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Tax Competition and Investment

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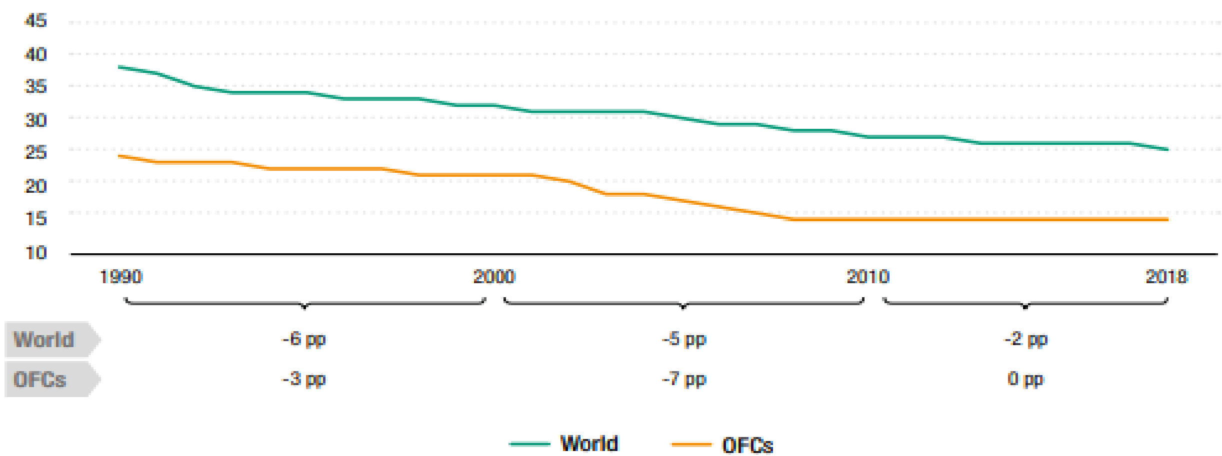
What is tax competition?

- Tax Competition is the process by which countries, states or even local administrations use tax cuts, tax breaks, tax loopholes or tax subsidies to attract investment, hot money and even wealthy individuals
- Tax competition exists when taxpayers have the ability to reduce their fiscal burdens by moving themselves, their businesses, and/or their money from high-tax jurisdictions to low-tax jurisdictions

Statutory tax rate – world view

- Over the two decades, global STRs declined markedly but gradually, from almost 40 per cent in 1990 to just over 25 per cent in 2010 - A key factor, for reduction in STR was competition between countries to attract and retain FDI
- Post 2010, while STR stabilized, fiscal incentives through OFCs increased

Figure III.1. **Average statutory corporate income tax rates, 1990–2018**
(Per cent)



Source: UNCTAD; Tax Foundation.
Notes: Top statutory corporate income tax rates, simple averages across countries. OFCs = offshore financial centres. World does not include OFCs. The list of OFCs follows that of Tørsløv et al. (2021). Only countries for which statutory tax rates are available for all years between 1990 and 2018 are included.

What's happening in India?

- CTR reduced from 30% to 25% to 22% (in certain cases)
- Incentives introduced for manufacturing companies with CTR of 15%
- Sunset clause included in most tax holiday

Pillar Two

Pillar Two - objective

Aims to reduce profit shifting by MNEs, improve the fairness of tax systems and increase revenue collection

- It also aims to reduce damaging tax competition between countries and to set a limit to the race to the bottom in CIT rates caused by countries competing to attract foreign direct investment (FDI

As Pillar Two introduces a global minimum tax, which could affect the locational choices of investors, Pillar II could have far-reaching consequences for FDI recipient countries and especially for those that compete to attract inward FDI through fiscal measure

Economic Impact Assessment

Pillar Two - objective

The EIA further argues that the decline in investment following BEPS resulting from higher tax rates is likely to be offset by the positive effect from other less quantifiable but significant channels, such as increased tax certainty. It identifies six policy areas in which the response of individual governments to the changes in the international tax system could have important effects on investment: (i) greater fiscal space, (ii) lower compliance costs for firms given uniform rules, (iii) a reduction in tax competition, (iv) greater use of non-tax incentives by countries and policies encouraging innovation, (v) more efficient use of tax incentives and better allocation of capital, and (vi) more beneficial competition between firms, including a level playing field among MNEs and non-MNEs

Tax-investment spillover channels

a. Location of investment	• Tax affects investor choices between different locations. If investments are equally profitable in different locations, investors will choose the location where taxes are lowest. • Even if the profitability of investments differs between locations, investors may still locate in the lower-profitability location if the tax rate differential is sufficiently high. This is the distortionary effect of tax on investment allocation. • A key concept in assessing the location effect of tax is the average effective tax rate (AETR), which is used in cross-country comparisons of the tax cost of investments, and hence a key factor in the analysis of the impact of Pillar II.
b. Scale of investment	• Taxing the income (return) on an investment affects how much an investor will commit. That is because tax will increase the amount of profit that the investment needs to generate in order to provide the minimum after-tax return that the investor requires. • An important concept in assessing the impact of tax on investment scale is the marginal effective tax rate (METR), which represents the amount by which, because of taxation, the pre-tax return on a project exceeds the investor's required after-tax return. • It is possible to devise tax rules to minimize the METR (and hence the size-impact of tax on investment decisions), while still raising revenues.
c. Profit shifting	• If profits generated by an investment in one location are declared for tax purposes in another (lower tax) location, the average tax rate for those profits becomes a weighted average of those in the countries involved; the overall AETR will thus be lower than the AETR in the country where the investment is located. • Because the possibility to shift profits generated by an additional investment to a lower-tax country reduces the tax payable on the additional earnings, it also reduces the METR, potentially increasing the scale of investment. • Profit shifting thus affects both the scale and location of investment. The goal for BEPS is therefore to tackle profit shifting while minimizing the potential negative effects on investment.
d. Tax competition	• A key objective of the global minimum tax is to set a limit on the downward tax competition between countries for the attraction of real investment and tax base. • Tax competition can take many forms. It is not only about the generally applicable tax regime, but also occurs through tax incentives such as reduced rates, allowances for investment or R&D spending, or special economic zones. Incentives have proliferated over the last few decades. • Because preferential tax schemes in one country can harm others, there is a strong rationale for collective action to limit tax competition.

Source: UNCTAD.

Tax-investment spillover channels – Impact of Pillar II

Spillover channel	Possible Impact
Investment location	For any given level of investment, adoption of Pillar II may thus lead to reallocation of the investment towards higher-tax countries not directly constrained by the minimum
Scale of investment	Countries which will be unaffected by P2, considering that opportunity of profit shifting may reduce, the marginal tax for additional investment may increase Countries affected by PE, marginal tax for additional investment may increase
Profit shifting	Pillar II is likely to mute profit shifting but not eliminate it
Tax competition	Setting of a floor on effective tax rates on excess profits inherently limits the downward potential for international tax competition

Thank you!