The international tax reform agenda (pillar two) and its implications on the future of tax incentives

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International tax system needs to be reformed

- Regimes exist across the world with varying levels and kinds of incentives

- These regimes are a function of the internal level of economic development but these get “externalised” via capital mobility

- There is also intra-nation tax competition for example capital income across US
Shifting goal posts of the OECD

• 1996 work on tax competition
• 1998 report defining harmful tax competition
• 2002 jurisdictions identified as tax havens
• 2011 work on expanding tax base and reducing tax rates
• 2013 IP regimes and Harmful Tax Practices (Action point 5) and Treaty Abuse (Action point 6)
• 2020 Pillar two proposal to implement minimum tax
International tax system needs to be reformed

CbCR statistics show that that kind of activity undertaken by category of jurisdiction varied widely and this may be related to the incentive regimes in these countries.

Source: OECD
Macroeconomic shocks vs. competition for investment

Chirinko and Wilson (2017) find that in the US the investment tax credits offered by states was not only the result of competition but also on account of macroeconomic changes, capital income shares.

Therefore, there are important considerations when discussing competition and tax expenditures.

- Such relationship is true also for developing countries. For example after capital account liberalisation India offered incentives to foreign investment.

- What are the kinds of factors that need to be considered prior to dismissing tax expenditures as wasteful.
How are tax incentives defined?

- Low tax rates
- Credits, exemptions and deductions
- Tax treaty rates
Tax Rates: race to the bottom

Distribution of Worldwide Statutory Corporate Tax rates, by decade 1980-2020

Source: Tax Foundation
Who has STR less than 15 per cent

[Bar chart showing various countries with their STR levels below 15%]
Tax Rates: Macroeconomic considerations

- Tax rates are a function of institutional features, norms and level of economic development
- Related to fiscal capacity
- Level of external debt

\[ y = 2.0794x + 44.338 \]
\[ R^2 = 0.0734 \]
Tax Rates: Macroeconomic considerations

• Tax rates and capital controls
  Corporate tax rate~ per capita GDP, CC inflows, CC outflows, share of services in GDP, share of natural resource rent
  preliminary results suggest
• Higher PC GDP is associated with lower STR
• Share of services tend to be associated with lower STR in Asia
• In all county groupings the countries with higher share of rents from natural resources tend to have higher STR
Do low corporate tax rates mean low tax to GDP ratio?

Direct Tax (as a % of GDP) and Corporate Tax Rates in 2019

Corporate Tax Rate vs. Direct Tax to GDP (%)
Tax incentives are offered by low income countries?

**1997**

\[ y = 0.3343x - 0.6081 \]
\[ R^2 = 0.0862 \]

**2019**

\[ y = 0.3641x - 0.9186 \]
\[ R^2 = 0.0854 \]

Source: Global Tax Expenditure Database and World Development Indicators
Do tax incentives work?

- Economic evidence is ambiguous. The results vary across time, countries and sectors

- Evidence from India suggests that it is hard to correlate growth in overall economic activity—exports, investments—with exemptions and deductions offered
Preliminary firm-level evidence in India

- R&D deductions do not enhance firm level productivity
- Direct tax benefits to exports tend to improve firm level sales

<table>
<thead>
<tr>
<th>Variables</th>
<th>Sales</th>
<th>Sales</th>
</tr>
</thead>
<tbody>
<tr>
<td>Export incentives</td>
<td>39.61***</td>
<td>7.089***</td>
</tr>
<tr>
<td></td>
<td>(1.366)</td>
<td>(1.002)</td>
</tr>
<tr>
<td>Total Assets</td>
<td>0.617***</td>
<td></td>
</tr>
<tr>
<td></td>
<td>(0.005)</td>
<td></td>
</tr>
<tr>
<td>Constant</td>
<td>10,095***</td>
<td>3,299.634***</td>
</tr>
<tr>
<td></td>
<td>(250.8)</td>
<td>(185.628)</td>
</tr>
<tr>
<td>Observations</td>
<td>18,701</td>
<td>18,694</td>
</tr>
<tr>
<td>R-squared</td>
<td>0.048</td>
<td>0.521</td>
</tr>
<tr>
<td>Number of companies</td>
<td>1,992</td>
<td>1,990</td>
</tr>
</tbody>
</table>
## Tax Rates and foreign investment

Table Long term and short term relation between FDI and Corporate tax 1970 to 2019

<table>
<thead>
<tr>
<th>Country</th>
<th>LR coefficient</th>
<th>SR coefficient</th>
<th>Error Adjusted LR coefficient</th>
</tr>
</thead>
<tbody>
<tr>
<td>US</td>
<td>-1.60e+10</td>
<td>1.21e+10</td>
<td>-.4165388**</td>
</tr>
<tr>
<td>UK</td>
<td>1.63e+09</td>
<td>1.09e+10</td>
<td>-.7224906***</td>
</tr>
<tr>
<td>India</td>
<td>-8.07e+09</td>
<td>-9.29e+07</td>
<td>-.1386789</td>
</tr>
<tr>
<td>Malaysia</td>
<td>-1.33e+09***</td>
<td>1.41e+09</td>
<td>-.7403951***</td>
</tr>
<tr>
<td>South Africa</td>
<td>2.33e+07</td>
<td>-7.64e+08*</td>
<td>-.9105641***</td>
</tr>
<tr>
<td>Singapore</td>
<td>-7.35e+09**</td>
<td>8.23e+09*</td>
<td>-.3398284*</td>
</tr>
<tr>
<td>France</td>
<td>-3.53e+09</td>
<td>1.27e+08</td>
<td>-.6274752**</td>
</tr>
<tr>
<td>Germany</td>
<td>7.12e+08</td>
<td>5.41e+09</td>
<td>-.5889237**</td>
</tr>
<tr>
<td>Brazil</td>
<td>1.28e+08</td>
<td>-7.42e+07</td>
<td>-.1616481</td>
</tr>
</tbody>
</table>
Tax treaties and investment

- Capital controls and regulatory changes can influence the domestic tax rates but the treaty rates can act as an added incentive when controls exist.
- The structural breaks in India’s annual FDI series is the same as the years in which there are significant shifts in capital controls except for 2017.

**Share in FDI inflows in India (%)**
## Tax treaties and minimum tax

<table>
<thead>
<tr>
<th>Average withholding rates</th>
<th>Developing-developed country</th>
<th>Developed-developed country</th>
<th>Developing-developing country</th>
</tr>
</thead>
<tbody>
<tr>
<td>Dividend withholding tax rate</td>
<td>13.14</td>
<td>12.93</td>
<td>11.38</td>
</tr>
<tr>
<td>Interest withholding tax rate</td>
<td>10.86</td>
<td>10.71</td>
<td>10.68</td>
</tr>
<tr>
<td>Royalty withholding rate</td>
<td>10.86</td>
<td>10.23</td>
<td>10.85</td>
</tr>
<tr>
<td>Fees for technical services</td>
<td>12.14</td>
<td>9.9</td>
<td>11.46</td>
</tr>
</tbody>
</table>

Source: constructed using ICTD data
## Tax treaties and minimum tax

<table>
<thead>
<tr>
<th>Number of treaties with withholding rate less than 9%</th>
<th>Dividend</th>
<th>Interest</th>
<th>Royalty</th>
<th>FTS</th>
</tr>
</thead>
<tbody>
<tr>
<td>Developed-developed</td>
<td>17</td>
<td>42</td>
<td>55</td>
<td>3</td>
</tr>
<tr>
<td>Developing-developed</td>
<td>117</td>
<td>240</td>
<td>302</td>
<td>47</td>
</tr>
<tr>
<td>Developing-developing</td>
<td>140</td>
<td>113</td>
<td>130</td>
<td>25</td>
</tr>
</tbody>
</table>

Source: constructed using ICTD data
Future of tax incentives

• The tax rates are not harmful per se, the macroeconomic factors are important
• Some incentives work in certain contexts and revenue foregone≠ revenue gained when incentive is discontinued
• IIR will apply to select companies and therefore incentives can continue to apply to others
• CFC regimes vary widely and with such differences tax competition for residence will continue
• Few tax treaties will change subject to bilateral agreement
• Exclusion for financial sector
• Capital gains may continue to be taxed lightly
Future of tax incentives

• CFC regimes vary widely and with such differences tax competition for residence will continue

Source: Tax Foundation