

# Neutral Taxation of Foreign Investment Income with Special Reference to Korea

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## I. Introduction

In order to induce foreign investments, developing countries provide various tax-concessions for them (Lent, 1967). At the same time, however, tax revenues are often the primary reason for seeking foreign capital (Smith and Wells, 1975). Such tax revenues are particularly important in fast growing countries because of the recurrent costs resulting from their ambitious growth plans (Anderson and Pinfold, 1979). Developing countries expect that foreign investment would provide not only an additional source of needed capital but also high technologies, managerial and marketing skills, raw materials and export markets. Hence, tax-concessions provided by them appear to be generous. It should be noted, however, that many capital-exporting countries allow credit against domestic tax for taxes paid to host countries. Hence, a reduction of the host country's tax is more likely to result in a transfer of income to the treasuries of capital-exporting countries, without production of tax burden for the investors. Therefore, tax-concessions are doubtful at best in their efficacy in inducing foreign capital, yet they surely lose tax revenues. Further, it has been claimed and supported by empirical studies that foreign investments acquire monopoly rents (Kopits, 1976). If so, the host country should be able to capture a fair share of the rents. However, it appears that little attention has been drawn to rent-capturing capacity of their tax incentive schemes. Therefore, important tasks of capital-importing developing countries are (1) to induce foreign investment by providing proper incentives, and (2) to raise an appropriate level of tax revenues from foreign investment without, at the same time, discouraging them.

These tasks may best be accomplished by neutral taxation. A tax is defined as neutral if it does not disturb economic decisions regarding the

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level, location or timing of investment. The concept of neutral taxation has been applied to actual tax policies (Kwon, 1983a). The existing literature on neutral taxation has however confined itself mainly to domestic investments. In spite of its apparent relevance, the concept has not applied to foreign investments. Therefore, the purposes of this paper are to extend the concept of neutral taxation to foreign investments and to evaluate Korea's foreign investment inducement policies in the light of neutral taxation. Korea has been chosen for this study because it is mainly developing countries which provide tax-concessions for foreign investments, and Korea is one of the best examples in this respect.

In order to formulate proper tax incentive policies toward foreign investments, the host country must understand the objectives of foreign investors and their means and strategies. Hence, the next section examines determinants of foreign direct investment. Then, neutral taxation will be analyzed in the context of foreign direct investment in Section III. Section IV will contain a brief description of Korea's new foreign capital inducement system which became effective on July 1, 1984, and an evaluation of the Korean system will be undertaken in the light of neutral taxation in Section V. The final section will contain conclusions.

## II. Determinants of Foreign Direct Investment

Foreign direct investment (FDI) is defined as foreign-owned equity in the host country's business.<sup>1</sup> There are a host of models of FDI which offer explanations of the determinants of FDI. It appears that most of them are based on the investor's perspective or related to outgoing investment, and that the host country's perspective draws little attention. That is, existing models address themselves to the question of "why do firms invest abroad," rather than to the question of "why does the host country attract FDI." In particular, it appears that most of available models of FDI assume that the

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1. Foreign investment includes portfolio investment as well as foreign direct investment. Given that international portfolio capital flows through an extraordinary broad and efficient market, the after-tax rates of return on financial instruments are equated across countries. Further, the foreign tax credits on interests against domestic taxes are in general insufficient. Hence, the host country's tax on interests paid to the home country drive a wedge between gross-of-tax returns of the two countries to restore net-of-tax parity. As a result, the host country's tax on interests pushes up its borrowing costs. For instance, Canada eliminated in 1975 the withholding tax on corporate bond interest paid to foreign lenders. From an analysis of the Canadian experience of this, Brean (1984) evidently demonstrated that the withholding tax raised borrowing costs and lowered portfolio capital inflows. Therefore, small countries in international capital markets should not impose taxes on foreign portfolio investments. The present study will not address portfolio investment.

inflow of FDI is unrestricted in the host countries. Frequently, however, this is not the case particularly in developing countries. Rather, capital-importing developing countries have foreign investment controls and regulations together with foreign investment inducements, and, under these regulations and inducements, FDI's are encourage for certain areas, and are restricted or prohibited for other areas. In general, developing countries require a certain extent of indigenous equity participation in FDI (Park, 1981), and hence FDI in developing countries is typically in the form of joint-venture with indigenous firms. Therefore, in order to properly account for the determinants of FDI in developing countries, the theories based on the investor's perspective should be consistent with the host country's and indigenous joint-venturer's perspectives.

Although it is extremely difficult to generalize policies adopted by developing countries, these countries appear to attract FDI as a vehicle with which to induce advance technologies, managerial and marketing skills, raw materials, and accesses to new export markets (Park, 1981). Hence, unless foreign capital is accompanied by these requisites, FDI may not be allowed. In other words, an appropriate model of FDI in developing countries is the one which takes into account these requisites as its integral part.

Although a number of models are available for FDI, most of them appear to be based on two premises. First, FDI's are largely undertaken by multinational enterprises (MNE), and, second, the world is characterized by imperfections in the output and factor markets.<sup>2</sup> The beginning in this direction of thinking on FDI was made by Hymer (Hymer, 1960). Hymer's original idea was refined by Kindleberger (1969), and their argument runs as follows. In establishing and operating plants in a country, foreign firms necessarily have some disadvantages as compared with local firms. If, in spite of this, foreign firms invest in that country, they should have compensating advantages over local firms. According to them, MNE's have firm-specific monopolistic or oligopolistic advantages such as superior technical knowledge, managerial and marketing skills, special access to market, cheaper sources of financing, economies of scale, and differentiated products.

The fact that a firm possesses monopolistic or oligopolistic advantages is, however, a necessary but not sufficient condition of FDI, because the firm can yet serve the foreign markets with exports or by licensing, renting or selling these advantages. In order to explain why a firm chooses FDI and not any of these alternatives for serving a particular foreign market, a set of

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2. For a survey of the theory of FDI, see, among others, Agarwal (1980) and Rugman (1980).

models have been further proposed, including the product cycle model and internalization model. The product cycle model proposed originally by Vernon (1966) argues that there is a sequential relationship between product innovation, exportation and FDI. That is, a new product is produced by an innovator in a country with the technological leadership (e.g., U.S.) and serves its home market. Then the product is exported to other developed countries, and finally expansion of demand and growing competition in these markets lead to FDI in developed countries first and eventually in developing countries. Recently, however, the conditions on the technological leadership have changed and, accordingly, the power of the product cycle model to explain the causes of FDI has weakened (Vernon, 1979).<sup>3</sup>

The internalization model was first proposed by Buckley and Cassen (1976) and refined by Dunning (1977). It argues that the markets for key intermediate products such as human capital, knowledge and information, managerial and marketing skills are imperfect. These intermediate products are largely held by MNE's, or are those for which MNE's possess firm-specific advantage. The market imperfections involve costs such as time lags, bargaining uncertainty and government interventions. Hence, MNE's replace these imperfect external markets by their own internal markets for these products. The internalization of markets across national boundaries leads to FDI.

The creation of an internal market facilitates the transformation of intangible intermediate goods such as technology invented by a firm into valuable properties specific to the firm, the retention of the exclusive right to use the innovation, and the exploitation of monopoly rents from them. Expanding their operation through FDI, MNE's may also realize internal and external economies of scale, as observed by Kindleberger (1969). Although internalization can be applied to any type of MNE with firm-specific advantages, empirical studies available draw the conclusion that the process of internalization is concentrated in industries with relatively high R&D expenditures (Agarwal, 1980: 754; Kojima, 1980: 638).

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

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3. In the case of Korea, the markets for consumer durable goods were mostly closed to foreign investors by government regulations, and the market for labor-saving producer goods has been relatively small. This indicates that the product cycle model does well FDI in Korea (Koo, 1984).

are seeking those intermediate goods.<sup>4</sup>

Given the multitudinous types of FDI, even the internalization model may not explain all kinds of FDI. In particular, it is not likely to apply well to FDI undertaken by small firms operating in one or two foreign countries. In this context, a couple of additional models may be worthwhile examining. They are Caves' model (Caves, 1971) and Kojima's model (Kojima, 1982). Caves argues that most of the FDI is undertaken either in horizontal expansion to produce the same kinds of goods abroad as in the home country (horizontal investment) or in the exploitation of raw materials involving vertical integration of foreign production in the same plant (vertical investment). For the horizontal type of FDI's, Caves argues that product differentiation is the critical element, and hence they are most likely to be found in the differentiated oligopolistic markets.<sup>5</sup>

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

It is impossible to judge on an *a priori* basis which model would be most appropriate in explaining FDI in developing countries, and data and information with which to test the models are extremely scarce. It appears, however, that FDI would generate economic (or monopoly) rents in the host country no matter which one of the above models is applied. If FDI is undertaken by an MNE as an internalizing process of its monopolistic or oligopolistic advantages, the firm is likely to acquire monopoly rents.<sup>7</sup> Monopoly rents may also arise in the case of Caves' horizontal investment because of its critical element of differentiated oligopolistic industries. In the case of Caves' vertical investment in raw materials and particularly in natural resources, it has often been claimed that the bounty of nature and internal and external economies of scale will generate economic rents

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4. Rugman further argues that internalization is a general theory of FDI and a unifying paradigm for the theory of the MNE (Rugman, 1980).

5. Caves' model of horizontal investment has not properly explained FDI in Korea, mainly because of government restrictions (Koo, 1984: 21).

6. Koo argues that Kojima's argument is quite valid in the case of FDI in Korea (Koo, 1984).

7. Foreign direct investment may also generate monopsony rent. Foreign investors do not necessarily carry with them all the capital required from their home countries. Rather, they may borrow a fraction of their capital in the host country. In case they do so in developing countries they may face a less than perfectly elastic supply of capital, and hence acquire monopsony rents (McCor-mick, 1982).

(Kwon, 1983a). Even the Japanese type of FDI as proposed by Kojima may generate monopoly rents in the short run by decreasing production cost resulting from superior technology and management.

The argument that FDI would generate monopoly rents may further be supported by the nature of the MNE and by some observed FDI's. One distinctive feature of the MNE is that it frequently undertakes package transactions combining the transfer of raw materials, capital goods, labor services, and technologies. The package transaction tends to confer greater monopoly power than do single transactions (Kopits, 1976). It has been observed that manufacturing FDI's particularly by American MNE's are largely centred in technology-based and highly differentiated oligopolistic industries, thereby generating economic rents (Kojima, 1980; Baldwin, 1979). In sum, all the models of FDI which have been so far examined indicate that FDI is highly likely to generate monopoly rents, and this is supported by various observations of FDI's undertaken by MNE's.

### III. Taxation of Foreign Investment Income

Given that FDI generates monopoly rents, one fundamental question regarding tax policy of the host country is then how to set up tax strategy so as to encourage FDI and, at the same time, to capture a fair share of the rents without discouraging FDI. This would best be accomplished by neutral taxation. A tax is defined as neutral if it does not affect the investment decisions of a profit-maximizing firm.<sup>8</sup> A tax will not affect investment decisions, if it does not affect the market price of an investment asset. The market price of an asset will not be affected by a tax if the tax provides tax-deductions equal in amount to its market price. A neutral tax thus defined may be briefly explained by means of a single asset. Out of a spectrum of investment assets, a profit-maximizing firm will carry on investments up to the marginal asset whose value is equal to the present value of its operating income. By being marginal, the operating income of the marginal asset is equal to its opportunity cost which in turn equals the sum of economic depreciation and interest costs on the undepreciated value of the asset. The value of the marginal asset is also equal to the present value of its annual opportunity returns to the original value of the asset. It should then be noted that the market prices of investment assets determined in the asset market are identical regardless of being marginal or not, and equal to the value of the marginal asset.

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

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

An intuitive explanation of the Brown scheme is that a tax reduction equal to the tax rate times the cost of an asset is immediately provided, that annual taxes are imposed at the same rate on operating income over the life of the asset (without allowing annual deductions for economic depreciation and interest costs), and that the present value of the tax payments equals the immediate tax reduction. Hence, the market price of the asset is independent of the tax. The Samuelson scheme requires the annual deduction of economic depreciation and interest cost from operating income and, since such the annual tax-deduction equals operating income from the marginal asset, the Samuelson scheme provides tax-deductions over the life of an asset, the percent of which equals the value of the original asset. Or, in other words, the Samuelson scheme allows annual tax-deductions equal to annual operating income, and hence annual taxable income is zero, thereby leaving the asset untaxed. Finally, the rate-of-return tax allows annual tax-deductions of the opportunity returns, the present value of which equals the value of the marginal asset, rendering the tax neutral. Since the present value of tax-deductions equals the value of the marginal asset under a neutral tax, it will raise no net tax revenue over the life of the marginal asset in terms of the present value.

So far the analysis of neutral taxation has been undertaken in terms of the marginal asset which raises neither pure profit nor tax revenue under a neutral tax. However, a zero tax on the marginal asset is certainly consistent with a positive tax on intramarginal assets. Recall that the market price of assets — marginal or not — are equal to the value of the marginal asset. Hence, the opportunity cost of an intramarginal asset should be equal to that of the marginal one, but the operating income generated by the former should be larger than that by the latter. Therefore, an intramarginal asset generates pure profit (or economic rent) which is defined as operating income less the opportunity cost. If a neutral tax is applied to an intramarginal asset, only economic rent will decrease in proportion to the tax rate without affecting the investment behavior of a profit-maximizing firm.

In implementing neutral taxation in practice, some modification may be required. It has so far been assumed that the price (or cost) of an investment asset is provided at the outset of an investment undertaking, and that a tax-refund is provided for losses. In practice, expenses for an investment project occur for a number of years before the project begins to generate operating income and tax-refunds for losses are politically impractical. Hence, there should be appropriate methods for calculating the cost of an investment project and for dealing with losses.

In order to be consistent with tax neutrality, the value of a multi-year investment project should be obtained by accumulating annual investment expenses compounded by the threshold interest rate up to the start of the commercial production stage, and losses should be carried forward without limit allowing interest thereon at the threshold rate.

Given the most probable ways of implementing these three schemes, the Brown scheme requires the least amount of information, and thus it appears to be most preferable from the administrative point of view.<sup>9</sup> It may also be preferred by firms because it would involve less uncertainty in recovering their capital prior to a positive tax payment.

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

A question then arises as to whether there is a stable principle (or convention) in the international interactions of tax systems with respect to foreign investments. If there is no such stable principle, then domestic tax strategies would have to adjust continuously to the repercussions from foreign countries. Fortunately, there is a undeclared principle among countries of the industrialized world. This is the so-called "source" principle (Brean, 1984: 124). Under this principle, source (host) countries have the primary right to tax foreign firm's earnings in their countries while

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



residence (home) countries typically allow credit for foreign taxes paid.

It should be noted that, in the international context, both domestic and foreign investors have investment opportunities both in domestic and foreign countries. It is thus the interaction of domestic and foreign tax systems that determine effective tax differentials involving the returns to domestic versus foreign investment. Based on the premise that international differentials in after-tax returns would be a driving force in the mechanism to allocate capital internationally, individual tax systems have been created in an attempt to allocate capital efficiently. This is reflected in the concepts of capital-export and capital-import neutrality.

Capital-export neutrality is referred to as a tax arrangement by which domestic investors experience no tax distortion with respect to decisions to invest at home or abroad, and capital-import neutrality as a situation where-in the domestic tax law does not discriminate among investors according to nationality. Hence, capital-export neutrality is consistent with efficient international allocation of resources of a capital-exporting country, while capital-import neutrality with efficient domestic allocation of resources in the capital-importing country.

Capital-export neutrality prevails if equal pre-tax returns on domestic and foreign investments provide equal after-tax returns. This is achieved by offsetting tax differentials between domestic and foreign countries by providing tax credits for taxes paid abroad against domestic taxes. As a result, the tax rate becomes the same regardless of the location of investment. Hence, under a system that achieves capital-export neutrality, investors are encouraged to invest where pre-tax returns are highest. Capital-import neutrality, on the other hand, exists when firms of all nations pay the same rate of tax on capital earnings in a particular country.

Although undeclared, there appears to be an apparent consensus among countries of the industrialized world that capital-export neutrality should prevail. This is reflected in the existing foreign tax credits incorporated into their national tax systems toward international investments (Anthoine, 1980; Brean, 1984).<sup>10</sup> However, in order to shield their treasuries, capital-exporting countries usually specify an upper limit on the foreign tax credits equal to the amount of the home country's tax liability otherwise due on foreign source income. Thus, foreign investments are

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10. The source principle to which industrialized countries are committed is not a matter of multinational design, but rather it is an uncoordinated consequence of unilateral policies regarding foreign investments.

taxed at the higher of the rates charged by the host and home country.<sup>11</sup>

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

Given that industrialized capital-exporting countries are committed to the source principle, what type of tax strategy should capital-importing developing countries adopt? It should be recalled that under the source principle investors invest where pre-tax returns — not after-tax returns — are highest. Therefore, investors invest in foreign countries because of higher pre-tax returns there, not because of low taxes. In particular, as was discussed in the preceding section, they may do so in order to capitalize on monopolistic or oligopolistic advantages and accordingly to gain monopoly rents from foreign investments. Under these circumstances, the host country's tax has little or no relevance to foreign direct investment decision as long as the host country's tax rate is lower than that of the home country's. If the former is higher than the latter, foreign source income is usually left abroad because domestic taxes are imposed only when foreign income is repatriated. Furthermore, in the case of investments undertaken by MNE's, the influence of tax on real decisions would be insignificant because their centrally coordinated transfer pricing and financial strategy tend to neutralize the influence of tax on real decisions. Therefore tax incentives by host countries do not increase net-of-tax profit of foreign investors and thus they may not be effective in inducing foreign investments. Rather they only transfer tax revenues from the host to home country. Also various studies evidently show that tax concessions offered by

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11. There are two ways of imposing an upper limit on the foreign tax credit. One is an overall limitation like the U.S. system, and the other is a per country limitation like the Canadian system. Under the former, the income of investments in all foreign countries are pooled and foreign taxes are likewise pooled in order to determine the allowable credit. Under a per country limitation, foreign tax credits must be matched to income earned in the country from which the credit is derived. In addition, home countries usually do not allow foreign subsidiaries to offset their losses against the parent firm's domestic income. Nor are domestically available investment incentives (e.g., investment tax credit) ordinarily extended to capital expenditures abroad. Finally, in order to strengthen the integrity of the home country's tax system the host country's taxes that are creditable are restricted to taxes that are consistent in structure and form with bona fide home country's taxes.

developing countries are insignificant or ineffective in inducing foreign investments, and that influential factors are non-tax ones (Lent, 1967; Shah and Toye, 1978; Park, 1980; Agarwal, 1981; Lim 1983; Brean, 1984)<sup>12</sup>. In particular, an empirical study by Lim (1983) has found that generous tax concessions are negatively related with foreign investments. He explains that this paradoxical relationship arises because generous tax concessions are seen by potential foreign investors as a danger signal and not a lure (incentive).

Under these circumstances, an appropriate tax strategy of a developing host country would be neutral taxation of foreign investment income. As explained above, a neutral tax does not affect investment decisions, and hence it does not hinder inflows of foreign capital. To the extent that the above analysis of tax effects on foreign investments holds, neutral taxation will be all that is required to be done by host countries with regard to their taxation of foreign investments.

As compared to taxation of indigenous investment earnings which is typically non-neutral and acts as an impediment to investments, neutral taxation of foreign investments provides some advantages over indigenous investments. Neutral taxation will enhance the expectation of capital recovery and thus stabilize the investment climate over the long run because capital will be recovered without being taxed. By providing a perfect loss-offset mechanism, it will also decrease risk involved in foreign investments in developing countries. By allowing imputed interest on equity capital to be deductible, neutral taxation will encourage equity capital vis-a-vis debt capital as compared to conventional corporate (company) taxes which typically do not allow deductions for interest on equity capital. Above all, a neutral tax distinguishes economic rent from normal returns and is able to capture part of the former without hindering investment undertaking. In sum, neutral taxation would achieve, for capital-importing developing countries, the twofold task of inducing foreign investments and raising an appropriate level of tax revenues from foreign investments. In the light of neutral taxation, therefore, Korea's taxation of foreign direct investment will be assessed in the following section.

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

#### IV. Korean Taxation of Foreign Investment Income

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

The principles of Korean policies toward foreign direct investment are contained in the Foreign Capital Inducement Act which was enacted in 1960, and revised in 1966, 1973 and 1984. The latest revision effective July 1, 1984 introduced substantial changes in the direction of the foreign investment system in Korea, reflecting its aspirations of decreasing its international debt burden and of inducing high technology in a more open economic system. The new system changed the notification system of projects to foreign investment from the previous "positive list" system to a "negative list" system. Under the new listing system, foreign investment projects will be approved unless they fall into categories of prohibited or restricted projects. Also the approval procedures were simplified and other restrictions of foreign investment and some of cumbersome administrative requirements were abolished.<sup>13</sup>

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

Under the revised Act, the exemptions and reductions of the six types of taxes, which were provided uniformly to all foreign investors under the previous system, are in principle abolished. Instead, the incentives are provided as an exception for foreign investment projects which are deemed to contribute greatly to the development of the Korean economy through improving the balance of payments, introducing advanced technology or pro-

13. For a further detail on the changes, see Department of Finance, Korea, (1984a, 1984b).

viding a large sum of capital.<sup>14</sup> In such a case, first, the 50% reduction of those six taxes in the subsequent three years after the first five years of tax holiday, which existed under the previous system, is eliminated. Second, the six taxes are treated differently under the new system. For the income and corporation taxes on foreign invested enterprises, a choice of one of two types of incentives is provided. One type of incentive provides exemptions from the taxes in proportion to the foreign investment ratio for any five consecutive years within ten years from registration of the enterprise. It should be noted that tax exemptions are provided for any single five-year period within ten years — not for the first five years as under the previous system. The other type of incentive is to allow a special depreciation deduction equal to 100% of the ceiling of allowable depreciation of fixed assets under the income and corporation tax Acts, multiplied by the foreign investment ratio. In this case the sum of the special depreciation for each year cannot exceed the amount invested by a foreign investor.

Taxes on dividends accruing to a foreign investor are also exempted for any single five-year period within ten years from registration. The acquisition and property taxes on the properties acquired and held by a foreign investor are exempted for the first five years from registration. Similarly, taxes on royalty from supplying technology are exempted for the first five years, unless requested otherwise by the supplier. In addition to incentives for the above six taxes, capital goods imported by a foreign investor for investment purposes are exempt from import duties, custom duties, the special consumer tax and the value added tax.<sup>15</sup>

## V. Evaluation of Korea Taxation of Foreign Investment Income

It has been demonstrated that tax concessions are not efficient in inducing foreign investments, and that they lose tax revenues and a share of economic rents unwarrantedly. Nevertheless, Korea has been providing generous tax concessions for foreign direct investments. It appears that the tax revenue aspect of foreign investment has not been a concern of the Korean foreign investment inducement policy. Raising an appropriate level of tax revenues or capturing a fair share of economic rents from foreign investment is not included as an objective of the policy (Ministry of Finance, 1984b). Given that the rate of the corporation tax in Korea ranges from

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14. In order to receive tax incentives for those qualified projects, foreign investors must apply for them at the time when they apply for approval of the projects.

15. Exemptions of these taxes on capital goods were provided under the old system as well.

20% to 33%, which is well below those of developed countries, Korea may gain tax revenues by abolishing tax incentives without losing foreign investments, and the only loser would be the treasuries of capital-exporting countries. In this respect, the abolition of the tax exemptions and reductions uniformly provided for all foreign investment projects under the old system is an improvement.

Although tax concessions are selectively provided under the new system presumably in line with development strategy, they appear to have been formulated without properly taking into consideration the source principle of the international taxation. The new system still provides tax holidays which is the most common tax incentive for foreign investments adopted by developing countries (Shah and Toye, 1978). Income earned during the tax holiday period is taxed by the home country when it is repatriated, making the tax exemption useless as seen by investors. The tax holiday does not distinguish investments by their recovery periods, nor does it distinguish investments by their scale. As a result, the tax holiday is discriminatory against investments with a longer recovery period and against those of a larger scale. Hence, the tax holiday is far from being neutral; taxes may be imposed even before a full recovery of capital, or no tax may be imposed even after a full recovery of capital.

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

It is interesting to note that an attempt has been made to introduce an idea of neutral taxation through the special depreciation for the income and corporation taxes. The special depreciation provides in effect an immediate write-off of fixed assets which is the Brown scheme of neutral taxation. However, it is far from being a proper neutral tax scheme because it contains neither a mechanism of measuring the value of assets nor a loss-offset system which are consistent with neutral taxation. Furthermore, the special depreciation is a part of conventional income and corporation taxes both of which allow interests on debt capital to be deductible, but does not do so for imputed interest on equity capital. As mentioned earlier, the Brown scheme is a most simple scheme of neutral taxation from the administration perspective. It may also be analogous to a tax-holiday in the sense that no tax will be imposed during the earlier part of investment operation. Therefore, by improving the current special depreciation system

and, at the same time, abolishing the tax exemption, the Korean tax system for foreign direct investments can develop into a neutral tax system and achieve the objectives underlying the current tax system.

It is difficult to find a sound rationale for exempting taxes on dividends. Again the current system of tax exemption for dividends for any single five-year period within ten years would be in effect more generous than the previous system. Net of tax profit may be repatriated as a form of dividend, and then be taxed by the home country at the home country's tax rate. Taxes paid to the host country are creditable against the home country's tax. Given that the Korean tax rate is lower than those of capital-exporting countries, tax exemptions for dividends in Korea surely transfer tax revenues to the treasuries of capital-exporting countries, without decreasing tax burden to foreign investors.

One important advantage of neutral taxation as compared to the conventional tax is that it is better able to take a fair share of economic rents without interfering with investments. This is done by distinguishing economic rents from normal return to capital and levying taxes only on the former. Taxes on economic rents can be progressively higher than the conventional corporation tax rate. Return to capital after its full recovery corresponds to economic rents. Hence, once capital is fully recovered, a progressive neutral tax may be implemented. In view of potential administrative difficulty involved in implementing a progressive neutral tax with multiple tax rates, perhaps a dual tax rate system might be appropriate. Once capital is recovered, the permanent tax regime operates as a regular income or corporation tax. Once net of tax profit repatriates as a form of dividend, a substantially high tax rate is applied. In this respect, the tax exemption for dividends should be eliminated.

Royalty payments from a technology-importing country constitute income of the technology licensor and are taxed on repatriation by the home country. Since income and corporation taxes paid to the host country are creditable against the home country's tax, the exemption of these taxes for royalty payments may not help the technology licensor, and yet it transfers tax revenues to the treasury of the home country. In the context of neutral taxation, a question may arise as to whether the royalty payment is economic rent or is a part of normal return to investment. Research and development activities for technology are undertaken in the home country. Once a new technology is developed, it is a type of public good in nature in the sense that the technology may be licensed out without hindering its usage by the firm. Hence, the opportunity cost of the technology licenced out to a host country may be zero as seen by the licensor. Furthermore, the fact that the technology is being licensed out indicates that it contains a

monopoly element, thereby raising monopoly rents. Hence, the royalty for technology may be regarded as a proper base of a neutral tax.<sup>16</sup>

With regard to the acquisition and property taxes, it should be noted that there are some generally accepted criteria for a host country's tax to be creditable in the home country. In general, to be creditable, a host country's tax must be similar in structure and intent to an income tax in the home country (Deutsch and Jenkins, 1982: 231). Hence, the acquisition and property taxes will not, in general, be creditable against the host country's tax. Hence, capital-export neutrality may not hold with respect to those two taxes. Further, the bases of these two taxes are not related to income or economic rent earned, and thus they may not be proper bases of neutral taxation. However, to the extent that the property tax is a benefit tax, then it is legitimized as a payment for public services rendered. In this respect, a complete elimination of property tax may be justified. Hence, the current system of the first-five year exemption appears to be justifiable.

The acquisition tax is imposed on the declared value at the time of acquisition of real estate, motor vehicles, heavy equipment, trees, and boats. It is equivalent to a selective consumption tax. Hence, it is distortionary and not justifiable; it should be completely eliminated for foreign investment. Finally, exemption of custom duties and other taxes for capital goods is justifiable because they are selective taxes on intermediate goods. Furthermore, these taxes will not be creditable against the home country's taxes. If neutral taxation is implemented, these taxes will be reflected in the value of capital goods, thereby raising the amount of capital. As a result, the exemption of those taxes is also justifiable with respect to taxation of foreign direct investments.

## VI. Conclusions

In formulating domestic tax policy in order to achieve the dual task of inducing foreign direct investments and raising an appropriate level of tax revenues from them, proper consideration must be given to the international interactions of tax systems. In particular, developing countries should take into account the source principle by which capital-importing

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



countries have the primary right to tax income earned there, and capital-exporting countries maintain capital-export neutrality. Under these circumstances the host country's tax has little or no consequence to investment decision of foreign investors. Hence, tax concessions may not contribute to the inducement of foreign investments, but transfer tax revenues to home countries.

Foreign direct investments appear to be undertaken as an internalizing process of firm-specific advantages such as advanced technologies, information, and managerial and marketing skills, and they generate monopoly rent. Given that tax concessions are ineffective in inducing foreign direct investments which in turn generate monopoly rent, the above dual task may best be accomplished by neutral taxation. This is so because neutral taxation does not hinder inflows of foreign capital, and it can capture monopoly rent without interfering with investment. In view of neutral taxation, or in order to achieve the dual task, the current tax system of Korea with respect to foreign investment income requires substantial improvement.

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