

## Chapter 49

# The Efficiency of Corporate Tax Incentives in Developing Countries Based on Foreign Direct Investments

Simla Güzel

*Namık Kemal University, Turkey*

### ABSTRACT

*During the last quarter century, a remarkable global growth was experienced in Foreign Direct Investment (FDI), especially the developing countries, considered FDI as an important factor in overall economic development strategies. The developing countries aim to attract foreign capital to strengthen their local economy, increase market opportunities, and provide better services to the society. For this purpose, these nations implement various types of tax incentives. Although there are several studies on the effectiveness of tax incentives in FDI, the issue has not been tackled with respect to developing countries. The present study scrutinized the effectiveness of corporate tax incentives in developing countries based on FDI. In conclusion, it could be suggested that tax incentives may be effective in increasing FDI; however, in this group of countries with low level of investments and complex laws in taxation and other fields and could not cope with innovations, red tape and poor governance, it is also important to develop the organizational infrastructure for investments.*

### INTRODUCTION

Foreign direct investments are considered among the most significant contributors to economic growth. Higher capital accumulation and additional economic activity could benefit economic growth in the short term. In comparison with the local corporations in the receiving economy, foreign investing firms could have higher overall productivity. Hence, a composition effect might come into play. By means of human capital and technological advancements and product and process innovations, FDI results in positive productivity spillover to local corporations in the long-run.

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During the last quarter century, a remarkable global growth was experienced in FDI, since several nations, especially the developing countries, considered FDIs as an important factor in overall economic development strategy. FDI is important in achieving economic growth not only in developed but also in developing countries. Foreign capital is used by the developed countries for a more stable growth, while developing countries aim to increase investments and to strengthen the economy.

Several policy instruments are used to attract FDI to a country. These policies include economic, political and social stability, entrance and functioning rules, treatment of foreign affiliate standards, market operation and structure policies, international FDI agreements, privatization and trade policies, coherence of FDI and tax policies. In order to increase FDI, countries began to utilize tax incentives widely, especially in recent years, and policy makers constantly re-evaluate the present tax regulations.

In developing countries particularly, it was noted that the importance of tax incentives in growing foreign investments became prevalent in the globalization period. On the one hand, the requirement to abandon most important source of income for the state, the tax revenues, forces the countries to implement relevant tax policies. Developing countries usually adopt corporate tax incentives such as, preferential or very low general tax rates, tax allowances and tax holidays.

In addition to the generosity of the incentives provided to attract foreign investments, the effectiveness of these incentives is also important. The success of tax incentives is associated with good incentive design and general economic characteristics of the country. Externalities, public goods, liquidity problems and coordination problems within the economic system lead to market failures and failure of effective investments. Furthermore, tax incentives could be effective if they could be used for their original purposes. In particular, the cost of tax incentives grows as a consequence of the budgetary constraints and the corruption in developing countries. Also, weaknesses in tax management capacity in developing countries lead to tax avoidance and evasion. In investment decisions, factors such as political stability, organizational quality, and market size play a role in addition to tax incentives.

The aim of this study is to evaluate the significance of corporate tax incentives for FDI in developing countries. Accordingly, the first section of the study covers definitions of tax incentives and corporate tax incentive types. In the second section, information on corporate tax incentives in developing countries and related problems are presented. In this section, primarily the definition of developing countries and information on the corporate tax incentives implemented in this group of countries are provided. In the third section of the study, the significance of FDI for developing countries is discussed. With the aim of rating the effectiveness of tax incentives in terms of FDI, general information is provided initially, and then the relevant literature is addressed and the last section included the results.

## **BACKGROUND**

The correlation between taxation and FDIs has been a major focus in tax policy studies. The findings in econometric studies have changed significantly over time. Historically, it was determined that fiscal considerations had an insignificant impact on FDIs. More recent research, however concluded that taxes could be effective on investment decisions under certain circumstances (Krandsdorf, 2010, p.71). Wilson (1999) maintained that in the event that a government increases the tax rate, a decline occurs in the net return and capital relocates elsewhere in line with the perfectly mobile capital assumption. Accordingly, the conclusions encourage the use of tax incentives in order to decrease tax rates and attract FDIs. Gastanaga, Nugent and Pashamova (1998) examined the factors determining FDIs. They saw that

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