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BEPS' ancillary matters concerning low income countries: Tax treaties and tax incentives

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Part 1 of the Report to G20 Development Working group (DWG) on the impact of BEPS in Low Income countries (LICs), dated July 2014, listed in its *Section 6: Other High priority BEPS Issues for developing countries*, paragraph c), the topic of base erosion through wasteful tax incentives designed to attract investment, labeling it as a major cause of concern, among LICs.

As explained therein, major causes of concern include: (i) the damage to the revenue base that erodes the resources to face the real drivers of investment decisions, such as infrastructure, education and security; (ii) the lack of transparency and clarity in the provision, administration and governance of tax incentives, mostly perceived in developing countries; (iii) the granting of tax incentives outside the country's tax laws (sometimes under multiple pieces of legislation) and beyond the exclusive monitoring reach of tax administration bodies; (iv) the design and administration of tax incentives under the responsibility of several government bodies which might result in lack of coordination, overlapping, inconsistencies or work at cross purposes; v) rent seeking and corruption risks arising from administrative discretion on the granting and administration of incentives; (vi) international competition on the granting or significantly augmenting tax incentives which, at the very end, make competing countries collectively worse off; and (vii) creation of unintended tax planning opportunities within MNEs; thus, for example, enabling opportunities for profits and deductions to be artificially shifted across related companies, whether domestically or internationally.

The Report called for further action to develop guidance on assessing costs and benefits of tax incentives, calculate the amount of revenue forgone, review effectiveness and efficiency of tax incentives, improve transparency and governance of tax incentives for investments, and enhance international cooperation to avoid harmful tax competition.

Part 2 of the Report, dated August 13th, 2014, further stated that DWG welcomed a join Report by IMF, OECD, UN and World Bank Group, expected this year, addressing tax incentive issues under a balance approach with investment and public revenue priorities, as well as an estimation of the cost of incentives.

Much more modesty, Part 2 of the Report (under the heading *Challenges deriving from the abuse of treaties*, receipted LICs and NGOs' concern on the relative costs and benefits of entering into tax treaties. A concern that it is twofold as it relates to (i) certain practical issues, such as the capacity of LICs to ensure that the negotiated treaty terms are beneficial to the country; and (ii) policy considerations that should be analyzed before deciding to enter into a tax treaty with another country. Among the recommendations DWG called on OECD, IMF, WBG and regional organizations to assess how to strengthen capacity development on treaty negotiations.

Although not expressly addressed by DWG, perhaps it is worth recalling that at the bottom of this discussion lays a more fundamental concern as it is the effectiveness of double tax treaties (DTTs) to foster FDI into the country.(1) This is a discussion that has mobilized fiscal economists for decades, partially influenced by a strong ideological component, and yielding contradicting empirical data depending on the adopted research perspective.

In very simple terms, the issue for those in charge of designing LIGs fiscal policy focuses on whether the loss of tax revenue in the short term due to the tax reduction on across- the-border returns from existing investments is compensated in a longer term by the economic benefits coming from additional FDI originated in the existence of the DTT.(2)

Research studies that consider FDI data from a bilateral perspective (investment flows between pairs of selected countries) mostly conclude that DTTs do not have a positive effect on FDI,(3) while research studies based on FDI global data from a particular country conclude in the opposite direction, i.e., holding that DTTs increase FDI.(4)

When calling to assess how to strengthen LICs' capacity development on treaty negotiations, the DWG's recommendation appears to be predicated on the basis that DTTs are by definition beneficial to LICs, so that an effectiveness study based on the effect on FDI flows it is not to be expected.

On July 9th, last, OECD opened a consultation regarding a Paper titled *Options for low income Countries' Effective and efficient use of tax incentives for investment*, jointly prepared with IMF, UN and World Bank. Based on DWG's last year recommendation, the Paper is aimed at developing principles for the design and governance of tax incentives, providing guidance on good practices in these areas, and discussing options for international coordination to address the risk of damaging spillovers from harmful tax competition. According to OECD's press release, comments and feedback are to be submitted not later than August 5th, 2015. The final Paper will be submitted to the G20 for its Leader Summit in November 2015, and made public through posting on the Websites of the international organizations involved.

The OECD's press release is also accompanied by a background document which reviews practical tools and models that can help assess the costs and benefits of tax incentives, something that is deemed essential to enhance transparency and support informed decision making.

One of the Paper's first definitions emphasizes an undisputed trust: A good revenue system adopts taxes that are simple, fair and efficient. This trust evidences, by contract, much of the cons associated with the practice of tax incentive regimes in LICs.

Tax incentives, particularly when adopting the form of tax holidays ruled by special legislative pieces, jeopardize clarity, complicates the tax system administration, creates horizontal inequities, and distorts production efficiency based on market rules. Moreover, when adopted as a way of improving unfair or inefficient market outcomes, unwarranted policy decisions are common place. Finally, tax incentives usually imply forgoing revenues that could have been used in public needs such as infrastructure, education and security, or replaced in a more damaging way in macroeconomic term (e.g., through inflationary financing).

When turning to the issue of effectiveness, the Paper recalls that the importance of the relationship between tax burdens and FDI is smaller in LICs than in advanced economies; and the reason is evident: FDI is much more dependent on general investment conditions than on tax incentives; the latter being unable to counterbalance poor conditions such as those concerning existing infrastructure, macroeconomic instability, unclear property rights, due process, and weak governance and/or judicial system.

The incentives' lack of effectiveness is also frequently associated either with their redundancy in attracting investments, because the investment would have been made even if no incentives had been provided, or with their wasteful nature if and when used to promote distressed geographical areas or unviable sectors of the economy, with the end result that investments do not settle beyond the incentive period.

From a different perspective, it is worth mentioning (as the Paper does) that effectiveness is also conditioned upon the tax treatment in the home country of a MNE. Thus, investors from home countries having a territorial taxation are likely to fully enjoy the host countries' tax incentives (e.g. tax exemptions), since there is no offsetting home country tax. On the contrary, host country's incentives granted to MNEs coming from tax credit countries are usually neutralize at the home country level, since the tax forgotten at source is not creditable against the home country's tax, unless a tax sparing clause is recognized under a DTT signed by and between the home and the host country.

As regards the efficient use of tax incentives, the Paper refers to taxpayers abusive practices, including but not limited to reducing the otherwise applicable tax burden on non-promoted activities by shifting taxable income to a related entity that qualifies for a tax holiday or that reside in a tax-free economic zone. When tax incentives are widespread in a given country, even anti-abuse or tax criminal laws might not be enough to counter these practices, simply because the tax administration lacks the resources needed to combat those practices effectively in practice.(5) And, as the Paper also points out, it is a fact that tax incentive regimes sharply increase the opportunities for rent seeking and corruption.

Calculations of "dollar cost per job created" are a popular metric for measuring the cost effectiveness of tax incentives, and allow a comparison with the cost of creating jobs by direct spending measures. As reported in the Paper, the numbers calculated are striking.

As regards guidance in the use of tax incentives, the Paper is equally revealing of well settled principles of design and governance elaborated by International organizations (IO's) on empirical studies over the years.

Concerning instrument choices, it is defined that tax incentives, that lower the cost of investments (e.g., by accelerated depreciation, special tax deductions and credits) are to be preferred over profit-based tax incentives (e.g., tax holidays, preferential tax rates, or income exemption).

As to eligibility criteria it is emphasized the need that tax incentives be well targeted, and based on clear eligibility criteria. However, when revising empirical data on targeted investments or sectors, including special free-tax sectors/zones that became popular in the last two decades, the Paper is trapped by the net of conflicting performance data available, since the discussion inescapably re-edit critics made to existing ill-practices in other parts of the document.

The Paper's guidance also refers to the on-going monitoring of approved promoted projects, and termination whether on the expiry of the incentive period or in case of failure to comply with the qualifying conditions.

Insofar as governance is concerned, the Paper focuses on the government decision making process, its policies and administration, all of which should be transparent and subject to scrutiny and evaluation. Turning to the key elements for good governance, it is first recommended that tax incentives be clearly prescribed in the law, and preferably consolidated in the tax law. The law should also specify the conditions for eligibility; so that eligibility, should be largely automatic by verification of the stipulated criteria; this is, leaving small room, if any, to administrative discretion.

As regards the granting authority, it is suggested that the Ministry of Finance be in charge as it is well positioned to weight alternative priorities with the cost of incentives. The Revenue Administration, in turn, should be in charge of the implementation and enforcement of the incentives.

International coordination is finally suggested since tax incentives are often instances of tax competition, with the risk that all countries lose from their use. Tax coordination might take the form of a non-binding code of conduct, a common framework for reporting tax incentives and information exchange to encourage mutual learning, or even something more binding, although it is recognized that implementing an agreement in this area is difficult for a variety of reasons nowadays.

The Paper is a highly significant document aimed at contributing good guidance in a controversial area in LICs where, for a variety of reasons, there has been traditionally an intuitive overestimation of the effectiveness of tax incentives.

For instance, the Argentine experience(6) of tax incentives granted on a project-by-project basis within a general legal framework, highly extended during the seventies and the eighties, was a complete fiasco: (i) It was economically inefficient in terms of job creation and growth, (ii) originated unfunded horizontal inequities among business players which competed in the same regional or national markets, (iii) rent seeking and corruption associated with the granting of benefits, project implementation, and fulfillment of the promotional obligations undertaken by taxpayer were widespread and out of control, particularly when as it happened during a significant period of time, the granting of the benefits and the monitoring of the obligations were delegated by law to the provincial governments where the promoted business where located, (iv) the granting of benefits concerning national (federal) taxes for businesses located in certain provinces made that the revenue sacrifice were borne by taxpayers located elsewhere, and that provincial authorities granted the benefits without any sense of responsibility, precisely because the cost was going to be geographically distributed that way; (v) finally, since practically all regions and activities ended up being subsidized, the tax incentives lost their inner sense and they became unable to motorize investments in selected sectors of the economy or regions chosen by the promoting rules.

The system was basically disarticulated in the nineties, and a new set of rules (mostly sectorial Incentives) was set forth since 2004 onwards (including rules promoting mining, forestry, software, biofuels, bioethanol, hydrocarbons, biotechnology, and hydrogen). The common feature of these regimes is that benefits are granted mostly on an investment cost rather than a profit basis. The only regional incentive still alive is Tierra del Fuego (full exemption) for manufacturing of technological devices for export of sale in Argentine mainland.

Bearing in mind that *striking the right balance between and attractive tax regime for domestic and foreign investment, by using tax incentives for example, and securing the necessary revenues for public spending is a key policy dilemma*,(7) it is expected that the final document follows the path initiated by the Paper, giving LICs strong guidance on a matter on which they need it almost desperately to avoid the wasting revenues through missguided practices that IOs have inventoried for decades.

(1) Avi-Yonah, *Double Tax Treaties: An Introduction*, in The Effect of Tax treaties on Foreign Direct Investment : Bilateral investment treaties, double taxation treaties and Investment Flows; Sauvant & Sachs, eds.; Vale Columbia center of Sustainable International investment, Columbia law School, December, 2007.

(2) Verstraeten, *Double Tax Convention between Developed and developing Countries. The Argentine-United States' Case*, in Diritto e Practica tributaria Internazionale, v. VIII, 1, March/April, 2011.

(3) For research studies on a bilateral perspective see, *inter alia*, Davies, *Tax treaties, Renegotiation and Foreign direct Investment*, Economic working paper 2003-14, University of Oregon, 2003, Blonigen & Davies, *The Effect of bilateral tax treaties on US FDI Activity*, International Tax and Public Finance, 2004, v. 11, p. 601-622. Eggen et. al., *The impact of Endogenous Tax treaties on foreign direct investment: theory and evidence*, Canadian Journal of Economics 3, 2006, p. 901-931. These same authors expanded the research, spectrum to 23 countries with OECD data between 1982 and 1992 and, contrary to their former research found a positive link between DTTs and investment flows (Blonigen & Davies, *Do Bilateral Tax Treaties Promote Foreign Direct investment?*, Handbook on International trade, Choi & Hartigan, eds., v.II, Blackwell, London, 2005, p. 526-546).

(4) Di Giovanni, *What drives Capital Flows? The case of Cross-border M&A Activity and Financial Deepening*, 65 Journal of International Economics 1, 2005, p. 127-149. In the same sense, even utilizing bilateral data, see Newmayer, *Do Double Taxation Treaties Increase Foreign Direct Investment to Developing Countries?*, 43 Journal of Development studies 8 (2007), p. 501.-519; and Barthel et. al., *The impact of double Taxation treaties on foreign Direct investment: Evidence from large Dyadic panel Data*, 28 Contemporary Economic policy 3, 2010, p. 366-377.

(5) In Argentina, where we have had a longstanding frustrating experience with tax holidays geared towards promoting activities or geographical areas, we have seen it all in term of taxpayers' gross abuses. Back in the seventies, with the implied complicity of corrupted local authorities, companies obtained tax holidays conditioned upon the establishment of manufacturing plans which never functioned as such but as mere invoicing centers for merchandise produced in other areas. The fraudulent maneuvers were disguised by paying fake operating costs at the promoted place (such as electricity, salaries and others), and contracting freight for the transport of raw materials and merchandise that was never dispatched to or from that place.

(6) See Teijeiro, *Régimen Tributario y Competitividad Empresaria: Pasado, Presente y Futuro de una conflictiva Relación*, Revista del Colegio de Abogados de la Ciudad de Buenos Aires, v. 65, #1, p. 84-100, 2006.

(7) IMF, OECD, UN and World bank, *Supporting the development of more Effective Tax Systems*, Report to the G20 Developing working Group, 2011.

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