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The effectiveness of corporate tax incentives for foreign investment in the presence of tax crediting

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Abstract

The value of corporate tax holiday incentives provided by Central-Eastern Europe (CEE) countries to attract foreign investment depends on whether a multinational company must pay corporate income taxes to its home government on income remitted from abroad (i.e. the multinational is said to be in a deficient credit position if foreign taxes paid are less than the home country tax owing on foreign-source income). This paper examines the value of corporate tax incentives given to manufacturing companies investing in CEE countries taking into account both the host country tax regime and the U.S. tax treatment of foreign-source investment.

Key words: Public economics; Taxation and subsidies; Socialist systems; Planning, coordination, and reform

JEL classification: H25; P2

1. Introduction

Many developing countries throughout the world are concerned about their ability to attract foreign investment to foster economic growth. Although policymakers recognize that many factors influence foreign investment, a particular issue of concern to them, and the one that is of most interest to this paper, is the attractiveness of their corporate tax incentive regimes for foreign direct investment. This issue is especially important in

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the Central-Eastern European (CEE) context where transformation from centrally-planned to market economies requires the importation of foreign capital and accompanying managerial expertise to develop CEE industries.

A common issue confronted by policymakers when considering the use of corporate tax incentives is whether these incentives can influence foreign investment or simply lead to a revenue loss for the host country's government in favour of the home country's government (e.g. Deutsch and Jenkins, 1979, and Damus et al. 1991). It is argued that the multinational can credit its host country taxes against the home country's taxes owing on foreign-source income; hence, any corporate tax incentives given in the host country will be taxed back by the capital exporter leading to a transfer of revenue from the host to the home country's public treasury.[1] A number of capital-exporting governments, such as Japan and the United Kingdom, have recognized this possibility in the developing country context by permitting 'tax sparing' which, in principle, allows tax incentives in the host country to flow through to the foreign investor without the home country clawing back the value of the tax incentive. We note that in the case of the United States, however, 'tax sparing' has not been granted.

A special argument has been raised to suggest that, even with international crediting arrangements, the home country's tax system has no impact on the marginal investment decision of the firm. The argument rests on the following observation due to Hartman (1985). If a home country taxes the foreign-source income of resident multinationals, it often taxes only the remitted earnings of subsidiaries (dividends, interest, royalties, and other forms of remitted income).[2] Reinvested earnings of subsidiaries are not taxed by the home country. Hence, even if the parent is in a deficient tax credit position as defined above and if investment is financed by reinvested earnings, the home country's tax on remitted income (e.g. dividends) has no impact on the marginal investment decision. The home country's tax is simply a lump-sum tax on dividends.

This argument about the irrelevance of the home country's taxes to the investment decision of the multinational has been challenged by Leechor

[1] Home countries limit the crediting of foreign corporate and withholding taxes on income to be no more than the home country tax liabilities on qualifying sources of foreign-source income. When the multinational is in an 'excess' credit position, the amount of taxes owed to the foreign government is more than the amount of tax owing to the home country. The excess tax credits can be carried back or forward but not against taxes owing on domestic-source income. With a 'deficient' tax credit position, the parent's tax liability to the home government on qualifying foreign-source income is more than the amount of taxes paid to the host country.

[2] Branch profiles are taxed by the home country with a credit given for foreign taxes paid. Under U.S. Sub-part F rules, passive income earned by subsidiaries is taxed as foreign-source income even if the income is not remitted as dividends or other forms of income back to parent in the United States.