# ENSURING THE FINANCIAL STABILITY OF ENTERPRISES DUE TO THE DEVELOPMENT OF THE BUDGET TAX AND INVESTMENT POLICY

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**Abstract:**
Many countries, developed and developing alike, offer various incentives in the hope of attracting investors and fostering economic growth. Yet there is strong evidence that calls into question the effectiveness of some tax incentives for investment, including in particular tax free zones and tax holidays. Indeed, ineffective tax incentives are no compensation for or alternative to a poor investment climate and may actually damage a developing country's revenue base, eroding resources for the real drivers of investment decisions - infrastructure, education and security.

**Keywords:** Assessment of the financial security of an enterprise, determinants of financial security, financial security**.**

Tax base erosion due to tax incentives is compounded by the lack of transparency and clarity in the provision, administration, and governance of tax incentives. The granting of tax incentives for investment is often done outside of a country's tax laws and administration, sometimes under multiple pieces of legislation. The design and administration of tax incentives may be the responsibility of several different Ministries (e.g., finance, trade, investment). Where various Ministries are involved, they may not coordinate their incentive measures (tax and non-tax) with each other or the national revenue authority, with the result that incentives may overlap, be inconsistent, or even work at cross-purposes. Administrative discretion in the management of incentives can seriously increase the risk of corruption and rent seeking.

Despite the widespread use of tax incentives for investment, in general there is inadequate analysis of their costs and benefits in a national context to support government decision-making. There is limited data collected on granted tax incentives, qualifying investments made, direct (and indirect) benefits to the host economy, and the cost of these tax incentives in terms of foregone revenue. Moreover, even information that should be more readily available – lists of tax incentives and beneficiaries – is not always collected or reported. Often missing from the discussion on tax incentives and their harmful effects are the unintended and unforeseen tax-planning opportunities that tax incentives and preferential tax treatments create. As the studies discussed in the box above indicate, tax incentives offered in developing countries result in little additional investment; most investors would have invested without the offer of tax incentives.

Even when targeted at new investors, tax incentives are always sought by businesses outside the target group. Existing firms attempt to reconstitute themselves as "new" ones towards the end of their holiday periods so that they can continue to be tax-exempt. Similarly, tax incentives enable opportunities for profits and deductions to be artificially shifted across entities with different tax treatments either domestically or internationally. These tax planning opportunities are commonly exploited by both developed and developing countries; however, their ill effects are especially pronounced in developing countries that have limited capacity to detect and counter the detrimental tax avoidance techniques. These challenges are gaining recognition, particularly in the context of the growing acknowledgement of the importance of mobilising domestic financial resources for development. Several countries, including some developing countries, are making efforts to assess, evaluate, and report foregone revenues as part of tax expenditure reports (which are linked to national budget processes). Internationally, there is an emerging consensus on the need to address the potential downsides of tax incentives for investment. The need is particularly pronounced today as many OECD donor governments, with generally weaker public finances than in the past, are increasingly looking to developing countries to better manage their revenue potential.

The importance of addressing the governance of tax incentives was raised in 2011 by the IMF, OECD, UN and World Bank in their joint report to the G-20 on supporting effective tax systems in developing countries (G20 report 2011). For its part, the OECD's Task Force on Tax and Development has identified the need for a more effective global transparency framework for tax incentives for investment -- the purpose of which is to promote transparency in decision-making processes, increase the information available on costs and benefits, to limit discretion and increase accountability. The development of a proposed set of principles (below) is the starting point in an international effort to promote the management and administration of tax incentives for investment in a transparent and consistent manner.

All tax incentives should be placed under the authority of one government body, ideally the Ministry of Finance. Currently, the granting and administration of tax incentives may be the responsibility of finance, trade, investment or other ministries, increasing the risk of corruption and rent seeking. Consolidating them under a single body increases transparency, helps to avoid unintended overlap and inconsistencies in incentive policies, limits discretionary power and enables policy makers to address problems that may arise with the governance of tax incentives. In countries where the granting and administration of tax incentives is decentralised and/or carried out by both the central and sub-national governments, to the extent possible, various levels of government should coordinate to maximize the efficiency and transparency of their efforts.

Once provisions have been enacted in the relevant tax laws and regulations, tax incentives may be claimed by a taxpayer by meeting the necessary conditions as prescribed, without negotiating with any granting authority, except as provided for under the relevant tax laws. A minimum necessary condition to be met by taxpayers in the case of a tax incentive should be the requirement to file a tax return in the case of VAT and Income Tax, and in the case of other taxes a statement detailing the duty or other exemptions availed in the prescribed period. In addition to enhancing transparency, such taxpayer information contributes to data for determining the efficiency and equity of tax incentives. Tax authorities should also periodically carry out audits of cases where tax incentives have been claimed to ensure that they are not misused. The amount of revenue loss attributable to tax incentives should be reported regularly, ideally as part of an annual Tax Expenditures Report (covering all main tax incentives). While cash expenditure budgets are usually scrutinised on a yearly basis, the revenue cost of tax incentives is hidden when estimates of revenues forgone are not calculated and reported. Embedding estimates of revenues forgone by tax incentives in the yearly budget process provides policy makers with the required inputs on a timely basis to inform policy decisions. It also supports medium term fiscal planning as what seems like a small amount of foregone revenue in good fiscal times may become quite high during periods of fiscal strain.

The calculation of revenue forgone should recognise that the benefits of some investments, mineral extraction, for example, may take many years to realise so losses should be assessed over the life of the business concerned. Analysis of tax incentives is data intensive – required for public statements, budgeting, periodic reviews, tracking of behavioural responses by business, etc. There is a need for the periodic collection of taxpayer data and on-going analysis of these data by revenue authorities. This may require introducing mechanisms to do so in some countries. A country's tax regime is a key policy instrument that may negatively or positively influence investment. Imposing a tax burden that is high relative to benefits realised from public programmes in support of business and high relative to tax burdens levied in other competing locations, may discourage investment, particularly where location-specific profit opportunities are limited or profit margins are thin. In addition, the host country tax burden is a function of not only statutory tax provisions but also of compliance costs. A poorly designed tax system (covering laws, regulations and administration) may discourage capital investment where the rules and their application are non-transparent, or overly-complex, or unpredictable, adding to project costs and uncertainty over net profitability. Systems that leave excessive administrative discretion in the hands of officials in assigning tax relief tend to invite corruption and undermine good governance objectives fundamental to securing an attractive investment environment. Policy makers are therefore encouraged to ensure that their tax system is one that imposes an acceptable tax burden that can be accurately determined, keeps tax compliance and tax administration costs in check and addresses rather than contributes to project risk. A modern, competitive, stable and transparent tax system, one that links host and home country tax systems through a well established tax treaty network to avoid double taxation, can send a strong positive signal to investors, both domestic and foreign. Investors generally prefer a low host country tax rate applied to a broadly defined profit base. At the same time, special incentives may play an important role in certain cases. Where tax incentives are used, care must be taken to ensure that incentive types and design features are chosen that are less likely than others to result in unintended and excessive revenue losses to non-targeted activities. Balancing revenue losses from tax relief against the possible investment response is an important consideration in the majority of cases where companies can manage a modest host country tax burden.

This recognises that tax relief may be too generous, in excess of that necessary to provide a tax environment that is supportive of investment. Where corporations are able to contribute to the financing of infrastructure development (e.g. roads, airports, telecommunications networks, and legal frameworks) that they benefit from, and are required to do so under a competitive but not easily manipulated set of tax rules, the tax system can serve to both attract investment and support parallel efforts to build a strong industrial base. A central challenge for policy makers endeavouring to encourage domestic and foreign direct investment, but with limited financial resources to commit, is a careful weighing of relative advantages and disadvantages of alternative tax policy choices and design options in meeting the twin goals of attracting investment while at the same time raising revenues to support infrastructure development and other pillars of an enabling environment for direct investment. In examining tax effects on investment, one can distinguish effects on direct investment representing a significant active equity interest, from effects on portfolio investment by those holding a passive equity interest. This article focuses on effects on direct investment, including business expansions, branch investment, investment in subsidiaries, and mergers and acquisitions. One can also distinguish tax effects in the "pure" domestic case (resident shareholders investing in domestic assets) versus cross-border investment, both inbound foreign direct investment (FDI) in domestic assets by non-resident shareholders, and outbound direct investment abroad (DIA) in foreign assets by resident investors. This article does not address special considerations relevant to the influence of home country taxation on outbound direct investment.

A further distinction is between tax effects on direct investment of various types: in physical capital [e.g. plant, property and equipment (PP&E)]; investment in intangible assets (e.g. patents) through R&D; and investment in human capital (e.g. education, training). This article concentrates on tax effects on physical capital, and in particular PP&E scale and location decisions. Special tax considerations relating to the development and use of intangibles are not covered. In examining the linkages between taxation and direct investment in physical capital, one is confronted with a range of taxes that form part of the tax system of developed (e.g. OECD) countries, as well as developing countries on an established transition path. The taxes include corporate income tax, non-resident withholding taxes, customs duties, personal income tax, social security contributions, value added tax, and other (generally less relevant) taxes.

Home as well as host country taxes may factor in The taxation of profit derived from investment in a given host country [in the pure domestic case, or in the case of foreign direct investment (FDI)] may directly affect the amount of investment undertaken by influencing after-tax rates of return on investment.3 In theory, a high (low) effective tax rate on domestic source income could be expected to discourage (encourage) domestic investment by resident investors, as well as inbound foreign direct investment.4 However, as in other areas, theory must be resolved with practice. It is clear that in general host country taxation adds to investment costs, particularly in the pure domestic case. However, the predicted direct effect – that investment would fall if host country taxes are increased, and would increase if taxes are reduced – is not always observed. Most would agree that a host country tax burden that is very high relative to other countries – influenced by statutory/legal provisions and by compliance costs – generally is discouraging to investment and could, in certain cases, be a deciding factor in not investing or reinvesting in a host country. The more difficult issue is when – that is, under what circumstances and by which means – can a relatively low host country tax burden discourage capital flight, encourage additional investment, and swing location decisions in a country's favour? When, for example, can reduced statutory tax rates or incentives be expected to attract additional investment? As elaborated in section3, by identifying the factors that condition whether host country tax relief or subsidies can be expected to deliver additional investment, policy makers can assess how best to design an overall policy approach, one with mutually reinforcing elements, to provide an environment encouraging to direct investment. While statutory tax provisions are clearly important, policy makers are also encouraged to consider difficult to measure (yet potentially impeding) business compliance costs associated with the level of transparency of the tax system.

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