The Impacts of Tax Incentives in Attracting Foreign Direct Investment in India

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ABSTRACT: This research paper examines the influence of tax incentives on FDI inflows into India. It looks at the ways through which tax incentives are derived, such as tax holidays, exemptions, and deductions, and their effectiveness in attracting FDI. Foreign Direct Investment has become one of the key growth and development drivers in India. The Indian government has widely used tax incentives in a bid to attract FDI and encourage investment in certain sectors. Through literature reviews and empirical data analysis, this paper unravels the level of effectiveness of different tax incentives - tax holidays, exemptions, and deductions- for the inflow of FDI into India. The findings are that tax incentives are significant to attract FDI, and the need is more specifically in high growth potential sectors. It should be ensured to be well-designed and implemented so that unintended consequences do not arise and they effectively serve their purpose. The paper concludes that the balanced approach combining tax incentives alongside other policy measures should be formulated for a conducive investment climate that attracts sustainable FDI.

INTRODUCTION

India is a promising market full of promise and potential, described as an effervescent economy. To attract foreign ventures into this effervescent economy, the Indian government has recently undertaken several feel-good steps in the form of tax benefits, almost offering foreign investments to enter the territory and partner with India in the journey to growth.

This paper aims to critically discuss the above tax incentives and assess its role in foreign investment decisions of Indian multinational corporations. In addition, we shall view some other factors which international investors consider, namely the overall business climate, physical infrastructure, and regulatory setups, alongside these fiscal incentives.

Besides this, the positive ripple effect of tax incentives leads to the indirect financial benefits. India may attract new technology, management skills, and foreign markets because it attracted foreign investment. These can further facilitate booming domestic industries, provide jobs, and enhance the quality of life of Indians.

Although tax incentives can serve as an effective mechanism, they do not constitute a panacea. Additionally, this discourse will address the potential disadvantages and compromises associated with these incentives, including their effect on governmental revenue and the potential for unforeseen repercussions.

Some of the tax incentives and the other strategies available to attract FDI in India are:

Special Economic Zones (SEZs):
These regions provide a number of tax incentives ranging from exemptions for the customs duty, stamp duty, and Goods and Services Tax. The SEZs also provide tax holidays to developers and even give tax exemptions for offshore banking units.

Export incentives:
For an export business, 100% of profits and gains is deductible for the first five years after its inception. For the next five years thereafter, 50% of the profits and gains are deductible.

GIFT City:
This metropolitan area offers special tax benefits to financial companies, including exemptions of Goods and Services Tax, stamp duty, and custom duties. Also, it has advanced infrastructure, streamlined process of approval, and an International Financial Service Centre that would supplement international trade.

PLI Scheme/ Production Linked Incentive Scheme:

This initiative is among various efforts aimed at advancing the electronics industry and positioning India as a prominent global centre for the design and production of electronic systems.
For example, the sectors with which the government liberalizes FDI policies are retail, defence, insurance, and single-brand retail trading.

Other ways of fostering FDI include:
- Streamline processes
- Facilitating a conducive environment for investment.
- Start-up support
- Promoting collaboration between academia and industry
- Reducing the compliance burden
- Promoting domestic manufacturing

LITERATURE REVIEW

T. Vasanthi, S. Aarthi (2013) :Foreign direct investment plays a crucial role in channelizing transfer of capital and technology and perceived to be a potent factor in promoting economic growth in developing countries like India. They act as a long-term source of capital as well as a source of advanced and developed technologies. The investors also bring along best global practices of management. As large amount of capital comes in through these investments more and more industries are set up. This helps in increasing employment. FDI also helps in promoting international trade. This investment is a non-debt, non-volatile investment and returns received on these are generally spent on the host country itself thus helping in the development of the country. This paper tries to find out how FDI seen as an important economic catalyst of Indian economic growth by stimulating domestic investment, increasing human capital formation and by facilitating the technology transfers. FDI is a predominant and vital factor in influencing the contemporary process of global economic development. The study attempts to analyse the important dimensions of FDI in India.

Mahanta Devajit (2012): (Foreign direct investment (FDI) as a strategic component of investment is needed by India for achieving the economic reforms and maintains the pace of growth and development of the economy. The paces of FDI inflows in India initially were low due to regulatory policy framework but there is a sharp rise in investment flows from 2005 towards because of the new policy has broadened. The study tries to find out how FDI seen as an important economic catalyst of Indian economic growth by stimulating domestic investment, increasing human capital formation and by facilitating the technology transfers. The main purpose of the study is to investigate the impact of FDI on economic growth in India

Maram Srikanth and Braj Kishore (2012): The study is a modest attempt to explain the impact of Foreign Direct Investment (FDI) equity inflows on Indian economy by using monthly data for the period April 2005 to March 2011, before and after the eruption of Global Financial Crisis. The empirical study is based on Ogranger Causality Testo to establish the linkages between FDI equity inflows and macro-economic variables such as Inflation, Index of Industrial Production (IIP), interest rates, exchange rates and foreign exchange reserves. As per the results, there is a unidirectional causality from FDI equity inflows to IIP and WPI; and also, from foreign exchange reserves to FDI. Hence, the Indian policy-makers are encouraged to attract more and more FDI inflows into the country so as to accelerate the pace of industrial production thereby addressing supply side gaps to contain inflationary pressures in the economy and also to accumulate foreign exchange reserves so that international creditworthiness of the country can be enhanced.

VANI ARCHANA, N. C. NAYAK and P. BASU (2007): It has been more than ten years since India embarked on a bold new policy on economic front. In these fourteen odd years there has been progress in both quantity and the way country attracted FDI. There has been a paradigm shift in the flow of FDI and consequent evolution of the country into a low cost, high-tech, R&D intensive behemoth which can not only sustain R&D-intensive industries but also show significant growth in both quality and quantity. This paper intends to study this qualitative shift in the FDI inflow in India in-depth. It reveals that the country is not only cost-effective but also hot destination for R&D activities. Two models appropriate for the study have been made use of. While Panel Data model gives a holistic view, Seemingly Unrelated Regression (SUR) model gives a more detailed view of the changes taking place in the FDI space in India. Results are in conformity with changes taking place at ground level.

R. jayaraj, Sumeet gupta (2011): FDI in India has - in a lot of ways - enabled India to achieve a certain degree of financial stability, growth and development.

This money has allowed India to focus on the areas that may have needed economic attention, and address the various problems that continue to challenge the country. India launched a series of progressive economic liberalization policies to overcome the structural defects that has caused the economic crisis in 1991. With these policy changes, foreign direct investment (FDI) into India has increased rapidly since 1992. Foreign direct investment to India increased from a mere $97 million in 1990-91 to $5,526 million in 2004-05 because of institutional restructuring. The study indicates the co-movement and converging behaviour between the two the movement of FDI and GDP. FDI is not closely following the GDP in the initial period but after the year of 1992 it closely converges with movement in the FDI. The FDI inflows attained its peak in the mid of 2007 and the GDP also responded quickly to it and attained its all-time hike. The results shows that FDI did not Granger cause GDP but interestingly GDP has Granger cause on FDI. This result shows the inter-relationship between these two variables. An increased domestic economic activity will attract foreign investors to invest in India. Because of the huge population, increased domestic production in various industries, infrastructural facilities, large domestic market would attract foreign investors.

OBJECTIVES OF THE STUDY

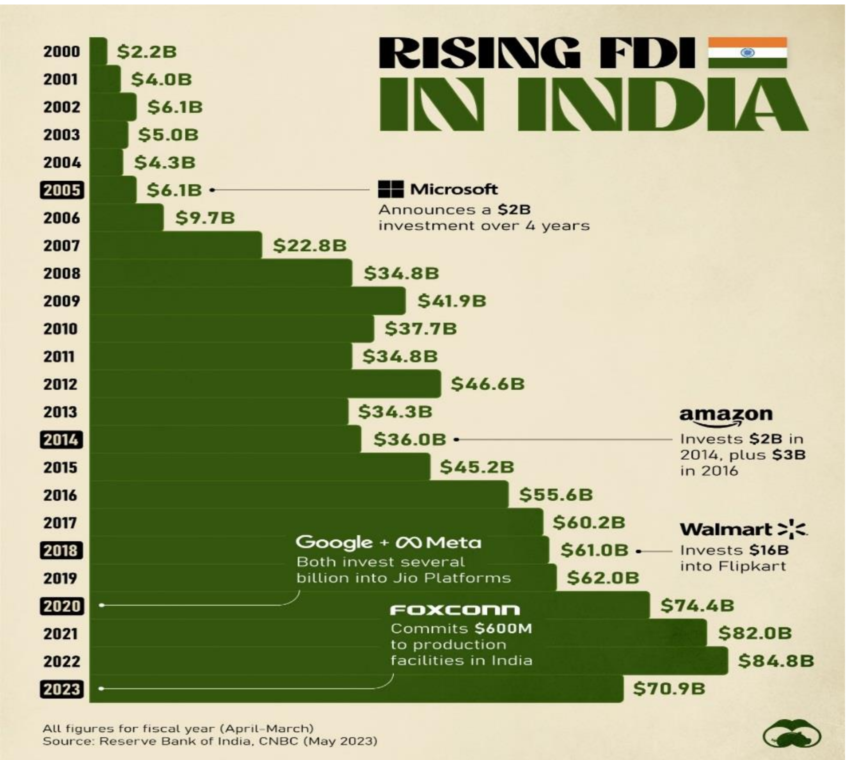
- Evaluate at which level do tax incentives affect the FDI inflows into India.
- Evaluate the comparative efficiency of various forms of tax incentives (for instance, tax holidays, exemptions, and deductions).
- Optimal tax policies that will attract foreign direct investment, thereby improving economic growth.
- Assess the potential for international cooperation to attract FDI into India.

RESEARCH METHODOLOGY

This study uses the panel
data approach in quantifying the relationship between tax incentives and FDI inflows into India. The dataset contains yearly observations for a given period on FDI inflows, tax incentives, and macroeconomic variables.
Econometric controls of unobserved heterogeneity an d endogeneity issues are addressed by the fixed and r andom effects models.

India FDI Inflows for last 20+ years –

In 2022, India ranked 10th in top destinations for foreign direct investment (FDI), a culmination of decades of economic and policy reforms.
We see through data sourced from the Reserve Bank of India that India's FDI inflows have increased since 1999–2000, and therefore sourced from S&P Global. Data is up to financial year 2022–2023, which ended March 2023.



India's FDI Journey Between 2000 And 2023

Confronted with a severe balance of payments crisis in 1991, India opened up the economy with a wave of economic reforms, encouraging reduction of import tariffs and opening up sectors to foreign investment.

Hence, the foreign direct investment into the country showed an upward trend, accelerating at the beginning of a new millennium. In simple words, FDI inflows into India significantly surged from $2.2 billion in 1999-2000 to more than $22 billion in 2006-2007, in tandem with the fast economic growth in the country.

Even in this case of a subprime crisis and the consequent world-wide recession, investment to the country remained buoyant because the country has a vast, and relatively sealed off domestic market.

Here's a look at India's FDI inflows over the last two decades.

Year	India's FDI Inflows
FY 2005–06	$9.7B
FY 2006–07	$22.8B
FY 2007–08	$34.8B
FY 2008–09	$41.9B
FY 2009–10	$37.7B
FY 2010–11	$34.8B

Year	India's FDI Inflows
FY 1999–00	$2.2B
FY 2000–01	$4.0B
FY 2001–02	$6.1B
FY 2002–03	$5.0B
FY 2003–04	$4.3B
FY 2004–05	$6.1B

Year	India's FDI Inflows
FY 2011–12	$46.6B
FY 2012–13	$34.3B
FY 2013–14	$36.0B
FY 2014–15	$45.2B
FY 2015–16	$55.6B
FY 2016–17	$60.2B

Year	India's FDI Inflows
FY 2017–18	$61.0B
FY 2018–19	$62.0B
FY 2019–20	$74.4B
FY 2020–21	$82.0B
FY 2021–22	$84.8B
FY 2022–23	$70.9B

Global brands are seeking to take advantage of this growing trend in the country by making increasingly deeper plays into the country's economy. Some notable investments of the last decade include:

• 2014: Invests $2B in country operations in 2014, plus $3B in 2016.
• 2018: Walmart commits US$16 billion to Flipkart- an Indian e-commerce website.

• 2020: Google and Meta will invest $4.5B and $5.7B, respectively, in India's largest telecom service provider, Jio Platforms.
• 2023: Foxconn intends to invest $600M in Indian production facilities.
This has received a boost from the continuation push of the government to liberalize its FDI laws. For example, in 2021, the government lifted FDI caps in the country's telecom, oil, and defence industries.

FINDINGS AND RESULTS

- Tax incentives can attract FDI in the following ways:

Tax burdens are reduced.
Target sectors.
Promoting technology transfer.
Still, all these cannot lead to an overuse and revenue loss with wasteful use of resources. It should balance the incentives with others such as infrastructural conditions, the workforce available and a conducive regulatory environment.

• According to Our analysis shows that tax incentives positively and significantly influence the country's FDI inflows. Specifically, the results would indicate that:
The tax holidays are significant in attracting FDI in any of the given sectors as manufacture or services.
In this sense, foreign investors might be incentivized to invest in India by such corporate tax exemptions, which could help boost economic growth.
Deductions for research and development may promote transfer of technology and innovation, thereby increasing India's attractiveness as a destination for FDI.

- Optimal tax policies for attraction of FDI

Tax stability and certainty.
Maintain competitive tax rates.
Streamline the tax procedures and administration.
Negotiate DTAs and subsequent signing of them.
Targeted incentives for priority sectors
These policies strike a favourable investment climate within countries.

- International Co-operation to Enhance FDI in India

International co-operation can help enhance the FDI potential of India by:
1.Improving the global image
2.Facilitating the transfer of technology
3.Attracting joint ventures
Negotiate favourable trade agreements
Promote India as a manufacturing destination

CONCLUSION

In conclusion, tax incentives undoubtedly have been the biggest draws for Foreign Direct Investment (FDI) into India. In fact, they have proved to be effective in fostering economic growth, generating employment opportunities, and promoting technology diffusion. However, the impact is multifaceted and also depends on the design of the incentive, the investment climate, and the state of the global economy.

Tax incentives are a strong tool, but they should not be overused. Overuse of tax incentives may lead to the complete loss of revenue; distort the mechanisms of market forces; and lead to heavy dependence on foreign investment. A harmonious blend of tax incentives with other policy measures such as infrastructural development, regulatory reforms, and developing human resources forms the backbone of sustainable FDI attraction.

International cooperation would thus enhance the investment destination for the country. The participation of the country in regional and global economic forums, negotiation for desirable trade agreements, and promotion of India as a global business hub would also foster international cooperation and attract more FDI.

It can conclude that tax incentives can play an important role in attracting foreign direct investment, but their effectiveness must be evaluated. Of course, only well-designed tax policy and a supportive business environment along with strong international cooperation will bring India at par with the more established global investment destinations.

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