

# An Analysis of Tax Incentives to Attract FDI in Bangladesh: An Empirical Study

A.M.Shahabuddin, Mustafa Manir Chowdhury, Md. Kazi Golam Azam  
International Islamic University Chittagong, Chittagong, Bangladesh

The purpose of the study is to understand whether it is still viable to use tax incentives to attract foreign direct investment (FDI) considering their effectiveness and costs to the country, and if not, what should be the alternative, effective, and viable means of promoting the vital FDI inflow. The study investigated various incentives provided by BOI, and other relevant sources available as secondary sources. However, the multinational enterprises (MNEs) are not attracting for investment in Bangladesh always with tax incentives and there are alternative means of attracting FDI such as direct financial grants, subsidies loan guarantees, etc. This paper focuses on tax incentives and the debate against the effectiveness and efficiency in attracting FDI.

*Keywords:* foreign direct investment (FDI), tax incentives, multinational enterprises (MNEs), BOI.

## Introduction

Bangladesh has attracted USD 913 million foreign direct investments (FDI) in 2010 calendar year, a leap by 30 percent. This upgrades the country's position to 114 from 119 out of 141 nations in the World Investment Report (WIR). Almost all countries now regard FDI as an important means for fostering their social and economic development. Increased awareness towards the benefits of FDI has led to the worldwide competition for FDI. In the world where an increasing number of governments compete hard to attract FDI, tax incentives have become a global phenomenon. Poor developing countries rely on tax holidays and import duty exemptions while industrialized western countries accord financial subsidies or accelerated depreciation allowances to investors.

Tax incentives are inefficient because their cost, in terms of tax revenue foregone, often exceeds any benefits that may accrue from them. It is argued that there would be no problem in so far as incentives stimulate investments that would not otherwise have occurred without them and which its benefits would exceed and offsets the costs incurred. They are said to be inequitable because they benefit some investors but not others who do not qualify, they pose more burden to tax administrators and sometimes lack transparency in deciding as to who qualify and who not. It is a common view among policy makers and academics that FDI can help to accelerate a country's social and economic growth. Attracting FDI is a top priority for developing countries and they see it as their duty to do everything in their power to create an environment that is conducive to FDI.

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A.M.Shahabuddin, Assistant Professor, Department of Business Administration, International Islamic University Chittagong.  
Mustafa Manir Chowdhury, Assistant Professor, Department of Business Administration, International Islamic University Chittagong.

Md. Kazi Golam Azam, Lecturer, Department of Business Administration, International Islamic University Chittagong.  
Correspondence concerning this article should be addressed to A.M.Shahabuddin, International Islamic University Chittagong, 240 Nabab Serajdullah Road, Chittagong-4203, Bangladesh. E-mail: ams\_iuic@yahoo.com.

### **Objectives of the Study**

- To highlight various forms of tax incentives for attracting FDI in their investment;
- To investigate the efficiency of tax incentives in view costs associated with them and to find out whether their benefits outweigh the costs;
- To give recommendations to improve their investment climate in order to attract more capital inflow and without using tax incentives.

### **Methodology of the Study**

Secondary sources like Bangladeshi law and references from various background papers, books, and academic or scholarly articles, various internet sites have been consulted for relevant up-to-date data and information.

### **Findings of the Study**

The investors enjoy the following incentives for investing in Bangladesh:

- Five to seven years corporate tax holiday for selected sectors;
- Private power companies enjoy corporate income tax exemption for a period of 15 years;
- Tax exemption on royalties, technical knowhow and technical assistance fees and facilities for their repatriation;
- Tax exemption on foreign loans regarding interest;
- Tax exemptions on capital gains from transfer of shares by the investing company;
- Remittances of up to 50% of salaries of the foreigners employed in Bangladesh and facilities for repatriation of their savings and retirement benefits at the time of their return;
- No restrictions on issuance of work permits to project related foreign nationals and employees.

Bangladesh makes no difference between foreign private investors and domestic investors regarding investment incentives or export and import policies. In Bangladesh, foreign investors enjoy the access to domestic capital markets for working capital in the form of loans sanctioned from the commercial banks and development financial institutions. The foreign investors have been given the opportunity to have access to the services of the country's stock exchanges. Some export-oriented industries of the thrust sector are provided with the benefit of cash incentives, venture capital, and other investment friendly facilities.

### **Classification of Tax Incentives**

#### **Reduced Corporate Income Tax**

This involves government setting a lower corporate income tax rate to attract FDI into specific sections or regions. It qualifies as an incentive because it allows investors to keep a larger portion of profits.

#### **Tax Holiday**

Tax holidays provide a strong incentive for tax avoidance, as taxed enterprises can enter into economic relationships with exempt ones to shift their profits through transfer pricing. Transfer pricing is the secret shifting of profits by firms between within the same country or between countries through manipulation of prices. It includes, for example, overpaying or underpaying for goods from the other enterprises and receiving.

### Losses Carried Forward

This is a tax incentive that allows investors to carry losses forward or backward for a specified period of time (usually three to five years) for tax accounting purposes. Under the Tanzania Investment Act a holder of a certificate of investment (with some few exceptions) is allowed to carry forward losses for up to three years.

### Investment Allowances

These are deductions from taxable income based on some percentage of a new investment. Such allowances tend to lower the effective price of acquiring capital. Similar to this are the investment tax credits which together are given as a specified percentage of qualifying investment expenditures.

### Exemption From Import and Excise Duties

These are exemptions given to a certified investor for the importation of taxable capital goods for the investment, which include industrial machinery, agricultural equipment, mining equipment, and raw material for export processing zones. Customs exemptions are believed to be important because they reduce the capital outlays required to set-up and run enterprises by bringing down the costs of imported capital inputs.

### Exemptions From Withholding Tax

Some countries exempt foreign investors from income remittances made abroad. This includes withholding tax on dividends, interests on loans, and royalty payments.

## Evaluating the Effectiveness of Tax Incentives in Attracting FDI

The duration of the tax holiday is prone to abuse and extension by investors through creative redesign of existing investment as new investment, for example, by closing down and restarting the same project under a different name but with the same ownership. Also the time limit provided in tax holidays tends to attract or encourage short-run projects, which are not so beneficial to the economy than longer-term investments. The fact that investors enjoying tax holidays do not file return makes the revenue cost to the country less transparent and therefore difficult to evaluate its efficiency.

The Foreign Investment Act of 1980 guarantees the right of repatriation of invested capital, profits, capital gains, post-tax dividends, and approved royalties and fees. Foreign firms are able to repatriate funds without much difficulty, provided the appropriate documentation is in order.

### Inflows of FDI

As of 2011, inflows of FDI recorded to \$1,136.38 million.

Table 1

*Private Investment Statistic*

Year/Investment	Proposed local		Proposed foreign		Total		Growth %
	Project	BDT	Project	BDT	Project	BDT	
2009-2010	1,470	27,414	160	6,261	1,630	33,678	5.67
2010-2011	1,298	39,976	148	26,935	1,446	66,912	98.71
2011-2012	1,604	497,078	209	338,910	1,813	835,989	212

*Note.* Source: Bangladesh Economic Review—2011, Ministry of Finance.

Bangladesh offers some of the world's most competitive fiscal non-fiscal incentives. BOI can advise further on this matter: in summary, remittance of royalty, technical know-how, and technical assistance fees. Repatriation facilities of dividend and capital at exit, permanent resident permits on investing US\$ 75,000 and

citizenship in investing US\$ 500,000, tax holidays.

In the Dhaka and Chittagong Divisions: 100% in first two years, 50% in the year three and four years, and 25% in the year five years. In the Rajshahi, Khulna, Sylhet, Barisal Divisions and three Chittagong Hilly Districts: 100% for first three years, 50% for next three years, and 25% in year seven.

### **Depreciation Allowances**

Some of them are accelerated depreciation for new industries which are available at the rate of 50%, 30%, and 20% for the first, second, and third years respectively, on the cost of plant and machinery. Cash and added incentives to exporting industries, businesses exporting 80% or more of goods or services qualify for duty free import of machinery and spares, bonded warehousing, 90% loans against letters of credit and funds for export promotion, export credit guarantee scheme, domestic market sales of up to 20% is allowed to export-oriented business located outside an EPZ on payment of relevant duties, cash incentives and export subsidies are granted on the Free On Board (FOB) value of selected exports ranging from 5% to 20% on selected products, the location decisions of foreign investors are influenced by many factors, which can be classified into two categories:

- The first category refers to all considerations other than government incentive policies that an investor would apply to a location decision including all advantages of production, marketing, transportation, exchange rate, and price stability, quality of public management of monetary, fiscal and social policy, political and social stability;
- The second category comprises all government incentives and disincentives that affect foreign investment, whether these are applied to foreign investment or to investment in general. These include tax holidays, customs duty exemptions, and various types of allowances, etc. that form the subject of this paper. One can therefore measure the effectiveness of tax incentives by finding out which of the two categories are the dominant factors. It is not uncommon for MNEs to extract raw materials in one country to be used in production in another country for goods to be sold in a third country. Under these circumstances, the rate of return in any one of these countries might be irrelevant in the location decision process.

Home country's tax policies and their implications to the host state many capital exporting countries extend their income tax jurisdictions to the worldwide income of their taxpayers. The result is that the same income ends up being taxed twice by two different tax jurisdictions. Therefore the double taxation is to eliminate the benefits from taxation which a corporation would have enjoyed as a result of the incentives.

The role of Double Taxation Treaties (DTT) and Double Taxation Agreements (DTA) in supplementing other efforts to attract foreign capital particularly the reform of tax systems includes tax incentives. Defining the residence of a taxpayer is a very important and sensitive issue for any DTA.

## **The Costs of Tax Incentives**

### **Revenue Foregone**

One of the clear costs of tax incentives is the amount of revenue that a country has to forego when granting tax incentives. The result is a reduction in fiscal revenue that is desperately needed in their budgets.

The major problem that threatens countries competing for FDI is the possibility of them "having a race to the bottom" by giving generous tax incentives which cannot be reflected in the benefits accruing, e.g., from creation of employment, technology transfer, etc..

**Diversion of Attention**

The fact that tax incentives can be granted to negate the negative investment climate in a country cause policy makers to ignore the more difficult though important reforms that will have a longer and wider impact on FDI. These include the general macroeconomic policies of a country like general fiscal policies, banking system, exchange rates, administrative barriers, corruption, physical and human infrastructure, FDI regulatory framework, and an effective and efficient judiciary, etc..

**Erosion of the Tax Base**

The revenue that a country foregoes by providing tax incentives creates an income gap. That means some ways have to be created to fill it. Raising the general tax rates for non-incentive holders or creating another form of tax so as to widen the tax base are among the methods used to fill the revenue gap. This tends to place a significant burden on other taxpayers that have to make up for the lost revenue. Higher general tax rates or introducing new types of taxes impose disincentives on other investors and on the recipient of incentives once the incentive period expires.

**Breeding Ground for Corruption**

Tax incentive administration if not well planned and regulated may lead to rampant corruption, e.g., to determine who qualifies for the incentives. With no clear rules authorities may start demanding bribes from incentive applicants in order for them to be favoured.

**Tax Avoidance**

It is common in some countries for firms to change their ownership and identity just immediately after or before the end of the incentive period so as to demand a new incentive period. Another way is by treating the invested capital as borrowed money so that they do not have to deduct tax on interests paid with in real sense is not as the capital would have come from a parent company abroad. Some types of incentives also attract short-term investment in which the investor operates within the incentive period make profit and leave, this is common especially for tax holidays.

**Recommendations**

- Countries should take deliberate measures to improve their macroeconomic policies, human and physical infrastructure, such as education, transportation, and telecommunication networks. They should undertake reforms of the general regulatory framework to reflect the needs for private sector development;
- Bangladesh should tax existing investment and use the revenues to foster fiscal stability, build infrastructure, and spend on health, education, and training for the labour force;
- To develop a capacity building program as to promote investors accurate information on the potential and risks of investing in poor countries to do away with the habit of claiming incentives on the basis of, sometimes, non-existent risk.
- Developed countries and international financial institutions (IMF and World Bank) have also play a role in improving developing country's investment climate. Many developing countries are still faced with huge external debts which affect their balance of payments and hence the general macroeconomic performance. External debts also reduce the ability to improve the human and physical infrastructure that is key to foreign investors. Efforts should therefore continue to look at the possibility of cancelling these debts especially for the highly indebted poor countries.

- When it is necessary to use tax incentives in some specific key sectors or projects that might need incentives, thorough studies have to be done beforehand to evaluate its possible effectiveness and benefits to the economy. Though this might be difficult in view of the availability of data in the area, still doing something would be better than just embarking on a trial and error situation. Emphasis may also have to be put on the determination of entitlement to incentives with preference being to a transparent rule-based system rather than a discretionary power to the relevant authorities which create room for possible corruption.
- Tax holidays need to be highly discouraged for being distorting and costly to the investor because sometimes they may not make a profit for the whole incentive period thus rendering it useless. Regional groupings should be used to address the problem of harmful tax competition by agreeing on accepted rules for the promotion of FDI to be regulated regionally than by individual countries.
- In order to ensure effectiveness of tax incentives and deal with the problem of double taxation in general, more efforts should be put on the negotiation and conclusion of DTT with countries that have a higher investment flow to developing countries.

### Conclusions

From the MNEs point of view there are other factors which are more important than tax issues including the general macroeconomic performance of a country, human, and physical infrastructure, political stability and the general investment regulatory framework. However, tax incentives have high revenue costs to developing countries considering the desperate demand for revenue in their budgets. Many developing countries have always been operating under big budget deficits. If the benefits of the FDI do not outweigh the costs of revenue foregone then the whole investment issue becomes nothing but a drain of the country's resources. Other costs from tax incentives include diversion of attention of the policy makers in dealing with the real bottlenecks of FDI and administrative costs and the possibility of creating rooms for tax avoidance by MNEs and corruption by the incentive granting authorities. The lesson that can be derived from the above discussion is that the whole competition amongst developing countries for attracting FDI by using tax incentives represents a race to the bottom scenario. Countries are increasingly competing to grant more and more generous tax incentives that in the end leaves no benefit to the country as one would have expected.

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