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An Overview of the Impact of Tax Incentives on Foreign Direct Investment in India

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Abstract

At present in a globalized scenario, Foreign Direct Investment (FDI) is crucial in stimulating economic growth and development of a country. Government of India for the purpose of accelerated growth of the Indian economy and in order to attract FDI has extended incentives in the form of tax holiday, investment tax allowances, depreciation allowances etc. Foreign investors are generally interested to take the benefits of differences in tax rates across various countries. This has resulted in an increased competition among government of different countries to attract foreign investors by offering tax incentives. Empirical research on tax incentives shows that they sometimes work in attracting FDI, but it remains unclear whether they are beneficial overall. Some studies concludes that developing countries do not need to offer tax incentives to attract Foreign Direct Investment (FDI) because the decision to invest in a country depends on the country's overall investment climate and some other factors. This paper attempts to analyse the effect of using different business tax incentives on Foreign Direct Investment

in India based on the overview of theoretical and empirical findings. Through an in-depth analysis it might be concluded that despite insufficient findings regarding its effectiveness, tax incentives plays a key role in the policy initiatives which are being used to increase their appeal to foreign investors. Investment by MNCs has made a significant contribution in the economic development of India.

Keywords : Tax incentive, FDI, MNCs & Allowances

Introduction

Capital formation is an important determinant of economic growth. While domestic investments add to the capital stock in an economy, foreign direct investment (FDI) plays a complementary role in overall capital formation by filling the gap between domestic savings and investment. In the initial stage of overall development of a country, Foreign Direct investment plays a vital role as now-a-days many developing countries are trying to attract more and more FDI in different sectors. Developing and developed countries both use certain incentives to try to attract FDI, but the types and frequency of incentives used differs somewhat. India is a country which is known to be an attractive destination by different international rating organization. With its highly skilled cost effective work force it offers opportunities for Multinational Companies to invest in India. The Government of India for the purpose of accelerated growth of the Indian economy has extended incentives in the form of tax holiday, deductions, rebates, investment tax allowances, depreciation allowances etc under the business taxes. Foreign investors or Multinational companies are generally interested to take the benefits of differences in tax rates across various countries. This has resulted in an increased competition among government of different countries to attract foreign investors by offering tax incentives.

Tax holidays are only given to some firms – new ones entering a market rather than all companies operating in the jurisdictions. The tax holidays then create a competitive advantage to new companies to the detriment of existing companies that have taken a longer run view of the economy. Governments are pressured to provide other incentives so that non-holiday companies can compete with tax holiday firms. Foreign investments in India have increased

of late but the strict FDI policies have restricted the possible growth in the above mentioned sectors. India is an attractive market because of technical expertise, skilled managers and a growing middle class market of more than 300 million. India emerged as an attractive FDI destination as far as service sector is concerned but has failed to deliver as a manufacturing hub which has greater economic benefit. FDI though one of the important sources of financing the economic development, but not is not a solution for poverty eradication, unemployment and other economic ills. India needs a massive investment to achieve the goals of vision 20-20. The major impact during the recessionary period was mainly due to the negative flow of FII in India while the FDI remained moderately unaffected with the global slowdown. The attractiveness of India for FDI is far from receding and can surely be expected to sustain over the next decade as well.

Literature Review

A number of literatures throwing light on the role played by policy environment discuss the issues regarding creating an investor friendly environment for FDI. According to the United Nations Conference on Trade and Development (UNCTAD 1995) as many as 67 countries offered this incentive. Tax holidays provide benefits as soon as a company begins earning income, while the benefits of a lower corporate tax rate accrue more slowly and over a longer time. But tax holidays benefit primarily short-term investments, typical of "footloose" industries in which companies can move quickly from one jurisdiction to another. They also tend to reward the founding of a company rather than investment in existing companies, and to discriminate against investments that rely on long-lived depreciable capital and they can lead to erosion of the tax base as taxpayers learn how to evade taxation of income from other sources. For all these reasons fiscal experts have generally been highly critical of tax holidays. Hines (1999) in an extensive review of econometric studies conducted over the last 15 years concluded that the consensus view is that on an average a 1 percentage point reduction in the effective tax rate would increase FDI by approximately 2 percent. This estimated effect however is not uniform. Tax incentives differ in their impact on FDI across industries and even among firms in a single industry.

UNCTAD (1999) conclude that Transnational Corporations (TNCs) can support local development efforts by (i) increasing financial resources for development; (ii) boost export competiveness; (iii) generate employment and strengthening the skill base; (iv) protecting the environment to fulfill commitment towards social responsibility; and (v) enhancing technological capabilities through transfer, diffusion and generation. Grubert and Mutti (2000) conclude that efficiency seeking FDI however especially in the export oriented manufacturing sector is more responsive to tax relief. Dunning (2002) analyzed that fiscal incentives carry less weights where firms are resource seeking or intends to serve the local market. In such a situation FDI is relatively location bound with market size and resources availability being the key determinants.

A country with broad bases and low tax rates will be a relatively attractive place to locate capital for firms which expect to earn rents. This approach is therefore useful in attracting highly profitable multinationals (Devereux, Griffith and Klemm, 2003). Blomstrom and Kokko (2003) attribute this sharp rise in the influence of tax incentives on FDI to the regionalization and globalization of the world economy. Iyare Sunday O, Bhaumik Pradip K, Banik Arindam (2004), in their work "Explaining FDI Inflows to India, China and the Caribbean: An Extended Neighborhood Approach" find out that FDI flows are generally believed to be influenced by economic indicators like market size, export intensity, institutions, etc, irrespective of the source and destination countries. According to Bolnick (2004) in addition to the integration of markets, globalization has also resulted in greater homogeneity in the infrastructure, skill base, labour costs, skills base, labour costs, macroeconomic performance and regulations particularly among OECD countries. Buettner and Ruf (2005) focused on a comparison between US states or EU countries and conclude that tax incentives have a strong effect on FDI. Evidence emerging around the world suggests that tax incentives have a more apparent effect on the composition of foreign direct investment than on its level. Indeed, most governments use tax policies to attract particular types of investment or to change conduct rather than to increase the overall level of investment. A recent study found that large foreign companies—such as those in the automobile sector—are generally in a better position to negotiate special

tax regimes and thus to extract rents from host governments (Oman 2000).

First investors emphasize more on incentives (Davidson,1980), such as subsidies, that reduce cost of establishment, while firms that reinvest, prefer more incentives that deal with taxation, such as tax-holidays (Mintz,1990; Shah,1995), accelerated depreciations and loss-carry forwards and loss-carry backwards (Hines, 2005). A specific incentive, such as repatriation scheme, was significant only for the decision of the initial investment (Coyne (1995). More specifically, there are studies that argue that exist a significant relationship in the case of taxes (Mody and Srinivasan, 1998; Bevan and Estrin, 2000), especially in the case of research and development (Hall and Van Reenen, 2000; Bloom, Griffith and Van Reenen, 2000).

Furthermore, results, in general, depend on the kind of tax-incentive that is taken into consideration, since different kind of tax has different impact on FDI In this way, the kind of tax incentives may be classified as follows: a). value-added tax, b).corporate income tax, c). Property tax, d).Royalty payments, e). Import-tariffs, f).sales-taxes, g). Tax-holidays, h). Grants, i).Depreciation allowances, j). Enhanced deduction, k). Tax-holiday, l). Special investment allowance (Boura, P; Koumanakos, E and Georgopoulos, 2006). During the decade of 1990, the most innovative incentives are the reduction of corporate income tax-rate. Nowadays, countries are led to a downwards pressure of tax-rates and for this reason tax-rate is very significant for the allocation of investment among countries (Axarloglou, 2005). For this reason, most of the studies emphasize on the host-country corporate taxes. According to Wilson (1999) and Fuest, Huber and Mintz (2005) tax competition refers to a process in which countries attempt to attract capital or taxable profits, by reducing taxes on capital. Countries may also follow more complex strategies and attempt to attract an industry so as to establish a future locational advantage.

Objectives

This research work is based on the following objectives:

- To analyse the inflow of FDI post liberalization
- To analyse the effect of using different business tax holidays on Foreign

Direct Investment in India and to identify the problems relating to inflow of FDI and to make suitable suggestions for attracting more FDI inflow to India.

Methodology

In this research work secondary source of data has been applied. An attempt has been made to study various books, journals, research papers and reports. An attempt have been made to make the analysis from the Indian point of view that combines national level and state level functions and suggests concrete steps in learning from Indian experiences.

FDI Inflows in India Post Reform Period Sine 1991: After mid 1990 the political disturbances along with other economic problem gave rise to severe financial crisis in the Indian economy. The high rate of inflation, fiscal deficit and political instability downgraded the international credit of the country. This resulted in the erosion of the international community's confidence on our economy. The outflow of deposits especially by NRIs, a virtual stoppage of remittances from Indian workers in the Gulf countries and a sudden break out of Gulf war in January 1991 exacerbated the balance of payments crisis. The foreign exchange became so scanty that, it was insufficient to pay even for one week imports. As a result the economic liberalization process was introduced under Structural Adjustment Programme (SAP) with the support of IMF and the World Bank. This culminated into a series of economic reforms in 1991 along with a host of industrial policy reforms. NIP 1991 recognized the role of FDI in the process of industrial development in India in terms of bringing greater competitiveness and efficiency and also modernization, technological up gradation, creation a sound base for export promotion and above all integrating India with rest of the world. Besides these in August 1999 government of India set up Foreign Investment Implementation Authority (FIIA) within the ministry of industry to facilitate quick translation of FDI approvals into implementation by providing a pro-active one step after care service to foreign investor like helping them obtain necessary approvals and sorting their operational problems.

Regulatory scenario: The policy for FDI in defence sector was notified in 2001 wherein the defence industry was opened up to 100% for Indian private

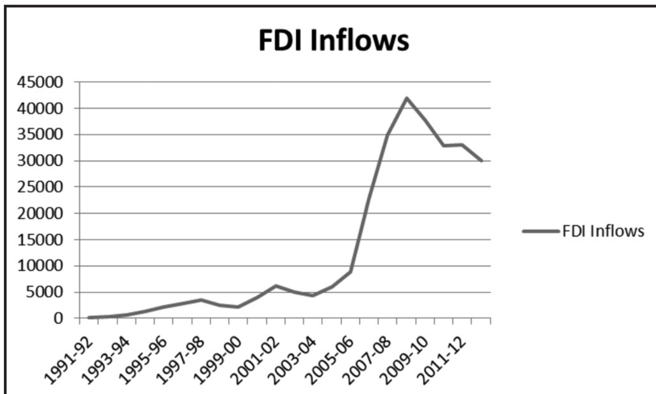
sector participation, with FDI permissible up to 26% both subject to licensing and Government of India approval. FDI of up to 100% is allowed under the automatic route. The Government of India permits 200% weighted deduction on R&D expenditure. Moreover, most state governments offer additional incentives to vehicle manufacturers, given the large investments and employment generation capacity of this industry, in order to encourage them to set up units in their respective states. The total aggregate foreign investment in private banks from all sources (FDI, FII and NRI) is limited to 74% with a limit of 10% for individual foreign institutional investors (FIIs) with the aggregate limit for all FIIs restricted to 24%, which can be raised to 49% with the approval of the board/general body. The FDI norms are not applicable to public sector banks where the FDI ceiling is still capped at 20%.Foreign investment is permitted in commodity exchanges, subject to a composite ceiling of 49%, with a FDI limit of 26% and FII limit of 23%. FDI is allowed with specific approval of the FIPB and FII purchases in equity of commodity exchanges are restricted to the secondary markets only. The regulatory landscape of the Indian power sector has evolved significantly. There is a sound and progressive legislative framework in the form of the Electricity Act, 2003, which was amended in 2007. The follow-on policies among others were being, the National Electricity Policy 2005, which provides guidelines for accelerated development of the electricity sector and the National Tariff Policy 2006, which assures electricity to consumers at reasonable and competitive prices. FDI up to 100% is permissible in the power sector segments (excluding atomic energy) under the automatic route. The power industry operates under the regulatory control of Ministry of Power. Governing bodies for the power sector consists of Central Electricity Regulatory Commission (CERC) at the national level, 28 State Electricity Regulatory Commissions (SERCs) at state level and joint electricity regulatory commission (JERC) for Goa and all union territories and for Manipur and Mizoram. The governing bodies have been established to determine tariff for generation and supply of electricity, regulate electricity purchase and procurement process, facilitate inter-state transmissions etc. The Government is considering the proposal for 100% FDI in multi brand retail, which may be the next boom in retailing. Triggered by a rise in income levels, the middle class of the country is poised to transform the retail landscape in India

Table 1: Statement showing Foreign Direct Investment Inflows in India Post Liberalization

Year	FDI Inflows	Annual growth rate (100%)
1991-92	129	
1992-93	315	144
1993-94	586	86
1994-95	1314	124
1995-96	2144	63
1996-97	2821	32
1997-98	3557	26
1998-99	2462	-31
1999-00	2155	-12
2000-01	4029	87
2001-02	6130	52
2002-03	5035	-18
2003-04	4322	-14
2004-05	6051	40
2005-06	8961	48
2006-07	22826	155
2007-08	34835	53
2008-09	41874	20
2009-10	37745	-10
2010-11	32901	-13
2011-12	32957	0
2012-13	30086	-9

(Source: RBI Bulletin)

Chart 1



Foreign firms are setting up joint ventures and wholly owned enterprises in services such as computer software, telecommunications, financial services, and tourism, and manufactured goods including transportation equipment, chemicals, pharmaceuticals, and food processing. Still Foreign Direct Invetsment in India remains samll when compared in context of GDP or total investment. The low rate of FDI inflow in India compared to other Asian neighbours like China, Malaysia, Thailand and Indonesia is because of internal and some external factors. There has been an increased competition among developing countries by offering higher investment incentives and tax holidays. This has resulted in an increased number of bilateral investment treaties. It is generally found that FDI inflows from developed and developing countries are attracted by different policies by host government. There is a need to analyze the impact created by host government policies and investment agreement or treaties in attracting FDI inflows. It is often observed that policies by same government can increase or decrease FDI inflows. Several studies with respect to incentives find that fiscal incentives do affect location decisions, especially for export oriented FDI, although other incentives seem to play a secondary role. However, fiscal incentives appear unimportant for FDI that is geared primarily towards the domestic market; instead such FDI appears more sensitive to the extent to which it will benefit from import protection. The impact of incentives on inward FDI flows is expected to be positive. But, it is interesting to see whether FDI from developing countries and from developed countries respond in a similar way to the investment incentives offered to the foreign firms in the developing countries.

Table 2: Statement of Sector wise FDI inflows from April 2000 to May 2013

S.no	Sector	Amount of FDI Equity Inflows (in US $ million)
1	Services Sector	37062.75
2	Construction Development	21953.51
3	Telecommunications	12645.05
4	Computer Software & Hardware	11640.37
5	Drugs & Pharmaceuticals	10202.44
6	Chemicals (Other than fertilizers)	8856.89
7	Power	7824.56
8	Automobile Industry	7652.59

9	Metallurgical Industries	7426.21
10	Hotel & Tourism	6561.78
11	Petroleum & Natural gas	5377.42
12	Trading	3758.68
13	Electrical equipment	3102.4
14	Information & Broadcasting	3093.57
15	Cement & Gypsum Products	2626.43
16	Miscellaneous Mechanical & Engineering Industries	2305.4
17	Industrial Machinery	2270.73
18	Consultancy Services	2077.67
19	Construction (Infrastructure) Activities	2003.32
20	Non-Conventional Energy	1959.19
21	Food Processing Industries	1800.9
22	Ports	1635.08
23	Hospital & Diagnostic Centres	1591.23
24	Agricultural Services	1488.63
25	Textiles	1223.09
26	Electronics	1197.62
27	Sea Transport	1166.23
28	Fermentation Industries	1134.63
29	Rubber goods	1067.19
30	Mining	976.98
31	Paper & Pulp	861.88
32	Prime Mover	768.99
33	Education	680.62
34	Machine tools	622.77
35	Soaps, cosmetics & Toilet	596.03
36	Medical & Surgical appliances	591.86
37	Ceramics	506.97
38	Air Transport	448.69
39	Glass	385.02
40	Vegetable oil & Vanaspati	384.53
41	Diamond & Gold Ornaments	381.2
42	Fertilizers	297.9
43	Printing of Books	272.14

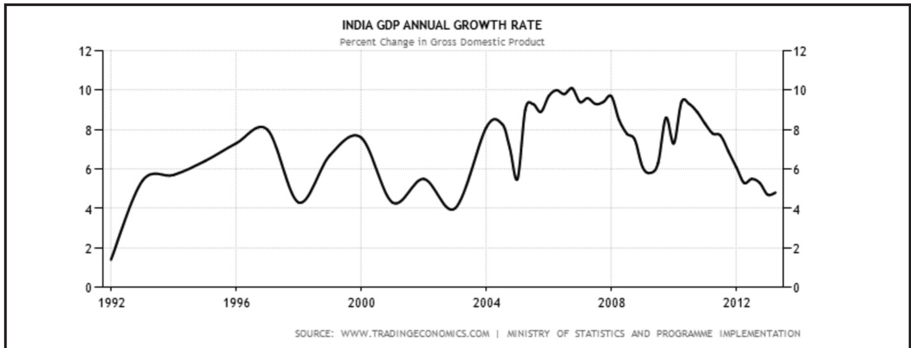
44	Railway related components	260.09
45	Commercial, office & household equipment's	253.29
46	Agricultural machinery	222.5
47	Earth Moving Machinery	174.95
48	Leather, Leather goods & Pickers	103.39
49	Tea & Coffee	101.21
50	Scientific Instruments	93.84
51	Timber products	79.02
52	Photographic raw film & paper	66.54
53	Industrial Instruments	66.53
54	Boilers & Steam generating plants	61.83
55	Sugar	51.82
56	Retail Trading (Single brand)	42.7
57	Coal Production	24.78
58	Dye stuffs	19.5
59	Glue & gelatin	14.55
60	Mathematical, surveying & Drawing instruments	7.98
61	Defence Industries	4.12
62	Coir	2.15
63	Miscellaneous	7829.68

(Source: As per DIPP's FDI data base)

FDI inflows and outflows slumped in all three sectors (primary, manufacturing and services) in 2009. The global economic and financial crisis continued to dampen FDI flows not only in industries sensitive to business cycles – such as chemicals and the automobile industry – but also in those that were relatively resilient in 2008, such as pharmaceuticals and food and beverage products. In 2009, only a handful of industries generated higher investments via cross-border M&A than in the previous year; these included electrical and electronic equipment, electricity services and construction. The service sector has been the primary destination of FDI in India since liberalization. As identified by the reports of India's Ministry of Commerce & Industry, the service sector accounted for 19.51 percent of total FDI inflows to India between August 1991 and December 2013. Another 11.56 percent of

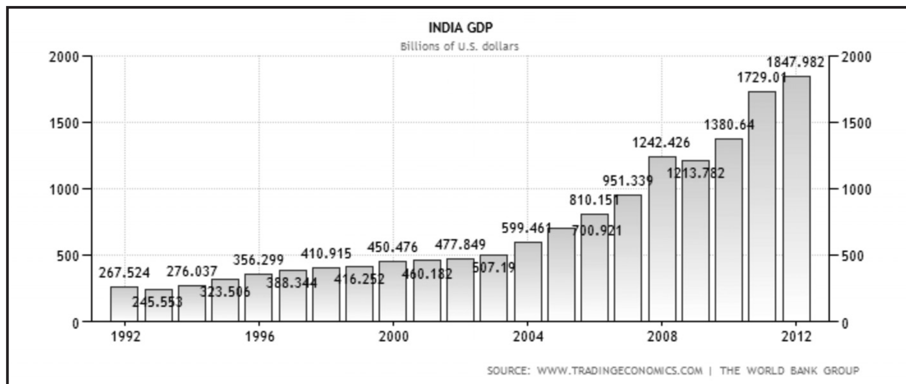
FDI inflows are invested in the construction development industries followed by Telecommunication, computer software and hardware. From the mid-1990s, India has been an important destination for investment in offshoring services such as software, call centers, and other business process outsourcing (BPO). India has offered substantial incentives to attract FDI in IT and BPO-related services offshoring, up to an estimated $6,000 per full-time equivalent worker (FTE) in the IT services area, and $2,000 per FTE in the BPO area. Other industries which maintain significant barriers to FDI include the insurance sector and newspaper publishing, where foreign equity is limited to 26 percent, and the retail sector, where foreign firms are permitted to invest up to 51 percent equity, but only in single-brand distribution outlets. Foreign investors have also expressed interest in investing in these sectors, as India's government debates whether to lift the limits. In the retail sector, Wal- Mart announced a joint venture with India-based Bharti in November 2006, under which Bharti would invest $2.5 billion in a new chain of retail stores that would be 100 percent owned by the Indian firm. Wal-Mart would provide logistics and wholesale supply services through a 50:50 joint venture with Bharti. The deal is widely seen as a way for Wal-Mart to enter the growing Indian retail market despite the FDI restrictions. In the insurance industry, foreign investment was first permitted in 2000, with the lifting of the Indian state-owned insurance company's monopoly, allowing competition from both domestic and foreign-owned private firms. Amid expectations that the government would raise the foreign equity limit to 49 percent, at least six insurance joint ventures concluded agreements that would allow the foreign partner to raise its share to that level once government regulations have changed, but as of April 2007, the equity limit for foreign insurance investors remains at 26 percent. Destination wise, economically advanced states have attracted the lion's share of FDI flows to India. The top six Indian states, *viz*., Maharashtra, Delhi, Karnataka, Tamil Nadu, Gujarat and Andhra Pradesh together accounted for over 70 per cent of FDI equity flows to India during the period April 2000 to June 2012 because of the infrastructural facilities and favorable business environment provided by these states and thus reflecting distinct signs of FDI concentration at the state level.

Chart 2



In order to achieve a growth rate of around 7 percent in the Gross Domestic Product of India, the net capital flows should increase by at least 28 to 30 percent on the whole. But the savings of the country stood only at 24 percent. The gap thus formed between expected investment and the actual savings of the country was filled up to some extent by portfolio investments by Foreign Institutional Investors, loans by foreign banks and other places, and foreign direct investments. Among major sources of financial assistance, India mainly tries to possess the maximum amount of Foreign Direct Investments. Thus FDI is considered as a developmental tool for growth and development of the country. The Gross Domestic Product (GDP) in India expanded 4.80 percent in the first quarter of 2013 over the same quarter of the previous year. GDP Annual Growth Rate in India is reported by the Ministry of Statistics and Programme Implementation. Historically, from 1951 until 2013, India GDP Annual Growth Rate averaged 5.84 Percent reaching an all-time high of 10.20 Percent in December of 1988 and a record low of -5.20 Percent in December of 1979. In India, the annual growth rate in GDP at factor cost measures the change in the value of the goods and services produced in India, without counting government's involvement. Simply, the GDP value excludes indirect taxes (VAT) paid to the government and includes the original value of products without accounting for government subsidies. The government has forecasted a growth of 6.1%-6.7% for the year 2013-14, whilst the RBI expects the same to be at 5.7%.

Chart 3



The Gross Domestic Product (GDP) in India was worth 1847.98 billion US dollars in 2011. The GDP value of India represents 2.98 percent of the world economy. GDP in India is reported by the World Bank Group. Historically, from 1960 until 2011, India GDP averaged 368.8 USD Billion reaching an all-time high of 1848.0 USD Billion in December of 2011 and a record low of 36.6 USD Billion in December of 1960. The gross domestic product (GDP) measures of national income and output for a given country's economy. India faces a variety of short-term policy challenges, key among which is sluggish growth and high inflation. GDP growth slowed sharply to 4.5% in the last quarter of 2012, from 5.3% in Q3. Inflationary pressures remain persistent, despite headline inflation easing to 7.3% in the last quarter of 2012 from the highs of 9-10% over the last two years. The moderation was mainly on account of the recent cooling in (volatile) food and fuel prices. Inflation is still significantly above the Reserve Bank of India (RBI)'s comfort zone of 5-6% with underlying inflationary pressures being further supported by the pass-through effects of higher regulatory prices remaining incomplete. Going forward, inflation expectations and core inflation are likely to remain elevated, limiting the scope for easing by the RBI to support GDP growth.

Conclusions

It can be observed from the above analysis that at the sectoral level of the Indian economy, FDI has helped to raise the output, productivity and

employment in some sectors especially in service sector. Indian service sector is generating the proper employment options for skilled worker with high perks. On the other side banking and insurance sector help in providing the strength to the Indian economic condition and develop the foreign exchange system in country. Countries receiving substantial foreign direct investment are relying less on tax holidays than on low corporate tax rate regimes. Although it is still popular to provide accelerated depreciation, investment allowances or other incentives for capital investments, the most innovative incentives in the 1990s have been to lower corporate income tax rates sharply. The implications of the changing structure of tax incentives for FDI are important to both domestic and international tax policy. At last, since economies that enjoy relatively higher rate of growth succeed in attracting a bigger chunk of foreign investment, which, in turn, is expected to accelerate their growth, it is fair to expect that India would have a larger share of FDI in the coming decades. The emergence of global companies will have a significant bearing on government revenues. These companies are likely to be more sensitive to tax incentives because they are better able to exploit them by transferring their activities from one country to another. Empirical research on tax incentives shows that they sometimes work in attracting FDI, but it remains unclear whether they are beneficial overall. So far the benefits are uncertain and the cost involved is large. Even if incentives have a purely domestic intent, they may have international effect and lead to tax competition. Some studies conclude that developing countries do not need to offer tax incentives to attract Foreign Direct Investment (FDI) because the decision to invest in a country depends upon the country's overall investment climate. The huge market size, availability of highly skilled human resources, sound economic policy, abundant and diversified natural resources all these factors enable India to attract FDI. Further, it was found that even though there has been increased flow of FDI into the country during the post liberalization period, the global share of FDI in India is very less when it is compared to other developing countries like China, Malaysia and Thailand. Lack of adequate infrastructure, stringent labor laws, corruption, instable government and political environment, high corporate tax rates and limited scale of export processing zones are considered to be the major problems for low FDI into the country.

To overcome this situation, the Government should revise the sectoral cap and bring more sectors under the automatic route. Further in India labor laws need to be flexible, debt market should be developed. There is a strong need to open up Foreign Direct Investment in Education sector. Besides this, India should sign the agreement of Double Taxation treaties with other countries in order to increase bilateral trade. Therefore, there is an urgent need to adopt innovative policies and good corporate governance practices on par with international standards, by the Government of India, to attract more and more foreign capital in various sectors of the economy to make India a developed economy

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