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A POLICY FRAMEWORK FOR INVESTMENT: TAX POLICY

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A POLICY FRAMEWORK FOR INVESTMENT: TAX POLICY*

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

A modern, competitive, stable and transparent tax system, one that links host and home country tax systems through a well established tax treaty network to avoid double taxation, can send a strong positive signal to investors, both domestic and foreign. Investors generally prefer a low host country tax rate applied to a broadly defined profit base. At the same time, special incentives may play an important role in certain cases. Where tax incentives are used, care must be taken to ensure that incentive types and design features are chosen that are less likely than others to result in unintended and excessive revenue losses to non-targeted activities.

Balancing revenue losses from tax relief against the possible investment response is an important consideration in the majority of cases where companies can manage a modest host country tax burden. This recognises that tax relief may be too generous, in excess of that necessary to provide a tax environment that is supportive of investment. Where corporations are able to contribute to the financing of infrastructure development (e.g. roads, airports, telecommunications networks, and legal frameworks) that they benefit from, and are required to do so under a competitive but not easily manipulated set of tax rules, the tax system can serve to both attract investment and support parallel efforts to build a strong industrial base.

A central challenge for policy makers endeavouring to encourage domestic and foreign direct investment, but with limited financial resources to commit, is a careful weighing of relative advantages and disadvantages of alternative tax policy choices and design options in meeting the twin goals of attracting investment while at the same time raising revenues to support infrastructure development and other pillars of an enabling environment for direct investment.

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

Section 1 begins by sketching out various economic decisions influenced by taxation, decisions that impact the path of a country’s economic development. Section 2 takes focus on the impact of taxation on investment, and highlights not only direct effects on after-tax rates of return (and thus possible effects on investment location and scale decisions), but also ‘budget effects’ linking taxation to non-tax government programs in support of investment financed out of tax revenues. Section 3 elaborates tax considerations for policy makers to consider when assessing the possible need for reform towards a tax system better able to support investment.

1. Tax policy and development

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

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

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

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

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

2. Taxation and investment – what are the linkages?

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

One can also distinguish tax effects in the ‘pure’ domestic case (resident shareholders investing in domestic assets) versus cross-border investment, both inbound foreign direct investment (FDI) in domestic assets by non-resident shareholders, and outbound direct investment abroad (DIA) in foreign assets by resident investors. This article 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 article 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 corporate income tax, non-resident withholding taxes, customs duties, personal income tax, social security contributions, value added tax, and other (generally less relevant) taxes. Home as well as host country taxes may factor in.

Focusing on domestic and inbound direct investment in physical capital, this article concentrates on primarily host country considerations, and highlights two main linkages between taxation and

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

investment.² The first is the direct effect of taxation on the after-tax hurdle rate of return on investment. The second is the ‘budget effect’ which recognizes the basic role of tax in funding government programs, and the importance placed by business on adequately funding infra-structure development and skills development programs and public governance initiatives central to creating an enabling environment for investment.

2.1. Direct effects of taxation on investment

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

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 fall if host country taxes are increased, and would increase if taxes are reduced – is not always observed.

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

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 incentives be expected to attract additional investment? As elaborated in section 3, by identifying the factors that condition whether host country tax relief or subsidies can be expected to deliver additional

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

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

4 Similarly, home country taxation of foreign source income may directly impact investment – the higher (lower) the net home country tax rate on foreign profit, generally the lower (higher) the level of direct investment abroad (DIA) by domestic firms in instances where tax impacts investment decisions. Effects on domestic investment of home country taxation of foreign source income are less than clear – whether an effective tax burden on foreign source income that is low relative to that on domestic income discourages or encourages domestic investment depend, in part, on whether DIA is a substitute for or complement of domestic investment.

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

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 of the tax system.

2.2. *Budget effects of taxation on investment*

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

It is often rightly emphasized that non-tax factors are of central importance to investment decisions – however often overlooked is the fact that public infra-structure, education and public governance policies and programmes and other key aspects of an enabling environment for investment require financing. And in many if not most countries, tax revenues are an important if not main source of funds (recognizing that printing money to finance projects is inflationary, while borrowing funds is also subject to constraint).

Corporate tax and other taxes derived from investment 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 is, under what circumstances and conditions can a relatively low host country tax burden operate to discourage capital flight, attract additional investment, and swing location decisions in a country's favour? Behind this question rests a central trade-off – by reducing taxes on host country investment and subsidizing investors, 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 the focus in most country contexts should be on the twin goals of designing tax systems and investor packages that are attractive to investment, while at the same time not foregoing funds that could be more usefully applied to fund public expenditures identified by investors as of critical importance.

3. *Taxation and investment – A Review of Main Considerations*

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

3.1. *Comparative assessment of the tax burden on business income*

1. *What is the current tax burden on domestic profit, on average, taking into account statutory provisions, tax-planning opportunities and compliance costs?*

The statutory host country tax burden on domestic profits should be assessed with reference to both quantitative measures and qualitative information, taking into account main statutory provisions and effects of tax-planning strategies commonly employed by domestic and foreign-owned business to lower the host country tax burden (e.g. thin capitalisation, non-arm's length transfer prices). Compliance costs from excessive complexity, non-transparency and unpredictability should also be factored in.

3.1.1. *Assessment of host country tax burden*

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

An attraction of measuring corporate marginal and average effective tax rates is that they can be modelled with reference to statutory tax provisions alone, found in tax legislation and regulations (i.e. they do not require information on actual tax revenues collected). However, as such summary measures cannot readily incorporate the effects of all relevant tax provisions bearing on the average host country tax burden, they need to be qualified with regard to such effects (e.g. the impact of rules governing the carry-forward of business losses, and capital 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.⁶

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.⁷

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

7 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.

3.1.2. 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, 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.⁸

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

3.1.3. Tax burden linked to a non-transparent business tax system

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

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

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

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

3.1.4. Tax burden linked to an unpredictable business tax system

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

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

2. Has the government evaluated the level of tax burden that would be acceptable generally to investors? Is this level consistent with the actual tax burden?

A central issue in gauging what host country tax burden would be expected to be acceptable generally to investors is whether the country offers attractive risk/return opportunities, taking into account framework conditions, market characteristics and location-specific profits of the host country, ignoring tax considerations.

Important to potential investors are questions over costs and non-diversifiable risks associated with securing access to capital and profits, adjusting to macro-economic conditions, and complying with laws and administrative practices. Also centrally important to investors are considerations of output demand and factor input supply. Another fundamental issue is the degree to which the host country offers location-specific profits (profits that require a physical location in the host country).

Investors are generally willing to accept a higher host country tax burden the more attractive are the risk/return opportunities the host country presents, taking into account host country framework conditions, market characteristics and opportunities for location-specific economic profits. Absolute and comparative assessments with regard to competing jurisdictions are relevant.

3.1.5. *Framework conditions*

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

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

3.1.6. *Market characteristics*

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

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

3.1.7. *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). Assessments would be made in absolute terms, and relative or comparative terms (to examine risk/return differences when serving a market from one or more alternative locations).⁹ In other words, a central question is how location-specific are the potential profits and risk when locating in/operating from a given host country?

9 Exceptions to this general approach would include certain privatizations where potential pure economic profit is both location and time-specific.

For many if not most investments, levels of profit and risk associated with undertaking a given business activity part of a value-added chain, or meeting a particular market demand, may vary significantly across alternative locations, and may in certain cases be ‘location specific’ – that is, may require a physical presence in a particular location. Examples of the latter would include privatizations, the extraction of natural resources, and the provision of restaurant and hotel services. In such cases, if profits can be expected at levels of risk investors are willing to assume, the profits are location-specific – that is, they cannot be realized by locating in another country or jurisdiction. This is not to say there would not be other similarly attractive (or more attractive) projects in other markets. It simply recognizes that such investment projects could be expected to be undertaken if profitable, at acceptable levels of risk.

At the other extreme, investment projects to serve particular markets (e.g. investments to support the provision of ‘head office’ or intra-group financial services) may be carried out from any one of a large number of alternative locations, at roughly the same profit/risk.

In between these extremes would be projects where there are several locations for a particular investment that offer similar economic profit at the roughly same level of risk (or alternatively, higher/lower profits at higher/lower levels of risk). Examples include R&D facilities and manufacturing plants producing outputs (e.g. pharmaceuticals, computer chips) for export markets.

3.1.8. Implications for tax policy

In general, investors are willing to accept a higher host country tax burden the more attractive are pre-tax profits for a given risk when investing in that country, with reference to framework conditions, market characteristics and location-specific profit opportunities. As emphasised in this article, the attractiveness of investment opportunities in a host country depends, in small or large part, on the type of business activity, on past and current public expenditure allocations towards public programs (e.g. education) and projects (e.g. infrastructure) supportive of framework conditions, and other market characteristics.

Where a profitable investment opportunity is specific to a particular host country, the tax burden may be largely irrelevant to an investment decision. Indeed, in principle, the tax burden on location-specific profit could be increased up to the point where economic profit is exhausted without discouraging investment.¹⁰ Moreover, tax comparisons across locations (states/countries) generally would not factor in (with profit being specific to a particular location). Thus, where an economy offers an abundant set of location-specific rents, policy makers may understandably resist pressures to adjust to a relatively tax burden, to avoid tax revenue losses and windfall gains to investors (and to foreign treasuries in the case of inbound investment). Reducing the effective host country tax rate (e.g. to levels observed in competing countries) while possibly attracting capital in elastic supply, would give up tax revenues without impacting investment capital in inelastic supply.

10 An eventual exhaustion of economic profit recognizes that not all revenues raised from an increase in host taxation would be allocated to public expenditures that directly support business (e.g. education, infrastructure). In principle, where revenues from taxes on business are allocated to programs that provide direct and immediate support to business, a higher tax burden could be levied without discouraging investment. However, this presumes that relevant program spending is as efficient as private spending, ignores lags between tax collection and the delivery of benefits to business, as well as other uses of public funds.

In the context of economic profit that is not location-specific, comparisons with tax burdens imposed in competing locations would be expected to factor in. Where the number of competing locations is many (few), then the number of relevant tax comparisons would be many (few). If a given business activity can be carried out in a competing location that imposes tax on business at a relatively low rate, while offering as attractive a pre-tax risk/return profile as location A (taking account of all benefits, non-tax costs and risks associated with each location choice), then in theory investors would be unwilling to bear a tax burden in location A in excess of that rate.¹¹ Where a competing location offers a less attractive pre-tax risk/return profile, then investors may be willing to pay a higher tax burden in location A without being encouraged to invest elsewhere. However, where a competing location offers a more attractive pre-tax risk/return opportunity, it does not follow that a relatively low tax burden in A could be expected to compensate for investment impediments and swing investment in location A's favour. This is particularly true where tax incentive relief is low relative to additional costs incurred in investing in A, and/or contributes rather than reduces project costs and risks.

These generalizations, while helpful in considering possible outcomes of different host tax burdens, gloss-over practical assessment difficulties, and must be qualified on several counts. Under the simplified predictions remain difficulties over how to assess the relative significance to business profits of business framework and market considerations in competing locations. Where investment conditions in a given location are on balance more attractive than those elsewhere, the question arises as to how much higher the tax burden at source may be set without significantly impacting investment. And where investment can be expected to decline, at what rate and in what sectors? There also remains the fact that for inbound investors resident in countries operating residence-based tax systems, significant scope may exist for such investors to partially or fully offset host country tax using foreign tax credits provided by the home country. Whether this type of relief applies depends on the relative setting of host and home country tax rates, rules on the pooling or separate treatment of different sources of foreign income, as well as the current needs of the investor for repatriated earnings.

3. *If framework conditions and/or market characteristics are weak, is it reasonable to assume that a low tax burden can impact investment decisions?*

Policy makers are encouraged to reflect on the disappointing experience of transition economies that have attempted to rely on a low tax burden (typically targeted at foreign investment) to boost investment. Where framework conditions and/or market characteristics are relatively weak, evidence suggests that a low tax burden cannot be expected to swing investment decisions in the country's favour. The more commonly observed outcome is the creation of unintended and unforeseen tax planning opportunities. Moreover, where framework conditions are weak, a low host country tax burden achieved through the use of special tax incentives may operate to *discourage* rather than encourage investment, by contributing to project cost and risk. This is especially the case where the introduction of and subsequent changes to incentive schemes give the impression of an unstable tax system.

A corollary to this is that a host country with weak framework conditions and following a special tax incentive strategy may be giving up significant tax revenues that could be collected without discouraging investment that has been made in the host country for reasons unrelated to tax – revenues that could be used to help strengthen the enabling environment for investment.

A further issue concerns the method by which a low tax burden is achieved, and in particular, whether tax relief applies to returns on marginal or infra-marginal investment. To varying degrees, tax

11 Transaction costs in decoupling business activities should be taken into account in considering alternative location choice.

relief will result in windfall gains – that is, tax relief to investors (or increased revenues to foreign treasuries) that does not result in additional investment, but supports investment that would have gone ahead in the absence of that relief – even where such relief is specifically targeted at additional investment.

Consider for example incremental tax credits, where tax relief is tied to some percentage of current investment in excess of average annual investment in prior years. Even in such cases, some fraction of qualifying investment would be expected to occur in the absence of the credit. Windfall gains are more likely where flat credits are used (that provide tax relief equal to some percentage of current investment), chosen for simplicity or to avoid certain distortions with the incremental model. Windfall gains are even more likely for incentives that provide tax relief equal to some percentage of profit derived from new and existing capital. A tax exemption for a certain fraction of profit, or a reduced statutory corporate income tax rate, would be examples of relief in respect of returns on new and existing capital. As existing capital is already in place, relief granted in respect of such capital provides a pure windfall gain.¹²

4. Is the tax burden on business appropriate with reference to the set of policy goals and objectives of the tax system?

In choosing the tax burden to levy on domestic profit, the analysis should weigh in the various objectives guiding overall tax policy design, including efficiency concerns, equity or redistribution concerns, compliance costs and revenue requirements. Where different goals suggest different tax burden levels, an appropriate balancing of competing objectives should be sought.

Choice over an appropriate host country tax burden on investment, shaped by balancing considerations, may begin with a fixed overall revenue requirement (to fund a given set of public expenditures including transfers to other levels of government, with revisions to overall revenue targets and expenditures possibly required). Given revenue requirements, policymakers would normally rely on a mix of taxes to meet those needs (e.g. taxes on income and profits, taxes on property and wealth, consumption taxes, trade taxes, other taxes) for reasons of equity, as some taxes tend to be borne more by some taxpayers compared with others, and efficiency, as various tax bases respond to a greater or lesser extent differently to taxation. In other words, there are limits to reliance on a given tax base, so a variety of taxes are typically included in the ‘tax mix’. In addition to efficiency and equity concerns, other considerations (e.g. taxpayer compliance costs, tax administration costs, as well as others) factor in.

Efficiency concerns, based on an assessment of individual utility derived from income, leisure and other factors impacting individual welfare (e.g. a clean environment) consider the extent to which the underlying activity of a tax responds to changes in the level of taxation. In general, efficiency is judged to be reduced where a productive activity such as labour or investment, generating returns in excess of opportunity costs, is reduced, for example by a tax on wages or profits. In contrast, efficiency or welfare may be enhanced where pollution is reduced, for example with the introduction of an environmental tax.

Equity concerns generally call for an equal sharing of the tax burden across different taxpayers with roughly the same income or purchasing power (horizontal equity), and a progressive tax burden as income is increased, with those earning more income paying a higher percentage of their income in tax.

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

A balancing of considerations finds support in most countries for tax on business income at the personal and corporate level – primarily for horizontal equity reasons (between employees earnings wage income, self-employed earning wage and capital income, owners of unincorporated businesses, and shareholders). Given a desire to tax income from capital, a corporate income tax provides a withholding function, taxing income that could otherwise be avoided (by profit retention) or difficult to tax under accrual rules.

Efficiency considerations in policy choices over the appropriate tax burden on business hinge on the sensitivity of the business income tax base to taxation. Where the tax base is sensitive, generally lower levels of taxation would be called for on efficiency grounds. That is to say that in setting the level of the tax burden on domestic business income, policy makers must factor in limits to taxation of business income, with higher taxation tending to encourage capital flight and non-reporting.

5. *Where the tax burden on business income differs by firm size, ownership structure, industrial sector or location, can these differences be justified? Is the tax system neutral as between foreign and domestic investors?*

Tax systems may impose a non-uniform effective tax rate on different businesses, depending on their size, ownership structure (e.g. domestic versus foreign-owned), business activity or location. Certain firms may be specifically targeted to receive preferential tax treatment. Where tax relief is targeted, policy makers should examine and weigh arguments (e.g. market failure) in favour and against such treatment, and ensure that the different treatment can be properly justified in order to respond to pressures for a broader target group. Where justifications are weak (e.g. where corporate tax relief is targeted at foreign investors to the exclusion of domestic investors), consideration should be given to a non-targeted approach.

In addressing this issue, the analysis could include an assessment of the average effective tax rate (AETR) on profits of i) small and medium-sized enterprises (SMEs), ii) large enterprises majority-owned by residents, iii) large multinational enterprises (MNEs) controlled by foreign parent companies, taking into account main statutory tax provisions?¹³ Such an approach could be used to inform an assessment of whether tax-driven variations in AETRs across businesses of different size, ownership structure, and industrial sector can be justified, taking into account unintended distortions and other costs that they create.¹⁴

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

14 This bullet concerns differences in effective tax rates that arise from the application of different tax rates and rules to similar transactions (i.e. it does not concern differences that arise from the application of similar rules to different transactions). For example, rates of capital depreciation, for tax purposes, typically differ by type of capital asset. This means that effective tax rates will differ across sectors to the extent that capital stocks of firms in one sector differ in composition from stocks of firms in another.

3.2 *Determination of taxable business income (profit/loss)*

6. *Are rules for the determination of corporate taxable income formulated with reference to a benchmark income definition (e.g. comprehensive income), and are main tax provisions generally consistent with international norms?*

In dealing with any given corporate tax system, investors expect basic tax provisions that adequately reflect business costs, including loss carry-forward provisions that are consistent with those commonly employed elsewhere. Investors also view negatively the double taxation of income within the corporate sector, and generally expect zero taxation of, or tax relief on, inter-corporate dividends particularly when paid along a corporate chain. In short, policy makers are encouraged to ensure that recognition is taken of reasonable expectations of main design features of the tax system.

Tax officials of Governments wishing to retain and attract investment should be encouraged to address (and weigh, within the set of overall policy objectives) various concerns of investors with respect to tax base rules. These concerns may be raised by the following set of questions:

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

Such differences may be viewed as structural, rather than tax driven. An example of the latter would be where the same type of asset is depreciated at a different rate depending on the sector. This bullet concerns tax-driven differences of this sort.

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

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

3.3. *Prudent use of targeted tax incentives*

7. ***Have unintended tax-planning opportunities created by targeted tax incentives been explored and taken into account in assessing the cost-effectiveness of such incentives? Have other problems associated with targeted tax incentives been explored 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 targeting tax relief at 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, in particular, offer significant scope for tax relief unintended by 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 income to low or no-taxed entities. The shifting of tax base in such cases is artificial in the sense that it takes the underlying business structure as given, and simply manipulates prices to shift the taxable income associated with the structure to obtain the most tax efficient outcome. As guarding against such abuse of the tax system is becoming increasingly difficult with increased trade in intangibles (for which an arm's length price is often difficult to fairly establish by tax authorities, due to limited or non-existent second markets to look to), so too is it becoming increasingly difficult to guard against excessive revenue losses stemming from incentives providing for a full or partial profit exemption.

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

To varying degrees depending partly on the instrument used, reduced host country taxation will provide tax relief in respect of investment that would have been undertaken in the absence of such relief – so-called '*windfall gains*' to investors and, in the case of FDI, foreign treasuries. Windfall gains arise even where tax relief is targeted at 'incremental' investment in excess of some average of past investment. Avoiding windfall gains, however, generally comes at the cost of increased complexity.¹⁵

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

Targeted tax incentives may create *unintended distortions* to the allocation of productive capital, and to corporate financing and repatriation decisions, implying welfare losses.¹⁶ Accelerated depreciation rates, for example, may create welfare losses where they do not adequately reflect variations

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

16 This paragraph concerns unintended distortions, recognising that tax incentives generally are intended to influence or distort the allocation of capital away from patterns that would be observed in the absence of the incentive. Whether intended distortions created by tax incentive use are welfare improving depends on whether the incentive corrects a true market failure.

in true economic rates of depreciation across capital asset classes (serving as benchmark rates). Similarly, reinvestment allowances providing a tax deduction equal to some percentage of reinvested (pre-tax) profit would tend to discourage investment financed by new equity, and may raise the overall cost of funds, implying welfare losses.¹⁷

Unintended distortions may also be created where inter-actions between tax incentives and other provisions of the tax code (e.g. depreciation treatment, loss treatment) are not adequately addressed. Furthermore, policy-making, if not properly co-ordinated, may result in the ‘stacking’ of multiple tax (and non-tax) incentives on offer by different Ministries, at the same level or by different levels of government (i.e. targeted at the same or similar business activities, assets, or regions), creating unintended distortions including possible over-investment in certain cases.

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

Tax incentives may also *encourage corruption* and aggravate concerns raised by poor public governance. When used, targeted tax incentives should be designed to be as automatic as possible in their application, to avoid the involvement of tax officials in the determination of the application of provisions to individual taxpayers. Also to be avoided are situations where tax officials undertaking audits have the power to withdraw tax incentive relief, without special safeguards against corrupt practices. Frameworks should be in place to discourage bribery of tax and customs officials in such cases.

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

8. *Where targeted tax incentives do not meet a cost-benefit test owing to investment impediments linked in part to government policies, what alternative strategies have been considered?*

Where strong political pressure is felt for introducing tax incentive relief – despite analysis indicating limited investment response relative to revenue losses and administrative costs entailed (implying failure to meet a cost-benefit test) – full attention should be given to alternative strategies, including addressing investment impediments directly. Relative pros/cons of other approaches should also be considered.

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

3.3.1. Addressing main impediments to investment

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

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

3.3.2. Broad-based tax relief and non-tax relief

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

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

3.4. Tax expenditure reporting and evaluation

9. Are tax expenditure accounts reported, are tax incentive evaluations carried out, and are sunset clauses used to properly manage and inform the budget process?

Tax expenditure accounts reporting tax revenues foregone by targeted tax incentives and other departures from a benchmark tax system should be a cornerstone of fiscal policy in countries where attracting capital and addressing public governance issues remain high on the political agenda. Such accounts should be subject to public scrutiny, for example by an appointed auditor of public accounts, and/or by independent research institutions, to hold the government to account for public use of funds. Tax expenditure amounts should be considered alongside direct expenditure amounts targeted at similar activities, to properly inform the budget process and positively influence ongoing fiscal reform.

Tax expenditure assessment requires 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. Assessing foregone revenues should take into account, to the extent predicted, likely tax planning responses. Such analyses should be based on a variety of inputs, including consultations with business and findings of other countries that have tested similar measures (taking into account different host country conditions in shaping outcomes).

For proper management of public finances, tax incentives targeted at investment should be assessed in advance and following implementation if introduced, to gauge whether such measures pass or fail a cost-benefit test. To enable such evaluations, the specific goals of a given tax incentive need to be made explicit at the outset to enable a proper assessment of the degree to which stated goals are met..

When introducing tax incentive legislation, ‘sunset clauses’ should be included calling for the expiry of the incentive (e.g. 3 years after implementation), to provide an opportunity for assessment in order to establish whether the incentive should be extended or not.

3.5. *International co-operation*

10. Are tax policy and tax administration officials working with counterparts in other countries to expand their tax treaty network, enhance exchange of information for tax purposes, and counter abusive cross-border tax planning strategies that artificially reduce the domestic host country tax base?

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

Tax treaties, by overriding domestic legislation, and by being based on widely recognized provisions, help to 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. A wide tax treaty network therefore tends to make countries more attractive, in relation to tax considerations, both as locations for business activity, and as places from which to conduct global business operations, by lowering projects costs as well as project risks.

Third, tax treaties generally 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. Furthermore, compliance costs are reduced where treaties provide for tax exemptions for business profits, or remuneration for employee services, derived from short-term activities. These aspects of tax treaties also serve to lower project costs.

At the same time, tax treaties provide a framework to enable exchange of information amongst tax authorities to counter more aggressive forms of tax-planning in relation to foreign source income as well as domestic source income (that may be stripped out to tax havens through the use of special corporate structures and financing and repatriation strategies).