Chapter II

A Review of the OECD Report on Corporate Tax Incentives for Foreign Direct Investment: Lessons for Developing Countries?

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1. Introduction

Earlier this year, the OECD released No. 4 of its series on Tax Policy Studies, entitled "Corporate Tax Incentives for Foreign Direct Investment" (hereafter "the Report"). Although this Report is not particularly meant for developing countries (hereafter: "DCs"), it was largely based on material prepared for the "Tax Programme for Non-Member Countries", and the main conclusions of the Report are the most meaningful for DCs.

First of all it should be noted that this Report is written from a fiscal policy point of view, and not really from a legal point of view. Primarily, the drafter (W. Steven Clark, Head of the Tax Policy and Statistics Unit, OECD Centre for Tax Policy and Administration) examines the empirical findings about the influence of host country taxation on foreign direct investment ("FDI") found in recent economic literature. Legal professionals as myself, who went to law-school to avoid mathematics, will not feel particularly at ease with the many algebraic functions found throughout the Report.

Nevertheless, the Report offers important information to those who approach the same subject matter from a legal point of view rather than from an empirical-economical perspective. In this article, some of the main suggestions of the Report are summarized and commented upon from the perspective of developing countries.

The Report discusses most of the well-known types of corporate tax incentives:

(1) *Tax holidays and tax rate reductions*: a temporary exemption of all or certain corporate income tax of a qualifying company or activity
(2) *Investment allowances*: an amount to be deducted from normally taxable income over and above normal deductible depreciation of qualifying invested assets

(3) *Investment credits*: an amount to be used as a tax credit, determined in function of qualifying investment assets
(4) *Finance incentives*: reduce taxation on the way the investment was financed (such as a waiver of withholding tax on interest and dividend)
(5) *Other corporate tax incentives* such as a reduction on the tax burden of technology transfers (withholding tax on royalties), etc.

2. Do Tax Incentives Really Attract FDI?

The Report reviews several empirical studies between 1984 and 1998 and highlights that in recent years, significant progress has been made in applied investigations of the response of cross-border direct investment flows to taxation. Those studies, according to the Report, using improved data and modeling would appear to offer convincing evidence that host country taxation does influence investment and that this influence is more pronounced over time. However, the empirical studies the Report refers to, do not really prove the effect of tax incentives on FDI as such. They tend to develop models that allow establishing valid relationships between the average tax rate and the amount of investment. Such mathematical models may certainly offer useful information, and indeed seem to support that "taxes do matter", but they have important drawbacks when it comes to trying to prove how effective tax incentives really are. Much of the data to offer conclusive evidence to that effect is simply not available. Also, the effect of losses is hard to take into account, besides the fact that investment location decisions are made before the fact, and not after. In a critical note on a study by Cummins and Hubbard[129], for example, (also quoted in the Report), which concluded that the results rejected the idea that tax does not influence investment, Hartman (himself an acclaimed researcher in this field) had this to say:

> "The papers' model describes a rather simple world. This is a world in which FDI increases or declines as companies adjust to a new equilibrium rate of return available in a specific location. Alternatively, one can view the foreign investment decision as a

[129] Cummins, J.G. and Hubbard R.G. "The tax sensitivity of foreign direct investment: evidence from frim-level panel data", in The Effects of Taxation on Multinational Enterprises, p. 123-153.

> lumpy process of one-time strategic decisions on how to serve an emerging market or change the locus of production."[130].

The Report does not advocate that tax incentives always attract FDI. As a matter of fact, a closer look reveals that according to the Report, the effect of most tax incentives in practice is quite limited or even non-existent. It is thereby in line with other studies, mostly conducted by means of (anonymously) interviewing investment decision makers, which tend to find that tax incentives have no or little effect on investment location decisions[131].

Even if it were true that a country's tax system, including its incentives, does indeed influence FDI, the Report emphasizes that this does not mean that *any* tax incentive will actually be worth it, or even effective at all. As a matter of fact, the rest of the Report seems to suggest just the opposite in most cases. Furthermore, it does not mean that the effect of a tax incentive will be the same on all sectors of business activity, as the Report also points out. It is now generally acknowledged that other, non-tax production and market factors have much more bearing on investment location decisions than income tax incentives[132]. Tax only enters into the equation when the production and market conditions (and other aspects of government policy) for competing location candidates are such that income tax incentives can swing the decision one way or another. In the

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[130] Hartman, D.G., in The Effects of Taxation on Multinational Enterprises", p. 147.

[131] Shah, S.M.S. andToye, J., "Fsical incentives for firms in some developing countries, Survey and critique", in Taxation and Economic Development, London, 1978, p. 279-284.; Lent, G.E., "Tax incentives in developing countries, in Readings on Taxation in Developing Countries, 3d ed., John Hopkins University Press, 1975, p. 370-371.; Yelpaala, K., The efficacity of tax incentives within the framework of the neoclassical theory of foreign direct investment, 19 *Texas International Law Journal*, 1984, p. 400-403.; Viherkentta, T., Tax Incentives in Developing Countries and International Taxation, Kluwer, 1991, p. 33; Simmons, R.S., "Corporate taxation and the investment location decisions of multinational corporations", *Asia-Pacific Journal of Taxation*, Vol. 4, No. 1 (Spring) 2000, p. 88-107.

[132] Holland, D. and Vann, R.J., "Income tax incentives for investment", in Tax Law Design and Drafting, Vol. 2, IMF, 1998, p. 986-988.; Simmons, R.S., "Corporate taxation and the investment location decisions of multinational corporations", *Asia-Pacific Journal of Taxation*, Vol. 4, No. 1 (Spring) 2000, p. 88-107.; World Bank Policy Research Working Paper No. 1720 of 1997.; Francis Ho, "FDI into the dynamic asian economies", in OECD, Taxation and Investment Flows, 1994 ("participants –of the workshop- concluded that although tax incentives were important promotional tools they had not played an overriding role. Investors tended to look more seriously at the fundamental conditions of their investments"); OECD, Taxation and Foreign Direct Investment: The Experiences of the Economies in Transition, 1995; See also the Ruding Committee Report of 1992, Chapter 5.

majority of cases, according to the Report, that does not happen. When tax incentives are used to compensate for "market failure" (to make up for a lack in other factors that influence FDI, such as domestic infrastructure or available human resources) the gap that needs to be bridged may simply be too wide in the case of some economies. In most cases, so says the Report, tax will not be able to make a sufficient difference[133].

This reasoning speaks to the heart of the tax incentive policy of a country. In the view of the OECD, tax incentives should only be granted if they are, based on the best assessment policy makers can manage, really in a position to swing the investment decision to their advantage. This assessment process will be discussed below.

Furthermore, the Report notes convincingly that in the future, *certain* tax incentives may play a larger role than today. The elimination of trade barriers and exchange controls expands the number of possible investment flows that incentives seek to attract. China's accession to the World Trade Organization, for example, will gradually open up a large scope of new business activities to foreign investors. Potentially, those new investment projects and companies may all seek to invoke tax incentives. Also, the opening up of artificially closed markets, would eliminate artificially high profit margins that usually cancel out tax incentives anyway. Or, quoting the Report: "Tax incentives are more likely to bite (i.e. operate at the margin to swing investment choice) where profit margins are thin, making tax relief a more important factor"[134].

3. Assessment: Will a Tax Incentive Make a Difference?

The central suggestion in the Report is that policy makers have to ask themselves what are the impediments to FDI in their country, and if they can be removed cost-efficiently by using tax incentives. To answer those questions, an assessment has to be carried out. This assessment speaks to the core questions about tax incentive policy. In all cases it must be acknowledged that factors concerning production (available skilled labor,

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[133] Report, p. 81: "Tax incentives may enhance the attractiveness of a potenial host country, but in many cases the relief provided will be insufficient to offset additional costs incurred when investing there". Holland and Vann are of the same opinion: "Tax incentives on their own cannot overcome these negative factors" (ibid, ft.132, p. 987).
[134] Report p. 9

natural resources, energy supplies, etc.) and size of the market (amount of consumers, transport costs to reach other markets, etc.) are more important considerations than income tax for any given investment. According to the Report, in most cases the relief provided by a tax incentive will be insufficient to offset other negative circumstances and factors. After all, if no profit is realized, income tax incentives do not matter any more. Also, other government policy is taken into consideration by investors, such as property rights, exchange rules, etc.
The impact of non-tax factors is different for each country and for each business activity. Only political stability is a factor that overrides all others. Before deciding that tax incentives should be introduced, or for that matter, continued, it must be assessed if the tax factor is in a position to make a difference; "if it bites". When other conditions relating to production and market are responsible for large differences between possible locations, tax incentives are not in a position to swing the choice in favor of one country or another. Introducing tax incentives in those circumstances has more disadvantages than advantages for a (developing) country, and should be avoided, according to the Report.

The Report recommends policy makers to verify, for each different business sector, which production and market factors are in play, and if tax might make a difference for that particular kind of business. To carry out this assessment in practice will not always be easy, and is according to some, simply impossible[135]. This is a particular challenge developing countries are faced with. Lack of information or resources for carrying out this assessment might induce developing countries to overshoot the target, extending tax incentives to most types of investment projects in an attempt not to miss out on any of them. The Report insists, however, that the assessment should be carried out anyway, if necessary on the basis of reasonable assumptions. "In other words", the Report notes eloquently "policy makers should be encouraged to undertake an analysis of the benefits and costs of a tax incentive use with the same rigor that foreign investors assess the relative private benefits and costs of investing in the host country"[136].

It is certainly true that, for some developing countries, whose Ministry of Finance or of Commerce may have less resources available for this

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[135] Easson, A., *Bulletin I.F.D.*, 2001, p. 272: ("Apart from unreliable anecdotical evidence, however, there is usually no way of determining whether an investment truly is incremental…"); Viherkentta, T, Tax Incentives in Developing Countries and International Taxation, Kluwer, 1991, p. 32.
[136] Report, p. 8.

purpose than a large multinational corporation, it will be hard to carry out this analysis. It must also be kept in mind that making such a comparative analysis for a whole business sector is much more complicated than doing so for only one enterprise, because the variables are much better determined in the latter case. Also, production or market differences *within* a certain business sector can render the assessment useless. An analysis of production and market factors for manufacturing wooden toys is for example not necessarily the same as for plastic toys. Can a (developing) country really be expected to examine those circumstances, and thus the possible effectiveness of its tax incentives, in such detail?

In the many cases where a policy maker of a developing country cannot make this admittedly useful analysis, and does not grant tax incentives, the country risks not attracting investment projects that would have come in case those tax incentives had been available. On the other hand, if it does grant the incentives, they may overshoot the target, and create windfall gains. While pondering this dilemma, a developing country may consider that the other effects of FDI, such as technology transfer, employment, social development, etc., warrant taking the risk of granting tax incentives that are actually not necessary[137].

In that way, therefore, the reasoning to be followed by a developing country may differ from that in the Report. But it is also true that at present, most developing countries simply do not carry out this kind of analysis at all, even if they have (some of) the available data. There is thus definitely room for improvement. It would also be useful to review the contribution international institutions such as the World Bank could make, insofar this has not already happened. In conclusion it is tempting to view the Report's recommendations on the tax incentive assessment as only suitable for developed countries with enough resources to carry out the recommended assessment, but the truth is that many developing countries could indeed do more to make sure tax incentives are only extended where necessary.

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[137] Viherkentta, T. ibid, ft. 135, p. 32: ("Policy makers should therefore weigh up the revenue loss against the benefits from the additional investment); Muten, L., Forms of Tax Incentives, their economic costs and benefits in Fiscal Incentives, Berlin, German Foundation for International Development, 1982, p. 23; Easson, A., *Bulletin I.F.D.*, ibid, ft.135, p. 273 ("Alternatively, a broader concept of social benefit could be adopted, taking into account factors such as employment creation, regional development and technology transfer")

4. The "Leakage" of Tax Incentives

The Report stresses on several places that there is a very real danger that tax incentives may be used for taxpayers or projects they were not intended for. This is, so states the Report, particularly the case for tax holidays. In principle, tax holidays apply to any activity, and not necessarily to a new activity only. Of course, local regulation may provide otherwise, but it may be complicated and expensive to implement, leaving room for planning and deceit[138].

Leakage, particularly in cases where tax holidays are limited to "new business", may occur by transferring already existing business activity to qualifying companies. Another common technique is shifting profits to associated enterprises that enjoy tax incentives, for example by means of transfer pricing. Also, deductible expenses such as interests, royalties and services may be charged by companies with tax incentives to associated non-qualifying enterprises (="base erosion"). The two latter mechanisms may or may not be carried out using arm's length conditions. Transfer pricing and base erosion may also occur internationally, provided the home country exempts the profit realized in the developing country, or extends a tax sparing credit[139].

Finally, leakage can also occur when qualifying companies with unutilized tax losses are "sold" to other taxpayers. This may happen also with tax incentives that are connected to the amount of capital expenditure such as investment allowances and investment credits.

The Report points out that the leakage of tax incentives becomes more of a problem (and more likely) when the host country has a high statutory corporate tax rate. Indeed, it is not so hard to understand that the higher the benefit, the more likely tax avoidance will occur. In addition, however, the normal corporate tax rate says something on how expensive it is to finance the tax incentives by the developing country, namely by taxing non-qualifying taxpayers.

Eventually, tax holidays (even when regulation is put in place to curb leakage) may end up to be rather the rule than the exception, applying in practice to almost every enterprise, to almost every project. It is for example noteworthy that, in preparation of the Indonesian tax reform, the

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[138] Holland and Vann, ibid, p. 999.
[139] Report, p. 45.

tax records of 900 investigated firms indicated that only 12% of the foreign and 8% of the domestic firms paid taxes at the full rate.

5. A Clear and Stable Tax System with a Low Overall Corporate Tax Rate

The Study points out, in line with its earlier work on the subject, that often, where taxation is identified as a significant factor influencing FDI, transparency, simplicity, stability and certainty in the application of the tax law and in tax administration, are ranked higher by investors than special tax incentives. This assertion is supported by other sources as well[140]. A lower overall corporate tax rate has most prominently been adopted in Ireland and Germany, and other countries may soon follow. Many developing countries have relatively high corporate income tax rates, although there are naturally exceptions.

The problem from the point of view of a developing country is, however, that creating an "easy" tax incentive, such as a tax holiday, is for a government often much less difficult than reforming its general income tax simple to be simple, clear and transparent. Problems relating to application and administration of tax laws and regulations are namely more difficult to solve than problems relating to design and drafting them, and developing countries are, in my view, even more confronted with the first kind of problems than with the second kind.

To a large extent, the circumstances differ in this respect from country to country. China, for example, has introduced its entire income tax system virtually overnight in 1994. It did not have to cope with a body of rules which had grown and complicated itself over decades, such as Thailand and India. On the other hand, China's system of rather vague Income Tax Laws, complemented with a number of Implementing Regulations, leaves quite a number of questions unanswered. Another problem for certain countries, especially those with fast growing economies, is that they change faster than those of developed countries. The policy makers of developing countries are faced with more reasons to amend tax laws and regulation, less time to do it in and less qualified people and resources to do it with.

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[140] Viherkentta, T., ibid, p. 33.; Easson, A., *Bulletin I. F.D.*, ibid, ft.135, p. 365.; Toshihide Endo "Taxationand sustained investment", in OECD, Taxation and Investment Flows, p. 125.

Nevertheless it is still a much neglected point of attention of many developing countries that an unclear, unstable and complicated tax treatment in general will, except for some kinds of short term or passive investment, simply cancel out any (expensive) tax incentive offered in the short run. An initiative by the developing countries to eliminate that effect is therefore crucial, or the only investment that will qualify for the incentives will be the one that would have taken place anyway. Although it must be recognized that developing countries are faced with special challenges, there is still room for improvement in many cases. In my view, regular modernization of tax codes and regulations to keep up with new business processes and transactions (e.g. cost sharing agreements, e-commerce, digital invoices), tax avoidance techniques (tax havens, thin capitalization) and international agreements (to clarify possible incompatibilities between tax treaties and domestic income tax rules) is an important part of that effort. In addition, legal rules and regulations should be both qualitatively (in terms of design and drafting) and quantitatively (meaningful guidance should available on all important corporate income tax questions) sufficient. It may even be commendable to adopt some arbitrary rules on questions of fact in order to avoid lengthy discussions with taxpayers or heavy audit burdens on the tax administration of the developing country (e.g. for thin capitalization and deductible expenses). Also, it may be useful to create safe-havens, i.e. a set of circumstances that guarantee a certain tax treatment (e.g. in case of complying with certain documentation requirements in matters of transfer pricing, advance price agreements, technology transfers, etc).

6. Tax Incentives and Tax Sparing

The Report also comments on the role tax sparing credits play with respect to tax incentives in developing countries[141]. It may be noted that the OECD has already earlier expressed the changing views on tax sparing credits of many of its members. In its report "Tax Sparing Credit: A Reconsideration" the OECD discusses ways to limit the granting of tax sparing credits in several ways[142].

Likewise, the Report on corporate tax incentives for FDI, emphasized the possibilities for abusing tax sparing credits and lays out other reasons

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[141] See on this subject, extensively, the doctoral thesis of Timo Viherkentta, Tax Incentives in Developing Countries and International Taxation, Kluwer, 1991.
[142] OECD, Tax Sparing Credit: A Reconsideration, Paris, 1997 and 2000, p. 31-38 (included in the OECD Model tax Convention as R-14)

why tax sparing credits should not be granted for all tax incentives. For example, the view is quoted that tax sparing credits should only be granted if those tax incentives really attract FDI. It may be noted incidentally, that the Report has the most criticism on those tax incentives that are, through tax sparing credits, usually the most costly for developed countries[143]. The Report also points out that tax sparing may be a "negotiating chip".

From the perspective of developing countries, the reconsideration of tax sparing credits by developed countries is followed with a wary eye. More and more limitations are introduced and some may see the use of tax sparing as a "negotiating chip" as fundamentally unfair[144]. Developed countries may take the position, for example during tax treaty negotiations, that tax holidays are an inefficient tool to attract FDI for the developing country, because they can be abused too easily and are not targeted enough, and that consequently no tax sparing credit should be given. Developing countries could reply that they themselves are in the best position to evaluate on the whole which tax incentives work better for their own country, and that the treaty partner is always free to suggest any anti-tax sparing abuse measures he wants included the treaty text.

One of the other important points of attention by developed countries in this matter is the possibility of changes to the developping's country's overall corporate tax rate. The tax sparing credit is in most treaties defined in function of the developing countries' overall corporate income tax rate, in such a way that if the overall rate is increased, the foreign tax credit will increase as well. With that result in mind, the developing country may be tempted to raise the overall corporate income tax rate, in a way that it in fact only affects foreign companies or companies with foreign shareholders. This concern is also expressed explicitly in the OECD Report "*Tax Sparing: A Reconsideration*"[145], together with the apprehension that developing countries might abuse the notion of "tax incentives similar to those currently in force" to expand the scope of conventional tax sparing credits[146]. To a certain extent, as the Report notes, this can be curbed by including explicit references and limitations in the text of the treaty, but it may still safely be said that certain other principles, such as for example the principle of good faith in international

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[143] Investment allowances and credits are much more difficult to calculate and are usually not covered by tax sparing relief on active income: Holland and Vann, ibid, p. 1013-1014.
[144] Qureshi, N.M., "Tax treaty needs of developing countries", IFA Sem. 1979, p. 34.
[145] OECD, "Tax Sparing – A Reconsideration", Paris, ibid, ft.142.
[146] R (14)- p. 28 in the OECD Model Tax Convention, 2000.

law will also to play an important role in this respect[147]. Although the starting point remains that a contracting state remains free to change its domestic tax incentives, and that the other contracting state will be obliged to continue extending tax sparing credits (provided no special conventional exception would apply), those changes must remain within reasonable proportions in the light of the prevailing practice on this subject of the international community of nations. One could argue that such would not be in accordance with the legitimate expectation of the treaty partner[148]. In addition, the domestic changes may not be tailor-made to exploit the provision in an unfair manner.

The OECD's reluctance towards tax incentives may be associated with the fact that both the OECD[149] and the EU[150] have recently however announced initiatives to curb the use of "harmful preferential tax regimes" within and outside of their member countries. Though it is true that as a principle neither of the harmful tax competition-initiatives is directed against tax incentives by developing countries to promote FDI, such measures are, quite unfairly, not explicitly excluded from the scope either.

7. Concluding Remarks

7.1. Summarizing the main features of the OECD Report

The main assertion of the OECD Report on Corporate Tax Incentives for Foreign Direct Investment is that tax incentives should only be considered when they can really make a difference in swinging the investment decision in favor of the country that grants the incentive. In all other cases, tax incentives are not a cost-efficient method of attracting FDI, according to the Report. Determining if they are indeed operative requires a careful analysis of all production, market and other factors

[147] OECD Commentary on art 25, par. 44.5; OECD Report on Tax Treaty Override, par. 9; Edwardes-Kerr, M., Tax Treaty Interpretation, Chapter 6.; Vogel, K. On Double Taxation Conventions, 3rd edition, Kluwer, p. 66.
[148] Byers, M. Custom, Power and the Power of Rules, Cambridge UP, 1999, p. 125.
[149] OECD, Report on Harmful Tax Competition, Paris, 1998; Rosembuj, T., "Harmful Tax Competition", *Intertax*, 1999, p. 316-334.; Malherbe, J., "Harmful Tax Competition and the EU Code of Conduct", *T.N.I.,* 2000, p. 18566.; Van der Bruggen, E., "State responsibility under customary international law in matters of taxation and tax competition", *Intertax*, 2001, p. 120-122.
[150] EU Code of Conduct, 1999.

involved per business sector, although data to support this analysis may not always be readily available.

Once it has been determined that granting tax incentives is appropriate, the pros and cons of different types of tax incentives must be weighed. The Report compares different possibilities, but states that the tax incentive (mix) should be different for each country in function of the assessment above. In general terms, however, the Report is rather wary of tax holidays, by far the most popular form of tax incentive in developing countries, noting that the possibilities of abuse and leakage are too important. Similar criticism on tax holidays has been noted by Holland and Vann[151],Easson[152] and others[153]. The Report points out fewer possibilities for abuse when it discusses investment allowances and credits. Also Holland and Vann are more in favor of this kind of tax incentives[154]. The Report is furthermore generally more supportive of sophisticated tax incentives, such as an incremental investment tax credit. The latter system only grants tax credits insofar a certain level of investment exceeded the average over the three last years. The effect and limitations of "finance incentives", such as reducing or exempting withholding tax on dividends, were also explained in the Report. It was also noted that refundable credits should be chosen with great care, because the refundability could greatly increase the cost of the program[155].

7.2 Some personal views on applying the OECD Report to China and other developing countries

a) *Carrying out the assessment*

In my view, the basic approach of this Report (assessing first if tax incentives can make a difference) can also be useful for developing

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[151] ibid, ft.150, p. 996 and p. 998-999, pointing out that (1) they only attract projects that generate large profits in a short time, which tend to be in trade, short-term construction and services, (2) that they are prone to abuse and (3) that usually it is more difficult to make sure only new investment qualifies.
[152] Easson, A., *Bulletin I.F.D.*, 2001, p. 371.
[153] Tanzi V and Zee, H., "Tax policy for emerging markets: developing countries", National Tax Journal, 2000, 316 ("Unfortunately, the most prevalant forms of incentives found in developing countries tend also to be the least meritious"); Mclure, J.R. CE, "Tax holidays and investment incentives", *Bulletin I.F.D.*, 1999, p. 327-330.
[154] Holland and Vann, ibid, ft.132, p. 1001.
[155] This concern is shared by Holland and Vann, ibid, ft.132, p. 997.

countries, but with one important caveat. Developing countries should indeed do more to assess if their tax incentives are not just windfall gains for investors, but if no persuasive evidence can be found to that effect, tax incentives may still be considered in view of the other, social benefits they cause in the developing country. Particularly in that situation, but also when tax incentives do "bite", those should be chosen that are least likely to be abused but still realistically possible to administer[156].

It is therefore recommended, before any new tax incentives are introduced, that the policy makers of a developing country would retain a body of experts to study the market and production factors concerning the activities that would fall within the scope of the tax incentive. Although it is clear that in many cases achieving the level of detail required for that study to be really conclusive may not be realistic, it is obvious that in any event such a study would greatly increase the insight of the policy makers into the implications of the tax incentive. Given the international nature of the issue, it is furthermore obvious that international organizations and institutions may play an important role in this respect.

Another approach that could be adopted is not to research the market and production factors of a certain business activity, but to identify the factors that play in the particular disadvantage of the own country. Such analysis should indicate which specific elements of the production or business process present relatively more problems in the developing country in question, and, conversely, in which areas the country scores rather better than comparable developing countries. In many cases, policy makers can draw upon existing studies and take into account the profitability of existing enterprises in this respect. If that analysis indicates that the availability of highly skilled managerial staff is a recurring problem, policy makers should for example consider reducing income tax for expatriate staff that fits that description. In the same vane, when the study indicates that the medical services industry in the country is performing quite successfully, further tax incentives for that type of business activity should perhaps not be considered.

There is no reason why tax incentives should not be used by developing countries to compensate for market or production deficiencies, provided that the policy in this respect is based on informed decisions rather than unsubstantiated general and popular beliefs.

[156] See on this issue also below.

b) Issues related to the abuse of tax incentives

The issue of abuse of tax incentives has had much attention in the reviewed Report and in the OECD Report on tax sparing, quoted above. Too a certain extent, however, international abuse of local tax incentives is an international problem rather than a local one. Remedies for the routing of loans and licenses for intellectual property, for example, should in the first place be sought on the international plane (namely by excluding the conventional tax sparing credits for such transactions by anti-abuse clauses in double taxation conventions) and in the domestic anti-avoidance measures of the developed countries. After all, the country where the tax credit is granted is in the end in the best position to examine the conditions that have led the taxpayer to claim the credit.

On a domestic level, it is most important that the tax privileges remain the exception in the developing country, and do not "leak" in such a way that in practice, nearly all taxpayers and all projects will benefit from them. Usually, designing rules to avoid that is not the real problem. Implementing those rules with few resources and without many sufficiently trained staff, is a typical concern for developing countries. Not always is this issue sufficiently taken into account by developing countries when designing unrealistically complicated qualifying regulations. Therefore, it may be suggested that especially in case no evidence is available that the tax incentive is really operative for a certain business sector, or that the positive side-effects that may reasonably be expected are quite significant, developing countries should choose for the kind of tax incentives that has the least chance of leakage. Generally, tax holidays that have quite a wide scope do not fall under this category.

It may indeed not be forgotten that in any event, tax incentives usually disturb and distort domestic tax collection. For starters, there is the complicated approval procedure that requires specialized government employees. Secondly, even during the tax holiday, the tax authorities will be required to control and administer the promoted company. This cannot bring about fiscal revenue, but is necessary to prepare for when the holiday is over.Further, on a practical level, it creates possibilities for avoidance and evasion schemes in transactions between domestic enterprises and enterprises with tax incentives, as was pointed out above.

Administrative discretion has long been the main tool for developing countries to safeguard that tax incentives are not applied to transactions and taxpayers they were not intended for. Although administrative verification prior to and during the period of the incentive will always

take an important place in the whole process, it is often overlooked that many tax incentives are needlessly rendered too vulnerable to abuse already in the design phase. As was pointed out above, complicated procedures and conditions tend to overburden the administration, and more emphasis should generally be put on straightforward systems that are easier to examine. It may be noted that according to the Report, for example, investment credits are for example less prone to abuse than wide scope tax holidays. Tax incentives on withholding taxes (interest, royalties, dividends, salaries, etc.) are also as a general rule easier to administer and audit than corporate income tax incentives. Finally, it should not be neglected that taxpayers and their advisors can also be educated to reduce their willingness for abuse and evasion by targeted information campaigns and dissuasive penalties.

In China, the abuse of tax incentives has not escaped the attention of policy makers[157], and a recent efficient step is the requiring of a certificate proving compliance of tax payments or exemption prior to remitting the foreign exchange outside China[158].

c) General tax system

Even if, pursuant to an assessment carried out, tax is deemed a determinative factor, it may not be forgotten by policy makers that it is usually much more effective to have a clear, stable and transparent general tax system with a low overall corporate income tax rate than to depend on special tax incentives. Although this is generally harder to achieve for developing countries than for developed countries, there may be much room for improvement by certain developing countries with respect to enhancing the transparency and certainty of their tax law. In my view, the influence a streamlined, stable and transparent tax system may have on FDI is too often overlooked, perhaps because it requires a sustained, intensive effort with little PR-value.

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[157] A much reported case before the Shanghai tax authorities, for example, concerned the right to the tax refund for reinvestment while restructuring the shareholdership *IBFD*, 48.6.; Jinyan Li, "PRC uses Substance Over Form in Determining Eligibility for Tax Incentives", *Tax Notes International,* 1997, p. 97-124.; See also Rijntjes, D., "Avoidance of Capital Gains Tax under China's Tax Treaties", *APTB*, 1995, p. 164 (165).

[158] Nelson, S. and Chan, D., "China Tax Update", conference paper of the Asia-Pacific Tax Conference, November 2000.

In my opinion, a regular review and modernization of the tax code and key-regulations of developing countries is only the starting point in this regard, provided that such does not lead to unnecessary overhauls in tax rules. The rapidly developing economies of developing countries are frequently confronted with new business procedures and transactions, such as cost-sharing, cash-pooling, e-commerce, interest-rate swaps, etc. In many developing countries, such creates important uncertainties regarding the tax treatment, and investors are reluctant to proceed in those circumstances. In China, practitioners have noted that that income tax laws are notoriously vague, and in fact designed to be implemented by so-called detailed regulations. The high level of discretionary power by the tax administration, and the limited experience with judicial remedies, particularly in tax matters, also enhances uncertainty.

Developing countries should furthermore attempt to enhance the level of certainty and predictability of tax treatment in their country by adopting a cooperative attitude to taxpayers, a climate where mutual consultation is encouraged. It may be recommended, for example, to put a legal framework into place for advance pricing agreements, which greatly increases the certainty in matters of transfer pricing while relieving some of the audit burden on tax authorities. If a system of rulings exists, that procedure should be formalized and rulings should be given a legal status and be published, which also adds to the transparency and predictability of tax laws in the developing country.

In this regard it may be noted that several European countries have chosen to reduce the corporate income tax rate while enlarge the corporate tax basis, which could be a useful exercise for certain developing countries as well[159] Although it is perhaps too early to assess whether this policy is in fact effective, at the very least it may be said that tax law has become less complicated as a consequence because many special deductions and exceptions have been abolished. In the same vane, corporate income tax laws and regulations of developing countries are teeming with small deductions and exceptions, many of which were introduced in the course of long forgotten tax reforms and no longer have much practical importance. A regular critical review of the tax codes of the country will ensure that the tax laws and regulations will be consistent and coherent, without a multitude of special cases where such is not really necessary.

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[159] On this issue, see for example Lingguang Bao, "Several issues at the forefront of the current tax theory debate in China", *Intertax*, 2001, p. 407-408.

With respect to the transparency and predictability of income tax treatment in China it is appropriate to place this issue against the backdrop of the rule of law in public affairs as a whole and of the resurgence of customary norms and its influence on regulatory behavior. As PETER HOWARD CORNE notes, who published an interesting study on law and reality in China[160]: "Laws that embody norms transplanted from foreign legal systems normally face substantial implementation problems. The experience of many Asian countries during the colonial and post-colonial periods shows that legal regulation is less relevant to social reality than are customary norms. Imported legal concepts may not correspond with entrenched societal values. Consequently, people may be unwilling to adjust their behavior to fit the new legal standards[161]". Maybe more in Communist China than in other Asian countries, this problem is worsened by the fact that China has been "denying law any role whatsoever in societal regulation[162]".

The same circumstances that account for the problematic implementation of (economic) law, are responsible for the lack of respect for tax law, and among other things render the tax system intransparant. Several contributing factors have been observed such as the lack of computerization, weak external control over tax officials by the legislature, complexity and uncertainty in tax legislation, etc.[163] Jinyan Li also poited out that: "Chinese tax laws are drafted in general, and sometimes in imprecise language, which makes a literal interpretation virtually impossible. The Chinese do not necessarily interpret their tax laws in the same manner as Western-trained lawyers. Rigorous statutory construction, no matter how logically impeccable or internally consistent, may not always be persuasive in dealings with tax officials; nor will it always be useful in predicting the treatment of a business transaction"[164].

Also Vnaderwolk identifies "a gap between legal requirements and practical reality in China"[165]. Hie Hok Fung, in his article on some taxation traps for property investors in China, concurs by saying that

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[160] Corne, P.H., *Foreign Investment in China. The Administrative Legal System,* Hong Kong University Press, Hong Kong, 1997, p. 1-50.
[161] Corne, ibid, ft.160, p.1.
[162] Corne, ibid, ft.160, p. 2-3.
[163] Reported by Field, T.F., "China seeks to Curb Tax Corruption", *Tax Notes International,* 1997, 97-12305.
[164] Jinyan Li, "China's Tax Treaties and Their Impact on Foreign Investment", *TNI*, 1995.
[165] Vanderwolk, J., *Practical China Tax Planning*, FT Law & Tax Asia Pacific, Hong Kong, (loose-leaf) 1996, C1-11.

"Another important feature of the PRC legal regime that is commonly experienced by foreign investors is that PRC authorities take a flexible approach towards enforcing the law. Statutes and regulations can be interpreted broadly to suit current policies"[166]. Finally, an IMF study identifies the "lack of a formulation of an appropriate legal framework" as a major issue to be addressed in tax policy[167].

Although at present the notices and circulars of the different Chinese government departments may provide some details and solutions to practical problems, little attention has been paid at this time to address certain fundamental issues including legal certainty, taxpayers' rights and judicial and administrative review[168].

d) *The OECD Report in the perspective of some particular Chinese tax incentives*

As several other developing countries, China's foreign direct investment-policy is characterized by a large variety of tax incentive possibilities, and an overview of the tax incentives on offer falls beyond the scope of this article. It may be noted that most tax incentive mechanisms quoted in the Report have been adopted in China at one time or another. Most famously, a complete exemption of foreign enterprise income tax for 3 to 10 years may be granted to certain investors[169], but reduced rates of tax of 24%, 15%[170] and 10% are also available in certain situations. In addition, export-oriented enterprises and enterprises using advanced technology may be granted an additional 50% reduction in the applicable tax rate[171]. China also has a 40%-100% tax refund, which refunds income tax already

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[166] Hie Hok Fung, D., "Leasing Property in China: Taxation Traps for Unwary International Investors", *Tax Notes International,* 1998, 98-21224.
[167] Arora, V.B. and Norregaard, J., Intergovernmental Fiscal Relations: The Chinese System in Perspective, IMF Working Paper, WP/97/129, October 1997, p. 3.
[168] Parnell, A., Alfert, A., and Liu, D., "Identifying Potential Misunderstandings Lurking in "One Country, Two Systems" – Different Ways of Making Tax Law and Resolving Tax Disputes", *APTB*, 1997, 3 (4).
[169] See for example Art. 8 FITL, art. 75 FITR
[170] Special Economic Zones, Economic and Technology Development Zones under art. 7 of the Foreign Enterprise Income Tax Law.
[171] In the case of enterprises using advanced technology, limited to a 3-year period. Note that China's accession to the WTO is expected to entail the phasing out of export-related incentives. See on this issue Sussman, L. and Lu Chai, "China's new corporate tax law post-WTO", Tax Notes International, Doc. 2001-26825.; Jinyang Li., "WTO and China's Tax Policy", *Tax Notes International*, 2000, 15284.

paid by an enterprise on profits that are reinvested[172]. Furthermore, various exemptions from withholding tax exist notably a general exemption on dividends distributed by a foreign investment enterprise and a qualified exemption for royalties and rent. More recently, special deductions were introduced for research and development expenses[173], and a special regime for software and integrated industries[174].

On a general note, it can be said that the reassessment the OECD currently carries out of the desirability and qualifications of tax incentives for FDI comes at a time that China is reconsidering its tax incentive policies for several reasons. First of all, for reasons of domestic equity, it has become increasingly difficult to justify extending tax reductions to foreign investors that are not available to domestic operators. Secondly, as was pointed out above, China's accession to the WTO poses some questions on the compatibility of certain (especially export-related) tax incentives with WTO-rules[175].

Turning our attention to the principles of the OECD Report, it is hard to determine whether the assessment the Report recommends indeed plays an important part in the design of China's policy. It is fair to say, however, that the focus seems to be shifting away from large-scope tax exemptions such as tax holidays, which have come under increased pressure, and that more attention has recently been observed for limited tax reductions for specific types of industry. A possible exception is the continued use of tax reductions to spur investment in particularly needy geographical areas, such as was recently undertaken with respect to central and west China[176], but it is noteworthy that the SAT has opted for a 15% tax rate during 3 years, and not for a 100 tax exemption. In line with my comments above, it may in any event be considered that the great need for development in such areas warrants the granting of tax incentives even without particular proof that such incentives would not be windfall gains for the investor, provided that the qualifying type of business activity is indeed likely to have beneficial side-effects (employment, construction, use of local raw materials, etc.).

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[172] Art. 10 FITL.
[173] Notice of the SAT Guo Shui Fa 1999 No. 173 of 19 September 1999; Note that a notice of 18 April 2000 of the Ministry of Foreign Trade and Economic Cooperatiuon, Waijing Mao Zifa No. 218.
[174] Notice of the State Council Guo Fa 2000 No. 18 of 24 June 2000.
[175] "China to remove Special Economic Zones", *Financial Times*, 13 November 2001.
[176] Notice of the SAT Guo Shui Fa 1999 No. 172.

Finally, it can be noted that certain considerations that are formulated in the Report, have already received attention in Chinese tax law and regulations. The Report, for example, suggests to focus on long term investment, and less on short term projects. The same concern is reflected in the conditions of several Chinese tax incentives, where it is required to conduct business operations during at least 10 years[177]. It is also noteworthy that attention is paid to the incremental effect of the measures adopted, another issue identified in the Report. Guo Shui Fa 1999 No. 173 (extra deduction of R&D expenses), for example, notes the condition that a foreign investment enterprise must increase its R&D expenses with at least 10% in order to qualify.

[177] Art. 8 FITL; [See banks, Ibfd 48.3.4.]; Notice of the SAT Guo Shui Fa 1999 No. 172.