Paper for Workshop on Tax Incentives and Base Protection New York, 23-24 April 2015

Tax Incentives: Protecting the tax base

Eric Zolt

Michael H. Schill Distinguished Professor of Law, UCLA School of Law

United Nations
Department of Economic and Social Affairs
United Nations Secretariat, DC2-2178
New York, N.Y. 10017, USA
Tel: (1-212) 963-8762 • Fax: (1-212) 963-0443
e-mail: TaxffdCapDev@un.org
http://www.un.org/esa/ffd/events/cd-2015-tibp-workshop.html

Contents

Tax incentives: protecting the tax base

Eric M. Zolt

1. Overview

The present chapter seeks to provide an overview of key issues facing policymakers in deciding whether to use tax incentives to attract investment and how to best design and administer these incentives to minimize erosion of the tax base in developing countries. It focuses on three key questions:

(a) How can developing countries best design and administer tax incentives to increase their effectiveness?

(b) How do tax systems in developed countries influence the desirability or effectiveness of tax incentives in developing countries?

(c) How does the project launched by the Organisation for Economic Co-operation and Development (OECD) to deal with base erosion and profit shifting (OECD project on BEPS)[1] change the tax environment related to developing countries' tax incentives?

Before turning to these questions, the following are some initial observations.[2] Some contend that tax incentives, particularly for foreign direct investment, are both bad in 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.

Yet almost all countries use tax incentives. In developed countries, tax incentives often take the form of investment tax credits, accelerated depreciation, and favorable tax treatment for expenditures on research and development. To the extent possible in the post-World Trade Organization (WTO) world, developed countries

---

* Michael H. Schill Distinguished Professor of Law, UCLA School of Law.

1 See Organisation for Economic Co-operation and Development, *Addressing Base Erosion and Profit Shifting* (Paris: OECD, 2013), available at http://www.oecd.org/tax/beps-reports.htm; and Ibid., *Action Plan on Base Erosion and Profit Shifting* (Paris: OECD, 2013), available at http://www.oecd.org/ctp/BEPSActionPlan.pdf.

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

also adopt tax regimes that favor 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.

Much has been written about the desirability of using tax incentives to attract new investment. The United Nations,[3] the International Monetary Fund (IMF),[4] the OECD,[5] and the World Bank[6] have produced useful reports that provide guidance to policymakers on whether to adopt tax incentives and how to best 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

---

3 See, for example, United Nations Conference on Trade and Development, "*Tax 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).

4 See, for example, George E. Lent, "Tax Incentives for Investment in Developing Countries," (1967) Vol. 14, No. 2 *Staff Papers, International Monetary Fund*, 249; 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); David Holland and Richard J. Vann, "Income Tax Incentives for Investment," in Victor Thuronyi, ed., *Tax Law Design and Drafting* (Washington, D.C.: IMF, 1998), Vol. 2, 986-1020.

5 See, for example, Organisation for Economic Co-operation and Development, *Tax Effects on Foreign Direct Investment: Recent Evidence and Policy Analysis*, Tax Policy Study No. 17, (2007); Ibid., "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).

6 See, for example, Robin W. Broadway 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.: WBG, 2013); Sebastian James, "Incentives and Investments: Evidence and Policy Implications," World Bank Group (Washington, D.C.: WBG, 2009); Alex Easson and Eric M. Zolt, "Tax Incentives," supra note 2.

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.

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.[7] 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 focusing 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.

1.1 Definition of tax incentives

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

---

[7] See, generally, Richard M. Bird and Eric M. Zolt, "Tax Policy in Emerging Countries," (2008) Vol. 26, *Environment and Planning C: Government and Policy*, 73-86; Richard M. Bird, "Tax Incentives for Investment in Developing Countries," in Guillermo Perry, John Whalley and Gary McMahon, eds., *Fiscal Reform and Structural Change in Developing Countries* (London: Canada: Macmillan in association with the International Development Research Centre, 2000), Vol. 1, 201-21.

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.

Tax incentives can also be defined in terms of their effect on reducing the effective tax burden for a specific project.[8] 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.

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.[9] 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 two years to ten 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 Howell H. Zee, Janet Gale Stotsky and Eduardo Ley, "Tax Incentives for Business Investment: A Primer for Tax Policy Makers in Developing Countries,'' supra note 3.

9 Alex Easson, "Tax Incentives for Foreign Investment, Part I: Recent Trends and Countertrends," (2001) Vol. 55, *Bulletin for International Fiscal Documentation,* 266.

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 different 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 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.

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 as compared to 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 granting favorable 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 providing investors additional tax benefits.

The effectiveness of tax incentives is directly related to the investment climate (including investors' confidence that a revenue authority will actually honor tax incentives without controversy) in a particular country.[10] While two countries could

---

[10] 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, WBG, 2009), available at http://ssrn.com/abstract=1568296.

provide identical tax incentives (for example, a ten-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.[11]

1.2 Different types of tax competition

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 favorable 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 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.

1.3 Additional investment incentives

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

---

11 Sebastian James, "Providing Incentives for Investment: Advice for Policymakers in Developing Countries," Investment Climate in Practice, No. 7, World Bank Group (Washington, D.C.: WBG, 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 favorable investment environments.

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.

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.

1.4 Role of non-tax factors

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.[12] A partial list of these factors is set forth in Box 1.

Box 1. 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.

[12] Sebastian James, "Effectiveness of Tax and Non-Tax Incentives and Investments: Evidence and Policy Implications," supra note 6.

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? And then, second, from a tax perspective, how would activities be structured to minimize tax liabilities (both on a country basis and an aggregate world-wide basis)?

1.5 Review of empirical evidence

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 to the effect of taxes on levels of foreign investment. Useful surveys are included in the Ruding Report,[13] Hines,[14] Mooij and Ederveen,[15]and Klemm and Van Parys.[16] These surveys note the difficulty of comparing the results of different studies because the studies contain different data sources, methodologies, and limitations. The studies also report different types of elasticities in measuring the responsiveness of investment to taxes.

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

---

13 Commission of the European Communities (CEC), "*Report of the Committee of Independent Experts on Company Taxation,"* (1992), (Official Publications of the EC, ISBN 92-826-4277-1).

14 James R. Hines, Jr., "Tax Policy and the Activities of Multinational Corporations," in Alan Auerbach, ed., *Fiscal Policy: Lessons from Economic Research* (Cambridge, MA: MIT Press, 1997) and James R. Hines, Jr., "Lessons from Behavioral Responses to International Taxation," (1999) Vol. 52, *National Tax Journal,* 305.

15 Ruud A. de Mooij and Sjef Ederveen, "Taxation and Foreign Direct Investment: A Synthesis of Empirical Research," (2003) Vol. 10 (6), *International Tax and Public Finance,* 673-93.

16 Alexander Klemm and Stefan Van Parys, "Empirical Evidence on the Effects of Tax Incentives," International Monetary Fund (Washington, D.C.: IMF, 2009).

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.

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.[17] Investors have several alternatives on how to fund new ventures or expand existing operations. 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.

When the results of tax incentive regimes are examined seriously, there are successes and failures.[18] A good review of the results of incentives is set forth in a 1996 United Nations study.[19] The United Nations study concludes 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."[20] The OECD reaches a similar conclusion in finding that host country taxation affects investment flows and that it is an increasingly important factor in locational decisions.[21]

---

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

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

19 United Nations Conference on Trade and Development, "*Tax Incentives and Foreign Direct Investment*," supra note 4.

20 Ibid., 44-45.

21 W. Steven Clark, "Tax Incentives for Foreign Direct Investment: Empirical Evidence on Effects and Alternative Policy Options," (2000) Vol. 48, *Canadian Tax Journal,* 1139.

2. Tax incentives: benefits and costs, design and administrative considerations

This section examines the benefits and costs of using tax incentives as well as important considerations in designing, granting and monitoring the use of tax incentives to increase investment and growth. Tax incentives are often criticized on grounds that they erode the tax base without any substantial effects on the level of investment. It is not easy, however, to separate criticism of the tax incentive regimes that are actually adopted from criticism of all tax incentives. Advisers have recognized that certain well-designed tax incentives have been successful in increasing investment.

2.1 Benefits and costs of tax incentives

2.1.1 Benefits of tax incentives

If properly designed and implemented, tax incentives are a useful tool in attracting investments that would not have been made without the provision of tax benefits. Tax incentives are justified if they correct market inefficiencies or generate positive externalities. Some commentators view such tax incentives as desirable, in that without government intervention the level of foreign direct investment will be sub-optimal.[22]

It is not surprising that governments often choose tax incentives over other types of government action. It is much easier to provide tax benefits than to correct deficiencies in the legal system or to dramatically improve the communications system in a country. Also, tax incentives do not require an actual expenditure of funds by the government. Some alternatives do, such as the provision of grants or cash subsidies to investors. Although tax incentives and cash grants may be similar economically, for political and other reasons, it is easier to provide tax benefits than to actually provide funds to investors.

New foreign direct investment may bring substantial benefits, some of which are not easily quantifiable. A well-targeted tax incentive programme may be successful in attracting specific projects or specific types of investors at reasonable

---

22 Yoram Y. Margalioth, "Tax Competition, Foreign Direct Investment and Growth: Using Tax Incentives to Promote Developing Countries," (2003) Vol. 23, *Virginia Tax Review*, 161.

costs as compared to the benefits received. The types of benefits from tax incentives for foreign investment follow the traditional list of benefits resulting from foreign direct investment. These include increased capital transfers, transfers of know-how and technology, increased employment and assistance in improving conditions in less-developed areas.

Foreign direct investment may generate substantial spillover effects. For example, the choice of location for a large manufacturing facility will not only result in increased investment and employment in that facility, but also at firms that supply and distribute the products from it. Economic growth will increase the spending power of the country's residents that, in turn, will increase demand for new goods and services. Increased investment may also increase government tax revenue either directly from taxes paid by the investor (for example, after the expiration of the tax holiday period) or indirectly through increased tax revenues received from employees, suppliers, and consumers.

This positive view of the benefits of foreign direct investment has recently been challenged by Yariv Brauner.[23] Like other scholars, Brauner questions whether tax incentives actually increase the level of foreign direct investment. However, Brauner goes further and challenges whether foreign direct investment actually generates economic growth that is beneficial for development. Under this view, even if tax incentives succeed in attracting new investment, it is not clear, with many types of foreign investments, that the developing country benefits.

One can provide a general description of the types of benefits of additional investment resulting from tax incentives. It is difficult, however, to estimate the benefits resulting from tax incentives with any degree of certainty. Sometimes the benefits are hard to quantify. Other times the benefit accrues to persons other than the firm receiving the tax benefits.

2.1.2 Costs of tax incentives

In considering the costs of a tax incentive regime, it may be useful to examine four different types of costs: (a) revenue costs; (b) resource allocation costs; (c)

---

[23] Yariv Brauner, "The Future of Tax Incentives for Developing Countries," in Yariv Brauner and Miranda Stewart, eds., *Tax Law and Development* (Cheltenham: Edward Elger Publishing, 2014).

enforcement and compliance costs; and (d) the costs associated with corruption and lack of transparency.[24]

2.1.2.1 Revenue costs

The tax revenue losses from tax incentives come from two primary sources: first, forgone revenue from projects that would have been undertaken even if the investor did not receive any tax incentives; and, second, lost revenue from investors and activities that improperly claim incentives or shift income from related taxable firms to those firms qualifying for favourable tax treatment.

Policymakers seek to target tax incentives to achieve the greatest possible benefits for the lowest costs. Ideally, the objective would be to offer tax incentives only to those investors who at the margin would invest elsewhere but for the tax incentives. Offering tax incentives to those investors whose decisions to invest are not affected by the proposed tax benefit just results in a transfer to the investor from the host government without any gain. However, it is very difficult to determine on a project-by-project basis which of them were undertaken solely due to tax incentives. Similarly, it is hard to estimate for an economy as a whole what the levels of investment would be with or without a tax incentive regime.

For those projects that would not have been undertaken without tax incentives, there is no real loss of tax revenue from those firms. To the extent that the firms become regular taxpayers or that these operations generate other tax revenue (such as increased profits from suppliers or increased wage taxes from employees), there are revenue gains from those projects.

An additional revenue cost of tax incentives results from erosion of the revenue base due to taxpayers abusing the tax incentive regimes to avoid paying taxes on non-qualifying activities or income. This can take many forms. Revenue losses can result where taxpayers disguise their operations to qualify for tax benefits. For example, if tax incentives are only available to foreign investors, local firms or individuals can use foreign corporations through which to route their local investments. Similarly, if tax benefits are available to only new firms, then taxpayers

---

24 Howell H. Zee, Janet Gale Stotsky and Eduardo Ley, “Tax Incentives for Business Investment: A Primer for Tax Policy Makers in Developing Countries,’’ supra note 3.

can reincorporate or set up many new related corporations to be treated as a new taxpayer under the tax incentive regime.

Other leakages occur where taxpayers use tax incentives to reduce the tax liability from non-qualified activities. For example, assume that a firm qualifies for a tax holiday because it is engaged in a type of activity that the government believes merits tax incentives. It is likely quite difficult to monitor the firm's operation to ensure it does not engage in additional non-qualifying activities. Even where the activities are separated, it is very difficult to monitor related party transactions to make sure that income is not shifted from a taxable firm to a related one that qualifies for a tax holiday.

2.1.2.2 Resource allocation costs

If tax incentives are successful, they will cause additional investment in sectors, regions or countries that would not otherwise have occurred. Sometimes this additional investment will correct for market failures. Other times, however, the tax incentives will cause allocation of resources that may result in too much investment in certain activities or too little investment in other non-tax favoured areas.

It is difficult to determine the effects of tax provisions in countries where markets are relatively developed. It is even more difficult to determine the consequences of tax provisions in developing countries where markets are not well approximated by existing competitive models. As such, where markets are imperfect, it is not clear whether providing tax incentives to correct market imperfections will make markets more competitive.[25]

2.1.2.3 Enforcement and compliance costs

As with any tax provision, there are resource costs incurred by the government in enforcing the tax rules and by taxpayers in complying. The cost of enforcement relates to the initial grant of the incentive as well as the costs incurred in monitoring compliance with the qualification requirements and enforcing any recapture provisions upon termination or failure to continue to qualify. The greater the complexity of the tax incentive regime, the higher the enforcement costs (as well as

[25] Richard George Lipsey and Kelvin Lancaster, "The General Theory of Second Best," (1956) Vol. 24, No. 11 *Review of Economic Studies*.

compliance costs) may be. Similarly, tax incentive schemes that have many beneficiaries are harder to enforce than narrowly targeted regimes.

It is also difficult to get revenue authorities enthusiastic about spending resources to monitor tax incentive schemes. Revenue authorities seek to use their limited administrative resources to improve tax collection, so it is not surprising that they prefer auditing fully taxable firms rather than those firms operating under a tax holiday arrangement.

2.1.2.4 Opportunities for corruption

The existence of corruption can constitute a major barrier to foreign investment in a country. This does not, however, prevent foreign investors from benefitting from a corrupt system. Recent scholars have focused on the corruption and other rent-seeking behaviour associated with the granting of tax incentives. Several different policy approaches exist to designing the qualification requirements for tax incentives. Policymakers can choose between automatic and objective approaches versus discretionary and subjective approaches. The opportunity for corruption is much greater for tax incentives regimes where officials have much discretion in determining which investors or projects receive favourable treatment. The potential for abuse is also greater where no clear guidelines exist for qualification.

The OECD, the IMF and the World Bank have projects that try to reduce corruption and provide assistance to countries to establish anti-corruption programmes.[26] One element of such programmes should be the monitoring of foreign investment projects and, especially, the granting of investment incentives. If a tax incentive is subsequently found to have been improperly obtained, then, in addition to any other legal sanctions, the privileges should be withdrawn and any tax that has been avoided should be repaid.

---

[26] OECD, United Nations Office on Drugs and Crime and World Bank (UNODC), *Anti-Corruption Ethics and Compliance Handbook for Business* (available at http://www.unodc.org/documents/corruption/Publications/2013/Anti-CorruptionEthicsComplianceHandbook.pdf); OECD, Asian Development Bank Organization for Economic Co-operation and Development Anti-Corruption Initiative for Asia and the Pacific (available at http://www.oecd.org/site/adboecdanti-corruptioninitiative/publications.htm); Vito Tanzi, “Corruption Around the World: Causes, Consequences, Scope and Cures,” (1980) Vol. 45, No. 4 *Staff Papers, International Monetary Fund.*

2.1.2.5 Estimates of costs of tax incentives

Even where tax incentives succeed in attracting investment, the costs of the incentives may exceed the benefit derived from the new investment. This is difficult to substantiate, as problems exist in estimating the costs and benefits of tax incentives. One method of cost-benefit analysis is to estimate the cost (in terms of revenue forgone and/or direct financial subsidies) for each job created. Studies using this approach may not provide a true measure of efficiency, because they measure only the cost, and not the value, of the jobs created. The cost of jobs, however, varies widely according to the country and the industrial sector, and the more "expensive" jobs may bring with them greater spillover benefits, such as technology transfer.

All revenue estimates are based on a set of assumptions as to responses of taxpayers to particular tax law changes. In assessing the performance of tax incentive schemes, the objective is to determine the amount of incremental investment resulting from tax incentives and to be able to determine the costs and benefits associated with attracting that investment.

This requires making assumptions as to such items as: (a) the amount of investment that would have been made without the tax incentive programme; (b) the amount of "leakage" from the tax base due to taxpayers improperly claiming the tax incentives or from shifting income from taxable to related tax-exempt (or lower-taxed) entities; and (c) the tax revenue gained from either activities from taxpayers granted a tax incentive after the incentive expired or from the activities generating other sources of tax revenue.

Two methods to increase accountability and transparency of tax incentives are tax incentive budgets and general tax expenditure analysis. As discussed below, in many countries, the tax authorities do not have sole responsibility or discretion in designing and administering tax incentive programmes. In many countries, different government agencies, such as foreign investment agencies or ministries of economy, have a role in designing investment regimes, approving projects, and monitoring investments. These agencies' major objective is in attracting investments; they are often less concerned with protecting the tax base.

One approach that merits consideration is to set a target monetary amount of tax benefits to be granted under a tax incentive regime. This would require both the tax authorities and other government agencies to agree on both a target amount and a methodology for determining the revenue costs associated with a particular tax incentive regime.

A second method that merits serious consideration is to include tax incentives in a formal "tax expenditure budget." All OECD countries and several other countries require estimates to be prepared as to the revenue impact of certain existing and proposed tax provisions. The goal of these budgets is to highlight the revenue consequences of providing tax benefits. This approach seeks to treat tax expenditures in a manner similar to direct spending programmes, and thus effectively equates direct spending by the government with indirect spending by the government through the tax system. While the scope of tax expenditure analysis goes beyond tax incentives, countries can choose to follow this approach for only certain types of tax incentives or for a broader class of tax provisions. For those countries that do not have a formal tax expenditure requirement, it makes good sense to go through the exercise in deciding whether to adopt or retain a tax incentive regime.[27]

2.2 Design considerations for tax incentives

2.2.1 Eligibility issues

Tax incentives are departures from the benchmark system that are granted only to those investors or investments that satisfy prescribed conditions. These special tax privileges may be justified only if they attract investments that are both particularly desirable and that would not be made without such tax benefits. Thus, the first question in designing a tax incentive system is "what types of investment are the incentives intended to attract?"

2.2.1.1 Targeting of incentives

Incentives may be broadly targeted—for example, they may target all new investment, foreign or domestic—or they may be very narrowly targeted, and designed with one particular proposed investment in mind. The targeting of incentives serves two important purposes: (a) it identifies the types of investment that host

[27] Sebastian James, "Effectiveness of Tax and Non-Tax Incentives and Investments: Evidence and Policy Implications," supra note 6.

governments seek to attract; and (b) it reduces the cost of incentives because it reduces the number of investors that benefit.

This raises the question of whether a government should treat some types of investment as more desirable or beneficial than others. Should a government seek to attract and target tax incentives at particular types of investments and not others, or should investment decisions be left solely to market forces? Justifiable doubt exists about the ability of politicians to "pick winners," particularly in countries where markets are less than perfect. Also, there are some types of investment that, while not prohibited altogether, may not deserve encouragement in the form of tax benefits. Ideally, incentives should be given only for incremental investment; that is, for investments that would not otherwise have occurred but for the tax benefits.

An initial question is whether the granting of tax incentives should be discretionary, or should be automatic once the prescribed conditions are met. In many cases it may be advisable to limit discretion. But if qualification for incentives is made largely automatic, it becomes necessary for the qualifying conditions to be spelled out clearly and in detail.

Many countries grant preferential tax treatment to certain sectors of the economy, or to certain types of activities. Sectoral targeting has many advantages; (a) it restricts the benefits of the incentives to those types of investment that policymakers consider to be most desirable; and (b) it also makes it possible to target those sectors that are most likely to be influenced by tax considerations. Among the activities commonly preferred are manufacturing activities, pioneer industries, export promotion, locational incentives and investments that result in significant transfers of technology.

Countries may elect to restrict investment incentives to manufacturing activities or provide for those activities to receive preferential treatment (for example, China, Ireland). This may reflect a perception that manufacturing is somehow more valuable than the provision of services, perhaps because of its potential to create employment, or a view that services (with some exceptions) tend to be more market-driven and therefore less likely to be influenced by tax considerations.

Some countries adopt a more sophisticated approach and restrict special investment incentives to certain broadly listed activities or sectors of the economy.

These countries can restrict tax incentives to “pioneer” enterprises. Generally, to be accorded pioneer status, an enterprise must manufacture products that are not already produced domestically, or engage in certain other listed activities that are not being performed by domestic firms and that are considered especially beneficial to the host country.

Many countries also provide tax incentives to locate investments in particular areas or regions within the country. Sometimes the incentives are provided by regional or local governments, in competition with other parts of the same country. In other cases, the incentives are offered by the central government, often as part of its regional development policy, to promote investment in less-developed regions of the country or in areas of high unemployment.

One benefit of foreign direct investment is the creation of new employment opportunities and, not surprisingly, incentives are frequently provided specifically to encourage job creation. Policymakers could provide for tax incentives for investment in regions of high unemployment, or they could tie the tax incentive directly to employment, with the creation of a stipulated number of new jobs as a qualifying condition for the tax holiday or other incentive.

Foreign direct investment often results in the transfer of technology. Even critics of tax incentives concede that they may be useful to promote activities such as research and development, if only as a way of correcting market imperfections. Countries attempt to attract technologically-advanced investment in several ways: (a) by targeting incentives at technologically-advanced sectors; (b) by providing incentives for the acquisition of technologically-advanced equipment; and (c) by providing incentives for carrying out research and development (R & D activities).

Finally, the experience of many developing countries is that export promotion, and the attraction of export-oriented investment, is the quickest and most successful route to economic growth. It is therefore hardly surprising that competition to attract such investment is especially fierce, and investment incentives are frequently targeted at export-oriented production. Incentives targeted specifically at export-oriented investment may be more effective than other tax incentives, due to the higher degree of mobility of such investment.

2.2.1.2 Forms of tax incentives

Designing tax incentives requires two basic decisions: one, determining the types of investment that qualify; and two, determining the form of tax incentive to adopt. Tax incentives for investment take a variety of forms. Table 1 sets forth the most commonly employed tax incentives.

Table 1: Prevalence of tax incentives around the world[28]

	Number of countries surveyed	Tax holiday /Tax exemption	Reduced tax rate	Investment allowance/ Tax credit	VAT exemption / reduction	R & D tax incentive	Super-deductions	SEZ/Free Zones[a/]EPZ/Free port [b/]	Discretionary process
East Asia and Pacific	12	92%	92%	75%	75%	83%	8%	83%	25%
Eastern Europe and Central Asia	16	75%	31%	19%	94%	31%	0%	94%	38%
Latin America and the Caribbean	24	75%	29%	46%	58%	13%	4%	75%	29%
Middle-East and North Africa	15	73%	40%	13%	60%	0%	0%	80%	27%
OECD	33	21%	30%	61%	79%	76%	18%	67%	27%
South Asia	7	100%	43%	71%	100%	29%	57%	71%	14%
Sub-Saharan Africa	30	60%	63%	73%	73%	10%	23%	57%	47%

a/ Special economic zone (SEZ).

b/ Export processing zone (EPZ).

28 Ibid.

This section examines three different types of tax incentives: tax holidays, investment credits and allowances, and tax credit accounts. While the first two types of incentives are used frequently, the tax credit account approach has received too little attention from policymakers.

2.2.1.3 Tax holidays

In developing countries, tax holidays are by far the most common form of tax incentive for investment. A tax holiday may take the form of a complete exemption from profits tax (and sometimes from other taxes as well), a reduced rate of tax, or a combination of the two (for example, two years exemption, plus a further three years at half-rate). The exemption or reduction is granted for a limited duration.

Tax holidays can vary in duration from as little as one year to as long as twenty years. In determining the length of the tax holiday, a clear trade-off exists between the attractiveness to investors and the revenue cost to the host country's treasury. Most studies have concluded that short tax holidays are of limited value or interest to most potential investors and are rarely effective in attracting investment, other than short-term, "footloose" projects. Substantial investments often take several years before they begin to show a profit, by which time the tax holiday may have expired. Short tax holidays are of the greatest value to investments that can be expected to show a quick profit and are consequently quite effective in attracting investment in export-oriented activities such as textile production. Since that sector is highly mobile, however, it is not uncommon for a firm to enjoy a tax holiday in one country and, when it expires, to move its entire operation to another country that is willing to give a new holiday. Consequently, the benefit of the investment to the host country may be quite limited.

Tax holidays have the apparent advantage of simplicity for both the enterprise and the tax authorities. The simplest tax holiday regime, and most investor-friendly, provides not only that no tax is payable during the holiday period, but also that taxpayers are not required to file information or tax returns. While this results in an absence of compliance or administrative costs, the better approach is to require the filing of a tax return during the holiday period. For example, if the enterprise is allowed to carry forward losses incurred in the holiday period or to claim depreciation allowances after the end of the holiday for expenditure incurred during the holiday, the enterprise will obviously need to file a return or at least keep appropriate records.

Additionally, tax holidays are especially prone to manipulation and provide opportunities for tax avoidance and abuse. Another disadvantage is that the revenue cost of tax holidays cannot be estimated in advance with any degree of accuracy, nor is the cost related to the amount of the investment or to the benefits that may accrue to the host country. Finally, tax holidays exempt profits without regard to the level or amount of profits that are earned. For potential investments that investors believe will earn above market returns, tax holidays will result in a loss of tax revenue without any benefits. Because of the high return, investors would have undertaken these projects even without the availability of tax incentives.[29]

2.2.1.4 Investment allowances and credits

As an alternative, or sometimes in addition, to tax holidays, some governments provide investment allowances or credits. These are given in addition to the normal depreciation allowances, with the result that the investor may be able to write off an amount that is greater than the cost of the investment. An investment allowance reduces taxable income, whereas an investment tax credit is set against the tax payable; thus, with a corporate income tax rate of 40 per cent, an investment allowance of 50 per cent of the amount invested equates to an investment credit of 20 per cent of that amount.

Investment allowances or credits may apply to all forms of capital investment, or they may be restricted to specific categories, such as machinery or technologically advanced equipment, or to capital investment in certain activities, such as research and development. Sometimes, countries limit eligibility to contributions to the charter capital of the firm. This approach may encourage investors to increase the relative amount of equity capital rather than related-party debt capital in the firm's initial capital structure.

One objection to the use of investment allowances and credits is that they favour capital-intensive investment and may be less favourable towards employment

---

[29] Vito Tanzi and Howell H. Zee, "Tax Policy for Emerging Markets: Developing Countries," International Monetary Fund (Washington, D.C.: IMF, 2000).

creation than tax holidays. They may also distort the choice of capital assets, possibly creating a preference for short-lived assets so that a further allowance or credit may be claimed on replacement.

Investment allowances and credits seem preferable to tax holidays in almost every respect: (a) they are not open-ended; (b) the revenue cost is directly related to the amount of the investment, so there should be no need for a minimum threshold for eligibility; and (c) their maximum cost is more easily estimated. A recent study, however, finds that investment credit and allowances are significantly less effective in attracting foreign investment than tax holidays.[30]

2.2.1.5 Tax credit accounts

Vito Tanzi and Howell Zee propose an interesting approach to offering tax benefits to potential investors that allows taxing authorities to determine with great certainty the revenue costs of the tax incentive programme.[31] This approach provides each qualifying investor a specific amount of tax relief in the form of a tax credit account (say, for example, potential exemption for US$500,000 of corporate income tax liability). The investor would be required to file tax returns and keep books and records just like any other taxpayer. If the investor determines it has US$60,000 of tax liability in year one, it would pay no tax, but the amount in its tax account would be reduced to US$440,000 for future tax years. The tax credit account has the advantage of providing transparency and certainty to both the potential investor and the government.

The tax credit account may be regarded as a sort of hybrid: a cross between a tax holiday and an investment tax credit. It resembles a tax holiday, except that the tax exemption period, instead of being a fixed number of years, is related to the amount of taxes due on the income earned (for example, the exemption applies to the first US$100,000 of taxable income). This has two important advantages: the cost of the incentive to the host government is known, and there is no strong built-in advantage for those investments that make quick profits. The tax credit account also resembles

---

[30] Alexander Klemm and Stefan Van Parys, "Empirical Evidence on the Effects of Tax Incentives," supra note 16.

[31] Vito Tanzi and Howell H. Zee, "Tax Policy for Emerging Markets: Developing Countries," supra note 29.

an investment tax credit in that the amount of the credit is a fixed sum: where it differs is that the amount is not determined by the amount of the investment. It consequently does not provide a preference to capital-intensive investments.

2.2.2 Implementation issues

2.2.2.1 Initial compliance with qualifying conditions

The first administrative issue is determining whether an investor meets the qualifying conditions. Some incentive provisions require initial approval or some other positive decision. For example, officials may need to determine that the investment is in a priority sector or that prescribed employment or export targets will be met, or that environmental requirements will be complied with. Generally, tax authorities will require some form of written certification as to qualification. A second type of qualifying condition requires what is essentially a factual determination: for example, that the foreign participation in a joint venture exceeds a stipulated percentage, that a certain number of new jobs have been created, that a particular capital investment falls within a category qualifying for accelerated depreciation, or that imported equipment can be classified as “advanced technology.” Tax authorities sometimes carry out this verification: otherwise, they can be expected to require written confirmation from the appropriate authority or department. A third type of condition requires a valuation of assets. For example, investors may be required to establish that the amount invested exceeds the minimum stipulated amount needed to qualify for a tax holiday, or that an investment qualifies for a tax credit of a given amount.

2.2.2.2 Reporting and monitoring continuing compliance

Conditions are sometimes attached to incentives that are related to ongoing performance -- for example, requirements that a given number of jobs are maintained, or that a certain percentage of production is exported, throughout the tax holiday period. Incentives of this type require continual monitoring. Although this imposes an additional administrative burden on authorities, it does have the merit of providing the host government with a reasonably accurate idea of how an investment is performing. Without a formal monitoring mechanism, investors have little reason to make realistic projections as to the number of jobs that will be created, or the volume of exports that will be produced, and some studies have shown large discrepancies between investor prediction and performance. However, it is important that administrative capabilities to conduct necessary monitoring are taken into account when incentive legislation is drafted so that unnecessary supervision is avoided.

2.2.2.3 Common abuses

On-going monitoring of investments is necessary not only to ensure continuing compliance with qualifying conditions but also to detect tax avoidance or evasion. Tax avoidance presents greater difficulties, because countries have different attitudes as to what constitutes avoidance, and what to do about it. For example, a tax holiday may be conditional on employing a given number of persons. In some countries an investor could legitimately make up the qualifying number by hiring "employees" with minimal duties and at low wages. In other countries, this course of action might be considered an abuse of the legislation and result in the denial or withdrawal of the tax privilege.

Box 2 sets forth some of the more common abuses associated with tax incentives. The related discussion provides additional details of some of these abuses.

Box 2. Top ten abuses of tax incentive regimes

1. Existing firms transforming to new entities to qualify for incentives.
2. Domestic firms restructuring as foreign investors.
3. Transfer pricing schemes with related entities (sales, services, loans, royalties, management contracts).
4. Churning or fictitious investments (lack of recapture rules).
5. Schemes to accelerate income (or defer deductions) at the end of a tax holiday period.
6. Over-valuation of assets for depreciation, tax credit, or other purposes.
7. Employment and training credits – fictitious employees and phony training programmes.
8. Export zones – leakages into domestic economy.
9. Regional investment incentives and enterprise zones – diverting activities to outside the region or zone.
10. Disguising or burying of non-qualifying activities into qualifying activities.

2.2.2.4 Round-tripping

Round-tripping typically occurs where tax incentives are restricted to foreign investors or to investments with a prescribed minimum percentage of foreign ownership. Domestic investors may seek to disguise their investments to qualify for incentives for foreign investment by routing their investment through a wholly-controlled foreign corporation. Similar practices have occurred in a number of transition economies, especially in connection with the privatisation of state-owned firms, where the existing management has acquired ownership of the firm through the vehicle of an offshore company.[32]

2.2.2.5 Double dipping

Many tax incentives, especially tax holidays, are restricted to new investors. In practice, such a restriction may be ineffective or counter-productive. An existing investor that plans to expand its activities will simply incorporate a subsidiary to carry on the activity, and the subsidiary will qualify for a new tax holiday. A different type of abuse occurs where a business is sold towards the end of the tax holiday period to a new investor who then claims a new tax holiday. Sometimes the “new” investor is related to the seller, though the relationship is concealed. A more satisfactory approach for policymakers may be to use investment allowances or credits, rather than tax holidays, so that new investments, rather than investors, qualify.

2.2.2.6 Transfer pricing

Transfer pricing has been described as “the Achilles heel of tax holidays,”[33] though it can be a problem with other forms of investment incentives as well. The tendency is to think of transfer pricing as a phenomenon that occurs internationally in transactions between related enterprises in different countries. Transfer pricing can also take place in a single country where an investor has two or more operations within a country or where the investor derives income from more than one activity. If one of those operations, or one type of income, enjoys a tax preference, profits will tend to be allocated to the preferred activity.

---

32 Round-tripping is not always undertaken in order to meet foreign ownership requirements; it may also be used to take advantage of favorable tax treaty provisions.

33 Charles E. McLure, Jr., “Tax Holidays and Investment Incentives: A Comparative Analysis,” (1999) Vol. 53, *Bulletin for International Fiscal Documentation,* 326-327.

Transfer pricing is likely to take place where: (a) an investor undertakes two or more activities, one of which qualifies for an incentive (for example, manufacturing, exporting) and another does not; (b) an investor has operations in two or more locations, one of which is in a tax-privileged region and another is not; or (c) an investor owns two or more subsidiaries, one of which enjoys a tax holiday and another does not. In each of these cases the investor will wish to allocate as much profit as possible to the tax-exempt (or tax-privileged) entity or activity. (In cases (a) and (b) there may be only a single entity, in which case there is no transfer-pricing as such, but an equivalent result is achieved through the allocation of revenues and expenditures.)

Substantial challenges exist for monitoring transfer-pricing, especially for small or less-developed countries. One approach may be to use those tax incentives that are less prone to transfer-pricing abuses. For example, in contrast to tax holidays, investment allowances or credits provide an exemption from tax of a given amount, rather than for a given period. Consequently, artificial transfers of profits to a firm that has been granted an investment allowance or credit may result in tax liability being postponed but not eliminated.

2.2.2.7 Over-valuation

Over-valuation (or sometimes under-valuation) is a constant problem in any tax system. Tax incentives, however, may provide additional temptations to inflate the values of assets. For example, where a tax holiday is conditional upon a certain minimum amount being invested, the value of assets contributed to the new firm can be manipulated to achieve the target figure. Sometimes this is done legitimately. For example, firms may purchase machinery rather than lease property from independent lessors. Other times, however, an inflated value is attributed to the property contributed, especially in the case of intellectual property. In cases where investors also receive an exemption from customs duty for newly contributed capital, no compensating motivation exists to correctly state the value, and no reason exists for customs authorities to pay much attention to the declared value.[34]

[34] Sometimes there is a further problem. Foreign investment agencies have an incentive to boost their investment figures, so that there is almost a conspiracy between the agency and

2.2.2.8 Abuse of duty-free privileges

A common investment incentive takes the form of an exemption from customs duty on imported equipment. A danger is that, once imported, items may be resold on the domestic market. A partial solution is to restrict the exemption to those assets that are contributed to the charter capital of the enterprise. Even so, it may be necessary to verify periodically that the assets remain in the enterprise. Another approach is to restrict the exemption to assets such as machinery (which are less likely to be resold) and to exclude items such as passenger vehicles and computer equipment.

2.2.2.9 Assets stripping and "fly-by-night" operations

Many countries have experienced problems with "fly-by-night" operators that take advantage of tax incentives to make a quick, tax-free profit and then disappear to begin operations in some other country that offers tax privileges. This problem most often arises with the use of tax holidays and export processing zones. A further problem sometimes occurs where a foreign investor acquires control of an existing local enterprise and instead of contributing new capital to modernize the enterprise; the investor strips it of its useful assets and simply disappears.[35]

Some countries have attempted to counter the "fly-by-night" problem by introducing "clawback" provisions. For example, a country can grant a tax holiday for a five-year period, but only provided the venture continues for a period of ten years. If the venture is terminated before the end of the ten-year period, any tax "spared" must be repaid. The difficulty with such a provision is that the investor may have vanished before it is possible to claw back any of the forgiven tax liability.

2.2.3 Review and sunset provisions

The costs and benefits of tax incentives are not easy to evaluate and are hard to quantify and estimate. Incentives that may work well in one country or region may be ineffective in another context. Tax incentive regimes in many countries have evolved from general tax holidays to incentive regimes that are more narrowly targeted.

---

the investor to inflate the amount of the investment. It is thus important for the tax administration to be involved in the valuation process.

35 This latter problem is not necessarily linked to the availability of tax incentives, though the ability to make a tax-free capital gain is an added attraction to the assets stripper.

It therefore may make sense (a) to limit the duration of tax incentive regimes to reduce the potential costs of unsuccessful or poorly designed programmes by including a specific "sunset" provision as part of the original legislation; (b) to design incentive regimes to require information reporting by beneficiaries to investment agencies and to specify what government agency has responsibility for monitoring and enforcing qualification and any recapture provisions; and (c) to require an evaluation as to the costs and benefits of specific tax incentive regimes and to specify the timing of the evaluation and the parties responsible for conducting the review.

2.2.4 Guidance for policymakers

No shortage exists on advice to policymakers on how to design and implement tax incentives. Richard M. Bird has put forth a relatively concise prescription.[36] He first recommends that policymakers keep tax incentives simple. Bird contends that attempts to fine-tune incentives to achieve detailed policy goals are likely to be costly to administer and unlikely to produce the desired result. Second, Bird recommends that the government keep good records as to who gets what tax incentives, for what time period, and at what costs in revenue forgone. This information is necessary to ensure transparency and accountability. Finally, governments must evaluate the effectiveness of tax incentives in achieving the desired results and be willing to terminate or modify those incentive programmes that fail to achieve their objectives.

The OECD has prepared a "best practice" guide to aid in the transparency and governance of tax incentives in developing countries. [37] Box 3 provides a summary of the OECD's recommendations.

---

[36] Richard M. Bird, "Tax Incentives for Investment in Developing Countries," supra note 7.

[37] OECD, Draft Principles to Enhance the Transparency and Governance of Tax Incentives for Investment in Developing Countries (available at http://www.oecd.org/ctp/tax-global/transparency-and-governance-principles.pdf).

Box 3. OECD draft principles to enhance the transparency and governance of tax incentives for investment in developing countries

1. Make public a statement of all tax incentives for investments and their objectives within the governing framework.
2. Provide tax incentives for investment through tax laws only.
3. Consolidate all tax incentives for investment under the authority of one government body, where possible.
4. Ensure tax incentives for investments are ratified through the lawmaking body or parliament.
5. Administer tax incentives for investment in a transparent manner.
6. Calculate the amount of revenue forgone attributable to tax incentives for investment and publicly release a statement of tax expenditures.
7. Carry out periodic review of the continuance of existing tax incentives by assessing the extent to which they meet the stated objectives.
8. Highlight the largest beneficiaries of tax incentives for investment by specific provision in a regular statement of tax expenditures, where possible.
9. Collect data systematically to underpin the statement of tax expenditures for investment and to monitor the overall effects and effectiveness of individual tax incentives.
10. Enhance regional cooperation to avoid harmful tax competition.

3. Impact of developed countries' tax systems on the desirability or effectiveness of tax incentives

The effectiveness of tax incentives is tied not only to taxes imposed in the country of the investment but also to the taxes imposed by other countries, most notably the home country of the foreign investor. Foreign investors focus on their aggregate world-wide tax liability, which requires consideration of the tax systems of those countries where they are required to pay taxes as well as the tax regimes of their country of residence. It is therefore important to consider the investor's home country's tax system in estimating the influence of tax incentives offered by the host country in attracting investment. Countries generally tax their corporate taxpayers on their foreign source income under one of two alternatives: (a) the "credit" method, whereby corporate taxpayers are taxed on their world-wide income and receive a foreign tax credit against their domestic tax liability for foreign income taxes paid on the foreign source income; or (b) the "exemption" or "territorial" method, whereby corporate taxpayers are generally taxed on only their domestic source income and can exempt certain foreign source income in computing their tax liability.

In theory, foreign investors from countries that adopt the credit method are less likely to benefit from tax incentives, as the tax revenue from the favored activities may be effectively transferred to the investor's revenue service from the tax authorities in the host country. In practice, however, because foreign investors have different alternatives to structuring their foreign investments, the effect of the different tax approach is likely to be relatively small.

3.1 Simple model

One approach to understanding how a foreign investor's home country's tax system affects the attractiveness of developing countries' tax incentives is to begin with a simple model of foreign direct investment. This simple model of direct investment assumes the foreign investor invests directly in a developing country either through a branch or through a subsidiary that immediately repatriates any profits to the parent corporation.

Under a "territorial" system, for many types of income, the tax imposed by the host country would constitute a final tax on profits earned in that country. Because foreign source income is generally not subject to tax in the investor's country of residence, any tax advantages from tax incentives will flow directly to the foreign investor.

In contrast, under a "world-wide" tax system, the foreign investor is subject to tax in both the country of the source of the income and the country of residence. This potential double taxation is generally reduced through the resident country providing a credit for foreign income taxes paid on foreign source income. But what happens if the foreign investor receives a tax incentive that substantially reduces or eliminates the tax in the country of investment?

The 2000 UNCTAD Study on Tax Incentives and Foreign Direct Investment provides an answer to the question above:

> "In order to assess the full tax treatment of FDI [foreign direct investment], it is necessary to look into the way home countries tax the income generated in host countries. Where an investor is subject to tax under a residence-based principle, the introduction of a tax incentive such as a tax holiday reduces or eliminates tax credit in the host country. It has the effect of increasing the tax revenues in the home country dollar for dollar. For an investor, the total tax burden remains unchanged, negating the benefits of tax incentives. Tax incentives simply result in the transfer of tax revenues from the host country treasury to the home country treasury."[38]

The following is a simple example, on the assumption that the corporate tax rate in South Africa is 30 per cent and the corporate tax rate in the United States is 35 per cent and that a United States corporation invests directly in a business in South Africa. If the South African business generates US$1 million in profits and repatriates the profits to the United States, the South Africa Revenue Service would collect US$300,000 in taxes and the United States Internal Revenue Service would collect US$50,000 (the United States would impose a 35 per cent tax on the foreign income but then allow a foreign tax credit for the US$300,000 tax paid to the South African Government). On the further assumption that the South African Government provided a tax holiday for this investment in South Africa while the South African tax liability on the US $1 million profits would be reduced to zero, the United States tax liability would be increased from US$50,000 to US$350,000 (the 35 per cent United States tax without any reduction for foreign income taxes paid). While the aggregate tax liability of the United States investor remained the same, the South African tax incentive results in an effective transfer of US$300,000 from the South African Government to the United States Government.

To address this concern, tax sparing provisions are often included in treaties between developed countries and developing countries. These provisions generally treat any source country tax that, but for the tax incentive, would have been treated as foreign taxes paid for purposes of computing the tax liability in the country of

---

[38] United Nations Conference on Trade and Development, *"Tax Incentives and Foreign Direct Investment: A Global Survey*," supra note 4.

residence. These tax sparing provisions ensure that the investor gets the tax benefit from tax incentives (rather than the investor's home government).

Several developed countries (with the notable exception of the United States) have included tax sparing provisions in their treaties with developing countries. Some scholars contend that the failure of the United States to provide tax sparing has severely limited the attractiveness for United States companies to invest in developing countries. In order to increase investment in less developed regions, they call for the United States to provide tax sparing in treaties with developing countries or adopt an exemption system for investment in certain countries.[39]

One view of tax sparing provisions is that they constitute a form of foreign assistance from developed countries to developing countries. In essence, the developed country is transferring an amount equal to the taxes they would have collected but for the tax sparing arrangement to the treasury of the developing country. The desirability of this form of foreign assistance rests on the effectiveness of tax incentives in providing benefits to developing countries as compared to the benefits from other forms of foreign assistance. Thus, if one believes that tax incentives in developing countries are largely ineffective in promoting foreign investment or economic growth, then developed countries should provide foreign assistance in a form other than tax sparing provisions.[40]

A different view of tax sparing considers the sovereign rights of countries to determine the tax liability of operations conducted in their country.[41] Here, the focus is not on paternalistic transfers from the rich to the poor, but rather the right of any

---

39 Other scholars have proposed alternatives to the simple tax sparing approach outlined above by either allowing tax sparing but only after grossing the amount of income to include the value of the tax subsidy or by allowing tax sparing only for the excess profits amounts, and only if the source country exempts the taxation of normal returns. Paul McDaniel, The U.S. Tax Treatment of Foreign Source Income Earned in Developing Countries (2003) Vol. 35, No. 2. *George Washington International Law Review*, 265; William B. Barker, An International Tax System for Emerging Economies, Tax Sparing, and Development: It is All About Source (2007) Vol. 29, *University of Pennsylvania Journal of International Law*, 349. While both approaches merit further consideration, the likelihood of them being adopted is small.

40 OECD, *"Tax Sparing: A Reconsideration"* (Paris: OECD, 1998).

41 Luis Eduardo Schoueri, "Tax Sparing: A Reconsideration of the Reconsideration," in Yariv Brauner and Miranda Stewart, eds., *Tax Law and Development* (Cheltenham: Edward Elger Publishing, 2013).

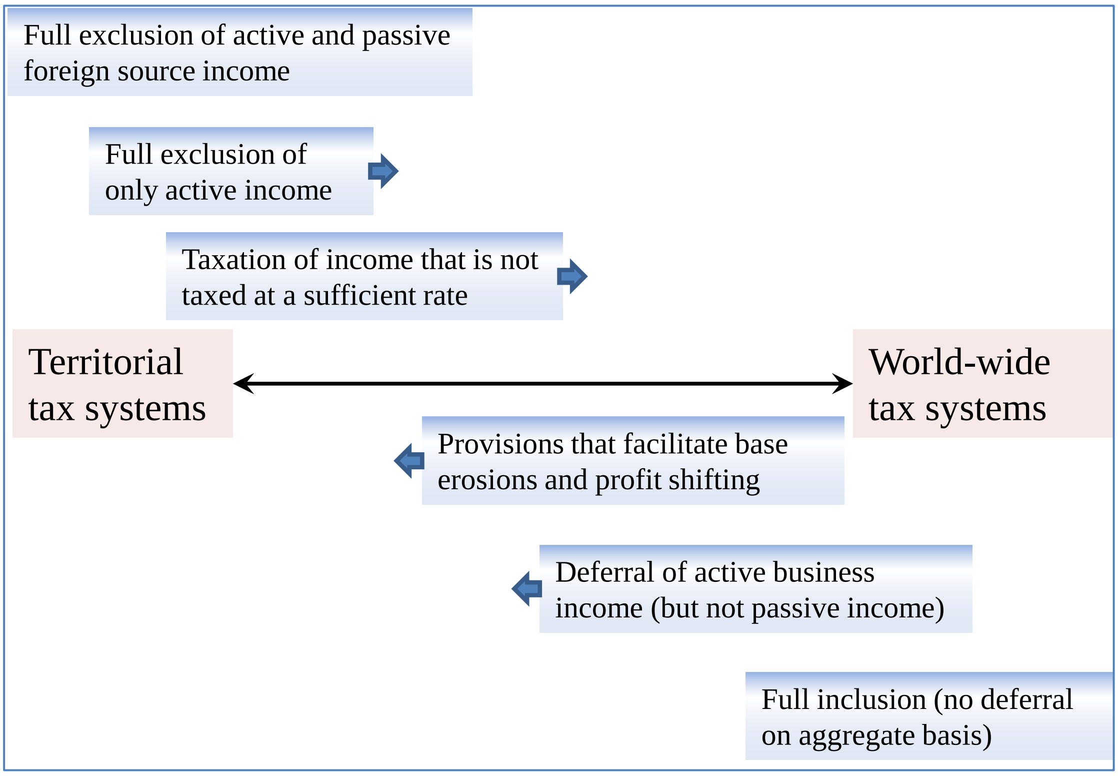
country to have its tax policy respected by other countries. Thus, treaty policy should respect the right of source countries to have exclusive jurisdiction to decide tax policy for activities conducted in their country.

3.2 A more complex view

The question arises as to how much revenue is really being transferred from developing countries to the treasuries of developed countries, and how much foreign investment is being deterred by the absence of tax sparing provisions. The answer is probably very little. This is partly because many countries that previously had world-wide tax regimes have moved to territorial regimes. But even if a country (most notably, the United States) still retained a nominal world-wide regime, several features of the tax regime make it highly unlikely that the income earned outside the country of residence would be subject to current (or, in many cases, future) taxation.

For the reasons set forth below, the simple model of foreign direct investment likely substantially overstates the degree to which the economic benefits from tax incentives are actually diverted from the foreign investor to the tax coffers of the resident country. To see why this is the case, it is helpful to appreciate that territorial tax systems and world-wide tax regimes may be much less different from one another in practice than they appear in theory. Figure 1 shows the continuum between tax systems that are purely territorial and those that are purely world-wide tax regimes. The distinction between world-wide and territorial regimes is blurred as some world-wide regimes have territorial features and some territorial regimes (primarily through Controlled Foreign Corporation (CFC) provisions) have world-wide features.

Figure 1. Continuum of types of international tax regimes



Although the general rule is that a taxpayer subject to world-wide taxation (such as in the United States) is taxed currently on income earned abroad, the key exception is that taxation in the home country of foreign income earned through a subsidiary is deferred until the income is repatriated. While sometimes the deferral is temporary, in many cases corporations choose to "permanently reinvest" their funds outside the United States. Because of the opportunity to defer tax on foreign source active income simply by non-repatriation, United States corporations have accumulated an extraordinarily large amount of cash and other liquid securities outside the United States. Some commentators have estimated the amount to be more than \$2 trillion.[42] With such a large amount of money looking for productive investments, very little investment in other developed or developing countries will be made directly from the United States.

---

[42] Martin A. Sullivan, "Economic Analysis: Designing Anti-Base-Erosion Rules," (2013) Vol. 70, *Tax Notes International*, 375.

But even without the availability of deferral of un-repatriated income, foreign investors would structure their investments in developing countries through other countries (including tax havens) so as to minimize the potential tax liability associated with foreign investment. So, for example, a large percentage of foreign investment in Africa from developed countries is routed through Mauritius, Netherlands Antilles or Switzerland. To make matters worse, these countries have been successful in negotiating treaties with several African countries that have zero withholding rates on dividends and other types of distributions. As a result, many developing countries with extensive tax incentive regimes are not collecting revenue on the income either when earned in their country or when it is transferred out of the country in the form of dividends or interest.

Additionally, as discussed earlier, the tax consequences for foreign investors depend on their world-wide tax attributes, not just their tax position in the country of investment. For those taxpayers whose countries of residence have world-wide tax systems with credits for foreign taxes paid, tax consequences will vary greatly depending on the availability of tax credits from taxes paid not only in the country which provided the tax incentives, but also from taxes paid in other foreign countries. For those taxpayers with substantial excess tax credits, the lack of tax sparing provisions does not prevent the foreign investor from obtaining the benefits of tax incentives for investments in developed or developing countries.

In sum, a strong argument can be made that the tax regimes of developed countries (even those with nominal world-wide tax systems) have little impact on the desirability or effectiveness of tax incentives in developing countries. Indeed, under certain circumstances, the potential availability of zero or low-taxed active income from foreign sources will often be very attractive to those tax directors in multinational corporations who seek to minimize the overall world-wide tax liability of the corporation. This results because tax directors can effectively “blend” other types of foreign income that are subject to tax rates above the tax rate of the country of residence with low-taxed income from developing or other countries to reduce the tax liability due to the investor's home country.[43] While foreign investors will likely not choose to invest in a particular company simply for the purpose of gaining low-taxed active income, for many investors the availability of zero or low-taxed income from countries using tax incentives will be a positive factor rather than a negative one.

Interestingly, proposed changes to the tax regimes governing cross-border transactions of some developed countries may change the conclusion that developed countries' tax regimes have little impact on the effectiveness of tax incentives. Mostly motivated by the success of multinational corporations in shifting income to low-tax jurisdictions while still maintaining substantial operations and sales in high-tax jurisdictions, some countries are considering imposing some type of minimum tax on foreign source income. While the types of minimum taxes being considered vary greatly both within and across countries, the basic notion is that the most desirable tax rate (for political and economic reasons) on active foreign source income is somewhere between zero and the full corporate tax rate imposed on domestic source income. For example, if the corporate tax rate imposed on domestic profits is 30 per cent, then income from foreign sources could be taxed at 15 per cent. Under tax systems that allow foreign tax credits, some or all of the foreign taxes paid could be used to offset the minimum tax imposed by the residence country. Depending on the form of minimum tax adopted, it may be that the desirability of tax incentives to foreign investors will be reduced.

4. How does the OECD project on BEPS change the tax environment for tax incentives in developing countries?

4.1 Overview

The OECD project to deal with base erosion and profit shifting (BEPS) has the potential to significantly change the tax regimes for cross-border transactions in both developed and developing countries. It is ambitious in both its scope and time tables. The magnitude of the changes will depend largely on what form the project takes in addressing the key action items identified in the OECD Action Plan on Base Erosion

---

43 Edward D. Kleinbard, "Stateless Income," (2011) Vol. 11, *Florida Tax Review*, 699; Edward D. Kleinbard, "Stateless Income's Challenge to Tax Policy," (2012) Vol. 68, *Tax Notes International*, 499.

and Profit Shifting (OECD Action Plan on BEPS)[44] and the willingness of countries to implement any proposed changes. From a high-level perspective, the OECD has three major options in proposing measures to limit base erosion and profit shifting:

- Narrow Approach, whereby OECD proposes some ad hoc fixes to address the major perceived abuses of multinational entities;
- Broad Approach, whereby the OECD adopts a more holistic approach to examine difficult issues and propose innovative solutions; and
- Fundamental Change Approach, whereby several of the existing fundamental principles and policies that shape the international tax regime would be open for re-examination. [45]

For example, if the OECD recommends a series of narrowly targeted recommendations to curb some of the most notorious schemes by multinational taxpayers, it is unlikely this will result in major changes in the cross-border tax regime. In contrast, if the OECD project on BEPS recommends reforms that significantly change the allocation of profits between source and residence countries, then the project will have substantially more impact.

In the OECD Action Plan on BEPS, there are 15 action items. It is unlikely that the OECD would adopt a uniform approach in addressing the various items. For example, the OECD could adopt a "narrow approach" in addressing concerns about hybrid mismatch arrangement and adopt (although unlikely) a "fundamental change approach" to address the challenges of the digital economy. Once the OECD completes its work on these projects, the question then becomes how countries will respond to the proposed recommendations. Without some type of coordinated effort among major countries, the chances for meaningful changes will be relatively small.

Even apart from the OECD project on BEPS, the notoriety around the aggressive tax planning by multinational entities has influenced the timing and scope of domestic efforts to reform tax regimes covering cross-border transactions. Many countries, including Ireland, the United Kingdom of Great Britain and Northern

---

44 OECD, "*Action Plan on Base Erosion and Profit Shifting*," supra note 1.

45 Yariv Brauner, "What the BEPS?," (2014) Vol. 16, *Florida Tax Review,* 55.

Ireland and the United States, have adopted or are considering reforms in the "shadow" of the OECD project on BEPS.

4.2 Relative change in tax burdens

The effectiveness and desirability of tax incentives have the potential to change substantially if the OECD project on BEPS succeeds in better matching reported taxable income with level of economic activity. This section examines two areas where tax changes resulting from the OECD project on BEPS could alter the relative attractiveness of tax incentives: first, the relative tax burdens between activities in a developing country that are not eligible and those that are eligible for tax incentives; and second, the relative tax burdens between activities conducted in developed and developing countries.

4.2.1 Relative tax burdens of activities that qualify or do not qualify for tax incentives

A key factor in considering the effectiveness and desirability of tax incentives is how much the tax liability is reduced because of tax incentives compared to the tax liability incurred by the foreign investor in the developing country under the regular tax regime. While the primary focus of the OECD project on BEPS is on how multinational entities reduce their tax liability in developed countries, it is important to appreciate that these corporations have used similar techniques in developing countries to shift taxable profits outside of the developing countries while still conducting substantial sales and manufacturing activities within the country.

As discussed below, the OECD project on BEPS has the potential to provide developing countries additional tools that would aid in improving the ability of these countries to tax foreign investors. For example, it may set forth proposed measures to strengthen CFC rules or limit base erosion via interest deductions that would provide guidance to countries on how best to reform their tax rules to more effectively tax the income of foreign investors. Similarly, proposals that improve the quality of information available to tax authorities in developing countries have substantial potential to improve tax compliance. Here, improved rules regarding transfer pricing documentation and other OECD efforts with respect to country-by-country reporting will likely aid increasing both the level of tax compliance and the effective tax burden of doing business in a developing country.

The insight here is that increasing the relative tax burden of those activities not qualifying for tax benefits will increase the relative attractiveness of conducting activities that qualify for tax incentives. Phrased differently, foreign investors have two options for decreasing tax liability related to activities in a country – they can use base erosion and profit shifting techniques to avoid paying taxes, or they can seek tax incentives. By reducing the availability of techniques to shift profits outside the country, the relative attractiveness of tax incentives will increase.

4.2.2 Relative tax burdens in doing business in developing and developed countries

If the OECD project on BEPS succeeds in better matching economic activity with reported taxable income, then the cost of doing business in developed countries will increase.[46] This increase in tax burdens in doing business in developed countries will likely make the tax regimes of developing countries relatively more attractive. The key determination is whether tax reform changes resulting from the BEPS Project increase the tax burdens of doing business in developed countries more than they increase the tax burdens of doing business in developing countries.

There are two primary reasons why the effective increase in tax burdens will be greater in developed than in developing countries. First, some of the proposed recommendations may be more easily adopted and implemented in countries that have the capacity to administer and enforce very complex rules to counter very complex structures to avoid tax liability. Second, if multinational enterprises can no longer conduct operations in developed countries and shift profits to low-tax jurisdictions, then the relative attractiveness of locating economic activity in developing countries will increase, especially with the availability of tax incentives.

4.3 Additional tools

One exciting aspect of the OECD project on BEPS is the potential to provide tax authorities with additional tools to improve tax collection in developing countries. While it is still too soon to determine whether it will be successful, the work will likely produce results that will be useful to tax authorities in developing countries. For

---

[46] IMF, "Spillovers in International Corporate Taxation," (2014) *Policy Paper, International Monetary Fund.*

example, if the OECD provides a summary of "best practices" to address specific abuses, then this work may aid developing countries in reforming their domestic tax law to improve the effectiveness of their tax regime. Depending on how well the proposed recommendations work in the tax environment in developing countries, great potential exists to improve rules related to such items as hybrid arrangements, CFC rules and provisions to curtail excessive interest stripping.

Similarly, developing countries could be major beneficiaries if the OECD project on BEPS increases the quality of information available to tax authorities. Again, this assumes the information is in a form that can be useful to tax authorities. So, for example, country-by-country reporting requirements and rules that require taxpayers to disclose aggressive tax planning arrangements could prove extremely useful to tax authorities in developing countries.

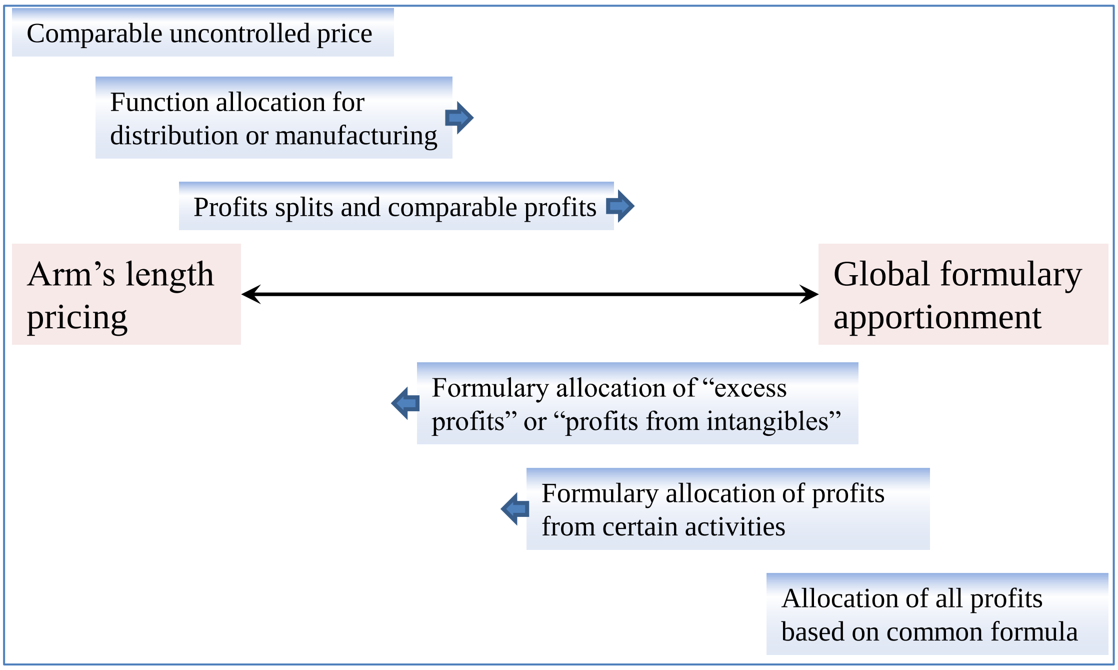
One important area in which the OECD project on BEPS could be useful to developing countries is transfer pricing. While the OECD has stated that they will maintain the basic foundation of arm's-length pricing, it likely does not preclude the introduction of "formula apportionment methods" as part of a nominal arm's-length pricing regime.

Here, the work of Reuven Avi-Yonah is useful in thinking about reform alternatives. He contends that the different types of transfer pricing arrangement are not a stark choice between arm's-length pricing and global apportionment but rather the choice of a point on the continuum that best works for a particular type of transaction (see Figure 2).[47]

---

[47] Reuven S. Avi-Yonah, "The Rise and Fall of Arm's Length: A Study in the Evolution of U.S. International Taxation," (1995) Vol. 15, *Virginia Tax Review,* 89.

Figure 2. Continuum of types of transfer pricing methods



The insight here is that changes in methods of determining transfer prices will likely change the allocation of taxable income among countries. In many instances, the move towards global apportionment type methods will increase the taxable income attributable to developing countries whose current share of total income may be less than the amount of income determined with respect to such factors as sales, employment or total assets. Changes that increase the potential tax liability for foreign investors will likely make tax incentives more attractive.

5. Conclusion

Tax incentives can play a useful role in encouraging both domestic and foreign investment. How useful they can be, and at what cost, depends on how well the tax incentive programmes are designed, implemented and monitored. The present chapter has examined the costs and benefits of tax incentives, the relative advantages and disadvantages of different types of incentives, and important considerations in designing, granting and monitoring the use of tax incentives to increase investment and growth.

No easy answers exist to the questions of whether to use tax incentives and what form they should take. There are, however, some clear guidelines that may improve the chances of success of tax incentive programmes. First, the objectives of the tax incentive programme should be clearly set forth. Second, the type of tax incentive programme should be crafted to best fit the objective. Third, the government should estimate the anticipated costs and benefits of the incentive programme in a manner similar to other types of tax expenditure analysis. Fourth, the incentive programme should be designed to minimize the opportunities for corruption in the granting of incentives and for taxpayer abuse in exploiting the tax benefits. Fifth, the tax incentive regime should have a definite "sunset" provision to allow for a determination of the merits of the programme. Finally, the government should be required at a specific time to assess the success and failure of each incentive programme.