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Interaction of tax, trade and investment

1. A paper (*ST/SG/AC.8/2003/L.4*), titled "The interaction of tax, trade and investment," was presented to the group. Another paper (*ST/SG/AC.8/2003/CPR.4)*, titled "Globalization and Tax Competition: Implication for Developing Countries," was also presented. The presenter discussed the central concern of the papers that harmful tax competition among developing countries is a major issue in regard to international tax cooperation. Tax competition and how to address it can be well understood by evaluating the interaction of tax, trade and investment as embodied in the bilateral tax treaty network and the multilateral World Trade Organization (WTO).

2. The goal of free and fair trade cannot be achieved through tariff agreements only because non-tariff policies such as quotas, preferential treatment and subsidies can generate trade-restricting effects. Of special concern are direct and indirect tax structures which can act as implicit production and export subsidies. Likewise, internal taxes should not discriminate between domestically produced and imported goods, especially when they are used in a particular sector, because such use produces a subsidy effect. Finally, taxation of income flows from foreign direct investment in both the source and the resident state can constitute a fiscal barrier to free trade. The resulting double taxation problems are alleviated by bilateral tax treaties. However, tax treaties are designed to maintain an equitable distribution of revenues in the presence of two-way capital flows.

3. A multinational enterprise shifts income to affiliates resident in a tax haven in order to take advantage of lower tax haven rates. Tax havens may be classified as "*production tax havens*," which are countries with a very low tax rate on manufacturing income, and "*traditional tax havens*," which are countries offering a low tax rate on the income of corporations whose legal domicile is in that country, especially financial centres. Bilateral treaties are of limited use because they are primarily between developed countries with similar economic structures. Due to their bilateral nature, treaties cannot deal with the predatory tax protectionism caused by either production or traditional tax havens. What is needed is a multilateral organization to deal with the tax competition problem. The United Nations is the obvious venue for setting up such an organization.

4. In his comments, the discussant remarked that developing countries are fighting for capital against developed countries. Taxation goes to the very roots of a country. This competition is a big dilemma for developing counties because capital is limited and the competition may cause them to offer overly generous tax concessions. Hence, developing countries may be relying on tax holidays which may not be in their best interests. Moreover, enterprises will always pressure developing countries not to remove tax incentive by threatening to move their operations out of the country. Developing countries are sensitive about export subsidies because their industry must be protected. Measures need to be taken regarding double non-taxation as bilateral treaties are not sufficient in this regard. A multinational agency is needed to deal with tax competition.

5. A member from a developing country asserted the need to work on the subject of headquarters tax havens. In this regard, it is useful to look at the EU guidelines on harmful competition. It was also noted that countries are not ready to give up their taxing sovereignty.

Yet, developing countries may be wasting their resources by giving tax concessions. As a practical matter, many countries will not give up tax incentives, whatever the merits of the arguments for doing so.

6. A member from a developing country expressed the view that there is a contradiction between the WTO and tax agreements. In his view, EU feels tax competition may harm it, but that the tax competition it is not a problem for countries outside its region. He also restated the concern of the Group that treaties have failed to avoid double non-taxation.

7. An observer from a developing country maintained that OECD policies are biased in favour of inward investment which in turn is a major obstacle to development by developing countries. If treaties were not biased, they would work much better. He also asked the Group to stay away from “tax haven” jargon because it means different things to different people. Instead the group should state what the problem actually is. Moreover, tax incentives are used extensively by developed countries during their development process; therefore, the possible use of tax incentives should not be dismissed. National capital in developing countries is not enough for economic growth at present so there is economic stagnation. Tax concessions come as a last resort to stimulate investment. Yet, if there are no tax incentives, in practice the investment is not likely to occur. The solution to the problem is harmonization of tax incentives.

8. A member from a developed country questioned what agreements developing countries should enter into. If developing countries do enter into tax conventions, what should their terms be? The member believed it very important for the Group to consider rigorous exchange of information agreements between countries.

9. The Chairperson noted that politicians have the last word on tax policy regarding tax incentives or an increase in taxes. The trend at the international level is a reduction in tax burden. Thus, it is not normal to have high taxes and tax concessions. If negotiating with a strong treaty partner, a country will provide tax concessions. If a country relinquishes source taxation, what does it get in exchange? There is a lack of balance in treaty structures because they are drafted for developed countries. A member from a developed country questioned the above conclusion because the United Nations Model Treaty was developed specifically for use by developing countries. The Chairman responded that the Group is here to build the United Nations Model Convention rather than dismantle it. It is important to promote the flow of capital by eliminating excessive international taxation, but this needs to be done in an equitable way.

10. An observer from a developing country commented that there is a contradiction between higher income taxes and exemptions for foreign investments. It leads to tax fraud and problems in collecting taxes. Use of a value added tax is better since it does not discriminate. The Chairman responded that regressive indirect taxes are obsolete. The value added tax is being offered by the IMF; however, poor people cannot support the burden of such taxes.

11. Some observers noted that the language used to describe tax regimes that provide various tax benefits should be chosen to avoid needless offence. They suggested that the use of neutral rather than pejorative language would facility debate and enhance the prospects for agreements on substance.

12. It appeared to be the consensus of the Group that developing countries need to design tax incentives for investment which are not harmful. In this regard, the OECD has produced some good work. The international community is not ready for a multinational agreement on tax competition. It is a sovereign decision for each country to make regarding the use of tax incentives. However, the Group noted the ongoing OECD study on how to design tax incentives. Further, the Secretary of the Group noted that on 5 August 2003 the Secretary General provided that the Group should be strengthened by converting it into an intergovernmental fiscal committee.

Financial Taxation and Equity Market Development

13. Two papers were presented dealing with analysis of the effects of tax structure on economic factors, such as economic growth, and equity markets. One of the papers *(ST/SG/AC.8/2003/L.5)* is titled "Financial taxation and equity market development." The other paper (*ST/SG/AC.8/2003/CRP.5*) is titled "Economic Equity Market, and Trade Implications of and Interactions with Taxation in a Multinational Setting."

14. As the papers were addressing similar topics, they were converged into a single presentation, with attribution, where appropriate. The papers focused on three areas of discussion: the relationship between tax structure and: (1) economic growth and investment flows, (2) capital investment flows and the capital transfer decision model, and (3) equity markets.

15. The presenter addressed each of the three areas and provided the results of research that was appropriate to each area. The results were presented as showing that in all three areas, there was evidence of a linkage between changes in tax structure and, specifically, economic movement in the country of tax change as well as in other countries in the sample, flows of Foreign Direct Investment occurred between high tax and low tax countries, as well as between countries using the exemption method to tax foreign income and those using the foreign tax credit method, and both the demand and supply factors affecting equity market development.

16. In general terms, the results were expressed as interesting and, in some cases, of significant magnitude, but the presenter cautioned the use of such results on two levels. First, inferences can be drawn, but the user must recognize that the research is limited in scope in that there are numerous non-tax factors that affect economic growth and market development that are not specified in the model. Second, without an in-depth review of the research design it is not clear whether biases have been introduced, for example, by including only short-term effects or by failing to distinguish between harmful, beneficial, or neutral tax concessions.

17. However, it was pointed out that even with those caveats, there was value in the use of economic analysis in the discussions held by the Group of Experts, but, it was further stated, that such value can only be assured if such research is done rigorously, correctly, and caution is taken to focus the effort on point.

18. The discussant presented his observations on the experience of the Mexico equity market. He emphasized the role of the non-tax factors in this type of analysis by his reference to the Mexico experience of equity market development through a series of economic and political

crises. Where, for example, he recounted how during the rise in the price of oil in the 1980's, Mexico offered better interest rates to attract investment. However when the price of oil fell so did the fortunes of the country. As a consequence the government had to nationalize the banks. The crises led to less participation in the equity markets. The government chose to issue high yield debt. These steps were taken in an effort to enhance flexibility and development of the markets, but did not involve the financial center in the process, with unfavourable results.

19. In another example, during the period of 1990-1992 there was a rise in share values. That was presented as one effect of the NAFTA and Free Trade Agreements, this was another example presented by the discussant, of the importance of non-tax factors in the assessment of the development. In summary, it was offered by the discussant that tax is not the only factor affecting the market or market development. Other factors include the search by investors for security and stability, and the fact, as in the case of financial derivatives, the fiscal framework is behind the equity market. Following the Discussants remarks, many members, observers and others made a number of important remarks and observations.

20. A reoccurring observation was that capital markets need: "*confidence*", "*transparency*", "good infrastructure", "*a ready work force*", "*a stable government*", and "*political stability*". In addition many remarked that tax incentives play a role.

21. Because the world is not homogeneous, several members as well as the Presenter recognized that not all capital markets are alike, nor do they react in the same way. Indeed one member observed that, in his own country, policy makers were so concerned with the consequence of creating a tax on capital that for some time they avoided doing so. When they finally imposed a capital gains tax, they found that the equity markets had little or no reaction.

22. Yet another member recounted the experience of India, which effectively imposed a tax on capital gains by limiting the ability of investors to engage in treaty shopping. The result was a decline in share values. It was suggested that this experience was an example of behavior based on taxation.

23. A lengthy portion of the open floor discussion concerned the imposition or non-imposition of taxes on capital gains of non-residents. For example the UN Model Tax Treaty and the OECD Model Tax Convention provide for no tax on capital gains of non-residents, while taxing dividend income of these persons. It was suggested by one observer that the non-taxation of capital gains in the source country probably results in double non-taxation in many cases.

24. An observer recounted her country's experience with equity markets and taxation of capital. She told of how her country during the 90's experienced a large inflow of capital. To avoid a "real shock," the country imposed a tax when capital entered the country; i.e. the tax is paid "up front". While not currently imposing the tax, the stated country has reserved the right to at any time re-impose it. The member then remarked that in her opinion the UN and OECD position on taxation of capital gains and dividends were inconsistent. In support, one participant noted that dividends can sometimes be converted into capital gains quite easily and that some restrictions on very rapid capital flows seems justified, given the economic waste resulting from the economic shocks of the late 1990s. An observer noted that conversion of dividends into capital gains is less of a problem for portfolio investment.

25. Other members suggested that, based on her experience, tax policy should not be introduced in times of fiscal crises. Indeed the Presenter agreed and suggested that this was precisely one of the observation made in the paper.

26. As an example of the differences in capital markets, another member compared the equity markets of the US and UK to the markets of developing countries and transitional economy countries. He pointed out that the US equity market is shrinking and the UK market has only has modest growth. His point was that neither would be a good example to test the effect of taxation on equity markets. His point was that an analyst must know the relevant market.

27. Another observer from a developing market noted that his country has recently opened a stock exchange and has provided generous tax incentives to stimulate it. Currently, it has about 20 companies on its stock exchange, and its index was about 100. He suggested that perhaps his country was a good place to study the effects of taxation on capital markets.

28. In response, the Chair said that if this country converted to a market economy, it very well might experience substantial growth, which would have nothing to do with taxation. He suggested that if a country tries to provide benefits and incentives to attract capital, in the long run, it may do damage to the economy. The Chair noted that some countries impose taxes on capital gain and dividends and their economies still work.

29. The Presenter observed that in reality one could not equate the taxation of capital gains with that of dividends. He noted that the tax on capital gain to a large part is a “secondary” tax; that is, it is imposed after the security has been created by its initial public offering (IPO). The tax on dividends, however, is a direct tax on corporate income being distributed to a shareholder. If the corporation does not make a dividend, the wealth remains in the corporation. Hence this distinction may be a valid basis to treat the two differently. It was noted, nevertheless, that the distinction has validity only if dividends cannot be converted into capital gains, as occurs in many countries.

30. Although everyone expects taxes to effect equity markets, this observation alone is not helpful, because other factors play a role. In twenty years of research of market behaviour, some analysts have confused the issue. Consequently, the results of their research may not be reliable.

31. The Discussant noted that not all equity markets are the same. Mature markets cannot be compared to immature markets. Taxation may not be as important in one market as it would be in another.

32. The Secretary referred to the Report of the Secretary-General on the Implementation of and follow up to commitments and agreements made at the International Conference on Financing for Development (A/58/216), and particularly para 167, where he referred to the need of the Ad Hoc Group of Experts on International Cooperation in Tax Matters to be converted into an intergovernmental body.

33. The Secretary also referred to the impact of tax incentive laws on tax competition and suggested that in as much as taxation may be an important element in the investment decision, tax policies might also be used as an instrument to enhance both foreign direct investment (FDI) and portfolio investment.

34. Tax authorities who are concerned that tax incentives are being directed at the foreign government rather than to the investor may review with tax authorities of the other Contracting State whether a tax sparing credit could be applied. However, he pointed out that to achieve the objective of attracting FDI and portfolio investment, there was a need for implementing far reaching reforms to create the enabling environment for private sector development and investment. This enabling environment could be provided with the support and assistance of the United Nations under the above mentioned suggested framework.
