A Framework for an Informed Study of the Realistic Role of Tax in a Development Agenda

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I. INTRODUCTION: TAX INCENTIVES, DEVELOPMENT AND THE INTERNATIONAL TAX REGIME

The elusive quest of developing countries for economic growth has frustrated many students as well as experts of development to date. Development encompasses a variety of goals, including progress in poverty eradication, education, health, and economic growth. When achieved contemporaneously these goals should work together to lift countries from poverty to wealth—a remarkable accomplishment in our world that is characterized more by frustration with the lack of development, the increasing gap between rich and poor countries, and failure of international initiatives to eradicate poverty, disease and famine, than by success stories. The concern with economic growth has frustrated many students as well as experts of development to date. Development encompasses a variety of goals, including progress in poverty eradication, education, health, and economic growth. When achieved contemporaneously these goals should work together to lift countries from poverty to wealth—a remarkable accomplishment in our world that is characterized more by frustration with the lack of development, the increasing gap between rich and poor countries, and failure of international initiatives to eradicate poverty, disease and famine, than by success stories.

1 Professor, University of Florida Levin College of Law. I thank Matthew Mauney for his assistance; and Graham Bradfield, Paul McDaniel, Martin McMahon, the participants in the taxation and development conference at McGill University (organized by Kimberly Brooks, of McGill University; and Allison Christians, of the University of Wisconsin), the participants in the faculty colloquia at the Universities of Cape Town and Florida, the editorial staff of the U.B.C. Law Review, and three anonymous reviewers for their useful comments. All mistakes or inaccuracies are mine.

2 This is the title of William Easterly's critically important book, The Elusive Quest for Growth: Economists' Adventures and Misadventures in the Tropics (Cambridge, Mass.: Massachusetts Institute of Technology Press, 2001) [Quest for Growth].

3 An exception to this gloomy reality is the story of the so-called Asian tigers—South Korea, Taiwan, Singapore, and Hong Kong. See e.g. World Bank, The East Asian Miracle: Economic Growth and Public Policy (New York: Oxford University Press, 1993). Recent success in China and India also show promise, despite some fundamental problems in
for development is almost universal, as is reflected particularly in the commitment of many countries, organizations and people to aid programs. In light of this commitment, the unsatisfactory progress is particularly frustrating.

The many reasons for current disappointment have been extensively explored, and are constantly debated in academic and other development literature, yet unambiguous consensus has yet to be achieved. What is clear is that the factors that affect the process of development (and may interfere with it) are genuinely complex and diverse, and that progress requires patience and sophistication, based on serious extensive research. This has not, however, been the dominant approach to date, as many players attempted to find quick, complete, overarching, unitary and clearly articulated solutions, or truths, based on opaque study and limited data. Indeed, this approach has


See e.g. OECD, Development Co-operation Directorate, *Aid Statistics*, online: OECD <http://www.oecd.org/department/0,3355,en_2649_344471_1_1_1_1_1,00.html>. But see Jeffrey Sachs, *The End of Poverty: Economic Possibilities for Our Time* (New York: Penguin Press, 2006), arguing that it is not enough. Regardless of one's position about the sufficiency of some countries commitments, it is clear that it is significant.


For criticism of the current state of affairs, see William Easterly, *The White Man's Burden: Why the West's Efforts to Aid the Rest Have Done So Much Ill and So Little Good* (Oxford:
proven to be ineffective. Alternative approaches emphasize patience, a trial-and-error, casuistic approach, transparence and constant evaluation. The alternatives do not mean a loss of focus, especially when experience suggests that they may be the only approaches that have a chance of success. The difficulty with these approaches is that they are slow, politically unattractive, and require careful coordination to avoid having potentially worthy projects cancelling each other's achievements. The alternative, however, is just motion with no action, proven to be futile and wasteful.

This article builds on the insights of this development research to develop a new agenda for tax incentives (and equivalent tax measures), the research of their merits when used by developing countries, and their optimal design. The stated goal of these incentives is to attract foreign direct investment, and ultimately enhance economic growth and promote development. Almost all countries use such tax incentives, and business interests strongly support and even demand their use, yet, economic research in general, and the international economic organizations in particular, have been skeptical about their effectiveness. Tax incentives are not only ubiquitous, but also very similar in their general structure and design, if not in the actual details, due mainly to tax competition. Another political aspect of this problem is that

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Oxford University Press, 2006) [White Man's Burden]. See also Stiglitz, supra note 4; Collier, supra note 4; William Easterly, “Can the West Save Africa?” (2009) 47 Journal of Economic Literature 373.

6 This gloomy conclusion is quite universal. See sources, supra note 5.

7 See e.g. sources, ibid.


9 A paraphrase on Hemingway’s “Never mistake motion for action.”

10 Economic growth is the most important aspect of development and the focus of this article.

11 See below, Part II(A)(2).

12 Reuven S. Avi-Yonah, “Globalization, Tax Competition, and the Fiscal Crisis of the Welfare State” (2000) 113 Harv. L. Rev. 1573 at 1645. Practically, multinational enterprises (“MNEs”) lobby and bargain forcefully for tax incentives, a practice that proves effective with government officials convinced that the risk of losing investment if incentives are withdrawn is significant. It is significant enough for them even in face of the opposition to the use of tax incentives by international institutions. The political reality in target
government officials often believe or at least project confidence that they are able to pick the “right horses,” so even if, on average, tax incentives are not effective, the incentives that they grant will be. For some, this fantasy justifies their jobs and promotions. An obvious result (and observation) is that tax incentives are not tailored to the very different needs of different countries, and are not flexible and adaptive to changes in circumstances.

This article analyzes this phenomenon beyond simple criticism of its failures in an attempt to better understand the forces that generated it. The article then proceeds to explore realistic avenues of advancement and the necessary conditions for such advancement. The primary contributions of this article are: the mapping of the gaps in the research of tax incentives (assuming that their stated goal is the true rationale for their use), the demonstration of the role of developed countries in the process of development, and the highlighting of international tax cooperation and coordination of tax policies as a condition for effective progress.

Part II follows this introduction with an analysis of the developing countries’ side of the story. It begins with a brief note of what they actually do: the type of tax incentives used by developing countries eyeing foreign direct investment. Then it explores why they pursue this policy. The rhetoric is powerful in practice, yet is challenged by both theoretical and empirical research. Consensus has not been reached on most of the relevant points, yet what we do know can assist progress. We can use it to redirect the use of tax incentives to avenues that will allow them at least a chance of success.

Progress, however, cannot happen without the support of developed countries, where investors reside. Their role is examined in Part III, based on a working assumption that they are interested in the development of develop-
The discussion begins with the most straightforward aspect of the role of developed countries: making sure that the benefits granted by developing countries do not end up in the treasury of developed countries. The most discussed measure to achieve that result is the controversial tax sparing provision. Currently, this provision is used mainly as a statement that developed countries do “something.” Tax sparing, however, is just one measure, and presumably not the most important among a variety of measures that developed countries may take to assist developing countries on a path toward development. The various measures are explored together with their limitations, and the necessary conditions for their effectiveness. Finally, lessons from the extensive practice and study of the non-tax aspects of foreign aid are drawn.

Part IV concludes with a realistic program for further research and action. It emphasizes the critical role of international cooperation and coordination of tax policies, without which this whole project is probably futile. In particular, it demonstrates some of the possibilities presented by a more educated use of tax incentives, and elaborates on the conditions that may be required to be met if redirected tax incentives’ programs are to be given a chance to succeed.

II. TAX INCENTIVES TO ATTRACT FDI FOR GROWTH

Most, if not all, countries employ tax incentives to attract foreign investment. They are willing to forgo potential revenue to secure foreign direct investment. This is based on the strong commitment to aid programs. Some powerful countries are even committed to tax-based development support programs. See Thomas Dalsgaard, “Japan’s Corporate Income Tax—Overview and Challenges” (IMF Working Papers, 2008), online: IMF <http://www.imf.org/external/pubs/ft/wp/2008/wp0870.pdf>; Kim Brooks, “Denying Tax Sparing Provisions: Another Way for High-Income Countries to Dictate the Tax Policy of Low-Income Countries?” (Paper presented at the annual meeting of the Law and Society Association in Berlin, Germany, 25 July 2007), online: All Academic <http://www.allacademic.com/meta/p177927_index.html>. This does not mean that this commitment is limitless, or sufficient (under whatever criteria one wishes to apply), of course.

See e.g. Brooks, ibid.

See e.g. Alex Easson, Tax Incentives for Foreign Direct Investment (The Hague: Kluwer Law International, 2004); UNCTAD, Incentives and Foreign Direct Investment, Current
investment:¹ in particular because they anticipate that increased investment will end up promoting their economic growth. Developing countries typically focus on economic growth in their quest for development. Development in the economic sense, in simplistic terms, means that poor states become richer.¹⁹ Development may mean many other things, such as improvement of quality of life, life expectancy, and reduction of poverty rates.²⁰ Nonetheless, economic development is a critical condition to development in general,²¹ and it is the main focus of this article.

Economic growth is a term of art, usually used by economists to describe increase, or growth, in one of the common measures they use to assess the state of an economy; measures such as national income or gross domestic product ("GDP"). This article usually refers to growth in terms of GDP or real income per capita, which are typical measures of growth in the economic literature.²² Economic growth (or "growth") does not guarantee development, yet it is a necessary condition for it, and therefore essentially every country in the world seeks certain growth targets and uses policy measures to achieve them. Tax incentives are just one of these measures. This section proceeds to explore what countries do by describing tax incentives programs in use. It then turns to analyze why countries do what they do; to assess

¹ Foreign direct investment (often abbreviated "FDI") is an investment in a company located in a foreign country (to the investor), to serve the business interests of the investor, often a corporation. In order for the investment to be "direct" it needs to be substantial and typically directed at fixed assets in the target country, such as factory, equipment, etc. Normally, however, percentage ownership is used to distinguish direct from indirect, or "portfolio" investment—typically at least 10% vote or value.


²¹ In the words of Professor Collier: "Growth is not a cure-all, but the lack of growth is a kill-all." See Collier, supra note 4 at 190.

whether, and under what conditions or circumstances, currently-used programs have a chance of success in terms of economic growth.

A. WHAT DO DEVELOPING COUNTRIES DO?

1. TAX INCENTIVES

Developing countries use a large variety of tax incentives, the comprehensive review of which is beyond the scope of this article. Instead, this section reviews the basic features and the intent behind incentives that generally fall into three basic types: rate reducing, tax base eroding, and special zones, only to the extent required for an assessment of their effectiveness and contribution to growth.

The first and most straightforward type of tax incentives merely reduce the tax rates that investors face in target countries. Tax holidays are possibly the most common form of such (or any other) tax incentives. A tax holiday simply grants investors exemption (or a significant tax rate reduction) from taxation by the target country for a defined period of time (thus "holiday"). It reduces, so goes the argument in its support, the high costs of new investment in a country and attract investors that may never have considered the tax incentive granting country. The attraction of a tax holiday goes beyond just exemption from taxation, since it also initially exempts foreign investors from some of the compliance burden, understanding the tax system and incorporating local considerations into their global tax planning. Target countries eliminate this additional burden and reduce the risk that first-time investors face at the time when her actual and perceived risk is often the highest.

Technically, therefore, tax holidays should target only "new" investment or investors. The expectation is for countries to lure these investors to come,
invest, establish their business, and thereafter begin paying taxes and participate in the economy. 27 In reality, however, tax holidays are often extended again and again for long periods even when they are initially limited in time. 28 Moreover, durations of tax incentives became standard, and similarly are often extended almost automatically for identical, standard periods of time. Long holidays, which are often granted to essentially all foreign investors regardless of whether they face market penetration costs or the extent of such costs, put into question the rhetoric justifying their adoption.

Design difficulties also interfere with the optimization of tax holiday periods. 29 Most foreign direct investment face losses in the initial investment period, and if these losses cannot be carried forward and used in later fiscal years they may increase the effective tax rate. Depreciation is also often available, which further delays the beginning day of positive tax liability. The straight-forward solution to this problem is to start the holiday period when profits are first generated. Yet, if a holiday begins when tax would have been first paid, it may be the case that it would begin only four or five years into the project. This means significant periods of non participation that may be difficult to justify based on the traditional argument. Longer holidays also have higher costs, and increased exposure to tax planning, complexity, etc. 30 With respect to depreciation specifically, one may wish to postpone the starting day of allowance for depreciation deductions, yet that may be too detached from the economic depreciation reality, and effectively extend the holiday period even more. Further, different investors and industries face very different “start-up” periods, while tax holidays typically are set and standard, which reduces their efficacy. An attempt to be more selective and fine-tune the details of holidays granted to different investors, if possible at all, has its own shortcomings, such as distortions, further exposure to corruption, etc. Actual experience is that longer holidays are at least arguably suc-

27 See ibid.
28 See Holland & Vann, supra note 12 at 990.
29 See ibid. at 990–91.
30 See ibid. at 991.
cessful in achieving their goal of attracting long-term projects that may benefit the target countries, a credit that shorter-term holidays can rarely claim.\textsuperscript{31}

Reduction or elimination of taxes may be achieved not only through tax holidays that are exclusive to foreign investors, but also through general reductions of tax rates. Countries that do not generate much income from foreign investment, or even domestic taxpayers, may choose to save the costs of monitoring incentives and enforcing their taxes, hoping to present a more competitive façade and reap the benefits from spillovers and the increased collection of other taxes, tariffs or rents. Corporate income tax rates are often the focus of analysis of general tax reductions as incentives for foreign direct investment, yet countries also reduce other taxes to amplify their competitive signal to investors or, alternatively, in response to investor demands.\textsuperscript{32} Withholding taxes are important in this context since they are typically final taxes imposed on gross receipts and often represent costs that cannot be quickly recovered by foreign taxpayers, and, thus, are especially concerning to them prior to their investment turning profitable.\textsuperscript{33} Other taxes that are sometimes eliminated or applied using reduced rates are individual income taxes, Social Security Contributions, custom duties, consumption taxes and various other exit taxes.\textsuperscript{34}

A second kind of tax incentives reduce the tax base rather than the rates, resulting in similarly reduced effective tax rates. These incentives are potentially better targeted, yet less transparent. Accelerated depreciation allowances are probably the most common of such measures.\textsuperscript{35} They permit the write-off of certain preferred assets' costs quicker than their actual reduced

\textsuperscript{31}See \textit{ibid.}.


\textsuperscript{33}Withholding taxes are typically reduced by tax treaties, though.

\textsuperscript{34}See e.g. Easson, \textit{supra} note 17 at 147–59.

\textsuperscript{35}For a concise description, see \textit{ibid.} at 147–48.
income production capacity.\textsuperscript{36} This and similar “acceleration” incentives focus on the timing of taxation, effectively differing taxation on current income, consequently reducing current dollar (present value) amount of taxation. Another example is the allowance of certain or all deductions beyond actual costs, or special incentives based on amounts spent on particular investments.\textsuperscript{37} Tax credits (or sometimes allowances or deductions) are granted to investors based on the level of spending, above and beyond depreciation, for instance. This incentive effectively transforms what would normally be pre-tax dollars to after tax dollars if invested according to specific rules. In terms of design, the first step is to clearly identify the investments that would accord the incentive. In addition, often an amount limitation is used to control the desirable effect. The difficulty with this format is that it induces maximization rather than optimization of the level of the relevant investment. This may result in revenue loss that exceeds potential benefits to the target country, and even worse if the incentive results in a no-risk net dollar gain to the investor (the tax benefit of the credit or depreciation exceed the invested amount). These types of incentives are also problematic because they do not benefit investors who lack taxable income in the target jurisdiction. The investors may simply lose the benefit if, for instance, benefit cannot be carried forward. Even then, the incentives they create may be significantly reduced or lost due to the uncertainty of benefits and their postponed usefulness, a characteristic that also makes it especially prone to wasteful tax planning.\textsuperscript{38}

A third type of tax incentives is different from the above in form rather than in substance. They include custom free trade or export processing zones that are used by many developing countries to attract export oriented in-

\textsuperscript{36} Note that the simplest and maybe most common depreciation method—the straight line method, that allows ratable recovery of cost base over the useful life of the relevant asset—is itself often more beneficial to taxpayers than real economic depreciation. Many countries, including the U.S., go further than that and grant “accelerated depreciation,” which allows taxpayers to write of more than the ratable portion of their cost base investment, detaching it even further from the economic reality, and results in an even lower effective tax rate.

\textsuperscript{37} See e.g. Holland & Vann, supra note 12 at 992–93.

\textsuperscript{38} See e.g. ibid. at 993.
vestment to operate within their tax jurisdiction, yet be treated as if they were out of it. So, the target country simply does not tax zone investments and if the product of the investment is sold in that country it would be treated similarly to other imports, as if it were produced outside the country's boundaries. The benefits to target countries include: job creation, skill training, technology spillovers and general regional development. They also often implement this scheme to improve their foreign exchange position, since the investments result almost exclusively in exports. Investors who choose zones are typically cost and tax conscious. They are also often very mobile and therefore do not truly offer future tax receipts for the host country. The track record of zones varies from mild success to horrible notoriety. When foreign exchange generated was meaningful enough for the host country zones were more useful then when not. Still, they are not considered good devices for development, even at the regional level, and all the challenges of the other tax incentives such as tax holidays, tariff and VAT elimination, etc., apply to zones as well.

2. INSTITUTIONAL OPPOSITION TO TAX INCENTIVES

Only a few countries may claim their tax incentives programs are successful. The only serious candidates in this regard are Singapore, Taiwan and Ireland, which are transition economies rather than least developed ones. Yet, tax incentives may not be only, nor the optimal, route toward development, as has been the case in Chile and Estonia, which have achieved comparable development despite their avoidance of tax incentives; but this article saves the

See ibid. at 1006–08.

See ibid. at 1007.


See Holland & Vann, supra note 12 at 1007.

Ibid. at 1006–08.

Ibid. at 988.
discussion of the desirability of tax incentives for a later section. This section briefly reviews the opposition to this practice by the international economic organizations that are typically powerful in the developing world to complete the picture of current practice.

The fundamental argument for the almost universal opposition by international economic organizations is that tax incentives are inefficient; they distort investment decisions by encouraging investment in countries or activities other than those that would have been invested in absent the incentives. Now, this, of course, is the explicit, even the sole, goal of the incentives. Therefore, opponents complement the inefficiency argument with the alternative argument that tax incentives are generally ineffective. Since tax is not an important determinant of investment, tax incentives cannot affect the relevant behaviour, or the investment decisions. Consequently, they are wasteful. Further, they are particularly expensive to administer and monitor, as a result they are often opaque and generally unfair.

Nonetheless, tax incentives carried the day, which softened the resistance, replacing it with an approach such as the one in recent OECD reports, for example, that focuses on the need to carefully use and design tax incentives. Interestingly, the most recent OECD publication on the relationship between tax and development does not refer directly to tax incentives, but focuses on better governance and international cooperation between developing and developed countries. Finally, although not part of the development efforts of the OECD, its (anti) harmful tax competition position also pre-

45 See below, Part II(B)(3).
46 For a more detailed discussion and evaluation of these arguments, see ibid.
47 Note that the primary (inefficiency) argument is irreconcilable with the complementary (ineffectiveness) argument against tax incentives. See ibid.
sents a general resistance to tax incentives in both developed and developing countries.\textsuperscript{50}

The International Monetary Fund ("IMF") is probably the most active among international institutions in the field of taxation in general and tax incentives in particular. Its policies, and particularly the infamous "conditionality," i.e., conditions that it dictates to its borrowers, are generally secretive, yet it is clearly the strongest opponent to the use of tax incentives by developing countries.\textsuperscript{51} It clearly has not been successful in convincing even the poorest of countries that depend on its funds more than others to refrain from using tax incentives,\textsuperscript{52} yet its influence has probably created some imbalances between competitors who are bound by its arrangements and those who are not. Independent research in this area is long due.\textsuperscript{53}

The (less active in this area) World Bank also generally cautions countries from using tax incentives. In its Tax Reform in Developing Countries publication, under Tax Reform Model for Developing Countries, it advises:

\textsuperscript{50} See the initiative's main website, online: OECD <http://www.oecd.org/department/0,3355,en_2649_33745_1_1_1_1_1_1,00.html>. The status and importance of this effort are still uncertain at the time this article is written, yet one should note that its relevance here is limited. It is interesting that even this universal and powerful initiative chose not to address initially tax incentives to manufacturing, but rather specially-taxed regimes (centres). See Easson, \textit{supra} note 17 at 208.

\textsuperscript{51} In its most recent relevant policy paper, it is willing to say that in some circumstances tax incentives may be used to correct for market failures, yet, it argues that this is a very limited and essentially academic argument and in practice: "The cost-effectiveness of providing tax incentives to promote investment is generally questionable." See Vito Tanzi & Howell Zee, "Tax Policy for Developing Countries" (2001) 27 Economic Issues, online: IMF <http://www.imf.org/external/pubs/ft/issues/issues27/>. See also Sanjeev Gupta & Shamsuddin Tareq, "Mobilizing Revenue" (2008) 45 Finance & Development 3, online: IMF <http://www.imf.org/external/pubs/ft/fandd/2008/09/gupta.htm> on tax incentives in sub-Saharan Africa:

Such incentives not only shrink the tax base but also complicate tax administration and are a major source of revenue loss and leakage from the taxed economy. Because investment decisions depend on a host of factors that often carry more weight than tax incentives, these countries need to improve the business climate while keeping the tax considerations as neutral as possible for investors.

\textsuperscript{52} See e.g. Gupta & Tareq, \textit{ibid}.

\textsuperscript{53} Exceptional in this context is Miranda Stewart & Sunita Jogarajan, "The International Monetary Fund and Tax Reform" (2004) 2 Brit. Tax Rev. 146.
Eschewing selective tax incentives and the tendency of government authorities to pick winners and losers in the economy. Incentives automatically narrow tax bases, diminish revenue yields, most likely misallocate investment resources most of the time, facilitate tax evasion, and seriously compromise the goal of horizontal equity. Korea is the only country that made a serious effort to employ tax incentives in support of industrial policy but ... quickly abandoned this policy because of these concerns.\textsuperscript{5}

Later publications, though, present a somewhat more receptive approach, yet not fundamentally different.\textsuperscript{55}

In conclusion, the various influential international institutions all oppose the use of tax incentives. Nonetheless, in practice, their current work involves the containment of the use of such incentives to limited cases, and to attempts to steer the design of such incentives in a manner less vulnerable to tax planning. Yet, the use of tax incentives by developing countries is not solely based on a belief in their desirability, but also, and maybe mainly, due to their belief that they do not have a choice in the face of tax competition, which is explored next.

3. TAX COMPETITION

Tax competition has had a critical role in the evolvement of tax incentives programs to date. Tax competition is not an easily definable concept, and it takes place at several, distinct levels. Most obviously, countries compete over foreign direct investment with other countries, and in that process wish to present themselves as more attractive \textit{inter alia} in terms of the tax burden that investors face. Simple thinking suggests a snowball effect that would result in no taxation of foreign investment that is subject to tax competition, and indeed this is what essentially happened.\textsuperscript{56}

\textsuperscript{54} Wayne Thirsk, ed., \textit{Tax Reform in Developing Countries} (Washington D.C.: World Bank, 1997) at 35.


\textsuperscript{56} See Avi-Yonah, \textit{supra} note 12 at 1573.
A more complete tale should include the investors, primarily the multina-
tional enterprises that wish to establish, say, a single factory in the south-east
Asian region. Investors are aware of the advantages of certain countries in
that region, and these neighbouring countries do not differ much in terms of
the relevant parameters (availability of skilled and unskilled workers, cost of
labour, political and economic stability, etc.). At that point research teaches
us that investors are probably the most sensitive to tax rates.\textsuperscript{57} They are pri-
marily interested in cutting their costs, and, if so, it is understandable that
they will request tax incentives packages, which intensify the tax competition
in certain settings (south-east Asia in our illustration).\textsuperscript{58} Such intensification
does not require active lobbying (bullying?) on the side of multinational cor-
porations since it may be enough that governments believe that tax is a cru-
ical factor in investors' decisions, and will all eventually offer essentially the
same incentives. This is exactly what happened in reality.

Tax competition therefore both changes the power balance between
countries and multinational enterprises in an opening world economy and
prevents countries in the above circumstances from tailoring tax incentives to
their needs and wishes. Tax holidays become the baseline rather than special
preferences with power to incentivize investment. The lack of tax holidays is
now effectively viewed as a disincentive to invest. Countries who need or be-
lieve that they need foreign investment lose control over their fiscal powers
vis-à-vis such foreign investors. They are not forced to do that, yet the alter-
native, as they see it, is receiving no or undesirable investment.

Another level of competition occurs within countries, between regions or
states. In the context of the developing world, the decision to promote one

\textsuperscript{57} See e.g. Rosanne Altshuler & Harry Grubert, "The Three Parties in the Race to the Bot-
tom: Host Governments, Home Governments and Multinational Companies" (CESifo
abstract=875308>; Rosanne Altshuler, Harry Grubert & T. Scott Newlon, "Has U.S. In-

\textsuperscript{58} See e.g. Reed E. Hundt, \textit{In China's Shadow: The Crisis of American Entrepreneurship}
(New Haven: Yale University Press, 2006) at 21–22. See also letter from Emeritus Profes-
sor Lawrie Lyons to the Productivity Commission, Australia (11 July 1996), online: Pro-
sub008.pdf>.
region over another still has a lot to do with the central or federal governments, so it is not materially different, just presents a different set of choices to investors.

A somewhat different level of competition occurs between regions of the world. Countries, both developed and developing, explore opportunities to organize and improve the mutual goals. Alas, in most cases these are unsuccessful, at least in the context of tax incentives in the developing world. The European Union presents a different model, yet it is a model that may not be implementable in the developing world.

Finally, there is internal competition between various sectors or industries. This is important since we have seen the importance of technology and technology spillovers to the success of incentives, as a possible true determinant of growth.

In conclusion, this section surveyed the use of tax incentives by developing countries, which is essentially universal and widespread. It is so despite the strong opposition to it by the very influential international institutions that are often able to dictate policy paths to developing countries, and despite the very weak or nonexistent evidence in support of their efficacy. It concluded with a short discussion of tax competition, which is part an explanation, part an important circumstance that plays a major role in the prevalence of tax incentives in developing countries. The next section analyzes the straightforward or stated rationale in support of tax incentives: that they attract foreign direct investment, which is instrumental for development.

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60 Even there, however, there is a serious struggle over what and how to do, and the tax incentives related regime, called "state aid" has gained strength only recently. For additional information, see the relevant European Commission website, online: <http://ec.europa.eu/competition/state_aid/reform/reform.html>.
A FRAMEWORK FOR AN INFORMED STUDY

B. WHY DO THEY DO WHAT THEY DO?

1. THE QUEST FOR DEVELOPMENT VIA GROWTH, AND GROWTH DETERMINANTS

The prevalence of tax incentives, especially in light of the strong opposition to their use, begs the question in the title: Why do they do what they do? There are at least three levels of analysis: theoretical, practical and political. One must ask whether in theory tax incentives can promote development, and in what manner. An optimistic answer is not sufficient, however, as design and implementation issues come into play if one were to pragmatically use the theoretical insights. Empirical evidence is particularly useful at this level of analysis. This is not the end; since political concerns are crucially important in this context, even the theoretically perfect and most beautifully designed mechanism may easily fail if it does not seriously take politics into account. This section cannot, of course, comprehensively cover all of this analysis, yet it wishes to highlight what must be discovered and make some key observations about what we already know about some of these issues. It begins with the theoretical exposure, following the standard justification of tax incentives, i.e. they encourage foreign direct investment that promotes growth that promotes development.⁶¹

A first step in this analysis would be to understand better the relationship between development and growth. It is not so much that the relationship between growth and development is in question rather it is important to know what are the determinants of growth that may support it in its role in development. A serious focus on the economic research of growth naturally took place in the second half of the 20th century as the postcolonial post-World War II world emerged from the ashes of those traumatic times. This is still

⁶¹ In a way, this section is an expansion of the work of Professor Yoram Margalioth, who argued for the use of tax incentives as a technological progress and therefore growth promoting mechanism. See Yoram Margalioth, "Tax Competition, Foreign Direct Investment and Growth: Using the Tax System to Promote Developing Countries" (2003) 23 Va. Tax Rev. 161. This article evaluates each link in the logical chain—tax incentives → FDI → growth → development—separately, and further explores the circumstances where tax incentives could promote development, such as international cooperation, which is an important condition to progress also according to Margalioth.
very much an evolving area of research, both theoretical and empirical, as much success, and yet even more smouldering failure, resulted from development policies that followed the guidance of such research. 62

The basic, obviously intriguing, question is: Why are some countries poor and others rich? 63 Growth rates since World War II were unprecedentedly high, yet growth rates differ significantly between countries, resulting in a quite consistent widening of the gap between rich and poor countries. 64 Moreover, rich countries have proven to be more resilient to economic downturns; they did not suffer long and significant economic decline following crises, whereas poor countries did, further increasing the widening gap. 65

Concern about this phenomenon triggered much of the interest in growth and development economics.

Economists commonly use real income (or GDP) per capita to measure national living standards. 66 Changes in real income per capita are then used to measure economic growth rates. The task of the relevant research was therefore to explain the increased inequality between poor and rich countries in times of overall significant average growth of real income per capita in our world. Early research emphasized the role of accumulation of capital, both physical and human, since scientists believed that it responded to economic incentives and therefore could be affected by economic policy. 67 The primary

62 Of course, research does not guarantee success.
63 A question asked continuously by economists since Adam Smith's 1776 Inquiry into the Nature and Causes of "the Wealth of Nations."
65 For example, the oil crisis of 1973. See Helpman, supra note 22 at 1–8.
66 Ibid. at 1. The UN attempted, with its Human Development Index, to develop a less rough measurement mechanism, including health and education in addition to income. See UNDP, Human Development Index, online: UNDP <http://hdr.undp.org/en/reports/publications/title,4182,en.html>.
67 They ignored the role of technological changes, assuming that it generally does not.
contribution of this research is attributed to Robert Solow, who observed that in the long run a country's growth depends on (and converges with) technological change. Since technological change was assumed not to respond to economic incentives, and therefore not to be affected by economic policy and incentives, Solow predicted that economic policy and incentives cannot affect long-term growth. A more particular observation was that growth is limited by a country's capital-to-labour ratio (there are just so many machines that one person can work). Empirical research generally supported these observations with respect to rich countries, yet it could not explain the divergence between poor and rich countries, a gap that was supposed to vanish in the long term.

Later research explored an alternative explanation that productivity of inputs is an important factor for growth, presumably a more important factor than its accumulation. Empirical research further found that quality or productivity of the inputs—labour, capital, or land—does not by itself explain the overall productivity levels. This meant that some or even a significant portion of productivity should be attributed to total factor productivity, which measures the joint effectiveness of all inputs combined in producing output. Investment in research and development explains much of the differing total factor productivity levels between countries. Technological change became therefore an important focus of this research. Rising technological change could also reconcile the Solow model with the fact that uni-

69 “Exogenous” in the economists’ language.
70 Which is a simple declining marginal productivity of capital observation.
71 Some economists attempted to explain these differences with the relationship between physical and human capital. See N. Gregory Mankiw, “The Growth of Nations” (1995) 26 Brookings Papers on Economic Activity 275. Yet, it is highly debatable that this explanation is sufficient. See Helpman, supra note 22 at 17–18.
72 See Helpman, ibid. at 19–33.
73 See ibid. at 33.
74 See ibid. at 34–85.
versal growth rate accelerates, since he held technological change constant and predicted decline in growth rates.

A critical contribution here was Professor Paul Romer's model that based output not only on private factors of production but also on an economy wide stock of knowledge that increases over time. His key contribution was the disposal of the assumption that technological change, that most important driver of growth, cannot be affected by economic incentives. Investment in knowledge may therefore wield economy wide positive externalities, and the governments are able to do something about the growth of their countries' economies. Further research expanded and developed this approach, and proved that the effect of technology and innovation is very important, yet due to the multiplicity of the "moving parts," the design of growth policies remained complicated.

A further complication in the process of understanding economic Growth is that growth in no country is truly independent of that of other countries. Cross-border flow of technology, knowledge, and trade and investment affect participating countries. The interdependence of countries' income levels is sometimes directly, and in other cases indirectly, effected through their effect on productivity. The key for this is country specialization that is possible only due to participation in international trade. A critical aspect in this context is the effect of research and development. It is well known that almost all research and development ("R&D") is performed in a few rich countries. The question is whether it benefits the rest of the world or simply fortifies rich countries in their advantaged position, further distinguishing them from the rest of the world. Recent research indicates that (foreign/rich countries) R&D significantly benefits developing countries that trade with the rich countries through its effect on the developing countries total factor productivity. The other side of it, however, is that rich countries


benefit from R&D more than developing countries and hence investment in R&D overall widens the gap between the rich and poor countries.

The effect of institutions (such as the substantive legal system, the rule of law, and politics) is another critical factor in materialization of economic growth. They are practically managing the relevant policies, such as innovation and knowledge accumulation. Limited progress has been achieved in this context, yet some things seem obvious, such as the intuition that corruption, lack of rule of law, and political instability limit the options for growth. Geography has also been blamed, yet there is little support for this contention as an alternative to the importance of institutions.

Another relevant aspect has proven to be inequalities within and among developing countries themselves. Inequality slows growth, yet research has not been able to convincingly demonstrate how exactly this result occurs, nor has research identified what can we learn about it in the context of development. For example, it cannot be said that democratic decision to redistribute wealth within a country is necessarily detrimental to growth. A more extreme aspect of inequality is the contention that growth is bad for the poor, based on the decreasing share of the poor in world wealth and the increasing gap. Research, however, demonstrates that average income of the poor has risen around the world.

In conclusion, the mystery of economic growth is sure to continue and engage further economic research. The role of institutions in particular will surely be the focus of much effort, yet there is much that we do know already, including that the effect of institutions on growth is important. We understand the important role of innovation as a driver of technological change, its effect on productivity, and the importance of productivity for growth. We also can appreciate the relationship between productivity and accumulation.

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77 See Helpman, supra note 22 at 111–44.
78 See Sachs, supra note 3 at 57–59.
79 See Helpman, supra note 22 at 93–94.
80 See ibid. at 109.
81 See ibid.
82 As well as the balance between economic growth and other determinants of development, an issue that is beyond the scope of this article. See however Sen, supra note 8.
of capital, both physical and human. We also know that we need to take into account the interdependence of countries, especially when the least developed countries are concerned. One challenge of future research is how to incorporate tax measures in support of these engines of growth.\textsuperscript{83}

Next, the article explores the next, less obvious link in the logical chain justifying the use of tax incentives: Whether foreign direct investment contributes to growth and, if it does, then how? Note that this section has not mentioned investment as a determinant of growth, since it relates to a different order question, which is explored later: Whether and in what manner does foreign direct investment affect the important growth determinants discussed in this section?

2. THE RELATIONSHIP BETWEEN FDI AND GROWTH

If development is to be achieved via economic growth, tax incentives may contribute to the achievement only if foreign direct investment that is allegedly attracted by these incentives contributes to economic growth.\textsuperscript{84} Despite the importance of this question and its extensive study, answers are hard to come by, bringing to question the rationale for using tax incentives.

The centrality of foreign direct investment stems from the assertion in the “Washington Consensus” that it promotes development and the more of it the better.\textsuperscript{85} This assertion was carried forward and argued conventionally

\textsuperscript{83} So, for example, tax incentives that promote innovation may be preferred to those that do not or to those that provide costly incentives to things other than innovation, some of which may not promote growth. Capital accumulation is just one example. Obviously such research is very sensitive to country and industry specific circumstances.

\textsuperscript{84} Let us assume for now that the single goal and relevant effect of tax incentives in this context is to attract FDI. This is the rhetoric behind tax incentives. This is important also because of the magnitude of FDI and the fact that it has been growing exponentially. See Maria Carkovic & Ross Levine, “Does Foreign Direct Investment Accelerate Economic Growth?” in Theodore H. Moran, Edward M. Graham & Magnus Blomström, eds., Does Foreign Direct Investment Promote Development? (Washington D.C.: Institute for International Economics, 2005) 195.

\textsuperscript{85} The term “Washington Consensus” was coined by John Williamson in a 1989 summary of ten key development advice items commonly shared by the Washington D.C. institutions—the IMF and the World Bank, and by the U.S. Treasury Department. The original context was advice to Latin American countries following the 1980s crisis. See John Wil-
by business groups and multinational enterprises as a standard argument for investment promoting incentives. Academic research, on the other hand, expressed skepticism about the uniqueness and utility of foreign direct investment for development. Developing countries generally bought the story of foreign direct investment’s importance, yet the strongest of them emphasized selectiveness, seeking “quality” investment that would ensure the desirable positive effects (externalities), through technology transfers, domestic production, domestic ownership, etc. This latter strategy signals that at least some countries do not believe that foreign direct investment is universally positive and worthwhile providing incentives for. If one conclusion may be drawn from the divergent relevant economic research, it is that the impact of foreign direct investment on growth is not one dimensional: it has some positive as well as potentially negative consequences, leading a recent study to conclude that “the search for universal relationships is futile.”

Often, foreign direct investment effectiveness is strongly associated with certain circumstances of the target economy. An economy that is fairly open to trade and investment may benefit immensely from foreign direct investment that would channel to it and expose it and its people (workers, skilled and unskilled, managers and business relations) to (developed) world-class R&D, management techniques, quality control, etc. Foreign direct invest-

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88 Multinational Enterprises (hierarchically organized) who trade internally, i.e. between parents and subsidiaries, may be instrumental to growth if allowed to perform such internal trading and freely invest. They are more likely to move more production, more technology, etc., to the target (developing) countries and generate more positive spillovers for such economy. It is the synergy between liberal trade and investment policies that result in economic growth. See Theodore H. Moran, Edward M. Graham & Magnus Blomström,
ment can make domestic firms perform better as it pushes the domestic economy to be more efficient, expand and even diversify. This may happen through competition with domestic firms, training them to partner or complement the foreign firms or implicitly by example or creation of new opportunities through introduction to foreign or global networks or agglomeration. In these cases, it is believed that foreign direct investment can contribute beyond the mere capital it contributes to such economy.

When foreign direct investment is accompanied with increases in trade, it has the potential to contribute to growth. Moreover, research has established that it is positively associated with growth particularly when the target economy has accumulated a minimal stock of human capital. Conversely, when the target economy is protective, with significant restrictions on trade and investment, foreign direct investment may simply compete with domestic firms over domestic resources, often leading to inefficiencies and "export" rather than increase of domestic welfare. Such investment results in either utilization of inferior technology and involvement of foreign firms with the narrow goal of domestic rent extraction, or involvement of inferior foreign investors that

"Introduction and Overview" in Moran, Graham & Blomström, supra note 84, 1 at 14–15.


But see Dani Rodrik, “Appel Inaugural Lecture” (Columbia University, 27 March 2003) (“One dollar of FDI is worth no more (and no less) than a dollar of any other kind of investment").

See Theodore H. Moran, Edward M. Graham & Magnus Blomström, “Conclusions and Implications for FDI Policy in Developing Countries, New Methods of Research, and a Future Research Agenda” in Moran, Graham & Blomström, supra note 84, 375 at 376.

See Moran, Graham & Blomström, supra note 88 at 10.

In these circumstances foreign direct investment is usually targeting the domestic markets rather than export oriented, and would often be required to be conducted through joint ventures with domestic ownership or even relinquish control to domestic ownership. Also, it is often required to use domestic material and share its technology with domestic elements, the consequence of which is a lack of incentive to use cutting edge technology and maximize involvement.
cannot positively contribute to the target economy. Not surprisingly, when accompanied with restrictions on trade and investment, foreign direct investment may hurt economic growth. These policies may prevent foreign direct investment from contributing to growth. This observation, however, is not nuanced enough to be useful in guiding policy. A related distinction is between export-oriented foreign direct investment that is typically associated with more liberal trade and investment policies and with foreign majority owned businesses, and accordingly with positive spillovers, and a (domestic) market seeking investment that is typically associated with domestic majority ownership and restrictive trade and investment policies, and accordingly is not associated with positive spillovers.

Finally, even if positive spillovers were to be detected, it is still not clear that foreign direct investment that generated them is desirable because its attraction involves costs. The challenge is to measure the existence and magnitude of these externalities. This is difficult to prove and calculate, and accordingly determining desirability of foreign direct investment attraction is very challenging. Consequently, this link in the logical (causality) chain is, at best, weak. Next, the article explores the final link in the chain (the relationship between tax incentives and foreign direct investment), independently of the doubt about the validity of the relationship between foreign direct investment and growth.

94 See Moran, Graham & Blomström, supra note 91 at 376.
95 See Marc J. Melitz, “Comment” in Moran, Graham & Blomström, supra note 84, 273.
96 Note, of course that policy discussion must take into account other possible ways to facilitate FDI in various ways, not only subsidies and tax incentives, but also with a supply of skilled workers, skill training, accommodating regulation, infrastructure, information providing, all of which reduces domestic costs.
3. TAX INCENTIVES AND THE ATTRACTION OF FDI

For tax incentives to attract foreign direct investment, firms must take taxes, and most importantly effective tax rates, into serious consideration in their decisions whether and when to invest. Taxation is, of course, just one consideration that these multinational enterprises weigh in the decision. There is extensive economic literature that explores their considerations. Key are: infrastructure, cost of labor, skilled labor available, availability of natural resources, political climate and stability, economic stability, bureaucracy level, lack of corruption, local or regional market size, costs and availability of transportation and communication, currency regulation, legal environment, and sometimes even taxation.98

Foreign direct investment has grown steadily in the last three decades consistent with globalization. Most of this growth, however, took place in developed countries. Investment in developing countries has grown as well. Typical foreign direct investment in a developing country take the form of what is commonly called “Greenfield investment,” i.e., opening a business and penetrating the market rather than acquiring an already up-and-running domestic business, which may explain some of the difference. Tax incentives, as already mentioned, are designed specifically to attract such Greenfield investment by first time foreign investors in a country.

In order to understand better the role of taxation in investment decisions, it is useful to elaborate a little on foreign direct investment generally. The main benefit attributed to foreign direct investment is efficiency. The basic story is that if investment flew freely it would end up where it would maximize its owner’s wealth and consequently global wealth (increase the global pie). Any restrictions or barriers would result in less than maximum global wealth gain. Global efficiency is not, however, a consensus goal, and in fact it typically carries little weight with the most important players in this game. The capital exporting country, which is the residence of the investor, sometimes called the “home country,” naturally wishes to maximize its own wealth. Maximization of global wealth may not mean maximization of every country’s wealth at the same time, and therefore such country may choose not to leave foreign direct investment free of its regulation. The target, or

98 See e.g. Easson, supra note 17 at 19–34.
“host” country faces similar incentives. Note that it is enough that one of the countries involved interfere and regulate the investment to potentially force all of them to do so even if some may be content with completely free flow of investment in the first place. Finally, the investors, i.e., multinational enterprises, may maximize their profits by taking a course that is not necessarily globally wealth maximizing. This is probably inevitable once the relevant countries regulate it in one way or the other. Since we do not have a world government and even not strong cooperation among the countries of the world, seeking the goal of global efficiency is probably unattainable under these circumstances. An important factor that makes this picture even more complex is that the players often have very different powers vis-à-vis each other.\footnote{\textsuperscript{99} See above, Part II(A)(3).}

One could assume that a multinational enterprise would not make an investment that does not benefit it,\footnote{\textsuperscript{100} Yet the countries involved may very well face not only insufficient increase in wealth but also wealth decreases or other harms from FDI, as has been explored in the former section.} and one such benefit could be low effective taxation. The vast literature attempting to isolate the effect of taxation on foreign direct investment, however, resulted in mixed results. The differences in results are large at times, so reaching general conclusions may be difficult. Nonetheless, one may say at least that taxation plays a relatively small role in the original decision to engage in foreign direct investment, yet it often plays a role, albeit not always important, in the decision where to locate it,\footnote{\textsuperscript{101} Studies found that often political and market climate were more important.} at least at the margin.\footnote{\textsuperscript{102} See UNCTAD, \textit{FDI}, supra note 17 at c. 4} Take for example, a multinational enterprise in the business of manufacturing sports goods that wishes to increase production to respond to demand. It concludes that it needs another plant. It is understandable that labour cost is key to the decision to do that outside the United States. Labour costs, skills and general stability lead it to choose South East Asia. Now, let’s say (hypothetically) that Thailand, Malaysia and Vietnam may all be appropriate in terms of infrastructure, transportation costs, etc. This is the stage where one can see tax entering the equation. If one
of these countries can secure a better financial, including tax, package for the investor, it may be in an advantageous position. Note in recent years, as globalization thrives, it becomes more likely that other conditions equalize, potentially leaving a more important role for taxation in such decisions.\(^3\) Still, that is true probably with respect to the final location decision (in contrast to the choice of region, etc.).

The effects of taxation on foreign direct investment may be significantly different also for different types of investments. Studies found that export-oriented investment is more sensitive to taxation than, for instance, investment that attempts to penetrate certain markets (import substituting investment).\(^4\) Note that we have seen this distinction in the context of the efficacy of foreign direct investment, and said that research supports the suggestion that export-oriented foreign direct investment is more likely to contribute to growth then import-substituting foreign direct investment. This is encouraging for the case in support of tax incentives, since at least they have the potential to attract certain desirable types of investment. A less researched issue is the difference between industries. Existing research suggests that there are significant differences between industries in their sensitivity to tax. Most obviously, the more portable industries will be more sensitive to taxation than the less portable ones.\(^5\) In general, legal tax research and tax laws essentially ignore differences between industries per se. In our case in particular, this kind of research seems particularly desirable.

Finally, one must be careful to attribute importance to taxation in general. The role of tax administration and other bureaucratic functions of tax

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103 Indeed, more recent U.S. studies may support this contention. See e.g. Harry Grubert & John Mutti, "Do Taxes Influence Where U.S. Corporations Invest?" (2000) 53 Nat'l Tax J. 825.

104 For example, the choice to locate a computer chip manufacturing facility in China, Vietnam or the Philippines may be more sensitive to domestic taxation than the choice between the same countries for the purposes of locating a television assembly facility for distribution in the respective domestic markets.

authorities are beyond the scope of this article. The corporate income tax is normally the focus of studies, yet custom duties and import taxes are important as well. There is some role also to individual tax, social contributions and consumption taxes, but no evidence that it is material.

Now we ask whether tax incentives themselves are capable of increasing desirable foreign direct investment (not only that foreign direct investment is sensitive to taxation generally)? Most academics and tax experts answer this in the negative, claiming that tax incentives are overall undesirable. The primary case against them is based on efficiency considerations: tax incentives distort behaviour and thus must result in efficiency losses in the relevant markets. This argument's biggest difficulty is that this is the essence of what tax incentives are trying to do: create an incentive for people to invest in a place where they would not otherwise invest. Global efficiency losses are not a primary concern of developing countries implementing tax incentives; their own markets' condition is. A more concerning argument is that tax incentives are not effective since tax is not an important determinant of foreign direct investment as we explored in the last section. Further, the critics argue that their costs often exceed their benefits; they are costly and difficult to administer and police. They are particularly exposed to corruption in countries where corruption is a major economic concern, and they are almost by definition inequitable, promoting certain investments and investors over others.

Against this consensus a few have argued that tax incentives might be desirable from a developing country's perspective. The most serious argument is that they promote investment that brings technology to these countries and positive spillover effects that assists them in their quest for growth. However, the theoretical opposition to tax incentives is somewhat academic (since everybody uses them), and hence the tax incentives discourse shifted focus from the desirability of tax incentives in general to their acceptance almost as a necessary evil and concentration on ways of making them more effective and efficient. Next, we examine the basic arguments against the use of tax incentives by developing countries, and some of the responses to these arguments.

106 See Margalioth, supra note 61.
The efficiency argument against tax incentives is based on the behavioural distortion created by tax incentives. Investors are encouraged to do something that they would not otherwise do: invest in country A rather than country B, in zone A rather than zone B, (in the extreme case) in industry A rather than industry B, or hire more workers than one optimally would. The achievement of the distortion is the goal of the tax incentive. If it is not achieved, for instance because the investor intended to invest in country A or in zone A anyway, then the incentive is a pure waste (since it does not have the intended effect). In that case it is also distortionary and inefficient because it provides an unintended advantage to the incentive recipient (over her competitors). This latter distortion may happen even if the tax incentive is effective if competitors of the tax incentive recipient or its indirect competitors (producer of substitutable goods, for example) do not get an exactly equivalent tax incentive—a very likely scenario.\textsuperscript{107} The competition distortion is exacerbated by the fact that developing countries' governments may be weak vis-à-vis the multinational enterprises seeking tax incentives, which may result in tax incentives that benefit only some of them and possibly in ineffective tax incentives of the various kinds described above.\textsuperscript{108} This story lies at the heart of the tax competition problem discussed above.\textsuperscript{109}

This distortion, however, is not necessarily efficiency reducing; it may be desirable if, for instance, it "corrects" a market failure.\textsuperscript{110} One such situation is when there is no functioning market to speak of, such as in the ex-communist countries. Another is sub-optimal R&D, yet this may not be very convincing in many developing countries.

Even if a market failure was evident, correcting it requires that it could be corrected by tax incentives and, very importantly, that governments would be able to use tax incentives for these purposes measurably and correctly. Governments are notoriously convinced that they could do that, and more importantly, they seldom take into account the side effects of such policies, such

\begin{itemize}
  \item \textsuperscript{107} We can expand the analysis to global distortions that are probable, but this is beyond the scope of this article.
  \item \textsuperscript{108} In addition, of course these are more prone to corruption, etc.
  \item \textsuperscript{109} See above, Part II(A)(3).
  \item \textsuperscript{110} See Easson, \textit{supra} note 17 at 64.
\end{itemize}
as decreased development of other industries or regions, diversion of skilled workers from a non-incentivized industry to one that receives incentives.

If tax incentives, however, do not change behaviour then they are even more obviously wasteful. General evidence may not be helpful since it averages many different situations and types of rules, however, it gives a general indication about the efficacy of this policy device, i.e. that only a small minority of tax incentives may actually work.\[11\] Familiarity with the specifics of the available data is important to understand it. Most of the data comes from survey studies, and little to no evidence comes from the employing countries themselves. This last point is very important since it signals there is a lack of “accountability,” that the utilization of the incentives is not transparent and there is no control post enactment—this creates a dilemma since stability is important for effectiveness as well—we shall elaborate on this separately.

Another key point in understanding the effectiveness of tax incentives is the existence of tax competition that potentially wipes out the incentive part, leaving a disincentive to invest absent a “tax incentive.”

Tax incentives are available to both market and export oriented investment. The former get it due to the fear that maybe they will leave after all, even though the evidence is quite clear that there is no incentive in them. The latter receive them as part of the package that target countries present to an investor that is interested in low costs of production, etc. Some countries with particular advantages may go even further, attempting to attract headquarters (and other, tax haven or offshore-style enterprises). The latter format does not normally fit productive developing countries since they need spillover effects to justify the loss of revenue. The offshore model is for countries that do not have any chance of attracting direct investment that may result in spillovers so they give up revenues that they never had a chance of getting anyway for some fees and a few particular non-productive jobs, etc. This activity will never feed millions of poor people so it is beyond the scope of this article.

\[11\] See ibid. at 66–67.
4. A COST-BENEFIT ANALYSIS OF THE DESIRABILITY OF TAX INCENTIVES

Even an effective tax incentive is not desirable if it does not generate enough of a benefit to cover its costs. The costs of tax incentives include both for-gone revenue and indirect costs, such as the distortions that they create in the target market. The revenue loss may seem the more obvious cost; yet, in a second glance one should understand that it has no cost at all if indeed effective. If a tax incentive attracts investment that would not otherwise land in the target country or more specifically would not result in taxable income in the target country, then no revenue is forgone. Unfortunately, it is very difficult to determine which investment is of the sort that would not otherwise be made in the target country. If the investment is of the sort that was increased in response to the investment or allocated differently accordingly it becomes much more difficult to delineate the part of the investment that is incremental, and consequently very difficult to assess the true revenue cost of the relevant tax incentive.\(^{112}\)

One direct response to this difficulty may be that better administration and enforcement can improve the purity of investments that benefit from tax incentives, yet there is a catch: the less general an incentives regime is the more it is exposed to the indirect costs or distortions created by them (substitution, corruption, discrimination, etc.). Part of the substitution story is that tax incentives will particularly attract short-term high profit investment\(^{113}\) that may not be of the type that has many beneficial spillovers.

Finally, there are some costs that are more technical. Tax incentives complicate the target countries' tax systems, and often facilitate tax avoidance as well.\(^{114}\) This increases the costs of compliance, administration and enforcement, and potentially affects the perception of the tax system's clarity and legitimacy, which may lead to reduced efficacy.

The benefit side of the analysis is not easier to figure out. Direct revenue benefits include revenue from taxation beyond the type that enjoys the in-

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113 See Holland & Vann, *supra* note 12 at 989.

114 See *ibid.*
centive or, for instance, revenue collected in the future, when the tax holidays expire. Both benefits, but particularly the latter, seem theoretical, since an investor is strong, etc. The more important benefits are the spillover effects, skill training and technology transfers, etc. It is easy to see how difficult it is to calculate such benefits, especially in periods that are less than long-term.

A cost-benefit analysis is therefore immensely difficult to honestly conduct, and most available studies took place in limited industries and in developed countries where the availability and sophistication of data are obviously materially different from that in the developing world. A better, and preferably simpler (usable), mechanism for such analysis is clearly required.

III. THE ROLE OF DEVELOPED COUNTRIES

A. WHAT DO DEVELOPED COUNTRIES CURRENTLY DO?

It is not difficult to understand that developed countries have an important role in the process of developing countries’ development. They regulate and often tax the investors in developing countries. These investors overwhelmingly reside or headquarter in developed countries. They also set the tone on the world stage and inside international organizations where international trade and investment regimes are modulated. Finally, much in line with the working assumption of this article, developed countries are heavily involved in activities in support of development, and they devote significant resources to this goal.\(^{15}\) This section analyzes the actions of developed countries in support of development in the context of taxation, the desirability of such actions, and proposed reforms.

1. TAX SPARING AND MATCHING CREDITS

The most direct, and controversial,\(^ {16}\) measure taken by developed countries in support of tax incentives programs of developing countries to date is their agreement to include tax sparing provisions in tax treaties that they conclude

\(^{15}\) Regardless of one’s opinion about the sufficiency of aid in general.

\(^{16}\) For a comprehensive review of the debate and the important literature, see Brooks, supra note 15.
with developing countries.\textsuperscript{117} It is also a popular measure, increasingly so, despite the controversy over its effectiveness and the disfavour of international organizations.\textsuperscript{118} This popularity has not recently been shared by the most developed countries, following the expressions of doubts about the desirability of tax sparing by the OECD,\textsuperscript{119} and famously has never been shared by the United States.\textsuperscript{120}

Tax sparing amends the normal foreign tax credit rules to make certain that tax incentives made by developing countries benefit the foreign investors that they target, rather than others, allowing these incentive programs a chance of success. The foreign tax credit rules are a common mechanism to reduce or eliminate double taxation. The residence country typically allows its resident taxpayers (the foreign investors) a tax credit (reduction of domestic tax liability dollar-for-dollar) for taxes duly paid by such taxpayers to foreign countries (the target countries). It reflects the international convention that the source country, where business is conducted, gets the first "bite" at taxing the income from such business, while the residence (of the investor) country is allowed to further tax such income to the extent that double taxation does not occur.\textsuperscript{121} This residual taxation by the residence country, so goes the argument, effectively eliminates the efficacy of tax incentives for foreign direct investment, since any tax concession by the target (source) country simply reduces its "first bite" at the income of the foreign investment and

\textsuperscript{117} For the origins of the practice, see e.g. Stanley S. Surrey, "The Pakistan Tax Treaty and "Tax Sparing" " (1958) 11 Nat'l Tax J. 156.

\textsuperscript{118} See Victor Thuronyi, "Recent Treaty Practice on Tax Sparing" (2003) 29 Tax Notes Int'l 301.

\textsuperscript{119} See OECD, \textit{Corporate Tax, supra} note 48.


\textsuperscript{121} The foreign tax credit is capped by the residence country's tax rate for revenue protection purposes and to ensure that source countries do not take advantage of this mechanism by maximizing taxation of foreign investors at the expense of the residence country.
accordingly increases the residual taxation by the residence country. The benefits of the incentives therefore go to the residence (developed) country instead of the investors, and consequently tax incentives have no chance of achieving the goal of incentivizing foreign direct investment. The investors are at best indifferent to the tax incentives since they face an overall (source and residence countries combined) identical effective tax rate. Tax sparing treats developed countries investors who enjoy developing countries' tax concessions as if they actually paid the conceded tax to the developing (source) country, eliminating, to the extent of the concession, the residual taxing right of the developed (residence) country.\(^\text{122}\) \(^\text{123}\)

Tax sparing is not always required to preserve tax incentives granted by target developing countries. If the investor resides, for instance, in a country that employs an exemption (double taxation relief) system rather than foreign tax credits, then there is no residual taxation by the residence (developed) country and the value of tax incentives is preserved.\(^\text{124}\) Some foreign

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122 A numeric example may be useful to illustrate this. Assume that a U.S. investor, who faces a worldwide 35% flat tax rate in the U.S., invests in a foreign country F that taxes foreign investors at a flat 10% reduced tax rate (from a normal 30%). The investor pays $10 on $100 of income to country F and $25 ($100\times35\% - $10 foreign tax credit) to the U.S. Overall the investor faces a $35 tax, which is the same tax that he would have faced without the concession by country F. Without the concession, the investor pays $30 to country F and a residual $5 to the U.S. The concession or tax incentive therefore merely transfers revenue from country F to the U.S. and has no impact on the investor (or the investment). If the U.S. granted tax sparing in this case, it would have treated the investor as if she paid $30 (the full/regular tax rate) rather than the actual $10 paid to country F, and accordingly require the investor to pay only $5 residual tax to the U.S. With tax sparing, the investor faces 15% effective tax rather than 35%, the U.S. collects the same 5% tax it would normally collect, and the 20% tax concession of country F would be enjoyed by the person whom it targets (the investor).

123 A similar mechanism that is often mentioned is the matching credit, i.e., the allowance of a fixed rate of a foreign tax credit regardless of actual taxation or tax rates in the source countries. This less popular mechanism is typically used in tax treaties and effectively embodies a taxing rights division or tax sharing that is formula-based. See e.g., *Convention between Brazil and the Netherlands for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion with Respect to Taxes on Income*, 8 March 1990, 1658 U.N.T.S. 202, Art. 23 (entered into force 20 November 2001).

124 See e.g., Brooks, *supra* note 15.
investors may not suffer residual residence country taxation because of their particular tax position: a consequence of excess foreign tax credits or some sophisticated tax planning. This, however, cannot serve as an argument against the use of tax sparing since chronic excess credit position does not indicate strength, as is evident by the fact that most United States multinational enterprises have excess limitation positions. Development policy may not want to encourage foreign direct investment by corporations with excess credit rather than excess limitation positions. Tax planning that avoids residual residence country taxation often relies on deferral, i.e., a country’s non-taxation of business income generated by subsidiaries of taxpayers out of jurisdiction.\(^1\) Deferral does not necessarily result in avoidance of the residual residence country taxation, since eventually when profits, as reinvested, are repatriated they will suffer similar taxation in present value terms. The United States rules, however, de facto permit indefinite deferral, which explains the consistently low effective tax rates that United States multinational enterprises’ foreign source income faces.\(^2\) This means that full residual residence country tax is not collected and therefore that the value of tax incentives is preserved, at least to a certain extent.\(^3\)

Tax sparing is typically granted by developed countries in tax treaties (with developing countries).\(^4\) Note, however, that if one believes in their desirability there is no reason to limit them to tax treaties.\(^5\) A country may simply provide for tax sparing in its domestic (unilateral) foreign tax credit rules. It would require a country to create a list of target countries or maybe even particular tax incentives that may benefit from the sparing, yet this is

\(^{125}\) This is based on the religious-like adherence to the legal fiction of the corporate separate legal personality. Most or all countries employ some anti-abuse or anti-deferral rules, such as the U.S. subpart F rules (see §§ 951–965), yet these rules never apply to genuine income bona fide generated through business activities in the subsidiaries’ countries of residence.


\(^{127}\) This is an important part of the consistent U.S. resistance to grant tax sparing.

\(^{128}\) For a good selective review of the history of tax sparing, see Brooks, supra note 15.

not extraordinarily exceptional: countries often use black and white lists in their domestic tax laws. Such an approach would better reflect a commitment to tax sparing as a desirable policy device and allow a country to use it in cases of countries with which the conclusion of a tax treaty may not be probable for reasons independent of development issues. Research of the practice of tax sparing does not reveal, to the best of my knowledge, any give-and-take involved in the inclusion of tax sparing in treaties between developed and developing countries, so the treaty context is not justifiable. Furthermore, to the best of my knowledge, no country has conducted follow-up studies to assess the efficacy of tax sparing, augmenting the conclusion that it is probably considered mainly an altruistic (conscience cleaning) mechanism rather than a true treaty measure. The conclusion of tax treaties between developed and developing countries itself may be important for development independently of the tax sparing debate, and therefore will be discussed separately below.

The design of tax sparing provisions may also carry importance. In reality, however, provisions are quite similar despite the fact that they are among the very few provisions in tax treaties that do not follow a “model” (the tax treaty models do not include tax sparing). One design issue relates to the type of income protected by the provision—passive or active. There is no reason to distinguish between the two unless one wishes to promote only foreign direct investment. In practice the distinction is relevant to countries that use an exemption for one type of income (often, active income) and a credit for the other, a non-substantive distinction. Another non-substantive distinction is between individual and corporate taxpayers, excluding the former, possibly for anti-abuse reasons. Similarly, abuse concerns lead countries to sometimes refer to specific tax incentives when they grant tax sparing. A more serious distinction is the time limitation on tax sparing: some articles are general, and some have sunset provisions, yet in reality these often are ex-

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130 This may not be true in treaties between developing countries.
133 See *ibid.* at 20–21.
134 See *ibid.* at 21–22.
tended. The OECD survey reviews these design issues and suggests “best practices,” which focus on abuse concerns. For the purposes of this article two aspects may be interesting: the suggestion not to extend tax sparing to passive income or to export-oriented business.

The notable U.S. opposition to tax sparing stems primarily from two concerns: a concern about implementing foreign aid programs in a non-transparent manner through the tax system and its stark departure from the usual foreign tax credit policy. The former is beyond the scope of this article; the latter, however, is very relevant for its purposes. The foreign tax

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135 See ibid. at 22–23.
136 For an analysis of design issues and the OECD suggestions, see OECD, Tax Sparing, supra note 131 at 24–28.
137 See ibid. at 41–43.
138 Another critical element in the tax sparing debate is the role of multinational enterprises. On one hand, developing countries suggest that they are pressured by multinational enterprises to grant tax incentives and demand tax sparing from developed countries and the U.S. in particular, and on the other hand there is indication that multinational enterprises, and especially U.S. multinational enterprises understand that the U.S. will not grant tax sparing and are not particularly worried about it, so long as a treaty is in place that would allow them with deferral and additional tax planning to reach a desirable tax position. See Lee Sheppard & Juliann Martin, “Berman, Part II: Departing U.S. Treasury Staffer Discusses Treaties” (1997) 15 Tax Notes Int’l 949 at paras. 139–142.
139 See Michael S. Knoll, “International Competitiveness, Tax Incentives, and a New Argument for Tax Sparing: Preventing Double Taxation by Crediting Implicit Taxes” (University of Pennsylvania Institute for Law & Economics Research Paper No. 08-21, 25 August 2008), online: SSRN <http://ssrn.com/abstract=1259927>. In his article, Professor Knoll supports tax sparing based on a competitiveness argument. Knoll explains that countries employing tax incentives replace creditable explicit taxes with non-creditable (yet effectively deductible) implicit taxes. He argues that tax sparing simply restores the neutrality between investors from worldwide tax countries and investors from territorial tax countries when calculated on total (implicit and) explicit tax basis, and if designed properly is superior to denial of tax sparing also by equalizing taxation of direct and tax subsidies, and by allowing tax incentives to be more effective. Knoll relies on two studies of tax sparing. The first, by James R. Hines Jr., “Tax Sparing and Direct Investment in Developing Countries” (NBER Working Paper No. 6728, 1998), online: SSRN <http://ssrn.com/abstract=129468>, compared investment by U.S. and Japanese firms in 1990 in countries with which Japan had tax sparing arrangements. It found that Japanese firms invested relatively more and were subject to lower effective taxation in countries with which Japan had tax sparing arrangements. Similarly to Knoll’s article, this study does not say
that tax sparing assists developing countries in their development but rather is concerned with the success and effective foreign taxation of U.S. multinational enterprises. Therefore, it is not very helpful for our purposes, yet one may note that this is a limited study that does not take into account aspects like the overall taxation level and alternative tax planning opportunities and limitation for Japanese and U.S. multinational enterprises. Moreover, other factors may also explain the allegedly better market position of the Japanese firms, and more importantly, maybe U.S. firms were able to find better yields regardless of tax incentives by the countries dominated by the Japanese multinational enterprises. Another study by Celine Azemar & Andrew Delios, "Tax Sparing Provision Influence: A Credit versus Exempt Investor Analysis" (University of Glasgow, Department of Economics Working Paper, July 2007), online: University of Glasgow <http://www.gla.ac.uk/media/media_44476_en.pdf>, follows Hines' study with a more substantial ten year dataset comparing Japanese multinational enterprises with French multinational enterprises that are subject to an exemption system. It concludes that tax sparing provisions affected location decisions of the Japanese firms, while not affecting the French multinational enterprises. Further they affected FDI decisions and had no effect on passive/portfolio earnings. The article appropriately cautions that it does not provide a conclusion about the overall desirability of tax sparing, and obviously it does not provide any insight into the desirability of tax incentives used by developing countries other than the conclusion that tax sparing is not completely ineffective for FDI from worldwide tax jurisdictions. This study is not very helpful therefore for our purposes, yet one should note that there is a possibility that tax sparing is granted in response to particular pressures by multinational enterprises in developed countries (Japan here), which would make the causation questionable (i.e. it is possible that the most desirable location was determined first and only then a pressure on both target and residence jurisdictions came about). Overall, assessing Knoll's analysis is beyond the scope of this article, because it does not have the goal of promoting development, but rather promoting competitiveness of U.S. multinational enterprises, yet, I would make a couple of observations since it is so directly related to an important aspect of this article. First, I do not subscribe to the concern over competitiveness, since it masks efficiency concerns, but in a distortive way. See e.g. Donald J. Marples, "Taxes and International Competitiveness" (CRS Report RS22445, 11 March 2008). More competitive multinational enterprises do not mean a more efficient U.S. economy or a welfare increase for its constituency. The interests of U.S. multinational enterprises are not necessarily identical to the interest of the U.S. and the American people. Second, our tax system does not tax implicit taxes that are apparent in various other circumstances, and therefore taking it into account in this context potentially reduces the effective tax on foreign investment in countries granting tax incentives. The use of double taxation as an excuse here is problematic. First, indeed the international tax regime is based on the single tax principle, yet this single tax clearly refers to a post-realization (explicit) tax, not all taxes however defined. Second, the single tax principle is a framework for division of revenue among countries, and rates may still vary freely, excluding implicit taxes universally. Inclusion of implicit taxes by one country should not necessarily im-
credit has always been considered an extraordinary benefit to taxpayers, granted by the United States in support of its rhetoric about adherence to capital export neutrality. As an extraordinary benefit, it should be granted only to taxpayers that are targeted by the benefit and that are in full compliance with its conditions. The United States does not view itself as conceding the right of primary taxation of income sourced outside its jurisdiction, but rather as granting relief to its own taxpayers who suffer foreign taxation acceptable under universal norms. This relief does not create a right for the source country, and definitely not an exclusive right to tax the income of the United States taxpayer. The current international tax regime is not in its basis a revenue or tax base dividing regime but rather a taxation ordering regime. Therefore, the source (developing) country in our context has no exclusive right to the tax base, as may be implicitly signalled by tax sparing. It simply has the right to tax the income domestically sourced, to tax it first in order and to tax it at whatever tax rate it determines for the particular type of income—reduced or not. Note that this is a very fundamental aspect of our current international tax regime that is based at its very core on non-cooperation and non-sharing, though there are very loose, decentralized coordination conventions. One alternative regime has been, interestingly, at the center of the tax discourse lately: a switch to a formula based system would potentially result in a tax base sharing mechanism that would be much more receptive to mechanisms such as tax sparing, since it could grant countries exclusive rights to tax or not to tax certain incomes. A critical point about this issue is that only enhanced international cooperation and coordination of tax policies could advance tax sparing like mechanisms that would be acceptable as the high road rather than as an altruist peculiarity. This is one demonstration of the desirability of enhanced cooperation for developing countries.

In conclusion, there is little support to a contention that tax sparing in its current format is effective as a supporting device for developing countries' tax incentives, and there is virtually no evidence or even studies that test this contention. Countries who grant tax incentives generally treat them as for-

prove efficiency. It would more probably result in more complexity and distortions introduced to the system. Finally, further study is required for a good assessment of the benefits and costs of universally taxing implicit taxes on cross-border transactions.
eign aid and as part of their treaty policy rather than as well targeted tax policy mechanisms. No studies have attempted a cost benefits analysis of tax sparing of any kind to the best of my knowledge.

A related, yet different question relates to the choice of double tax relief mechanism and its effect on development. Professor Karen Brown suggested that moving to an exemption system would be beneficial to United States investment in developing countries and particularly in Africa, since it would lead to enhanced effectiveness of developing countries' tax incentives’ programs.\(^{140}\) Professor Paul McDaniel responded that a similar result may be achieved through corrections made to our foreign tax credit rules, and that it is not clear that a complete or partial switch would indeed enhance investment in developing countries in general and in African countries in particular.\(^{141}\) Beyond this particular debate, the choice between an exemption and a credit system involves a large variety of aspects, including a heated debate over the relative costs of the two systems. In any event there seems to be little evidence that a complete switch to an exemption system would benefit developing countries or United States investment in such countries. A deeper analysis of this point may be a worthy future project. Next, the more general question of the benefits of concluding tax treaties between developed and developing countries is picked up.

2. **Tax Treaties Between Developed and Developing Countries**

A large network of (largely) bilateral tax treaties constructs the current international tax regime.\(^{142}\) Almost all of them closely follow the OECD model


\(^{141}\) See McDaniel, *supra* note 120.

convention, yet some treaties follow a competing model convention, known as the United Nations model. The United Nations model was initially published in 1980, with a recent revision in 2001. The United Nations model attempts to accommodate the needs of developing countries that conclude tax treaties with developed countries primarily by allowing additional taxation at source, i.e., to the developing countries. Otherwise, it practically clones the OECD model and its language, and at least in the last two decades the United Nations model has been marginalized. Actual tax treaties follow the OECD model more closely. Developing countries, therefore, failed to follow the United Nations’ model, and, so to speak, “make it their own.” This may be because they did not have the power to compel their developed country treaty partners to accept its premises, or may be because they were not convinced that the model treaty was in their best interest. Another problem is that increased taxation at source may be counterproductive to developing countries that attempt to attract investment. Taxation at source may be an unrecoverable cost for investors, or it may increase the effective tax rate they face. It may be the case that the only way source countries can benefit from rights to increase taxation at source is through cooperative action.

This has wider implications, and will be discussed further in the concluding section, yet there is another, more specific question here: Is the conclusion of bilateral


145 This may be because of insufficient foreign source income to allow full foreign tax credit recovery, a real loss position, or an effective tax rate at source that exceeds the investor’s effective worldwide tax rate.

146 See e.g. Margalioth, supra note 61.
tax treaties is helpful for developing countries in their quest for development?\footnote{147}

Currently, there is very little research of this question, and particularly little evidence exists to answer it specifically for developing countries. A study of United States foreign direct investment did not find evidence that bilateral tax treaties increase investment, but rather found economically and statistically significant negative effects of new bilateral tax treaties on United States outbound activity to the tax treaty partner country, concluding that the primary role of tax treaties is to combat tax evasion.\footnote{148} A follow up paper suggested that even renegotiation of tax treaties did not result in a robust positive impact on foreign direct investment.\footnote{149} A more recent and wider in scope study used data of bilateral OECD outward foreign direct investment between 1985 and 2000, and found a significant negative impact of newly implemented tax treaties on outward foreign direct investment stocks.\footnote{150} Finally, the most recent study found slightly more positive results. It found evidence that middle-income developing countries that have signed a treaty with the United States or a higher number of tax treaties with important capital exporters actually do receive more foreign direct investment from the

\footnote{147}{This is particularly interesting because the more preliminary question of why do countries conclude tax treaties at all has not been answered conclusively. The main challenge to the need for tax treaties is Tsilly Dagan's "The Tax Treaties Myth" (2000) 32 N.Y.U.J. Int'l L. & Pol. 939. It is quite clear that the stated goal of elimination of double taxation cannot explain the practice since it is easy to achieve that unilaterally, yet, other aspects explored in the literature, and especially the "belonging to the club" of cooperative countries aspect have better explanatory force, which is particularly relevant for developing countries in our context. See e.g. Yariv Brauner, "An International Tax Regime in Crystallization" (2003) 56 Tax L. Rev. 259.}


United States and in total. However, tax treaties are not useful for low-income developing countries.\textsuperscript{151}

This gloomy picture is deceiving, however. One should not jump to conclusions based on so little and very limited research. This is definitely an area that requires more attention and analysis. What we could say is that one cannot automatically argue that tax treaties promote foreign direct investment. Similarly, it cannot be said that developing countries always benefit from tax treaties they conclude or from adhering to the United Nations model. Finally, better exploration of the promise to development in international cooperation and coordination of tax policies is essential to fully answer the above questions.

3. **TECHNICAL ASSISTANCE, ADVISING, ETC.**

Developed countries may also take up what may be viewed as a more proactive role in assisting developing countries to develop. This type of involvement takes various forms. In general, though, the idea is that sometimes monetary aid or incentives to developing countries are not enough or not effective: maybe because of the lack of political will or capability to effectively or efficiently put these to use, or maybe because it is very difficult to buy what the developing country needs on the market. Support of developed countries that send their troops of experts (somewhat similarly to military troops) may be, at times, more effective than sending money.\textsuperscript{152} Technical assistance may be viewed as an "in kind" substitute to aid, so conceptually tax measures may support it or its fruits similarly to other aid projects. Other, more particular measures, may also be considered, such as, say, beneficial treatment of the earnings of the posted experts, whether they work directly for the posting government or not.

An obvious area where such assistance may be particularly useful is the design and implementation of a better tax system in developing countries: a tax system that would not hinder their efforts to develop, and that would be compatible with the world tax regime. This type of assistance would result in

\textsuperscript{151} See Eric Neumayer, "Do Double Taxation Treaties Increase Foreign Direct Investment to Developing Countries?" (2007) 43 Journal of Development Studies 1495.

\textsuperscript{152} See Collier, \textit{supra} note 4 at 111–15.
an environment which is more accommodating for foreign investment, less costly, and would make it easier for developed countries to use other measures in support of the developing countries’ efforts to develop. Enforcement may be critical and at times experience in effective enforcement may be more important than the general design of the system. Signing bilateral tax treaties is an important first step in the direction of inclusion in the community of nation states comprising the current international tax regime as have been explained above, yet, a stable and functioning domestic system is the precondition to any development.

Various efforts, completely independent of tax treaty conclusions, have been taken by developing countries, their agents, and by international organizations to advise developing countries about the reform, design and implementation of their tax systems. These efforts faced two major doubts regarding their efficacy. First, their intent and sincerity was in question, since developed countries have interest, and in particular short term interest that may be in conflict with the development goal of developing countries. Second, their usefulness was in question due to the concern that what was perceived as desirable for developed countries may not be desirable for developing countries, either in principle or in practice because developed countries and their experts were not familiar enough with the full scale of circumstances of the advisee developing countries. This is clearly an area where systematic study of the theory and practice may be useful. Especially useful may be an honest study of the truth in the claim that prescriptions do not work in this context and more specifically whether countries in different stages of development (least developed, developed, or emerging) should think differently about the design of their tax systems. Current scholarship does not provide much insight on this point, reflecting almost a disbelief that developing countries may actually develop.


4. THE ROLE OF INTERNATIONAL INSTITUTIONS

International organizations played a central role in advising developing countries about their tax systems. The involvement of the IMF in particular suffered the most heated criticism of the sort mentioned above. The IMF has a long-standing tax experts group, both on the legal and the economics sides. A detailed analysis of the IMF’s role in the process of use of tax measures by developing countries is beyond the scope of this article, yet the main criticism is important to the purposes of this article, since it criticizes the one-size-fits-all "planner" approach of the IMF that is no different from its general approach to foreign aid. On one hand, the sensibility of this approach has been and should be further challenged and assessed; on the other hand, the IMF is a bank, a lending institution with a duty to ensure repayment of the loans it makes. In this capacity it must at least take into account the interests of its capital contributors, i.e., the developed countries. It is therefore arguably not fit to serve as a development promotion institution. The problem is that it is the sole international factor that is engaged in this activity. Assessment of the IMF’s proper role and potential alternative arrangements to internationally support tax reforms in developing countries are other areas where additional research is required.


156 See Stewart, supra note 153.

5. **SPONSOR COUNTRIES**

Some country-to-country specific initiatives also took place, yet these were mostly wider in scope and their tax-related component was just a small part of an overall assistance effort. In most cases these initiatives were conducted by former colonial powers in their former colonies. A true global solution should better assess the wisdom of these arrangements.

This section mapped the various ways taken by developed countries to accommodate developing countries in the field of taxation. It also made some observations on potential reforms, innovations and, most importantly, issues that require further study before we can say anything wise about them. The next sections suggest that one direction that further study can take is to learn from the more extensive research done in the foreign aid field that may be useful to our task.

**B. LESSONS FROM ECONOMIC DEVELOPMENT LITERATURE**

Focus on foreign direct investment dictated a focus on tax incentives and tax sparing by tax experts, practitioners and academics. This, of course, fits also the concerns of multinational enterprises—the investors—in their attempt to minimize their costs of investment in (the more risky) developing countries. This focus, however, resulted in the neglect of other aspects of the quest of developing countries and their people for growth and development. Tax-related issues are naturally minor in the broad scheme of development and the efforts of developed countries in this context are generally less proactive than their role in, e.g., aid, technical assistance, etc. Hence, one can find a much more extensive literature and study of foreign aid in particular. The question is whether it is possible to learn a lesson from these non tax development efforts by developed countries (aid, technical assistance, etc.) that would assist us in the evaluation of the role of tax in development.

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158 See Kris James Mitchener & Marc D. Weidenmier, "Trade and Empire" (2008) 118:533 Economic Journal 1805 (An interesting recent study demonstrating generally that originally belonging to an empire roughly doubled trade relative to those countries that were not part of an empire. The use of a common language, the establishment of currency unions, the monetization of recently acquired colonies, and the establishment of preferential trade agreements and customs unions help to account for the observed increase in trade associated with empire.).
The centrality of aid to the efforts to promote development is well documented and extensively researched and discussed. Aid has grown immensely over the years and reached the $100 billion mark in 2005.\footnote{For an extensive statistics, see e.g. OECD, Aid Statistics, supra note 3.} Further, unprecedented press coverage and celebrity power were recruited to support and promote aid in the name of development and poverty reduction in particular.\footnote{U2's Bono even wrote the introduction to the economist Jeffrey Sachs popular book, The End of Poverty. See Sachs, supra note 3. See also Edward Schwerin, "Celebrity Activism: Can Bono, Bill, and Jeffrey Save Africa?" (Paper presented at the ISA's 49th Annual Convention, Bridging Multiple Divides, San Francisco, 26 March 2008), online: All Academic <http://www.allacademic.com/meta/p254291_index.html>.} Notwithstanding the success in coverage and volume, aid has been very disappointing in achievements to date.\footnote{See William R. Easterly, "Introduction: Can't Take it Anymore?" in Easterly, Reinventing Foreign Aid, supra note 4, 1 at 2.} This article does not participate in the discourse over the necessity or effectiveness of aid, yet it wishes to draw from the insights available from its intensive study that may be useful in the more humble context of development-promoting tax-related measures.

Aid results in infusion of capital of various kinds or knowledge into the targeted economies. It may fall into the hands of the developing country's government, particular people or organizations within such countries. Tax measures do not have to operate only as incentives for foreign direct investors, and may similarly result in money in the hands of developing countries' governments or otherwise. The experience of other development efforts may assist us in studying the potential desirability of these alternative measures, if any. The first example that comes to mind is the issue of corruption, which is ubiquitous among developing countries governments. Straightforward aid to such governments is unlikely to be effective for development, and similarly tax measures that result only in money at the hands of such governments are likely to be ineffective and undesirable.

The reality is, however, much more nuanced than this simplistic example. There is much disagreement among aid experts themselves over the desirability of various policies and their implementation. Similarly, the actions of the major international organizations, such as the IMF, the World Bank, the United Nations, USAID, and other governmental and non-governmental
organizations are challenged. The primary focus of these organizations has been central planning and generally free market philosophy, even when these two were difficult to reconciled, and obviously not compatible. The general response of these organizations and their sponsors, the developed countries, has been to admit failure, yet promise that current and future plans will be much better than past failing plans and therefore require more funding that would guarantee success. They ride mainly the argument that aid is required to overcome a poverty trap—people in developing countries are too poor to save and invest, so they are stuck in decline without hope, and aid could lift them above mere subsistence and release their entrepreneurial and growth powers.\textsuperscript{162} Alas, this promising theory has no strong support in research and indeed its bearers consistently fail in implementing their own plans.\textsuperscript{163}

A competing philosophy called these organizations to admit the failure of central planning and grand goals, and replace them with assistance to what Professor William Easterly, a leading figure in this critical group, calls “searchers”, in contrast to “planners”\textsuperscript{164} those who search for successful, maybe smaller scale projects, yet projects whose success may be accurately defined and measured. Searchers may not be able to revolutionize and turn around countries suffering from years of deprivation, yet they do lead to progress, a claim that traditional aid organizations cannot make. This approach emphasizes the role of the people of developing countries in helping themselves and their countries, and the power of foreigners to potentially support and fortify these entrepreneurial forces. Note that there is a difference in scale between these approaches, yet searchers’ successes may be scaled up, yet it is impossible to plan ahead what would work. First, claims Easterly, one must search for it, and then maybe planning may help in scaling it up; this process cannot work in a different order.\textsuperscript{165} This criticism of the current framework goes back to the very origins of the central planning attitude towards foreign aid.

\textsuperscript{162} See e.g. Sachs, supra note 3.

\textsuperscript{163} See citations in Easterly, Reinventing Foreign Aid, supra note 4 at 14–15.

\textsuperscript{164} See e.g. Easterly, White Man’s Burden, supra note 5 at 3–36.

\textsuperscript{165} See Easterly, Reinventing Foreign Aid, supra note 4 at 9.
The role of government and its quality is very important to the debate, since the plans of planners are difficult to implement in countries with bad governments, whereas searchers may still operate in such countries and account for these difficulties. The debate then turns to political questions, foreign policy and human rights issues, and the definition of potentially well governed states, which meddles with the focus of the debate. We have mentioned the importance of institutions and corruption for growth, so clearly their research will be relevant to new approaches to the design of tax measures in support of growth and development.

The stakes are so high and the uncertainties in research are so prevalent that it is safe to say that the debate will persist, yet one avenue of tax-relevant potential action may emerge: developed countries are clearly in a position to support searchers in their searches, and tax incentives could be uniquely suited to be successful in that: they support only successful searches, they provide information, and are possibly capable of measuring accomplishments. They also do not directly fund corrupt regimes, although this is something to be concerned about (corrupt rulers rather than searchers and entrepreneurs taking advantage of it). This is a direction that would be almost entirely new, although to some extent a similar approach is taken in the conclusion of tax treaties between developed and developing countries, yet treaties are not well-tuned mechanisms for such a task.

Note that the debate between planners and searchers is important and that operations in both modes do not result in synergies and benefit from the combination, because planners dominate the money and they crowd out searching efforts and contradict the patient approach that searching requires. Searching by definition cannot promise results and cannot be planned with particular goals, yet promises and goals have led to little progress so maybe it is worth it trying another approach that research finds to be at least successful as an approach. No elixirs can be aspired to, yet an understanding of what type of actions may assist development may assist us in the tax world to make sure that our policies at least do not hinder such actions and hopefully also are able to support them. It seems not to be the case that

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166 See ibid. at 24.
uncertainty about the economics of development prevents us developed
countries from taking any action.\textsuperscript{167}

The foreign aid discourse is more complex than the “searchers versus
planners” dichotomy. Future study of the lesson we should take from the aid
literature must include other approaches. For example, Professor Paul Col-
lier, who in a way takes a middle ground in the debate, appreciating the im-
portance of aid on one hand, yet criticizing the development policies taken
by the international community,\textsuperscript{168} takes the position that focusing on the
poverty trap and attempting to eliminate it with aid alone may be pointless.
This is because there are many other reasons, or even traps that stop the
poorest countries from developing. He mentions especially the conflict trap
(internal turmoil and coups), the natural resources trap (or “curse” as it is
commonly described), the geographical limitations of countries landlocked
while having “bad” neighbours and bad governance (corruption, lawlessness)
in small countries.\textsuperscript{169} Then, Collier matches five primary instruments—aid,
military intervention, regulation, laws and charters, and trade policy—that
may serve as solutions to these limitations, or traps.\textsuperscript{170} He demonstrates how
different poor countries face a mix of different traps or challenges, and there-
therefore should benefit from different mixes of instruments to support their at-
tempt to get out of poverty.\textsuperscript{171} In particular, he emphasizes the potential role
of the G8 in the solution,\textsuperscript{172} yet for our purposes it is important to follow his
methodology and manner of thinking about development and think what
tax measures could support such an effort, if any.

In conclusion, legal tax scholarship should follow the developments in
the economic development literature in general and the aid literature in par-
ticular in its attempts to design tax measures to support the general initia-
tives. Unfortunately, there has been little to no work done in this area to date.

\textsuperscript{167} For additional ideas, see \textit{ibid.} at 37–38.
\textsuperscript{168} See Collier, supra note 4.
\textsuperscript{169} See \textit{ibid.} at Part 2.
\textsuperscript{170} See \textit{ibid.} at Part 4.
\textsuperscript{171} See \textit{ibid.}
\textsuperscript{172} See \textit{ibid.} at 175–92.
Such future research should fit generally into the measures taken by developed countries in support of the development of developing countries.

In order to seriously tackle the question of the appropriate role of developed countries in this process one must confront the questions of interest, responsibility and commitment. Part of this commitment may include revision of the international tax norms that construct the current world tax regime: base splitting, formulary apportionment, revenue sharing and a more dynamic approach (also relevant to new tax treaties' framework). However, probably the most important step should be to embrace productive progress in international cooperation and coordination of tax policies that simply cannot be made without the assistance, or, more realistically, the leadership of developed countries. Next, the article concludes with a particular focus on the role of international cooperation.

IV. CONCLUSION: (HOW) COULD A STRONGER INTERNATIONAL TAX REGIME (AND A REALITY CHECK) PROMOTE DEVELOPMENT?

The goal of this workshop was to jumpstart the legal academic discourse about the relationship between development and taxation. This article attempted to map the issues, that could use further study and analysis (namely, alas, all relevant issues). The article constructs a framework for the discussion of the relevant issues, some of which are obvious and even extensively analyzed, studied and debated, such as tax holidays and tax sparing, and some of which have been completely ignored. All of them, however, require rigorous theoretical and empirical study that is sometimes difficult to conduct because of its strong political implications. Nonetheless, it is clear that piecemeal, tax technical analysis of the various measures discussed in this article is of little use if it were not part of a comprehensive, coherent and systematic approach to the relationship between taxation and development; an approach that follows a relatively clear goal of promoting development.

An educated, comprehensive approach does not mean that it cannot be pluralistic. It does mean, however, that clear goals, success measurement and accountability standards must be accepted and followed. It also means that some level of coordination should be at the center of the inevitably international effort. The desirable level or manner of coordination or cooperation should be left for future discussion, yet some of the potential merits of a co-
Cooperation presents an opportunity to directly confront (harmful) tax competition, and most obviously stop the snowball effect of continually decreasing tax rates that foreign investors face in target developing countries. This does not mean that they will be able to impose high tax rates on foreign investors, but that they can collect "some" revenue that is duly theirs under the current international tax consensus. Moreover, this does not mean the end of tax incentives; in fact, this is the only way to make tax incentives effective. Tax incentives could then be set at more appropriate levels (just enough to offset the increased risk of investing in a developing country, maybe) rather than race to the bottom zero rates, and they could be diversified to reflect idiosyncrasies of the different economies with less concern about "beggar-your-neighbour" type of behaviour. Finally, productive developing countries will need to worry less about competing with tax havens, especially since this is a concern that is common to them and the developed countries, which should make a cooperation effort in that direction more likely to succeed. In conclusion, cooperation may allow developing countries to retake control over the use and design of tax incentives. Note, however, that there will be a price to pay, as cooperation means that cooperating countries will not be completely free to do whatever they wish to do. The research of the benefits of cooperation and the design of workable limitations into a cooperative regime are the first major areas where research is required.

Other issues that demand further research if we were to seriously attempt to incorporate tax measures into development policy were exposed in the article. First, we must better understand and keep up with the evolving economic research about the relationship between foreign direct investment and economic growth. Such understanding will allow us to limit the use of tax incentives only to circumstances where they have a chance of achieving their goals. Furthermore, it can provide us with insight into better design of tax incentives. Second, the next link in the chain: the relationship between tax incentives and foreign direct investment has been studied to some extent, yet

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173 I.e. that countries where business takes place may tax the income it generates at reasonable rates so long as it is not discriminative.
very little information is available in this context from developing countries. Empirical study of this data is particularly challenging due to the lack of interest among those who may be able to collect the information, namely the governments. Nonetheless, international cooperation may provide enough incentives to these governments, and supplement collected information with data on the investors side to reach more informed conclusions that will allow us to choose to implement only tax incentives that have a chance of boosting desirable investment (as identified in the above mentioned line of study). A third area where almost no research exists is tax sparing. We essentially know nothing about the effectiveness of this measure that is advertised as a necessary complement to tax incentives implemented by developing countries. We only have rhetoric; it is time for some facts and clear statements of why we do what we do.

As mentioned in the discussion of tax sparing, it is not only its ineffectiveness that generated resistance. Partly, it was its incompatibility with the current paradigms on which our current international tax regime relies. In particular, the use of formulas to divide revenue among competing tax jurisdictions, which is essentially what tax sparing is all about, is not an idea unique to the context of this article. Several scholars have advocated the use of formulas in one manner or another in core (and usually more important) areas of international tax law, such as taxation of cross border business and transfer pricing. This and other changes of paradigms also fit into the formerly discussed apparent need to increase international cooperation in the

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field of taxation, since without it, an effective fundamental reform of the inter-
national tax regime may not be realistic.

Finally, and no less importantly, is the need to learn from the economic development literature and particularly the aid literature about possible roles for developed countries in the process beyond tax sparing and traditional tax incentives. The poorest countries use the same tax incentives that more developed or developing countries use in the competitive global market for investment. Yet, we already know that usually they have no chance of becoming a factor in this market without “something else,” or some help. Indeed, they remain poor. Therefore maybe both developing and developed countries can design tax incentives with a direct focus on their contribution to specific goals of development. This ties into the aid discourse and particularly to a non-centralistic approach that advocates support of domestic entrepreneurship, in a patient, trial and error manner rather than central planning and panaceas that dominated development policy to date with little success. Another attraction of this alternative approach is that it allows developed countries to help even when support of the developing countries’ governments seems unproductive, such as in cases of corruption, etc. Maybe tax incentives granted by developed countries that will allow developing countries’ entrepreneurs easier penetration of developed markets or access to technology may prove more productive than current efforts.

Of course, all of these ideas should be developed further based on future research and much more empirical study and data that are simply unavailable at the present. Further, there are issues and challenges that were just briefly mentioned in the article or not at all. The purpose of this article was to erect the first foundations for a framework of serious study of the issues at the intersection of taxation and economic development.