THE EFFECTIVENESS OF THE TAX INCENTIVES ON FOREIGN DIRECT INVESTMENTS

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Abstract: *The economic integration trend has freed the capital movement and many new locations became available for investment. That is why the policy makers had to think for new and more efficient ways to lure the capital owners. One of the most used and dynamic method is the fiscal policy. The fiscal incentives were in many cases the main reason for choosing a country and stay away from another. The main reason for this situation is that the fiscal policy is one of the most flexible public tools to manipulate the market and the decisions on it. Public administrations can encourage or block different kinds of investment decisions according to its policy and long term plans.*
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Introduction

In the last two decades, many governments have actively promoted their countries as investments locations, to attract private capital investment, technology and managerial skills associated with the idea of achieving the development targets. So, they have adopted measures to facilitate the attraction of foreign direct investment. Tax incentives were one of the important measures that were used. In some cases certain types of investment and fiscal incentives have proven to be a major factor in the decision related to the choice of investment location. In addition, for countries that offer to investors the same framework, tax incentives can make a difference, because governments can quite easy to change, modify or extend tax rate / tax base restriction, while other factors influencing change investments would not be achieved so easily and would consume more time, usually very important in making any decisions.

Advantages of granting tax incentives to attract investment

Increased mobility of international companies and the gradual elimination of barriers to global capital flows have stimulated competition between governments to attract FDI and, often, this was done through fiscal facilities. But it is important to know which the effective use of these tools is, on the one hand, and the cost of their use is, on the other hand.

Increasingly, governments are trying to attract more multinational companies and to enhance technology transfer associated with them. Tax incentives have become a global phenomenon - the tax holiday (UNCTAD reports confirmed a large number of countries that offer this kind of fiscal stimulus. They provide benefits as soon as companies start to earn revenue while the benefits of a lower rate tax result slower, after a longer period of time. Primarily, from these facilities benefits short-term investments, the kind that can move easily from one jurisdiction to another. These tools tend to reward particularly the establishment of the companies than investing in existing companies and can lead to erosion of the tax base as taxpayers learn how to avoid taxation of income from other sources. All these reasons lead to critical acclaim from tax experts) and import tax exemptions for investment and accelerated depreciation.

At first glance, the impact of tax incentives on FDI is ambiguous. Over the past decades many supervisors of the international investment and econometric analyzes have shown that tax incentives are not the most powerful tool to influence the decisions of multinationals in choosing their locations. Most important are factors such as basic infrastructure, political stability, cost and availability of labor. The conclusions of the analysts and supervisors confirm that tax relief is a tool that compensates for weak negative factors that are found in a climate of investment.

But it does not mean that fiscal incentives have no effect on FDI. It is no coincidence that between 1985 and 1994 the investments have increased more than five times in tax havens such as the Caribbean and South Pacific. And fiscal incentives have been recognized as Ireland's bald elements in attracting international investors in the last two decades. In recent years, are becoming more frequent evidence that tax rates and tax incentives influence corporate location decisions within regional economic groups such as the European Union free trade zone in North America, or South Asian Nations Association. Similarly, in the U.S., incentives can play a decisive role in the decision of choosing the final location of foreign companies since the choice is limited to a small number of locations with similar characteristics.

Most governments use these tax incentives to attract a certain type of investment rather than to change their aggregate level. Oman (2001) revealed that several foreign companies - such as the automotive sector - are in a better position to negotiate special tax regimes and thus attain income from host governments. These new findings have revived the debate about the effectiveness of tax incentives. Two questions appear in research. What tax incentives have the greatest impact on investment location choice of multinationals? What kind of investment seems to be most sensitive to changes in taxes?

In choosing the appropriate fiscal instrument for attracting the investments, many executives appeals to the other countries tradition. In developed countries, a popular tax incentive is to eliminate corporate income tax for some time by "tax holidays" or exemptions / reductions for certain types of investment companies. Another measure is to quickly recover costs of investments for all or only those investments that the government wants to promote, through deductions or tax credits (which can take three forms: accelerated depreciation, which allows companies to fully amortize capital faster than through taxation by accounting, tax cuts for investment expenditure, which enable companies to recover a percentage of investment expenses from taxable income or investment tax credits, which allow companies to reduce taxes paid by a percentage of their investment expenditures). Tax relief for investment limitations are especially for projects with long gestation periods.

Some countries have chosen to reduce the effective rate of corporate income tax for all companies. Small economies such as Hong Kong (China), Lebanon, Mauritius have chosen this option. International investors looking favorably to a country with low tax statutory rate which gives the signal that the government is interested to let the market determine what is most profitable investment. But this approach can reduce tax revenues, at least for a transitional period (long term can simplify the tax system to attract more investors, which may increase the tax base effect can offset the initial reduction).

An extreme approach would be to eliminate taxes for all investors or only for certain categories. Countries that have become fiscal havens usually suppress all channels on direct taxes and taxes on consumption and the workforce related. Other countries have limited incentives to export-oriented activities in certain areas, known as areas of food processing for export. These extreme images have had mixed results, especially if the goal was to attract sustainable investment projects or high added value. These regimes are challenged by OECD countries and multilateral organizations because they are often associated with suspicious capital flows.

Effectiveness of fiscal incentives varies depending on business activity in question and its motivation to invest abroad. Increasingly more evidence shows that tax incentives are a critical factor for the mobile companies operating in multiple markets, such as banks, insurance companies and e-business, because these firms can exploit better tax regimes from different countries. Such strategies can explain the success of tax havens to attract global companies' subsidiaries. Tax rates produce stronger effects on investment decisions of export-oriented companies than those who seek the advantages of location, because these companies are not only mobile but operate in competitive markets.

Since it appears that fiscal policy affects the location decision of multinational companies, particularly in regional markets, the risk that governments will emulate the commitment of these tax incentives. Such competitions have already begun, especially in Asia. Concern may come because countries may end up in a bidding war favoring multinationals at the expense of states and citizens. This risk has stimulated governments to try to harmonize their fiscal policies by regional or international agreements. Beyond these wars of the offers, these fiscal measures can lead to lower tax revenues and create growth opportunities illegal behavior by companies and tax administrations. This issue has become very important in developing countries facing severe budget constraints and corruption rather than do industrialized countries.

Costs involved in tax incentives

No doubt these tax incentives are costly. The most important costs (Morisset, 2003) are those associated with the possible loss of revenue from the host governments. In Tunisia, a relatively successful in attracting foreign direct investment, fiscal cost associated with incentive regime reached 20 percent of total private investment in 2001. The question that arises here is whether the new investment should come into the country if they would have offered little or no incentives. If so, then free-rider type of investors benefit while Treasuries have lost. This example clearly illustrates the need to evaluate the welfare implications in terms of tax incentives, both at the firm level and globally.

But there are other costs perhaps less visible. Thus, because they influence the investment decisions of private companies, can distort resource allocation and may attract investors seeking only short-term profits in countries where political and economic stability is poor.

Another problem with these incentives is generated by the difficulties of managing them, because they require a complex administrative task, so that would be more effective than the purpose of covering costs of their implementation and to produce net benefits. Discretionary arrangements involving evaluation of each case are very difficult to manage. These regimes could result in delays that may lead to increases in investment costs or generate corruption affecting the healthy development of competitive markets. Non-discretionary arrangements are much simpler to administer and easier to implement. These involve incentives such as investment tax credits, accelerated depreciation and subsidies related to easily measured indicators such as exports, imports of technology, skilled labor.

The debate about the impact of fiscal incentives for foreign direct investment is far from close, benefits appear as uncertain and the costs are quite complex. Emergence of global companies has and will have a significant impact on public revenues. They are more sensitive to tax incentives because of their ability to exploit them by transferring activities from one country to another.

Clark (2000) in one of his works conducted a review of empirical findings about the impact of the corporate tax burden on foreign investment decisions by highlighting the first major category of tax incentives for corporations of various host countries. Economist continues to discuss the main interaction analysis of tax systems of the host country level and at the mother country in shaping the host country tax burden and behavioral implications for investment and financing alternatives in the context of tax credits. Recent work brings the issue to increase sensitivity over time of real or financial affairs of the host country taxation.

Competitive pressures encourage policy makers to continually revise tax rules to ensure they are competitive internationally. Ability to provide a tax system to attract foreign capital is seen as a critical component of national strategy to ensure high standards of living. Multinational companies record profits above average, invest significantly in research and development and well-paid employment opportunities. Meanwhile, the corporate tax system generates government revenue sources of income of non-residents. The desire to tax such income without deterring foreign investors raise questions about the response to tax and investment flows to the appropriate setting fiscal parameters that determine the tax burden of the host country, taking into account different behaviors and effects on tax revenues.

Non-tax factors influencing FDI

OECD (1995) qualifies as the most important factors political stability and stable economic environment. Of course, political instability or the threat of it is a serious obstacle for FDI. In the context of macroeconomic, exchange rate instability, the price will increase uncertainty and risk in foreign investments, tend to discourage them. Another important factor is the legal and regulatory framework of the host country. Foreign investment could be lost if trade legislation or other rules would be incompatible with the establishment and operation of companies with foreign capital. Important areas are those concerning the protection of property, ability to repatriate profits and free foreign exchange. Access to utilities and infrastructure are considered key factors in locating an investment like those mentioned. And another factor is considered market size.

Fiscal factors influencing foreign direct investment

Tax incentives that can be used aimed at corporate impact on their tax burden. Host countries can "ease" the tax burden measures that can take different forms. Thus, we find examples like the following:
- Tax holidays;
- Reductions in statutory tax rate of corporate profits;
- Increase / accelerate depreciation of capital expenditures;
- Investment tax credits specific or general
- Reduction in tax rates on dividends or interest.

These incentives can be classified according to mechanism or channel through which affect the benefits or costs of additional investment as follows:
- Incentives that reduce tax rates on profits derived from corporate investments;
- Incentives to reduce corporate costs after tax of obtaining new capital (tax credits, depreciation);
- Incentives to reduce costs after tax growth of capital to obtain funds for us.

Starting from the three categories of incentives we consider a framework for the operation of tax incentives: the three categories can be placed on the following equilibrium conditions describing investment incentives of the managers to maximize the market value of firms on the competitive market. As theory suggests, competitors will

invest capital only to the point where the marginal benefit of the last unit of capital invested equals its marginal cost. The condition of equilibrium has the following form[5]:
$(\Delta Y/\Delta K)(1 - u) = (r + d)(1 - A)$, (1) can be written as
$(\Delta Y/\Delta K) = (r + d)(1 - A)/(1 - u)$, (2) where:
$\Delta Y/\Delta K$ = increase in gross income, Y driven by growth in a unit of capital stock, K of the company, whose value decreases as the capital stock increases. Investment incomes are subject to statutory tax rate, denoted by u.

The left side of the first equation measures the marginal benefit of tax due to an additional unit of investment. Marginal cost of tax is measured through the right side and is the product of two terms: first, (1-A) gives the purchase price after tax of an additional of one unit of capital, measuring the present value of tax incentives related to the acquisition of one unit of additional capital, either as investment tax credits, either as depreciation expenses, the second term, (r + d) is the sum of the actual rate of return on investment required by investors for the capital they invest and the rate of economic depreciation capital due to physical and moral wear.

This framework is useful to make the analysis different channels through which tax incentives can work to encourage investment behavior. First, by reducing the rate of income tax / corporate profits (or even elimination of taxation as is the case with tax holidays) will increase investment income after taxes and as a result tends to lead to a higher level of equilibrium capital stock. The same measure has the effect of also reducing the present value of depreciation deductions, increase elbow borrowed capital after tax, by reducing the amount of deductible interest. In this sense, we can say that the effects are ambiguous, but in general we support the income tax reduction is an impetus for investment. Secondly, the introduction of an investment tax credit will increase to A, tends to encourage investment. Similarly, increasing the rate at which capital can be depreciated for tax purposes (for example, accelerated depreciation) will increase to A and hence the incentives to invest. Third, government policy can influence the cost of financing the company before tax (r), cost of financing that will tend to increase as the statutory rate of corporate income tax is reduced. In some cases, equity financing may be a function of personal tax parameters.

Tax holidays are a common form of tax incentives used especially by developing countries to attract FDI. The newly established companies are not required to pay tax for a certain period of time (e.g. five years) to encourage investment. In this period firms may be exempted from the payment of other fees also, but at the same time, may exclude certain deductions (expenses related to interest and depreciation). Tax holiday for new firms can be established in a specific region or a particular industry. Incentives of this kind for a particular industry can become sources of benefits of "externality" including knowledge transfer to domestic firms. Tax holidays are attractive to companies that operate in sectors where profits are generated in the first years, such as trade, services and less attractive to firms in sectors that require long-term capital involvement. For the host country tax holidays tend to be problematic, because loss of income, given that there are significant enterprises in the industries or areas subject to these regimes, as a cause of the tendency to create new business beside existing ones.

Reducing statutory corporate tax rate is a measure used as developing countries and developed countries. This reduced rate may be an overarching, applying to all foreign and domestic sources of income or target revenues from certain activities or sources (such as external sources of income) or income earned by nonresidents or various combinations of these forms. Maybe brought as a temporary measure or as a definitive measure.

Investment tax credits can be fixed, established as a share of the investment made during the year and the franchise that set a fixed percentage of the costs of investments made in a year over a certain amount (base).

The financial structure of a company is influenced in some cases significantly, the tax regime in the host country. The empirical results tend to confirm global central place played by the statutory tax rate of profits in the host country to influence the choice proportions Debt / equity. In essence, a statutory rate of corporate tax encourages high price loans in the host country. And increasing loans tend to erode the tax base. Thus, generous tax deductions and credits, which are financed by high tax rates put pressure on the tax base and increase the need for laborious and fiscal management to formulate new rules to protect the tax base.

International findings have at least two important implications of creating a tax system suitable for attracting FDI. In 1996 the OECD Council of Ministers instructed the organization to develop measures to combat harmful tax practices, followed by the EU initiative on direct taxes. The project led to the adoption by the OECD Council in April 1998 a report (Harmful tax competition - a global problem), which establishes the conditions that characterized the tax competition to attract mobile financial activities or services can become harmful as and counter measures that can be applied (such as denial of deductions for payments made in transactions involving jurisdictions develop harmful tax practices, prohibit concluding tax treaties with tax havens, non-fiscal measures).

There are three general classes of tax incentives used to reduce the cost of business to increase its investment funds:

- Tax incentives upstream (deductions or tax credits), which provides shareholders a relaxation of fiscal costs of equity investments in certain activities;
- Downstream tax incentives (deductions or tax credits), which provides an easing tax earnings to shareholders (dividends) from investments made in certain areas;
- Tax incentives "flow-through" which causes businesses to transfer unused tax deductions or credits to be used by investors to compensate the shareholder level rather than the level of taxation. This form of incentive is generally applied to situations where the business is expected to be taxable to a number of years and therefore have no immediate interest to exercise tax preference.

FDI equation

In one of his works, Hartman (1984) estimated the following equation for FDI I *:

$$\ln(I^*) = a_0 + a_1 \ln (r(1 - t)) + a_2 \ln (ro(1 - t)) + a_3 \ln ((1 - to)/(1 - t)),$$

where r (1-t) measures the rate of return after tax profit of foreign direct investment, stock investment divided by the end of the year, en (1 - t), measures the rate of return after tax profit of U.S. capital stock home and abroad, t is the average U.S. corporate tax (assumed to be equal for domestic and foreign firms) and ¬ t is the average capital income tax for both corporations and individuals. Variables enter into the equation the natural logarithm to facilitate expression in terms of elasticities.

Hartman's results show that estimated coefficients of the equation have the expected signs (a1> 0, a2> 0, a3 <0) and are statistically significant.

Factors influencing input and output flows of FDI in various countries were analyzed in several works by various economists or recognized organizations. Thus, in a recent review of UNCTAD (2006) argues that there are several categories of determinants of investment attracted in one area, namely:

- General political factors (political stability, privatization);
- FDI specific policies (incentives, performance requirements, investment promotion, international trade, investment treaties);
- Macroeconomic factors (human resources, infrastructure, market capacity);
- Business-specific factors (technology).

In a study by the OECD in 2003 reveals that factors influencing FDI flows in SE-Europe and other countries in transition in Central and Eastern Europe. Thus, considering the same factors for both sets of countries.

Table 1 Determinants of FDI in SE Europe

	ISD/loc	Risk[1]	Liberty[2]	Coruption[3]	Reform[4]	Privatization[5]
Albania	38	62	2.7	-	2.1	2.5
Bosnia	30	-	2.1	-	1.9	2.5
Bulgaria	103	67	2.6	4.1	2.8	3.8
Croatia	323	70	2.6	3.9	2.8	3
Macedonia	108	-	2.7	-	2.3	3
Moldova	26	49	2.6	2.8	2.3	3
Romania	48	58	2.3	3.7	2.8	3.5
Serbia	9	45	1.8	-	1.5	1

Source: The OECD Tax Centre for Tax Policy and Administration in Co-operation with the Investment Compact Team, Directorate for Financial, Fiscal and Enterprise Affaires, Tax Policy Assessment and Design in Support of Direct Investment, A Study of Countries in South East Europe, OECD, April 2003, p. 168

Notes:

(A) composite index based on risk assessment (International Country Risk Guide-ICRG), December 2000, high scores correspond to lower levels of perceived risk, source: World Bank;

(2) based on the economic freedom index, 2002, scores from 1 to 5 show a high score for the high level of freedom, source: Heritage Foundation;

(3) based on the corruption perception index, 2001 and 2007, higher scores correspond to low levels of corruption, source: Transparency International;

(4) based on Transition Report, 2001, high scores represent important progress in the institutional reform, source: EBRD;

(5) based on the same report on the transition, 2001, a score of 4 indicates specific performance standards and advanced industrial countries, source: EBRD.

One of them is the country risk and noted that it is a very important factor with negative influence affecting Belarus and Ukraine, which have the smallest streams. Table 1 countries with the highest level of FDI per capita, Croatia and Bulgaria have the lowest risk. The relationship between corruption and investment is less clear, but each country progress made in privatization is a significant factor. Slovenia (Table 2) is a special country because the factors taken into account action leads to low investment flows. Approaching the European Union (at that time), geographical and temporal, is analyzed in this study appears to have particular importance.

Table 2 Factors influencing foreign direct investment flows in transition countries in Central and Eastern Europe

	ISD/Loc	Risk [1]	Liberty[2]	Corruption [3]	Reform[4]	Privatization [5]
Poland	212	74	3.3	4.1	3.5	3.5
Hungary	198	72	3.6	5.3	3.6	4
Czech	525	73	3.6	3.9	3.3	4
Slovakia	242	71	3.1	3.7	2.8	4
Estonia	293	74	4.2	5.6	3.5	4
Latvia	139	71	3.5	3.4	2.9	3
Lithuania	125	72	3.7	4.8	2.9	3.5
Belarus	23	60	1.6	-	1.4	1
Ukraine	13	62	2.1	2.1	2.3	3
Slovenia	133	76	2.9	5.2	3.1	3

Source: The OECD Tax Centre for Tax Policy and Administration in Co-operation with the Investment Compact Team, Directorate for Financial, Fiscal and Enterprise Affaires, Tax Policy Assessment and Design in Support of Direct Investment, A Study of Countries in South East Europe, OECD, April 2003, p. 170

Stimulating foreign investment is usually either to increase their recovery rate or to reduce their costs and risks. Fiscal stimulus is done to reduce the tax burden of enterprises in order to spur them to invest in certain projects or certain sectors and concerns exceptions to the general tax system. Tax incentives can include reduced corporate tax rates, tax holidays, accelerated depreciation accounting rules, low-cost imported equipment, components, raw materials and high tariffs to protect its market (UNCTAD, 2000). They are rarely offered without strings attached.

Usually providing these tax incentives aims to certain objectives pursued by policymakers. One of these objectives is regional development. Thus, some countries also provide measures for the development of certain areas or regions, for example, support for rural development, building industrial centers away from major cities, reducing environmental threats, excessive urbanization and pollution concentrations. Angola, Brazil, Ecuador, Ghana, India, Pakistan, Thailand offers incentives directed towards these targets. In Egypt, incentive schemes for the cultivation of barren and desert land fall into this category. Other stimulants integrated regional development goals and objectives sectors (OECD, 2007).

Another objective is the structural development (OECD, 2010). Some governments offer such incentives to develop certain industries or activities considered crucial for development, which may be related to me, industrial parks, export activities, the film industry or business with new technologies. Thus, Singapore offers exemptions from taxation for a period of five years companies begin work in industries that are not sufficiently developed in the country and Costa Rica has special incentives for tourism, hotel services applicable, and water or air transport of tourists, travel agencies or companies that rent cars.

Enhancing performance is another concern covered by such incentives. Free trade zones offering incentives for export-oriented activities (UNCTAD, 2011). Panama falls into this category. An important objective for using tax incentives to attract foreign investment is the transfer of technology. Some countries have introduced a set of incentives specifically directed to research and development, technology projects. They relate to tax exempt funds channeled towards technological development, tax credits for research and development spending or over-qualified human resources employed in research and development.

FDI flows have emerged in OECD countries in 2007, according to OECD statistics, reached a record USD 1 820 billion, compared to 1 200 billion in 2006, but fell sharply in 2008. On the other hand, investment flows have entered OECD countries in 2007 have meant 1 370 billion dollars to 1050 billion in 2006. Structural analysis shows that the United States continues to remain in the top investor and recipient of FDI in 2007, with output flows of 333 billion dollars and 238 billion input streams. UK ranks second with 230 output streams and 186 billion dollars billion dollars, followed by France which has invested 158 billion dollars and has received investment flows of 225 billion dollars in 2007. In Spain, FDI increased by more than 80% mainly due to Italian investments in the electricity sector. Foreign investment in Japan was exceptionally high due to major investments in the financial sector.

Regarding Romania, according to data reported by national banks, the country retains its leading position in the ranking recipient of FDI flows in the region. A study of Ernst & Young investment attractiveness of the SE Europe in April 2008, shows Romania as the main destination for the implementation of new investment and expansion in Europe. Furthermore, the evolution of FDI in Romania during 2000-2011 is as follows:

Table 3 Evolution of FDI in Romania in 2000-2011 (mil EUR)

Year	2000	2001	2002	2003	2004	2005	2006	2007	2008	2009	2010	2011
FDI	1147	1294	1212	1946	5183	5213	9059	7141	9496	3490	2220	1917

Source: NBR

The sector which attracted the largest amount of foreign investment in our country is industry. Among the facilities offered by the Romanian authorities to attract foreign direct investment flows can remember carry forward tax losses, the facilities provided by local authorities, to stimulate employment, incentives to support growth. State aid may be included in the same category, representing important reasons for some investors to enter and remain in our market.

In conclusion, the tax factor, seen against the capacity to influence the macroeconomic environment to attract foreign direct investment flows, can be considered as having significant importance in deciding the location of investment outside the native corporation that defray costs to support the workforce involved in the work itself as a result of tax incentives granted to labor taxation by state-recipient of foreign investment or allowing the recovery of the financial volume necessary to ensure continuity in the business because of the depreciation process, or to allow saving of money as a result of exemption from income tax for this company over fewer years or more. If we approach this issue in terms of advantages and disadvantages that generate to both, states receiving foreign investment flows and flows to the output, we observe that researchers' opinions are often contradictory. What is important, however, refers to the personal impact of the individual case, impacts to be analyzed precisely and objectively.

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