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TAX COMPETITION AND INVESTMENT INCENTIVES

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Summary of Contents

1. INTRODUCTION

It is curious how particular issues move in and out of fashion in the world of taxation. A few years ago the hot topic - certainly in Europe and in the United

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States - was the reform of corporate taxation. Then attention switched to the problem of transfer pricing. Now, the talk is all of 'tax competition' - a phenomenon that is also described by a variety of more colourful expressions. The term 'fiscal degradation' appeared in the Monti Memorandum, of May 1996,[2] and this was soon followed by talk of tax 'dumping', and fiscal 'piracy' or 'poaching'. A recent headline, which read 'NETHERLANDS 2 BELGIUM 0, referred not to the result of a World Cup qualifying match but to the fact that two Dutch companies had moved their corporate finance centres from Belgium back to the Netherlands following changes in the Dutch tax law that had come into effect at the beginning of 1997 - changes that had been introduced with precisely the intention of inducing multinational coordination and finance centres to return to the Netherlands. Suddenly, tax competition has moved to the top of the European Union's agenda for the latter half of 1997.[3]

In response to the concerns that have been expressed, principally by the governments of those member states that perceive themselves to be losing out in the battle to attract investment, a 'High-Level Group of Experts' was established within the EU to examine the issue of tax competition, and commenced deliberations in March 1997.[4] At more or less the same time, the issue was being raised in the forum of the OECD. Initially the intention was to deal with investment incentives in the context of the proposed Multilateral Agreement on Investment (MAI).[5] Subsequently it became apparent that the announced deadline for publishing the proposed agreement would not be met if it were to deal at any

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2 *Taxation in the European Community*, discussion document for the meeting of the ECOFIN ministers, Verona, 12-13 April 1996 (hereafter the 'Monti Memorandum').

3 V Smart, 'Luxembourg plays fast and loose on Taxation', *The European*, 3rd July, 1997, p.1.

4 'High-Level Tax Group gets down to Work', *European Union Financial Industry Monitor*, March 1997, p.VII; 'Abolition of 'harmful' Tax Competition between the Member States', *Tax News Service* (International Bureau of Fiscal Documentation), 27th March, 1997.

5 In May 1995, the OECD Council committed the organisation to start negotiations on the establishment of a Multilateral Agreement on Investment, with a view to reaching agreement by May 1997. Among other topics, the agreement was intended to deal with some aspects of the taxation of foreign direct investment: see R Couzin, 'Taxation and the Multilateral Agreement on Investment', *Tax Notes International*, 24th April, 1996 (96 TNI 122-14).

length with tax issues, and a separate 'Task Force' was set up in January 1997 to examine the specific problem of tax competition.[6]

Although tax competition is not a new phenomenon it attracted relatively little attention until quite recently. However, as is pointed out in a comprehensive new study, incentives for investment have increased substantially, in range and in scope, since the 1980s and strong competition to attract foreign direct investment has developed.[7] And the globalisation process, with the removal of barriers to trade and investment, has greatly increased the importance of taxation in investment decisions.[8]

The problem, naturally, is not confined to the member countries of the EU and the OECD. One regularly reads of tax competition among the members of the ASEAN and MERCOSUR groups, and among the provinces or states of countries with federal systems of government, such as Brazil, Canada and the United States. For example, Indonesia, after a period of almost twelve years during which no significant tax incentives were offered to foreign investors, recently felt compelled to grant tax breaks for hi-tech investment in order to compete with neighbouring Malaysia and Singapore, which offer an array of attractive incentives.[9] Argentina has complained strongly of the 'unfair' incentives that Brazil grants to auto manufacturers and there has been talk of an 'incentives battle' in South America.[10] There have been reports of 'tax wars' developing between the states

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6 The task force is expected to report in mid-1998: 'OECD Task Force examines Tax Competition', *Worldwide Tax Daily* (Tax Notes International), 22nd January, 1997 (97 TNI 14-24). For additional background, see A.Ahnlid, 'The Multilateral Agreement on Investment: Special Topics' (Paris: 1996, OECD).

7 United Nations Conference on Trade and Development, INCENTIVES AND FOREIGN DIRECT INVESTMENT (New York. 1996, U.N.) (Doc. UNCTAD/DTC1/28), p.17 (hereafter UNCTAD 1996). According to a recent OECD study, public subsidy to industry has been increasing; more than half of 1,437 programmes reported had the stimulation of investment as their goal, absorbing 37% of all public support to industry during the period 1989-93: M Murphy and U Pretschker, 'Public Support to Industry', *OECD Observer*, 1997, No.204, p.11.

8 See J Owens, 'Globalization: the Implications for Tax Policies', (1993) 14 *Fiscal Studies* 21.

9 S Sim, 'Indonesia prepared to offer Tax Breaks to Chip Makers', *Straits Times* (Singapore), 21st February, 1997, p.54.

10 M Osava, 'Mercosur: no Truce in Battle for Foreign Investment', *Inter-Press Service*, 26th December, 1996.

of Brazil and of the USA to attract investment.[11] Thus, although this article will focus principally upon problems and possible solutions within the EU and the OECD, it must be remembered that tax competition is a global issue.

2. WHAT IS MEANT BY 'TAX COMPETITION'?

Confronted by talk of 'wars' and 'piracy', 'degradation' and 'dumping', the natural reaction is to ask what actually lies behind all this colourful language. In reality, the current controversies seem to revolve around two distinct but obviously related issues:

(a) the problem of taxing international portfolio investment income, and the perception that some countries are seeking to attract such investment by refraining from imposing withholding tax on income - especially interest income - that is paid to non-resident investors; and

(b) the attempt by many countries to attract foreign direct investment by offering low tax rates or other special incentives to potential investors.

A. 'Fiscal Degradation'

For some years now, commentators have remarked upon the increasing difficulty of taxing investment income, due largely to the facility with which investors can move their capital offshore, take advantage of low tax rates in the country in which the investment is located, and avoid further taxation in their country of residence by not reporting the income. Investment income of non-residents is usually taxed at a relatively low, flat, rate in the country of source or, especially in the case of portfolio interest income, is exempted entirely from source-country tax:[12] if such income escapes tax in the country of residence then there will be a substantial revenue loss to that country. Since it is now comparatively easy in most countries for those who have capital to invest abroad, investors of country A invest tax-free in country B, and those of country B invest in country A: alternatively, investors of country A invest in their own country through a corporation or trust located in country B. The result is a substantial revenue loss worldwide. This is the 'fiscal degradation' of which the Monti Memorandum speaks.

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11 E.g., 'Brazilian States compete for Investment *Worldwide Tax Daily*, 9th May, 1997 (97 TNI 90-2); P Behr, 'Battle to attract Firms, Teams, hurting some States', *Washington Post*, 24th May, 1996, p. F-1.

12 See further J Norregaard, 'Tax Treatment of Government Bonds', *Tax Notes International*, 14th July, 1997 (97 TNI 134-4).

For the most part, this problem is not really about tax competition. It is true that accusations of 'poaching' portfolio investment have been made against some countries, but there are many countries, within the EU and OECD and outside, that levy no withholding tax on dividends or interest paid to non-residents: moreover, the problem would still exist even if all countries charged the withholding rates recommended in the OECD model double-taxation treaty, since those rates are substantially lower than the full rates of income tax that most investors would pay if they invested at home or if their overseas investment income were fully reported.

The real problem here is one of tax evasion, and a solution is not readily apparent: at any rate, no attempt will be made here to propose one.[13] What is apparent is the effect: as Commissioner Monti points out, the resulting shortfall in tax revenue leaves countries unable to maintain the desired level of expenditure - and of social programmes - without raising other taxes. The taxes most likely to be raised are those on less mobile factors, notably wages and consumption. The result is a less equitable tax system, higher prices and labour costs, a less competitive economy and, probably, more unemployment. These consequences are also perceived to flow from the second type of tax competition - the competition to attract direct investment by means of low taxes or special incentives - which is the focus of this article.

B. 'Fiscal Dumping'

'Tax competition', as the term will be used here, refers to the competition to attract direct investment (especially foreign investment) by providing an attractive fiscal environment for investors. It becomes objectionable (to other countries) when the tax burden on foreign investors is artificially reduced so that the host country is charging less tax than would normally be levied on comparable domestic investment - hence the analogy with dumping.

Tax competition usually takes the form of offering special incentives, in the form of tax exemptions or reductions, for particular types of investment or activity, though a country can compete to attract investment by having generally low rates of tax (especially corporation tax), or by having no tax at all. (Tax havens obviously compete to attract certain types of investment.) Inducements to invest may also take the form of non-tax incentives (for example, direct grants or other forms of financial aid or subsidies) and even incentives of a non-financial nature. The main focus of this article, as it is of the current studies being conducted in the

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13 For further discussion, see S Cnossen, 'Company Taxes in the European Union: Criteria and Options for Reform', (1996) 17 *Fiscal Studies* 67.

EU and OECD, is upon special tax incentives but, as will be suggested later, no study of the subject should ignore their relationship to 'general' tax provisions and to non-tax incentives.

Until recently, competition among countries to attract foreign direct investment caused little concern. The major capital-exporting nations were more intent upon eliminating restrictions imposed upon foreign investment undertaken by their own multinationals than with the possible adverse effects of their being granted incentives to invest.[14] The impetus within the OECD to adopt the MAI derived primarily from the desire to facilitate foreign investment: the possible distorting effects of investment incentives seems to have been regarded as a fairly minor side issue.[15] Only subsequently, in May 1996, did the OECD member countries decide to make an independent study of the problem of tax competition. The same seems to have been broadly true within the European Union. The principal objective of direct tax harmonisation has been the removal of barriers to the freedom of establishment and the free movement of persons, services and capital. All of the directives so far adopted - and all of those that have been proposed - have been designed primarily to facilitate economic integration and the creation of a single market through the elimination of barriers to free movement. The Ruding Report, too, was principally concerned with the distortions caused by direct tax systems that hindered the free movement of capital and the completion of the single market.[16] Nevertheless, Dr Ruding and his colleagues did also draw attention to the possible dangers of competition among the member states to attract investment. The Committee 'found no convincing evidence that independent action by national governments is likely to provoke unbridled tax competition...and lead to a drastic and undesirable erosion of corporate tax revenues.'[17] Nevertheless, it did express

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14 An exception has been the concern of American labour unions, and some politicians, that investment abroad by US multinationals leads to the loss of jobs at home; this concern has led to calls for the introduction of 'runaway plant' legislation: see L Sheppard, 'Deferral, Runaway Plants and Capital Allocation', *Tax Notes International*, 7th June, 1993 (93 TNI 108-3). The complaints have mostly focused on low labour costs in other countries, and against US tax laws that are perceived as being too favourable to investment abroad, rather than against tax incentives offered by other countries to attract such investment.

15 The principal concern seemed to be that tax incentives could constitute a barrier to investment if they effectively imposed performance requirements, or if foreign investors were discriminated against; see Couzin, Ahnlid, supra nn. 5, 6.

16 REPORT OF THE COMMITTEE OF INDEPENDENT EXPERTS ON COMPANY TAXATION (Luxembourg. 1992; E.C.) (hereafter the 'Ruding Report'). Thus the conclusions in chapter 4, that all member states discriminated to a greater or lesser extent *against* both inward and outward foreign investment.

17 Ibid., at p.200.

concern about the tendency of member states to introduce special tax regimes designed to attract internationally mobile business.[18] And its specific recommendation that a statutory minimum rate (of 30%) of corporation tax should be established by directive was largely dictated by a desire to prevent excessive tax competition.[19]

Two principal reasons are commonly given for the concern about tax competition:[20]

(a) special tax incentives distort 'normal' investment decisions and thus tend to produce an inefficient allocation of resources and an overall reduction in global welfare; and

(b) competition among states to attract investment leads to a tax-cutting 'race to the bottom', producing either undesirably low levels of tax revenue or, more probably, an inequitable or inappropriate distribution of the tax burden (i.e. tax competition causes fiscal degradation).

The first objection reflects a general antipathy, among theorists, towards special provisions that upset the 'level playing field': the second is not necessarily opposed to the use of incentives, but is concerned with the economic and social effects of inter-state competition.

3. IS TAX COMPETITION REALLY A PROBLEM?

Before considering what should be done about tax competition it seems appropriate to ask whether there really is a problem - at any rate, one of such a scale that concerted international action has become necessary. The two separate concerns over the use of investment incentives can be countered in two ways:

(a) tax incentives for investment do not matter because they do not work; and

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18 Ibid., at p.201.

19 Ibid., at p.209.

20 For reviews and summaries of the voluminous literature on investment incentives, see UNCTAD, 1996, supra n. 7; INVESTMENT INCENTIVES AND DISINCENTIVES: EFFECTS ON INTERNATIONAL DIRECT INVESTMENT (Paris. 1989; OECD); FISCAL INCENTIVES FOR INVESTMENT IN DEVELOPING COUNTRIES (Washington. 1992; World Bank).

(b) tax competition between states, far from being a problem, is actually a healthy state of affairs.

A. How Effective are Tax Incentives for Investment?

An initial distinction must be drawn between the *effectiveness* of tax incentives and their *efficiency*. A tax incentive is effective if it induces a person to act in the desired manner, *i.e.* to do that which the incentive was designed to encourage. It is effective if it results in investment (of the desired type) that would not have occurred but for the availability of the incentive. An incentive is efficient if the costs of granting it are lower than the value of the benefits that result from its being granted.

A number of studies have concluded that tax incentives for investment are relatively ineffective, since they are rarely important determinants of investor behaviour, and even where they do have the desired influence, they are almost always inefficient. If that is indeed the case, then there is obviously no need to worry about this form of tax competition: competitors either miss the target altogether or shoot themselves in the foot!

However, whilst both propositions seem to be broadly supported by empirical studies, there is also convincing evidence that tax incentives are, in certain circumstances, an important factor in locational decisions. And whilst most tax incentives seem to have been inefficient, in the sense of being excessively costly in relation to the benefits produced, this may be principally due to poor design and targeting.

(i) Effectiveness

There is fairly broad agreement in the literature on the determinants of foreign direct investment that tax incentives - and, more broadly, general tax provisions - do not, in themselves, constitute a sufficient inducement to invest in a country.[21] Other factors, such as political and economic stability, the size of the relevant market, the existence of adequate infrastructure and of a skilled workforce, the ability to repatriate profits, all normally rank much higher among the factors taken into consideration in making the initial investment decision. Such factors determine whether or not it is worth contemplating investing in a country at all.

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21 See UNCTAD 1996, supra, n. 7, at p.41; United Nations Centre on Transnational Corporations, THE DETERMINANTS OF FOREIGN DIRECT INVESTMENT - A SURVEY OF THE EVIDENCE (New York. 1992: United Nations) (Doc.ST/CTC/121) (hereafter UNCTC 1992).

Having made that decision, tax considerations probably figure more or less equally prominently with other financial factors such as labour costs and the costs of premises and of transportation in determining whether the proposed investment is likely to be sufficiently profitable to justify going ahead with it. Thus, tax is often an important secondary consideration. Just how important is almost impossible to estimate, and the numerous empirical studies and anecdotal evidence point to drastically different conclusions. However, one can be reasonably confident in asserting that:

(a) certain types of investment are more tax-sensitive than others. In particular, export-oriented investment is much more sensitive to taxation, and likely to be influenced by incentives, than is investment aimed at the domestic market, since the tax is, in effect, exported as part of the cost of the product.

(b) tax considerations may be decisive, as between different possible locations, where other conditions are largely equal. In particular, tax incentives seem to be particularly important in determining the location of an investment within a particular country or region.

If these conclusions are correct, then it would seem that tax considerations will be most important, and tax competition potentially most effective, among the sub-units of a federal state and among the member states of a customs union or economic union. The factors that are the primary determinants of foreign investment are likely to be relatively similar, and the ability to select one location from which to serve the entire union, if there is free movement of goods and services, makes all enterprises potentially 'export-oriented'.

(ii) Efficiency

Even if tax incentives for investment are relatively effective in some circumstances, and for some types of investment, tax competition is unlikely to pose too much of a problem if the incentives that are offered are inefficient. Tax competition may be objectionable on the ground that it leads to misallocation and waste of resources, but if the injury caused by offering excessive inducements to potential investors is caused principally to the country offering them, then perhaps there is no need to take international action to prevent it?

Most studies do show that most investment incentives are inefficient, largely because they are commonly made available to investors who would have invested in any event.[22] However, careful design and targeting can minimize these inefficiencies,[23] and even inefficient incentives that end up costing the offeror country more than the value of the benefits that are produced may still cause injury to other countries by diverting investment away from them.

B. Is Tax Competition Harmful?

A second argument that needs to be considered before contemplating action to curb tax competition is that such competition is essentially not harmful, and may even be beneficial. This argument generally takes one of two forms:

(i) Costs and Benefits: You get what you pay for

Investment incentives have a cost, in revenue foregone, unless they are given only to investors who would otherwise have gone elsewhere. That cost has to be paid for, either by a reduction in the services provided by the host government or by an increase in other taxes. If a government reduces expenditure on education, health or infrastructure, the result may be to make the country less attractive to other potential investors. If it increases taxes on wages and consumption to compensate for the revenue lost on account of the incentives, labour and living costs will rise, again with a possible detrimental effect on other investment. Some investors may be attracted by tax incentives, others may be deterred by the consequences that flow from the costs of granting the incentives. Thus, things will tend to balance out. There is, of course, no satisfactory way of testing this hypothesis.

(ii) Curbing 'Leviathan' and 'Sauce for the Gander'

The principal argument in favour of tax competition derives largely from an antipathy to big government. Tax competition among nations imposes some restraint upon the tendency of government to expand. And, if competition between private enterprise is a good thing, then why not also competition among

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22 They are also often easily abused. See the OECD report, TAXATION AND FOREIGN DIRECT INVESTMENT: THE EXPERIENCE OF THE ECONOMIES IN TRANSITION (Paris. 1995; OECD)(hereafter OECD, 1995).

23 See D Holland and R J Vann, 'Income Tax Incentives for Investment', in V.Thuronyi (ed), TAX LAW DESIGN AND DRAFTING, Vol 2 (Washington. 1997: International Monetary Fund) (forthcoming).

governments?[24] Tax competition spurs governments to provide the most attractive environment for economic activity at the lowest cost. One might expect such arguments to find favour with investors - but not with governments. There is also no guarantee that tax competition will lead to enhanced efficiency: a real concern, as it also is with the problem of fiscal degradation, is that tax competition will simply cause the burden of taxation to be shifted from capital to those less able to avoid it - in particular, to wage earners and consumers.

4. IDENTIFYING THE PROBLEM AREAS

Neither of the above arguments -- that tax incentives for investment are ineffective and/or inefficient and therefore are not a cause for concern, nor that tax competition is essentially harmless or even beneficial -- is totally convincing. In some circumstances, tax incentives seem to be an important factor in determining the location of investment. Perhaps tax incentives can be made more efficient. Tax competition probably does have beneficial effects, but also has the potential to be harmful. There is a growing perception, among governments in the EU and elsewhere, that the world would be a better place with less tax competition, and there now appears to be a resolve to take action at a supranational level to restrict 'unfair' or 'harmful' competition. But before determining what action might be taken, it is necessary to establish precisely which practices should be considered offensive or undesirable, as opposed to those that may be justifiable or innocuous. That, essentially, is what is currently going on within the EU and the OECD.

A. Unfair Competition or Harmful Competition?

As a first step in the EU campaign against tax competition a working group of national tax officials was established at the end of 1996, with a mandate to consider how to eliminate harmful tax competition and, in particular, to draft a code of conduct to distinguish between fair and unfair competition. At its first meeting, in March 1997, the group set itself the task of compiling an inventory of

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24 See C E McLure, 'Tax Competition: is what's good for the private Goose also good for the public Gander?' (1986) 39 *National Tax Journal*, 341. McLure concludes that the likely benefits from reducing tax competition (in the USA) are slight and the benefits of tax competition are substantial. That conclusion is also reached in a study of tax competition in Switzerland; G Kirchgaessner and W Pommerehne, 'Tax Harmonisation and Tax Competition in the European Union: Lessons from Switzerland', (1996) 60 *Journal of Public Economics*, 351. See also the Ruding Report, at pp.149-51.

national tax concessions that might be considered 'harmful', rather than attempting to define competition that might be 'fair' or 'unfair'.[25]

The OECD's project on tax competition, which was announced in response to a request from the ministers of the member countries to develop measures to counter the distorting impact of harmful tax competition on investment and financing decisions, aims to:

- identify the effects of tax competition;
- examine criteria for distinguishing between fair and harmful competition;
- assess the effectiveness of existing defences against harmful tax competition; and
- recommend ways in which governments acting individually or collectively could ameliorate negative tax competition effects.

In order to do so, the project proposes to examine 'special' regimes to quantify the scope and effects of tax incentives. Factors which might be taken into account in classifying a measure as unfair, harmful tax competition include:

- are effective tax rates lower for internationally mobile sectors compared with domestic investment?
- is the scale of the incentive large enough to affect location decisions?
- is there a time limit on the benefits?
- is there a clear economic objective for the regime?[26]

It is interesting that both groups appear to acknowledge that 'unfair' competition and 'harmful' competition are not necessarily the same thing, but both agree that it is harmful competition that needs to be eliminated. Certainly, measures that are ineffective can safely be ignored, whether or not they are fair. But measures that are effective, in the sense that they induce investment to locate in one country or region rather than another, are 'harmful' to the unsuccessful candidates whether

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25 Abolition of 'harmful' Tax Competition between the Member States', supra n.4.

26 See the OECD homepage at http://www.oecd.org/daf/fa/taxcomp.htm. Presumably what is intended by the last factor is that there should be some clear economic objective *other* than simply to attract investment.

or not they are 'fair'. The approach that seems to be inherent in the mandates of both the EU and OECD working groups accepts that incentives may legitimately be employed for certain purposes and within certain limits. That is, 'fair' measures should be permitted, even though they might be effective in determining the location of investment.

B. Non-tax Incentives

To describe the problem as one of *tax* competition seems to imply that it is only fiscal incentives for investment that are relevant and that need to be considered. That, surely, should not be the case.

Certainly, there are measures of a non-financial nature, that are sometimes listed as investment incentives in promotional literature issued by foreign investment agencies, and which may have an impact on investment decisions, but which could not be regarded as constituting unfair or harmful competition.[27] There are also incentives of a non-financial nature that should be classified as unfair,[28] though it seems unnecessary to consider those further in this article.

A distinction is commonly drawn between 'financial' and 'fiscal' incentives. In much of the theoretical literature a preference is expressed for direct (financial) grants as opposed to tax exemptions or reductions, principally on grounds of greater transparency and the fact that the cost of grants is established immediately, whereas the cost of tax incentives is frequently difficult to estimate. Such a preference is not entirely rational: some forms of tax incentive (for example, exemptions from property tax) are as readily quantifiable as are grants. In any event, it is fairly obvious that direct financial grants can have the same effects as tax exemptions: for example, an investment grant to acquire capital equipment has much the same effect as a tax credit in respect of the same equipment.[29] Where large investments are involved it is now common practice for a comprehensive incentives 'package' to be negotiated: it would be perverse to have regard only to the fiscal elements of such a package and to leave out of consideration any direct financial support.

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27 E.g. the availability of a 'one-stop' approval procedure for investment in a particular region or zone.

28 An extreme example is that offered by the Seychelles (since repealed) to exempt from criminal prosecution persons investing US $10 m. or more.

29 That is so, at any rate, if the investor has taxable profit. Some tax incentives (import duty and property tax exemptions) are of benefit even to unprofitable enterprises.

Within the EU it is the practice with respect to state aids to take account of both grants and tax exemptions. According to the Commission, in the period 1992-94, approximately 48% of total EU state aids to industry were in the form of financial grants and 26% in the form of tax exemptions. However, whereas tax exemptions constituted less than 10% of total aids in Denmark, Spain, Ireland, Luxembourg and the United Kingdom, they amounted to 45% in Belgium and 38% in Italy.[30] To outlaw or restrict tax incentives without according similar treatment to direct grants would have a discriminatory effect as between member states and would simply encourage a switch from fiscal to financial aids. Internationally, the same objection holds good. Indeed, one concern expressed by several less-developed countries, when it was announced that the MAI might restrict the use of tax incentives, was that to do so would discriminate in favour of the richer nations, which tend to use financial rather than fiscal incentives, and against poorer countries, which cannot afford to make immediate cash grants to attract investment but which can more easily allow reductions in future tax liabilities.

C. 'General', and 'Special' Tax Provisions

One of the most difficult issues is likely to be the determination of what constitutes an 'incentive' provision.[31] The OECD project intends to examine 'special' regimes, which suggests that a country's general tax system is outside the scope of the review. Within the EU, general tax measures, or what is described as 'the benchmark tax system', are not regarded as constituting state aids: the starting point in making the distinction seems to be the OECD concept of 'tax expenditure'.[32] But tax expenditures are notoriously difficult to define and the distinction between general and special provisions may not always be obvious. For example, in Thailand tax rates and other provisions vary according to the designated zone in which an enterprise is located: the declared objective of the policy is as much to draw investment away from the densely-populated Bangkok region as it is to attract investment to less-developed parts of the country. It is consequently difficult, and somewhat unhelpful, to determine which is the 'general' provision and which the 'special' one.

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30 See EC Commission, FIFTH SURVEY ON STATE AID IN THE EUROPEAN UNION IN THE MANUFACTURING AND CERTAIN OTHER SECTORS (Doc. COM 97/170) (hereafter referred to as Commission 1997).

31 According to the 1996 UNCTAD report (supra, n. 7, at p.3), 'Incentives are any measurable economic advantage afforded to specific enterprises or categories of enterprise by (or at the direction of) a government, in order to encourage them to behave in a certain manner.' However, the Report adds, 'they do not include broader non-discriminatory policies, such as ...the general regulatory and fiscal regime for business operations...'

32 Commission 1997, supra, n.30, in Annex I.

Apart from the difficulty of determining what is an incentive, and the obvious opportunities that exist to manipulate the distinction between general and special provisions, there is the broader consideration that the 'benchmark' tax system can itself be employed as an instrument of tax competition. Indeed, it is frequently asserted that potential investors are more interested in matters such as the standard corporation tax rate, reasonable depreciation schedules and loss carry-over rules, than they are in special incentives.[33] Developing and transition countries are advised that they should look to the design of the general tax system, and especially the corporation tax system, rather than introduce special investment incentives, if they wish to attract substantial, long-term, investment. On the whole, that would seem to be good advice. But if an investor-friendly benchmark tax system is a more effective investment incentive than a special incentive regime, it seems rather perverse to ignore the former and focus only on the latter when considering what to do about tax competition.

The apparent intention to have regard only to special measures stems perhaps from a perception that general measures are necessarily 'fair' By and large, that may be a reasonable view. If a country is prepared to extend the same favourable treatment without discrimination to all investors, domestic as well as foreign, and to all forms of investment, regardless of sector or location, then it can scarcely be accused of cheating. However, if general measures were to be exempt from scrutiny, it would seem a relatively easy matter to design a general tax system to achieve much the same result as a special incentive regime. For example, a system with a low rate of corporation tax and low or zero rates of withholding tax, benefits foreign investors far more than domestic ones.[34] Or a standard depreciation schedule could be designed that, in effect, operates to the advantage

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33 See, for example, OECD 1995 (supra n.22); Holland and Vann (supra, n.23). The OECD report was based principally on studies conducted in countries of central and eastern Europe. The conclusion is not entirely supported by a survey of investors in the EU commissioned by the Ruding Committee, which found that 49.8% of firms considered the CT rate a relevant consideration, and 28.3% a major factor, whereas the corresponding figures for special investment incentives were 48.0% and 30.9% respectively - in effect, general and special provisions were more or less equally important: see M Devereux, 'The Impact on International Business: Evidence from the Ruding Committee Survey', 1992/2 *EC Tax Review*, 105.

34 The two-tier Hungarian corporation tax system is especially favourable to foreign investors if, as is usually the case, the withholding tax rate on dividends is reduced by treaty: see D Deak and R Krever, 'Company and Shareholder Tax Reform in Hungary', *Tax Notes International*, 25th November, 1996 (96 TNI 228-13). The Irish proposal to introduce a standard rate of corporation tax of 12.5% appears to be aimed primarily at foreign investors: see C Regan, 'Early Decision on Tax Regime is Vital', *Irish Times*, 30th September, 1996, p.17.

of new investment in particular favoured sectors. At the very least, this suggests that general tax provisions should not be exempt from scrutiny.[35]

D. Types of Incentive

Another question to be addressed is whether any distinction should be drawn between different types of tax incentive. There is substantial evidence that some types of incentive are more effective or more efficient than others, and therefore likely to be more 'harmful'. For fairly obvious reasons, attention has focused on corporation tax, although other forms of tax incentive may also be important factors in investment decisions. The following section briefly reviews the more common types of tax incentive.

(i) Reduced Rates of Corporation Tax

Reduced CT rates (and exemptions) are commonly provided on a temporary basis, in connection with tax holidays for new investors: incentives of this nature will be considered later. Reduced rates for small companies are also commonly encountered but are not generally considered specifically as investment incentives, but rather as a part of the general tax system. However, since the rate of corporation tax is generally believed to be the most important tax consideration in investment decisions,[36] specially reduced rates for particular types of activity or for investment in a particular region must obviously be an important incentive,[37] although what really matters is the way in which the incentive is targeted - a question to be discussed later.

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35 It will be recalled that the Ruding Committee recommended the adoption of a minimum rate of corporation tax, and did so principally out of concern over tax competition: supra, n. 16, at p.209.

36 One recent study of foreign investment in the EU, carried out by the firm Deloitte & Touche, found that 51% of firms surveyed considered that low CT rates were the most valued incentive; that was followed by special rules for distribution, etc., centres (22%), high depreciation rates (18%), and relief for expatriate employees (8%): see 'Taxation: Foreign Firms unaware of Member States' Incentives', European Information Service, *European Report* No.2148, 13th July, 1996. Overall, 80% of the firms surveyed claimed to have been influenced by tax factors, though a surprising number were unaware of incentives even in the countries they had chosen to invest in.

37 The Deloitte & Touche study (supra) found that the Irish (10%) reduced rate was the best-known incentive in the EU, though that was probably due to Ireland's aggressive'' information and marketing policy.

(ii) Tax Holidays

The most common form of tax incentive for investment, especially in less-developed countries, is the tax holiday. Tax holidays vary in duration from as little as one year to as long as twenty years, and may take the form of a complete exemption from CT (and sometimes from other taxes as well), or of a reduced rate of tax.[38] The OECD statement on tax competition[39] seems to accept the legitimacy of relatively short tax holidays, where they can be regarded as a form of 'pump-priming', and this is consistent with the policies of several countries which, in their tax treaties with developing countries, allow for 'tax sparing' in respect of investment incentive provisions, but only for a limited duration.

Most studies have concluded, however, that short tax holidays are rarely effective in attracting investment, other than short-term, 'footloose', projects. Moreover, tax holidays are especially prone to manipulation and provide considerable opportunities for tax avoidance and abuse.[40] It would be perverse to condone short holidays that are ineffective and inefficient, whilst prohibiting those that may be effective, and it may be difficult to come up with a compromise that allows the use of effective tax holidays that are still compatible with the pump-priming principle.

(iii) Investment Allowances, Investment Credits and Accelerated Depreciation

In the tax incentive literature, investment allowances and credits are generally considered preferable - in terms of efficiency - to tax holidays: they are not open-ended, their cost is more easily estimated, and the cost is related to the amount of the investment.[41] This type of incentive also seems compatible with the pump-priming principle, though much depends upon the way in which it is targeted. Additionally, in the case of accelerated depreciation, it may be difficult (as already noted) to determine what is a special provision and what is part of a general depreciation schedule.

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38 The Chinese provision of two years full exemption followed by three years at half the normal rate is fairly typical. Poland's free economic zones provide a 10-year holiday free of CT, followed by a further 10 years at half-rate.

39 Supra, n.26.

40 See OECD 1995 (supra n.22): J M Mintz, 'Corporate Tax Holidays and Investment', (1990) 4 *World Bank Economic Review* 81.

41 See OECD 1995 (supra n. 22); D Holland and J Owens, 'Tax, Transition and Investment', *OECD Observer*, No.193, April 1995, p.29. However, this type of incentive seems to be of less interest to potential investors: see Devereux, supra n. 33.

(iv) Reduced Withholding Taxes

It is not uncommon for countries to advertise reduced or zero rates of withholding tax as an incentive for foreign investment, either generally or to promote such objectives as the transfer of technology. Generally, reductions in withholding tax are desirable, since such taxes probably constitute the largest barrier to the free movement of capital and frequently result in discrimination against foreign investors: consequently, one might expect there to be a presumption in favour of this type of incentive. However, as with most other types of tax incentive, it is the targeting that is important.

(v) Personal Income Tax Reliefs

Considerations of personal income tax rarely have much impact on investment decisions,[42] although it is not uncommon to encounter incentives in the form of special tax treatment of 'expatriate' executives and employees. Usually the rules apply to individuals who are temporarily resident in the host country, and take the form of a 'cap' on the tax rate, additional deductions for extra living expenses, or the exclusion of certain 'fringe' benefits that would otherwise be taxable. Provisions of this nature are often objectively justifiable, are rarely if ever likely to have a substantial impact on investment decisions, and can probably safely be ignored. The same is probably true of reductions in social security contributions or payroll taxes, which are sometimes used as an incentive to invest in regions of high unemployment or to employ certain categories of workers.

(vi) Property Tax Relief

Exemption from, or reduction of, property taxes is a not uncommon, and relatively effective, form of investment incentive, although the usual effect is to influence the location of an investment within a particular country, rather than to influence the choice of country. Property tax exemption has the advantage, from the granting government's point of view, that its cost is predictable and, from the investor's point of view, that it is applicable even where there are no profits to be taxed. Consequently, its effect is much the same as a cash grant. A factor to consider, in reviewing incentives of this sort, is that they are commonly granted by local, rather than central, government authorities and one should consequently be careful not to restrict local autonomy unduly.

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42 See the Deloitte & Touche survey, supra n. 36.

(vii) Import Taxes and Duties

A number of studies have shown that exemption from import duties and taxes, in particular for capital goods, can be an important factor in investment decisions. This form of incentive shares with property tax exemptions the advantage that it is not dependent upon profitability: it is an 'up front' benefit and constitutes an immediate saving to the investor. Since the reduction and eventual elimination of import duties is a declared objective of all the international bodies that may have an interest in limiting tax competition, it seems unlikely that a general exemption for capital goods would feature on any proscribed list, though selective exemptions for components and raw materials are more problematic.[43]

(viii) Special Economic Zones

Specially designated 'zones' are commonly established with the intention of attracting (mainly) foreign direct investment: worldwide, more than 500 such zones exist, mostly in less-developed countries.[44] To the extent that such zones merely provide special import procedures to avoid taxing goods that are destined to be re-exported, they would seem to be fully consistent with international rules on trade. However, investors in the zones frequently also receive other tax privileges, such as tax holidays or reduced rates of tax, as well as non-tax incentives in the form of subsidised infrastructure. Such privileges should obviously be reviewed in the same way as those others described above.

E. The Targeting of Incentives

The preceding analysis suggests that some types of tax incentive are more likely than others to influence investment decisions, though almost all forms of tax privilege have a potential impact. However, in attempting to determine whether a tax incentive constitutes unfair competition, what seems to be more important than the type of incentive employed is the manner in which it is targeted: that is, in what circumstances do investors qualify for tax privileges?

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43 Within the EU, import duties and taxes are already regulated at Community level. The exemption for car kits imported for assembly in Poland has caused concern to EU officials: 'European Commission concerned over Polish Trade Policies', *Worldwide Tax Daily*, 25th July, 1996 (96 TNI 144-8).

44 Within OECD member countries, the zones of Ireland (Shannon) and Korea (Masan) are probably the best known. Similar zones exist in Mexico, Poland, Spain and Turkey, and the US 'foreign trade zones' offer some of the same privileges. In the EU, apart from Shannon, special zones exist in Portugal (Madeira) and in Spain (Canary Islands): see C Benitez, 'The Canary Special Zone (ZEC)', (1996) 1 *EC Tax Journal* 187.

The precise targeting of tax incentives is important, since a major reason for the inefficiency of many incentives is that they are made available to enterprises that would have invested (or have already invested) in any event. Consequently, the cost of providing tax concessions frequently exceeds any benefit derived from new investment that is attracted. This cost can be reduced substantially if eligibility to receive an incentive is carefully restricted. A tax privilege that is enjoyed only by investors who would not otherwise have invested has no 'cost'. However, it is this type of targeting that often causes an incentive to be perceived as 'unfair'. The argument tends, of course, to be somewhat circuitous: targeting makes incentives more effective and efficient, and only effective and efficient incentives are likely to be 'harmful' to other countries. Nevertheless, since tax incentives are employed as an instrument to pursue a variety of objectives, some of which are perceived as more legitimate than others, consideration must obviously be given to the purposes for which incentives are granted.

(i) Automatic or Discretionary?

A preliminary issue is whether tax exemptions and reliefs should be granted automatically where prescribed conditions are met, or should be granted only on a discretionary basis. Despite the greater potential cost of a non-discretionary system and the greater risk of tax avoidance inherent in such a system, an objection to discretionary incentives may be raised on the ground of lack of transparency and, in some countries, the increased opportunities for corruption. There seems to be a growing tendency, especially among more advanced countries, to eliminate automatic incentives and to employ incentive packages that are 'tailor-made' to the requirements of large investors. Private deals of this nature would seem to have a greater potential for investor poaching than open, generally available, tax concessions.[45]

(ii) Foreign or Domestic Investment?

To the extent that the proposed MAI seems likely to deal with the question of investment incentives, it will probably do little more than require that incentives be granted on a non-discriminatory basis and that foreign investors receive national treatment. That, however, is already normally the practice and discrimination

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45 See P Cannon, 'Europe Competes for Investors', (1996) *International Tax Review*, No.2, p.15. There has been criticism of the Dutch practice of issuing advance rulings to potential investors: whilst these appear to set out how 'general' tax provisions will apply to particular transactions (and as such are a legitimate and useful way of reducing investor uncertainty), it is sometimes suggested that such rulings can be unduly generous and really amount to special derogations.

against foreign investors is rarely the problem.[46] Of greater concern, in terms of fair competition, is the granting of *more* favourable treatment to foreign investors.

For larger, more developed, countries, such an option seems inadvisable. In return for attracting some foreign investment, it would be likely to drive domestic enterprises abroad. That would be especially so in the EU where, in theory, all enterprises are free to establish wherever they choose. However, in countries that still have exchange controls, in transition economies or countries where most domestic enterprise is state-owned,[47] and in smaller countries that have very few enterprises sufficiently large to make re-location abroad a viable option, the restriction of investment incentives to foreign investors is a tempting strategy.[48] A consensus seems to be developing that this form of discrimination should be proscribed in any code of tax competition conduct. The real difficulty, however, may be to identify provisions that effectively discriminate in favour of foreign investors, because of the absence of any viable domestic competition, whilst appearing to be formally neutral.[49]

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46 An OECD study found that only 4.4% of support programmes restricted access to domestically-owned enterprises: Murphy and Pretschker, supra, n. 7. It is more common to find incentives restricted to domestically-incorporated enterprises; i.e. denied to branches of foreign companies, but available to their local subsidiaries. This form of discrimination may be acceptable if there are differences in the way in which resident and non-resident companies are taxed.

47 For example, in China most tax incentives are given only to foreign-invested enterprises, although this practice is apparently about to change: see D Marris, 'Reforms hit Foreign Investors', (1996) *International Tax Review*, No.4, p.74. Most transition countries initially restricted incentives to joint ventures with a stipulated proportion of foreign participation, and some still do so.

48 In the longer term it may have the negative effect of impeding the growth of domestic enterprise and is a policy that probably should not be recommended. It also tends to lead to fictive foreign investment and 'round-tripping': see United Nations Conference on Trade and Development, WORLD INVESTMENT REPORT 1996 (New York. 1996: UN), at pp.54-55.

49 Incentives are often restricted to investments exceeding a certain amount. Sometimes, in practice, this means that only foreign investment qualifies. For example, only one investment in the entire country qualified for a Romanian incentive that applied to investments exceeding US $50 m.: 'Romania's so-called Daewoo Law', *Tax Notes International*, 20th February, 1996 (96 TNI 34-26).

(iii) Regional Incentives

The experience of many countries has been that tax incentives have been a relatively unsuccessful and excessively costly way of attracting investment to less-developed regions. To the extent that such incentives distort locational decisions the result is a less efficient allocation of resources, and it is probably a better strategy in the longer term to employ available resources to improve the infrastructure of the region rather than to disburse them in the form of tax concessions. Nevertheless, such incentives are widely used and seem to be regarded as a legitimate and necessary aspect of regional policy.[50]

The evidence is that tax considerations normally have relatively little influence on the choice of the country in which to invest but have more influence on where to locate the investment *within* that country. Consequently, regional incentives would normally not seem to be a major instrument of international tax competition. However, if one regards the EU as a single 'country' in this sense, then it is obvious that regional incentives must be taken into account in determining Community policy on tax competition. An incentive to locate in Saxony may attract investment that might have otherwise gone to Hesse, or to Lombardy.[51]

Regional incentives may cause less concern outside the EU, although it may still be necessary to attempt to distinguish between genuine regional incentives and unfair tax competition that masquerades as regional policy.[52]

(iv) Employment Incentives

Tax incentives for job creation are frequently linked with regional policies: the incentives seek to attract investment to regions of high unemployment. In other cases, the incentive is given to promote labour-intensive investment or the employment of particular categories of workers, such as young persons, the long-term unemployed, or the disabled. The effectiveness of such incentives is questionable. Generally, increased investment automatically means more jobs, and

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50 See the Opinion of the (EU) Economic and Social Committee on Direct and Indirect Taxation (OJ 96/C 82/11), para. 4.2.3.

51 More than 100 development agencies exist throughout the EU, with national incentive packages being supplemented by regional and local authorities. The result is that cities in the same region compete with each other as well as with their rivals in other countries: see E Brown, 'Every Town for Itself', *Euro Business*, March 1995, Vol.2, No.10, p.87.

52 For example, an investor might be able to insist upon a chosen location being designated a special zone as a condition for investing: see 'Polish Enterprise Zone lures GM to Gliwice', *Tax Notes International*, 8th July, 1996 (96 TNI 131-16).

to seek to influence the location of that investment, or the composition of its workforce, is likely to result in a misallocation of resources and, ultimately, to less new jobs being created.[53] Nevertheless, as with regional policy, employment creation is perceived to be an important objective of government and the use of tax incentives to that end would probably be considered legitimate, at least so long as the incentives are proportionate to the objective. After all, one of the objections to tax competition is that it has the effect of shifting the tax burden to wages, thereby increasing labour costs and aggravating unemployment problems.

(v) Technology and Research and Development

Many countries seek to attract technologically-advanced investment or R&D activities through the grant of tax incentives, often with little success or at excessive cost. Usually, the enterprise receives a tax break for doing what it would have done anyway. However, this is another objective that is likely to be considered legitimate. Additionally, such incentives, to the extent that they are effective, will normally result only in modifying the activities of existing investors, rather than in 'poaching' investment. A different view might be taken of incentives designed to induce multinational enterprises to locate their group research facilities within a country - an issue that is discussed in more general terms in the next section.

(vi) Sectoral Incentives

The granting of preferential tax treatment to certain sectors of the economy, or to certain activities, has been a common practice ever since taxes were first introduced. Many countries grant preferences to agriculture or to manufacturing. The rationale for such treatment varies, but in the great majority of cases the principal aim has been to support or promote domestic industries and activities. In recent years, however, the practice has grown of introducing much more selective incentives targeted at particular types of foreign investment. Reference was made at the beginning of this article to the current competition in south-east Asia to attract the microprocessing industry:[54] other countries have targeted R&D activities, software development, film-making and aircraft leasing.[55]

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53 The promotion of export-oriented investment (see below) is widely considered to be a more effective way of creating employment: see S.Lall, 'Employment and Foreign Investment: Policy Options for Developing Countries', (1995) 134 *International Labour Review* 521.

54 Supra, n. 9 and accompanying text. An interesting recent development is the promotion by Malaysia of a 'Multimedia Super Corridor': see 'Malaysia releases 1997 Budget', *Worldwide Tax Daily*, 10th February, 1997 (97 TNI 27-23).

55 Until quite recently, Ireland was home to the world's largest aircraft leasing company.

In the recent tax competition debate, the greatest hostility has been reserved for those incentives that are directed towards sectors or activities that are considered to be especially 'internationally mobile'. Particular attention has been drawn to the generous tax breaks given to the co-ordination centres, operational headquarters, international financing companies and similar divisions of multinational enterprises.[56] These incentives seem to be unusually effective,[57] which is doubtless one reason why they have incurred the wrath of countries that feel they have been the victims of poaching. The activities at which the incentives are targeted are, in many cases, ones that can be carried on equally well almost anywhere. A firm does not require extensive premises, or a large workforce, in order to borrow money and re-lend it to affiliated companies within the same group. Given good telecommunications and easy access to an international airport, there is little to distinguish one location from another apart from the liability to tax. Countries that attempt to subject such activities to 'normal' taxation find that the activities are being re-located elsewhere, where there is little or no tax liability.

(vii) Exporting

Somewhat similar considerations apply to incentives for exporting. Several of the studies on investment incentives conclude that export-oriented investment is comparatively strongly influenced by considerations of host country taxation.[58] That is not surprising. In the case of investment aimed primarily at serving the domestic market, the level of host-country taxation - unless it is unusually high - is of relatively little concern, since most competitors bear the same tax burden. But in the case of export-oriented investment, the host country tax is in effect exported: it constitutes part of the production cost and has to be taken into account in the same way as wage rates and transportation costs.

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56 The 'war' between Belgium and the Netherlands has already been referred to (supra n. 2 and accompanying text). Special ire seems to be reserved for the International Financial Services Centre in Dublin: J Dunne, 'EU States target Tax Haven Role of Dublin Centre', *Irish Times*, March 10, 1997, p.3. However, special 'headquarters' regimes exist in most of the countries of the EU and elsewhere in Europe: see the ESC opinion (supra n.50) at para. 4.1.6., and P-J. Douvier, 'Choosing the right Location for Pooled Services of a Group of Companies', (1994) 44 *Bulletin for International Fiscal Documentation* 7. They also exist in many Asian countries: see D Yoost and J Fisher, 'Choosing Regional HQs in Asia', (1996) *International Tax Review*, Vol.7, no.3, p.35.

57 The study conducted for the Ruding Committee (see Devereux, supra n. 33) found that whereas only 22.0% of firms found taxes a major factor in the location decisions of production plants, and only 14.1 for sales outlets, the proportion rose to 34.5% for co-ordination centres and to 52.6% for financial service centres. The figure for R&D centres was perhaps surprisingly low, at 15.3%.

58 See UNCTC 1992, supra n. 21, at pp.48-49; UNCTAD 1996, supra n. 7, at pp.48-51.

Various forms of tax incentive are employed to promote exports and to attract export-oriented investment. In some countries, enterprises are eligible for tax reductions or special privileges if they export more than a stated proportion of total production. In others, export-orientation is one of the factors that qualify a firm for special tax status.[59] The creation of export processing zones, in which preferential tax rates apply, is another form of incentive commonly employed.

Incentives of this nature, targeted specifically to export-oriented investment, tend to be more effective than most other forms of tax incentive: they are also more efficient, since in many cases no investment would be made at all without the tax exemption. Export-oriented firms are comparatively mobile, and it is not uncommon for a firm to enjoy a tax holiday in one country and, when it expires, to move its entire operation to some other country that is willing to give a new holiday. The experience of many developing countries is that export promotion, and the attraction of export-oriented investment, is the quickest and most successful route to economic growth: it is therefore hardly surprising that competition to attract such investment is especially fierce.[60] Competition specifically to attract export-oriented investment (other than service-exporting headquarters companies) is somewhat less common in developed countries, though that is presumably due in part to rules restricting the subsidization of exports.

F. Some Conclusions

The preceding analysis suggests that, in any effort to devise a remedy against unfair or harmful tax competition, the following factors ought to be taken into account:

- financial and fiscal incentives are to some extent interchangeable and should be considered together;

- 'general' as well as 'special' tax provisions need to be reviewed, at least to the extent that provisions that are apparently general in nature are actually equivalent to special incentives in their effects;

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59 For example, it is one of the ways of qualifying for 'pioneer' status, and hence for tax privileges, in Malaysia and in the Philippines.

60 The link between export promotion and economic growth is well established in Asian countries: see THE EAST ASIAN MIRACLE (Washington. 1993: World Bank). That study concludes that investment incentives have not been an especially important factor. Nevertheless, it is true that countries such as China, Malaysia and Singapore offer particularly generous incentives, especially for export-oriented investment.

- the type of incentive employed is normally much less important than the way in which it is targeted, and there are probably some types of incentive measures that can safely be ignored;

- incentives that are restricted to foreign investors, whether in form or in effect, should probably not be permitted;

- incentives intended to pursue genuine economic or social objectives, such as regional development, employment creation, technological advance or environmental protection, are widely considered to be acceptable and should probably be permitted provided they are not designed primarily to attract foreign investment;

- special incentives designed to attract only internationally mobile investment appear to be regarded as the most unfair and should be subject to special scrutiny;

- less-developed countries may have a greater justification for employing tax incentives, and should be allowed to do so, at least for a limited period, in circumstances that would not be permitted for developed countries.

An additional, and very important, factor is that tax competition presents special problems in an economic union such as the EU. Just as globalisation has increased the importance of taxation and of tax competition in the international community generally, so has integration increased its relevance in the EU. It is said that taxation is rarely a major determinant in foreign investment decisions, but may be important 'at the margin' when other factors are more or less equal. The removal of barriers within the EU has to a substantial extent equalised those other factors, with the result that investment decisions are increasingly being taken at the margin, and tax incentives become the 'tie-breaker'.[61]

A further reason for the increased relevance of tax considerations within the EU is that all enterprises enjoy the freedom of establishment and are thus potentially 'mobile': they are also potentially export-oriented, in the sense that they are able to supply their goods and services from a single location to all parts of the union. There is therefore no real distinction between domestic and foreign investment. Within the EU, at any rate in theory, the tax incentives of country A are attractive

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61 See the fascinating study by G P Wilson, 'The Role of Taxes in Location and Sourcing Decisions', in A Giovannini, R G Hubbard and J Slemrod, STUDIES IN INTERNATIONAL TAXATION (Chicago. 1993: U.of Chicago Press). The increased importance of tax competition was predicted by H-W. Sinn, 'Tax Harmonization and Tax Competition in Europe', (1990) 34 *European Economic Review* 489.

to an enterprise of country B, and a potential inducement to re-locate, even if that enterprise intends primarily to market its goods in country B.

5. DEFENDING AGAINST TAX COMPETITION

The preceding section has attempted to identify the types of tax competition that are potentially most harmful and that are regarded as unfair. A more difficult exercise is to try to suggest what might realistically be done about it. Thus far, within the EU, the only specific proposal is the elaboration of a 'code of conduct', whilst the OECD project aims to assess the effectiveness of existing defences against harmful tax competition and to recommend ways in which governments, acting individually or collectively, could ameliorate negative tax competition effects.

A. Existing Mechanisms

The OECD approach, of making an assessment of existing defences the starting point, has much to commend it. Before contemplating new international agreements or codes of conduct, it is important to examine those existing instruments that do, or could be made to, inhibit unfair tax competition.[62]

(i) EC Law and Policies

No doubt the High-level Group of Experts, in addition to compiling its list of 'harmful' measures, will also pay close attention to the ways in which the EC Treaty, Community legislation and established policies can be employed to deal with the problem. To an outside observer, lacking a close familiarity with many aspects of Community law, it is somewhat puzzling that tax competition has been allowed to develop as a major problem in the EU. Although there appears to be no clear jurisdictional basis specifically relating to taxation of foreign investment,[63] other than by harmonisation under art.100/EC, several other treaty provisions may be applicable. Certain types of investment incentives, such as special exemptions from import duties and taxes, are clearly ruled out by the common customs policy and by the VAT directives; some types of export

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62 A useful review of the principal international instruments is provided in UNCTAD 1996 (supra n. 7), Chapter 5.

63 See further J Goldsworth, 'The EEC, State Aids, Tax Incentives and Harmonization', *Tax Notes International*, 15th November, 1989 (89 TNI 46-4).

incentives might be prohibited by art.96/EC; and discrimination in favour of foreign investors could perhaps be attacked under art.6/EC.

However, it is the Community rules on competition and state aids, notably arts. 92 and 93/EC, that are most obviously relevant. Article 92 provides:

1. Save as otherwise provided in this Treaty, any aid granted by a Member State or through State resources in any form whatsoever which distorts or threatens to distort competition by favouring certain undertakings or the production of certain goods shall, insofar as it affects trade between Member States, be incompatible with the common market.

Paragraph (2) goes on to provide that certain types of aid (e.g. to make good damage caused by natural disasters) are regarded as compatible with the common market, and paragraph (3) lists further types of aid that *may* be considered compatible, including aid to promote the economic development of areas where the standard of living is abnormally low or where there is serious unemployment, aid to facilitate the development of certain economic activities or of certain economic areas 'where such aid does not adversely affect trading conditions to an extent contrary to the common interest', and other categories of aid specified by the Council. Article 93 requires the Commission to keep under constant review all systems of aid existing in member states. If it finds that a particular aid is not compatible with the common market it may require the offending state to eliminate or modify the aid and, if the state does not comply, may refer the matter to the Court of Justice. Member states are further required to notify the Commission of any plans to grant new aids.

Taken together, these provisions appear to provide the necessary basis for dealing with most aspects of the problem of tax competition. They apply to aid 'in any form whatsoever', which clearly includes both financial and fiscal incentives for investment.[64] They apply to both new and existing measures. And they permit aids to be employed for clearly defined economic and social purposes, subject to supervision and approval by the Community institutions, which normally require that the measure in question meets the criteria of necessity and proportionality and may impose detailed conditions.[65]

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64 The Commission considers that 'aid' includes tax credits, allowances, exemptions, rate reliefs, deferred tax provisions such as tax-free reserves and accelerated depreciation, and reductions in social security contributions. The Court has, on occasions, applied art.92 to tax reliefs: e.g. Case 173/73, *Italy v Commission* [1974] ECR 709; Case C 313/90, *CIRFS v Commission* [1993] ECR 1125.

65 Regional aids, in particular, are subject to highly detailed rules; see Commission 1997, supra n. 30.

Why, then, are these provisions considered insufficient to deal with the problem of tax competition within the EU? A possible obstacle is that art.92 refers only to 'goods' and to 'trade', and not to 'services' or 'investment': that raises the question whether the words 'favouring certain undertakings' are sufficient to bring provisions such as those favouring multinational headquarters companies within the net. It is difficult to see why they should not be. A further limitation on the scope of art.92 is the requirement that it favour certain enterprises or the production of certain goods: this has been taken to mean that it applies only to 'special' provisions and not to provisions of the 'general' tax code.[66] In the view of the Commission, it has no basis for acting against general taxation policies designed to attract business to a country - only harmonisation could deal with that issue.[67] However, although this article has suggested that general tax rules need to be considered as well as special incentives, that is principally to prevent special incentives masquerading as general rules, and it would be consistent with established principles of Community law for the Commission, and the Court, to have regard to the substance of the provision in question rather than to the form alone.

The state aids provisions of the EC Treaty, then, seem capable of providing a fairly satisfactory basis for action to combat the most harmful types of tax competition within the EU. There appear to be several reasons why these provisions have proved relatively ineffective in the past. First, the competition directorate of the Commission is over-worked and under-staffed:[68] there have been more pressing problems to deal with. Second, most state aids in the EU take the form of direct financial assistance rather than of fiscal measures, and direct aid has consequently attracted more attention. Third, enforcement procedures are complex and lengthy, and necessarily involve the participation of the Commission: whereas unfair (excessive) tax can be readily challenged in the national courts, using the 'direct effect' principle, taxpayers do not normally complain about being

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66 See, for example, Commission Decision 96/369/EC, in which the question was raised whether accelerated depreciation facilities for German airlines were a special aid, or part of the general tax system.

67 See the statement of Commissioner Van Miert to the Parliament's Economic and Monetary Affairs Committee on 17th June, 1997: 'Competition Policy: Life grows more complex for short-staffed DG IV', European Information Service, *European Report*, No.2234, 21st June, 1997.

68 See supra, n. 67.

given preferences.[69] Fourth, and perhaps most important, there is a natural reluctance to take tough action against investment incentives offered within the EU when similar incentives are readily available in other countries. There seems little point in stopping Belgium, Ireland and the Netherlands from poaching each other's headquarters companies if the end result is that those companies will move to Cyprus, Malta or Switzerland.

(ii) The OECD

As noted in the first part of this article, action against tax competition, parallel to that being taken within the EU, has also been initiated in the OECD. The subject has been a concern of the OECD at least since 1976, when the Declaration on International Investment and Multinational Enterprises identified the problem and called upon its members to ensure the transparency of investment incentives. A further agreement was reached in 1984, when a revised Decision on International Investment Incentives and Disincentives provided a procedure for consultations at the request of a member country if that country considered its interests to be adversely affected by the impact of measures taken by other members which provide significant incentives or disincentives to international direct investment. The purpose of such consultations is stated to be to examine the possibility of reducing such effects to a minimum.

Although some progress has been made in increasing the transparency of investment incentives, and various OECD studies have led to a considerably better understanding of the effects of such incentives, comparatively little has been achieved in terms of eliminating unfair tax competition, except that there has been some pressure on new members to eliminate tax incentives as a condition of admission to the organisation. Action against tax competition has been stepped up since 1995, first in the context of the proposed MAI and subsequently with the creation of a special tax competition task force, but the likely outcome seems to be confined to the publication of some sort of code of conduct and an agreement among the members to cooperate to reduce negative tax competition effects.

(iii) The World Trade Organisation

Until quite recently, the GATT and WTO rules had little application to investment incentives, except in so far as international trade in goods was affected. The Agreement on Subsidies and Countervailing Measures ('Subsidies Code'),

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69 It is possible, however, for private parties (e.g. competitors of aid recipients) to initiate proceedings: in Case C 313/90 (supra n. 64) it was a private group that sought to have a Commission aid decision overturned, and in the German airlines case (supra n. 66) proceedings were instigated by a competitor British airline.

concluded in 1979 as part of the Tokyo Round of negotiations, restricted the power of member states to subsidize exports and, although 'subsidy' was not defined, it was clear that fiscal measures such as incentives could properly be considered to be within the scope of the agreement.[70] However, the Subsidies Code applied only to the countries that specifically acceded to it, and contained no effective enforcement mechanism.

The (now) WTO rules were considerably strengthened by agreements reached in 1994 in the course of the Uruguay Round. The Agreement on Trade-Related Investment Measures (TRIMs) prohibits measures that apply to investment, domestic or foreign, that offend against the requirement of national treatment for imported goods and the prohibition of quantitative restrictions: investment incentives that contain performance requirements, such as a requirement of local sourcing, are consequently prohibited. The General Agreement on Trade in Services (GATS) treats foreign direct investment as a form of 'presence' for the purpose of delivery of services, and provides that rules on subsidies on international provision of services are to be negotiated in the near future. More important, in the present context, the Uruguay agreements substantially modified the Tokyo Subsidies Code. The new code applies to all members of the organisation, has a strengthened enforcement procedure, and contains more specific provisions as to what constitutes a subsidy. Subsidies are classified in three categories:

(a) those which are prohibited, being non-agricultural subsidies that are contingent on export performance or local content requirements;[71]

(b) those that are 'actionable', being subsidies that have adverse effects on international trade or cause serious prejudice to the interests of another member country; and

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70 The agreement provides a number of examples of what might be considered subsidies, several of which are tax provisions: see G Pearson, 'Business Incentives and the GATT Subsidies Agreement', (1995) 23 *Australian Business Law Review* 368.

71 Developing and transition countries are given various (temporary) exemptions from these prohibitions, and 'least developed' countries are exempt from the prohibition against subsidies that are contingent on export performance.

(c) those that are non-actionable, being subsidies for certain purposes recognised as legitimate, such as regional aid, environmental protection, or (within certain limits) the promotion of research and development.[72]

Although enforcement procedures have been strengthened, the impact of the new rules remains somewhat limited. Action can be taken only at the instance of a complainant country,[73] which must demonstrate adverse effects, and then may be authorised to take retaliatory measures. But the problem with tax competition is that it frequently involves more than two countries. Country A and country B (and others) compete to attract investors from country X. If the investor chooses country A, it is difficult for country B to show that it has suffered an adverse effect, except where an undertaking has actually moved from B to A, and even then there may be no suitable retaliatory measure that can be taken.

(iv) Other International Bodies

Other regional associations, such as ASEAN, CEFTA and NAFTA, have few, or no, rules restricting tax competition, though they normally provide a framework for cooperation between national authorities which might permit policies to be developed and some action to be taken. However, the Caribbean Community (CARICOM) adopted, as early as 1973, a comparatively detailed scheme designed to limit rivalry among member states in attracting industrial activity and to rationalise the criteria applied in granting investment incentives. The scheme also allowed for the creation of preferential incentives for the less developed countries of the region. In practice, the scheme does not seem to have been particularly successful, principally because of the inadequacy of monitoring and of follow-up mechanisms.[74]

The policies of the IMF and of the World Bank also merit a brief mention. Those bodies share the common philosophical antipathy towards special tax incentives,

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72 For a comprehensive analysis, see M Lovely, 'Economic Development in a Global Context: Implications of the Uruguay Round for Federal Tax Policy', (1995) 48 *National Tax Journal* 397.

73 New members, by contrast, will be required to conform as a condition of admission. One reason given for the Chinese proposal to remove existing discriminations in favour of foreign investors is said to be the need to observe the WTO requirement of national treatment: see O Nee and A Parnell, 'A Loss of Investor Privileges: China's Capital Import Duty, (1996) 23 *China Business Review*, No.4, p.32. This seems a little strange, since national treatment appears only to require that foreign investors are not treated less favourably than their domestic equivalents.

74 See UNCTAD 1996, supra n.7, at pp.67-68.

and this is sometimes reflected in the advice given to less developed countries that are engaged in tax and economic reform. What makes these policies effective, to some extent, is that the carrying out of structural reforms is often a condition of receiving financial assistance.[75] Although the advice to eliminate special tax incentives is usually good advice, it does seem paradoxical that those countries that perhaps have the greatest justification for using incentives are also the ones that can most easily be induced to eliminate them.

B. A Code of Conduct

The present intention, in both the EU and the OECD, seems to be the formulation of a 'code of conduct' to outlaw among their members the more harmful types of tax competition. Apparently, a draft code of practice has already been formulated in the EU, which would 'curb the worst beggar-thy-neighbour tax breaks but would not go down the path to full harmonisation of income tax and other levies.'[76] The code would be a 'gentleman's agreement' without enforcement measures, though it would require a firm political commitment from member states, and might serve as a set of standards by which Community policies on state aids should be applied.[77] The OECD's task force is not due to report until May 1998, but its study is also expected to result in the formulation of some sort of code, with provision for cooperation between governments. Both codes seem likely to endorse the principle that there should be no preference given to foreign investors over domestic investors, and no preferential treatment should be accorded to arrangements made by multinational groups. How much further either code will go remains to be seen.

C. The Problem of Non-Member States

An obvious limitation upon the powers of either the EU or the OECD to eliminate harmful or unfair tax competition is that their measures, if they bind anyone at all,

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75 For recent examples, see M Dodd, 'IMF asks Tanzania's Mkapa to oppose Tax Holidays', *Reuter's Financial* Service, 23rd May, 1997; 'Philippine Government faces Opposition in meeting IMF Expectations', *Tax Notes International*, 7th May, 1996 (96 TNI 89-13); 'Pakistani Government, IMF disagree over special fiscal Arrangements to encourage Investment', *Tax Notes International*, 16th April, 1996 (96 TNI 74-13).

76 See Smart, supra n.3.

77 See further Europe Information Service, 'High-level Group makes Progress on Code of Conduct', *European Report* No.2236, 28th June, 1997.

can only bind their member states.[78] It is this fear, that strict and binding rules forbidding certain types of investment incentives will simply cause investment to go elsewhere, that partly accounts for the lack of action to date.[79] The concluding part of this article examines whether there is any effective action that might possibly be taken, unilaterally or collectively, to make the EU or OECD measures effective against external tax competition.

(i) Unilateral Measures

There is, in theory, a simple way in which tax incentives for foreign investment, fair or otherwise, can be neutralised. Countries should tax their own residents who invest abroad on what is commonly referred to as the 'residence basis'. That requires that a resident of a country is taxed on her, his, or its, worldwide income, with a credit for foreign tax imposed in the country of source. The benefit of a tax incentive in the source country is consequently neutralised by a reduction in the foreign tax credit, and hence the higher income tax levied in the residence country.

That, of course, is the system which already operates in the great majority of countries, but it has not been effective to prevent tax competition. The principal reason is that where a multinational company establishes a subsidiary (rather than a branch) in another country the profits of the subsidiary are normally not taxed in the parent company's country of residence unless and until they are repatriated there.[80] Since repatriation can be deferred almost indefinitely, the benefit of low taxes and of incentives in the source country is preserved.

In order to counter tax competition more effectively it would be necessary for capital exporting countries to abandon the 'deferral principle' and to adopt comprehensive controlled foreign corporation (CFC) legislation, under which the business income (and not just portfolio income, as is now usually the case) of

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78 And potential members: it sometimes appears that new applicants are held to stricter standards, as a condition of admission, than are existing members.

79 A parallel can be found in the reluctance of EU members to take harmonised measures, such as the imposition of a substantial withholding tax on interest payments, in order to tackle the problem of 'fiscal degradation'.

80 And frequently not even then, since many countries exempt from tax dividends received from foreign subsidiaries. There are additional reasons, such as the use of the exemption method and of tax sparing, and the opportunities for tax evasion that the residence principle affords: for further discussion of the relationship between incentives and the international tax system, see Holland and Vann, supra n. 23.

foreign subsidiaries is taxed to the parent company or controlling shareholders as it accrues.

That might provide an effective response to the 'runaway plant' problem,[81] and would eliminate the advantage of moving operations offshore rather than staying at home. However, as we have seen, tax is rarely a major factor in the decision to invest abroad, but it often determines *where* abroad to locate the investment. The problem of tax competition in the EU is not principally about Belgium seeking to attract Irish firms and vice-versa, but about Belgium and Ireland competing with each other to attract American and Japanese firms. Countries that are home to multinational enterprises are reluctant to subject those enterprises to strict CFC rules when to do so is likely to place them at a competitive disadvantage as against the multinationals of other countries which have no such rules. Unilateral measures consequently do not seem to provide more than a very partial solution to the problem.

(ii) Harmonised CFC Rules

One is thus forced back to the idea of harmonisation, or some other form of concerted action. However, what seems to be needed is not so much the harmonisation of the tax rules applicable to foreign investors, but rather the adoption - by the major capital exporting countries - of harmonised CFC rules affecting the overseas operations of a country's own multinationals. Such rules would require all income of foreign subsidiaries to be taxed in the 'home' country of the parent on an accrual basis, where such income derives from investment in a country that levies unduly low rates of tax or offers 'unfair' incentives. The rules could accommodate a form of tax sparing, to allow less developed countries to offer incentives of limited duration, without the benefits of those incentives being neutralised.

The attraction of this approach lies in its flexibility. The rules would not need to be identical, nor would they need to be adopted universally in order to be effective. So long as they were adopted in broadly similar form by a substantial number of capital exporting countries, potential host countries would hesitate to offer large tax breaks to foreign investors - or to reduce their standard CT rate below the internationally accepted norm - since such incentives would be of no attraction to investors from the countries that had adopted the rules and would

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81 See supra, n. 14.

consequently be far less cost efficient. The disadvantage of the approach, if there is one, lies in the probable complexity of such rules.[82]

(iii) The 'Centre' Question

The principal concern within the EU, as we have seen, is directed towards the special treatment that is accorded to the centralised operations of multinational groups - co-ordination centres, distribution centres, financial centres, operational headquarters, research and development centres, and the like. This problem calls for a different approach.

What is suggested is that the income of such centres or, rather, the income derived by such centres from payments from other members of the group, should be exempt from tax. If that were so, there would be no reason to move from Amsterdam to Brussels, or from London to Labuan, other than for genuine business considerations. However, lest one be accused of simply 'throwing in the towel', it is further proposed that the exemption should be accompanied by a rule disallowing the deduction of payments, including the payment of interest and royalties, made to such centres by related companies for certain types of services. The non-deduction rule would effectively allocate the income generated by the centre among the countries in which the group carried on business, in proportion to the value of the services provided by the centre. In other words, group services would be taxed according to a sort of 'destination principle': such a solution seems appropriately *communautaire*.

The result would be that multinational groups would be able to establish one or more centres anywhere within the EU, or outside, without major tax consequences. Whether or not, and how much, the centre charged for its services to companies within the group would be entirely a matter of internal bookkeeping, since intra-group payments would be neither taxable nor deductible. Such a rule also has the advantage of eliminating many difficult transfer pricing problems.[83] But more important, it would eliminate what has come to be regarded as the single most artificial and offensive form of tax competition, both within the EU and OECD and outside.

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82 Also, no doubt, some countries would find other ways of 'cheating' - for example, by turning a blind eye to blatant transfer pricing, or by simply not enforcing their tax laws. Such practices would in turn have to be countered.

83 This approach is discussed more fully by A Easson, 'Taxing International Income', in R Krever (ed), TAX CONVERSATIONS (London. 1997; Kluwer).