

A Critique of Korea's Foreign Capital Inducement Policy in The Light of Neutral Taxation*

O. Yul Kwon**

I. Introduction

The economic success story of Korea is well known. Its economy grew at a fabulous rate of 8.4 percent per year (in real terms) over the 22-year period from 1962 to 1984 (EPB). The Korean model of economic policy and its growth strategy have been recently being emulated by other developing countries.

A large portion of economic growth in Korea has been financed by foreign capital, of which the predominant form has been public and commercial loans. Having experienced a decline in the share of foreign direct investment and bulging foreign debt in the recent past, Korea appears to have recognized the problems with its policy towards foreign capital and started to put more emphasis on foreign direct investment.

The principles of the Korean policies toward foreign direct investment are contained in the Foreign Capital Inducement Act which was enacted in 1960, and revised in 1966, 1973 and 1984. The latest revision effective July 1, 1984 has introduced substantial changes in taxation (or in tax incentives) of income from foreign direct investment, reflecting its aspirations of decreasing its international debt burden and of inducing high technology in

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** University of Regina, Regina, Saskatchewan, Canada.

host of models of FDI which offer explanations of the determinants of FDI. It appears that most of them are based on the investor's perspective, and that the host country's perspective draws little attention. In particular, it appears that most available models of FDI assume that the inflow of FDI is unrestricted in the host countries. Frequently, however, this is not the case, particularly in developing countries. Rather, capital-importing developing countries have foreign investment controls and regulations together with foreign investment inducements, and under these regulations and inducements, FDIs are encouraged for certain areas, and are restricted or prohibited for other areas. Although it is extremely difficult to generalize policies adopted by developing countries, these countries appear to attract FDI as a vehicle with which to induce advanced technologies, managerial and marketing skills, raw materials, and access to new export markets (Park, 1981). Hence, unless foreign capital is accompanied by these requisites, FDI may not be allowed. In other words, an appropriate model of FDI in developing countries is the one which takes into account these requisites as an integral part.

Although a number of models are available for FDI, most of them appear to be based on two premises. First, FDIs are largely undertaken by multinational enterprises (henceforth MNE), and second, the world is characterized by imperfections in the output and factor markets.² The beginning in this direction of thinking of FDI was made by Hymer. Hymer's original idea was refined by Kindleberger and their argument runs as follows. In establishing and operating plants in a country, foreign firms necessarily have some disadvantages as compared with local firms. If, in spite of this, foreign firms invest in that country, they should have compensating advantages over local firms. According to them, MNEs have firm-specific monopolistic or oligopolistic advantages such as superior technical knowledge, managerial and marketing skills, special access to markets, cheaper sources of financing, economies of scale, and differentiated products.

1975 Canada eliminated the withholding tax on corporate bond interest paid to foreign lenders. From an analysis of the Canadian experience of this, Brean evidently demonstrated that the withholding tax raised borrowing costs and lowered portfolio capital inflows. Therefore, small countries in international capital markets should not impose taxes on foreign portfolio investments. The present study will not address portfolio investment.

2. For a survey of the theory of FDI, see, among others, Agarwal and Rugman.

economies of scale, as observed by Kindleberger. Although internalization can be applied to any type of MNE with firm-specific advantages, empirical studies available conclude that the process of internalization is concentrated in industries with relatively high R & D expenditures (Agarwal; Kojima, 1980).

It appears that the internalization model is an appropriate explanation of FDI particularly in developing countries, because this model, which is based on the investor's perspective, is compatible with the attraction of FDI by developing countries. As mentioned earlier, developing countries are seeking those intermediate goods.⁴

Given the multitudinous types of FDI, even the internalization model may not explain all kinds of FDI. In particular, it is not likely to apply well to FDI undertaken by small operating in one or two foreign countries. In this context, a couple of additional models may be worthwhile examining. They are Caves' model and Kojima's model (1982). Caves argues that most FDIs are undertaken either in horizontal expansion to produce the same kinds of goods abroad as in the home country (horizontal investment) or in the exploitation of raw materials involving vertical integration of foreign production in the same plant (vertical investment). For the horizontal type of FDIs, Caves argues that product differentiation is the critical element, and hence they are most likely to be found in the differentiated oligopolistic markets.⁵

Kojima's model, different from the models examined so far, is based on the premise of perfect markets. He argues that FDI originates in the home country's comparatively disadvantaged (or marginal) industry, which is potentially a comparatively advantaged industry in the host country. He further argues that FDI will improve the comparative advantages of the host country's industry by transplanting superior technology and management, thereby lowering the production costs.⁶

It is impossible to judge on an a priori basis which model would

4. Rugman further argues that internationalization is a general theory of FDI and a unifying paradigm for the theory of the MNE. See Rugman.

5. Caves' model of horizontal investment has not properly explained FDI in Korea, mainly because of government restrictions. See Koo, p. 21.

6 Koo argues that Kojima's argument is quite valid in the case of FDI in Korea.

maximizing firm.⁷ A tax will not affect investment decisions if it does not affect the market price of an investment asset. The market price of an asset will not be affected by a tax if the tax provides tax-deductions equal in amount to its market price. A neutral tax thus defined may be briefly explained by means of a single asset. Out of a spectrum of investment assets, a profit-maximizing firm will carry on investments up to the marginal asset whose value is equal to the present value of its operating income. By being marginal, the operating income of the marginal asset is equal to its opportunity cost which in turn equals the sum of economic depreciation and interest costs on the undepreciated value of the asset. The value of the marginal asset is also equal to the present value of its annual opportunity returns to the original value of the asset. It should then be noted that the market prices of investment assets determined in the asset market are identical regardless of being marginal or not, and equal to the value of the marginal asset.

A neutral tax can therefore be effected through a number of schemes. Some specific schemes are: (a) an immediate write-off of the asset; (b) annual deduction of economic depreciation and interest on the undepreciated asset value; and (c) annual deduction of opportunity returns (interest) on the original value of the asset. These schemes are referred to as the Brown, the Samuelson, and the rate-of-return tax schemes, respectively (Kwon, 1983b). In essence, each of these schemes allows tax-deductions over the life of an asset, whose present value is equal to the market price of the asset, thereby rendering the tax neutral.

An intuitive explanation of the Brown scheme is that a tax reduction equals to the tax rate times the cost of an asset it immediately provided, that annual taxes are imposed at the same rate on operating income over the life of the asset (without allowing annual deductions for economic depreciation and interest costs), and that the present value of the tax payments equals the immediate tax reduction. Hence, the market price of the asset is independent of the tax. The Samuelson scheme requires the annual deduction of economic depreciation and interest cost from operating income and, since such the annual tax-deduction

7. For a detailed explanation of neutral taxation and its practical application, see Kwon (1983a, 1983b, 1983c).

tion stage, and losses should be carried forward without limit allowing interest thereon at the threshold rate.

Given the most probable ways of implementing these three schemes, the Brown scheme requires the least amount of information, and thus it appears to be most preferable from the administrative point of view.⁸ It may also be preferred by firms because it would involve less uncertainty in recovering their capital prior to a positive tax payment.

So far it has been demonstrated that neutral taxation can capture a fair share of monopoly rents without affecting FDI. Then, how would the home country's national tax policy be set up to induce foreign investments and to capture a fair share of monopoly rent therefrom? Taxation is a national prerogative, and tax systems are invariably designed to achieve national objectives. In the process, however, national tax policies often involve international economic phenomena and tax bases outside the national tax jurisdiction. Taxation of foreign investment income is a case in point, which will inevitably create international fiscal overlaps. Hence, the task of setting up domestic tax strategy to induce foreign investments and to raise an appropriate level of tax revenues therefrom cannot be undertaken without considering possible interactions of domestic and foreign tax systems.

A question then arises as to whether there is a stable principle (or convention) in the international interactions of tax systems with respect to foreign investments. If there is no such stable principle, then domestic tax strategies would have to adjust continuously to the repercussions from foreign countries. Fortunately, there is a undeclared principle among countries of the industrialized world. This is the so-called "source" principle (Brean). Under this principle, source (host) countries have the primary right to tax foreign firm's earnings in their countries while residence (home) countries typically allow credit for foreign taxes paid.

In the international context it should be noted that both domestic and foreign investors have investment opportunities both in domestic and foreign countries, and that the interaction of

⁸. For further detail on the implementation of the three schemes of neutral taxation, see Kwon (1983b).

industrialized capital-exporting countries are committed to capital export neutrality, it appears that they have not committed themselves to capital-import neutrality; they have adopted various tax and non-tax schemes which discriminate against foreign investors. In sum, under the source principle, capital-importing countries are in the privileged position of having the primary right to tax income earned there, and capital-exporting countries are virtually forced to take fiscal responsibility for establishing capital-export neutrality.

Given that industrialized capital-exporting countries are committed to the source principle what type of tax strategy should capital-importing developing countries adopt? It should be recalled that under the source principle investors invest where pre-tax returns — not after-tax returns — are highest. Therefore, investors invest in foreign countries because of higher pre-tax returns there, not because of low taxes. In particular, as was discussed in the preceding section, they may do so in order to capitalize on monopolistic or oligopolistic advantages and accordingly to gain monopoly rents from foreign investments. Under these circumstances, the host country's tax has little relevance to foreign direct investment decisions as long as the host country's tax rate is lower than that of the home country. Therefore, tax incentives by host countries may not increase net-of-tax profit of foreign investors, and thus they may not be effective in inducing foreign investments. Rather, they only transfer tax revenues from the host to home country. Also, various studies show that tax concessions offered by developing countries are insignificant or ineffective in inducing foreign investments, and that influential factors are non-tax ones (Lent; Shah and Teye; Park, 1980; Agarwal; Lim; Brean).¹⁰ An empirical study by Lim has found that generous

pooled in order to determine the allowable credit. Under a per country limitation, foreign tax credits must be matched to income earned in the country from which the credit is derived. In addition, home countries usually do not allow foreign subsidiaries to offset their losses against the parent firm's domestic income. Nor are domestically available investment incentives (e.g., investment tax credit) ordinarily extended to capital expenditures abroad. Finally, in order to strengthen the integrity of the home country's tax system the host country's taxes that are creditable are restricted to taxes that are consistent in structure and form with bona fide home country's taxes.

¹⁰ Some important non-tax factors cited in the literature include: convertibility of currencies, political stability of the country, availability of product markets and of resource supply, availability of low-cost yet high-skilled labor, pre-tax rate of return, availability of industrial sites and social overhead capital, and freedom from burdensome bureaucratic control.

the notification system of projects eligible for foreign investment from the previous "positive list" system to a "negative list" system. Under the new listing system, foreign investment projects will be approved unless they fall into categories of prohibited or restricted projects. Also, the approval procedures were simplified and other restrictions on foreign investment and some cumbersome administrative requirements were abolished.¹¹ These clearly indicate an aspiration of the Korean government to induce more foreign direct investment in a more open economic system.

The 1984 reform of the Act also introduced important changes in taxation (or tax incentives) of foreign investment income. Under the preceding foreign investment system, a uniform incentive was provided for six different taxes: the income tax on unincorporated enterprises; the corporation tax on incorporated enterprises; the dividend income tax; the tax on royalty (income from supplying technology); the property tax; and the property acquisition tax. All of these taxes were exempted for the first five years, and reduced by 50% for the ensuing three years, in proportion to the foreign investment ratio (the ratio of the stock or shares owned by foreign investors to the stock or shares of the enterprise concerned). This uniform incentive was applied to all foreign investors with respect to their initial capital and subsequent increases therein.

Under the revised Act, the exemptions and reductions of the six types of taxes, which were provided uniformly to all foreign investors under the previous system, are in principle abolished. Instead, the incentives are provided as an exception for foreign direct investment projects which are deemed to contribute greatly to the development of the Korean economy through improving the balance of payments, introducing advanced technology or providing a large sum of capital. In case a project meets the requirements and gets approved, first, the 50% reduction of those six taxes in the subsequent three years after the first five years of tax holiday, which existed under the previous system, is eliminated. Secondly, the six taxes are treated differently under the new system. For the income and corporation taxes on foreign invested enterprises, a choice of one of two types of incentives is provided. One type of incentive provides exemptions from the

11. For a further detail on the changes, see MF (1984a, 1984b).

capital-exporting countries. In this respect, the abolition of the tax exemptions and reductions which were uniformly provided for all foreign investment projects under the old system is an improvement.

Although tax concessions are selectively provided under the new system presumably in line with the development strategy, they appear to have been formulated without properly taking into consideration the source principle of the international taxation. The new system still provides tax holidays which is the most common tax incentive for foreign investments adopted by developing countries (Shah and Toye). Income earned during the tax holiday period is taxed by the home country when it is repatriated, making the tax exemption useless as seen by investors. The tax holiday does not distinguish investments by their recovery periods, nor does it distinguish investments by their scale. As a result, the tax holiday is discriminatory against investments with a longer recovery period and against those of a larger scale. Hence, the tax holiday is far from being-neutral; taxes may be imposed even before a full recovery of capital, or no tax may be imposed even after a full recovery of capital.

The five-year tax holiday for any single five-year period within ten years of income and corporation taxes and taxes on dividends under the new system appears to be more generous than the tax exemptions and 50% tax reductions under the previous system. Investment projects are not likely to earn substantial income during a few years of the gestation period. Thus, foreign investors will choose the five-year period for tax exemptions after the gestation period. Hence, they would have in effect tax exemptions for more than five years, and some of them may not pay any tax up to ten years.

It is interesting to note that an attempt has been made to introduce an idea of neutral taxation through the special depreciation for the income and corporation taxes. The special depreciation provides in effect an immediate write-off of fixed assets which is the Brown scheme of neutral taxation. However, it is far from being a proper neutral tax scheme because it contains neither a mechanism of measuring the value of assets nor a loss-offset system which are consistent with neutral taxation. Furthermore, the special depreciation is a part of conventional income and corporation taxes both of which allow interest on debt capital to be

may not help the technology licensor, and yet it transfers tax revenues to the treasury of the home country. In the context of neutral taxation, a question may arise as to whether the royalty payment is economic rent or is a part of normal return to investment. Research and development activities for technology are undertaken in the home country. Once a new technology is developed, it is a type of public good in nature in the sense that the technology may be licensed out without hindering its usage by the firm. Hence, the opportunity cost of the technology licensed out to a host country may be zero as seen by the licensor, and the return to the technology has the quality of an economic rent. Furthermore, the fact that the technology is being licensed out indicates that it contains a monopoly element, thereby raising monopoly rents. Hence, the royalty for technology may be regarded as a proper base of a neutral tax.¹²

With regard to the acquisition and property taxes, it should be noted that there are some generally accepted criteria for a host country's tax to be creditable in the home country. In general, to be creditable, a host country's tax must be similar in structure and intent to an income tax in the home country (Deutsch and Jenkins). Hence, the acquisition and property taxes will not, in general, be creditable against the host country's tax. Hence, capital-export neutrality may not hold with respect to these two taxes. Further, the bases of these two taxes are not related to income or economic rent earned, and thus they may not be proper bases of neutral taxation. However, to the extent that the property tax is a benefit tax, then it is legitimized as a payment for public services rendered. In this respect, a complete elimination of the property tax may not be justified. Hence, the current system of the first-five year exemption appears to be justifiable.

The acquisition tax is imposed on the declared value at the time of acquisition of real estate, motor vehicles, heavy equipment, trees, and boats. It is equivalent to a selective consumption tax. Hence, it is distortionary and not justifiable; it should be completely eliminated for foreign investment. Finally, exemption

¹². Care should be taken that the tax credit by the home country may not be sufficient for taxes on royalty because the host country's tax is assessed on gross royalty whereas the home country's tax credits for foreign taxes paid are based on net royalty. Net royalty is the difference between royalty earned from abroad and all expenses incurred.

appropriate tax strategy of a developing host country for the above dual task would be neutral taxation of foreign investment income. This is so because a neutral tax does not hinder inflows of foreign capital, and it can capture monopoly rent without interfering with investment.

In view of neutral taxation, the current tax system of Korea with respect to foreign investment income requires substantial improvement. The five-year tax holiday for any single five-year period within ten years for income and corporate taxes and for taxes on dividends under the new system appears to be unwarranted in view of neutral taxation, and to be more generous than the tax-concessions under the previous system. In addition, exemptions of taxes for the first five years on royalty payments for foreign technology also appear to be unwarranted.

An innovative idea introduced by the current system is the special depreciation which foreign investors can elect as the alternative to the five-year tax holiday. It appears that this special depreciation is intended to provide an immediate write-off which is the Brown scheme of neutral taxation. However, the Korean system is far from being a neutral tax scheme because it does not contain a proper mechanism of measuring the value of assets nor a proper loss-offset system, and because it allows interest on funds borrowed deductible. While the Korean taxation of foreign investment income clearly falls short of the norm of neutral taxation, this rather innovative approach to taxation of foreign investment income constitutes a fruitful line of development which other developing countries, as well as Korea, should further explore. The defects of the system in the achievement of tax neutrality are readily identifiable and probably correctable. As a result, the Korean system may serve as a constructive guide for the future development of taxation of foreign investment income.

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