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

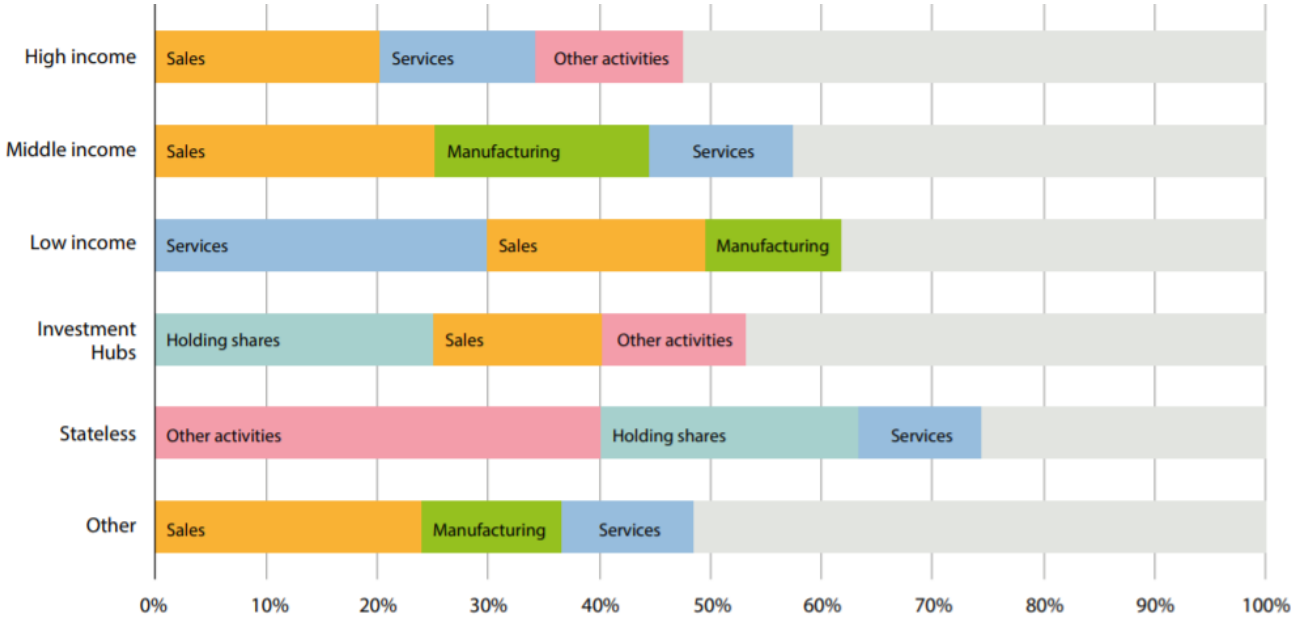
- There is also intra-nation tax competition for example capital income across US

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

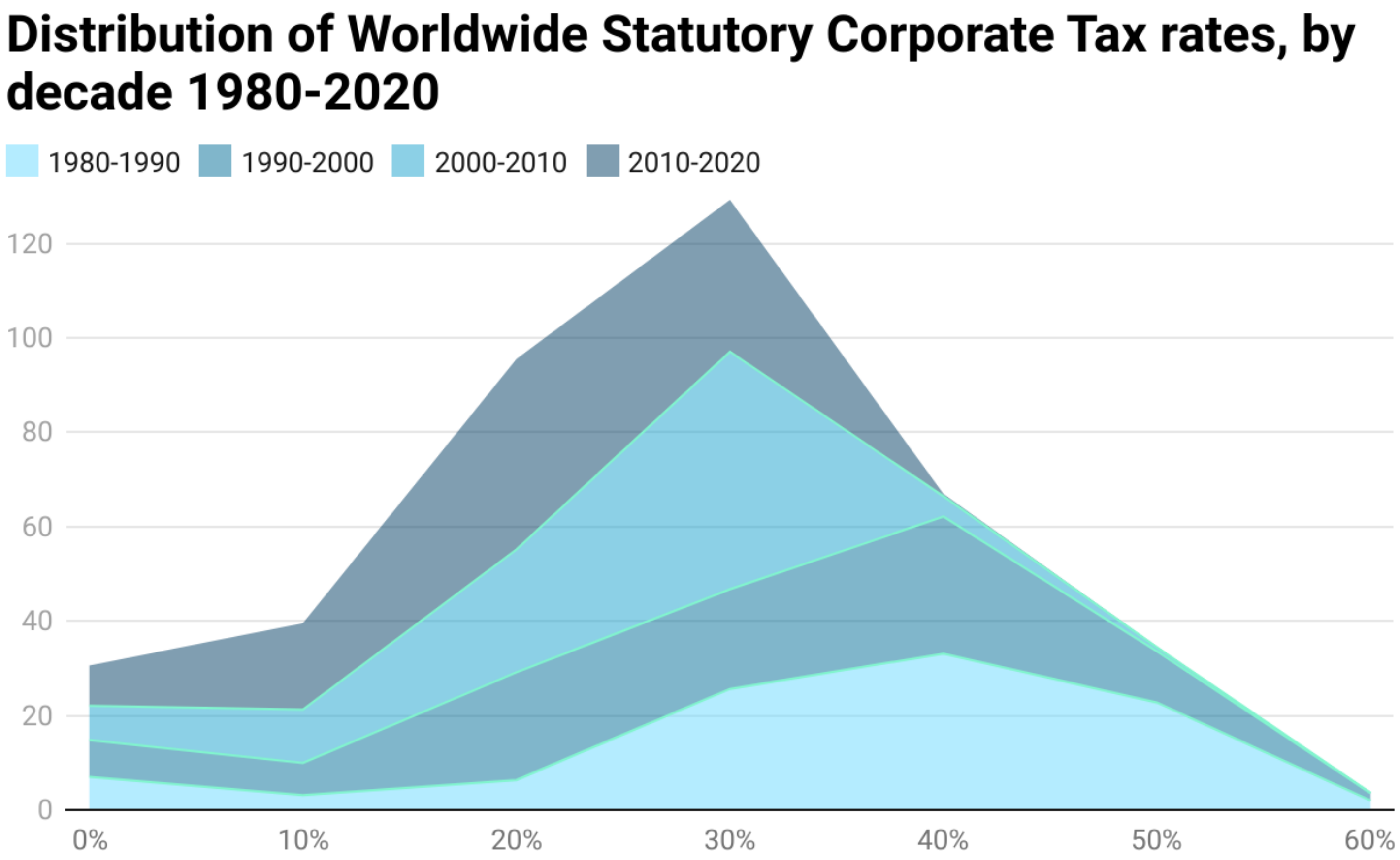
How are tax incentives defined?

Low tax rates

Credits, exemptions and deductions

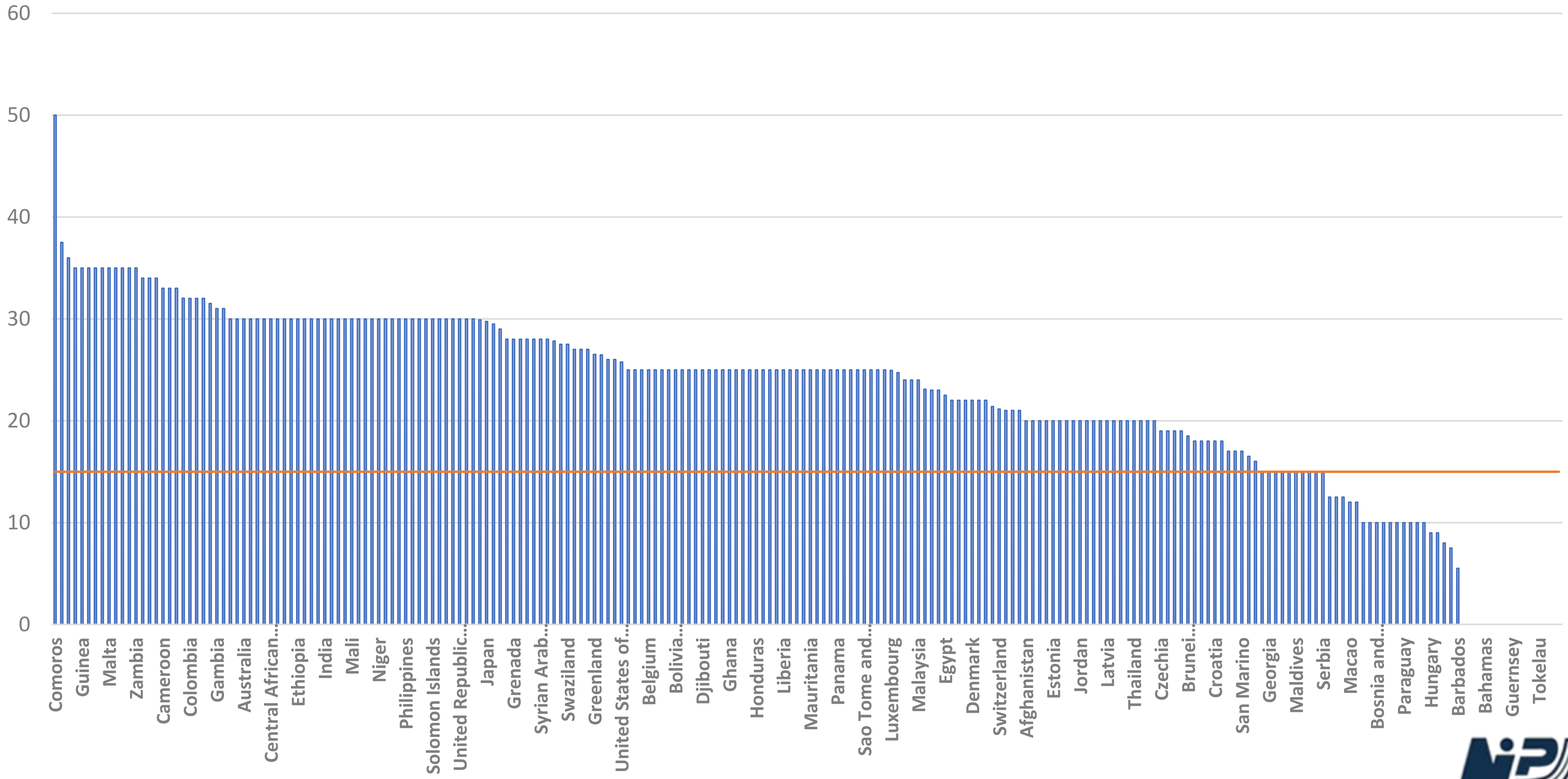
Tax treaty rates

Tax Rates: race to the bottom



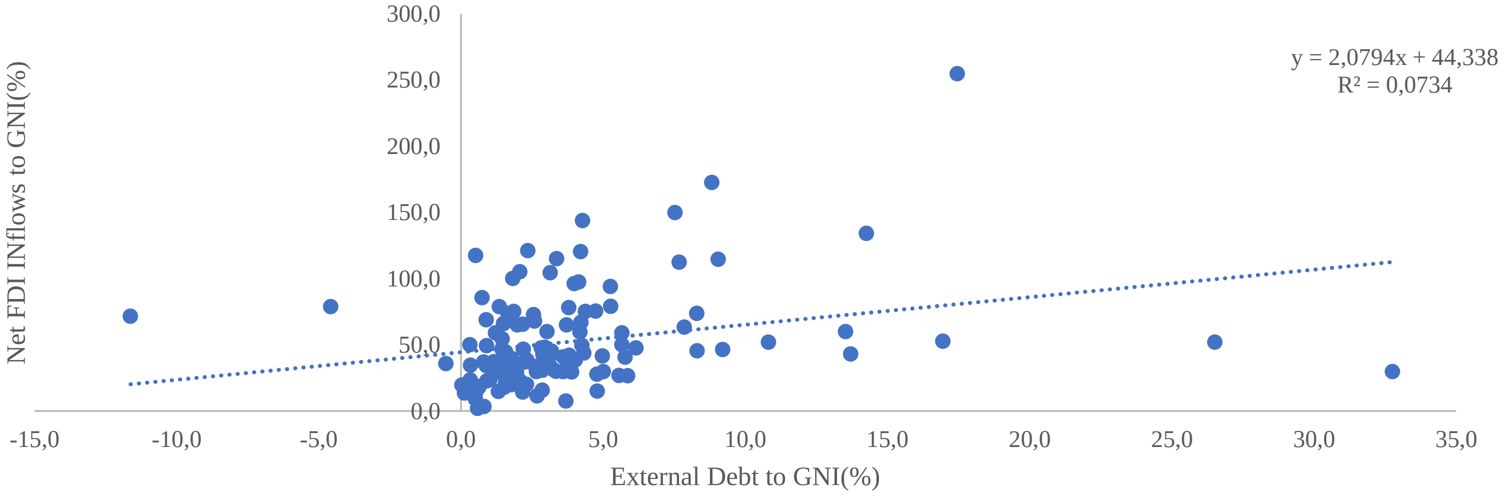
Source: Tax Foundation

Who has STR less than 15 per cent



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



Tax Rates: Macroeconomic considerations

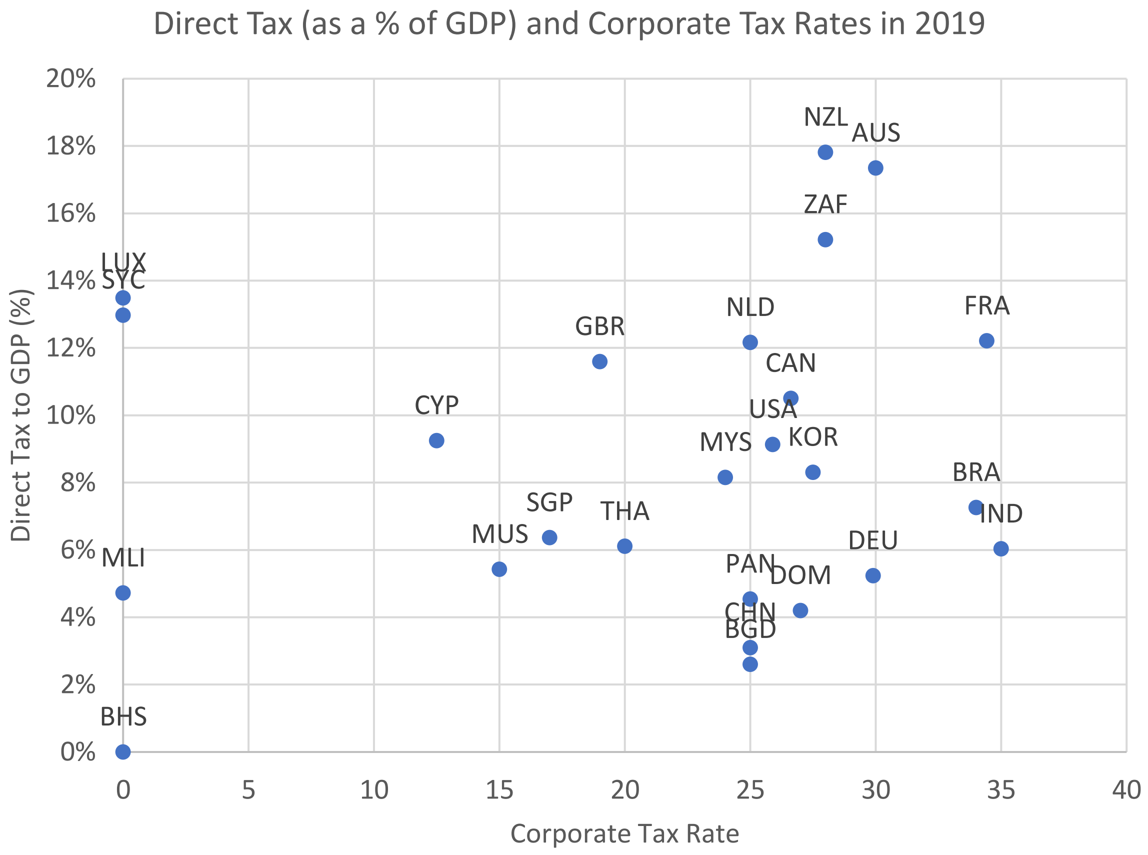
- Tax rates and capital controls

Corporate tax rate~ per capita GDP, CC inflows, CC outflows, share of services in GDP, share of natural resource rent

preliminary results suggest

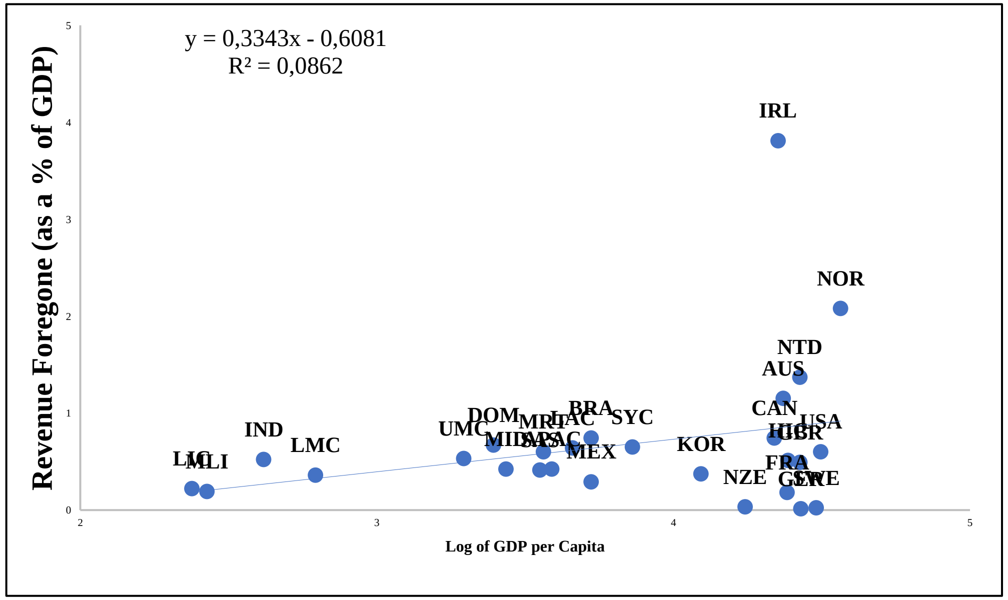
- Higher PC GDP is associated with lower STR
- Share of services tend to be associated with lower STR in Asia
- In all county groupings the countries with higher share of rents from natural resources tend to have higher STR

Do low corporate tax rates mean low tax to GDP ratio?

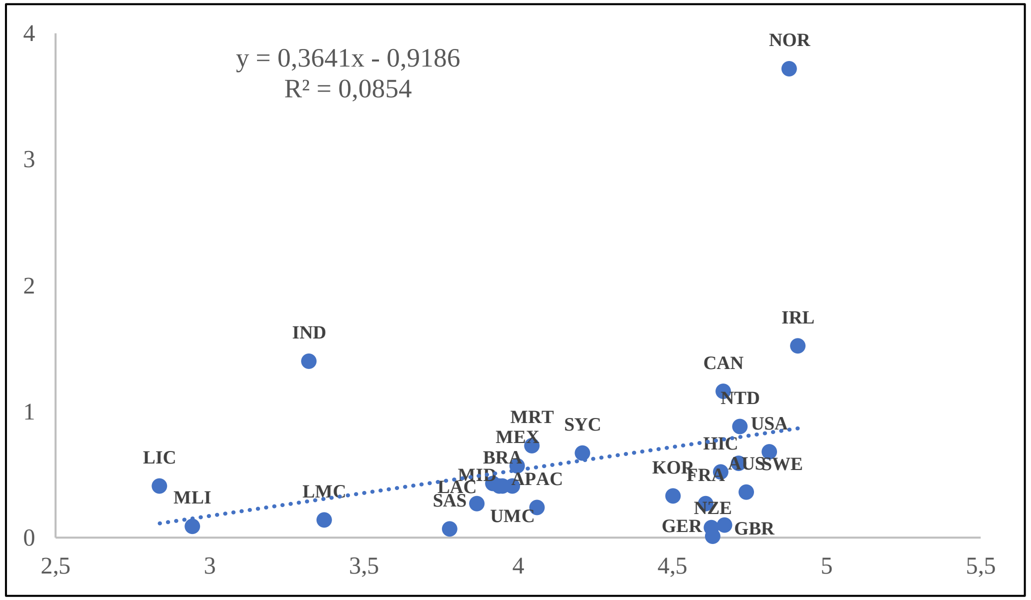


Tax incentives are offered by low income countries?

1997



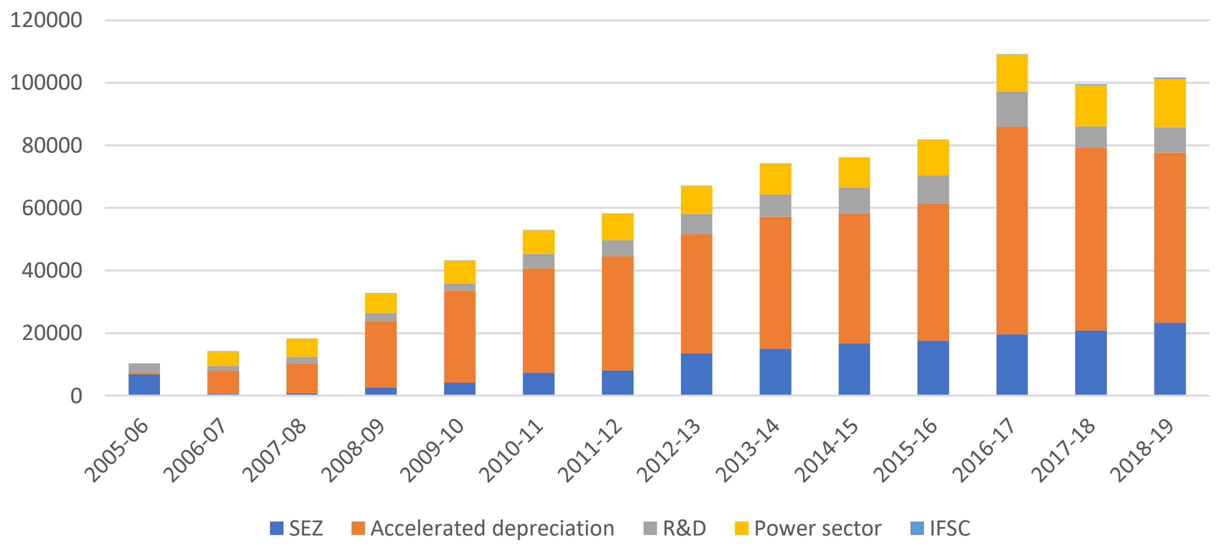
2019



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

Variables	***Sales***	***Sales***
Export incentives	39.61***	7.089***
	(1.366)	(1.002)
Total Assets		0.617***
		(0.005)
Constant	10,095***	3,299.634***
	(250.8)	(185.628)
Observations	18,701	18,694
R-squared	0.048	0.521
Number of companies	1,992	1,990

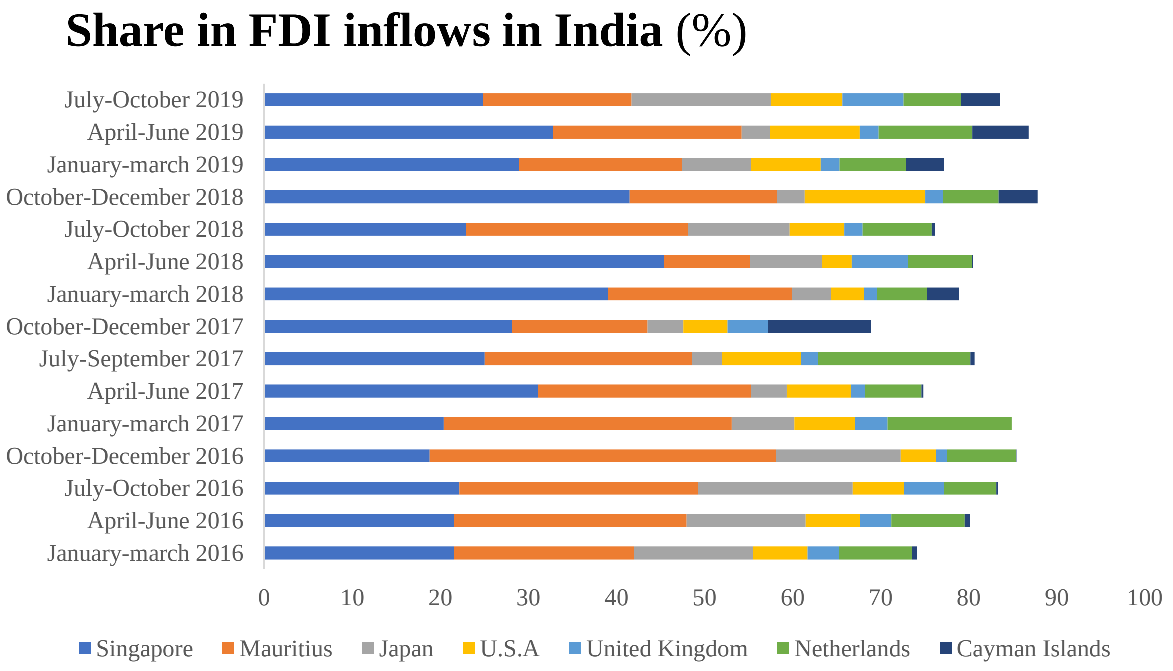
Tax Rates and foreign investment

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

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

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



Tax treaties and minimum tax

Average withholding rates	Developing-developed country	Developed-developed country	Developing -developing country
Dividend withholding tax rate	13.14	12.93	11.38
Interest withholding tax rate	10.86	10.71	10.68
Royalty withholding rate	10.86	10.23	10.85
Fees for technical services	12.14	9.9	11.46

Source: constructed using ICTD data

Tax treaties and minimum tax

Number of treaties with withholding rate less than 9%	Dividend	Interest	Royalty	FTS
Developed-developed	17	42	55	3
Developing-developed	117	240	302	47
Developing-developing	140	113	130	25

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$\neq$ 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

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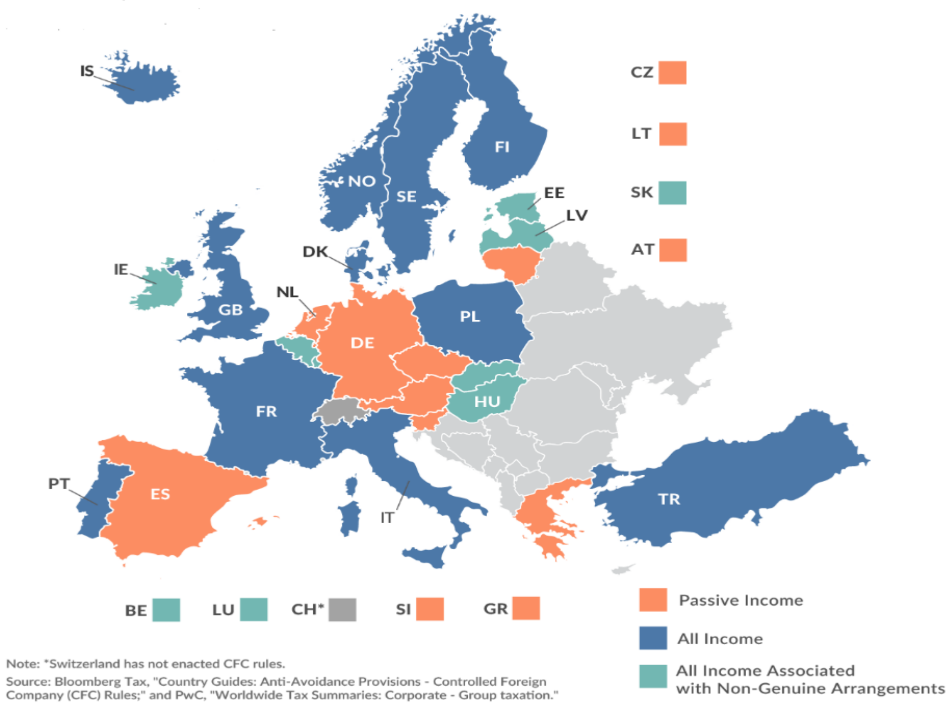

Source: Tax Foundation