



27-28 March 2008

GLOBAL FORUM VII

ON International Investment

TAX COMPONENT OF THE OECD INVESTMENT REFORM INDEX

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Session 1.4.: Tax policy

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Tax Component of the OECD Investment Reform Index

This draft: 21 March 2008

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I. Introduction

This note proposes a set of tax policy topics and a framework for addressing them under the tax component of the OECD *Investment Reform Index* (IRI).¹ The IRI, to be applied in 2008 to countries participating in OECD-MENA and OECD-SEE regional programmes, aims to ‘score’ policy performance in terms of identifying key areas where policy measures should be assessed given the goal of encouraging economic development, critically examining policy options, and carrying forward reform agendas.

Given the relative complexities involved in the area of taxation, a critically important element in the development of tax policy reform measures is implementing, applying and drawing main results from suitable analytical frameworks to inform policy decisions. The tax component of the IRI elaborated in this note proposes a framework to underpin *assessments of tax policy development*. The issues and questions raised critically examine how a country analyzes and develops its tax policy with a focus on whether best practices are routinely followed, with attention to revenue effects, efficiency and equity considerations, and tax administration and tax compliance costs.

The range of issues to address is broad, given the need for policy makers to balance competing considerations when establishing policy measures supportive of economic development. Through discussion of five tax policy topics (see below) centred around the IRI framework, and elaboration of issues raised, policy makers are encouraged to aim towards implementation of best practices in policy analysis as applied by most OECD countries and by an ever-increasing number of non-OECD countries.

In addition to examining the scope of tax policy analysis, the coverage explores the underlying data and tax models used, that to a large extent determine the overall capacity of tax officials to critically examine tax policy pertaining to investment and employment. Assessments of capacity in this area recognize the advantages of using transparent modelling approaches, and relying on data subject to quality checks. Emphasis is placed on the need to have access to not only macro data, but also micro (taxpayer-

¹ The work builds on that developed under an earlier formulation of the tax chapter of the IRI. See Chapter 5 (Tax Policy) of OECD (2006), *Investment Reform Index 2006: Progress in Policy Reform to Improve the Investment Climate in South East Europe*. The genesis of the IRI is the OECD *Policy Framework for Investment* (2006).

level) data. Positive recognition is given to efforts by countries to develop micro databases (requiring a not insignificant allocation of resources) where such databases are not currently in place and operational.

Main findings from these areas of inquiry, based on questionnaire responses provided by host countries and follow-up interviews with policy officials, may be used to help identify areas where analytics and capacity could be enhanced through technical training. As one avenue, host country tax officials may be invited to participate in tax policy seminars, tax modelling workshops, and other technical assistance events organized by the OECD Centre for Tax Policy and Administration through its outreach programme.

Main findings of assessments of tax policy development may feed into a follow-up IRI exercise, to be carried out in 2009, that will involve *tax policy assessments* examining specific tax policies adopted, with such assessments carried out with host country tax officials. Tax policy assessments and suggested options for possible tax reform to improve investment performance will draw on findings emanating from applications of best practices in assessing tax policy (note above). Suggested areas and options for reform will also involve consideration of findings from assessments under other (non-tax) components of the IRI framework applied to the country, as well as other information. Resource considerations and the degree of active support and participation by country officials would determine the level of involvement of the OECD Secretariat in undertaking this second stage of work.

While proper assessment of most central tax policy issues – for example, the appropriate setting in a given country of the effective corporate tax rate on domestic profit, and an appropriate degree of integration of corporate and personal tax systems – requires additional information, extraneous to that gathered as part of the current exercise (e.g. public expenditure plans, degree of openness of capital markets), certain tax policies may be addressed and ‘scored’ in the absence of such information. For example, it is widely accepted that targeting tax relief to investment expenditures is more efficient and desirable than targeting tax relief using tax holidays. Therefore, in a limited number of areas, the current exercise scores systems on the basis of tax policy.

The proposed five tax policy topics to be considered in assessing a country’s capacity and normal practice in analyzing tax policy impacting investment and employment are as follows:²

1. fiscal position and planning
2. taxation of investment
3. taxation of employment
4. taxation of SMEs
5. taxation of MNEs

Unless otherwise indicated, tax policy development assessments consider activities of the main central government department normally responsible for the development and legislation of national tax policy.³ In many if not most countries, the relevant department is the Ministry of Finance. However, in some countries, and in particular for IRI elements addressing tax administration issues, activities of the central government Tax Administration may also be included in the review.

² The list of topics may be expanded or reduced, depending on feedback received from participants in the exercise.

³ While in general an IRI exercise is conducted with central government, sub-central taxation must be taken into account (e.g. factored into effective tax rate measures).

Section II of the note proposes various issues for assessment pertaining to the tax policy topics listed above. For each, the assessment first lists modelling frameworks and underlying data that are commonly employed by policy makers, for analytical purposes, which may be seen as standard required inputs. Countries assessed under the IRI would be asked to indicate whether such models and data are maintained and applied on a regular basis, and where they are not, whether steps are underway towards implementation, or whether other (substitute) approaches are taken. The assessment then considers whether countries carry out what may be recognized as mainstream tax policy analysis. The range of modelling frameworks, underlying data, and tax policy analyses identified in this note is not exhaustive, but selective, based on discussions with tax policy officials in advanced (OECD and certain non-OECD) countries on how tax policy issues are addressed.

Section III concludes with a review of steps on how the Secretariat plans to revise the framework, presented in this note, based on input from country Delegates and other interested parties. It also sets out a tentative timetable for applying the framework with participating countries under the MENA-OECD Investment Programme and with SEE countries, under the Investment Compact of the Stability Pact.

II. Proposed Elements of Assessments of Tax Policy Development

1. Fiscal position and planning⁴

A. Assessment of models and data⁵

- GDP-based tax revenue estimation models (for each main tax.)⁶
- Historical tax revenue data.
- National Accounts income, expenditure and balance of payments data (historical data).⁷
- Non-tax revenue data (current year, forecast years).
- Public expenditure data, grouped by function (current year, forecast years).

B. Assessment of analysis

⁴ Revenue and expenditure data should be analyzed for both central and sub-central levels of government, as fiscal imbalances at the sub-central level may impact fiscal balance of the central government. Issues and questions related to fiscal federalism are not addressed in this current version of the tax component of the IRI.

⁵ Micro-simulation models may be applied to estimate current year and forecast future year aggregate tax revenues, by type of tax (e.g. personal income tax, corporate income tax, value-added tax), and provide a useful check on GDP-based tax revenue model estimates, as part of a macro assessment of a country's fiscal position. Micro-simulation models can be expected to provide greater accuracy in current year and forecast year aggregate revenue estimates where a tax policy change (affecting a simulated tax) has been introduced in the preceding, current or a forecast year. Given the particular strength of micro-models in estimating revenue adjustments to tax policy reform, and distributional effects, their use is considered under sections 2.B.2.

⁶ A 'main tax' may be defined as one that contributes 5% or more of total tax revenues. Examples include income tax (corporate and personal), payroll tax, value-added tax, excise taxes, property tax, customs duties (trade taxes).

⁷ GDP/National Accounts-based tax forecasting frameworks estimate for each major tax the time-series relationship between adjusted tax revenue (net of estimated changes resulting from tax policy changes), and a proxy for the relevant tax base from National Accounts (e.g. consumption expenditures for VAT; tobacco sales for excise tax on tobacco; wages, salaries, interest, dividends rents, unincorporated business profits for personal income tax). Forecasts for the proxy (National Accounts) tax base are then applied to forecast tax revenues, by type of tax.

1. GDP-based forecasting of aggregate tax revenues for each main tax.

Q: Are GDP-based tax revenue forecasting models in place and regularly used to estimate and forecast aggregate tax revenues separately for each main tax (current year, forecast years)?

Indicators for Forecasting of Aggregate Tax Revenues

1. The Ministry of Finance does not maintain aggregate tax revenue forecasting models to enable forecasting of tax revenues, to inform tax and expenditure policy making. No current plans for implementation.
2. The Ministry of Finance does not maintain aggregate tax revenue forecasting models to enable forecasting of tax revenues, but is currently taking steps towards implementation within one year.
3. The Ministry of Finance has implemented a GDP-based tax revenue forecasting model for one or more taxes, but not for all main taxes (contributing 5 per cent or more to total tax revenues).
4. A GDP-based tax revenue forecasting model is maintained by the Ministry of Finance for each main tax.
5. Level 4 plus the requirement that forecasts of total tax revenue, for each main tax, differ from actual total tax revenue by less than 10 per cent.

2. Consideration of fiscal balance (total tax revenues, non-tax revenues, public expenditures).

Q: Is an efficient information system in place to accurately monitor tax revenue collection on an on-going (e.g. weekly/bi-weekly/monthly) basis? Is an efficient information system in place to accurately monitor public expenditures on an on-going basis? Are expenditure items, classified by type, prioritized/ranked on the basis of policy objectives? Are estimates of planned public expenditure considered alongside estimates of total tax revenues, aggregate non-tax revenues, and overall fiscal balance (current year, forecast years)? Are rules in place requiring adjustments to government expenditure and/or tax design where the fiscal balance is negative and exceeds some fixed percentage of GDP (i.e. mandatory feed-back of fiscal balance/debt projections into budget decisions including tax policy)?

Indicators for Assessment of Fiscal Balance and Policy Feedback

1. Neither tax revenue collection nor public expenditures are monitored on a regular basis to enable assessment of the fiscal balance. No current plans to implement systematic data collection systems for tax revenues and public expenditures.
2. Tax revenue collection and public expenditures are not monitored on a regular basis, but the government is currently taking steps towards implementation of systematic data collection systems within one year.
3. Tax revenue collection and public expenditures are monitored on a regular (e.g. monthly) basis.
4. Level 3 plus requirement that estimates of planned public expenditure are routinely considered and decided alongside estimates of total tax revenues, aggregate non-tax revenues, and overall fiscal balance (current year, forecast years).
5. Level 4 plus the requirements that: a) expenditure items classified by type are ranked/prioritized on the basis of policy objectives, with budget allocations addressing priority expenditures; and b) formal or informal rules are in place requiring adjustments to government expenditure and/or tax design where the fiscal balance is negative and exceeds some fixed percentage of GDP (i.e. mandatory feed-back of fiscal balance/debt projections into budget decisions including tax policy).

Notes

2. Taxation of investment⁸

A. Assessment of models and data⁹

- Corporate income tax (CIT) micro-simulation model.
- Corporate tax return data (stratified sample of tax returns), survey data.
- Marginal and average effective tax rate (METR/AETR) model.
- Depreciation calculator model.
- Corporate and shareholder-level tax parameter data.

B. Assessment of analysis

1. Sectoral analysis of tax burden on corporations - estimation of:

- CIT payments at the firm level, with the corporate sample stratified by industry and location,¹⁰ and total CIT payments in the current year and forecast years.¹¹
- average tax rates (ATRs) on corporate profits by firm asset size, industry, and location, in the current year.¹²

⁸ Special issues concerning the taxation of SMEs are considered in sub-section 4. Special issues arising in the context of cross-border investment (inbound/outbound) are considered in sub-section 5. METR/AETR analysis in section B considers the pure domestic investment case (i.e. taxation of profits on direct (non-portfolio) domestic investment by domestic-owned resident corporations). Micro-simulation based corporate income tax (CIT) estimates cover domestic tax, where levied, on outbound investment of resident corporations, and on inbound investment of non-resident corporations (domestic branch income).

⁹ A GDP-based corporate income tax (CIT) revenue forecasting model (as considered under section 1, based on historical aggregate CIT revenue data and National Accounts profit data) is not included in this section, as such a model generally does not provide a basis for yearly estimates of effective tax rates on investment, or for analyzing the impact of corporate tax reform on CIT revenues (and on the tax burden on investment).

¹⁰ Industry, location, asset size and possibly other criteria may be used to stratify a corporate dataset. Stratification by asset size would involve setting asset size ranges (note that a corporate sample would normally include all corporations with assets in excess of a 'large' asset size threshold, with 'large' corporations assigned to different cells depending on their characteristics and stratification criteria). Other stratification criteria of policy interest (e.g., high/low R&D expenditure/total assets) may be used. Location would generally be an important stratification criterion in a federal country (and possibly in a unitary country comprised of various departments/regions). Using firm-level data that distinguishes domestic versus and foreign-owned/controlled corporations, separate CIT revenue estimates may be made for both groups. For domestic-owned corporations, it is generally not possible to isolate CIT revenues on domestic versus foreign-source income.

¹¹ Total CIT payment (tax revenue) estimates may be obtained as the weighted sum of CIT payment estimates for each firm in the stratified corporate sample. Micro-simulation assessments of total CIT revenue may also feed into assessments of fiscal position (section 1)).

¹² ATR measurement of weighted adjusted corporate tax, as a percentage of weighted adjusted pre-tax corporate profit requires inclusion of pre-tax (book) profits as a data field (not a stratification variable) in the dataset. Adjustments to tax and profit are normally required to ensure consistency between numerator and denominator amounts (e.g. excluding loss carry-forward claims in the measurement of tax). See *Using Micro-data to Assess Average Tax Rates*, OECD Tax Policy Studies Series No.8. In general, total assets (or possibly turnover) would be used as a stratification variable relevant to firm size (not profit, given that large companies may be in a loss position).

- tax revenues foregone by main corporate tax incentives.

Q: Is a CIT micro-simulation model maintained and regularly used to estimate CIT revenues at the sectoral/industry level, total CIT revenues, (backward-looking) ATRs on corporate profits, tax revenues foregone by corporate tax incentives, and to compare such (base-case) estimates with post-reform estimates under revised tax parameters?¹³

Indicators for Sectoral Analysis of the Taxation of Corporate Profits

1. The Ministry of Finance does not maintain a corporate income tax (CIT) micro-simulation model enabling sectoral analysis of corporate tax revenues and the effective tax rate on corporate profits. No current plans for implementation.
2. The Ministry of Finance does not maintain a CIT micro-simulation model enabling sectoral analysis of corporate tax revenues and the effective tax rate on corporate profits, but is currently taking steps towards implementation within one year.
3. The Ministry of Finance maintains a CIT micro-simulation model. The model is routinely used to analyze the tax revenue implications of tax reform proposals.
4. Level 3 plus the requirements that a) underlying corporate tax return data are checked to identify entry and/or transcription errors; and b) the CIT model is updated each year (involving transcription of new tax return data each year).
5. Level 4 plus the requirement that a) estimates of total corporate tax revenue for the sample year differ from actual corporate tax revenues by less than 2 per cent; and b) forecasted corporate tax revenue from the micro-simulation model are cross-checked with forecasts from a GDP-based corporate tax revenue model.

Notes

¹³ In a pre- versus post-reform assessment, actual current CIT revenues (total and disaggregate) would normally be taken as a pre-reform 'base case', with post-reform revenues simulated under a revised tax structure.

2. Analysis of tax impediments to domestic investment - measurement of marginal effective tax rates (METRs) on domestic corporate profits.¹⁴

Q: Is a METR model in place and regularly used to assess non-neutralities introduced by the corporate tax system on domestic investment scale and location decisions?

Indicators for Analysis of Tax Impediments to Domestic Investment

1. The Ministry of Finance does not maintain a marginal effective tax rate (METR) model to enable analysis of tax impediments (distortions) to investment. No current plans for implementation.
2. The Ministry of Finance does not maintain a METR model to enable analysis of tax impediments (distortions) to investment, but is currently taking steps towards implementation within one year.
3. The Ministry of Finance maintains a METR model. The model is routinely used to analyze tax distortions to domestic investment and the implications of tax reform proposals.
4. Level 3 plus the requirement that the METR model is based on actual capital stock weights (i.e. those that reflect the national economy, based on National Accounts data), and is disaggregated across machinery and equipment, buildings, inventory and land.
5. Level 4 plus the requirement METR results are explained in summary reports in a non-technical way (for the non-tax expert) and are represented in graphical form to illustrate to policy makers the various factors explaining results.

Notes

¹⁴ Unlike backward-looking ATR measures, which depend on actual corporate tax paid (influenced by not only tax policy but also profitability and other factors), METR measures (and corresponding parameter-based average effective tax rates (AETRs) are based on specified non-tax factors (e.g. interest rates, profit rates), isolating the influence of tax parameters in explaining METR differences.

3. Cross-country comparative analysis of tax depreciation systems.

Q: Are cross-country comparisons of tax depreciation systems undertaken, to assess the relative complexity and generosity of the tax depreciation system, taking into account the number of depreciable capital asset classes, depreciation methods and rates, mandatory versus discretionary depreciation claims and interaction with loss carry-forward rules, and recapture provisions? Is a depreciation calculator model in place and used to measure the present-discounted value (PDV) of maximum tax depreciation allowances by depreciable capital asset type and industry? Are PDV calculations made for other countries, to enable cross-country comparisons?

Indicators for Comparative Analysis of Depreciation Systems

1. The Ministry of Finance does not undertake comparisons of capital depreciation systems in neighbouring countries and other countries regarded as main competitors for investment. No current planning for undertaking such comparisons.
2. The Ministry of Finance does not undertake comparisons of capital depreciation systems in main competing countries (e.g. neighbouring countries competing for investment), but is gathering information to enable comparisons within one year.
3. The Ministry of Finance regularly (e.g. annually) undertakes cross-country comparisons of capital depreciation systems, taking into account the number of depreciable capital asset classes, depreciation methods and rates.
4. Level 3 plus the requirement that comparisons take into account whether depreciation claims are mandatory or discretionary, interaction of claims with loss carry-forward rules, and the operation of recapture provisions.
5. Level 4 plus the requirement that a depreciation calculator model in place and used to measure, and compare across countries, the present-discounted value (PDV) of maximum tax depreciation allowances by depreciable capital asset type and industry.

Notes

4. Transparency of corporate tax incentives for investment - tax expenditure (TE) accounting, and publication of tax expenditure reports.

Q: Are tax expenditure accounts prepared periodically, including estimates of tax revenues foregone by main corporate tax incentives for investment? Are reports including such estimates published?

Indicators for Transparency in Provision of Corporate Tax Incentives for Investment

1. The Ministry of Finance does not produce tax expenditure estimates of tax revenues foregone by main corporate tax incentives for investment, to inform tax incentive policy-making and to provide transparency in the provision of tax incentives. No current plans for preparing such estimates.
2. The Ministry of Finance periodically prepares tax expenditure estimates of tax revenues foregone by main corporate tax incentives for investment, but does not publish such estimates.
3. The Ministry of Finance periodically publishes tax expenditure reports that include main corporate tax incentives for investment.
4. The Ministry of Finance annually publishes (e.g. together with budget documents) tax expenditure reports that include main corporate tax incentives for investment.al description of the interpretation of tax expenditures.
5. Level 4 plus the requirements that a) tax expenditure reports include a definition and description of the interpretation of tax expenditures, and b) publication is accompanied by a press release announcement.

Notes

5. Avoidance of tax holiday incentives for investment.

Q: Where targeted corporate tax incentives for investment are introduced, does policy choice favour incentives tied to investment expenditures rather than a tax holiday (full or partial profit exemption)?¹⁵

Indicators for Avoidance of Tax Holiday Incentives for Investment

1. The Ministry of Finance has introduced tax holidays (providing a full exemption from profit tax for a definite or indefinite number of years) in the last two years to encourage investment. The tax holidays are targeted at new foreign direct investment.
2. The Ministry of Finance has introduced tax holidays (providing a full exemption from profit tax for a definite or indefinite number of years) in the last two years to encourage investment. The tax holidays are not targeted at foreign direct investment (i.e. are available in the case of domestic investment).
3. The Ministry of Finance has introduced tax holidays in the last two years to encourage investment, but has recently publicly indicated a policy move away from the granting of tax holidays in the future (except possibly in exceptional cases).
4. The Ministry of Finance has publicly indicated a policy move away from the granting of tax holidays, and has not introduced tax holidays in the last two years to encourage investment (tax holiday relief may be provided under 'grandfathering' provisions to investment previously qualifying for tax holiday treatment.)
5. Level 4 plus the requirement that cost-benefit assessments have been undertaken for tax holidays previously granted to illustrate experience. The assessments take account of unintended tax-planning opportunities (e.g. enabling investment outside the targeting criteria to obtain tax holiday relief) possible under tax holidays.

Notes

¹⁵ For a discussion of reasons explaining why expenditure-based investment tax incentives are viewed a more efficient instruments than tax holidays, see OECD (2001), *Corporate Tax Incentives for Foreign Direct Investment*, OECD Tax Policy Studies, No.4.

6. Cost-benefit assessment of tax incentives for investment.

Q: Are cost-benefit evaluations undertaken for main tax incentives? Is such information used to inform policy making and budget decisions?

Indicators for Cost-Benefit Assessment of Tax Incentives for Investment

1. The Ministry of Finance has not undertaken a study of theoretical, empirical and survey literature examining the impact of corporate taxation and tax incentives on investment. No current planning for such a study.
2. The Ministry of Finance has not undertaken a study of theoretical, empirical and survey literature examining the impact of corporate taxation and tax incentives on investment, but has chosen one or more experts (e.g. tax policy officials) to provide an examination of the literature.
3. The Ministry of Finance has recently undertaken a study of the theoretical, empirical and survey literature examining the impact of corporate taxation and tax incentives on investment.
4. Level 3 plus the requirement that the main findings of the study have been reviewed by external experts and summarized in an 'executive summary' for consideration by senior Ministry of Finance officials. The main findings have been used in the last year, together with tax expenditure (foregone revenue) estimates, to inform a cost-benefit assessment of at least one main corporate tax incentive for investment.
5. Level 4 plus the requirement that the main findings have been used, together with tax expenditure (foregone revenue) estimates, to inform a systematic cost-benefit assessment all main corporate tax incentives for investment.

Notes

3. Taxation of employment

A. Assessment of models and data¹⁶

- Personal income tax (PIT) micro-simulation model.
- Personal tax return data (stratified sample of individual/household tax returns); survey data.
- Marginal and average tax rate (MTR/ATR) model.
- Individual/household tax parameter data.

B. Assessment of analysis

1. Household-level analysis of tax distortions to employment and income inequality - estimation of:

- PIT payments at the taxpayer (individual or household) level, based on taxpayer sample stratified by pre-tax total income, taxpayer characteristics (e.g. number of children, married status, location) (sample year, current year);¹⁷
- total PIT payments in the current year and forecast years;¹⁸
- PIT payments on wage income at the taxpayer level in tax systems that separately tax wage/salary income;¹⁹
- average tax rate (ATRs) and marginal tax rates (MTRs) on wage/salary income, by pre-tax employment income band, and taxpayer characteristics, in the current year.²⁰

Q: Is a PIT micro-simulation model in place to estimate total PIT revenues, disaggregate average and marginal tax rates (ATRs/MTRs) by employment income band, and GINI coefficients, and to compare such (base-case) estimates with post-reform estimates under revised tax parameters?²¹

¹⁶ A GDP-based personal income tax (PIT) revenue forecasting model (based on historical aggregate PIT revenue data and National Accounts income data) is not included in this section, as such a model (while used to estimate aggregate tax revenues, under section 1), being based on aggregate data, does not provide a basis for accurate estimation of effective tax rates on employment.

¹⁷ Pre-tax income, number of children, married status and location are common criteria used to stratify an individual taxpayer dataset. Where wage income is taxed together with other taxable income (non-dual system) so that, for a given taxpayer, the average tax rate on total income determines the tax rate on wage income, it remains necessary to include wage/salary income as a data field (not a stratification variable) in order to measure an average tax rate on wage income that reflects the distribution of wage/salary income across taxpayers.

¹⁸ Total PIT payment (tax revenue) estimates may be obtained as the weighted sum of PIT payment estimates for each individual/household in the stratified sample of taxpayers. Micro-simulation assessments of total PIT revenue may feed into assessments of fiscal position (section 1).

¹⁹ Where a scheduler tax system applies that taxes employment income separately from other income, PIT revenues on wage/salary income should be estimated separately to measure effective tax rates on employment income at the taxpayer level. As footnoted above, where labour income is taxed together with other types of taxable income, the average/marginal tax rate on employment income, for a given taxpayer, is the taxpayer's average/marginal tax rate on all taxable income.

²⁰ Measurement of a weighted-average ATR/MTR on wage/salary income, for a given range/band of employment income, requires inclusion of wage/salary income as a data field (not a stratification variable) in the dataset, in order to weight taxpayer-level ATRs/MTRs.

Indicators for Household-level Analysis of the Taxation of Employment Income and Income Inequality

1. The Ministry of Finance does not maintain a personal income tax (PIT) micro-simulation model that enables household-level analysis of personal tax revenues, the effective tax rate on employment income, and income inequality. No current plans for implementation.
2. The Ministry of Finance does not maintain a PIT micro-simulation model that enables household-level analysis of personal tax revenues, the effective tax rate on employment income, and income inequality, but is currently taking steps towards implementation within one year.
3. The Ministry of Finance maintains a PIT micro-simulation model. The model is routinely used to analyze the personal tax revenue, effective tax rate and income distribution implications of tax reform proposals.
4. Level 3 plus the requirement that a) the micro-dataset distinguishes taxpayers by type (e.g. married/single, with/without children); b) taxpayer data are checked to identify entry and/or transcription errors; and c) the PIT model is updated each year (involving transcription of new personal tax return data each year).
5. Level 4 plus the requirement that a) estimates of total personal tax revenue for the sample year differ from actual personal tax revenues by less than 2 per cent; and b) forecasted personal tax revenue from the micro-simulation model are cross-checked with forecasts from a GDP-based personal tax revenue model.

Notes

²¹ A GINI coefficient assessment of the impact of taxation on income inequality would compare a GINI coefficient measure based on pre-tax income, and a GINI coefficient measure based on post-tax income. An assessment of the impact of tax reform would additionally compare the pre-reform GINI coefficients based on post-tax income, with a post-reform GINI coefficient based on post-tax income.

2. ‘Tax wedge’ analysis of tax impediments to employment - measurement of (parameter-based) marginal and average tax rates on labour income.²²

Q: Is a (parameter-based) model measuring marginal and average tax rates on labour income (by gross wage income level, household type, full versus part-time employment, including personal income tax and employee/employer social security contributions, as per OECD *Taxing Wages* methodology) used regularly to assess distortions introduced by the income tax and social security contribution system²³ on employment decisions?²⁴

Indicators for ‘Tax Wedge’ Analysis of Tax Impediments to Employment

1. The Ministry of Finance does not maintain a model/framework measuring marginal and average tax rates on labour income to assess tax distortions to employment. No current plans for implementation.
2. The Ministry of Finance does not maintain a model/framework measuring marginal and average tax rates on labour income to assess tax distortions to employment, but is currently taking steps towards implementation within one year.
3. The Ministry of Finance maintains a model/framework measuring marginal and average tax rates on labour income. The model is used to analyze tax distortions to employment (e.g. unintended ‘jumps’ (i.e. significant changes) in marginal tax rates) and the implications of tax reform proposals.
4. Level 3 plus the requirement that the model/framework covers a number of possible household structures (e.g. single individual, married couple, with and without children), and alternative wage earnings levels, and part-time as well as full-time work.
5. Level 4 plus the requirement that the results from the model/framework are compared with results for other countries (e.g. as available in OECD *Taxing Wages* publication) and are used systematically to inform policy makers of the labour market implications of alternative policy adjustments to the taxation of wage income.

Notes

²² Unlike backward-looking ATR measures which depend on actual personal taxes paid (influenced by the mix of personal taxable income, the tax treatment of all forms of taxable income, standard and non-standard reliefs, other factors), marginal and average tax rates on wage income derived using the *Taxing Wages* methodology isolate the effects of taxation (excluding non-standard reliefs).

²³ In general, models explaining tax distortions to the labour market should factor in levies on employment income by government-administered social security contribution systems (virtually all such systems have an element of redistribution, in that benefit entitlements are not strictly based on contributions (i.e. unrequited payments)).

²⁴ A future component of the IRI could include measurement of marginal and average net tax rates on labour income (net of social assistance benefits, as per OECD *Benefits and Wages* methodology) and analysis of adjustment to policies affecting the net (tax less benefits) burden on labour income, examining the interaction of tax and benefit systems in influencing labour market participation and work effort [Q: routinely prepared to assess current policy and proposed tax and benefit reform?].

4. Taxation of SMEs

A. Assessment of models and data

- Corporate income tax (CIT) and personal income tax (PIT) micro-simulation models.
- Corporate income tax data (stratified sample of corporate tax return (or survey) data; stratification variables include total asset size/range).
- Personal income tax data (stratified sample of individual/household tax return (or survey) data; stratification variables include total asset size/range of unincorporated business).
- Marginal and average effective tax rate (METR/AETR) model, by firm size.
- Corporate and individual/household tax parameter data.
- Survey evidence of tax compliance costs for SMEs.

B. Assessment of analysis

1. Analysis of the tax burden on firms by asset size - micro-simulation model estimation of:

- CIT payments by SMEs (defined as corporations with total assets below some threshold), based on a corporate sample stratified by firm asset size (sample year, current year);²⁵
- PIT payments on total income, for taxpayers earning business income, based on taxpayer sample stratified by pre-tax total income;
- PIT payments on non-wage income (including business income) in tax systems that tax non-wage income separately from wage/salary income;²⁶
- average and marginal tax rates (ATRs/MTRs) on i) profits of incorporated SMEs, and ii) unincorporated business income, by business asset size, in the current year.²⁷

Q: Are micro-simulation models used to analyze possible tax impediments to SME creation and growth? Is a CIT micro-simulation model in place and regularly used to estimate total CIT revenues paid by incorporated SMEs, and average and marginal tax rates on SME profits, and to compare (base-case) estimates with post-reform estimates under revised tax parameters?²⁸ Is a PIT micro-simulation model in place and regularly used to estimate total PIT revenues on unincorporated business income of individuals, average and marginal tax rates on unincorporated business income, and to compare such (base-case) estimates with post-reform estimates under revised tax parameters?

²⁵ See footnote 10. Other stratification criteria could include industry and location.

²⁶ Where a scheduler tax system applies that taxes employment income separately from other income, PIT revenues on other (non-wage) income should be estimated separately to measure effective tax rates on business income at the taxpayer level.

²⁷ Measurement of a weighted-average ATR/MTR on unincorporated business income, for taxpayers with total business assets within a given range/band, would use total business assets (a stratification variable) to weight individual taxpayer ATRs/MTRs on business income.

²⁸ Adjustments to tax policy affecting SMEs could include less restrictive loss offset provisions for SMEs (business loss offset rules; capital loss offset rules for SME equity shares). Where loss offset rules apply generally (i.e. do not target (differentially treat) SMEs), consideration of loss offset rules is particularly relevant to section 4, given the special importance to SMEs of loss treatment (with many if not most small enterprises being in a loss position during initial years, owing to large set-up costs (and possibly limited market entry)).

Indicators for Analysis of Tax Burden on SMEs

1. The Ministry of Finance does not maintain a corporate income tax (CIT) micro-simulation model and a personal income tax (PIT) micro-simulation model that distinguish taxpayers by turnover (gross business revenue) and total business assets. No current plans to implement such models.
2. The Ministry of Finance does not maintain CIT and PIT micro-simulation models distinguishing taxpayers by turnover and total business assets. However the Ministry plans to implement within one year CIT and PIT micro-simulation models and datasets distinguish SMEs and non-SMEs.²⁹
3. The Ministry of Finance maintains CIT and PIT micro-simulation models distinguishing taxpayers by turnover and total business assets. The models are routinely used to analyze the contribution of SMEs to total corporate income tax revenue, and total personal income tax revenue on business income, and to analyze the tax revenue implications of tax reform proposals.
4. Level 3 plus the requirement that analyses of SME (versus non-SME) income tax liability are carried out at the industry (rather than economy-wide) level (requiring datasets stratified by industry).
5. Level 4 plus requirement that CIT and PIT micro-simulation models are used to compare, at the industry level, a) the average corporate income tax rate, versus the average personal income tax rate on business income; and b) the marginal corporate income tax rate on profit, versus the marginal personal income tax rate on business income, versus the marginal personal income tax rate on wage income.

Notes

²⁹ Development of a micro-dataset based on tax return information requires that taxpayers provide, in their tax return, balance sheet data showing business assets and financial statements showing gross business revenue, and that this information is transcribed from tax returns into an electronic database.

2. Analysis of tax impediments (distortions) to investment in SMEs - measurement of marginal effective tax rates (METRs) on domestic profits of SMEs.

Q: Is a METR model in place and regularly used to compare non-neutralities introduced by the corporate and personal income tax system on investment/scale decisions of SMEs, versus large domestic companies, versus multinationals (MNEs) (inbound investment, inclusive of tax planning)?

Indicators for Analysis of Tax Impediments to SME Investment

1. The Ministry of Finance does not maintain a marginal effective tax rate (METR) model that specifically addresses tax impediments to SME investment (versus investment by large firms). No plans for implementation.
2. The Ministry of Finance does not maintain a METR model that specifically addresses SME investment (versus investment by large firms), but is currently taking steps towards implementation within one year.
3. The Ministry of Finance maintains a METR model that specifically addresses SME investment (versus investment by large firms). The model is routinely used to analyze tax distortions to SME investment and the implications of tax reform proposals.
4. Level 3 plus the requirement that the METR model is based on actual capital stock weights for SMEs (e.g. based on balance sheet information provided in tax returns), and is disaggregated across machinery and equipment, buildings, inventory and land.
5. Level 4 plus the requirement METR results are explained in summary reports in a non-technical way (for the non-tax expert) and are represented in graphical form to illustrate to policy makers the various factors explaining results.

Notes

3. Analysis of tax impediments to equity financing of SMEs - measurement of effective tax rates on distributed profits and retained profits of incorporated SMEs held by resident taxpayers; consideration of possible tax distortions to SME financial policy and investment.

Q: Are (parameter-based) effective tax rates measured for distributed profits and retained profits of incorporated SMEs³⁰ to analyze possible tax impediments to SME equity finance, and to consider neutrality implications of alternative integration approaches/measures to avoid double taxation of equity income?³¹

Indicators for Analysis of Tax Impediments to SME Equity Finance

1. Studies examining implications for enterprise financing and investment of double taxation of distributed and retained profit have not been undertaken by tax officials.
2. Studies examining implications for enterprise financing and investment of double taxation of distributed and retained profit have been undertaken by tax officials, with study findings documented and reported to senior Ministry of Finance officials for discussion and consideration.
3. Level 2 plus the requirement that the analysis of double taxation includes an assessment of pros and cons (advantages, disadvantages) and tax revenue implications of alternative 'integration' systems to relieve double taxation of distributed and retained profits.
4. Level 3 plus the requirement that findings of studies of double taxation and alternative integration systems are addressed in current tax policy or in planned tax reform over the next two years.
5. Level 4 plus the requirement that studies of special tax incentives in the current system, or planned for introduction over the next two years, or being proposed by business (main provisions) to increase financing of small enterprises, have been undertaken, documented, and reported to senior Ministry of Finance officials. Tax revenue and efficiency implications of adjusting (possibly eliminating) these incentives have been considered alongside implications of adjusting the degree of double taxation relief in respect of distributed and retained profit.

Notes

³⁰ Effective tax rates on dividends and retained profits should factor in integration relief (if provided) in respect of dividend income and capital gains.

³¹ Double taxation arises where business profits are taxed first at the corporate level (without integration relief) and then after-corporate tax profits are taxed in full at personal tax rates (on dividends or capital gains).

4. Analysis of tax arbitrage by SME owners - measurement of (parameter-based) effective tax rates on distributed profits of incorporated SMEs held by resident individual taxpayers, versus effective tax rates on wage income; consideration of possible tax distortions to earnings payout decisions of closely-held corporations and sole entrepreneurs.³²

Q: Are (parameter-based) effective tax rates measured for distributed profits of incorporated SMEs versus effective tax rates on wage income, to analyze incentives for tax arbitrage by SMEs?

Indicators for Analysis of Tax Arbitrage by SME Owners

1. Studies examining implications for enterprise financing and investment of double taxation of distributed and retained profit have not been undertaken by tax officials.
2. Studies examining implications for enterprise financing and investment of double taxation of distributed and retained profit have been undertaken by tax officials, with study findings documented and reported to senior Ministry of Finance officials for discussion and consideration.
3. Level 2 plus the requirement that the analysis of double taxation includes an assessment of pros and cons (advantages, disadvantages) and tax revenue implications of alternative 'integration' systems to relieve double taxation of distributed and retained profits.
4. Level 3 plus the requirement that findings of studies of double taxation and alternative integration systems are addressed in current tax policy or in planned tax reform over the next two years.
5. Level 4 plus the requirement that studies of special tax incentives in the current system, or planned for introduction over the next two years, or being proposed by business (main provisions) to increase financing of small enterprises, have been undertaken, documented, and reported to senior Ministry of Finance officials. Tax revenue and efficiency implications of adjusting (possibly eliminating) these incentives have been considered alongside implications of adjusting the degree of double taxation relief in respect of distributed and retained profit.

Notes

³² Distortions to remuneration decisions may arise (for closely-held corporations and unincorporated businesses) under dual income tax systems that separately apply a low personal tax rate to actual or imputed capital income. Such distortions may also arise in non-dual tax systems where CIT/PIT treatment of profits is fully or partly integrated, and the base of social security contributions is gross wage earnings.

5. Treatment of risky investment in SMEs - cross-country comparisons of business loss offset provisions, and capital loss offset provisions for SME shares.

Q: Are cross-country comparisons made of business loss offset provisions, and capital loss offset provisions for SME shares, to address the tax treatment of risk-taking and possible effects (risk-taking discouraged or encouraged by the tax system)? {Note: also to consider - micro-simulation analysis of revenue implications of adjustments to loss offset provisions.}

Indicators for Analysis of Tax Impediments to Risky Investment in SMEs

1. Possible impediments to investment in early-stage, high-risk companies of alternative loss-offset rules governing limits to tax deductibility of business losses, and capital losses on shares, have not been analyzed, documented and discussed amongst senior tax officials of the Ministry of Finance.
2. Possible impediments to investment in early-stage, high-risk companies of alternative loss-offset rules governing limits to tax deductibility of business losses, and capital losses on shares, have been analyzed with findings documented and reported to senior Ministry of Finance officials for discussion and consideration.
3. Level 2, plus the requirement that tax-planning opportunities under alternative loss-offset provisions have been examined (taking into account limits to tax audit surveillance that can be carried out by the tax administration), with study findings reported to senior Ministry of Finance officials for discussion and consideration.
4. Level 3 plus the requirement that main findings of studies of possible impediments to risk-taking (including investment in equity shares), and possible tax-planning opportunities, under alternative loss-offset provisions, are addressed in current tax policy, and/or in planned tax reform over the next two years.
5. Level 4 plus the requirement that following the adoption of tax reform that expands or limits loss offset provisions, and/or broadens or contains scope for tax-planning around losses, an ex-post evaluation is carried out that examines implications for risk-taking and tax-planning.

Notes

6. Assessment of tax compliance costs of SMEs and alternative tax administration approaches³³

Q: Are assessments made of tax compliance costs of SMEs, linked to tax policy and tax administration? Has tax administration been adjusted where compliance costs are found to be too high, to encourage SME compliance and business activities?

Indicators for Assessment of Tax Compliance Costs for SMEs and Remedial Tax Administration

1. The Ministry of Finance (or Tax Administration) has not assessed the average cost to SMEs of complying with any of the main taxes (current design) imposed by central government.
2. The Ministry of Finance (or Tax Administration) has assessed the average cost to SMEs of complying with certain main taxes (e.g. income tax, general consumption tax (VAT or sales tax), in their current design) imposed by central government.
3. The Ministry of Finance (or Tax Administration) has assessed the average cost to SMEs of complying with all main taxes (current design) imposed by central government.
4. Level 3, plus the requirement that studies have been prepared to determine the pros/cons of simplifying certain elements of central government tax administration (e.g. less frequent tax instalments, electronic filing). There has been some initial implementation of reforms that address the main findings of these studies.
5. Level 4, plus evidence that a) reforms have been implemented that address the main findings of studies of possible simplification of central government tax administration; and b) meetings have been held with senior provincial/state-level tax officials to discuss SME compliance costs where studies reveal that tax compliance costs in relation to sub-central government axes (e.g. property tax) are excessively high.

Notes

³³ Issues to address in tax compliance costs surveys: a) complexity and transparency of tax rules and obligations (taxpayer access to information, documentation, tax forms; taxpayer assistance and education services); b) consistency of policy design/complexity and capacity of tax administration; c) efficiency of tax administration (functional vs. structural organisation (LTU/SME)); d) contribution of tax administration procedures to SME tax compliance (reporting requirements (data, frequency), payment requirements, treatment of VAT refunds; audit procedures, appeal procedures; scope for tax avoidance.

7. Assessment of alternative tax policy measures to reduce tax compliance costs for SMEs

Q: Has consideration been given to the pros/cons of alternative tax policy measures to reduce the tax compliance burden on SMEs, to encourage SME tax compliance and business activities?

Indicators for Assessment of Policy Measures to Lessen Tax Compliance Costs for SMEs

1. The Ministry of Finance has not assessed the implications of alternative tax policy regimes to apply to SMEs to address tax compliance costs (e.g. under application of basic income tax and basic VAT systems, versus presumptive tax regime for SMEs, VAT exemption for SMEs).
2. The Ministry of Finance has assessed the implications of alternative tax policy regimes to apply to SMEs to address tax compliance costs (e.g. basic income tax and basic VAT systems, versus presumptive tax regime for SMEs, VAT exemption for SMEs).
3. Level 2 plus the requirement that analyses have been prepared that consider criteria and options for establishing threshold level(s) determining the application of alternative regimes (e.g. VAT exemption, versus presumptive tax regime, versus basic VAT regime), and possible distortions (e.g. to firm size) introduced by different threshold levels.
4. Level 3 plus the requirement that there has been some initial implementation of reforms that apply different tax regimes to SMEs, depending on their size (e.g. turnover), where analyses indicate that such reforms would be desirable and appropriate.
5. Level 5 plus evidence of implementation of that apply different tax regimes to SMEs, depending on their size (e.g. turnover), where analyses indicate that such reforms would be desirable and appropriate.

Notes

8. Assessment of taxpayer assistance and education services to reduce SME tax compliance burden.

Q: Are taxpayer assistance and education service programs in place to reduce the tax compliance burden on SMEs?

Indicators for Assessment of SME Taxpayer Assistance to Reduce Tax Compliance Burden

1. Limited taxpayer access (at regional/local tax offices) to information, supporting documentation and assistance towards understanding and complying with the main taxes imposed on business by central government. No immediate plans by central government to significantly improve taxpayer service.
2. Information and documentation to assist taxpayers in complying with the main taxes imposed on business by the central government is disseminated to registered taxpayers along with tax returns. Plans are being developed by central government to improve its taxpayer service.
3. Level 2 plus the requirement that tax returns and information and supporting documentation are widely available to taxpayers (e.g. available at non-government sites, downloaded from government websites). A toll-free telephone service, with adequately trained tax specialists, is provided to respond to taxpayer questions.
4. Level 3 plus the requirement that additional services to educate business on its tax obligations, reporting and filing requirements are provided through an 'outreach programme' that includes tax seminars organized at the local level (e.g. with local chambers of commerce), special advertising, and possibly other strategies to actively disseminate tax information to business.
5. Level 4 plus regular discussions with national Chambers of Commerce and other bodies to consider how taxpayer assistance and education could be improved.

Notes

5. Taxation of MNEs (cross-border investment)

A. Assessment of models and data³⁴

- Corporate income tax (CIT) micro-simulation model.
- Corporate tax return data (stratified sample of corporate tax return data; stratification criteria for corporate sample includes ownership information (domestic versus foreign-ownership (control))).
- Cross-border marginal and average effective tax rate (METR/AETR) model, incorporation of MNE tax-planning behaviour.
- Non-resident withholding tax model.
- Corporate and international tax parameter data.

B. Assessment of analysis

1. Analysis of the tax burden on MNEs (cross-border investment) – estimation of

- CIT payments at the firm level, with the corporate sample stratified by ownership and industry.
- average tax rates (ATRs) on corporate profits by firm ownership and industry.

Q: Is a CIT micro-simulation model in place and regularly used to estimate CIT revenues paid by foreign-owned firms, corresponding (backward-looking) ATRs, and to compare such (base-case) estimates with post-reform estimates under revised tax parameters?

Indicators for Analysis of Tax Burden on Inbound FDI

1. The Ministry of Finance does not maintain a corporate income tax (CIT) micro-simulation model based on a sample dataset that distinguishes resident-controlled versus non-resident-controlled corporations. No current plans to develop a model with a dataset that makes this distinction.
2. The Ministry of Finance does not maintain a corporate income tax (CIT) micro-simulation model with a sample dataset that distinguishes resident-controlled versus non-resident-controlled corporations, but is currently taking steps towards implementation within one year.³⁵
3. The Ministry of Finance maintains a corporate income tax (CIT) micro-simulation model with a sample dataset that distinguishes resident-controlled versus non-resident-controlled corporations.
4. Level 3, plus the requirement that comparisons are regularly made between average tax rates (ATRs) on corporate profits for resident-controlled versus non-resident-controlled firms.
5. Level 4, plus the requirement that ATR measures consider corporate profits grossed-up by estimates of profit stripping (e.g. by 'excessive' related party debt financing).

Notes

³⁴ A GDP-based corporate income tax (CIT) revenue forecasting model (as considered under section II.A, based on historical aggregate CIT revenue data and National Accounts profit data) is not included in this section, as such a model generally does not provide a basis for yearly estimates of effective tax rates on investment, or for analyzing the impact of corporate tax reform on CIT revenues (and on the tax burden on investment).

³⁵ Steps may include revised the corporate tax return for the next tax year, or data transcription fields for the next model year.

2. Analysis of tax distortions to cross-border investment (FDI).

Q: Is a METR model in place and regularly used to assess non-neutralities introduced by the corporate tax system on inbound and outbound FDI location and scale decisions? Does the cross-border METR model factor in implications of tax-planning activities?

Indicators for Analysis of Tax Distortions to Cross-border Investment (FDI)

1. The Ministry of Finance does not maintain a marginal effective tax rate (METR) model that specifically addresses tax distortions to cross-border investment (FDI). No plans for implementation of such a model.
2. The Ministry of Finance does not maintain a METR model that specifically addresses tax distortions to FDI, but is currently taking steps for implementation within the next year.
3. The Ministry of Finance maintains a METR model that specifically addresses tax distortions to FDI. The model is routinely used to analyze tax distortions to FDI and the implications of tax reform proposals.
4. Level 3 plus the requirement that the METR model takes into account differences (if any) of the financial structure (in particular, debt/asset ratios) of MNEs versus domestically-owned resident corporations. Balance sheet information available from financial statements or provided in tax returns are used as sources of information.
5. Level 4 plus the requirement a) the framework computes not only METRs but also average effective tax rates (AETRs) relevant to location decisions, and b) the METR/AETR model takes into account various forms of tax planning commonly used by multinationals (including the use of tax haven finance affiliates).

Notes

3. Assessment of non-resident withholding tax.

Q: Are cross-border payments underlying non-resident withholding tax analyzed, and is a model in place to estimate the revenue impact of changes in non-resident withholding tax rates?³⁶

Indicators for Analysis of Non-Resident Withholding Tax

1. The Ministry of Finance does not have a framework for estimating and analyzing non-resident withholding tax. No steps are currently being taken to implement such a framework.
2. The Ministry of Finance does not have a framework for estimating and analyzing non-resident withholding tax, but steps are currently being taken to implement such a framework within the next 6 months.
3. The Ministry of Finance has a framework for estimating and analyzing non-resident withholding tax. The underlying cross-border payments data are based on international balance of payments statistics (National Accounts data).
4. The Ministry of Finance has a framework for estimating and analyzing non-resident withholding tax. The underlying cross-border payments data are drawn from returns that taxpayers and agents making payments to non-residents on behalf of taxpayers are required to provide (indicating the type and amount of income paid, the amount paid, the recipient country, and the amount of tax withheld).
5. Level 4 plus the requirement that the non-resident withholding tax data is gathered (transcribed into an electronic format) for estimation purposes annually or bi-annually.

Notes

³⁶ A country's international balance of payments statistics would normally report, under the current account, investment income payments to non-residents including i) direct investment income (income on equity, interest income on debt); ii) portfolio investment income (income on equity, interest income on debt); and iii) other investment income (including interest on loans and other capital). Direct investment income on equity includes dividends, branch profits and reinvested earnings. If a national statistical agency producing National Statistics data can provide data on interest income, and components of equity income, rough estimates may be made of the revenue impact of adjustments to statutory non-resident withholding tax rates on interest and dividends (and to adjustments in a branch profits tax.) However, additional detail on individual payment amounts showing the country of residence of non-resident recipients is needed for roughly accurate estimates given differences between statutory and tax treaty withholding tax rates. Similarly, estimates of the revenue impact of adjusting a given tax treaty rate require data on payments to the relevant treaty country.

In some countries, taxpayers and agents (e.g. bank, trust company) who make payments to non-residents on behalf of taxpayers are required to complete and submit forms that provide the government with information on income, such as interest, dividends, royalties, rents, paid to non-residents, the amount paid, the recipient country, and the amount of tax withheld. Compilation of a non-resident withholding tax model on the basis of such data is ideal.

4. Analysis and treatment of thin capitalization (erosion) of the corporate tax base.

Q: Is the financial structure of resident corporations analyzed, by industry, to assess possible thin capitalization of foreign-controlled companies (inbound FDI)?³⁷ Does the host country have thin capitalization rules?

[A related issue (not examined in the indicators below, but possibly at a later stage) is whether the financial structure of resident corporations is analyzed to assess corporate income tax revenue loss from interest deductions on debt borrowed to capitalize foreign affiliates (outbound FDI)?³⁸]

Indicators for Analysis of Thin Capitalization of the Tax Base

1. The Ministry of Finance does not have a framework for analyzing possible thin-capitalization of resident foreign-controlled companies. No steps are currently being taken to implement such a framework.
2. The Ministry of Finance does not have a framework for analyzing possible thin-capitalization of resident foreign-controlled companies, but steps are currently being taken to implement such a framework within the next year.
3. The Ministry of Finance has a framework for analyzing possible thin-capitalization of resident foreign-controlled companies, based on balance sheet information required for inclusion in a corporation's tax return. Where data reveal that thin-capitalization is leading to an excessive reduction in the corporate tax base, policy proposals have been developed to introduce or strengthen thin capitalization rules.
4. Level 3 plus the requirement that, where data reveal excessive reduction in the corporate tax base, steps are currently being taken to implement or strengthen thin capitalization rules within the next year.
5. Level 4 plus the requirement that, where data reveal excessive reduction in the corporate tax base, policy proposals are being developed to consider alternative design features of the thin-capitalization rules to make them more robust.

Notes

³⁷ Possible thin capitalization may be assessed by comparing, at the disaggregate industry level, the debt/asset ratio of foreign-controlled firms (inbound FDI) versus domestic-controlled firms. Inbound FDI may include capital of resident shareholders invested in the domestic economy through offshore tax havens. High debt/asset ratios of foreign-controlled firms may signal the need to consider the introduction or tightening of thin capitalisation rules, possibly together with a reduction in the statutory corporate income tax rate.

³⁸ Possible thin capitalization on outbound FDI may be assessed by comparing, at the disaggregate industry level, the debt/asset ratio of resident companies without foreign affiliates versus resident companies with foreign affiliates. High debt/asset ratios of multinational companies may signal the need to consider the introduction of rules limited domestic interest deductions on funds used to finance outbound FDI (typically generating limited net domestic corporate tax revenue, implying violation of the matching principle).