Do lower taxes encourage investment?

by

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Conventional wisdom holds that countries with lower taxes attract higher levels of foreign direct investment (FDI). At first glance, this intuitive assumption seems to be supported by the evidence. Some tiny jurisdictions with low or no taxes on foreign investment do seem to attract more FDI than major economies, but “investment” is the wrong term for billions of dollars that flow in and out of these places as part of the strategies multinationals use to pay less tax.

A new methodology for calculating FDI has been developed at the OECD to provide a clearer and fuller picture of FDI flows. Long time series of these new-generation FDI statistics are not yet available. In the meantime, we analysed the financial statements of around 10,000 multinationals for the 2015 OECD Business and Finance Outlook to model the relationships between their capital spending, rates of return, and tax holidays and exemptions, among other factors of investment. We found that tax holidays and exemptions do matter in investment decisions, but they are not the only factor and not necessarily the most important.

At the same time, governments around the world have become increasingly concerned with “double non-taxation”, i.e. companies not paying tax in either the country where they make their profits or the country where their headquarters are. Double non-taxation is one of the targets of the OECD/G20 project to counter tax base erosion and profit shifting (BEPS). Over 120 countries have participated in the project in recognition of the fact that a country trying to tackle BEPS on its own would probably lose out to more generous rivals. With the recent release of the final BEPS package, and the ongoing work on exchange of tax information, governments are well equipped to meet this challenge. However, governments also have three additional means at their disposal to prevent tax abuses without undermining investment.

Public governance of tax incentives according to internationally-agreed best practices.

The new tax chapter of the OECD Policy Framework for Investment (PFI), used by dozens of countries and regions such as the South African Development Community and the Association of
Southeast Asian Nations, provides multilaterally-agreed guidance to help countries avoid potential abuses of tax incentives and resist undue pressure to offer tax incentives. The PFI calls for incentives to be granted only following a proper legislative process. The PFI also provides guidance on the implementation and administration of tax policy regarding investment, for instance on making sure different levels of government are working together, addressing capacity constraints in tax offices, establishing criteria for analysing the costs and benefits of incentives, and providing for “sunset clauses” that say how long the agreement stays in force. This ultimately works in favour of the broader business community concerned with public sector transparency and a level playing field. As this issue is of particular relevance for developing countries, the OECD, in collaboration with the IMF and World Bank, has also developed a report on Options for Low Income Countries’ Effective and Efficient Use of Tax Incentives for Investment.

**Clarifying the degree of exposure of tax measures to investor claims under investment treaties.**

Many governments see investment treaties as a way to increase the investor confidence and long-term trust needed to encourage investment. However, there is concern that some investors and law firms are claiming that sovereign states who change tax regimes to phase out excessive advantages, or who enforce tax laws more energetically, are violating investment treaties and should pay compensation. Most investment treaties currently apply to tax measures, but to differing degrees. Some of these treaties – especially more recent ones – contain mechanisms that give the state parties the power to make joint determinations on individual tax measures, but these are still the exception: only 3.6% of the 2 060 treaties in a sample the OECD analysed contain a clause of this kind related to tax measures. Other investment treaties limit the types of claims that can be brought against tax measures and permit, for example, only claims for expropriation.

Clarifying the scope of application of investment treaties to tax measures can help provide a more certain policy landscape for governments and investors.
Under the legally binding OECD Code of Liberalisation of Capital Movements, certain tax measures can amount to a restriction to the free flow of capital and can fall within the scope of the Code. But the Code gives governments adequate policy space – for example, taxes that are not identically applied to residents and non-residents but are levied in accordance with widely accepted principles of international tax law, are not considered as a discriminatory restriction under the Code.

Violations of tax laws by investors may also be relevant to the application of investment treaties. This is because illegality of the initial investment is increasingly expressly recognised as a bar to treaty coverage and, for instance, the recently-negotiated Comprehensive Trade and Economic Agreement between the EU and Canada would limit the definition of investments to those made “in accordance with law”.

**Communicating collectively to companies the expectation that they should obey not only the letter but also the spirit of tax law.**

The OECD Guidelines for Multinational Enterprises (the Guidelines), a set of recommendations to companies by OECD and non-OECD governments, call on enterprises to comply with both the letter and spirit of the tax laws and regulations of the countries in which they operate and not to seek or accept exemptions outside the statutory or regulatory framework related to taxation. Complying with the spirit of the law means discerning and following the intention of the legislature. Tax compliance also entails co-operation with tax authorities to provide them with the information they require to ensure an effective and equitable application of the tax laws. The Guidelines’ recommendation that enterprises should also treat tax governance and tax compliance as important elements of their oversight and broader risk management systems is reinforced by the recently revised Principles of Corporate Governance. Governments should increase their efforts to raise public awareness of the tax chapter of the Guidelines in support of their broader agenda to modernise and cooperate on tax policies.

Trade and FDI drive economic globalisation and help stimulate the growth of national economies. Fair and efficient tax systems are
central to sharing the fruits of that growth equitably among nations and citizens. The challenge for governments is to put in place policies that attract investment and enable them to collect their fair share of taxes.

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