TAX POLICY, TRANSFER PRICING AND FOREIGN DIRECT INVESTMENT: THE CASE OF INDIA

ABSTRACT
OF THE THESIS

BY
GANAPATI BHAT
UNDER THE SUPERVISION OF
PROF. KHAN MASOOD AHMAD
DEPARTMENT OF ECONOMICS
JAMIA MILLIA ISLAMIA (A CENTRAL UNIVERSITY)
NEW DELHI-110025,
&
DR. NAGESH KUMAR
Chief Economist & Director, Macro Economic Policy &
Development Division, UNESCAP, Bangkok, Thailand
May,2010

1.1. This is a study of Foreign Direct Investment (FDI) with a focus on tax policy as one of its determinants. The objective of the study is to find out how tax policy influences FDI across the countries of the world as well as how it affects the FDI in the context of India. It also analyses the post investment decision of the investors while repatriating profit through transfer pricing. Tax differentials between two tax jurisdictions are expected to cause transfer pricing manipulations resulting into profit shifting from high tax jurisdiction to low tax jurisdiction. Therefore the objective of this study was also to understand how tax policy affects transfer pricing activities of Foreign Direct Investors.

In the first step, 120 countries are taken for the analysis. Data used are for the year 2005 and 2006 from WDI data CD & UNCTAD website. Cross country analysis is carried out using linear regression. Secondly, Countries are grouped based on their per capita income in to three categories and analyzed further. Thirdly, Time series analysis of 9 countries including India, in the same level of development, is also carried out. Fourthly, the impact and incidence of FDI at the State level using 18 states of India are carried out. Further, sample survey of the opinion of the Business Executives, Policy Advisors, Government Officers who are at the policy formation level and Researchers are conducted and their responses are examined to know how they have ranked taxation and other policy instruments, among other things, as determining FDI. Finally, transfer pricing issues are analyzed at the global and Indian level.

1.2. Results: Infrastructure is the most important variable in attracting FDI. In the same way, the traditional variables like population and size of the market are found to be having significant explanatory power. Knowledge related assets are seen as one of the reasons for the advantage enjoyed by the Multi National Corporations (MNCs). Two new variables unused so far in the econometric analysis were used: they were Knowledge- pull factor and Ease of Doing Business Index (Easdb) of the World Bank. Royalty receipt was used as the proxy for knowledge pull factor which were significant in all the equations. World Bank comes out with the publication ' Ease of Doing Business' and its Index (Easdb) is used as one of the independent variable in the econometric

examination. As this index is suppose to measure the entire business environment of the country, it was expected to bear significant impact on attracting FDI. However, it was not significant in any of the equations casting a doubt about its efficacy.

Taxation measure, (differently constructed) as one of the variables, was used in all the equations in the analysis. However the regression results were not on the expected line. In none of the samples, it is significant. In the case of the regression equation using total sample: it has a positive sign also, which is contrary to the expectation. However, as seen from the survey of literature, taxation as a variable has mixed results, and doubtful explanatory power. But a closer look at the country groupings gives interesting insights. This variable has a negative sign in the developing country sample. This means, in a developing country, since other attractions like abundance of physical and financial infrastructure is not available and if the country is still a high tax location, then it will reduce the flow of investment. The investor may compromise on the need for high quality infrastructure, since the investor can choose a low tax country with poor infrastructure: the choice seems to be either a high tax country with better infrastructure or a low tax country with poor infrastructure. A kind of trade off exists between these two since the investor cannot get the ideal situation of low taxation and high infrastructure. This is because taxation is a major source to build infrastructure. To maintain a high standard infrastructure is also costly and the cost is borne by the taxpayer. In a low income country, where corruption is much higher than the developed countries, the tax collected may not result into provision of public goods. Therefore more taxes coupled with low infrastructure are a disadvantage in attracting FDI. Therefore in the low income and middle income group, taxation is negatively related, even though in all the groups, it is not having any significant results. Therefore, excessive dependence on taxation as a tool to attract FDI may not lead to expected results.

The Indian experience with tax havens and issues related to transfer pricing are analyzed in this thesis including the Indo-Mauritius Tax Treaty and its impact.

This thesis encompasses three areas; namely, determinants of FDI in general, taxation policy in particular and how tax policy influences the post investment scenario in terms of transfer pricing activities. These issues are examined at Global level (cross country analysis), national level and local level (Indian state level) across various time periods. However, in no way it should mean that other issues or determinants are less important, but the focus of this thesis is on the above issues. Different tax measures used are not having significant results. One of the possible reasons for this is the opportunity of transfer pricing manipulations available for the MNCs. The transfer pricing manipulations can nullify the tax policy of the government since MNCs can shift the profit at their will. Therefore, excessive dependence on tax policy may not yield expected results.