



## GLOBAL FORUM ON INTERNATIONAL INVESTMENT

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#### **CORPORATE TAX INCENTIVES FOR FOREIGN DIRECT INVESTMENT**

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The report *Corporate Tax Incentives for Foreign Direct Investment*, the fourth issue in the new *Tax Policy Studies* series launched by the OECD, examines the currently highly topical issue of corporate tax incentives for foreign direct investment, or FDI. The work follows a 1995 OECD study on the use of tax incentives, entitled *Taxation and Foreign Direct Investment – The Experience of the Economies in Transition*. The report extends that study which focused on the experience of the previously socialist economies, by drawing additional information and lessons from the theoretical and empirical economic literature and the practical experience of OECD countries in the area of tax policy. While the report is intended primarily as a guide for policy makers in emerging market economies, it may also serve as a reference document to tax policy analysts more generally.

#### **EXECUTIVE SUMMARY**

Attracting foreign direct investment is an important policy goal for all countries, enhancing productivity and economic growth. Thus policy makers strive to ensure that their tax systems are internationally competitive and that impediments to foreign direct investment (FDI) are removed. Corporate income tax is at the centre of this debate, with much attention given to ensure that the burden it imposes is not excessive.

It is also recognised that the corporate tax system plays an important withholding function, collecting tax revenues on income derived in the host country. The desire to tax this income, while not discouraging foreign investors, raises difficult questions concerning the appropriate design of various tax rules including tax incentive provisions that together determine the host country tax burden.

This report reviews various types of corporate tax incentives for FDI and arguments often advanced for their use. The discussion takes a largely non-prescriptive approach that reviews basic considerations and conveys some of the lessons learned from a mix of theoretical, empirical and case study analysis. After first considering the role of corporate taxation in a country's tax mix, the analysis turns to consider the possible channels of influence of main tax incentive types, empirical evidence on the sensitivity of cross-border direct investment to host country tax burdens, possible host and home country tax inter-action effects and various design, implementation and tax base protection issues. The report stresses the need for efforts by policy makers to assess the likely benefits and costs of incentives, while recognising that policy officials may be confronted with demands for the adoption of investment incentives with insufficient data to assess overall effects, and possibly little leverage to discourage their use even where roughly estimated costs exceed the likely benefits.

Generally the considerations raised in the report can be seen on balance as cautionary over the introduction of special tax incentives, with simplification and base protection advantages identified with reducing the statutory corporate income tax rate as a means to lower the host country tax burden. However, the report stops short of policy recommendations, recognising that decisions over the use of incentives will depend on the specific country situation, and moreover rest in the sovereign domain of national governments.

Tax systems may be used to achieve a variety of policy objectives, with the most important role being the revenue raising function. Tax systems also have an important redistribution function, particularly in the case of income taxation. And while in general tax systems should be designed to be neutral, they may be called upon to influence resource allocation. Several arguments can be made in support of this function in the cross-border investment context, including concerns over international competitiveness, and perceived instances of market failure. For example, from a 'textbook' public finance perspective, an inefficiently low level of FDI may result in a given host country where there are positive externalities or beneficial effects from FDI that are not taken into account by foreign companies when making their outbound investment decisions.

For example, where a multinational firm is determining the amount of investment, R&D and production to undertake in a given foreign host country, the benefits that 'spill-over' to the host country economy generally would not be taken into account. The spillover benefits could include the application of new knowledge and production and process technologies by other host country firms. Similarly, FDI may confer general training and skills that could be employed elsewhere in the economy or generate demand for various factors of production in the host country that might not otherwise exist. Where foreign direct investors do not take these social benefits into account, a private market result may yield FDI levels below what would be observed if these benefits were instead factored in. In these instances, it can be argued that intervention is necessary to correct for instances of 'market failure' to yield a more globally optimal allocation of capital.

However, while market failure, international competitiveness and perhaps other arguments may point towards intervention in the market, possibly through the tax system, it is critical that host country investment conditions and characteristics be assessed in order to gauge whether possible impediments to investment could be overcome by subsidies, including the use of tax incentives. As stressed in the report, when tasked with addressing calls for the introduction of incentives for FDI, it is critical that host country policy makers ask:

What are the impediments inhibiting investment, and can they be addressed in a cost-efficient way through the use of tax incentives?

This difficult question runs to the heart of the decision of whether or not to introduce special tax relief mechanisms. In cases where FDI activity is low, policy analysts need to address the impediments and

question whether these should be tackled through the tax system, or through structural policy changes in other areas, or both. The report reviews a number of market and policy related considerations that bear on private FDI decisions and condition the influence of tax incentives. The review highlights the need for policy makers to identify and assess the implications of possible impediments, at least on an approximate basis and for broad industry classifications.

Often, where taxation is identified as a significant factor influencing FDI, transparency, simplicity, stability and certainty in the application of the tax law and in tax administration are often ranked by investors ahead of special tax incentives. Tax relief may enhance the attractiveness of a potential host country, but experience shows that in many cases the relief provided will be insufficient to offset additional business costs incurred when investing there. Where incentives cannot be expected to compensate for additional business costs and losses incurred when investing in a potential host country, then their use and the net burden imposed on the host country from running the program should be avoided. In particular, in such cases it would be best to avoid the administration and compliance costs and tax revenue losses from the inevitable 'leakage' of tax incentive relief to non-targeted business activities.

Where a firm is able to generate profits from undertaking certain business activities in a given host jurisdiction, tax incentives may be successful in attracting additional FDI, and may be viewed as necessary where similar relief is being offered by another (e.g., neighbouring) jurisdiction also competing for foreign capital. This raises questions concerning the appropriate form and scale of tax incentive relief, as well as a range of other design issues. It also raises the question of whether foreign direct investors could earn competitive "hurdle" rates of return in a given host country and in competing jurisdictions in the region in the absence of special tax incentives. In such cases, policy makers may wish to discuss the possibility of policy co-ordination in the area of tax incentives to avoid revenue losses and providing foreign investors with "windfall gains" – that is, tax relief above that necessary to realise competitive after-corporate tax rates of return – and also to address possible equity and efficiency concerns linked with the use of special tax incentives.

Where additional FDI resulting from tax relief can be expected, it remains prudent to assess whether the stream of benefits from increased FDI, including host country taxes collected on profits from an increased capital stock and possibly other spill-over effects, can offset the stream of costs associated with the tax incentive provisions. In other words, policy makers should be encouraged to undertake an analysis of the social benefits and costs of tax incentive use with the same rigour that foreign investors assess the relative private benefits and costs of investing in the host country.

Host countries may provide relief from tax on income generated at the corporate level in a number of ways. A 'tax holiday' exempts newly-established firms from corporate income tax, and possibly other taxes, for a specified number of years. A targeted (or broad based) reduction in the statutory or "headline" corporate income tax rate reduces the amount of host country tax levied on targeted (or broadly defined) taxable profits. Enriched capital cost allowances, including accelerated and enhanced write-offs for qualifying capital costs, lower the calculation of taxable profits. General or targeted investment tax credits earned at a given rate on qualifying investment provide a straight reduction to corporate tax otherwise payable where, unlike tax deductions, the value of the incentive is independent of the setting of the statutory corporate tax rate. Dividend withholding tax rate reductions and imputation relief providing an offset to corporate tax on distributed profit may operate in certain cases to lower the discount rate applied by foreign investors to after-tax cash flows from FDI.

Investment expenditures may respond positively to each of these tax incentives. A reduction in the statutory tax rate applied to corporate profits, or a temporary waiving of this tax as under a tax holiday, generally would be expected to boost investment by increasing the amount of after-tax profit earned on new investment and on the existing capital stock. Theory predicts that 'up-front' incentives, including

investment tax credits and immediate expensing of capital costs, would yield a larger investment response for each currency unit of tax revenue foregone. Unlike a corporate tax rate reduction, investment tax credits and other up-front subsidies to the cost of purchasing capital benefit only new investment. Therefore, they provide a larger reduction in the effective tax rate on investment at a lower cost, taking into account the impact of taxation on both marginal revenues and costs. A reduction in the statutory corporate tax rate, in contrast, benefits both "new" as well as "old" (previously installed) capital. Financing incentives may also operate to encourage new equity investment in a host country, provided the relief is offered to the "marginal investor" establishing required hurdle rates of return, and is not offset by home country taxation.

The potential impact of tax incentives in influencing investment behaviour would also be expected to vary across business activities/sectors, host jurisdictions and over time, and to be greater the more competitive is an investment location on a pre-tax basis. In general, the FDI response to a given amount of tax relief would be greater where provided to business activities where non-tax business costs (factoring in labour, material, energy, and capital costs) and expected risk-adjusted pre-tax profit rates are similar in competing jurisdictions. In other words, a narrowing of differences in non-tax business costs and pre-tax profit rates across competing locations would tend to make tax differentials a more important factor in locational choice.

Where for example, a number of countries are short-listed as potential locations on the basis of similar expected pre-tax profit rates, incentives may be influential at least in the short run in influencing location decisions. The ability to realise similar pre-tax profits out of alternative sites would depend on not only the countries examined, but also the nature and geographic mobility of the business activity, with certain activities more mobile than others. To take an example, tax incentives could be expected today to have a significant effect on the locational choice for group financing and related activities, where recent advances in data management and telecommunications have significantly reduced non-tax cost differentials across competing alternative sites through which to conduct such activities.

Finally, the trend towards increased trade and investment liberalisation and increased competitive pressures accompanying globalisation could also be expected to increase the potential role of taxation in influencing investment behaviour. Most obviously, the process of trade and investment liberalisation, by expanding investment opportunities and the overall level of cross-border investment, expands the number of possible investment flows that incentives seek to attract. Another important factor is that tax incentives are more likely to 'bite' (i.e., operate at the margin to swing investment choice) where profit margins are thin, making tax relief a more important factor. In general, the creation of economic rents (profits in excess of minimum shareholder required rates of return) made possible by protected markets and output restrictions tends to dominate (cancel out) tax incentive considerations. Tax relief may alter realised rates of return, but where these rates are in excess of required rates of return, the importance of such relief is diminished. In contrast, tax incentive relief may be expected to be more of a factor with increasing competition and a narrowing of profit margins over time in a number of sectors, accompanying economic liberalisation.

These considerations offer a first round summary of the potential effects of host country tax incentives. However, they are subject to a number of important qualifications concerning the amount of tax relief that ultimately gets realised by investors, and the 'incremental' (i.e., additional) amount of investment that can be expected. The first issue involves addressing tax-interaction effects, where often the tax rules of several countries will factor into the relevant investment structure (for example where financing is through an offshore affiliate). After reviewing the basic approaches used by OECD countries in taxing profits on foreign direct investment, the report considers a number of factors that tend to either offset or reinforce host country tax relief. Factors considered include the sources of funds used to finance FDI at the margin, the possible 'mixing' of foreign source investment income for foreign tax credit purposes, and possibilities for deferral of home country taxation. Also factored into the analysis is the use of tax havens to shelter

foreign source income, challenged in some cases by the application of ‘controlled foreign company’ rules which can fully offset host country tax relief (so that incentives merely cause a transfer in tax revenues from the host to the home country treasury). Advantages and constraints associated with ‘tax sparing’ agreements, which have the explicit goal of protecting host country tax incentives, are also reviewed.

Assessing the net benefit to a host country of introducing a given tax incentive depends critically on the *additional* amount of FDI undertaken as a result of the tax relief. Where an incentive is introduced and investors take advantage of the tax relief, a certain amount of FDI activity will be observed and associated with the tax incentive program. But that activity may have occurred in any event, in which case the tax relief provides a ‘windfall gain’ to investors. Much thought and empirical analysis has addressed the question of the relationship between the level of investment flows and the effective rate of corporate taxation in attempting to identify the link between tax relief provided and resulting incremental activity.

While answers to these questions have by no means been fully resolved, important developments in the understanding of the main factors and their inter-dependencies have been achieved, and some real progress has been made over the last decade in empirical testing of investment models. Recent applied work using improved data on FDI and sophisticated estimation techniques would appear to offer convincing evidence that host country taxation does indeed influence investment flows, and that this influence is increasing over time.

An important implication of the recent work is that host country taxation is an increasingly important factor in locational decisions, which is not surprising given the gradual pervasive reductions over time in non-tax barriers to FDI flows, including the abolition of investment and currency controls, and the ongoing process of globalisation with increased mobility of an expanding set of business activities. However, due to a number of persistent limitations ranging from data measurement problems to restrictive modelling assumptions, the estimates provided of the responsiveness of FDI to changes in the after-tax rate of return on FDI (and through this channel, to changes in the level of tax incentives for FDI) must be used with caution when applied to measure the cost-effectiveness of a given tax incentive measure.

While indicating that the sensitivity of FDI to host country tax burdens appears to be increasing over time, the empirical applications of investment models unfortunately offer few clues to the question of how host country tax burdens might best be lowered to attract additional FDI. The reason is that the explanatory variables used (summary marginal and average effective corporate tax rates) are measured as an amalgam of relevant tax and non-tax parameters. By aggregating relevant factors, the individual influence played by each is masked. Thus policy makers must look to other areas to guide their choice over alternative tax instruments and policies to encourage FDI. The report therefore reviews a number of policy considerations and design issues relevant to the choice of alternative tax incentive measures. The report emphasises that the exercise should begin with policy makers assessing their own country situation and the strength of arguments calling for tax incentives for FDI to correct for market failure or other market or policy-related impediments to FDI. Often a preferable route will be to address non-tax policy-related impediments to FDI prior to, or at a minimum, parallel with, the introduction of tax incentives.

The analysis in the report, which touches on a number of considerations tied to the use of tax incentives, indicates perhaps above all that there are a variety of difficult issues for policy makers to contend with. Identifying impediments to FDI and assessing whether these can be offset by tax incentives raises difficult data availability and analytical problems. Assessing the likely investment response is made difficult by the paucity of information on the elasticity or responsiveness of FDI with respect to host country effective corporate tax rates. It would be prudent for analysts to use lower bound estimates in cases where host country impediments to FDI are more pronounced than in host countries from which reported sample estimates are derived. These lower bound estimates translate into conservative estimates of additional tax base and other spillover benefits to the host country economy. At the same time, policy makers should not

underestimate tax-planning initiatives of investors and should assess the strength of domestic base protection provisions, particularly if a tax holiday or similar measures are being considered.

Importantly, the choice over alternative tax incentives will depend on the specific country circumstances. For example, the findings in the report call for caution in the use of up-front tax incentives, particularly if the basic statutory corporate income tax rate is relatively high and if refund provisions are offered. Some would judge the evidence on balance as favouring a lowering of the statutory corporate tax rate, which not only spurs investment (despite dampening effects working through the cost of debt finance and the valuation of depreciation allowances), largely by rewarding the productive use of inputs in generating profit rather than subsidising the purchase of inputs, but also can alleviate tax-planning pressure on the domestic tax base. However, where tax revenues are derived largely from an existing capital stock that would enjoy a windfall benefit from a rate reduction, the revenue loss on existing capital may be viewed as too large. In other words, the policy decision may depend critically on the amount of existing versus new tax base that benefits from the rate reduction.

In the end, the choice over the appropriate tax incentive or mix of tax incentives and the basic decision of whether or not tax incentives should be used to bolster FDI will depend on individual country circumstances and perspectives. The report offers a range of information and analysis that may be useful to policy makers in shaping policy decisions in the area of tax incentives for FDI.