	Thailand	Japan	South Korea
Standard CIT Rate	33% (state tax of 30% and local tax of 3%)	<i>domestic company:</i> 35.875% ^a <i>foreign company:</i> 41%	28% ^b	30%	30% ^c	27% ^d
Inter-company dividends	fully/partially excluded ^e	fully/partially excluded ^e	included as a part of the taxable income	fully/partially excluded ^e	fully/partially excluded ^e	fully/partially excluded ^e
Dividend withholding taxes	20%	dividends are no longer taxed in the hand of recipient equity shareholders but subjected to DDT if distributed	included as a part of taxable income for PIT	10%	partially included as a part of taxable income for PIT or 20% ^f	included as a part of taxable income for PIT
Capital gains	CIT rate	<i>Short-term:</i> CIT rate <i>Long-term:</i> 20.5%	CIT rate	CIT rate	CIT rate surtax of 5% on gains from land or similar properties	CIT rate
Treatment of Losses	5 years carried forward	<i>Business losses:</i> 8 years carried forward <i>Capital losses:</i> carried forward indefinitely	Carried forward Indefinitely	5 years carried forward	5 years carried forward; 1 year carried back	5 years carried forward

^a The tax rate of 35.875 is levied on retained earnings; dividends are taxed under the dividend distribution tax (DDT) at the rate of 12.81. Moreover, both resident and non-resident companies are liable to pay tax on their book profits where the tax liability of the year is less than 7.5% of the adjusted book profit; the tax rate is fixed at 7.688.

^b Companies with paid-up capital of 2.5 million RM and below are taxed at a rate of 20% on chargeable income of up to RM500,000. The CIT rate on the remaining income is 28%. In case of petroleum companies, the tax rate is 38%; different rates are applied to insurance companies.

^c If the corporation's paid-up capital is more than 100 million YEN the tax rate is 30%; otherwise, on taxable income up to 8 million YEN a tax rate of 22% is levied; excess over 8 million YEN is taxed at 30%.

^d The tax rate of 15% is levied on taxable income less than 100 million WON; the excess is taxed at 27%.

^e Under specific conditions on the proportion of shares in the payer company and, in some cases, on types of subsidiaries.

^f If dividends are taxed as separate income, otherwise they benefit from a tax credit equal to 10% of dividend income.

Source: KPMG (2004) and others.

Table 1 summarizes the main feature of the corporate tax systems of the countries analyzed in the sample. In considering the information reported in the Table 1, it is first of all important to point out that, generally, for tax purposes, domestic company is liable to be taxed on its worldwide income (except Malaysia; see below), while the tax liability of foreign company is normally limited to host-source income.

Moreover, with regard to the treatment of foreign source income, in order to avoid double taxation, almost all countries adopt the “residence” or “worldwide” approach in computing tax liability, combined with tax credits. Under this system, foreign source income is subject to home country taxation, but a credit or deduction is allowed for taxes paid to the host government. The foreign tax credit is typically limited to the home country tax liability on foreign source income. In Japan and Korea any remaining excess of tax credit can be carried forward for crediting in succeeding years (three years in Japan and five years in Korea). In this respect, Malaysia represents a special case: income arising from foreign sources and received by a resident company⁴ is not taxed at all (“territorial” system). Concerning the structure of the corporate tax rates, Malaysia, Japan and Korea have a graduated structure while India, China and Thailand have adopted a flat rate. Most countries have a statutory rate of around 30 percent at the national level (see Table 1). In India, the rate depends on the nationality of the firm: for foreign companies it is set at 41 percent against 35.875 for domestic ones.⁵ In China, different tax codes are in force for domestic and foreign enterprises, even if, after WTO accession, there are increasing pressures to adopt a unified legislation. The national CIT rate (formally equal for foreign and domestic enterprises) is 30 percent plus a local surtax of 3 percent. However, the state rate is reduced to 24 percent for foreign investment enterprises (FIEs) operating in coastal regions; the rate even goes down to 15 percent for FIEs located in one of the special economic zones (as Shenzhen and Shanghai); moreover the local tax of 3 percent may be waived or reduced by the local government. As a result, generally, the Chinese domestic companies are penalized with

⁴ The exemption is not allowed for companies whose business is in banking, insurance, sea and air transport.

⁵ If the tax liability for the year is less than 7.5 percent of the adjusted book profits, both Indian resident and nonresident companies are liable to pay tax on their book profits; the current tax rate of the minimum alternative tax (MAT) is 7.688 percent, including 2.5 percent surcharge.

respect to foreign-funded companies.⁶ Among industrialized countries, Japan has a low statutory rate; the picture substantially changes when corporate taxation levied by the central government is combined with local taxes to determine the overall statutory rate.

Given the graduated rates in the calculation of both corporate and business taxes and the different local tax rates, the “all-in” statutory rate varies in Japan within the range of approximately 39 to 43 percent.

Most of the countries in the sample adopt a broadly similar definition of taxable income; although certain relevant differences may be noted in relation to the types of deductions allowed, the amount of deductible expenses, and the types and the amounts of exemptions. In some cases, special rules in determining tax liabilities vary according to the size, location, and industry of the companies (in particular in China, Malaysia and Korea).

The depreciation system differs in many aspects from country to country. The Chinese depreciation system is calculated on the straight line-basis; accelerated depreciation may be conceded in a few specified circumstances. In India depreciation is calculated on the declining-balance method. The general rate of depreciation for plant and machinery is 25 percent. Additional depreciation of 15 percent on new machinery and plant is allowed. The higher rate of depreciation was initially adopted to offset the negative effect of the high corporate tax rate on internal accrual of resources for replacement and modernization. However, the cut in the tax rate realized in the last decade, and a new reduction currently under discussion, make less justified generous depreciations. In the absence of adequate profits, unabsorbed depreciation on both tangibles and intangibles can be carried forward indefinitely. Any accounting method of depreciation can be used under the Malaysian and Thai systems; in both countries, accelerated depreciation may be allowed for accessories used in research and technological development. The Japanese corporations may select either the straight-line method or the declining balance method depending on the type of asset;⁷ special depreciation by means of either increased initial depreciation or accelerated depreciation

⁶ Haung (2003) gives evidence that the business environment is more “friendly” to FIEs than domestic firms.

⁷ More precisely, both methods are allowed for tangible fixed assets; intangible assets must be amortized using straight-line method.

is available for corporations in relation to specific IT related assets and R&D related machinery/equipment.

Most of the countries permit losses to be carried forward for a maximum period of five years (China, Thailand, Korea, Japan), while Malaysia allows unabsorbed losses to be carried forward indefinitely. Under the Indian income tax system rules change depending on the nature of losses: the operating business losses are allowed to be carried forward for eight years; capital losses arising from depreciation are carried forward indefinitely.⁸

In all countries of the sample, excluding Malaysia, inter-corporate dividends are partially or fully exempt from corporate income tax for resident enterprise or company. The exemption is granted under specific conditions prescribed by the tax laws with respect to the proportion of the shares of subsidiaries owned by their company. For example, in Thailand and in Japan inter-corporate dividends are fully excluded from taxable income if the corporation owns more than 25 percent of the shares of the domestic corporation which pays dividends;⁹ otherwise, the amount excluded is reduced to 50 percent. In Korea, in addition to the proportion of shares of subsidiaries owned by the company, the amount of dividends excluded depends on the type of subsidiary (listed or non-listed in the Stock Exchange) and whether the company receiving dividends is a holding company or not.

Generally, capital gains of corporations are included in ordinary taxable income and are subject to taxation in full as they are realized; in certain countries they are charged under corporate tax, but at a different rate. This, for example, applies to the Indian tax system, which uses different rules depending whether they refer to short or long-term capital gains: short-term capital gains are taxed at the normal domestic rate of 35.875 percent; long-term capital gains¹⁰ are taxed at the rate of 20.5 percent. In Japan, capital gains from short term transactions of land carry an additional special tax burden (surtax of 5 percent).

⁸ According to the Kelkar Task Force (Government of India 2004) the differentiate treatment between unabsorbed depreciation and unabsorbed business should be removed and business loss, like unabsorbed depreciation, should be allowed of carrying forward indefinitely.

⁹ In Thailand, full exemption is allowed for companies listed in the Stock Exchange of Thailand irrespectively of the proportion of shares owned by the company.

¹⁰ Long-term capital gains on sales of shares in a government approved enterprise wholly engaged in specified infrastructure sectors are exempt from corporate income taxation.

Finally, in most countries, the system of integrating personal and corporate taxation is fairly conventional, adopting essentially the “classical” model. Three countries (China, Thailand and Japan) apply final withholding tax on dividends paid to domestic individuals (the withholding tax rate varies from 10 to 20 percent). In order to mitigate the burden of double taxation the Japanese taxpayers may either benefit from a tax credit equal to 10 percent of their dividends if dividends income are taxed as part of aggregate income, or, if dividends are taxed as separate income, pay a withholding tax at the same rate as capital gains and interest (20 percent). With respect to the classical model, India and Malaysia represent important exceptions. Under the Indian system, the company paying the dividends is subject to a dividend distribution tax (DDT) of 12.5 percent plus a surcharge of 2.5 percent on DDT; the tax rate on retained earnings is the standard CIT rate (35.875 percent). Dividends are exempt from income tax in the hands of shareholders, irrespective of their residential status. The taxation of companies in Malaysia is based on a full imputation system where the shareholders are taxed on the grossed dividends at their own respective tax rates and are given full tax credit in respect of the tax deducted at source from the company.

Of course, depending on the interactions between the different features of the corporate tax system, effective tax rates may differ substantially from the statutory rates. The differences depend on the determinants of the tax base and on the tax incentives granted by the tax systems.¹¹ The erosion in the tax base is a serious problem for most countries, whether due to generous deductions and exemptions or to heavy use of a large number of multifaceted incentives. For example, in India, for manufacturing companies, the erosion in the tax base measured by the difference between the statutory and the effective corporate tax rate corresponded to about 22 percentage points in 1996-7 (43 percent against 21.36 percent) and about 13 points in 2002-3 (36.75 percent against 23.53).¹² Evidence on the distortions caused by the incentive regimes in force in Malaysia and Thailand in 1999 are reported by Chalk (2001). In the absence of any incentive, the effective tax rate was 30 percent in Malaysia and 46 percent in Thailand;

¹¹ See section 4.2 for a detailed description of tax incentives.

¹² The data are taken from the Report of the Task Force on Implementation of the Fiscal Responsibility and Budget Management Act, 2003 (Government of India 2004).

the incentives (in the form of tax holiday and indirect tax concessions) reduced the effective tax burden by 8 percent points in Malaysia and by 39 percent in Thailand.¹³

4.2 Corporate tax incentives

Following the standard classification (see, among others, Owens 2004 and Zee *et al.* 2002), corporate tax incentives can be broadly divided into two main categories: profit/income based and capital investment based. The first category includes: exempted profits (tax holidays), profits taxed at a lower nominal rate than the standard CIT rate, and losses carried forward or backwards. The second type of incentives are intended to reduce the cost of capital through investment and reinvestment allowances, investment tax credit and accelerated depreciation.

Tables 2-3-4 compare in some detail corporate tax incentives across the selected countries, distinguishing among the various incentive categories.

4.2.1 Profit/income based incentives

Tax holidays

As previously mentioned, all the six countries, excluding Japan, adopt tax holidays, notwithstanding their numerous shortcomings. Furthermore, the reforms designed and implemented to mitigate the adverse impact of the Asian financial crisis of 1997 have reinforced the use of such incentives, rather than reduce it, as suggested by international organisms (see among others, OECD 2003; UNCTAD 2003 and Wells and Allen 2001).

It is important to note that, in China, foreign investment enterprises enjoy tax holidays (and some other policy incentives) denied to local firms; on the contrary, in India, Malaysia and Thailand, tax holidays are granted to both domestic and foreign companies, but, generally, additional benefits are limited to foreign enterprises.

¹³ This comparison is with respect to the most generous incentive regime in Thailand that applied to exporters located in underdeveloped regions.

Table 2 Summary of corporate tax incentives in China and India

	China	India
<i>Sector qualifying for incentives</i> (not exhaustive)	Newly established FIE with a term of not less than 10 years and engaged in production-oriented activities (Group A); technologically advanced and export-oriented enterprises (Group B); enterprises engaged in farming, forestry or located in remote and economically underdeveloped areas (Group C); port and wharf construction Sino-foreign joint ventures (Group D);	New industrial undertakings located in specific backward states and districts (Group A); companies engaged in R&D, commercial production, developing and building and project, and various other activities (Group B); power generating and distributing companies, enterprises providing communication services, infrastructure facilities (Group C).
<i>Tax holidays</i> - duration and rate of tax exemption	- 2 years at 100% plus 3 years at 50% (Groups A, B,C) - further reduction of 50% of CIT for 1 to 3 years (Group B); - further 15/30%reduction for 10 years (Group C); - 5 years at 100% plus 5 years at 50% (Group D);	- 5 years at 100% plus 5 years at 30% (Group A); - 5-10 years at 100%, following years at 30/50/100%, further year at 50% (Group B); - 10 years at 100% rate of exemption (Group C);
- dividend	Dividend incomes distributed during holiday period are exempt	Dividend incomes distributed during holiday period are exempt
<i>Reduced CIT rate</i>	Special economic Zones (SEZs): 15% for FIE and FE Other Designed Zones (ETDZs): 24/15% for 3 years Technologically advanced FIE : 10%	
<i>Accelerated Depreciation</i>	Allowed in a few specified circumstances	Additional depreciation of 15% on new machinery and plant for new industrial undertaking and to existing one if the installed capacity increases by 25% or more in the same year
<i>Reinvestment Allowance</i>	Refund of 40% (extended to 100% for export-oriented or technologically advanced enterprises) of tax already paid on the reinvested amount	
<i>Other</i>	Double deduction of R&D if these expenditures exceed previous years by over 10%	

Source: Chalk (2001), Fletcher (2002), KPMG (2003), UNCTAD (2000).

Differentiate regimes apply in Korea: tax holidays are explicitly targeted on FDI and are limited to foreign investment enterprises; less generous tax holidays are allowed for domestic small and medium sized enterprises.

As shown in Tables 2-3-4, in almost all countries tax holidays are used to support priority, hi-tech, and pioneer industries.¹⁴ In addition, incentives may be adopted in different countries to support also more specific sectors and/or geographical areas or to encourage investments by export oriented firms. For example, in China, tax exemption is granted mainly to export-oriented manufacturing; in Thailand the incentive regime is explicitly targeted by geographical area and progressively more generous the more underdeveloped is the region; companies that benefit from tax holidays in Korea are high technology service businesses and different types of advanced technology FDI.

There are important differences across countries in terms of holiday periods and percentage of statutory CIT rates exempted. In China, newly established foreign investment enterprise is eligible for tax holiday as long as it is engaged in production or business operations for the specific minimum period of 10 years. The standard holiday entails a tax exemption for the first two profit-making years¹⁵ and allowed a 50 percent reduction in the third to fifth year, upon approval by the appropriate authority; further reduction may be allowed for technologically advanced and export-oriented firms and for enterprises engaged in farming, forestry and other low-profit industries or that are located in remote and economically under-developed areas (15-30 percent reduction in state CIT rate for ten years). Finally, a ten years tax holiday (five years at 100 percent plus five years at 50 percent) is granted to Sino-foreign joint ventures engaged in port and wharf construction.

An initial period of tax holiday, followed by rebates at a decreasing percentage in later years, is allowed to Indian companies. The full tax exemption period varies from sector to sector (see Table 2). In India, the negative impact of tax incentives, in general, and of tax holidays in particular, has been well documented in the numerous reports of committees, task forces, and study groups.

¹⁴ Industries in sectors that are not sufficiently developed in the host countries.

¹⁵ The definition of the “first profit-making year” is the first year during which all prior losses are used, leaving a taxable profit.

Table 3 Summary of corporate tax incentives in Malaysia and Thailand

	Malaysia	Thailand
<i>Sector qualifying for incentives</i> (not exhaustive)	Companies involved in promoted activities, located in certain promoted areas, that provide intermediate goods, or are of national and strategic importance (heavy capital investment and high contract and R&D companies, export-oriented manufacturing;	Priority activities (use of domestic resources, create employment opportunities, develop infrastructure; conserve natural resources, strengthen industrial and technological capability; develop basic and support industries) and companies technological projects); in certain geographical area;
<i>Tax holidays</i>		
- duration and rate of tax exemption	5 – 10 years at 70 – 100% of CIT reduction of tax exemption, depending on location, specific activities or industries	3 – 8 years at 100%, plus 5 years at 50% for enterprises located in less developed regions
- treatment of losses during holiday period	Not permitted to be carried forward after the end of holiday period	5 years carried forward after the end of holiday period
- dividends distributed during holiday period	Excluded from taxable income	Excluded from taxable income
<i>Reduced CIT rate</i>	Offshore companies in Labuan: 3% Operational Headquarters companies: 10%	SMEs and companies listed on the Stock Exchange and on the Market for Alternative Investment: 20-25% Regional Operating Headquarters (ROH): 10%
<i>Investment Tax Allowance and Credit</i>	ITA of 60% of the qualifying capital expenditure to a maximum of 70% of the statutory income (5 years); more generous ITA (100% for 5 years) are allowed for specific activities (industrial adjustment allowance, infrastructure allowance);	ITA of 25% of the costs of installation infrastructure facilities for 10 years; ITC of 25% for ROH buildings costs for 10 years
<i>Accelerated Depreciation</i>	AD of computer, technology, and environmental protection equipment, and capital exp. on approved agriculture projects	AD for cash registering machines and machinery and/or accessories used in R&D technology
<i>Reinvestment Allowance</i>	15 years of 60% of expenditure on a factory, plant, machinery or other apparatus used for qualifying project	
<i>Other</i>	Double deduction for promotion of exports (publicity and advertisements, approved R&D expenditure and other specific expenses	Double deduction of cost of transportation, electricity and water supply expenses

Source: Chalk (2001), Fletcher (2002), KPMG (2003), UNCTAD (2000).

The resulting common view is the need for a new re-design of Indian corporate tax where, specifically, the generous tax holiday should be progressively grandfathered; however, the fiscal policies implemented by the government in the last years have only partially gone in this direction. In fact, rather than minimizing them, the recent coalition governments have gone about proliferating tax incentives that complicate the tax system, creating a wide wedge between the nominal and effective corporate tax rates.

A company granted pioneer status¹⁶ in Malaysia can choose to receive an income holiday of 70 percent of statutory income for a period of five years. The benefit is partially reduced as unabsorbed losses are not permitted to be carried forward to the post-pioneer period. Furthermore, a Malaysian company granted the pioneer status incentive is not eligible for investment tax allowance. More generous tax holidays (100 percent reduction in standard CIT for a period of ten years) are allowed for high technology companies, strategic projects, manufacturers of specific machinery and equipment, and R&D companies. Companies with Multimedia Super Corridor status¹⁷ enjoy similar incentives or investment tax allowance of 100 percent for five years.

Thai and foreign companies satisfying a minimum requirement of investment capital, a minimum Thai shareholding in the project company, and minimum levels of products destined to export (not less than 80 percent of its total sales), enjoy progressively more generous tax holidays the more underdeveloped the region where the company is located. The holiday CIT periods range from three years up to eight years (extended for an additional five years with 50 percent of CIT rate reduction). Losses may be carried forward and deducted as expenses for up to five years after the end of the income tax holiday period. In addition to the privilege entitled to each zone and regardless of location, companies engaged in priority activities (agricultural products, technological and human resource development, public utilities and infrastructure, environmental protection and conservation, and other targeted industries) are eligible for a CIT exemption of eight years.

¹⁶ Includes companies involved in promoted activities, located in certain promoted areas, that provide certain types of intermediate goods, or that are of national and strategic importance (heavy capital investment and high technological project).

¹⁷ Recognized to ICT enterprises operating in a special area in the south of Kuala Lumpur.

Table 4 Summary of corporate tax incentives in South Korea and Japan

	South Korea*	Japan
<i>FDI qualifying for incentives</i>	Advanced technology and high-technology service businesses that support domestic industry; companies located in Korea's Free Trade Zone and Customs Free Zone or designated Foreign Investment Zone (FIZs)	
<i>Tax holidays</i> - duration and rate of tax exemption	Full exemption for first 7 years; 50% for next 3 years	
<i>Investment tax credit</i>		Total R&D expenditure; increase in R&D expenditure; improving technological infrastructure; IT investment

*Incentives reported on the table refer only to tax incentives for FDI. In addition to these specific industrial incentives, the Korean tax system also provides various tax abatements that are available to all companies including a lower corporate tax rate for SMEs, tax credits for investment in machinery or energy saving technologies, tax holidays on withholding on dividend distributions, tax credits to relocate companies to less congested areas, tax deferrals for investment reserve provisions, and others.

Source: Chalk (2001), Fletcher (2002), KPMG (2003), UNCTAD (2000).

Tax holidays are not granted in Japan. However, there are certain exemptions from fixed assets tax and business tax for local purposes. Also, a special taxable income deduction has been granted for qualifying financial institutions operating in a designated financial operation zone in Okinawa.

While tax holidays have been strongly used in the past in Korea, currently such incentives are only granted to advanced technology FDI, new high technology service businesses that are expected to support domestic industries and newly established small and medium sized enterprises. The period of time during which tax exemptions and reductions stay in effect for FDI has been recently extended from eight to ten years (full exemption for the first seven years and 50 percent reduction for the next three years). A reduction of 50 percent in the CIT rate for the first six years is granted for newly established SMEs.¹⁸

Reduced CIT rate

As shown in Tables 2-3, preferential corporate income tax is allowed in China, Malaysia, and Thailand. Foreign investment enterprises (FIEs) and foreign enterprises (FEs) in Chinese Special Economic Zones (SEZs) are taxed at the reduced rate of 15 percent; other reduced tax rates are allowed for technologically advanced FIE and for companies located in designated zones.

In Malaysia a tax rate well below the standard CIT rate is accorded to offshore companies in Labuan and to companies that set up operational headquarters in the country (10 percent for five years with the possibility of renewal for a further five years). Similarly in Thailand, new tax and non-tax incentive packages were introduced in 2002 to attract foreign Regional Operating Headquarters that provide services, including management, technical support, research and development and training to subsidiary companies or branches in the host country. Tax incentives include a preferential tax rate of 10 percent on net profits. It should be noted that, with increased globalization, many countries have been adopting new tax policies for multinationals to establish headquarters, financial and trading operations in their jurisdictions; these

¹⁸ In addition, SMEs are eligible for a 30 percent of reduction if located in non-metropolitan areas; for small sized enterprises located in metropolitan areas the cut in CIT rate is 20 percent.

policies seem to be have become common in the last years in many developing countries (see Mintz 2004).

4.2.2 Capital/investment based incentives

Particularly generous investment tax allowances (ITA) are authorized in Malaysia. Companies that are not granted pioneer status are eligible to apply for the investment tax allowance instead of a tax holiday. A company granted ITA is permitted to offset an amount equal to a percentage of the capital expenditure incurred on a factory and the provision of plant and machinery against its taxable profits. Any ITA that cannot be utilized against taxable income may be carried forward indefinitely for off-set against future taxable income derived from the same project.

In Korea research and development expenditures are favored by the presence of a tax credit allowance: companies may choose the larger amount between a flat tax credit (15 percent of expenses for technology and human resources development) or a incremental tax credit (50 percent of the exceeds of the average expenses disbursed during the preceding four business years). Less generous tax credits (ranging from 3 to 10 percent of the investment amount) are allowed for specific investments.¹⁹ Corporate tax incentives in Japan are mainly offered through investment tax credit for R&D expenses. In this respect, and for strengthening the global competitiveness of Japanese business, a new proportional R&D tax credit was introduced by the 2003 tax reform as an alternative to the previous one. Corporations are granted a tax credit of 8 percent plus 2 percent (applicable only for FY 2003 to FY 2005) of the amount of R&D expenditures.²⁰ Moreover, a tax credit (10 percent) or special allowance for accelerated depreciation (50 percent) is applied for qualifying IT investment.

¹⁹ A tax credit of 3 percent of the investment amount is granted for investment in anti-pollution and non-pollution facilities, mine safety facilities, welfare increasing facilities for employees, facilities for advanced technology and skill of manufacturing business, facilities for improvement of distribution industry and other kinds of investments; for SMEs and for specific investment among the above mentioned, the percentage grows up to 5 percent; where a corporation invests in energy saving facilities, the amount that can be credited increases to 10 percent.

²⁰ The percentage is augmented for corporations with a higher proportion of R&D expenses, for R&D activities conducted jointly by academic, business and government circles, and for R&D expenses of SMEs. The amount of the credit shall not exceed 20 percent of the amount of corporation tax; under certain conditions, there is the possibility to carry forward the unused credit for one year.

Two different forms of reinvestment incentive, reinvestment tax refund and investment tax allowances, are employed in China and Malaysia. China offers to foreign investment firms a tax refund of 40 percent (100 percent if reinvested in an exported-oriented or technologically advanced enterprise) on profits that are reinvested for at least five years to increase the capital of the firm or launch another firm. A more traditional reinvestment allowance is granted in Malaysia. Indeed, companies engaged in manufacturing or agricultural activities are eligible for reinvestment allowance for qualifying expenditures in plant, machinery, and industrial buildings.

Finally, double deduction of specific expenses are available for corporations in Malaysia and Thailand (see Table 3).

5. Tax policy considerations

As mentioned above, FDIs of the countries analyzed vary greatly in their level. Moreover they are also different in their composition. Dunning (1993) identifies different types of FDI, according to the economic rationale driving them: resource and asset and capabilities seeking investments, aiming at securing specific resources (raw materials, high skilled workforce, intangible assets) present in the host country; market seeking investments, that have the objective to produce locally for the host country's market instead of serving it with exports; finally, efficiency seeking investments, aiming at cost minimization. This kind of investments typically exploit the presence of very low labor costs and less regulation in certain developing countries. When assessing the sensitiveness of FDIs to tax considerations, FDIs typologies play an important role: resource and asset and capabilities seeking investments are obviously the less sensitive to fiscal considerations; even if tax incentives are considered not very effective on market seeking investments, the growing number of regional free trade areas could generate fiscal policy competition between member countries in order to attract headquarters and production plants. Finally, fiscal incentives could have a major impact in attracting efficiency seeking investments: given the aim of cost minimization of this

kind of investments, a reduction of the tax burden could enhance the attractiveness of a particular country.

Japan and Korea are characterized by the presence of market and capabilities seeking FDI (as typical in developed countries). The minor role of tax incentives in these countries is then justified by the fact that this kind of investments are less sensitive to tax considerations. Incentives are offered only to enterprises that could trigger positive spillovers on the domestic economies (typically IT investment). More complex is the situation in Malaysia and Thailand, where FDI has contributed to economic growth permitting the achievement and maintenance of very high levels of investment. As long as FDI in these countries have typically been driven by efficiency considerations, tax incentives have played a major role in their attraction. But economic development has boosted costs and the initial comparative advantage in labor intensive goods was progressively lost. This has forced Malaysia and Thailand to change their economic specialization, moving to sectors characterized by higher technological content. Tax incentives are in fact now targeted (especially in Malaysia) on IT and R&D enterprises. In this case incentives cannot be the only policy used for the attraction of investments, but they should be only an element of a comprehensive industrial policy including long term investment in infrastructure and human capital.

The last two countries analyzed have similar economic characteristics, and are attracting (or trying to attract) primarily efficiency seeking investments. In China, thanks to the strong comparative advantage in labor intensive goods, tax incentives play a role in attracting efficiency seeking investments, cutting further costs. On the other hand, the high potential of the Chinese consumer market could cause, in the medium term (if strong economic growth continues as expected), a surge in market oriented investments, that need not be subsidized with tax incentives. Finally India, with an economic structure similar to the Chinese one, but with no success in attracting foreign investment inflows. The home bias of the domestic tax system (underlined by a substantially higher statutory corporate tax rate for foreign enterprises) and its complexity are just two elements of an economic policy that does not show a clear will to make the country attractive to foreigners. Fiscal reforms should be part of a wider process of normative simplification and market liberalization. Particularly advisable in

this perspective is the abolition of the discrimination in tax rates between domestic and foreign enterprises and a comprehensive simplification of the overall fiscal system.

Coming back to more general considerations, two more points have to be noted. By now most of the empirical and theoretical work on tax incentives and FDI has analyzed only the benefit side of the problem. In this direction many studies (see section 3) have tried to quantify the tax elasticity of investment or the extent of the positive spillovers generated by foreign investment on the host economy. There is instead lack of evidence on the opportunity costs of this kind of incentives. In designing an expensive policy of investment incentives this kind of consideration should be instead kept clear in mind, since incentives often imply high costs for scarce public funds. Incentives offered to a company for an investment that would have taken place even without it, constitute a clear revenue loss for the host country. Moreover, tax incentives usually create loopholes in the tax system, giving a chance for aggressive tax planning. Incentives not justified by the presence of positive externalities in foreign investment, would also introduce costly distortions in the host economy, disadvantaging existing domestic firms (Zee *et al.* 2002). In a cost-benefit analysis, positive results of a tax incentive policy should be weighted against opportunity costs, that is, gains that would have occurred with alternative uses of public funds (for example, policies enhancing infrastructures and human capital). A comprehensive cost benefit analysis of different foreign investment promoting policies is not easy to put in place, due to the difficulty of estimating the complex and multifaceted elements on the ground (OECD 2003). Notwithstanding this, in the design of a costly incentive policy, all the elements above mentioned should be kept in mind by analysts and policy-makers.

Finally, in the assessment of tax incentives to foreign investment, the possible rise of tax competition between countries should be kept in account. Evidence emerging by interviews with corporate managers (Oman 2000), suggests that, while investors attach increasingly more importance to economic fundamentals than to incentives in the location decision for a long-term investment, they also tend to create a shortlist of preferred sites that have all the required economic characteristics and facilities. Then they usually negotiate incentives and other conditions with each government. This practice is clearly conducing to a prisoner's dilemma in the host countries perspective: for each country it is optimal to offer higher incentives in order attract more investment,

but all of them end up with a similar amount of aggregate investment and with heavy revenue losses. Tax competition can be particularly strong in countries included in free trade areas, such as ASEAN. The fact that Malaysia and Thailand have introduced a special corporate tax rate reduction for MNEs that establish their regional operating headquarters is a clear signal that the South and Eastern Asian countries are not immune to tax competition and they should try to subscribe to agreements in order to contain it.

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