

**How Do Tax Incentives Affect the Composition
of Foreign Direct Investment (FDI)
in North-East Asia**

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Abstract

The intense competitions among countries of using tax incentives to stimulate Foreign Direct Investment (FDI) suggest that an in-depth study of relationship between tax incentives and FDI is necessary. The early debates among tax incentives and FDI suggested that tax incentives did not have strong impact on FDI. However, those debates were far from over given the complexity of tax incentives and FDI. As a result of this, this study will focus on the relationship between tax incentives and FDI composition and analysis how tax incentives can affect the composition of FDI in different countries. The result indicate that tax incentives are only effective in affecting FDI composition in high-tech industries as well as capital-intensive sectors such as finance sector. Traditional industries such as agriculture industry are less sensitive to the availability of tax incentives. However, the limitation of this study is that data obtained from China and Indonesia government website was not comprehensive and reliable. In addition, round-tripping activities was excluded to carry out this study.

Key Words: Foreign Direct Investment, Tax Holidays

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1. Introduction

1.1 Definition of FDI

With the growing mobility of global companies and the elimination of global capital-flow barriers, more and more countries have begun to realize the importance of foreign direct investment (FDI) to their overall long-term economic growth. Today, attracting quality FDI has become an important policy goal for most countries to secure and enhance their productivity and future economic growth.¹

Two main types of investment are affected by international tax policies. These are portfolio investment (PFI) and FDI. In general, PFI and FDI are distinguished by percentage shares held by an investor. If the investor has less than a 10% shareholding or holds less than the amount needed to gain a majority vote, that investment is categorized as PFI. PFI normally takes the form of security acquisition and is deemed to be passive. In general, it does not control or participate in assets management of foreign enterprises.² In contrast, FDI is essentially active and relates to business operations management. FDI, by and large, involves the direct purchase of assets in a country that often consists of tangible properties.³

According to the third edition of Organisation for Economic Co-operation and Development (OECD) benchmark definition, FDI is defined as:

“...Investment with the objective of acquiring a lasting interest by a resident entity of one economy (direct investors) in an enterprise operating in an economic environment other than that of the investor. The lasting interest implies the existence of a long-term relationship between the direct investor and the enterprise and a significant degree of influence on the management of the enterprise.”⁴

FDI can take various forms. The most common are through:

- Acquisition of, or merger with, an enterprise in another country;
- Creation of a joint venture with an enterprise in another country;

¹ *Corporate Tax Incentives for Foreign Direct Investment*, OECD Tax Policy Studies No4 (2001).

² Alex Easson, *Tax Incentives for Foreign Direct Investment* (2004), 4.

³ Clinton Alley et al, *New Zealand Taxation 2006* (2006), 731.

⁴ *OECD Benchmark Definition of Foreign Direct Investment*, OECD (3ed, 1996), 7.

- Creation of a new venture (“Greenfield” investment) in another country;
- Additional investment or reinvestment in an existing foreign-invested project⁵

In general, most FDI's are often motivated either by gaining access to bigger markets or by securing access to the resources of a particular country.⁶ This leads to the question of what determines the choice of location by multinational enterprises (MNEs) deciding to invest overseas. The determinants may vary depending upon whether the investment is market-oriented or resource-oriented; but Alex Easson has identified some factors that are considered to be important to all types of investment:

- Economic and political stability;
- Physical, business and legal infrastructure;
- Absence of bureaucratic obstacles;
- Adequate communications;
- Availability of skilled labour force;
- Ability to freely repatriate profits;
- Availability of an adequate dispute-resolution mechanism
- Preferential fiscal policies, such as tax incentives, investment incentives etc⁷

It is important to be aware that the ranking among those determinants might change over time as a result of policy development as well as the creation of free-trade areas and customs unions among countries.⁸ With the understanding that it is the combination of all those factors that jointly affected the location of FDI, this study will focus on isolating tax incentives and analysing the extent to which these factors affect the composition of FDI.

⁵ Easson, above n 2, 5.

⁶ Glauco De Vita and Kevin Lawler, ‘FDI and its Determinants: A Look to the Past, A View to the Future’ in Harbhajan S. Kehal (ed), *Foreign investment in developing countries* (2004) 13, 18.

⁷ Easson, above n 2, 19-20.

⁸ Ibid 27.

1.2 Definition of tax incentives

Tax incentives can be defined from two different perspectives. From a statutory perspective, a tax incentive can be defined as:

“...a special tax provision granted to qualified investment projects that represents a statutorily favorable deviation from a corresponding provision applicable to investment projects in general.”⁹

While, in effective terms, a tax incentive can be then defined as:

“...a special tax provision granted to qualified investment projects that has the effect of lowering the effective tax burden – measured in some way – on those projects, relative to the effective tax burden that would be borne by the investors in the absence of the special tax provision. Under this definition, all tax incentives are, therefore, necessarily effective.”¹⁰

It is important to acknowledge both definitions in this study as the statutory definition can be used to classify tax incentives while the effective definition can be used as one among a number of considerations to assess the comparative merits of different tax incentives.

2. Overview of Tax Incentives and Correlation with FDI

2.1 Types of Incentives

For the purpose of this study, tax incentives can be divided into two categories based on the definitions above. These are: direct and indirect. Direct tax incentives, in general, relate directly to a country’s corporate income tax (CIT) rate. A good example of direct tax incentives can be CIT rate incentives and investment cost-recovery incentives.¹¹ On the other side, indirect tax incentives usually target export-oriented industries, by granting them exemption, either fully or partially, from import tariffs, excises, or sales tax. Those incentives can take forms such as export-oriented incentives, value added tax -related incentives (VAT), or export processing zones.¹² In regard to FDI, although both types of tax incentives, either direct or indirect, share the common goal of reducing the tax burdens of foreign enterprises so

⁹ Howell H. Zee, Janet G. Stotsky, and Eduardo Ley, ‘Tax Incentives for Business Investment: A Primer for Policy Makers in Developing Countries’ (2002) 30 *World Development* 1497, 1498 <<http://search.ebscohost.com.ezproxy.aut.ac.nz/login.aspx?direct=true&db=bth&AN=8767296&site=ehost-live>> at 12 April 2009.

¹⁰ *Ibid* 1499.

¹¹ *Ibid* 1503.

¹² *Ibid*.

as to stimulate and maintain a high level of FDI, it is important to remember that they are not equally effective and could entail significantly different policy and administrative implications due to their unique features.¹³ To enable a better understanding of this study, some important tax incentives have been selected to build up a picture of tax incentives.

Tax Holiday

As one of the most commonly adopted and abused tax incentive policies, the tax holiday no doubt received much criticism compared to other incentive policies. The general nature of such an incentive policy provides investors with an exemption or reduction from CIT or other taxes for a limited period of time.¹⁴ Sometimes, to secure a certain type of investment, both forms might be used jointly to enable investors to enjoy a longer-term tax holiday.

The tax holiday has the apparent advantage of being simple to use by the recipient companies and easily monitored by the tax authorities of the host country. No tax returns filing and auditing is required during the tax-holiday period, which saves on compliance and administrative costs for each party.¹⁵ However, the nature of a tax holidays casts doubt on the effectiveness of using such a policy to attract FDI. In fact, the debate over using tax holidays as a means to attract FDI has continued for decades among tax professionals as well as members of governments.

The major point of debate focuses on the uncertainty around both the current and future costs of implementing a tax holiday. Alex Easson argued that the actual costs incurred with the introduction of a tax holiday might not directly relate to the amount of investment attracted or to the benefits that the host country might hope to accrue. He believed that the majority of investments attracted by the availability of a tax holiday were footloose type and brought limited benefits to the host country.¹⁶ Moreover, the tax holiday was criticised for increasing the opportunity for tax avoidance and transfer pricing, which can be detrimental not only to

¹³ Howell H. Zee et al, above n9, 1503.

¹⁴ It is important to understand that, deduction from CIT can be permanent under some circumstances.

¹⁵ Easson, above n 2, 140.

¹⁶ Ibid.

Footloose - (Definition from Cambridge Advanced Learner's Dictionary) means free to do what you like and go where you like because you have no responsibilities. It is used here to refer to foreign companies have no intention of settling in host countries for a long-term period, but rather just invest in host countries to take advantage of the preferential tax incentive policies.

the host countries but also to the home countries of those investments. For example, it is not uncommon for a parent company located in the home country with a higher tax rate to transfer its profits to its subsidiaries in host countries that offer tax holidays. Under such circumstances, the home country will suffer from tax-revenue loss if the revenue subject to tax is transferred to a host country with a lower tax rate. On the other hand, transfer pricing can happen solely in a host country where an MNE can transfer profits from businesses located outside the investment-incentive zones (IIZ) to its business located inside the IIZs so as to reduce its overall tax liabilities.

Overall, despite its popularity, the tax holiday must be considered to be among the least efficient of all types of tax incentives and should be employed with due care.

Investment Allowances & Credits

Unlike tax holidays, not only new investors, but also new investments, if eligible, can apply for either investment allowances or credits. Either type of incentive provides immediate benefits to investors in a profitable situation.¹⁷ The differences between investment allowances and investment credits are that the first is granted to reduce taxable income using an immediately initial cost write-off methodology. Such cost reduction is granted in addition to the normal depreciation allowances on the full costs of such investment.¹⁸ On the other hand, investment credits are set against tax payable and calculated as a percentage of investment costs.¹⁹

Both investment allowances and credits may apply to different forms of capital investment subject to various restrictions, which differ between countries. Such types of incentives are normally granted to investors in the first year their investment was made and, in general, are calculated based on a percentage of such qualifying investment. Again, this varies according to the type of asset invested or the activities carried out. Sometimes, the location can also affect the amount of investment allowances and credits available to investors.²⁰ Similar to tax holidays, investment allowances and credits are, in general, subject to time constraints.

¹⁷ Easson, above n 2, 143.

¹⁸ Howell H. Zee et al, above n 9, 1504.

¹⁹ Easson, above n 2, 144.

²⁰ Ibid 143.

It is argued that, compare to a tax holiday, one of the greatest advantages of using investment allowances or credits to attract FDI is that their future maximum costs are more transparent and more easily controlled.²¹ Unlike tax holidays, which tend to attract unwanted investments, for the same costs incurred, a better class of investment can be attracted using investment allowances and credits as a mean.²²

However, like other tax incentives policies, both investment allowances and credits tend to distort investors' judgements regarding which capital assets to invest. Generally speaking, in the absence of any safeguard, the majority of investment leans towards short-lived assets of which a further allowance becomes available each time an asset is replaced. Moreover, the nature of such incentive policies encourages firms to manipulate the system by selling and purchasing the same assets so as to claim multiple allowances, or sometimes by acting as a purchasing agent for enterprises not qualified to receive the incentive.²³

Accelerated Depreciation

A conservative way of granting tax incentives is by way of accelerated depreciation. The common view towards such a type of incentive is that it will lead to fewer costs in terms of tax revenue foregone. This is because merely allowing accelerated depreciation simply affects the timing of tax payable – the total allowable depreciation of an asset if depreciated in an ordinary way does not increase as a result of such a policy. Consequently, there is less incentive for firms to lean towards investing in short-lived assets or to abuse the use of such incentives to obtain advantages.²⁴

However, it is important to note that, accelerated depreciation can provide benefits to investors only if investors are in a profitable position. In many cases, at the initial stage of many investments, investors are always in a loss position. Therefore, unless depreciation allowances can be elective or losses can be carried forward in full, benefits provided by such an incentive policy are said to be very limited.²⁵

Tariff Exemption

²¹ Howell H. Zee et al, above n9, 1504.

²² Easson, above n 2, 144.

²³ Howell H. Zee et al, above n 9, 1504.

²⁴ Ibid 1505.

²⁵ Easson, above n 2, 148.

Tariff exemption generally takes two forms: duty drawback schemes, and suspensive schemes.²⁶ Duty drawback schemes operate based on the general input-output relationships of the exported goods in question; whereas, under the suspensive schemes, tariffs are collected only after goods are sold domestically. Each regime has its own advantages and disadvantages. Drawback schemes impose lower leakage risks but impose a cash-flow burden on exporters. Suspensive schemes, on the other hand, release exporters from cash-flow burdens but put host countries in a position of higher tax-revenue leakage risks. As a result, duty drawback schemes are recommended as more suitable for countries that do not have strong and reliable tax administrative capabilities. For countries with strong audit, enforcement and collection capabilities in terms of tax administration, suspensive schemes are a better option to help attract FDI.²⁷

VAT Exemption

A straight VAT exemption is said to have no benefit on manufacturers engaging in exports and imports, especially when exports and imports are zero-rated under a destination-based VAT system.²⁸ Only when investors engage in large-scale import and export activities that subsequently create a perpetual VAT credit position, does VAT exemption then become an important consideration. In such cases, VAT exemption is granted by way of providing a prompt VAT refund so as to release investors from heavy cash-flow burdens.²⁹

However, just like the tariff suspensive scheme, providing the potential tax revenue leakage risk involved in providing a prompt VAT refund, such tax incentive policies may be more

²⁶ Howell H. Zee et al, above n 9, 1506

²⁷ Ibid.

²⁸ Easson, above n 2, 154-55.

Alex Easson pointed out that to grant a manufacturer an exemption from VAT on its purchases or imports simply means that it receives no input VAT credit to set against the VAT that it must charge on its sales; similarly, to give it exemption on its sales means that its customers receive no input credit.

²⁹ Easson, above n 2, 152-3.

While VAT will be recaptured through the credit mechanism eventually, it may be several years before a new investment commences full production and has sales against which to set the credits. The better approach to such problems is to improve the VAT legislation, in particular by providing prompt refund, rather than by granting exemption from import duties.

appropriately adopted by countries with strong audit, enforcement and collection capabilities in terms of tax administration.³⁰

2.2 General Reasons for Granting Tax Incentives

For more than a century, studies have looked at the effectiveness and efficiency of tax incentives in attracting FDI. It is the generally accepted principle that tax policies are capable of influencing the flow of FDI, given that all other determinants are equal. However, in the real world, it is impossible for all other determinants to be equal. Different countries have different regulatory and commercial policies, market sizes, infrastructure levels, and human capital. It is all these factors together that influence the decision about where to locate an investment.³¹

Up until the mid 1980s, research was primarily focused on understanding whether tax incentives were one of the key factors in attracting FDI. By using either selective surveys or a time-series econometric analysis approach, early studies concluded that tax policy was one of the key factors in the decision-making process of MNEs, but not a decisive one.³²

Moving forward, more and more researchers began to question the accuracy of earlier findings. An early study conducted in Mexico on the role of tax incentives in attracting FDI revealed that less than 5% of the total sample of investors was influenced by fiscal incentives.³³ A later study undertaken in 1966 by Aharoni also revealed that tax incentives did not bring about the decision to invest and were considered a weak stimulant.³⁴ Moreover, in his 1975 research, Martin reinforced the general position that tax incentives are not major determinants of FDI. By focusing on industries that were granted pioneer status, Martin noted that few pioneer industries were attracted by tax incentives.³⁵

³⁰ Howell H. Zee et al, above n 9, 1506

³¹ Jacques P. Morisset and Nede Pirnia, 'How Tax Policy and Incentives Affect Foreign Direct Investment: A Review' (Working Paper No 2509, World Bank, 1999) 5 <<http://ssrn.com/abstract=632579>> at 20 March 2009.

³² Ibid.

³³ Stanford G. Ross and John B. Christensen, *Tax Incentives for Industry in Mexico: a Report of a Study carried out in Mexico during the summer of 1958* (1959).

³⁴ Yair Aharoni, 'The Foreign Investment Decision Process' in Peter J. Buckley (ed), *International Business* (2003) 87, 87-97.

³⁵ Antony Martin, *Minding Their Own Business: Zambia's Struggle Against Western Control* (1975).

The general position held by early literatures is described vividly in a statement in Aharoni's study:³⁶

“Tax exemption is like a dessert; it is good to have, but it does not help very much if the meal is not there.”

Despite the contribution of early studies, we should also be aware of some of their limitations. One of the important features of early literatures were that many of them focused on highly aggregated FDI data across firms of all types and paid little attention to differences across sectors or industries as well as between region and countries. The downside of using aggregate data as a research base is that variables other than tax incentives that affect the change of FDI could be well omitted. The result is that it can be very difficult to separate the taxation effect from the effects of other variables that are, in turn, correlated with tax rates.³⁷

To compensate for the limitation of early literatures, studies from the early 1980s onward began to take an in-depth look at the role tax incentives played in the investment decision-making processes of MNEs. Many studies tried to resolve the inconsistency between positions held by early literatures that tax incentives have a relatively weak impact on FDI inflow and the worldwide dramatic increase of FDI flow, especially in some tax-haven countries such as the Caribbean and the South Pacific.³⁸ Generally speaking, the majority of recent studies still upheld the position of early literatures that using tax incentives to stimulate FDI inflow was ineffective and inefficient. Such policies might trigger aggressive “incentive competition” or “bidding wars” between countries, especially among developing countries. It was argued that, while the use of tax incentives to attract FDI certainly has its benefits, the negative impact on the economy of the host country should also be considered. The main negative effect of using such a policy was linked with the direct and indirect costs associated with tax incentives, such as forgoing fiscal revenues as well as the possibilities of suspicious behaviours from tax administrations and companies.³⁹

³⁶ Aharoni, above n 34, 169.

³⁷ Morisset and Pirnia, above n 31, 5.

³⁸ Javier G. Salinas, ‘The OECD Tax Competition Initiative: A Critique of Its Merits in the Global Marketplace’ (2003) 25 *Houston Journal of International Law* 531, 531-60.

³⁹ Morisset and Pirnia, above n 31, 4.

However, these criticisms did not stop many countries granting tax incentives so as to stimulate FDI inflow. In fact, it was one of the most popular fiscal policies politicians used to improve a country's economy. Many of them sincerely believed that it was necessary to have a certain degree and combination of tax incentives in place in order to attract and stimulate FDI inflows. In general, the policy-makers' preference for using tax incentives to attract FDI can be explained from three directions.

The most straightforward explanation is that because other countries introduced tax incentives, it was necessary for the country concerned to do the same in order to remain competitive.

Secondly, while many policy makers understood that tax incentives alone were insufficient to attract FDI, they believed that failure to provide such incentives would cause their country to be uncompetitive with others doing so.⁴⁰ Such a view was based on the grounds that it is the nature of investors to bargain hard to get whatever incentives are available.⁴¹

Thirdly, from a purely political perspective, many governments felt that, compared with other factors that influenced the level of FDI, tax incentive policies were the easiest to change and maintain. For many countries, providing financial incentives was said to be impossible as the funds were simply not available. Other influential factors that could improve host countries' investment environment were costly and time-consuming. Sometimes, a certain degree of political agreement and commitment might be involved but, again, the result would not be seen within a short period of time.⁴² By contrast, most tax incentives could be introduced overnight with no apparent cost. Many politicians believed that "doing something is almost always better than doing nothing" and they were generally more interested in the "symbolic content" of their actions than in their concrete effects.⁴³ Upon till now, there has been no explicit empirical measurement of the efficacy and cost of having tax incentives in place.

⁴⁰ Easson, above n 2, 85.

⁴¹ Joel Bergsman, 'Advice on Taxation and Tax Incentives for Foreign Direct Investment' (FIAS Paper, 1999) <[http://www.ifc.org/ifcext/fias.nsf/AttachmentsByTitle/Advice_on_Taxation_and_Tax_Incentives_for_FDI.pdf/\\$FILE/Advice+on+Taxation+and+Tax+Incentives+for+FDI.pdf](http://www.ifc.org/ifcext/fias.nsf/AttachmentsByTitle/Advice_on_Taxation_and_Tax_Incentives_for_FDI.pdf/$FILE/Advice+on+Taxation+and+Tax+Incentives+for+FDI.pdf)> at 12 April 2009.

⁴² Easson, above n 2, 86.

⁴³ P.D. Enrich, "Saving the States from themselves: Commerce Clause Constraints on State Tax Incentives for Business" (1996) 110 *Harvard Law Review*, 377, 392-396.

However, the ostensible benefits from introducing tax incentives to encourage FDI are visible – more jobs are created with an improvement in host country’s economy.

Bearing all the above propositions on mind, the second section of this research will involve an in depth cost-and-benefit analysis of tax incentives so as to develop a better understanding of this popular fiscal policy.

2.3 Tax Incentives Cost-Benefit Analysis

2.3.1 Cost of Tax Incentives

Revenue Costs

The most obvious and direct costs associated with tax incentives are revenue costs. Loss of revenue may arise under two different circumstances. First of all, tax incentives are granted to foreign investors that would have made their investment in the host country should no such incentives have existed. In this case, it is argued that tax incentives should be regarded as a free gift from the host country to those investors receiving them. In fact, the effectiveness of tax incentives towards foreign investors also depends on their home country’s tax system. For countries with a residence-based tax system, the availability of tax incentives might easily result in double taxation unless there is a bilateral tax agreement between the two countries. However, many bilateral tax agreements simply allow investors to use taxes paid by them in host countries to offset their home country tax liabilities. If this is the case, the availability of tax incentives does no good to foreign investors unless their home countries agree to include a “tax-sparing” clause in the bilateral tax agreements between the home and host countries.⁴⁴ Overall, putting other factors aside, as long as foreign investments attracted by the availability of tax incentives are not limit to those that might not have been undertaken but for the existence of tax incentives, revenue costs will arise and sometimes can override the benefits those incremental investments bring to the host countries.⁴⁵ Secondly, despite its inability to attract FDI due to other social and economic impediments, the availability of tax incentives simply encourages potential abuse by investors not eligible to receive them.

Administrative Costs

⁴⁴ Howell H. Zee et al, above n 9, 1501.

⁴⁵ Easson, above n 2, 75.

It is said that, given the inherent nature of tax incentives, the availability of strong and quality administrative resources is essential in order to closely scrutinize the implementation of tax incentives policy and to prevent potential abuse and leakage of such a policy. In general, countries adopt one of two types of incentive regime: the automatic incentive regime and the discretionary incentive regime.⁴⁶ Under the automatic incentive regime, incentives are granted based on various pre-set criteria, which, upon fulfillment, will enable investors to access different type of incentives. The advantage of using such tick-the-box regimes is that they tend to be very objective and, accordingly, demand fewer administrative resources. However, such non-discriminated treatment towards different foreign investments imposes high risks of granting incentives to un-incremental investments, which will then increase the overall cost of such a system.⁴⁷ On the other hand, the discretionary incentive regime grants tax incentives based on case-by-case evaluations. Such evaluation processes are said to be very subjective as they always involve a degree of discretion on the part of the officials charged with granting the incentives.⁴⁸ In contrast with the automatic incentive regime, one of the obvious advantages of implementing a discretionary system is that it helps reduce the potential costs by restricting incentives only to those incremental investments. In addition, given the nature of such a system, if designed and administered appropriately, it can be used as a tool to encourage investment in certain industries, which can then help to improve overall economic conditions. Despite the potential benefits embedded in discretionary incentive regimes, the need to assess investments on a case-by-case basis can substantially increase both the investment costs and administrative costs, given the amount of time involved in accessing and processing each investment application. Moreover, the subjective decision-making process reduces the level of transparency of such incentive regimes as well as facilitating corruption among administrative officials and investors. Finally, it is believed that competition is more likely to be distorted under a discretionary incentive regime since decisions applying to similar investments can hardly be consistent across investors.⁴⁹

Generally speaking, in practice, it is impossible to have a straight discretionary or automatic incentive regime. In order to minimize tax administrative costs in terms of FDI assessment, many countries tend to design their tax-incentive regime by combining the two regimes.

⁴⁶ Morisset and Pirnia, above n 31, 22.

⁴⁷ Easson, above n 2, 163.

⁴⁸ Ibid.

⁴⁹ Ibid 164.

Whether to put more emphasis on either regime depends on the overall economic and social conditions of that particular country.

Spillover Costs

As mentioned above, using tax incentives to attract FDI will inevitably result in a degree of revenue loss, either anticipated or unanticipated. Such revenue loss will then need to be offset by reducing public benefits provided by the host government or by increasing tax in other areas. However, in many countries, given the inflexibility of domestic consumption and salary payment, the only way to increase tax revenue is to increase general tax rates over these areas, which will then cause an increase in labour and living costs. The consequences of all these changes might be detrimental to other investments in the future.⁵⁰ Alternatively, a host country can try to cut the level of public benefits. In the long-term, this will impact negatively on its residents.

2.3.2 Benefits of Tax Incentives

The extent to which benefits can be achieved by the introduction of tax incentives largely depends on whether investments attracted are incremental or not. Tax incentive benefits arise if they can attract investments that would not come to a country but for the availability of those incentives. Not only will the tax revenues will increase accordingly, but the overall economic well-being will also improve.⁵¹ Initially, more job opportunities will be created with an increase in FDI. And, since the majority of FDI qualifying for tax incentives is in the area of advanced technology, the increase in FDI coupled with technology transfers will also help improve the efficiency of domestic industries. What's more, foreign-exchange earnings will increase as a result of more frequent trade between domestic and overseas enterprises, which are boosted as a result of the availability of tax incentives.⁵²

In summary, the complex nature of tax incentives shows that it is very difficult to accurately calculate the difference between its inherent costs and potential benefits. In fact, such difficulties will increase when taking account the cost result from potential abuse of using tax incentives. After the cost-benefit analysis of tax incentive policies, the following section will

⁵⁰ Easson, above n 2, 77.

⁵¹ Alex Easson, 'Tax Incentives for Foreign Direct Investment in Developing Countries' (1992) 9(4) *Australian Tax Forum* 387, 414.

⁵² Easson, above n 2, 77.

go in the other direction and look at the potential abuse as a result of the availability of tax incentives.

2.4 Potential Abuse

Round-tripping

In order to attract and stimulate FDI, many countries – especially developing countries – tend to provide a range of preferential tax policies. However, in many cases, those preferential policies are only available to foreign investments.⁵³ Due to the discrimination against domestic investments, in order to take advantage of preferential policies, some domestic enterprises opt to transfer their domestic-investment capital outside the country and return it disguised as foreign investments.⁵⁴ The result of such activities is that the significantly high level of FDI in one particular country might include a large amount of round-tripping activities. This means, the costs incurred as a result of introducing preferential tax policies do not help host countries attract the investments they intended to target.

Fly-by-night operations

The majority of preferential tax policies are only provided for a limited period of time. At the time they expire, without certain restrictive criteria, one of the potential consequences can be that foreign investors wind up their operations and move on to another country so as to continue enjoying similar preferential tax policies. It is noted that footloose firms are more likely to engage in such abusive activities, as tax incentives by themselves cannot stop those firms becoming footloose.⁵⁵ One way of reducing such potential abuse is to embed restrictive criteria when granting tax incentives. For example, in many countries, to be eligible for certain tax incentives, approved investments are bonded to be carried on for a minimum period of time, such as 10 years or more. If the approved foreign investment has been wound up within the minimum period, investors must pay back the amount of income tax exempted or reduced.⁵⁶

⁵³ Geng Xiao, 'Round-Tripping Foreign Direct Investment in the People's Republic of China: Scale, Causes and Implications' (Discussion Paper 7, ADB Institution, 2004) 11 <<http://www.adbi.org/discussion-paper/2004/06/01/450.prc.foreign.direct.investment/>> at 17 April 2009.

⁵⁴ Easson, above n 2, 110-11.

⁵⁵ Ibid 168-69.

⁵⁶ Ibid.

New firms for old

This is another common abusive practice to continuously enjoy tax incentives. As discussed in the fly-by-night abuse, to terminate investment within the minimum period might run the risk of paying back all exempted or reduced tax, unless the firm can prove that it is in a loss situation. In addition, for some enterprises, transferring their existing investment to another country might be impossible and costly.⁵⁷ Therefore, instead of winding up and relocating their investment when the tax-incentives period expires, some firms choose to form a new company, to which existing business assets are to be transferred, and the same business will be continued within the new company with new tax incentives granted. The consequence of such abuse is that tax incentives are granted twice for the same investment, which will then increase the host country's cost of introducing preferential tax policies.⁵⁸

Capital asset over-valuation

Over-valuation has been agreed to be one of the important causes of revenue loss. It is also said that such revenue loss can be made worse as a result of the availability of tax incentives. Investments with a large amount of capital assets tend to over-estimate the value of the capital asset so as to take advantages of preferential tax policies. For example, many countries introduce depreciation allowances to eligible FDI. By over-valuing capital assets, eligible investment can receive greater depreciation allowances. Moreover, some countries offering tax incentives set a minimum capital assets investment threshold. In order to meet the minimum threshold, some investors will over-estimate their capital assets so as to receive significant tax savings.⁵⁹

Transfer pricing

Tax incentives are considered one of the primary motives in transfer-pricing activities since a well-planned transfer-pricing policy can help multi-national enterprises minimise their

⁵⁷ For example, for firms engaged in petroleum exploration and refining, it is more sensible to locate their operation in countries that have all those raw materials. They will not relocate their investment simply due to the availability of tax incentives, since the cost of relocation as well as future business operation, can be very high.

⁵⁸ Easson, above n 2, 141.

⁵⁹ Ibid 170.

overall corporate tax liabilities.⁶⁰ Generally speaking, countries with a high income-tax rate and less preferential tax policies are more concerned about transfer pricing issues. This is because a logical tax planning is to shift income from high-tax countries to low-tax countries. Under such circumstances, home countries with higher income-tax rates run the risk of revenue loss. However, under some circumstances, the host countries might also suffer severe revenue loss. For instance, many countries will set up SEZs in order to attract FDI. If an MNE sets up two companies in the host country with one within the SEZ and one outside, transfer pricing happens when the MNE shifts income from the company outside the SEZ to the company within the SEZs so as to reduce the overall corporate taxes.⁶¹

In order to prevent such potential abuse, many countries have started to introduce implicit anti-tax avoidance rules with heavy penalties in the case of non-compliance. Countries such as the United States require extensive records during an IRS audit under its Revenue Reconciliation Act 1990.⁶² Other countries might specify allowable transfer pricing so as to ensure the inter-company transactions are at arm's-length.⁶³

Allocation and timing issues

Due to the nature of some activities or their location, tax incentives are sometimes only available for a portion of investment activities. In such circumstances, in order to minimise overall tax liabilities, companies will try to allocate income to activities that are eligible for tax incentives, and expenditures to normal taxable activities. Another potential abuse concerns timing. For example, although many countries provide tax holidays for a certain period of time, their start date varies. In some countries, the tax holiday starts on the date the business commenced, while other countries determine that a tax holiday starts on the date the business started earning profits. In the latter case, because profits generated in the first one or two years are generally considered small, some investors might push revenue to a later year

⁶⁰ Clive R. Emmanuel, 'Income Shifting and International Transfer Pricing: A Three Country Example' (1999) 35(3) *Abacus*, 252, 252-67.

⁶¹ Easson, above n 2, 170.

⁶² R. A. Leitch and K.S. Barrett, 'Multinational Transfer Pricing: Objectives and Constraints' (1992) 11 *Journal of Accounting Literature* 47, 47-52.

⁶³ Agnes Lingane, 'Transfer Pricing - Practical Issues in the Asia Pacific Region: Part 1' (2006) 9(4) *The Tax Specialist* 222, 222-7.

so as to maximise profits during the tax-holiday period and reduce them correspondingly after the holiday expires.⁶⁴

Overall, the weighting of all these types of abuse varies between countries. Countries with generous tax incentives and a lack of potential anti-avoidance policies might be in a more vulnerable position and will be more likely to encounter all of these types of abuse. In addition, although those potential abuses are triggered by the availability of tax incentives, it is important to understand that tax incentives are not the only cause of abuses – other factors, such as the economic environment, market conditions, the political system, and the availability of resources might also trigger the possible abuses outlined above.

Having introduced the nature of tax incentives in the first two sections, the following sections will focus on particular countries in order to obtain a better understanding of the relationship between tax incentives and FDI. For the purposes of this study, three countries were selected: Singapore, China and Indonesia. FDI data will be abstracted to analyse how tax incentives might affect the composition of FDI in these three countries.

3. Development of FDI Policies & Tax Incentives by Specific Country

3.1 Singapore

3.1.1 Political & Economic Environment analysis

Singapore is a parliamentary republic. Since its independence from Malay, the country's politics have been dominated by the People's Action Party (PAP).⁶⁵ Although Singapore considers itself a democratic country, Western democracies believe its political environment to be closer to authoritarianism rather than true democracy, and sometimes categorize it as a de facto one-party state.⁶⁶ In terms of its economy, Singapore is said to have one of the best business environments and most open economies in the world.⁶⁷ Its rapid growth can be attributed to sound policies, which, on one hand have promoted macro-economic stability and

⁶⁴ Easson, above n 2, 171.

⁶⁵ 'Political risk assessment in Singapore' (2000) *Singapore Economic Studies* 1, 62 <<http://search.ebscohost.com.ezproxy.aut.ac.nz/login.aspx?direct=true&db=bth&AN=5843566&site=ehost-live>> at 29 March 2009.

⁶⁶ *Politics of Singapore*, Wikipedia <http://en.wikipedia.org/wiki/Politics_of_Singapore> at 29 March 2009.

⁶⁷ Donald J. Lecraw, 'Some Determinants and Effects of FDI in Singapore' (1985) 2(2) *Asia Pacific Journal of Management* 71, 71-80. <<http://search.ebscohost.com.ezproxy.aut.ac.nz/login.aspx?direct=true&db=bth&AN=16855188&site=ehost-live>> at 29 March 2009.

on the other have limited relative price distortions in the economy.⁶⁸ Given its relatively small size and general lack of natural resources, Singapore relies heavily on foreign investment and external trade. Because of this, the Singapore Government has committed to establishing a liberal climate so as to enable rapid investment and export-led growth. ‘Market-leading’ policies were adopted to actively promote investments in sectors that might possess the greatest growth potential.⁶⁹

The development of Singapore’s economy can be divided into four phases. The first period, known as the semi-closed period, lasted from 1959 to 1965.⁷⁰ During this time, Singapore faced serious poverty and unemployment problems and its traditional economic activities, entrepot trade, were clearly incapable of generating sufficient job opportunities to reduce its high unemployment rate. In order to solve the unemployment problem, the Singapore Government decided to liaise with Malaya, as well as adopting an import-substitution strategy so as to promote its industrialization policy. During this period, a number of fiscal incentives were also introduced to encourage Singapore’s manufacturing sectors. The Economic Development Board (EDB) was established in 1961 as a means to promote industrialization. The other important feature in this period was the introduction of import-protection policies where tariffs and import quotas were imposed on a variety of products. Moreover, to keep up with the continued industrialization, the Singapore Government also vowed to improve the skill and education levels of the workforce by introducing a five-year

⁶⁸ Thomas Rumbaugh, ‘Singapore Experience as an Open Economy’ in Kenneth Bercuson (ed), *Singapore: a Case Study in Rapid Development* (1995) 34, 34-9.

Policies that promoted macroeconomic stability include low inflation, positive real interest rates and sound fiscal management. Limited relative price distortions in the economy was achieved by introducing liberal foreign trade policies and an exchange rate policy that avoided prolonged periods of real exchange rate misalignment.

⁶⁹ Robert G. Carling, ‘Fiscal and Monetary Policies’ in Kenneth Bercuson (ed), *Singapore: a Case Study in Rapid Development* (1995) 20, 20-7.

⁷⁰ Rachel Van Elkan, ‘Rachel van Elkan’ in Kenneth Bercuson (ed), *Singapore: a Case Study in Rapid Development* (1995) 11, 11-8.

education plan in 1960.⁷¹ The result was an annual 5% increase in GDP between 1959 and 1965, as well as a significant increase in job opportunities in the manufacturing sector.⁷²

From 1966 to 1973 was the so-called 'low-wage and labor-intensive' period, when the Singapore government started to realize that the existing union with Malay was insufficient to exploit its economies of scale in manufacturing.⁷³ In addition, the downside of import-substitution strategies and import-protection policies started to show as a result of imbalances between imports and exports. Therefore, from 1967, Singapore decided to move away from an import-substitution strategy to an export-oriented strategy. At the same time, import quotas were removed with a reduction in tariffs so as to encourage exports, improve the balance of payments and reduce unemployment.⁷⁴ The new development strategies, combined with other factors, soon made Singapore a very attractive region for foreign investments.⁷⁵ The increase in foreign investment certainly benefited both the manufacturing and the financial service sectors.⁷⁶ On one hand, the rapid development in the manufacturing sectors helped reduce the level of unemployment. On the other hand, in 1968, the export-oriented strategy successfully attracted the Bank of America to establish its Asian currency unit in Singapore. This was viewed as a signal of Singapore emerging as a major international financial center. Overall, Singapore's export-oriented strategy was successful at this stage, not only because it helped to rapidly increase its foreign investment and exports, but also because it pushed Singapore to transform from a low-wage, surplus-labor economy to a relatively high-wage, full-employment economy.

The overall success in phase two soon created a new problem for the Singapore Government, that is, labour scarcity. The Government soon realized that to solve the problem, it needed to redesign its development strategy to promote, not labour and export-intensity, but skill and

⁷¹ Ibid 11-12.

The plan was designed to produce a well-equipped workforce with knowledge of basic mathematics, science, and other technical subjects required in a modernizing economy.

⁷² Elkan, above n 70, 11-2. Although a large number of new jobs were created, the unemployment rate remained above 10%.

⁷³ Ibid 12-3.

⁷⁴ Elkan, above n 70, 12-3.

⁷⁵ Other factors include, low wages and labour intensive, its strategic location in Asia, a good transportation infrastructure.

⁷⁶ Elkan, above n 70, 12-3.

technology intensity, so as to generate more value from the same amount of labor.⁷⁷ Between 1974 and 1984, Singapore entered into a so-called ‘capital and skill-intensive’ period. The main task of EDB at this stage was to focus on encouraging foreign investment in high-technology industries. At the same time, the Singapore Government carried out a series of human-capital development and labour-market policies that helped restructure its industrial sector toward technologically sophisticated ‘upstream’ activities.

Statistics showed that compared to the impressive performance of the business and finance-services sectors, the value-added growth in the manufacturing sector between 1974 and 1984 was relatively weak. As a result, the Singapore Government decided to exploit new profitable sectors so as to maintain high growth and improve performance in the manufacturing sector.⁷⁸ From 1985 onward, Singapore entered into the industrial-base diversification period. An economic diversification policy was adopted and sectors such as biotechnology, computer peripherals and aerospace were chosen and targeted as potential high-growth sectors. The promotion towards business and financial services was also part of the development plan. Moreover, in 1989, the Johor-Batam-Singapore growth triangle was established with Malaysia and Indonesia. This arrangement enabled Singapore to shift its labour-intensive technological foreign investment to Indonesia and Malaysia while retaining those MNCs skill-intensive headquarters in its own country. By doing so, the labour-scarcity problem was significantly improved.⁷⁹

3.1.2 Singapore Tax System Overview

Singapore operates under a territorial tax system, while China and Indonesia levy tax on the worldwide income of resident companies.⁸⁰ Unlike Hong Kong, which also has a territorial tax system, Singapore levies taxes on both income that accrues in or is derived from within Singapore, and foreign-source income if it will later be remitted into the country.⁸¹ This

⁷⁷ Ibid.

⁷⁸ Elkan, above n 70, 13-4.

⁷⁹ Ibid.

⁸⁰ Peter Gillies, ‘Taxation in Asia and the Pacific: Some comparisons’ (1996) 22(2) *International Tax Journal* 37, 37-40 < <http://www.proquest.com.ezproxy.aut.ac.nz/> at 17 April 2009.

⁸¹ Gillies, above n 80, 37.

means there is no tax differential between businesses carried on in Singapore by residents and non-residents.⁸²

Singapore has one of the lowest tax rates among Asian countries. There has been a progressive reduction in the corporate tax rate from 40% in 1985 to 18% in 2008. From 2003, the old imputation system of taxing dividends was replaced by a one-tier corporate tax system. Under this system, income tax payable on a company's normal chargeable income is a final tax and shareholders will not be taxed on such dividend income.⁸³ Moreover, foreign dividends have generally been exempt from tax since 1 June 2003, and there is no withholding tax on dividends as a result of the new one-tier tax system.⁸⁴ In addition, unlike China and Indonesia, Singapore has no thin capitalisation rule, therefore it imposes no limit on deduction. Moreover, as long as a company in Singapore maintains its beneficial ownership at around the same level (at least 50%), unused tax losses and capital allowances can be carried forward indefinitely to offset future taxable income.⁸⁵ However, since Singapore has no capital gains tax, therefore no deduction is allowed for capital-loss expenditures incurred. Interestingly, there are no specific rules monitoring transfer-pricing activities in Singapore. This is explainable since, given the low corporate tax rate in Singapore, the chance of incurring transfer pricing is relatively low.

3.1.3 The Development of Tax Incentives to Attract FDI

There is no doubt that the activist industrial policy adopted by the Singapore Government has contributed to the economic growth achieved over the past four decades. Industries with high growth potential that complemented Singapore's required resources were promoted under the activist industrial policy. In conjunction with this, various instruments were also adopted to encourage diversified investment. Among them, tax incentives were one of the most

⁸² Norbert Hennig, 'Bye Bye Imputation, Welcome One-Tier: The New Corporate Tax System in Singapore' (2004) 32(5) *International Tax Review* 231, 231-250.

⁸³ *Singapore Corporate Taxation* (2008) AsiaBiz <<http://www.asiabizsetup.com/singapore-corporate-taxation.aspx>> at 12 January 2009.

⁸⁴ Knut Unger, *Your Guide to Establish a Business in Singapore* (2007) Luther LLP <<http://www.entersingaporebusiness.info/Bus08.htm>> at 17 April 2009.

⁸⁵ Unger, above n 84.

N.B. In regard to taxable allowance, in order to carry it forward indefinitely, the same trade or business in respect of which these capital allowances arose need to be carried on.

prevalent instruments employed by the Singapore Government over the years.⁸⁶ From a broad perspective, perhaps the biggest tax incentive it offered to foreign enterprises was the continued attempt to lower the overall income tax rate. Over the years, Singapore's corporate tax rate was reduced from 40% in the early 1980s to 18% in 2008. By 2008, Singapore's corporate tax rate ranked as the second lowest among East-Asian countries. Furthermore, an in-depth analysis of Singapore's tax-incentives regime reveals that incentive policies were designed based on the social needs and economic conditions of that particular period. As mentioned above, the Singapore Government began to formally grant tax incentives to foreign investment with the enactment of the Pioneer Industries Ordinance and the Industrial Expansion Ordinance in 1959.⁸⁷ At that time, given the severe poverty and unemployment problem Singapore was facing, incentives such as tax holidays were mainly granted to Pioneer foreign enterprises invested in labour-intensive activities, as such investment helped alleviate unemployment. Also, in order to promote the industrialization policy, incentives were also granted to investment that helped improve the workforce's skill levels.⁸⁸ The tax-incentive packages changed from the mid-1960s when the Singapore government moved to an export-oriented development strategy. Tax-incentive policies at this stage were governed by the Economic Expansion Incentives Act 1967, which focused on further reducing unemployment.⁸⁹ Manufacturers engaged in export also enjoyed a concessionary tax rate under the Act, as such activities helped to develop the export-oriented strategy. In the early 1970s, as mentioned above, the ageing unemployment issue was no longer of concern to the Singapore Government, instead it proposed to switch industry composition to more skill- and technology-intensive activities that could generate more incremental value from the existing labour level. Investment in labour-intensive activities that did little to upgrade technology was no longer of interest to the Singapore Government. Instead, policies were designed to encourage investment in skill- and technology-intensive activities.⁹⁰ Incentives such as tax holidays and various tax allowances were granted to foreign investors engaged in either favoured high-technology industries or activities that helped upgrade employees' skill and education levels.⁹¹ The industrialization policy adopted by the Singapore Government,

⁸⁶ Elkan, above n 70, 15.

⁸⁷ Ibid 12.

⁸⁸ Ibid.

⁸⁹ Ibid.

⁹⁰ Ibid.

⁹¹ Ibid.

that of diversification, was started in the early 1980s. Such a diversification strategy, coupled with a wide range of tax incentives, helped Singapore maintain its leading economic position in southeast region. Today, Singapore offers a comprehensive tax-incentives regime, which covers areas such as manufacturing, services, trade, finance, and local and overseas investment.⁹² Tax incentives were introduced in various forms, such as the double tax-deduction scheme, operational headquarter corporation (QHQ) incentives, the financial sector incentive scheme, integrated industrial capital allowance incentives, a research incentives scheme for companies, and many more.⁹³ Of these incentives, the majority were granted to Pioneer enterprises, given the significant value those firms had generated in the past four decades.

In summary, given the comprehensive nature of its tax incentive system, Singapore is no doubt one of the few countries to successfully use tax incentives to attract FDI without suffering from huge revenue losses.

3.2 China

3.2.1 Political & Economic Environment Analysis

As one of the world's fastest-growing countries in recent times, the China's economic reform from socialism to consumerism has been described as lengthy and circuitous. The 10-year Cultural Revolution, which ended in 1978 not only nearly destroyed the country's entire economy, but also left it with serious poverty and unemployment issues. When Deng Xiaoping took over power and became president in 1978, he decided to carry out ambitious economic reforms to transform China from a planned economy to a market-oriented economy, and to bring massive foreign investments into the country. In the agricultural sector, the 'responsibility system' was introduced to replace the collective-farming system that operated in the period of 'Mao'.⁹⁴ In terms of international trade, the open policy was introduced in 1979 and, at the same time, several cities were chosen as the special development zone (SDZ) where both tax concessions and liberal policies were granted to

⁹² *2008 Singapore Tax Facts and Figures* (2008), PriceWaterHouseCoopers,

<<http://www.pwc.com/extweb/pwcpublications.nsf/docid/4610e4db559ef813852569a6001fc64c>> at 12 January 2009.

⁹³ *2008 Singapore Tax Facts and Figures*, above n 92, 16.

⁹⁴ *Quick Guide: China's Economic Reform* (2006) BBC News <<http://news.bbc.co.uk/2/hi/asia-pacific/5237748.stm>> at 12 April 2009.

investors in exchange for revenue and technical knowledge. The implementation of the open-door and market-oriented economic policies had an enormous impact. First of all, they helped to trigger an acceleration of China's economy.⁹⁵ Over the years since 1979, the annual growth rate of China's economy remained at an average of nearly 10% and that pace did not slow down much, even during the 1997 Asian Economic Crisis. In fact, the amount of FDI that flowed into China in 1997 was US\$45.3 billion, making it the world's second-largest FDI recipient just behind the US.⁹⁶ Secondly, they helped to rescue China from its previous isolated position by encouraging close interaction between China and the world. For example, within all the multinational treaties signed between China and other countries to date, about 92% were signed by China and became applicable after its adoption of an open policy in 1979.⁹⁷ In addition, its joining of the World Trade Organization (WTO) in 2002 showed a further commitment by China to open its market even more to international competition in the future, as well as revising its rules and regulations to meet the WTO's standards for reliability, credibility and transparency.⁹⁸

3.2.2 China Tax System Overview

The Chinese Government undertook major tax reforms almost every 10 years in order to keep the tax system consistent with China's macro-economic environment, and to enhance the impact of tax on China's social and economic development.⁹⁹

Since the establishment of the People's Republic of China (PRC) in 1949, the Chinese Government has carried out six major tax reforms.¹⁰⁰ The most important of these reforms are the 1994 and the 2008 reforms. The 1994 tax reform preliminarily helped China set up a

⁹⁵ Malory Greene, Chrls Tsai and Ralph Lattimore, 'China' in Raed Safadi and Ralph Lattimore (ed), *Globalisation and Emerging Economies: Brazil, Russia, India, Indonesia, China and South Africa* (2008) 373, 373-95.

⁹⁶ Han Gyu Lheem and Sujian Guo, 'Political economy of FDI and economic growth in China: a longitudinal test at provincial level' (2004) 9(1) *Journal of Chinese Political Science* 43, 43-62.

⁹⁷ Hanqin Xue, 'China's Open Policy and International Law', (2005) 4(1) *Chinese Journal of International Law* 133, 133-9

⁹⁸ Sean Silverthorne, *Special Report - Asia Business Conference 2002 (China WTO) - Promises and Problems for China in the WTO*, (2002) Harvard Business School Working Knowledge <<http://hbswk.hbs.edu/archive/2801.html>> at 16 May 2009.

⁹⁹ Shoushuang Li, *The Legal Environment and Risks for Foreign Investment in China* (2007) 264.

¹⁰⁰ The six tax reforms took place in 1953, 1963, 1973, 1983, 1994 and 2004.

streamlined tax system geared to the socialist market economy.¹⁰¹ The 1994 tax reform further opened up the Chinese market to the world and promoted the rapid and sustained development of China's national economy. However, it was hard to ignore its inadequacy, especially after China's entry into the WTO in 2002.¹⁰² It was said that the biggest problem with the 1994 tax system was the different tax treatment towards domestic investors and foreign investors.¹⁰³ Such discrimination not only imposed significantly heavier tax burdens in domestic investors and breached the principle of neutral taxation, but also endangered the national revenue base, of which tax revenue comprised a significant portion.¹⁰⁴ For example, under the 1994 tax regime, many preferential tax policies were only available to foreign investors. With the higher general corporate tax rate imposed on domestic investors, in order to reduce their tax burden, many domestic investors might engage in so-called "round-tripping" activities. This involved transferring their investment capital overseas, for example to Hong Kong, and later repatriating it disguised as foreign investment.¹⁰⁵

In order to redress the unfair tax treatment, in 2004 the Chinese Government launched its sixth tax reform proposal. One of the important changes proposed under the reform was to unify income tax laws for domestic and foreign enterprises. This was also consistent with the general course of development under the WTO's principle of national treatment for all enterprises.¹⁰⁶ After a series of debates and analysis, the new income tax law came into force on 1 January 2008. Under this new tax regime, both foreign enterprises and domestic enterprises were taxed at a unified CIT rate of 25%. At the same time, most of the existing tax incentives were withdrawn. However, for those foreign enterprises granted tax incentives

¹⁰¹ *An Overview of China's Tax System* (2007) State Administration of Taxation, <<http://www.chinatax.gov.cn/n6669073/n6669133/6886066.html>> at 17 May 2009.

¹⁰² *Ibid.*

¹⁰³ Li, above n 99.

Under the 1994 tax regime, the corporate income tax rate for domestic companies is 33% while that for foreign-invested enterprises is 15%. If at the same time also take all tax preferential policies into account, actual domestic companies' average tax burden rate is about 23% while foreign-invested enterprises' average tax burden rate is about 13%. From LI SHOUHUANG., *The legal environment and risks for foreign investment in China, in, 2007*

¹⁰⁴ *Ibid.*

¹⁰⁵ Easson, above n 2, 110.

¹⁰⁶ Li, above n 99.

prior to 2008, a five-year transition period was allowed under the new tax regime.¹⁰⁷ The unified tax rate will undoubtedly have an adverse effect on foreign investors since their general tax burden will increase from 15% to 25%, with many incentives phased out. What's more, the 2008 tax law re-defined Chinese tax residence so as to broaden its tax net. Companies that are incorporated outside China but maintain overall management and control of production, business, employees, assets and finance within China will be classed as tax resident in China and subject to tax on their worldwide income.¹⁰⁸ In addition, in order to address the severe tax wrongdoings, the new law imposed comprehensive anti-tax avoidance rules in line with the international practices.¹⁰⁹ One of the important anti-tax avoidance rules is the introduction of the 'thin capitalization' rule, which forbids interest deductions on related party debt if the interest-bearing loans are in excess of a specified ratio to equity.¹¹⁰ The other newly introduced anti-tax avoidance regulations are the Controlled Foreign Corporation (CFC) rules. The CFC rules aim at limiting the benefit to domestic companies from moving profits into low-tax jurisdictions to escape the Chinese tax net.¹¹¹

It is clear that more work is still required to ensure efficient operation of the new tax law. It is expected that in the near future, more detailed tax measurement will be introduced to help better implement the new law as well as to alleviate the adverse impact on foreign investors.

3.2.3 The Rise of Tax Incentives and Resulting FDI Policies

As one of the largest FDI host countries in the world, China has a rather short history (only 30 years) in terms of the development of its foreign-investment policies. Without doubt, the open-door policy, which proposed granting tax incentives to attract FDI, has played a significant role.

¹⁰⁷ Mario Petricclone and William Zhang, *China's New Tax System and its Implications* (2007) The Chartered Institute of Taxation <http://www.tax.org.uk/attach.pl/6305/7339/020-022_TA_1207low.pdf> at 12 April 2009.

¹⁰⁸ Fiona Lewis, Ann-Marie Nolan and Lisa McCleane, *China's Income Tax Law reform* (2008) Ernst & Yong, <[http://www.ey.com/Publication/vwLUAssets/Tax_-_China_s_income_tax_law_reform/\\$FILE/China's%20income%20tax%20law%20reform%20-%20200805.pdf](http://www.ey.com/Publication/vwLUAssets/Tax_-_China_s_income_tax_law_reform/$FILE/China's%20income%20tax%20law%20reform%20-%20200805.pdf)> at 12 April 2009.

¹⁰⁹ Matthew Mui and Raymond Wong, 'Tax Regime Change' (2008) 35(2) *The China business review* 32.

¹¹⁰ Petricclone and Zhang, above n 107.

¹¹¹ Ibid.

The common view towards China's foreign-investment policies is that they are generally regionally based. The development of FDI policies started with the first establishment of four Special Economic Zones (SEZ) in 1980, i.e. Shenzhen, Zhuhai, Xianmen and Shantou.¹¹² In general, preferential tax treatments were offered to both domestic and foreign investments in SEZs, and foreign investments in SEZs, in particular, were exempt from import licenses etc.¹¹³ In 1984, with the success of attracting foreign capital into the SEZs, 14 cities were selected and established as Open Coastal Cities (OCC). Despite the fact that no separate custom areas were established and less autonomous authority was granted compared with the SEZs, the OCCs enjoyed greater flexibility in investment and tax policies than other areas in China.¹¹⁴ In addition, within the 14 OCCs, special areas were further selected as Economic and Technology Development Zones (ETDZs). In 1985, the three Open Economic Zones (OEZ) were formally established, namely, the Yangtze River Delta, the Pearl River Delta and the South Fujian Triangle area.¹¹⁵ In the early reform period, unlike other areas in China, the OEZs were granted administrative decentralization to carry out investment decisions largely outside the state plans. However, restrictive access to foreign exchange and domestic markets remained at that time, and this significantly limited the ability of foreign enterprises to expand their investment scope into export-oriented activities.¹¹⁶ In the early 1990s, the Chinese Government decided to establish the first two Free Trade Areas (FTA) in Shenzhen and Pudong, where exports and imports could be traded freely.¹¹⁷

China has since opened more than 100 Investment Incentive Zones (IIZ), including five SEZs, 14 COOs, several ETDZs, FTAs, new and high-technology industrial development zones, Provincial Capitals, as well as bonded zones.¹¹⁸ All of these IIZs were granted concessionary

¹¹² Yingqi Wei and Xiaming Liu, *Foreign Direct Investment in China: Determinants and Impact* (2001) 12.

¹¹³ Wanda Tseng and Harm Zebregs, 'Foreign direct investment in China: Some lessons for other Countries' (Working Paper No 21, International Monetary Fund, 2002) 14 .
< <http://www.imf.org/external/pubs/cat/longres.cfm?sk=15615.0>> at 15 May 2009.

¹¹⁴ Wei and Liu, above n 112,15.

The 14 COOs are Dalian, Qinhuangdao, Tianjin, Yantai, Qingdao, Lianyungang, Nantong, Shanghai, Ningbo, Wenzhou, Fuzhou, Guangzhou, Zhanjiang and Beihai.

¹¹⁵ Wei and Liu, above n 112,15.

¹¹⁶ Tseng and Zebregs, above n 113, 16.

¹¹⁷ Ibid 14.

¹¹⁸ Samuel Tung and Stella Cho, 'Determinants of Regional Investment Decisions in China: An Econometric Model of Tax Incentive Policy' (2001) 17(2) *Review of Quantitative Finance and Accounting* 167, 171-2.

tax rates and tax incentives to a certain degree. As a result of those tax incentives and concessions, the effective tax rate for foreign investment enterprises is about 10% lower than that for domestic enterprises and, in return, such privileges have indeed helped those IIZs successfully attracted large amounts of FDIs over the years.¹¹⁹

FDI in China generally takes three forms: equity joint ventures (EJV), contractual joint ventures (CJV), and wholly foreign-owned enterprises¹²⁰. Prior to 1991, these three forms of FDI were originally governed by two income tax laws, namely, the 1980 Income Tax Law concerning EJVs and the 1981 Income Tax Law concerning CJVs and wholly foreign-owned enterprises.¹²¹ Different levels of tax incentives were offered under the two tax laws where more generous tax incentives and unified tax rates were provided under the 1980 tax law. In 1991, with the introduction of the new Income Tax (the 1991 Income Tax law), all foreign investments were taxed under a unified tax umbrella. Such an enactment not only removed the tax inequities resulting from the previous two tax laws, but also helped to create a better investment environment to attract FDI into China.¹²² Under the 1991 Income Tax Law, previously available concessionary tax rates were maintained and granted to investments in IIZs where a reduced statutory rate of 30% was introduced to all types of FDI outside IIZs. Compared with the 1980 and 1981 income tax laws, more generous tax incentives were introduced to investments both within IIZs and outside IIZs.

The subsequent 1994 tax reform mainly targeted the income tax system for domestic enterprises to help reduce its complexity. One of the main projects involved in the 1994 tax reform was the Value Added Tax (VAT) reform. The uneven treatment between foreign investment enterprises and domestic enterprises still remained after the reform.¹²³ It was not until 2004 that the Chinese Government started to raise concerns about such differentiated

¹¹⁹ Jinyan Li, 'The Rise and Fall of Chinese Tax Incentives and Implications for International Tax Debates' (2007) 8(7) *Florida Tax Review* 669, 679.

¹²⁰ Samuel Tung and Stella Cho, 'The Impact of Tax Incentives on Foreign Direct Investment in China' (2000) 9(2) *Journal of International Accounting, Auditing and Taxation* 105, 105-35.

¹²¹ Tung and Cho, above n 118, 172.

¹²² Ibid.

The 1991 Income Tax Law is known as the Income Tax Law for Foreign Investment Enterprises and Foreign Enterprises

¹²³ Charles A. Pigott, *China in the World Economy: the Domestic Policy Challenges: synthesis report* (2002) 626.

treatment. After a series analysis, on 1 January 2008, the old dual tax system was replaced by a unified tax system under which both domestic and foreign-invested firms were taxed at a unified CIT rate of 25%.¹²⁴ Large amounts of previously available tax incentives will be gradually abolished over the next five years starting in 2008. It was said that the implementation of the Enterprise Income Tax (EIT) Law in 2008 officially declared the end of the existing FDI tax incentive regime in China.¹²⁵

3.3 Indonesia

3.3.1 Political & Economic Environment Analysis

Since its independence, Indonesia has been a very attractive market for foreign investors. Like China, Indonesia is also known for its rich natural resources, a large potential domestic market, and a competitive and productive labour force.¹²⁶ However, its policy uncertainty was viewed as one of the major investment constraints to the rapid development of FDI in Indonesia. Indonesia is governed by a constitutional democratic political system. Since 1967, when the Indonesian government decided to open its market to foreign investment, the amount of FDI attracted increased steadily over the years until the 1997 Asian Economic Crisis. The structural relationships across the entire Indonesian economy were damaged as a result of the economic crisis, which then caused severe macro-economic instability. In addition, the trade capabilities of both domestic and foreign companies were adversely affected by the crisis. It is interesting to note that, while countries like Indonesia suffered from the crisis, other countries such as China saw it as opportunity and quickly emerged to dominate the world market, which no doubt increased the competitive pressure on Indonesian industries.¹²⁷ In order to recover from the crisis and to achieve and maintain high rates of growth in the future, Indonesia has gone through tremendous economic and political change

¹²⁴ Lewis et al, above n 108. 76.

¹²⁵ Li, above n 119, 10.

¹²⁶ Arumugam Rajenthiran, 'Indonesia: An Overview of the Legal Framework for Foreign Direct Investment' (2002) 4 *Economic and finance* 3, 3-7.

¹²⁷ Margit Molnar and Molly Leshner, 'Indonesia' in Raed Safadi and Ralph Lattimore (ed), *Globalisation and Emerging Economies: Brazil, Russia, India, Indonesia, China and South Africa* (2008) 333, 333-64.

since 1997.¹²⁸ The reforms mainly focused on changes to help reduce Indonesia's investment barriers with the aim to help create an atmosphere where foreign investment was welcome. The three recent major pillars of the post-crisis reform are: the introduction of several trade facilitation measures, and the reform of the infrastructure policy reform and the financial sector policies. Moreover, the introduction of new investment laws in 2007 also improved the transparency of Indonesia's legal system. In addition to this, the new law closed the gap between treatment of domestic and foreign investment. Moreover, in order to rationalize the country's trade-related procedures, the Indonesian Government committed to consolidating its major ports dealing with international trade, as well as introducing a single window for customs procedures so as to accelerate the flow of goods.¹²⁹ The result of these efforts is said to be satisfactory. Today, Indonesia is considered to have fully recovered from the 1997 financial crisis and become more stable, democratic and resilient to both internal and external changes.¹³⁰ With regards to foreign investment, Indonesia has enjoyed an increased flow of foreign funds into such sectors as petrochemicals, chemicals, textiles, and pulp and paper.¹³¹

However, despite all these positive achievements, an OECD report pointed out that Indonesia's economy was currently still facing several significant challenges, including the strict foreign ownership constraint, sharp currency depreciation, a strong rise in global oil prices, high unemployment and a continuous increase in inflation and interest rates.¹³² The foreign ownership constraint in selected industries, especially technology-intensive industries, became one of the biggest impediments to the development of foreign investment, and also reduced the quality of FDI.¹³³ Its high unemployment rate is partly because investment in Indonesia did not spread evenly across sectors. Unlike other developing countries that tend to have investment concentrated on labour-intensive industries, the majority of both domestic and foreign investment in Indonesia tends to be focused on capital-intensive sectors coupled with a strong annual growth rate since 2000. With such a slow growth in labour-intensive

¹²⁸ *Overview on Indonesia's Economy 2008* (2008) State of Israel Ministry of Industry, Trade and Labor <
<http://www.israeltrade.gov.il/NR/rdonlyres/20FBD328-33ED-45C7-8097-92EDFBAA30A8/0/OverviewonIndonesianEconomy2008.pdf>> at 15 May 2009.

¹²⁹ Molnar and Leshner, above n 127, 337

¹³⁰ *Overview on Indonesia's Economy 2008*, above n 128.

¹³¹ Ibid.

¹³² Molnar and Leshner, above n 127, 333-64.

¹³³ *Indonesia: Economic Assessment*, OECD Economic Surveys (2008) 17, 78.

sectors as well as a strong population growth, the unemployment rate in 2006 was twice that of 1997.¹³⁴

Overall, given all the challenges that Indonesia faces and the severity of the financial crisis there, its overall trade performance, although not as strong as either China or Singapore, is still very impressive. In fact, the uneven investment across different sectors in Indonesia helps the local government see which areas it can work on to enhance the external competitiveness.

3.3.2 Indonesian FDI Development Overview

FDI in Indonesia has several important characteristics. With its relatively larger size, the majority of FDI in Indonesia is concentrated on capital-intensive sectors with a heavy investment on R&D activities and advertising. It also has a higher level of exports intensity and, more importantly, higher wages and higher value added per worker.¹³⁵

FDI has started to flow into Indonesia since the publication of its first foreign investment law in 1967. Prior to 1966, foreign investments were strongly opposed and restricted under the Sukarno Government, which resulted in several FIEs been taken over during the early 1960s.¹³⁶ In 1996, with the change of government, solving the serious economic problems of the country became top of the agenda. During that period, Indonesia relied heavily on foreign aid from Western countries so as to rehabilitate its obsolete infrastructure. At the same time, the new government also realized the importance of FDI to help develop the country's vast natural resources, as well as the embryonic manufacturing sectors.¹³⁷ It was with such an understanding that, in 1967, the new government published the first Foreign Investment Law (Law 1967). Under this law, an open-door policy was introduced to encourage foreign investments for a brief period of time. Various favorable incentives were also granted to

¹³⁴ Molnar and Leshner, above n 127, 334.

It was noticed that the unemployment rate in 2006 was 10.3% while the unemployment rate in 1997 was only 4.8%

¹³⁵ Mohamad Ikhsan, 'FDI and Tax Incentives in Indonesia' (Paper presented at the International Symposium on FDI and Corporate Taxation: Experience of Asian Countries and Issues in the Global Economy, Japan, 17 and 18 February 2006).

¹³⁶ Thee Kian Wie, 'Industrial and Foreign investment Policy in Indonesia Since 1967' (1987) 25(3) *Southeast Asian Studies* 83, 83-96.

¹³⁷ Ibid

attract foreign investments.¹³⁸ However, this welcome atmosphere for investment was ended by the so-called ‘Malari affair’ in 1974, which then led to tight investment policies towards foreign investments.¹³⁹ These intense foreign investment policies dominated Indonesia until 1980s. Due to the international recession with the attendant weakening of the world oil market, in 1982 the Indonesian Government proposed relaxing some restrictive measures to control foreign investments in place since the 1970s so as to improve the country’s investment climate.¹⁴⁰ Compared with the ‘open-door policy’ introduced in 1967, which aimed at a fundamental turnaround in Indonesian foreign investment policies, the 1980s reform of foreign investment policy was more to do with the adverse economic conditions.¹⁴¹ Since the late 1980s, the reforms have significantly improved the investment climate in Indonesia and, accordingly, increased the amount of FDI inflow.¹⁴² While control over FDI operations and screening are relatively relaxed compared with other countries, Indonesia’s FDI regime does have specific requirements on equity-percentage holdings for each foreign investment. In particular, the regime set up very strict equity-holdings caps on transportation sectors, including maritime, air, and surface transport, as well as telecommunication sectors, mainly with respect to the provision of fixed-line services.¹⁴³

There is no doubt that FDI played an important role in promoting the modern economic development in Indonesia despite the fact that the FDI share in total GDP was relatively low.¹⁴⁴ It is therefore in the Indonesian Government’s interests to attract and stimulate a high level of FDI so as to enable the long-term sustainable development of Indonesia’s economy.

3.3.3 The Development of Tax Incentive Policies to Attract FDI

It is said that Indonesia has been more open to offering tax incentives to encourage Foreign Investment since the publication of the Investment Law No.1 of 1967 (Law No.1). The law

¹³⁸ Wie, above n 136.

¹³⁹ The ‘Malari affair’ in January 1974 was against the perceived ‘over-presence’ of Japanese investment in Indonesia.

¹⁴⁰ Wie, above n 136.

¹⁴¹ Ibid.

¹⁴² Thee Kian Wie, ‘Policies for Private Sector Development in Indonesia’ (Discussion paper No 46, ADB Institute, 2006).

¹⁴³ OECD above n 133, 66.

¹⁴⁴ Ikhsan, above n 135.

granted the Indonesian Government authority to determine which operating areas were open for foreign investments. Law 1967 required determination to be made in accordance with national and regional economic developments. Article 6 and 7 of Law No.1 also identified fields of activity closed to foreign investments.¹⁴⁵ At the time as Law No.1 was published, the CIT rate in Indonesia was as high as 60% under the 1925 Company Tax Ordinance. Law No.1 exempted foreign investors from CIT for a period up to five years as well as from dividend tax on profits accrued within the five-year period.¹⁴⁶ On the expiry of tax holidays, a concessionary tax rate might be granted to foreign investors for an extra five years.¹⁴⁷ In addition, Law No.1 also provided exemption on import duties and capital stamp duties, allowing losses to be carried forward for a certain period as well as accelerated depreciation on fixed assets. Law No.1 was subsequently modified by Law No.11 of 1970 (Law No.11) three years later. Unlike Law 1, where a tax holiday was granted to foreign investors automatically as long as they fell into the priority criteria, Law No.11 set out clearer criteria for FIE tax holidays, and any eligible firms would be entitled to a total of six years tax holiday. Aside from offering different special tax incentives, the Indonesian Government also committed to reducing the CIT rates and negotiating tax treaties with other countries over the years. By the early 1980s, the CIT rate in Indonesia had already fallen to 45% and various treaties were signed between the Indonesian Government and other countries to avoid double taxation and lower dividend withholding taxes.¹⁴⁸ The other phenomenon in Indonesia at that time was that Indonesia had successfully attracted several named MNEs to invest there. Therefore, the need to attract firms as role models had disappeared and the Government decided there was no need to offer tax holidays as a means to attract foreign investments.¹⁴⁹ The Government proposed a further reduction of the CIT rate to 35% with no tax holiday offered. This decision was made based on various empirical studies carried out in Indonesia

¹⁴⁵ Under Article 6 of the Law 1967, harbours, production, transmission and distribution of electric power for the public, shipping, telecommunications, aviation, drinking water, public railways, development of atomic energy and mass media were closed to foreign investment, as those areas are important to Indonesia and many people. It also states that industries performing a vital function in national defence, among others, the production of arms, ammunition, explosive and war equipment are absolutely prohibited to accept foreign investment.

¹⁴⁶ Article 15, Law No.1 of 1967.

¹⁴⁷ The tax rate can be reduced up to 50% under Article 15 (b) (1) of the No.1 Law 1967.

¹⁴⁸ Louis T. Wells and Nancy J. Allen, 'Tax holidays to attract foreign direct investment: Lessons from two experiments' (Occasional Paper 15, FIAS, 2001) 8.

¹⁴⁹ Wells and Allen, above n 148, 8.

and elsewhere, which showed that tax incentives played a relatively minor role in influencing the investment decision-making of MNEs. In addition, research carried out in Indonesia revealed that a 45% CIT rate with a tax holiday had a similar effect on an investor's internal rate of return as a 35% CIT rate without a tax holiday.¹⁵⁰ Moreover, by taking into account all potential costs of providing tax incentives, the Indonesian Government decided in 1984 to drop tax holidays while leaving other incentives available to foreign investors.

The 2007 Law No.25 (Law 2007) was published to replace the unified Law 1967 which had governed foreign investment and Law 1968 had governed domestic investment. The new investment law not only improved Indonesia's legal framework for foreign investment, but also ensured equal legal status and treatment of both foreign and domestic investors. Nearly all sectors are open for foreign investment unless explicitly listed in Law 2007 as protected. Sectors may be closed or opened with restrictions if stated in Law 2007 as protected. Generally speaking, any sector considered strategically important for small and medium-sized enterprises (SMEs) is protected and closed to foreign investment. Other protected activities, although not completely closed to foreign investment, will normally be subject to one or a few restricted criteria.¹⁵¹ In terms of tax incentives, tax breaks are available for projects that can generate employment, promote infrastructure and technological development, as well as develop rural areas and pioneer industries, in Law 2007. In addition, the new investment law provides various special tax incentives, including tax holidays, in order to encourage investment to support the Indonesian economy and long-term sustainable development.¹⁵²

4. Methodology

The research is designed using a qualitative data analysis with a comparative approach. Various tax incentives will be analyzed on a general basis and compared across three selected countries: Singapore, Indonesia and China respectively. The research will be conducted within six months, and such a time constraint means that it is impossible to conduct a longitudinal study, which generally requires a few years of field studies. Other than the time constraints, there are several other internal and external constraints, namely, practical

¹⁵⁰ Wells and Allen, above n 148, 8.

¹⁵¹ OECD above n 133, 65.

¹⁵² Ibid.

constraints, political constraints as well as legal constraints.¹⁵³ Generally speaking, different countries tend to have different tax-incentives systems, and the introduction of each incentive normally involves numerous political concerns.¹⁵⁴ For example, internally speaking, revenue constraints can be an important issue. Such constraints occur because tax incentives cost money in terms of revenue forgone. But, understandably due to the negative political impact, governments introducing tax incentives will not admit revenue losses as a result of tax incentives. The above example suggests that the data collected can be potentially biased and might not present the real findings. This is particularly true with regards to China and Indonesia.

Various documents will be used as sources of data. These will include public documents, government discussions, organizational documents, as well as some media outputs. Data will be collected through a comprehensive literature review. It is important to note that the quality of some government discussion papers might not be of a high standard. This could be because there were not many formal government discussions in regard to tax incentives and most only focused on the benefits of having tax incentives. Secondly, in terms of organizational documents, the likely obstacles for the research can be that some documents tend to be very sensitive and must be kept confidential. For example, companies that used tax incentives as a way to gain tax benefits will be reluctant to allow researchers access to their internal organizational documents; and if they did the reliability of such information can be expected to be poor.

5. FDI Data Analysis

5.1 Singapore

The data adopted for current research was obtained from the Singapore Ministry of Trade and Industry, Department of Statistics' *Foreign Equity Investment in Singapore 2006* Report (Report 2006). It provides very comprehensive information regarding Singapore's FDI inflow between 2002 and 2006. Information was presented in a very systematic way, which facilitates the research being carried out. In addition, the data was believed to be one the most reliable among all three selected countries and were constantly adopted by various world

¹⁵³ Easson, above n 2, 3.

¹⁵⁴ Mukul G. Asher and Ramkishen S. Rajan, 'Globalization and Tax Systems: Implications for Developing Countries with Particular Reference to Southeast Asia' (Discussion Paper No 99/23, CIES, 1999) 3.

institutes, such as OECD, United Nations Conference on Trade and Development (UNCTAD), to carry out a range of analyses.

Three sectors were chosen from Report 2006. These are manufacturing, wholesale & retail trade and restaurant & hotel, and Financial and insurance services. They were chosen because Singapore FDI inflows between 2002 and 2006 were concentrated on these three sectors with an average investment in these sectors of up to 87% of the total annual FDI inflow (See table 1). Among these three sectors, both the manufacturing sectors and the financial and insurance services sectors have a similar share of the total annual FDI inflow – an average of 34% and 36% respectively. The share of FDI inflow in the wholesale & retail sectors and the hotel and restaurant sectors did not vary between 2002 and 2006, with an average of 17% over five years. Moreover, from table 1, it can be seen that from 2002 onwards, total FDI inflow in the manufacturing sector and the financial and insurance service sectors increased steadily but at a different pace. On one side, foreign investment in the financial and insurance service sectors started to accelerate from 2003. On the other hand, foreign investment in the manufacturing sector tends to slow down during the same period. Table 1 shows that, between 2002 and 2003, the level of FDI inflow in the manufacturing sector was higher than that of the financial and insurance services. The FDI composition changed after 2003, with more and more FDI flowing into the financial and insurance services sectors.¹⁵⁵

With respect to the manufacturing sector, FDI inflows concentrated on three areas: petroleum and petroleum products, pharmaceutical and biological products, and electronic products and components (Table 2). Among these three sectors, pharmaceutical and biological products absorbed most of the total FDI inflow in the manufacturing sector (33%). However, the pace of growth in this particular industry cannot be described as very steady. Beginning with an impressive 25% increase from 2002 to 2003, FDI inflow in pharmaceutical and biological products only increased 8% between 2003 and 2004 and by the end of 2006, the annual change of FDI inflow level experienced a negative growth (-1%).

Secondly, to break down the total FDI inflow in the wholesale and retail trade sectors and hotels and restaurants, it is noted that FDI concentrated on wholesale trade with an average of 92% between 2002 and 2006 (Table 3). Moreover, while wholesale trade experienced a

¹⁵⁵ There was an average 14% increase in the financial and insurance services with an average increase of only 6% in the manufacturing sector between 2002 and 2006. Moreover, the total increase in FDI in both sectors between 2002 and 2006 was 23% for manufacturing and 44% for financial & insurance services.

steady growth rate in the last five years, retail trade seemed to suffer with FDI inflow in the retail trade sector in 2003 was roughly 96% less than in the previous year. Finally, with regard to the financial and insurance services sectors, the most popular foreign investment form is providing financial services through investment holding companies (Table 4).¹⁵⁶ From 2002, FDI in such industries increased 46% to \$114 million by the end of 2006.

Such a trend is interesting and to understand it thoroughly, it is necessary to bring the relative policy in line with reading such data. As mentioned above, from 1985 onwards, growth in the manufacturing sector began to slow and was caught by other sectors such as the financial and insurance sectors. Between 2002 and 2006, the average growth rate in the manufacturing sector was 6%, while the total FDI across the country was growing at about 11% annually, which, to some extent was the result of an impressive performance by the financial and insurance service sectors.¹⁵⁷ To break down the total investment in financial and insurance services sectors, it is interesting to note that foreign investors tend to invest heavily in Singapore in the form of investment holding companies. Table 4 shows that between 2002 and 2006, FDI in the form of investment holding companies takes the biggest share of total investment in the financial and insurance sectors, amounting to an average of 86% annually. Since 1985, the Singapore Government has been committed to diversifying the economy. Not only did it try to exploit new sectors in order to maintain a high and improved performance in the manufacturing sector, it also aimed to encourage investment in financial and insurance services. In fact, ever since the establishment of the Bank of America's Asian currency unit in Singapore in 1968, the Singapore Government has developed various policies to encourage investment in financial sectors so as to turn Singapore into a major international financial centre and a centre for Asian dollar market.¹⁵⁸ Among all those policies, tax incentives have inevitably been used as an important fiscal policy to help attract FDI in the financial and insurance sectors.

For example, in 2005 many of the financial services in Singapore were either exempted from taxes or taxed at a concessionary rate. In Singapore's 2005 tax incentives packages, qualified financial activities were granted either financial sector incentives (FSI) or finance and

¹⁵⁶ FDI inflow in financial services – Investment holding company makes up 82% of total FDI inflow into financial and insurance sectors.

¹⁵⁷ The financial and insurance sector annual growth rate between 2002 and 2006 was 14%.

¹⁵⁸ Carling, above n 69, 20-7.

treasury centre incentives (FTC). Either of the two incentive regimes granted a qualified FDI concessionary tax rate of 5% or 10% for periods up to 10 years.¹⁵⁹ In its 2008 budget, the policy allowed family-owned investment holding companies to be exempted from tax similar to those offered to individuals in the same period. In addition, under the 2008 FDI regime, qualified listed insurance companies can elect to be taxed at a concessionary tax rate of 10% on the income they derive from offering insurance broking and advisory services to offshore clients.¹⁶⁰ Such policies was believed to influence the decisions of foreign investors to some extent. As can be seen from Table 4, an enormous amount of foreign capital flowed into financial sectors between 2002 and 2006.

Moreover, within the total FDI inflow, 82% of it concentrated on financial services provided in the form of investment holding companies. However, only 17% of foreign capital was invested in banks and other financial services sectors. Such a disparity might be explained by the distinguishing features of these three types of investments. When making decisions to invest overseas, factors such as location, market and economic conditions are more important than the availability of tax incentives. Despite its leading position in Southeast Asia as an international financial centre, the lack of natural resources and the country's relatively small domestic market limited, to some extent, the potential benefits foreign investors could exploit. For example, a comprehensive risk assessment is essential to successfully running an insurance business. In addition, large and diversified population bases as well as a mature and developed economic system are also required for an insurance business to grow long term. Assuming that both China and Singapore have the same economic and social standard, it is not very difficult to predict that an insurance investment in China will make much higher returns than one in Singapore.

On the other hand, economic conditions might be a more decisive factor if the population and tax bases, as well as location are similar in the selected countries. Under such circumstances, the one with an advanced economy will probably be selected to carry out insurance business. From the above two assumptions, it can be said that, in regard to the insurance industry, tax incentives are not an important factor for a foreign investor when deciding which country to

¹⁵⁹ *2008 Singapore Tax Facts and Figures*, above n 92, 38-49.

¹⁶⁰ Rikvin Consultancy Pte Ltd, 'Singapore Budget 2008 - Key Corporate Tax Reliefs at a Glance' (Press Release, 15 February 2008) <<http://www.prlog.org/10051478-singapore-budget-2008-key-corporate-tax-reliefs-at-glance.html>> at 18 June 2009.

invest in. However, if the proposed investment involves setting up a holding company, tax incentives will then become an important criteria. In many cases, holding companies are set up to gain control over several other companies with minimum investment. Setting up a holding company in one country is always coupled with objectives to pay little or no tax on income earned in that country.¹⁶¹ Investors are happy as long as the amount of tax payable in a country where the holding companies were set up is less than the amount of tax saved in the host country or the home country, or both.¹⁶² Also, where there is a tax agreement between countries, the availability of tax incentives can be more effective.

5.2 China

The FDI inflow statistics came from the Foreign Investment Department of the Ministry of Commerce (MOFCOM) and were selected to cover the period from 2002 onward. Given the complexity and diversity of China's economy and social norms, a study of the correlation between the FDI-inflow composition and tax incentive policies enacted since the launch of the open-door policy can be unique and beneficial. It is clear that the internal and external economic structure of China changed dramatically with the inflow of FDI.¹⁶³ However, it is important to understand that a substantial amount of FDI inflow might relate to round-tripping activities.

In general, since the initiation of the open-door policy in 1979, the amount of FDI received by China has increased over the years in terms of both the number of projects and the amount of capital value invested (Table 5). When the open-door policy was first introduced, the amount of FDI inflow was very low, and the annual growth rate was very slow. Less than 2000 FDI inflow projects were begun between 1979 and 1983, and most of them were located in the newly established four SEZs. In 1984, with the establishment of 14 OCCs, FDI in China experienced its first acceleration. In 1984 alone, over 2000 FDI projects were attracted with a total realized value of US\$14 billion. The growth pace in terms of FDI inflow between 1984 and 1990 was said to be encouraging while steady. From 1991 to 1993, FDI in China enjoyed unprecedented growth in terms of both the number of FDI inflow projects and the realized value. The amount of FDI inflow increased from less than 10,000 projects a year to

¹⁶¹ Easson, above n 2, 51.

¹⁶² Ibid.

¹⁶³ OECD, 'Main Determinants and Impacts of Foreign Direct Investment on China's Economy' (Working Paper No 4, OECD, 2000) 3.

nearly 80,000 projects, together with an overall US\$270 billion realized value. However, after this unprecedented growth, both FDI project numbers and capital value started to decrease in 1994. This downturn continued until 2000. In 2002, with the joining of WTO, China successfully maintained its growth in FDI inflow while the world was experiencing an economic recession. Today, China has become the world's second largest FDI destination. However, the accuracy and validity of its FDI inflow figures are subject to constant questions. Between 1983 and 2002, over 40% of the total FDI inflows were originated from China with more than US\$375 billion contracted FDI flowed from Hong Kong.¹⁶⁴ Such phenomenon raised the question of to what extent FDI from Hong Kong was, in fact, a round-tripping activity. In fact, according to the World Bank 2002 report, round tripping accounted for nearly 30% of total FDI inflows into China.¹⁶⁵ However, since this study focuses on how tax incentives may affect the composition of FDI, such round-tripping activities will not be taken into account.

The Chinese Government classified FDI into four categories: encouraged, permitted, restricted and prohibited.¹⁶⁶ Foreign investments engaged in high-technology industries are always subject to favourable taxes policies. For example, in general, they might be exempt from tariffs and import VAT when they import equipment counted as part of their total investment and involving technology transfer. In addition, foreign investment engaged in energy, transportation and urban infrastructure facilities, construction and operations are also encouraged by the Chinese Government, with preferential tax incentives granted.¹⁶⁷

According to the Provisions on Guiding Foreign Investment, encouraged foreign investment projects can be classified in five main categories. Firstly, those engaged in new agriculture technology, energy, transportation and key raw-material industries. Secondly, projects involving new technologies that can subsequently improve the performance of existing products, and the economic efficiency of existing enterprises were also encouraged. Thirdly, foreign investments that meet market demand and help promote product quality to enhance

¹⁶⁴ Busakorn Chantasawat, K.C. Fung, Hitomi Iizaka and Alan Siu, 'Foreign direct investment in East Asia and Latin America: Is there a People's Republic of China Effect?' (Research Paper 66, ADB Institute, 2004) 8 <<http://www.adbi.org/discussion-paper/2004/11/16/810.fdi.prc.effect/>> at 12 May 2009.

¹⁶⁵ Chantasawat et al, above n 164, 8.

¹⁶⁶ Investment promotion agency of Ministry of Commerce, P.R.China. *I am China-invest in China serials*. (2007) 176.

¹⁶⁷ Ibid 165.

China's competitiveness in the international market are recognized as encouraged investments. Fourthly, environmental foreign investments or investments that adopt new technology and equipment so as to better utilize resources will be encouraged. Finally, the Chinese Government also encourages foreign investments located in Mid-West China that are in line with national industrial policies.¹⁶⁸

Both Table 6 and 7 show that manufacturing industry has always been the leader in attracting FDI inflows, at an average of 70%. This is because tax incentives in China have been traditionally been offered to production-oriented enterprises.¹⁶⁹ However, nearly half of that FDI has been directed towards labour-intensive industries with the rest split evenly among technology-intensive and capital-intensive sectors. This FDI sector distribution might suggest that, compared with the availability of preferential tax policies, China's low labour cost is a more important determinant in attracting foreign investments.¹⁷⁰ Investment project number around financial intermediation was very limited which was not over 1% of the total FDI in China. However, the amount of foreign capital concentrated in this sector was significant compared with the number of FDI projects invested. By 2005 alone, over US\$12 billion FDI flew into the Finance sector (Table 7). With regards to wholesale and retail trade, although varied over the years, it reached its highest level of 11.25% in 2006. There were moderate increases in real estate as well as leasing and business services over the years. The percentage investment in leasing and business services stayed around 10% to 11% between 2000 and 2003.

Within the manufacturing industry, electronic and telecommunication equipment manufacturing makes up the biggest share at an average of around 10% each year. A 2003 report by The Ministry of Foreign Trade and Economic Cooperation (MOFTEC) pointed out that the electronic manufacturing industry was the biggest domestic industry utilizing foreign capital, with Motorola (China) Electronics Ltd as the leading foreign investor in China whose annual sales reached US\$6.5million.¹⁷¹ Bearing this figure in mind and looking back at

¹⁶⁸ Ibid 177.

¹⁶⁹ Qingsong Wang, *China Introduces Tax Incentives for Venture Capital Investment in High-tech Sector*, (2007) Orrick <<http://www.orrick.com/fileupload/1164.pdf>> at 20 May 2009.

¹⁷⁰ OECD, above n 163.

¹⁷¹ MOFTEC, *The Survey of Foreign Investment in China's Electronic Telecommunication Industry of 2003*, (2004) Invest in China <http://www.fdi.gov.cn/pub/FDI_EN/Economy/Sectors/Manufacturing/Electronics/t20060422_25184.htm> at 20 May 2009.

China's tax incentive policies, the electronic and communication industry is classified as a priority industry in the Foreign Investment Catalogue and can enjoy preferential tax treatment such as tax holidays. Such preferential tax regime might explain why the electronic and telecommunication industry attracted a large amount of FDI.¹⁷²

In the finance and real estate area, although the number of FDI projects invested each year accounted for only a small portion of the total FDI projects begun, the amount of foreign capital involved in these two areas is said to be enormous. In 2006, despite the fact that only 2,462 approved foreign projects were involved in these two areas (64 in finance and 2,398 in real estate) the capital invested in the finance and real estate areas was US\$6.7 billion and US\$8.2 billion respectively. Prior to China joining the WTO, the finance sector was very poor at attracting FDI, and the amount of FDI inflow into the financial sector only accounted for US\$86 million in 2001. In 2002 alone, the amount increased to US\$460 million, five times more than the amount attracted in 2001. Over the years, the amount of FDI inflow into the finance sector grew continuously, and by 2007 it reached US\$9 billion. The finance sector is one of the 40 service areas in which the Chinese Government decided to reformulate laws and regulation so as to honour its WTO commitments.¹⁷³

Moreover, it is interesting to note that agriculture was also one of the areas the Chinese Government tried to promote. However, the total FDI in this area was very small – an average of around US\$1.5 billion from 2002 to 2007.

At the moment, 2008 FDI data is unavailable but it will be interesting to see how the new CIT law affects each industry. For example, in terms of the finance area, a unified tax rate of 20% will apply to financial institutions. This is 5% lower than the tax rate under the old law.

¹⁷² Economist Intelligence Unit, *Country Commerce. China* (2008).

<<http://search.ebscohost.com.ezproxy.aut.ac.nz/login.aspx?direct=true&db=bth&AN=31654943&site=ehost-live>> at 20 May 2009

¹⁷³ Investment promotion agency of Ministry of Commerce, P.R.China, above n 166, 200.

As a member of the WTO, China will be obliged to liberalize limits on the introduction of foreign capital, that is, to gradually broaden investment fields and regions to commercial and foreign trade, finance, insurance, security, telegraphy, and tourism.

5.3 Indonesia

Unlike Singapore and China, for confidentiality reasons, systematically organized and comprehensive Indonesian sectoral FDI data are hard to obtain. The lack of data, to some extent, prevents a more comprehensive and reliable FDI composition analysis from being carried out. The data used to carry out this research were obtained from the Indonesian Investment Coordinating Board (BKPM), whose reliability and comprehensiveness was however doubted by many analyzers because only investments that go through BKPM channels are counted.¹⁷⁴

Generally speaking, from 1990 to 2008, despite a slight drop, Indonesia's FDI realization in terms of project numbers and project values tended to increase over the years (Table 8). Compared with the number of FDI projects realized in 1990, the number of FDI projects in 2008 increased tenfold. Similarly, project values, were 20 times more than the total FDI inflows in 1990. From table 8, it can be seen that between 1990 and 2008, Indonesia experienced four big drops in its total FDI inflow values. The first happened in 1994 where the FDI project values dropped 33% from US\$5.6 billion to US\$3.7 billion. Interestingly, the number of FDI projects realized in that year by the Indonesia Government doubled, increasing from 183 to 392. The following decline in FDI inflow happened a year later and continued until 1997. Such a decline can be partly explained by the 1997 Asian economic crisis which caused a cross-boarder decline in FDI inflows over south-east Asia. The biggest drop happened in 2001 when the number of FDI projects realized in that year dropped 29%, and the amount of realized FDI project value was 64% less than the previous year. Such a decline, however, spread nearly all over the world. According to one of the United Nations Conference on Trade and Development (UNCTAD) reports, FDI inflow in 2001 in developing Asia dropped US\$19 billion, from US\$144 billion in 2000 to US\$125 billion in 2001.¹⁷⁵ It is well recognised that the September 11 terrorist attack definitely contributed to the sharp decline. The other reason was the continued divestments in Indonesia whose FDI

¹⁷⁴ Patung, *2006 FDI*, (2007) Indonesia Matters <<http://www.indonesiamatters.com/1066/2006-fdi/>> at 13 June 2009.

¹⁷⁵ UNCTAD, 'FDI Downturn in 2001 Touches Almost All Regions' (Press Release TAD/INF/PR/36, 21 January 2002). < <http://www.unctad.org/Templates/webflyer.asp?docid=2470&intItemID=2079&lang=1>> at 13 June 2009.

inflow in 2002 only reached \$3 billion.¹⁷⁶ The recent FDI recession happened in 2006 where the realized FDI inflow in this year fell 33% from the previous year's \$8.9 billion to the current year's \$5.9 billion. At the same time, the number of approved FDI projects also dropped from 907 in 2005 to 869 in 2006. According to both UNCTAD and the Central Bank, such deterioration of Indonesia's FDI levels also strongly affected its world FDI ranking, which dropped from 26th to 42nd within a year.¹⁷⁷ Without further explanation of the drop in the FDI level by the Indonesian Government, it was no doubt that there was a need to reform the country's business regulation framework and improve the investment environment and political stability.

When to break the picture down into sectors, it is interesting to note that, unlike domestic investments, which predominantly focused on labour-intensive activities, FDI is concentrated on more capital-intensive activities. Table 9 and 10 show that the majority of FDI in Indonesia concentrated on secondary and tertiary sectors. Sectors such as large plantations, chemicals and pharmaceuticals, as well as the automotive industry attracted the majority of FDI, with significant levels invested in transportation, communications, warehousing, storage and construction.¹⁷⁸

Foreign investments in the primary sector were insignificant compared to the other two sectors. From 2005 to 2008, total FDI in the primary sector each year never exceeded 10% of that year's total FDI, both in the number of projects and the value of the projects (Table 9 and 10).

Within the secondary sector, the top three industries that attract most of the FDI inflows were the metal, machine & electronics industry, the food industry, and the chemical and pharmaceutical industry. From 2005 to 2008, the level of FDI investment within the three industries fluctuated dramatically, especially in the chemical and pharmaceutical industry. In 2005, with only 12% of total approved FDI projects invested in this sector, the value of

¹⁷⁶ UNCTAD, 'Asia-Pacific FDI Inflows Down 24% Last Year, But Neared 1990s Peak' ((Press Release TAD/INF/PR/51, 17 September 2002). <<http://www.unctad.org/Templates/webflyer.asp?docid=2518&intItemID=2079&lang=1>> at 13 June 2009.

¹⁷⁷ *Investing in Indonesia*, (2008) Alibaba <<http://news.alibaba.com/article/detail/country-profiles%2523indonesia/100019530-1-indonesia-investing.html>> at 15 June 2009.

¹⁷⁸ Dominicus Supratikto, 'Country Note on Trade and Investment Policy Coordination Country: Indonesia' (Paper presented at the ARTNeT Consultative Meeting on Trade and Investment Policy Coordination, Bangkok, 16 and 17 July 2007). <http://www.unescap.org/tid/artnet/mtg/tipc_indonotes.pdf> at 15 June 2009.

investment took up more than 30% of the total realized FDI value, at US\$1.2 billion (Table 10). However, both the number of approved FDI projects as well as the inflow value declined in the following year. In particular, a nearly 77% drop in the FDI inflow value was said to be very dramatic. The total FDI inflow in the chemical and pharmacy industry in that year was therefore only US\$264 million, which only accounted for 7% of total FDI in the secondary sector. Surprisingly, such decline was changed in 2007, with the same number of FDI projects were approved, and the FDI inflow value in the chemical and pharmaceutical industry was eight times more than in the previous year, reaching the sky-high figure of US\$1.6 billion. It is interesting to note that investment in the chemical and pharmacy industry seems to follow a two-year cycle so it was no surprise that FDI in this industry followed a significant drop to only \$6.3million in 2008. According to BKPM, as a member of the Association of Southeast Asian Nations (ASEAN), the fact that ASEAN commitments that obligate all ASEAN member states to open their markets to prescription drugs and ASEAN-produced pharmaceutical products by 2008 helps to explain why this industry absorbed such a large amount of FDI inflow.¹⁷⁹ Interestingly, in BKPM's commentary on Indonesia's foreign investment, it did not mention the importance of using tax incentives to attract FDI. However, it is important to bear in mind that a recently introduced tax holiday regime did cover the chemicals and pharmaceuticals industry. Since Indonesia has been one of the few countries to stop offering tax holidays over the past few decades, the re-introduction of tax holidays might be an important factor in attracting FDI.

FDI in the tertiary sector concentrated on transport, storage and communication. In 2005, FDI inflow in this sector alone made up 59% of total FDI in the tertiary sector, and 33% of the total FDI in all three sectors. Despite a major setback in 2006 with only US\$647 million invested, in 2008 alone total amount of FDI in transport, storage and communication sectors accounted for 85% of total investment in the tertiary industry as well as 57% of the annual FDI inflow.

6. Correlation between Tax Incentives and FDI Composition

The empirical study of the three countries suggested some correlation between the availability of tax incentives and the composition of FDI. For the purposes of this study and

¹⁷⁹ *Indonesia: Trade and Investment Highlights* (2006) Embassy of the United States Jakarta <<http://www.usembassyjakarta.org/econ/Trade%20and%20Investment%20Highlights%20July%2006.pdf>> at June 16, 2009.

to build a better picture of any inherent correlation between the two components, three economic sectors (agriculture, manufacturing and finance) were chosen based on the above countries' individual FDI analysis. These sectors were singled out for two reasons. First, the above analysis revealed that recent years' FDI inflow was concentrated in one or all of the three sectors. Secondly, the three sectors are believed to be essential in developing and maintaining a long-term sustainable economy in any of the three countries.

Agriculture Sector

It was noted that, despite it being the backbone of every economy in the world, none of the three selected countries attracted a significant amount of FDI into the traditional agriculture sectors. According to the data obtained, regardless the availability of tax incentives, none of the countries' average FDI inflow in this particular sector exceeded 2% of the annual total FDI inflow. With regards to Singapore, its small territory area, lack of natural resources, and limited labour force, has meant that agriculture will never be a strong sector in Singapore's economy. In fact, as mentioned above, in order to overcome its labour shortage, the Singapore Government changed its economic policy to focus on technology and capital-intensive industries rather than labour-intensive industries. All these inherent shortages might well explain Singapore's weak performance in attracting FDI into the agricultural sector. However, none of these obstacles can be found in either China or Indonesia. Both countries are known for their large land area and population bases, as well as rich natural resources, all of which are all essential for the development of agricultural industries. Given the strategic importance of the agricultural sector in sustainable development, all three countries are more or less engaged in introducing different types of tax incentives with the hope of attracting quality FDI to improve the productivity of their agricultural industry. Disappointingly, the amount of FDI flowing into the agriculture sector did not increase significantly over the years but rather remained stable.

In conclusion, while the combination of different economic factors influences foreign investment decisions, the availability of tax incentives certainly cannot be the driving factor that helped to increase the FDI inflow in the agricultural sector.

Manufacturing Sector

From the analysis of these three countries, it is clear that all three absorbed a significant amount of FDI in the manufacturing sector. While the level of FDI flow into the

manufacturing sector stayed above other sectors in both Singapore and China, FDI flow into Indonesia's manufacturing sector ranked after its tertiary sector.¹⁸⁰

Electronic Industry

As the most attractive sector that FDI tends to flow into, it is important to note that the composition and average weighting of different industries within the manufacturing sector differed between the three selected countries. In Singapore, the majority of FDI concentrated on petroleum, pharmaceutical, biological and electronic products, which accounted for nearly 79% of the total investment in manufacturing. Similar to Singapore, a large amount of the FDI flowing into Indonesian manufacturing concentrated on chemical, pharmaceutical, machine and electronic industries. China absorbed a vast amount of FDI in the equipment, electronic and raw-material manufacturing industries. It is interesting to note that, despite differences in their economic and political environments, all three countries successfully attracted a large amount of FDI into the electronic-products industries. However, it is important to understand that while the electronics industry in Singapore is of a high-tech nature, those in both China and Indonesia are mainly low-tech and labour intensive. Despite this difference, all three countries engaged in providing different types of tax incentives to encourage FDI flow into their electronics industry. In Singapore, if an electronics company can prove itself to be either of pioneering nature or able to generate significant economic benefits for Singapore, tax exemption or reduced CIT will be available. Similarly in China, many qualified electronics companies were exempted from tax for a period of time or were taxed at a reduced rate. Over the past few years, China also set up several investment zones to encourage investment in the electronic industry. After some debate, Indonesia introduced tax concessions for electronics-related industries from 1997.¹⁸¹

While it is clear that other economic factors also influence investment decisions in the electronics industry, the positive correlation between tax incentives and they industry's FDI level cannot be ignored, and with more comprehensive studies in the future, such a link will become more obvious.

Pharmaceutical Industry

¹⁸⁰ When refer to the ranking of industry, it is important to put financial sector aside since FDI data collected in regard to Indonesia does not include financial sector.

¹⁸¹ Easson, above n 2, 97.

Data collected for this study suggested that the pharmaceutical industry may well be categorized as one of the strong FDI-led industries. It is noted that both Singapore and Indonesia absorbed vast amounts of FDI into the pharmaceutical industry between 2002 and 2006. China was the only non-ASEAN countries among the three and, as is mentioned above, members of the ASEAN were obliged to open their markets to both prescription drugs and ASEAN-produced pharmaceutical products by 2008. Such a commitment certainly sent a welcome signal to the rest of the world to invest in the pharmaceutical industries of any of the ASEAN countries. In addition, the nature of the pharmaceutical industry suggested the need for high and advanced technologies, and therefore most activities related to this industry might well be of a research and development (R&D) nature.

Both Singapore and Indonesia have been very actively engaged in R&D. This is especially the case in Singapore, where pharmaceuticals are the main source of foreign investment. Over the years, the Singapore Government has been eager to make Singapore the Asian hub of biomedical technology so as to attract foreign investment by industry heavyweights.¹⁸² With a sound economy, well-established infrastructure, highly educated labour force, and generous tax-incentive policies, Singapore has achieved great success in the pharmaceutical industry. In 2006, 37% of the total FDI flowing into the manufacturing sector came from pharmaceutical industries.¹⁸³

Despite the leading position of the pharmaceutical industry in absorbing FDI over the years, the type of investment attracted into Indonesian pharmaceutical industry was quite different from those in Singapore's. A large number of foreign pharmaceutical firms operating in Indonesia are of a retail nature. Instead of investing in Indonesia through the establishment or physical production facilities, the majority of them came there simply to take advantage of the market. Therefore, in Indonesia's case, the availability of R&D tax incentives might not be such an important factor in influencing the decision-making of foreign investors. In fact, in 2008, the Indonesian Government introduced new rules requiring foreign pharmaceutical investors to have local production facilities, and offering reduced CIT rates to qualified pharmaceutical enterprises. The purpose of this was to encourage technology transfer into Indonesia by those foreign enterprises with the hope of subsequently boosting investment to

¹⁸² Simon Green, *Singapore's Incentives to Attract Foreign Pharma Investment* (2007) Asia-Lifesciences < <http://www.asia-lifesciences.com/news-16-asia-pharmaceutical-bioplis-sars-news3.html>> at 18 July 2009.

¹⁸³ In Singapore, reduced CIT rates are available for foreign enterprises engaged in certain R&D activities. For start-up enterprises, cash grant of up to \$20k is allowed for the first few years' tax loss incurred.

create jobs.¹⁸⁴ The issuing of this new policy might explain the sudden drop in FDI levels in the pharmaceutical industry in 2008. In fact, with such policy in place, it will be interesting to see how foreign enterprises engaged in pharmaceutical activities react to such dramatic changes.

Unlike Singapore and Indonesia, as a result of its recent development China is known for being the world's biggest factory. The government has tried to shape the country into a world R&D base by issuing various tax incentives to encourage R&D activities in China. However, the lack of a mature infrastructure, knowledge base, and industrial policies, might reduce the effect the tax incentives to encourage the flow of FDI in any R&D-related industries, in this case, the pharmaceutical industry.¹⁸⁵

To sum up, while tax incentives might increase the FDI level in the pharmaceutical industry, other factors, such as a mature infrastructure, high education level and sound investment policies cannot be ignored.

Finance Sector

There is no doubt that a world-recognised finance centre is strategically important in enhancing a country's overall development. With the growing mobility of global capital-flow, a sufficient amount of foreign capital is one of the most important ingredients for building up an international finance centre.¹⁸⁶

Unlike the manufacturing sector, which has always been in a leading position of absorbing FDI inflow over the years, the level of FDI flowing into the finance sector only started to rise and accelerate from 2002 in both China and Singapore. It was understandable that both countries suffered from the 1997 economic crises and it took them several years to recover.

¹⁸⁴ Ed Silverman, *Indonesia To Pharma: Build A Factory Or Else* (2008) Pharnalot, <<http://www.pharnalot.com/2008/11/indonesia-to-pharma-build-a-factory-or-else/>> at 18 July 2009.

¹⁸⁵ PWC China Pharmaceutical Team, '*Investing in China's Pharmaceutical Industry – 2nd Edition*' (2009) PWC, <<http://www.pwc.com/extweb/industry.nsf/docid/EEF90CB5C1DFC3E28025758C0039EA1B>> at 18 July 2009. From 1st January 2008, any qualified high/new technology enterprises (HNTE) will be entitled to a reduced CIT rate of 15%. Tax holidays are also available for those newly established HNTEs if they located in one of the five SEZs. In addition, qualified pharmaceutical companies can also enjoy an extra 50% expenses deduction for eligible R&D costs.

¹⁸⁶ In finance sector analysis, Indonesia will not be taken into consideration as the information relates to Finance sector is not available from the data collected.

For China, joining the WTO in 2002 certainly helped increase the level of FDI flowing into the finance sector. As a WTO member, China started to free up its economic environment especially with regards to the finance sector. Today, China's banking, insurance and securities industries have begun to claim their share of the world's attention. By the end of 2008, China has successfully formed partnerships with many of the largest international banks, such as Citibank, HSBC and ING bank etc. Aside from opening up the market to foreign investors, there was no strong evidence of the Chinese Government's enthusiasm to offer tax incentives to the finance sector. Prior to the new 2008 CIT law, foreign financial institutions paid the same rate charged to domestic banks, that is 30% in general. Under the new 2008 CIT law, finance enterprises are subject to the ordinary 25% tax rate.¹⁸⁷ Moreover, the Chinese Government has the final say on the currency exchange rate, bank interest rates, and mortgage rates etc. Should the finance sector been very sensitive to tax incentives, it can be predicted that China will not be a popular destination for foreign financial institutions. However, as mentioned above, China achieved rather fascinating results since its admission to the WTO and leading consulting firm Booz Allen Hamilton predicted that China would become the world's third-largest financial market overall by 2015, behind Japan and the United States.¹⁸⁸

With regards to Singapore, from the above economic analysis, it was evidential that since 1974, the Singapore Government has been committed to encouraging the development of the finance industry by introducing various tax incentives. By focusing on Singapore's current finance industry, no doubt this country is a thriving international financial centre with a diversified financial sector that includes banking, the Asian dollar market, foreign exchange market and bond market etc.¹⁸⁹ Take the banking sector as an example; a wide range of financial services was offered under Singapore's banking system, and between 2002 and 2006, over US\$57 billion of FDI flowed into this sector. Moreover, the Singapore Government introduced very generous tax incentives to encourage the development of the finance sector and the availability of these generous tax incentives undoubtedly contributed to the rapid growth of the financial sector. However, there were suspicions about the extent to

¹⁸⁷ Economist Intelligence Unit, above n 172, 52.

¹⁸⁸ Andrew Caine, *The Path to Profit in China's Financial Sector* (2006) Booz Allen Hamilton, <http://www.boozallen.com/consulting-services/services_article/2406333>, at 18 July 09.

¹⁸⁹ Shane Lim, *The Banking and Finance Industry in Singapore* (2005) JobsCentral Community <<http://community.jobscentral.com.sg/node/466>> at 12 June 2009.

which tax incentives influenced the development of the finance sector. The fact that finance sector-related tax incentives have existed since the 1970s, while the FDI level flowing into the financial industry only started to accelerate from 2002 might suggest that, in the case of Singapore, while tax incentives might influence FDI flow into the finance sector, they are clearly not the most decisive factor.

Overall, it seems that while many countries – especially developing countries such as Singapore, Malaysia and India – sincerely believed the availability of tax incentives would help the development of the finance sector, evidence found during this study does not reveal a strong correlation between the two. In fact, in-depth analysis in the future may reveal that FDI in the finance sector is indifferent to the existence of tax incentives.

7. Conclusion

A number of interesting conclusions can be drawn from this study. This final section will identify some important findings, and suggest some areas for future research.

Firstly, tax incentive policies can be viewed as a double-sided coin with both costs and benefits embedded. Given the complexity of the real world, the overall costs of tax incentives still remain uncertain. However, for costs that have been identified, such as round-tripping, ver-valuations and anti-abusive policies etc, are needed to reduce the chance of this happening. Most importantly, those anti-abusive policies have to be designed and customised to each country's unique economic and politic environment. While this study focused on the correlation between tax incentives and FDI composition, it did not present an in-depth analysis on how to design sound ad-hoc anti-abusive policies to reduce the cost of implementing tax incentive policies. However, this is an area certainly worthy of exploration in the future with some close examination of the effectiveness of existed anti-abusive policies in the world.

The second direction concerns the need for an in-depth study of how tax incentives affect individual economic sectors. Such a study can be carried out within countries of similar or distinguished features. The current study chose to select countries with rather different and extreme political and economic environments. Singapore, on one hand, is a well-developed democratic country with a long history and successful track record of introducing tax incentives to attract FDI. China, on the other hand, is the largest communist country in the world and has a very short and unique experience in developing tax incentive policies to bring in foreign investments. Indonesia was selected on the grounds of its dramatic

experience in introducing tax incentives. Despite the continuous debates on tax incentives, this country was believed to never truly develop and implement tax incentive policies as a mean to attract FDI. By selecting these three countries, this study hoped to present a comprehensive view of the relationship between tax incentives and FDI composition. The results, although not very compelling, still revealed some important information. Firstly, high technology-related industries, such as electronic products and the pharmaceutical industry seemed more sensitive to the existence of tax incentives. Secondly, financial enterprises, while very mobile in nature, were not very affected by the existence of tax incentives. Based on the findings, it is suggested that future studies concentrate on one specific economic sector, for example, the finance sector, to obtain an in-depth and clear understanding of the correlation between tax incentives and FDI in a particular economic sector. It is believed that studies in those areas can also help to reduce the potential costs resulting from introducing tax incentives to attract FDI in the future.

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9. Appendix

9.1 Table 1 – Singapore FDI by sectors

	2002	% per 2002	2003	% per 2003	2004	% per 2004	2005	% per 2005	2006	% per 2006	Average
Manufacturing	84,146.40	37%	90,021.10	37%	95,234.90	34%	103,666.00	32%	108,852.20	30%	34%
Wholesale & Retail Trade, Hotels & Restaurants	37,907.70	16%	39,903.20	16%	45,808.30	17%	56,592.00	17%	66,090.10	18%	17%
Financial & Insurance Services	78,410.00	34%	86,430.20	35%	101,909.20	37%	121,659.30	38%	140,985.70	39%	36%
Total	230,149.10		246,185.40		276,819.20		323,821.10		363,935.00		87%

	2002	% Change	2003	% Change	2004	% Change	2005	% Change	2006	Average Increase	Total Increase
Manufacturing	84,146.40	7%	90,021.10	5%	95,234.90	8%	103,666.00	5%	108,852.20	6%	23%
Wholesale & Retail Trade, Hotels & Restaurants	37,907.70	5%	39,903.20	13%	45,808.30	19%	56,592.00	14%	66,090.10	13%	43%
Financial & Insurance Services	78,410.00	9%	86,430.20	15%	101,909.20	16%	121,659.30	14%	140,985.70	14%	44%
Total	230,149.10	7%	246,185.40	11%	276,819.20	15%	323,821.10	11%	363,935.00	11%	37%

Resources from: Singapore Department of Statistics

9.2 Table 2 – Singapore FDI by sectors - Manufacturing

Manufacturing	2002	% per 2002	2003	% per 2003	2004	% per 2004	2005	% per 2005	2006	% per 2006	Average
Petroleum & Petroleum Products	12,631.40	15%	13,636.90	15%	13,665.50	14%	13,937.80	13%	14,337.20	13%	14%
Pharmaceutical & Biological Products	21,991.20	26%	29,312.90	33%	31,864.90	33%	38,679.80	37%	38,334.60	35%	33%
Electronic Products & Components	30,879.50	37%	28,789.60	32%	29,041.00	30%	29,795.90	29%	32,347.80	30%	32%
Total Manufacturing	84,146.40		90,021.10		95,234.90		103,666.00		108,852.20		

Manufacturing	2002	% Change	2003	% Change	2004	% Change	2005	% Change	2006	Average Increase	Total Increase
Petroleum & Petroleum Products	12,631.40	7%	13,636.90	0%	13,665.50	2%	13,937.80	3%	14,337.20	3%	12%
Pharmaceutical & Biological Products	21,991.20	25%	29,312.90	8%	31,864.90	18%	38,679.80	-1%	38,334.60	12%	43%
Electronic Products & Components	30,879.50	-7%	28,789.60	1%	29,041.00	3%	29,795.90	8%	32,347.80	1%	5%
Total Manufacturing	84,146.40		90,021.10		95,234.90		103,666.00		108,852.20	5.3%	20%

Resources from: Singapore Department of Statistics

9.3 Table 3 – Singapore FDI by sectors - Wholesale & Retail Trade/Hotels & Restaurants

Wholesale & Retail Trade, Hotels & Restaurants	2002	% per 2002	2003	% per 2003	2004	% per 2004	2005	% per 2005	2006	% per 2006	Average
Wholesale Trade	33,854.70	89%	36,499.80	91%	42,305.30	92%	53,452.20	94%	61,773.30	93%	92%
Retail Trade	1,739.70	5%	887.90	2%	980.10	2%	1,095.90	2%	1,522.60	2%	3%
Restaurants & Hotel	2,313.40	6%	2,515.50	6%	2,522.90	6%	2,043.90	4%	2,794.30	4%	5%
Total Wholesale & Retail Trade, Hotel etc	37,907.70		39,903.20		45,808.30		56,592.00		66,090.10		

Wholesale & Retail Trade, Hotels & Restaurants	2002	% Change	2003	% Change	2004	% Change	2005	% Change	2006	Average Change	Total Change
Wholesale Trade	33,854.70	7%	36,499.80	14%	42,305.30	21%	53,452.20	21%	61,773.30	14%	45%
Retail Trade	1,739.70	-96%	887.90	9%	980.10	11%	1,095.90	28%	1,522.60	-12%	-14%
Restaurants & Hotel	2,313.40	8%	2,515.50	0%	2,522.90	-23%	2,043.90	27%	2,794.30	3%	17%
Total Wholesale & Retail Trade, Hotel etc	37,907.70		39,903.20		45,808.30		56,592.00		66,090.10	1.67%	16%

Resources from: Singapore Department of Statistics

9.4 Table 4 – Singapore FDI by sectors – Financial and Insurance Services

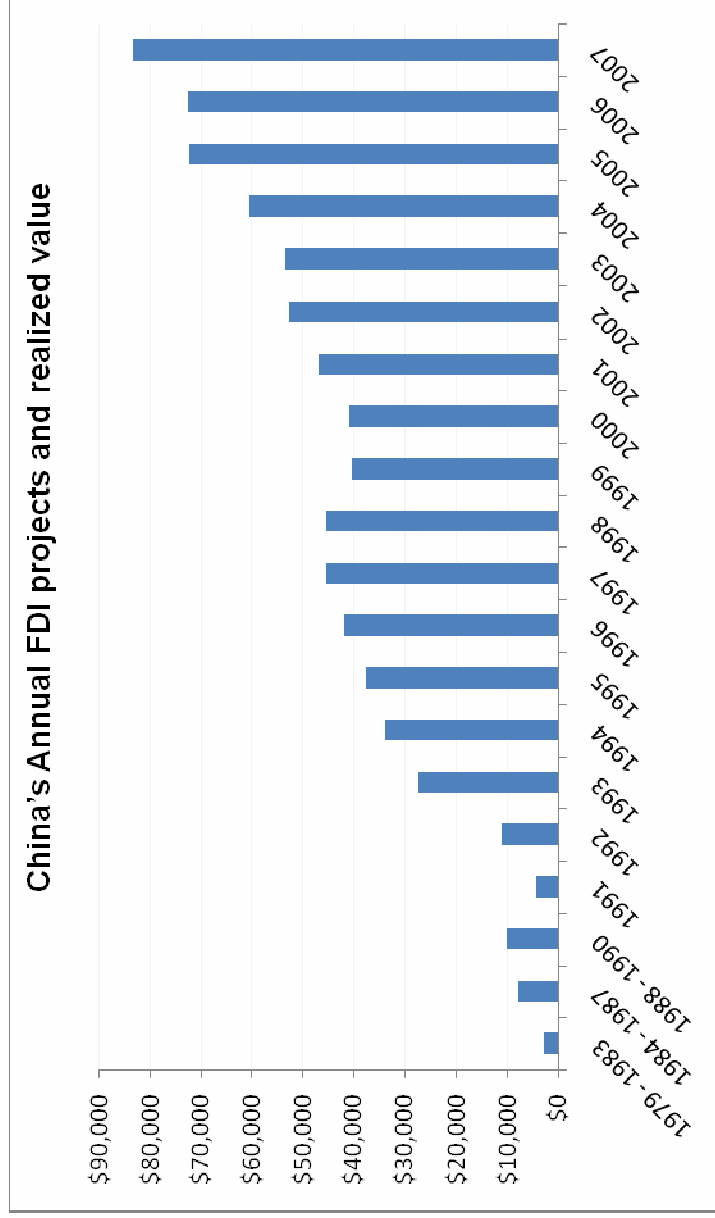
Financial & Insurance Services	2002	% per 2002	2003	% per 2003	2004	% per 2004	2005	% per 2005	2006	% per 2006	Average
Financial Services - Banks	8,393.90	11%	8,927.10	11%	8,844.80	9%	9,741.00	8%	9,902.80	7%	9%
Financial Services - Investment Holding Companies	61,550.60	81%	67,363.10	81%	79,917.50	82%	95,418.40	82%	114,867.50	86%	82%
Financial Services - Other Financial Service	5,631.00	7%	6,613.80	8%	9,181.50	9%	10,816.60	9%	9,236.80	7%	8%
Total Financial Services	<u>75,575.40</u>	96%	<u>82,904.00</u>	96%	<u>97,943.80</u>	96%	<u>115,975.90</u>	95%	<u>134,007.10</u>	95%	96%
Total Financial & Insurance Services	<u>78,410.00</u>		<u>86,430.20</u>		<u>101,909.20</u>		<u>121,659.30</u>		<u>140,985.70</u>		

Financial & Insurance Services	2002	% Change	2003	% Change	2004	% Change	2005	% Change	2006	Average Change	Total Change
Financial Services - Banks	8,393.90	6%	8,927.10	-1%	8,844.80	9%	9,741.00	2%	9,902.80	4%	15%
Financial Services - Investment Holding Companies	61,550.60	9%	67,363.10	16%	79,917.50	16%	95,418.40	17%	114,867.50	14%	46%
Financial Services - Other Financial Service	5,631.00	15%	6,613.80	28%	9,181.50	15%	10,816.60	-17%	9,236.80	10%	39%
Total Financial Services	<u>75,575.40</u>		<u>82,904.00</u>		<u>97,943.80</u>		<u>115,975.90</u>		<u>134,007.10</u>	13%	44%
Total Financial & Insurance Services	<u>78,410.00</u>		<u>86,430.20</u>		<u>101,909.20</u>		<u>121,659.30</u>		<u>140,985.70</u>		

Resources from: Singapore Department of Statistics

9.5 Table 5 – China’s Annual FDI projects and realized value

Year	No of Projects	Realized Value
1979 - 1983	1,558	\$ 2,685
1984 - 1987	8,970	\$ 7,933
1988 - 1990	18,997	\$ 10,074
1991	12,978	\$ 4,366
1992	48,764	\$ 11,008
1993	83,437	\$ 27,515
1994	47,549	\$ 33,767
1995	37,011	\$ 37,521
1996	24,556	\$ 41,726
1997	21,001	\$ 45,257
1998	19,799	\$ 45,463
1999	16,918	\$ 40,319
2000	22,347	\$ 40,715
2001	26,140	\$ 46,878
2002	34,171	\$ 52,743
2003	41,081	\$ 53,505
2004	43,664	\$ 60,630
2005	44,019	\$ 72,406
2006	41,496	\$ 72,715
2007	37,892	\$ 83,521
Grand Total	632,348	\$ 790,747



Source: MOFCOM FDI Statistics

9.6 Table 6 – China FDI Project number by Sectors (1996-2006)

China's FDI Project number by Sectors											
Sector	1996	1997	1998	1999	2000	2001	2002	2003	2004	2005	2006
Agriculture, Forestry, Animal Husbandry and Fishing	812	814	876	762	821	887	975	1,116	1,130	1,058	951
Manufacturing	17,981	14,716	13,477	12,042	15,988	19,106	24,930	29,307	30,386	28,928	24,790
Wholesale and Retail Trade	1,655	1,198	1,184	825	852	1,232	1,716	2,048	1,700	2,602	4,664
Financial Intermediation					5	8	17	23	43	58	64
Real Estate	855	862	834	669	684	820	1,316	1,553	1,767	2,120	2,398
Leasing and Business Services	1,025	1,257	1,634	1,474	2,679	2,673	3,418	458	2,661	2,981	2,885

China's FDI Project number by Sectors %											
Sector	1996	1997	1998	1999	2000	2001	2002	2003	2004	2005	2006
Agriculture, Forestry, Animal Husbandry and Fishing	3.31%	3.88%	4.42%	4.50%	3.67%	3.39%	2.85%	2.72%	2.59%	2.40%	2.29%
Manufacturing	73.2%	70.1%	68.1%	71.2%	71.5%	73.1%	73.0%	71.3%	69.6%	65.7%	59.8%
Wholesale and Retail Trade	6.74%	5.70%	5.98%	4.88%	3.81%	4.71%	5.02%	5.37%	3.89%	5.91%	11.25%
Financial Intermediation					0.02%	0.03%	0.05%	0.06%	0.10%	0.09%	0.13%
Real Estate	3.48%	4.10%	4.21%	3.95%	3.06%	3.14%	3.85%	3.78%	4.05%	4.82%	5.78%
Leasing and Business Services	4.17%	5.99%	8.25%	8.71%	11.99%	10.23%	10.00%	10.33%	6.09%	6.77%	6.96%

Source: MOFCOM FDI Statistics

9.7 Table 7 – China FDI Value by Sectors (1996-2006)

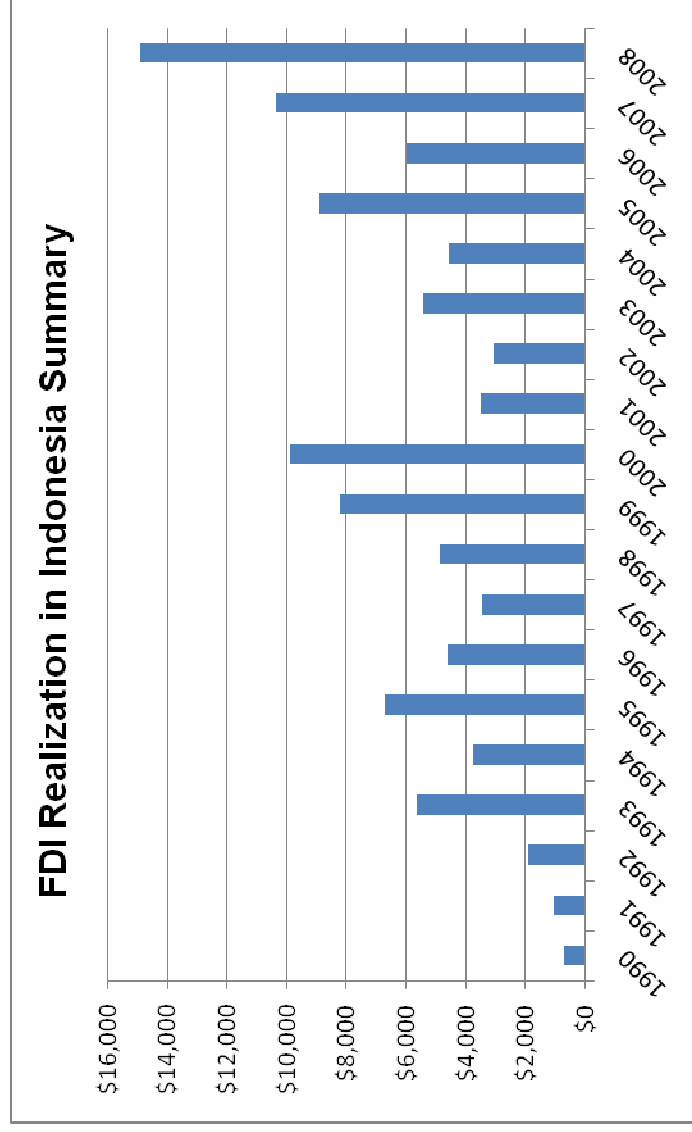
China's FDI Project number by Sectors											US\$10,000	
Sector	1996	1997	1998	1999	2000	2001	2002	2003	2004	2005	2006	2006
Agriculture, Forestry, Animal Husbandry & Fishing	\$ 106,524	\$ 106,531	\$ 120,420	\$ 147,170	\$ 148,314	\$ 176,174	\$ 168,804	\$ 226,711	\$ 111,434	\$ 71,826	\$ 59,945	
Manufacturing	\$ 4,651,933	\$ 2,706,457	\$ 3,082,722	\$ 2,533,180	\$ 4,425,430	\$ 4,884,686	\$ 5,926,985	\$ 3,746,670	\$ 4,301,724	\$ 4,245,300	\$ 4,007,671	
Wholesale and Retail Trade	\$ 157,071	\$ 183,901	\$ 131,352	\$ 120,413	\$ 143,514	\$ 139,806	\$ 166,364	\$ 111,604	\$ 73,959	\$ 103,900	\$ 178,941	
Financial Intermediation						\$ 8,612	\$ 46,002	\$ 23,199	\$ 25,248	\$ 1,230,069	\$ 674,069	
Real Estate	\$ 1,006,192	\$ 622,227	\$ 664,752	\$ 417,785	\$ 523,213	\$ 503,061	\$ 721,713	\$ 523,560	\$ 595,015	\$ 541,807	\$ 822,950	
Leasing and Business Services								\$ 172,002	\$ 282,423	\$ 374,507	\$ 422,266	

China's FDI Project number by Sectors %											
Sector	1996	1997	1998	1999	2000	2001	2002	2003	2004	2005	2006
Agriculture, Forestry, Animal Husbandry & Fishing	1.45%	2.09%	2.31%	3.57%	2.38%	2.55%	2.04%	4.24%	1.84%	0.99%	0.86%
Manufacturing	63.48%	53.06%	59.17%	61.45%	70.94%	70.59%	71.61%	70.03%	70.95%	58.63%	57.69%
Wholesale and Retail Trade	2.14%	3.61%	2.52%	2.92%	2.30%	2.02%	2.01%	2.09%	1.22%	1.43%	2.58%
Financial Intermediation	0%	0%	0%	0%	0.00%	0.12%	0.56%	0.43%	0.42%	16.99%	9.70%
Real Estate	13.73%	12.20%	12.76%	10.13%	8.39%	7.27%	8.72%	9.79%	9.81%	7.48%	11.85%
Leasing and Business Services	0.00%	0.00%	0.00%	0.00%	0.00%	0.00%	0.00%	3.21%	4.66%	5.17%	6.08%

Source: MOFCOM FDI Statistics

9.8 Table 8 – Indonesia Annual FDI projects and realized value

Year	US\$ million		
	No of Projects	% Change	Project Values % Change
1990	100		\$706
1991	149	49%	\$1,059
1992	155	4%	\$1,940
1993	183	18%	\$5,653
1994	392	114%	\$3,771
1995	287	-27%	\$6,698
1996	357	24%	\$4,628
1997	331	-7%	\$3,473
1998	412	24%	\$4,866
1999	504	22%	\$8,230
2000	638	27%	\$9,877
2001	454	-29%	\$3,509
2002	442	-3%	\$3,083
2003	569	29%	\$5,445
2004	548	-4%	\$4,573
2005	907	66%	\$8,911
2006	869	-4%	\$5,991
2007	982	13%	\$10,341
2008	1,138	16%	\$14,871
Grand Total	9,417		107,625
Average Movement		18%	34%



Resources from BKPM, Indonesia Investment Coordinating Board
http://www.bkpm.go.id/file_uploaded/Table-1.pdf

Figure exclude Oil & Gas, Banking, Non-bank financial institution, Insurance, Leasing, Mining in terms of Contracts of Workm Coal mining in terms of agreement of work, investment which licences issued by technical/sectoral agency Porto Folio as well as Household investment

9.9 Table 9 – Indonesia FDI Project number by Sectors

Sector/Year	2005		2006		2007		2008	
<i>Primary Sector</i>	No of Prj		No of Prj		No of Prj		No of Prj	
Food Crops & Plantation	17	39%	13	33%	16	26%	10	18%
Mining	15	34%	13	33%	34	55%	41	75%
Fishery	7	16%	5	13%	5	8%	3	5%
Livestocks	3	7%	7	18%	7	11%	1	2%
Forestry	2	5%	1	3%	0	0%	0	0%
Total Primary Sector	44		39		62		55	
<i>Secondary Sector</i>								
Metal, machinery & electronic industry	87	26%	86	24%	99	25%	141	28%
Food industry	46	14%	45	12%	53	14%	42	8%
Chemical and pharmaceutical industry	41	12%	32	9%	32	8%	42	8%
Textile industry	31	9%	61	17%	63	16%	67	14%
Motor Vehicles & other transport equip industry	31	9%	28	8%	38	10%	47	9%
other industry	29	9%	25	7%	24	6%	34	7%
Rubber and plastic industry	27	8%	33	9%	36	9%	50	10%
Wood industry	18	5%	18	5%	17	4%	19	4%
Non metallic Mineral Industry	11	3%	7	2%	6	2%	11	2%
Leather Goods & Footwear Industry	6	2%	11	3%	10	3%	20	4%
Paper and Printing Industry	6	2%	16	4%	11	3%	15	3%
Medical Preci. & Optical Instru, watches & Clock Industry	2	1%	1	0.3%	1	0.3%	7	1%
Total Secondary Sector	335		363		390		495	
<i>Tertiary Sector</i>								
Trade & Repair	261	49%	266	57%	312	59%	375	64%
Other Services	139	26%	96	21%	126	24%	112	19%
Transport, Storage & Communication	53	10%	37	8%	43	8%	35	6%
Construction	35	7%	18	4%	16	3%	21	4%
Hotel & Restaurant	33	6%	31	7%	22	4%	22	4%
Real Estate, Ind. Estate & Business Activities	5	1%	16	3%	8	2%	19	3%
Electricity, Gas & Water supply	2	0.4%	3	1%	3	1%	4	1%
Total Tertiary Sector	528		467		530		588	

Resources from: BKPM, Indonesia Investment Coordinating Board.

9.10 Table 10 – Indonesia FDI value by Sectors

US\$ million

Sector/Year	2005		2006		2007		2008	
<i>Primary Sector</i>	Value		Value		Value		Value	
Food Crops & Plantation	\$ 171.5	43%	\$ 351.9	66%	\$ 219.1	37%	\$ 147.4	44%
Mining	\$ 53.4	13%	\$ 98.5	18%	\$ 309.8	52%	\$ 181.4	54%
Fishery	\$ 5.8	1%	\$ 32.8	6%	\$ 24.7	4%	\$ 2.4	1%
Livestocks	\$ 52.8	13%	\$ 18.8	4%	\$ 45.7	8%	\$ 4.5	1%
Forestry	\$ 118.8	30%	\$ 31.0	6%	\$ -	0%	\$ -	0%
Total Primary Sector	\$ 402.3		\$ 533.0		\$ 599.3		\$ 335.6	
<i>Secondary Sector</i>								
Metal, machinery & electronic industry	\$ 521.8	15%	\$ 955.2	26%	\$ 714.1	15%	\$ 1,281.4	28%
Food industry	\$ 603.2	17%	\$ 354.4	10%	\$ 704.1	15%	\$ 491.4	11%
Chemical and pharmaceutical industry	\$ 1,152.9	33%	\$ 264.6	7%	\$ 1,611.7	34%	\$ 627.8	14%
Textile industry	\$ 71.1	2%	\$ 424.0	12%	\$ 131.7	3%	\$ 210.2	5%
Motor Vehicles & other transport equip industry	\$ 360.6	10%	\$ 438.5	12%	\$ 412.3	9%	\$ 756.2	17%
other industry	\$ 195.9	6%	\$ 117.1	3%	\$ 30.2	1%	\$ 34.7	1%
Rubber and plastic industry	\$ 392.6	11%	\$ 112.7	3%	\$ 157.9	3%	\$ 271.6	6%
Wood industry	\$ 75.5	2%	\$ 58.9	2%	\$ 127.9	3%	\$ 119.5	3%
Non metallic Mineral Industry	\$ 66.2	2%	\$ 94.8	3%	\$ 27.8	1%	\$ 266.4	6%
Leather Goods & Footwear Industry	\$ 47.8	1%	\$ 51.8	1%	\$ 95.9	2%	\$ 145.8	3%
Paper and Printing Industry	\$ 9.9	0.3%	\$ 747.0	21%	\$ 672.5	14%	\$ 294.7	7%
Medical Preci. & Optical Instru, watches & Clock Industry	\$ 3.1	0.1%	\$ 0.2	0.01%	\$ 10.9	0.2%	\$ 15.7	0.3%
Total Secondary Sector	\$ 3,500.6		\$ 3,619.2		\$ 4,697.0		\$ 4,515.2	
<i>Tertiary Sector</i>								
Trade & Repair	\$ 383.6	8%	\$ 434.3	24%	\$ 482.9	10%	\$ 582.2	6%
Other Services	\$ 298.5	6%	\$ 143.6	8%	\$ 488.6	10%	\$ 123.0	1%
Transport, Storage & Communication	\$ 2,946.8	59%	\$ 646.9	35%	\$ 3,305.2	66%	\$ 8,529.9	85%
Construction	\$ 921.9	18%	\$ 144.2	8%	\$ 448.2	9%	\$ 426.7	4%
Hotel & Restaurant	\$ 180.3	4%	\$ 111.2	6%	\$ 136.4	3%	\$ 156.9	2%
Real Estate, Ind. Estate & Business Activities	\$ 208.3	4%	\$ 254.0	14%	\$ 64.5	1%	\$ 174.9	2%
Electricity, Gas & Water supply	\$ 68.7	1%	\$ 105.3	6%	\$ 119.3	2%	\$ 26.9	0.3%
Total Tertiary Sector	\$ 5,008.1		\$ 1,839.5		\$ 5,045.1		\$ 10,020.5	

Resources from: BKPM, Indonesia Investment Coordinating Board.