Taxation and Investment

LAC Tax Policy Forum, 12-13 July 2012

Steven Clark
Head, Business and International Tax Unit
Tax Policy and Statistics Division
steven.clark@oecd.org
Presentation topics

- Assessing tax effects on investment
- Factors influencing investment decisions
- Possible corporate tax effects on investment
- Rationale for taxing corporate income
- Policy considerations in taxing inbound FDI, and taxing outbound investment
- Various instruments of tax competition
- Potential pitfalls of current tax policies
Assessing tax effects on investment

• Three main approaches:
  – survey questions on investment decision-making.
  – theoretical analyses of influence of tax on profit-maximizing solutions for investment – yields:
    • average effective tax rates, used to examine tax effects on choice over alternative investments (e.g. location choice)
    • marginal effective tax rates, used to examine tax effects on the optimal level/scale of investment in a given project.
  – Econometric (statistical) regression analyses:
    • estimate relationship between investment and explanatory variables including effective tax rate, and use results to measure the sensitivity of investment to tax (elasticity).
    • wide range of estimates (data and estimation problems).
Factors influencing investment decisions
(findings based mostly on investor surveys)

- **Key host country factors/fundamentals:**
  - political and macro stability.
  - rule of law; property rights; public governance.
  - market size, physical infrastructure.

- **Tax considerations:**
  - taxation not discouraging to investment earning location-specific profit (physical presence required).
  - taxation discouraging to highly mobile investment earning location-independent profits (minimal physical presence required).
Factors influencing investment decisions (cont’d)

- Further tax considerations:
  - taxation may be discouraging to investment earning mobile firm-specific profit – sensitivity depends on:
    - type of business activity (some more mobile than others)
    - strength of key host country factors/ fundamentals
  - relatively low tax rate unable to offset/ compensate for weak host country fundamentals.
  - all taxes on businesses are relevant to tax burden assessment (on profits, revenues, assets, etc).
  - profit-insensitive taxes (e.g. on net capital assets) are discouraging to mobile investment.
Possible corporate tax effects on investment

- Investment location choice.
- Level (scale) of investment.
- Risk-taking (investments with uncertain returns).
- Type of investment (M&E, buildings, intangibles).
- Financing instrument (debt vs. equity, hybrid).
- Financing structure (direct, indirect/ triangular).
- Method/ type of payment of earnings of foreign affiliates (e.g. dividends, gains, interest, royalties).
Rationale for taxing corporate income

• Vertical equity.
• Enable current taxation of capital income.
• Enable taxation (at source) of economic profit accruing to non-resident investors.
• Instrument for influencing corporate decisions (e.g. R&D).
• Negative effects on investment may be mitigated by particular CIT design.
Policy considerations in taxing inbound FDI

- Revenue requirements, competitiveness, equity, efficiency objectives.
- Ongoing pressures for competitive tax system.
- All taxes on business relevant – but particular focus on corporate income tax (CIT), with pressure to reduce statutory CIT rate:
  - highly visible ‘headline’ rate, attractive to investors
  - takes tax planning pressure off the tax base.
- More limited statutory CIT rate reductions in LAC countries (with exceptions).
Chart 1

1994: 37.1
2000: 32.6
2011: 25.5
Chart 2
CIT rates in LAC countries (2000, 2012)
Policy considerations in taxing inbound FDI (cont’d)

- Limited ability to tax firm-specific profits on mobile investments.
- Ability to tax location-specific profits.
- Market size matters:
  - general ability of larger OECD economies to impose higher CIT rates,
  - more limited evidence of this in countries in LAC region (notable exceptions are Brazil and Mexico with relatively low CIT rates).
Chart 3
CIT rates in OECD countries, 2011

Source: OECD Tax Database
Table 1
CIT rates in OECD area, by country size

<table>
<thead>
<tr>
<th></th>
<th>Statutory corporate income tax rate</th>
</tr>
</thead>
<tbody>
<tr>
<td>Larger OECD economies</td>
<td></td>
</tr>
<tr>
<td>US-JPN-GER-UK-FRA-ITA</td>
<td>39.5</td>
</tr>
<tr>
<td>Medium-sized OECD economies (NLD)</td>
<td></td>
</tr>
<tr>
<td>CAN-ESP-KOR-MEX-AUS-NLD</td>
<td>35.4</td>
</tr>
<tr>
<td>Smaller OECD economies</td>
<td></td>
</tr>
<tr>
<td>AUT-BEL-CHE-CHL-CZE-DNK-EST-FIN-HUN-IRL-ISR-LUX-NOR-NZL-POL-PRT-SVK-SVN-SWE-TUR</td>
<td>(35.0)</td>
</tr>
<tr>
<td>OECD Average</td>
<td>32.6</td>
</tr>
<tr>
<td>Category</td>
<td>Statutory CIT rate, 2012</td>
</tr>
<tr>
<td>--------------------------------</td>
<td>--------------------------</td>
</tr>
<tr>
<td>Larger LAC countries</td>
<td>27.5</td>
</tr>
<tr>
<td>- Brasil, Mexico</td>
<td></td>
</tr>
<tr>
<td>Medium-sized LAC countries</td>
<td>30.1</td>
</tr>
<tr>
<td>- Argentina, Colombia, Venezuela, Chile, Peru</td>
<td></td>
</tr>
<tr>
<td>Smaller LAC countries</td>
<td>26.3</td>
</tr>
<tr>
<td>- Ecuador, Dominican Republic, Guatemala, Uruguay, Costa Rica, Panama, El Salvador, Bolivia, Paraguay, Honduras, Nicaragua</td>
<td></td>
</tr>
<tr>
<td>LAC Average</td>
<td>27.5</td>
</tr>
</tbody>
</table>
Considerations in taxing outbound investment

- Revenue, competitiveness, equity, efficiency.
- Competitiveness concerns tend to dominate.
- Preferential treatment of foreign profits – production inefficiencies, domestic job losses?
- Similar inefficiencies under worldwide tax systems and territorial/exemption systems.
- Calls for tax relief extend beyond exemption/indefinite deferral of home country tax on foreign active business income (significant scope for tax avoidance/profit shifting/base erosion).
Direct financing and licensing of IP (intellectual property) to foreign manufacturing affiliate

**Figure 1**

Parent Co (PCo)  
Home country A  

Manufacturing Co (MCo)  
Host country B  

R&D  
Economic ownership of IP retained by PCo

equity and debt finance  
license of IP  
dividends  
interest  
royalties
Indirect (‘triangular’) financing and licensing of IP to foreign manufacturing affiliate through offshore holding company.
Chart 4
Average effective tax rates (AETRs) with direct vs. indirect (triangular) FDI

Assumptions: 30% home country CIT rate, 15% host country CIT rate, 5% withholding tax rate on dividends and interest, 30% pre-tax rate of return, tax depreciation equals economic depreciation.
Various instruments of tax competition

- Basic statutory ‘headline’ CIT rate.
- Targeted tax relief (tax incentives).
- Loss carryover/ group consolidation rules.
- Rules governing interest deductibility.
- Reduced rates of non-resident withholding tax on dividends, interest and royalties.
- Treatment of income of offshore affiliates.
- Tax administration/ base protection.
- Compliance costs.
Potential pitfalls of current tax policies

- Significant CIT revenues foregone with cuts in CIT rates (tax competition).
- Limited effectiveness of tax incentives.
- Reductions in top personal income tax (PIT) rates, in part to avoid distortions arising where CIT and PIT rates differ widely.
- Income inequality concerns with reduced CIT, reduced top PIT rates, alongside increased reliance on VAT and property taxes.
• Possible output loss where inbound FDI is taxed at relatively low host/home country tax rate, displacing investment by resident-owned firms with a higher pre-tax return.

• Possible output loss where outbound FDI displaces domestic investment with a higher pre-tax return (e.g. higher foreign production costs are more than offset by tax relief).

• Increased tax administration (and compliance) costs with increased complexity in tax laws (e.g. countering aggressive tax planning).
Thank you!