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TAXATION AND INVESTMENT PROMOTION[*]

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Introduction

Most developing countries make extensive use of tax policy instruments to attract investments, promote industrial and technological development and create jobs. Nevertheless, the actual effect of tax incentives on business activities and behavior is still a matter of extensive debate[1]. Many technical studies have highlighted the limitations of tax instruments but most policymakers are reluctant to accept the possibility that tax incentives usually have little effect on ultimate business decisions. Yet taxes do matter to business and influence investment decisions. When taxation is not sound it hurts the business climate and hampers economic activities. Since the primary intent of tax incentives is to encourage capital accumulation in specific activities or locations, the question remains open if their extensive use will result in the desired response.

A thorough survey[2] of 75 studies conducted in the US on the role of taxation by state and local governments on economic development, namely of employment growth, investment growth and firm location, concludes that taxes usually have a small effect on firm behavior. According to this survey the median <u>interregional</u> elasticity of economic activity with respect to taxes of 38 studies conducted in the past present medians clustering around –0.1, which means that 10% lower taxes would raise employment, investment or firm births by 1%. However, <u>intraregional</u> studies produce tax elasticities that are quadruple or more of those found in the interregional studies. The reason may be that the smaller the area over which a business is choosing a location, the more similar the non-tax factors are, and hence taxes would matter more.

In the international context, taxes are also secondary elements in the attraction of investments, following more relevant factors like market size, presence of competitors, access to raw materials, availability of skilled or cheap labor, political and macroeconomic stability and the rule of law. However, as a result of increasing economic integration, particularly regional trade agreements, tax incentives are becoming a decision factor of growing importance for FDI location. Regional economic integration tends to develop more homogeneous regional markets, and as non-tax factors become more similar, taxes will matter more to the final location decision.

The tax environment of the host country and how it interacts with the tax provisions of the home country will have direct effects on how firms structure themselves and do business abroad. The tax treatment of technical assistance, assignments rights, use of patents and technology transfer, copyright royalties, and even of expatriate employees' income working for MNEs have great influence in shaping FDI. The same holds when there are differentiated withholding tax treatments for interest payments on debt securities or bank loans obtained abroad, for instance. Since taxes constitute a cost component, firms will always try to reduce them in order to increase competitiveness and maximize net gains. Governments know that, and many times face a dilemma since they need tax revenues but have other considerations in their agenda as well.

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[1] Shah, Anwar (ed.) 1995. "Fiscal Incentives for Investment and Innovation." Oxford University Press.
[2] Wasylenko, Michael. 1997. "Taxation and Economic Development: The State of the Economic Literature." New England Economic Review, March/April, pp. 37-52.

Objectives and instruments

Tax incentives can be defined as those provisions in tax legislation that give privileged treatment to some activities, assets, forms of organization or financing. Governments provide them in order to encourage specific enterprises or categories of enterprises to behave in a certain manner. They act by either increasing the rate of return of a particular investment or by reducing its costs or risks. The ultimate objective is to promote additional investments that will increase income and create jobs. However, from the economic standpoint, the incentives should not affect the precedence of the different investments (Harberger neutrality).

Since development tends to be unevenly distributed, countries often employ tax incentives to channel investment to foster economic development in certain regions, by creating differential treatment in comparison to the tax treatment prevailing in other regions. The same holds for economic sectors, especially for industries and activities considered crucial for development. Most of the time they relate to investment in manufacturing, exploration or extraction of minerals, promotion of exports or tourism. Incentives can also be used to attract investment that will favor the transfer of technology, R&D and pioneer industries.

According to an extensive survey[3] of tax incentive regimes in 45 countries from all regions of the world, nearly all had incentives targeting specific sectors, over 90% offered some type of export-oriented incentive and 70% had regional incentives targeting rural or underdeveloped areas. The types of incentive most extensively used are tax holidays or tax rate reductions, offered by 85% of the countries.

Most governments actively promote their countries as investment locations to attract FDI. The fundamental premise behind this behavior is that foreign investment creates more value for the host country than for the foreign investor. That may be so because FDI involves more than the mere flow of capital, but also the application of intangible assets such as technology and managerial expertise. If these intangible assets were completely internalized, they would be fully captured by the rate of return of the investments, and tax incentives would not be justified. But since there are spillover effects, free ridership will occur and these intangible assets will end up benefiting other sectors of the host economy, and that would justify the tax incentives.

Tax incentives can be profit or income-based and focused to reward capital investment or labor-related expenditures. The tax benefits can be given in exchange for sales, job placements, value-added, import substitution or export targets.

Tax holidays are the most common form of tax incentives. Under this modality of incentive, eligible newly established firms are exempt from paying corporate income tax for a specified time period. However most new enterprises usually do not produce

[3] UNCTAD. 2000. "Tax Incentives and Foreign Direct Investment: a Global Survey." United Nations, New York and Geneva.

positive net income in the first years. If the losses incurred in the holiday period are not allowed to be carried forward to compensate future profits, the incentive may be useless. The use of reduced corporate income tax rate is also observed in many countries as an incentive for investments in certain regions or sectors, yet tax holidays and reduced corporate income tax rates can be useless as incentives to attract FDI from countries like the US that adopt the worldwide income approach to taxation. Under this system all the net revenues of American companies and their controlled foreign corporations (CFC) are subject to US taxation, although a tax credit is provided to avoid double taxation. Therefore, if a host country provides a tax holiday or reduced taxation to an American CFC this would probably only result in additional tax revenue to the U.S. Treasury.

A more effective way of lowering the tax burden is by artificially reducing the companies' net revenues and not the nominal tax rates. One mechanism often used is to permit investors to carry losses forward (or backward) for a significant number of years. Accelerated depreciation also allows investors to reduce taxable revenues as a result of investments, and this is very important to a firm's cash flow in the years they are paying debt associated with the investments. In some countries direct investment allowances are granted as deductions against taxable income (enhanced deduction), usually as multiples of the actual capital cost. But the ultimate result of all these incentives depends on the applicable corporate income tax rate, and for that reason they are frequently granted together with tax rate reductions or are provided not as deductions (allowances) but as investment tax credits. Another form of incentive to attract FDI is the use of reduced taxes on remittances of dividends or of interest abroad. The latter reduces financing costs but the former could eventually stimulate the repatriation instead of reinvestment of capital.

Double taxation and the treatment of foreign income

In the case of international investments, both home and host countries may tax income of foreign firms. This possibility of overlapping jurisdiction can result in double taxation, a very unfavorable situation for FDI. The preferred way of dealing with this problem is the negotiation of double taxation treaties (DTT's), and they either allow for exemption of income generated in a host country or a credit for the taxes paid. These agreements, however, may offer a windfall gain to the investor and may not ensure net additional investments. That is, DTT's may encourage the repatriation of profits instead of promoting reinvestments in the host country[4].

The full tax treatment of FDI will ultimately depend on the way that home countries tax income earned in host countries. There are two basic principles adopted: the worldwide or residence principle, where all income is taxed in the home country, even when it was already taxed in the host country, and the territorial principle, whereby all income generated in the country's territory is equally taxed, regardless of the residency of the owners. When the territorial principle is adopted in the home country of the foreign investors (such as France), no tax is imposed on the foreign earnings of residents, and tax incentives granted by host countries can be highly effective. As mentioned before, when

[4] Another benefit of DTT is legal protection and stability.

home countries adopt a residence-based principle of income taxation (such as the US, UK and Japan), tax incentives can many times be useless. In this case, countries limit themselves to applying a withholding tax on repatriation of profits, levied at rates that do not exceed home country rates, since this will ensure a full compensation from the home country tax credit. However, most capital exporting countries that adopt the worldwide system (except the US) have entered tax-sparing agreements with developing countries. This means that the home country allows the tax credit at the home country tax rates for foreign taxes that have not been effectively paid. In this case, the lower the effective tax rate of the host country, the greater the incentive to attract FDI.

Incentive administration and credibility of the tax regime

The four stages concerning the establishment of a tax incentives system are: a) design, b) concession, c) implementation, and d) compliance control. The success of a tax incentive regime will depend on each and every stage. Although incentives are part of the tax legislation, they are often managed by agencies other than the tax administration, and this can lead to business inconveniences and ultimately seriously affect the final results. In federal systems of government, the national and state governments may offer different tax incentive packages and not coordinate between themselves. Competition between different subnational governments could be good for firms but detrimental to the overall interests of the country.

Frequent changes in the tax regime or excessive flexibility in the design or application of the incentive package (including other non-tax benefits) can complicate the analyses of the tax incentives. A policy that is seen as temporary may have little effect to attract investments. Furthermore, the perspective that a competitor might receive an even better treatment further down the road can also water down what was originally intended. If the tax regime is not credible, investors seek rates of return significantly higher than in a lower risk environment and the subsidies provided through the tax incentives may prove to be insufficient. Stability and predictability are highly appreciated particularly in long-run investments such as oil and mineral industries.

It is not advisable to provide tax incentives as a form of ad hoc tax reform in order to remedy systematic deficiencies of the tax system. If the business climate in a country is a problem, this may indicate that a comprehensive tax reform may be needed rather than makeshift adjustments. Tax incentives usually only provide assistance to new companies, and the sound functioning of existing firms may prove essential to the economy and the overall business climate.

Globalization, trade agreements and investment promotion

Globalization is the result of the growing integration of economies and societies around the world. Integration has resulted from reduced transport costs, lower trade barriers, rising capital flows and faster communication of knowledge and ideas. Although it has generated economic opportunities, the integration process does not come without risks and problems. The growing interdependency among national economies generates a

smaller tolerance for divergence in their domestic policies, which calls for stronger international coordination.

Particularly in tax matters, there is a potential conflict between greater transnational economic activity and the desire of policymakers to retain their sovereign ability to take whatever domestic decision they believe is proper, including the concession of tax incentives to promote foreign investment. With increased economic integration it has become more difficult to separate domestic from international policies. Now and even more in the future, national tax policies affect other countries, and are influenced by other countries' tax policies as well. The increased mobility of factors, especially capital, implies that flows to different countries become very sensitive to tax treatment differentials, and the growth of economic activities taking place outside a country's borders may hinder its capacity to properly levy its taxes as it wishes.

With the growing interdependency of economies and rising cross-border activities, countries are changing their tax instruments and this results in the redistribution of the tax burden and less incidence on mobile factors. Capital is being taxed less and less, and labor and consumption more. This means that taxation is becoming less equitable and promotes more economic distortions as the quality of the tax systems is deteriorating in most countries. In the long run this works against promoting a generally sound business environment needed to foster economic activities.

Furthermore, with globalization the distinctions between trade, investment and tax agreements are becoming increasingly blurred. The importance that was given to the trade in service negotiations of the Uruguay Round and the growing presence of FDI is making clear that taxation of factor incomes can constitute a barrier to free trade as tariffs have traditionally done. The increased competition for FDI and the eagerness to expand exports and gain international market share has led to the growth of tax incentives.

For this reason trade agreements can no longer ignore taxes. Inadequate tax policies and incentives are included within the host of non-tariff barriers that are being abolished in order to enhance free trade. Among them the classical quantitative restrictions, sanitary regulations and anti-dumping rules as well as production and export subsidies. All subsidies that increase exports or decrease imports are scrutinized, including those granted through the tax system. The GATT established a Subsidies Code in 1994 including cases where "government revenue that is otherwise due is foregone or not collected." The WTO has gone further in the pursuit of eliminating tax distortions to free trade. Even free trade zones within low-income countries that were tolerated in the past are to be eliminated by 2007 in accordance with the agreements of the Doha Development Agenda. This will severely restrict the possibilities that countries have to promote the attraction of FDI through the use of tax incentives, whenever they are seen as a means of affording these enterprises with an export competitive edge.