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Discussion of substantive issues related to international cooperation in tax matters: other issues: capacity-building

Capacity development programme in international tax cooperation

Note by the Secretariat

The paper contained in the annex to the present note was prepared by Eric M. Zolt, Michael H. Schill Distinguished Professor of Law, UCLA School of Law, at the request of the Financing for Development Office of the Department of Economic and Social Affairs of the United Nations Secretariat, pursuant to Economic and Social Council resolutions 2014/12 and 2013/24. In those resolutions, the Council recognized the progress made by the Office in its work in developing, within its mandate, a capacity development programme in international tax cooperation aimed at strengthening the capacity of the ministries of finance and national tax authorities in developing countries to develop more effective and efficient tax systems, which support the desired levels of public and private investment, and to combat tax evasion, and requested the Office, in partnership with other stakeholders, to continue its work in this area and to further develop its activities.

One of the current areas of focus of the above-mentioned programme is on strengthening the capacity of developing countries to increase the potential for domestic revenue mobilization through enhancing their ability to effectively protect and broaden the tax base. Wasteful tax incentives have been identified by developing countries as major contributor to tax base erosion. The paper aims to provide developing countries with an overview of key concepts and issues regarding tax incentives and their use to attract investment.

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Annex

Tax incentives: an overview of key concepts and issues*

I. Introduction

1. The present paper seeks to provide an overview of key concepts and issues regarding tax incentives and their use to attract investment.[1] Some contend that tax incentives, particularly for foreign direct investment, are bad in both theory and in practice. Tax incentives are bad in theory because they distort investment decisions. Tax incentives are bad in practice because they are often ineffective, inefficient and prone to abuse and corruption.

2. Yet almost all countries use tax incentives. In developed countries, tax incentives often take the form of investment tax credits, accelerated depreciation and favourable tax treatment for expenditures on research and development. To the extent possible in the post-World Trade Organization world, developed countries also adopt tax regimes that favour export activities and seek to provide their resident corporations a competitive advantage in the global marketplace. Many transition and developing countries have an additional focus. Tax incentives are used to encourage domestic industries and to attract foreign investment. Here, the tools of choice are often tax holidays, regional investment incentives, special enterprise zones and reinvestment incentives.

3. Much has been written about the desirability of using tax incentives to attract new investment. The United Nations,[2] the International Monetary Fund (IMF),[3] the Organization for Economic Cooperation and Development (OECD)[4] and the World

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[1] Parts of the discussion in the present paper rely on Alex Easson and Eric M. Zolt, "Tax Incentives", World Bank Institute (Washington, D.C., World Bank Group, 2002), available from http://siteresources.worldbank.org/INTTPA/Resources/EassonZoltPaper.pdf.

[2] See, for example, United Nations Conference on Trade and Development, *Incentives and Foreign Direct Investment* (United Nations publication, Sales No. E.96.II.A.6); and *Tax Incentives and Foreign Direct Investment: A Global Survey* (United Nations publication, Sales No. E.01.II.D.5).

[3] See, for example, George E. Lent, "Tax Incentives for Investment in Developing Countries", *IMF Staff Papers*, vol. 14, No. 2 (Washington, D.C., IMF, 1967); Howell H. Zee, Janet Gale Stotsky and Eduardo Ley, "Tax Incentives for Business Investment: A Primer for Tax Policy Makers in Developing Countries", International Monetary Fund (Washington, D.C., IMF, 2001); Alexander Klemm, "Causes, Benefits and Risks of Business Tax Incentives", International Monetary Fund (Washington, D.C., IMF, 2009); and David Holland and Richard J. Vann, "Income Tax Incentives for Investment", in *Tax Law Design and Drafting* , Victor Thuronyi, ed., vol. 2 (Washington, D.C., IMF, 1998).

[4] See, for example, Organization for Economic Cooperation and Development, *Tax Effects on Foreign Direct Investment: Recent Evidence and Policy Analysis*, Tax Policy Study No. 17 (2007); Organization for Economic Cooperation and Development, "Tax Incentives for Investment: A Global Perspective: experiences in MENA and non-MENA countries", in *Making Reforms Succeed: Moving Forward with the MENA Investment Policy Agenda* (Paris: OECD, 2008).

Bank[5] have produced useful reports that provide guidance to policymakers on whether to adopt tax incentives and how best to design them. The empirical evidence on the cost-effectiveness of using tax incentives to increase investment is inconclusive. While economists have made significant advances in determining the correlation between increased tax incentives and increased investment, it is challenging to determine whether tax incentives caused the additional investments. This is partly because it is difficult to determine the amount of marginal investment associated with the tax benefit; that is to say, the investments that would not otherwise have occurred "but for" the tax benefits. While foreign investors often claim that tax incentives were necessary for the investment decision, it is not easy to determine the validity of the claim. Governments often adopt tax incentives in a package with other reforms designed to improve the climate for investment, making it difficult to determine the portion of new investment that is attributable to tax benefits and the portion that relates to other pro-investor reforms. With these qualifications, it is sometimes easy to conclude that a particular tax incentive scheme has resulted in little new investment, with a substantial cost to the government. In other cases, however, tax incentives have clearly played an important role in attracting new investment that contributed to substantial increases in growth and development.

4. One place to start thinking about tax incentives is to consider what role governments should play in encouraging growth and development. Governments have many social and economic objectives and a variety of tools to achieve those objectives.[6] Tax policy is just one option, and taxes are just one part of a complex decision as to where to make new domestic investment or commit foreign investment. Governments have a greater role than to focus on relative effective tax burdens. Governments need to consider their role in improving the entire investment climate to encourage new domestic and foreign investment, rather than simply doling out tax benefits. Thus, while much of the focus on tax incentives is on the taxes imposed by government, it is also important to examine the government spending side of the equation. Investors, both domestic and foreign, benefit from government expenditures. A comparison of relative tax burdens requires consideration of relative benefits from government services.

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[5] See, for example, Robin W. Boadway and Anwar Shah, "Perspectives on the Role of Investment Incentives in Developing Countries", World Bank (Washington, D.C.), World Bank, 1992); Sebastian James, "Effectiveness of Tax and Non-Tax Incentives and Investments: Evidence and Policy Implications", World Bank Group (Washington, D.C., World Bank Group, 2013); Sebastian James, "Incentives and Investments: Evidence and Policy Implications", World Bank Group (Washington, D.C., World Bank Group, 2009); and Alex Easson and Eric M. Zolt, "Tax Incentives", World Bank Institute (Washington, D.C., World Bank Group, 2002), available from http://siteresources.worldbank.org/INTTPA/Resources/EassonZoltPaper.pdf.

[6] See, generally, Richard M. Bird and Eric M. Zolt, "Tax Policy in Emerging Countries", in *Environment and Planning C: Government and Policy*, vol. 26 (UCLA School of Law, 2008); Richard M. Bird, "Tax Incentives for Investment in Developing Countries", in *Fiscal Reform and Structural Change in Developing Countries*, Guillermo Perry, John Whalley and Gary McMahon, eds., vol. 1 (London: Canada: Macmillan in association with the International Development Research Centre, 2000).

II. Definition of tax incentives

5. At one level, tax incentives are easy to identify. They are those special provisions that allow for exclusions, credits, preferential tax rates or deferral of tax liability. Tax incentives can take many forms: tax holidays for a limited duration, current deductibility for certain types of expenditures or reduced import tariffs or customs duties. At another level, it can be difficult to distinguish between provisions considered part of the general tax structure and those that provide special treatment. This distinction will become more important when countries become limited in their ability to adopt targeted tax incentives. For example, a country can provide a 10 per cent corporate tax rate for income from manufacturing. This low tax rate can be considered simply an attractive feature of the general tax structure as it applies to all taxpayers (domestic and foreign) or it can be seen as a special tax incentive (restricted to manufacturing) in the context of the entire tax system.

6. Tax incentives can also be defined in terms of their effect on reducing the effective tax burden for a specific project.[7] This approach compares the relative tax burden on a project that qualifies for a tax incentive to the tax burden that would be borne in the absence of a special tax provision. This approach is useful in comparing the relative effectiveness of different types of tax incentives in reducing the tax burden associated with a project.

7. Commentators contend tax incentives may now play a larger role in influencing investment decisions than in past years. Several factors explain why tax considerations may have become more important in investment decisions.[8] First, tax incentives may be more generous now than in past years. The effective reduction in tax burden for investment projects may be greater than in the past, as tax holiday periods increase from 2 years to 10 years or the tax relief provided in certain enterprise zones comes to include trade taxes as well as income taxes. Second, over the past several decades there has been substantial trade liberalization and greater capital mobility. As non-tax barriers decline, the significance of taxes as an important factor in investment decisions increases. Third, business has changed in many ways. Firms have made major changes in organizational structure, production and distribution methods and the types of products being manufactured and sold. Highly mobile services and intangibles are a much higher portion of cross-border transactions than in past years.

8. Fewer firms now produce their products entirely in one country. Many of them contract out to third parties (either unrelated third parties or related "contract manufacturers") some or all of their production. With improvements in transportation and communication, component parts are often produced in multiple countries, which results in increased competition for production among several countries. In addition, distribution arrangements have evolved, where the functions and risks within a related group of corporations are allocated to reduce tax liability through so-called commissionaire arrangements. Finally, there has been substantial growth in common markets, customs unions and free trade areas. Firms can now

[7] See Howell H. Zee, Janet Gale Stotsky and Eduardo Ley, "Tax Incentives for Business Investment: A Primer for Tax Policy Makers in Developing Countries", International Monetary Fund (Washington, D.C., IMF, 2001).

[8] See Alex Easson, "Tax Incentives for Foreign Investment, Part I: Recent Trends and Countertrends", *Bulletin for International Fiscal Documentation*, vol. 55. (2001).

supply several national markets from a single location. This will likely encourage competition among countries within a common area to serve as the host country for firms servicing the entire area.

9. While tax incentives can make investing in a particular country more attractive, they cannot compensate for deficiencies in the design of the tax system or inadequate physical, financial, legal or institutional infrastructure. In some countries, tax incentives have been justified because the general tax system places investments in those countries at a competitive disadvantage compared with other countries. It makes little sense, however, to use tax incentives to compensate for high corporate tax rates, inadequate depreciation allowances or the failure to allow companies that incur losses in early years to use those losses to reduce taxes in later years. The better approach is to bring the corporate tax regime closer to international practice, rather than grant favourable tax treatment to specific investors. Similarly, tax incentives are a poor response to the economic or political problems that may exist in a country. If a country has inadequate protection of property rights, rigid employment laws or a poorly functioning legal system, it is necessary to engage in the difficult and lengthy process of correcting these deficiencies rather than provide investors with additional tax benefits.

10. The effectiveness of tax incentives is directly related to the investment climate (including investor confidence that a revenue authority will actually honour tax incentives without controversy) in a particular country.[9] While two countries could provide identical tax incentives (for example, a 10-year holiday for corporate income taxes), the relative effectiveness of the incentive in attracting foreign direct investment is substantially greater for the country with the better investment climate.[10]

III. Different types of tax competition

11. Tax incentives are all about tax competition — how can a country attract investment that otherwise would have gone to a different region or country? Countries may seek to compete for different types of investments, such as headquarters and service businesses, mobile light assembly plants or automobile manufacturing facilities. The starting point in thinking about tax competition is to consider the reasons why foreign investors invest in a particular country. At a highly stylized general level, there are three primary reasons to engage in cross-border investments: (a) to exploit natural resources; (b) to facilitate the selling or production of goods or services in a particular market; and (c) to take advantage of favourable conditions in a particular country (such as relatively low wages for qualified workers) to produce goods for export (either as finished products or as components). The competition for foreign investment will differ depending on the reason for the investment. For example, tax competition will exist among countries of a common

[9] See Stefan Van Parys and Sebastian James, “Why Tax Incentives May be an Ineffective Tool to Encouraging Investment? — The Role of Investment Climate”, International Monetary Fund, World Bank Group (Washington, D.C., IMF; World Bank Group, 2009), available from http://ssrn.com/abstract=1568296.

[10] See Sebastian James, “Providing Incentives for Investment: Advice for Policymakers in Developing Countries”, Investment Climate in Practice, No. 7, World Bank Group (Washington, D.C., World Bank Group, 2010). He estimates that tax incentives in a country with a good investment climate may be eight times more effective in attracting foreign investment than in countries with less favourable investment environments.

customs union for the manufacturing or distribution facility that will service the entire region. In contrast, for export platforms, the competition will be among countries that have similar comparative advantages. As such, the competition for investment may be global, among countries in a particular region or even among States within a particular country. The key point is that the design and the effectiveness of tax incentives will differ depending on the type of investment.

IV. Additional investment incentives

12. Countries will compete for foreign investment using any means available to them. Non-tax incentives, such as training grants, low-cost loans or infrastructure improvements can be substitutes or complements to tax incentives. If challenges exist to using tax incentives (for example, due to agreements not to use particular types of tax incentives or because of the structure of the tax regime in the foreign investor's home country), then countries will likely make greater use of non-tax incentives.

13. A different form of investment incentives is tax-related, but not generally included in the list of types of tax incentives. These disguised tax incentives can include liberal safe harbours in transfer pricing rules, provisions that facilitate aggressive tax planning and even tacit forms of lax tax enforcement. For example, the United States "check-the-box" regulations can be viewed as a tax incentive to allow United States multinational entities to compete more effectively with non-United States multinational entities by using hybrid entities to minimize foreign tax liability in high-tax countries.

V. Role of non-tax factors

14. Deciding whether and where to invest is a complex decision. It is not surprising that tax considerations are just one factor in these decisions. Commentators have listed several factors that influence investment decisions, particularly those of foreign investors.[11] A partial list of these factors is set forth in the box below.

Non-tax factors influencing investment decisions

1. Consistent and stable macroeconomic and fiscal policy.
2. Political stability.
3. Adequate physical, financial, legal and institutional infrastructure.
4. Effective, transparent and accountable public administration.
5. Skilled labour force and flexible labour code governing employer and employee relations.
6. Availability of adequate dispute resolution mechanisms.
7. Foreign exchange rules and the ability to repatriate profits.
8. Language and cultural conditions.
9. Factor and product markets — size and efficiency.

[11] Sebastian James, "Incentives and Investments: Evidence and Policy Implications", World Bank Group (Washington, D.C., World Bank Group, 2009).

15. Most surveys of business executives conclude that taxes were often not a major consideration in deciding whether and where to invest. For most types of investments, there is a two-part decision. First, from a business perspective, which country would be the best choice for achieving a particular investment objective? Second, from a tax perspective, how would activities be structured to minimize tax liabilities (both on a country basis and an aggregate worldwide basis)?

VI. Review of empirical evidence

16. Several economic studies have examined the effect of taxes on investment, particularly foreign direct investment. While it is not easy to compare the results of different empirical studies, scholars have attempted to survey the various studies and to reach some conclusions as regards the effect of taxes on levels of foreign investment.[12] Such surveys note the difficulty of comparing the results of different studies because the studies contain different data sources, methodologies and limitations.[12] The studies also report different types of elasticities in measuring the responsiveness of investment to taxes.

17. Part of the difficulty in determining the effect of taxes on foreign investment is getting a good understanding of the different types of foreign investment and the different sources of funding for foreign investment. Foreign investment consists of both portfolio and direct investment. While different ways to distinguish portfolio and direct investment exist, a common approach is to focus on the foreign investor's percentage ownership of the domestic enterprise. For example, if the foreign investor owns a greater than 10 per cent stake in an enterprise, the investment is likely more than a mere passive holding for investment purposes. Foreign direct investment can be further divided into direct transfers from a parent company to a foreign affiliate through debt or equity contributions and reinvested earnings by the foreign affiliate.

18. The different forms of foreign investment are also important, as each form may respond differently to taxes. Types of foreign investment include: (a) real investments in plant and equipment; (b) financial flows associated with mergers and acquisitions; (c) increased investment in foreign affiliates; and (d) joint ventures. Finally, commentators have noted that taxes may affect a decision as to the source of financing more than decisions as to the level of investment.[13] Investors have several alternatives on how to fund new ventures or expand existing operations.

[12] See Commission of the European Communities, *Report of the Committee of Independent Experts on Company Taxation* (Brussels, Office for Official Publications of the European Communities, 1992); see also James R. Hines, Jr., "Tax Policy and the Activities of Multinational Corporations," in *Fiscal Policy: Lessons from Economic Research* (Cambridge, Massachusetts: MIT Press, 1997), Alan Auerbach, ed., and James R. Hines, Jr., "Lessons from Behavioral Responses to International Taxation", *National Tax Journal*, vol. 52 (1999); Ruud A. de Mooij and Sjef Ederveen, "Taxation and Foreign Direct Investment: A Synthesis of Empirical Research", *International Tax and Public Finance*, vol. 10, No. 6 (2003); and Alexander Klemm and Stefan Van Parys, "Empirical Evidence on the Effects of Tax Incentives", International Monetary Fund (Washington, D.C., IMF, 2009).

[13] See Alan Auerbach, "The Cost of Capital and Investment in Developing Countries", in *Fiscal Incentives for Investment and Innovation*, Anwar Shah, ed., vol. 1 (Washington, D.C., World Bank Group, 1995).

Taxes likely play a role in the choice of whether to make a new equity investment, use internal or external borrowing or use retained earnings to finance investments.

19. When the results of tax incentive regimes are examined seriously, there are successes and failures.[14] A good review of the results of incentives is set forth in a 1996 United Nations study.[2] The United Nations study concluded that "as other policy and non-policy conditions converge, the role of incentives becomes more important at the margin, especially for projects that are cost-oriented and mobile."[2] OECD reached a similar conclusion in finding that host country taxation affects investment flows and that it is an increasingly important factor in locational decisions.[15]

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[14] See Ngee Choon Chia and John Whalley, "Patterns in Investment Tax Incentives Among Developing Countries", in *Fiscal Incentives for Investment in Developing Countries*, Anwar Shah, ed. (Washington, D.C., World Bank, 1992).

[15] See W. Steven Clark, "Tax Incentives for Foreign Direct Investment: Empirical Evidence on Effects and Alternative Policy Options", *Canadian Tax Journal*, vol. 48 (2000).