The Effect of Tax-Sparing Credit on Foreign Direct Investment and Income Shifting

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Abstract

Many developed countries including Japan permit tax-sparing credits for their own firms to receive the full benefits of tax reductions provided by developing countries, which are often willing to give foreign investors significant tax incentive such as tax holidays in order to encourage their investment. Although the previous researchers conclude that tax-sparing is effective in stimulating foreign direct investment, they miss the fact that the firms tend to abuse it to avoid home-country tax obligations. If the firms increase their subsidiary's pretax earning by shifting their income, they can obtain large amount of tax-sparing credit and reduce home-country tax burden. This paper provides clear evidence that the provision of tax-sparing credit stimulates income shifting rather than investment. This suggests that tax-sparing credits are aggressively used to reduce home-country taxes.

Key word: Tax-sparing credit, Foreign direct investment, Income shifting
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