The Budget and Foreign Investment

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The whole approach to taxation of income from foreign investment in India is based on the premise that taxation is a major impediment to foreign investment.

This is a premise of doubtful validity. Studies conducted in the capital exporting countries show that taxation is not a major factor influencing investment abroad.

However, even assuming that tax concessions have some influence of a psychological nature in creating a climate favourable to investment, their effectiveness is considerably reduced by the practice in the capital exporting countries of taxing the entire work! income of their citizens. And where this is avoided by tax-sparing agreements, there emerges a distinct inducement to repatriate earnings from the capital importing countries.

These considerations have to be borne in mind while examining the 1965-66 Budget proposals relating to taxation of foreign individuals and companies.

TO attract foreign investment in India the 1965-66 Budget continues and extends the scope of the policy of giving tax concessions to foreigners and foreign enterprises. The major change made in the Budget in the taxation of non-residents other than companies is the abandonment of the concept of 'total world income.' At present such non-resident assessees are charged to tax on their income arising or received in India at the maximum rate of income-tax (including surcharge) plus super tax at 19 per cent, amounting in all to 48.37 per cent. In the case of non-resident assessees whose income attracts super-tax at a rate higher than 19 per cent, super-tax is charged at: the higher rate. However, if the non-resident exercises the option to be assessed on his income in India at the average rate of tax applicable to his total world income, tax is charged on that basis. Under this system the non-resident had to declare both his Indian and world income, although the tax was levied only on the Indian income. This method of assessment led to taxation of the personal income of many non-residents at unduly high rates. Besides this, there was the difficult administrative problem of determining and ascertaining the total world income. The change made in the 1965-66 Budget, undoubtedly would provide considerable tax relief to non-residents.

Favoured Treatment

It should be also noted that although a non-resident will not be able to avail of the minimum exemption limit and also of the personal allowances for married individuals which are available to a resident, he will continue to enjoy allowances on expenses wholly and necessarily incurred in the performance of the duties — living allowance, travelling allowance and children allowance of Rs 2,000 per child or 25 per cent of his total income, whichever is less.

Further as a consequence of the changes in the Finance Act, 1964, a non-resident who derives any income from purchasing goods in India and exporting them will not be liable to tax on such income even though he may have an office or agency in India and even though the goods may be subjected to some kind of manufacturing process before being exported from India. Similarly, any income earned by a foreigner on tour of duty in India is exempted from income-tax if his stay does not exceed in the aggregate a period of 90 days in any financial year.

Taxation of Companies

The 1965-66 Budget extends the scope of tax-exemption enjoyed bv foreign technicians. Under the existing provisions, in the case of a technician who has special knowledge and experience in industrial or business management techniques his income from salary is exempted for a period of six months while in the case of other technicians this period of exemption is three years if the contract of service is approved by the Government and is further extended for two years if the tax on his income is paid by his employer. The 1965-66 Budget extends this latter exemption to a further three years, i e, upto a maximum of five years. Thus the total tax holiday enjoyed by a technician in India would be eight years, instead of five years as at present.

With regards to non-resident companies no major changes are made except in the capital gain tax. If non-residents or foreign companies invest the whole or a part of the capital gains accruing to them, the tax on capital gains or a proportionate part thereof will be refunded to them. The purpose of this concession is to encourage reinvestment in the economy. Here it is also necessary to note that in the 1964 Finance Bill a large number of non-resident companies who have invested in Indian companies or who are giving technical assistance to Indian industries were given major tax concessions. For example, the income earned by non-resident companies by way of fees for rendering services is taxed at 50 per cent. Similarly, at present on income from dividend payable by a Sec 103 company (on old 23A company) or a wholly-owned subsidiary of such a company which is engaged in priority industries (some 16 industries are mentioned) the tate of tax is only 15 per cent. If such dividend is payable by an Indian company the rate of tax is 25 per cent. But the most important change made in last year's Budget is the complete abolition of super-tax on inter-corporate dividends. It is true that in respect of incomes other than dividend income, royalties or fees for technical services or interest from tax-free Indian securities, the rate was raised from 63 per cent to 65 per cent. It may be noted, however, that the income tax and super tax rate of 65 per cent would be levied only after taking into consideration the various exemptions and reliefs, such as the five-year rax holiday for new industrial undertakings and hotels, the Development Rebate, etc.

Comparisons Misleading

If these various tax concessions arc taken into consideration it would be obvious that any comparison of the tax rate *on* foreign companies in India with that in other countries would be extremely difficult, if not misleading. The net burden would depend on the nature of income received by the companies. Similarly, any international comparison of marginal tax rates applicable to individuals must take into account the base to which these rates are applied. It is true that marginal rates of taxation in India are quite

high but due to various tax concessions and tax-exemptions, the base on which these rates are applied is considerably narrowed, with the result that the effective rates in India may not be very unfavourable as compared with the effective rates in other countries.

Moreover, in the case of non-resident companies which are merely branches or subsidiaries of international concerns, there is scope for . them to reduce the tax burden by 'profit shifting*. Since such companies sell or buy from the foreign company of the same group, the prices charged are in fact internal accounting prices. It is well known that an international concern operating through a chain of subsidiaries can easily "shift" its profits from one country to another by changing the prices which the subsidiaries charge to one another. Thus the profits made in refining petroleum may be under-stated by invoicing export at unduly low prices and by invoicing imports at high prices.

Wrong Premise

The whole approach to taxation of foreign income in India is based on the doubtful premise that taxation is the obstacle impeding foreign investment and that hence tax concessions can act as an incentive to foreign investment. But several studies *in* U S A, which is one of the greatest exporters of capital, show that taxation does not play a very important part in influencing investment abroad. It has been observed that for many economically less developed countries the tax system is relatively unimportant, compared to other factors impeding investing.*

The more important obstacles to foreign investment are (1) the underdeveloped state of the economy itself; (2) scarcity of domestic capital; (3) limited market or restricted potential demand; (4) the unavailability of credit facilities or skilled or industrially disciplined labour and technicians; (5) inadequacies in the country's transportation power, health and educational facilities; (6) political uncertainty and unrest; (7) ignorance of foreign investor about investment opportunities; (8) uncertain and erratic changes in economic and taxation policies; and, (9) procedural delays, etc.

Assuming that tax concessions have some indirect influence of a psychological nature in creating a climate of general encouragement to investment, its effectiveness is considerably reduced because of the general practice in the capital exporting countries of taxing the entire world income of their citizens. In such a situation any concession given to foreigners in the capital importing countries only results in increase in the revenues accuring to the Governments of the capital exporting countries, leaving the burden on the investor unchanged, except in those cases where the rates of tax in the capital importing countries are relatively higher. Of course, some of the capital exporting countries have shown recently their readiness to make adjustments in their tax structure in order to encourage overseas investment. India has recently entered into such tax-sparing agreements with Japan and West Germany, and U K and U S A also have moved in this direction. Such tax-sparing agreements in addition to providing the tax credit for foreign taxes paid in the country of income origin, also give credit for taxes that would have been paid in the country of income origin if certain tax exemptions had not been given.

Tax-Sparing Agreements

It should be noted that such tax-sparing agreements are destructive to progressivity and equity in the tax structure of both capital importing and capital exporting countries and, therefore, go against the very spirit of double taxation agreements which aims at equal treatment of equally situated individuals whatever may be the source of their income. What is more important is the fact that such agreements do not eliminate or modify the numerous obstacles impeding foreign investment. In fact, such agreements are likely to provide incentive to foreign investors to withdraw income from the capital ..importing country instead of reinvesting them in the country of origin. For example, tax-holiday type of concessions are available only for the first few years and if the investor wants to benefit from such concessions the tax-sparing agreement would provide an incentive to withdraw earnings from the capital importing country.

Another important implication of tax-sparing agreements is that they bring the largest benefits to the most profitable enterprises with the result that the capital exporting country sacrifices considerable revenue in subsidising very profitable investment, whose development-worth from the view point of the capital importing country may be questionable. Further, it *need* not be emphasized here that when an enterprise in very profitable it needs less incentives, not more.

Self-Defeating Concessions

Another factor which reduces the effectiveness of tax concessions is the tendency on the part of the many capital importing countries to copy-tax concessions given by one another with the result that the competing concessions largely cancel out each other. Here there is a clear case for international discussion possibly leading to conventions or agreements that would eliminate the competition which undoubtedly exists at present.

Besides this, one of the ways of increasing foreign investment is to encourage reinvestment. We have already observed that existing tax-sparing agreements are likely to encourage withdrawals at the very time when we need more foreign investment. Perhaps what is needed at present is some kind of agreement with the capital exporting countries that they would tax the incomes of their citizens only when the incomes are withdrawn from the capital importing country. Such a provision would discourage withdrawals and encourage reinvestment in the country of origin if other impediments are removed. It is also possible to encourage non-resident companies to retain profits by taxing such profits preferentially.

Finally, investment whether foreign or domestic depends on profitability and the profitability of investment is guaranteed in India because the building up of the infra-structure of development and the increased tempo of investment in the Plans, coupled with the continuation of a restrictive import policy, ensure an expanding and profitable domestic market. This is clear from the fact that the earning

* See Barlow and Wender : "Foreign Investment and Taxation". According to this study, one of the important factors .retarding the inflow of foreign investment was that potential foreign investors were either ignorant or disinterested. This indicates the need for opening more investment centres for providing information to foreign investor about investment opportunities in India.

The U N study on "The Effects of Taxation on Foreign Trade and Investment" also found that taxation was not a major factor inhibiting investment abroad.

of U S investments in India were as high as 20.6 per cent in 1962, whereas the figure in respect of certain other Asian countries and Latin America was lower. Similarly, a study of the British Board of Trade shows that British direct investments in India had an earning ratio of 9.4 per cent which was higher than similar investment in the U S, Canada and Australia.

It is true that taxation cannot be totally neglected as one of the factors influencing profitability and, therefore, the foreign investment. Nevertheless, it would be more correct to maintain that what investment, whether foreign or domestic, needs is not just lowering of taxation (which may be of doubtful utility in attracting foreign investors particularly, for the reasons staled above) fbut stability in economic policies *in* general and taxation policies in particular.