Asian Law Institute Inaugural Conference

Singapore

May 2004

Locational considerations in attracting multinational corporate regional headquarters: the relevance and role of tax law and tax incentives

by

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Abstract

The last decade has witnessed an intensification in the global competition for foreign investment. In particular, both developed and developing nations alike have sought to attract investment by multinational companies in high level service operations. Increasingly these nations have turned to tax policy with a view to enhancing their attractiveness as a destination.

The competition to attract Southeast Asian regional headquarters of multinational corporations is a case in point. This competition has been stimulated by the perception that the market leader, Hong Kong, is losing its lustre. This was certainly the dominant view leading up to 1997.

In an effort to improve their competitive position many Southeast Asian nations have enacted tax concessions targeted at regional headquarters. Undoubtedly Singapore has been the most proactive nation in this regard although Malaysia, the Philippines, China, Thailand, Taiwan and Australia have also enacted regional headquarters tax incentives to some degree.

Whilst Singapore's success in attracting regional headquarters may appear a compelling case for these incentives there is evidence to suggest that other factors dominate the locational decision namely:

- geographical location and proximity to markets,
- political stability,
- quality of infrastructure,
- availability of skilled labour, and
- pre-existing operations.

Tax would appear to be simply viewed as a cost by multinationals and, although relevant, is not decisive except possibly at the margin. That is, all else being equal then the tax regime of a country may be determinative in a negative sense. Most significantly, however, research has identified that tax concessions cannot compensate for critical deficiencies in the other determinants.

These conclusions should be of particular interest to policymakers in developing Asian nations considering introducing or extending tax incentives to attract foreign direct investment. Of course the analysis is restricted to the influence of tax incentives on one particular type of foreign investment. Nevertheless the findings underscore the need for careful consideration of the costs and benefits of such measures before implementing them.

This is not to deny fiscal policy any role in encouraging investment in a developing nation. However in lieu of legislative tax incentives or negotiating special confidential deals a moderate tax regime that is both clear and non-discriminatory in its application may best serve to foster a positive environment for both domestic and foreign investment.

Locational considerations in attracting multinational corporate regional headquarters: the relevance and role of tax law and tax incentives

Introduction –tax policy and the global competition for foreign investment

With the increased mobility during the last decade of capital and labour the competition between nations for foreign investment has intensified. Many nations have turned to a strategy of providing tax incentives with a view to enhancing their attractiveness.

Whilst the evidence might suggest that such incentives may be important in attracting manufacturing operations[1] it is less clear that multinational corporations place much significance on these incentives when locating higher level service functions. This is particularly significant for Asian nations because as nations develop and wage rates and the skills and expectations of the labour force increase it is common for such countries to focus on attracting higher level service operations.[2]

Southeast Asian casestudy

In this respect the competition in the Southeast Asian region to attract regional headquarters of multinational corporations ("RHQs") serves as an interesting casestudy. Whilst the functions performed by such companies can vary essentially they act as a hub for the group's activities in the region. Thus the most senior regional management will typically be based at the RHQ and it is likely to also employee IT professionals, marketing professionals, financial accountants and lawyers. Furthermore, often these companies will serve as a conduit for the flow through of profits from the local subsidiaries to the parent company.[3]

The location of a multinational RHQ to a nation is generally considered to provide many benefits in the form of financial gains to the country and employment opportunities for its citizens. Furthermore, there is prestige associated with the successful wooing of such enterprises and the possibility of achieving a transfer in intellectual property to the host nation. Also, the operations may have a clustering effect in the sense that not only might they encourage other multinational corporations to establish RHQs in the same jurisdiction but supporting enterprises, such as lawyers and accountants, are also likely to be attracted to the location.

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[1] The evidence is, in fact, inconclusive although it has been suggested that possibly tax considerations are becoming more significant: see T Edgar, "Corporate income tax coordination as a response to international tax competition and tax arbitrage" (2003) 51 *Canadian Tax Journal* 1079 and the references there referred to at footnote 126. Contrast the findings in H Wunder, "The effect of international tax policy on business location decisions" 24 *Tax Notes International* 1331 (December 24, 2001).

[2] Such as IT, marketing, management, accounting, legal and financial. This is starkly illustrated by the Hong Kong experience: see B Jessop and Ngai- Ling Sum, "An entrepreneurial city in action: Hong Kong's emerging strategies in and for (inter)urban competition" (2000) 37 *Urban Studies* 2287.

[3] Termed a "regional holding company".

The competition to attract Southeast Asian headquarters has been particularly strong given the perception, rightly or wrongly, that the market leader, Hong Kong, is losing its lustre. This was certainly the dominant view leading up to 1997.

Tax policy implications

In an effort to improve their competitive position many Southeast Asian nations have enacted tax concessions focussed on luring RHQs. Undoubtedly Singapore has been the most proactive nation in this regard although Malaysia, the Philippines, China, Thailand, Taiwan and Australia have also enacted regional headquarters tax incentives to some degree.

Common features of these incentives are:[4]

- a reduced corporate tax rate on profits from RHQ activities,
- a withholding tax exemption for profits flowing through the RHQ to the parent company,[5]
- some form of expatriate tax relief,[6]
- where appropriate, transfer pricing safe harbours,[7]
- special tax deductions, especially accelerated write-offs of capital investment,
- relief from other taxes such as consumption tax, payroll tax and stamp duty, and
- various undertakings to provide non-tax logistical assistance possibly including the payment of subsidies.

In 1994 when Australia was considering such incentives the writer prepared a comprehensive report on the utility of such measures. A decade on it is proposed to revisit the findings of that report and explore subsequent developments with a view to identifying the extent to which tax incentives and tax law generally have a role to play in encouraging foreign direct investment.

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[4] Most of the regimes borrowed heavily from the 1986 Singapore model which itself was based on earlier European regimes. Overtime the various regimes have adapted their own peculiarities.

[5] These profit flows typically take the form of dividends, royalties, interest payments or management fees.

[6] Such as tax exemptions on salary payments to short-term residents seconded to the RHQ and exemptions for tax on earnings from foreign investments held by these employees.

[7] In particular management fees charged by RHQs to associated companies could readily be the subject of a transfer pricing audit. This risk can be averted where some acknowledgement is provided by the taxing authority of acceptable charge out rates or profit margins.

The writer's 1994 report[8]

Background to the report: RHQs and the fire in the Chinese laundry

In the early 1990s the Australian Federal and State Governments had some initial success in convincing multinational companies to relocate high level service functions to Australia.[9] Traditionally such operations have been based in Hong Kong but with the uncertainty associated with the imminent change in control of the Territory it appeared that a number of multinationals were contemplating relocating. Research identifying that on average each RHQ generated 66 direct jobs and 200 indirect jobs, brought valuable intellectual property into the country and generated the opportunity for spin-off operations[10] prompted Australian State and Federal Governments to take this matter very seriously.

This opportunity, of course, was not lost on other Governments within the region. In particular, Singapore had long seen itself as the pretender for the title of the corporate hub of Southeast Asia. Malaysia, Taiwan, the Philippines and Thailand were other possible contenders for Hong Kong's crown.[11]

One of the reasons often cited for Hong Kong's success in attracting the foreign investment associated with these corporate operations is its low tax regime. Although Singapore with its more traditional tax system could not match Hong Kong's low flat rates of tax with its territorial limitations[12] and absence of withholding taxes on income flows out of the country, it was able to offer special tax incentives for the location of such operations in its jurisdiction. In particular, it offered an operating headquarters tax concession that provided low rates of tax on income derived within Singapore and tax exemptions for income flowing through the State.[13]

The Australian Governments, buoyed by their initial successes, also looked to further measures to entice multinationals to Australia. Given that one of these early immigrants was Hong Kong's Cathay Pacific, apparently encouraged through the

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8 J Dabner, *Should taxation incentives be introduced to encourage the location of South East Asian/South West Pacific regional corporate headquarters to Australia?*, University of Tasmania November 1994. The findings were summarised in J Dabner, "Are taxation incentives designed to attract regional corporate headquarters likely to be effective?" (1996) 2 *International Trade and Business Law Annual* 21.

9 In particular Cathay Pacific relocated its data communications centre to Sydney and a similar relocation was carried out by Data General Corporation.

10 See the report by the Australian Financial Centre Committee, *Capitalising on Australia's comparative advantage: developing Australia as an international financial centre,* Sydney February 1992 and the other reports and submissions canvassed in appendix D of the writer's 1994 report referenced at footnote 8.

11 Numerous statistics have been cited identifying one or other of the competing nations as the leading site for RHQ companies. Most acknowledge Hong Kong but sometimes Singapore is cited as the leading location. It is not proposed to reproduce or refer to any of these statistics. Often they are self-serving to support a particular nation's claim. However their primary deficiency is the lack of uniformity in the manner in which an RHQ is defined. It is also common for multinational companies to characterise operations as RHQs in order to access any incentives or government assistance that might be forthcoming.

12 Foreign source income is generally not taxable in Hong Kong.

13 This regime has since been amended and enhanced considerably. See http://www.sedb.com/edbcorp/browse.jsp?cat=40&type=2&parent=36&root=36

provision of sales tax concessions,[14] tax concessions were firmly on the agenda as a policy tool to attract RHQs. This was notwithstanding anecdotal evidence suggesting that Cathay's move to Australia had more to do with a fire in a downstairs Hong Kong laundry that corrupted the integrity of its call centre activities and the relatively low cost of office space in Sydney's suburbs compared with Hong Kong,[15] than to do with tax concessions.

In any event, various State tax concessions were introduced[16] and sales tax exemptions legislated.[17] The first significant income tax concession to encourage the relocation of RHQs to Australia, a clone of the Singapore regime, was proposed in February 1994. In due course this did not proceed but rather a watered-down conduit relief regime together with the availability of extended tax deductions was enacted.[18]

The report and its findings

It was against this background that the writer's report on the use of tax incentives to encourage RHQ operations was prepared.[19] The research involved a comprehensive literature review, a survey of multinationals with RHQ operations already in Australia and interviews with corporate advisers throughout the Southeast Asian region.

The report concluded that tax considerations were not significant to the decision where to locate such operations. Rather the most significant considerations were:

- geographical location and proximity to markets,
- political stability,
- quality of infrastructure,
- availability of skilled labour, and
- pre-existing operations.

Tax was simply viewed as a cost by multinationals that was relevant although not decisive. It appeared that its significance had been completely overstated by corporate lobbyists and politicians.

The findings did acknowledge, however, that tax issues could be decisive at the margin. That is, all else being equal then the tax regime of a country may be determinative in a negative sense. Thus a tax regime that is perceived as relatively

[14] M Dwyer, "Tax breaks to lure multinationals", *Australian Financial Review* 7 (January 19, 1994).
[15] Cathay's operation was established in North Ryde where the cost of real estate was reported as 2% of that of Hong Kong: G Lynch, "RHQ blues" (2000) *America's Network* 32.
[16] The first by Queensland, see the *Offshore banking units and regional headquarters Act* 1993.
[17] *Taxation Laws Amendment Act (No 3)* 1994.
[18] Announced in the White Paper entitled "*Working Nation*" released on 4 May 1994 and enacted by *Taxation laws Amendment Act (No 3)* 1994. Discussed further in N Fuller, "Regional headquarters" (1994) 23 *Australian Tax Review* 168; M Wachtel and D Scott "Australia" *International Tax Review* 7 (April, 1995) and R Fisher, "Regional headquarters incentives" (1997) 26 *Australian Tax Review* 169. Under the conduit relief regime foreign source dividends flowing through Australia to a foreign parent company are not subject to additional Australian income tax.
[19] See the reference at footnote 8.

onerous may induce a multinational to locate its operations to an otherwise similar jurisdiction.

Most significantly the research identified that tax concessions cannot compensate for critical deficiencies in the other determinants. This was certainly the Malaysian experience where a generous tax incentive had at that time failed to achieve much success. In fact some corporations that had located to Malaysia had apparently withdrawn their operations shortly thereafter.

One of the findings supporting the conclusion that income tax incentives are of little value in attracting RHQs was that RHQs were not profit centres. Their function was to support the income generating operations elsewhere within the region and, therefore, tax, particularly income tax, was less likely to be of significance. To the extent that they did generate a profit that was sheltered by an RHQ tax concession it was likely that the tax regimes in their parent company's jurisdiction, especially any controlled foreign company ("CFC") rules,[20] might simply result in an effective transfer of tax revenue from the host nation to that other country.[21]

Policy considerations

In addition to the evidence from the surveys, interviews and literature review supporting these conclusions there were also policy arguments against the provision of such tax concessions. One argument in particular was the potential for exploitation and tax avoidance embodied in such concessions. In fact, there was anecdotal evidence of this in relation to the Australian sales tax and State tax concessions that some multinational companies had negotiated. These were available for RHQ companies as defined but it was not always clear that the operations actually being carried out really fell within this description.

Furthermore, it was not clear that the types of operations that these multinational companies might conduct would necessarily derive substantial benefits for the local economy. Where the operation was primarily a conduit for income flows through to the parent company, whilst it might take advantage of tax concessions, any economic benefit for the local economy would be marginal.

One of the strongest policy arguments against such regimes was the bias they potentially generated in favour of foreign owned multinational companies over domestically owned operations. Such a tax bias is particularly undesirable where the foreign and domestic businesses are competing.

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[20] These rules seek to tax in the jurisdiction of the parent company income of foreign subsidiary companies that has been taxed in the foreign jurisdiction at a concessional rate and not repatriated.

[21] Significantly the OECD as part of their current harmful tax practices project encourages greater reliance by nations on residence taxation and, in particular, CFC regimes to combat the use by residents of preferential tax regimes of foreign countries: Organisation for Economic Co-operation and Development, *Harmful tax competition: an emerging global issue* (Paris, 1998). See also Organisation for Economic Co-operation and Development, *Towards global tax co-operation: the progress in identifying and eliminating harmful tax practices* (Paris, 2000); and Organisation for Economic Co-operation and Development, *The OECD's project on harmful tax practices: the 2001 the progress report* (Paris, 2001). http://www.oecd.org/topic/0,2686,en_2649_33745_1_1_1_1_37427,00.html

The conflict between the introduction of such incentives and the global trend away from the provision of subsidies through the tax regime was also identified.[22]

In concluding the report the writer recommended against Australia introducing tax concessions focused on attracting RHQs and rather recommended more general changes to the tax system that might be attractive to both domestic and foreign owned businesses and not merely operations conducting regional headquarters. These included the establishment of a transfer pricing safe harbour,[23] the renegotiation of tax treaties to reduce foreign withholding tax,[24] clearer and less tax regulation[25] and permitting the flow-through of the tax exemption for non-portfolio foreign source dividends and foreign tax credits through the company tax imputation system to shareholders.[26]

Subsequent developments

The first point that can be made is that the expected exodus of RHQs from Hong Kong did not occur or, at least, has not occurred yet. In fact with the opening up of the mainland Chinese market to Western multinational companies if anything there has been a shift northwards in business activity. Thus, given that proximity to major markets is a prime locational determinant Hong Kong has, in fact, strengthened its position in this regard.[27]

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[22] Notably the use of such incentives by foreign Governments is particularly poorly regarded by developed nations due to the tax revenue leakage and tax avoidance opportunities that they generate. Hence the OECD's harmful tax project directed at the elimination of incentives of this nature: see the previous footnote.

[23] Subsequently introduced in the form of an administrative concession: see Taxation Ruling 1999/1.

[24] This is now Government policy. See for example the recently renegotiated US/Australia double tax treaty (http://www.ato.gov.au/content.asp?doc=/content/Businesses/15715.htm).

[25] Since this recommendation was made the Government attempted to simplify the income tax laws but this process was terminated before it was completed. The result is that the income tax laws are now contained in two pieces of legislation the *Income Tax Assessment Act* 1936 and the *Income Tax Assessment Act* 1997. Furthermore, there has been continual amendment and additions to the legislation, particularly since the 1999 Ralph Review of Business Taxation: J Ralph, *Review of Business Taxation, Final Report*. Commonwealth of Australia July 1999.
(http://www.rbt.treasury.gov.au/publications/paper4/index.htm)
The Government's Board of Taxation has recently raised simplification as a priority once again: see the address by the chairman of the Board, Richard Warburton at the 2nd Annual Australian Taxation Summit, Sydney 10 February 2004 at http://www.taxboard.gov.au/content/speeches/2004_02_12.asp.

[26] A proposal that the Federal Government effectively rejected in its May 2003 Budget: 2003 Budget Paper no 2, p 28; Treasurer's Press release 13 May 2003.
(http://www.treasurer.gov.au/tsr/content/publications/InternationalTaxFactSheet.asp).
Thus currently where a company with tax advantaged income pays dividends the lower company tax liability will result in less imputation tax credits being available to pass on to shareholders resulting in more tax being imposed at the shareholder level. Thus the exemptions or credits at the corporate level are nullified.

[27] R Jacob, "The right choice for its Asian base: four years after the handover to China, multinationals remains committed as ever to the Territory" *Financial Times (London)* (July 13, 2001) 4. Contrast K Stephan and M Hiebert, "Singapore steals the Crown" 160 *Far Eastern Economic Review* 50 (December 26, 1996 and January 2, 1997). Possibly the explanation for these differing views is that there is evidence that some multinational corporations may be splitting their RHQ operations between Hong Kong in relation to their North Asian activities and Singapore in relation to their South Asian activities and India: J Van Eck, "What's in store for Hong Kong?" 13 (1997) *Financial Executive* 30. For a detailed account of Hong Kong's efforts to promote itself as a service centre see B Jessop and Ngai- Ling Sum, "An entrepreneurial city in action: Hong Kong's emerging strategies in and for (inter)urban competition" (2000) 37 *Urban Studies* 2287.

This, however, has not prevented a raft of new nations entering the competitive arena. Taiwan,[28] Thailand[29] and the Philippines[30] have all introduced RHQ tax incentives. Both Beijing and Shanghai have also become viable alternatives to Hong Kong[31] and in 2002 Shanghai enacted its own RHQ regime.[32] Even Korea has introduced tax concessions and has been talking up its advantages as a base for Northeast Asia.[33] Meanwhile Singapore has continued to develop its regime now recognising different types of headquarters companies and providing additional tax incentives where they provide global functions.[34] Kuala Lumpur and Sydney remain second tier competitors.[35]

In November 2000 a major two-year report by the University of Hong Kong was completed. This report identified that political stability and proximity to markets continued to be critical to the location decision. Tax, particularly incentives, remained fairly insignificant. Cost and quality of life issues were only of middle significance. Hong Kong remained the main site for RHQs. Interestingly the report also suggested that Tokyo was a competitor, although it was less attractive to Western multinational groups.[36]

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[28] See KS Wu, "ROC tax holidays in effect for foreign branches" 27 *Tax Notes International* 761 (August 12, 2002). Also noted in M Oesnicky, R Weisman and F Burke "Tax incentives in Asian jurisdictions may require a closer look" (1999) 10 *Journal of International Taxation* 28 at 37.

[29] Discussed in Anon, "Cabinet approves extension of tax exemptions, reductions" 26 *Tax Notes International* 292 (April 22, 2002); E Van der Bruggen, Tax planning with Thai regional operational headquarters" 27 *Tax Notes International* 479 (July 22, 2002) and E Van der Bruggen, "Royal decree provides guidance on regional operational headquarters" 28 *Tax Notes International* 244 (October 10, 2002).

[30] The regime was extended in 1999. Discussed in "AmCham urges incentives to lure foreign investors" *Businessworld* 1 (February 23, 1999) and "Taxwise or otherwise: regional operating headquarters" *Businessworld* 1 (September 30, 1999).

[31] For example, see "Multinationals set up 24 regional headquarters in Beijing" *Xinhua News Agency* 1008157h7522 (June 6, 2003) and J Yiren "Foreigners invest more in City, open headquarters" *Asiainfo Daily China News* 1 (September 3, 2002).

[32] See M Wong, "Shanghai offers tax incentives to promote regional headquarters" 28 *Tax Notes International* 20 (October 7, 2002).

[33] See A Ward, "Seoul's drive to become a finance hub. South Korea's optimists believe it can compete with Hong Kong and Singapore" *Financial Times* 21 (April 17, 2003) and So-Yong Kim, "Government broadens tax exemptions to attract foreign investment" 31 *Tax Notes International* 723 (August 25, 2003).

[34] For a period of time Singapore recognised four types of headquarters companies. Since 2003 it has only differentiated between regional and international headquarters. Under the international award a company that is willing to commit to substantially more than the minimum requirements of the regional headquarters award may qualify for a customised incentive package and a further reduced tax rate: see L Ng, " Singapore revamps corporate headquarters tax incentive" 29 *Tax Notes International* 454 (February 3, 2003) and the Government's headquarters' website at:
http://www.sedb.com/edbcorp/sg/en_uk/index/industry_opp/headquarter_services0.html

[35] Of varying significance depending on who is reporting: compare "Second-tier RHQ locations, The new pretenders, meet Sydney, Taipei, Shanghai and Kuala Lumpur" 32 *Business Asia* 7 (December 11, 2000) and J Shaw, "Top international companies show confidence in the financial marketplace" 8 *Australian Banking and Finance* 3 (July 14, 1999). Also see C Jacoby, "Regional HQs: on the move" *Corporate Location* 29 (4th quarter 2000). For a recent discussion of the extension of Malaysia's RHQ tax regime see J Kasipillai "Malaysia" 33 *Tax Notes International* 58 (January 5, 2004).

[36] Critiqued in "The RHQ question" 32 *Business Asia* 1 (December 11, 2000). Also see See KC Ho, "Competing to the regional centres: a multi-agency multi-locational perspective" (2000) 37 *Urban Studies* 2337. For an interesting, although dated, comparison of Singapore, Japan and Hong Kong tax

This more recent research has suggested that the locational considerations may, in fact, vary in their significance depending upon the jurisdiction of the parent company. Comparisons of United States and the Japanese corporate groups have identified that Japanese companies tend to place more significance on their proximity and access to Japan and whether the location has a multicultural orientation. Most interestingly tax issues would also appear to be more important to Japanese multinational companies, although still a secondary consideration.

Observations

The financial pages of magazines and newspapers often contain articles where corporate representatives and their advisers cite the importance of taxation incentives to the destination of corporate investment. Naturally multinational corporations would wish to encourage this view as a strategy to achieve cost savings.[37] Possibly politicians, with an eye to re-election and the desire to be viewed as doing something, might also wish to champion this view as the enactment of tax concessions is often easier than tackling the real issues that might be discouraging foreign investment.

However the evidence would suggest that developing Asian nations should be hesitant to enact tax incentives to attract foreign investment. In particular the writer's findings support the view that:

- it is not clear that foreign direct investment is sufficiently sensitive to tax to warrant such incentives,
- the quality of foreign investment is as important as its quantity as some investment may only marginally benefit a country,
- accordingly it is not clear that any net revenue loss arising from employing tax incentives would necessarily be offset by sufficient increase in benefits to the country,
- the provision of tax incentives to foreign owned businesses may provide them with a comparative advantage over domestically owned operations,
- any tax concessions might merely result in a transfer of tax revenue to foreign treasuries, and
- other non-tax factors are more important than tax considerations.

It is acknowledged that this research was focused on a specific type of foreign investment, namely investment in high level corporate functions in the nature of headquarters operations. It may be that other types of business activity more focused on profitability and cost minimisation might be more sensitive to tax measures.[38] However the issues relating to the potential transfer of revenue to foreign treasuries,

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issues relating to RHQs see DA Yoost and JE Fisher, "Choosing regional HQs in Asia" (1996) 7 *International Tax Review* 35.

[37] There is even pressure on the Hong Kong Government to introduce tax incentives for regional headquarters: "Tax incentives likely to attract regional headquarters" *China Daily* (May 11, 2003) http://www1.chinadaily.com.cn/en/doc/2003-11/05/content_278704.htm

[38] Although the evidence appears ambivalent. See footnote 1 and the references there referred to.

the quality issue and the potential “unleveling” of the playing field with domestically owned operations remain as concerns for policy makers considering such incentives.

What alternatives exist to attract foreign direct investment?

Given these findings as to the relative insignificance of tax policy a Government seeking to attract foreign direct investment should focus on improving and maintaining the quality of those other considerations that have been identified as being the primary determinants of the locational decision. In particular the Government might focus on enhancing infrastructure, simplifying and harmonising the regulatory structures, ensuring a reservoir of skilled labour and leveraging off the country’s comparative advantages and successes in other arenas.[39]

If nevertheless fiscal policy is to be employed then whilst it has been argued that the use of legislative tax concessions targeted at foreign corporations is a questionable policy the alternative of negotiating special deals behind closed doors with potential investors seems equally unpalatable.

Possibly, however, the latter is the preferred strategy. This would permit a Government to assess the value of any proposed investment from the perspective of the country’s national welfare and ensure that there is no unfair advantage provided to foreign investors who would be competing with domestically owned operations. That is, the Government can ensure that the investment is of "high-quality" from the host nation’s perspective.

This might also enable the Government to ensure that the deal negotiated with the potential investor takes into account their actual tax profile so that they are provided with a real benefit that does not simply result in a transfer of tax revenue to a foreign treasury.

There is no easy answer. On one hand, a policy of screening foreign direct investment and providing incentives for investment that is perceived as generating the greatest benefit for a country appears attractive. However there is a danger in the Government taking on the role of "picking winners" and becoming too close to business.[40] This could lead to a loss of objectivity in the stewardship of the economy and subsequent policy might be predicated on supporting the foreign business with a view to justifying the earlier decision. Large multinationals could also be expected to

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[39] The availability of skilled labour and adequate infrastructure (especially in telecommunications) may be emerging as the most significant determinants. See the analysis in FL Bartels and NJ Freeman, “Multinational firms and FDI in Southeast Asia: post-crisis changes in the manufacturing sector” (2000) 17 *ASEAN Economic Bulletin* 324.

[40] This has been the Japanese experience, even though Japan is often cited as the blueprint for emerging nations. Japanese tax policy post Second World War is well endowed with the use of tax incentives to encourage particular businesses and industries. Whilst these were successful at the micro-economic level they have generated a narrowing of the income tax base with attendant inequities, have tended to proliferate, are difficult to remove and lack transparency. The evidence would suggest that whilst Japanese tax policy may have influenced the country’s spectacular economic success it was not the driver. Furthermore, many of the institutional and fiscal problems now faced by the Japanese economy can be, in part, attributed to this tax policy. For an interesting account of the Japanese experience see H Baum, “Emulating Japan?" in *Japan, Economic success and Legal system,* Walter de Gruyter, Berlin 1997. Also see H Ishi, "The tax system of Japan" 10 *Tax Notes International* 1407 (April 17, 1995).

explore their various options and be very adept at commercial negotiations. The prospect of a developing nation engaging in bidding wars with other sovereign States, resulting in a race to the bottom, would not be inconceivable.

A policy of permitting multinationals to negotiate benefits with a sovereign State might be particularly unattractive where it lacks transparency. However the commercial reality is that both multinationals and the Government will have a strong incentive to keep the specifics of any negotiation confidential. Multinationals would not want their rivals to appreciate what is potentially on offer any more than the Government would want previous deals to be used as a precedent in future negotiations. What the Government would want, however, is for it to become common knowledge in the international investment community that it is prepared to do deals, without the detail of specific deals being known.

Conclusion

Given the importance of foreign investment to developing nations the technological advances that have greatly enhanced the mobility of capital both provide opportunities and threats for these nations. Developing nations are forced into a fierce competition to attract multinational investors and need to employ every competitive advantage that they can muster. Many nations view their tax laws as potentially one such advantage.

However whilst the evidence is inconclusive as to whether tax is a significant factor in the decision where to locate production processes there is compelling evidence that it is not significant to the decision where to locate high level service functions such as regional headquarters.

This finding is particularly significant for developing Asian nations. As the standard of living in these nations has increased, with attendant increases in wages and the skills and expectations of the population, most Asian nations have actively sought to attract RHQs and other high level operations of multinational companies to their shores. To this end the offering of tax incentives has become a common strategy.

However, the provision of these tax incentives comes at a cost to the host nation. They represent an effective revenue transfer out of the host nation and they disrupt the playing field between foreign and domestically owned operations. They might also distract the policy makers’ focus away from the true drivers of the location decision.

Policy makers in developing nations need to carefully weigh up the costs and benefits of providing these tax concessions. In lieu of such concessions or negotiating special secret deals it may be that the more appropriate policy is to establish a readily understandable, non-discriminatory and relatively non-invasive tax regime.