

**THE USE OF TAX INCENTIVES TO ATTRACT FOREIGN DIRECT  
INVESTMENT IN KENYA AND OTHER DEVELOPING COUNTRIES:  
ASSESSMENT OF COSTS VIS A VIS THE BENEFITS.**

**BY**

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**A Thesis submitted in partial fulfillment of the requirements for the Degree of  
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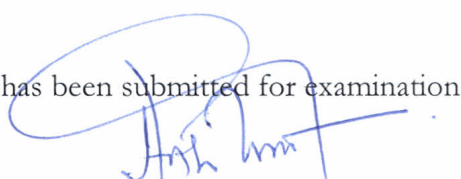
**Declaration**

I, **Bett Jackson Kiprotich**, do hereby declare that this is my original work, and has not been submitted for the award of a degree in any other University

Signed:  .....

Dated: 28/11/2007 .....

This thesis has been submitted for examination with my approval as University Supervisor

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PROFESSOR ARTHUR A. ESHIWANI.

## **Dedication**

This work is dedicated to my parents, Joseph Kipkony and Grace Chelimo, and to my siblings, for their faith and commitments, without which this endeavor would never have reached fruition.

It is also dedicated to the family of my High School Principal, the late Thomas Kivondo Musau, who molded me to who I am today.

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## Table of Abbreviations

BIT	Bilateral Investment Treaty
CIT	Corporate Income Tax
GATT	General Agreement on Trade and Tariffs
GDP	Gross Domestic Product
GNP	Gross National Product
EPZ	export processing zone
ERT	European Round Table of Industrialists
EU	European Union
FDI	Foreign Direct Investment
HG	Host Government
ILO	International Labor Organization
IPA	Investment Promotion Agency
IPR	Intellectual Property Rights
IMF	International Monetary Fund
JBICI	Japan Bank for International Cooperation Institute
LDC	Least Developed Country
MAI	Multilateral Agreement on Investment
METR	Marginal Effective Tax Rate
MIGA	Multilateral Investment Guarantee Agency
MNE	Multinational Enterprise
NAFTA	North American Free Trade Agreement
OECD	Organization for Economic Cooperation and Development

OLI	Ownership-Location-Internalization
P & E	Performance and Exploration
PR	Performance Requirement
R&D	Research and Development
SDT	Special and Differential Treatment
SCMs	Subsidies and Countervailing Measures
TRIMs	Trade-Related Investment Measures
TIs	Tax Incentives
UNCTAD	United Nations Conference on Trade and Development
VAT	Value-Added Tax
WTO	World Trade Organization
MUB	Manufacturing Under Bond

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## CHAPTER ONE

### INTRODUCTION AND BACKGROUND

Foreign Direct Investment and Tax incentives are interrelated concepts. FDI is believed to be a significant factor in economic growth of a country with direct impacts on economic and social welfare of a country. On this basis, Kenya has engaged in a number of measures to attract foreign investment. Among these measures are the use of tax incentives. This chapter outlines the main areas of study, including, the statement of the problem, importance of the study, theoretical foundations of foreign investment, research objectives and the research hypothesis.

## 1.1 Introduction

The last 2 decades of the 20<sup>th</sup> Century witnessed a worldwide increase in Foreign Direct Investment (FDI), accompanied by a marked change in attitude of most countries towards inward FDI. Until the middle of the late 1970s, many countries, including most of the developing countries, were highly suspicious of FDI, often regarding it as a form of post-colonialism or imperialism. That attitude has now changed and almost all countries now regard FDI as an important means for fostering their social and economic development.<sup>1</sup>

Kenya, a fast growing economy in the 80s, joined the rest of the world in competition for FDI. As this competition increased, tax incentives were adopted as a strategy to attract FDI. Whereas the industrialized countries accord financial subsidies and accelerated depreciation allowances, Kenya and other developing countries rely on tax holidays and import duty exemptions, *inter alia*, to attract foreign investors.

While the usual objective of basic tax reforms is to increase revenue, eliminate arbitrariness or unfair differences in tax burden distribution and to modernize and strengthen the tax administration, the enactment of Tax incentive legislation has the opposite effect. This type of legislation reduces government revenue, introduces new differences in tax burden distribution for taxpayers with equal income and imposes new burdens upon tax administrations.

Whereas tax incentives are perceived as a major factor in attracting FDI, the reality is that when deciding on where to invest, investors look more at long lasting factors than short-term incentives. They look at the general macro-economic condition of a country, political

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<sup>1</sup> Easson, Alex (2001a): Tax incentives for Foreign Direct Investment – Part I: Recent Trends and Countertrends, Bulletin for International Fiscal Documentation, Vol. 55, pp. 266-274. at 3.

stability-both human and physical, the general regulatory framework for investment and exuberant legal framework.

The question of the effectiveness of tax incentives is further complicated by the host country tax policies. In situation where a home country does not recognize the incentives provided by the host country when taxing the profits of its multinationals, incentives provided by the host countries will not be useful to attract investment from that country. This brings in the need for Double Taxation Agreements and their operation in balancing the rights of the source and home country to tax.

The efficiency of tax incentives in stimulating investment that would not otherwise have accrued without them vis a vis costs in terms of tax revenue foregone raises a question as to whether there is indeed a trickle down effect or a gushing up phenomenon. Do these benefits offset and exceed the costs incurred?

There are other criticisms that are leveled against tax incentives. They are said to be inequitable as they benefit some investors but not others, that they pose more burden to tax administrators and sometimes yielding corrupt practices due to lack of transparency in deciding who qualifies for it.

Notwithstanding the above criticism, coupled with a lack of empirical evidence on the benefits accrued on its use, Kenya and other developing countries have continued the use of tax incentives. This trend is threatening the general welfare of these countries since poverty still afflicts almost half their population, there is a continuous budgetary and balance of

payment deficit. These concerns could be easily addressed through the revenue foregone in the form of tax incentives.

## **1.2 Statement of the Problem**

This study examines various tax incentives provided in Kenya and a few developing countries in order to attract foreign investors. It also evaluates whether these incentives are major determinants in influencing investors' decisions to invest in a particular country. Further, the study investigates the efficacy of these incentives in view of costs, revenue foregone and other burdens associated therewith. This study concludes that although it cannot be said that tax incentives have absolutely no effect on FDI, they are, however, poor FDI determinants, and further suggests that perhaps collective action by harmonising tax policies under regional or global arrangements, *inter alia*, would be in the better interest of Kenya and other developing countries.

## **1.3 Importance of the Study**

The assessment of the effectiveness and efficiency of tax incentives in attracting FDI is important, as Kenya and other developing countries have increasingly realized that FDI can help speed up social and economic growth. This study therefore shall be useful particularly to:-

- a. Policy makers; to understand whether Tax Incentives have achieved their intended purpose and if not, to formulate alternative policies to attract FDI without necessarily using Tax Incentives.
- b. Legislature; on the specific amendments to the law to address increased imbalance of the cost vis a vis the benefits of using Tax Incentives to attract FDI.

- c. Academics to provoke the debate on whether or not Kenya and other developing countries should forego revenue, increase the tax burdens within the local populace and other costs associated therewith whereas there is no evidence of accrued benefits.
- d. The public, to be informed of their roles in improving the investment climate through holding elected leaders responsible for ensuring improved infrastructure, health, human capital formations, security, accountability and independence of the judiciary, zero tolerance to corruption etc and in the analysis attracting FDI while helping in phasing out the costly use of Tax Incentives.
- e. Regional partner states on the need to have a harmonized taxation measures and a common agenda on measures to attract FDI without necessarily engaging in harmful tax competition measures.
- f. Multilateral agencies on the need to regulate investment specifically through the expansion of TRIMs Agreement in the WTO to include tax incentives.

## **1.4 Theoretical Foundations of Foreign Direct Investment.**

### **1.4.1 Definition**

FDI is an investment by a multinational enterprise (MNE) across borders that aim at influencing and/ or controlling a business. MNEs engage in FDI and own value-adding activities in more than one country.<sup>2</sup> The IMF suggests the following definition that is widely used in literature on FDI:

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<sup>2</sup>Dunning, John H, *Multinational Enterprises and the Global Economy* (Reading: Addison-Wesley), at 3, (1993).



“Direct Investment is the category of international investment that reflects the objective of a resident entity, in one economy obtaining a lasting interest in an enterprise resident in another economy... The lasting interest implies the existence of a long-term relationship between the direct investor and the enterprise and a significant degree of influence by the investor on the management of the enterprise.”<sup>3</sup>

Though investments are defined as widely as possible, many Bilateral Investment Treaties confine the benefits of the treaty only to investments approved by the state parties to the treaty.<sup>4</sup> This limitation, at once, creates two categories of foreign investments originating from the same state party, one which is protected by the treaty because it is approved by the state party which receives the investment, and one which is not because it lacks such approval.<sup>5</sup>

Therefore, the difference between portfolio<sup>6</sup> and direct investment is the factor control. While portfolio investment is made with the objective to participate in expected returns of an enterprise and only involves the transfer of capital, a direct investment additionally implies a change of ownership. This includes, aside from the transfer of capital, a package of assets such as intellectual property rights (IPRs), technology, or production processes.

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<sup>3</sup> The International Monetary Fund's (IMF) Balance of Payment Manual (1993, p. 93)

<sup>4</sup> In *Grueslin v. Malaysia* (2000) 5 ICSID Rpts 483, the tribunal ruled that jurisdiction under treaty could not be invoked by investors who did not have specific approval. The parties who do not qualify as investors or whose investments do not fall within the definition of investment will not be able to invoke the dispute settlement provision of the treaties. *Young Chi Oo Ltd v. Myanmar* (2003) 42 ILM 540

<sup>5</sup> See Sornarajah, M (2005) “The International Law on Foreign Direct Investment.” Pp 225.

<sup>6</sup> Portfolio Investments are instruments connected with companies like shares or unconnected with them like promissory notes and bonds. They are used to raise capital for ventures and are freely circulated through stock exchanges or through other markets or means. See Sornarajah, M (2005) *The International Law on Foreign Direct Investment*.

There is no general agreement between countries, enterprises, or academics on the minimum equity stake that is assessed to be necessary to exert a significant degree of influence by the investor on the management of the enterprise. For the majority of the countries a 10 percent to 25 percent of the total equity stake of an enterprise is necessary to distinguish a direct investment from a portfolio investment.<sup>7</sup> Others recommend a 10 percent of ordinary shares or voting power to qualify an investment as a FDI.<sup>8</sup>

In the context of this paper, the definition is important as it assists the tax administration departments in classification as to whether an investor qualifies for various fiscal incentives that are available to foreign investors.

## **1.4.2 Foreign Direct Investment in Developing Countries**

### **a) Potential Contributions**

The so-called 'resource-gap' model<sup>9</sup> must be reviewed to understand the potential contribution that inward FDI might have in a developing country. The 'resource-gap' model follows the prevailing assumption that gaps in savings and in foreign exchange are the main impediments to long-term growth. Developing countries find themselves trapped in a vicious circle: low productivity leads to low wages, low wages cause low levels of savings, due to low levels of saving, there is low investment which maintains low productivity.<sup>10</sup> In a world with perfect competition and functioning markets FDI enables developing countries to get off the low growth path by easing out the shortage of capital.<sup>11</sup> The foreign capital

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<sup>7</sup> Dunning: 1993: 5

<sup>8</sup> The Organization of Economic Cooperation and Development (OECD 1996, p. 8)

<sup>9</sup> OECD 2001, section 22

<sup>10</sup> Moran 1998, p.20

<sup>11</sup> Japan Bank for International Cooperation Institute: 2002, p. 27

provides a complement to local savings and thus allows investment expenditures. A striking advantage of FDI is that it is less volatile than other capital flows. Hence, its positive effect is expected to be more durable.<sup>12</sup>

FDI can also benefit the host economy via spillover effects. Foreign Direct Investors bring with them some amount of proprietary technology, e.g. production technologies, managerial skills, or organizational advantages. These factors are referred to as 'firm-specific assets'. Often the foreign investor might not fully be able to internalize these benefits.<sup>13</sup> Through upstream or downstream linkages with the local economy these technologies, certain skills, or other advantages may lead to productivity spillovers. Local upstream firms may benefit from supplying inputs to MNEs as they might be forced to diversify their products or improve its quality. Local content in the production of MNEs is one of the determinants of the existence and the strength of upstream spillovers.<sup>14</sup> There is much more empirical evidence of upstream linkages than of downstream linkages.<sup>15</sup>

Another form of productivity spillovers might occur due to the entry and presence of a new competitor on the market. This spillover is often referred to as horizontal spillovers in contrast to vertical spillovers mentioned above that occur due to direct contact with suppliers or purchasers.<sup>16</sup> The increase in competition and the resulting disturbance of the existing equilibrium forces the local firm to take action in order to stay competitive.<sup>17</sup> The

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<sup>12</sup> Ibid at 27.

<sup>13</sup> Blomstrom et al: 2000, p. 103.

<sup>14</sup> Ibid at 118.

<sup>15</sup> Ibid at 115.

<sup>16</sup> OECD: 2002, p. 13

<sup>17</sup> Blomstrom et al: 2000., p. 103

influence of MNEs on market structure might be various. Market access spillovers may benefit the local export performance.<sup>18</sup>

An often analyzed channel of technology or knowledge spillovers are training programs provided by foreign direct investors to local employees. This training and learning effects applies to some skill levels working in an MNE; from simple manufacturing workers to top-level managers. Since the education and training system is quite weak in developing countries, there is a need to have clear policies to ensure transfer of technology and knowledge.<sup>19</sup>

#### **b) Potential Shortcomings**

Despite the positive effects that FDI might have on productivity and economic growth, various objections have been raised on their net effects. First, these positive effects might be partly offset by a crowding-out of local investment that would take place even without FDI.<sup>20</sup> Secondly, there is a high propensity for foreign investors to suppress local entrepreneurship that would evolve without the financially sound foreign competitors and thirdly, FDI can bring negative externalities such as infrastructure congestion<sup>21</sup> or pollution.

Another common objection against FDI is the possible deterioration in the balance of payments due to increased imports and profit repatriation. Transfer pricing<sup>22</sup> has also

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<sup>18</sup> Ibid at 109.

<sup>19</sup> Ibid at 117.

<sup>20</sup> OECD: 2002, p. 7.

<sup>21</sup> Halvorsen: 1995, p. 400

<sup>22</sup> Transfer pricing refers to the allocation of profits among parts of the corporate group. Since there is no arm's-length principle for the pricing between branches and its parents, MNEs are able to set prices so as to minimize tax liabilities in home and host countries. For further information on

been cited as a mechanism employed by the MNEs to reduce tax revenues for the host country. Indeed, tax administrations in developing countries face problems in dealing with transfer pricing due to the lack of technical expertise to challenge prices set by MNEs. Thin capitalization also raises concerns that it is a scheme well intended to minimize tax liabilities for MNEs at the expense of host country development.<sup>23</sup>

### c) Foreign Direct Investment and Economic Growth

The empirical evidence of FDI as a stimulator for economic growth is mixed.<sup>24</sup> There is evidence that least developed countries (LDCs) benefit relatively little from FDI.<sup>25</sup> One possible explanation is that in order to benefit from FDI a country requires a minimum development standard in education, technology, infrastructure, health system as well as in political and financial institutions.<sup>26</sup> This “threshold level”<sup>27</sup> is necessary to be able to absorb positive spillovers. For example, employment and learning effects only take place if a country is able to provide sufficient skilled human capital. In cases where local skilled workers are missing, the investing MNE brings with it the needed work force. Hence, positive employment and learning effects are not strengthened.

Despite this minimum development standard another determinant that seems to be important in order to benefit from FDI are industry characteristics. According to

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transfer pricing see internet resources of the World Bank:  
<http://www1.worldbank.org/publicsector/tax/multinationalenterprises.htm>

<sup>23</sup> Thin Capitalization is the practice of excessively funding a branch or subsidiary with interest bearing loans from related parties rather than with share capital. For further information on thin capitalization see internet resources of the World Bank:

<http://www1.worldbank.org/publicsector/tax/multinationalenterprises.htm>.

<sup>24</sup> See among others Nunnenkamp and Spatz (2003, p. 1), Velde (2001, p. 10), Moran (1998, p. 25). For a comprehensive review on the topic see JBICI (2002, pp. 31-39). 8

<sup>25</sup> Blomström et al. 1992, p. 23.

<sup>26</sup> OECD 2002: p. 10.

<sup>27</sup> JBICI 2002: p. 10

Nunnenkamp and Spatz<sup>28</sup> technology intensity, factor requirements, linkages to local and foreign markets and the degree of vertical integration of the foreign affiliates are likely to shape the growth impact of FDI. Additionally, the empirical results of Nunnenkamp and Spatz<sup>29</sup> suggest that the smaller the technological differences between home and host country the more likely are positive growth effects.<sup>30</sup>

The topic of this paper is the use of tax incentives to attract FDI. Therefore, countries which engage in that competition but do not meet minimum development standards and certain industry characteristics will not benefit even if they offered generous tax incentives.

While Kenya has taken a number of steps in order to improve its investment climate<sup>31</sup>, the generous tax incentives offered for foreign investors need be further examined. It should be noted that incentives alone will not enhance technology transfer or economic improvements from FDI. Unless there is a clear policy to guide on the level of investment required (High level research and development desirable), then the incentives provided will merely be a windfall to the investors with no tangible benefit to the country.

#### **d) Obstacles to Foreign Direct Investment**

These shortcomings mentioned above not only reduce the ability of countries to absorb positive spillovers but are also major constraints and disincentives for MNEs to undertake FDI in developing countries. In this context, it is necessary to mention macroeconomic

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<sup>28</sup> Nunnenkamp and Spatz: 2003, p. 5

<sup>29</sup> Ibid at 40

<sup>30</sup> Ibid

<sup>31</sup> These include infrastructure development, human resource development, macroeconomic improvements, security and health.

instabilities as another important disincentive to FDI in developing countries. The large international debt overhang in developing countries causes an uncertainty that is extremely counterproductive to long-term investment and constitutes an important constraint to FDI.<sup>32</sup> Inflation might also be a disincentive to inward FDI. This happens as it alters the actual tax burden of an enterprise and may also offset the effect of some tax incentives.<sup>33</sup> Fluctuations in the exchange rate can constitute an important element of the cost-competitiveness of MNEs, though; altogether it is assumed that macroeconomic instabilities are negatively correlated to FDI.

Weak IPRs also are a major constraint to FDI. Many developing countries do not provide sufficient protection for intellectual property.<sup>34</sup> As mentioned in the following part on the motives of FDI, the enforcement of IPRs is crucial for a company's decision on which internationalization strategy it chooses.<sup>35</sup>

Kenya has in the past taken elaborate measures to resuscitate the economy which had been greatly hampered by bad governance in the 90s. Indeed, there is a remarkable achievement that has seen the economy grow from -1.2 in 2002 to a high 6.0 in 2007. In addition, both legal and institutional framework has been put in place for Intellectual property protection. Industrial Property Act No 3 of 2001 was enacted which also established the Kenya Industrial Property Institute<sup>36</sup> whose mandate is to promote invention and innovative activities through grant of patents, utility models and technovations. It should also be

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<sup>32</sup> Fitzgerald et al. 1998, p. 44.

<sup>33</sup> Mintz and Tsiopoulos: 1995: 456.

<sup>34</sup> Though, according to Ferrantino (1993, p. 311) the enforcement of IPRs seems to be independent of the rest of the economic policies pursued by a country. There is only a rough connection between the adherence to IPR treaties and the level of development.

<sup>35</sup> Ferrantino: 1993: 302.

<sup>36</sup> Section 3 of Industrial Property Act No 3 of 2001.

pointed out that inflation rates in Kenya have been maintained at 10%-12% in the past decade.

A conclusion that can be drawn from the above is that Kenya has made tremendous attempts to eliminate obstacles to inward foreign investment. Having stated this, it should be noted that tax incentives, which is part of the wider scheme to attract investors need not be prioritized since major obstacles enumerated above been addressed. While it is time to re-think the essence of tax incentives, it is also important to understand the motives for MNEs activities abroad.

#### **1.4.3 Motives for Foreign Direct Investment**

The nature of FDI is extremely varied. To capture this variety, it is necessary to identify different motives of FDI. The underlying question is what strategic motives and objectives do companies drive to engage in FDI. The MNE, like all modern business enterprises, are driven by profit maximization. Their decision-making is based on what is perceived to be in the interest of their stakeholders<sup>37</sup>. The following motives, like most theories on FDI, are based on the assumption of existing market imperfections. To evade different negative effects of market imperfections MNEs pursue varying motives in FDI.

Dunning identifies four main types of foreign production, according to their key motive in the foreign location:<sup>38</sup>

- (1) Resource-seeking

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<sup>37</sup> According to Dunning (1993, p. 54) stakeholders include employees, managers and shareholders since all these groups get a recompense for their 'stake' in the production process. Following that definition in a broader sense governments are also stakeholders since they get taxation for the provision of infrastructure and the legal and political framework.

<sup>38</sup> Dunning: 1993: 54



- (2) Market-seeking
- (3) Efficiency-seeking
- (4) Strategic asset or capabilities-seeking.

### **1) Resource-Seeking Foreign Investment**

When enterprises identify an attractive source of natural resources at a lower cost than in their home country, vertical integration takes place as resource-seeking investment. According to Caves, a vertically integrated enterprise “produces outputs in some of its plants that serve as inputs to its other activities”.<sup>39</sup>

The rationale behind this vertical integration is twofold. On the one side, the enterprise pursues an immediate cost minimization; on the other hand it seeks to secure its source of supply for intermediate products on a long term basis<sup>40</sup> Traditional resource-seeking investment in the primary sector amounts to around five percent of total FDI both in developed and developing countries.<sup>41</sup>

It should be noted that despite this, the developed countries still struggle to compete for FDI, even if their motive is extremely geographically bound. The developing countries ought to be cautious not to subject this form of FDI to fiscal incentives as its attraction is automatic i.e. that even if a host country offers no tax incentives, resource seeking investors would not be deterred as they are attracted by the existence of a specific resource available in that particular country.

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<sup>39</sup> Caves: 1996: 2

<sup>40</sup> Dunning: 1993: 57.

<sup>41</sup> UNCTAD 2001: 259.

## **2) Market-Seeking Foreign Investment**

MNEs that supply goods or services in a host country by an affiliate company instead of using exports to serve the markets are identified as market-seekers. This type of foreign production has an immediate import substitution effect in developing countries during the import-substituting industrialization.<sup>42</sup> “Tariff-jumping” FDI, as a special form of market-seeking investment, was prevalent<sup>43</sup> especially in the sixties and seventies when market access became the predominant factor that drove manufacturing FDI into developing countries. A prominent example is the car industry in Brazil and Argentina that emerged due to tariff-jumping FDI.

Market-seeking investments depend on a specific market and a company’s opportunities in it. Therefore, they are not prone to investment incentives and as a matter of fact, countries should not grant tax incentives to market-seeking investors.

## **3) Efficiency-Seeking Foreign Investment**

Efficiency-seeking investment is characterized by a rationalization and production cost minimization at the firm level. The driving factors for efficiency-seeking investment are international cost considerations. The investing firm takes advantage of differences in availability and cost of traditional factor endowment, of differences in culture, institutional arrangements, economic systems and policies, and/ or market structures. A mutual efficiency-seeking investment between two countries with broadly similar economic

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<sup>42</sup> Rugman and Verbeke: 2001: 158.

<sup>43</sup> Banga: 2003: 8.

structures can be explained by additional benefits from economies of scale and scope and risk diversification that may arise to the investing company.<sup>44</sup>

Efficiency-seeking investment is mostly export-oriented, serving one or various national markets from one production location. Often efficiency-seeking investment is part of a vertically integration of companies that produces intermediate products in a low-cost production site.<sup>45</sup>

Due to the liberalization of trade and investment and increased regional integration, the sequence and distinction between market-oriented and efficiency-oriented investment has become less clear. While in the past traditionally, a successful investment to enter a new market was followed by a foreign manufacturing, today, MNEs pursue multiple internalization strategies.<sup>46</sup> By its very nature efficiency-oriented investment is more footloose than other types of investment. Thus, it is subject to an intensively increasing competition between countries and regions where developing countries are participating more and more. Since the market potential of the host country is not of such a big importance for efficiency-seeking investment, other factors such as investment incentives become more important determinants of this kind of investment<sup>47</sup>

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<sup>44</sup> Juergen B. Donges, *Competition for Foreign Investment in Developing Countries: The Role and Impact of Investment Incentives* (2005) pp 12.

<sup>45</sup> *Ibid* :13

<sup>46</sup> *Ibid*

<sup>47</sup> Easson: 2001a: 272.

Another reason for the competition for efficiency-oriented investment is that attracting this type of investment seems to be a quick and successful route to economic growth for developing countries<sup>48</sup>

Efficiency-seeking investment is crucial for the analysis of investment incentives since it is the investment where most competition, exceptionally between developing countries, takes place. This type of investment to a limited extent therefore qualifies for host country benefits including tax incentives.

#### **4) Strategic Asset-Seeking Foreign Investment**

The acquisition of strategic assets by a foreign company may lead to synergy effects with the already existing pool of assets<sup>49</sup> or may constitute a complement to their own strategic assets.

The main source of wealth creation in the twentieth century is knowledge. Strategic assets, embodied in intangible assets such as patents, learning capabilities, and organizational structures today are crucial for an enterprise long-term success.

MNEs undertake strategic-asset seeking investment in order to protect or advance the companies competition Position.<sup>50</sup> However, since only little strategic asset augmenting FDI takes place in the developing world<sup>51</sup> this form of investment will not be affected by existence or not of tax incentives.

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<sup>48</sup> Easson: 2001b: 369.

<sup>49</sup> *Rugman and Verbeke: 2001: 160*

<sup>50</sup> Dunning: 1993: 60.

<sup>51</sup> Dunning: 1999: 24

Hence, efficiency-seeking investment is the only kind of FDI that is highly sensible to tax investment incentives, others, resource-seeking, market-seeking, and strategic-asset seeking FDI, by their very nature, do not react to them at all and incentives are therefore just 'nice to have'.

However, a major problem in empirical analyses of FDI is that FDI data is highly aggregated. It also includes investment that is not attracted by specific incentives such as resource- and market-seeking investments. Even though these categories are an important fundamental to the analysis of FDI, they are not able to fully explain the phenomenon of FDI. The taxonomy fails in explaining two important aspects of FDI. First is the question of pluralistic motives resulting in interrelated motives which are not captured in the above classification<sup>52</sup> Second, it remains unclear why companies do invest abroad instead of licensing or exporting with the same motives. The following overview of FDI theories examines these questions.

A logical conclusion that can be drawn here, having established that only efficiency seeking investors could possibly be influenced by tax incentives, is that Kenya and other developing countries should promote policies that do not merely result in a windfall to investors with no benefits to its citizenry. A survey of all investors based on the above categorization should be done.

#### **1.4.4 Overview of Theories of Foreign Direct Investment**

Theoretical analysis of FDI started in the fifties and sixties, focusing mostly on the determinants of U.S. investment in Europe and Latin America during that time. Early

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<sup>52</sup> Dunning: 1993: 56,

streams of thought are mostly country-specific approaches. FDI is traced back to different site conditions in the home and host country locations, such as market size, factor costs, or real exchange rates.<sup>53</sup> Other approaches are firm-specific theories. These approaches concentrate on enterprise-related factors such as risk diversification, oligopolistic reactions or cash flows.<sup>54</sup> These approaches are important as they seek to further clarify the underlying reasons for FDI.

Starting with Hymer's research activities, there was a shift in focus of FDI theories. Hymer<sup>55</sup> saw the actual capital flows related to FDI as only one dimension of a much broader phenomenon. By analyzing industry structures in which U.S. companies invested in Europe and Canada, he started to emphasize the value-adding activities related to FDI. He found out that foreign investors generally face barriers to international operations, such as higher communication and information costs, cultural and language barriers, or various forms of discrimination that are not immanent to indigenous companies<sup>56</sup>

The foreign investors are able to outweigh these disadvantages due to their "firm-specific assets"<sup>57</sup> Firm-specific assets are monopolistic advantages, which imply certain structural market imperfections<sup>58</sup> e.g. superiorities in technologies or management skills, established

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<sup>53</sup> See for example Aliber (1971) who explains FDI by arguing with differences in currencies. He explains FDI solely by an advantage in the capital market a home country firm might have over a host country firm (Aliber 1971, pp. 51).

<sup>54</sup> See Stehn: 1992: 17.

<sup>55</sup> Hymer, Stephen Herbert (1976): *The International Operations of National Firms: A Study of Direct Foreign Investment* (Cambridge: The MIT Press).

<sup>56</sup> Rugman and Verbeke: 2001: 157

<sup>57</sup> See Hymer: 1976: 85.

<sup>58</sup> Hymer: 1976: 25,

brand names, favorable access to credits or production factors or a superior distribution network<sup>59</sup>

For the first time Hymer explained by arguing with industrial structure, why companies supersede market-based export or licensing by FDI as their internationalization strategy.

Dunning (1993) resumed this point and integrated it in his eclectic approach that is addressed further below.

Like Hymer's approach the internalization theory is based on market imperfections but instead of focusing on the industry structure it puts its emphasis on transaction costs. In addition to the existing structural market imperfections, economic agents suffer from cognitive limitations such as bounded rationality and a possibility of opportunism.

Instead of relying on these costly imperfections, MNEs organize their international interdependencies by integrating their activities in hierarchies. Thus they internalize costly externalities that arise from arm's-length based transactions.<sup>60</sup> The internalization theory is one of the dominant theories to explain international business activities since it focuses exclusively on identifying and evaluating market imperfections and characteristics of interdependencies.

#### **1.4.5 Dunning's Ownership-Location-Internalization Paradigm**

A comprehensive theory on FDI is still lacking. The complexity of FDI is best captured in Dunning's OLI paradigm that combines various former theories. Today Dunning's paradigm is still seen as the dominant model in international business activities. It does

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<sup>59</sup> Stehn: 1992: 57.

<sup>60</sup> Hennart: 2001: 131.

not only explain FDI activity but also demarcates it from the other two strategies of internationalization: exporting and licensing. Dunning integrated the most important former streams of theories and added a location-specific factor that was mostly neglected by former theories. Therefore, the OLI paradigm is sometimes referred to as ‘eclectic theory’. According to Dunning FDI takes place when there are:

- (1) Ownership Advantages
- (2) Location-Specific Assets
- (3) Internalization Advantages

#### **1) Ownership Advantages: The “Why” of MNE Activity**

Enterprises can gain temporary competition advantages due to firm-specific assets. Dunning defines assets as “resources capable of generating future income”<sup>61</sup> These assets may be tangible, like natural endowments, manpower, or capital as well as intangible assets such as management or organization system, possession of certain technologies, or information access to input markets or distribution networks. These assets are not connected to any location but can be exploited in any foreign production site.

#### **2) Location-Specific Assets: The “Where” of Production**

Particular countries present location advantages to the investing firm that can be seen as “complementary assets”<sup>62</sup> to the ownership advantages. These location-specific factors may consist of differences in level of investment incentives or other economic and investment policies<sup>63</sup>. In Dunning’s approach, location-specific advantages are a necessary condition for

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<sup>61</sup> See Dunning: 1993: 77.

<sup>62</sup> See Dunning: 2001: 43

<sup>63</sup> See Stehn: 1992: 58



enterprises to expand their production to a host country. If enterprises do not face these kinds of advantages they are going to export rather than to invest abroad.

The relative importance of the various location advantages will depend upon the motives for FDI<sup>64</sup> Thus, policy makers try to strengthen and reinforce the location advantage according to the desired investment. In this analysis the focus is set on the role tax incentive-based measures in this process. How the actual location advantage is composed for a certain firm, depends crucially on the industry sector and the motive of FDI. Different location factors may act as advantages and thus as determinants in one country, but may be without effect in another country.

### **3) Internalization Advantages: The How of Involvement**

Dunning acknowledges structural market failures and transactional market failures as preconditions for an international production. The former, primarily identified by Hymer (1976), discriminates between companies and causes competition disadvantage. As identified by the internalization theory above. Transactional market failures arise due to cognitive imperfections such as information asymmetry and moral hazard. Some costs and benefits of market transactions are not internalized into that transaction. Hence, integrated companies are able to exploit certain additional advantages that arise in international capital and exchange markets or different national fiscal policies.<sup>65</sup> Another source of transactional market failures exists for products whose demand is not sufficiently large to capture full economies of scale.

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<sup>64</sup> Brewer and Young: 1997:177.

<sup>65</sup> Dunning: 1993: 78

These market deficiencies lead directly to advantages of hierarchical control or internalization. FDI enables companies to internalize markets in the face of market failures. Licensing, as a market-based transaction that would allow to exploit location advantage, is problematic since property rights are often not sufficiently protected. The incentive to internalize, therefore, the degree of internalization advantage, may vary with the country and the industry sector. The strength of the internalization advantage is an indicator for the firm's likelihood to utilize its ownership advantage in a foreign location.<sup>66</sup>

These OLI advantages are not static; rather the whole OLI configuration is dynamic and subject to changes. Due to the interaction of the individual factors a firm's strategic decision as well as a government decision may influence the whole OLI configuration.<sup>67</sup>

Stehn identifies an important problem related to the eclectic theory that might be important for this analysis<sup>68</sup>. It does not explain reciprocal and multiple strategies of internationalization. By requiring the three factors as necessary conditions to undertake a FDI, it underestimates the incentives for investing abroad that proceed from location-specific factors. Especially when considering the opening of markets to trade and investment and thus increased choices for MNEs of multiple and complex integration strategies. It is even more important than before to take into account the interdependencies between the OLI advantages.

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<sup>66</sup> See Joergen:2005: 13

<sup>67</sup> Ibid, p 14

<sup>68</sup> See Stehn: 1992: 63

Dunning's approach was often criticized to be tautological since it is a collection of factors rather than a complete theory. The strength of Dunning's eclectic theory is its flexibility. It serves as analytical framework for a wide range of questions within the subject area of FDI. Even though it is not a clearly operational model, it serves as a conceptual framework for evaluating the role and impact of host country investment incentives since all motives as well as all possible determinants of FDI can be included into the location factor of the OLI configuration.

Within the eclectic paradigm as propounded by Dunning, government investment policies, both in home and host countries, play a vital role. They are not only a source of market imperfections and thus contribute to the decision to invest abroad but they also directly contribute to or weaken the given advantages. The attractiveness of the location advantage for instance is highly influenced by government policies. The above analysis shows that a country is able to tinker its policies with a view of achieving certain objective. The country should assess its investment climate to find out whether investors are keen on tax incentives before they make up their mind on investment destination. The next chapter shall synthesize various incentives provided in Kenya and other select countries with a view of establishing whether they have impacted on FDI inflows in the recent past.

## **1.5 Research Objectives.**

This research seeks to: -

- a) Study various forms of tax incentives provided in Kenya and other developing countries for attracting Foreign Direct Investment.

- b) Evaluate the effectiveness of these incentives in attracting Foreign Direct Investment in view of whether taxes matter when it comes to investor's decision to invest in one country or the other.
- c) Investigate the efficiency of tax Incentives in view of costs associated therewith and other tax distortions and burdens created and whether their benefits outweigh costs.
- d) Suggest measures to be taken to avoid the use of tax incentives with an objective of abolishing their use in the long run.

## **1.6 Research Hypothesis**

There are two hypotheses in this research. First, is that Foreign Direct Investment is so critical to the economic growth of a country that it must be attracted at all cost. Secondly, is that tax incentives are the most essential factors that can influence investors' investment decision. These hypotheses are related but shall be pursued independently with a view of making conclusive distinctions in the analysis.

## **1.7 The Research Methodology.**

This study has been literature based. A thorough analysis of the available literature has been given preference. Emphasis has been laid on the various statutory provisions dealing with tax incentives, international instruments, case laws, declarations and policy papers, International Organizations and state reports, general documents, case studies etc. Further, reference was taken from various background papers, books, and academic or scholarly articles. Internet sites with relevant up to date data and information was consulted throughout this research.

This paper is comprised of five chapters. The first chapter gives an introduction, statement of the problem, theoretical foundations of Foreign Direct Investment, research objectives and hypotheses and the general profile of the study. The second chapter examines the legal and institutional framework for tax incentives in Kenya and other select countries. The third chapter covers the description of the concept of tax incentives, classification of the main tax incentive instruments and rationale for its use. Chapter four examines the usefulness of tax incentives, evaluates the effectiveness and efficacy of their use in attracting FDI while assessing whether there are any substantial benefits accrued from their usage and the last chapter is dedicated to conclusion and suggestions.

## CHAPTER TWO

### A REVIEW OF LEGAL FRAMEWORK FOR TAX INCENTIVES IN KENYA AND OTHER SELECT COUNTRIES.

Since the policy makers in Kenya and most developing countries insist on the use of tax incentives in attracting foreign investors, they have put an array of legislations to provide for their use. A number of incentives such as income tax exemptions, investment allowances, VAT and customs duty remissions for equipment and goods destined for production in designated areas, tax holidays and tax credit accounts *interalia* are provided. This chapter examines tax incentive legislations in Kenya and other selected developing countries. The aim is to evaluate their effectiveness in attracting direct foreign investors.

## 2.1 Introduction

Tax incentives for FDI can be defined as any measurable tax advantage accorded to specific enterprise or categories of enterprises by or at the direction of the government in order to encourage them to behave in a certain manner e.g. influencing them to invest in a particular country, transfer of technology through importation of various equipment, training the locals etc <sup>69</sup> Put simply, they are exceptions to the general tax regimes. Specific to the incentives in the mining industry, they are those fiscal elements emplaced by Host Governments that make mining exploration and production more economically attractive, and would include, for example, mechanisms such as tax or royalty holidays or tax abatement, etc<sup>70</sup>

However, to be considered an investment incentive, a TI must not be available to all investors but, rather, must be tailored to specific investors or types of investors;<sup>71</sup> this would explain why in developing countries, where TIs are especially common, they are aimed at foreign investors and not available to domestic investors.<sup>72</sup> This idea of discrimination

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<sup>69</sup> UNCTAD, *Tax Incentives and Foreign Direct Investment: A Global Survey*, 12 (2000).

<sup>70</sup> There are also other mechanisms that Host Governments can use to try to influence investor behaviour, like lower government take, reduced government participation or widening of the ring fence. However, these mechanisms are more contractual in nature, and therefore, have not been included here.

<sup>71</sup> Thus, for example, accelerated depreciation offered to all investors would not be an investment incentive in the sense used here, even if accelerated depreciation might benefit certain specific investors – those operating in highly capital-intensive sectors – more than others.

<sup>72</sup> The granting of incentives to desirable investors and not to others raises the issue of discriminatory treatment. Although such discrimination is opposed by the US on the ground that it distorts international trade, this is nothing more than an economic reason, for as long as the discrimination is not on racial grounds, there is nothing in international law against discrimination between foreign

against investors who qualify to investments has brought criticisms that tax incentives benefit some investors and not others. This creates unequal playing field to investor, especially when the value of investment is used as a threshold to determine the entitlement to incentives. This may lead to investors in the same sector having different treatment by the host country.<sup>73</sup>

Tax incentives are commonly used in developing countries as opposed to developed countries where a combination of financial incentives such as grants, subsidies loans or loan guarantees are commonly used.<sup>74</sup> This is due to the fact that many developing countries do not have the financial abilities to give financial subsidies. Developing countries, also find tax incentives to be easy to establish, as the government has only to enact legislation and leave it to investors to explore the benefits.<sup>75</sup>

Because Tax incentives are intended to encourage investment not just in Exploration & Production, but also in certain geographical areas, they are rarely provided without conditions attached. Very often countries design special incentive regimes that detail the tax benefits as well as the key restrictions. For instance, these regimes may require that a project

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investors if the discrimination is based entirely on economic factors - Sornarajah M., The International Law on Foreign Investment, 99 (1994).

<sup>73</sup> Countries have different methods of determining who qualifies for tax incentives. Some use monetary value of the investment while others use the sector approach. Under the Investment Promotion Act No 6 of 2004 Laws of Kenya, a monetary value is used where the foreign investors with starting capital of US\$ 100,000 are considered for an issuance of an investment certificate guaranteeing their eligibility for tax incentives. See. Investment Promotion Act No. 6 of 2004 section 4 (1) (b).

<sup>74</sup> See Morrisset and Pirnia:2002:71 in Well:2002

<sup>75</sup> Ibid



be established in a certain region(s), have a certain turnover, require the transfer of technology from abroad or employ a certain number of individuals<sup>76</sup>

## 2.2 Kenya

### 2.2.1 The Income Tax Act

In order to encourage foreign direct investment in Kenya, various incentives have been provided in a number of statutes. Section 13(1) of the Income Tax Act<sup>77</sup> provides that the Minister may by notice in the gazette exempt a certain class of income accrued or derived from Kenya. Over time, the Ministers in charge of Finance have invoked this provision to exempt foreign investors from payment of taxes. For instance in 2001, the Minister gazetted the Income Tax (withholding) Rules which has elaborate procedures on deduction of withholding tax<sup>78</sup>

Section 7A(1) provides that a company resident in Kenya shall establish and maintain a Dividend Tax Account where the balance of the dividend tax account as of the due date for filing a return of income as defined in Section 52B shall be carried forward to the subsequent year of income.

Section 39A of the Act provides for set - off of import duty and here, where a Minister is satisfied that the investment is capable of generating net income benefits to the country, he

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<sup>76</sup> For instance, China offers foreign-invested firms a tax refund of 40% on profits that are re-invested to increase the capital of the project or launch another firm. The profits must be re-invested for at least five years. If the re-invested amounts are withdrawn within five years, the firm has to pay the taxes. India, similarly, offers a tax exemption on profits of firms engaged in tourism or travel, provided their earnings are received in convertible foreign currency – see UNCTAD, *supra* note 69, at 12.

<sup>77</sup> Chapter 470 Laws of Kenya

<sup>78</sup> Rule 4

is empowered to set off any amount of import duty for purposes of collection against the tax charged on the income of the person who incurred investment expenditure. Accordingly, the minister in 1996 gazetted the Income Tax Duty Set off Rules to guide the duty set off process. With respect to double taxation relief, the Act<sup>79</sup> empowers the minister through notice to make provisions for relief from double taxation in relation to income and other taxes of similar character. This facility is only applicable where there is a double taxation agreement.

Part 1 of the second schedule of the Act provides for deduction in respect to capital expenditure on certain buildings. For instance where a person incurs capital expenditure on the construction of an industrial building to be used in a business carried on by him or his lessee, he receives 1/40<sup>th</sup> (one fortieth deduction) from his taxable income. Part II provides for wear and tear deductions in respect of capital expenditure on the machinery. Here, during a year of income, there shall be made in computing investor's gains or profits for that year of income, a deduction, referred to as a "wear and tear deduction", in respect of machinery owned for the purposes of his business.

Part III provides for deductions in respect to mining operations for expenditure incurred in the operation. Here, where a person carrying on a business of mining incurs expenditure in a year of income there shall be made, in computing his gains or profits for that year of income, a deduction equal to two-fifths of that expenditure and in each of the following six years of income a deduction equal to one-tenth of that expenditure. Further, where the Commissioner is satisfied that, having regard to the estimated ore reserves and to any other relevant information, the mine is likely to be worked before the expiration of six years from

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<sup>79</sup> Section 41

the end of the year of income in which the expenditure was incurred, he may, upon the application of the person who incurred the expenditure, increase the amount of the deductions for a year to such amount as he may consider just and reasonable. Where the amount of a deduction under this Part has been in any manner varied for a year, then deductions for subsequent years of income shall be so adjusted that the sum of deduction for all years of income shall not exceed the expenditure incurred in the overall.

Deductions in respect to capital expenditure on Agricultural land are provided for in part IV. Here, where in a year of income the owner or tenant of agricultural land incurs capital expenditure on the construction of farm works, there shall be made, in computing his gains or profits for that year of income and the four following years of income, a deduction equal to one-fifth of that expenditure. Provided that, where in any year of income commencing on or after the 1st January, 1985, the owner or tenant of agricultural land incurs capital expenditure on the construction of farm works there shall be made, in computing his gains or profits for that year of income and the two following years of income a deduction equal to one-third of that expenditure.

Part V provides for investment deductions and this is so where capital expenditure is incurred on the construction of a building and on the purchase and installation therein of new machinery. Where the owner of that machinery, being also the owner or lessee of that building, uses that machinery in that building for the purposes of manufacture; or on the purchase and installation of new machinery in a part of a building other than a building or part thereof previously used for the purposes of manufacture, he is entitled to an investment deduction. Accordingly, 60% of the capital expenditure is deducted where the construction installation or use occurs outside municipalities of Nairobi and Mombasa and

where construction or installation occurs within Nairobi or Mombasa, a 25% deduction is allowed.

Under the eleventh schedule of the Act,<sup>80</sup> the export processing zones enterprise is exempt<sup>81</sup> from corporation tax according to paragraph 2 (e) of the third schedule. Here, the enterprise is deemed to be a non-resident subject to a non-resident rate of withholding tax on payments made to such an enterprise and, where such payments are made by a person who is not an export processing zone enterprise, the tax shall be final tax and also payments by an export processing zone enterprise to any person other than a resident person shall be deemed to be exempted from tax.

### 2.2.2 The VAT Act<sup>82</sup>

The Act provides<sup>83</sup> that the minister may, by order in the Gazette, remit wholly or partly tax payable in respect of any taxable goods and taxable services, if he is satisfied that it is in the public interest to do so. This remission applies in respect of capital goods (excluding motor vehicles) imported or purchased for investment.<sup>84</sup> It also applies for capital equipment and machinery imported or purchased solely for use in the manufacture of goods in a licensed customs bonded factory for export only. This provision also covers goods imported under bond for manufacture of exports, indirect exports, goods free of import duty, goods for use in official aid-funded projects and goods for use in manufacture of goods which are in turn supplied to another manufacturer of goods under the Essential Goods Support Programme.

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<sup>80</sup> Taxation for the export processing zones enterprises

<sup>81</sup> Rule 3

<sup>82</sup> Chapter 476, Laws of Kenya

<sup>83</sup> Section 23

<sup>84</sup> Ibid

Consequently, the minister has published regulations<sup>85</sup> which requires the investor to disclose the total value of the investment in Kenya shillings; make a full description of the investment including, where applicable, the physical location of the investment, the personal identification number of the applicant and a report of a feasibility study of the investment with sufficiently detailed proforma cash flow statement including the itemization of the cash flows.

The VAT (Remission) order 2005 provided for tax remission for the entire of the duties payable on materials, supplies, consumable items, plant, machinery, motor vehicles or equipment imported by Woodside Energy (K) Limited, Dana Petroleum Limited and Global Petroleum Limited and all non-resident person(s) with whom they are in contract (whether by way of direct contract or sub-contract) solely for the purpose of carrying out petroleum operations.

### **2.2.3 Customs and Excise Duty Act<sup>86</sup>**

Whereas the purpose of this act is to provide for the management and administration of the customs, assessment, charge and collection of customs and excise duties, there are provisions exempting certain goods from the levy of this duty. Under section 138, the minister is empowered to remit whole or in part duty payable in respect of goods to be utilized for investment. Section 139 gives discretion to the commissioner to remit any excise duty payable for goods to be utilized for investment.

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<sup>85</sup> Includes the Value Added Tax (Remission) (Investments) Regulations, 2004

<sup>86</sup> Chapter 472 Laws of Kenya

Duties on certain goods entered for expropriation are also exempted from the provisions of the Act<sup>87</sup>. These include goods entered under bond used in the Export Processing Zone, exported from EPZ to any place outside Kenya and those exported from a bonded factory. Similarly, raw materials imported for the manufacture of goods for export and goods for home use are exempt from duty provided that the users and the approved quantity of such raw materials have been gazetted by the minister.

Under the third schedule of the Act, duty remission has been provided<sup>88</sup> for tax under items in part C where the application to the minister for purposes of remission should be submitted together with a detailed list of the goods in respect of which the application is made; the personal identification number of the applicant; a full description of the investment including, where applicable, the physical location of the investment; the total value of the investment in Kenya shillings; a report of a feasibility study of the investment with sufficiently detailed proforma cash flow statement including the itemization of the cash flows for all traded or tradable goods to be produced, undertaken or purchased; and any financial obligations or commitments made thereunder. Like the VAT Act, this Act has also provided for import duty tax remission<sup>89</sup> for the entire of the duties payable on materials, supplies. Consumable items, plant, machinery, motor vehicles or equipment imported by Woodside Energy (K) Limited, Dana Petroleum Limited and Global Petroleum Limited and all non-resident person(s) with whom they are in contract (whether by way of direct contract or sub-contract) solely for the purpose of carrying out petroleum operations.

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<sup>87</sup> Section 141

<sup>88</sup> Under the Customs and Excise (Remission) (Investments) Regulations, 2004

<sup>89</sup> Under the Customs and Excise (Duty Remission) Order, 2005

Under the Customs and Excise (Investment) regulations, 2003, remission of duty may be granted in respect of capital goods, plant and machinery for new investment in an industry; the extension or expansion of an existing industry and for replacement or addition of capital goods, plant or machinery.

#### **2.2.4 The Export Processing Zones Act<sup>90</sup>**

The export processing zone enterprises, the export processing zone developers and the export processing zone operators are granted exemption<sup>91</sup> from all existing and future taxes and duties payable under the Customs and Excise Act and Value Added Tax Act on all export processing zone imports for use in the eligible business activities of the export processing zone enterprise including machinery and equipment, spare parts, tools, raw materials, intermediate goods, construction materials and equipment, office equipment and supplies, and transportation equipment. This is subject to the limitations on goods specified in the Second Schedule to the Act and also in line with the conditions specified in the Customs and Excise Act and the Value Added Tax Act.<sup>92</sup>

Subject to subsection (1)<sup>93</sup>, the export processing zone enterprises, export processing zone developers and the export processing zone operators also benefit from the following exemptions;

- a) Exemption from registration under the Value Added Tax Act;
- b) Exemption from the payment of excise duties as specified in the Customs and Excise Act;

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<sup>90</sup> Chapter 517 Laws of Kenya

<sup>91</sup> Section 29(1)

<sup>92</sup> Ibid

<sup>93</sup> Ibid

- c) Exemption from the payment of income tax as specified in the Income Tax Act for the first ten years from the date of first sale as an export processing zone enterprise, except that the income tax rate shall be limited to twenty-five per cent for the ten years following the expiry of the exemption granted;
- d) Exemption from the payment of withholding tax on dividends and other payments made to non-residents during the period that the export processing zone enterprise is exempted from payment of income tax;
- e) Exemption from stamp duty on the execution of any instruments relating to the business activities of an export processing zone enterprise;
- f) Exemption from quotas or other restrictions or prohibitions on import or export trade with the exception of trade in firearms, military equipment or other illegal goods;
- g) Exemptions from rent or tenancy controls; and
- h) Any other exemptions as may be granted by the Minister for the time being responsible for finance by notice in the Gazette.

### **2.2.5 The Stamp Duty Act<sup>94</sup>**

This is an Act that provides for the levying and management of stamp duties. It provides for duty exemption<sup>95</sup> on all instruments with respect to licences of business activities of an export processing zone enterprise licensed under the Export Processing Zones Act<sup>96</sup>.

### **2.2.6 Double Taxation Treaties (DTTs) and Bilateral Investment Treaties (BITs).**

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<sup>94</sup> Chapter 480 Laws of Kenya

<sup>95</sup> Section 117 (1)(t)

<sup>96</sup> Chapter 517 Laws of Kenya



This is provided for under the Act.<sup>97</sup> Kenya has signed Bilateral Investment Treaties with Germany and Netherlands, and Double Taxation Treaties with Austria, Netherlands, Bangladesh, Belgium, Canada, China, Denmark, France, Germany, Greece, India, Indonesia, Ireland and Netherlands. Agreements with Tanzania, Uganda and Thailand are in various stages of discussion, but are not yet ratified. As Kenya otherwise gives significant discretion to the commissioner at permitting tax deductions for the overseas expenses of Kenyan branches of non-resident companies, the treaties are particularly helpful for company branches resident in treaty countries with Kenya's high rates of non-resident withholding tax, the treaties in some cases reduce the rate of withholding or removing it entirely, when paying residents of treaty countries.<sup>98</sup>

In addition to the above legal regimes for investment promotion, the Investment Promotion Act<sup>99</sup> establishes an institution, Investment Promotion Authority, whose mandate is to promote and facilitate investment by assisting investors in obtaining the licenses necessary to invest and by providing other assistance and incentives.<sup>100</sup>

The Act<sup>101</sup> defines "foreign investor" and "local investor" and specifies that the former must have an investment certificate granted under the Act<sup>102</sup> in order to invest in Kenya. In addition the Authority facilitates investment by among other things: issuing investment

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<sup>97</sup> Section 41, Cap 480

<sup>98</sup> Pricewaterhouse Coopers.: "Taxation in Kenya". (2007) available at <http://www.pwc.com/ke>

<sup>99</sup> Act No. 6 of 2004. A new investment law, superseding the Investment Promotion Centre Act of 1986, which it repealed, was passed by Parliament and assented to by the President in December 2004. It came into force on publication in the *Kenya Gazette Supplement No. 87* on 3 January 2005.

<sup>100</sup> Section 2

<sup>101</sup> Section 2

<sup>102</sup> Section 4

certificates; assisting investors in obtaining licenses, permits, incentives and exemptions; providing information on investment opportunities and sources of capital; and advising the Government on improving the investment environment.

A foreign investor is required to invest a minimum of \$500,000 or the equivalent. (A local one must invest KShs 5 million or about \$65,000 to be eligible for an investment certificate.)<sup>103</sup> Most current foreign investors do not cross the threshold of \$500,000 but their status is unaffected, as the law is not retroactive. If they hold a general authority issued under the previous Act, that authority is continued as an investment certificate under the present Act.

The legal and institutional frameworks provided in Kenya in the recent past are an indication of the country's commitments to attracting foreign direct investors. What is not clear though is whether these measures have increased FDI inflows. It is time for the government to take stock on whether the costs in terms of revenue foregone, administrative costs and other tax burdens associated therewith outweigh the benefits accrued.

### **2.3 Other selected Developing Countries**

For a clear review of incentive regimes, comparative analysis on other countries is inevitable. The choice of these countries is informed by their distinct circumstances. Malawi for instance falls in the category of a Least Developing Country with a relatively weak infrastructure and low literacy levels compared to Kenya. South Africa on the other hand has almost similar characteristics as Kenya, although it is a more preferred investment destination than Kenya. Singapore, though classified as a developing country has succeeded

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<sup>103</sup> Ibid

in not only attracting investors generally, but it now attracts investors involved in high level research and development ventures. Australia, being a developed country has enacted laws to allow for specific types of direct foreign investment.

### 2.3.1 Republic of South Africa

#### (a) Sectoral incentives

A tax holiday scheme is available for any newly formed company commencing new manufacturing activities that qualify under the law<sup>104</sup>. To qualify under this scheme, the law requires: An investment exceeding 3 million rand in plant, machinery, land and buildings; The entity must commence with new manufacturing activities and must not have started the manufacturing process prior to applying for the tax holiday scheme; The company may take over assets from a connected party, provided that the company makes an equal investment into new and unused assets.

The criteria for eligibility include the following components:

*Spatial component:* The Company should set up its new manufacturing activities in an area that qualifies as an eligible area.

*Industry component:* The Department of Trade and Industry has set guidelines that outline which industries qualify for tax holiday approval.

*Human resource component:* To qualify under this component, the total salaries and wages bill should exceed 55 per cent of the total value added.

Each of the three criteria outlined above that the company meets, entitles it to a two-year tax holiday, with a maximum tax holiday of six years on condition that: The six-year tax holiday must be used within 10 years of approval; The tax holiday status will come into effect in the year that the company earns a taxable income; The tax holiday must be used in consecutive

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<sup>104</sup> Income Tax Act of South Africa

years (i.e. once the company starts receiving the benefit, it cannot skip years if it subsequently makes losses.

In addition, South Africa offers accelerated depreciation for certain sectors such as farming (50 per cent, 30 per cent, and 20 per cent over three years) and manufacturing (33 per cent for new and unused machinery brought into use before September 30, 1999).

A textile, clothing and footwear programme provides for the duty-free import of products based on the attainment of certain export levels. This Duty Credit Certification Scheme for the clothing and textile industry has been extended to March 2000. The scheme allows companies to use 30 per cent of the value of their exports to import textiles.

*(b) Export incentives and free trade zones*

Rebates from various customs and excise duties for exporters are available, as is zero rating for VAT on export of goods and services.

*(c) Statutory tax rate*

The national rate of corporate tax is 30 per cent. A rate of 40 per cent applies to income earned in South Africa by a branch of a company, which has its place of effective management outside South Africa. This rate applies in respect of years of assessment ending on or after 1 April 1996.

Under domestic law, dividends are exempt from income tax and withholding tax. However, all dividends declared are subject to Secondary Tax on Companies (STC), payable by the

company declaring the dividend. Interest accruing on or after 3 June 1992 is also exempt from income tax if the person earning the interest is a person who is ordinarily resident outside South Africa (subject to certain limitations), or a company that is managed and controlled outside South Africa.<sup>105</sup>

### **2.3.2 Malawi**

#### *(a) Sectoral incentives*

New corporate investors investing in excess of US\$10 million are given the option of paying a corporate tax at the rate of 15 per cent or taking a 10-year tax holiday. For those investing less than US\$10 million but more than US\$5 million, the options are corporate tax at the rate of 15 per cent or a 5-year tax holiday. Manufacturing companies can deduct operating expenses incurred up to 24 months before the start of operations. Indefinite losses carry forward for tax allowances are offered and there is no duty on import of raw materials.

Qualifying expenditures for new and old buildings and machinery are given a 40 per cent and 20 per cent investment allowance respectively, while training costs are given a 50 per cent allowance. Horticultural producers are also allowed duty-free import of equipment and raw materials.

#### *(b) Export incentives and free trade zones*

Incentives for establishing export manufacturing operations include an export tax allowance equal to 12 per cent of export revenue and a transport tax allowance equal to 25 per cent of

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<sup>105</sup> The entire analysis of Tax incentives in South Africa has been a review of UNCTAD Report on Tax Incentives in South Africa, available at: <http://www.unctad.org/publications> (Accessed before 25th November 2007)

international transport costs for non-traditional exports. No duties are levied on the import of capital equipment, raw materials and packaging materials.

*(c) Other incentives*

In addition to the normal capital allowances, qualifying training costs are allowed at 150 per cent of actual amounts expended.

*(d) Statutory tax rate*

The rate of national corporate tax is 38 per cent and there are no local corporate taxes. Further, there is no withholding tax on dividends; on interest and royalties, the rate is 15 per cent.<sup>106</sup>

### **2.3.3 Australia**

Australia has been chosen for this study because of its uniqueness. While some developing countries have considered it as developed,<sup>107</sup> others classify it as a developing country.<sup>108</sup> Nevertheless, Australia's tax incentives regime is also unique as it is specific on the type of investment worth attracting.

*(a) Regional incentives*

State and territory governments provide incentives to assist businesses situated overseas, in other states, or in urban areas to relocate to specified zones. Rules vary from state to state, but the incentives generally take the form of subsidies as well as reductions in payroll taxes, land tax and stamp duty.

*(b) Sectoral incentives*

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<sup>106</sup> This has been a review of UNCTAD Report on Tax incentives in Malawi, available at: <http://www.unctad.org/publications> (Accessed before 25th November 2007)

<sup>107</sup> If compared to developing countries like Kenya, it can effectively be said that Australia is a developed country.

<sup>108</sup> It is so if compared to giant economies like the US, UK, Germany and Japan

### Banking incentives

Certain profits of an offshore banking unit established by a resident financial institution authorized to deal in foreign exchange are taxed at the effective rate of 10 per cent. Income (excluding capital gains) from eight types of offshore banking activities conducted in Australia is eligible. Interest paid to a non-resident lender by an offshore banking unit generally is not subject to withholding tax.

### Film industry incentives

A resident taxpayer who invests in a qualifying Australian film is granted a 100 per cent tax deduction for capital expenditure incurred in producing or contributing to the production of the film if, as a consequence, the investor becomes the first owner of the copyright. Losses generated by the tax deduction may be carried forward and must be set off solely against income from qualifying Australian films.

### Mining and petroleum incentives

Taxpayers carrying out prescribed mining or petroleum operations may obtain an immediate write-off of expenditure incurred on exploration or prospecting for minerals or petroleum. The deduction is available against income of any category, and not only mining or petroleum income. Deductions are also available for particular capital expenditure incurred in the course of mining and quarrying operations over either a period specified in the legislation or the life of the mine.

### Primary production incentives

Taxpayers who engage in the cultivation of land, forestry or horticulture, in fishing operations, or in the sale of livestock and their products may qualify for the following tax concessions as primary producers: Income averaging over five years so that taxpayers are not disadvantaged when tax is levied at progressive rates on income that fluctuates from year to

year. This provision applies to individuals and trustees only; Deductions over 10 years for telephone line costs; immediate deductions for expenditure on soil conservation or measures to prevent land degradation in the year in which it is incurred; deductions over three years for capital expenditure on water conservation and distribution systems; and Deductions over 25 years for capital expenditure on timber access roads and timber mill buildings, and a special deduction for timber depletion when the consideration for the land purchased by the taxpayer includes a price for standing timber.

*(c) Export incentives and free trade zones*

Bonded warehouse facilities are available, subject to a license being granted by the Australian Customs Service. There is no time limit for removing the bonded goods. In addition, import credit schemes are offered to exports of Australian manufactured items in the textile, clothing and footwear (TCF) industries and to passenger motor vehicle (PMV) components.

Duty drawback and duty-free imports for goods to be further manufactured in Australia and re-exported are also available. The state and territory governments also offer tax incentives to attract new industry and can assist in the research and development (R&D) of new products.

*(d) Other incentives*

Among other tax incentives that Australia offers are special incentives for R&D in the form of tax deductions of up to 125 per cent of eligible R&D expenditure in determining taxable income. In addition, other tax incentives are available to attract regional headquarters operations to Australia (e.g. certain deductions and exemptions from withholding tax).



An exemption from withholding tax applies to non-resident shareholders in respect of the unfranked portion of certain dividends received from an Australian resident company which are funded from foreign source dividends received by the company on or after 1 July 1994. The types of foreign source dividends that qualify are as follows: dividends that are exempt from Australian income tax. These are dividends received from companies in listed countries where the relevant shareholding is at least 10 per cent; and dividends received in respect of shareholdings of at least 10 per cent in foreign companies, where the Australian company's recipients are deemed to have paid the underlying tax under the foreign tax credit provisions.

Under Australia's domestic law, certain types of interest are exempt. For example, interest paid to non-residents by offshore banking units (OBUs) on deposits made by, or borrowings from, non-residents is exempt from withholding tax on interest, provided that the deposits or borrowings are on-lent to non-residents or other OBUs. However, an OBU that applies funds obtained with the benefit of the exemption in a way unintended by the legislation will be liable for income tax at punitive rates. Other exemptions include interest on certain debentures and government loans.<sup>109</sup>

### **2.3.4 Singapore**

#### *(a) Sectoral Incentives*

##### Investment Allowances

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<sup>109</sup> The foregoing was a review UNCTAD Report on Tax incentives offered to attract Foreign Investors in Australia, available at: <http://www.unctad.org/publications> (Accessed before 25th November 2007).

An incentive in the form of a tax investment allowance is available to companies that undertake manufacturing or construction operations, provide engineering or technical services, perform research and development work, operate projects that reduce drinking water consumption, or carry on any of the qualifying activities of a pioneer service company. Companies have to apply to the Economic Development Board (EDB) for this type of allowance. It is granted as a deduction from taxable income, in addition to the normal tax depreciation deductions available, of up to 100 per cent of capital expenditure on factory buildings (not land) and new equipment to be used in Singapore.

The actual rate of the investment allowance is subject to negotiation, and the capital expenditure must be incurred within five years following the issue of an investment allowance certificate by the EDB. In the case of tourism projects, the period within which the capital expenditure must be incurred following the issue of the certificate is 3-5 years for expenditures between 20 million and 50 million Singapore dollars, 5-8 years for expenditures of between 50 million and 100 million Singapore dollars and up to 10 years for expenditures over 100 million Singapore dollars.

When an investment allowance is set off against a company's taxable income, an equivalent amount can be credited to an exempt income account. Dividends declared out of this exempt income account are tax-free for shareholder recipients. If the shareholder is a company, the exempt dividends received could in turn be passed on to its shareholders as tax-exempt dividends. Any investment allowance not fully set off against taxable income in a year of assessment can be carried forward until it is fully used.

Pioneer industries

Companies involved in an industrial activity that is not being carried out in Singapore on a scale adequate to the country's economic needs may apply for pioneer industry company status. An eligible company (called a pioneer company) is granted complete exemption from Singapore income tax for five years, and a period up to a maximum of 10 years may in some cases be negotiated.

At the end of their tax holiday periods, manufacturing and service companies operating under pioneer or pioneer service certificates qualify for the post-pioneer company incentive. This incentive is extended to other activities as the Ministry of Trade and Industry may decide.

Companies incurring capital expenditure of at least 10 million Singapore dollars on new productive assets for the manufacture of approved products, qualify for an expanding enterprise incentive. Companies undertaking qualifying pioneer service activities also qualify for this incentive if they intend to substantially increase the volume of that activity. Under this incentive, profits attributable to the new capital expenditure are exempt from tax for up to a maximum of 20 years.

*(b) Export incentives and free trade zones*

Export services

An enterprise providing qualifying services outside Singapore to customers not resident or not having permanent establishments in Singapore may apply for approval as an export service company or firm. Under this incentive, 90 percent of qualifying export profit, after

deducting related tax depreciation, is exempt from tax. The tax-exempt period is 10 years, extendible by the Ministry of Trade and Industry.

#### International trade incentive

A company exporting from Singapore more than 10 million Singapore dollars of qualifying manufactured goods or domestic produce or more than 20 million Singapore dollars of qualifying commodities may apply for the international trade incentive. Under this incentive, 50 percent of export profit is exempt from tax, usually for five years.

#### Warehousing and servicing incentives

A warehousing company that incurs fixed capital expenditure of 2 million Singapore dollars or more on facilities for the storage and distribution of manufactured goods for export, is eligible for exemption from tax on 50 percent of its qualifying export income. The duration should not exceed 10 years from the date of its approval as a warehousing operation or such later date to which the EDB may agree. Further extension of the tax relief period may be extended, but in aggregate, cannot exceed 20 years.

#### *(c) Other incentives*

Enterprises providing specified services can claim double tax deductions for expenditure incurred on R&D. In determining what expenditure is eligible for this benefit, the EDB takes into consideration the extent of expenditure on R&D activities, the level of expertise and qualifications of the researchers and the complexity of the research project in question.

*(d) Statutory tax rate*

The national rate of corporate tax is 26 per cent. Singapore operates an imputation system, under which a resident company may distribute as dividends the amount of its after-tax profits (taxable at the corporate income tax rate) without a further tax charge. However, when dividends are distributed in excess of such profits they can be subject to further tax at the prevailing corporate income tax rate of 26 per cent, although this tax paid on the excess dividends may be carried forward for set-off against the company's future Singapore tax liabilities.

The withholding tax rate on interest is 15 per cent. However, there is no withholding tax on certain bank deposits placed in approved banks, and on interest on government-approved loans. The rate of withholding tax on royalties is 15 per cent. The rate may be wholly or partly reduced if the use of the property is of economic benefit to Singapore and its use in Singapore is approved by the Government, provided that this reduced rate does not result in an increased tax liability in the recipient's country of residence. The rate is 26 per cent for royalties and rent for movable property derived from operations carried out in or from Singapore.<sup>110</sup>

## **2.4 Singapore Experience**

Singapore is a small island nation with 3 million people living in an area of about 600 sq. km. Except for a seaport located strategically along an international trade route, it has neither

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<sup>110</sup> This has been a review of UNCTAD Report on Tax Incentives in Singapore, available at: <http://www.unctad.org/publications> (Accessed before 25th November 2007).

natural resources nor a large market. Despite these constraints, the Singapore economy has grown in the past four decades at an enviable rate.<sup>111</sup>

### **Job creation in the 1960s**

When Singapore became independent in 1965, the major economic problem was mass unemployment. Entrepot trading activities could not create enough jobs. The solution was rapid industrialization of the economy, with the participation of foreign investors in manufacturing and financial services. An Economic Development Board was formed to manage the industrialization programme. In 1967, the Economic Expansion Incentives Act (EEIA) was introduced in order to give tax incentives to manufacturers in pioneer industries and to promote export. A prudent development policy, which provides a wide range of incentives to foreign and local investors, is credited with the transformation of the economy. In the late 1960s, the annual growth rate averaged 9 per cent, and by 1970, the unemployment rate had been reduced to 6 per cent.

### **Upgrading technology in the 1970s**

The industrialization programme was successful in attracting many Trans National Corporations, especially in the electronics industry. The strategic location of Singapore also attracted foreign investment in the ship repairing industry. By the mid-1970s, unemployment was no longer a problem. In fact, the increased demand for skilled workers resulted in a labour shortage. Consequently, the Government embarked on a massive training programme to upgrade the skills of workers and to increase the supply of technicians and engineers. Consequently, enrolment at the polytechnics and universities increased.

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<sup>111</sup> UNCTAD. (2002). Investment Policy Review for Singapore, Geneva. United Nations,. Available at: <http://www.unctad.org/publications> (accessed before 25<sup>th</sup>, November, 2007).

### **Focus on high-tech policy in the 1980s**

In line with the strategy to restructure the economy, the EEIA was amended in 1979. In the early 1980s, owing to an acute labour shortage, the main objective was to encourage diversification into high-tech industries and the upgrading of skills. In 1984, further amendments were made to the EEIA to provide benefits covering knowledge-skills, computer-related industries and R&D activities.

### **Knowledge-intensive industries in the 1990s**

A strategic Economic Plan (SEP) was formulated to chart economic policies for the 1990s and beyond with a continuing focus on high-tech knowledge-intensive industries. In 1991, the National Technology Plan set out the core philosophy and major incentives for technology development in Singapore. It emphasized the promotion of relevant R&D activities in key technology areas. A National Science and Technology Board was set up that supports R&D activities through such schemes as the Research Incentive Scheme for Companies, R&D Assistance Scheme, Manpower Development Assistance Scheme, Patent Application Fund and the Innovator's Assistance Scheme.<sup>112</sup>

The Singapore experience is important in this analysis as many countries are still grappling with attracting direct foreign investment generally. Kenya for instance has not developed a policy on desirable forms of investment worth attracting. Lack of policy effectively means that the country continues losing on the desired benefits of direct foreign investment. A policy framework is also essential in determining those investments worth attracting through the use of tax incentives. The next chapter explores the rationale and further classification of tax incentives.

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<sup>112</sup> Ibid

## CHAPTER THREE

### CLASSIFICATION AND RATIONALE OF TAX INCENTIVES.

Having enumerated the various statutory regimes on tax incentives in the previous chapter, this chapter examines the rationale and classification of tax incentives. The aim of this is to lay the foundation for a critique on their effectiveness in attracting foreign direct investment, to be addressed in the proceeding chapter.



### 3.1 Introduction

The recognition of the need for FDI, coupled with the gradual elimination of barriers to foreign investment amongst countries with similar investment climate, has led to most host governments, over the past two decades to actively compete amongst themselves to promote their countries as investment locations<sup>113</sup> They are increasingly striving to create a favourable and enabling climate to attract FDI as a policy priority by adopting such measures as liberalizing the laws and regulations for the admission and establishment of FI projects; providing guarantees for repatriation of investment and profits; and establishing mechanisms for the settlement of investment disputes. Tax incentives, are also part of these promotional efforts

Attracting FDI is a top priority for developing countries and they see it as their duty to do everything in their power to create an environment that is conducive to FDI. It is on this basis that countries have taken specific steps to establish institutions and enact legislations aimed at promoting FDI which include providing tax incentives to investors<sup>114</sup>

The efficacy of these incentives as a determinant for attracting FDI is often debated, with some schools of thought arguing that the offering of tax incentives to foreign investors will (a) increase the aggregate amount of FI available to developing countries; and (b) affect the spatial distribution of investment<sup>115</sup> even if the first argument does not fully stand up.<sup>116</sup>

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<sup>113</sup> UNCTAD, Tax Incentives and Foreign Direct Investment: A Global Survey, 11 (2000).

<sup>114</sup> See Mosoti:2001:pp2-3

<sup>115</sup> That is to say that if governments of locales that are alternative locations for foreign investors offer incentives, then the government eager to ensure that it gets the investment must match those incentives or face the prospect of losing investment to the competing countries.

However, other schools argue that tax incentives have little, if any effect on the total foreign investment that is made world-wide and thus in the aggregate, incentives create a net transfer from taxpayers to investors. In the case of foreign investors in developing nations, this transfer is primarily from a poor country to a richer one.

Despite the foregoing, developing countries have increasingly resorted to such measures in recent years,<sup>117</sup> especially those that consider themselves to be alternative locations for FDI. Countries that are in close geographical proximity to others countries with similar attractive features have enhanced tax incentives competition with a view to attracting more investment inflow.<sup>118</sup> In addition to this, there has been the emergence of a new issue, i.e. the recognition that the tax policies of the home and host countries are interconnected, breeding the view that this link influences the behaviour of MNEs. There has been a great deal of evidence, especially after the changes in the United States' tax laws during the late 1980s, that home country tax policy affects both the MNE's behavior and the effectiveness of tax policy in the countries where these firms operate and invest<sup>119</sup> This chapter makes a brief, analytic excursion into the definition, objectives and classification of the major tax incentives used in promotion of FDI

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<sup>116</sup> Wells L.T. & Allen N.J., *Tax Holidays to Attract Foreign Direct Investment: Lessons from Two Experiments*, viii (2001).

<sup>117</sup> Morisset J. & Pirnia N., *How Tax Policy and Incentives Affect Foreign Direct Investment: A Review*, 4 (2001).

<sup>118</sup> This has a lot to do with investment experts, particularly from investment promotion agencies, viewing incentives as an important policy variable in their strategies to attract FDI for economic development – see UNCTAD, *supra* note 69, at 11.

<sup>119</sup> See Morisset & Pirnia, *supra* note 73, at 4.

### 3.2 Classification of tax incentives

Designing tax incentives requires two basic decisions; one, determining the types of investment that qualify; two, determining the form of tax incentive to adopt.

Tax incentives for investment take a variety of forms. As seen in chapter two, the most commonly employed are:-

- (1) Reduced corporate income tax rates;
- (2) Tax holidays (i.e., reduction of or exemption from tax for a given duration);
- (3) Investment credits or allowances;
- (4) Tax credit accounts;
- (5) Accelerated depreciation of capital assets;
- (6) Favorable deduction rules for certain types of expenditure;
- (7) Deductions or credits for reinvested profits;
- (8) Reduced rates of withholding tax on remittances to the home country;
- (9) Personal income tax or social security reductions for executives and employees;
- (10) Sales tax or VAT reductions;
- (11) Reduced import taxes and customs duties;
- (12) Property tax reductions;
- (13) Creation of special "zones."

#### 3.2.1 Reduced Corporate Income Tax Rates.

This involves government setting a lower corporate income tax as an exception to the general tax regime in order to attract FDI into specific sections or regions.<sup>120</sup> It is widely

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<sup>120</sup> See Wells: 2000:60

used in South-East Asian countries like Hong Kong, Indonesia, Lao and Cambodia.<sup>121</sup> It qualifies as an incentive because it allows investors to keep a larger portion of profit. This is always accompanied by specific conditions that the investor has to meet and sometimes is done on concessional basis between the government and the investor.

Countries may provide exemptions from, or reduced rates of, corporate income or profits tax to particular types of activity. Some countries provide a reduced rate of tax for certain types of investment (e.g., the reduced rate for manufacturing in Ireland).<sup>122</sup> Other countries provide reduced tax rates for investment in particular locations or regions (e.g., the reduced rate for investment in special economic zones and other designated regions of China).

This type of tax incentive is believed to be simple to administer, as what authorities have to do is to use the reduced rate against the profit of the investor to assess the tax. It is also easier to calculate the revenue foregone as the tax authorities are able know the profit which the company has made from the returns filed by the investor. This makes them able to calculate would be tax had it not been for the reduced rate. Reduced corporate income tax is different from tax holiday where tax authority lacks information of the investor's income due to the fact that the investor is totally excluded from submitting returns. Reduced corporate income tax results in larger benefits to high return firms who are likely to have invested even without incentives but who may thus receive a windfall to existing investments.<sup>123</sup>

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<sup>121</sup> See Fletcher:2002: 7-8

<sup>122</sup> This special rate is being eliminated because of EU rules

<sup>123</sup> Ibid at 47

### 3.2.2 Tax Holidays.

This is a full or partial exemption from and corporate taxes for firms investing in prescribed activities or industries.<sup>124</sup> Tax holidays allow firms to recover their capital more quickly and maintain greater financial position in their early years of business, thus reducing risk.

In developing countries, tax holidays are by far the most common form of tax incentive for investment. A tax holiday may take the form of a complete exemption from profits tax (and sometimes from other taxes as well), of a reduced rate of tax, or of a combination of the two (e.g., 2 years exemption, plus a further 3 years at half-rate). The exemption or reduction is granted for a limited duration.

Tax holidays can vary in duration from as little as one year to as long as 20 years. In determining the length of the tax holiday, a clear trade-off exists between the attractiveness to investors and the revenue cost to the host country's treasury. Most studies have concluded that short tax holidays are of limited value or interest to most potential investors and are rarely effective in attracting investment, other than short-term, "foot-loose," projects. Substantial investments often take several years before they begin to show a profit, by which time the tax holiday may have expired. Short tax holidays are of the greatest value to investments that can be expected to show a quick profit and are consequently quite effective in attracting investment in export-oriented activities such as textile production. Since that sector is highly mobile, however, it is not uncommon for a firm to enjoy a tax holiday in one country and, when it expires, to move its entire

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<sup>124</sup> See Sheriff: 38

operation to another country that is willing to give a new holiday. Consequently, the benefit of the investment to the host country may be quite limited.

However, this incentive is beneficial to the firm only if it earns profit during the period of the holiday otherwise it is of no use to the investor who makes a loss for the whole period of the holiday.<sup>125</sup> As stated, it is the most commonly used tax incentive in developing countries as it is considered to be simple to administer and it allows for taxpayers to avoid contact with the tax administration.<sup>126</sup>

However it remains the most controversial system due to its numerous shortcomings. By exempting profits irrespective of their amount, tax holidays tend to benefit an investor who expects high profits and would have made the investment even if this incentive were not offered. Tax holidays provide a strong incentive for tax avoidance, as taxed enterprises can enter into economic relationships with exempt ones to shift their profits through transfer pricing. Transfer pricing is the secret shifting of profits by firms within the same country or between countries through manipulation of prices.<sup>127</sup> It includes, for example overpaying or underpaying for goods from other enterprises and receiving the incentives.

Tax holidays have the apparent advantage of simplicity for both the enterprise and the tax authorities. A common misperception is that, if no tax is payable during the holiday period, no formalities should be required, such as information or tax returns, and there

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<sup>125</sup> See Kibuta:1991:60

<sup>126</sup> Tanzi and Zee:2001: 14

<sup>127</sup> Kibuta: 1991: 80

should be no compliance or administrative costs. Under the Income tax Act,<sup>128</sup> the EPZs are required to submit an annual return of income under the Act<sup>129</sup> or return of income together with self assessment of tax<sup>130</sup> and business accounts<sup>131</sup> as is the case with all taxable enterprises, and in the event of failure to submit a return or late submission of a return, the enterprise will be liable to a penalty of two thousand shillings per day for as long as the failure continues. It should be noted that this provision applies only with respect to EPZs; the other investors are not required to file returns during the period of tax holiday.

The duration of tax holidays is prone to abuse and extension by investors through creative re-designation of existing investment as new investment for example by closing down and re-starting the same project under a different name but with the same ownership.<sup>132</sup> The time limit provided for tax holiday also tends to attract or encourage short-run projects, which are not so beneficial to the economy than the long-term investments. The fact that investors enjoying tax holidays do not file returns make the revenue cost to the country less transparent and therefore difficult to evaluate its efficiency.<sup>133</sup>

Additionally, tax holidays are especially prone to manipulation and provide opportunities for tax avoidance and abuse. Another disadvantage is that the revenue cost of tax holidays cannot be estimated in advance with any degree of accuracy, nor is the cost

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<sup>128</sup> Chapter 470 Laws of Kenya

<sup>129</sup> Ibid, Section 52

<sup>130</sup> Under section 52B

<sup>131</sup> Under section 54

<sup>132</sup> Most manufacturing companies under the EPZ in Kenya have been accused of relocating.

<sup>133</sup> Tanzi and Zee: 2001:14

related to the amount of the investment or to the benefits that may accrue to the host country.

Finally, tax holidays exempt profits without regard to the level or amount of profits that are earned. For potential investments that investors believe will earn above market returns, tax holidays will result in a loss of tax revenue without any benefits. Because of the high return, investors would have undertaken these projects even without the availability of tax incentives.<sup>134</sup>

### **3.2.3 Investment Allowances and Credits.**

As an alternative, or sometimes in addition, to tax holidays, some governments provide investment allowances or credits. These are given in addition to the normal depreciation allowances, with the result that the investor may be able to write off an amount that is greater than the cost of the investment. An investment allowance reduces taxable income, whereas an investment tax credit is set against the tax payable; thus, with a corporate income tax rate of 40 percent, an investment allowance of 50 percent of the amount invested equates to an investment credit of 20 percent of that amount.<sup>135</sup>

Investment allowances or credits may apply to all forms of capital investment, or they may be restricted to specific categories, such as machinery or technologically advanced equipment, or to capital investment in certain activities, such as research and development. Sometimes, countries limit eligibility to contributions to the charter capital of the firm. This

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<sup>134</sup> Tanzi & Zee, "Tax Policy for Emerging Markets: Developing Countries", IMF Working Paper No. 35 (2000).

<sup>135</sup> See Easson:2001: 20



approach may encourage investors to increase the relative amount of equity capital rather than related-party debt capital in the firm's initial capital structure.<sup>136</sup>

Investment allowances and credits seem preferable to tax holidays in almost every respect: (i) they are not open-ended; (ii) the revenue cost is directly related to the amount of the investment, so there should be no need for a minimum threshold for eligibility; and (iii) their maximum cost is more easily estimated.

One objection to the use of investment allowances and credits is that they favour capital-intensive investment and may be less favorable towards employment creation than tax holidays. They may also distort the choice of capital assets, possibly creating a preference for short-lived assets so that a further allowance or credit may be claimed on replacement.

The value of investment allowances depends among other things on the value of the corporate income tax rate applicable to the tax base. The higher or lower the tax rates are, the higher or lower the amount of tax relief. This is due to the fact that tax allowances are given as a percentage of the total tax payable by the firm.<sup>137</sup> Also depending on whether the investment allowances must be claimed in the year they were earned or not, their value to the firm will differ. In most countries however, unused appreciable capital costs can be carried forward to offset future tax liabilities.<sup>138</sup>

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<sup>136</sup> Ibid :22

<sup>137</sup> Kibuta :59

<sup>138</sup> Ibid

### 3.2.4 Tax Credit Accounts.

Tanzi and Zee propose an interesting approach to offering tax benefits to potential investors that allows taxing authorities to determine with great certainty the revenue costs of the tax incentive program.<sup>139</sup> This approach provides each qualifying investor a specific amount of tax relief in the form of a tax credit account (say, for example, potential exemption for \$100,000 of corporate income tax liability). The investor would be required to file tax returns and keep books and record just like any other taxpayer. If the investor determines it has \$60,000 of tax liability in year one, it would pay no tax, but the amount in its tax account would be reduced to \$40,000 for future tax years. The tax credit account has the advantage of providing transparency and certainty to both the potential investor and the government.

The tax credit account may be regarded as a sort of hybrid i.e. a cross between a tax holiday and an investment tax credit. It resembles a tax holiday, except that the tax exemption period, instead of being a fixed number of years, it is related to the amount of income earned: i.e. the exemption applies to the first \$x earned. This has two important advantages: the cost of the incentive to the host government is known, and there is no strong built-in advantage for those investments that make quick profits. The tax credit account also resembles an investment tax credit in that the amount of the credit is a fixed sum: where it differs is that the amount is not determined by the amount of the investment. It consequently does not provide a preference to capital-intensive investments.

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<sup>139</sup> Ibid.

### **3.2.5 Accelerated Depreciation.**

As already noted, an investment credit or allowance is provided in addition to any amount of depreciation that may be claimed. The term “accelerated depreciation” generally refers to any depreciation scheme that provides for writing off the cost of an asset, for tax purposes, at a rate faster than the true economic depreciation. Many countries use some type of “declining balance” method of depreciation or other type of accelerated depreciation as part of their benchmark tax system. For those countries, however, that do not generally provide accelerated depreciation, a tax incentive can provide for deducting the cost of acquisition more quickly than would be allowed under the normal “benchmark” depreciation schedules.

The cost of accelerated depreciation, in terms of tax revenue foregone, is normally less than that of tax holidays or investment allowances/credits, since it is only the timing of the tax payable, and not the amount of tax, that is affected. That, of course, can still be a substantial benefit to established businesses that are planning to increase their investment, but in the case of most initial investments, where there may be no profit for several years, accelerated depreciation will be of no benefit.

### **3.2.6 Favorable Deduction Rules.**

Policy makers may influence investment by providing favorable rules for deducting certain types of expenditures. These include accelerated depreciation provisions and rules that allow the immediate expensing of capital outlays.

A somewhat different type of incentive is the double (or multiple) deduction of preferred expenditures (e.g., for re-training employees or for promoting tourism).<sup>140</sup>

A double deduction reduces the taxpayer's taxable income and operates in much the same manner as a "matching grant" from the host government. For example, if the taxpayer expends \$1 million on training employees in new skills, it is permitted to deduct \$2 million in computing its taxable income. At a corporate income tax rate of 30 percent, the host government effectively contributes an additional \$300,000 to the cost of training.<sup>141</sup>

### 3.2.7 Reinvestment Incentives.

Some countries provide incentives for the reinvestment of profits. This can be done two ways. First, the tax liability of the enterprise itself can be reduced by allowing a deduction for the amount reinvested (or a proportion thereof) from the profits otherwise taxable. Second, the shareholder, or parent company, can be given a refund of the tax paid by the local enterprise up to a stated proportion of the amount reinvested (whether in the original enterprise that made the profit or in some other qualifying enterprise).

Whether reinvestment incentives are really effective is questionable. Once an enterprise has made its initial investment it will normally base its additional investment decisions on actual business needs, so that the incentive probably rewards the enterprise for doing what it may have done in any event. Provided the host country has a reasonably generous system of depreciation allowances, there would seem to be little need to provide any further inducement to reinvest.

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<sup>140</sup> This type of incentive is used in Malaysia and Singapore.

<sup>141</sup> The deduction does not, of course, necessarily have to be double the amount of expenditure: it could be a 150% or 300% deduction.

### **3.2.8 Reduced Withholding Taxes.**

It is not uncommon for countries to provide reduced or zero rates of withholding tax as an incentive for foreign investment, either generally or to promote particular objectives such as the transfer of technology. Exemption from withholding tax is sometimes given in the case of interest on loans made at preferential rates or in the case of royalties or technical assistance fees paid in respect of technology transfers. It is also quite common for dividends paid out of exempt profits (for example, profits earned during a tax holiday period) to be exempt from withholding tax.

There is some evidence that high withholding tax rates provide a disincentive to FDI, though it is less clear that exemptions, or reductions to rates that are below the international norms, will have much if any effect on initial investment decisions. A further objection is that this form of relief actually reduces the incentive to reinvest profits (by reducing the disincentive to repatriate them).

### **3.2.9 Personal Income Tax, Payroll Tax and Social Security Reductions.**

As seen in the previous chapter, some countries accord special tax treatment to "expatriate" executives and employees, such as the granting of additional allowances (accommodation, children's education, home leave, etc.). Other countries go further and exempt certain categories of expatriate employees from income tax or payroll taxes or tax them at lower rates than other resident individuals. Concessions of this type are rarely likely to influence investment decisions, though they may be perceived by investors as one of the factors that make for a favorable investment environment.

Reductions in payroll taxes and social security contributions are also sometimes used as an incentive to invest in regions of high unemployment or to employ certain categories of workers (e.g., youths or the disabled). Such incentives are likely to be moderately effective, especially in countries where payroll taxes and social security contributions form a substantial part of the cost of employment, and they have the advantage of being relatively simple to administer.

### **3.2.10 VAT and Sales Tax Exemptions.**

These exemptions have been employed by most developing countries as an inducement to foreign investors. For export-oriented investment, consumption taxes are normally refunded on export. The better approach is to improve the VAT legislation, in particular by providing prompt refunds rather than by granting exemptions.

### **3.2.11 Reduced Import Taxes and Customs Duties.**

Customs duties increase, often substantially, the cost of imported raw materials, components and capital goods. While the taxes or duties on raw materials and components may be passed on to domestic consumers, or refunded on export, the taxes on capital goods may be less easily recovered and can add substantially to the initial cost of an investment. Exemption from customs duties and import taxes can consequently be an important factor in investment decisions. Many investors consider this type of incentive to be the most valuable type of investment incentive.

Exemptions normally apply only to imported capital equipment. Sometimes all capital equipment qualifies; in other cases, only certain categories qualify, such as machinery or

technologically advanced equipment. Occasionally, however, exemption also extends to imported components and raw materials used in production, though such exemptions are usually granted only on a temporary basis. This type of exemption especially when granted selectively to particular investors, can severely distort competition and may violate international trade rules.

### **3.2.12 Property Tax Reductions.**

Exemption from, or reduction of, property taxes is a common and relatively effective form of investment incentive. It has the advantage, from the granting government's point of view, that its cost is fully predictable. The relief is normally limited in duration, and its effect is much the same as a cash grant spread over a number of years. Property tax incentives are often part of more general regional development policies and are often granted by local, rather than central government authorities.

### **3.2.13 Special Zones.**

Countries use two types of special “zones” to attract investment: (i) duty-free zones, enjoying exemption from customs duties (and usually from VAT); and (ii) special economic zones, in which investors enjoy other tax privileges not granted in other parts of the host country. In practice, the distinction between the two types of zones is not always so clear. Investors in duty-free zones often receive other tax privileges (especially in export processing zones) and special economic zones sometimes enjoy customs privileges.<sup>142</sup>

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<sup>142</sup> It is not uncommon for a separate “bonded” duty-free zone to exist within a special economic zone.

Duty-free zones and export processing zones (EPZs) are intended to facilitate the trans-shipment of goods, and the processing of imported materials or components for export. Exemption from VAT and customs duty is granted on imported goods, because those taxes would normally be refunded on export. To grant additional tax privileges (e.g., tax holidays) to these activities may be inappropriate and may violate the WTO prohibition against export subsidies.

By contrast, special economic zones are intended to promote economic activity within a designated area, and are not restricted to exporting. They consequently should not be given favorable customs treatment.

### **3.3 Objectives of Tax Incentives**

As stated above, developing countries accept the fact that FDI can lead to faster social and economic growth.<sup>143</sup> At the same time, these poor countries need tax revenues for financing the provision of services to their people and for the day to day running of the government.<sup>144</sup> For many developing countries tax revenue form the major part of government income in their annual budget.<sup>145</sup> Many developing countries run huge budget deficit each year that has to be financed from foreign grants and loans. If tax incentives means that the government had to forbear to collect a certain amount of tax, a question comes as to whether a country that is in desperate need of tax revenues should exempt a certain class of tax payers despite a lack of empirical evidence of more direct benefits from FDI.

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<sup>143</sup> See. UNCTAD 2000, Wells:2002; and Shah:1995

<sup>144</sup> See UNCTAD: 1998:11

<sup>145</sup> While attending a KANU Delegates conference on 28<sup>th</sup> September 2007, President Mwai Kibaki of Kenya stated that 93%of the Annual budget was financed through taxation.



Capital starvation due to lack of domestic savings and huge annual trade deficits among developing countries make them rely mainly on foreign capital inflow for their economic development.<sup>146</sup> Thus the demand for foreign capital has spurred competition among countries to attract FDI.<sup>147</sup> One of the methods that are used to influence investors to invest in one country rather than the other is the provision of tax incentives. This has led to a heated debate among tax experts and policy makers, with the basic question asked being whether tax incentives are effective means of influencing the decision of Multinational corporations of where to invest and if so whether the cost of these incentives reflect the benefits accruing to the host country.<sup>148</sup> Policy makers in government and supporters of tax incentives have come up with rationale and justification for countries embarking in such costly ventures. Most countries use tax incentives for the following reasons:-

### **3.3.1 Compensation for Negative investment climate**

One of the basic reasons advanced in support of the use of tax incentives is that incentives help to compensate for a country's negative investment climate. This may range from poor macroeconomic policies that do not favour private sector development. Poor Physical and human infrastructure, political instability, corruption, inefficient regulatory framework for investment, inefficient and unfavorable general tax systems. These factors tend to add costs to the business, and the idea is that tax incentives will help compensate for these unnecessary costs.<sup>149</sup> Whether this is a viable solution or not is country specific.

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<sup>146</sup> See Dahl:2002:3

<sup>147</sup> See Sheriff: 2002:39

<sup>148</sup> Ibid:41

<sup>149</sup> See Shah:1995:45

It is generally believed that developing countries use tax incentives because they either lack resources to deal with other factors which may create conducive investment or they lack commitment and sacrifice to do so. The latter assumption is more evident in Africa with the existing corruption and undisciplined public spending by some leaders and the raging civil wars which collectively create bad image of Africa to investors

### **3.3.2 Investments for Technology Transfer**

It is believed that Foreign Direct investment in addition to bringing in new valuable capital can help to transfer new technology, which is a catalyst for broader industrial development.<sup>150</sup> Improved technology and industrial growth helps a country to diversify its economy by adding new sectors which were not there.<sup>151</sup> It is for this reason that countries do not allow deductions of expenses used in training of employees, research and development programmes or implementation of new capital equipment as tax incentives.<sup>152</sup>

### **3.3.3 Development of Economically backward Regions**

Countries often employ a mix of incentives to channel investment for development of a particular area or region. Regional development objectives include support for rural development, building industrial centres away from major cities and reducing environmental hazards, over-urbanization and concentration of population. Angola, Brazil, Ecuador, Ghana, India, Pakistan and Thailand are some of the countries that use such incentives.<sup>153</sup>

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<sup>150</sup> See Nigel:2003: 3

<sup>151</sup> See UNCTAD:2000: 14

<sup>152</sup> Ibid

<sup>153</sup> See Nigel:2003:20

In Egypt, incentive schemes for the reclamation and cultivation of barren and desert land also fall in this category. Some of those incentives integrate regional development and sector-specific objectives. For instance, Egypt's tax exemption schemes for poultry and animal husbandry have a longer exemption period if they contribute to decentralization and are set up in new industrial zones and new urban communities. Such exemption schemes are common in other developing countries as well. Colombia, for example, has special incentives regime for the Rio Paez region, in the south of the country. Tax incentives include a 10-year tax holiday from profits tax, income tax, remittance tax and customs duties, and tax reduction for shareholders.<sup>154</sup> Malawi also has a regional incentives system that gives allowances ranging from 100 per cent to 5 per cent to companies that establish operations in rural areas where there are no facilities such as electricity, tarred roads, telephones and water supply.<sup>155</sup>

### **3.3.4 Sectoral Investment**

Countries employ tax incentives in order to promote sectors of industry or activities considered crucial for development. These may be targeted at mining and industrial parks, export-led activities, the film industry and businesses with new technologies. Singapore, for example, provides exemption from income tax for 5 years to pioneer companies involved in industries that are not adequately developed in the country. Costa Rica has special incentives for tourism applicable to hotel services, air and water transportation of tourists, travel agencies and car rentals. In Pakistan, hi-tech industries, which include power tools, information technology and solar energy utilization, benefit from a wide range of fiscal incentives.

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<sup>154</sup> See UNCTAD:2000:13

<sup>155</sup> Ibid: 16

The majority of tax incentives granted by developing countries relate to investment in manufacture, exploration and extraction of mineral reserves, promotion of export and, increasingly, the tourism and leisure sectors. Developing countries generally do not attract headquarters of companies and service activities and therefore few countries have incentives aimed at the service sectors. Some exceptions are Malaysia, Singapore and the Philippines, which employ incentives primarily, reduced corporate tax rates to attract headquarters of companies. The question however remains as to what extent these investment incentives help a country in fighting poverty, taking into account the amount of revenue foregone each year.

### **3.3.5 Performance enhancement**

Sometimes incentives are provided in order to attract investment which will help enhance the performance of certain specified sectors.<sup>156</sup> The creation of free trade zones and export processing zones are aimed at increasing the country export trade performance. To achieve this, a country has to take special initiatives to influence investors to produce goods only for exports. Enterprises wishing to invest in such areas can be offered special initiatives packages for example exemption from import duties on imported raw materials and special depreciation allowances on machinery. It is expected that this encourages manufacturing industries that provide the much needed foreign exchange.

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<sup>156</sup> See UNCTAD: 2000: 13

### 3.3.6 Infant industry Issue

Economists believe that infant industries have a higher per unit cost of production because of lack of experience in production and low capital structure.<sup>157</sup> In order to allow them to be able to compete with experienced and well established industries tax incentives have to be given to allow them to acquire the required comparative advantage, skills, confidence to creditors and consumers to be able to compete with others effectively.<sup>158</sup>

This would, however, be unjustified for a developing country where the larger percent of the investments are either branches or affiliates of big and experienced multinational corporations with very few businesses or industries which can in the real sense of the word qualify to be infant.<sup>159</sup> Thus, unless the definition of infant industry is extended to exclude a branch or subsidiary of a MNE, which is being opened in a developing country, there is no justification of calling these industries infant thus awarding them generous incentives.

Generally speaking therefore, the justification for the use of incentives comes from the fact that investment create some benefits which create major beneficial effects to other sectors of the host country, and that this always happens when those intangibles are not internalized by the transnational investor involved by letting them spillover to the general country's economy.

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<sup>157</sup> See Robin and Shah: 1995:31-59

<sup>158</sup> See Kojo:1985: 33

<sup>159</sup> In legal lexicology, infant industry is defined as any newly established industry in a country as compared to one well established in that country. See Barron's Dictionary of International Business Terms:2000:258

The abovementioned illustrates the propositions for justifying the use of tax incentives as advanced by developing countries. However, many of these countries have little knowledge as to how these multinational corporations that form the major part of capital inflow operate.<sup>160</sup> This makes them unable to measure the possible benefits and costs of the investment based on the tax incentives they give. This is also aggravated by the fact that many countries give very little attention to the costs, burdens and distortions created by the use of tax incentives. Further, there is no evidence of empirical studies on the net benefits of tax incentives.<sup>161</sup>

What the policy makers know is that they have to offer tax incentives to be able to compete effectively because other countries are doing so,<sup>162</sup> and forget or neglect the fact that for poor countries, the aim is not to maximize foreign investment, but to make investment enable the country to grow out of poverty. Thus assessing the relative advantages and disadvantages of tax incentives remains an essential but complicated and controversial issue due to its own contradictions.

### **3.4 Conclusion**

In summary, the foregoing chapter attempted to show the rationale of countries using tax incentives and investment promotional institutions in attracting FDI. Countries compete for FDI because of the ruling view that FDI can be a solution to countries social and economic problems. As a result of competition for FDI, various methods are employed to try and influence the location decisions of MNE, who are the major players in the world capital flow.

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<sup>160</sup> Kojo:1985:32

<sup>161</sup> Ibid

<sup>162</sup> Balasubramanyan & Sapsford:2001:19

The rationale for the use of these incentives include the facilitation of technology transfer, creation of employment, development of backward regions in a country and performance improvement of certain sectors in the economy eg export trade, mining etc. these tax incentives take different forms from those aimed at the taxation of profit, to capital based tax incentives. The use of these incentives has however resulted in a protracted debate among academics, policy makers and scholars on the question as to whether they are an effective and efficient means of attracting FDI. The following chapter will discuss the question of the effectiveness of tax incentives and related costs to the country's economy.

## 4.1 Introduction

This chapter attempts to evaluate the effectiveness and costs of tax incentives on attracting FDI in developing countries. The basic question to be answered here is whether tax incentives are effective means of inducing the inflow of or attracting FDI to a country. Related to the above is the question of costs accompanying these instruments, that sometimes they might outweigh the benefits accruing thereof.

There isn't a single method accepted among policy makers and academics of measuring or evaluating the effectiveness of tax incentives in attracting FDI.<sup>163</sup> One of the common methods used is to look at the behavior of MNEs to find out whether their location decisions are influenced by tax incentives provided by the host country. Secondly is to look at the home country tax policies that also, depending on how they treat the unpaid tax of their MNEs. Related to the above are the double taxation agreements and their role in solving the problem of different tax policies between the host and home country.<sup>164</sup>

## 4.2 Do tax incentives influence the investors' location decision making?

Several studies have been conducted on the subject of tax incentives specifically on the question of whether tax incentives influence the investors' location decision making.<sup>165</sup> In order to understand the effectiveness of tax incentives one needs to look at the business behavior of MNEs, who are the key players in the global direct capital flow. This will help provide a view as to what factors MNEs consider in deciding where to invest between different competing locations.

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<sup>163</sup> See Kibuta:76-77

<sup>164</sup> Dahl:2003:42

<sup>165</sup> See Shah:1995, Wells 2001., Kibuta:1991



Incentives granting countries and particularly developing countries assume that all investors have a short term profit motive, which can be induced by tax rate deductions.<sup>166</sup> This view is based on the theory that investors always look for places where they can maximize their profits and tax being part of the deterrent to profit can influence the investor if it is reduced.<sup>167</sup> This is commonly known as arbitrage theory.<sup>168</sup>

The location decisions of foreign investors are influenced by many factors, which can be classified into two categories.<sup>169</sup> The first category being all the considerations other than government incentives policies that an investor would apply to location decision including all advantages of production, marketing, transportation, exchange rate and price stability, quality of public management of monetary, fiscal and social policy, political and social stability.<sup>170</sup>

The second category comprises all government incentives and disincentives that affect foreign investment, whether these are applied to foreign investment or to investment in general. These include tax holidays, custom duty exemptions, and various types of allowances etc that are the subject of this paper.<sup>171</sup> One can therefore measure the effectiveness of tax incentives by finding out which of the two categories is dominant. The patterns of preferences suggest that MNEs are attracted to the countries with the greatest economic potential and stronger markets. Tax burdens in these markets have not been significant deterrent to investment.<sup>172</sup>

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<sup>166</sup> Kojo: 2

<sup>167</sup> Ibid.3

<sup>168</sup> Ibid

<sup>169</sup> See Guisinger:1985:40

<sup>170</sup> Ibid

<sup>171</sup> Ibid .41

<sup>172</sup> Kojo: 2

MNES constitute a system of interconnected operations all responding to a general global strategy and an operating loss in any particular country or region may have little or no effect on the overall strategy and profit structure of the MNE. It is not uncommon for MNEs to extract raw materials in one country to be used in production in another country for the goods to be sold in a third country. Under these circumstances, the rate of return in any one of these countries might be irrelevant in the location decision process.<sup>173</sup>

Considering the general market, economic and investment environment for many developing countries, tax systems becomes less important to MNEs than the underdeveloped state of the economy itself or fundamental lack of natural resources or both. Limited market size, unavailability of skilled or industrial disciplined workforce and inadequacies in the country, infrastructure would discourage the inflow of FDI even if tax incentives are non-existent. Lack of transparent, administrative and judicial system and inefficiency or ineptitude in the implementation of reform of tax and other laws that have to do with industrial activity are presumed to be other factors, which discourage foreign investment in developing countries. Thus tax incentives cannot compensate for such negative factors but surprisingly, the developing countries are still using them in a big way<sup>174</sup>

Foreign investors often cite high initial investment costs in poor countries as a deterrent. These include complex and lengthy company registration procedures and intrusive rules for the location and manner of investment. They also mention unreliable and expensive power supply especially electricity.<sup>175</sup>

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<sup>173</sup> See Avi-Yona:2000:7

<sup>174</sup> See Heller and Kauffman: 1963:60

<sup>175</sup> See Schmidt and Culpeper:2003:11

What many tax incentive providing countries ignore is that incentive legislation does work or operate in isolation, they go together with the given economic and political framework and an existing underlying tax system which is transparent, effective, favourable to the investor not in terms of incentives but the operation of general tax system e.g. general tax rates, effectiveness of tax administration, physical and human infrastructure etc.<sup>176</sup>

It should be acknowledged that international experience from some countries indicates that fiscal incentives may have only a limited impact in some cases. Studies of whether generous tax policies can compensate for weaknesses in the commercial environment and attract TNCs have led to the broad conclusion that tax exemptions can influence some of the investors, some of the time, but are generally only marginal factors.<sup>177</sup> In the words of one investor cited by Morisset & Pirnia (2000), “tax exemption is like a dessert; it is good to have, but it does not help very much if the meal is not there”. In a survey of Taiwanese firms, only 8% of firms rated tax incentives as the single most effective government policy for promoting technological development: last, after educating more R&D personnel (18.8%), coordinating firms to conduct joint research (18.6%), introducing new technology from abroad (17.2%) and transferring technology through government-sponsored research institutions.<sup>178</sup>

Despite this, and despite some limitations to the effectiveness of fiscal incentives in promoting high-risk activities or in compensating for the lack of economic fundamentals, many countries nevertheless continue to offer extensive fiscal incentives in the belief that

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<sup>176</sup> Heller and Kauffman:63

<sup>177</sup> Morisset & Pirnia, 2000:

<sup>178</sup> Lall, 2000: 22

they are integral instruments in promoting investment. The review of countries' different incentive schemes suggests that, by and large, countries' investment promotion strategies remain geared to attracting multinational companies.<sup>179</sup> The challenge for government planners is to take the different types of players in their home market into account and to tailor fiscal incentives to the needs of their economy to maximise their impact.

A general conclusion which can be derived here is that the effect of tax incentives for FDI at least in developing countries is limited if compared to other factors mentioned above such as political stability, the costs and availability of skilled labour, the basic physical infrastructure and the general macroeconomic policies.<sup>180</sup> Notwithstanding the generous tax incentives that are being offered, developing countries particularly, least developing countries are lagging behind in terms of FDI inflow if compared to the developed or newly industrialized countries of Eastern Europe and South East Asia.<sup>181</sup>

Critics argue that this has resulted in what has been called a "race to the bottom" by some development economists in a form of 'tax competition', whereby countries undercut their neighbors in offering investors lower rates of corporation tax or preferential exemptions. This is despite the fact that large TNCs may in fact be less in need of preferential tax treatment, and are often in a stronger position for tax planning (with the option to recharge revenues between sources, countries and subsidiaries using for example, transfer pricing).

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<sup>179</sup> Philippa BIGGS:2007, *Tax Incentives to Attract FDI*, a paper presented at UNCTAD meeting, in March 2007 in Geneva in honor of Sanjaya Lall.

<sup>180</sup> See Morisset & Pirnia:9

<sup>181</sup> See UNCTAD: 1998:5-6

TNCS are generally less affected by the prevailing tax regime than Small and Medium-Sized Enterprises (SMEs).<sup>182</sup>

Instead of providing benefits, these incentives have ended up giving windfall gains to investors in areas where they would still have invested even without tax incentives. This experience suggests that tax incentives popular in developing countries have not been effective in making up for fundamental weaknesses in the investment climate, and that foreign investors look on more than only on tax incentives in deciding to invest. It becomes even more complicated when the investors start demanding for generous tax incentives before they will decide to invest in a country. This is done knowing the dilemma of developing countries that are in desperate need of foreign capital. As a result, investors have been using tax incentives to get more tax relief from two competing countries even when they have already made up their decision on where to invest. It is said that one multinational firm approached the Indonesian government in the early 1990s with a proposal to locate a very large export oriented electronic plant there. Company managers claimed that Indonesia would have to offer incentives including tax holidays that matched or were better than those offered in the region if it wanted the project. In the end, the electronics firm did not locate in Indonesia but added to an existing plant in another South Asian Country. People close to the company reported that firm never had any intentions of investing in Indonesia but wanted an offer from Indonesia to use it to improve its terms where it had already decided to place the investment. Many Indonesian officials were deceived to believe that the country had lost the project because of inadequate tax incentives.<sup>183</sup>

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<sup>182</sup> Biggs: 2007: 4

<sup>183</sup> See Wells: 30-31

This competition for FDI continue to put developing countries in a dilemma as to whether to continue or stop using tax incentives even when they have realized that they do no work. This is because other countries will continue using them on the misguided belief that if they do not, investors will not be attracted in their countries. Thus in the absence of a multilateral or regional initiative to deal with the issue of tax incentives to come up with clear rules on the regulation of investment promotion activities, developing countries will continue to use these measures that defeat the whole purpose of attracting investment to help a country stimulate quick economic growth.

#### **4.3 Home country's Tax policies and their Implication to the Host State.**

It is widely accepted that the tax policies in the foreign investor's home country bear directly on the effectiveness of tax incentives provided by the host country.<sup>184</sup> Many capital exporting countries extend their income tax jurisdictions to the worldwide income of their taxpayers. The result is that the same income ends up being taxed twice by two different tax jurisdictions. For the investor who is exempted from tax by the host country's incentive legislation, being taxed by the home country on the same income renders the incentives useless and thus irrelevant to its business. Therefore the result of double taxation is to eliminate the benefits from taxation that a corporation would have enjoyed as a result of the incentives.

Countries have therefore created a system of dealing with the problem of double taxation by signing bilateral Double Taxation Agreements. In a study conducted in Japan by Hines in 1998, it was found that Japanese firms have a tendency to favour investment in countries

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<sup>184</sup> Wells:89

where Japan has agreements to claim foreign tax credits for income taxes that they would have paid to a foreign government in the absence of tax incentives.<sup>185</sup>

Since much of FDI inflows to developing countries originate from developed countries and looking at the number of DTAs concluded, it is clear that more effort has to be put in dealing with the double taxation problem.<sup>186</sup> Negotiating a DTA is not a simple task for many developing countries considering the importance it carries for the country's revenue and the reciprocal commitments that have to be made between the parties taking into account inequalities in their economic position. As such, developing countries have been slow in negotiating and concluding DTAs. Thus the effectiveness of tax incentives in influencing MNEs in their investment decisions is aggravated by lack of proper instruments to deal with the effects of home countries tax policies. In order to gain substantial benefits from tax incentives on FDI, the developed countries which form the major source of FDI flow will have to cooperate to harmonize their tax policies with those of the host countries as far as FDI is concerned.

#### **4.4 The role of Double Taxation Treaties.**

From the developing country's perspective, DTAs are incentives by themselves. This is part of their recognition of DTAs in supplementing other efforts to attract foreign capital particularly the reform of tax systems that include tax incentives. Thus even in the absence of tax incentives, DTTs continue to be an important part of the general framework relevant for the smooth operation of FDI. DTTs have the role of allocating revenue in case of

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<sup>185</sup> Hines:1998

<sup>186</sup> Between 1980 and 1996, African countries have concluded 140 DTTs but many have been concluded among developing countries themselves which brings little effect to the tax incentives much as FDI continue to flow from developed countries. See UNCTAD :1998:2-4

national tax jurisdiction overlapping.<sup>187</sup> The existence of international capital movement makes rules about how taxes paid in the host country are treated in the home country more important.<sup>188</sup> Negotiating and concluding DTA is one of the methods used to offset this unwanted overlap. As earlier stated, the number of DTTs between developed and developing countries are not satisfactory. Larger percentage of DTTs is between developing countries themselves who have very minimal share in international capital movement.<sup>189</sup>

From developing countries perspective, their weak position during the negotiation of these treaties is what makes them skeptical knowing that much of the benefits in the treaty will be going to the developed country. Many of the treaties between developed and developing countries give primary right of taxation to the country in which the recipient of foreign source income is resident. In doing so, the treaties restrain the power of taxation of the source country. This is not a good scenario for developing countries knowing that many of their investments will have their permanent establishment and thus residence in their home countries and they remain to be the source countries of the incomes of those MNEs. The OECD model that is widely used is notorious in defining the residence of a taxpayer narrowly in favour of developed countries.<sup>190</sup>

From the foregoing, DTAs are important for developing countries' efforts to attract FDI. With them, tax incentives lose their validity for the investor who is going to pay tax anyway

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<sup>187</sup> Kibuta:48

<sup>188</sup> Wells: 90

<sup>189</sup> See UNCTAD:1998:3

<sup>190</sup> Article 5(2) of the OECD Model of DTA: a permanent establishment refers to a place of management, a branch, an office, a factory, a workshop, a mine, an oil or gas well... it also includes a building site and construction or installation project where the activity lasts for more than twelve months. It is this definition that is susceptible to abuse by some developed countries.



even if he is exempted by the host country. This is also the case even when it comes to non-incentive income. The major problem however is in negotiating and concluding treaties, which will balance the interests of both parties, and not only operate in favour of the developed partner.<sup>191</sup> It is for that reason that developing countries have become more careful in negotiating with developed countries. Unless more treaties are concluded between developing countries and developed countries, some investors will continue to shy away from these countries in spite of tax incentives being offered.

#### **4.5 Why tax incentives should be prohibited.**

The high costs associated with tax incentives necessitate a prohibition on its use. The following are some of the costs of using tax incentives.

##### **4.5.1 Revenue foregone.**

The modern developed state is not the only state that needs tax revenue; developing countries need tax revenue as well. Some may argue that developing countries do not need the revenue because they do not outlay the services that developed countries do.<sup>192</sup>

This circular logic may actually halt true development, leaving little opportunity for growth. Developing countries may face different challenges, but their needs are as real as that of the developed ones. Often government expenditures need to be increased in developing countries because the private resources are not available.

One of the clear costs of tax incentives is the amount of revenue that a country has to forego when granting tax incentives. The result is a reduction in fiscal revenue that is

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<sup>191</sup> See Kibuta:57

<sup>192</sup> Avi-Yonah: 2000: 1640.

desperately needed in developing countries' budgets. The major problem that threatens countries competing for FDI is the possibility of them engaging in a "race to the bottom" by giving generous tax incentives which cannot be reflected in the benefits accruing e.g. from creation of employment, transfer of technology and fight poverty.<sup>193</sup>

Incentive granting countries do not have a clear picture of the amount of revenue lost by granting incentives in order to have a comparison with the benefits accrued thereof. No proper studies or research are done before a country decides to offer tax incentives. Sometimes, even when studies are done, the fact that other countries are using incentives leaves them with no alternatives but to use it as well. As a result, these incentives end up giving windfall gains to few MNEs that sometimes would have invested even without tax incentives. Lost revenue therefore becomes a cost when it is not outweighed by the benefits accruing to the country in terms of transfer of technology, employment, performance improvement etc.

#### **4.5.2 Erosion of tax base**

The revenue that a country foregoes by providing tax incentives creates an income gap. That means some ways have to be created to fill it. Raising the general tax rates for non-incentive holders or creating another form of tax so as to widen the tax base are among the methods used to fill the revenue gap. This tends to place a significant burden on other taxpayers that have to make up for the lost revenue.<sup>194</sup>

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<sup>193</sup> Morrisset & Pirnia:94

<sup>194</sup> Wells:24-25

Higher general tax rates or introducing new types of taxes impose disincentives on other investors and on the recipient of the incentives once the incentive period expires. This has been the major argument against the use of tax holidays, which is taken to have higher costs to the country's revenue. Though considered as the most disadvantageous form of tax incentives, some countries have continued using it because of perceiving it as simple to administer and appealing more to the investor than other forms of incentives.<sup>195</sup>

#### **4.5.3 Tax avoidance or evasion**

Sometimes tax incentives may provide opportunity to avoid tax by structuring their transactions in such a way that they don't have to pay tax at all. It is common in some countries for firms to change their ownership and identity just immediately after or before the end of the incentive period so as to demand a new incentive period.<sup>196</sup> Another way is by treating the invested capital as borrowed money so as they do not have to deduct tax on interest paid which in real sense is not as the capital would have come from a parent company abroad.<sup>197</sup> Some types of incentives also attract short term investment in which the investor operates within the incentive period make profit and leave, this is common especially for tax holidays.<sup>198</sup>

#### **4.5.4 Tax Incentives are Artificial Barriers to Investment**

Foreign investments by multinational corporations can be beneficial for both the country and the corporation. In fact, it is the ability to facilitate the benefits of trade that makes

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<sup>195</sup> See Fletcher: 7

<sup>196</sup> See Morrisset & Pirnia: 26

<sup>197</sup> See Kibuta:58

<sup>198</sup> See Fletcher:7

investment so worthwhile by locating production to countries with a comparative advantage.<sup>199</sup>

However, the tax incentives used to attract the investment can actually create barriers to investment. Specific tax incentives can have negative effects on trade flows and competitive relationships.<sup>200</sup> At first, this seemed counter intuitive, how can a measure designed to attract investment actually become a barrier to investment? Tax incentives given by individual countries to attract particular investment do not increase global investment; there is no increase in the common good put forth under the theory of comparative advantage. One country's specific tax incentive becomes a barrier to another country's ability to attract investment. Over the long term, incentives will result in a loss for all competing countries involved, with the benefits going back to the foreign investor.<sup>201</sup>

### 1) **Tax Incentives Discriminate Amongst Nations.**

Tax incentives are artificial distortions and can be seen as protectionist measures of "deep pocket" countries, able to attract then monopolize on foreign investment.<sup>202</sup> The current form of investment incentives can result in a distortion of trade flow in favor of countries

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<sup>199</sup> Kevin C. Kennedy, *Global Trade Issues in the New Millennium: Foreign Direct Investment and Competition Policy at the World Trade Organization*, 33 *GEO. WASH. INT'L L. REV.* 585, 595-96 (2001).

<sup>200</sup> Paul Civello, *The TRIMs Agreement: A Failed Attempt at Investment Liberalization*, 8 *MINN. J. GLOBAL TRADE* 97, 99 (1999). pp 99

<sup>201</sup> WTO, *Report of the Working Group on the Relationship between Trade and Investment to the General Council*, WT/WGTI/2 at 81 (1998).

<sup>202</sup> Richard Blackhurst and Adrian Otten, *Trade and Foreign Direct Investment*, (visited Sept. 25, 2007) <[http://www.wto.org/English/news\\_e/pres96\\_e/pr057\\_e.htm](http://www.wto.org/English/news_e/pres96_e/pr057_e.htm)>.

that can afford to finance the investments.<sup>203</sup> This practice keeps investment linear when investment should be viewed as more liberal and more global.

International agreements can address discriminatory and protectionist measures. A keystone of the WTO is the principle of Non-discrimination. The reality is that these incentives are no different from any other subsidy program. The fact that some tax incentives work for some countries does not imply the need for further study as some would suggest.<sup>204</sup> The difference highlights the discriminatory effect these incentives create and perpetuate and therefore calling for an immediate commitment among countries to regulate their use. The sooner the policy of lack of mutually exclusive connection between tax incentives and investment ends, the sooner the global benefits can be realized.

## 2) **Tax Incentives Discriminate Within Nations.**

Tax incentives should be based on the principle of Non-discrimination.<sup>205</sup> Selective and discretionary incentives may lead to different treatment not only between foreign investors, but between foreign and domestic investors as well. A production tax haven extends tax incentives to foreign corporations to the exclusion of national corporations. This process is a form of reverse protectionism. Just as you cannot discriminate against foreign investors, countries should not be able to discriminate in favor of foreign investors. Both use the same resources, both avail themselves of the same protections; both should be responsible for

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<sup>203</sup> WTO, Report of the Working Group on the Relationship between Trade and Investment to the General Council, WT/WGTI/2 at 81 (1998). Pp 81

<sup>204</sup> *Ibid.* at 100.

<sup>205</sup> *Ibid.* at 92.

their share of the cost. In simplest terms, foreign corporations are able to enjoy the benefits of the host nation without paying for them.<sup>206</sup>

Specific investment attracting tax incentives seen as violating GATT Article 3 should be covered by the TRIMs Agreement. The WTO would have immediate jurisdiction over these investment issues. Because of the political reality within the WTO, this argument is not likely to carry the day, further; it is for this reason that the Agreement has been halted. However, the WTO can modify the TRIMs Agreement to include these investment incentives specifically.

Some experts suggest that countries should consider offering investment incentives in a Non-discriminatory way, without distinguishing between foreign and domestic investor.<sup>207</sup>

This approach would make investment incentives part of a country's overall economic policy. If tax incentives are used, the best option is lower taxes for everyone.<sup>208</sup>

### **3) As Artificial Barriers, Implementing Tax Incentives are Costly**

The cost of tax incentives is more than the price tag on a specific incentive (the loss of revenue.) The added burden to the existing tax regime must be carefully considered. Tax issues in general can be costly, but incentives based on exceptions, given in a bidding

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<sup>206</sup> Avi-Yonah: 2000: 1588.

<sup>207</sup> UNCTAD, Report of the Expert Meeting on the Development Dimension of FDI: Policies to enhance the Role of FDI in Support of the Competitiveness of the Enterprise Sector and the Economic Performance of Host Economies, Taking into Account the Trade/Investment Interface, in the National and International Context, at 3, U.N. Doc. TD/B/Com.2/48 (2002).

<sup>208</sup> Piritta Sorsa, Special Incentives may come at a high cost to the economy, CAPITAL, Mar. 2003 < <http://www.imf.org/external/country/bgr/rr/030803.pdf>> (accessed on Sept, 28, 2007)

atmosphere require substantial human resources.<sup>209</sup> The implementation and monitoring costs of discretionary tax incentives can quickly negate the initial and even long term benefits from foreign investment.

The fact that incentives are artificial should not discredit their usefulness per se. The good news is that because they are artificial they can be dealt with more easily and arguably by the WTO.

#### **4.5.5 Tax incentives play a minor role in Investment Location; there are more effective ways to attract investment**

The actual ability for tax incentives to attract foreign investment is relatively low compared to the possible negative effects. There are more efficient and effective alternatives to reach the desired results. Such alternatives may include increase spending on human capital in a particular region.<sup>210</sup> Most foreign direct investment not only originates with the developed world, but is destined for it as well.<sup>211</sup> Developing countries only account for 19% of global foreign direct investment inflow.<sup>212</sup> This suggests that there is not the huge flow of investment circulating throughout the world, merely a transfer of resources and benefits between like, developed nations.

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<sup>209</sup> Blackhurst and Otten: 2000: 7.

<sup>210</sup> Working Group: 90.

<sup>211</sup> Jurgen Kurtz, A General Investment Agreement in the WTO? Lessons from Chapter 11 of NAFTA and the OECD Multilateral Agreement on Investment, 23 U. PA. J. INT'L ECON L. 713, 757 (2002). Pp 716

<sup>212</sup> Ibid.

Foreign investors choose investment location by considering a wide range of factors, including resources and investment protection measures.<sup>213</sup> Foreign investors will typically base their investment location decisions on long-term criteria, with specific incentives playing a minor role.<sup>214</sup> It is only when a location is narrowed down to a few sites, when tax incentives play a deciding role. This is important in two respects. First the obvious: tax incentives have little actual investment attracting power. A developing country would be wiser to improve their legal and judicial framework, human capital formations, infrastructure, health, security etc. Developing countries may increase attractiveness by creating a simple and stable tax policy e.g. reducing corporate income tax. Foreign investors tend to favor a simple and stable tax policy over generous tax incentives, particularly in governments that might carry with them political or institutional risks.<sup>215</sup> If countries want to improve their attractiveness, studies show they are better off improving their overall tax system with clear, predictable and transparent rules.<sup>216</sup>

It has been emphasized that the overall improvement of investment climate is the key determinant to FDI attraction. Speaking on behalf of the European Union, a delegate from Greece emphasized the role of the overall investment environment.<sup>217</sup> An attractive investment environment consists of a strong legal framework, adequate infrastructure, an

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<sup>213</sup> To Offer or not to Offer Tax Incentives – That is the Question, IMF Survey (IMF, Washington D.C.), June 10, 2002, at 182.

<sup>214</sup> Working Group: 75.

<sup>215</sup> Morisset and Pirnia, 2000: 23

<sup>216</sup> Piritta Sorsa, Special Incentives may come at a high cost to the economy, CAPITAL, Mar. 2003 < <http://www.imf.org/external/country/bgr/rr/030803.pdf>> (accessed on Sept, 28, 2007)

<sup>217</sup> UNCTAD, Report on the Commission on Investment, Technology and Related Financial Issues on its Seventh Session, UN Conference on Trade and Development, at 9, U.N. Doc. TB/B/EX(31)/3, (2003).



effective judicial system and a strong rule of law.<sup>218</sup> A stable macro-economic framework based on predictability and transparency helps reduce investment risk, thereby increasing a country's attractiveness.<sup>219</sup> It is generally accepted that improving domestic capacity is a key to attracting investment while there still remains concerns regarding specific investment attracting tax incentives.<sup>220</sup>

The second reason it is important to recognize that incentives have a limited effect on investment location, is because it confines competitive usefulness to only similarly situated nations. If tax incentives are a competing factor only when the investment location is narrowed down to a handful of sites, then these sites have comparably similar characteristics.<sup>221</sup> So in respects to developing nations, governments are using tax incentives to take investment away from other developing nations, and not luring it from the developed world. As previously stated, foreign direct investment going to developing countries comprises only a minority of investment worldwide, and even within this subset, investment has become concentrated in particular pockets of the world.<sup>222</sup>

However, there are studies that do suggest that tax incentives play a significant role. "In spite of all the other economic and political considerations that are clearly very important, taxation exerts a significant effect on the magnitude and location of FDI."<sup>223</sup> These studies do not

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<sup>218</sup> UNCTAD, *supra* note 29, at 9.

<sup>219</sup> *Ibid.* at 14.

<sup>220</sup> *Ibid.*

<sup>221</sup> *Ibid.* at 22

<sup>222</sup> Kurtz: 2002: 717.

<sup>223</sup> Avi-Yonah:2000: 1590 (quoting James R. Hines Jr., *Lessons Tax Policy and the Activities of Multinational Corporations*, *Fiscal Policy: Lessons from Economic*

detract from the central point, that is: tax incentives are only a factor if other countries do not have them. The problem arises when every country offers tax incentives and each country attempts to make theirs more attractive than their neighbor's. Consequently, the race to the bottom begins.

At a conference on trade and development, a delegate from Thailand speaking on behalf of the Group of 77 and China expressed concern regarding the intensifying competition to attract foreign investment.<sup>224</sup> "This race to the bottom has direct effects."

Developing countries are confronted with a prisoner's dilemma, feeling compelled to forgo revenue in order to attract investment. This prisoner's dilemma presents another reason why the WTO has a role to play in regulating investment. Individual countries are unable to form truly binding agreements prohibiting negative investment incentives. Without binding agreements, countries are compelled to offer incentives based on their neighbors' tax incentives. Countries will inevitably choose domestically less desirable incentives in attempts to attract foreign investment.<sup>225</sup>

#### **4.5.6 Tax Incentives are Harmful to Development**

A delegate from Morocco speaking on behalf of the African Group noted the importance for policies not only to attract investment, but to benefit from investment as well.<sup>226</sup>The

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Research, 401, 414-15 (Alan J. Auerbach ed., 1997)).

<sup>224</sup> UNCTAD, *supra* note 185, at 6.

<sup>225</sup> Daniel P. Petrov, Prisoners No More: State Investment Relocation Incentives and The Prisoner's Dilemma, 33 CASE W. RES. J. INT'L L. 71, 82-83, (2001).

<sup>226</sup> UNCTAD: 2000: 8.

European Union and the OECD have stated that this specific tax competition is harmful to member countries.<sup>227</sup> They agree that investment attracting tax incentives are harmful to the modern developed state.

#### 4.5.7 Tax Incentives May Actually Contribute to Corruption

The argument follows that developing countries may be inefficient and corrupt and as such should not be rewarded with tax revenue. True, there are inefficient and corrupt regimes. But the entire developing world should not be denied needed and earned, not rewarded, revenue because of a few isolated cases. Where tax incentives are eliminated across the board, developing countries can promote greater transparency and predictability, two important factors when addressing corruption and attracting investment. Over time, investment will gravitate to those governments that are less corrupt and inefficient, and the added revenue may help improve good governance.<sup>228</sup>

The current form in which tax incentives are granted could actually lead to corruption. Not only do tax incentives have a direct effect on the revenue, they can, and frequently do create an atmosphere for “suspicious behaviours” from governments and investors alike.<sup>229</sup> This is particularly harmful in developing nations where “suspicious behaviour” can be used to offer specific tax incentives due in part to less than good governance conditions. Furthermore, corruption has the dangerous potential to become entrenched, attracting the wrong type of investments.

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<sup>227</sup> Morisset and Pirnia: 2000: 20.

<sup>228</sup> Ibid. at 1641.

<sup>229</sup> Morisset and Pirnia:2000: 4.

#### 4.5.8 Tax Incentives do not Increase Prosperity for all Parties Involved

If there is a winner in the discussed investment environment, then it is the foreign investor. The foreign investor enjoys the tax incentives while poorer developing nations compete amongst themselves. The OECD argues that tax competition should be curbed to prevent revenue loss of OECD nations (developed nations).<sup>230</sup> It seems that tax competition among developing nations should be curbed as well to prevent revenue loss among developing nations.

Exactly how much revenue lost is debatable, particularly when viewed with benefits gained from foreign investment. Ireland is the best example of the positive connection between tax incentives and investment. Ireland offered tax incentives to attract high technology foreign investment. Ireland's estimated revenue loss from its tax incentives was about \$1.2 billion in 1991 and 1992.<sup>231</sup> It may be argued that this forgone revenue was worth it, given Ireland's economic prosperity resulting from foreign investment. However, it is still forgone revenue. There were other factors that made Ireland an attractive place to invest, like highly skilled labour. Despite having offered tax incentives beginning in the early 1980's, Ireland's foreign investment did not grow until the mid 1990's after the economy had stabilized and education had improved.<sup>232</sup> If tax incentives were taken out of the competitive process, then in essence Ireland could have their cake and eat it too.

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<sup>230</sup> Avi-Yonah: 2000: 1597.

<sup>231</sup> Ibid. at 1601.

<sup>232</sup> Sorsa: 2002: 20.

There is another fear that foreign investors may become victims of double taxation, from both the home and host countries.<sup>233</sup> In reality, there is often a foreign tax credit available in the home country. If that is the case, the host country is merely giving away revenue to the home country.<sup>234</sup> If their repatriated profits are taxed, the incentive becomes less attractive.<sup>235</sup> However, because traditional and production tax havens coexist, a large amount of revenue may go untaxed. Considering political and economic realities within countries, specific incentives often create a situation where the benefits of the investment are realized by a few elite.<sup>236</sup>

Foreign investment is more likely to benefit a specific community or politically persuasive group within the host country than the country as a whole. Nevertheless the cost is spread among all the people in an increase tax burden or loss of services.

#### **4.5.9 Other Concerns with Tax Incentives**

In theory, incentives make sense only if they cover the difference between the private gains for the investor and the social and economic gains for the host country. However, it is very difficult to determine the difference between private and social gains, especially when viewed over a period of time.<sup>237</sup> Data is not always readily and reliably available. Countries often offer tax incentives without a complete understanding of the foreign investment and the benefits that will come with it.<sup>238</sup> The problem is more pronounced in developing countries, where there are not the same resources available. The result is nations bet big. The

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<sup>233</sup> Avi-Yonah: 2000: 1642.

<sup>234</sup> Ibid.

<sup>235</sup> Avi-Yonah: 2000: 1644.

<sup>236</sup> Blackhurst and Otten: 2000: 22.

<sup>237</sup> Working Group: 1998: 75.

<sup>238</sup> Blackhurst and Otten: 2000: 22.

investment goes to the biggest bid, even if the bid is a gross overestimation. The winning nation is the one that is the most overoptimistic.<sup>239</sup>

Investment attracting tax incentives also raise distributional concerns. By competing among themselves, developing countries are transferring part of the value of the investment back to the investor.<sup>240</sup> The foreign investor is able to exclude tax considerations in the decision making process. Since a majority of countries offer tax incentives, investors no longer need to weigh the cost of greater government services against the benefit of lower tax accompanied by reduced services. Host countries are spending valuable resources neutralizing other countries advantages without actually increasing their own investment potential.<sup>241</sup> Since the tax concession represents a constant among equally desirable states, it is a pure windfall for the foreign investor.<sup>242</sup>

The host country's resources are not spent to attract foreign investment in so much as they re-establish the unique characteristics each nation had prior to the incentives. The WTO wants to liberalize global trade. Though there may be individual losers in this process, the world as a whole will be better off by creating greater prosperity for all. The same principles of liberalization can be applied to investment. Looking at developing nations in general and not any one specifically, forgone revenue from tax incentives is not likely to be offset by the benefits of foreign investment because developing countries are not competing amongst all

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<sup>239</sup> Ibid.

<sup>240</sup> Ibid

<sup>241</sup> Ibid.

<sup>242</sup> Avi-Yonah: 2000: 1592.

other countries. Developing countries are competing among a limited subset of countries with characteristics similar to themselves.<sup>243</sup>

#### **4.6 The WTO Should Include Tax Incentives in the TRIMs Agreement**

For all the above reasons, the developing nations should commence negotiations within the WTO that focus on investment regulations. These negotiations should address tax incentives, and specifically prohibit the targeted tax incentives used to attract foreign investment.

##### **4.6.1 Regulating Investment is within the WTO's Jurisdiction**

The GATT does not formally address foreign investment. However, with the realization that investment affects trade, the Uruguay Rounds made sure investment could be addressed by the WTO. Trade and investment are linked, and as such should be addressed by the WTO. Even the OECD feels a need for a rules based system dealing with investment within the WTO.<sup>244</sup>

True, the WTO is all ready a contentious subject, and expanding the WTO's reach to include more investment issues may actually lead to greater contention. However, the "it's not the right time, and the WTO is not the right place for a multilateral agreement on investment" argument does not make sense when considering the alternatives. Using the OECD framework to negotiate Multilateral Agreements on Investment excludes developing

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<sup>243</sup> Ibid. at 1646.

<sup>244</sup> Robert Madelin, An Investment Framework for Development Needs: The WTO Contribution, Global Forum on International Investment, (December 2002) <http://www.oecd.org/pdf/M00037000/M00037910.pdf>. (accessed on Sept, 27, 2007)

countries from having input at the creation<sup>245</sup>. Developing countries are not members of the OECD, and are less likely politically to accept an agreement that may be viewed as economic colonialism, an edict handed down from the developed countries. Bilateral agreements such as NAFTA do not offer the comprehensive approach needed to remove the prisoner's dilemma. Nor can these frameworks offer the strong dispute resolution mechanisms already established and accepted by the WTO.

Governments have reported that restraint on the use of incentives, though desirable, was difficult to achieve in unilateral or bilateral contexts.<sup>246</sup>

#### **4.6.2 The TRIMs Agreement is the logical place to Regulate Tax Incentives**

The existing TRIMs agreement would be a logical place for regulating tax incentives aimed at attracting investment. It is often easier to reach an agreement by amending existing regulations, rather than creating an entirely new regulatory regime. The existing TRIMs Agreement, with its acceptable WTO dispute resolution built in, can adequately address the problem with minimal changes to the actual Agreement.

As stated above, the TRIMs Agreement does not define the trade related measure it seeks to regulate; rather it gives examples that violate principles of GATT. These examples are illustrative, not exhaustive. Thus the TRIMs agreement should be viewed more broadly, with the ability to respond as needed to trade related investment concerns. In reality, the TRIMs

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<sup>245</sup> During an International Investment Law class discussion Justus Wabuyabo Esq. stated that the developing countries had been forced to jump into a bandwagon blindly, without a clear understanding of the applicable rules.

<sup>246</sup> Working Group: 1998: 86.



agreement does not need to be changed all that much. Simply adding an additional sentence to the annex, giving another example may be all that is needed.

### 4.6.3 Issues of Sovereignty

There are always be concerns over sovereignty and discomfort with developed countries or the WTO assuming they know what is good for developing countries. However, informal pressures created by the prisoner's dilemma already significantly limits sovereignty. A perceived limitation is a limitation nonetheless. These pressures are no worse than formal WTO rules that all nations must abide in. Thus restricting a country's ability to compete for investment by offering tax incentives does not impinge their sovereignty anymore than all ready has been.<sup>247</sup>

The decision to limit sovereignty is never easy, but that is exactly what countries have decided to do through their participation in WTO. They have opted to limit decision making power for the predictability and the benefits of a liberal trade regime.<sup>248</sup> It is becoming clearer, if not already, that foreign investment is part of trade, making the decision to regulate tax incentives a little more palatable. Developing nations indeed would refrain from granting tax incentives if they could be assured that other countries would not grant incentives as well. Bilateral and regional agreements as seen in Chapter 11 of NAFTA can not make such assurances, however the WTO can. Even without regulations many countries

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<sup>247</sup> Avi-Yonah: 2000: 1646.

<sup>248</sup> Blackhurst and Otten: 2000: 45.

are abandoning specific investment attracting tax incentives for a more improved overall tax policy.<sup>249</sup>

Investment Regulation within the WTO answer can be beneficial for both developed and developing countries. Developed countries are concerned with opening market and protecting their investments. Since these specific tax incentives do not significantly affect a corporation's investment decision, they can be used as a bargaining chip by developing countries. Regulating tax incentives through the WTO has very little cost, while the potential benefits are great, particularly for developing nations where the need is great. Since the developed nations are advocating for the inclusion of investment regulation, here is a way for the developing world to benefit from these negotiations.

#### **4.7 Conclusion**

The use of tax incentives continues to put developing countries in a dilemma. They are obliged to promote FDI for a variety of good reasons. Generally, the level of FDI flows into a country is seen as an indicator to economic growth. The competition to attract FDI between these countries is intense. Thus as we have seen, most countries resort into provision of generous tax incentives as a means of attracting FDI. The efficiency and effectiveness of these incentives is still doubted. The belief that investors expect tax incentives brings in a fear that without them, potential investment will go elsewhere. Thus despite the costs and other disadvantages, governments are under pressure to offer investment incentives. To quote Prof. Enrich, "The absence of empirical evidence for the economic efficiency of tax incentives does little to quell the political enthusiasm for them..."

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<sup>249</sup> Sorsa: 2002: 21.

By taking visible steps to encourage economic growth, elected officials can take credit for subsequent economic successes, whatever their actual causes, and avoid blame for any losses of jobs to other states that otherwise would have been attributed to them if they had failed to act. From a political perspective, doing something is almost always better than doing nothing...Thus the political costs of adopting tax breaks for business are lower than the costs of failing to participate aggressively in the incentives bidding competition.”<sup>250</sup>

This means that there is need for all countries to agree together to eliminate the use of tax incentives for investment and to restrict their use within certain agreed limits. Failure of which the race to the bottom will continue to the detriment of developing countries. Therefore, as suggested above, there is a need for developing countries to initiate talks within the WTO with a view to regulate the harmful tax competition.

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<sup>250</sup> See Enrich: 1996: 393-396.

## CHAPTER FIVE

### CONCLUSION AND SUGGESTIONS

#### 5.1 Conclusion

This study sought to find out whether Foreign Direct Investment is so critical to the economic growth of a country that it must be attracted and pursuant to this, whether tax incentives are the most essential factors that can influence investors' investment destinations. The benefits of FDI need not be overemphasized. The study has found out that they are essential in ensuring flow of foreign capital, performance enhancement, and transfer of technology, economic development and development of infant industries amongst others.

Kenya has in the recent past engaged in measures to improve its investment climate. For instance the ministry of trade and industry formulated an investment action plan 2005-2007 with a view to create an enabling business environment that would encourage foreign private investment, "because without investment, the desired growth will not take place and without growth, there will be no new employment opportunities."<sup>251</sup> The prioritized areas under the plan have been; controlling rampant and escalating insecurity, addressing the poor state of roads, fast tracking construction approvals, removal of inefficient, unnecessary, unfriendly and cumbersome licensing, improving business registration, improving land administration, improving power hook-ups and improving customs and tax administration. Most of these measures are already in place or at an advanced stage. It is therefore imperative that tax incentives ought to be minimized so that the revenue collected can be used to further

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<sup>251</sup> "Kenya: Economic Recovery Strategy for Wealth and Employment creation, 2003-2007." Government of Kenya, June 2003, foreword by President Mwai Kibaki, p.xi.

improve on these areas, which in turn attract more investors. This will effectively create a virtuous cycle where more investors are attracted by a higher number of players in an improved investment climate.

Although at first glance the impact of tax incentives on FDI appears to be ambiguous, the literature review analysed herein, and especially from a study by Morrisset and Pirnia in Indonesia, shows that tax incentives are not the most influential factor for multinationals in selecting investment locations. This therefore answers the second hypothesis, which sought to examine whether tax incentives are the most essential factors influencing investors' investment destination. The findings have clearly shown that they are not.

But that does not mean that tax incentives have no effect on FDI, as there have been some successes as well as some notable failures in their role as facilitators of FDI. The point to be made is that as a factor in attracting FDI, incentives are secondary to more fundamental determinants stated above. Investors generally tend to adopt a two-stage process when evaluating countries as investment locations. In the first stage, they screen countries based on these and other fundamental determinants. Only those countries that pass these criteria go on to the next stage of evaluation where tax rates, grants and other incentives may become important. Thus, more accurate would be to say that tax incentives affect the decisions of some investors some of the time.

In conclusion, tax incentives seem to be neither necessary nor sufficient for a country to attract FDI in the first instance. Using them to compete for FDI carries the covert risk of "racing to the bottom." With competitive tax incentives, countries either, (a) end up in a

bidding war, favouring multinational companies at the expense of the State and the welfare of its citizens, and/ or (b) face reduced fiscal revenue and thereby creating frequent opportunities for illicit behaviour by companies and tax administrators. This effectively disposes off the first hypothesis, which sought to establish whether Foreign Investment is so critical to the economic growth of a country that it must be attracted at all cost. The findings have shown that contrary to this belief; they are costly and carry with it the risk of being an economic burden. Indeed, the Latin American countries have started questioning the essence “Foreign Investment” and now emphasize on policies to promote domestic investment.

## 5.2 Suggestions

From the above discussion, it is widely accepted that tax incentives are not the best way of attracting FDI in Kenya and other developing countries. The policy makers insist on their use in order to outshine those offered by the neighbouring countries, on the belief that they will attract more foreign investors. This brings us to the question of what should be done to do away with this harmful competition.

It is suggested that instead of blindly offering tax incentives to any investor, policy-makers may find it more beneficial to stick to the fundamentals, realistically appraising their national FDI balance sheet with the strategic intelligence to target the right investors, while implementing macroeconomic and political reforms to ensure stability and predictability of policy measures, and then promote their countries as investment locations with a prowess that has been effectively and efficiently tailored like has seen from the Singapore experience.

It is important for Kenya and other developing countries to address other important problems that make them. Generally, countries should take deliberate measures to improve their macroeconomic policies, human and physical infrastructure, such as education, health, security and telecommunication networks. The policy makers should undertake reforms of the general regulatory framework to reflect the needs for private sector development. There is also a need for reforms of general tax systems by creating efficiency and transparency in tax collection and elimination of unnecessary taxes and levies, which adds unnecessary costs to transactions.

Kenya, which has already put in place elaborate measures to attract foreign investors besides the use of tax incentives, should now strive to undertake empirical studies to assess the benefits of FDI vis a vis the costs incurred. The next most important step is to formulate policies to target specific forms of investment and not general attraction. Tax incentives should then be eliminated gradually starting from those with low benefits accruals to the economy. In the analysis, instead of offering tax holidays to attract FDI, Kenya should tax existing investment and use the revenues to foster fiscal stability, build infrastructure, and spend on health, security, training for labour force and eradication of poverty.

It is also suggested that Kenya should take the lead in persuading other countries within the regional blocs i.e. East African Community, COMESA, NEPAD and finally AU to undertake measures geared towards tax harmonization. This should be done with a view of eliminating tax incentives that are harmful to their economies. The second option is to persuade developing countries to use their numerical strengths in the WTO to entrench tax

incentives in the TRIMS agreement so that they operate within the WTO principles of non discrimination.

Developed countries and international financial institutions (IMF and World Bank) have also a role to play in improving developing countries investment climate. Many developing countries are still faced with huge external debts which affect their balance of payment and hence the general macroeconomic performance. External debts also reduce the ability to improve the human and physical infrastructure that is key to foreign investors. Efforts should therefore continue to look on the possibility of canceling these debts especially for the heavily indebted poor countries, so that they can have a chance to improve their investment climate and eliminate the use of tax incentives.

Forms of tax incentives such as tax holidays should be highly discouraged for they are not only distorting but also costly to the granting country. Tax holidays are not beneficial either to the investor since they may not make profit for the whole incentive period thus rendering them ineffective.

In order to ensure effectiveness of tax incentives and deal with the problem of double taxation in general, more efforts should be put on the negotiation and conclusion of DTT with countries that provide a higher investment flow to Kenya. Emphasis however should be placed on ensuring that the same does not undermine the revenue interests of the host country by giving more benefits to the home country. This has to be accompanied with capacity building for tax treaty negotiation panel so as to improve its participation during those negotiations.



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