

## MOTIVATION OF FOREIGN INVESTORS AND TAX INCENTIVES OFFERED BY THE HOST COUNTRIES\*

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### *I. The Background and the Purpose of This Paper :*

Private international capital movements during the last two decades can be characterized by two outstanding features. On the one hand, there has occurred a massive flow of investment capital from the USA to Western Europe — and that current is still very strong today. On the other hand, only insignificant amounts of private capital has trickled into the less developed countries — and the prospect that private foreign investments could contribute significantly to the economic progress of the low-income countries is very dim<sup>1</sup>.

The question arises to what extent can these capital flows be discouraged or encouraged by appropriate tax measures. A government might wish to know whether and how could taxes be used to attract foreign capital. Alternatively, the level of foreign borrowing could be accepted as “given”, and the government might wish to control the quality of foreign investments, that is, to encourage certain types of investments for purposes of economic development.

Since the main objective of this paper is to evaluate the effectiveness of taxes in guiding foreign capital, it was thought desirable to begin with a discussion of the main economic factors behind recent foreign private investments.

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\*) This paper was written in the Institute of Finance at Pavia University, and the author wishes to thank Professor Emilio Gerelli, the director of the Institute, for allowing him to use the facilities during his Fulbright appointment.

1) See for example A. Basch, **Financing Economic Development**, London: Macmillan, 1964.

From the standpoint of taxation, it is especially important to know what role is played by the rate of current earnings as an inducement; after all, earnings are directly affected by the taxes. Consequently, the first part of this paper attempts to evaluate the empirical evidence concerning the importance of current earnings (as compared to other variables) as a determinant of private capital movements. Against that background, the second part of the paper presents the essential facts about the tax policies of several countries and inquires how effective were these tax measures in controlling the flow of foreign capital.

It is hoped that the arguments of this paper are relevant for the less developed countries, but the author must apologize for basing his conclusions primarily on the experience of the European countries. The reason for this is that it is mainly these countries which have been receiving substantial amounts of private foreign capital (primarily but certainly non exclusively from the USA). Moreover, the relevant statistics and tax information are readily available for the European but not the less developed countries<sup>2</sup>.

## II. *Motivation of Private Foreign Investments :*

### a) *Earlier descriptive studies and our quantitative approach :*

Several recent studies attempt to identify the economic reasons behind U.S. private investments abroad<sup>3</sup>. These surveys, usually based on

2) The reader's attention is called to the following studies which bear directly and indirectly on the problem of taxation of foreign investments in underdeveloped countries:

W. A. Brown, "Treaty, Guaranty and Tax Inducements for Foreign Investments", **American Economic Review, Proceedings**, May 1950;

G.D.A. Mac Dougall, "The Benefits and Costs of Private Investment from Abroad: A Theoretical Approach," **Economic Record**, March 1960;

W. J. GIBBONS, **Tax Factors in Basing International Business Abroad**, Cambridge: Harvard University Press, 1957;

U.N. Economic and Social Council, **International Tax Problems: Taxation in Capital-exporting and Capital-importing Countries of Private Foreign Investment** (1956);

P. G. Richman, **Taxation of Foreign Investment Income**, Baltimore: Johns Hopkins Press, 1963.

3) See for example R. F. Mikesell, **U. S. Private and Government Investment Abroad**, Eugene, Oregon: Univ. of Oregon Books, 1962;

questionnaires answered by business firms, identify many allegedly different motives such as : the search for higher profits, expanding foreign demand, foreign trade restrictions, lower costs abroad, the need to maintain supplier relationship with the customers, poor performance of local distributors, and the need to adapt products to foreign demand. Taxes are either regarded to be of secondary importance, or are not mentioned at all. The most important and the most frequently mentioned reasons behind the investment decisions can be summarized into one : the desire to increase business profits by penetrating the foreign market. In the next section, I shall offer statistical evidence regarding the importance of the market size as compared to annual earnings and the debtor's balance of payments as determinants of foreign investments.

It should be pointed out that private foreign investments in recent years have been predominately *direct* rather than portfoliotype. This is especially true of U.S. investments in Europe and of foreign investments in the less developed countries. However, unlike foreign investments in the underdeveloped countries, U.S. direct investments are *demand-oriented* in the sense that the output produced by foreign capital is sold primarily in the local markets of the host countries. Foreign investments in the underdeveloped countries are typically *supply-oriented* in the sense that foreign capital employs local resources in order to sell the output outside of the host country.

Thus, our investigation of the motivation and taxation of U.S. investments in Europe pertains to a special category of direct demand-oriented investments. In contrast to the existing surveys of investment motivation, an attempt is made to make certain conclusions on the basis of a statistical study. Next, we shall try to evaluate quantitatively the relative significance of national income (which determines the size of the domestic market), current earnings, and the size of international reserves as determinants of foreign direct investment.

b) *Statistical techniques used*<sup>4</sup> :

Regression and correlation analysis is employed here to test the significance of earnings (G), national income (Y), and external liquidity

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H. J. Robinson, **The Motivation and Flow of Private Foreign Investment**, Stanford Research Institute, 1961;

E. R. Barlow and I. T. Wender, **Foreign Investment and Taxation**, Harvard, Law School International Program in Taxation, 1955.

4) The author wishes to thank Dr. J. T. White for his permission to use

(L), as possible variables explaining the level of U.S. direct investments (D) in the European countries between 1953 and 1962. We seek a confirmation of the functional relationship.

$$D = f(Y, G, L)$$

The reason for considering G as a potential explainer of D is self-evident. Since national income is a potent determinant of demand, Y is regarded here an index of the size of the domestic market. The index of external liquidity, L, is in our context a proxy variable for governmental policies with respect to foreign capital and the transferability of earnings; the convertibility of foreign currency is sometimes a major consideration in foreign investment decisions.

The following three equations are computed for the manufacturing trade, and petroleum sectors :

- I.  $D = A_0 + A_1Y$
- II.  $D = A_0 + A_1Y + A_2G$
- II.  $D = A_0 + A_1Y + A_2G + A_3L$

The coefficients of the independent variables are tested for statistical significance by the t-test at .025 level.

Appended to each regression equation are the coefficients of determination,  $R^2$  (R is of course the coefficient of correlation). Equation I involves two variables, Y and D, and therefore the simple  $R^2$  is computed. Multiple  $R^2$ 's are computed in connection with the other equations. Comparisons of the simple with the multiple coefficients of determination offer additional evidence about the extent to which D is explained by Y as opposed to G and L.

*c) Statistical results :*

As summarized in Table I, regression and correlation results show consistent and statistically significant interdependence between D and Y but fail to produce any evidence that either G or L influence D. Let us interpret in some detail the results for the manufacturing sector which

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certain statistical results contained in his "U.S. Direct Foreign Investment and Host Nation Income", unpublished Ph. D. dissertation, Boston College, 1966.

## REGRI

## EQUAT

MANUFACTURING	A <sub>0</sub>	A <sub>1</sub> (Y)
Italy	-.281	.0000 t=18
Belgium-Lux.	-.325	.0007 t=6.1
France	-.395	.0030 t=4.1
Netherlands	-.132	.0052 t=8.1
West Germany	-.773	.0052 t=9.1
U. K.	-4.6	.264 t=15
Sweden	.102	-.00 t=2.0

## PETROLEUM

Italy	-.207	.0000 t=17
Belgium-Lux.	-.054	.0001 t=5.1
France	-.300	.0019 t=6.0
Netherlands	-.094	.0057 t=9.0
West Germany	-.276	.00196 t=12
U. K.	-1.734	.0938 t=18
Sweden	-.133	.0033 t=9.4

## TRADE SECTOR

Italy	-.068	.0000 t=21
Belgium-Lux.	-.053	.0001 t=5.9
France	-.189	.0009 t=6.1
Netherlands	-.047	.0021 t=6.1
West Germany	-.062	.0005 t=16
Sweden	-.098	.0020 t=6.6

- \*) Critical values for t .025  
 Equation I (8 degrees of f  
 Equation II (7 degrees of f  
 Equation III (6 degrees of

B. GROSS NATIONAL PRODUCTS OF EUROPEAN COUNTRIES  
(in national currency units, at constant prices)<sup>2</sup>

	1953	1954	1955	1956	1957	1958	1959	1960	1961	1962
<b>BELGIUM-LUX</b>										
(Billions of Francs)	473	488	518	542	560	551	566	596	619	612
<b>FRANCE</b>										
(Billions of Francs)	181.2	194.2	205.4	221.5	242.0	239.6	245.2	260.2	271.1	297.0
<b>GERMANY (F. R.)</b>										
(Billions of D. M.)	158.2	170.0	189.7	204.6	217.9	228.5	245.4	276.8	295.2	308.9
<b>ITALY</b>										
(Billions of Lire)	13444	13864	14846	15505	16487	17114	18290	19646	21069	22650
<b>NETHERLANDS</b>										
(Billions of Guilders)	28.5	30.3	33.3	35.4	36.1	35.9	38.0	41.5	43.5	44.9
<b>SWEDEN</b>										
(Billions of Kronor)	47.1	49.1	51.6	54.1	55.7	55.7	57.9	60.8	65.1	67.2
<b>U. K.</b>										
(Billions of Pd. Sterling)	19.7	20.3	21.1	22.1	22.6	22.9	23.7	23.2	26.1	25.8

has been favored by U.S. direct investments. Simple  $R^2$ 's are very high for most countries. The exceptionally low  $R^2$  and the statistically insignificant  $A_1$  for Sweden can be attributed to the sharp decline in the value of U.S. manufacturing investment in 1959 and 1960 when the assets of an established company in Sweden were sold out.

The coefficients of the Y variable in all three equations are significant at the .025 level, with the exception of Sweden as noted. When L is added in equation II and G in Equation II and III, multiple  $R^2$ 's remain high and the coefficients of Y statistically significant<sup>5</sup>. However, the coefficients of G and L are not statistically significant even though they are usually positive as expected. Thus we can generalize that Y is consistently related to D, while G and L are not.

*d) Some generalizations :*

The various motives identified by U.S. enterprises as important in their decisions to invest in Europe could be adequately summarized as the desire to penetrate the growing markets in the host countries. External liquidity and annual earnings seem to play a secondary role. In the advanced countries, the bright prospects created by income expansion are not being dimmed by "accidental" balance - of - payments difficulties and, consequently, variations in external reserves are not noticed. This is certainly not the case with the underdeveloped countries where chronic balance - of - payments deficits constitute a major obstacle to foreign capital inflow.

As for the rate of return on capital, certainly, its adequacy must be regarded as a precondition for the movement of capital. However, fluctuations in annual earnings are apparently of secondary importance when a good growth record sets the mood of foreign investors.

Since the relationship between foreign investments and the rate of earnings thereon is especially important from the standpoint of taxation, we shall explore this aspect still further in the next section.

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5) The exceptionally high  $R^2$  values are partly due to autocorrelation among the variables which all show an upward trend. Significantly, the positive results for demand-oriented investments contrast with the absence of any evidence that supply-oriented foreign investments in Latin America depend on the national income of the host countries. These two types of investments are contrasted by J.T. White, *op. cit.*

Our empirical findings are suggestive with regard to the question of why demand-oriented foreign investments stay away from the backward economies. There, foreign capital has been traditionally supply-oriented, that is, the output produced by foreign-owned firms is benignly marketed in the industrialized half of the world<sup>6</sup>. And yet, demand-oriented investments could be very stimulating to economic development because they can help to create new skills, encourage entrepreneurship, and introduce advanced technology to the countries struggling with poverty. Unfortunately, unlike in Europe, the absence of local markets and a dim prospect for "sustained growth" of consumer incomes in underdeveloped countries discourage private capital from becoming a partner and a catalyst in economic development.

### *III. The Effects of Taxes on Foreign Capital :*

In this part of the paper, we shall assess the role of taxes in controlling the flow of foreign capital. The tax structure is important because it can directly affect the profits earned by foreign enterprises and because it affects the "general climate" in which foreigners must perform.

#### *a) Earnings need not be excessive :*

The lack of evidence that annual earnings are associated with the level of foreign investment suggests that the marginal impact of taxes on earnings plays a secondary role in attracting or discouraging foreign capital. Surprised by the results of our statistical tests, we sought additional evidence concerning the role of earnings.

It is useful to compare the rates of return on capital in the capital-providing and the capital-receiving countries. As the chart for the comparable economic sectors suggests, the differences in the rates of return on both sides of the Atlantic did not exert the dominant influence on the pattern of foreign investments. It is true that in the mid 1950's the rate of return on U.S. direct investments in Europe was about 5 percentage points higher than the returns in U.S. domestic manufacturing. However, that gap began to narrow since 1959, and appears to be absent since 1962. Thus, the rising trend in U.S. investments in Europe during the

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6) In recent years, however, the poor but huge market of India has attracted foreign capital. The role of India's tax policies is discussed in M. Kidron, **Foreign Investment in India**, Oxford University Press, 1965.



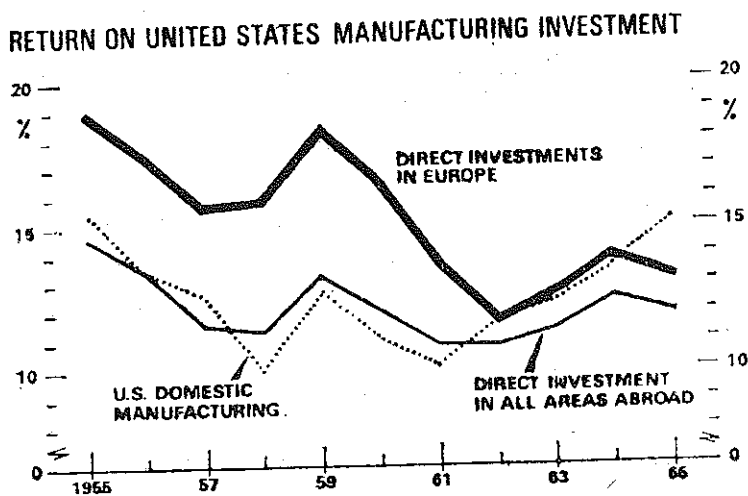
1960's cannot be adequately explained by the differentials in earnings. Thus, at least in Europe, it was not the high earnings but the growth of the markets which determined the investment climate. The growing markets can constitute the main inducement when they promise "adequate" (and not necessarily excessive) long-run (rather than temporary) returns on investments.

It is generally believed that the earnings on private investments in the less developed countries have been very high. This is indeed the case in particular instances, for example, in the petroleum industry. However, the apparent "excessive earnings" often constitute a premium for risk and uncertainty. When expropriations, uncertainties due to inflations, and actual business failures are accounted for, the return on foreign capital as an aggregate would no longer appear "excessive".

In short, taxes undoubtedly affect the climate for foreign investments, however, when that climate is favorable, the incidence of taxation on earnings probably does not significantly affect capital movements.

*b) An evaluation of European tax provisions :*

At this point, we must consider directly the tax provisions of the European Countries and try to assess their role in attracting and guiding foreign capital. We start with depreciation rules which are especially important in the first few years of investment. As can be seen from Table III, depreciation provision are least advantageous in West Germany, about the same in France, Holland, and the USA, and most attractive in Belgium and Italy. However, the differences among the countries are rather small.



RESOURCE: The Economist (London), Dec. 17, 1966, p. 1255.

Also taxation of undistributed profits does not show great variation from country to country. Only Belgium has distinctly low tax rates on undistributed profits, a policy which promotes self-financing or "reinvestments" by young firms.

The potential discrepancy between European and U.S. income tax rates is reduced by the fact that personal incomes from foreign investments received by U.S. citizens usually become subject to U.S. income taxes (making appropriate adjustment for taxes paid abroad). Thus, the less progressive tax rates on dividend income in Europe do not benefit U.S. investors as much as they favor the acquisition of foreign stocks by the natives.

With the exception of Belgium, then, there is at best only a small tax advantage for an American firm to invest its funds in Europe rather than in the U.S. The existing tax differentials were certainly reduced in the U.S. The existing tax differentials were certainly reduced in the early 1960's when U.S. firms were granted tax incentives to invest at home; nevertheless, the rate of U.S. investments in Europe kept on increasing during the 1960's.

TABLE III

## A. POSSIBLE DEPRECIATION IN EUROPEAN COUNTRIES AND THE U.S.A.\*

Country	Average tax life in years	Depreciation as percentage of capital values		
		1st year	2nd year	3rd year
Belgium	8	25%	50%	75%
France	10	25	43.7	51.8
Holland	10	26.6	46.6	51
Italy	10	25	50	70
W. Germany	10	20	36	48.8
U. S. A.	12	29.5	42.4	51.4

TABLE III

## B. TAX BURDEN WITH RESPECT TO UNDISTRIBUTED AND DISTRIBUTED PROFITS ATTRIBUTABLE TO FOREIGN FIRMS\*

Country	Undistributed profits tax rates	Distributed profits tax rates :	
		Paid by firms incurring the profits	Dividend tax paid by share holders (or a comparable income tax)
Belgium	28.6%	45.3%	None
France	50	50	22%
Holland	47	47	15
Italy	43.6	43.6	20
W. Germany	53.2	26.9	25
U. S. A.	52	52	30

\*) Source : K. H. Standke, *Amerikanische Investitionspolitik in der EWG*. Berlin: Beuth-Vertrieb; 1965.

The Belgian case is of special interest to us. The statistics shows that Belgium has been rather neglected by foreign investors. Evidently, her liberal tax incentives did not provide a sufficient inducement to foreign investors. Only during the last three years (1964-67) new U.S. investments seem to be placed in Belgium in preference to France and other countries. At this time, however the lagging Belgian growth rate no longer discourages foreign investors because the dominant inducement now is the growth of the European Common Market which may now be supplied from the Belgian base.

We can conclude that tax differences among the capital receiving countries and the tax differential between the U.S. and the European countries did not play a significant role in direct investments, perhaps less significant than labor cost differentials and the desire to avoid trans-Atlantic transportation costs. This conclusion is in accord with the studies of taxation in the less developed countries which indicate that foreign capital is not responsive to tax inducements<sup>7</sup>.

7) A similar conclusion has been reached by K. M. Kaufman on the basis of the experiences of Puerto Rico, Mexico, and the Philippines. See his excellent article "Income Tax Exemption and Economic Development" which discusses domestic as well as foreign investments. *National Tax Journal*, June, September 1960.

*c) Taxes can guide the allocation of foreign capital :*

Although it can not be demonstrated that European taxes significantly modified the *level* of capital inflows, it appears that taxes have been playing an important role in controlling the *quality* of foreign investments, especially in guiding them into areas where capital is most needed. Thus, Germany offers special tax advantages to investors in Berlin, Belgium encourages investment expenditures on new industrial buildings and permanent structures, Italy offers special tax concessions to investments in non-urban communities, and so on. In my judgement, when the climate or the preconditions for foreign investment in a country are adequate, taxes could then be used — and should be used — to guide the allocation of capital so as to achieve certain desirable economic objectives.

*d) Taxes can help to create a favorable investment climate :*

But we must not conclude that tax policies are irrelevant for foreign investments. As I survey the tax policies of the European countries, certain important features stand out:

1. The tax codes and concrete investment guarantees were adopted in the early 1950's. Thus foreign investors were notified that their capital and knowhow was needed, and that their rights will be protected.

2. Tax regulations are stable and have not changed with political winds.

3. Tax regulations are uncomplicated and quite similar among the industrial countries.

Such carefully formulated taxes make it possible for the foreigners to make reliable calculations of future returns on capital during the long life of investments. In these respects, equitable and favorable tax provisions should be regarded as a necessary but not a sufficient condition for foreign investments.

#### **IV. Implications for the Developing Countries :**

In conclusion, let us briefly restate the relevance of our arguments for the problem of foreign investment in the less developed countries.

As stated earlier, the results of the statistical study are suggestive with regard to the question of why demand-oriented foreign capital is avoiding the underdeveloped countries. Ragnar Nurkse understood the dilemma properly when he wrote:

"The direction of private investment is naturally swayed by the pull of the market. The big markets in the past were in the industrial countries. Foreign capital in the underdeveloped areas found it profitable to work for these markets rather than for the domestic consumers whose purchasing economy of a low-income country the inducement to invest is weak because the size of the domestic market is small"<sup>8</sup>.

Where the domestic markets are absent and, moreover, the climate for foreign investments is chilled by political and economic instability and uncertainty, the preferential tax treatment of foreign capital is not likely to be an effective policy instrument. It is doubtful whether modest tax encouragements — the kind we find in Europe — could provide sufficient incentives in the less developed countries. On the other hand, historical evidence suggests that it might be dangerous to offer excessive encouragement to foreign capital, that is, to pursue a policy permitting foreign capital to "exploit" the country without restrictions. Well known are the dangers that foreign investors might establish monopolies, that the development of domestic firms might be impeded, and that the debtor's balance of payments might be overburdened by service payments on foreign loans<sup>9</sup>. Yet, in spite of these economic sacrifices, there is no guarantee that the debtor country will be able to attain a faster rate of economic growth or the magic status of "self-sustained" growth.

Perhaps I should conclude my paper on a more optimistic note. Since private foreign capital cannot be easily induced into the less developed countries, alternative sources of capital must be found. Fortunately, some opportunities already exist for promoting economic development by international public loans and grants<sup>10</sup>. Hopefully, the role of the

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8) R. Nurkse, **Problems of Capital Formation in Underdeveloped Countries**, Oxford: Blackwell, 1957, ch. II.

9) Such was the experience of European debtor countries between the World Wars. See my study **Foreign Capital as an Investment of National Economic Policy**, The Hague: M. Nijhoff, 1964.

10) See R. F. Mikesell, **Public Foreign Capital for Private Enterprise in Developing Countries**, Princeton University, "Essays in International Finance", No. 52, April 1966.

I.B.R.D. and related "supranational" institutions will substantially increase. In that way, the economic and humanistic objectives could take precedence over politics in solving the great problem of our times: The problem of economic development of the deprived areas of the world. Since private foreign capital cannot be attracted, "internationalized" capital must be made available for the task at hand.

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