**The Impact of Supply Side Taxation on Foreign Direct Investment in Developing Countries: The Case of Egypt**

**By**

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Fiscal incentives are widely employed by many developed and developing countries to stimulate private investment in specific economic sectors which increases economic growth rates and mitigates unemployment levels. Fiscal incentives granted to private investment include using government expenditures and/or tax expenditures. The former entails expensing the government revenue on specific programs such as granting subsidies to private investment in specific economic sectors, such as subsidizing energy prices and supporting research and development (R&D) activities, while the latter refers to the forgone tax revenue, which results from using tax incentives to encourage investment such as tax exemptions, deductions, and credits(Vermeend, Ploeg, & Timmer, 2008). Taking into account the revenue shortage that most governments face, particularly in resource-poor countries, it is usually difficult to use government expenditure as a tool to stimulate private investment. Therefore, most of these countries prefer granting tax incentives to private investment in general and, to foreign direct investment in particular (FDI)(UNCTAD, 2000).

Tax incentives that are designed to attract foreign direct investment include various types of such as, (i) tax holidays, (ii) reduced tax rates, (iii) investment tax credit, and (iv) tax-free economic zones (Brauner, 2013). These types of tax incentives have many advantages such as, encouraging FDI inflows which are expected to have a positive impact on the economy through technology transfer, increasing employment rates and consequently increasing economic growth rates. On the other hand, tax incentives have a number of disadvantages such as the costs of foregone tax revenue and also the economic distortions that occur on some economic sectors (Zolt, 2013). Therefore, many countries started to abolish or rationalize using investment tax incentive, such as Ireland, Indonesia and Egypt.

In Egypt, it was believed that tax incentives are the main stimulus to private investment in general and to FDI in particular. Therefore, tax incentives were used extensively from 1974 to 2005. There were two main types of tax incentives: (i) tax holidays granted for a period from five to 20 year to domestic investment and (ii) absolute tax exemption for investment companies established in free zones. Those incentives were used to be granted in accordance with specific eligibility criteria which stipulated by either investment or tax legislations. The eligibility criteria used to be dependent on; (i) location of the investment and (ii) the type of investment activity or both. Some studies on the effectiveness of these tax incentives on private investment in Egypt concluded that investment tax incentives led to increasing private investment in new urban communities and also encouraged the flow of FDI to specific economic sectors (Holland & Vann, 1998). However, other studies found out that there are other important factors that affect the FDI flow rather than tax incentives, which are usually accused of creating economic

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distortions and also losses of tax revenue (Zolt, 2013). This conflict enforced the Egyptian government to rethink of other means to encourage private investment as well as the flow of FDI.

In 2005, a new tax policy was introduced which is based on eliminating tax incentives and broadening the tax base with lower tax rates schedule (the highest income tax rate is reduced from 40% to 20%) through the ratification of Income Tax Law No 91 of 2005(OECD, 2010). Accordingly, tax incentives were repealed from the investment legislation, particularly, those incentives that were used to stimulate domestic investment projects, and also the bulk of tax incentives that were included in the abolished income tax law No 157 of 1981. However, companies established in a fee zones are not subject to the income tax law as they are liable to only one percent of its annual value added (Abdellatif, 2009). Such tax policy is implement by number of developed countries such as the US in 1980s and Ireland in 1990s. Also few developing countries, such as Taiwan implemented such tax policy in the late of 1980s, which is known as supply side tax policy. Such new tax policy raises the following research question: “what is the impact of using the supply tax policy on FDI flow in Egypt”. Many scholars studied the causal relation between FDI and economic development, in order to justify granting tax incentives. Also many scholars examine the relation between tax incentives and FDI flow. On the other hand, there is a meager scholarly works related to assessing the relation between FDI flow and supply side taxation in developing countries (Chang & Cheng, 1992).

Accordingly, this paper aims to do the following; (i) identifying the relationship between tax policy and FDI flows in Egypt before and after the removal of tax incentives, and (ii) assessing the impact of supply side tax policy on FDI flow to Egypt. Thus, the paper is important in identifying the relevance of using supply side taxation in Egypt to create neutral tax system and its impact of attracting FDI. It is also important to support or reject ongoing debate over reintroducing tax incentives in Egypt accompanied by progressive tax rates system. In doing so, the paper is going to test the following hypothesis “ Tax incentives are important to encourage FDI flow to Egypt and Supply side tax policy is irrelevant to Egypt ”. in order to achieve research objectives and test the research hypothesis, a quantitative research methodology is going to be employed through using time series analysis. It is implemented to examine the trend of FDI flows during the period 1990 -2014 and identify the main factors affecting FDI. While existing literature uses Johansen cointegration techniques to capture the impact of tax policy changes on FDI in a time series framework, this study employs Autoregressive Distributed Lag (ARDL) approach. This approach, which was first introduced by Pesaran and Shin (1999) and then extended by Pesaran et al.(Pesaran, Shin, & Smith, 2001), is a more statistically significant approach for determining cointegrating relationships in small samples, while the Johansen cointegration techniques require larger samples for the results to be valid (Ghatak and Siddiki, 2001).

Another advantage of the ARDL is that, while other cointegration techniques require all of the regressors to be integrated of the same order, the ARDL can be applied irrespective of their order of integration (ARDL approach can be applied whether the regressors are I(1) and/or I(0)) and thus, it avoids the pre-testing problems associated with standard cointegration tests (Pesaran et al., 2001). Pahlavani (2005) points out that if the unit root properties of the data are not known for certain, then applying the ARDL procedure would be more appropriate than other cointegration techniques. Also, the ARDL approach allows different variables to have different optimal lags while this is allowed in Johansen cointegration techniques. Finally, the study tests for structural breaks in FDI data using Bai-Perron test in order to examine how significant tax policy shocks are in affecting FDI.

This paper is structured as follows; section one provides an introduction to the study, section two reviews the scholarly work related to tax incentives and FDI in developing countries, section three presents a preview of the history of tax incentives in Egypt, section four develops the theoretical model, section five tests the relationship between the tax policy and FDI using ARDL model and analyse the model results, finally, section six presents the concluding remarks.

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