Investment attraction through the tax system: competition, cooperation or harmonization?

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Navigating Global Tax Governance

Session 4

Universiteit Leiden
The Netherlands

European Research Council
Established by the European Commission

GLOBTAXGOV
A NEW MODEL OF GLOBAL GOVERNANCE IN INTERNATIONAL TAX LAW MAKING

AFRICAN TAX ADMINISTRATION FORUM
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Philippines Creates Tax Incentives to Attract Shipbuilding Investors

HHIC-Phil, the largest yard in the country, filed the largest bankruptcy proceeding in Philippine history in 2019 and remains closed today (HHIC-Phil)

PUBLISHED SEP 20, 2021 5:49 PM BY THE MARITIME EXECUTIVE

15 Sep

Give tax breaks to drive investment in townships, says property tycoon Mike Nkuna

fin24 Carin Smith

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Protesters in 2018 hold up anti-Amazon signs during a demonstration against subsidies given to Amazon to locate to Long Island City, New York. | Bebeto Matthews/AP Photo

Tax breaks remain intact more than a year after Amazon's departure

By JANAKI CHADHA | 08/10/2020 05:03 AM EDT

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Opinion: It's time the world commit to a global minimum tax

Discussions about unifying taxation of multinational corporations have been going on for years. But, now more than ever in an interconnected digital economy, some of the billion-dollar profits belong to the people.

Just say no: Kansas City Council must reject incentives for downtown luxury hotel

BY THE KANSAS CITY STAR EDITORIAL BOARD

OCTOBER 05, 2021 5:00 AM

If Hotel Bravo's developers want to build their project, let them borrow money from a bank, or put up their own cash. *COURTESY OF E. J. HOLTZE CORPORATION*

05/10/2021 10:51:27am

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Malawi losing US$87m annually to tax incentives for multinational companies

Today‘s objectives

1. Understanding debates around the desirability of tax competition and tax incentives for investment attraction
2. Understanding different policy proposals that deal with tax competition (among them Pillar 2)

Tax incentives

- “tax provisions that deviate from baseline provisions” (Margalioth)
- No or lower taxes for
  - a period of time, or
  - for specific sectors (e.g., manufacturing), or
  - for specific locations (e.g. disadvantaged areas), or
  - for specific types of investors (e.g., foreigners)
- Tax credits
- Accelerated depreciations
- Lax (or discretionary) enforcement / Tolerating avoidance (Rohatgi 2005, Hong/Smart 2010)

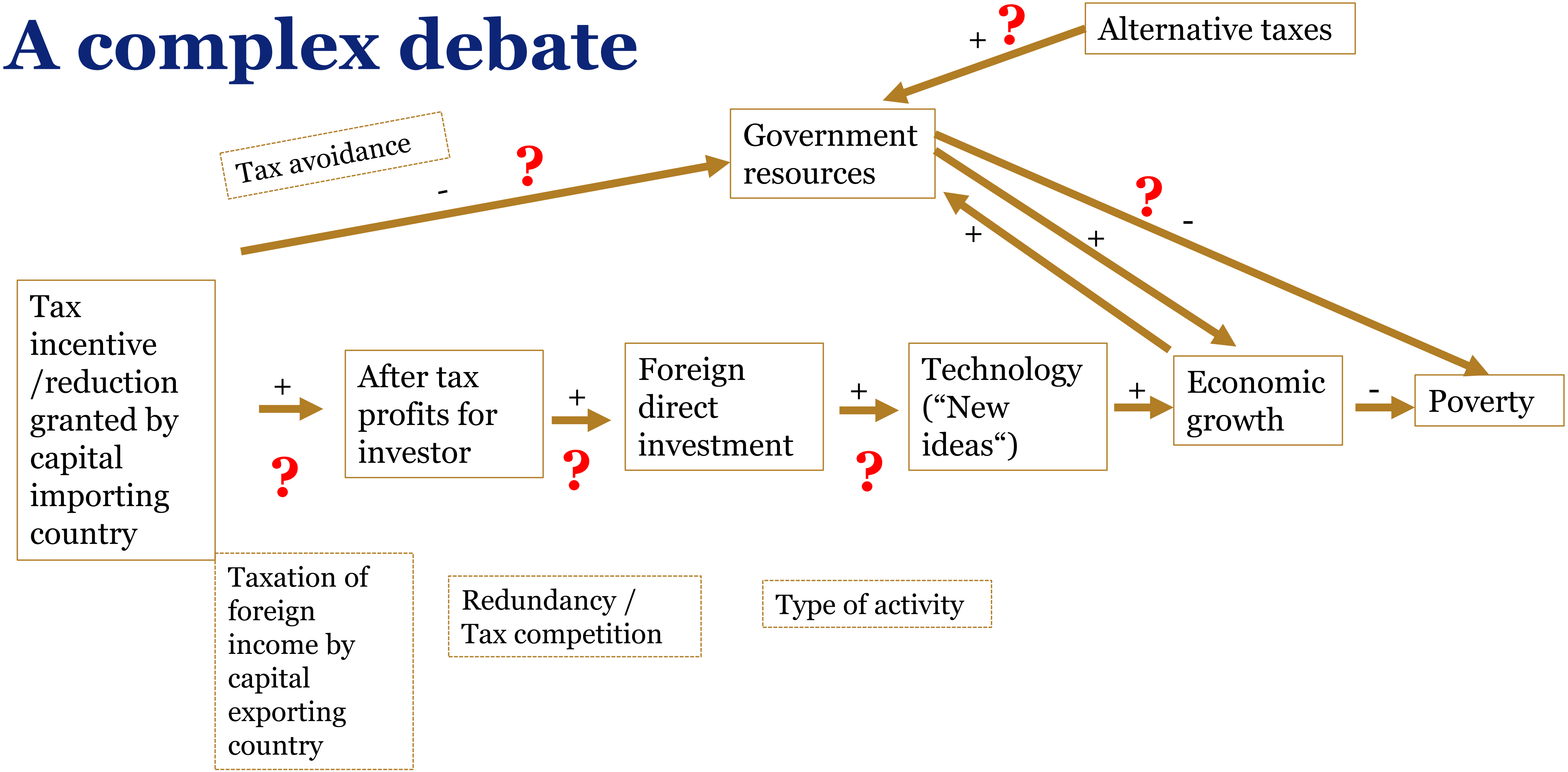
Margalioth: Using the tax system to promote countries’ development

Tax incentive/reduction granted by capital importing country $\xrightarrow{+}$ After tax profits for investor $\xrightarrow{+}$ Foreign direct investment $\xrightarrow{+}$ Technology (“New ideas“) $\xrightarrow{+}$ Economic growth $\xrightarrow{-}$ Poverty

But…

- Does foreign direct investment lead to technology spillovers?
- Is tax a decisive factor for attracting FDI?
- Are countries able to underbid each other?
- What about tax avoidance?
- Neutralization of benefit by capital exporting country

A complex debate



Is tax a decisive factor for attracting FDI?

- Others are more important: „market size, labor skills, infrastructure, trade policies and political and macroeconomic stability"
- But:

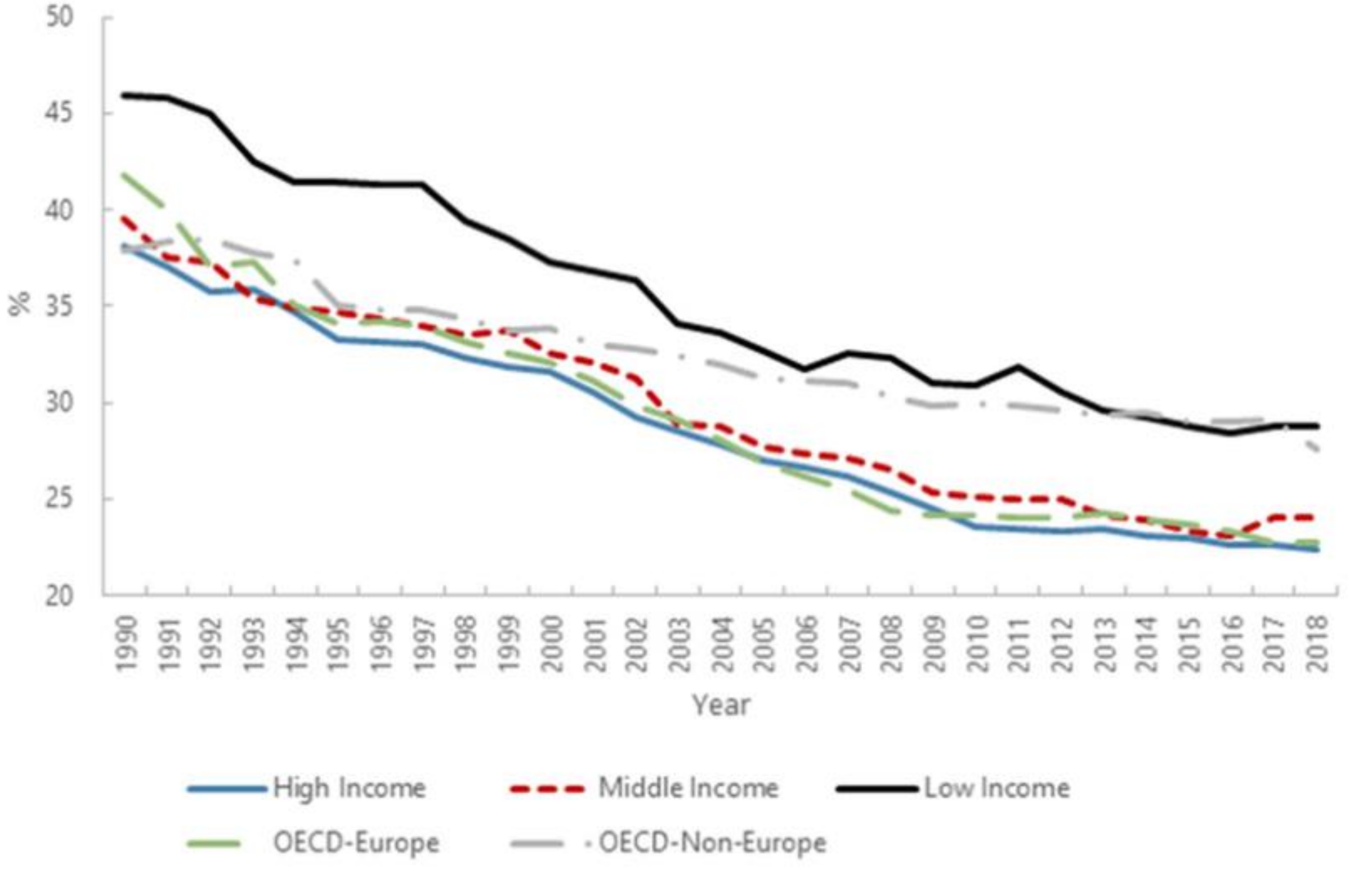
„If developing countries could create good infrastructure, a highly skilled labor force, zero inflation, a progressive tax and transfer system, political stability, and a functioning judicial system, they would not be developing countries; they would be the United States. One must be realistic." (Margalioth)

- But: Activities involving economic rent
  - Natural resources
  - Market-seeking investment
- Solution: targeting incentives to activities that do not involve economic rent

Are countries engaging in a race-to-the-bottom? (1)

- Recall definition: “tax provisions that deviate from baseline provisions”
- If baseline is low, then difficult to provide an incentive
- Prisoner‘s dilemma among countries

Are countries engaging in a race-to-the-bottom? (2)

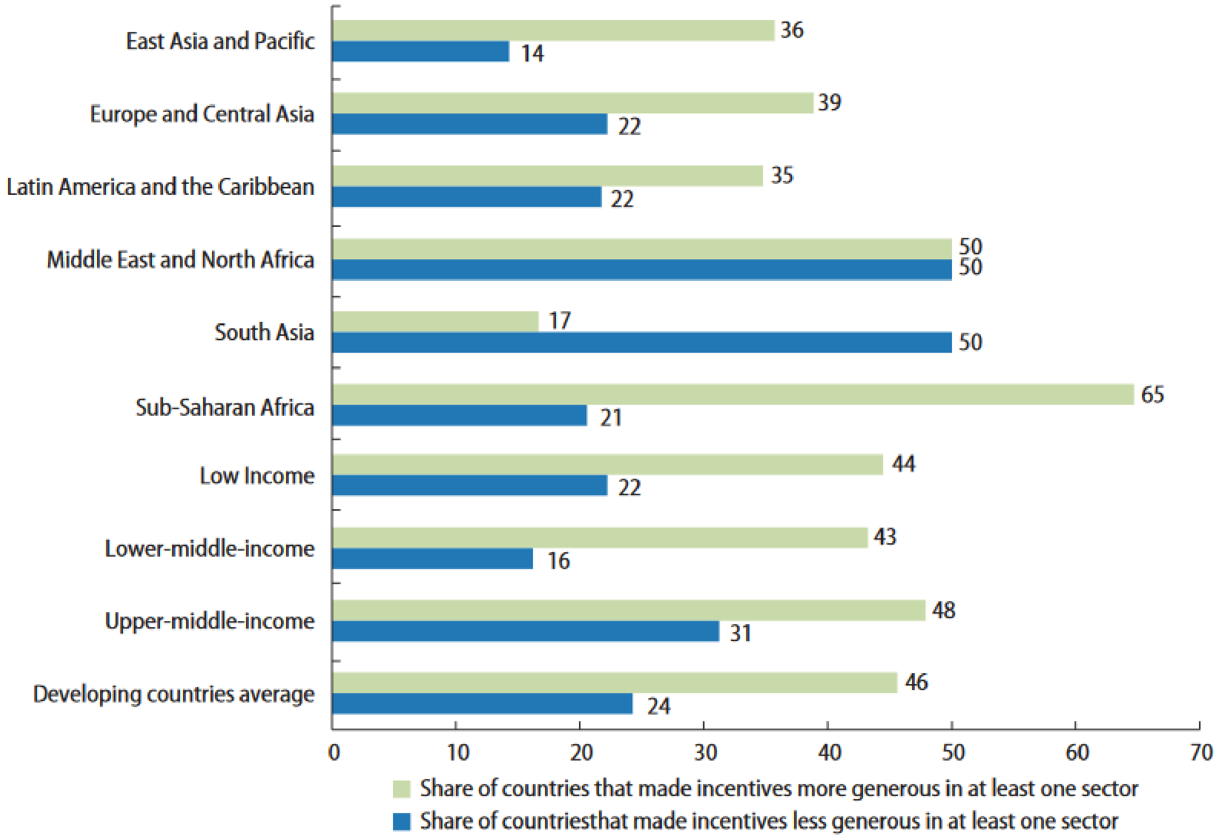


Statutory corporate income tax rates, source: IMF 2019, [Corporate Taxation in the Global Economy](), page 12

Are countries engaging in a race-to-the-bottom? (3)

FIGURE 3.3 Nearly Half of Developing Countries Have Introduced New Tax Incentives or Increased the Generosity of Existing Ones

Share of countries with changes in use of tax incentives, 2009–15 (percent)



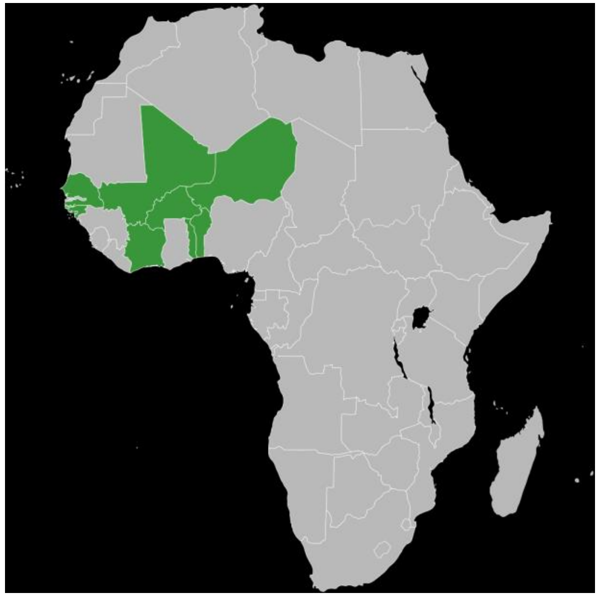
Source: Developing Country Tax Incentives Database.
Note: Making a tax incentive more generous refers to either extending the maximum duration of a tax holiday or reducing the preferential tax rate offered.

Source: World Bank. *Global Investment Competitiveness Report 2017/2018: Foreign Investor Perspectives and Policy Implications*. The World Bank, 2017, page 76

Different policy approaches to limit tax competition

- Cooperation / harmonization among capital importing countries
  - The case of the WAEMU
- Soft law
  - BEPS Action 5 / EU Code of Conduct
- Interaction between host country and home country taxation
  - Credit vs. exemption systems
  - Income inclusion rule (Pillar 2)

Cooperation in setting tax rates: the case of the West African Economic and Monetary Union



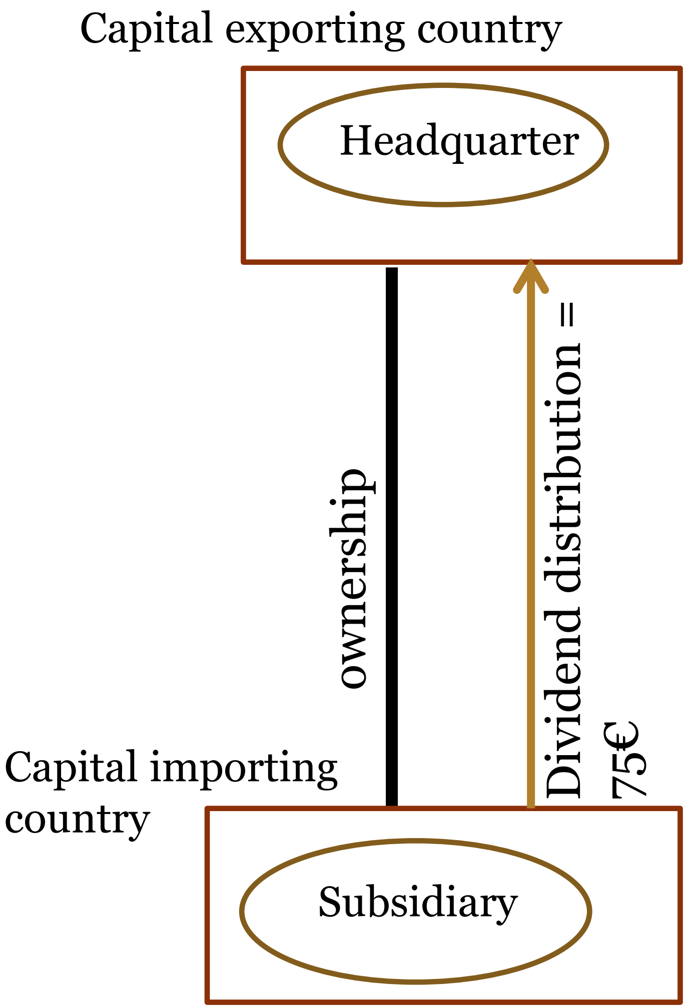
- WAEMU: foundation in 1994, 8 members French speaking West Africa
- Directive N° 08/2008/CM/UEMOA: Harmonization of corporate tax rates to 25% - 30 %
- Prevents countries from lowering rate below 25%
- But: no country had lower rate than 25% previously, some had rates higher than 30%
- Incentives granted through investment codes excluded

Soft law: Harmful Tax Practices Agenda

- 1998 OECD report „Harmful Tax Competition: An emerging issue“
- EU Code of Conduct
- BEPS Action 5
- Effective when combined with threats (see session 2)
- But:
  - issues of legitimacy
  - Reports only about certain forms of tax competition; Low rate alone not problematic (only when granted through companies without sufficient substance in country)

Impact of home country taxation on effectiveness of tax incentives in host countries

Taxing foreign income: exemption



Income = 75€

Tax rate on foreign income= 0%

Taxes = 0€

Tax paid = 0€

Overall after tax profit = 75€

Territorial system (exemption)

No tax incentive in source country

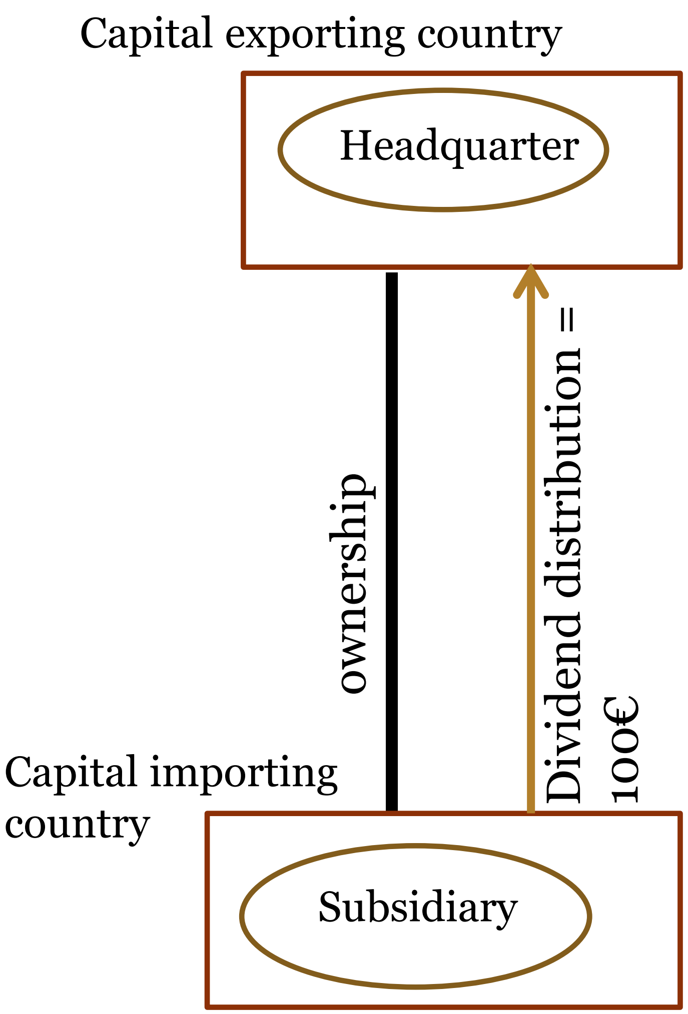
Income from sales = 100€

Tax rate = 25%

Tax paid = 25€

Profits after tax = 75€

Taxing foreign income: exemption



Income = 100€

Tax rate on foreign income= 0%

Taxes = 0€

Tax paid = 0€

Overall after tax profit = 100€

Territorial system (exemption)

Tax incentive in source country

Income from sales = 100€

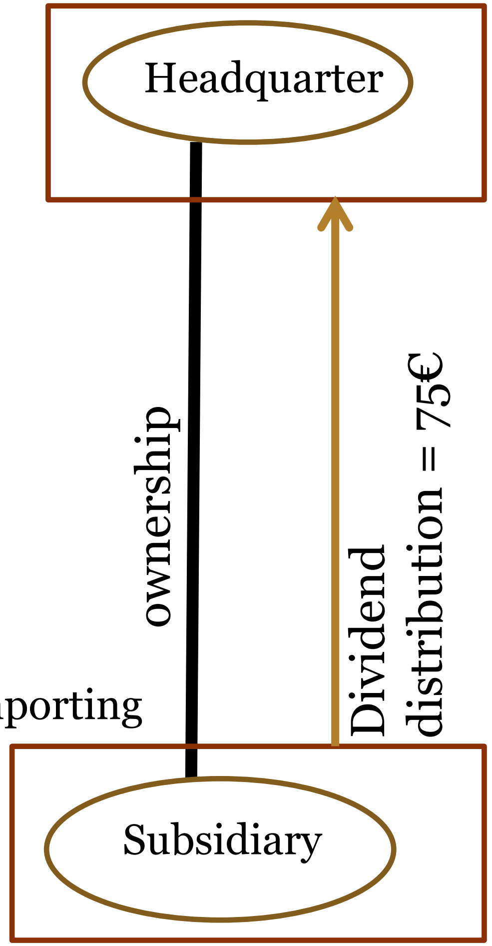
Tax rate = 0%

Tax paid = 0€

Profits after tax = 100€

Taxing foreign income: tax credit

Capital exporting country



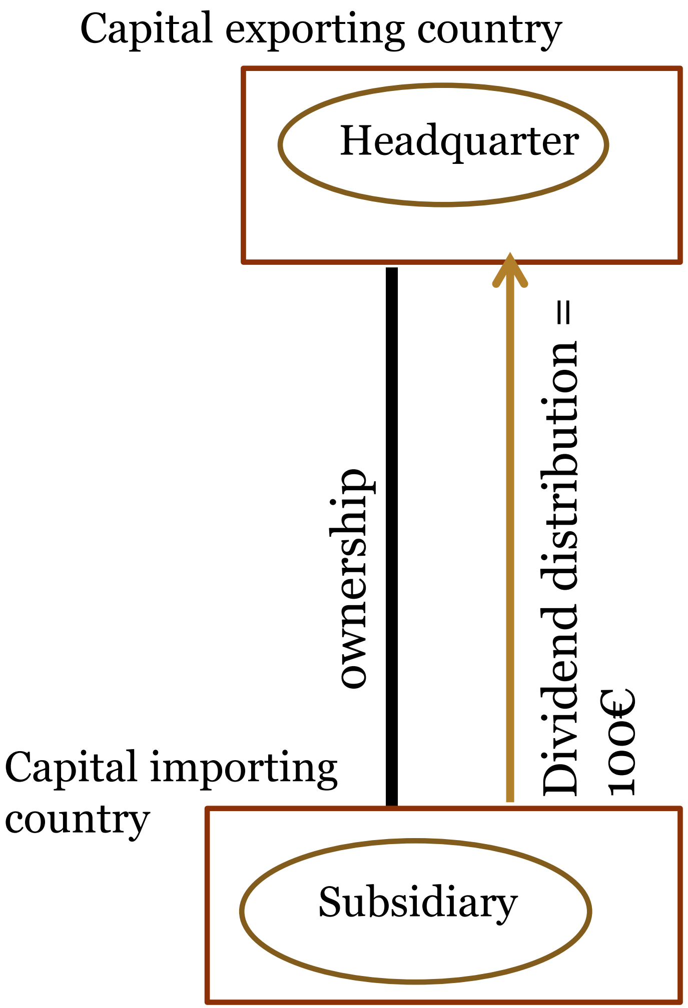
Capital importing country

Tax rate on foreign income = 30%
Income = 75€
Grossed-up income = 100€
Taxes = 30€
Credit = 25€
Tax paid = 5€
Overall after tax profit = 70€

Income from sales = 100€
Tax rate = 25%
Tax paid = 25€
Profits after tax = 75€

Worldwide system (tax credit)
No tax incentive in source country

Taxing foreign income: tax credit



Income = 100€

Tax rate on foreign income = 30%

Grossed-up income = 100€

Taxes = 30€

Credit = 0€

Tax paid = 30€

Overall after tax profit = 70€

Worldwide system (tax credit)

Tax incentive in source country

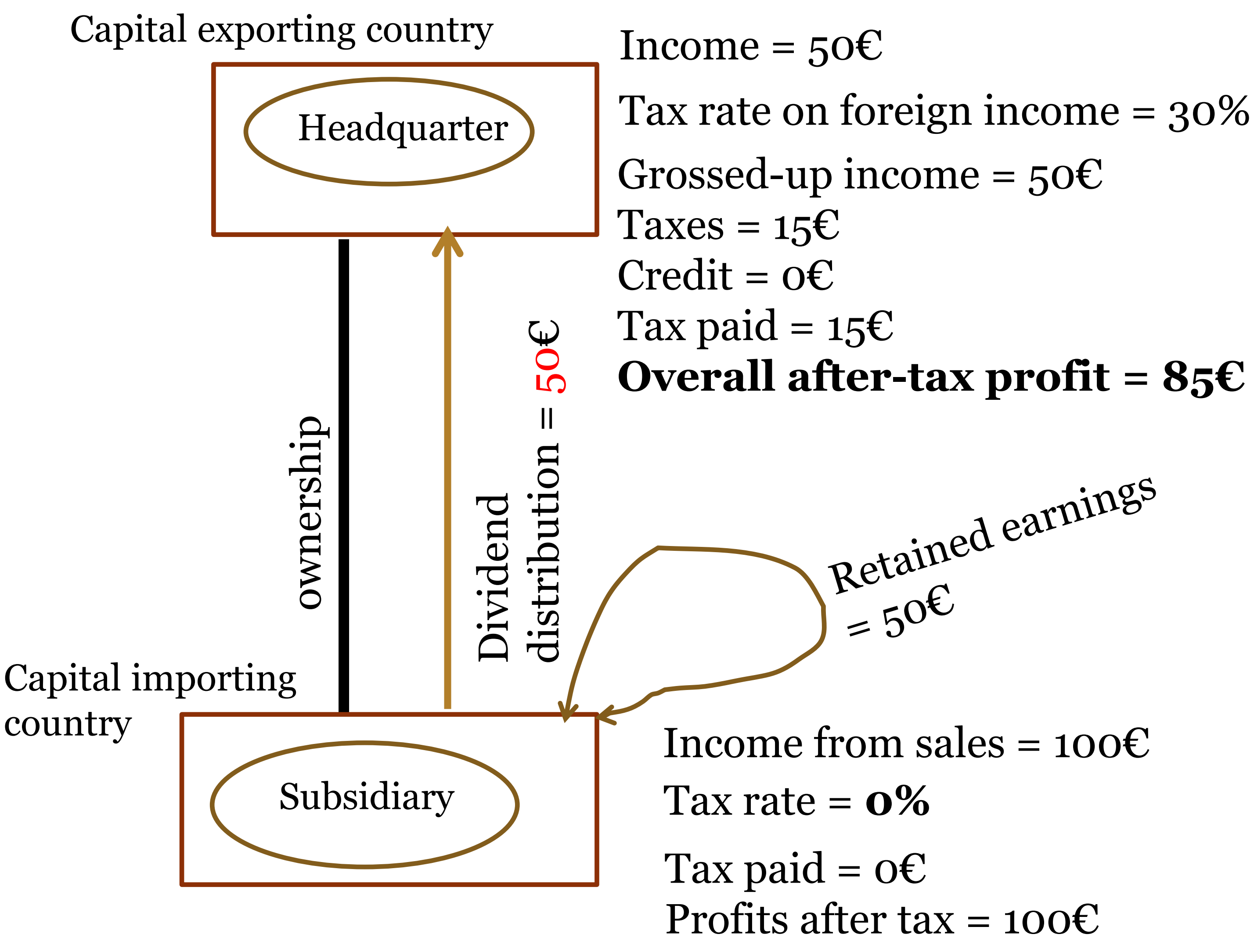
Income from sales = 100€

Tax rate = **0%**

Tax paid = 0€

Profits after tax = 100€

Taxing foreign income: tax credit



Worldwide system (tax credit)
Tax incentive in source country

A Global Minimum Tax

- Immediate worldwide taxation of income taxed under 15%
- Depending on design, tax incentives under 15% ineffective

Taxing foreign income: income inclusion (minimum tax)

Capital exporting country

Headquarter

ownership

Dividend distribution = 50€

Retained earnings = 50€

Capital importing country

Subsidiary

Income = 50€

Tax rate on foreign income = 30%, minimum tax = 15%

Grossed-up income = 50€, minimum tax income = 100€

Taxes = 15€ (50*30%) + 15€ (100*15%) = 30€

Credit = 7.5€ (50*15%)

Tax paid = 22.5€

Overall after-tax profit = 77.5€

Worldwide system with income inclusion rule

Tax incentive in source country

Income from sales = 100€

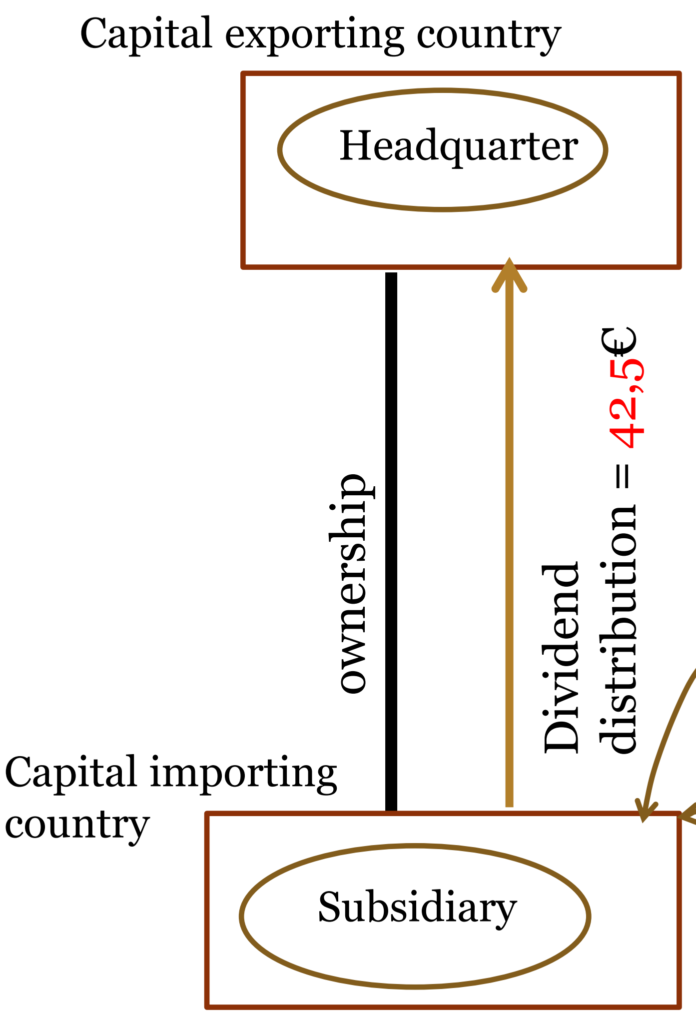
Tax rate = **0%**

Tax paid = 0€

Profits after tax = 100€

Note: This example is based on an assumption about how countries would adjust their credit system to Pillar 2 – this is to date still uncertain, though.

Taxing foreign income: income inclusion (minimum tax)



Income = 42.5€

Tax rate on foreign income = 30%, minimum tax = 15%

Grossed-up income = 50€, minimum tax income = 0€

Taxes = 15€ (50*30%)

Credit = 7.5€ (50*15%)

Tax paid = 7.5€

Overall after-tax profit = 77.5€

Worldwide system with income inclusion rule

Tax incentive in source country

Income from sales = 100€

Tax rate = **15%**

Tax paid = 15€

Profits after tax = 100€

Note: This example is based on an assumption about how countries would adjust their credit system to Pillar 2 – this is to date still uncertain, though.

Would the income inclusion rule proposed under pillar 2 reduce tax competition?

- Yes:
  - Less incentives to grant tax incentives for foreign investors below 15% rate
- No:
  - Compliance dilemma among capital exporting countries (incentive to favor own MNEs)
  - Substance based carve out allow for some income to be low-taxed
  - Only applies to MNEs with revenue over 750 Million EUR
  - Complexity: To gain revenue, capital importing countries need domestic minimum taxes or abolish tax incentives → difficult to calibrate given complexity of income inclusion rule
  - Most countries with larger economies have higher rates than 15% (Africa on average 30%)

Debate: What should ideally be done?

- Should tax competition be limited?
- If yes, through harmonization or incentive-based mechanisms?
- How could a global minimum tax regime be designed that maximizes both investment and tax revenue in capital importing countries?

A differentiated minimum tax?

- Margalioth: “Transfers from rich to poor countries further benefit by imposing limitations on rich countries' abilities to engage in tax competition with poor countries. […] For example, Ireland would be required to raise its current corporate tax rate of 12.5% in order to decrease the relative disadvantage that developing countries have when competing with Ireland for FDI. […] With the application of anti-tax competition rules to developing countries, we establish two different harmonized tax levels - one for developed countries and the other for developing countries.” (p. 194 – 195)

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Thank you!

Questions?
Comments?

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