Are tax incentives attracting more foreign direct investments in Asia and the Pacific?

Tax rates are key tools for mobilizing domestic resources and addressing specific market failures. Countries often offer tax concessions or reduce corporate tax rates in order to boost private investment or to direct investment to “desired areas”. Corporate tax rates, especially for foreign investors, have been reduced significantly in many Asia-Pacific economies during the last seven years. However, this policy has had limited success in the region in terms of foreign direct investment (FDI) inflows, but at the same time has deprived governments from valuable resources required to support inclusive and sustainable development especially when government budget is in distress. Estimated tax losses due to the reduction of corporate tax rates, as well as alternative options for attractive FDI, including regional tax agreement on avoidance of tax competition, are analyzed in this policy brief.

In comparison with other regions of the world, excluding Europe, the Asia-Pacific region is generally characterized by low corporate tax rates (figure 1). In fact, Asia-Pacific countries have significantly cut their corporate tax rates during the period from 2006 to 2013 with an average cut of corporate tax rate of more than 15% in many countries.

Among others, two main reasons can explain the changes of tax rates as follows: the provision of more financial space to enterprises during the peak of 2008-2009 global financial crisis and the attraction of foreign direct investment (FDI). In fact, 79% of reductions of tax rates were recorded during the period from 2007 to 2009 resulting in tax reductions of 30% in Fiji, Kazakhstan and Thailand; and less than 7% in Japan. This trend suggests that there is a “race to the bottom” in terms of taxation of corporate profits.¹

Results of the above policy were mixed. In general, in countries with stable tax rates, the share of total FDI inflows increased by 46% between 2006 and 2013 (figure 2). Particularly, FDI inflows received by Kazakhstan, the Republic of Korea, Philippines, and Viet Nam did not exceed flows received before their first tax cut during the period from 2006 to 2013. In Bangladesh and Fiji, these flows exceeded previous values only once.

¹ Source: Author’s calculations based on data from UNCTAD.
Policy implications

By reducing their tax rates in order to attract more FDI inflows, governments have lost sizeable amount of resources which could have been used to tackle different socioeconomic challenges. Estimated losses of revenues are based on projected values of corporate taxes that a country would have had if the government did not decrease the corporate tax rate in 2009; the year with the highest number of tax cuts. Corporate taxes received by the government (actual values) are compared with projected values of corporate taxes to derive losses.

These losses range between 9% of the actual corporate tax revenues in Bangladesh and 50% in Kazakhstan (figure 3); and have deprived governments from valuable resources required to support inclusive and sustainable development through social protection spending, infrastructure spending, and investments in renewable energy. For instance, analyses performed by ESCAP show that, in several countries of the region, some of the challenges of inclusive and sustainable development are formidable and the required additional resources to meet those will amount between 5% and 10% of the GDP.²

Figure 3. Estimated losses of corporate tax revenue as a percentage of actual corporate tax revenues

![Chart showing estimated losses of corporate tax revenue as a percentage of actual corporate tax revenues for different countries.]

Source: Author’s calculations based on various sources.

Tax rates are not the only determinants of FDI inflows. Other factors need to be considered such as: (i) the size of the market; (ii) the availability of reliable infrastructures; (iii) the quality and quantity of skilled labour force; and (iv) the business environment.

In particular, an increase of social spending can help to increase the size of the market through the reduction of inequality and the availability of more cash for low income households. Filling infrastructure gaps would be critical to boost productivity and decrease price pressures faced by both producers and consumers. According to ESCAP analyses, there is a significant shortage of infrastructure provision in the region, and $600 billion per annum would be necessary to address this shortage. ADB’s estimates are even higher with $900 billion per annum which would be required.³ Pertaining to the labour force, more than 750 million young women and men, aged 15 to 24, are still facing challenges to secure their employment, and there is a need to match education, training and skills development systems with employers’ requirements.

Finally, the questionable effectiveness of tax incentives to attract more FDI inflows points to a regional problem as this race to the bottom increases pressures on governments’ budgets, and delays the implementation of different programmes in many countries. Addressing this regional issue would certainly require from countries to agree on a set of tax practices. A regional tax agreement on corporate tax rate for multinational enterprises can avoid tax competition as well as revenue losses. Moreover, while re-considering tax incentives in the implementation of industrial policies, research shows that the provision of tax credits and subsidies cannot significantly increase the attractiveness of a country unless policies aiming at improving the business climates are implemented.⁴

Endnotes:


