FAIR TAX COMPETITION

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A Pillar of Positive Economic Reform

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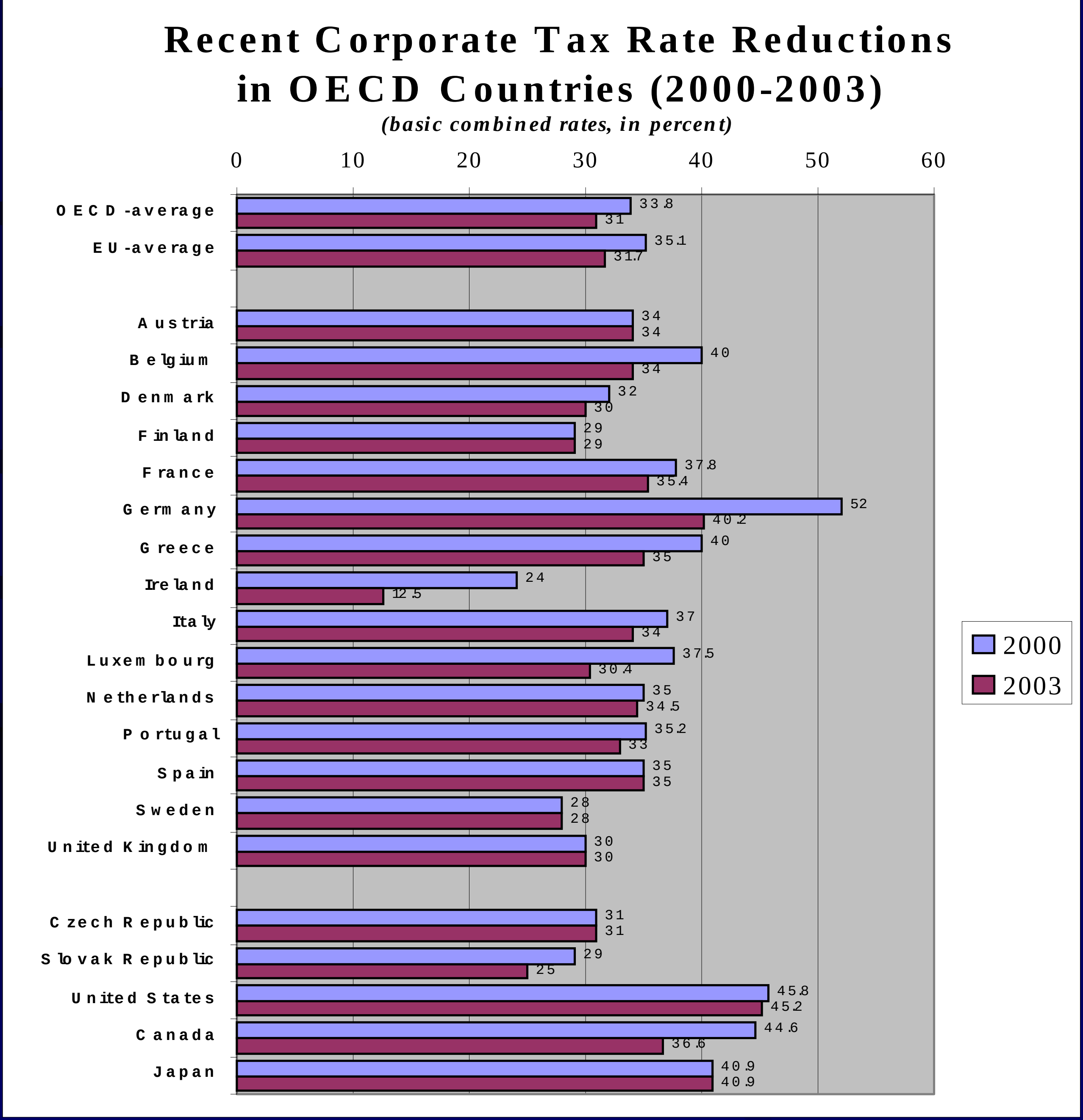
OECD Favours Rate Reducing and Base Broadening Tax Reforms

- High tax rates applied to a narrow tax base create undesirable economic distortions, and motivate aggressive tax-planning.
- Since mid-1980s, OECD tax reforms have broadened the income tax base, enabling significant reductions in tax rates.
- Governments and business gain from low ‘headline’ tax rates, transparent tax rules.

CHART 1



Recent Corporate Tax Rate Reductions in OECD Countries (2000-2003)
(basic combined rates, in percent)
0 10 20 30 40 50 60
OECD-average 33.8 31
EU-average 35.1 31.7
Austria 34 34
Belgium 40 34
Denmark 32 30
Finland 29 29
France 37.8 35.4
Germany 52 40.2
Greece 40 35
Ireland 24 12.5
Italy 37 34
Luxembourg 37.5 30.4
Netherlands 35 34.5
Portugal 35.2 33
Spain 35 35
Sweden 28 28
United Kingdom 30 30
Czech Republic 31 31
Slovak Republic 29 25
United States 45.8 45.2
Canada 44.6 36.6
Japan 40.9 40.9
2000
2003

OECD Favours Fair Competition

- OECD countries favour fair tax competition – offers choice between low-tax/low-public expenditure locations, and higher-tax/higher expenditure locations.
- Requires transparent systems, non-discrimination, and co-operation to avoid double taxation and non-taxation (for an equitable and efficient outcome).
- Competition through basic tax rates and main base provisions enhance transparency.

OECD Work to Promote Fair Tax Competition in Economies in Transition (EIT)

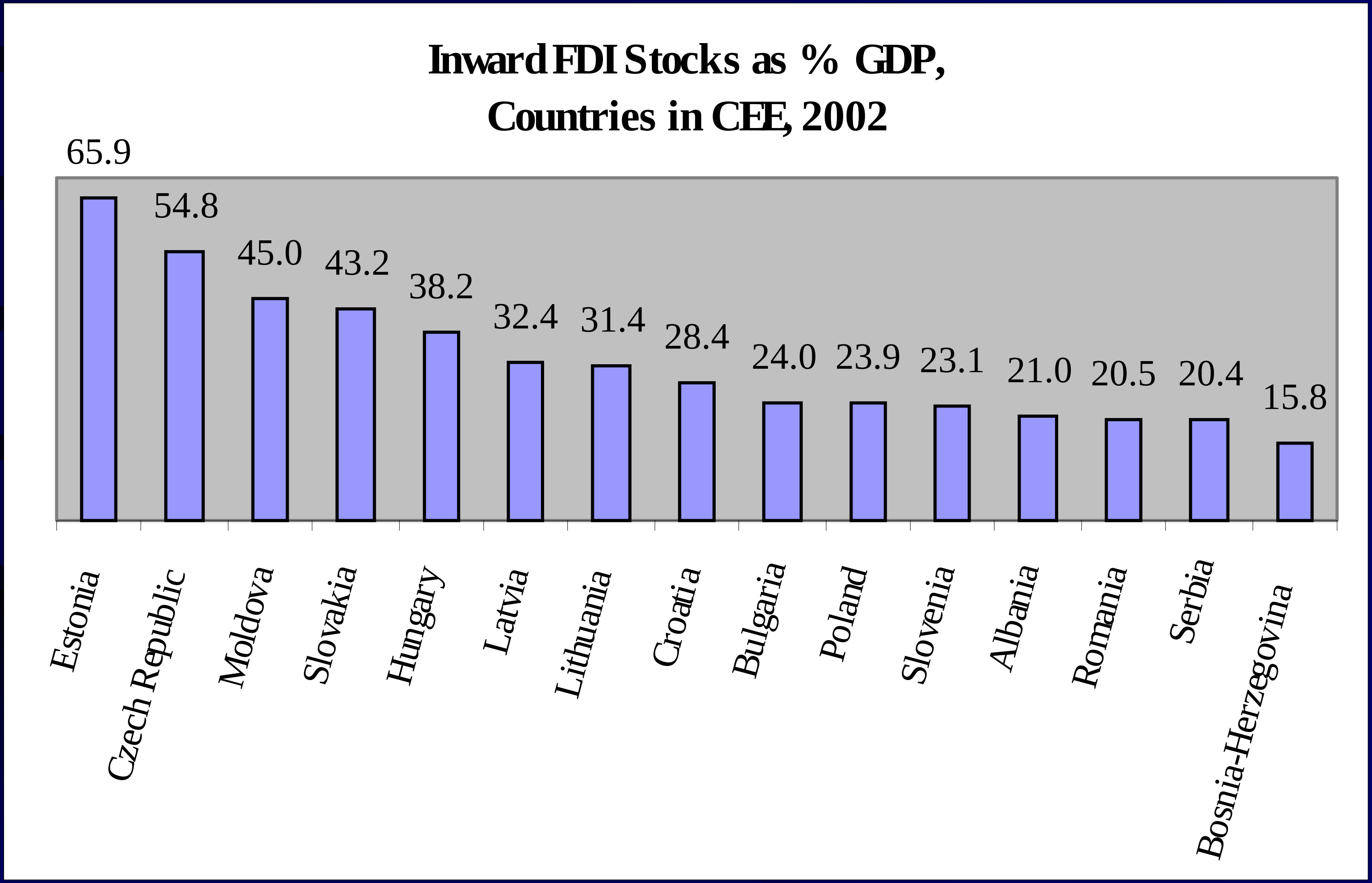
- OECD works with economies in transition to help strengthen ability to attract FDI.
- Tax work aimed at providing an “enabling” fiscal environment for FDI.
- Investors generally prefer tax systems with:
  – Attractive ‘headline’ corporate tax rate
  – Income tax provisions in line with international norms
  – Transparent tax rules applied fairly
  – Well established tax treaty network

Each country must decide its optimal tax incentive policy

BUT

- All countries benefit from an exchange of experience.
- OECD experience largely negative on targeted profit-based incentives (tax holidays) – inefficient mechanism to attract FDI – invites aggressive tax planning (“round tripping”).
- Yet tax holidays widely observed in developing countries (inefficient competition).
- Greater efficiency with incentives targeted directly at investment expenditure (e.g. accelerated depreciation and tax credits), and reductions in ‘headline’ corporate income tax rates (smart competition).
- The ‘BEST’ tax incentive is a stable tax system, consistent with international norms and applied fairly.
- “Add-on” tax incentives are not a substitute for a well-designed tax system – repeated message from case studies.

CHART 2



Inward FDI Stocks as % GDP,
Countries in CEE, 2002
65.9
54.8
45.0
43.2
38.2
32.4
31.4
28.4
24.0
23.9
23.1
21.0
20.5
20.4
15.8
Estonia
Czech Republic
Moldova
Slovakia
Hungary
Latvia
Lithuania
Croatia
Bulgaria
Poland
Slovenia
Albania
Romania
Serbia
Bosnia-Herzegovina

Tax Policy Challenges

- Pressures for tax harmonization within EU.
- Risk that EIT will attract FDI but lose their revenue base.
- Public pressures to maintain some elements of progressivity in the tax system.
- Need to fund social/physical infrastructure.
- Need to establish when tax relief offered to multinationals is excessive (recognize ability to tax location specific rents).

The End Game

- Relatively low corporate tax rates applied to broad tax base (few targeted tax incentives).
- Wider recognition of associated benefits:
  - Low ‘headline’ rates attractive to investors
  - Reduced tax planning pressures on tax base
  - Fewer tax distortions to financing structures
  - Fewer tax distortions to allocation of capital
- Greater co-operation to counter tax abuse.
- Fair but fierce tax competition.