Dalhousie University Schulich School of Law

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Tax Sparing: A Needed Incentive for Foreign Investment in Low-Income Countries or an Unnecessary Revenue Sacrifice?

Kim Brooks

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Low-income countries often offer tax incentives to induce foreign investment, but the effectiveness of these measures may be limited by the domestic tax practices of investors' high-income home countries. Most high-income countries provide a tax credit for the amount of tax paid to a foreign jurisdiction on the international profits of resident companies or individuals. Where no tax, or reduced tax, is paid to the foreign jurisdiction because of a tax incentive, the result is that the investor pays the same amount of tax they would have paid in the absence of the tax incentive, but simply pays a larger proportion of it to the resident (high-income) state. In other words, the tax incentive offered by the low-income country has operated as a revenue transfer from the treasury of the low-income state to the treasury of the high-income state. A tax sparing provision, included in a tax treaty negotiated between the two countries, preserves the tax incentive by reducing the tax owed to the high-income country by the amount of tax that would have been paid to the low-income country, but for the tax incentive. In theory, by incorporating tax sparing provisions into tax treaties with low-income countries, high-income countries assist those countries in their efforts to attract investment by protecting their ability to offer effective tax incentives. However, there has been much debate over whether these provisions are effective in practice.

The author outlines the history of tax sparing provisions in Canada, Australia, the U.K. and the U.S., and illustrates the early reluctance of these countries to follow the recommendations of international bodies regarding tax sparing. The OECD has opposed these incentives and has concluded they have long-term shortcomings: they are vulnerable to abuse, may erode tax bases and may fail to achieve their purported goal -- attracting investment to low-income countries. The author argues that despite some recent empirical evidence to the contrary, tax sparing provisions are ineffective in preserving tax incentives designed to attract foreign investment. She concludes that tax sparing provisions used to support tax incentives are an ill-designed mechanism through which to improve social and economic conditions in low-income countries. Cognizant that some low-income countries will continue to seek tax sparing provisions in their tax treaties, the author recommends design features of those provisions that should maximize their contribution to the development of the low-income countries while minimizing the potential for their abuse.

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Introduction: The Role of Tax Sparing

One of the most pressing needs to ensure more equitable development around the world is increased investment in low-income (capital-importing) countries. To attract private foreign direct investment (FDI), those countries frequently, indeed almost universally, offer tax incentives. Some high-income (capital-exporting) countries, including Canada, have attempted to facilitate the effectiveness of these incentives by agreeing to “tax sparing” provisions in their tax treaties with low-income countries.

*508 This paper argues that capital-importing countries should not seek to negotiate tax sparing provisions in their tax treaties, and that if they do ask for them, capital-exporting countries should not agree to them. This might seem like a surprising claim, given the admitted importance of private investment in achieving the urgent objective of raising the standard of living in low-income countries. Nevertheless, I argue that negotiating tax sparing provisions is an illustration of good intentions leading to bad results.

The remainder of this introduction explains the operation and significance of the concept of tax sparing. To place the discussion in its historical and contemporary context, Part I outlines the history of tax sparing provisions, and compares their use by tax treaty negotiators in the United Kingdom, the United States, Canada and Australia. Although many high-income countries used such provisions in their tax treaties with low-income countries between the 1970s and 1990s, in recent years these provisions have fallen somewhat into disfavour. Canada was the last of the four counties under review to agree to a tax sparing provision, and granted its most recent one in 2002. Part I concludes by reviewing the current position of the United Nations (UN) and the Organization for Economic Co-operation and Development (OECD) on tax sparing. Part II reviews the evidence on the effectiveness of tax sparing provisions in light of their intended purpose. Part III deals directly with the arguments for and against the use of tax sparing provisions and suggests that the adverse consequences of tax sparing provisions outweigh their benefits. Part IV goes on to examine the design features of tax sparing provisions and recommends that if they are included in tax treaties they should be tightly drawn.
For those uninitiated in the Byzantine world of tax treaties, what follows is a quick overview of how tax sparing provisions work, how in theory they might benefit capital-importing countries, and why, even if they operated as they should, they are likely not as important as they are often claimed to be. I will use Canada's tax treaty with Mongolia as an example. Although every low-income, capital-importing country faces unique problems, Mongolia's challenges are typical. In 2006, roughly 32 per cent of the Mongolian population lived below the poverty line. It is the least densely populated country in the world and has very little arable land and no significant access to water. The domestic food supply is limited, and meat products in particular are scarce. Much of the population remains nomadic or semi-nomadic. While Mongolia is rich in mineral resources, including copper, coal, molybdenum, tin, tungsten and gold, it has a desperate need for foreign capital, technology, know-how and markets to develop these resources.

In 1990, the Mongolian democratic revolution ended a 70-year period of Russian-dominated socialism. Since then, the Mongolian government has enacted a series of new economic policies, including tax and trade policies, in an effort to improve the economic and social environment. To provide foreign investors with some certainty as to the tax consequences of investing in Mongolia, and to remove any risk of being taxed in both Mongolia and in their home countries, Mongolia has negotiated 24 bilateral tax treaties since its first, with China, signed in 1991.

Mongolian treaty negotiators have commonly insisted on tax sparing provisions in their tax treaties; all but six of the country's 25 treaties include such provisions. In eight, the tax sparing provision is mutual -- in other words, Mongolia has granted a tax sparing provision to its trading partner and has received one in return. Mongolia's four most recent treaties, all signed after 1999, including one with Canada in 2002, include tax sparing provisions.

As an illustration of how a tax sparing provision works, assume a Canadian corporation sets up a gold mining operation in Mongolia and earns $100 of mining profits. Normally, if the Canadian corporation had sufficient presence in Mongolia, it would be subject to a tax on its mining profits at the Mongolian corporate tax rate of 25 per cent. However, since the corporation is resident in Canada, and therefore subject to tax in Canada on its world-wide profits, it would also be taxed in Canada on the $100 of profits it earns in Mongolia. Assuming the Canadian corporate tax rate is 35 per cent, it would have to pay $35 to the Canadian government in addition to the $25 tax it paid to the Mongolian government. It would thus be taxed twice on the same income. To avoid this result, Canada, like almost all countries, unilaterally grants its residents a tax credit for foreign taxes they pay on their foreign-source income. Therefore, the corporation's Canadian taxes of $35 would be reduced by the $25 paid to the Mongolian government in addition to the $25 tax it paid to the Mongolian government. It would thus be taxed twice on the same income. To avoid this result, Canada, like almost all countries, unilaterally grants its residents a tax credit for foreign taxes they pay on their foreign-source income. Therefore, the corporation's Canadian taxes of $35 would be reduced by the $25 paid to the Mongolian government, and it would in the end pay only $10 in Canadian tax. In effect, since Canada agrees to provide a tax credit for the Mongolian tax, the corporation will only have to pay tax at the same rate as if it had invested in Canada. Of course, Canada agrees to provide a tax credit for Mongolian tax only up to the maximum Canadian tax owing. If the Mongolian tax rate were higher than the Canadian rate, Canada would not refund the excess Mongolian tax.

In an attempt to attract foreign investment in its mining industries, Mongolia provides various tax incentives. From time to time it has even provided a complete tax holiday for new foreign investment in its natural resources sector. If the Canadian corporation's mining operations are able to benefit from one of these tax holidays, the corporation will pay no tax in Mongolia on its profits earned there. However, it will still be liable to pay tax to the Canadian government on its world-wide income. Therefore, it will owe $35 to the Canadian government. Since it paid no Mongolian tax, it will not be entitled to any amount as a foreign tax credit. Thus, even with the tax holiday in Mongolia, the corporation's overall tax position will not change. Instead of paying $25 tax to Mongolia and $10 to Canada, it will simply pay the full $35 to Canada. In effect, the incentive provision in Mongolia has simply served as a $25 transfer from Mongolia's treasury to Canada's. Obviously, in this case, the Canadian tax laws completely offset the effect of the Mongolian tax incentive. In such cases, the argument is that if tax incentives in capital-importing countries are to have their intended effect, a tax sparing provision is needed.
In short, tax sparing provisions preserve the tax incentives granted by one jurisdiction (normally a low-income jurisdiction) by requiring the other jurisdiction (normally a high-income jurisdiction) to give a tax credit for the taxes that would have been paid to the low-income country if the incentive had not been granted. In this example, since Canada and Mongolia have agreed, subject to certain conditions, that Canada will grant its resident a $25 tax credit for Mongolian tax, (even though Mongolia itself does not actually collect that $25 because, to attract foreign investment, it has created a tax holiday for foreign firms operating mining businesses there), Canada will receive only the $10 of tax it would have received if Mongolia had not granted this tax incentive for foreign firms, and the Canadian firm receives the full benefit of the Mongolian tax incentive.

Without getting into the staggeringly complicated details of how transborder income flows are taxed in most countries, it is important to provide some background on those tax rules to highlight the significance of tax sparing provisions. Generally, tax sparing provisions are not as significant as the above illustration suggests. In many cases, the foreign corporation pays no tax to its home country on the income it earns in the other country, or only pays the tax many years after earning the income, when the profits are repatriated to the home country.

In the illustration above, it was assumed that the Canadian corporation operated its mining business in Mongolia through a branch. However, the corporation might instead incorporate a subsidiary corporation in Mongolia to operate the business. In this case, the subsidiary corporation is not taxed in Canada since it will not be resident in Canada. Furthermore, when the profits it earns in Mongolia are paid back to its Canadian parent in the form of dividends, the dividends also will not be taxed in Canada, because Canada exempts from tax the business income of foreign affiliates of Canadian corporations earned in a country with which Canada has a treaty. In other words, tax sparing provisions are important to Canadian corporations when they operate in a foreign country through a branch, but not when they incorporate in the foreign country.

Tax sparing provisions are, in theory, more important in countries that do not exempt the business income of foreign subsidiaries of their corporations and instead have what is often called a “gross-up and credit system.” The United States, for example, taxes the business income of subsidiaries of U.S. corporations and provides a tax credit for foreign taxes paid when that income is repatriated to the U.S., usually in the form of a dividend paid to the parent corporation. In such countries, tax sparing provisions are more significant because when the income is repatriated, if no foreign taxes have been paid because of a tax incentive, the full resident country tax will have to be paid. However, even in those countries, a tax sparing provision might not be too significant. First, using the U.S. as an example, the U.S. tax is deferred until the income is repatriated, which in some cases might be indefinitely. This diminishes the importance of a tax sparing provision, often to the point of irrelevance, as the present value of the future tax liability might be close to zero. Second, instead of repatriating their foreign profits directly to the U.S., multinationals are often able to route payments through a third country that does not tax the income. Third, corporations that are repatriating profits from countries with tax incentives might be in what is referred to as an excess foreign tax credit position, meaning that the multinational has foreign tax credits from the country in which it earned the income which exceed its U.S. tax liability on that income. In these circumstances, a tax sparing provision is not required to preserve the effects of tax incentives in capital-importing countries.

Although tax sparing provisions may sound esoteric, and are little known outside the world of international tax specialists, much has been written about them since they first appeared in tax treaties in the 1950s. Commentators remain sharply divided on their merits. Some emphasize their importance to low-income countries, arguing passionately in their favour. Others adamantly oppose them, citing their futility, their potential for abuse and other perverse effects. Nevertheless, tax incentives continue to proliferate in low-income countries, and tax sparing provisions intended to preserve their effectiveness remain popular.
The central claim of this paper is that although tax sparing provisions may appeal to low-income countries that perceive themselves to be in a competition for badly needed foreign investment, those countries should resist the temptation to compete for investment by eroding their tax bases by introducing tax incentives preserved by tax sparing provisions. This topic remains vitally important because of the widely recognized need to rectify inequalities in standards of living between low-income and high-income countries and to alleviate poverty in low-income countries. If tax incentive programs can provide low-income countries with needed foreign investment that results in increased standards of living, and if tax sparing provisions can help these programs have that effect, surely high-income countries should be strongly encouraged to include such provisions in their tax treaties. However, if tax incentives protected by tax sparing provisions simply result in increased abuses of tax regimes in high-income countries, or in lost tax revenue for low-income countries without growth-enhancing and productivity-enhancing investment, surely such provisions should be abandoned.

As further justification for one more paper on tax sparing, the subject raises a number of the issues addressed in the broader literature on the appropriate design of international tax regimes. In the last several years, a number of tax scholars have turned to the question of how tax regimes might best be designed both to ensure the collection of taxes in an increasingly globalized world and to promote the development of tax regimes in low-income countries. This paper examines one small but important question within that broader debate: should countries preserve the tax incentives of other jurisdictions as a way of promoting development?

I. The Rise and Stall of Tax Sparing

A. The Genesis: U.K. Royal Commission on Taxation, 1953

Debates about the efficacy of tax sparing provisions have been ongoing since the provisions were first considered in the early 1950s. The first reported allusion to them can be found in the 1953 report of the British Royal Commission on the Taxation of Profits and Income. That Commission was asked by the Chancellor of the Exchequer to consider, on an urgent basis, whether special tax relief should be given where a United Kingdom resident had overseas profits and those profits were subject to special relief in the overseas jurisdiction. Although the question was narrowly posed to address the U.K. colonies, the Commission took on the broader question of whether “the taxation net [was] drawn too widely or too narrowly in relation to ... the taxation of United Kingdom residents (companies or individuals) on overseas profits.”

The ... particular difficulty is that the United Kingdom's present system of taxing overseas profits may involve this country (and the concerns which it taxes) in a position of embarrassment towards other governments by frustrating the tax policies of those governments with regard to their own territories. For instance ... the government of another area may provide special tax concessions for “pioneer industries” or industries it desires to encourage, e.g., a tax holiday for the opening years or very liberal allowance for amortisation or depreciation .... [T]he more it reduces its tax claims the larger is the balance left for the United Kingdom Exchequer. The area itself gets no benefit from this forbearance, and the concern which operates from the United Kingdom becomes the less attractive a concessionaire. Can it be right ... for this country to persist in a policy which has these results ...?

The Commission determined that some accommodation for tax incentives offered by overseas countries was appropriate for two reasons: first, Britain's responsibility for the economic development of its colonies, and second, the possible damage to Britain's external relations if it failed to take the problem seriously. Interestingly, the Com-
mission concluded that whether or not the overseas tax concessions were wise was unimportant given that they were in fact being offered. [FN16] It decided that the appropriate instruments for preserving tax incentives were bilateral agreements, and dismissed the idea of a general statutory provision out of fear that such a provision would be open to abuse. [FN17]

*517 In 1953 and again in 1956, the British Parliament debated the Commission's recommendation on the use of tax treaties to preserve overseas incentives. The focus of the 1953 debates was on the degree to which tax sparing provisions should be limited to Commonwealth countries or extended to include other countries in need of economic development. Although the urgency of the issue was stressed, the proposed clause was withdrawn for lack of consensus. [FN18] Three concerns dominated the 1956 debates: concerns about appropriate support for economic development in the colonial territories, about the ability of the U.K. government treasury to sacrifice revenues, and about the potential lack of competitiveness of U.K. investors overseas if other high-income jurisdictions (particularly the United States) took similar steps to protect tax holidays granted by the U.K.'s colonial territories. [FN19] In 1957, the Chancellor of the Exchequer put an end to the discussion by rejecting the Commission's proposal. [FN20]

In 1961, although not the first country to do so, the United Kingdom did ratify a tax treaty (with Pakistan) that included a tax sparing provision. [FN21] The U.K. has since been one of the most active jurisdictions in negotiating tax sparing provisions, [FN22] including them in *518 forty-seven of its tax treaties. However, since 1999, no new treaties have included tax sparing provisions.

It is difficult to say why the United Kingdom was historically so willing to agree to tax sparing provisions. Its colonial past may have led it to believe it had a paternal interest in preserving tax incentives offered by its former colonies or by countries with whom it had a close economic connection. For example, its treaties between 1970 and 1974 were with Barbados, Belize, Cyprus, India, Indonesia, Jamaica, Kenya and Kiribati/Tuvalu. Each of these countries, except Indonesia, has had a direct colonial relationship with Britain at some point, and although in the colonial era Indonesia was generally subject to Dutch rule, there was extensive British influence and trade in the region during that period.

B. Derailed in the United States, 1957

The first attempted use of a tax sparing provision in a tax treaty (and perhaps the most widely told tax sparing story) was the failed provision in the tax treaty between Pakistan and the United States. [FN23] Bolstered by statements made by President Eisenhower in 1955, [FN24] the U.S. negotiated a tax treaty with Pakistan in 1957 which gave U.S. domestic corporations a foreign tax credit for Pakistan taxes that would have been *519 paid were it not for Pakistan's special tax incentive legislation. [FN25] The Treasury Department was very supportive of U.S. efforts to conclude tax treaties with developing countries in the hope of building trade relations with some low-income countries during the Cold War.

The Pakistan treaty was considered before the Senate in July and August, 1957. Both the Deputy to the Secretary of the Treasury, Dan Throop Smith, and Professor Stanley Surrey were invited to speak to the Senate. Although Throop Smith was supportive of the tax sparing provision, [FN26] Surrey's remarks against the provision were powerfully phrased and included a warning to the Senators that tax sparing provisions were a clear break from previous treaty policy because they allowed a reduction not only of American taxes owing by foreigners, but also of American taxes owing by Americans. [FN27] Surrey went on to articulate a list of reasons against tax sparing. Among these, he argued that tax sparing provisions were counter to the approach taken in domestic tax legislation (enacted by Congress) that opposed any corporate tax concessions for foreign income; that once this concession was granted to one country, it would inevitably need to be granted to myriad other countries; that tax sparing provisions distorted the tax credit mechanism; that tax sparing provisions were largely unnecessary given the deferral advantages offered
to operations conducted in foreign jurisdictions in corporate subsidiary form; that tax sparing provisions encouraged irrational and unstable foreign country tax design; and that they rewarded and encouraged corrupt practices by foreign governments. [FN28]

Ultimately, the U.S. Senate was persuaded by Surrey and refused to ratify the tax sparing provision in the Pakistan treaty. Although the refusal to ratify was “without prejudice” for future treaties, the same story can be told about the U.S. tax treaties negotiated with India, Israel and the United Arab Republic in the 1950s, each of which included a tax sparing provision and failed to obtain Senate approval. [FN29] The negotiation of further tax treaties that would include tax sparing provisions was precluded by the appointment of Stanley Surrey to Assistant Secretary of the Treasury in 1961.

The United States Treasury Department has steadfastly maintained its position against tax sparing. [FN30] Despite this position, the U.S. does often agree, in an exchange of notes, to grant a tax sparing provision to countries with whom it negotiates tax treaties if it ever grants such a provision to another country in a subsequent tax treaty. [FN31] However, the U.S. has never entered into a tax treaty that contains a tax sparing provision, conveniently making the offer of no real substance. [FN32]

There are a number of possible explanations for the U.S.’s steadfast refusal to grant tax sparing provisions. First, Surrey’s opposition was highly influential. He was a widely recognized tax expert and many political players seem to have been willing to follow his lead. Second, as a former colonial state itself, the U.S. may feel little obligation to protect the economic interests of other states. Third, as a capital-exporting country, the U.S. has always taken a strong stance in favour of “investment at home.” Also, of course, because of its large potential capital-exporting position, the United States has greater revenue loss concerns than many other countries. Finally, its position on tax sparing provisions may reflect its general position in tax treaty negotiations: the U.S. has always been reluctant to grant any concessions to low-income countries.

C. A Reluctant OECD, 1963

Serious analysis of the problems raised by the potential for international double tax began as early as the 1920s. Most famously, the League of Nations commissioned four prominent public finance scholars to report on the issues. However, neither their report, [FN33] nor any of the subsequent reports issued by groups of technical experts, [FN34] explored the issue of whether one jurisdiction had any obligation to preserve the tax incentives provided by another jurisdiction. Over the years, the League of Nations and related international organizations produced a number of additional reports and model international tax treaties, but none addressed tax sparing. In the late 1950s, concerned about the effect of tax uncertainty on the increasing amount of international trade and investment, the international business community persuaded the Organization for European Economic Cooperation (the OEEC, later the OECD) to form a Fiscal Committee to explore the possibility of a uniform multilateral treaty that would avoid double taxation. In 1963, the work of the Fiscal Committee culminated in the publication of the draft OECD model bilateral income tax treaty.

Although at least some countries had included tax sparing provisions in their tax treaties by 1963 when the OECD released its first model tax treaty, the OECD did not explicitly endorse the practice in its model. However, the commentary to Article 23 of the 1963 model treaty -- the provision dealing with methods of relieving double taxation -- recognized that there may have been some cases where a developing state sought to grant tax incentives. In those cases, the model suggested that the developing country’s treaty partner might consider either exempting from tax the income from the activity that the developing country sought to encourage, or agreeing to a tax sparing arrangement that would give credit for the amount of tax that would have been paid had no relief been granted. [FN35] Under the commentary to Article 23, member states were free to settle the form of their tax sparing provi-
sions. Even in the face of their lukewarm endorsement by the OECD, some countries were quick to include tax sparing provisions in their treaties with low-income countries. Among them was the U.K., which in 1975 had at least ten treaties with tax sparing provisions.

Despite the increasing use of tax sparing provisions by many of its member states, with the notable exception of the United States, the OECD has never formally embraced the use of tax sparing in its model. In its 1977 revised model and commentary, the OECD enhanced its discussion of the use of tax sparing clauses in the commentary to Article 23, [FN36] becoming more explicit about the need to draft the tax sparing provision carefully and to delimit its scope. In particular, the OECD suggested three approaches to the design of the provision: (1) the residence state could grant a credit for the amount of the tax that would have been paid had the source state not waived the tax (classic “tax sparing”); (2) the residence state could give a credit for an amount of tax at a higher rate than that imposed by the source state (“matching credit”); or (3) the residence state could exempt the foreign income from tax. Also new in 1977 was the suggestion that the relief from residence taxation could be made subject to rate limits where the income subject to the incentive was dividends, interest or royalties, and the suggestion that tax sparing provisions might be subject to time limits.

On first review, it may appear curious that the OECD model convention did not embrace tax sparing provisions in its early days given that many OECD members were actively employing them in tax treaties. However, on further reflection, the OECD's reluctance may not be so surprising. At least some member states did not tax foreign-earned income, so tax sparing provisions were irrelevant for them. Also, the U.S. has always played a significant role in setting the OECD's tax policy, and its strong opposition, particularly in that era, must have had some effect. Finally, the OECD model convention was essentially drafted to apply between two high-income countries, and its effects on low-income countries, while always well-known, have never been seriously taken into account in its drafting.

D. Canada Embraces Tax Sparing, 1966

Although the OECD failed to wholeheartedly endorse the use of tax sparing provisions in its model treaty, various countries continued to include tax sparing provisions in their tax treaties with low-income countries. The late 1970s to the late 1990s were a high-water period. Canada ratified its first tax sparing provision in 1966 with Ireland. It ratified thirteen more from 1975 to 1979, [FN37] eleven from 1980 to 1984, [FN38] four from 1985 to 1989, [FN39] two from 1990 to 1994, [FN40] and eight from 1995 to 1999, [FN41] for a total of 39.

*524 It is not surprising that Canada was later than the U.K. in granting tax sparing provisions. Canada’s tax credit for foreign taxes paid was first introduced in 1919 for Commonwealth countries and countries who granted a reciprocal credit, and in 1944 it was extended to all countries (without the reciprocity requirement). [FN42] In contrast, until 1953, the U.K. provided only a restricted foreign tax credit for countries with whom it did not have a double taxation agreement. [FN43] Thus, for some time, Canada’s system for taxing foreign income was more generous than that of the U.K.

Nevertheless, Canada’s willingness to grant tax sparing provisions is somewhat surprising, as it provides a generous exemption for foreign active business income earned through a foreign affiliate. Indeed, in the same year that Canada granted its first tax sparing provision in a tax treaty, Alan Short, one of Canada’s long-standing tax treaty negotiators, argued that tax sparing was unlikely to be necessary since Canada already provided generous exemptions for dividends from foreign subsidiaries and affiliated companies. [FN44] Perhaps the willingness to grant tax sparing provisions can be explained by the likelihood that Canada would lose little tax revenue by their introduction given its comparatively small amount of foreign investment, its generous exemptions for foreign income and its historic role (particularly relative to its American neighbour) as a capital-importer. [FN45] This generally empathetic attitude toward the aims of lower-income countries is illustrated by the brief reference to tax sparing in the 1966
Report of the Royal Commission on Taxation. In noting that the proposal for the treatment of foreign income would “neutralize” tax concessions granted by low-income countries, the Commission suggested that tax sparing provisions might be used on a country-by-country basis through tax *525 treaties to assist low-income countries who seek to encourage legitimate investment. [FN46]

E. Australia Adopts Tax Sparing, 1967

Australia ratified its first treaty with a tax sparing provision in 1967 with Singapore. [FN47] Prior to 1975, tax sparing provisions were of limited importance in Australia, largely because it had an exemption system for foreign-earned income. However, in 1975, the Asprey Report by Australia's Taxation Review Committee recommended a move to a credit-based system. [FN48] The Report noted that the special tax incentives that some developing countries might provide to attract Australian businesses would be negated by this change in Australia's international tax policy. However, the Report concluded that tax sparing should only apply where the tax system was likely to provide better encouragement for the activity in question than any other possible mechanism, and that where a tax sparing provision was adopted, its design should be specific and explicit. [FN49] The fact that Australia has implemented tax sparing provisions in its treaties to a lesser extent than either the United Kingdom or Canada may be explained in part by its history as an *526 exemption jurisdiction, but perhaps also by the early cautions reflected in the Asprey Report. [FN50]

F. The United Nations Equivocates, 1980

Shortly after the release of the 1963 OECD draft model convention, the UN Economic and Social Council, concerned about the bias toward high-income countries inherent in that convention, began a study of the principles that should underlie tax treaties between developed and developing countries. In part to address some broad concerns about the implications that tax treaties based on the OECD model convention would have on the revenue base of low-income countries, in 1967 the Economic and Social Council of the United Nations established the Ad Hoc Group of Experts on Tax Treaties Between Developed and Developing Countries. That Group had representatives from ten developed and ten developing countries, [FN51] and it worked throughout the 1970s toward a UN model treaty. As documented earlier in this paper, there were clear differences of views about the efficacy of a tax sparing provision. In 1974, the Group concluded:

The problem of tax sparing was one of the important issues before this Group, which expressed strong support for this method, designed to avoid a nullification of incentives given by the host country to the foreign investor. However, the Group abided by the recommendation of the Secretariat that alternatives should be considered, because not all developed countries considered it appropriate to grant a credit for a tax spared. [FN52]

*527 The UN model treaty was released in 1980. Although it was designed to be more favourable to low-income countries, it did not go so far as to support tax sparing provisions. Indeed, the commentary of the UN model treaty simply adopted in its entirety the commentary on the 1977 OECD model treaty. [FN53]

The closest the United Nations came to endorsing tax sparing was in the observations to the 1980 UN model convention, which notes that “the most effective method of preserving the effects of the tax incentives and concessions extended by developing countries would be the application of a tax sparing credit.” [FN54]

When the draft UN model treaty was released in 1979, the absence of an express provision on tax sparing arrangements was interpreted by numerous commentators to reflect either a continued bias in favour of high-income countries or a failure of those countries to appreciate the distinct needs of low-income countries. [FN55]
The increased use of tax sparing provisions which had occurred through the 1970s, '80s and '90s, (at least in the United Kingdom, Canada and Australia) came to an end in 1998, when the OECD released a report on the subject. That report did not argue outright that tax sparing provisions should be abandoned, but it urged a reconsideration of their use for a number of reasons: the increase in standards of living in many non-OECD countries; the reported ineffectiveness of tax incentives in promoting foreign investment (as documented in the OECD’s 1995 report on the taxation of foreign direct investment); and a concern about the concessions that non-OECD countries had made to obtain tax sparing provisions (for example, reducing their withholding tax rates). After reviewing the arguments against tax sparing provisions, the OECD report made several recommendations for best practices in their use.

In the light of its 1998 report, in 2000 the OECD modified its commentary on tax sparing. While some of it remained the same, including that on possible methods of granting tax sparing, much of it was adjusted to reflect the conclusions of the 1998 report. In particular, the 2000 commentary warned that tax sparing is “very vulnerable to taxpayer abuse,” that it may not be effective in promoting development and that it may erode the tax bases of other countries. Finally, it recommended that tax sparing be used only where the economic level of the country to which the sparing is granted is significantly below that of the OECD country. Nevertheless, several non-member countries continue to assert their right to include tax sparing provisions in their treaties.

It is difficult to ascertain whether this reconsideration by the OECD led to a change in treaty negotiation policy on the part of such countries as the U.K., Canada and Australia, or whether changing attitudes in those countries about the effectiveness of tax sparing provisions led to the OECD reconsideration. The U.K. entered into its last treaty with a tax sparing clause in 1997, Canada in 2002 and Australia in 1999. Given the proximity of these dates to the release of the OECD’s 1998 reconsideration, it appears that the OECD’s initiative influenced the approach of those three countries, and not the reverse.

 Perhaps because of the influence of the OECD model and 1998 OECD report on the UN model itself, nothing on tax sparing was added to the 2001 revision and re-release of the UN model convention, despite the widespread use of tax sparing provisions by low-income UN member states in the 1980s and 1990s. Indeed, the commentary on tax sparing in the 2001 revision is identical to that in the 1980 UN model convention. As it had done before the release of the 1980 model convention, the UN Group of Experts simply decided that, because of its internal division of opinion about the effectiveness of tax sparing provisions, nothing on the matter would be added to the UN model treaty.

H. The Stall, 2000

The 1998 OECD report and the revisions to the model convention have clearly had a significant impact on member states' willingness to grant tax sparing provisions. As noted above, since the release of the report, Australia, for example, has not granted any tax sparing provisions in its tax treaties. Canada has taken the position that, generally speaking, it will not grant tax sparing provisions in its tax treaties, and where it does, a short sunset period will be applied. Indeed, Canada has granted only one tax sparing provision since 2000 -- to Mongolia -- with a three-year sunset period. Even the United Kingdom, despite its early enthusiasm, has not granted a tax sparing provision in a treaty since 1997.

Despite the emerging consensus among OECD countries against tax sparing provisions, many low-income countries and tax commentators continue to bemoan their absence from the international tax policy agenda of high-
income states. Although one might conclude that we are entering a period where their use is less likely, all it would take to reverse this trend is a proposal to end deferral on active business income of subsidiaries, a shift away from territorial taxation by some of the major OECD countries which continue to take that approach to defining their tax base, or a renewed intellectual commitment to increasing foreign investment in low-income countries through the use of tax incentives. These factors seem to have been the dominant drivers of countries' decisions to include tax sparing provisions in their treaties. A renewal of interest in tax sparing provisions is likely, given the OECD's tax policy studies report, issued in 2007, which suggests that tax incentives are more effective now than in the past.

II. The Case against Tax Incentives

The case for tax sparing rests squarely on the efficacy of business tax incentives in low-income countries. If such incentives are costly and do little to achieve the economic development objectives of those countries, it would be odd for high-income countries to negotiate tax treaty provisions that encourage their use. This part of the paper is divided into four sections. The first reviews the justification for tax incentives in low-income countries. The second refers to the theory and empirical evidence on their effectiveness in attracting foreign direct investment. The third enumerates the serious costs of enacting tax incentives. The fourth offers possible explanations for their continued popularity. The conclusion is that while there is some recent empirical evidence that tax incentives might be somewhat effective in attracting new investment, the costs they impose on low-income countries outweigh the benefits.

A. The Misguided Case for Tax Incentives for Foreign Direct Investment

(i) The Justification for Tax Incentives

In free market economies, the normal assumption is that the market will allocate resources to their most productive use -- that government interference with investment decisions, by favouring some investments over others, will impair the efficient allocation of capital and the long-run prosperity of the economy. However, even if this general proposition is accepted, supporters of tax incentives make a number of arguments in support of their use to correct market failures in low-income countries: that foreign direct investments generate positive externalities in those countries; that tax incentives are necessary to compensate for information inadequacies in their capital markets; and that tax incentives signal that the country is open for investment and compensate for deficiencies in the general investment climate. Since their purpose is to distort investment decisions, it is not a criticism of tax incentives to acknowledge that they do this. However, some justification must still be given for such distortions.

*533 (a) Positive Externalities

Some commentators argue that foreign direct investment in low-income countries should be subsidized because it has external benefits: that is, benefits beyond the rate of return earned by the investor. Thus, relying on the marketplace rate of return alone will not bring the optimal amount of such investment to those countries. In addition to supplying capital, it is claimed that foreign direct investment benefits the economy and local firms generally by, among other things, stimulating competition, increasing the skill level of workers, introducing new technologies and transferring knowledge on quality control and advanced management techniques. Tax incentives justified on this basis would typically include those given to the following types of projects: those located in less developed regions of a country, either to reduce congestion or pollution in the developed regions or to reduce income disparities; those which use advanced technologies and which could raise the general technological absorption capacity of a country; those which lead to the development of human capital; and those which involve research and development. In such cases, an economic justification in the classic Pigouvian tradition can be made for tax incentives as a corrective policy instrument.
The difficulty with this argument is that these positive spillover effects, although compelling in theory, are difficult to find in practice. As Dani Rodrik has noted, “Today's policy literature is filled with extravagant claims about positive spillovers from FDI but ... the hard evidence is sobering.” Also, even if such effects exist, to realize them would require the careful targeting of investments. At a minimum, the evidence suggests that to be effective in generating these externalities, such investment must be coupled with infrastructure development, stable political climates and an educated and healthy workforce. Finally, even to the extent that some positive externalities might be generated by such investment, there is a significant revenue loss involved in providing the tax incentives. This loss, and the other costs enumerated below, will very likely outweigh any positive spillovers.

(b) Information Inadequacies

It is sometimes also claimed that tax incentives are necessary to correct information inadequacies that lead to underinvestment in the economies of low-income countries, and which may cause markets to be incomplete because, for example, they result in liquidity constraints or distortions in labour markets. Such inadequacies may result from the fact that high-income country investors simply cannot see that investment in the low-income country would lead to a higher market return than investment elsewhere, or they may result from discrimination by those investors. Presumably the most effective way of combating investors' non-market biases against low-income countries is for high-income countries to provide accurate, unbiased information about the suitability of particular low-income markets, or to directly correct such biases in other ways. In addition, in a period of unprecedented capital mobility, it is hard to imagine that investors would not work hard to get sufficient information about foreign jurisdictions to know whether extra-normal rents might be earned from investment there.

(c) Compensating for Deficiencies in Investment Climate

Another common justification for tax incentives is that attractive fiscal benefits are essential to gain the interest of investors who are deterred by perceived adverse social and economic conditions in low-income countries. To some extent, tax incentives can offset the lack of infrastructure, complicated or antiquated laws, and bureaucratic complexities and weak administration in the tax area or elsewhere. If these are the reasons for insufficient foreign investment, the appropriate solution is to reform the existing laws and build the necessary administrative capacities and infrastructure. Because this is often easier said than done, tax incentives may seem necessary to provide temporary relief until the more fundamental reforms have been carried out. However, unless the investment climate disadvantage is relatively marginal, tax incentives are unlikely to counteract these negative factors.

(ii) The Effectiveness of Tax Incentives for Foreign Direct Investment: Theory and Evidence

The effect of tax incentives on foreign direct investment has been the subject of countless empirical studies of various types: econometric studies, surveys of corporate officials involved in investment locations decisions and case studies focused on the experience of particular countries with tax incentives. Even the synthesis and meta-analysis of the results of these studies has proliferated.

Traditionally, surveys of corporate executives and case studies have suggested that tax incentives are generally ineffective in attracting new investment. However, the results of the econometric studies are mixed. In an often cited survey of studies in the late 1990s, James Hines concluded that foreign investment was quite sensitive to tax policies. Other reviews of the same and more recent literature generally conclude that while there is some evidence that tax incentives attract investment, the size of the effect remains unclear. The effects of tax incentives on growth are notoriously hard to measure, in part because there are so many independ-
ent variables to control for. [FN83] Nevertheless, on the basis of this research, most international economic and aid organizations have opposed the use of tax incentives by low-income countries. [FN84]

*537 In theory, it is easy to see why tax incentives in low-income countries might have little impact on where multinationals invest. Multinationals invest in locations where they can earn the highest risk-adjusted rate of return. In any country, a myriad of factors influence the rate of return to direct investment, including these: the distance to major markets; the proximity to raw materials; the climate; the size of the local market; the quality of the infrastructure, particularly transportation, telecommunications, energy and water; the state of property and contract laws, which determine the costs of transacting; the extent of corruption, which in some low-income countries imposes a heavy implicit tax on business; the skill and reliability of the workforce, which in turn depends on good education and health services; the costs of complying with regulations and other government procedures, including the costs of dealing with inefficient civil servants and meddling government officials; and the extent of customs duties and other barriers to international trade.

The perceived risk of an investment depends on an equally long list of factors, including these: the macroeconomic stability of the country, including the inflation rate, the size of any budget deficit and the stability of the real exchange rate; the general security of property rights and the enforcability of contracts, which depend on an effective and unbiased police force and judicial system; the extent of bureaucratic discretion in law enforcement; the risk of financial crises brought on by inadequate regulation and supervision of the financial sector; whether capital and profits can be repatriated without restrictions; and whether *538 political stability is put at risk by the failure to respect human rights or the lack of participatory governance.

Because there are so many fundamental factors that might affect the expected rate of return and the risk of investing in low-income countries, tax laws are unlikely to be of overriding significance, particularly if they are certain, transparent, stable and fairly administered. Moreover, in view of the overriding influence of non-tax factors, tax considerations could at most affect only a relatively small number of marginal investments. It would be impossible to target a tax incentive only at those investments.

In specific cases, other factors further reduce the effect of tax incentives in encouraging investment in low-income countries. The natural resources and location of some countries means that multinationals are likely to be able to earn rates of return that are substantially above normal. In theory, so long as taxes do not completely erode these economic rents, they will not deter investment in those jurisdictions. Also, some businesses that invest in low-income countries will not be able to make full use of tax incentives because, for example, they have loss carryforwards, they will realize considerable start-up losses or their home country's tax system will neutralize the effect of the tax incentive. Moreover, if an incentive is to be of any benefit to an investor, it must increase the investor's after-tax profits. In some cases, that will not happen because the tax savings will be passed on to consumers of the end products in the form of lower prices or to suppliers of capital goods in the form of higher prices.

(iii) The Costs of Tax Incentives

Recent empirical studies suggest that tax incentives for foreign investment likely have some effect in attracting new investment. [FN85] Even if this is true, tax incentives impose a number of serious costs on the economy and the tax system of the low-income country -- costs that will usually dwarf whatever benefit they might bring to that country but which sometimes appear to be overlooked or discounted by the *539 authors of studies on tax incentives and by countries which enact such incentives. Therefore, those costs will be reviewed here in some detail.

(a) They Cause Revenue Losses
The most obvious and also most important cost of tax incentives is lost revenue. Most low-income countries face a critical need to enhance tax collections to finance urgent demands for public services, including those that everyone agrees are essential to economic growth and social welfare, such as education, health, public security, legal and judicial systems, and economic infrastructure.

It is occasionally argued that if properly structured, tax incentives will not lead to revenue loss -- that if a foreign investment which is attracted by a tax incentive would not otherwise have come, there is no direct revenue loss. This might conceivably be true where an investment would be equally viable in two countries with similar cost factors, and a tax incentive tips the balance in favour of one of them. Or it might occur where the investment would not be viable but for the tax incentive. However, it would be a rare case where a tax incentive provided the precise amount of subsidy required to attract an investment in either of those scenarios. It is more likely that an incentive will cover many cases, particularly highly profitable ones, in which the investment would have been made in the country for other reasons, without the incentive. In these cases, the revenue cost is the full amount of the foregone tax, which is a pure windfall to the multinational. In other cases, the incentive might be partly responsible for the investment, but is more generous than was necessary to attract it. In this case, the revenue cost is some portion of the foregone taxes.

In addition, all tax incentive programs have substantial indirect revenue costs. These costs arise from a number of sources: from the fact that tax-favoured firms might undercut the profitability of other producers who do pay taxes, by bidding away customers or bidding up the price of skilled labour and raw materials; from increased tax avoidance and tax evasion; from political pressure to extend the incentive (for example, to domestic firms); and from less effective tax collection because of the need to divert administrative resources to administering the tax incentives.

The revenue losses caused by tax incentives will, in most cases, make them counterproductive. If the loss is compensated for by cutting funding for public goods and services, it will reduce productivity in the long run. If it is made up for by higher taxes on other productive activities, it will impair growth in those areas of the economy. And if the government makes up the revenue loss through other sources of financing, such as increasing the deficit or printing money, the negative macroeconomic effects could easily overwhelm any positive effects of the tax incentives.

(b) They Foster a Sense of Unfairness

A significant cost of tax incentives results from the sense of unfairness they engender. Tax incentives for foreign direct investment invariably benefit large multinational corporations. Although tax-induced investments made by these corporations allegedly lead to a more productive and prosperous economy that benefits all citizens, to domestic taxpayers this link may be obscure. This is particularly true if the tax incentives mean that less revenue comes from corporate taxes and that more must be raised through regressive sales and excise taxes, which fall directly and immediately on individuals. Domestic firms will also undoubtedly feel discriminated against by tax incentives that benefit large foreign firms. Low-income countries often struggle to establish the legitimacy and acceptability of their tax system. Insofar as tax incentives reduce the perceived fairness of that system, they are likely to provide one more rationalization for taxpayers to cheat in reporting their income.

(c) They Introduce Unintended Economic Distortions

Tax incentives are intended to distort investment decisions by attracting more investment to the host country than it would otherwise receive. But even if there is some justification for this intentional distortion, tax incentives also have a number of unintended distorting effects that reduce efficiency and productivity.
• Tax-induced investments may discourage other investments that would have a higher rate of return were it not for the tax incentive. [FN88] If the incentives are given only to foreign firms, this might have the perverse effect of driving competing, more productive domestic firms out of business.

• Tax incentives frequently favour capital-intensive over labour-intensive investments, thereby reducing job creation.

• Because tax incentives frequently favour short-term over long-term investments, they tend to attract footloose projects that are less likely to lead to extensive knowledge transfer and to other beneficial spillover effects that can easily move elsewhere when the tax incentives run their course.

• To the extent that tax incentives lead to revenue loss and thus drive up the tax rates on other economic activity, they will cause distortions elsewhere in the economy that would not occur with a lower, equal tax rate.

*542 (d) They Provide Opportunities for Avoidance and Evasion

As is well known among tax analysts, almost any departure from a comprehensive tax base can lead to tax avoidance planning. Every type of tax incentive provides clear opportunities for tax avoidance gambits. Tax holidays are notoriously subject to company “churning,” “round tripping” and “income shifting.” If a particular tax holiday applies only to new firms and for only a limited time, existing firms will “churn” their assets by closing down part or all of their operations and establishing a new company that qualifies for the tax holiday. A similar strategy can be used when the holiday period expires for a particular company. If the holiday applies to only foreign firms, domestic enterprises will engage in “round tripping” by channeling their investments through holding companies incorporated in foreign jurisdictions with strict secrecy laws. If a corporation that is entitled to a tax incentive is related in some way to another corporation in the jurisdiction that is not entitled to the incentive, the latter corporation will arrange to shift its income to the former. Several well-known arrangements can be used for this purpose, including the manipulation of transfer prices on goods and services exchanged between the companies, inter-corporate loans at above-market rates, excessive management fees and royalty charges, and the sale and leaseback of depreciable property. [FN89]

If the tax incentives take the form of an upfront incentive-based, for example, on the cost of eligible property, firms will use transfer-pricing arrangements to increase the cost of the assets, they will use finance leasing and other arrangements to transfer the tax advantages to firms that can best use the incentive, and they will sell and purchase the same asset in order to produce multiple access to the incentive. The legislation governing the tax holidays can attempt to prevent these well-known tax avoidance strategies by drafting specific and general anti-avoidance rules. However, enforcement of such rules is extremely difficult, and is often beyond the limited resources of tax departments in low-income countries.

*543 (e) They Complicate the Tax System and Introduce Uncertainty

Multinationals report that one of the most important factors they consider before investing in a country is the predictability and stability of the tax system. If it is difficult to discern the precise rules, or if the rules are not stable, corporations will demand a greater risk return before investing. Moreover, potential investors look not only to their own tax liability, but also to the tax their competitors will pay. They will want assurances that competitors who may enter the market later will not be given tax benefits to which they themselves were not entitled. Complicated and uncertain tax systems also increase the cost of compliance and the incidence of conflict with taxpayers. Because tax incentives often turn on arbitrary and ambiguous distinctions and inevitably lead to a steady stream of anti-avoidance measures, they are a substantial contributor to increased complexity.
(f) They Consume Administrative Resources

The central task of tax departments in low-income countries should be to collect desperately needed revenue. Tax incentives impede this task in several ways. First, they divert the efforts of tax administrators toward delivering tax subsidies -- toward ensuring that applicants qualify for the incentives, that their activities are monitored and that tax offsets are correctly claimed. Second, the fact that different rules apply to different taxpayers complicates the interpretation of the legislation, the collection of tax return information and the ability to automate the tax system. Third, even where a corporation is entitled to a tax holiday, tax authorities still have to audit its books and records to verify that asset purchases, depreciation charges and other accounts are not improperly reported in a way that would lower its taxes after the holiday period. Finally, and perhaps most importantly, tax incentives consume administrative resources that must be devoted to preventing incentive-related tax avoidance activity. Given the difficulty of recruiting, training and retaining tax officials in low-income countries, it would seem imperative that the efforts of the most skilled members of the department be devoted to the central function of raising revenue, rather than to more peripheral tasks. [FN90]

(g) They Lead to Corruption

It is widely agreed that one of the most serious tax administration problems in low-income countries, and indeed one of the most significant barriers to development in these countries, is corruption. [FN91] Low-paid tax officials are often easy targets for taxpayers willing to engage in illegal transactions to reduce their tax liabilities. Tax incentives, which often involve substantial cash values, are an open inducement to bribery and corruption. Approvals are sometimes discretionary, and even when they are not, the criteria for eligibility are often vague and ambiguous. Moreover, tax returns are usually confidential, and the controls for verifying the work of auditors are weak. In a widely cited study of the determinants of foreign direct investments that focused on corruption, Shang-Jin Wei concluded that “an increase in corruption from the Singapore level to the Mexico level would have the same negative effect on inward FDI as raising the corporate income tax rate by eighteen percentage points.” [FN92]

(h) They Lead to Unproductive Rent-Seeking Activity

Because tax incentives can give rise to large savings, multinationals have strong motivation to lobby for their enactment. In fact, it has been observed that in many countries, tax incentives reflect the political strength of competing interest groups more than they reflect a dispassionate assessment of the economic costs and benefits. Once a particular incentive has been enacted, similar incentives tend to proliferate as other pressure groups lobby for similar treatment. In addition, political realities mean that even though incentives may initially be enacted for a limited time, they are usually extended because an identifiable and easily organized clientele will have a stake in their continuation and spread. [FN93]

As well as distorting economic policy, lobbying activities that seek to sustain or increase tax expenditures themselves represent a loss of economic efficiency because companies devote resources to seeking profit through political influence instead of through higher productivity and improved product quality. Tax incentives also distract policymakers and politicians from more difficult economic reforms, such as those needed for improved macroeconomic conditions, better infrastructure and a more highly educated and trained work force -- reforms that will have a larger impact on foreign investment in the long run. [FN94]

(i) They Lead to Wasteful Tax Competition

Low-income countries frequently claim that they must enact tax incentives for foreign investment in order to compete with other countries in their region. In his study of duty-free zones and special economic zones in central
and eastern Europe and the former Soviet Union, Alex Easson found the following:

Perhaps the most important influence on a country's policy toward the creation of special tax zones is what its neighbours are doing. As we have seen, the creation of special economic zones in Poland may have been a factor in Hungary's decision to establish further zones in its less-developed regions. Poland's actions may, in turn, have been taken as a response to the perception that Hungary's comparative success in attracting foreign investment was in part due to its more generous tax incentives. The Czech Republic is now contemplating the introduction of tax incentives, fearing that otherwise it will not compete with its neighbors. [FN95]

This kind of tax competition should of course be discouraged. It means that any new investment in a low-income country simply comes at the expense of other low-income countries, and that all are worse off. [FN96]

(iv) Explaining the Apparent Popularity of Tax Incentives

In spite of the costs of tax incentives, officials and politicians from low-income countries often appear to be their strongest supporters. They insist that such incentives are critical to the economic development of their countries. A number of obvious factors likely explain the popularity of tax incentives in low-income countries. [FN97]

- Multinationals put continuous pressure on developing countries to enact tax incentives. Moreover, multinationals negotiate with individual countries over tax incentives and may play those countries off against each other. A company that promises to locate in a particular country if it receives a tax break may merely be trying to improve its bargaining position with another country where it really intends to locate. Large accounting firms and other lobbying groups maintain a catalogue of incentives provided in each country, and they use this information to persuade neighbouring countries to offer similar incentives. When a multinational decides not to locate in a country, it can easily claim that the reason was a lack of tax incentives. Such stories of lost investment, and of incentives offered by neighboring countries, are likely to leave an indelible impression on local politicians.

- Foreign investment promotion agencies in developing countries often have an interest in the enactment of tax incentives. Those agencies are unlikely to bear the costs of the tax incentives, and their enactment may appear to legitimize an agency's work and increase its bureaucratic power.

- Because the real economic cost of tax incentives is difficult to measure and is usually not transparent, political resistance to their enactment is likely to be much less than to the enactment of alternative policy instruments.

- Factors that will undoubtedly increase foreign direct investment, such as creating a well-educated workforce and efficient infrastructure and reducing corruption, are very long-term goals, often far beyond the horizon for policy makers. Tax incentives, by contrast, can be enacted immediately and can make it appear that those politicians are coming to grips with current problems.

- The potential benefits of tax incentives are easy to understand, while their many costs are often indirect and hard to evaluate.

Given these factors, it is not surprising that bureaucrats and politicians in low-income countries champion tax incentives, in spite of their well-documented shortcomings.

III. The Case for and against Using Tax Sparing Provisions To Preserve Tax Incentives

The arguments above suggest that low-income countries should not enact tax incentives in an attempt to attract foreign investment. However, if they do, then a different set of considerations bear on whether they should try to maximize the effectiveness of these incentives by negotiating tax sparing provisions in their tax treaties. [FN48] This part of the paper reviews the arguments frequently made for and against tax sparing provisions.
A. Arguments Supporting Tax Sparing

(i) Levels the Playing Field for Multinationals

Multinationals often urge their high-income resident countries to grant tax sparing provisions so that when they invest in low-income countries, they are not disadvantaged compared to competitors resident in countries that do agree to such provisions. [FN98] If, for example, Canada agrees to a tax sparing provision in its treaty with Brazil, but the U.S. does not, the cost to investing in Brazil will be lower for Canadian investors than for American investors.

Although this argument is undoubtedly true, taxpayers investing abroad always incur relative advantages and disadvantages from their home jurisdiction's tax base and tax rate choices. Other factors are likely much more significant than tax sparing in giving a country's multinationals a competitive edge in international investment markets -- for example, its general tax treatment of foreign-source income and *549 foreign taxes; its allocation of interest and head office expenses; and its treatment of loans between affiliates, un-repatriated earnings, and research and development expenditures. If taken seriously, the argument suggests that whenever a multinational could point to a tax rule in some foreign country which gave it an advantage over the rules of its resident country, the rules of the resident country should be changed. The only logical end to this argument is no tax at all.

(ii) Avoids the Paternalism of Foreign Aid

If the tax that the capital-exporting country gives up through the operation of tax sparing provisions is regarded as aid to the capital-importing country, the argument can be made that it avoids the paternalism often inherent in direct grant programs for foreign aid administered by high-income countries. Direct aid or debt relief programs are well-known to have extensive reporting requirements and specific targets. In contrast, at least in theory, tax incentives preserved by tax sparing provisions can be designed, chosen and fully implemented by the low-income country without what might be seen as paternalistic interference by the high-income country. However, this is not so much an argument in favour of tax sparing provisions as it is an argument against attempts by high-income countries to use foreign aid programs to direct the growth and investment patterns of low-income countries.

(iii) Respects the Sovereignty of Low-income Countries

Some commentators argue that failing to provide for tax sparing in treaties curtails the sovereignty of low-income countries because it prevents them from offering tax incentives for foreign investment (or at least neutralizes the effect of such incentives). [FN99] There are two responses *550 to this argument. First, deciding not to support tax sparing provisions in a tax treaty is very unlikely to force low-income countries not to use tax incentives. In most cases, it will just reduce the incentive for enterprises operating in those countries to repatriate profits to their home jurisdictions. Second, refusing to put tax sparing provisions into tax treaties may actually enhance the independent decision-making capacities of low-income nations by making it easier for them to develop their international tax systems in a manner that best meets their domestic needs. Instead of feeling pressured by non-resident multinationals to provide targeted incentives, the low-income country may feel free, for example, to provide a lower tax rate for all domestic and international businesses. Finally, while the sovereignty of low-income countries should be respected, high-income countries also have the sovereign right to determine how they should tax their own residents. [FN100]

The sovereignty argument sometimes focuses on the symbolic value of tax sparing provisions -- their value as a signal to low-income countries that high-income countries respect their tax regimes and incentive programs.
However, high-income countries have a moral obligation to low-income countries to do much more than make symbolic gestures. If all high-income countries refused to grant tax sparing provisions, and otherwise fashioned their tax systems in a way that discouraged low-income countries from competing among themselves for foreign direct investment, the latter countries might have less fear of broadening their tax bases and raising their corporate tax rates closer to those of high-income countries. This would facilitate the revenue-raising aims of income tax systems in low-income countries, many of which rely largely on income taxes collected from foreigners. High-income countries that are serious about achieving economic and social equality between nations should worry more about advancing the revenue-raising capacity of low-income countries and less about preserving their own tax incentive decisions.

(iv) Maintains Neutrality between Tax Incentives and Direct Grants

Some argue that tax sparing provisions are necessary to maintain the equivalence between direct grants to foreign businesses by low-income governments and tax expenditures by those governments. Direct subsidies and tax subsidies are functional equivalents. Therefore, the tax consequences of receiving a direct subsidy should be identical to those of receiving a tax subsidy. However, unless foreign domestic tax regimes are altered, tax sparing provides a different tax result than a direct subsidy of the same amount. Generally speaking, if a low-income government provides a direct grant to a business operating in its jurisdiction, some portion of that direct grant is subject to tax, either because it is directly included in the taxable income of the business or because it reduces the cost of a depreciable asset to which the grant relates. If the corporation is resident in a capital-exporting country that provides a foreign tax credit, its taxes levied on the amount of the grant will be reduced by the amount of tax that was paid in the low-income country. If the low-income government provides the same grant through the tax system, and no tax sparing provision prevents high-income country taxation, then, generally speaking, the entire grant is taxed by the high-income country. Thus, without tax sparing, there is a significant after-tax difference between a direct grant and a tax expenditure. This interaction of the tax systems biases the low-income country in favour of direct grants. Many would argue that this bias at least runs in the right direction -- that countries should be encouraged to provide business assistance not by tax expenditures but by direct grants, for which they tend to be more accountable. More importantly however, tax sparing overcorrects for this bias. With tax sparing, the tax expenditure is completely free of the resident country's tax. In theory, to make the tax expenditure equivalent to the grant, the resident country should include the value of the tax expenditure in the corporation's income and provide a tax credit for any source tax paid. The tax outcomes could be made uniform with changes to the tax credit mechanism or with changes to the tax sparing mechanism, but in the absence of such reforms, tax sparing does not lead to a more neutral or equitable result.

(v) Necessary to Conclude Treaties with Low-income Countries

Finally, it is sometimes claimed that if high-income countries do not include tax sparing provisions in their treaties, low-income countries will not conclude treaties with them. The U.S. refuses to negotiate tax sparing provisions, and the fact that it has relatively few treaties with developing countries is often used to support this argument.

There are two reasons why this concern may not be significant. First, it is not clear that the refusal to negotiate tax sparing provisions has held up many tax treaties with low-income countries; other provisions are often more important to developing countries. For example, while tax sparing appears to have been a major issue delaying the tax treaty between the United States and Brazil, an equally important obstacle has been the tax treatment of fees for technical services. In other words, tax sparing is just one of many issues that must be resolved before a tax treaty can be concluded, and it is probably seldom (if ever) the deal breaker. Second, for at least some
countries, tax sparing may be of particular significance only in limited circumstances. For example, in the Canadian context, active business profits of a foreign affiliate earned in a country with which Canada has a tax treaty can be repatriated tax-free as exempt surplus, so tax sparing provisions to exempt this form of income are unnecessary. Moreover, it is much less important to low-income countries to negotiate a tax sparing provision with Canada than it is to conclude a treaty (either a tax treaty or a tax information exchange agreement) so that business income earned by Canadian corporations in those countries can be repatriated to Canada free of tax. [FN110]

B. The Arguments against Tax Sparing

In the section above, it was suggested that the arguments often given in favour of tax sparing provisions, and the reasons why high-income countries should be willing to negotiate them with low-income countries, are not particularly compelling. Even if one accepts that there is a case to be made for tax incentives in low-income countries, this section argues that tax sparing provisions create so many difficulties that they should not be negotiated.

*554 (i) Infringes Export Neutrality

There is a widely accepted international tax principle of capital export neutrality. Under this principle, there are reasons to provide particular incentives; a country's international tax rules should seek to provide an environment where its resident's investment decisions are made without tax bias in favour of domestic or foreign investment. [FN111] Although this principle of capital export neutrality is frequently violated, and no one would argue that it should be strictly applied, it provides the traditional baseline in thinking about international tax rules. But it is obviously infringed by tax-sparing provisions, and such an infringement requires justification. [FN112] The arguments in favour of tax sparing provisions would have to be compelling in order to overcome the principle of capital export neutrality.

(ii) Unnecessary

Although this point has been made a number of times above, tax sparing provisions are in most cases simply unnecessary. Tax incentives provided by low-income countries will in most cases be effective without a tax sparing provision for these reasons: they will benefit all multinationals resident in countries which tax international income on a territorial basis (as many European countries do); they will also benefit all multinationals resident in countries with exemption systems (like *555 Canada), if those multinationals incorporate a subsidiary in the low-income country; and they will provide a deferral to all multinationals resident in countries (like the U.S.) which defer tax on overseas income until that income is repatriated.

(iii) Provides Needless Tax Planning Opportunities

Tax sparing agreements are notoriously abused through aggressive tax planning strategies. Relieving enterprises that engage in particular types of activities from taxation when other activities are taxed inevitably gives taxpayers an incentive to characterize their activities as being among those that are tax-free. [FN113] Policing the boundaries of tax sparing provisions inevitably creates administrative burdens, both for the low-income country, which is bound to forgive a tax that would otherwise be payable, and for the high-income country, which will need to consider whether the enterprise properly qualifies for the incentive. Sunset periods on tax sparing provisions present additional policing problems and can result in the manipulation of payments to be made near the commencement date or termination date of the provision. For example, activities that would generate revenue immediately before the tax sparing clause comes into effect may be deferred, and activities that would generate revenue closely following its termination may be accelerated. This kind of timing manipulation is relatively easy to do, and it abuses the source country's tax regime.
(iv) Encourages Remittances Rather than Reinvestments

Tax sparing creates a bias in favour of the remittance of profits over reinvestment in the host country, and this encourages short-term investments. [FN114] Under most high-income country tax regimes, if the *556 income earned in the low-income country is business income earned through a subsidiary, and that income is not subject to a tax sparing agreement but instead is simply subject to a lower rate of tax in the low-income country, the investor has an incentive to reinvest the income in the low-income country. However, once investors are given the opportunity to repatriate profits and receive a tax credit for taxes not paid, that bias in favour of reinvestment is removed. Although the efficiency of such a bias might be questioned, presumably it makes more sense, as a mechanism for development, to encourage reinvestment in low-income countries.

(v) Subverts Sensible Treaty Negotiations

In order to obtain a tax sparing concession in a tax treaty, low-income countries may weaken their bargaining position on other aspects of the treaty, most often by granting high-income countries more favourable withholding tax rates and higher thresholds for taxation in the source country for a permanent establishment. [FN115] The trade-off between reduced source-base taxation and obtaining the ability to preserve source tax incentives was recognized almost as soon as high-income countries began negotiations with low income countries. [FN116] This *557 exacerbates the problem of reduced revenue for low-income countries. Not only do the low-income countries give up tax revenue by granting the tax incentive for which they require a tax sparing provision; in order to obtain that provision, they also agree to reduce withholding tax rates.

(vi) Conditioned on Negotiating Strength of the Low-Income Country

Granting one low-income country a tax sparing arrangement will undoubtedly encourage other such countries to seek similar arrangements with their treaty partners, thereby reducing the advantage any one country has. This inevitably discriminates against low-income countries that have neither the political nor the economic clout to press for tax treaties in the first place, even though they are likely the ones that most need to encourage investment in some fashion. [FN117] Indeed, a review of the countries that have been able to command a tax sparing provision with each of Australia, Canada and the United Kingdom reveals them to be middle-income countries, including Argentina, China, India, Malaysia, Malta, Papua New Guinea, Singapore and Thailand. Their effectiveness in commanding tax sparing provisions is likely a testament to their treaty negotiators' determination and to their importance as trading partners for the high-income countries.

*558 (vii) Tax Sparing Is an Inadequate Way to Support Low-Income Countries

Instead of agreeing to tax sparing provisions in their tax treaties with low-income countries, high-income countries should look for ways to prevent tax competition among low-income countries, and for ways to design their own international tax rules in order to assist tax collections in low-income countries.

IV. The Design of Tax Sparing Provisions

In spite of the strong arguments against the use of tax sparing provisions, some countries will undoubtedly continue to include them in their treaties. Therefore, this section reviews some of the detailed characteristics of tax sparing provisions and recommends design features that will help to achieve their purposes while minimizing their unfairness and limiting their abuse. [FN118] To illustrate the design of existing tax sparing provisions, reference will be made to the tax treaties of Australia, Canada and the United Kingdom.
A. Non-Reciprocal

When a tax sparing provision is properly constructed, it provides what is in effect a grant from a capital-exporting country to a taxpayer operating in a capital-importing country, to assist in the latter country's development. Therefore, tax sparing provisions should only be included in tax treaties between high- and low-income countries, and they should not be reciprocal. High-income countries should develop an explicit policy defining the circumstances under which they are prepared to negotiate tax sparing provisions and the types of low-income countries to which they are prepared to extend them. When high-income countries enter into tax sparing provisions with one another or with medium-income countries, such provisions simply facilitate erosion of the tax base and inter-country tax competition. None of the tax treaties entered into by Australia, Canada, or the United Kingdom contain reciprocal tax sparing provisions.

B. Types of Income Eligible for Tax Sparing

The focus of tax sparing provisions for Canadian and Australian tax treaty administrators has been to preserve incentives granted for business income. Of Canada's 37 tax treaties with tax sparing provisions, only seven provide tax sparing for passive income earned in the form of interest, royalties or dividends. [FN119] The equivalent figures for Australia are 14 and three. [FN120] The type of income that is subject to tax sparing is not ascertainable on the face of the treaties negotiated by the United Kingdom.

Tax sparing provisions should only be used to protect incentives that are necessary to the development of the particular low-income country. The OECD suggests that tax sparing should never be extended to tax expenditures relating to passive income, [FN121] but this seems to be too broad a restriction. Where manufacturing processes are an important import, the low-income country's tax concessions for royalty income might appropriately be the subject of tax sparing. Similarly, although interest income should rarely be the subject of tax sparing, there may be cases where it is unlikely to attract abuse and where loans may create real economic growth in the low-income country -- for example, where a non-financial business lends to a manufacturer in the low-income country.

The tax sparing provision should usually be restricted to business income, but some types of business income should not be covered. For example, tax incentives for the exploitation of natural resources in low-income countries are generally unnecessary, since the return to such exploitation usually contains a good deal of economic rent.

*560 C. Types of Eligible Taxpayers

The older treaties made by both Canada and Australia tend to permit both individual (or non-corporate) taxpayers and corporate taxpayers to rely on the tax sparing provision. Over time, however, both countries have tended to restrict such access to corporate taxpayers only. Presumably this move is designed to reduce possible abuses of the tax sparing provision, and to facilitate auditing. It would seem to represent best practice.

D. Specific Versus General Tax Sparing Provisions

Tax sparing provisions usually refer to specific legislated incentives for which the tax will be spared. Normally, the provisions allow for minor modifications in such legislation, and also allow the competent authorities to agree to grant tax sparing where provisions of a substantially similar character are enacted. All of the tax sparing provisions in the Australia and U.K. tax treaties refer to specific incentive legislation to which they apply. However, in nine of its tax treaties, Canada has agreed to a more general tax sparing provision which allows investors to benefit from tax sparing for a wide range of tax incentive provisions. The provision in Article 23.4 of Canada's treaty with Bulgaria
is illustrative:

[T]ax payable under the law of Bulgaria by a company which is a resident of Canada in respect of profits attributable to manufacturing, tourism and agricultural activities, exploration or exploitation of natural resources and construction or telecommunication projects carried on by it in Bulgaria shall be deemed to include any amount which would have been payable thereon as Bulgarian tax for any year but for an exemption from, or reduction of, tax granted for that year or any pan thereof under specific Bulgarian legislation to promote economic development .... [FN122]

*561 It would seem important that tax sparing provisions be restricted to specific incentive provisions (with minor modifications) in order to prevent abuse, to assist with oversight and to ensure that the particular incentive is one which both countries agree will provide benefits to the low-income country.

E. Limiting the Rates for Relief

Another concern is that granting a tax sparing clause will lead the low-income country to artificially increase its reported notional or not-collected taxes -- for example, to argue that the tax forgone is 40 per cent when realistically it would only have been 30 per cent. To avoid manipulation of the value of the tax sparing credit, the tax sparing provision should limit the rate of tax reduction that will be recognized. This would reduce the risk that the low-income country will abuse the provision by artificially increasing the rate of the underlying tax incentive or by “soaking up” the possible foreign tax credit.

F. Sunset Clauses

Treaty negotiators have often imposed time restrictions on the ability of investors to benefit from tax sparing clauses. Two approaches have been used. First, a time limit may be set that begins to run either when the treaty is signed or when it comes into force. This approach has become increasingly popular. In the United Kingdom, for example, of the 15 treaties with tax sparing provisions negotiated in the 1990s, eleven had time limits based on the date of entry into the tax treaty. Similarly, in Canada, of the eleven tax treaties negotiated during the 1990s and up to 2003, four included this kind of sunset period. While this does not sound like a high ratio, in fact all four of the Canadian treaties which have taken this approach to the sunset period were negotiated relatively recently. Australia has included some form of sunset period in all of its *562 tax sparing provisions, and of the 14 Australian tax treaties that include tax sparing provisions, all but three rely on this general approach. [FN123]

Second, some tax treaties limit how long a particular taxpayer may have access to the tax sparing provision. In other words, that provision may be invoked so long as the tax treaty itself is in force, but any particular taxpayer can only access it for a restricted period of time. This is the method commonly used in the United Kingdom, where in 29 treaties with tax sparing provisions, taxpayers' access to the provision is restricted to ten years, and in Canada where 23 tax treaties also include a ten-year restriction. No Australian treaty takes this approach.

If there is no time restriction on accessing a tax sparing provision taxpayers can benefit from it as long as the treaty is in force. Australia provides unlimited access to the tax sparing provision in three of its 14 treaties, Canada in eleven of thirty-seven, and the United Kingdom in only five of 46.

Despite the obvious attraction of sunset clauses in tax sparing provisions, they do create perverse incentives. If the time limit begins to run when the treaty is signed or takes effect, it creates an incentive to quickly repatriate profits out of the low-income jurisdiction. If the time limit is tied to a particular taxpayer, it creates incentives to set up “new” companies, [FN124] or to use transfer pricing to move profits between related companies. [FN125] Given the
difficulty of policing the boundaries between new investment and reinvestment, and as a concession to simplicity, tax sparing provisions should terminate upon notice by the high-income country (the low-income country can always repeal the legislation), and *563 such notice should have to be provided within a reasonable period of time (for example, three years). This would ensure that if circumstances change (for example, if a lower-income country becomes middle-income), each party to the treaty can terminate the tax sparing provision without needing to renegotiate the treaty. If the low-income country would like some certainty about the duration of the provision, a minimum term could be set in advance.

In any case, if the time limit for use of the tax sparing provision is short, it may provide an inadequate incentive to encourage new investment or reinvestment. The tradeoff between encouraging investors and incurring excessive losses to the treasury is one that each low-income country must weigh in designing its tax incentives, but if a tax incentive really is needed to attract a particular kind of investment, short time periods are unlikely to be effective. [FN126]

G. Anti-Abuse Clauses

A tax sparing provision should include an anti-abuse clause to deal with cases where foreign investors use it for tax evasion activities with no economic purpose. No treaties entered into by Australia, Canada or the United Kingdom include an anti-abuse clause specific to tax sparing.

H. Reporting Requirements

None of the treaties containing tax sparing provisions signed by Australia, Canada or the U.K. includes any requirement that the companies which benefit from those provisions, or the high-income government, must report on their use. High-income countries should have to monitor the actions of their investors in order to increase public accountability for the use of tax sparing provisions, since ultimately those provisions create a subsidy for the investor. Before agreeing to *564 them, investors should have to provide their home government with an accounting of the activities they will undertake, and an annual report of the activities that qualify for relief. High-income countries should be required to include the cost of tax sparing provisions in tax expenditure accounts.

Conclusion: The Quest for International Tax Policy that Assists Low-Income Countries

This paper has argued that tax sparing provisions may have their basis in good intentions, but that they can ultimately have bad results, among the most serious of which is the erosion of the tax revenue that low-income country governments badly need. Hopefully this analysis will contribute to the emerging literature on how high-income countries can design their international tax systems to facilitate the strengthening of tax bases and tax revenues in low-income countries. Supporting the ability of low-income countries to raise revenue is critical, and avoiding tax sparing provisions in tax treaties is one small step that high-income countries can take to that end.

[FN1]. Associate Professor, H. Heward Stikeman Chair in the Law of Taxation at McGill University. Senior Research Fellow in the Taxation Law and Policy Research Institute at Monash University. The author wishes to thank the participants at the Symposium in Honour of the late Alex Easson (Queen's University, Faculty of Law, 2008), the University of Western Ontario, Faculty of Law seminar series (2007), the James Hausman Tax Law and Policy Workshop (University of Toronto, Faculty of Law, 2006), the Canadian Law and Economics Association annual conference (2006), Karen Brown, Allison Christians and Diane Ring. The author is indebted to the Social Sciences and Humanities Research Council of Canada for their support through the standard research grant program and to San Jose State University's international tax policy fellow program. Thanks to Daniel Girlando, Blair Lowther and Morgan Troke for their research assistance.

[FN2]. See Mongolia’s treaties with Austria, Belgium, Bulgaria, Canada, Czech Republic, France, Germany, Hungary, India, Indonesia, Kazakhstan, Kuwait, Malaysia, the Netherlands, Poland, Singapore, Turkey, the United Kingdom and Vietnam.

[FN3]. See Mongolia’s treaties with Hungary, India, Indonesia, Kazakhstan, Kuwait, Malaysia, Singapore and Vietnam.


[FN5]. In one defence of the U.S. position against the use of tax sparing credits, David Rosenbloom asserted that “it is firm United States policy not to use tax treaties to accord tax sparing or other incentives for foreign investment .... Our response to developing country arguments that the United States should not invalidate their tax incentives is that United States statutory law (deferral, the dividend ordering rules, and the overall foreign tax credit) tends to preclude such invalidation.” H. David Rosenbloom, “Trends in Tax Treaties Between the United States and Developing Countries” in UN Draft Model Taxation Convention: Proceedings of a Seminar held in Copenhagen in 1979 during the 33rd Congress of the International Fiscal Association (Hingham, Mass.: Kluwer Law and Taxation, 1979) 18 at 19.


[FN7]. For a discussion of some of the circumstances where tax sparing plays no role, including the case where it plays no role because the parent company may be able to take advantage of excess foreign tax credits, see Alex Easson, Taxation and Technology Transfer: Key Issues, UNCTAD, 2005, UN Doc. UNCTAD/ITE/IPC/2005/9 at 38 [Easson, “Taxation and Technology”].


[FN11]. See Victor Thuronyi, “Recent Treaty Practice on Tax Sparing” (2003) 29 Tax Notes International 301 at 301, for an analysis of how many countries entered into tax treaties between 2000 and 2003 (the years following the release of the OECD report that cautioned against the use of tax sparing clauses) that contained tax sparing provisions. Thuronyi did not include the U.S. or other countries that typically exempt active business income, on the basis that tax sparing provisions are either not negotiated or are unnecessary in those jurisdictions. He determined that despite the OECD report, one third of recent treaties (33 of 107 treaties) contained a tax sparing provision.


[FN14]. Ibid.

[FN15]. Ibid. at 11.

[FN16]. Ibid. at 18.

[FN17]. Ibid.


[FN20]. See the review of this history as told by Stanley Surrey in his representations to the U.S. Senate in 1957: U.S., Double Taxation Convention with Pakistan: Hearing Before the Committee on Foreign Relations, 85th Cong., 2nd Sess. (1957), 9 Aug. 1957 at 7-8 [Hearing Before the Committee on Foreign Relations].

[FN21]. The first countries to include tax sparing provisions in their tax treaties were the Federal Republic of Germany (with India) and Sweden (with Israel), both in 1959. See H.W.T. Pepper et al., Tax Relief Provisions between Developed and Developing Countries, (12 EUR. TAX. 1/3), (1972); Harry A. Shannon III, “Tax Incentives and Tax Sparing” (1992) 2 Intertax 84; Mongolian Statistical Yearbook 2006, supra note 1 at 88. For an early review of the number of tax treaties with developing countries that included a tax sparing provision (between 1959 and 1976), see J, Chrys Dougherty, “Tax Credits under Tax Treaties with Developing Countries” (1978) 6 Int'l Bus. Law. 28 at 32-36.

[FN22]. After negotiating treaties with Israel and Portugal before 1970, the U.K. negotiated eight treaties that included tax sparing provisions between 1970 and 1974 (with Barbados, Belize, Cyprus, India, Indonesia, Jamaica, Kenya and Kiribati/Tuvalu), seven between 1975 and 1979 (with Bangladesh, Botswana, Egypt, Fiji, Spain, Sri Lanka and Sudan), nine between 1980 and 1984 (with China, Gambia, Mauritius, Morocco, Thailand, Trinidad and Tobago, Tunisia, Yugoslavia and Zambia), five between 1985 and 1989 (with Bulgaria, Ivory Coast, Nigeria, Pakistan and Turkey), seven between 1990 and 1994 (with Ghana, Guyana, Malta, Mexico, Papua New Guinea, Uganda and Vietnam), and eight between 1995 and 1999 (with Argentina, the Falkland Islands, Korea, Lesotho, Malaysia, Mongolia, Singapore and Venezuela).


[FN24]. In his economic report to Congress, President Eisenhower stated: “Under proper safeguards, we should be prepared to give full credit for income taxes that are waived by a foreign country for a specified initial period, just as we now grant credit for taxes that are imposed. This change would give maximum effect to the laws of other countries designed to encourage new enterprises.” (Cited in the statement of Dan Throop Smith in Hearing Before the Committee on Foreign Relations, supra note 20, 9 Aug. 1957 at 52).

[FN25]. For a thorough discussion of this particular tax incentive, see Joseph P. Crockett, “‘Tax Sparing’: A Legend Finally Reaches Print” (1958) 11 Nat'l Tax J. 146 at 149-53.

[FN26]. See the testimony of Dan Throop Smith, Deputy Minister of the Secretary of the Treasury in the Hearing before the Committee on Foreign Relations, supra note 20, 30 Jul. 1957 at 11-14.

[FN27]. For a discussion of the influence of Stanley Surrey on U.S. international taxation throughout the 1950s, '60s and '70s, including a brief note on his “crusade against tax sparing,” see Stanford Ross, “A Perspective on International Tax Policy” (1985) 26 Tax Notes International 3.


[FN31]. See e.g. the exchanges of notes with China, India, Israel, Kazakhstan, Malta, Morocco, Thailand, Tunisia and Ukraine. This exchange of notes was apparently critical for the conclusion of the China-U.S. tax treaty. See Paul D. Reese, “United States Tax Treaty Policy Toward Developing Countries: The China Example” (1987) 35 UCLA L. Rev. 369 at 389-98.

[FN32]. But see Charles I. Kingson, “The Coherence of International Taxation” (1981) 81 Colum. L. Rev. 1151 (describing some of the United States' earlier arrangements, with Puerto Rico, Brazil and Mexico in particular, as akin to tax sparing).


[FN35]. The commentary on tax sparing in the 1963 model convention is included at paras. 47-51.

[FN36]. The revised and enhanced commentary was included at paras. 70-76 of the 1977 OECD commentary. Paragraphs 70-72 were essentially the same as paras. 47-49 of the 1963 commentary. However, paras. 73-76 were altered.

[FN37]. Canada's treaty partners were the Dominican Republic, Indonesia, Israel, Jamaica, Korea, Liberia, Malaysia, Morocco, Pakistan, Philippines, Romania, Singapore and Spain.

[FN38]. The treaty partners in this period included Bangladesh, Barbados, Brazil, Cameroon, Cyprus, Egypt, Ivory Coast, Kenya, Thailand, Tunisia and Zambia.

[FN39]. The countries in this period were China, Guyana, Malta and Papua New Guinea.

[FN40]. The two countries in this period were Argentina and Nigeria.

[FN41]. These countries included Algeria, Bulgaria, India, Latvia, Lithuania, Tanzania, Trinidad and Tobago, and Vietnam.


[FN47]. Australia has entered into thirteen in total. One in 1975-1979 (with the Philippines), three more between 1980 and 1984 (with Malaysia, Malta and South Korea), four between 1985 and 1989 (with China, Papua New Guinea, Sri Lanka and Thailand), four between 1990 and 1994 (with Fiji, India, Kiribati and Vietnam), and one between 1995 and 1999 (with Argentina). For an early Australian review of the need for tax sparing provisions (and more specifically for their lack of usefulness in Australia’s then-exemption system), see David Flint, “Tax Sparing: Australia and Developing Countries” (1980) 9 Australian Tax Review 150.


[FN49]. Ibid. at paras. 17.34, 17.35.

[FN50]. Ibid.

[FN51]. Argentina, Brazil, Chile, France, the Federal Republic of Germany, Ghana, India, Israel, Japan, the Netherlands, Norway, Pakistan, the Philippines, Sri Lanka, Sudan, Switzerland, Tunisia, Turkey, the U.K. and the U.S. comprised the group of twenty countries. There were also several observing countries, including Austria, Belgium, Finland, the Republic of Korea, Mexico, Nigeria, Spain, Swaziland and Venezuela, and several observing organizations, including the International Monetary Fund, the International Fiscal Association, the Organisation for Economic Cooperation and Development, the Organization of American States and the International Chamber of Commerce.

[FN52]. Department of Economic and Social Affairs, Guidelines for Tax Treaties Between Developed and Developing Countries, UN DESA, 1974, UN Doc. ST/ESA/14 at 12.

[FN53]. Commentary to Article 23 of the 1980 UN model tax convention.

[FN54]. Observations to Article 23 of the 1980 UN model tax convention. The observations to Article 23 also note the view of “a developed country,” which strongly opposed tax sparing. In his monograph on the United Nations model, Stanley Surrey speculated that this country was the United States: Stanley S. Surrey, United Nations Model Convention for Tax Treaties Between Developed and Developing Countries: A Description and Analysis, vol. 5 (Amsterdam: International Bureau of Fiscal Documentation, 1980) at 53. As Surrey was one of the U.S. members on
the Group of Experts (Nathan Gordon was also present), it would be surprising if his speculation about the country
most opposed to tax sparing was incorrect. Indeed, one suspects that Surrey's strong views on the issue of tax spar-
ing had a telling influence on the ultimate inability of the Group of Experts to come to a consensus on the use of a
tax sparing provision in the UN model.

*Seminar held in Copenhagen in 1979 during the 33rd Congress of the International Fiscal Association* (Deventer,
Needs of Developing Countries with Special Reference to the UN Draft Model” in *Copenhagen 1979, ibid.*, 27 at
30; L.J. Griffioen, “Trends in Treaties Between European Countries and Developing Countries” in *Copenhagen
1979, ibid.*, 22 at 24; N.M. Qureshi, “Tax Treaty Needs of Developing Countries” in *Copenhagen 1979, ibid.*, 31 at
38-39; Wolfgang Ritter, “Requirements of Developed Countries from Double Tax Treaties with Developing Coun-
tries” in *Copenhagen 1979, ibid.*, 42 at 45.


[FN57]. This reported context is entirely questionable, given: (1) the concern articulated by the UN in 2000 about
the ever-increasing inequality between countries that sparked the development of the Millennium Development
goals; (2) evidence (largely post-1995) that some tax incentives are effective in some specific cases; and (3) the fact
that the OECD's model tax treaty itself deprives source countries of much-needed revenue by, for example, suggest-
ing a zero withholding tax rate on royalties.

[FN58]. See *OECD Report, supra* note 56 at 21-30: In Part IV of its Report, the OECD raises the following objec-
tions to the use of tax sparing provisions: that they can create inequities between high-income country investors; that
they lack many of the control benefits of direct foreign aid programs; that they encourage repatriation of profits; that
in many cases tax sparing provisions are unnecessary since the high-income country does not subject the source
country income from tax: that evidence suggests that tax incentives are largely ineffective; that the underlying tax
incentives introduce unnecessary complexity and avoidance opportunities into the source country's tax system; that
tax incentives encourage inter-jurisdictional competition; and that tax incentives encourage lobbying from non-
incentivized businesses.

[FN59]. The OECD's discussion of best practices and related recommendations is set out in Parts IV and V of its
Report. See *ibid.* at 35-43.

(Paris: OECD, 2000) at 232-33 [*2000 OECD Model Convention*]. The revised commentary is reflected in paras. 72-
78.1 of the *2000 OECD Model Convention*. Paragraphs 72-74 mirror the opening paragraphs of the 1977 commen-
tary. Paragraphs 75-78.1 provide the “new” commentary based on the 1998 OECD Report.


The Non-Member Countries’ Positions on the July 2008 condensed version of the OECD Model Income and Capital Tax Convention include reservations to Articles 23A and 23B on the right to add tax sparing provisions or matching credits from Albania, Argentina, Brazil, China, India, Ivory Coast, Malaysia, Serbia, Thailand, Tunisia and Vietnam: OECD Committee on Fiscal Affairs, Model Tax Convention on Income and on Capital: Condensed Version (Paris: OECD, 2008) 375-409.


See the commentary to Article 23 of the 2001 UN model: Department of Economic and Social Affairs, United Nations Model Double Taxation Convention between Developed and Developing Countries, UN DESA, 2001, UN Doc. ST/ESA/PAD/SER.E/21 at 264.


In one study, the authors found that offering tax incentives acted as a signal for a favourable investment climate. See Horst Raff & Krishna Srinivasan, “Tax Incentives for Import-Substituting Foreign Investment: Does Signaling Play a Role?” (1998) 67 Journal of Public Economics 167. This signal may be of value to a particular country, but not in the long run if it results in other countries responding by sending the same signal.


Obviously, Professor Brown's proposal would create a bias in favor of developing country investment over U.S. investment and a bias in favor of locating FDI in developing countries versus other industrialized countries. As a result, there could be efficiency losses, with resulting adverse effects on worldwide welfare. These biases, of course, are exactly the ones that Professor Brown seeks to create. If change did not create such distortions, the exercise thereof is a waste of time and, perhaps, revenue. So for those agreeing with her objective, arguments that the proposal will result in losses in worldwide welfare may be true, but irrelevant.


Dani Rodrik, The New Economy and Developing Countries: Making Openness Work (Baltimore: Johns Hopkins University Press, 1999) at 37.

[FN76]. See e.g. Alex Easson, “Tax Incentives for Foreign Direct Investment -- Part I: Recent Trends and Counter-trends” (2001) 55 Bulletin for International Fiscal Documentation 266 at 272 [Easson, “Tax Incentives -- Part I”]. Easson reported that in Liberia, the costs of establishing the infrastructure for an export-processing zone were $15 million, but that that expenditure resulted in only 50 jobs and $650,000 investment.

[FN77]. Robin Boadway & Anwar Shah, *How Tax Incentives Affect Decisions to Invest in Developing Countries*, Policy Research Working Paper 1011 (Country Economics Department, The World Bank, 1992) at 14-25. The authors reviewed a large number of possible market failures that might be rectified by the use of tax incentives by developing countries, including: the existence of intergenerational externalities resulting from the provision (or non-provision) of public goods; incomplete markets because of liquidity constraints; incomplete markets because there is insufficient provision of markets for risk; information asymmetries; distortions in other markets (for example, in the provision of labour); and because of failures in government policy consistency.

[FN78]. See e.g. the historic bias against entering into tax agreements with sub-Saharan African countries identified by Karen B. Brown in Brown, “Missing Africa,” supra note 8.

[FN79]. Haroldine Wunder, “The Effect of International Tax Policy on Business Location Decisions” (2001) 24 Tax Notes International 1331. The author surveyed 75 of the Fortune 500 companies about the factors that informed their investment location decisions and found that only four of the 75 identified tax as the most important variable, with most reporting that non-tax factors dominated their decision-making.

[FN80]. See e.g. Antonio Estache & Vitor Gaspar, “Why Tax Incentives Do Not Promote Investment in Brazil” in Anwar Shah, ed., *Fiscal Incentives for Investment and Innovation* (New York: Oxford University Press, 1995) 309 at 310. After reviewing the tax incentives introduced in Brazil, the authors conclude that they “have led to complex, inefficient, and largely evaded taxes on capital, yielding little revenue and not increasing investment.”


in its 2003 investment report, which identifies six kinds of undesirable consequences associated with the granting of FDI incentives, such as “offering incentives to transnational corporations that would have invested anyway, so the incentive is a mere transfer from governments to companies (or, in some circumstances, to the treasuries of the home countries).” The report asks if those incentives are worth the cost. The answer appears to be clear -- at least among economists (as opposed to politicians), there is an emerging consensus that countries should try to attract FDI not by offering incentives, but by building genuine economic advantages and offering stable, low and transparent tax rates. See also OECD, “Checklist for Foreign Direct Investment Incentive Policies” (Paris: OECD, 2003) at 22: “[I]ncentives are hardly ever a first-best option. Significant improvements of the enabling environment for investment (e.g. the removal of undue impediments and improvement of regulatory frameworks) can often be achieved at a low budgetary cost and should be considered ....”; World Bank, Global Economic Prospects 2003: Investing to Unlock Global Opportunities (Washington, D.C.: The International Bank for Reconstruction and Development/The World Bank, 2003) at 77, online: <http://sitesources.worldbank.org/INGEP2003/Resources/gep2003complete.pdf>. According to that World Bank report, “countries try to use specific investment policies, such as tax incentives, to attract investment or to channel it in particular directions. Such schemes are often poorly designed, inadequately implemented, and costly, and may largely benefit investors who would have invested anyway.”

[FN85]. See e.g. OECD 2007 Report, supra note 70.


[Tax sparing] has been subject to the criticism that although providing a general incentive, tax sparing does not present the encouragement to continuous reinvestment of earnings provided by deferral combined with taxation of remitted earnings .... From the developing countries' own interests, it is difficult to limit the exemption to capital from abroad, but if applied to all capital the exemption results in a loss of tax revenue which the developing countries can ill afford. Furthermore, widespread use of profits tax exemptions, as in all cases of tax competition of this sort, may result in insufficient gain in foreign capital to offset the revenue loss.

[FN87]. The distortionary effect of particular tax incentives will obviously depend upon their precise design features.

[FN88]. In a frequently-cited example, Chad Leechor illustrated how tax incentives could cause the most productive sector in a low-income country's economy to become the one with the lowest after-tax rate of return. Chad Leechor, Tax Policy and Tax Reform in Semi-Industrial Countries, vol. 13, Industry and Finance Series (Washington: World Bank, 1986).

[FN89]. For a discussion of these avoidance and evasion strategies in the context of tax sparing, see OECD Report, supra note 56 at 28-30.

[FN90]. See Howell H. Zee, Janet G. Stotsky & Eduardo Ley, “Tax Incentives for Business Investment: A Primer for Policy Makers in Developing Countries” (2002) 30 World Development 1497 at 1501 (“The more scarce resources are devoted to administering tax incentives, the more other important administrative tasks would be impaired -- thus jeopardizing tax collection as a whole ....”).

[FN91]. See e.g. Morisset & Pirnia, supra note 73 at 3.

[FN93]. Michael Porter, The Competitive Advantage of Nations (New York: Free Press, 1990) at 666. Porter says that the idea of a “temporary” subsidy or protection is an oxymoron, because “it becomes an addictive drug” that creates a strong political dynamic to preserve the benefits.

[FN94]. Treaties Between Developed and Developing Countries: Sixth Report, Department of Economic and Social Affairs, UN Doc. ST/ESA/42 [UN Tax Treaties, Sixth Report].


[FN96]. Competition between developing countries was one of the concerns of the UN Group of Experts in their discussions leading up to the release of the 1980 UN model convention. At their sixth meeting, the Group reported, “there is the need for developing countries to agree among themselves, at least on a regional basis, as to how far they are willing to go in generating tax incentives. Such agreements might reduce some wasteful competition among the developing countries.”: UN Tax Treaties, Sixth Report, supra note 94 at 57.


[FN98]. Even in the earliest discussions of the usefulness of tax sparing provisions, business lobby groups supported their enactment. See the representations of Mitchell B. Carroll, tax counsel to the Tax Committee of the National Foreign Trade Council of New York (a trade association composed of American corporations and individuals interested in trading and investing abroad) in the 1957 Hearing Before the Committee on Foreign Relations, supra note 20, 9 Aug. 1957 at 34-49. See also Arthur Andersen & Co., Tax Sparing -- Should the United States Adopt such a Concept as a National Policy? (Chicago: Arthur Andersen & Co., 1981) at 15-16 (“We believe the no tax-sparing policy previously followed by the U.S. government should be reconsidered by the Administration and Congress, and a policy of highly selective tax-sparing should be adopted through the tax treaty mechanism.”); International Chamber of Commerce, “Policy Statement: Tax sparing in tax conventions” (1 December 2005) (Doc. 180-486) at 4 (the ICC concludes that “developed economies should, in principle, accept tax sparing in bilateral conventions with developing countries ....”). See also B. A. Billings & G. A. McGill, “Tax Sparing on U.S. Multinationals” (1990) 48 Tax Notes 615; Darcy, supra note 8. (Billings & McGill and Darcy all base their argument in favour of tax sparing almost entirely on the competitive bias against U.S. firms, who are unable to access tax sparing opportunities available to investors in other countries.)

[FN99]. See e.g. Oh, supra note 8 at 56-57. Some developed countries also take the position that tax sparing should be offered on the basis of comity. See e.g. the position of Germany as reflected by Shannon, supra note 21 at 89. See also the comments of Dan Throop Smith, Deputy to the Secretary of the Treasury, in his statement to the U.S. Senate during the 1957 hearings: Hearing Before the Committee on Foreign Relations, supra note 20, 9 Aug. 1957 at 54.

Dan Throop Smith relied on the symbolic value of tax sparing provisions in his reply to Stanley Surrey's concerns in the 1957 Senate hearings (“But [tax sparing] has symbolic value. It has overtones in terms of international attitudes toward investments .... tax sparing of this sort in many instances [does] not actually go much further than was already possible under our law insofar as operations through subsidiaries are involved. It nonetheless has a significant symbolic value.”) See Hearing Before the Committee on foreign Relations, supra note 20, 9 Aug. 1957 at 55.

This incentive has long been recognized. See e.g. Organization of American States, Some Aspects of International Double Taxation Between Developed and Developing Countries (Technical Document, Washington, 1970) at 31.

Laurey, supra note 8 at 490 (“A tax holiday is the functional equivalent of a direct government grant and should be treated as one.”).

A similar point in the context of the operation of the foreign tax credit generally is made by McDaniel, supra note 72 at 274-75.

See e.g. the proposal put forward by McDaniel, ibid. at 275-76.

See e.g. the proposal put forward by Shannon, supra note 21 at 93-96.


Mitchell, ibid.

If there are cases where the failure to negotiate a tax sparing clause may be a deal breaker, those cases may well be diminishing. See e.g. the position of India as reflected in the comments of O.P. Vaish, “Double Tax Conventions Between Industrialised and Developing Countries: India's Experience” in Double Taxation Treaties Between Industrialised and Developing Countries; OECD and UN Models, a Comparison (Boston: Kluwer Law and Taxation Publishers, 1992) at 24-25.

See David R. Tillinghast, “Tax Treaty Issues” (1996) 50 U. Miami L. Rev. 455 at 477. Not only would it not be feasible to limit tax sparing to Latin American countries, given the U.S. commitment to providing tax sparing to a number of jurisdictions should it be granted to one (reflected in the exchange of notes discussed in supra note 31), it would be impossible.
In their testimony before the Subcommittee on Oversight of the House Ways and Means Committee in 1980, Rosenbloom & Langbein noted their continued objection to “using” tax treaties to favor foreign investment over domestic investment ....”: Rosenbloom & Langbein, supra note 2-3 at 392.

For a thorough review of the possible abuses afforded by tax sparing provisions, see Toaze, supra note 9 at 908-14.

It is this feature of tax sparing arrangements that led Peggy Musgrave to argue that in many cases a credit-with-deferral mechanism for the taxation of earnings in low-income countries would better serve low-income country interests. See Peggy Musgrave, “Coordination of Taxes on Capital Income in Developing Countries” in Tax Policy in the Global Economy: Selected Essays of Peggy B. Musgrave (Cheltenham, U.K.: Edward Elgar, 2002) 368 at 385. See also the memorandum prepared by Stanley Surrey and submitted as part of the Senate hearings in Hearing Before the Committee on Foreign Relations, supra note 20, 9 Aug. 1957 at 29. See also Alex Easson, Taxation of Foreign Direct Investment: An Introduction (Cambridge, Mass.: Kluwer Law International, 1999) at 78.


[A] pattern of modification to the standard form treaty [the OECD Model] is emerging in which the conflicts between the capital-poor and capital-rich countries can be settled. A basis of negotiation is being found in the area of investment incentives. Even though bilateral tax agreements may involve revenue sacrifices, the developing countries are displaying an interest in such agreements where the advanced country agrees to a special incentive provision designed to stimulate the flow of private investment. The basis of negotiation reflects the developing countries' need for development capital and their willingness to reduce taxes to obtain it.

See also the statements of Dan Throop Smith in the Hearing Before the Committee on Foreign Relations, supra note 20, 30 Jul. 1957 at 13: “Also, and of at least as much importance, we think this should be done only by treaty, because it is a significant bargaining point, a basis for concessions, getting concessions from the other countries.”

It is perhaps not surprising that lower-income countries with more economic clout have found it possible to consistently command tax sparing provisions in their tax treaties. China provides a good example -- and not surprisingly Australia, Canada and the United Kingdom have all granted it tax sparing provisions. Several articles on China's international tax system have touched on this element of China's international tax policy, including Jinyan Li, “China's Tax Treaties and Their Impact on Foreign Investment” (1995) 10 Tax Notes International 1891; Pierre Maugé, “Tax Incentives in the People's Republic of China: Who Benefits?” (1997) 5 Tul. J. Int'l & Comp. L. 155; and Paul D. Reese, “United States Tax Treaty Policy Toward Developing Countries: The China Example” (1987) 35 UCLA L. Rev. 369.

These guidelines build on suggestions made in the OECD Report, supra note 56. Sec also Ashiabor, supra note 115 at 80; Buss, supra note 83 at 101; Easson, “Tax Incentives -- Pan II”, supra note 6 at 366-67.

See Canada's tax treaties with Brazil, Cameroon, China, Malaysia, Malta, the Philippines and Vietnam.

See Australia's treaties with Malta, the Philippines and South Korea.
OECD Report, supra note 56 at 36.


In most cases where these general sunset provisions are used, the treaty provides that the period can be extended through administrative negotiation.

As noted by Easson, “Tax Incentives -- Part II”, supra note 6 at 367, granting tax holidays only to new investors tends to ignore the fact that a substantial proportion of FDI takes the form of contributing additional capital to existing operations or of reinvesting the profits from those operations. One would have thought that capital invested in these ways would be no less valuable and desirable than capital invested initially by new investors .... In practice, restricting incentives to new investors tends to be ineffective and may be counterproductive. An existing investor, planning to expand its operations, simply incorporates a new subsidiary to undertake those operations.

Ibid. at 375.

See ibid. at 370: “[T]he tendency in recent years has been towards longer tax holiday periods, reflecting a growing realization that short tax holidays are of limited value or interest to most potential investors. Substantial investments often take several years before they begin to show a profit, by which time the tax holiday may have expired.”

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