Journal of
Taxation and Regulatory Framework

Volume 5, Issue 1, 2022
(January-June)
DOI (Journal): 10.37591/JTRF

http://lawjournals.celnet.in/index.php/jtrf/index

Review JTRF

Shaping Foreign Direct Investment (FDI) Policy 2022 through “Tax Incentives” in India

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Abstract

Foreign direct investment (FDI) is vital to a country’s economic growth and development in the current globalised environment. Tax holidays, investment tax exemptions, depreciation allowances, and other incentives have been provided by the Indian government to spur economic growth and entice FDI. Foreign investors are often interested in capitalising on disparities in tax rates across nations. This has heightened the rivalry among governments to attract foreign investment via tax incentives. Some studies find that developing nations do not need to give tax incentives to attract FDI since the choice to invest in a country relies on its overall investment environment and other criteria. On the basis of a review of theoretical and empirical results, this study seeks to assess the impact of using various corporate tax incentives on FDI in India. Through in-depth research, it is possible to conclude that, despite the lack of empirical evidence about their efficacy, tax incentives play a crucial part in the policy initiatives that are used to attract foreign investors.

Keywords: Foreign direct investment, IT Act 2000, MNCs and allowances, tax incentive

INTRODUCTION TO FOREIGN DIRECT INVESTMENT FRAMEWORK IN INDIA

Capital creation is a significant factor in determining economic development. While domestic investments contribute to an economy’s capital stock, foreign direct investment (FDI) fills the gap between domestic savings and investment to contribute to total capital creation. FDI plays a crucial part in the early stages of a country’s overall development since many emerging nations want to attract more and more FDI in various areas. Both developing and wealthy nations utilise incentives to attract FDI, although the forms and frequency of incentives vary. Different worldwide rating organisations recognise India as a desirable travel destination [1]. With its highly trained and cost-effective labour population, India presents investment prospects for multinational corporations. For the objective of accelerating the development of the Indian economy, the Indian government has provided company tax benefits such as tax holidays, deductions, refunds, investment tax allowances, depreciation allowances, etc.

Foreign investors and multinational corporations are often interested in capitalising on disparities in tax rates across nations. This has heightened the rivalry among governments to attract foreign investment via tax incentives. Only new enterprises entering a market are eligible for tax vacations, not all companies functioning in the jurisdiction. The tax breaks give a competitive advantage to new enterprises at the expense of older businesses with a longer-term perspective on the economy.

Governments are under pressure to provide additional incentives so that non-holiday enterprises can compete with holiday industries. Lately, foreign investments in India have expanded, but the tight FDI laws have stifled development in the

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Received Date: September 04, 2022
Accepted Date: November 06, 2022
Published Date: February 05, 2023

Citation: Dev Agrawal. Shaping Foreign Direct Investment (FDI) Policy 2022 through “Tax Incentives” in India. Journal of Taxation and Regulatory Framework. 2022; 5(1): 11–17p.

aforementioned industries. India is an appealing market because of its technological competence, talented management, and rapidly expanding middle class of over 300 million people. As far as the service sector is concerned, India has emerged as an attractive FDI destination, but it has failed to deliver as a manufacturing powerhouse, which has more economic value [2]. Even though FDI is one of the most significant means of funding economic growth, it is not a remedy for eradicating poverty, unemployment, or other economic evils. Vision 20-20 requires a large investment for India to attain its objectives. During the time of the recession, the negative flow of FII into India had the greatest effect, whereas FDI was only minimally influenced by the global slump. India’s allure for FDI is by no means waning and is likely to persist over the next decade as well.

A number of works shedding light on the significance of policy environment examine the difficulties of developing an investor-friendly climate for FDI. The UN Conference on Trade and Development (1995) reported that 67 countries offered this incentive. Tax holidays give advantages as soon as a firm starts receiving revenue while the advantages of a reduced corporation tax rate accumulate more slowly and over a longer period of time. But tax holidays typically favour short-term investments which are characteristic of “footloose” sectors in which corporations may move rapidly between jurisdictions (1954, 1 QB 45) [3]. Furthermore, they discriminate against investments that depend on long-lived depreciable capital, favour the establishment of new businesses over investments in existing ones, and may cause the tax base to erode as individuals look for loopholes to avoid paying income taxes from the other sources present. Due to these factors, fiscal experts have typically had a negative view of tax vacations.

In a comprehensive analysis of econometric research undertaken during the previous 15 years, [4] determined that a 1 percent point drop in the effective tax rate would boost FDI by around 2 percent on average. However, this predicted impact is not uniform. The influence of tax incentives on FDI varies between sectors and even among enterprises within the same industry. According to UNCTAD (1999) [5], TNCs may help with community development when they: (i) increase financial resources for development; (ii) increase export competitiveness; (iii) create jobs and bolster the skill base; (iv) protect the environment to meet social responsibility obligations; and (v) generate, diffuse, and spread new technologies. Grubert H, Mutti J (2000) argued that efficiency-seeking FDI is more sensitive to tax relief, particularly in export-oriented manufacturing sectors [6]. Dunning (2002) determined that enterprises which are resource-seeking or want to service the local market, place less emphasis on fiscal incentives [7]. In such circumstances, FDI is highly location-restricted with market size and resource accessibility serving as the primary factors.

A nation with large tax bases and low tax rates will be a comparatively appealing location for enterprises that anticipate earning rents. This strategy is consequently effective in luring extremely lucrative international corporations [8]. Blomstrom and Kokko (2003) explain this significant increase in the impact of tax incentives for FDI on the regionalization and globalisation of the global economy [9]. Economic indicators, like market size, export intensity, institutions, etc. are widely believed to affect FDI flows regardless of the source or destination countries, as shown in “Explaining FDI Inflows to India, China, and the Caribbean: An Extended Neighbourhood Approach” by Iyare Sunday O, Bhaumik Pradip K, and Banik Arindam (2004) [10, 11]. In addition to the integration of markets, globalisation has led to more uniformity in infrastructure, skill base, labour prices, macroeconomic performance, and laws, notably across OECD nations, according to Bolnick (2004) [12].

Buettner and Ruf (2005) [13] compared US states and EU nations, and concluded that tax incentives had a significant impact on FDI. Emerging evidence from throughout the globe indicates that tax incentives have a greater impact on the mix of FDI than on its level. In fact, the majority of governments employ tax policies to attract certain forms of investment or alter behaviour rather than to boost the general investment level. According to recent research, huge international firms, such as those in the car industry, are typically in a stronger position to negotiate special tax regimes and so collect rents from host governments [14]. First investors prioritise incentives [15], such as subsidies that decrease the cost of establishment, while enterprises that reinvest prefer tax-related incentives, such as tax-holidays [16, 17], accelerated depreciations, and loss-carry forwards and loss-carry backwards.

A particular inducement, such as a repatriation programme, was meaningful solely for the first investment choice [18]. Specifically, studies contend that there is a considerable association between taxation and research and development [19, 20], in particular [21, 22]. Furthermore, outcomes rely on the kind of tax-incentive considered, since various types of tax have varying effects on FDI. In this manner, tax advantages may be categorised as follows: (a) value-added tax, (b) corporate income tax, (c) property tax, (d) royalty payments, (e) import-tariffs, (f) sales-taxes, (g) tax-holidays, (h) grants, (i) depreciation allowances, (j) enhanced deduction, (k) tax-holiday, (l) special investment allowance [23].

The most creative inducement throughout the 1990s was the lowering of the corporate income tax rate. Today, governments are subject to downward pressure on tax rates, and as a result, the tax rate plays a crucial role in the distribution of investment across nations [1]. For this reason, the majority of studies focus on the corporation taxes of the host nation. Wilson (1999) [24], and Fuest, Huber, and Mintz (2005) [25] define tax competition as the endeavour of nations to attract capital or taxable earnings by decreasing taxes on capital [4]. Countries may also pursue more intricate techniques in an effort to entice an industry and create a future locational advantage.

FDI INFLOWS IN INDIA POST REFORM PERIOD SINCE 1991: REGULATORY COMPLIANCES

After the middle of the 1990s, political unrest and other economic problems triggered a serious financial crisis in the Indian economy. The high rate of inflation, budget deficit, and political instability lowered the country's international credit rating. This caused the world community's faith in our economy to erode. The outflow of deposits, particularly from non-resident Indians, the effective cessation of remittances from Indian workers in Gulf nations, and the abrupt outbreak of the Gulf War in January 1991 aggravated the balance of payments issue [26]. The foreign currency had become so scarce that it was unable to cover even one week's worth of imports. As a consequence, the process of economic liberalisation was initiated under the structural adjustment programme (SAP) with the assistance of the IMF.

NIP 1991 acknowledged the importance of FDI in India's industrial growth in terms of providing increased competitiveness and efficiency as well as modernization, technical upgradation, the construction of a solid platform for export promotion, and, most importantly, integration with the rest of the world. In addition, in August 1999, the government of India established the foreign investment implementation authority (FIIA) within the ministry of industry to expedite the implementation of FDI approvals by providing a proactive, one-step after-care service to foreign investors, such as assisting them in obtaining the necessary approvals and resolving operational issues.

Regulatory Scenario

The policy for FDI in the defence sector was established in 2001, allowing Indian private sector involvement of up to 100 percent, with FDI acceptable up to 26 percent, subject to licence and government permission. A 100 percent FDI is allowed through the automated approach. The Indian government allows a 200% weighted deduction on R&D expenditures. In addition, the majority of state governments provide extra incentives to car manufacturers in order to encourage them to establish units in their respective states, considering the substantial investments and employment capabilities of this sector [18]. There is a maximum of 74% of foreign direct investment (FDI), foreign institutional investor (FII), and non-resident Indian (NRI) ownership in private banks. This cap may be increased to 49% with board/general body approval. The FDI limit remains at 20% for public sector banks which are exempt from the FDI regulations. Foreign investment in commodities exchanges is permissible, subject to a composite cap of 49%, with FDI limits of 26% and FII limits of 23%.

Foreign direct investment is permitted with FIPB clearance, and FII stock purchases in commodities exchanges are confined to secondary markets only. The regulatory environment of the Indian electricity industry has undergone tremendous change. The 2003 Electricity Act, which was revised in 2007, provides a strong and innovative legal framework. The subsequent policies included, among others, the National Electrical Policy of 2005, which gives directions for the fast growth of the power sector, and the National Tariff Policy of 2006, which guarantees acceptable and competitive pricing for electricity to customers. Under the automated approach, 100% FDI is permitted in the power sector (excluding atomic energy). The electricity sector is under the oversight of the ministry of power. At the national level, there is the central electricity regulatory commission (CERC); at the state level, there are 28 state electricity regulatory commissions (SERCs); and in Goa, all union territories, Manipur, and Mizoram, there is a joint electricity regulatory commission (JERC).

The governing organisations have been formed to decide tariffs for the production and distribution of energy, to control the acquisition and procurement of power, and to enable interstate transfers, among other responsibilities. The government is exploring a plan for 100 percent FDI in multi-brand retail which might be the next retail boom. As a result of a growth in income levels, India’s middle class is set to change the retail environment. The manufacturing industries of transportation equipment, chemicals, medicines, and food are all seeing an influx of foreign investment in the form of joint ventures and wholly owned businesses, while the service industries of computer software, telecommunications, and tourism are also seeing an influx of foreign investment. Even now, FDI in India represents a tiny fraction of the country’s GDP and overall investment. India’s low rate of FDI influx relative to its Asian neighbours—China, Malaysia, Thailand, and Indonesia is attributable to both internal and foreign causes. There has been a rise in competitiveness between emerging nations that provide more investment incentives and tax breaks [27]. Consequently, the number of bilateral investment treaties has expanded. In general, FDI inflows from developed and developing nations are drawn by host government policies that are distinct from one another.

CASE STUDY: STATEMENT OF SECTOR-WISE FDI INFLOWS FROM APRIL 2011 TO MAY 2021

In 2009, FDI inflows and outflows decreased in each of the three sectors (primary, manufacturing, and services). The global economic and financial crisis continued to restrict FDI flows not just in sectors susceptible to business cycles, such as chemicals and automobiles, but also in businesses that were relatively resilient in 2008, such as medicines, and food and beverage items. In 2009, only a few sectors, including electrical and electronic equipment, power services, and construction, produced more cross-border M&A investments than the previous year. Since deregulation, the Indian service sector has been the principal target of FDI. Between August 1991 and December 2013, the service sector accounted for 19.51 percent of India’s overall FDI inflows, as reported by the Ministry of Commerce and Industry. The building development industry receives an additional 11.56 percent of FDI inflows, followed by the telecommunications sector, and computer software and hardware. India has been a place to set up offshore operations since the mid-1990s, particularly for software, contact centres, and other forms of business process outsourcing (BPO).

India has offered large incentives to attract FDI in the information technology (IT) and BPO service sectors. These incentives can reach as high as $6,000 per full-time equivalent employee (FTE) in the IT services sector and $2,000 in the BPO service sector. Other areas with major obstacles to FDI include insurance and newspaper publishing, where foreign participation is restricted to 26%, and retail, where foreign businesses may invest up to 51% of their equity in single-brand distribution outlets only. Foreign investors have also indicated interest in participating in certain areas while the Indian government discusses whether or not to loosen investment restrictions. In the retail industry, Wal-Mart and India-based Bharti announced in November 2006, a joint venture in which Bharti would invest $2.5 billion in a new network of retail outlets that would be wholly controlled by the Indian company. Together with Bharti, Wal-Mart would offer logistics and wholesale supply services via a 50/50 joint venture [7].

Despite FDI limitations, the transaction is largely seen as a method for Wal-Mart to penetrate the expanding Indian retail sector. Foreign investment was first legalised in the insurance market in 2000, when the Indian state-owned insurance company's monopoly was lifted, enabling competition from both local and foreign-owned private enterprises.

At least six insurance joint ventures have signed agreements allowing the foreign partner to expand its participation to 49 percent if government restrictions are amended, as they had anticipated the government would do so. The percentage of foreign stock that an insurance company may accept has been capped at 26% since April 2007. Economically developed nations have garnered the lion's share of India's FDI flows. The top six Indian states, namely Maharashtra, Delhi, Karnataka, Tamil Nadu, Gujarat, and Andhra Pradesh, collectively accounted for over 70 percent of FDI equity flows to India between April 2000 and June 2012, due to the infrastructure facilities and favourable business environment provided by these states, thereby demonstrating FDI concentration at the state level.

To attain a growth rate of about 7 percent in India's gross domestic product (GDP), total net capital flows must rise by at least 28 to 30 percent. However, the nation's savings were just 24 percent. To bridge the gap between desired investment and available funds, FIIs' portfolio investments, FII loans, and FDI all played a role. India primarily seeks to amass the greatest number of FDIs among its primary sources of financial aid [28]. Consequently, FDI is seen as a growth and development instrument for the nation. India's GDP increased to 4.80 percent in 2013.

CONCLUSION: THE RELEVANCE OF 'WEB-DATA SCRAPING' IN CYBER SECURITY LAW

Based on the preceding study, it is clear that FDI has boosted production, productivity, and employment in some sectors of the Indian economy, most notably the service sector. The growth of India's service industry has created enough opportunities for qualified workers to earn competitive salaries and benefits. However, the banking and insurance industries contribute to the improvement of India's economic situation and the growth of the country's foreign exchange system. Low corporate tax rate regimes, rather than tax vacations, are increasingly being used by countries to attract FDI. Providing expedited depreciation, investment allowances, or other incentives for capital expenditures is still common, but in the 1990s, it became more customary to drastically reduce corporate income tax rates as an incentive. Domestic and international tax policies are affected by the shifting structure of tax incentives for FDI [14]. At last, since economies that enjoy a relatively higher rate of growth succeed in attracting a bigger chunk of foreign investment, which, in turn, is expected to accelerate their growth, it is fair to expect that India will have a larger share of FDI in the coming decades. The growth of multinational corporations will have a major impact on tax collections.

These businesses are in a better position to take advantage of tax benefits by moving operations to countries with more favourable tax policies. Tax incentives have been shown to encourage FDI on occasion, although it is uncertain whether or not they are advantageous in the long run. So far, the benefits are uncertain, and the cost involved is large. Incentives may cause tax competition and international effects, even if their original goal is local. Research has shown that a country's investment environment, not tax breaks, is the primary factor in determining whether or not a company would set up shop there; hence, some argue that developing nations may forego tax breaks to draw in FDI.

India is able to entice FDI because of its large consumer base, plentiful labour force, stable government, and diverse array of natural resources. In addition, it was discovered that the worldwide proportion of FDI in India is quite small compared to other emerging nations like China, Malaysia, and Thailand, even though there has been an increasing flow of FDI into the country during the post-liberalisation period. Low levels of FDI are often attributed to a number of factors, including a lack of suitable infrastructure, strict labour regulations, corruption, an unstable government and political climate, high corporate tax rates, and a lack of export processing zones.

Acknowledgments

Self-funded; attained literary knowledge (no direct contribution); Acknowledgement to Ms. Dhwani Mainkar [https://jgu.edu.in/jgls/dhwani-mainkar/]

Brief Career History

Participated (through an invitation) at the 3rd International Conference on Arbitration in the Era of Globalization at Federation House, Tansen Marg, New Delhi, with the Chief Justice of India, Justice Sharad Arvind Bobde, as the chief guest. Understood arbitration under contract law, through participating in the 10th Indian Willem C. Vis International Commercial Arbitration Moot 2020, by Surana and Surana; with Internships at Supreme Court of India and Delhi High Court.

Conflicts of Interest

The authors declare no conflict of interest. This is to solemnly swear that the submitted research article is the author’s, i.e., Dev Agrawal’s original work, and is being submitted for publication in the Journal of Taxation and Regulatory Framework exclusively.

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