Name of the Scholar: **AMRITA KAUR**

Name of the Supervisor: **PROF. A. AZIZ ANSARI**

Name of the Co-Supervisor: **LATE PROF. A.K. SETH**

Title of the Thesis: **"TAX SENSITIVITY OF FOREIGN DIRECT INVESTMENT IN INDIA"**

ABSTRACT

The primary purpose of the study is to examine the tax sensitivity of foreign direct investment and generate some policy recommendations based on the findings. It seeks to identify the forms of investment incentives likely to attract FDI.

DATA AND DATA SOURCES: This study uses annual time series data for the 16-year period (1992-2007). The data used in all estimations are reproduced in Appendix A. The data source for FDI in India includes Economic Survey 2007-08 and various issues of International Financial Statistics, IMF. The data on India's GNP is obtained from Handbook of Statistics on Indian Economy 2008 (www.rbi.org). The data for overall and foreign rates of return are based on the profitability ratios published by Centre for Monitoring Indian Economy (CMIE) (www.prowess.com).

MODEL SPECIFICATIONS

The present study uses four econometric models to study the tax sensitivity and foreign direct investments in Indian context. First, the Harman model, which explained relations to the influence of domestic tax policy on foreign direct investment in United States leading to the following regression model:

$$\ln\left(\frac{\mathrm{I_{re}}}{\mathrm{Y}}\right) = a_0 + a_1 \ln\big(r(1-t)\big) + a_2 \ln\left(r'(1-t)\right) + a_3 ln\left(\frac{(1-\mathrm{t}')}{(1-\mathrm{t})}\right)$$

Where, *r(l - t)* is the after-tax rate of return actually realized by foreign investors in the host country. *r'*(l - *t*) is the overall gross rate of return on capital in the host country, reduced by the tax rates appropriate to current income earned by a foreign investor. The final term $\frac{(1-t')}{(1-t)}$ measures the tax rate on host country's capital owned by foreigners (t), relative to the tax rate on the country by domestic investors.

To have a better understanding of the relationship between FDI and growth, the impact of the two monetary anchors Inflation and exchange rate of the Rupee against the U.S. dollar (i.e. Rs./$) on FDI is considered in the modified Harman model which leads to the following equation:

$$\ln\left(\frac{\mathrm{I_{re}}}{\mathrm{Y}}\right) = a_0 + a_1 \ln\big(r(1-t)\big) + a_2 \ln\left(r'(1-t)\right) + a_3 ln\left(\frac{(1-\mathrm{t}')}{(1-\mathrm{t})}\right) + a_4 ln(\mathrm{WPI}) + a_5 ln(\mathrm{USDINR})$$

Third, a refined model of Hartman given by Young in 1988 is estimated using the following regression equation:

$$\ln\ \mathrm{I} = a_0 + a_1 \ln\big(r(1-t)\big) + \ a_2 \ln\left(r'(1-t)\right) + a_3 \ln\left(\frac{(1-t')}{(1-t)}\right) + a_4 \ln Y + a_5 \ln \mathrm{I}(-1)$$

Where, I represents foreign direct investment in the host country, Y is U.S. GNP, and I(-l) is the lagged value of I and rest of the terms have the same meanings as in the Hartman model.

Fourth, the study includes a modified model of Young with Inflation and the exchange rate as the additional regressors. The estimating equation of the modified Young model can be written as:

$$\ln(\mathrm{I}) = a_0 + a_1 \ln\big(r(1-t)\big) + a_2 \ln\left(r'(1-t)\right) + a_3 ln\left(\frac{(1-\mathrm{t}')}{(1-\mathrm{t})}\right) + a_4 ln(\mathrm{Y}) + a_5\, ln(\mathrm{I}_{-1}) + a_6 ln(\mathrm{WPI}) + a_7 ln(\mathrm{USDINR})$$

The present study could undertakes only elementary determinants of FDI, other determinants like mergers and acquisitions, reinvested earnings, fiscal incentives can give a better understanding of the effect of tax policies on the composition of FDI and may give the host country a better ways of attracting the right type of investments. The growing tax competition among countries to attract foreign investors has led them in unfair tax competition by subsidizing income at a relatively low rates combined with special features, constituting harmful tax competition. There is a need for a detailed econometric evidence of these unusual practices and their impacts on the economy of the host country.