Corporate Tax Competition and Coordination

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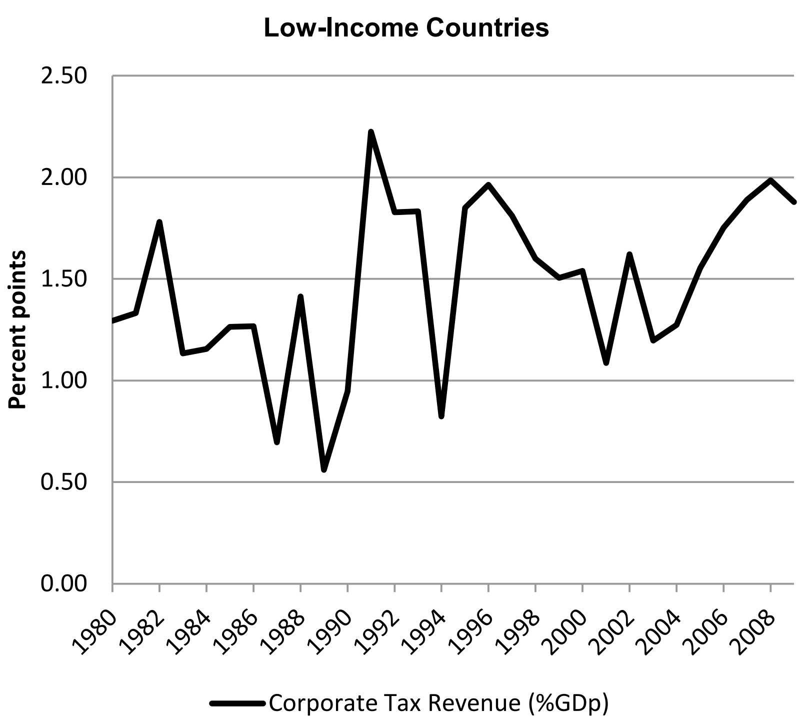
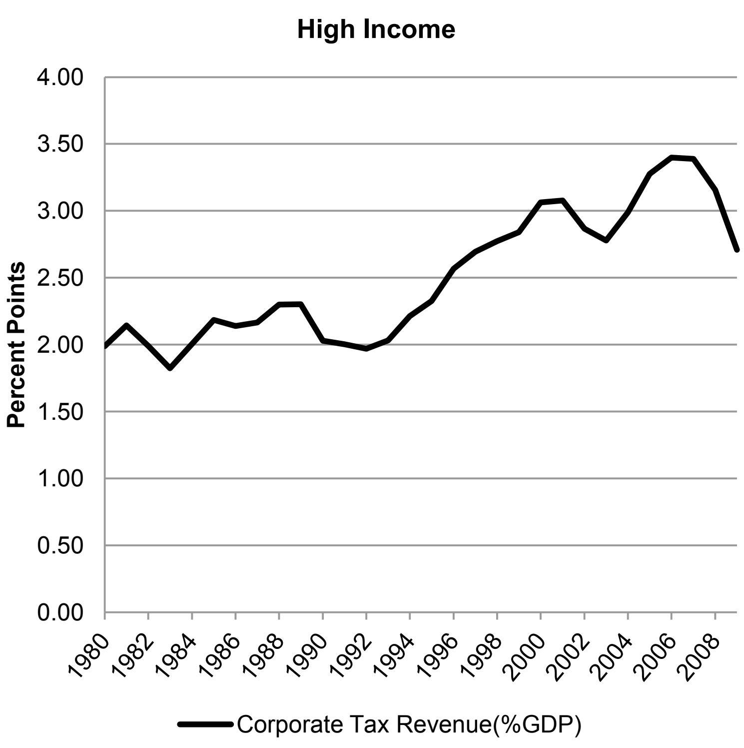
Why it matters

- Developing countries are more reliant on CIT
- Robust so far but vulnerable





- Evidence on impact of tax incentives is mixed—can matter for FDI, but:
  - a secondary consideration
  - no impact in the absence of other (more important) factors – e.g. governance, transparency
  - may not affect total investment in a country —i.e. simply tilt the allocation of resources

Types of corporate tax competition in DCs

- Standard tax law
  - Lower corporate tax rate(s)
  - Tax credits, accelerated depreciation, investment allowances
  - Tax holidays
- Other laws
  - Investment laws; Free Zone laws; sectoral laws
- Negotiated agreements
  - Prevalent in many countries, but no hard data
  - Anecdotal evidence suggests that they are attractive to private enterprises (but reputational risk for public)

Trends in corporate tax competition in DCs

- Tax holidays have been the primary tool
  - income tax, tariff and VAT exemptions, other taxes (e.g. wage taxes, SSC, minimum tax, local taxes, etc.)

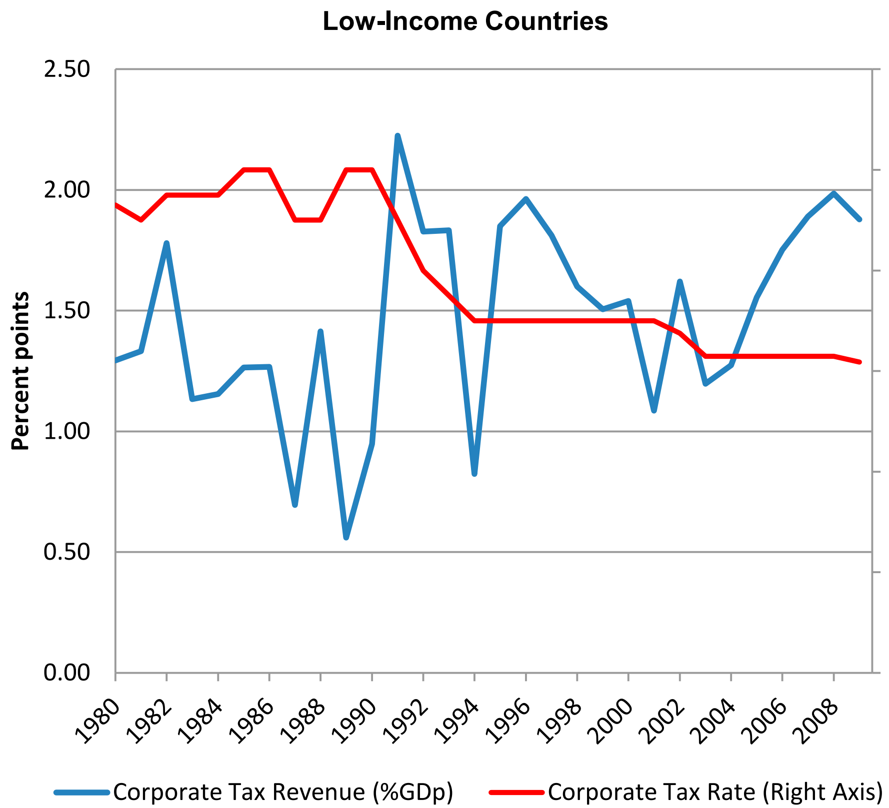
- Since early 1990s, marked decline in tax rates

- But unlike most high-income countries, both rate reduction and base narrowing have taken place

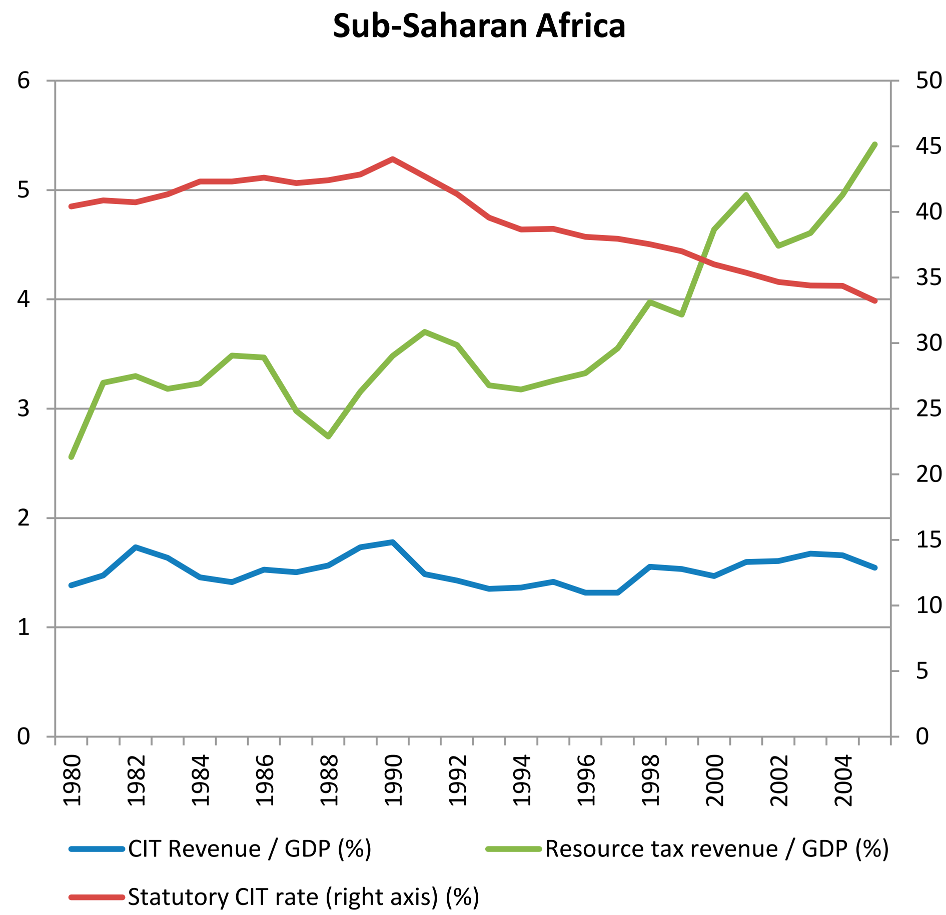
  - Use of tax holidays has intensified in Sub-Saharan Africa—50% of countries have Free-zone laws today; less than 5% had them in the early 1980s

  - Some evidence though that the average lifespan of some sectoral tax holidays has declined

- Simultaneous CIT rate decline and base narrowing have not caused a decline in CIT revenue—yet
  - Of course, this does not mean that there is no revenue loss



- Resource revenue has played a major role, but not always in offsetting other revenue loss
- Changes in both level and (likely) composition of non-resource profits in GDP are probably important



Protecting CIT revenue in developing countries

- Unilateral options: broader tax base
  - Rethink tax holidays – as they have both direct and indirect revenue consequences (e.g. domestic and international profit shifting)
  - Rethink exempt sectors—old ones (e.g. agriculture), and newer ones (e.g. telecoms)
- Good for revenue, greater neutrality, and transparency
- Some countries have tried it, successfully

- Regional/international coordination option:
  - No evidence it has worked so far—e.g. WAEMU vs. other SSA countries
  - Extensive use of tax incentives—noted earlier
  - corporate tax rates in regions that coordinate are only marginally higher than in other regions—mainly a natural resource effect
  - But explicit rate coordination in WAEMU is very recent—has actually reduced rates (25-30%)
  - State aid rules could help make coordination effective
    - discretionary tax incentives are in effect subsidies

Issue: should developing countries de-link CIT rate on resource sector from rest of economy

- In resource countries CIT plays role of a rent tax
  - Hard to compete through lower rates since they yield lower share of resource rent
  - Fall back is discretionary tax incentives for non-resource sector
- Two CIT rates?
  - Higher rates in resource countries could be a transition issue toward developing better tax tools for this sector
  - But what about other sectors earning above-normal returns (e.g. banking; telecoms)?

- A resource rent tax weakens the case for two rates
  - Allows rate reduction/base broadening reform for the non-resource economy
- But application to other sectors raises issues of feasibility and even political economy
  - Highlights importance of other mechanisms (e.g. auctions; licenses)