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How will countries compete for FDI in light of the new global tax environment?

by
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Investors consider several factors when determining the locations of their investments. While the tax system is one of them, it is not the sole or main basis for an investment decision. Despite this, countries have widely used tax incentives to attract FDI. Developing countries in particular use these incentives to offset their shortcomings in terms of the underlying factors that make for an attractive business environment. However, the effectiveness of tax incentives in attracting FDI has been challenged, with many economists seeing the widespread use of incentives as encouraging a "race to the bottom."

The global tax environment has undergone several changes that present constraints to the use of tax incentives. First, the OECD Pillar II introduces a global minimum effective tax rate of 15% for MNEs that have annual revenue above EUR 750 million. The application of a top-up tax on a group's ultimate parent entity by its resident country will affect certain incentives offered in capital importing countries, as the revenue forgone by these countries will be collected in the ultimate parent entity jurisdiction; this may cancel out the fiscal benefit to the group as a whole. Consequently, the affected tax incentives will have less impact on MNEs' locational investment decisions. The revenue impact on capital importing countries may be mitigated through a qualified domestic minimum top-up tax. Second, European Union State Aid rules, which often intervene to avoid direct tax measures that distort competition, continue to be relied on to challenge tax incentives offered to MNEs. Similarly, several cases have been raised within the WTO dispute-settlement body challenging incentives considered to be in breach of the Agreement on Subsidies and Countervailing measures that regulates the provision of subsidies (including tax specific incentives). This new environment places limitations on the types of tax incentives that countries can introduce if they are to avoid a breach of their international obligations.

Despite these constraints, countries will continue to compete not just for FDI, but also for services, top talent and high net-worth individuals to increase economic activity within their jurisdictions. This is particularly important as countries face the pressing need to increase revenue to meet their development goals. This raises the question of what competition will look like, given the constraints faced in the use of traditional tax incentives.

The new environment presents an opportunity to rethink the measures adopted to attract FDI, especially where there has been an over-reliance on profit-based incentives. Several options are available to countries:

- Incentives targeted at substantial activity. Pillar II will have little or no impact on incentives that target tangible assets and payroll. The substance-based income exclusion provides an opportunity for countries to offer incentives that reduce taxes on routine returns from investment in substantive activities, without triggering additional top-up tax.
- Qualified refundable tax credits. For Pillar II purposes, these are treated as income, making them more attractive to countries. However, developing countries could face fiscal and legal challenges due to limited resources.
- Incentives for out-of-scope taxes, such as personal income, indirect and property taxes, customs duties, mineral royalties, and employer contributions to social security. However, offering incentives for indirect taxes may trigger conflicts with trade obligations. In addition, countries should consider the feasibility of these taxes providing the competitive advantage desired.
- Tax incentives for out-of-scope companies. However, in the long run, countries may agree to lower the revenue threshold, capturing a larger group of MNEs.
- Enhanced tax administration and dispute resolution. Administrations that provide predictability and consistency in the application of rules and streamlined dispute-resolution mechanisms reduce compliance costs and increase the overall attractiveness of a country. Countries may want to invest in their tax administrations, including through the digitalization of their processes and the implementation of cooperative compliance programs and dispute-settlement systems.
- Investment and grants for infrastructure, skilled workers and the overall ease of doing business. Countries may want to place greater emphasis on public spending to improve the overall investment environment to attract investors. However, offering such grants may be difficult for developing countries that have limited fiscal capacity.
- Redesigning SEZs, to take account of the new constraints faced and to ensure that incentives affected by Pillar II are reformed. This will require rethinking the incentives

offered in these zones, to ensure that countries do not lose revenue while also ensuring that the incentives adopted are in line with international agreements and rules.

Despite these new constraints on the use of tax incentives, countries will continue to compete for FDI, to help them advance sustainable growth. Competition will spill over to a broad range of tax and non-tax incentives. Pillar II is not the end of the "race to the bottom"—but more the start of another round of competitive bidding for FDI, through measures that extend beyond the corporate tax realm.

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