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Tax Policy for Investment

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

I. I

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

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

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

Focusing on domestic and inbound direct investmee tax c

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

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

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

While statutory tax provisions are clearly important, policy makers are also encouraged to consider difficult to measure (yet potentially impeding) business compliance costs associated with the level of transparency, complexity and stability of
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not most countries, tax revenues are an important if not main source of funding for government expenditure (recognizing that printing money to finance government programmes is inflationary, while borrowing funds is also subject to constraint).

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

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

Thus a focus in most country contexts should be on the twin goals of designing tax systems and investor packages that are attractive to investment, while at the same time

country characteristics (e.g. market size, transportation and communication networks)

Prevalence of location-specific profits

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

In considering location choice, a central question is, how location-specific are potential profits for a given level of risk? For certain investments, profit from meeting market demand for a final product or unde

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

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

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

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

Having established a target tax burden on business income, measurement of the actual tax burden is required in order to assess what possible adjustments to tax policy and/or expenditure programmes may be required. The statutory tax burden on domestic profits ought to be assessed using Twi20.005[(tax burde and in hom assessular tax b)4(itenera)-nt collected). However, as such summary measures cannot readily incorporate the effects of all relevant tax provisions bearing on the average host country tax burden, they need to be qualified with regard to such effects (e.g. the impact of rules governing the carry-forward of business losses).

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

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

Tax burden linked to an excessively complex business tax system

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

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

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

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

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

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

[11] A related tax policy issue is whether depreciation rates adequately

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

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

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

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

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

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

differ by type of capital asset. This means that effective tax rates will differ across sectors to the extent

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

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

Policy-makers are encouraged to reflect on the often disappointing experience of economies that have attempted to rely on a low tax burden - typically targeted at foreign investment - to boost investment.[17]

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

- Do tax depreciation methods and rates adequately reflect true economic rates of depreciation of broad classes of depreciable property (serving as benchmark rates) and account for inflation?
- Are possible time limits on the carrying forward (and possibly back) of business losses, to offset taxable income in future (prior) years, sufficiently generous/consistent with international norms? [The case for generous carry-forward is particularly strong where depreciation claims are mandatory, rather than discretionary. Also important to consider is the interaction between depreciation and loss carry-forward rules.]
- Are inter-corporate dividends (paid from

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

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

Tax expenditure assessment generally involves the Ministry of Finance or Tax Administration Department maintaining a micro-simulation model to estimate tax revenue and income distribution effects of proposed and actual tax reforms, drawing on a representative sample of personal and corporate income tax returns and other data sources. Assessing foregone revenues should take into account, to the extent predicted, likely tax planning responses. Such analyses should be Tl a featur.6(l taxTJ-19ion of rule

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

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

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

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