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REPORT OF THE AD HOC EXPERT GROUP MEETING ON EFFICIENCY AND COST BENEFIT ASSESSMENT OF HOST COUNTRY TAX INCENTIVES AND TECHNICAL ASSISTANCE NEEDS

Held at Palais des Nations, Geneva, Switzerland,
from 8 to 9 July 1999

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CONTENTS

List of participants

ASCM	Agreement on Subsidies and Countervailing Measures
EU	European Union
FDI	Foreign Direct Investment
FPI	Foreign Portfolio Investment
IBFD	International Bureau of Fiscal Documentattion
IMF	International Monetary Fund
LDCs	Least Developed Countries
MNCs	Multinational Corporations
R & D	Research and Development
OECD	Organisation for Economic Co-operation and Development
VAT	Value-added tax
WTO	World Trade Organization

Ad Hoc Expert Group Meeting on Efficiency and Cost-Benefit Assessment of Host Country Tax Incentives and Technical Assistance Needs

A. Introduction

1. In the Expert Meeting on Investment Promotion and Development Objectives, [1] convened by UNCTAD in September 1997, there was a preliminary discussion on the role of incentives in investment promotion. The experts agreed that interalia: "With regard to the role of incentives, experts noted that the pros and cons on incentives for inward investment have never been conclusive and are unlikely ever to be so. There have been some spectacular successes as well as notable failures; the outcome has often depended on the interaction of a host of complex factors. That said, many experts, particularly practitioners from investment promotion agencies, held that incentives remain an important policy variable in the development strategies of host countries. Of course, the most important incentive is the removal of disincentives and other impediments to inward investment. Moreover, it was widely agreed that financial grants are more costly than fiscal and other incentives."

2. The experts also recommended that "UNCTAD, through its technical assistance programme, should examine how host countries can employ incentives more efficiently and, upon request, assist them in the cost-benefit assessment of their incentive schemes". This was the basis of the present Ad Hoc Expert Group Meeting on Efficiency and Cost-Benefit Assessment of Host Country Tax Incentives and Technical Assistance Needs held in Geneva, 8 to 9 July 1999.

3. The UNCTAD secretariat engaged an international private tax firm, Deloitte and Touche to provide technical advice and prepare a global survey on tax incentives

[1] See Report of the Expert Meeting on Investment Promotion and Development Objectives (24-26 September 1997, Geneva), Document TD/B/COM./8.

(UNCTAD/ITE/IIP/Misc.16). An informal intergovernmental meeting for brainstorming, convened in Geneva on 2 November 1998 helped in identifying the issues related to tax incentives and preparing the agenda of this meeting.

B. Ad Hoc Expert Group Meeting

4. Substantive contributions were received from the country experts of Brazil, Ireland, Lebanon, Pakistan, Singapore and Zambia, three of whom (Brazil, Pakistan and Zambia) had been chosen by their Governments. [2] Some institutions interested in contributing to the work programme on tax incentives were also contacted. The International Monetary Fund (IMF), Organisation for Economic Co-operation and Development (OECD), and the International Bureau of Fiscal Documentation (IBFD) also agreed to send experts to the meeting. The corporate sector was represented by BASF ZR/W International Wirschaftsbeziehungen of Germany. (For the experts participating see Annex I)

5. Background documentation made available to the meeting comprised:

(a) An issue note and an introductory note by the UNCTAD secretariat (Annexes II - III);

(b) Country papers from Pakistan, Singapore, Zambia and Ireland and one from Brazil on The Ford Motor Company's multimillion dollar investment under the automobile regime and the interstate "fiscal war" (Annexes IV - VIII);

(c) Papers from OECD, Deloitte and Touche and IBFD (Annexes IX - XI);

(d) An article from the private sector by Abu Nasr of Lebanon (Annex XII); and

(e) An oral presentation by the expert from BASF.

6. In introducing the subject of tax incentives, the UNCTAD secretariat discussed its relevance to investment promotion for developing host economies. The salient points were:

(a) To attract foreign direct investment (FDI), tax incentives have been an integral part of host countries' investment strategy. Traditionally, incentives were found in the United States and several European capitals. [3] Incentive policies in the developing countries usually started only after colonization

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[2] The experts from Mauritius and Chile could not attend due to other official engagements.

[3] For instance, the types of incentive enjoyed by the United States's investments in the Latin American mining enterprises, the expansion of the packing industry in South America, the banana enterprises in Central America and the sugar plantation in Cuba could be instructive.

and were adopted from the experience of the developed countries. They were based initially on import substitution models and late on export-led strategies. The recent abundance and movement of international capital, the process of globalization and the need for FDI to mobilize resources, have led to an interest in FDI movement and in policies and strategies for investment promotion. With investment promotion, tax incentives too are becoming an issue for debate.

(b) FDI's role as a contributor to development and growth is being stressed more often, along with the growth of tax incentives. Also, the potential interchange of FDI with foreign portfolio investment (FPI) and the volatility of FPI have alerted the developing host countries to the importance of stabilizing and improving their FDI and developing the relevant policies and incentives. [4]

(c) This new approach to improving and diversifying the development and growth impact of FDI compels host countries to create incentives that could lead to technology transfer and R&D. Similarly, income distribution among social classes and regions, value addition and employment and income generation are yardsticks for the success or failure of those incentives as well as of the FDI. That approach will likely characterize the discussions on FDI at the forthcoming UNCTAD X.

(d) The debate on investment promotion at the country level in the developing world is likely to shift from the more conventional liberalization policies towards balanced, targeted and well structured objectives for development. Future tax incentive policies would hopefully have similar goals.

(e) Tax incentives have a longer and more well-structured development in the developed countries than in the developing countries, where it has had more pitfalls and failures. Developed countries are in a position to impart their research and experiences to the developing countries, directly or through their institutions, and the experiences of the more advanced developing countries, as well as the OECD countries should be exploited.

(f) The rule-based globalization process and compliance with World Trade Organization's (WTO) Agreements are an important constraint to formulating incentives. The WTO's Agreement on Subsidies and

[4] One story the experts heard was about a fly-by-night operation of a North American manufacturer of computer microprocessors, who loaded his equipment on trucks and transported it from Malaysia to Thailand. After having exhausted the prescribed period of a tax holiday in one country, he shifted his operations almost overnight to a neighboring country with new and additional years of tax incentives.

Countervailing Measures (ASCM) established certain disciplines. As financial contributions, some incentives are a benefit that is equivalent to a subsidy, some are revenue foregone; and some are direct transfer of funds, while the provision of land and infrastructure at less than market rates are indirect subsidies. Similarly, certain incentives within the WTO provisions could be causing adverse effects or presumption of serious prejudice. This is an area where developing countries have to be better prepared.

(g) Incentives have a direct bearing on investment promotion and also implications for double taxation, transfer pricing, competition policies and multilateral obligations. In the light of these factors, host countries' potential needs for technical assistance and coordination, by UNCTAD with IBFD, IMF and OECD, should be explored.

C. Discussions

7. The one-and a half-day discussion on tax incentives that followed was divided into four parts. Item 1: types and instruments; Item 2: advantages and disadvantages; Item 3: administration; and Item 4: technical assistance.

Item 1: Types and instruments

8. The experts reviewed the most widely used definitions of tax incentives and agreed to conceive this as "all direct and indirect transfers of resources through the tax system by a central or local government to an enterprise". Tax incentives usually are relaxed variations of the standard rules normally applied in the relevant jurisdiction.

9. According to Terry Browne of Deloitte and Touche, the moderator for the discussion of this item, tax incentives are not limited to particular countries or regions, nor are they unique to specific areas. The most common tax incentives are: (a) tax holidays (full or partial) and rate reductions; (b) tax credits (e.g. research and development credits); (c) accelerated or multiple deductions for capital expenditures and other significant costs (e.g. training costs); (d) customs duty reduction; (e) value-added tax (VAT) reduction; and (f) tax-free profit remittances. The majority of tax incentives granted by developing countries are for investment in manufacture, exploration and extraction of mineral reserves, and, increasingly, the tourism and leisure sectors. The service-sector incentives also include a reduced rate of corporate taxes that would attract headquarters companies, an incentive limited to Malaysia, Singapore and Hungary.

10. Three main categories of incentive regimes identified by Mr. Browne are: (a) regional incentives; (b) sectoral incentives; (c) export incentives; and free trade zones. Many tax

incentive regimes can of course belong in more than one category and can interact and apply concurrently. Dali Bouzoraa of IBFD, citing the example of the State aid surveys of the European Union, classified the incentives as did Deloitte and Touche, but added: (d) horizontal incentives generally available to all enterprises for certain functions (R & D, employment creation and environment protection). Steven Clark of the OECD grouped incentives in terms of policy considerations or arguments for attracting FDI, namely: (a) international competitiveness, as a means of enhancing a country's ability to attract internationally mobile capital; (b) correcting for market failure, where the operation of private markets fails to yield a socially optimal level of investment; (c) macroeconomic considerations, i.e. broad-based incentives that address cyclical or structural unemployment, balance-of-payment deficits and the effects of high inflation on tax liabilities etc.; and (d) regional considerations, as mentioned also by Deloitte and Touche and the IBFD.

11. The discussion of the Ad Hoc Expert Group centered on the survey of Deloitte and Touche on some 40 countries. They found that most countries provide some form of fiscal incentive: *sectoral-specific incentives* are the most widely used for attracting FDI to manufacturing, exploration and extraction of mineral reserves and, increasingly, to the tourism and leisure sectors; *regional incentives* channel investment to assist in the development of underdeveloped regions in national jurisdictions and regional integration groups, thereby alleviating regional disparities that often result in intense interstate competition. [5] Equally important are the export incentives and free trade zones, each of which has sub-categories. *Regional development* objectives help countries to support rural development, to build industrial centres away from major cities and to avoid environmental hazards, over urbanization and concentration of population. Angola, Nigeria, Ghana, Thailand, India, Pakistan, Brazil and Ecuador are some of the countries that use such incentives. Egypt's exemption schemes for the reclamation and cultivation of barren and desert land also fall in that category. Some of those incentives could integrate regional development and sector-specific objectives. For instance, Egypt's tax exemption schemes for poultry and animals have a longer exemption period if they contribute to decentralization and are set up in new industrial zones and new urban communities. This phenomenon is common in other developing countries also. *Sectoral fiscal incentives* are targeted at the services sector, the film industry, mining and industrial parks, export-led activities and businesses with new technologies. In Pakistan, for instance, hi-tech industries, which include processing control equipment and systems, power tools, information technology, solar technology and hermetical sealed technology are some of sectors that benefit. *Some examples of export incentives* are VAT exemptions, profit tax reductions (Angola), export tax allowances (Malawi), reduced tax rates for companies in export processing zones (Mauritius), and reduced

[5] The most recent regional incentives cited were those of (a) Mercedes Benz plant in Alabama, United States and (b) the Ford Motor Company's multimillion dollar investment in the underdeveloped State of Bahia in Brazil, details of which are discussed in the Mr. Gomes's paper, the expert from Brazil.

tax rates on manufacturing, services and export activities (Viet Nam).

12. Nearly 85 per cent of the countries surveyed have fiscal incentives in the following areas: reductions in the standard rate of corporate income taxes is the most widely used fiscal incentive, followed by tax holidays, exemptions from import duties on capital equipment, raw materials and semi-finished components, duty drawbacks, accelerated depreciation, deductions from gross earnings for income tax purposes, investment and reinvestment allowances and deductions from social security contributions.

13. An objective of incentives in developing countries is to attract investment to manufacturing. Some countries have introduced a reduced tax rate of 10 per cent across the board for manufacturing industries, others have introduced incentives for research and development (R&D) activities and high-tech projects (e.g. tax-exempt technology development funds and tax credits for R&D and for upgrading human resources related to R&D). Across the board tax rates are accompanied by special allowances. Targeted deduction for certain types of expenditure, income exemption for a specified period, exemption of import duty and a higher percentage of reduction in import duties for inputs used in exportable manufactures are some examples of export- led incentives. Sikatema Mulonda of Zambia referred to another type of fiscal incentive, which is designed to support the privatization of State and public-sector enterprises.

14. There was consensus that while incentives have their pros and cons, their role essentially remains subsidiary. More fundamental factors are political and economic stability, project feasibility, market considerations, investment climate and infrastructure. The low tax regime in Ireland is a class by itself, and, as mentioned in paragraph 8 above is substantially lower than the standard market international rates (in Europe, the rate is over 30 per cent). A low corporate tax rate in Ireland as explained by Richard Ryan, expert from Ireland, is the most popular incentive for 90 per cent of investors. Based on his country's experience, Mr.Ryan remarked that investment is a two-stage process. "The first stage evaluates political and economic stability, access to markets, availability of skills, reasonableness of cost structure, etc. Only those countries which pass these tests go on to the next stage of evaluation where the tax rate, and tax incentives become important."

15. The experts' presentations, together with Deloitte and Touche's survey, revealed both similarities and differences in approach to incentives and their priorities. The incentives reflect country characteristics, such as size of the economy, disparity in growth between poor and rich regions in the same country and priority areas as defined by the planners and others. The following checklist of questions drawn up by the experts could help understand the impact, functions and role of incentives:

- Who are the beneficiaries of the tax incentives ? Are they residents or non-residents and how are these terms defined so that they can benefit from the incentives?

- Do the regions in a country benefit equally from the various incentives? How are they monitored? Do they compete for investments?

- Which groups of investors have access to the incentives? Who decides on the discretionary incentives? Are these incentives negotiable between investors and host governments? Who administers them?

- Is there a trade-off for having a simple or a sophisticated incentive system that targets specific activities?

- How transparent are the laws on incentives?

- How stable is the current regime? Will it be replaced, and thus affect investors' confidence and trust?

- What are the criteria for measuring the effectiveness of the incentives? Are these criteria transparent?

- Do countries compete for investors by simply lowering tax rates or by offering more generous incentives without considering the real benefits and long-term consequences?

- In offering incentives to investors, should countries also take into consideration ways of integrating into the world economy?

- In countries that adopt privatization as a development strategy, should alternative forms of financing, such as equity swaps and bonds, be considered ?

Item 2: Advantages and disadvantages

16. The article by Steven Clark of OECD, and other presentations, covered several issues that impinge on cost-benefit assessment. They are, for example, potential pitfalls, experience of OECD member countries with corporate tax incentives for FDI, econometric evidence, case studies, claw-back of the host country tax incentives by home-country corporate tax systems, and the role of tax-sparing or double tax avoidance and tax compliance issues. Drawing largely on the experience of OECD member countries and on several research articles on this issue, Mr. Clark made the following points:

(a) The focus should be on the amount of additional investment that would not have been undertaken in the absence of tax incentives. A tax incentive must have positive substitution effects for it to be truly operative, and will be cost efficient only if the additional amount of investment forthcoming exceeds the amount of tax revenue lost.

(b) In assessing the cost-effectiveness of a given tax incentive, the determination of the incremental investment that results from the incentives is often highly uncertain because of, *inter-alia*, limitations to the empirical analysis due to problems of data measurement, simplistic modeling assumptions, estimates of the responsiveness (elasticity) of FDI to changes in the after-tax rate of return on FDI, and, through this channel, to changes in the level of tax incentives for FDI.

(c) While the investment theory predicts that investment expenditures will respond positively to tax holidays, particularly if offered to the "marginal investor", the impact of different tax incentives has mixed implications. Thus a reduction in the corporate income tax rate would be expected to both encourage investment by lowering the amount of tax on revenues, and at the same time discourage it by lowering the present value of capital cost allowances and increasing the after-tax cost of debt finance. In general, the overall response should be positive, but may not be, depending on the rate of depreciation for tax purposes and the debt/equity ratio. For high leverage firms with enhanced and/or highly accelerated depreciation (e.g. immediate full deduction of capital costs), a reduced corporate tax rate may in fact discourage investment at the margin. Similarly, variations could occur in the matter of up-front tax incentives or different forms of investment subsidies such as investment tax credits and accelerated depreciation (limited to new capital expenditures).

(d) The impact of tax incentives across sectors and time differs. The positive impact on FDI should be greater when there is little differential in non-tax business costs among competing jurisdictions, as this would tend to make tax differentials a more important consideration in locational choice. [6]

(e) Other factors should also be included in cost-benefit assessment such as the possible nullifying or clawing-back effect of the home country tax on the host country relief, reduction and exemption of tax. In those situations, the incentives would either be having neutral effect or effect only to the extent of the tax differential between home and host countries. That analysis should also distinguish between FDI investors "operating out of countries with exemption systems" and those who are within "residence-based systems" that tax investors on their worldwide income. The discouraging impact of the increased United States taxation on FDI financed by new equity was also

[6] Recent advances in data management, telecommunications and other technologies have almost eliminated cost differentials among business locations for a range of business activities requiring only rented office space, computer and telecommunication equipment and staff, all of which can be either readily accessed in a given host country or transported at minimal cost. The list of mobile business activities falling under this description might also include head-office and coordination activities, holding company, financing and risk management activities, leasing and distribution activities, as well as others, spanning a wide and growing range of service sectors (e.g. wholesale (increasingly retail) banking, financing, insurance, certain telecommunications and entertainment industries.)

cited in that context.

(f) The case-study approach suggested that if market-based project analysis finds an investment to be unsound due to cost considerations linked to government policy (e.g. lack of infrastructure, political and legal instability), then it generally will be more efficient to address these considerations directly. Similarly, careful case-study analysis tends to confirm the view that generally tax incentives are unlikely to be a determining factor in investment decisions involving significant amounts of real (tangible) capital, particularly in the case of FDI into developing countries.

(g) Corporate-level tax incentive programmes introduced by OECD member countries to promote domestic investment, whether by domestic or foreign investors, often have not proven to be cost-efficient, as indicated by a mix of case studies and empirical analyses. While evidence on the effectiveness of incentives varies across targeted sectors and from one incentive programme to the next, the overall track record generally has been disappointing -- estimated benefits in terms of incremental investment activity and spin-off effects generally fall below the estimated foregone tax revenue (i.e. an efficiency index of less than one.)

(h) To a large extent, the success or failure of a tax incentive programme to promote investment in a cost-effective way will depend on the specific design features and targeting of the programme, and the existence or not of supporting provisions (e.g. thin-cap rules, transfer pricing rules.) With "the devil in the details", much can be learned from the past experience of other countries, including how they have responded to difficulties (e.g. tax base erosion) as they arose.

17. Mr. Browne considered that:

(a) It was almost impossible to evaluate scientifically cost-benefits of different regimes and categories of incentives, some of which could conflict with others. Results should be seen in broad macroeconomic terms, such as infrastructure development, employment creation, increased exports, etc.

(b) More suitable approaches to assess the impact of fiscal incentives on location decisions were country-specific in-depth economic analysis and surveying of multinational companies.

18. Richard Ryan cited a few examples of some incentives from his country's experience. Although Ireland's low corporation tax of 10 per cent for manufacturing is attractive to mobile investors and stimulates the economy, it has the disadvantage that, in some situations, it could result in a tax haven; export sales relief and incremental export sales relief (both discontinued)

stimulated an export-led outward-oriented economy, but discriminated against non-export companies and even infringed on European Union (EU) and WTO rules; the low corporation tax of 10 per cent for certain businesses at Shannon Airport encouraged the development of a regional airport and an airport town; capital allowances on buildings, plants and machinery facilitated investments in new equipment and building but potentially had the risk of encouraging excessive investment, e.g. unutilized buildings. Mr. Ryan also cited a survey of multinational corporations (MNCs) on the influence of tax incentives on investment decisions (by Deloitte and Touche, May 1996). According to that survey:

(a) 80 per cent of the respondent MNCs said: "tax issues were influential when making an overseas investment"; and

(b) 83 per cent of the above included the EU as a location where incentives had been influential in the locational decisions.

19. Abu Nasr of Lebanon generally favoured tax incentives and countered the conventional argument of revenue loss due to tax incentives. His reasons were:

(a) A long time framework is needed for an adequate cost-benefit assessment of incentives. The short-term revenue loss, on account of tax incentives, would be recouped in the long run by the taxation of the additional investments, which would occur on account of those tax incentives.

(b) Incentives in the developing countries are needed to outbid the developed home country's relatively better infrastructure and economic environment, while the cheap labour advantage of developing host countries was gradually receding.

20. However, because of Lebanon's real estate experience, he was concerned that "tax incentives may lead to an over-supply or over-investment". In Lebanon, the overall supply of real estate, due to a 50 per cent reduction on the normal income tax rates on real estate development companies, led to a concentration of investments in real estate and to an absence of investment in other sectors. Abu Nasr also emphasized the need for the management and monitoring of incentives to determine their optimum duration and time span and for establishing alternatives before the incentives start to have diminishing returns.

21. Sikatema Mulonda, the official expert from Zambia, said that one of the outcomes of the two conventions held in 1998 and 1999 in Zambia at the national level was "a realization that tax incentives were an important factor but not the only determinant of business success".

22. Dali Bouzoraa of IBFD cited both the positive (Malaysia) and negative (Argentina, Canada) effects of tax incentives, and concluded that "no definitive statements can be made about the effectiveness of tax incentives in general. Investors would prefer a stable, low and

straightforward *standard* tax system." Nevertheless, certain types of incentives may indeed play an important role in developing countries, particularly in the early phases of industrial development, and in setting up and financing the investment project. Other things being equal, an investor may be tempted to invest in locations with generous tax incentives (e.g. Ireland) as compared to locations without, or with less generous, tax incentives (e.g. United Kingdom). Also, in choosing a location for a holding, finance or headquarters company, he agreed with the expert from Zambia that the tax factor, while not the only factor, can play a determining role.

23. Grant Taplin of IMF fully agreed with the experts who had underscored the importance of a stable macroeconomic and political framework for attracting foreign investment funds, and that tax incentives were low on the list of effective instruments. It was the Fund's experience that the cost-effectiveness of providing tax incentives for investment was questionable under the best of circumstances; they would be of marginal significance in an environment of political and macroeconomic instability, nontransparent legal and regulatory frameworks and inadequate supporting institutions and facilities. Often such incentives were self-defeating and costly, and frequently the source of corruption. The first-best strategy for sustained investment promotion consisted invariably of appropriate measures to rectify these problems, together with putting a tax system in place that was in line with international norms.

24. The experts generally agreed that in seeking investment capital, countries were competing with each other and indulging in so-called incentive tournaments which could be a costly exercise, particularly for developing countries. In that context, the case of fiscal war for getting the location of the multimillion dollar investment plant of the Ford Motor Company, was cited by Gustavo Maia Gomes, the official expert of Brazil. Under the incentive regime being considered by the State of Bahia in Brazil, the Ford Motor Company's plant "will have exemption of tax imports on machinery and equipment, a 90 per cent reduction of the same tax as applied to raw materials, tires and other components parts, a 50 per cent reduction on the import tax on automobiles, exemption of the tax on industrialized products on machinery and equipment, exemption of the tax on the net income generated by the plant, and so on. On top of all that, the federal state-owned investment bank will finance (in favored conditions) the undertaking, and the Bahian government will give free of charge the land where the plant will be built, unspecified reduction of the state VAT tax, and an additional $100 million in low cost credit (Folha de Sao Paulo, 30 June 1999)". Mr. Gomes said that over the last three to four years, virtually every State in Brazil engaged in one form or another in the so-called fiscal war. In his view:

(a) Ford's decision to invest in Brazil had been previously taken; it was only after that the company went to negotiate with the States in order to reap additional, and always welcome, benefits.

(b) A pessimistic assessment has to be made of the utilization of virtually limitless tax and credit incentives as instruments for attracting FDI.

25. The experts shared the view that ,even in developed countries, competition between different cities and regions had increased the costs of incentives for the host regions. Investing in development was considered a better option. It was therefore imperative to carry out studies before granting any tax incentives, and undertake analysis of potential benefits to the firm and the country as a whole.

26. The appendix to Richard Ryan's article on tax measures in Ireland was recommended as a useful framework for analyzing the advantages and disadvantages of the wide range of measures. It was suggested that, for easy comparison, tables similar to his be drawn up to reflect the situation in each country. A general table would also serve as a starting point to advise developing countries.

Item 3: Administration

27. The effectiveness of a fiscal incentives system depends on its proper implementation, administration and monitoring. The problem areas identified by the experts are:

(a) Different governmental agencies offer incentives packages. There are instances where federal (or national) governments and State (or local) governments had their own programmes, while the potential investors preferred to deal with one agency and would have liked to know upfront what was the availability of the total package of incentives.

(b) Inadequate availability of laws, rules and procedures on incentives and the need for transparency;

(c) Lack of administrative capacity to administer the incentives, particularly in the least developed countries (LDCs).

(d) Lack of uniform "concepts" and definitions of different incentives in different situations. [7]

(e) Difficulties due to the scattering of incentives in different laws (foreign investment laws, tax laws, import/export policies, custom manuals).

28. Some of the questions that need to be dealt with are:

(a) Is the administrative system in a country consistent and transparent?

(b) How easy is it to get information from the administrators of tax incentives?

[7] For example, "high-tech" had a different meaning for a technologically less developed country than for a country with a developed technological infrastructure.

(c) Is the present administration stable enough to ensure that changes in the future will be minimal?
(d) Is the tax administration a fair process?
(e) How does the tax administrator treat transfer pricing and related issues?
(f) Does the administration have enough trained manpower to monitor compliance of the tax regulations and identify tax leakages?
(g) How does the administration deal with cross-border tax incentives?

Item 4: Technical assistance

29. Abu Nasr, suggested, inter alia , that there is a need for an ongoing plan to monitor incentives, which has sufficient data, accounting standards, tax-filing procedures, statistics collection, training, fiscal policies and regulations. He also recommended learning from countries experienced in tax incentives evaluation, implementation, monitoring, management and institutional matters (structure of fiscal departments) of tax incentives. Such experiences need to be backed up by case studies, training and expert advice.

30. Steven Clark of OECD provided two case studies to illustrate the issues and modeling approaches in the cost-benefit assessment of tax incentives in investment (FDI and other investments). The case studies evaluated: (a) The economic effects of the Cape Breton Investment Tax Credit (CBITC) [8] and (b) the economic and fiscal impacts of the exploration tax credit (ETC) [9].

31. Iqbal Farid (moderator) said that Pakistan has done case studies on incentives and exemptions at its Economic Research Institute in Karachi and the Institute of Development Economics in Islamabad, which were needed to determine how economic, social, political and infrastructural-factors inhibit investment, particularly foreign investment. He supported setting up an advisory service in UNCTAD and an UNCTAD/OECD website/Internet with the following goals:

(a) To disseminate information on the incentives used by different countries, and analyze their impact (cost-benefit) on employment, industrial efficiency, transfer of technology and competitiveness through effective protection rates (EPRs) and domestic resource costs (DRCs).
(b) To provide information on the short-and long-term implications of

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[8] A regional tax incentive system designed to create alternative employment on the Cape Breton Island with the objectives of alleviating regional economic disparities.

[9] As part of the Canadian Frontier Energy Policy, this tax credit was designed to encourage oil and gas exploration in Canada’s frontier lands.

incentives, and the administrative measures required to apply them.

(c) training programmes for the above.

Technical assistance on these issues would be required.

32. Exchange of country experiences was one way to provide technical assistance. Singapore's unique experience for instance, which was based on research and an analysis of incentives before and after their application, could be valuable, but that information was usually confidential. Information on OECD was relatively transparent.

33. Grant Taplin of the IMF suggested that the UNCTAD secretariat establish informal bilateral contacts with the IMF and the World Bank which is essential to avoid duplication. UNCTAD would want to be cautious that its assistance respond to the countries' requests, and not promote the incentives.

34. The global survey is useful in helping developed countries to provide technical assistance to developing countries, particularly by surveying other countries' experience since the survey reviews the most common tax incentives. The experts suggested that countries be selected based on their geographical location, since they are interested in other countries in their vicinity.

35. The experts also noted that the survey, although an important tool, is only a descriptive exercise and should be complemented by the above-mentioned studies to assess the cost-benefits of each type of tax incentive. The difficulty of those studies is in identifying whether a given investment is incremental, and in quantifying the advantages and disadvantages of tax incentives. Empirical studies carried out by the IMF and the OECD should be used. A survey of multinationals corporations in order to examine the reasons for their foreign investment decisions and their assessment of the various tax incentive measures was supported.

36. The experts appreciated UNCTAD's position not to encourage countries to introduce tax incentives, but rather to provide information on which would help them determine their advantages and disadvantages, as well as their relationship with the GATT/WTO rules.

37. The experts agreed that information on fiscal incentives, particularly for investment promotion agencies, would help to better understand the rationale for tax incentives, i.e. the need for incentives from the perspective of investment promotion and not only from that of taxation. The experts also identified the institutions most involved in technical assistance programmes, such as IBFD, OECD and Harvard.

38. The experts agreed that UNCTAD could be most effective in providing information to countries seeking to introduce tax incentives or to restructure their tax system to attract more FDI, and as the facilitator between those countries and the institutions and organizations dealing with technical assistance programmes and their funding, rather than building up its own international tax expertise. Countries would then turn to UNCTAD for information on: (a) the types of incentive in other countries, particularly in their geographical vicinity; (b) cost-benefit assessment of the most common types of tax incentive; (c) the relationship between tax incentives and multilateral and regional rules on trade and investment, such as GATT/WTO rules and custom zone agreements; (d) designing incentives and their policies; and (e) providing basic principles on tax incentives and cost benefits. UNCTAD could enlist other relevant institutions such as IBFD, OECD and Harvard.

D. Related issues

WTO compliance

39. Regarding WTO compliance, individual country-level technical assistance and advisory needs should be demand driven and country specific. UNCTAD's in-house capacity could be strengthened. Under WTO's Agreement on Subsidies and Countervailing Measures (ASCM), a range of multilateral disciplines applies to investment incentives. [10]

40. The information available to the experts, based on the WTO, covered the following points:

(a) Investment incentives meeting the definition of a subsidy, and contingent upon exportation of goods produced (or to be produced) by an investor, or contingent upon use of domestic over imported goods, are prohibited under the ASCM. [11] Investment incentives other than those meeting the definition of prohibited subsidies are likewise subject to ASCMs disciplines. That is, even if not prohibited, incentives that cause adverse effects, as defined by the ASCM, potentially are subject to compensatory action, either multilaterally or under WTO member's national legislation.

(b) In a multilateral context, the ASCM's provisions pertaining to serious prejudice refer directly to investment incentives. In particular, Annex IV, (which provides guidance for calculating whether the total *ad valorem* rate

[10] There were no dispute settlement cases involving investment incentives under the GATT (1974) or the Tokyo Round Subsidies Code, perhaps in part because the extent of any binding on domestic subsidies was unclear.

[11] The latter type of incentive is also prohibited under Paragraph 1 of the annex to the TRIMS Agreement.

of subsidization of a product is sufficient to give rise to a presumption of serious prejudice), includes subsidies to firms in “start-up situations”, that is, where financial commitments have been made for product development or construction of facilities, but where production has not yet begun.

(c) The underlying concepts of the ASCM are oriented towards trade in goods, and as such may not in all cases be easily applied to investment incentives.

(d) Under the ACSM, *adverse effects* of subsidization are defined in terms of distortions of trade flows of subsidized goods; that is, the extent to which subsidies increase the level of exports from, or reduce the level of imports into, the subsidizing country, and thereby harm producers of like goods in another country. In the context of investment, because the granting of an incentive generally predates production, often by a considerable period, such an after-the-fact measurement of adverse effects is unlikely to exercise discipline over the provision of investment incentives. A similar issue arises in the context of *remedies.* By the time production and exportation have commenced, incentives aimed at attracting the investment often will have ended. In this situation, neither a recommendation to withdraw or modify a subsidy, nor a countervailing duty applied to the exported goods, will be able to “undo” or to change an investment that already has been made. [12]

41. While ASCM provides the framework for establishing disciplines to reduce competition to attract FDI, developing countries are in no position to compete with the investment incentives offered by various levels of government in the developed countries. The spirit of the ASCM imposes less rigorous demands on developing countries. The question remains as to how much flexibility there should be in offering investment incentives for those developing countries that find themselves in ruinous competition to attract FDI.

Transfer pricing

42. To reduce the tax liability on FDI, the MNCs indulge in an arbitrary transfer of profits from operations that do not qualify for tax relief to those which do. Thus, profit derived from different branches of MNC in one country could be attributed by the MNC entirely to one branch which enjoyed a tax holiday. This issue is being discussed in the Economic and Social Council. Developing countries, particularly LDCs, require expertise and training, and therefore the

[12] *Annual Report (1996) of the World Trade Organization*; see volume 1: *Special topic Trade and Foreign Direct Investment,* under item (4) on Agreement on Subsidies and Countervailing Measures (page 72).

Council's work needs to be followed up.

<u>Tax havens/double taxation</u>

43. These issues are also being dealt with in the Economic and Social Council's Ad Hoc Group of Experts on International Cooperation in Tax Matters.

E. Follow-up

The follow-up recommended by the experts for the above activities is summarized below:

(a) The Global Survey and the report of the Ad Hoc Expert Group should be published.

(b) A technical assistance project should be prepared in consultation with the IBFD/OECD, IMF/World Bank and Deloitte and Touche and include the following:

(i) Capacity building in designing tax incentives based on country experiences.

(ii) Conducting case studies on countries' request.

(iii) Devising a global chart on the advantages and disadvantages of tax incentives.

(iv) Creating a training programme and a module on tax incentives for developing countries, particularly LDCs.

(v) Seminars and workshops on experiences.

F. Annexes: Annexes II to XII

Annexes II to XII are available on request from the UNCTAD secretariat (DITE).

Annex I

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