

**THE IMPACT OF TAX POLICY ON THE INVESTMENT CLIMATE: A COMPARATIVE ANALYSIS OF DEVELOPING COUNTRIES**

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| <b>ABSTRACT</b>   | <b>KEYWORDS</b>  |
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| <p>This article examines the impact of tax policy on the investment climate in developing countries. A comparative analysis of tax practices across various countries is provided, examining the mechanisms by which corporate tax rates and tax incentives influence foreign direct investment (FDI). Key factors determining the effectiveness of tax policy are identified, including the quality of administration, transparency, and institutional conditions.</p> | <p>Tax policy, investment climate, foreign direct investment, developing countries, tax incentives, corporate tax, economic development.</p> |

**Introduction**

The research's novelty lies in its comprehensive comparative analysis of the impact of tax policy on the investment climate of developing countries, taking into account institutional factors, transparency, and international coordination. The work combines recent empirical data with theoretical approaches, demonstrating that the effectiveness of tax incentives depends not only on tax rates but also on the quality of governance, the legal environment, and socio-environmental standards. This allows for the development of more targeted recommendations for creating a sustainable investment environment.

The investment climate is a key factor in the economic development of developing countries. Foreign direct investment (FDI) is often viewed as a source of long-term economic growth, as it facilitates technology transfer, job creation, increased productive capacity, and improved infrastructure. Many developing countries compete to attract FDI using a variety of economic and fiscal instruments, among which tax policy plays a significant role.

On the other hand, states must also ensure the sustainability of their budgets and mobilize tax revenues to finance public goods. In this context, tax policy finds itself at the center of a dilemma: how to stimulate investment without depriving a significant portion of revenue. This problem is particularly acute in the current context, where global changes in tax rules are increasing competition between countries (for example, the introduction of a minimum corporate tax). These trends require developing countries to develop balanced strategies for tax competition and sustainable development.

Understanding the impact of taxes on FDI is based on classical economic theories of international capital flows. FDI theories (F-DI theory) assume that firms carefully weigh both macroeconomic and institutional factors in the host country when making investment decisions. Theoretical concepts of

capital flows include models based on comparative advantage, economies of scale, and the internal competition of transnational corporations (TNCs) [1]. From a fiscal policy perspective, reducing the tax rate reduces the cost of capital for foreign investors, making investment in the country more attractive.

Laffer curve model illustrates that there is an "optimal" level of taxation at which tax rates maximize government revenue without discouraging economic activity and investment [2]. If the tax rate is too high, the incentive effect is reduced, while if it is too low, the government may lose revenue.

supply-side theory In economics, tax reduction stimulates investment and economic growth because it reduces barriers to entrepreneurship and allows economic agents to reinvest profits [3]. In this approach, tax policy is viewed as a tool for stimulating capital-intensive investment.

Strong competition between countries to lower corporate tax rates can lead to a "race to the bottom," where countries sacrifice tax revenues for short-term investment. Empirical studies and economic reports warn that such measures are not always sustainable, especially in countries with limited institutional and administrative resources (tax administration, transparency) [4].

The type of corporate tax system-territorial or global-is of particular importance in the tax policy of developing countries. Research by the International Monetary Fund shows that the transition of large economies to a territorial system (where taxes are levied only on profits earned domestically, rather than globally) can change the sensitivity of corporations to tax rates in recipient countries [4]. This is especially important for low-income countries trying to maintain their competitiveness and tax base.

Based on the above, the main objectives of this study are:

1. Analyze how key elements of tax policy, such as the corporate tax rate, the structure of the tax base, and tax incentives, affect the investment climate of developing countries.
2. Compare the practices of tax incentives for FDI in different developing economies and identify the main institutional factors (administrative quality, transparency, legal stability) that strengthen or weaken this effect.
3. Identify the risks associated with tax competition and propose recommendations for a balanced fiscal strategy that combines investment attraction and sustainable budget revenues.

To achieve these goals, the following methods are used:

1. Review of theoretical and empirical literature, including works of international organizations (IMF, OECD) and academic research.
2. A comparative analysis of country experiences based on IMF and OECD publications, as well as studies on developing countries. For example, the OECD report "Tax Effects on Foreign Direct Investment" examines the sensitivity of FDI to tax rates and the structure of the tax system [5].
3. Case study (case study ) practices of specific developing countries, drawing on academic papers such as the analysis of Georgia, which discusses the role of tax policy in FDI inflows [6].
4. Analysis of institutional factors influencing the fiscal effect of such incentives, taking into account research on tax competition and administration.

We review key empirical studies analyzing the impact of tax policy (tax rates, tax burden, and incentives) on foreign direct investment (FDI) inflows in developing and transition economies. The analysis is grouped by type of empirical approach and thematic findings.

Table 1 – Main empirical studies

| Research (authors, year)                       | Countries/Research Area                            | Key variables   | Conclusions   |
|--|--|---|---|
| Korytin A. V.                                  | Russia (industry data, 29 industries, 2006–2015)   | Average tax rate (OECD), profitability, industry characteristics  | There is a negative relationship between the tax burden and FDI inflows: the elasticity of FDI flow to the tax burden is about 0.88 , which indicates a high sensitivity of foreign investors to the amount of capital tax [7].   |
| CA&C Press (using Georgia as an example)       | Georgia (2003–2012)                                | Tax rate, depreciation, tax administration  | The authors conclude that tax policy factors play only an indirect role in investor decisions. In a ranking of ten factors influencing investor decisions, tax policy ranked fourth, after macroeconomics, labor legislation , and transportation costs [6].  |
| Petrushkevich E.                               | Developing countries (general overview)            | International initiatives, transparency, and standards of responsibility for transnational companies                      | It is emphasized that FDI, particularly in labor-intensive and extractive industries, can have negative effects, including low transparency and weak social responsibility among TNCs. The authors note the role of international initiatives (for example, within the UN and other organizations) in minimizing these risks [8]. |
| IMF Blog ( Ahn , Habib , Presbitero And etc. ) | Emerging/Developing Markets                        | FDI fragmentation, geopolitical risks   | Analysis shows that the growing fragmentation of global supply chains is hitting developing economies particularly hard. This indirectly impacts the attractiveness of tax incentives, as geopolitical risk becomes a more important factor than low tax rates [9].   |
| Faruq , ATM Omor                               | 24 Emerging Asian Economies (Panel Data 2002–2018) | Economic factors (GDP, natural resources), institutional (legal environment, information disclosure), political stability | The study shows that economic factors (market size, resources) have a strong influence on FDI, and among the institutional factors, the most significant is the business disclosure index , while the tax rate (in the analysis) is less significant compared to the basic economic determinants [10].                            |

Thus, empirical studies confirm that tax policy influences FDI flows, but its effectiveness significantly depends on the institutional environment, transparency, geopolitical risks and economic structure, which highlights the need for a comprehensive approach to tax strategy formulation in developing countries.

A discussion of empirical and theoretical evidence shows that tax policy is an important tool for shaping the investment climate in developing countries, but its effectiveness depends on the quality of the institutional environment, transparency, international coordination, and socio-environmental factors:

1. Tax Competition and the Risk of a "Race to the Bottom." Developing countries, seeking to attract FDI, often reduce tax rates or provide incentives. However, this behavior can lead to uncontrolled tax competition, undermining long-term budget revenues. The IMF warns in its research that competition for lower corporate taxes reduces global tax revenues, and one way to mitigate this is to introduce a global minimum tax (e.g., 15%) for multinational corporations [4]. At the same time, as noted in an

earlier IMF report, it is important to minimize indirect tax incentives and tax holidays, as they often prove ineffective and are subject to abuse. Thus, tax competition policies must be balanced: aggressive incentives can attract investment, but the risks of losing the tax base and fiscal sustainability are too great.

2. The Role of Institutional Quality. Empirical evidence suggests that not only the tax rate but also the institutional environment (governance, legal effectiveness, transparency) are critical. For example, studies of developing countries show that institutional factors (including the business disclosure index) significantly influence FDI attraction [10]. This is also supported by the literature that examines the broader risks of FDI: multinational companies in developing countries can create negative externalities (environmental, social), especially if the legal system is weak [8]. Therefore, tax policy should be accompanied by institutional reforms: strengthening governance, improving transparency, and enhancing accountability mechanisms for investors.

3. The need for international coordination. Current trends of globalization and capital mobility increase the need for international coordination of tax policies. The introduction of a global minimum tax, as proposed by the IMF, could reduce incentives for base erosion and mitigate the “race to the bottom” [4]. Revisiting tax treaties is also important: research shows that double taxation agreements (DTAs) do indeed promote FDI inflows to developing countries, provided that their tax environments (e.g., tax haven status or transfer pricing rules) are taken into account [11]. This means that preference policies should not be simply national, but part of a global system in which countries coordinate their rates and mechanisms for a sustainable and equitable distribution of tax benefits from FDI.

4. Social and environmental impacts of FDI. FDI does not always bring exclusively economic benefits: in developing countries, it can be accompanied by the exploitation of natural resources, environmental degradation, and weak compliance with social responsibility standards [8]. Therefore, tax policy cannot be the only instrument: a combination of fiscal incentives and regulatory measures is required to ensure sustainable development. This may include obligations for investors to comply with environmental standards, social obligations, or conduct impact assessments on local communities.

5. The political feasibility of reforms in the context of developing countries. In low-income countries with weak administration, tax incentives can be an important motivator for investors. However, as the IMF emphasizes, such countries must also work to strengthen the tax base: limit discretionary exemptions, improve budget forecasting, and enhance transparency. Furthermore, to sustainably attract investment, incentives must not be the only tool: reforms must include improving infrastructure, enhancing human capital, combating corruption, and strengthening legal protection for investors.

Based on the analysis conducted, the following recommendations can be identified:

1. Targeted tax incentives: provide incentives only for investments with high added value and socio-economic benefits.
2. Strengthening tax administration: increasing transparency, reducing bureaucratic barriers and combating tax evasion.
3. Monitoring the effectiveness of tax policy: regularly assess the impact of tax incentives and rates on FDI inflows.
4. International coordination: participate in global tax initiatives and agreements to ensure sustainable distribution of tax benefits.

Tax policy has a significant impact on the investment climate in developing countries. However, its effectiveness is determined not only by tax rates and incentives provided, but also by the quality of the institutional environment, transparency, the level of legal security, and compliance with social and environmental standards. Empirical evidence shows that reducing the tax burden can stimulate FDI inflows, but without a comprehensive approach including institutional reforms and international coordination, the effect will be limited. Therefore, to achieve sustainable development, fiscal incentives must be combined with improved governance, increased transparency, and the implementation of social accountability mechanisms to create a favorable and stable investment climate.

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