A Critique of Korea’s Foreign Capital Inducement Policy in The Light of Neutral Taxation*

O. Yul Kwon**

I. Introduction

The economic success story of Korea is well known. Its economy grew at a fabulous rate of 8.4 percent per year (in real terms) over the 22-year period from 1962 to 1984 (EPB). The Korean model of economic policy and its growth strategy have been recently being emulated by other developing countries.

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 the 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 has introduced substantial changes in taxation (or in tax incentives) of income from foreign direct investment, reflecting its aspirations of decreasing its international debt burden and of inducing high technology in

* The author is grateful to his colleague Dr. J. Carlson for his helpful comments and suggestions, without implicating him for any remaining errors.
** University of Regina, Regina, Saskatchewan, Canada.
a more open economic system. These changes would have significant impacts on foreign investment and its environment in Korea. They would also have important implications for other capital-importing countries in Asia because these countries are all competing for foreign capital. In particular, the 1984 reform has introduced the idea of neutral taxation into the Korean foreign capital inducement system. Not only is this a significant change in the Korean policy, but also this may be regarded by developing countries as an innovation in the field of their policies toward foreign capital. It is thus important for the future development of foreign capital inducement policies that the new Korean policy be evaluated properly and be placed in a proper perspective. Therefore, the purpose of this paper is to analyse and evaluate Korea's foreign capital inducement policy and, in particular, its taxation of income from foreign direct investment in Korea. This will be done in the light of the concept of neutral taxation.

In order to formulate proper tax incentive policies toward foreign investments, the host country ought to understand the determinants of foreign direct investments. Hence, the next section will examine briefly available models of foreign direct investments. Then the concept of neutral taxation, which will be employed as the main evaluation criterion, will be examined 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 and its taxation of income from foreign direct investment in Korea. An evaluation of Korean taxation of foreign investment income 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 (henceforth FDI) is defined as foreign-owned equity in the host country's business.¹ There are a

¹. Foreign investment includes portfolio investment as well as foreign direct investment. Given that international portfolio capital flows through an extraordinarily broad and efficient market, the after-tax rates of return on financial instruments are equated across countries. Further, the tax credits for foreign taxes on interest against domestic taxes are in general insufficient. Hence, the host country's tax on interest 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 borrowing costs. For instance, in
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, and that the host country’s perspective draws little attention. In particular, it appears that most available models of FDI assume that the 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, FDIs are encouraged for certain areas, and are restricted or prohibited for other areas. 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 advanced technologies, managerial and marketing skills, raw materials, and access 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 an integral part.

Although a number of models are available for FDI, most of them appear to be based on two premises. First, FDIs are largely undertaken by multinational enterprises (henceforth MNE), and second, the world is characterized by imperfections in the output and factor markets. The beginning in this direction of thinking of FDI was made by Hymer. Hymer’s original idea was refined by Kindleberger 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, MNEs have firm-specific monopolistic or oligopolistic advantages such as superior technical knowledge, managerial and marketing skills, special access to markets, cheaper sources of financing, economies of scale, and differentiated products.

1975 Canada eliminated the withholding tax on corporate bond interest paid to foreign lenders. From an analysis of the Canadian experience of this, Brean 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.

2. For a survey of the theory of FDI, see, among others, Agarwal and Rugman.
The fact that a firm possesses monopolistic or oligopolistic advantages is, however, a necessary but not sufficient condition of FDI, because the firm can also serve 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 models have been further proposed, including the product cycle model and the 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).³

The internalization model was first proposed by Buckley and Casson and refined by Dunning. 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 MNEs, or are those for which MNEs possess firm-specific advantages. The market imperfections involve costs such as time lags, bargaining uncertainty and government intervention. Hence, MNEs 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 invested 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, MNEs may also realize internal and external

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 not properly explain FDI in Korea. See Koo.
economies of scale, as observed by Kindleberger. Although inter-
nationalization can be applied to any type of MNE with firm-specific
advantages, empirical studies available conclude that the process
of internalization is concentrated in industries with relatively high
R & D expenditures (Agarwal; Kojima, 1980).

It appears that the internalization model is an appropriate ex-
planation 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 are seeking those intermediate
goods.4

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 operating in one
or two foreign countries. In this context, a couple of additional
models may be worthwhile examining. They are Caves' model and
Kojima's model (1982). Caves argues that most FDIs are 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 FDIs, Caves argues that product differentia-
tion is the critical element, and hence they are most likely to be
found in the differentiated oligopolistic markets.5

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 advan-
taged industry in the host country. He further argues that FDI
will improve the comparative advantages of the host country's in-
dustry by transplanting superior technology and management,
thereby lowering the production costs.6

It is impossible to judge on an a priori basis which model would

4. Rugman further argues that internationalization is a general theory of FDI and a uni-
fying paradigm for the theory of the MNE. See Rugman.
5. Caves' model of horizontal investment has not properly explained FDI in Korea, main-
ly because of government restrictions. See Koo, p. 21.
6. Koo argues that Kojima's argument is quite valid in the case of FDI in Korea.
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. 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 (Kwon, 1983a). Even the Japanese type of FDI as proposed by Kojima may generate monopoly rents, in the short run, by decreasing production costs resulting from superior technology and management.

The argument that FDI would generate monopoly rents may further be supported by the nature of their MNE and by some observed FDIs. 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). It has been observed that manufacturing FDIs particularly by American MNEs are largely centred in technology-based and highly differentiated oligopolistic industries, thereby generating economic rents (Kojima, 1980; Baldwin). 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 FDIs undertaken by MNEs.

III. Neutral Taxation of Foreign Investment Income

Given that FDI generates monopoly rents, one fundamental question regarding tax policy of the host country is now 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.\textsuperscript{7} 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.

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 equals to the tax rate times the cost of an asset it 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

\textsuperscript{7} For a detailed explanation of neutral taxation and its practical application, see Kwon (1983a, 1983b, 1983c).
equals operating income from the marginal asset, the Samuelson scheme provides tax-deductions over the life of an asset, the present value 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 an asset — marginal or not — is 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 produc-
tion 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.\(^8\) 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 and to capture a fair share of monopoly rent therefrom? 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 investment 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 to raise an appropriate level of tax revenues therefrom 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). Under this principle, source (host) countries have the primary right to tax foreign firm's earnings in their countries while residence (home) countries typically allow credit for foreign taxes paid.

In the international context it should be noted that both domestic and foreign investors have investment opportunities both in domestic and foreign countries, and that the interaction of

\(^8\) For further detail on the implementation of the three schemes of neutral taxation, see Kwon (1983b).
domestic and foreign tax systems determines effective tax differentials with respect to 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 wherein 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 is consistent 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 taxes 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 (Athoine; Brean).\(^9\) Although

\(^9\) 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 taxed at the higher of the rates charged by the host and home country. 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 from investments in all foreign countries are pooled and foreign taxes are likewise
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 in-
estors. 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 com-
mitted to the source principle what type of tax strategy should
capital-importing developing countries adopt? It should be recall-
ed that under the source principle investors invest where pre-tax
returns — not after-tax returns — are highest. Therefore, in-
estors 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 accor-
dingly to gain monopoly rents from foreign investments. Under
these circumstances, the host country's tax has little relevance to
foreign direct investment decisions as long as the host country's
tax rate is lower than that of the home country. Therefore, tax in-
centives by host countries may 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 show that tax con-
cessions offered by developing countries are insignificant or ine-
effective in inducing foreign investments, and that influential fac-
tors are non-tax ones (Lent; Shah and Toye; Park, 1980; Agarwal;
Lim;Brean). An empirical study by Lim has found that generous

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 in-
vestment incentives (e.g., investment tax credit) ordinarily extended to capital expen-
ditures 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.

10. Some important non-tax factors cited in the literature include: convertibility of curren-
cies, 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 in-
dustrial sites and social overhead capital, and freedom from burdensome bureaucratic
control.
tax concessions are rather 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 as an 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 investment, 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 therefrom (or capturing a fair share of monopoly rents). In the light of neutral taxation, therefore, Korea’s taxation of foreign direct investment will be assessed in the following section.

IV. Korean Taxation of Foreign Investment Income

As stated earlier, the principles of the Korean policies toward foreign direct investment are contained in the Foreign Capital Inducement Act. The latest system effective July 1, 1984 changed
the notification system of projects eligible for 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 on foreign investment and some cumbersome administrative requirements were abolished. These clearly indicate an aspiration of the Korean government to induce more foreign direct investment in a more open economic system.

The 1984 reform of the Act also introduced important changes in taxation (or tax incentives) of foreign investment income. Under the preceding 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 direct 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 providing a large sum of capital. In case a project meets the requirements and gets approved, 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. Secondly, 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

11. For a further detail on the changes, see MF (1984a, 1984b).
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. Finally, 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.

V. Evaluation of Korean 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 unwarrentedly. 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 (MF, 1984b). Given that the rate of the corporation tax in Korea ranges from 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 which were 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 the 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). 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 of income and corporation taxes and taxes on dividends under the new system appears to be more generous than the tax exemptions and 50% tax 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 any 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 interest on debt capital to be
deductible, but does not do so for imputed interest on equity capital. As mentioned earlier, the Brown scheme is the most simple scheme of neutral taxation from the administration perspective. 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 the tax burden to foreign investors.

One important advantage of neutral taxation as compared to the conventional taxation is that it is better able to take a fair share of economic rents without interfering with investments. This is done by distinguishing economic (or monopoly) 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 licensed out to a host country may be zero as seen by the licenser, and the return to the technology has the quality of an economic rent. 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.12

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 extent to an income tax in the home country (Deutsch and Jenkins). 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 these 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 the property tax may not 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

12. 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.
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 these taxes is also justifiable with respect to taxation of foreign direct investments.

VI. Conclusions

Korea has recently introduced a new set of foreign capital inducement policies including some innovative ideas, and they would have important implications for other capital-importing developing countries. In order to formulate proper tax incentive policies toward foreign investments, the host country ought to understand the determinants of foreign direct investments. Hence, various models of foreign direct investment have been briefly examined. From these examinations of the models it appears that foreign direct investments are undertaken in developing countries as an internalizing process of firm-specific advantages such as advanced technologies, information, and managerial and marketing skills, and that foreign direct investment in developing countries generates monopoly rents. Therefore, important tasks of capital-importing developing countries would be to induce foreign investments by providing proper incentives and to capture a fair share of monopoly rents from foreign investments without, at the same time, discouraging them. These tasks may best be accomplished by neutral taxation. Hence, the concept of neutral taxation has been examined and used as the main evaluation criterion.

In formulating domestic tax policy in order to achieve the above dual task, a proper consideration must be given to the international interaction of tax systems. In particular, developing countries should take into account the source principle by which capital-importing countries have the primary right to tax income earned there, and capital-exporting countries maintain capital-export neutrality by providing tax credits for taxes paid abroad against their domestic taxes. Under these circumstances, tax-concessions may not contribute to the inducement of foreign investment, but transfer tax revenues to home countries. Hence, an
appropriate tax strategy of a developing host country for the above dual task would be neutral taxation of foreign investment income. This is so because a neutral tax does not hinder inflows of foreign capital, and it can capture monopoly rent without interfering with investment.

In view of neutral taxation, the current tax system of Korea with respect to foreign investment income requires substantial improvement. The five-year tax holiday for any single five-year period within ten years for income and corporate taxes and for taxes on dividends under the new system appears to be unwarranted in view of neutral taxation, and to be more generous than the tax-concessions under the previous system. In addition, exemptions of taxes for the first five years on royalty payments for foreign technology also appear to be unwarranted.

An innovative idea introduced by the current system is the special depreciation which foreign investors can elect as the alternative to the five-year tax holiday. It appears that this special depreciation is intended to provide an immediate write-off which is the Brown scheme of neutral taxation. However, the Korean system is far from being a neutral tax scheme because it does not contain a proper mechanism of measuring the value of assets nor a proper loss-offset system, and because it allows interest on funds borrowed deductible. While the Korean taxation of foreign investment income clearly falls short of the norm of neutral taxation, this rather innovative approach to taxation of foreign investment income constitutes a fruitful line of development which other developing countries, as well as Korea, should further explore. The defects of the system in the achievement of tax neutrality are readily identifiable and probably correctable. As a result, the Korean system may serve as a constructive guide for the future development of taxation of foreign investment income.

References


Kwon, O.Y., "Neutral Taxation and Provincial Mineral Royalties: The


