The Platform for Collaboration on Tax

Tax Incentives Principles

Public Consultation Draft

This document is posted on 10th December, 2024 on the PCT website as a public consultation draft to seek feedback on its contents from tax policymakers, practitioners and experts

International Monetary Fund (IMF)

Organisation for Economic Co-operation and Development (OECD)

United Nations (UN)

World Bank Group (WBG)

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Platform for Collaboration on Tax

Public Consultation on Draft "Tax Incentives Principles"

Tax incentives—various forms of preferential tax treatment—have been widely used by countries to encourage desired activities and behaviors. However, while tax incentives can be effective in promoting specific goals, they can also erode tax revenue, create unintended distortionary and distributive consequences, and pose governance challenges. Policy makers, therefore, face complex decisions especially in light of ongoing and fundamental changes in the international tax landscape.

To support these decisions, the PCT partners aim to provide a concise set of high-level *principles* that are easily accessible to policy makers and other stakeholders. These principles are designed to help navigate the policy, legislative and administrative issues related to tax incentives. The accompanying more detailed *remarks* aim to further elaborate on the underlying reasoning for each of the principles, and direct readers to sources of further advice and analysis. The *Tax Incentives Principles* build on the 2015 PCT report: *Options for Low Income Countries' Effective and Efficient Use of Tax Incentives for Investment* (Main Report and Background Paper). While these principles are intended to be applicable to all countries, they are framed with a particular focus on the circumstances of developing countries.

To maximize the usefulness of the principles and remarks, responses to the following questions are sought:

1. Do you find the principles and remarks presented in the document appropriate and well-balanced in terms of content and coverage? If so, please explain why. If not, please provide any suggestions you may have for refining the document.
2. The document references additional material to help apply the principles. Given this, are there areas where you feel more guidance is needed?
3. What kind of support might countries require to effectively apply the principles?
4. Do you have any recommendations to refine the principles and remarks, given your experiences with tax incentives (either positive or negative)?
5. Do you have any other comments or suggestions?

Please answer as many questions as you find appropriate. In your submission, kindly include the name of your organization, department, as well as the contact person's name along with their contact details. Please send your responses to taxcollaborationplatform@worldbank.org, with a copy to arajca@worldbank.org. The deadline for submission is February 11th, 2025. Kindly note that all responses will be publicly posted on the PCT website.

The Platform for Collaboration on Tax (PCT) is a joint initiative of the International Monetary Fund (IMF), Organization for Economic Co-operation and Development (OECD), United Nations, and the World Bank Group to strengthen collaboration on domestic resource mobilization (DRM). The PCT, launched in April 2016, fosters collective action for stronger tax systems in developing and emerging countries.

TAX INCENTIVES PRINCIPLES

'Tax incentives'—meaning here tax provisions that offer preferentially favorable treatment to some subset of taxpayers with the intention of promoting particular activities—can serve useful purposes. But their provision does inherently run two types of significant risk: of compromising tax revenue and distorting behavior without generating more than offsetting social benefit, and of creating governance problems, including risk of abuse and corruption.

The principles set out here are intended to help policymakers identify and secure any potential social gains from tax incentives while avoiding their pitfalls. They are aspirational. Few countries, if any, fully comply with all the principles. Many face capacity constraints which make meeting even some of the more basic among them challenging—which in itself suggests particular caution in offering incentives. For all however, a clear view of what it is important to aim at can provide a firm and actionable basis for progress.

There are six broad principles, each with sub-principles, spanning the life cycle of a tax incentive: Justification, Design, International Considerations, Legislation, Implementation and Evaluation. Accompanying Remarks provide further elaboration on the principles, and suggest guidance material that may be useful in moving towards their fuller realization.

Principle 1: Justification

Incentives may be warranted only if net social benefits can reasonably be expected, for reasons that are publicly articulated

It is practically impossible, and would likely be undesirable, to tailor tax rules to the circumstances of each potential taxpayer or activity. Common basic rules have to be set, with an eye to overall country-specific circumstances and concerns. There may, however, be cases in which preferential treatment could generate net social benefit. Even then, however, other policy instruments may be preferable.

P1.1 ***An incentive can be warranted only if the activities it is intended to promote generate benefits to society beyond the private benefit the incentive will convey on recipients***

Only if some activity generates benefits to society beyond the private benefits to those undertaking it is private decision making likely to lead to too little of some activity being undertaken. These social benefits could take many forms, including: reduced environmental harm, enhanced knowledge and productivity spillovers, regional development, the promotion of disadvantaged groups, strengthened national security, the easing of market failures, supporting macro-critical activities, and the protection of tax revenue.

P1.2 ***The likely social costs of any incentive, including—but not only—its implications for tax revenue, should be identified***

Account must be taken of the full range of costs associated with any incentive, including of compliance and implementation—likely eased by simplicity—and those to wider society, such as effects on activities that there is no policy reason to affect, and impacts (for instance, through prices) affecting non-recipients. Effects on tax revenue need close attention. bearing in mind the other uses which it might be put.

P1.3 ***An incentive may be justified if there is good reason to expect its social benefits to exceed its social costs—with an ex ante assessment, ideally quantified, made public***

Only if the social benefits under P1.1 can be expected to exceed the social costs of P1.2 can the incentive be expected to generate a net social benefit. Transparency and accountability in the use of public funds require that the public be provided with a clear articulation of why this is expected to be the case. While ex ante quantification will often be hard, at a minimum the key considerations and outcome indicators should be specified, with enough precision to enable effective monitoring and meaningful ex post evaluation.

P1.4 ***Tax incentives should not be used if more appropriate policy instruments serving the same policy objectives are available***

Even if expected net social benefits are positive, there may be better alternatives to a tax incentive, such as direct spending to support favored activities or tax disincentives to penalize dis-favored ones. The capacity of tax measures to offset non-tax problems is intrinsically limited. Alternatives to tax incentives may raise their own efficiency and governance concerns, and a portfolio of measures, combining tax and non-tax measures, will often be needed.

Principle 2: Design

Incentives should be designed to promote the favored activity while avoiding unnecessary distortions to other activities and limiting the revenue cost

The success (or otherwise) of a tax incentive depends largely on its 'bang for buck'; the net social benefit it generates relative to its revenue cost. Maximizing this, and avoiding unintended distortions, requires that the incentive be designed to focus on the favored activity, so as to avoid distorting activities that are not problematic, and to limit the likely revenue cost.

P2.1 *Incentives should be targeted as closely as possible on the expected source of social benefit—which, in the investment context, commonly rules out profit-based incentives*

While it is not always possible to explicitly condition on the favored activity (such as knowledge spillovers), care can be taken to guard against excessively broad application (for instance by ensuring that cosmetic surgery is excluded from preferential VAT treatment intended to ensure access to basic medical interventions, and that routine product development does not qualify for any R&D preference). Profit is a source of purely private benefit, and taxing it at a preferentially low rate forgoes revenue without necessarily promoting any activity.

P2.2 *Unintended side effects should be anticipated and guarded against*

Profit-based incentives, for instance, may create opportunities for shifting profits through domestic transfer pricing or other methods, which can be addressed only if appropriate legislation is in place; and environmental measures that improve performance on some dimensions may have 'rebound effects' that worsen it on others. Incidence issues—with the incentive affecting prices rather than activity—may potentially undermine intended impact, and may have significant bearing on the distributional impact of an incentive.

P2.3 *Exposure to revenue loss should be limited, including by using sunset provisions*

Guarantees of fiscal stability or excessively long incentive periods risk creating a drain on revenue that is hard to stop. Providing a sunset clause—giving an explicit date at which the incentive will be either terminated or, on the basis of review, extended—guards against this while providing a reasonable degree of tax certainty. Caps might be placed on the tax benefit provided, and the risk of redundancy—forgoing revenue without impacting the favored activity—can in some cases be limited, without compromising targeting, by rewarding only increases in the favored activity.

PRINCIPLE 3: INTERNATIONAL CONSIDERATIONS

Incentive design should be sensitive to international commitments and circumstances, and with an openness to mutually beneficial cooperation

Investment incentives in particular are often largely intended to attract foreign investors. But even if not motivated by a potential cross-border impact, incentives need to be designed in a wider context of international rules and interactions, with a view to preserving tax certainty and a reputation for credible tax policy while achieving a balance between the pursuit of national interest, respect for the interests of others, and an awareness of overarching collective concerns.

P3.1 *Incentives should be consistent with international commitments*

Obligations arise under tax treaties and a range of bilateral, multilateral and regional agreements. Commitments that are of a softer nature also need to be respected in order to preserve credibility in tax policy making, support tax certainty, preserve good order in international tax relations and perhaps to avoid various forms of penalization.

P3.2 *Incentive design should take account of tax rules and strategic responses elsewhere*

The effects of a tax incentive may be partly or wholly undone, as an essentially mechanical matter, by tax rules in place abroad, a possibility amplified in the investment context by instruments such as the Global Minimum Tax and Controlled Foreign Company Rules. Strategic considerations include the possibility that other countries may respond to enhanced incentives by increasing the generosity of their own, reducing or eliminating the expected national benefit.

P3.3 *Incentive design should pay due regard to the impact on other countries*

It is natural for policy makers to look above all to their national interests, but there is also obligation to consider any significant effects (good or bad) on others. The social costs and benefits of Principle 1 should thus take account of effects on other countries, including those on their tax revenue.

P3.4 *Through international cooperation, opportunities should be sought to limit the risks and mutual damage that incentives can create*

Incentives are often motivated by a perceived need to compete with those offered by others. But if each country ignores the damage its incentives might cause others (through, for example. increased pollution, reduced activity and/or lower tax revenue), the resulting tax competition means that all countries may ultimately lose. They might then benefit from cooperation, for example by agreements or guidelines delineating permissible or best practice incentives. While most effective if adopted at global level, regional cooperation can also be valuable.

Principle 4: Legislation

Incentive legislation should be clear, integrated into tax law and subject to effective oversight

In providing favorable treatment to some subset of taxpayers, incentives can pose particular risks to transparency and accountability, create potential for abuse and corruption and add to the complexity of the tax system. Legislative and related organizational arrangements to limit these risks and provide reasonable clarity and certainty to taxpayers, which are needed for all tax measures, thus require especially close attention in the context of incentives.

P4.1 *Tax incentives should be under the sole authority of the ministry of finance*

The role of the ministry of finance as the guardian of public revenues and the tax system is fundamentally compromised if line ministries or others are able to grant incentives. Ensuring instead that all incentives require approval by the finance ministry serves to protect revenue and the integrity of the tax system, limit scope for discretion, enable overlap or inconsistencies across incentives to be identified and addressed, and brings tax expertise to their design.

P4.2 *Incentive legislation should be clear, minimize discretion and adopt robust governance safeguards*

To limit the risks of abuse and corruption (and foster tax certainty), incentive legislation should provide eligibility criteria that are clear and readily verifiable, spell out sunset provisions, equip the revenue administration with adequate powers, detail any specific anti-abuse provisions that may be needed, make clear the reporting and other obligations on beneficiaries, provide for self-assessment of eligibility so far as possible and, where it is not possible, include a statement of where approval authority lies and provide for a robust appeal process.

P4.3 *Incentives should be ratified by the law making body or parliament.*

Proving tax incentives through lower rank instruments that are not scrutinized by the law making body, such as executive decrees or contractual agreements, does not provide sufficient transparency in, and accountability for, their granting and operation. Parliamentary oversight, or its equivalent, is essential to limiting the risks of poor policy decisions and governance problems, and to holding the executive accountable.

P4.4 *All incentives should be consolidated in the main body of tax law, and publicized*

Providing tax incentives as part of legislation with a wider purpose (such as promoting job creation, investment or tourism) and/or through secondary instruments (such as decrees or contractual agreements) can obscure their existence and extent, compromising oversight, and lead to incoherence and inconsistency in the wider tax system. To avoid this, tax incentives should be provided only in tax laws and, whatever the instrument by which they are provided, information on their existence and conditions should be readily available to the public.

Principle 5: Implementation

Tax incentives should be implemented so as to promote voluntary compliance, mitigate revenue and governance risks, and provide the data needed to evaluate them

The distinct revenue risks posed by incentives are sometimes neglected by revenue administrations focused more on collecting revenue than avoiding its loss. Recognizing and managing these risks, including those of abuse and corruption, requires a tailored compliance/anti-fraud strategy and close cooperation across involved agencies. Overly complex or burdensome incentives can distract implementing agencies from more productive work. Ex post evaluation may require information additional to that needed for monitoring and implementation.

P5.1 ***The administration of incentives should be under the control of the revenue administration, appropriately empowered***

Other agencies (such as sectoral ministries and investment agencies) may have a role in issuing certifications and checking eligibility criteria, but implementation of tax incentives, including the decision to grant them under the law, should be under the sole authority of the revenue administration. For this, it should be equipped with adequate technological capacity and other tools, and (subject to safeguards) appropriate legal authorities.

P5.2 ***Basic compliance obligations should not be waived***

No benefits should be awarded unless the taxpayer has been registered, subject to standard pre-registration checks (including to avoid 'phoenix' companies). Timely and complete filing (preferably electronic) should be mandatory (even in cases of full exemption). Imports benefiting from reliefs should not enter without appropriate authorization and the beneficiary's commitment to respect associated conditions and restrictions. Full due diligence, with possible recapture, is required when an incentive ends.

P5.3 ***Drawing on a close understanding of potential recipients, voluntary compliance should be supported by tailored service, assurance, and enforcement strategies***

Effective use of revenue administrations' scarce resources requires taking stock of the compliance risks posed by distinct categories of taxpayer and differentiating their treatment accordingly. Clear guidance, assistance, and information are key to voluntary compliance—and strong take-up by intended recipients. Increasing tax certainty is critical for those demonstrating sound levels of cooperation. Audits and investigations should be primarily for higher risk beneficiaries.

P5.4. ***Rules and institutional arrangements should be in place to assure the inter-agency cooperation, and provide the data, needed for implementation, monitoring and assessment***

The implementation, monitoring (in terms of both compliance with the rules and outcomes), and ex post evaluation of incentives will likely require close cooperation and information exchange between agencies. Beyond a direct role in advising on design and processing applications, other agencies may have an essential role in providing and verifying information needed (for instance on emissions, or on employment and investment of non-incentivized firms in the same sector or region). Collecting these data requires forethought, and perhaps formal agreements.

PRINCIPLE 6: ASSESSMENT

All tax incentives should be subject to periodic, public and evidence-based assessment

Special tax privileges require special and transparent evaluation. Tax expenditure reporting is needed to place the scrutiny of implicit public spending though tax incentives on the same footing as explicit budgetary spending. It is also an essential input into the wider evaluation of incentives that is required to ensure that they are achieving the net social benefits expected, to inform decisions as to their continuation or reform (bearing in mind past commitments), and to flag potential governance issues.

P6.1 ***Tax expenditures associated with all incentives should be estimated and published regularly***

Explicit reporting of the 'tax expenditure' associated with each incentive—the revenue consequently foregone, assuming that the incentive has not changed behavior—indicates the revenue risk it poses and provides a sense of how large the offsetting social benefits must be if it is to have proven warranted. This information, whose preparation should be embedded in the annual budget process, should be published regularly, along with a listing of all incentives, how they depart from standard treatment and where their legislative basis can be found.

P6.2 ***Tax expenditure reports should indicate the largest beneficiaries from each provision***

It may be that just a few or especially powerful taxpayers benefit from an incentive, which could raise legitimate public concerns. To guard against this, and subject to (or with amendment of) rules around taxpayer confidentiality, tax expenditure reports should provide information not only on the total amount of tax expenditure associated with each incentives but also (anonymized as need be) the distribution of tax benefits across recipients.

P6.3 ***Incentive legislation should include a program for periodic, credible and public evaluation***

Committing to undertaking a full evaluation of the benefits and costs generated by the incentive, following a timetable aligned with any sunset provisions, and publishing the results, guards against arguments for their continuation based on unverified claims of large behavioral responses and/or large unmeasured external benefits. Credibility of the analysis—which may in some cases be enhanced by use of external expertise—and its publication are essential.

P6.4 ***Evaluations should pay attention to behavioral impact and external effects from incentives, and be undertaken with an intensity proportional to their likely significance***

Evaluation requires more than tax expenditure analysis. At a minimum, it requires reporting changes in the targeted activity and the measurable outcomes by which it was justified. Fuller assessment requires forming a counterfactual as to outcomes in its absence. That is hard, but possibilities include illustrative calculations or comparison with an appropriate control group. Any unintended side effects, such as the creation of avoidance opportunities, should be recognized.

Remarks

Preamble

The definition of incentives, and the principles that follow, extend to the full range of taxes. In this the coverage goes beyond that of PCT (2015a,b), on which these principles build, which was limited to investment projects and in effect focused on business taxes. While these remain a primary concern here, the principles are also intended to apply to tax incentives that may be delivered, for example, through the VAT, excises or customs, the personal income tax, or in special economic zones of various kinds. In such other contexts, however, they may not be fully exhaustive.

Tax incentives may be applied at national or subnational levels. Some of the language (especially in Principle 3) presumes the former, but subnational analogues follow on simple reinterpretation (of 'cross border effects', for instance as including those between subnational jurisdictions).

'Preferential' treatment is defined relative to some 'benchmark' tax system. The detail of this benchmark may vary across countries, reflecting different conceptual positions as to the appropriate reference point; this issue is extensively discussed in the wider literature on 'tax expenditures' referenced below. For the most part, however, the benchmark in any country can be taken to be close to the tax rules most widely applied there.

'Activities' is interpreted broadly, to include all aspects of production or consumption, and so includes the promotion of particular sectors or industries. The principles recognize that the use of tax incentives to encourage specific activities may have distributional effects (that is increase the real incomes of some while perhaps reducing those of others), and that account needs to be taken of these.

By 'social benefit' is meant a benefit to wider society beyond any private benefits to those receiving the preferential treatment (and similarly for 'social cost'): see also the remarks on Principle 1.1. It encompasses not only what might be thought of as narrowly 'economic' benefit (such as increased output of some favored good) but all forms of wider social benefit (such as reduced pollution, or increased opportunities for disfavored minorities and other possible distributional effects).

The aspirational nature of the principles recognizes that their full implementation may face substantial practical and, perhaps, political constraints. Each of them requires that adequate human and other resources be available, which, especially in many lower income countries is, and is likely.to remain for some time, far from the case. This overarching point is not repeated below. With such constraints in mind, the principles are intended to support the most effective use of such resources as can be made available.

A lifecycle perspective on the design and management of tax incentives, with a focus on low and middle income countries, is provided in OECD (forthcoming). Background information on the use of tax incentives is provided in OECD (2022a) and in the Global Tax Expenditure Database (Aliu, Redonda and von Haldenwang, 2022).

Remarks on Principle 1

Concerns shaping the general tax system would include, for instance, the urgency of the need for tax revenue, the effectiveness of the revenue administration, the international mobility of the generality of real activity and tax base, the strength and nature of taxpayers' behavioral responses to taxation, and the social benefits or costs that their activities generate. While taxpayers will differ across many of these and other dimensions, practical considerations—costs of implementation and of collecting the information needed, and the need to ensure fair treatment—dictate that a common system apply to the bulk of taxpayers. Only if circumstances or policy priorities diverge sufficiently from the norm might special tax treatment be appropriate.

P1.1: An incentive that conveyed only private benefit to recipients would effectively be serving only a distributional purpose; and that would generally be best pursued in ways that did not directly affect decisions on levels of activity, since that would needlessly distort the allocation of resources. In requiring positive benefits 'external' to the recipient—social benefits—the focus in this principle and those that follows is on 'efficiency,' in the sense of ensuring that resources are used in a way that avoids unnecessary waste.

Nonetheless, effects on the distribution of real income need to be considered in both the design and evaluation of incentives. It might be, for example, that a private gain to some recipient is seen as having particular social merit because they have especially low income or are in some other respect seen as especially deserving.

Many arguments are heard in favor of incentives. A common theme is the idea that some incentive will generate positive external benefits by at least partly correcting a 'market failure' which is leading, in the absence of government intervention, to too little of an activity being undertaken. Many such cases can be thought of as ones in which the activity generates a positive 'externality': a benefit to someone other than those determining its level. In such cases, in looking only to their private interests, decision makers will undertake too little of it.

In practice, incentives are often offered in order to attract (or retain) inward investment and/or tax base. While a case can indeed be made to tax more mobile activities less heavily than immobile, this needs to be applied with great caution. The fundamental obstacles to foreign direct investment, for instance, may lie in non-tax considerations, and FDI as such does not necessarily generate external benefits: it might, for instance, simply displace domestic investment or simply have little palpable effect on the domestic economy. Differential tax treatment also creates implementation challenges, may result in distortions of competition (see remarks on P1.2) and may make it harder to resist other calls for preferential treatment. Account also needs to be taken of the strategic and other considerations addressed in Principle 3, including not least the possibility that appropriate coordination between jurisdictions may ultimately serve their interests better than competition between them.

P1.2: Complex incentives can be burdensome for both recipients and agencies involved in their implementation. Beyond the direct costs implied, this can discourage take up, particularly by smaller or less well-resourced potential beneficiaries, and distract revenue authorities from higher priority tasks.

Incentives can give rise to external costs of several kinds. Prominent among these are effects on competitive conditions and the wider allocation of resources. An incentive for startups, for instance, will disadvantage established firms and allocate resources away for them; a distortion that may or not be seen as acceptable given the importance of the underlying policy objective, but which in any case needs to be recognized.

Any incentive has two types of effect on tax revenue: those which arise even if there is no impact on behavior, and those resulting from behavioral responses (of recipients and perhaps others too). The former are generally conceptually straightforward to estimate; and it is particularly useful to do so, because—that effect being a pure private gain to recipients—it provides something of an upper limit to how large offsetting social benefits must be for the incentive to be warranted. Behavioral responses, in contrast, introduce a complex range of possibilities. To the extent that the activity of interest is indeed increased and remains subject to tax, the revenue loss will be mitigated (and, in principle, might even be reversed—though examples of this are rare). Other effects may be subtle but important: Incentives for the use of electric vehicles, for example, may reduce fuel tax revenues.

One important element in assessing the social value of effects on tax revenue is the need to value 1 LCU (Local Currency Unit) of tax revenue at more than 1 LCU. This is because, at the margin, a higher social value is placed on government revenue than on resources in the private sector (otherwise tax revenue should simply be reduced). Put differently, this difference in valuations is needed to take account of the distortionary and other costs of recovering 1 LCU of revenue foregone as the result of an incentive by increasing other taxes. Where revenue needs are more urgent—as in many lower income countries—the excess of the social value of 1 LCU of tax revenue over 1 LCU will be greater, which weakens the case for tax incentives. On this, see PCT (2015b) and World Bank (2024); the latter cites an average value for selected African countries of 1.21.

P1.3: A critical test in assessing the desirability of an incentive is whether there exists good—preferably, quantified—reason to expect it to generate positive net social benefits (benefits, that is in excess of costs). In this, account needs to be taken of the uncertainties and risk involved: Governments that face significant borrowing constraints may be especially averse to risk of revenue loss. 'Good reason' requires some specificity, going beyond, for instance, a goal of simply attracting FDI to explain what benefits this will generate.

Resource limitations mean that the intensity of the ex ante assessment of an incentive should be geared to its likely fiscal and social significance. But none should be introduced without at least a clear indication of intended and, ideally, measurable outcomes. It may indeed be appropriate to formally require some ex ante assessment—at a minimum, of likely revenue impact—to accompany all proposed incentive legislation. In some cases substantial preliminary work will be appropriate, with benefits from public consultation in so far as this can be done without creating undue expectations. (Indeed the 'gold standard', albeit sometimes proscribed by legal or other considerations and often impracticable for policy measures, is to test an incentive by a controlled experiment). Consideration also needs to be given at an early stage to the appropriate nature and data requirements of the program of ex post evaluation (as envisaged by Principle 6).

The public statement envisaged here might take the form, for example, of a standalone document and/or be included in budget documentation.

P1.4 Even if not dominated by other instruments, incentives may be less effective than, and best accompanied by, other measures. There is, for instance, extensive survey evidence that foreign investors often attach less importance to tax than to nontax considerations (such as the quality of the infrastructure)) in making location choices. Using tax measures in an attempt to offset non-tax problems is not only poorly targeted (see P2.1) but unlikely to succeed if those problems are severe. Businesses that require a steady supply of electricity, for example, will not be attracted by a tax incentive if supply remains unreliable, Attention certainly needs to be paid to the tax environment offered to investors, and there is broad econometric evidence that favorable tax treatment can attract investment. But there are many cases in which even very generous tax treatment has manifestly not increased investment.

In the environmental context**,** taxing bad things is generally preferable to providing tax subsidies for good ones, both as better aligning prices with the source of the problem and in raising rather than using tax revenue. (This is often less practicable with other externalities: it is hard, for example, to tax a failure to innovate). Regulation may be preferable, for example, when additional damage rises rapidly beyond some critical level of activity; and tort liability may be preferable when the extent of possible damage is hard to predict. As with tax measures, some degree of cross-border coordination may be appropriate in the use of such instruments.

Remarks on Principle 2

This principle focuses on the core policy challenge in designing any incentive: ensuring that it succeeds in promoting the favored activity whilst limiting unneeded distortions to other private decisions—that is, encouraging or discouraging activities for which private decision making creates no problems—and doing so at the least possible revenue cost. Some distortions may be unavoidable, in the sense that increasing the favored activity may require reducing others: the design problem is to limit the damage, including through effects on revenue, that such effects might cause.

Even the best designed policy, might be undermined by weaknesses in legal formulation and implementation; these concerns are addressed in Principles 4 and 5.

P2.1 By 'targeting' is here meant, in broad terms, matching the incentive to the promotion of only the favored activity. As a general principle, the more closely an incentive is targeted on its objective the less is the risk that it will generate unnecessary social costs of the kind mentioned in connection with P1.2. This consideration affects both the choice of incentivizing instrument and the details of its design. If the intention is to promote production of photovoltaic cells, for instance, this is best achieved by incentivizing production directly rather than by setting a reduced rate of VAT: the latter also encourages imports and (because of the crediting of any input tax) has no impact on business purchases. If the intention is to promote consumption by domestic consumers, on the other hand, the reduced VAT is better targeted than a production subsidy since the latter distorts the choice between domestic production and imports. Similarly, if the intention is to promote the development of a particular vaccine, close targeting requires that the incentive be conditional on that rather than general support for pharmaceutical development.

There is, however, a potential trade off to be made: Closer targeting may require greater complexity in incentive design so as to match the incentive more tightly on the favored activity; but that may increase costs of implementation and compliance. Within this trade off, there may be cases in which capacity constraints mean that only poorly targeted instruments are available but the inefficiencies consequently associated with their use are seen as a price worth paying in pursuit of the underlying policy objective..

By effectiveness is meant here the extent to which the incentive acts to encourage the favored activity. Useful tools for gauging this—developed in the context of investment projects but with potentially wider applications—include the concepts of the marginal effective tax rate (METR), which captures the extent to which the tax system discourages increasing the level of some activity, and the average effective tax rate (AETR), which measures the total amount of tax payable relative to pre-tax earnings. Reductions in the METR increase the incentive to undertake rather more of the activity (the 'intensive' margin): to expand the production of electric cars, for instance, or use more renewable energies. Reductions in the AETR encourage limited resources to be shifted into the favored activity (the 'extensive' margin): to begin producing electric cars at home rather than abroad, for instance, or to relocate closer to convenient sources of renewable energies.

Appropriate policy objectives thus include setting an METR on an activity—investment of some favored kind being the leading example—that is low enough (possibly negative) to recognize the social benefits that it generates while maintaining an AETR that is consistent with revenue needs and, for internationally mobile activities, reasonably consonant with treatment elsewhere.

Rough estimation of the impact of a proposed incentive on METRs (which largely depend on the tax base) and AETRs (which largely depend on the rate) can usefully inform design decisions, and (especially for the AETR) need not be especially difficult. Being relevant to cross-border location decisions, the AETR may also need to be calculated for comparator countries—and, in line with Principle 3.2, account taken of how those AETRs might change as comparators respond to adoption of the incentive. Guidance on the calculation of AETRs and METRs is in PCT (2015b), Asian Development Bank (2023) and World Bank (2024).

The fundamental difficulty with profit-based incentives—such as reduced rates of taxation, or outright holidays—is that they forego tax revenue even if there is no change in the recipient's behavior. They thus risk conveying a windfall benefit without achieving the intended policy objective.

That said, there may be cases in which, acting through the AETR, profit-based incentives can lead to shifts in the allocation of scarce resources. This might be so, for example, for some activity that is highly mobile internationally and so might locate instead in a jurisdiction offering a lower AETR. Even then, however, the weighing of social cost and benefit highlighted in Principle 1, the international responsibilities in Principle 3 and governance considerations may mean that no incentive is warranted.

Particular governance concerns arise in relation to tax holidays, which in some cases seem to have appealed to investors partly to insulate them from tax administrations in which they have low trust—and which may have little trust in them. Building that trust, and so securing long-term compliance, requires that holidays, like all incentives, be implemented along lines set out in

Principle 5.

P2.2 As an example of a rebound effect: an incentive that promotes vehicle fuel efficiency may, by reducing private costs per mile, increase miles traveled and, to that extent, fuel use.

The incidence concern is that the incentive may change prices in ways that significantly moderates its effect. For example, an incentive to use a particular form of technology, or to hire a particular class of skilled worker, may simply drive up prices and wages, mitigating the impact on real activity and having potentially significant distributional effects.

P2.3 The period to sunsetting should be no longer than is likely required for private costs to be recovered and social benefits and costs to begin to be realized and assessed, with the timetable providing for a process to review the incentive as provided for in Principle 6.

The duration of any commitment to offering the incentive should not be so long that future reforms would raise significant legal issues and/or undue competitive distortions and revenue cost—the last of these being a consequence of the 'grandfathering' of benefits (ensuring that those enjoying them will continue to do under the original terms) that may be needed to honor past promises.

In some cases, incentives may be addressed to very immediate concerns and so announced as explicitly temporary (as, for instance, with some support measures during the Covid-19 pandemic). Experience warns, however, that temporary provisions can become in effect permanent. In all cases, sunset provisions should be treated as meaningful deadlines.

'Caps' might take the form, for example, of limiting the proportion by which an incentive may reduce taxable income, or imposing a minimum tax on a base that excludes the impact of the incentive.

Remarks on Principle 3

P3.1 This sub-principle does not endorse entering into any specific commitment on international tax matters, but stresses that such commitments as are made should be honored.

Hard law obligations potentially relevant to the design and implementation of tax incentives include investment and trade agreements, WTO and WCO rules, the OECD Multilateral Convention on Mutual Administrative Assistance in Tax Matters and regional coordination agreements. Softer commitments include those accepted under the OECD/G20 BEPS project, both 'minimum standards' (Action 5 of the OECD/G20 BEPS Project on Harmful Tax Practices being especially relevant to incentive design) and 'common approaches,' as well as commitments in relation to Pillars One and Two. The precise implications of all such commitments will likely change over time as their intention is clarified and/or their substance amended in response to emerging circumstances and concerns.

Attention may also need to be paid to potential inclusion (with consequent reputational damage and potentially more direct harm from 'defensive measures') in the EU's evolving listing of 'noncooperative jurisdictions' (European Council, 2024) and conditions that may be required as a condition for receiving EU development funds).

P3.2 Under the Global Minimum Tax (GMT), foreign application of an Income Inclusion Rule or UTPR will substantially diminish the impact of domestic measures that would otherwise reduce effective tax rates for in-scope entities with positive excess profits. This will heighten the importance of reviewing policy on tax incentives. Analysis and guidance on the impact of the GMT on tax incentives is provided by O'Sullivan and Cebreiro Gómez (2022), OECD (2022b), and, with particular reference to the extractive industries, UN Committee of Tax Experts (2024). This though remains an area in which the landscape continues to evolve.

There are other cases in which a mechanical rule applied abroad may limit the impact of domestic policies. The effects on exports of providing fuel subsidies through tax incentives (or simply low prices) to domestic producers, for example, may be dampened by the application of carbon border adjustment mechanisms elsewhere; and the impact of incentives for clean technologies may be mitigated by protectionist measures adopted by others to support their own domestic development of those technologies.

It is harder to anticipate strategic responses abroad: whether, for example, the introduction or increased generosity of an incentive will lead other countries to do the same. But the possibility of reactions elsewhere should not be ignored: Even smaller countries may have close rivals that are liable to respond to their measures.

P3.3 This obligation is clearest for larger economies, given their potentially greater impact on global investment flows and environmental conditions. But incentives in smaller countries may also have significant effects on those close to them in a geographical or other sense: Incentives to reduce the use of pesticides, for instance, will benefit neighbors through reduced damage from runoff and leaching, while incentives offered by investment hubs often have widespread effects, including on large countries, even if their domestic economy is small.

P3.4 The tax competition in mind here is not only that in relation to corporate taxation, but, for instance, the attraction of skilled workers by offering favorable tax treatment to foreign experts or of retirees by offering low rates on pension income.

Regional coordination agreements (such as those of CEMAC, the EAC, EU, GCC and WAEMU) may be easier to attain than wider ones, and, also beneficial in fostering collaboration across tax administrations in their enforcement activities. To avoid similar issues reappearing in different form, cooperation agreements could usefully cover the use of non-tax instruments with effects similar to those of tax incentives, such as cash subsidies and loan guarantees.

Remarks on Principle 4

This principle is concerned with the legislative approach, framework and processes. A detailed template for assessing performance relative to many of the sub-principles that follow is in Platform for Collaboration on Tax (2015b).

P4.1 To ensure this, the ministry of finance can be designated by the Finance/Budget Law (or equivalent) as the only ministry which can submit to parliament proposals governing revenue or spending.

This sub-principle does not preclude an important but subordinate role for line ministries or other agencies in proposing incentives, advising on their design, vetting applications, ensuring that eligibility criteria are met, and in their monitoring and evaluation. They may also have a key role in obtaining and providing to the Ministry of Finance and revenue administration data on which such monitoring and evaluation must rest. The importance of inter-agency cooperation more generally is stressed in P5.4 below.

P4.2 : Clarity is aided by quantification wherever possible. Verifiability argues against criteria based on intentions or unmonitored actions (such as the use to which some product supplied to or by the beneficiary is intended to be, or is, put). Also to be avoided, wherever possible, are tax incentives restricted to a single or to specific taxpayers. On the use of anti-abuse provisions in relation to tax incentives, see World Bank (2024).

Allowing taxpayers to self-assess their entitlement to an incentive, rather than requiring pre-approval, removes one discretionary step at which rent-seeking may arise. Appropriate monitoring and verification are then of course critical.

Considerations for the pursuit of transparency in providing investment incentives are set out in OECD (2023).

P4.3 This scrutiny should be informed by the clear statement of the reason for proposing the incentives required by Principle 1, and (whether in the case of possible renewal or at termination), by the results of the evaluations required by Principle 6.

The use of lower ranked instruments can also undermine taxpayer certainty, and so lead to requests for formal agreements as protection against regulatory interference—which then compounds the lack of transparency and oversight.

P4.4 This does not preclude the tax incentive law from referring to sectoral or other legislation for key concepts and definitions, for instance around eligibility criteria—indeed this can be good practice.

This subprinciple implies that tax provisions in negotiated agreements, such as are common in the extractive industries, should be made public (along the lines, for example, of Requirement 4.1 of the Extractive Industries Transparency Initiative (2023) and Guidelines 5-6 of the UN guidance on taxing government-to-government aid (UN, 2021).

Remarks on Principle 5

Implementing tax incentives is primarily a matter for the revenue administration (tax and customs) but often with an important subsidiary role for other agencies, including in monitoring and evaluation.

The specific revenue risks associated with incentives include those of: interpretation (when recipients exploit grey areas of the rules); evasion (such as entities misrepresenting themselves as meeting eligibility criteria when they do not, or disguising ineligible income or expenditure as qualifying); outright fraud (such as false invoicing) and avoidance (such as profit shifting with related entities facing a higher tax rate). Further examples are in Pecho and others (forthcoming).

P5.1 Necessary legal powers include those to obtain information from the recipient of the incentive and third parties; deal with infractions of eligibility criteria by requiring payment (with compensatory interest) of taxes saved; impose graduated penalties; enter premises; control the movement and use of goods and assets; and specify such physical standards of control as may be needed to limit abuse. Attention may also be needed to ensure that other agencies have the legal powers needed for their intended roles, for example to verify that conditions on employment or emissions have been met.

Notwithstanding any exemption of duties and taxes in free zones, the legal enforcement powers of the customs and tax administrations should remain available in these zones.

P5.2 By 'phoenix' company is here meant one that claims a time-limited tax benefit but is in substance a continuation of one that has already enjoyed the benefit to the point of expiry. For imports benefiting from tax or duty exemptions, government authorizations specifying key information, such as the nature and volume of the reliefs granted, should be required.

The strictures on filing also apply to any additional information that implementation requires (such as transfer pricing documentation).

P5.3 To develop the necessary understanding of the taxpayer population, revenue administrations may need to access information from public entities (such as the environmental agency), private entities (such as free zone authorities) and other jurisdictions. This may require explicit inter-agency and cross-border agreements, including on information exchange, and, for full effectiveness, interoperable information systems.

Providing guidance, assistance and information is easier the simpler is the design of an incentive and the more readily available are the provisions governing it: the former may need to be traded off against the objective of close targeting, as set out in Principle 2; the latter calls for transparency as set out in Principle 4.

Measures to promote tax certainty include advance pricing agreements, private rulings and applying fewer, more selective customs controls for those with good track records.

Inter-agency cooperation is also needed to. ensure that potential beneficiaries are not only aware of but can readily apply for available incentives. 'One stop shop' arrangements can significantly reduce taxpayers' compliance costs and help ensure that the incentive reaches its intended beneficiaries.

Broad guidance on compliance risk management specifically for incentives is provided in Pecho and others (forthcoming).

P5.4 Forethought, and action, may also be needed, for example, if the evaluation requires information on the situation prior to its implementation that will be hard to obtain subsequently.

In countries where the granting and administration of tax incentives is decentralized and/or carried out by both the central and sub-national governments, the various levels of government should, to the extent possible, coordinate to maximize the efficiency and transparency of their efforts.

Though not addressed by this principle, appropriate arrangements may also be needed within the ministry of finance. In particular, the ability to undertake meaningful ex ante (and ex post) evaluation of incentives can be one of the major benefits from developing a capable tax policy unit.

Remarks on Principle 6

Ex post evaluation, covering both the social benefits and the social costs associated with an incentive, is needed not only to assess, and account publicly for, its success or failure, but also to inform decisions on future incentive policies, including—but more widely than—its termination or reform.

In either case, it may be important to recognize potential risks to the credibility of tax policy making, and hence to tax certainty, from any failure to honor commitments already made. This may require 'grandfathering' provisions, ensuring that recipients who have received assurances that they will continue to enjoy tax benefits will indeed continue to do so.

P6.1 The calculation of tax expenditures—covering not only what are here referred to as incentives but also tax preferences with primarily distributional objectives—is a largely mechanical exercise. Conceptual nuances do arise, for instance: in defining the benchmark tax system; dealing with interactions between incentives (as when both a rate reduction and base narrowing apply); and from the fractional nature of the VAT (which implies that exemptions within the production chain may actually increase revenue).

Regular tax expenditure analysis is envisaged in Principle 1.1.4 of the IMF's Fiscal Transparency Code (IMF, 2014), with best practice including some budgetary control on their extent (IMF, 2014); IMF (2018) elaborates.

Extensive guidance on the estimation and reporting of tax expenditures is available, including, with a particular focus on lower income countries: Asian Development Bank (2023), Heady and Mansour (2019), Laporte and others (2018) Phillips, Tyskerud and Warwick (2021), and Platform for Collaboration on Tax (2015a,b).

P6.2 At a minimum, it should be possible to publish anonymized information on the distribution of benefits, at a sufficiently high level of aggregation to prevent identifying taxpayers. For example, "The largest *N* (or *n* percent) of recipients account for *y* percent of the total revenue foregone." Such data have considerable value for independent analyses of incentives by civil society and academics. Still more valuable would be to make available the (anonymized) full administrative data at the level of recipient taxpayers.

Consideration might also be given to listing the value of tax incentives enjoyed by sensitive groups, such as political parties.

P6.3 External evaluation (by, for example, local academics, think tanks or genuinely independent consultants) can also serve to draw on specialist expertise in evaluation methods. If this is done, the ministry of finance should publish its own views along with the commissioned report. The use of external expertise in this and other areas should not, however, be allowed to substitute for developing in-house capacity for tax policy analysis.

As a matter of due diligence in the use of public funds, a commitment should be made to evaluate incentives even when there is no prospect of their renewal.

P6.4 Ex post evaluation "may be difficult, [but] a more serious problem may be the failure to try", with "[s]ystematic evaluations… needed to…avoid a situation where the narrative….is primarily driven by profiting stakeholders."[1] The capacity to conduct evaluations may in some cases be very limited, but, at least for incentives with potentially sizable impact, it is critical that an effort be made.

In assessing realized social benefits and costs, including distributional effects, attention needs to be paid to all the issues raised in relation to the ex ante assessment of Principle 1 above. The key analytical difference is in assessing actual rather than projected outcomes.

Resources being limited in all countries, the depth of analysis will need to be guided by an a priori sense of the economic and fiscal significance of each incentive. The minimal form of assessment should not be difficult if Principles 1 and 5 have been followed: a comparison of measurable outcome indicators with those set out at introduction of the incentive. Beyond that, simple Illustrative calculations can give a sense of how plausible it might be that net social gain has been realized: asking, for example, how much of the observed level of activity would have to be due to the incentive for its overall effect to have been socially beneficial. More robust methods include the 'natural experiment' approach: identifying some otherwise similar but not incentivized taxpayers or activities and comparing developments across the two.

Guidance on processes and methodologies for the evaluation of incentives is provided by Beer and others (2022), OECD (forthcoming), UN and CIAT (2018) and World Bank (2024).

[1] Quotations from OECD (2010, p.29) and Beer and others (2022, p.1).

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