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Developing Fair Tax Competition in the Latin American Region

A Proposal by the Mexican Minister of Finance,

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Introduction

The recent economic evolution of Latin America has been favorable. Since 2003, the region has experienced high levels of growth, whilst poverty and unemployment have fallen. FDI is flowing into the region – in some cases as Brazil's at record levels –, while at the same time a growing number of "local" multinationals are beginning to operate on a global basis, a sign that the region is successfully integrating into the global economy. Sustainable growth will, however, require that countries in the region continue tackling social problems, especially that of high levels of poverty and inequality.

In the fiscal area there remain major challenges. How do we ensure that a better fiscal performance becomes a driving force for democratic legitimacy and governance and provides financing for the regions' social and physical infrastructure needs? How can tax and benefit systems help reduce inequalities in the distribution of income and wealth without generating large distorsions for economic activity? Can tax systems become more business friendly but at the same time achieve better compliance and a broadening of the tax base? More generally, can Latin American countries achieve a more balanced tax structure?

It is in this context that this paper examines the role of tax competition in the region. As in other regions of the world, tax systems in Latin America have to operate in a more competitive environment. An important issues is that as firms and high wealth individuals have become more geographically mobile, governments are increasingly tempted to use tax incentives to attract investment and service activities. At the same time, there is intense competition from certain countries within the region for the legal location of the tax base – even if economic activity is carried out somewhere else –, with countries competing for financial activities and deposits by creating an environment which is characterized by a lack of transparency, a lack of cooperation to counter international tax abuse and weakly regulated financial sectors.

This paper looks at five related issues:

1. What is the Influence of Taxes on Location Decisions?
2. How to Design Tax Policy for Foreign Direct Investment?
3. How to Address Mobile Tax Bases?
4. What Lessons can be learned on the Use of Tax Incentives?
5. How to deal with Competition from Tax Havens in the Latin American Region?

We see this paper as the start of a dialogue between finance ministers and Mexico would be pleased to support an ongoing dialogue In our view uncoordinted action imposes costs on all countries in the region.

1. What is the Influence of Taxes on Location Decisions?

The short answer is: tax is increasingly important. The removal of non-tax barriers to cross-border activities, new communication technologies, the shift from a "bricks and mortar" to a "service" economy, the development of regional economic blocks have all made capital (including intangible capital), skilled professionals and even consumption increasingly geographically mobile and increasingly sensitive to tax differentials.

It is important to emphasize, however, that few of these decisions are driven just by tax considerations. If tax were the only determinant of these location decisions, we would see a massive outflow of activities from high tax to low tax countries, which clearly has not been the case.

Companies look at long-term profitability in making decisions as to where to locate. In turn, this depends on access to markets, availability of qualified labour, institutions such as the degree of protection of property rights and the quality of contract enforcement, political stability and unit production costs. Tax is one of these costs and businesses will, other things being equal, prefer a low tax to a high tax jurisdiction. But other things are not equal. A relatively high tax country which uses its revenues to provide a first class infrastructure, a well-educated and flexible labour force, and an efficient judicial system will be more attractive than a low tax country which has none of these productivity enhancing features.

Within integrated economic areas where institutions converge it can be expected – and this is confirmed by recent economic studies for the European Union – that tax is set to become a more important factor determining where companies and individuals locate their activities. And, of course, tax will remain one of the major factors that determine how a company structures and finances its investments.

Most of the debate on tax competition focuses on the corporate income tax, particularly the headline rate of tax. In the region the dominant trend has been to reduce corporate tax rates which in many cases has lead to falling revenues. This is understandable since this has an immediate impact on after-tax profits. Corporations will also look at how headline rates of corporate tax translate into effective tax rates, after account is taken of the impact of tax reliefs and tax minimization strategies. But other taxes may be equally important in influencing location decisions:

- Non-profit related business taxes which firms pay even when they do not make a profit.
- Social security contributions, which impact the cost of hiring labour.
- VAT can also be a competitive factor which may be used to influence the location of e-commerce activities.

Corporations will take all of these tax factors into account. Yet there is no ambiguous index – a sort of total tax contribution for business index – which can measure the overall attractiveness of a country's tax system (the World Bank "Doing Business" series has attempted constructing a series of indicators, but these are very crude and have recently been criticized by CIAT amongst others). Table 1 provides some comparison of the tax systems in selected Latin American countries, the G7 and China, India and Russia.

Table 1

How do Latin America's tax systems compare with other economies?

	TAX / GDP	% OF TOTAL TAX REVENUES				Top Statutory Personal Income Tax Rate	Top Corporate Income Tax Rate	Tax Wedge	Top Rate on Dividends	Standard VAT Rate
		Personal Income Tax	Corporate Tax	Social Security Contrib.	Consumption Taxes					
	2005	*2005*	*2005*	*2005*	*2005*	*2006*	*2007*	*2007*	*2007*	*2007*
Canada	33.4	35.6	10.5	14.8	25.4	46.4	36.1	31.3	51.8	6.0
France	44.1	17.3	6.2	37.0	25.3	55.9	34.4	49.2	55.9	19.6
Germany	34.8	23.3	4.9	39.9	29.0	45.4	38.9	52.2	53.4	19.0
Italy	41.0	25.5	6.8	30.8	26.4	44.1	33.0	45.9	45.0	20.0
Japan	27.4	18.3	15.5	36.8	19.4	50.0	39.5	29.3	45.6	5.0
Mexico	19.9	24.1		15.7	56.7	29.0	28.0	15.3	28.0	15.0
Spain	35.8	18.0	10.8	33.7	28.0	45.0	32.5	38.9	44.7	16.0
Turkey	32.3	14.7	7.1	22.4	49.3	35.6	20.0	42.7	34.0	18.0
United Kingdom	36.5	29.2	9.3	18.8	30.3	40.0	30.0	34.1	47.5	17.5
United States	27.3	35.1	11.4	24.7	17.4	41.4	39.3	30.0	48.7	-
OECD average	36.2	24.6	10.3	25.6	31.9	43.0	27.6	37.7	42.9	17.7
EU15 average	39.7	24.8	8.6	28.4	30.3	47.6	28.4	42.5	45.5	20.0
Argentina	26.8	5.7	13.7	12.2	54.3	35.0	35.0	--	35.0	21.0
Brazil	33.1	6.5	10.2	23.7	46.3	27.5	34.0	--	27.5	17.0
Chile	19.6	5.4	13.7	7.2	58.1	40.0	17.0	--	--	19.0
Guatemala	13.4	2.3	19.5	14.9	61.0	31.0	31.0	--	31.0	12.0
Peru	15.4	7.6	15.1	9.9	55.0	30.0	30.0	--	--	17.0
	2004 data for the rest of NON-OECD countries					**2006 data**	**2007 data**		**2006 data**	**2007 data**
China	16.1	7.3	14.9	--	76.6	45.0	33.0	--	46.4	17.0
India	15.8	15.4	26.5	--	57.8	30.0	42.2	--	43.6	12.5
Russia	36.9	8.9	16.8	14.9	33.3	13.0	24.0	--	--	18.0

Source: OECD, 2008

But it is not just the tax variables set out in that table that count: it is also the way in which the system is administered. In today's rapidly changing environment, corporations increasingly expect tax administrations to provide predictability, certainty, consistency and to engage the business sector in the formulation of new rules.

2. <u>How to Design Tax Policy for Foreign Direct Investment?</u>

A central challenge for policy makers to encourage investment is a careful weighing of advantages and disadvantages of alternative tax policy choices and design options in pursuing the twin goals of offering investors an attractive host country tax system, while at the same time raising revenues from corporate income tax and other taxes on business, to support infrastructure development, education and other public programs central to creating attractive host country conditions. The following paragraphs sketch out a number of key considerations guiding policy choices including an assessment of tax and non-tax determinants of investment, the ability to tax location-specific profits, the increasing difficulty in taxing profits of highly geographically mobile activities, considerations in the use of targeted tax incentives including the need for fiscal transparency, and the role of tax expenditure reporting.

A first observation is that tax is typically not a key driver of capital-intensive investment decisions. Important to investors are questions over costs and non-diversifiable risks associated with securing access to capital and profits, managing macroeconomic conditions, complying with laws and administrative practices, including contending with corruption. Also of course central are market considerations that determine the level of expected profits when operating from a given location, including the size of domestic markets and accessibility of other markets including those in neighbouring countries. These considerations turn investor focus to the state of the host country's infra-structure, covering transportation services, telecommunications, and other business services; labour force skills availability and employee benefits provided by the state; energy sources and raw materials availability in the host country.

In setting the tax burden on investors – imposed by corporate income tax, withholding taxes, property taxes, social security contributions, and other taxes[1] – policy makers assess investment opportunities in their host country taking into account 'framework conditions' (i.e. political, monetary, fiscal stability; legal protection; public governance), as well as 'market characteristics' (i.e. market size, availability/cost of labour, energy, state of infrastructure), and the prevalence of location-specific profits. As elaborated below, certain business activities require location in a host country, while others do not. The distinction is important when addressing the level of taxation that investors will bear. At the same time, policy makers are encouraged to respond not only to mobile business activities, but also mobile tax bases where the location of underlying economic activity can become disentangled from the location where the tax is paid.

For certain investments, profit may vary significantly across alternative locations, and in certain cases may be location-specific – that is, may require investment in a specific host country location.[2] Examples include not only resource extraction, but a range of service

1 Foreign investors may be subject to non-resident withholding tax on dividends, interest, rents and royalties (possibly reduced by tax treaty). Compulsory social security contributions may be viewed negatively by investors, in particular where significant and unrequited. In some countries, a key tax burden on investors is unrecoverable VAT.

2 With location-specific profit, costs in accessing required business inputs (e.g. labour, raw materials, energy) and/or costs in delivering products to market are significantly higher (not profitable) from other locations. In the case of

activities that require a physical location in the host country. In such cases, tax comparisons across competing locations (states/countries) may be largely irrelevant to an investment decision, and the tax burden on location-specific profit may be increased to the point where economic profit is limited to a normal level without discouraging investment. Thus, where a host country offers an abundant set of location-specific profits, policy makers may understandably resist pressures to adjust to a relatively low tax burden, to avoid revenue losses and windfall gains to investors and/or foreign treasuries. Reducing the effective host country tax rate to levels observed in certain competing countries, while possibly attracting geographically mobile capital, would give up tax revenues on business activities less sensitive to the setting of the host country tax rate.

This contrast to investments where costs in accessing business inputs and delivering products to market are roughly the same across a large number of geographically disperse candidate host countries, implying that profit is not location-specific. Examples include the manufacturing of pharmaceuticals and computer chips, where production and delivery costs may be similar across many alternative host countries. A variety of back office services may also be readily out-sourced to low-cost locations. Other examples include investment in intra-group financial services and certain head-office functions. In such cases, host countries may be unable to impose a relatively high host country tax burden on profits from these activities where competing jurisdictions offer a no/low tax environment.

In between these extremes are investments where profit is location-dependent, but not specific to one country (e.g. required rates of return may be realized in a number of neighbouring locations), and trade costs are important. A location offering relatively attractive host country advantages in terms of relatively low input costs, or delivery costs, or taxes on profit, could be expected to be more successful in attracting FDI.[3] Relatively low input costs could be in relation to a large pool of suitably skilled labour. Relatively low

privatizations, profits are generally time as well as location-specific. Examples of activities generating location-specific profit include the extraction of natural resources, the provision of restaurant, hotel, legal, medical, repair, and other services. In such cases, if the anticipated risk-adjusted return on capital meets or surpasses a required 'hurdle' rate of return, investment can be expected.

3 The relative attractiveness of a given host country as a location for investment depends on the host country framework conditions and market characteristics, which in turn depend on past and current levels of public expenditures on programs in areas of critical importance to investors (e.g. education, infra-structure development). This link establishes the importance of collecting tax where possible on economic rents in order to finance public expenditures that eventually strengthen host country fundamentals, and attract FDI.

delivery costs could be realized with a large domestic market, and/or well-developed road, airport or seaport system, giving relatively low cost reach to neighbouring countries with large markets. Where relative advantages are significant, they could give rise to location-dependent profits that could be taxed without discouraging investment.

3. How to Address Mobile Tax Bases?

Two types of mobile tax bases can be distinguished. First are the profits of geographically-mobile business activities (e.g. pharmaceuticals, computer chips, R&D, financial services). As noted above, the location of such activities tends to be highly sensitive to tax rate differentials. Given this, countries may be tempted to target special tax incentives at such activities, in order to retain and attract them, while avoiding the revenue loss of a broad-based corporate tax reduction. The use of tax incentives or special tax regimes may be considered fair or unfair, depending on targeting features and other features including the degree of transparency (see Boxes I and II). Where mobile activities are separated from core activities of a resident parent company, and located in a tax haven – either because tax incentives are not offered, or lower effective tax rates (including no taxation) apply elsewhere – countries may respond by taxing the foreign profits from the activities on an accrual basis under so-called controlled foreign company rules. Other anti-abuse measures may also be considered.

A second type of mobile tax base is profit that is artificially shifted from a location where the profit is generated, to a low or no-tax jurisdiction, to avoid tax. This type involves pure 'paper' profit shifting without any shifting of underlying economic activity. For example, an investment may be located in a high-tax country for non-tax reasons, while the profit from the investment is shifted to an affiliated company in a tax haven, through choice of financial structure, method of earnings repatriation, and use of non-arm's length prices on inter-affiliate transactions. Such tax base erosion, generally regarded as unfair, may be limited through the adoption by host countries of a number of base protection measures. Such measures include thin capitalization rules that limit the amount of debt, relative to equity or assets, that an inbound investor uses to capitalize a resident firm in a given host country. Mexico has adopted a different approach with its IETU tax. This limits the amount of profit that may be shifted out as deductible interest to a related company. Transfer pricing rules also guard against artificially base erosion by aiming to ensure that (deductible) prices charged to resident firms by foreign affiliates do not exceed prices that would be used on an arm's length transaction. Similarly, when selling goods or services to a foreign affiliate, the price obtained should reflect market value.

4. What Lessons can be learned on the Use of Tax Incentives?

Policy makers may be interested in targeting tax relief to certain business activities, to small firms, or to economically depressed regions of their country. While 'market failure' arguments may be used to justify targeted incentives, often a main reason for their use is to avoid revenue losses that broad-based tax relief would provide. Tax relief may also be targeted to business activities seen as more sensitive to taxation, with some examples noted above.

From an efficiency perspective, policy makers increasingly recognize tax holidays, providing an exemption from profit tax, and possibly other taxes, typically targeted at 'new' companies, as problematic. Existing capital may be artificially characterized as new (through so-called 'round-tripping'), while at the same time techniques may be applied by investors to artificially shift non-targeted profits into the scope of the tax holiday regime, implying unintended revenue leakage. Rather than profit-based incentives, many policy makers point to the advantages of expenditure-based incentives, including accelerated or enhanced depreciation allowances, and investment tax credits. These incentives increase after-tax profits available for investment, while at the same time provide tax relief conditional on investment expenditure. While inevitably providing investors some degree of 'windfall gain', subsidizing investment that would have occurred in any event, this category of incentive generally offers less scope for excessive revenue loss.

Whether profit-based or expenditure-based, host country tax incentives may be viewed by other countries as legitimate, or harmful, depending on the degree of transparency with which they are provided. Transparency is encouraged at the economy-wide level with the publication of tax expenditure reports, indicating aggregate tax revenues foregone each year by tax incentives as well as other departures from a benchmark tax regime. Such accounts are required for proper budget management and control of direct and tax expenditures.

Box I

Distinguishing between Fair and Unfair Tax Competition: The OECD Approach

The first practical proposal to address the issue of tax competition on a widespread basis was the 1998 OECD report "Harmful Tax Competition: An Emerging Global Issue" (the report).

What is harmful? The OECD report identifies two main concerns; Tax havens and harmful preferential tax regimes regimes. As regards tax havens the report noted that:

> *" Tax havens serve three main purposes: they provide a location for holding passive investments ('money boxes'); they provide a location where 'paper' profits can be booked; and they enable the affairs of taxpayers, particularly their bank accounts, to be effectively shielded from scrutiny by tax authorities of other countries."*

The report's concern in relation to harmful preferential tax regimes had to do with regimes intended to attract geographically mobile activities, such as financial and other service activities. It noted that:

> *" These regimes generally provide a favourable location for holding passive investments or for booking paper profits. In many cases, the regime may have been designed specifically to act as a conduit for routing capital flows across borders. ... Such tax regimes can be particularly successful if targeted to attract income from base company activities and from passive investment."*

The report lists four criteria to identify harmful preferential tax regimes and similar criteria to identify tax havens. Briefly these are:

- low or no tax on the income in question;
- lack of effective exchange of information;
- lack of transparency; and
- "ring-fencing" in the case of preferential regimes; or no need for substantial local activities in the case of tax havens;

Two points deserve attention. First while "low or no tax on the income in question" is a necessary identifying factor, for a tax haven or harmful preferential regime it is not of itself sufficient to result in harm; at least one of the other factors must also be present. Thus the report does not object to differences in tax rates.

Second the report does not object to preferential regimes as such, i.e. regimes designed to encourage an activity in a particular sector of an economy even if the preference involves geographically mobile activities. Concern arises where such regimes are ring-fenced or where they lack transparency or the country hosting the regime does not engage in effective exchange of information. A preferential regime is considered to be ring-fenced where it excludes resident taxpayers from the benefits of the regime or where the enterprise qualifying for the regime does not have access to the domestic market.

In June 2000 the OECD tentatively identified 47 "potentially harmful" preferential tax regimes found in OECD member states and compiled a list of tax havens. Its goal was the voluntary elimination of harmful preferential tax regimes by OECD members and the cooperation of tax havens in eliminating harmful practices. A follow up report in 2006 showed that the goal of eliminating harmful preferential regimes in OECD member countries was achieved. The work on encouraging tax havens to eliminate harmful practices continues.

Box II

Distinguishing between Fair and Unfair Tax Competition: the European Union Approach

In addition to the OECD project there is a regional project in the European Union to address the issue of tax competition in the European Union. This initiative started when the EU council agreed a package of measures in 1997 to tackle harmful tax competition among other things. The package included a code of conduct on business taxation. The code identifies potentially harmful regimes in the field of business taxation. It covers business tax measures that affect, or may affect, in a significant way, the location of business activity in the Community. The criteria for identifying potentially harmful measures under the code include:

- An effective level of taxation which is significantly lower than the general level of taxation in the country concerned;
- Tax benefits reserved for non-residents;
- Tax incentives for activities which are isolated from the domestic economy and therefore have no impact on the national tax base;
- Granting of tax advantages even in the absence of any real economic activity;
- The basis of profit determination for companies in a multinational group departs from internationally accepted rules, in particular those approved by the OECD;
- Lack of transparency.

The Code is not a legally binding instrument but it had political force. By adopting the Code, the EU Member States undertook to:

- Roll back existing tax measures that constitute harmful tax competition, and
- Refrain from introducing any such measures in the future ("standstill").

Again, this approach has been very successful with almost all of the 100 plus regimes identified as potentially harmful being dealt with.

5. How to deal with competition from Tax Havens in the Latin American Region

The increasing freedom of capital movement across borders both for firms from industrialised countries investing in Latin American countries and for individual owners of financial assets in Latin American countries poses two serious problems for Latin American tax authorities. The first problem is how to tax intra-group transactions and thus overcome the problem of international transfer pricing and the second how to tax the income from assets held overseas by their own residents. These problems are magnified where tax havens are used in financing or transfer pricing strategies so that profits are reported in the tax haven or where practices such as bank secrecy are used by tax havens to encourage residents of Latin American countries to evade taxes on their income and assets. While it is difficult if not impossible to quantify the problem with any exactitude the amounts involved are very significant (it is estimated that between $5-7 trillion is held offshore). If only a small percentage of these assets (and the income they generate) are unreported to tax authorities in the taxpayer's home jurisdiction, the off-shore non-compliance would still amount to many billions of dollars of tax revenue lost.

Secrecy and lack of transparency and exchange of information are key to the success of tax haven operations. Following sustained pressure from the FATF, IMF. OECD and other international organizations many tax havens have made improvements in transparency. For example, ownership information is now more widely available thanks in large part to the efforts of FATF and other organisations working to counter corruption, money-laundering and terrorist financing. What countries need now is effective exchange of information agreements with tax havens.

Such agreements are important in reducing the possibility that taxpayers resident in Latin American countries can evade tax by using tax havens. Similarly, to combat the use of tax havens to avoid corporate taxes countries need to rely on CFC or other anti-abuse legislation. But they are unlikely to be able to enforce such legislation without information on tax haven corporations owned by their residents. Further, unless countries can gain access to information on transactions with tax-haven affiliates of their corporations they are unlikely to be able to determine whether transfer prices used to value such transactions are being reported consistently.

OECD countries have had some success in getting tax information exchange agreements (TIEAs) with tax havens (the USA currently has about 20 such agreements). There have been no such agreements between Latin American countries and tax havens. Ultimately, a tax haven will calculate whether or not it is of economic interest to adopt the global standards of transparency and exchange of information. This will depend on the costs imposed for not doing so, and on the potential benefit available in the event that the jurisdiction does sign a TIEA. This has led to a shift in approach by many countries, which are now tailoring international aspects of their tax law to the existence of a tax information exchange mechanisms with a foreign jurisdiction. For example, Spain imposes more onerous requirements on transactions involving entities in certain “blacklisted” jurisdictions, but removes a jurisdiction from the blacklist if it has a tax information exchange agreement (or full tax treaty) in force with Spain. A number of Latin American countries have adopted similar approaches but there may be greater scope for multilateral action by Latin American countries to combat tax haven abuse.

Exchange of information and anti-avoidance rules are not sufficient to deal with tax havens on their own. Making them work requires an effective tax administration and a coordinated approach to tax compliance designed to prevent offshore tax evasion and fraud. Recently there have been a number of very successful initiatives undertaken in countries such as Argentina, Australia, Ireland and the US which point to a new type of approach in addressing offshore compliance. In Ireland almost 900 million euros have been collected in recent years related to tax evasion through offshore bank accounts by targeting information held by domestic banks and financial institutions. Countries that are trying to improve their capabilities to address tax evasion through tax havens can look to some of these initiatives for ideas on how to address offshore tax evasion.

Box III

Possible Coordinated Approach by Latin American Countries to Tax Incentives

Phase I*: Definitions*

Latin American Countries could:

- Agree on how to define "Tax Incentives" and under what conditions an incentive is appropriate.
- What would constitute "Harmful tax competition" in the regional context and what kinds of competition could be beneficial?

Phase II: Creation of a Database

Latin American countries could build up a tax database. This will involve:

- Providing information on existing tax incentives.
- Providing information on the cost of such incentives and any estimates of their impact in generating new investment.
- Developing an analytical framework for evaluating tax incentives. This will involve analysing:
  - The effectiveness of incentives in achieving their stated policy goals.
  - The revenue cost developing a standard tax expenditure reporting framework.

Phase III: Develop a set of Guidelines for Coordinating Tax Incentives in the Region

This phase could involve the following:

- Agreement on an evaluation framework and timetable for publication of standards and / or criteria for introducing new tax incentives / removing harmful tax practices.
- Agreement on implementation process.
- Initial consideration of enforcement strategies.

Box IV

A Latin American Action Plan on Tax Havens

Stage 1: Latin American Finance Ministers publically endorse the OECD's principles of transparency and effective exchange of information. (These are broadly consistent with the Exchange standards developed by CIAT)

Stage 2: Specific legal instruments are developed to facilitate the Exchange of Information between tax authorities in the region:

- Bilateral Tax Information Exchange Agreements.
- Bilateral Tax Treaties with full Exchange of Information provisions.
- Multilateral Administrative Assistance Convention.

Stage 3: Annual review of the progress made in implementing the international standards.

Stage 4: Develop an inventory of anti-abuse measures that countries can take to protect their revenue base.