The Impact of Tax Incentives on Foreign Direct Investment in China

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Scholes and Wolfson (1989, 1992) argue that tax rules jointly influence investment decisions and organizational form. The present research uses Chinese data to test these assertions. Specifically, our study investigates whether (1) the creation of special tax incentive zones is an effective tax policy for China to induce new foreign direct investment (FDI) into specific regions, and (2) changes in the tax rules influence the particular form of foreign direct investment selected: equity joint ventures, contractual joint ventures, and wholly foreign-owned enterprises. Our results indicate that tax incentives are effective in attracting FDI to China, and moreover, influence the selection of a particular form of FDI. One limitation of our study is that we were unable to completely control for the correlated-omitted-variable problem. © 2000 Elsevier Science Inc. All rights reserved.

Key Words: *Foreign Investment; Tax Effects; Investment Forms; Tax Clientele Effects*

Introduction

Today, virtually all developing countries use tax incentives to attract foreign direct investment (FDI) (Hadari, 1990; Usher, 1977). However, research concerning the effectiveness of tax incentives in attracting such investment has yielded conflicting results. The purpose of the present study is to examine the effect of tax incentives on attracting FDI into special tax incentive zones in China, and to determine their influence on the selection of a particular form of FDI.

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In China, foreign investment enterprises or FDI has taken three forms: equity joint ventures, contractual joint ventures, and wholly foreign-owned enterprises. Equity joint ventures take the form of limited liability corporations, in which Chinese and foreign partners jointly invest and manage the operations. There is a 25% minimum foreign participation requirement, and profits and losses are shared according to the proportion of investment contributed by each partner. Contractual joint ventures may or may not form as legal entities and there is no minimum foreign participation requirement, whereas profits and losses are shared in accordance with the terms and conditions laid down in the venture contract. Wholly foreign-owned enterprises may be established by foreign companies using their own capital, technology and management entirely. They are responsible for all the risks, gains, and losses.

In the 1980s, two different income tax laws determined the tax rates and incentives for the different forms of FDI: Sino-foreign equity joint ventures paid taxes in accordance with one set of income tax laws, whereas Sino-foreign contractual joint ventures and wholly foreign-owned enterprises paid in accordance with another set of laws. In 1991, the laws were simplified and all forms of FDI were granted the same tax benefits. In addition, since 1984, the Chinese government has sought to attract FDI to designated special tax incentive zones and has done so by providing additional tax incentives to FDI in these areas.

Motivation

Scholes and Wolfson (1992) argue that tax rules influence investment decisions by affecting the rates of return on assets. They assert that the rates of return on assets can differ because (1) the returns on similar assets are taxed differently if they are located in varying tax jurisdictions, and (2) the returns on similar assets located in the same jurisdiction are taxed differently if they are held in different legal organizational forms. The present study uses Chinese data to test these assertions. Specifically, if foreign firms investing in China seek to increase their after-tax returns, increased amounts of FDI would be expected in the special tax incentive zones that offer concessionary rates of 15% or 24%, compared with other areas where FDI is subject to higher statutory tax rates. Further, before 1991, inconsistencies in the tax rules resulted in more favorable tax treatment for some forms of FDI. We would, therefore, expect dominance of the forms of FDI receiving preferential tax treatment, ceteris paribus.

China provides an excellent opportunity to test these assertions because of the relatively large amounts of FDI that it has secured and because of the variety of tax incentives that China has offered to attract FDI during the past two decades. China's total FDI has grown an average of 41% annually; from US$1.258 billion in 1984 to US$41.726 billion in 1996 (State Statistical Bureau, 1983–1997). By 1993 China had already become the second largest recipient of FDI in the world (second to the U.S.), and the largest beneficiary in the developing world (United Nations, 1994).