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IMPACT OF TAXATION ON FOREIGN DIRECT INVESTMENT

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ABSTRACT

Foreign direct investment is a powerful tool in promoting the economic growth of a country in the present era of globalization. It causes large jumps in the expansion of different sectors such as education, healthcare, manufacturing industries and leads to creation of more jobs thereby increasing the level of employment in the country. The rate of FDI inflows has been increasing in India each year since 1991. In order to attract more FDI, many countries try to reframe their tax policies by introducing different tax incentives such as tax holidays, investment allowances, exemptions, deductions etc. The purpose of the present paper is to review the impact of taxation and tax incentives on FDI inflows of a country. Based on the review, the study concluded that tax incentives have an impact on the investment contribution made the foreign investors and reduction in corporate tax is the widely used measure adopted by countries to attract FDI.

KEYWORDS

corporate tax, economic growth, foreign direct investment, taxation, tax incentives**.**

1. INTRODUCTION

1.1 FDI AND ITS IMPORTANCE

According to International Monetary Fund, Foreign Direct Investment refers to an investment made to acquire lasting or long term interest in enterprises operating outside of the economy of the investor. It is direct as the investor which can be a foreign company, an individual or a group of entities can control or manage the foreign enterprise. (Barry Kalodkin, May 2017). Historically, technological advancement paved the way to the emergence of faster means of communication and transport which led to the movement of investors across national and political boundaries. (Pritchard, 1996). FDI is an important source of external finance for the countries with limited capital as they can receive finance across the national boundaries from richer countries. (Barry Kalodkin, May 2017). According to the study by Misra, FDI offers various benefits to the country such as providing long term capital that is necessary for economic development of the country, creation of new workplaces, bringing new technologies, providing greater access to foreign markets, bringing new managerial skills, attracting companies from innovative sectors, bringing 'clean technologies' which can improve environmental conditions, increasing employment and level of wages and providing positive impact on trade balance. (Srikant Misra, 2012). Romer states that FDI helps in the economic development of the country by strengthening human capital which is the most critical factor in Research and Development. It causes increase in innovation and competition which in turn accelerates technological progress and productivity and hence leads to economic growth in the country. (Grossman and Helpman, 1991)

1.2 TAX INCENTIVES

Taxation is important because it funds necessary activities and in turn benefits the people of the country. (Holmes, 1904). According to the definition given by UNCTAD, tax incentives are any incentives which reduce tax burden of a party and encourages them to make investment in a project or sector. They may include tax holidays, reduced tax rates, carry forward of losses and reduced tariffs. (Hilda M. Alegana, Nov 2014).

Gruber states that tax expenditures are losses that a government undertakes by providing tax deductions, allowances, exemptions, tax credits or preferential tax rates (Gruber, 2005).

Tax incentives can be broadly divided into four categories- tax holidays, tax credit and investment allowance, timing differences and reduced tax rates. Tax holidays exempt the new companies from tax for a particular period of time, investment tax credits provide deductions from tax payable whereas investment allowances are deductions that reduce taxable income. Timing differences can be in the form of deductions in first year or shorter period of depreciation. However, reduced corporate income tax is the most common form of tax incentive that is used by many countries to encourage investment. (Alicja BRODZKA, 2013)

2. OBJECTIVE OF THE STUDY

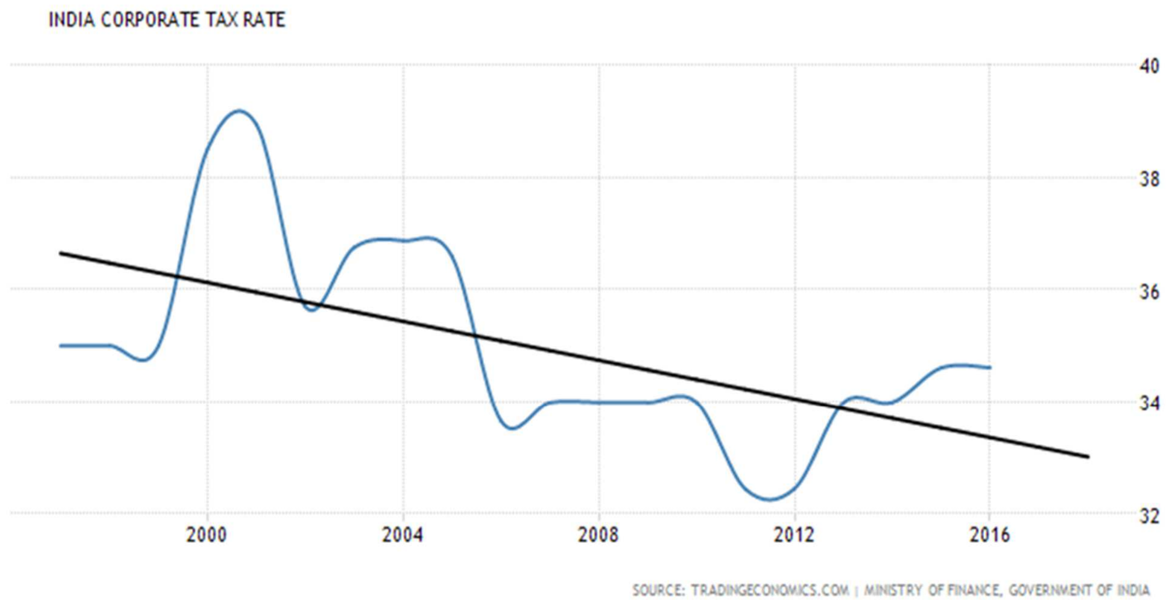
To examine the impact of taxation and tax incentives on foreign direct investment (FDI) of a country and draw suitable conclusion.

3. RESEARCH METHODOLOGY

Research work is done by using secondary data which includes various books, research papers, journals and articles from internet.

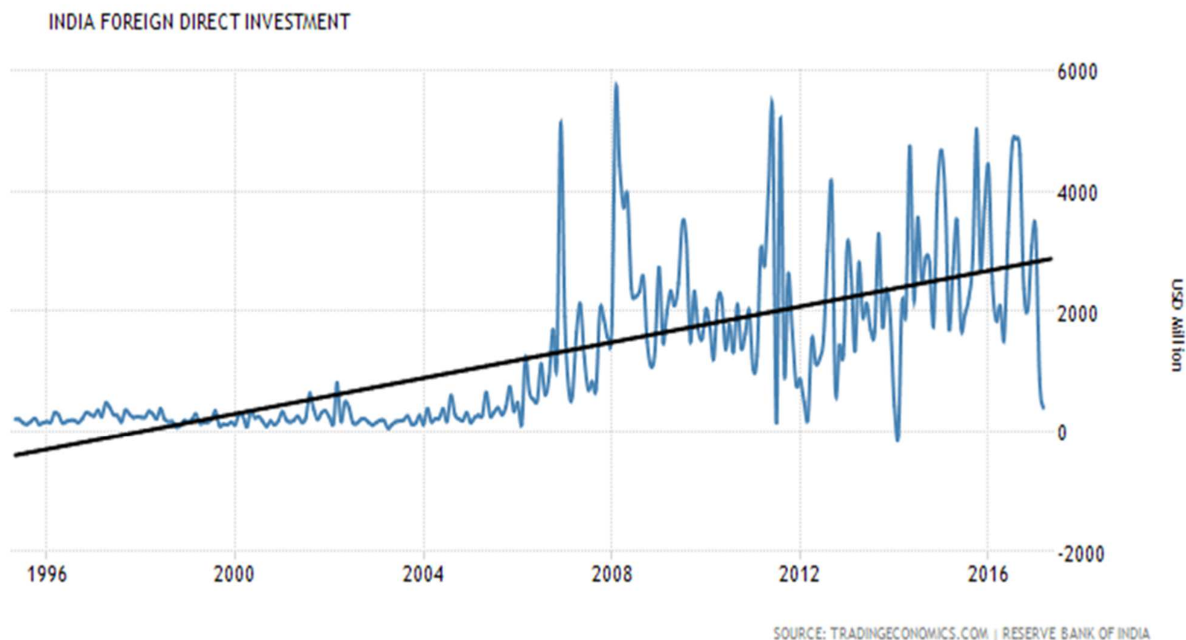
4. TRENDS IN FDI AND CORPORATE TAX RATES IN INDIA SINCE 1995

FIGURE 1: CORPORATE TAX RATES IN INDIA SINCE 1995



Source: Trading Economics, 2017

FIGURE 2: FDI IN INDIA SINCE 1995



Source: Trading Economics, 2017

Figure 1 represents corporate-tax-rates in India since 1995. The figure clearly shows that there has been a declining trend in the corporate-tax-rates which can be due to a number of reasons. The highest tax rate, according the data (given by trading economics) was 38.95% in 2001 whereas the lowest was 32.44% in the year 2011. Figure 2 represents that there have been fluctuations in investment made by foreign countries in India. The figure, however, clearly represents an increasing trend which is a positive indicator for the country. Average amount of FDI in India from 1995 till 2017 has been 1222.53 USD Million (Trading Economics, 2017)

5. DISCUSSION

Several theories have been conducted on analyzing the impact of taxation on FDI of a country. Evidences around the world reveal that tax incentives are effective in attracting FDI. According to Y. Brauner, Multinational Corporations looking for an optimal investment location are attracted by universal and standardized tax incentives. (Brauner, 2012). A study conducted in Ireland reveals that for every 1% increment in corporate tax, FDI falls by 3.7%, (Roinn Airgeada, 2014). However, this estimate cannot be taken as uniform.

Various theories state that reduction in corporate-tax-rates has been the most preferred method adopted by countries. Many tax officials consider reduction in corporate tax rate as a relatively simpler tax adjustment, readily observed and directly relevant to the investors. (OECD,2007). Study by Dr. Kandpal also states that countries with considerable FDI rely more on low corporate taxes than on tax holidays. He emphasized that the changing structure of tax incentives has important implications for domestic and international tax policy. (Kandpal and Kavidayal, 2014)

There are other implications of the tax incentives for the countries. Favoring FDI by involving tax incentives can give an impression that the system is unfair giving preferences to the foreign investors which can undermine voluntary compliance within the framework. (OECD,2007). Use of tax incentives results in huge costs in the form of forgone revenue which would have otherwise used for funding different activities, resource allocation costs which arise when tax incentives create distortions in investment decisions among different sectors and enforcement and compliance costs in terms of qualifying different requirement and schemes. The best practice is to discourage special tax incentives in order to attract FDI and favour reduced corporate-tax. It also stated that the elimination of tax incentives can be a challenge for the policy makers. (OECD, 2007)

6. CONCLUSION

Based on the literature and findings, it can be concluded that FDI plays an important role in the economic growth of the country and introducing tax reforms or tax incentives is one of the important factors in attracting foreign direct investment in the country. Literature also suggests that reduction in corporate tax rates is the most preferred method because of simplicity in its application. However, there is no denying the fact that there are other key factors that are considerably important in attracting FDI such as political environment of the country, infrastructure, labour market conditions, availability of resources, financial factors, government and legal factors etc.

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