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Tax Policy for Investment

W. Steven Clark*

Abstract

The Policy Framework for Investment (OECD, 2006) proposes guidance in ten policy fields, including tax policy, to encourage policy makers to ask appropriate questions about their country's economy, its institutions, and policy settings in order to identify priorities, develop an effective set of policies, and monitor progress. A central challenge for tax policy makers endeavouring to encourage domestic and foreign investment, but with limited financial resources to commit, is a careful weighing of advantages and disadvantages of alternative tax policy choices and design options in meeting the twin goals of offering an attractive tax system, while at the same time raising revenues to support infrastructure development and other pillars of an enabling environment for investment. This paper reviews some of the main issues and proposes a set of questions for policy makers to address in formulating an appropriate tax strategy supportive of investment.

I. INTRODUCTION

A country's tax regime is a key policy instrument that may negatively or positively influence investment. Imposing a tax burden on business that is high relative to host country advantages, including access to markets and cost savings derived from public programmes in support of business, and high relative to tax burdens met in competing locations, may discourage investment, particularly where location-specific profit opportunities are limited and profit margins are thin. In such comparisons, a host country tax burden is influenced not only by statutory tax provisions but also compliance costs. A poorly designed tax system (covering laws, regulations and administration) may discourage capital investment where the rules and their application are non-transparent, or overly-complex, or unpredictable, adding to project costs and uncertainty over net profitability. Systems that leave excessive administrative discretion in the hands of officials in assigning tax relief tend to invite corruption and undermine good governance objectives fundamental to securing an attractive investment environment. Policy makers are therefore encouraged to ensure that their tax system is one that imposes an acceptable tax burden on business that can be readily determined, keeps tax compliance and tax administration costs in check, and addresses rather than contributes to project risk.

A modern, competitive, stable and transparent tax system, one that links host and home country tax systems through a wide tax treaty network aimed at providing certainty of tax treatment including the avoidance of double taxation, can send a strong positive signal to investors, both domestic and foreign. Investors generally prefer a low host country tax rate applied to a broadly defined profit base, rather than a high rate, narrow base approach to levying corporate tax. At the same time, special

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incentives may play an important role in certain cases. Where tax incentives for investment are used, care must be taken to ensure that incentive types and design features are chosen that are less likely than others to result in unintended and excessive revenue losses to non-targeted activities.

Balancing revenue losses from tax relief against the possible investment response is an important consideration in the majority of cases where companies can manage a modest host country tax burden. This recognises that tax relief may be too generous, in excess of that necessary to provide a tax environment that is supportive of investment. A central challenge for policy makers endeavouring to encourage domestic and foreign direct investment, but with limited financial resources to commit, is a careful weighing of advantages and disadvantages of alternative tax policy choices and design options in meeting the twin goals of offering an attractive tax system, while at the same time raising revenues to support infrastructure development (e.g. roads, airports, telecommunications networks, and legal frameworks) and other pillars of an enabling environment for direct investment.

This paper explores these issues with the objective of providing background information and a summary “checklist” to guide policy makers when formulating a tax policy strategy that is supportive of investment, taking a “holistic” view of the role of the tax system.

Section II begins by sketching out various economic decisions influenced by taxation, decisions that impact the path of a country’s economic development. Section III takes focus on the impact of taxation on investment, and highlights not only direct effects on after-tax rates of return (and thus possible effects on investment location and scale decisions), but also “budget effects” linking taxation to non-tax government programs in support of investment financed out of tax revenues. Section IV elaborates tax considerations for policy makers to consider when assessing the possible need for reform towards a tax system better able to support investment.

II. TAX POLICY AND DEVELOPMENT

Tax policy influences economic development through its influence over a number of economic decisions, including employment decisions, decisions over how much to invest in skills (human capital), as well as scale and location decisions involving investment in plant, property and equipment. Taxation also influences the relative attractiveness of purchasing or leasing tangible business property. The tax treatment of research and development (R&D) in different countries, and of payments under licensing agreements, impacts decisions over whether to produce intangibles (and if so, where) or purchase them or license them from others, with special tax-planning considerations arising in the case of intra-group transactions.

Some of the key linkages between tax policy and development may be highlighted as follows:

- *Employment.* Tax policy affects labour supply and labour demand decisions. Labour supply is influenced by the personal income tax (PIT) system (marginal PIT rates, thresholds, non-wastable earned income tax credits), and the social security contribution (SSC) system (employee SSC rates, thresholds) bearing on wages and salaries. Labour demand is influenced as well by the SSC system (employer SSC rates, thresholds) impacting labour costs, and by tax effects on investment.

- *Investment in education & training (e.g. post-secondary education, skills upgrading).* Tax factors in by influencing the benefits of (returns on) investment (with PIT and SSC contributions reducing, or augmenting with employment tax credits, wage income), and influencing the costs of investment incurred by firms (e.g. where firms are provided with special tax breaks to help defray the cost of training) and/or individuals (e.g. tax relief for education expenses).
- *Investment by firms in tangible and intangible assets.* Taxation alters the after-tax rate of return on investment by influencing after-tax revenues, net acquisition costs of assets and costs of equity and debt finance, leading to direct effects on investment.
- *Access to intangible assets through purchase or license agreements.* Rather than investing in R&D to develop intangible assets, influenced by the availability (or not) of special tax deductions and/or tax credits for R&D, a firm may purchase intangibles from others, or acquire the rights to use such assets. Taxation influences the optimal amount of intangible capital to hold, as well as the relative attraction and reliance on alternative means to acquire such capital (with possible implications for the scale of “spillover” effects on the domestic economy).

Tax policy also plays a role in influencing whether economic development is sustainable:

- *Income distribution effects:* Tax policy influences income distribution (e.g. progressive versus flat PIT rate structure, basic allowances, non-wastable tax credits). As sustainable economic development places constraints on inequality in income distribution, tax policy may hinder or help underpin support for a growth agenda.
- *Environmental effects:* Tax policy may be used as a market-based instrument to address environmental degradation (e.g. so-called “green” taxes). The use of market based instruments (environmental taxes, tradable permits) is now widely recognized as a more efficient means to address certain environmental concerns (e.g. global warming), than regulatory approaches.
- *Budget effects:* Tax policy, covering the tax treatment of investment, employment, as well as other activities, transactions and assets, also has budget consequences, by influencing the amount of tax revenue available to fund public expenditures including infrastructure and other programmes identified by investors as of critical importance in shaping the investment environment.

III. TAXATION AND INVESTMENT – WHAT ARE THE LINKAGES?

In examining tax effects on investment, one can distinguish effects on direct investment representing a significant active equity interest, from effects on portfolio investment by those holding a passive equity interest. This paper focuses on effects on direct investment, including business expansions, investment in subsidiaries and branches, and mergers and acquisitions.

One can also distinguish tax effects in the “pure” domestic case (resident shareholders investing in domestic assets) versus cross-border investment, both inbound foreign direct investment (FDI) in domestic assets by non-resident shareholders, and outbound direct investment abroad (DIA) in foreign assets by resident investors. This paper

does not address special considerations relevant to the influence of home country taxation on outbound direct investment.¹

A further distinction is between tax effects on direct investment of various types: in physical capital (e.g. plant, property and equipment (PP&E)); investment in intangible assets (e.g. patents) through R&D; and investment in human capital (e.g. education, training). This paper concentrates on tax effects on physical capital, and in particular PP&E scale and location decisions. Special tax considerations relating to the development and use of intangibles are not covered.

In examining the linkages between taxation and direct investment in physical capital, one is confronted with a range of taxes that form part of the tax system of developed (e.g. OECD) countries, as well as developing countries on an established transition path. The taxes include profit or income taxes, non-resident withholding taxes, property taxes, capital taxes, customs duties, social security contributions affecting labour costs, excise taxes, single-stage sales tax and multi-stage value added tax influencing product demand in the host country, and other (generally less relevant) taxes. Home as well as host country taxes may factor in.

Focusing on domestic and inbound direct investment in physical capital, this paper concentrates on primarily host country considerations, and highlights two main linkages between taxation and investment.² The first is the direct effect of taxation on the after-tax hurdle rate of return on investment. The second is the budget effect which recognizes the basic role of tax in funding government programs, and the importance placed by business on adequately funding infra-structure development and skills development programs and public governance initiatives central to creating an enabling environment for investment.

A. Direct effects of taxation on investment

The taxation of profit derived from investment in a given host country either in the pure domestic case, or in the case of foreign direct investment (FDI), may directly affect the amount of investment undertaken by influencing after-tax rates of return on investment.³ In theory, a high (low) effective tax rate on domestic source income could be expected to discourage (encourage) domestic investment by resident investors, as well as inbound foreign direct investment.⁴

¹ The tax treatment of foreign source income generally would be an important tax consideration when deciding where to locate a corporate base from which to hold foreign assets. However, a discussion of the special tax considerations arising in this context are beyond the scope of this article, which concentrates on investment for production purposes rather than management/co-ordination purposes.

² The term “host country” is commonly used in the context of cross-border (inbound or outbound) investment to refer to the country in which a productive asset is located (e.g. where a company is located and income is sourced), with the term “home country” used to refer to the country in which the investor (owner of the productive asset) resides. In this article, we also use the term “host country” to refer to the country in which a company is located, and apply this term both in the context of inbound foreign direct investment (non-resident investor in a domestic enterprise) and pure domestic investment (resident investor in a domestic business). Thus use of the term “host country” need not imply FDI.

³ Both the level of the effective tax rate on profit and the method (types of tax, and their design features) by which that effective tax rate is set may be relevant.

⁴ Similarly, home country taxation of foreign source income may directly impact investment – the higher (lower) the net home country tax rate on foreign profit, generally the lower (higher) the level of direct investment abroad (DIA) by domestic firms in instances where tax impacts investment decisions. Effects on domestic investment of home country taxation of foreign source income are less than clear –

However, as in other areas, theory must be resolved with practice. It is clear that in general host country taxation adds to investment costs, particularly in the pure domestic case.⁵ However, the predicted direct effect – that investment would increase if host country taxes are reduced – is often not observed.

Most would agree that a host country tax burden that is very high relative to other countries – influenced by statutory/legal provisions as well as tax compliance costs associated with completing and filing tax returns – generally is discouraging to investment and could, in certain cases, be a deciding factor in not investing or reinvesting in a host country.⁶

The more difficult issue is when – that is, under what circumstances and by which means – can a relatively low host country tax burden discourage capital flight, encourage additional investment, and swing location decisions in a country's favour? When, for example, can reduced statutory tax rates or special tax incentives be expected to attract additional investment? As elaborated in Section IV, by identifying the factors that condition whether host country tax relief or subsidies can be expected to deliver additional investment, policy makers can assess how best to design an overall policy approach, one with mutually reinforcing elements, to provide an environment encouraging to direct investment.

While statutory tax provisions are clearly important, policy makers are also encouraged to consider difficult to measure (yet potentially impeding) business compliance costs associated with the level of transparency, complexity and stability of the tax system.

B. Budget effects of taxation on investment

Host country taxation also impacts investment indirectly by supporting or constraining the financing of the expenditure side of the budget equation. This point recognizes that investment may be encouraged or discouraged by the state of infrastructure in a country (e.g. roads, airports, seaports), the skills profile and strength of the workforce, the state of public governance, and other aspects of the investment environment that are supported by tax revenues.

It is often rightly pointed out that non-tax factors are of central importance to investment decisions. However, equally important to emphasize is the fact that public infrastructure, education, expenditures in support of public governance and other key aspects of an enabling environment for investment require financing. And in many if

whether an effective tax burden on foreign source income that is low relative to that on domestic income discourages or encourages domestic investment depend, in part, on whether DIA is a substitute for or complement of domestic investment.

⁵ In the cross-border situation, this need not be the case. In particular, private investment costs generally would not be affected where increased (decreased) host country taxation is offset by an increased (decreased) foreign tax credit being allowed by the home country tax system of the investor.

⁶ A high host country tax burden may also encourage tax evasion, particularly for small firms that face relatively high compliance costs (relative to turnover or income). Non-compliance inhibits economic development by: constraining the amount of tax revenue to fund infrastructure projects, education and other programmes central to building attractive host country conditions; requiring increased tax rates on income, property and transactions of taxpayers in the formal economy (leading to higher efficiency losses than would be observed under a broader tax base through increased compliance); and limiting the growth prospects of 'underground' firms (e.g. by restricting output (export) markets and the range of potential sources of finance). Tax policy and administration practices geared at encouraging taxpayer compliance are not specifically addressed in this paper.

not most countries, tax revenues are an important if not main source of funding for government expenditure (recognizing that printing money to finance government programmes is inflationary, while borrowing funds is also subject to constraint).

Corporate tax and other taxes derived from business activities contribute to general tax revenues used to finance government expenditure. While these taxes may form a relatively small percentage of total tax revenues, the absolute amounts may be large and should be seen as a potential source of revenue that may be used to help address non-tax investment deterrents identified as seriously impeding investment activity.

As noted, a central question facing policy makers when formulating a target tax burden on business is: under what circumstances and conditions can a relatively low host country tax burden operate to attract additional investment, and swing location decisions in a country's favour? Behind this question rests a central trade-off – by reducing taxes on existing (infra-marginal) capital, or reducing the effective tax rate on new investment that would proceed regardless of whether special tax relief is provided, revenues are foregone that could instead be used to build up infrastructure, improve labour skills, strengthen governance, and address what in many country contexts are the real impediments to investment.

Thus a focus in most country contexts should be on the twin goals of designing tax systems and investor packages that are attractive to investment, while at the same time not foregoing funds that could be more usefully applied to fund government expenditures identified by investors as of critical importance to encouraging host country business activity.

IV. TAXATION AND INVESTMENT – A REVIEW OF MAIN CONSIDERATIONS

The following provides a list of issues that policy makers are encouraged to consider when assessing whether a given host country tax system, and in particular corporate tax system, is supportive of direct investment in real productive capital, while also adequately addressing other tax policy objectives.

A. Comparative assessment of the tax burden on business income

Has the government established a target tax burden on business income consistent with its economic development strategy, and with its ability to collect tax on business? How does the target tax burden compare with the actual tax burden?

How much tax revenue policy makers aim to collect from business depends on the government's overall spending plans, including planned spending under its economic development and investment attraction strategy, and the availability of alternative sources of finance. Under a 'top-down' approach to budget preparations, an overall spending ceiling is set by the aggregate amount of funding that the government aims to raise from various sources, including estimated tax revenues from a number of tax bases. Allocations to public expenditure programmes, ranked in terms of their importance in meeting priority government objectives (e.g. including strengthening the pillars of an enabling environment for investment) may then be considered alongside a spending cap. Where public expenditures in support of priority areas (e.g. infrastructure, education, health) are severely constrained, policy makers may be encouraged to reconsider potential financing sources, and possibly revise its target tax burden on business income.

In deciding the tax burden to impose on business income (domestic profits), and the reliance on this tax relative to other sources of revenue, governments would normally

be expected to balance various considerations, including not only revenue concerns, but also equity concerns, competitiveness and efficiency considerations, as well as tax administration and tax compliance costs. In balancing these, policymakers would normally rely on a mix of taxes – such as taxes on income (or a proxy), social security contributions, payroll taxes, property taxes, general consumption taxes, excise taxes, customs duties, non-resident withholding taxes, and possibly other taxes.

Equity considerations would normally call for a mix of taxes, with the economic incidence or burden of certain taxes falling disproportionately on taxpayers with relatively low (or high) income. Taxpayer demands for fairness in the sharing of the tax burden would normally call for business-level income tax, particularly where its incidence falls on shareholders. In the absence of corporate-level tax on profits of incorporated closely-held firms, for example, tax on business profit could be deferred indefinitely by retaining rather than distributing profit to shareholders (given practical difficulties with taxing unrealized accrued capital gains on shares). Moreover, where the net income of shareholders tends to be relatively high, vertical equity may call for combined corporate and personal taxation at top marginal tax rates of corporate profits accruing to domestic shareholders.

On the other hand, ‘competitiveness’ arguments and efficiency considerations emphasising the mobility of business activities may caution against such an approach and call for preferential treatment of capital income.⁷ Under certain assumptions including mobile capital and immobile labour, a simple efficiency analysis suggests that small capital-importing countries should waive tax on capital income, as this tax would be fully borne by labour, in terms of reduced wages and employment. However, under a broader set of considerations that recognize the implications of trade costs to the mobility of capital, host country taxation of capital income may be efficient, with scope for taxation being greater the larger are ‘business concentration’ economies in a host country.⁸ A key insight from this literature is that certain host

⁷ Economic efficiency losses imposed by the tax system arise where taxes (depending on their base) alter decisions over savings, investment, consumption, or work/employment, and in so doing, generate reductions in individual welfare in excess of the amount of tax revenue collected (‘dead-weight’ efficiency losses). With efficiency losses of a given tax tending to rise non-linearly with the effective tax rate, policy-makers are encouraged to rely on a mix of taxes, with moderate tax rates applied to tax bases broadly defined.

⁸ The literature exploring efficiency considerations in the taxation of domestic investment continues to evolve (see Wilson (1999)). Under a basic tax competition model that ignores labour taxation, the geographic mobility of capital is predicted to result in tax rates on capital income that are inefficiently low from a public perspective. Extending the analysis to include the taxation of immobile labour finds that for a small capital-importing country facing a perfectly elastic supply of foreign capital (implying that the cost of capital is fixed, set in international capital markets) it is optimal to waive host country income tax on investment, with this tax being fully shifted onto labour. In this case, it is optimal for the host country to instead tax labour income directly, and avoid production efficiency losses that result from taxing capital income. Subsequent work finds that if economic profit cannot be fully taxed, then some host country taxation of inbound FDI by small capital importing countries is efficient. When introducing trade costs and business concentration economies, emphasized in the ‘new economic geography’ literature, certain results from neo-classical models carry over, while other predicted effects are qualified (see Baldwin et al. (2003)). Where capital is more mobile (with reduced trade costs), or more generally when business concentration forces decrease, the optimal tax rate for a host country declines (consistent with the basic tax competition model.) Furthermore, the impact on location choice of tax rate differences between two countries is predicted to differ across industries that differ in terms of the importance of business concentration benefits. A further insight is that tax competition effects may differ depending on whether foreign capital benefits or not from the provision of local public goods.

country characteristics (e.g. market size, transportation and communication networks) determine the scope for imposing tax on businesses, without encouraging capital migration.

Indeed, a central consideration for policy-makers in establishing a target tax burden on business is a careful assessment of the ability of the country to impose and collect tax on this base. In this context, a central issue in setting a tax burden on business is whether the host country offers attractive risk/return opportunities, taking into account framework conditions, market characteristics and location-specific profits (see below), independent of tax considerations. Governments are encouraged to give recognition to the reasonable expectations of taxpayers when designing or reforming the tax system, with businesses generally willing to accept a higher tax burden the more attractive are the risk/return opportunities in the host country.

Framework conditions

Important to potential investors are questions over costs and non-diversifiable risks associated with securing access to capital and profits, adjusting to macro-economic conditions, and complying with laws, regulations and administrative practices, including the following:

- How stable is the political system? How stable and accessible is the legal system protecting property rights including, in the foreign investor case, the right to withdraw capital and repatriate profits? Do capital controls exist?
- How stable is the monetary system and fiscal framework and what is the accumulated public debt? What are expectations over future inflation, interest and exchange rates?
- In what areas is public governance weak and where is corruption a problem?
- How significant are the costs and risks to business associated with the preceding considerations?

Market characteristics

Also centrally important to investors are considerations of output demand and factor supply:

- What is the domestic market size? How large is the domestic consumer market (number of households, average level and distribution of per capita income)? How large is the domestic producer market (number of firms, asset size, input requirements)? How large and accessible are markets in other (e.g. neighbouring) countries?
- What labour force skills are available in the host country and what employee benefits (e.g. social security) are provided by the state? What energy sources and raw materials are available in the host country? Are labour costs (wages plus mandatory employer social security contributions), energy costs, raw material costs high/low relative to competing jurisdictions?
- What is the state of the host country's infra-structure covering transportation services (airports, seaports, rail systems, roads), telecommunications (phone/fax/internet services), other services important to business? Are private costs of using/purchasing infra-structure services high/low relative to competing jurisdictions?

Prevalence of location-specific profits

Assessments by investors of the risk/return on investment in a host country would normally factor in framework conditions and market characteristics of the country (or a region of the country where market characteristics vary by region). In setting the tax burden on inbound investment, policy makers are encouraged to assess whether their host country offers attractive risk/return opportunities, taking into account framework conditions (e.g. political/monetary/fiscal stability; legal protection; public governance), market characteristics (market size, availability/cost of labour, energy, state of infrastructure), and the prevalence of location-specific profits.

In considering location choice, a central question is, how location-specific are potential profits for a given level of risk? For certain investments, profit from meeting market demand for a final product or undertaking production part of a value-added chain may vary significantly across alternative locations, and in certain cases may be location-specific – that is, may require investment (i.e. a physical presence) in a specific location. With location-specific profit, costs in accessing required factor inputs (e.g. labour, raw materials, energy) and/or costs in delivering outputs are generally significantly higher from other locations. In the case of privatizations, profits are generally time as well as location-specific. Other examples include the extraction of natural resources, and the provision of restaurant, hotel and certain other services. In such cases, if the anticipated risk-adjusted return on capital meets or surpasses a required ‘hurdle’ rate of return, investment can be expected.

Where profit is specific to a particular host country, tax comparisons across competing locations (states/countries) may not factor in, and the tax burden may be largely irrelevant to an investment decision. In principle, the tax burden on location-specific profit may be increased up to the point where economic profit is exhausted without discouraging investment. Thus, where an economy offers an abundant set of location-specific profits, policy makers may understandably resist pressures to adjust to a relatively low tax burden, to avoid tax revenue losses and windfall gains to investors and/or foreign treasuries. Reducing the effective host country tax rate to levels observed in certain competing countries, while possibly attracting geographically mobile capital, would give up tax revenues on business activities less sensitive to the setting of the host country tax rate.

In contrast are examples where costs in accessing factor inputs and delivering outputs are roughly the same across a large number of geographically disperse candidate host countries, implying that profit is not location-specific. Examples include investment in intra-group financial services and certain head-office functions. Attracting these generally non-capital intensive activities requires satisfactory framework conditions, but local market characteristics (e.g. market size) tend to be relatively unimportant. Other examples are the manufacturing of pharmaceuticals and computer chips, where input costs may be similar across many alternative host countries, and delivery costs to global markets are low relative to profit. In such cases, candidate host countries may be unable to impose a relatively high host country tax burden where competing jurisdictions offer a no/low tax environment.

In between these extremes are investments where profit is location-dependent, but not specific to one country (e.g. required rates of return may be realized in a number of neighbouring locations), and trade costs are important. A location offering relatively attractive host country advantages, in terms of relatively low input costs, or delivery costs, or taxes on profit, could be expected to be more successful in attracting FDI.

Relatively low input costs could be in relation to a large pool of suitably skilled labour. Relatively low delivery costs could be realized with a large domestic market, and/or well-developed road, airport or seaport system, giving relatively low cost reach to neighbouring countries with large markets. Where relative advantages are significant, they could give rise to location-dependent profits that could be taxed without discouraging investment.

The relative attractiveness of a given host country as a location for investment depends on the host country framework conditions and market characteristics, which in turn depend on past and current levels of public expenditures on programs in areas of critical importance to investors (e.g. education, infra-structure development). This link establishes the critical importance, in particular for developing countries, of collecting tax where possible on economic rents in order to finance public expenditures that eventually strengthen host country fundamentals, and attract FDI.

These generalisations, while possibly helpful in shaping views over appropriate host country tax policies, gloss-over practical assessment difficulties, and must be qualified on several counts. Under the simplified predictions remain questions over how to assess the influence on business profits of varying market characteristics in competing locations. Where on balance investment conditions in a particular location are more attractive than those elsewhere, how much higher may the host country tax burden be set relative to other countries without significantly impacting investment? And if a competing country lowers its tax rate, how much capital relocation can be expected, and at what rate and in which sectors? There also remains the question of whether the now common use by MNEs of tax haven finance/holding companies effectively eliminates the influence of home country tax rules (in dividend credit countries) on the overall tax burden on outbound FDI, so that only host country taxation matters.

What is the 'all-in' tax burden on business income that factors in not only statutory tax provisions, but also corporate tax-planning and compliance costs? How are these considerations being addressed by tax policy and tax administration?

Having established a target tax burden on business income, measurement of the actual tax burden is required in order to assess what possible adjustments to tax policy and/or expenditure programmes may be required. The statutory tax burden on domestic profits ought to be assessed using quantitative measures and qualitative information, taking into account main statutory provisions and the effects of commonly-employed corporate tax-planning strategies. Compliance costs from excessive complexity, non-transparency and unpredictability should also be factored in.

Assessment of host country tax burden

On the quantitative side, corporate marginal effective tax rates (METRs) and corporate average effective tax rates (AETRs) are commonly used to assess the net effect of (certain) main statutory provisions in determining effective tax rates by type of capital asset (machinery and equipment, buildings, inventories, intangibles), financing (debt, retained earnings, new equity) and by investor type (taxable resident, non-resident). Such measures may be finessed by factoring in effects of tax-planning strategies employed in the host country to strip out taxable profits (e.g. thin capitalisation, non-arm's length transfer prices) to tax havens.

An attraction of measuring corporate marginal and average effective tax rates is that they can be modelled with reference to statutory tax provisions alone, found in tax legislation and regulations (i.e. they do not require information on actual tax revenues

collected). However, as such summary measures cannot readily incorporate the effects of all relevant tax provisions bearing on the average host country tax burden, they need to be qualified with regard to such effects (e.g. the impact of rules governing the carry-forward of business losses).

Furthermore, where taxpayer-level information is available (i.e. taxpayer financial statements, tax returns), a stratified sample of corporations should be chosen and relevant micro-data examined in order to obtain measures of the tax burden on domestic firms, on an aggregate and disaggregate basis (profitable and taxable, profitable and non-taxable, non-profitable; small, medium and large with reference to total assets; main industry sector; region). As examined elsewhere, results based on micro-data provide a much stronger basis to analyze tax burdens across sectors and over time.⁹

Compliance costs should also be factored in, at least on a qualitative basis. Too often, policy makers assess a host country tax burden with reference to only the direct effects of statutory provisions. A more appropriate measure takes into account tax compliance costs, which in some cases may be quite significant, depending on the degree and sources of complexity, transparency and predictability.¹⁰

Tax burden linked to an excessively complex business tax system

In addressing today's complex business structures and transactions, a certain degree of complexity in the tax system is to be expected. However, where investors view a tax system (laws, regulations and/or administration) to be excessively complex relative to other tax systems, or relative to an alternative approach, the added expense to project costs incurred in understanding and complying with the tax system would tend to discourage investor interest.

Such a review would begin by identifying the various sources of complexity – including those linked directly to tax policy, those relating to mechanisms by which policy is implemented, and those linked to tax administration – and examining whether the degree of complexity is avoidable with consideration given to approaches adopted by other countries.

One area to consider is whether the structure of the depreciation system for tax purposes (number of classes of depreciable capital cost, assignment of depreciation methods) is consistent with international norms. If the depreciation system has been characterized frequently by business as overly complex, then serious consideration should be given to possible simplification.¹¹

As an illustration of possible trade-offs when addressing complexity, consider integration of corporate and personal income taxation of equity income to reduce or

⁹ See for example OECD 2003, Using Micro-data to Assess Average Tax Rates, OECD Tax Policy Studies No. 8.

¹⁰ In addressing this issue, one can measure for SMEs and MNEs, the average amount of professional time (of tax accountants, tax lawyers, tax administrators) per year required to comply with the tax code. This can be converted to an average annual compliance cost to business, with reference to the average hourly wage of a tax professional, and included in the calculation of total tax liability of a representative sample of firms.

¹¹ A related tax policy issue is whether depreciation rates adequately reflect true economic rates of depreciation of broad classes of depreciable property (serving as benchmark rates) and account for inflation.

eliminate double taxation of domestic profits. Where double taxation relief is desirable (e.g. creates investment (host country benefits) that more than outweighs tax revenues foregone), it is important for policy makers to recognize the advantages that a simple approach could bring. In this example a relevant trade-off could be between efficiency, calling for a variable imputation tax credit at the personal level that depends on the amount of corporate tax actually paid on distributed income, and simplicity, which may call for partial inclusion of dividend income, or a fixed dividend tax credit based on a notional or assumed level of corporate tax.

Tax burden linked to a non-transparent business tax system

Another important aspect of tax compliance costs concerns transparency. In considering this issue, it must first be recognized that even a relatively simple system may lack transparency, as for example where tax laws and terms are unclear, tax returns and information materials are difficult to obtain, and taxpayer compliance support is weak. As with complexity, a lack of transparency contributes to project costs. It also raises concerns of fairness, and may lead to suspicion that the tax system is tailored to the interests of a subset of taxpayers, including those earning higher incomes, able to afford professional tax advice and possibly benefiting from special tax treatment. Perceptions of unfairness challenge tax systems based on voluntary compliance, as they tend to encourage non-compliance and transition of business activity to the “underground economy”, raising revenue concerns and concerns of the weakening of government performance more generally.

Policy makers are therefore encouraged to satisfy themselves that tax laws and regulations are drafted clearly and preferably by those trained in legal drafting of tax provisions. Tax returns, explanatory notes and information circulars should be readily available to taxpayers (e.g. electronically), and services should be available to provide advance rulings on the tax treatment of transactions where tax outcomes are unclear.

Another important “transparency” issue is whether business tax liability in certain cases is established at the discretion of tax authorities (e.g. through individual rulings, or informal dealings), rather than through uniform application of tax laws and regulations. Where administrative discretion is provided, the policy reason for providing this discretion should be questioned, as a key concern is whether administrative discretion contributes to or invites corrupt practices on the part of tax officials (e.g. the taking of bribes). Where it does, administrative discretion may contribute to investor uncertainty over final tax liability and the tax liability of other firms. Where corruption is a problem and administrative discretion contributes to project risk due to uncertainties over tax treatment, the potential benefits of such discretion (e.g. tighter control over tax relief) should be weighed against the various costs including those linked to reduced transparency.

Tax burden linked to an unpredictable business tax system

Non-transparency in the tax area contributes to investor difficulty in gauging with some degree of certainty the tax burden on returns to investment in a given host country. So too can frequent reforms of tax systems, even where they are relatively simple and transparent. While a certain degree of unpredictability may be associated with all tax systems, a system may be judged to be relatively or excessively unpredictable if the host country has a history of frequent and dramatic changes to important elements of the tax system, that is, elements bearing significantly on investment returns.

Relevant questions on this issue include: what elements of the tax system have contributed to unpredictability and how can these be best avoided? Is responsibility for tax legislation governing the taxation of business income assigned to a single ministry of the central government (e.g. Ministry of Finance), recognizing difficulties that arise where this is not the case? Are (all) income tax laws/regulations contained in a single body or act of legislation, recognizing difficulties that arise where this is not the case? Is a single ministry, department, or agency of central government responsible for the administration of corporate income tax and personal income tax (e.g. with local/regional offices)? If income tax legislation and administration are not centralised, what problems of co-ordination have arisen, what has been the impact on taxpayer tax compliance costs (in relation to complexity, predictability, transparency), and what reforms are desirable?

B. Prudent use of targeted tax incentives

Where the tax burden on business income differs by firm size, age of the business entity (new versus existing capital), ownership structure, industrial sector or location, can these differences be justified? Is the tax system neutral in its treatment of foreign and domestic investors?

Tax systems may purposefully impose a non-uniform effective tax rate on businesses, based on criteria such as the size of an enterprise (large versus small), whether the invested capital is 'new' or existing, its ownership structure (e.g. domestic versus foreign-owned), the type of business activity or its location. In some systems, certain firms may be specifically targeted to receive preferential tax treatment. Where tax relief is targeted, policy makers should examine the arguments in favour and against such preferential treatment, weigh up these arguments and be in a position to justify differential tax treatment. Where justifications are weak, first consideration should be given to a non-targeted approach, so as not to induce a misallocation of resources.

In addressing this issue, the analysis could include an assessment of the average effective tax rate (AETR) on profits of i) small and medium-sized enterprises (SMEs), ii) large enterprises majority-owned by residents, iii) large multinational enterprises (MNEs) controlled by foreign parent companies for different business activities, locations and ownership structures, taking into account main statutory tax provisions.¹² Such an approach could be used to inform an assessment of whether tax-driven variations in AETRs across businesses of different size, ownership structure, and industrial sector can be justified, taking into account unintended distortions and other costs that they create.¹³

¹² In modelling effective tax rates on SMEs, consideration should be given to enterprises structured in corporate and unincorporated form (information on the relative (asset) size of the incorporated versus unincorporated sector would indicate the relative importance of alternative measures). For incorporated firms (SMEs and possibly large resident-owned firms) with limited access to international capital markets, consideration should be given to average effective corporate tax income rates inclusive of corporate and personal income taxation to incorporate possible personal tax effects on the cost of funds. In modelling FDI, consideration should be given to inbound investment from several different countries. This could include a non-treaty case where a statutory (non-treaty) dividend withholding tax rate would apply, and where one could assume no home country taxation. In considering treaty cases, the sample should include a major capital exporting country operating a source-based system (dividend exemption), as well as one or more operating a residence-based tax system (dividend gross-up and credit).

¹³ This concerns differences in effective tax rates that arise from the application of different tax rates and rules to similar transactions (i.e. it does not concern differences that arise from the application of similar rules to different transactions). For example, rates of capital depreciation, for tax purposes, typically

Have targeted tax incentives for investment created unintended tax-planning opportunities and distortions? Are these opportunities, distortions and other problems associated with targeted tax incentives evaluated and taken into account in assessing their cost-effectiveness?

Unfortunately, tax incentives are all too often viewed as a relatively easy “fix” by those working outside the tax area, and those with limited experience working in it. A tax incentive may be quickly incorporated into a budget announcement, and holds out the apparent advantage of not requiring a cash-equivalent outlay, in contrast with an infrastructure development, manpower training, or other programme introduced to foster investment. The reasoning goes as follows: by providing tax relief to new investment, a tax incentive will only reduce the amount of tax revenue raised on additional investment – revenue that would not have been raised anyway in the absence of the incentive.

However, this perception misses the fact that tax incentive relief, even when targeted at new investment, will always be sought by businesses outside the target group. Existing firms will attempt to characterize themselves as “new”, and other similar tax-planning strategies can be expected that will deplete tax revenues from activities unrelated to any new investment attributable to the tax relief, with lost revenues often many multiples in excess of original projections. In contrast, direct cash grants, while raising possibly greater concerns over inviting corruption (unless significant administrative discretion is also involved in the granting of targeted tax incentives), may offer greater control over various types of abuse.

Tax holidays and partial profit exemptions, typically targeted at “new” companies, offer significant scope for tax relief unintended by the tax authorities. Other forms of targeted tax relief may also create unintended scope for tax planning, and result in revenue losses well in excess of levels originally anticipated (e.g. where the relief spills over to benefit non-targeted taxpayer groups). While notoriously difficult to predict, policy makers are encouraged to consult widely to sharpen estimates of the revenue losses from a given incentive.

Tax holidays and partial profit exemptions are typically targeted at “new” companies. However, it is hard for tax administrators to determine if a newly-established company is actually financed by new capital, or instead by capital already invested in the host country. In other words, much of the “new” capital may in fact be previously existing capital that has been re-characterised as new (e.g. through liquidation of an existing company, with the capital invested temporarily in an offshore holding company, then re-invested in the host country with the appearance of new investment by that offshore company).

Provisions providing for a partial or full profit exemption also open up transfer pricing opportunities to artificially shift taxable income of business entities in the host country that do not qualify for special tax relief to entities that do. Aggressive transfer pricing techniques essentially involve the use of non-arm’s length prices on intra-group transactions, and non-arm’s length interest rates on intra-group loans, to shift taxable

differ by type of capital asset. This means that effective tax rates will differ across sectors to the extent that capital stocks of firms in one sector differ in composition from stocks of firms in another. Such differences may be viewed as structural, rather than tax driven. An example of the latter would be where the same type of asset is depreciated at a different rate depending on the sector. This concerns tax-driven differences of this sort.

income to low or no-taxed entities. The shifting of tax base in such cases is artificial in the sense that it takes underlying business activities as given, and simply manipulates prices to shift taxable income associated with these activities to obtain the most tax efficient outcome. As guarding against such abuse of the tax system is becoming increasingly difficult with increased trade in intangibles (for which an arm's length price is often difficult to fairly establish by tax authorities, due to limited or non-existent second markets to look to), so too is it becoming increasingly difficult to guard against excessive revenue losses stemming from incentives providing for a full or partial profit exemption.

It should also be pointed out that where a tax incentive is in place and previously unforeseen tax-planning opportunities become all too apparent, it is not without cost for the government to withdraw the incentive to protect the domestic tax base from further erosion. While cancelling incentive relief for future investment may be accepted by investors, cancelling relief tied to prior investment decisions – that may have been based on the expectation of tax incentives previously on offer – can carry a significant cost. In particular, policy credibility is seriously undermined, weakening the ability of government to influence investment behaviour in the future through policy adjustment. Given this, where tax incentive relief linked to investment expenditure (e.g. enhanced or accelerated depreciation) is cancelled, tax relief tied to prior investment generally should be respected (not withdrawn) – unless the costs are so exorbitant that respecting past commitments would be devastating to public finances.

To varying degrees depending partly on the instrument used, reduced host country taxation will provide tax relief in respect of investment that would have been undertaken in the absence of such relief – so-called “*windfall gains*” to investors and, in the case of FDI, foreign treasuries. Windfall gains arise even where tax relief is targeted at “incremental” investment in excess of some average of past investment. Avoiding windfall gains, however, generally comes at the cost of increased complexity.¹⁴

Within the context of a general policy goal to avoid windfall gains (and losses), *transitional considerations* related to the introduction and removal of tax incentives should be addressed. Where tax relief is provided, a general aim is to target tax relief to incremental investment, that is, investment that would not have occurred in the absence of the incentive. Conversely, where tax relief is withdrawn, it is important to attempt to ensure that past investments are not penalised.

Targeted tax incentives may create *unintended distortions* to the allocation of productive capital, and to corporate financing and repatriation decisions, implying welfare losses.¹⁵ Accelerated depreciation rates, for example, may create welfare

¹⁴ For example, avoiding windfall gains on accelerated depreciation requires that the balance of undepreciated capital cost, at the time of introduction of this incentive, be depreciated at pre-reform as opposed to accelerated rates to avoid tax relief in respect of pre-reform capital stocks. Windfall gains are inevitable in certain cases, depending on the mechanism used to deliver tax relief. For example, in general it is not practically possible to target a new reduced corporate tax rate to profits from new investment alone (i.e. not practically possible to ring-fence such profits, to the exclusion of profits from prior investment).

¹⁵ This paragraph concerns unintended distortions, recognising that tax incentives generally are intended to influence or distort the allocation of capital away from patterns that would be observed in the absence

losses where they do not adequately reflect variations in true economic rates of depreciation across capital asset classes (serving as benchmark rates). Similarly, reinvestment allowances providing a tax deduction equal to some percentage of reinvested (pre-tax) profit would tend to discourage investment financed by new equity, and may raise the overall cost of funds, implying welfare losses.¹⁶

Unintended distortions may also be created where inter-actions between tax incentives and other provisions of the tax code (e.g. depreciation treatment, loss treatment) are not adequately addressed. Furthermore, policy-making, if not properly co-ordinated, may result in the “stacking” of multiple tax (and non-tax) incentives on offer by different Ministries, at the same level or by different levels of government (i.e. targeted at the same or similar business activities, assets, or regions), creating unintended distortions such as negative effective tax rates (overall tax subsidies) to investment.

Tax incentives, even those held out as simplifying measures, may also create *additional complexity* and add to compliance and tax administration costs. For example, some argue that tax holidays are a simple incentive to administer, as there is no need for corporations (or government) to worry about maintaining financial records to support tax returns over the holiday period. However, in order for firms to claim tax deductions (e.g. business loss carryovers) following the holiday period, a full record of revenues and costs over the holiday period would normally be required. Assembling and verifying this data post-holiday may be more difficult and time consuming than would be the case had the required financial records been maintained all along.

Tax incentives may also *encourage corruption* and aggravate concerns raised by poor public governance. When used, targeted tax incentives should be designed to be as automatic as possible in their application, to avoid the involvement of tax officials in the determination of the application or not of provisions to individual taxpayers. Also to be avoided are situations where tax officials undertaking audits have the power to withdraw tax incentive relief, without special safeguards against corrupt practices. Frameworks should be in place to discourage bribery of tax and customs officials in such cases.

Lastly, targeted tax incentives may be *inconsistent with international obligations* (e.g. national treatment obligations, State Aid Rules applicable for member countries of the European Union).

Where strong political pressure is felt for introducing tax incentive relief, despite analysis indicating limited investment response relative to the revenue losses (to existing qualifying and non-qualifying investors) and administrative costs entailed – implying failure to meet a cost-benefit test – policy makers should argue the case for exploring options to address the impediments to investment directly.

of the incentive. Whether intended distortions created by tax incentive use are welfare improving depends on whether the incentive corrects a true market failure.

¹⁶ In contrast, an enhanced investment allowance providing a deduction equal to some percentage of qualifying investment, providing relief regardless of the source of finance, would not raise the same problem.

If framework conditions and/or market characteristics of a host country are discouraging to investors, has the government evaluated the limitations of using tax policy alone to influence favourably investment decisions?

Policy-makers are encouraged to reflect on the often disappointing experience of economies that have attempted to rely on a low tax burden - typically targeted at foreign investment - to boost investment.¹⁷ Where framework conditions or market characteristics are weak, first consideration should be given to addressing the sources of a weak investment environment. Realistic expectations should be made of how much additional investment a reduced tax burden would bring forth and the scale of tax-planning opportunities created. Where a low tax burden is to be achieved through the use of special tax incentives, evaluations of their potential to attract investment ought to take into consideration the unlikelihood of special tax relief offsetting non-tax impediments to investment, as well as the possibility that tax incentives themselves may discourage investment by contributing to project cost and risk and induce a misallocation of resources.

A corollary to this is that a host country with generally weak framework conditions and following a special tax incentive strategy may be giving up significant tax revenue collection on returns on investment projects in the host country undertaken for reasons unrelated to tax – revenues that could be used to help strengthen the enabling environment for investment.

A further issue concerns the method by which a low tax burden is achieved, and in particular, whether tax relief applies to returns on marginal or infra-marginal investment. To varying degrees, tax relief will result in windfall gains – that is, tax relief to investors (or increased revenues to foreign treasuries) that does not result in additional investment, but supports investment that would have gone ahead in the absence of that relief – even where such relief is specifically targeted at additional investment.

Consider for example incremental tax credits, where tax relief is tied to some percentage of current investment in excess of average annual investment in prior years. Even in such cases, some fraction of qualifying investment would be expected to occur in the absence of the credit. Windfall gains are more likely where flat credits are used (that provide tax relief equal to some percentage of current investment), chosen for simplicity or to avoid certain distortions with the incremental model. Windfall gains are even more likely for incentives that provide tax relief equal to some percentage of profit derived from new and existing capital. A tax exemption for a certain fraction of profit, or a reduced statutory corporate income tax rate, would be examples of relief in respect of returns on new and existing capital. As existing capital is already in place, relief granted in respect of such capital provides a pure windfall gain.¹⁸

¹⁷ Interviews with policy-makers in a number of countries in South East Europe, for example, carried out in 2000-2001 as part of an OECD study of tax effects on investment in the region, highlighted the disappointing response to tax incentives that resulted mainly in the erosion of host country tax bases.

¹⁸ Where additional investment is constrained by cash flow, tax relief on profit derived from previous investment may encourage current investment by supplying a source of funds. However, where such financing constraints do not exist, tax relief on returns to installed capital (e.g. through a reduction in the statutory corporate tax rate) will provide a pure windfall gain.

Addressing main impediments to investment

When considering the use of targeted tax incentives to support investment, due attention should be paid to scope for addressing investment impediments directly. Attention to tackling real impediments unrelated to tax should be addressed prior to, or at a minimum parallel with, attempting a tax solution.

Where weak framework conditions (poor budget management, poor public governance, corrupt practices on the part of tax and customs officials) and/or high project costs (linked to poor infrastructure, high labour costs or other factor costs) are impeding to investment, certain public officials may be attracted to the option of recourse to tax incentives. In such cases, policy makers should be encouraged to consider what policy and administrative changes may be implemented to address investment impediments directly, beginning with areas where progress can be achieved quickly. Where policy adjustments require additional tax revenues, priority areas should be identified and revenues bases examined.

Broad-based tax relief and non-tax relief

When considering possible tax strategies to attract investment, consideration should be given to non-targeted relief measures to avoid the problems encountered with targeting. Such approaches could include a reduced statutory corporate tax rate applied to a broadly-defined corporate tax base (in order to avoid unintended consequences and revenue losses) as an alternative to a strategy of narrowing the tax base through a reliance on targeted tax incentives. Consideration should also be given to addressing possible impediments in the tax system owing to restrictive provisions (e.g. limited loss carry-forward rules), or provisions contributing to compliance costs.

Finally, it is important for tax officials to recall that financial assistance to business may be delivered outside the tax system. This more transparent mechanism may be more desirable, particularly where the tax administration system is relatively inexperienced or weak and open to corruption.

C. Determination of taxable business income***Are rules for the determination of taxable business income formulated with reference to a benchmark income tax structure? Are main tax base provisions generally consistent with international norms?***

Where a host country's tax system includes an income or profit tax, investors generally expect rules governing the calculation of taxable business income that adequately reflect business costs, with main provisions (e.g. over loss carry-forward) that are not more onerous than those commonly found elsewhere. Investors also view negatively the double taxation of income within the corporate sector (and generally expect tax relief on inter-corporate dividends, particularly dividends within a related corporate group), and may have other expectations.

Tax officials of Governments wishing to retain and attract investment should be encouraged to consider the concerns of investors with respect to tax base rules, and to assess how best to address these, guided by the country's tax policy goals and objectives (e.g. equity, efficiency, simplicity, revenue). Where, for example, a general aim is to adhere to a broadly defined income tax tax-base, enabling a lower tax rate, requests for amendments would normally be assessed against this standard, with deviations from a benchmark requiring careful assessment and a balancing of considerations.

An illustrative list of possible investor concerns is raised by the following set of questions:

- Do tax depreciation methods and rates adequately reflect true economic rates of depreciation of broad classes of depreciable property (serving as benchmark rates) and account for inflation?
- Are possible time limits on the carrying forward (and possibly back) of business losses, to offset taxable income in future (prior) years, sufficiently generous/consistent with international norms? [The case for generous carry-forward is particularly strong where depreciation claims are mandatory, rather than discretionary. Also important to consider is the interaction between depreciation and loss carry-forward rules.]
- Are inter-corporate dividends (paid from one resident company to another) excluded from corporate taxable income to avoid double/multiple taxation? Are domestic dividends paid to resident individuals subject to classical treatment, or is integration relief provided in respect of corporate tax on distributed income (e.g. partial inclusion of dividend income, or provision of an imputation or dividend tax credit)? Is there evidence that such relief lowers the cost of funds for small and medium-sized companies, alleviates a possible tax impediment to profit distributions, and/or encourages total domestic savings? Where integration relief is given in respect of distributed profit (dividends), is similar relief provided in respect of retained profit (e.g. partial inclusion of capital gains)?
- Where capital gains are subject to tax on a realisation basis, are taxpayers allowed a deduction for capital losses (e.g. against corresponding taxable capital gains and possibly other investment income)? Do “recapture” rules apply to draw into taxable income excess tax depreciation claims on depreciable property?
- Is the tax treatment of wage income, as well as interest income, dividends and capital gains (realised at the personal or corporate level) designed to minimize incentives to i) characterize one form of income as another, and ii) choose one organizational form over another (incorporated versus unincorporated) for purely tax reasons? In other words, are efforts made to minimize tax arbitrage possibilities?

At the same time as addressing investors’ concerns, policy makers should be encouraged to:

- Limit windfall gains (i.e. the provision of tax relief that does not achieve desired goals) to investors and, in the case of inbound direct investment, foreign treasuries.
- Minimize scope for the exploitation by business of the tax system (e.g. through tax arbitrage).
- Ensure single taxation of income sourced in the host country (e.g. through enforcement of domestic tax rules, and negotiation of tax treaties).
- Keep tax administration costs in check.

D. Tax expenditure reporting, management and evaluation

Are tax expenditure accounts prepared and reported? Is the framework for authorizing and managing tax expenditures clear and are sunset clauses used to ensure tax incentive evaluation?

The maintenance of annual tax expenditure accounts, indicating the rationale for tax expenditures and providing estimates of total revenues foregone by targeted tax incentives and other departures from a benchmark tax system should be a feature of fiscal policy in countries where attracting investors and addressing public governance issues are high on the policy agenda. Such accounts should be subject to public scrutiny and be considered alongside direct expenditure accounts, so that policy-makers, government and the public are able to fully and properly assess budget allocations.

The framework for authorizing and managing tax expenditures should be clear. This requires the formulation of rules setting out which ministries and departments have authority to provide special tax relief, and clearly defined limits to administrative discretion in deciding such relief. Preferably, legal authority for setting tax liabilities and providing tax relief provisions should rest with tax authorities (that is, the main ministries/departments responsible for tax policy and administration).

Tax expenditure assessment generally involves the Ministry of Finance or Tax Administration Department maintaining a micro-simulation model to estimate tax revenue and income distribution effects of proposed and actual tax reforms, drawing on a representative sample of personal and corporate income tax returns and other data sources. Assessing foregone revenues should take into account, to the extent predicted, likely tax planning responses. Such analyses should be based on a variety of inputs, including consultations with business and findings of other countries that have tested similar tax incentives (taking into account different host country conditions in shaping outcomes).

For proper management of public finances, tax incentives targeted to boost investment should be assessed in advance and, if introduced, evaluated on a periodic basis to gauge whether such measures continue to pass a cost-benefit test. To enable a proper evaluation and assessment, the specific goals of a given tax incentive need to be made explicit at the outset. Further, if tax incentive legislation is introduced, “sunset clauses” calling for the expiry of the incentive (e.g. 3 years after implementation) should be included to provide an opportunity to assess whether the availability of the incentive should be extended or not.

E. International co-operation

Are tax policy and administration officials working with counterparts in other countries to provide a wide tax treaty network to avoid double taxation, secure treaty-reduced non-resident withholding tax rates, provide investors with greater certainty over tax treatment, and enable exchange information on tax matters to counter tax avoidance and evasion?

A wide (broad-based) tax treaty network is helpful in several ways to countries seeking to raise and attract investment. First and foremost, tax treaties operate to avoid double taxation of cross border returns – with the prospect of double and possibly multiple taxation of returns being a major concern in the cross-border investment context. In the absence of a tax treaty between a host and home country, double taxation of returns will normally arise where the two countries treat a given return differently. For example, countries may take different views on the source or origin of income, and/or the type of income paid (e.g. interest versus dividends), with different characterizations triggering different tax treatment. Tax treaties operate to avoid these different characterizations and thereby minimize the scope for double taxation, thereby reducing project costs (with tax viewed as a business cost).

Tax treaties also stipulate lower non-resident withholding tax rates on dividends, interest and royalties. Indeed, treaty negotiated rates are often significantly lower than statutory withholding tax rates that would otherwise apply. This aspect of tax treaties also serves to lower project costs.

Tax treaties, by providing greater transparency over the tax treatment of cross-border investment, by enabling a framework for dispute resolution, and by securing reduced non-resident withholding tax rates also help reduce investor uncertainty over tax treatment. Indeed, certain articles of tax treaties are specifically aimed at establishing procedures (e.g. mutual agreement procedures (MAPs)) to help resolve disputes over the allocation of taxing rights between host and home countries. As tax treaties tend to be renegotiated infrequently, they also provide investors with greater certainty over applicable non-resident withholding tax rates on future returns on investment, with treaty rates overriding host country statutory withholding tax rates which may be changed at the host country's discretion. By providing greater certainty over tax treatment, a wide tax treaty network therefore tends to make countries more attractive as locations for business operations, as well as places from which to conduct global business operations, by lowering project risks, in addition to lowering projects costs.

At the same time, tax treaties provide a framework to enable exchange of information amongst tax authorities to address aggressive forms of tax-planning (e.g. involving the artificial shifting of taxable profits to tax haven finance affiliates through the use of special corporate structures and financing and repatriation strategies) and curb tax avoidance and evasion.¹⁹

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¹⁹ The term 'tax avoidance' is used here to mean tax-planning that while possibly within the letter of the law (unlike tax evasion, including the non-reporting of taxable income) is contrary to the spirit or intent of the law. Thus 'tax avoidance' would not include tax-planning aimed at mitigating tax paid, anticipated by tax authorities drafting tax law.

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