ECONOMIC DEVELOPMENT AND ATTRACTING FDI: TAX INCENTIVES IN CASE OF UZBEKISTAN

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Abstract

In this paper we tried to define existing problems on attracting foreign direct investments to developing economies and their effect to local industries. We analyzed advantages and disadvantages of tax exemptions, presenting to foreign investors. Moreover, we studied the current situation of tax stimulating foreign investors in the economy of Uzbekistan and developed some practical recommendations aimed at eliminating negative consequences of assigning tax incentives.

Keywords: foreign direct investments (FDI), foreign investors, tax incentives, multinational corporations (MNCs), Uzbekistan, FDI-created spillovers.

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1. Introduction

In condition of the economy modernization and creating favorable conditions to foreign direct investments (FDI), the issue of improving tax policy conducted in the country is very important. It is logically known, that there is a positive effect of the measures undertaken in the field of taxation. In particular, reduction of the tax burden which creates favorable opportunities to attract FDI. But many local or foreign investors get used to receive tax exemption from government and it does not encourage the industry to reach the apex. The problems existing in the field of tax benefits and the assessment of their possible negative impact on the economy stipulates the importance of this research.There have been a lot of researches aimed to encouraging investment activities via introduction of tax exemptions. However, there is no single research in the field of how tax benefits influence the national economy in framework of attracting FDI. In particular, there is necessity to study the role of the protectionism tax policy in the reforms implemented in taxation, its impact on the basic macroeconomic indicators.

So the aim of the research paper is to determine the problems existing in the field of tax benefits and their possible negative impact on the economy and to develop scientific proposals and practical recommendations aimed at eliminating these problems and further development of the economy. The object of the research is impact of tax incentives to the economic development of Uzbekistan. In the research, we used deductive, comparative study techniques.

2. Contribution of FDI to economic development

One of the major channels for technology diffusion from developed to developing countries is FDI by multinational corporations (MNCs). They are among the most technologically advanced firms in the world, accounting for a substantial part of the world's research and development (R&D) investment. Most studies confirm the assumption that foreign-owned firms are more productive than their domestically owned competitors (Haddad and Harrison 1993, Sinha 1993). Domestic firms have better knowledge and access to domestic markets (Graham and Krugman 1989) therefore if a foreign firm decides to enter the market: it must compensate itself for the disadvantages compared to domestic firms. It is most likely that, a foreign firm that decides to invest in another country enjoys lower costs and higher productive efficiency than its domestic competitors. In the case of developing countries in particular, it is likely that the higher

efficiency of FDI would result from a combination of advanced management skills and more modern technology. Hence, FDI seems to be an important channel through which advanced technology could be transferred to developing countries.

Some case studies suggest that substantial technological diffusion to domestically owned firms takes place (Blomstrom and Kokko 1997). Firms in sectors with relatively high presence of MNCs tend to be more productive (Kokko, Tansini and Zejan 1996, Aitken and Harrison 1994). There is of course, a difficult question of causality in these cases. It is possible that FDI is attracted only to sectors or firms that have greater productivity potential. But, it seems at least plausible to assume that FDI inflows raise the levels of technology in the host economy and contribute to higher productivity. This can be carried through a variety of mechanisms. One plausible mechanism is that FDI inflows increase the variety of intermediate products and types of capital equipment in the host economy (Borenzstein, De Gregorio and Lee 1998). In so doing, FDI inflows lead to an increase of the productivity in growth is learning. FDI inflows diffuse knowledge about production methods, product design and new organizational and managerial techniques. In this light, imitation becomes a crucial element. Another important mechanism is that FDI raises the productivity of domestic R&D activities.

A different kind of productivity spillover takes place when domestic firms learn from the export activities of MNCs or their host subsidiaries through information externalities. Exporting involves fixed costs, such as establishing distribution networks, transport infrastructures, marketing and market research, copying with regulation, and more. MNCs have already had knowledge and experience in these fields and have established networks and procedures of managing those international transactions. Domestic firms can back on some of these investments, such as those in infrastructure, and can benefit from some of the marketing that MNCs created for the developing countries' market. In addition, information such as technologies and management techniques often leak through local clients, suppliers and MNCs workers. Some argue that employees are the most important channel for spillovers (Fosfury, Motta and Ronde 2001, Haacker 1999).

FDI-created spillovers are not limited to the everyday meaning of the term 'technology'. The spillovers are what enable FDI to create, in developing countries, markets that do not yet exist

and improvement of the quality of existing markets. They can even help build and strengthen growth-required institutions in developing countries.

MNCs' activity in developing countries can help a developing country to get out of a lock-in situation, such as having a comparative advantage in traditional industries, that dooms it to be permanently worse off compared to a country with a comparative advantage in more advanced industries (CIA World Factbook 2002). Knowledge spillovers in general – and in the case of a developing country that hopes to use FDI spillovers to acquire a more advanced comparative advantage – in particular, require active participation on behalf of the local firms. The ability and motivation of the domestic firms to engage in investment and learning to absorb the foreign knowledge and skill is a central determinant of whether or not the potential spillovers will be realized. Therefore, the developing country has to do more than merely attracting FDI in order to benefit from the FDI's spillovers. It has to provide its local firms with good incentives to increase the chances of knowledge absorption. Lastly, hosting MNCs' activity can help developing countries keep their more competent residents from immigrating to developed countries, a wide spread phenomena known as the "brain drain". The better educated people are attracted to developed countries where their higher education level can be matched, yield higher returns, and allow them to benefit from higher standards of living. Multinationals create a working environment that is more likely to provide the better-educated individuals the kind of opportunity that will keep them in their home countries. Surely, attracting FDI is not the only way in which technology could transfer from developed to developing countries.

3. Tax incentives: advantages and disadvantages for developing economies

Developing countries' economies contain underdeveloped markets because domestic production is not efficient enough to improve the economy and to fulfill the needs of the population. For that reason, developing countries greatly depend on foreign investment to promote their local economy, increase market opportunities and provide better services for the local population.

Generally, investors from developed countries benefit from tax and nontax advantages that developing countries offer. Underdeveloped markets, low product competition, cheap labor and currency exchange are advantages that attract foreign investors to developing countries. However, some situations are not always attractive for foreign investors to engage in business

and commercial activities in developing countries. There are risks that must be considered before deciding to invest in a developing country, because they may have economic, political or social circumstances that may discourage foreign investors from doing business there.

Developing countries must find ways to attract foreign investment that is good enough to outweight the economic, political or social instabilities that can arise. Measures to reduce the negative influence of nontax issues are addressed through the implementation of beneficial tax policies, which may include tax incentives, tax holidays and tax sparing provisions. These are factors that investors take into account when deciding in the location of foreign production and investment. These types of tax benefits are becoming more important in the decision-making process of foreign corporations. Sometimes, these tax policies create competition among developing countries in the hopes of attracting foreign investment, but this can also lead to harmful tax competition that can cause negative economic consequences for developing countries. It is a vital for countries to determine whether tax incentives from developing countries are a good thing or whether they create negative economic consequences while benefiting foreign investors.

Almost every argument used to support or criticize the implementation of tax incentives, tax holidays and tax sparing provisions in developing countries is debatable and can be used by both sides. Because there is no model, developing countries do not have the guidance to implement an established system to achieve the economic goals these kinds of policies are intended to achieve, so usually the tax policies implemented in developing countries are based on trial and error. As Barker wrote: "the problem, simply put, is that emerging economies do not have a model to rely on that demonstrates the efficient use of their tax systems to provide the critical ingredients for development, including increasing and retaining investment and at the same time increasing tax revenue"(Barker 2007).

Since the economies in developing countries are not strong enough to dictate their own rules, they are often forced to implement tax policies simply because neighbor countries are doing so and their economy could be severely affected if they do not. To combat this problem, developed countries should implement tax policies that provide aid that promotes the economic growth of

developing countries. Referring to UN report wrote “In addition to positive aid, the UN Report calls on developed countries to remove trade barriers” (McDaniel 2003). UN suggests that “additional source country measures should also be devised to encourage and facilitate investment flows to developing countries” (UN Report 2002).

Developed countries greatly depend on FDI to promote their economies and domestic markets, and they are continually trying to attract foreign investment through the implementation of attractive tax policies and other tax measures, because “private international capital flows, particularly foreign direct investment, along with international financial stability, are vital compliments to national and international development efforts” (UN Report 2002). Emerging economies are not self-sustaining and foreign investment constitutes a large source of revenue. The need for revenues in developing countries, however, goes far beyond social insurance. In some developing countries, revenues are needed to insure the very survival of organized government. In other, more stable developing countries, revenues are needed primarily to provide for adequate education (investment in human capital), which many regard as the key to promoting development (Avi-Yonah 2005).

Tax policies must be established for the long run “a policy that is seen as temporary may have little effect to attract investments” (Villela and Barreix 2002). For developing countries, the goal would be implement lasting tax policies that guarantee foreign business investment; also they must achieve policies without engaging in harmful tax competition with other developing countries.

According to Avi-Yonah and Margalioth (2007), tax incentives are: tax provisions that deviate from baseline provisions. If the baseline is the standard international or regional tax rate, or even the individual tax rate, then a low corporate rate qualifies as a tax incentive. If the motivation behind the low tax rate is attracting investment, then it is more appropriate to classify it as a tax incentive.

According to Villela and Barreix (2002), tax incentives: can be profit or income based and focused to reward capital investment or labor-related expenditures. The tax benefits can be given

in exchange for sales, job placement, value-added, import substitution or export targets. Tax holidays are the most common form of tax incentives under which new businesses are exempt from paying corporate income tax for a specified time period.

As for tax sparing provisions, Barker (2007) defines them as: a device used both by countries taxing worldwide income, which allow a foreign tax credit, as well as exemption countries, which allow a foreign tax credit for certain kinds of income that are not exempt. The object is to permit developing economies to reduce their income taxes under an incentive scheme for foreign taxpayers without having the residence country collect the spared tax.

Some authors note the negative consequences of tax incentives: developing economies are not able to support themselves and there are other problems like poverty, lack of education, inadequate healthcare, low employment, lack of infrastructure and corruption that need to be addressed before implementing tax incentives. These problems may be in some way solved by foreign investment, but the question is whether tax incentives are the right approach.However, some authors argue that tax incentives are the best way to address these problems since foreign companies would not engage in business activities in the country without them. Others argue that tax incentives are not the best approach because developing countries are distorting their economic system, and that tax incentives never bring the expected consequences to emerging economies because they sometimes create a negative impact on the region by creating harmful tax competition between similar countries which may distort the international economy.

One of the major arguments in favor of tax incentives from developing countries is that foreign investment may bring development and improvements to local economies. The United States has argued that FDI contributes toward financing sustained economic growth over the long term. It is especially important for its potential to transfer knowledge and technology, create jobs, boost overall productivity, enhance competitiveness and entrepreneurship and ultimately eradicate poverty through economic growth and development (UN Report 2002).Other positive effect of tax incentives includes “a reduction in poverty and general economic development” (McDaniel 2003). Developing countries face many problems that cannot be addressed by the local government because of the lack of resources and corruption among the authorities. However,

these kinds of tax policies are not always beneficial from a tax standpoint, even though they favor the nation's economy through the creation of jobs, environmental investment, construction of infrastructure, and reduction of poverty.

A few years ago, tax issues were not determining factors for businesses to decide whether to invest in one country over another. Some studies showed that "the statistical determinants of the location of investment are market size, labor cost, infrastructure quality, and growth of industrialization, level of foreign investment, growing domestic markets and stable international relations (Mallampally and Sauvant 1999). However according to more recent studies, tax issues are becoming a more important factor in the decision-making process: "globalization has dramatically reduced the importance of these factors, and elevated the role of tax incentives" (Margalioth 2003) and "as a result of increasing economic integration, particularly regional trade agreements, tax incentives are becoming a decision factor of growing importance for FDI location" (Villela and Barreix 2002). These new arguments have driven developing countries to increase the implementation of tax incentives to attract more foreign investment.

To attract and enhance inflows of productive capital, countries need to continue their efforts to achieve a transparent, stable and predictable investment climate, with proper contract enforcement and respect for property rights, embedded in sound macroeconomic policies and institutions that allow businesses, both domestic and international, to operate efficiently and profitably and with maximum development impact. Special efforts are required in priority areas such as economic policy and regulatory frameworks for promoting and protecting investments, including the areas of human resource development, avoidance of double taxation, corporate governance, accounting standards and the promotion of a competitive environment (UN Report 2002). There are many other issues developing countries must work on correcting before engaging in the implementation of tax incentives: "One conclusion that is relatively clear, however is that tax incentives for FDI provide host country benefits only if the country has achieved minimum levels of human capital, stock, infrastructure and others" (McDaniel 2003). Political issues, education, healthcare systems, infrastructure, poverty and social conflicts are problems affecting developing countries and tax incentives would not make them disappear. Developing countries must address these issues under a safe tax and economic policy. It is the

only way of promoting the local economy and improving the welfare of the population.

4. Current situation of tax stimulation in Uzbekistan

Uzbekistan has adopted a policy of import substitution and export orientation. The multiple exchange rate system and the highly over-regulated trade regime has led to both import and export declines since 1996, although imports have declined more than exports, as the government squeezed imports to maintain hard currency reserves. High tariffs and border closures imposed in 2002 led to massive decreases in imports of both consumer products and capital equipment. Uzbekistan's traditional trade partners are CIS states, notably Russia, Kazakhstan, Ukraine and the other Central Asian countries. Non-CIS partners have been increasing in importance in recent years, with Korea, China, Japan, Malaysia and Turkey being the most active (Statistical Yearbook 2015).

The basic laws on coordinating FDI activity are: "On guarantees and measures for the protection of rights of foreign investors» and "Foreign investments law" – provide the legal framework for foreign investment in Uzbekistan. The laws define the type of entities in which foreigners can invest, the conditions governing repatriation of profits and earnings and the general rights and guarantees of foreign investors.

To qualify for definition of an enterprise with foreign investment, the enterprises should have following characteristics:

- their charter capital is 150,000 USD or more;
- at least one of the participants is a foreign legal entity, and;
- foreign investor(s) own at least 30% of the total charter capital.

Under the investment laws, investments cannot be nationalized or confiscated without the payment of compensation. The foreign investment laws also provide for protection against adverse changes in the law for a 10-year following registration. This 10-year guarantee had been

widely challenged in the past by the tax authorities so that it would not apply to taxation changes, i.e. introduction of new taxes and/or increase of tax rates or taxable objects.There used to be a number of tax incentives available to investors and enterprises with foreign investment. Some of these incentives were set in the general tax legislation; some of them were granted on a case-by case basis, mostly in respect of investments made to key industries.

On 21 April, 2012 the President of Uzbekistan signed a Decree “On additional measures to stimulate direct foreign investment”. Based on the decree above, enterprises with foreign capital in which the foreign investor’s contribution in cash is not less than USD 5 million are covered by ‘a grandfathering clause’ protecting them from adverse changes in the tax legislation for the period of 10 years from the date of state registration with respect to corporate income tax, value-added tax, property tax, tax on the improvement and development of social infrastructure, unified social tax, unified tax payment, as well as mandatory contributions to the Republic Road Fund and the Fund on Reconstruction, Capital Repair and Equipment of Educational Institutions and Medical Institutions.

Enterprises and organizations – residents of Uzbekistan – supplying materials and rendering services to foreign companies are exempt from value-added-tax.
Enterprises exporting goods of their own production for freely convertible currency may apply reduced rates of corporate income tax as follows:

- if export share in total sales ranges from 15% to 30%, the effective rate shall be reduced by 30%;
- if export share in total sales is 30% or more, the tax rate shall be reduced by 50%. This incentive is applied likewise in regards to property tax. Thus:
- if export share ranges from 15% to 30%, the property tax rate is reduced by 30%;
- if export share ranges from 30% and higher, the property tax rate is reduced by 50%.

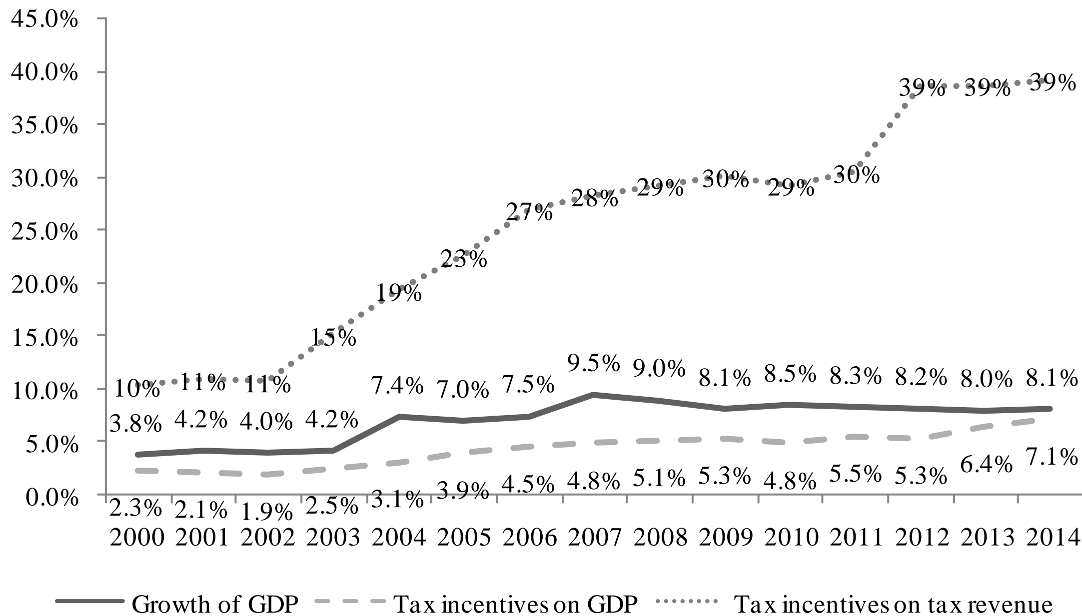
The incentive in both cases is subject to a restriction that it does not apply to wholesale/retail sale or intermediary companies, not to revenues from the export of specific items such as cotton fiber, oil, gas, precious metals, etc.Producers can also defer the payment of their import VAT in respect of material and technical resources used for production of goods to be exported. The deferral is granted for up to 90 days without application of any interest.

The taxable profits may be reduced by the amounts of expenditure that qualify as “investments” less the total annual depreciation charge. The term “investments” for the purpose of the relief is defined broadly and includes any investments to develop entity’s own production base, such as the purchase or construction of business premises, plant and machinery, or settlement of loans used for this purpose. The aggregate tax relief for “investment” expenditure is generally limited to 30% of taxable profits.

Additional tax concessions are available for production entities with a substantial with a substantial foreign investment component. Thus foreign investors may import free of import duties goods for their own production and their personal needs of foreign citizens working in Uzbekistan.

Graph 1

Indicators of tax incentive performance in Uzbekistan



The Uzbek legislation mainly provides tax incentives to encourage manufacturers, importers and exporters of strategically important products.

There have been created special economic industrial zones in Navoi, Angren and Djizzak for a preliminary term of 30 years with opportunity for prolongation. During that period special customs, foreign currency and tax regimes will be in force within its territory, as well as a simplified procedure for issuing works permits for non-residents who come to work.

Furthermore, legal entities registered with the special zones are exempt from land tax, property tax, corporate income tax, infrastructure development tax, unified tax payment for small companies, contributions to the Road and Fund on Reconstruction, Capital Repair and Equipment of Educational Institutions and Medical Institutions, provided that the amount of their direct investments are (Mirzaev and Oteuliev 2015):

- if located in Free Industrial Economic Zone "Navoi":
  - From EUR 3 mln to 10 mln – exemption is valid for 7 years;
  - From EUR 10 mln to 30 mln – exemption is valid for 10 years (after this the following 5 years, the income tax and unified tax payment rates are set at half of the effective general rate);
  - In excess of EUR 30 mln – exemption is valid for 15 years (after this the following 10

years, the income tax and unified tax rates are set at half the effective general rate).

- if located in Special Industrial Zones "Angren" and "Djizzak":
  - From USD 300,000 to USD 3 mln – exemption is valid for 3 years;
  - From USD 3 mln to USD 10 million – exemption is valid for 5 years;
  - Over USD 10 mln – exemption is valid for 7 years.

Another exemption provided to legal entities registered with the special is a relief from customs payments (except for customs clearance fees) on imported equipment, raw materials and spare parts required for production of the goods for export for the whole period of the special zones functioning. The customs payment on raw materials and spare parts imported for production of the effective general rates with a payment deferral for up to 180 days, unless the Uzbek legislation provides a more preferable regime.

5. Conclusion and policy recommendations

Developing countries must find ways to attract foreign investments that is good enough to outweigh the economic, political or social instabilities that can arise. Measures to reduce the negative influence of nontax issues are addressed through the implementation of beneficial tax policies, which may include tax incentives, tax holidays and tax sparing provisions. We made some conclusions that show negative benefits of tax incentives. Tax holidays are open to abuse many opportunities for tax avoidance. For instance, by using transfer pricing or other devices to shift earnings into holiday companies. Tax holidays are most attractive for footloose industries that tend to exit the country at the end of the holiday period and these industries are likely to bring the smallest benefit to the overall economy. If the home country of the foreign investor operates a worldwide system of taxation, without tax sparing, then the impact of the holiday may be diluted once profits are repatriated. This is because the home country ultimately ensures that repatriated earnings pay tax at its own rate.

Every year Uzbekistan reviewed and adopted regulations that extend and implement tax incentives. Nevertheless, above mentioned analyzes show that the tax incentives may affect to short term increase of GDP. The aim of developing knowledge based economy has raised

interest in the effectiveness of these tax incentives for two opposing reasons. First, R&D tax incentives are viewed as tools that protect innovative activity at economically challenging times and potentially promote growth. A second, emerging reason is that large government budget deficits trigger a re-examination of innovation policies associated with large amounts of foregone tax revenue.

So it is advisable for Uzbek economy to divide all tax benefits in to benefits included in non-taxable base shown in the Tax Code and tax benefits. In addition, taking into account foreign experience, we recommend to create a normative legal framework, methods assessing the degree of necessity of tax benefits targeted use of which is not shown for free funds arisen from tax benefits, apply tax benefits only to import and profit-bearing investments. It is also recommended to apply tax benefits to not existing innovations or technologies, but to new scientific researches.

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