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TAX POLICY FOR FOREIGN DIRECT INVESTMENT ATTRACTION IN SOME DEVELOPING COUNTRIES– THE CASE OF VIETNAM

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ABSTRACT: Recently, tax incentives are considered as important influencing factors to attract foreign direct investment (FDI) flows inwards developing countries. Some developing countries in the East Asia are under a pressure of lowering tax rates competitiveness, which raises negative issues of fair business environment and other social economics impacts. This paper focused on theoretical and practical issues related to incentives in corporate income tax (CIT) policies. Then by synthesizingmethod and analyzing data, the paper compared and contrasted CIT incentives among developing countries; evaluated current status and impacts on FDI inflow during effective period and proposed some recommendations to reform tax legislation in Vietnam.

KEYWORDS: Developing countries, Foreign direct investment, Tax incentives, Vietnam

I. INTRODUCTION

Currently some countries, even developed ones are considering about applying tax preferential measures in tax policy related to FDI enterprise. Investment promotion agencies are under pressure to offer incentives to race in the global battle to attract FDI. Incentives for FDI enterprises could be effective for different kinds of taxes, such as corporate income tax, international profit shifting tax, tariffs, landfill taxes. In the context of this research, some theoretical and practical issues in respect of preferential treatment of CIT would be discussed due to its numerous impacts on FDI enterprises decisions making. Therefore the aim of the research is to: (1) provide general background of CIT incentives; (2) evaluate the current status of applying tax incentives in 107 developing countriesfor the period 2009 – 2017 based on The developing country tax incentives database of World Bank report; (3) propose some recommendations to improve tax policies and investment environment in Vietnam.

II. BACKGROUND OF TAX INCENTIVES

Classifications of tax incentives:

Tax incentive is one of important factors of the national policies for FDI attraction. Through preferential tax legislation, tax expenditure of FDI enterprises are cut down, thereby the government aims to promote more attractive and fairly competitiveness business environment in that country among the region and global. FDI supports to some macro economic targets, such as job creation, advanced technology transfer; export growth and sustainable economy development.

Some main tax incentives instruments available in developing countries are classified into two groups, namely (i) profit – based incentives and (ii) cost – based incentives. The advantages and disadvantages of those incentives are also mentioned below.

(i) Profit – based incentives

These instruments are tax holiday (known as time bound exemption of new firms or investments form taxes) and preferential tax rates (reduced tax rates that act as a partial exemption of the standard CIT rate). The governments lower CIT rate for profits earned by the FDI enterprises, by reducing the tax rate to zero for a limited period during a tax holiday. A plus of the incentive is a direct impact on the firm's profit. As a result, the instrument heavily favors multinational companies with high profits, which least need the government's support. It could lead to high redundancy of tax expenditure on incentives because an investor predicting high profits would likely have proceeded in any way. Moreover, host governments deal with the risk of losing substantial public revenue when a firm earns huge profits in a given period. It also raises an issue of the possibility of tax evasion through profit shifting. The risk is high for performance – based instruments because the multinational companies could artificially allocate profits within subsidiaries enjoying concessionary tax treatment (UNCTAD, 2018). The widespread use in developing countries is a remark in the upcoming design of tax policy.

Box 1: Advantages and disadvantages of profit – based incentives

Advantages	Disadvantages
- Strong directly signaling influencing to investors, easy communication and advertisement to FDI firms.	- Unfairly favors investments with high profit margins and investment with short time of tax holidays. - High likely of tax evasion through profits shifting within firms. - Remarkable loss of actual fiscal revenue

(ii) Cost – based incentives:

They include: tax allowance (considered as a deduction of taxable income of a firm); tax credit (direct deduction of tax liability of a firm); accelerated depreciation (depreciation of fixed assets for tax purposes at a faster schedule than what is normally applied). Compared to profit – based instruments, cost – based ones lower the cost of specific production factors. In term of tax allowances, the government allows the qualified firm to reduce a certain share of the investment value from its taxable income. The extent of the benefit to the firm does not depend on its profit level but the magnitude of the investment that is undertaken. These incentives are numerous strengths: they avoid the weakness of profit – based incentives in favor of high profitable companies. They are not prone to tax evasion abuse through international earnings shifting, but their benefit directly linked to the outcome which they are conditioned. However, few of developing country still are joining a battle of reducing CIT rates, which bring negative impacts on business environment.

Box 2: Advantages and disadvantages of cost – based incentives

Advantages	Disadvantages
- Extent of benefit to investors is linked directly to extent invested. - Less prone to abuse through transfer pricing than profit – based instruments. - More transparent tax filling process due to easy tracking forgone revenue. - Tax revenue loss (tax expenditure) of the government is more anticipate than profit – based instruments.	- More challenging and complicated for tax administration. - Likely to bias production technology toward more capital intensive investment.

Positive impacts of tax incentives

The effectiveness of tax incentives in the aim of FDI attraction is debatable in many academic studies for many years. Most quantitative evidence on a large scale concludes that tax incentives bring positive impact to FDI inflows (IMF, 2015; WB 2017) but not on a top decision factor. According to Global investment report of UNCTAD (2018), the changes in tax policy stands 7th out of 13 macro influencing factors in FDI attraction. Besides, the different impact depends on the purposes of FDI projects into a host country. For instance, tax incentives is big plus to attract efficiency - seeking FDI, not to markets seeking FDI and strategic assets seeking FDI (trademark, advanced technology…). In the WB survey of Investment competitiveness, 64% of efficiency - seeking foreign investors agreed that tax incentive has important influences to their decisions while only 40% other – seeking investors supported to that. The explanation might be that CIT is considered as a cost, directly affects net profits of the firm. Hence, for efficiency - seeking FDI, the main motivation is maximizing profits by minimizing costs, including tax payment. The investors would compare CIT rate between target host countries and take it as one decision factor of investment. On the contrary, for other different types of FDI projects, production cost reduction is not on a top priority. Thus, tax incentives of developing countries become less attractive. The investors seek for a destination of various natural resources, market magnitude, strengths of technology, labormarket and distribution network.

As mentioned, the effects of tax incentives rely on specific kinds of instruments. Performance – based incentives (tax holiday and preferential tax rate) are suitable for high profit FDI firms during given years. It may cause the issue of abuse to unsustainably expand the scope of investment in the short period (WB, 2017). In contrast, cost – based incentives (tax allowance, tax credit and accelerated depreciation) are effective for large scale of capital investment in the long term, such as some projects relating to information technology, healthcare and green technology).

Negative impacts of tax incentives

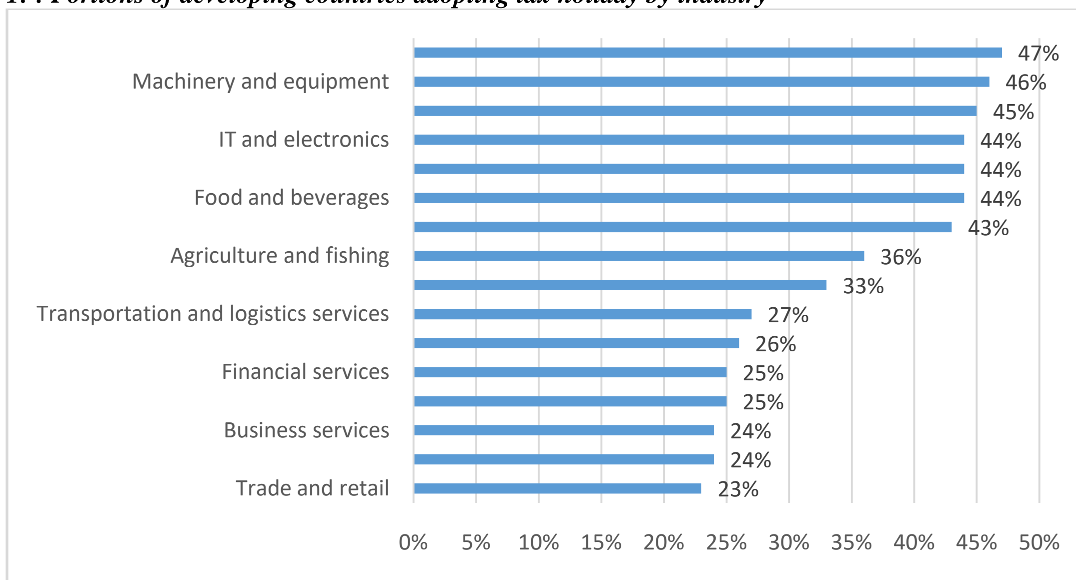
In fact, tax incentives causes significant loss on tax revenue. Budget deficit is a common problem of developing counties although the government seems to be too generous for FDI attraction related policies. Some of countries unlikely disclosure information on tax expenditures (tax revenue foregone) in the report of IMF (2015). In spite of data limitation, WB (2017) researcher still could estimate high rate of loss of CIT revenue out of GDP, specifically, up to 5.9% in Cambodia; 5.2% in Ghana; 5% in Brazil and 3.9% in Dominican Republic.

It seems that tax incentive regimes in developing countries suffer from weak design, lack of transparency and inefficient administration. Tax holidays and lower tax rates are widely used in spite of their shortcomings well-documented. Sufficient transparency and expensive administrative costs make tax instrument less attractive and raise some indirect costs in term of economic distortions and potential risk of corruption. In the short term, developing countries could conduct tax reform better targeted and more cost – efficient. By focusing incentives on those types of investors high likely to respond, developing countries can minimizeunnecessary loss of tax revenue resulting from incentives granted to FDI enterprises which would invest anyway. It is clear that tax reform to improve the transparency and administration of tax instruments could help to reduce unnecessary impacts and expenditures. As a result, it would improve the cost – benefit ratio of tax incentive in a sustainable way.

III. TAX INCENTIVES ADOPTION IN SOME DEVELOPING COUNTRIES

Host country can offer favors of tax policy for FDI enterprises under many different forms. Most popular incentives are used as tax holiday and preferential tax rate. In 2017, World bank data set has been collected and synthesized from 107 developing countries during 2009 – 2015. It concluded that 51% of chosen developing countries offering tax holiday for at least one aspect of industry or field of investment. If sorting out of industry, the highest rate is construction field with 47% of developing nations applying tax credit for that; whereas the lowest rate is trade and retail business at only 23%. The average tax free period ranges from 8 to 10 years. Most developing countries in the database offered tax holiday with strict conditions of specific destinations (about 77%) and research and development industry (40%).

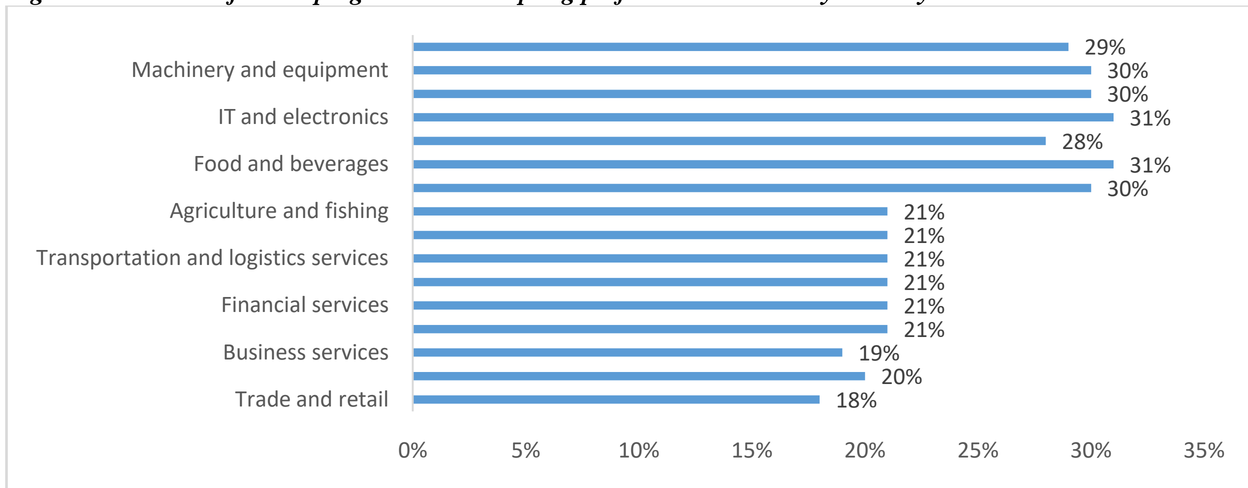
Figure 1: : Portions of developing countries adopting tax holiday by industry



Source: Developing Country Tax incentives Database, Worldbank (2017)

Similar to tax holiday, preferential tax rate is widely used in host developing countries. Approximately 40% of nations supplied this instrument for at least one field of investment. The average preferential tax rate is 13%. The highest favor is offered for production industry, especially food and beverages, IT and electronics (31% of 107 developing countries applied)

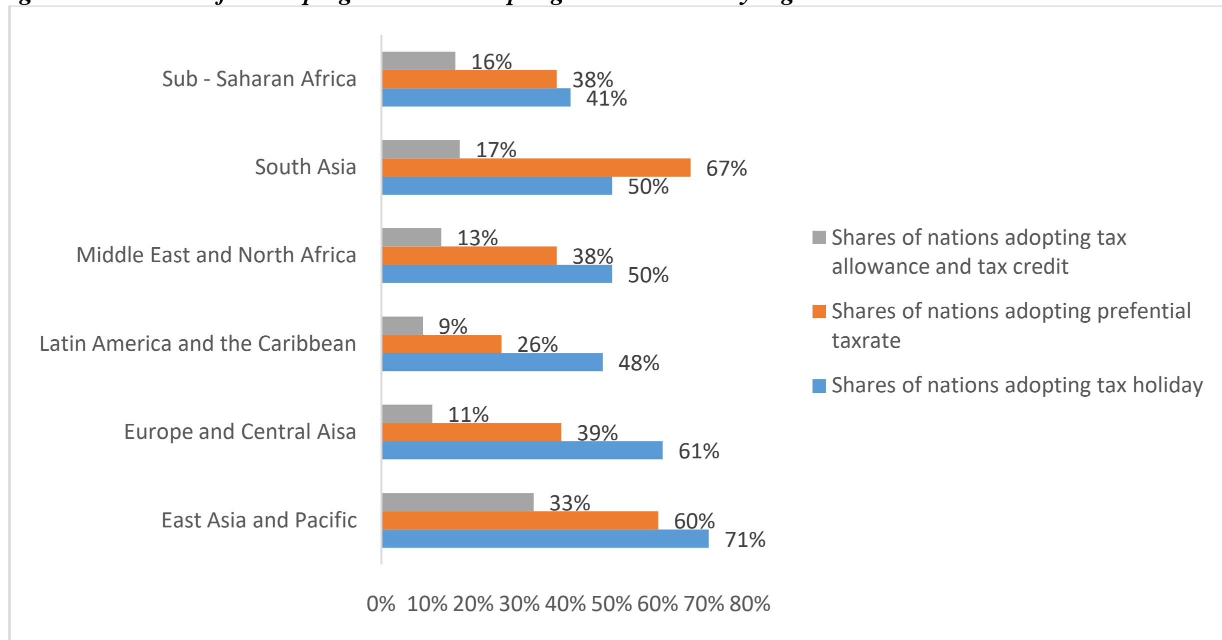
Figure 2: Portions of developing countries adopting preferential tax rate by industry



Source: Developing Country Tax incentives Database, Worldbank (2017)

In terms of cost – based incentives, they are applied least popular than profit – based ones. According to the research, only 16% of data offering tax allowance and tax credit for at least one industry. Almost of these incentives normally focus on production field (R&D; machinery and equipment) and with specific conditions relating to performance based outcome of FDI firms.

Figure 3: Portions of developing countries adopting tax incentives by region



Source: Developing Country Tax incentives Database, Worldbank (2017)

If classified by region, developing countries in the East Asia and Pacific are under fierce competitiveness of tax incentives, specifically 71% of that adopting tax holiday; 60% of that adopting preferential tax rate; 33% of that adopting tax allowance and same as tax credit. Additional qualified conditions go with investment destination; export orientation and national benefit in return…

IV. TAX INCENTIVES ADOPTION IN VIETNAM

In Vietnam, many CIT incentives have been applied for a given or entire investment duration. The preferential tax rates from 10% to 20% depend on the locations and fields of investment. The government offers tax favor to which projects in difficult socio-economic areas, high- teach zones or encouraging industry (for scientific and technology development) under some specific terms. In particular, more

than 30 preferential investment fields and 27 special preferential areas spreading up 53 out of 63 provinces in Vietnam (Truong Ba Tuan, 2019).
The period of tax holiday used in Vietnam (from 2 to 4 years) is much shorter than other countries (normally 8 to 10 years). However, after tax holiday, foreign investors in Vietnam are deducted up to 50% tax liability in the next 4 – 9 years. Besides, profitable FDI firms could use accelerated depreciation for fixed assets as long as no more than 2 times as standard depreciation. Other incentives as tax allowance and tax credit have been not available in Vietnam.

Table 1: Comparison of CIT rate in some developing countries in 2017

Country	CIT rate in law	Average preferential tax rate	Total tax rates in host country (Note 1)	Level of impact of tax rate on investment decision (Note 2)
Vietnam	20%	13.1%	39.4%	3.7
Thailand	20%	22.6%	32.6%	4.1
Philippine	30%	20.3%	42.9%	3.5
Indonesia	25%	16.6%	30.6%	4.2
China	25%	11.1%	68%	4.4
India	30%	23.5%	60.6%	4.5

*** Note 1: Including all tax direct and indirect tax rate in the host country
Note 2: Range from 1 – 7, explained as 1: most remarkable impact to 7: least remarkable impact
Source: World Economic Forum (2017)

Comparing to other countries in the Asia, CIT rate it Vietnam is quite low. It could be said that tax incentive is advantageous in Vietnam to attract FDI inflow. In addition, OECD report (2018) admitted about the positive impact of low CIT rate on FDI in some developing countries, such as Vietnam, Cambodia and Thailand. However, according to Nguyen et.al (2013) research, the efficiency of tax incentives in Vietnam has not been optimal, about 60% of FDI firms interviewed still invested in Vietnam whether preferential tax policy was adopted or not. Therefore, tax expenditure foregone relating to loss of tax revenue is higher than expected. Tax revenue in FDI sector reduced by 70% of total revenue due to tax incentive in Vietnam in 2017 (Truong, 2019).
There are main tax incentives of CIT rate based on invested areas and fields of industry.
(i) Regional incentives

A 10% CIT rate applies for 15 years for polices such as: infrastructure projects established in a location where natural or socio-economic conditions are severe; project in mountainous or remote areas; reforestation projects; special projects. Moreover, these projects are entitled to CIT exemption for 4 years from the first profit making year and a 50% CIT rate deduction for the subsequent 4 years. Reforestation and infrastructure projects in mountainous and remote areas and large and special projects may be entitled up to an 8 year holiday from the first profitable year.
(ii) Sectorial incentives

For projects that meets one of the following criteria, a 15% CIT rate applies for 10 years from the first year of operations: at least 50% of production is exported; at least domestic 500 workers are employed; the project involves farming or the processing of agricultural, forestry or marine products; advanced technology is used or a research and development industry is involved and/ or substantial local raw materials are used in accordance with special conditions. The above projects are entitled to a profit tax exemption for one year from the date of profitable operation and a reduction of 50% for the subsequent two years.
For projects involved in activities listed below, a 10% CIT rate applies for 12 years from the first year of operation: project in which at least 80% of production is exported; investment in chemicals, petroleum, electronic component production and automobile and motorbike component production; the building and operating of infrastructure; cultivation of perennials; investment in locations where natural or socio-economic conditions are severe…In some special circumstances, these projects are entitled to CIT exemption for 2 years for the first profit making year and a 50% CIT rate reduction for the subsequent three years.
(iii) Export incentives and free trade zone

Foreign enterprises investing in the Export processing zones (EPZ), regardless of industry, are entitled to special tax incentives as follows: a CIT rate of 10% for manufacturing projects; a CIT rate of 15% for service projects; exemption from income tax for the first 4 profit – making years for manufacturing firms and a 50% CIT rate reduction for the subsequent 4 years; exemption from income tax for the first 2 profit – making years for services firms and a 50% CIT rate reduction for the subsequent 4 years; a 5% tax on remittance of profits abroad for

all types of EPZ enterprises; and exemption from import and export duties for all kinds of machinery and equipment, raw materials and finished products imported to, or exported from Vietnam.

V. RECOMMENDATIONS TO REFROM TAX POLICY TO ATRACT FDI INTO VIETNAM

First, the government should improve the design, administration and transparency of tax incentives to reduce indirect costs and avoid unintended consequences as additional burden to public budget.A key point for tax policy is to achieve clarity and consensus among stakeholders as to the specific and measurable policy goals to be pursued via tax incentives. A monitoring and self evaluation framework to track progress toward such objectives is inseparable to justify the public cost of tax incentives and to adjust inefficient costs.

Second, it is time for the government to target incentives straightforward at those investors whose decision to invest influenced the most. To do this, it is necessary to well understanding of types and motivation for specific FDI orientation as well as the cost – benefit evaluation of existing tax instruments. Tax incentives should be aimed at efficiency – seeking investors, however principles of the investment climate must be addressed first. Tax competition for efficiency seeking FDI is intense; thus for developing counties including Vietnam, the most promising strategy is to avoid the use of incentives and instead project their revenue base to support investment in infrastructure and improvement of the investment climate while designing a medium term strategy to become more competitive for efficiency seeking FDI.

Third, the government could improve the design of incentives by switching from profit based to cost based incentives connected to clear policy targets. Tax holiday and preferential tax rate have been widely used in some developing countries, creating loss on tax revenue and heavy burden to public budget. The upcoming of such profit based instruments have been well applied for foreign investors whose high profits in the short time horizons. Thus, it encourages tax planning and international profits shifting. In contrary, cost based incentives could be more close to policy goals, host country should be realistic for setting up national targets and design tax instruments accordingly. Controlling and self evaluation system should be in a priority. By enhancing transparency and administration policies, the government has a chance to avoid indirect costs resulting from rent seeking and firm corruption.

Fourth, apart from tax incentives, to attract quality FDI inflow, the government should focus on globally and regionally comparable firm level data and seek further micro – based incentives such as rates of returns on foreign investment and marker size as well as firm expansion, because FDI enterprises also look forfair competitiveinvestment environment between foreign and domestic firms.

VI. CONCLUSION

The evidence of the efficiency of tax incentives to attract quality FDI inflows needs to be further researched and developed. Recently, in some developing countries, including Vietnam have been applying traditional tax incentives widely without careful selection. Thus, the paper aims to evaluate the current issues and results of preferential tax instruments into FDI inflows, based to this, some feasible solutions to the government to consider about policy reform for sustainable investment and economic development.

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