TAX INCENTIVES: ILL-ADVISED TAX POLICY OR GROWTH CATALYSTS?

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Abstract. 1. Introduction. 2. Definition of tax incentives. 3. The state perspective. 3.1. Why tax incentives are offered? 3.2. Why tax incentives should not be offered? 4. The investor perspective. 5. European Union. 6. Recommendations. 7. Conclusions

I. INTRODUCTION

Countries are sovereign to determine the characteristics of their tax systems. The sovereignty gives them the right not only to make decisions about the general features of their tax systems but also to create special measures that make it attractive for companies to carry out business activity within the country territory. Those measures may take the form of reduced rates, tax holidays or tax credits. Some of them are aimed at stimulating a particular activity (research and development, environmental protection), while others seek to attract foreign capital in general.

However, in a tax competitive world, the fiscal sovereignty is not unlimited: although countries may perceive that they have the freedom to design their tax systems as they wish, in reality, they are forced to do so according to what their neighbours are doing. Nowadays, tax policies are rarely dictated by the aim of imposing a reasonable part of the cost of public expenditure on every production factor.

Tax incentives are an extremely broad and multi-dimensional topic. It is about the attraction of investments, (fair and unfair) tax competition, the exploitation of tax systems by taxpayers and the states' efforts to counteract it. Without incentives there would be less intense tax competition and less need for the implementation of extensive anti-abuse measures.

This article aims to examine whether and under which circumstances tax incentives are the right policy tool to attract economic activity. It proceeds in five parts. Section 2 provides the definition of tax incentives and distinguishes their types. Section 3 looks at the issue of tax incentives from the state perspective. It examines the reasons why special tax measures might be introduced. It also describes the challenges and mistakes that countries make while implementing them. Section 4 is focused on investors and discusses what encourages them to select a particular location, i.e. when tax incentives are effective in attracting capital. Section 5 looks at the legislative framework for tax incentives in the European

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Union, which is, with more than 500 million inhabitants and a GDP of over EUR 12,629 billion, a major economic player in the world. Moreover, the competition to attract investment and concerns about its negative outcomes are especially strong among neighbouring countries. The movement to limit tax competition and the use of incentives has probably progressed further within the European Union than elsewhere in the world. Section 6 deals with design considerations. It gives some recommendations that governments should keep in mind while implementing tax incentives. The article concludes that it would be far more efficient to improve the investment climate and to remove non-tax impediments to investment before it makes sense even to consider the need for tax incentives.

II. DEFINITION OF TAX INCENTIVES

A tax incentive is a measure designed to encourage a particular economic activity by providing a deduction, exclusion or exemption from tax liability. It is selective in nature, i.e. it gives preferential treatment to certain types of investment that the government seeks to attract or to certain regions suffering from structural problems. Tax incentives may take a wide variety of forms: tax holidays, depreciation allowances, accelerated depreciation, tax credits and employment-related measures.[2]

Incentives are used to encourage two kinds of activities: direct and portfolio investments (mobile capital). The latter can be attracted by imposing low or non-existent withholding taxes or low substance requirements. Where low/no withholding tax is combined with secrecy, there is a great temptation for the taxpayer not to declare the income in the residence country. Thus, portfolio investment incentives are often discussed in connection with the hotly debated issue of harmful tax competition and the EU and OECD efforts to curb it. As this topic has already received extensive coverage in the tax literature,[3] this article seeks to focus on tax incentives to attract direct investments, i.e. less mobile activities that require a significant amount of economic substance to be performed.

An important but still unanswered question is how to measure the efficiency of tax incentives. It is not even clear what one should be measuring, let alone how to measure it. Offering tax incentives has two implications for national budgets. The first effect is that tax revenue is foregone, and the provision of public goods and services may fall short of the social optimum. On the other hand, incentives may also spur economic activity and create additional tax revenue. The cost of tax incentives could be measured purely in fiscal terms by taking the increased tax revenues and setting them against the revenue foregone as a consequence of the incentive. Alternatively, a broader concept of "social" benefit could be adopted, taking into account factors such as employment creation, regional development and technology transfer.

2 For a detailed description of various types of incentives, see C.E. McLure, Tax Holidays and Investment Incentives: A Comparative Analysis, 53 Bull. Intl. Fisc. Doc. 8 (1999); A. Easson, Tax Incentives for Foreign Direct Investment Part I: Recent Trends and Countertrends, 55 Bull. Intl. Taxn. 7 (2001); A. Easson, Tax Incentives for Foreign Direct Investment Part II: Design Considerations, 55 Bull. Intl. Taxn. 8 (2001); D. Holland & R.J. Vann, Income Tax Incentives for Investment in: V. Thuronyi, Tax Law Design and Drafting, vol. 2 (IMF 1998).

3 See, for example, P. Lampreave, Fiscal Competitiveness versus Harmful Tax Competition in the European Union, 65 Bull. Intl. Taxn. 6 (2011), C.E. McLure, Will the OECD Initiative on Harmful Tax Competition Help Developing and Transition Countries? 59 Bull. Intl. Fisc. Doc. 3 (2005); L. Cerioni, Harmful tax competition revisited : why not a purely legal perspective under EC law? 45 Eur. Taxn. 7 (2005); V. Kalloe, Corporate Tax Treatment of Interest: EU State Aid and the EU Code of Conduct as a Means of Combating Harmful Tax Competition, 51 Eur. Taxn. 12 (2011).

III. THE STATE PERSPECTIVE

3.1. Why tax incentives are offered?

Countries have introduced tax incentives for varying reasons. At the most general level, they hope to achieve an increase in national welfare. It is anticipated that there will be spill-over effects from the foreign investment, which may include the adoption by domestic firms of superior management and production techniques brought in by the foreign multi-national companies, the increase in demand for local goods and services and the possibility that investors will source at least some of their raw materials from local suppliers.[4]

The investment climate in developing countries is unfavourable in various respects: inadequate infrastructure, high cost of credit or unskilled labour. To raise the investment levels in the economy, not only the mobilization of domestic resources but also foreign capital is necessary. Governments of developing countries are urged to promote foreign direct investment (FDI) as the level of FDI flows into a country is often seen as an indication of that country's economic health. Incentives are also implemented in such countries to encourage industrialization. Such policies have often been ill advised, since they encourage migration to cities, aggravating urban problems. Moreover, the encouragement of manufacturing inevitably occurs at the expense of agriculture, which may be a more appropriate economic activity in many countries. Taxing agriculture to subsidize manufacturing generally implies transfers from the poorest members of society to the more affluent.

Tax incentives may be seen as a counterweight to the investment disincentives inherent in the general tax and economic system. In some countries, tax incentives are intended to offset other disadvantages that investors may face, such as lack natural resources, unfavourable legal framework or inefficient tax administration.

Finally, countries introduce incentives to keep up with other countries in competing for international investment. Legislators may feel the need to do something to attract investment, but may find it difficult to address the chief reasons that discourage investment: tax incentives are at least something over which they have control and which they can enact relatively easily and quickly. Some countries may feel under pressure from multinational companies which are likely to locate investment where they receive the most beneficial treatment.

4 A. Miller & L. Oats, Principles of International Taxation ch. 20, 3rd ed. (Haywards Heath Bloomsbury Professional 2012).

3.2. Why tax incentives should not be offered?

The selectivity of tax incentives raises the question whether some types of activities should be considered to be more desirable than others. Should governments seek to select and attract particular types of investments and not others, or should it be left to the market to decide? The selectivity reflects the mentality of picking "winners and losers", which is characteristic of central planning. The ability of politicians to decide what is good for their country may seem questionable.

There is very little evidence that politicians and bureaucrats can do better than the market in this regard. If that strategy had been a good one, it would not have led to the impoverishment of the former Soviet Union and Eastern Europe.[5] Another problem with selective tax incentives is that they inevitably lead to pressure for similar treatment from other sectors. This pressure is much more difficult to withstand once some targeted incentives have been given.

Tax incentives, once implemented, introduce complexity into the tax system. The rules on incentives themselves are quite complex, which creates opportunities for tax avoidance. As a result, anti-avoidance measures must be introduced to limit the tax planning opportunities. All this imposes costs on administrators and taxpayers and increases the uncertainty of tax results. The implementation of tax incentives requires a high level of administrative capability and integrity. The tax administration in some countries may lack the necessary competence in enforcing compliance partly due to corruption and unskilled officials and partly due to the complexities and ambiguities in the tax.

Tax incentives by their nature represent a revenue cost for the government. These costs need to be considered and compared to any benefits that they may convey. While offering incentives, countries' tax policies become prone to a kind of winner's curse. The winner's curse refers to the problem that the winner of an auction is (by definition) the one who most overestimates the value of the object. It may happen that the incentive cost, in terms of tax revenue foregone, far exceeds any benefits that they produce. In one extreme case, the costs of establishing the infrastructure for an export-processing zone in Liberia were estimated to exceed USD 15 million; the zone attracted one investor, an investment of USD 650,000 and created 50 jobs.[6] Offering too generous incentives means that countries have to recover revenue losses from others, for example, less mobile taxpayers who consequently have to pay higher taxes on their income from labour and on their consumption. The loss of revenue inherent in the provision of tax incentives implies that tax rates must be higher than in the absence of incentives, which has adverse effects on non-preferred activities. Taxpayers try to shift income (from non-preferred activities) to jurisdictions where tax rates are lower and to shift deductions into the jurisdiction offering the incentives.

5 McLure, supra n. 1, at sec. VI.A.
6 Easson, Part 1, supra n. 1, at sec. 5.

Tax incentives intensify tax competition: if they are given by one country, others feel the necessity to do so as well. A country that views itself as competing for foreign investment will respond to the tax incentives of another country by introducing similar ones. In the end, the tax incentives offered by the two countries do nothing to alter the relative benefit to invest. The only result of the competition is that both countries receive lower tax revenues. They would both be better off if they could agree not to compete.

IV.. THE INVESTOR PERSPECTIVE

Numerous empirical studies that attempted to establish the role of tax incentives in promoting foreign direct investment showed that the availability of tax incentives is a secondary consideration in location decisions, following more commercial considerations, such as market size, access to raw materials and skilled labour. The importance of tax incentives is heightened when countries in close geographical proximity share similar infrastructure capabilities.[7]

To determine the effectiveness of tax incentives, it is necessary to look beyond the country where the activity takes place (the source country). There are often further tax consequences in the residence country of the investor on income that is earned and taxed in the source country. No discussion that fails to consider these aspects is complete. Many countries which operate worldwide taxation systems tax all income of their residents, but allow a credit for income taxes paid in the source country. Tax incentives are ineffective in attracting foreign investment from such countries, as they merely result in the payment of higher taxes in the country of residence. An incentives provided by source country creates a transfer of revenue to the treasury of the residence state. To preserve the benefit for the investor, tax sparing provisions are included in double tax treaties. The precise terms of tax sparing provisions depend on the preferences of the particular countries and the relative bargaining power of each of them. Developing countries will obviously try to have tax sparing provisions included in treaty negotiations and secure as much credit as possible. A study of the impact of tax sparing provisions on Japanese outbound FDI between 1989 and 2000 concluded that Japanese FDI flows in tax sparing countries were almost three times bigger than in non-tax sparing countries, indicating that tax sparing provisions influence investors' location choices.[8]

7 Miller & Oates, supra n. 3, at ch. 20 with further references.
8 C. Azemar et al., Do Tax Sparing Agreements Contribute to the Attraction of FDI in Developing Countries? 14 Journal of International Tax and Public Finance, pp 543-562 (2007).

V. EUROPEAN UNION

Competition to attract investment by means of incentives is especially strong among different regions of a country or among neighbouring countries. Tax considerations do not always figure prominently in the initial decision to invest abroad, but once the decision is made to invest in a particular region of the world, the tax differences between the countries in that region, or between the provinces, states or municipalities within a country, tend to have a major impact on the precise location of the investment.

The movement to limit tax competition and the use of tax incentives has probably progressed further within the European Union than elsewhere in the world. In a region where economies are increasingly integrated and capital is increasingly mobile, the trend of offering tax benefits has resulted in fears of a "race to the bottom", the “bottom” being a situation in which too little tax revenue is raised to keep up decent public service, infrastructure and social security, to the unjustified benefit of internationally mobile capital.

The limited competences of the European Union in the field of direct taxation and the principle of subsidiarity could lead to the conclusion that tax competition using general tax measures is fair. In competing with each other, Member States exercise their competence in a matter reserved to them and differences arising from general tax measures are covered by the principle of fiscal sovereignty, which is only limited by the prohibition of unjustified discriminations and restrictions. However, the European Commission policy towards Member States’ tax incentives is characterized by a strict application of the state aid provisions and rigorous criteria for determining harmful tax measures.

The rules of the Treaty on the Functioning of the European Union (TFEU) that prohibit the granting of state aids significantly restrict Member States' efforts to implement tax incentives.[9] State aid is defined as any financial aid granted through a Member State’s resources that threatens to distort competition or affect intra-Community trade by favouring certain undertakings. Its important feature is selectivity, which means that potential beneficiaries are restricted in terms of size, location or sector. Tax incentives that are aimed at a particular region or economic sector or at a certain function within an enterprise are considered to be selective and therefore open to investigation by the Commission. The consequences of non-compliance with state aid rules are severe. If the Commission considers a measure to be unlawful state aid, the recipient is required to repay the benefit plus interest.

However, the European Commission have noticed that certain types of aid might be desirable or even necessary. Article 107 of the TFEU defines three types of aid that is automatically compatible with the internal market (legal exemption) and lays down five instances in which aid may be declared acceptable by the Commission. These are, inter alia, regional aid and assistance for certain activities (research and development, environmental protection).

9 For more detailed information on state aid rules, see C. Pinto, EC State Aid Rules and Tax Incentives: a U-turn in Commission Policy? Part I and II, 39 Eur. Taxn. 8 and 9 (1999) C. Micheau, Fundamental Freedoms and State Aid Rules under EU Law: The Example of Taxation, 52 Eur. Taxn. 5 (2012); F.A. Engelen, State Aid and Restrictions on Free Movement: Two Sides of the Same Coin?, 52 Eur. Taxn. 5 (2012).

In 1997, the Economic and Financial Affairs Council adopted the Code of Conduct for Business Taxation, which is intended to prevent losses of tax revenue resulting from relocating business activities to Member States offering tax benefits. Under the Code, harmful tax measures are those that have a significant influence on business location by providing for a significantly lower effective level of taxation than the general level. It specifies that the following characteristics make a national tax measure harmful: aiming at offshore companies, ring fencing (protecting one's existing tax base against one's own competitive measures), the application of the competitive measure notwithstanding a lack of economic substance of the economic operator in that Member State, lack of arm's length profit determination, non-transparency of administrative practices, especially of individual revenue rulings. The Code mainly targets non-selective incentives for mobile foreign investors. Its adoption was necessary as the state aid rules could not be used to prohibit non-selective tax legislation which would not *reduce* but, on the contrary, *increase* state resources.

The EU State aid rules and the Code of Conduct are negative integration rules: they both prohibit certain national measures that distort competition in the internal market and damage a level playing field for all EU economic operators. The two sets of rules differ in that state aid preclude distinctions between economic operators within the same country, while the Code of Conduct prevents interstate distinctions which are perceived as harmful tax measures.

The Code of Conduct and state aid rules have no direct impact on other countries, but their indirect impact may be substantial. If the Member States are compelled to eliminate all tax incentives for investment, those countries (which make up a majority of OECD Members) are likely to favour more vigorous action against tax competition from non-members.

VI. RECOMMENDATIONS

Tax incentives can have undesirable effects if not designed carefully. This section gives some recommendations that governments should keep in mind while implementing them.

Proper targeting: First of all, it is necessary to consider who / what should benefit from a special tax measure, i.e. what an incentive is supposed to achieve. It is obvious that tax incentives should not be restricted to foreign investment. Such a restriction is likely to cause resentment and to restrict the growth of domestic enterprises. It may also result in "round-tripping", in which domestic investment capital leaves the country to return disguised as a foreign investment in order to take advantage of special tax measures.

Certain types of incentives may have a double effect: despite being aimed at attracting investments, they actually discourage them. Tax holidays are regarded as particularly ineffective: as the tax exemption reduces the value of deductions, there is an incentive to postpone investment until the tax holiday expires in order to maximize the value of depreciation allowances.[10] In such a case, investment incentives would be preferable, as they are less subject to abuse. Even if the price of a capital good is overstated in a sales transaction between two related firms in order to increase the value of the incentive, the overstatement is likely to be corrected on the basis of transfer pricing rules.

Selective incentives are said to distort competition and a level playing field for economic operators. However, the long-standing debate on tax incentives and tax competition in the tax literature lacks a clearly defined idea of what constitutes a level playing field. In terms of taxation, it could be that investments face the same effective tax rate. However, in broader terms, a level playing field does not mean equal tax rates and tax bases as some countries face more structural disadvantages than others. For example, investors take the country size into account when making their location decisions. Investment locations within a large jurisdiction are more attractive than locations in a small country. Investors prefer large countries because of an easier access to large consumer markets and labour. When states of different size engage in tax competition for foreign direct investment, the larger state is likely to win.[11]

Therefore, the proper question to discuss is not *whether or not* market competition is distorted, but *how* it is distorted. Although incentives granted by governments affect the forces of free competition inherent to open markets because companies, sectors, or regions benefiting from them are put in a comparative advantage, there might be a justification from an economic and/or a social point of view for doing so.

A common argument for tax incentives for research and development (R&D) suggests that there will be too little private investment in research and development because it is difficult to capture its full social benefits. The benefits of such investments are usually higher for the general public than for the investing company. However, it is the investing company, which has to bear the high costs of R&D performance.[12] Tax incentives employed to implement regional policies, i.e. to encourage the development of remote depressed areas may be acceptable as unfavourable geographical location can hardly be remedied by other means.

10 McLure, supra n. 1, at sec. III.
11 H. Vording, A Level Playing Field for Business Taxation in Europe: Why Country Size Matters, 39 Eur. Taxn. 11 (1999).
12 For an overview of tax incentives for research and development in selected European countries, see A. Bal & R. Offermanns, R&D Tax Incentives in Europe, 52 Eur. Taxn. 4 (2012).

Transparency: Tax incentives add to the complexity of tax legislation. They are sometimes contained in various pieces of legislation even where there is a clear possibility of merging various provisions into one. Complex legislation increases the risk of double financing: multiple incentives may be offered for the same activity. This may also occur if a country provides assistance through direct subsidies in addition to tax incentives. Therefore, it is essential that the tax incentive legislation be coordinated with other policy measures. The number of incentives should be kept low and well targeted. The more transparent the incentive system, the easier it will be for investors to understand. This includes clarity about conditions attached to the incentives. In order to limit the availability of the benefits of incentives, it is necessary to write the eligibility requirements carefully and comprehensively. If, for example, "manufacturing" is to benefit from a preferential rate, it is necessary to distinguish between manufacturing, per se, and ancillary activities, such as transportation and marketing, and specify the tax treatment of each such activity. Otherwise, taxpayers will attempt to classify all their activities as part of manufacturing to make them eligible for the preferential rate.

Administrative system: Several administrative factors, such discretion and monitoring, impact the effectiveness of tax incentives. The question of discretion relates to the extent to which tax authorities are able to use their own discretion in making decisions about the granting of incentives. Allowing too much discretion may pave the way for corruption; on the other hand, a certain degree of discretion facilitates greater flexibility in tailoring incentives to the needs of particular investors. The monitoring of companies that have benefited from the incentives is also important, ensuring that, where conditions have been attached to the incentive, such as completion within a particular time frame, those conditions have been fulfilled. If projects are not properly monitored, it becomes impossible to ensure that the expected investment actually materialises.

Limitation of abuse possibilities: It is necessary to limit the opportunities to avoid taxes on account of tax incentives. The legislators and tax administrators should ensure that tax incentives do not end up being tax loopholes. Loopholes in the tax incentive legislation, coupled with inefficient administration, lead to large-scale tax evasion. Taxpayers may try to claim double benefits under two different provisions in respect of the same income. Usually, it is not possible for the government to foresee in advance all "creative" tax planning structures that taxpayers may use to get benefits unintended by the legislation. Specific anti-abuse measures often turn out to be inadequate for successfully catching up with novel aggressive tax planning structures. To counteract aggressive tax planning practices which fall outside the scope of the specific anti-avoidance rules, countries should implement general anti-abuse provisions (GAAR). In its recommendation on aggressive tax planning, the European Commission has encouraged the Member States to introduce the following clause in their national legislation:[13]

[13] Commission Recommendation of 6 Dec. 2012 on aggressive tax planning, C(2012) 8806 final.

An artificial arrangement or an artificial series of arrangements which has been put into place for the essential purpose of avoiding taxation and leads to a tax benefit shall be ignored. National authorities shall treat these arrangements for tax purposes by reference to their economic substance.

Stability of the tax and economic system: The choice of a location for business activities is primarily determined by non-tax factors: proximity to suppliers, productivity of the local workforce, transportation costs, quality of the public infrastructure. The general features of the tax system (tax base and tax rates) are also more important for investors than special tax incentives. Tax incentives cannot overcome other more fundamental problems that inhibit investment. Therefore, the appropriate approach is to reform the existing laws and to build the necessary administrative capacities and infrastructure before any additional measures are implemented. However, many governments tend to rely too much on tax incentives, while little is done to improve the underlying business environment.

Investors want to be able to predict the tax consequences of their actions. This requires clear laws that are stable over time. In many developing and transition countries, the tax laws are not clearly written and may be subject to frequent revisions, which makes long-term planning difficult. It often happens that incentives, once introduced, do not continue to remain in force for several years. They are either replaced by other incentives or changed within a short span of their operation. This creates uncertainty and is not likely to attract investors.

Complicance with WTO rules: Incentive programmes may give rise to liability if they do not comply with the rules laid down by the World Trade Organization (WTO). Penalties range from the imposition of additional duties on goods to the claw-back of benefits conferred to the cessation of such incentive programmes. The Agreement on Subsidies and Countervailing Measures (ASCM) is part of the WTO agreements and is an essential part of international trade law. Whilst recognizing that governments have the right to utilize subsidies to promote various policy objectives, the ASCM prevents them from granting subsidies that have significant trade-distorting effects.[14]

14 Easson, Part 1, supra n. 1, at sec. III.B; E. Lim & A-L. N.T. Hoang, Tax Incentives and International Trade, 12 Asia-Pac. Tax Bull. 3 (2006).

VII. CONCLUSIONS

Incentives are here to stay: especially in developing countries, governments are under pressure to compete for foreign direct investment by offering special tax measures. Governments are not willing to take the risk of eliminating their own tax concessions unless their neighbours and competitors do so as well. Competition that occurs is matched by states' attempts to impose taxes under the label of anti-abuse measures.

Countries that intend to implement tax incentives have a particular objective in mind: to boost employment, to stimulate research or to revitalise a certain region. However, before introducing any tax measures, it is worth considering what caused the problem that is to be tackled (for example, too strict labour policy, undeveloped infrastructure or insufficient administrative capacities). The proper course of action is to deal with the causes first. When those structural disadvantages are removed, the next step is to think about further improvement strategies, which may take the form of tax incentives. It must be kept in mind that tax incentives are an *additional* measure that *may* help to attract economic activity to a country. They should not be offered as a counterweight to investment disincentives inherent in the general tax and economic system.