# *Tax Policy*

## Policy Framework for Investment, PFI User's Toolkit, Investment Reform Index

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# Focus of GFI tax panel discussions

- Tax panel of the GFI – to address the tax component of three related OECD-led projects:
  - ***Policy Framework for Investment*** **(PFI)**
  - ***PFI User's Toolkit***
  - ***Investment Reform Index*** **(IRI)**
- Brief review of these projects, discuss around original questions of the tax chapter of the PFI.
- Subsequent panel presentations on taxation of SMEs, tax incentives, tax expenditure reporting, tax treaty issues.
- Final session – open discussion of issues raised, possible revisions of tax component of PFI, user's toolkit, and IRI.

# Policy Framework for Investment and related projects

- ***Policy Framework for Investment* (PFI)** - non-prescriptive checklist of issues / questions for governments to consider when undertaking policy reform supportive of investment.
  - Policy areas covered by PFI – investment policy, trade policy, competition policy, tax policy, investment promotion, corporate governance, human resource development, infrastructure development and public governance.
  - Task Force established to oversee development of PFI.
- ***User's Toolkit*** – developed to facilitate analysis under the PFI.
- ***Investment Reform Index* (IRI)** – developed to encourage policy reform through 'scoring' countries on policy performance. Draws and expands on the PFI and User's Toolkit.

# Tax component of PFI, User's Toolkit and IRI

- Tax component of the *Policy Framework for Investment*
  - Emphasis on tax &  non-tax determinants of FDI, balancing need for attractive tax system, and tax revenues to fund key programs for FDI (e.g. infrastructure development ).
- Tax component of the *PFI User's Toolkit*
  - Provides guidance to addressing tax issues raised in PFI.
- Tax component of the *Investment Reform Index*
  - Aims to 'score' countries on policy performance:  first assess ***tax policy development***, and then ***tax policy***.
  - Five policy topics addressed:  fiscal position and planning;  taxation and investment;  taxation and employment;  taxation of SMEs;  taxation of MNEs.

# PFI Questions Q1 to Q3

- **Q1.** Has the government evaluated the level of tax burden that would be consistent with its broader development objectives and its investment attraction strategy? Is this level consistent with the actual tax burden?
- **Q2.** What is the average current tax burden on domestic profits, taking into account statutory provisions, tax-planning opportunities and compliance costs?
- **Q3.** Is the tax burden on the business enterprises of investors appropriate with reference to the policy goals and objectives of the tax system?

# Guidance in User's Toolkit for Q1-Q3

- Emphasis on the need to address tax policy alongside expenditure policy.
- Measures of corporate income tax burden
  - Estimates based on aggregate data:

$$T^{C} = \frac{CIT}{GDP} = \frac{CIT}{OS^{c}} \cdot \frac{OS^{c}}{GDP} = ATR^{c} \cdot \frac{OS^{c}}{GDP}$$

  - Estimates based on micro-data:

$$ATR^{C} \approx \frac{\sum_{i=1}^{N-X} w_i \sum_{j=1}^{s_i} CIT_{ij}^{adj}}{\sum_{i=1}^{N-X} w_i \sum_{j=1}^{s_i} Y_{ij}^{adj}}$$

  - Analytical power of micro-simulation models.

# Guidance in User’s Toolkit for Q1-Q3 (cont’d)

- Measures of corporate tax burden factoring in tax-planning:
  - Backward-looking indicators:

$$Y_{ij}^{TP} = Y_{ij}^{adj} + \max(0, \theta_{ij} INT_{ij})$$

$$\theta_{ij} = \left(\frac{B_{ij} - (B/A)^{*} A_{ij}}{B_{ij}}\right)$$

  - Forward-looking indicators:
    - Review in *OECD Tax Policy Study Series* No.17 of common forms of tax-planning by multinationals.
    - OECD study provides formulae for illustrative marginal and average effective tax rates (METRs/AETRs) inclusive of tax-planning.

# IRI Assessment of ‘Fiscal Position and Planning’

- IRI assesses a country’s ability and practice in identifying / prioritizing public expenditures, forecasting tax and non-tax revenues, fiscal balance, feedback on choice over tax mix, appropriate tax burden on investment and employment.
- Assessment of models and data :
  - GDP-based tax revenue estimation models (each main tax).
  - Historical tax revenue data, non-tax revenue data, National Accounts income, expenditure, balance of payments data.
- Assessment of analysis :
  - Are GDP-based tax revenue forecasting models in place and regularly used to forecast revenues for each main tax?

# IRI Indicators ('scoring') for Forecasting 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.

# PFI Question 4 & Guidance in User's Toolkit

- **Q4.** If framework conditions and market characteristics for investors are weak, is it reasonable to assume that a low tax burden can compensate by impacting favourably on investment decisions?
- Guidance in User's Toolkit:
  - Review standard approach used by policy-makers to estimate investment response to host country tax reform.
  - Contrast predicted tax effects on FDI of standard neo-classical models versus new economic geography models.
  - Emphasize non-tax determinants of FDI , limited impact of tax on investment in certain cases; ability to tax location-specific profits.

# PFI Question 5 & Guidance in User’s Toolkit

- **Q5.** Where the tax burden on business income differs by firm size, age of the business entity, ownership structure, industrial sector or location, can these differences be justified? Is the tax system neutral in its treatment of foreign and domestic investors?
- Guidance in User’s Toolkit:
  - Encourage measurement of disaggregate average tax rates (based on micro-data, METR/AETR models).
  - Underline importance of explaining /justifying policy-driven variation in effective tax rates (by firm size, age, ownership) industry, location).

# PFI Question 6 & Guidance in User's Toolkit

- **Q6.** Are rules for the determination of corporate taxable income formulated with reference to a benchmark income definition (e.g. comprehensive income), and are the main tax provisions generally consistent with international norms?
- Guidance in User's Toolkit:
  - Encourage review of policies determining the tax base for business income, consideration of alternative design options, approaches followed in other countries.
  - Consideration of treatment of: depreciation, inventories, business losses, inter-corporate dividends, corporate capital gains/losses, allowances for the cost of corporate equity.

# IRI Assessment under 'Taxation and Investment'

- Assessment of models and data :
  - Corporate income tax (CIT) micro-simulation model, METR model, depreciation calculator model.
  - Corporate tax return data (stratified sample), survey data. Corporate and shareholder-level tax parameter data.
- Assessment of analysis :
  - Sectoral analysis of tax burden – estimation of CIT payments at firm level; total CIT payments in current year, forecast years; average tax rates (ATRs) by firm asset size, industry and location; tax revenues foregone by incentives.
  - Analysis of tax impediments to domestic investment – measurement of METRs on domestic corporate profits.

# IRI Indicators for Sectoral Analysis of taxation of corporate profit

1. 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. No current plans for implementation.
2. The Ministry of Finance does not maintain a CIT micro-simulation model, 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 tax revenue implications of tax reform.
4. Level 3 plus the requirements that a) underlying corporate tax return data are checked to identify entry/transcription errors; b) 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 sample year differ from actual corporate tax revenues by less than 2%; b) forecasted corporate revenues from micro-simulation model are cross-checked with forecasts from GDP-based corporate tax revenue model.

# IRI 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, but is currently taking steps towards implementation within one year.
3. The Ministry of Finance maintains a METR model, used to analyze tax distortions to investment and 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.

# IRI Indicators for Comparative Analysis of Tax Depreciation Systems

1. The Ministry of Finance does not undertake comparisons of depreciation systems in neighbouring countries/countries regarded as main competitors for investment.  No current planning for undertaking such comparisons.
2. The Ministry of Finance does not undertake comparisons of depreciation systems, but is gathering information to enable comparisons within 1 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.

# PFI Question 7 & Guidance in User's Toolkit

- **Q7.** Have targeted tax incentives for investors and others created unintended tax-planning opportunities? Are these opportunities and other problems associated with targeted tax incentives evaluated and taken into account in assessing their cost-effectiveness?
- Guidance in User's Toolkit:
  - Illustration – example of unintended tax planning opportunities and consequences of tax holiday incentive.

# PFI Question 8 & Guidance in User's Toolkit

- **Q8.** Are tax expenditure accounts reported and sunset clauses used to inform and manage the budget process?
- Guidance in User's Toolkit:
  - Rationale for tax expenditure accounts and reporting.
  - Incorporation of tax expenditures in fiscal planning.
  - Authorization and management of tax expenditures.

# PFI Question 9 & Guidance in User's Toolkit

- **Q9.** Are tax policy and tax administration officials working with their counterparts in other countries to expand their tax treaty network and to counter abusive cross-border tax planning strategies?
- Guidance in User's Toolkit:
  - Assessment of tax treaty network.
  - Key tax treaty articles (to be elaborated)

# Overview of topics for assessment under IRI (1st tax policy development, 2nd tax policy)

- **Fiscal position and planning:**
  - Forecasting of aggregate tax revenue for each main tax.
  - Consideration of fiscal balance.
- **Taxation and investment:**
  - Sectoral analysis of tax burden on corporations.
  - Analysis of tax impediments to domestic investment.
  - Comparative analysis of tax depreciation systems.
  - Transparency (tax expenditure reporting) and cost benefit assessment of corporate tax incentives for investment.
- **Taxation and employment:**
  - Micro analysis of taxation of wage income, income equality.
  - ‘Tax wedge’ analysis of tax impediments to employment.

# Review of elements of assessments of tax policy analysis under the IRI

- **Taxation of SMEs:**
  - Analysis of tax burden on firms by asset size.
  - Analysis of tax impediments/distortions) to SME investment.
  - Analysis of tax impediments to equity financing of SMEs.
  - Analysis of tax arbitrage by SME owners.
  - Analysis of treatment of risky investment in SMEs.
  - Assessment of tax compliance costs, alternative tax policy approaches, alternative tax administrative approaches.
  - Assessment of taxpayer assistance and education services to reduce SME tax compliance burden.

# Review of elements of assessments of tax policy analysis under the IRI

- **Taxation of MNEs:**
  - Analysis of tax burden on MNEs (cross-border investment).
  - Analysis of tax distortions to cross-border investment (FDI).
  - Analysis and treatment of thin capitalization of corporate tax base.

***Thank you***