FEBRUARY 2008 Policy Brief

ORGANISATION FOR ECONOMIC CO-OPERATION AND DEVELOPMENT

Tax Effects on Foreign Direct Investment

Introduction

Virtually all governments are keen to attract foreign direct investment (FDI). It can generate new jobs, bring in new technologies and, more generally, promote growth and employment. The resulting net increase in domestic income is shared with government through taxation of wages and profits of foreign-owned companies, and possibly other taxes on business (*e.g.* property tax). FDI may also positively affect domestic income through spillover effects such as the introduction of new technologies and the enhancement of human capital (skills). Given these potential benefits, policy makers continually re-examine their tax rules to ensure they are attractive to inbound investment. Tax policies may also support direct investment abroad, as outbound investment may provide efficient access to foreign markets and production scale economies, leading to increased net domestic income.

At the same time, governments continually balance the desire to offer a competitive tax environment for FDI, with the need to ensure that an appropriate share of domestic tax is collected from multinationals.

But while tax is recognized as being an important factor in decisions on where to invest, it is not the main determinant. FDI is attracted to countries offering: access to markets and profit opportunities; a predictable and non-discriminatory legal and regulatory framework; macroeconomic stability; skilled and responsive labour markets; and well-developed infrastructure. All of these factors will influence the long-term profitability of a project.

Policy makers face many complex issues and questions in this area, such as: How sensitive is FDI to taxation? How does tax planning factor in? What are the main policy considerations guiding the taxation of inbound investment, and outbound investment? How have countries responded to pressure to reduce taxes on FDI? This *Policy Brief* looks at recent OECD work on these issues. ■

Observer oecd

How sensitive is FDI to taxation?

At the centre of debate over what is the appropriate level of a host country's corporate tax burden is the difficult question of how FDI reacts to taxation. Addressing this issue is crucial to assessing how to address pressures for internationally competitive tax treatment of FDI. It is also essential for carrying out cost/benefit assessments of tax relief provided for such investments, and for estimating the impact on tax revenues of any reform of corporate tax policy.

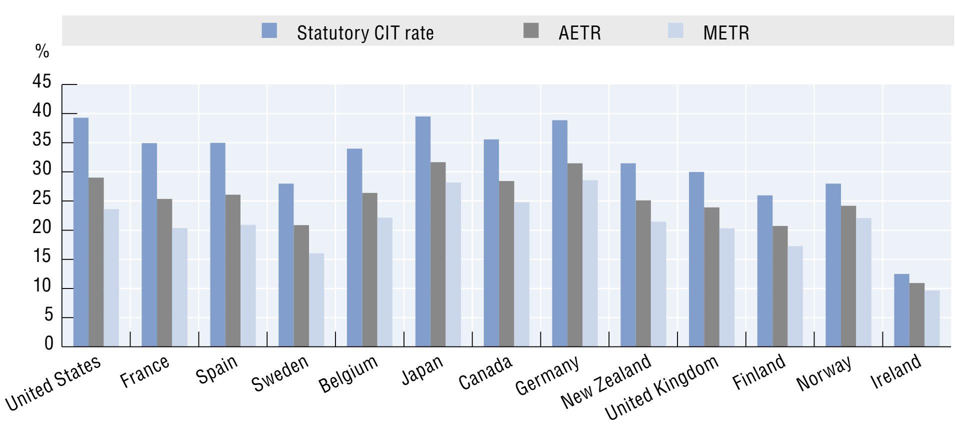
Studies examining cross-border flows suggest that on average, FDI decreases by 3.7% following a 1 percentage point increase in the tax rate on FDI. But there is a wide range of estimates, with most studies finding decreases in the range of 0% to 5%. This variation partly reflects differences between the industries and countries being examined, or the time periods concerned. Some recent studies find, for example, that FDI is becoming increasingly sensitive to taxation, reflecting the increasing mobility of capital as non-tax barriers to FDI are removed. Such estimates may be used to estimate the long-run impact on FDI of corporate tax reform.

In gauging how FDI responds to tax reform, one uncertainty is how tax factors into FDI decisions, and what tax rate(s) are considered by investors. Comparisons may focus on statutory "headline" corporate income tax (CIT) rates. Or it may be that average effective tax rates (AETRs) or marginal effective tax rates (METRs) matter more than headline rates, as they incorporate rules determining the percentage of profits that are taxable. AETRs consider the average tax burden on investment projects, while METRs consider the tax burden at the margin (on the last unit of capital invested in a given project, where profits are exhausted). Statutory tax rates may differ significantly from effective tax rates, to the extent that taxable profits differ from true (economic) profits (see Figure 1).

There is also the question of how tax planning factors in (discussed below). Another difficulty is that the FDI response to tax reform is unlikely to be uniform (as standard analytical frameworks assume), and could be expected to depend on a number of factors that are difficult to measure and account for.

Figure 1.

STATUTORY AND EFFECTIVE CORPORATE TAX RATES, 2005



Recent analysis supports the view that the sensitivity of FDI to tax depends on the host country and the mobility of business activities underlying the tax base. In particular, where firms benefit from locating production in large markets to reduce the costs of trade, such as transportation costs, a certain degree of inertia is predicted in the location choice of firms. Host country benefits and some fixity of capital mean that profits may be taxed up to some point without discouraging investment. This view is consistent with the observation that a number of OECD economies with large domestic output markets and strong FDI inflows (*e.g.* US, Japan and Germany) have relatively high corporate tax rates (see Figure 1). New explanatory models also suggest that the optimal tax rate on business falls as trade costs fall and capital is more mobile. This view is consistent with the observation that a number of countries impose a lower tax burden on more mobile business activities such as shipping, film production or head-office activities. ■

How does tax planning factor in?

Most studies of the effects of tax reform on FDI ignore tax-planning strategies used by investors to lower their tax burden. But tax planning activities seem to be significant and growing, and recent OECD work encourages analysts to factor in the effects of tax planning activities when analyzing the impact of taxation on FDI (see Box 1). Future work in this area might lead to improved estimates of the tax burden on FDI and of the tax sensitivity of FDI. ■

What policy considerations shape taxation of inbound FDI?

Tax competition for FDI is a reality in today's global environment. Investors routinely compare tax burdens in different locations, as do policy makers, with comparisons typically made across countries that are similar in terms of location and market size. A widely-held view is that taxes are likely to matter more in choosing an investment location as non-tax barriers are removed and as national economies converge.

There is broad recognition that international tax competition is increasing, and that what may have been regarded as a competitive tax burden on business in a given host country at one point in time may no longer be so after rounds of tax rate reductions in other countries.

However, it is not always clear that a tax reduction is required (or is able) to attract FDI. Where a higher corporate tax burden is matched by well-developed infrastructure, public services and other host country attributes attractive to business, including market size, tax competition from relatively low-tax countries not offering similar advantages may not seriously affect location choice. Indeed, a number of large OECD countries with relatively high effective tax rates are very successful in attracting FDI. This points to the importance of market size and other host country attributes in attracting FDI and the presence of location-specific profits that governments are able to tax.

It is also clear that a low tax burden cannot compensate for a generally weak or unattractive FDI environment. Tax is but one element and cannot compensate for poor infrastructure, limited access to markets, or other weak investment conditions. Also, while attention often focuses on corporate income tax, the importance of other taxes must be recognised. Energy taxes, payroll taxes and non-profit-related business taxes are increasingly under the spotlight by investors and policy makers.

Another factor is how business-friendly the tax administration is perceived to be. Investors look for certainty, predictability, consistency and timeliness in the application of tax rules, and in many cases these considerations are as important as the effective tax rate paid.

The tax environment will also be influenced by the need of governments to introduce anti-abuse measures to protect the tax system from sophisticated tax planning and aggressive tax schemes which exploit differences across tax systems. A key challenge is striking a balance in devising rules to adequately protect the tax base, without imposing excessive compliance cost on business. In doing so, it can be difficult to accurately weigh business arguments that FDI will locate elsewhere unless the scope of tax base protection measures is reduced. ■

What policy considerations shape taxation of outbound FDI?

In many countries, while there has been a great deal of debate about taxing inbound FDI, there has been surprisingly little public debate over what tax policies should be followed for outbound investment, and how the tax burden should compare with that for domestic investment and inward FDI.

Tax neutrality between domestic and outbound investment (imposing the same tax burden on both) is an underlying policy goal for certain countries. Neutrality encourages investment decision-making on the basis of business considerations aiming to maximise (pre-tax) returns. Indeed, the approach of taxing domestic and outbound investment at equivalent rates is often identified as a core principle underlying the adoption of a "dividend credit"

Box 1.

TAX PLANNING TO REDUCE EFFECTIVE TAX RATES ON FDI

Tax planning can significantly reduce the tax burden on FDI. Consider an illustrative example of a parent company taxed by its home country at 30% on profits on domestic investment, while taxed by LowTax country at 19% (income plus withholding tax) on profits on FDI in LowTax (see Figure 2).

If the home country taxes profits on FDI under a dividend credit system that provides a tax credit for taxes imposed by LowTax, the tax burden on FDI, as measured by the average effective tax rate (AETR) would be the same, at 30% (column CR1). If instead the home country operates a foreign dividend exemption system, the tax burden (AETR) on FDI is only 19% (column Ex1), implying a tax bias towards FDI. If the parent company borrows to finance FDI, the AETR would be lower in both cases, given the tax deductibility of interest expense (Cr2, Ex2). If the multinational partly finances FDI using a hybrid instrument (regarded as debt by LowTax authorities, but as equity by home country authorities), the AETR is significantly lower in the dividend exemption case (Cr3, Ex3).

And if the multinational routes its FDI to LowTax through a finance subsidiary in a tax haven, enabling it to avoid home country tax and lower taxable profit in LowTax (*e.g.* using deductible interest payments on an inter-affiliate loan), the AETR on FDI is only 0.5% under both dividend credit and exemption systems (Cr4, Ex4).

system (taxing foreign profits at domestic rates, with a tax credit for foreign taxes already paid on foreign profit). The main insight is that a fixed pool of capital is most productive when allocated across countries so that pre-tax rates of return are everywhere the same, a result predicted in the absence of taxation under competitive conditions. The same outcome may be predicted with taxation, where investors allocate capital so that after-corporate tax rates of return are equalized, if domestic and foreign profits are subject to the same effective tax rate.

Fully equivalent treatment of domestic and foreign profits requires current taxation at domestic tax rates of foreign profits, with full relief for income and withholding tax levied by the host country. In practice, this treatment is not observed for various reasons, including complexity, cash-flow problems, possible revenue loss, and international competitiveness pressures that limit the reach of domestic taxation of foreign profits.

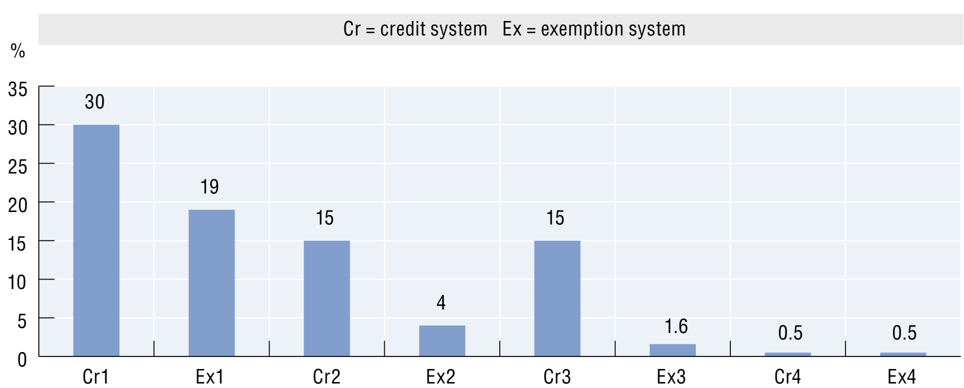
Dividend credit systems generally allow deferral of home country tax until foreign profits are paid out. Also, rules may not exist to tax foreign profits routed to a tax haven. If such rules are in place, various techniques (*e.g.* the use of so-called "hybrid entities" regarded by one country as a separate corporation, and by another as a branch) may be used by investors to circumvent their application. Home country tax may also be avoided by using sophisticated financial instruments, for example so-called "hybrid instruments" regarded by one country as debt, and by another as equity.

Most OECD countries operate dividend exemption systems. Exempting foreign profit from domestic tax avoids a possible tax impediment for domestic firms competing in foreign markets with other investors subject only to

Figure 2.

AVERAGE EFFECTIVE TAX RATES (AETRs) FOR FDI INTO LOWTAX COUNTRY

Under four alternative financing cases



the same local (host country) tax burden. Moreover, exempt treatment may avoid distorting ownership patterns which, when free of tax, would tend to maximise world output through a competitive bidding process that would normally result in firms with higher productivity outbidding others competing for capital.

However, this argument assumes that investors face only local competitors operating in a given host location. While this may be the case for certain business activities, it may not be the case for geographically mobile business activities employing intangibles, such as research and development or computer chip production. Such mobile activities may access markets efficiently from any one of a number of locations. In such cases, consideration must be given to effective tax rates in (all) host countries in which competing businesses are located, which may differ considerably across host countries. Moreover, various tax-planning strategies used by companies may mean different effective tax rates on profits for different competing investors, even where competition is localised in one country. Thus, on balance, tax distortions to investment may result under either system (dividend credit or exemption) on account of these considerations. ■

How have countries responded to pressures to lower tax on FDI?

Governments have responded to these competitive pressures in different ways. Many have reduced the statutory corporate income tax rate, as this is a relatively simple change to introduce and is readily observed. It is also directly relevant to investors anticipating pure economic profits, improves tax efficiency when combined with reforms to broaden the tax base and limits incentives for tax avoidance. However, such reductions tend to be expensive in terms of revenue foregone, may be seen as unfair, and may create pressures to reduce personal income tax rates as well. In general, rate cuts have been accompanied by measures to broaden the tax base, thereby reducing the overall revenue costs.

Rather than reducing the burden of general tax provisions, some countries prefer to explicitly target tax relief to certain sectors or activities, to encourage investment at lower foreign revenue cost. Belgium, for example, previously targeted relief to co-ordination centres performing certain group service functions, while certain other countries give preferential treatment to holding companies. Targeting mobile activities is regarded by some as an attractive option. Some countries target certain activities as a matter of national industry policy, while others target tax relief only where there is believed to be market failure.

Governments are also reviewing the tax treatment of outbound FDI. Some provide tax treatment that permits relief from home country tax that goes well beyond that under the 'old' competitiveness argument, which calls for a home country tax exemption or deferral for undistributed foreign active business income, despite neutrality and equity considerations favouring increased (not reduced) taxation of foreign income. Decisions to waive or preferentially treat outbound FDI reflect increased mobility of capital and business calls for more lenient home country treatment. These developments, combined with the "hollowing-out" of host country corporate tax bases by exempting interest, royalties and other amounts deductible at source are inconsistent with equity and neutrality, but may be viewed as difficult to resist given their acceptance by other governments, and fears over the mobility of capital.

Governments are trying to improve the business friendliness of their tax administration by improving the transparency and certainty of tax treatment. At the Fourth meeting of the OECD's Forum on Tax Administration in January 2008, which brought together Tax Commissioners from over 40 OECD and non-OECD countries, discussions focused on approaches to enhance the relationship between revenue bodies and taxpayers. Many countries have introduced advance ruling procedures where tax authorities will respond in advance to questions about the tax status of a particular type of investment. Tax treaties and mutual agreement procedures are also identified as key to certainty and stability in the treatment of cross-border investment. ■

Where do we go from here?

Going forward, the limits of tax competition can be expected to be further tested, with further reductions in corporate tax burdens on inbound investment resisted where viewed by policy-makers as unnecessary to attract investment, owing to host country attributes, and raising equity concerns.

Increased vigilance by countries may also be exercised to limit artificial shifting of tax base to no/low tax havens, to avoid imbalances in the global tax system. Different approaches in the treatment of inbound and outbound investment can be expected across countries, reflecting different country circumstances. The sharing of experiences in addressing these challenges will no doubt be increasingly helpful, as policy makers refine the scope of their national tax systems. ■

For further information

For more information on the OECD's work on FDI and taxation, please contact W. Steven Clark, tel.: +33 1 45 24 96 66, e-mail: steven.clark@oecd.org.

The OECD Policy Briefs are available on the OECD's Internet site: *www.oecd.org/publications/Policybriefs*

ORGANISATION FOR ECONOMIC CO-OPERATION AND DEVELOPMENT

For further reading

OECD (2008), **Tax Effects on Foreign Direct Investment – Recent Evidence and Policy Analysis**, OECD Tax Policy Studies No. 17, ISBN 978-92-64-03837-0, € 50, 188 pages.

OECD (2006), **Policy Framework for Investment**, available at: *www.oecd.org/daf/investment/pfi*.

OECD (2006), **Policy Framework for Investment: A Review of Good Practices**, ISBN 978-92-64-02586-8, € 50, 258 pages.

OECD (2002), **Checklist for Foreign Direct Investment Incentive Policies**, available at: *www.oecd.org/dataoecd/45/21/2506900.pdf*.

For information on proceedings of the Fourth meeting of the OECD's Forum on Tax Administration, visit: *www.oecd.org/document/39/0,3343,en_2649_37427_39886055_1_1_1_37427,00.html*.

Also visit: *www.oecd.org/taxation*.

OECD publications can be purchased from our online bookshop:
www.oecd.org/bookshop

OECD publications and statistical databases are also available via our online library:
www.SourceOECD.org

Where to contact us?

OECD HEADQUARTERS
2, rue André-Pascal
75775 PARIS Cedex 16
Tel.: (33) 01 45 24 81 67
Fax: (33) 01 45 24 19 50
E-mail: sales@oecd.org
Internet: *www.oecd.org*

GERMANY
OECD Berlin Centre
Schumannstrasse 10
D-10117 BERLIN
Tel.: (49-30) 288 8353
Fax: (49-30) 288 83545
E-mail: berlin.centre@oecd.org
Internet: *www.oecd.org/berlin*

JAPAN
OECD Tokyo Centre
Nippon Press Center Bldg
2-2-1 Uchisaiwaicho,
Chiyoda-ku
TOKYO 100-0011
Tel.: (81-3) 5532 0021
Fax: (81-3) 5532 0035
E-mail: center@oecdtokyo.org
Internet: *www.oecdtokyo.org*

MEXICO
OECD Mexico Centre
Av. Presidente Mazaryk 526
Colonia: Polanco
C.P. 11560 MEXICO, D.F.
Tel.: (00.52.55) 9138 6233
Fax: (00.52.55) 5280 0480
E-mail: mexico.contact@oecd.org
Internet: *www.oecd.org/centrodemexico*

UNITED STATES
OECD Washington Center
2001 L Street N.W., Suite 650
WASHINGTON DC. 20036-4922
Tel.: (1-202) 785 6323
Fax: (1-202) 785 0350
E-mail: washington.contact@oecd.org
Internet: *www.oecdwash.org*
Toll free: (1-800) 456 6323

The OECD Policy Briefs are prepared by the Public Affairs Division, Public Affairs and Communications Directorate. They are published under the responsibility of the Secretary-General.

00 2008 17 1 P4