PLATFORM FOR COLLABORATION ON TAX

TAX INCENTIVES PRINCIPLES

OECD

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IFC International Finance Corporation

MIGA Multilateral Investment Guarantee Agency

TAX INCENTIVES PRINCIPLES (TIPS)

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'Tax incentives'—by which is meant 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 runs two types of risk: of compromising tax revenue and distorting behavior without generating more than offsetting social benefit; and of creating governance problems, including 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 of them. Many face capacity constraints which make meeting even some of the most basic of these principles challenging—which highlights the importance of carefully assessing the design and implementation of such measures in light of available capacity. For all countries, however, a clear view of what should be aimed for can provide a firm and actionable basis for progress.

There are six broad principles, each with sub-principles. They span the life cycle of a tax incentive: Justification, Design, International Considerations, Legislation, Implementation and Evaluation. Accompanying Remarks elaborate on the principles, and point to guidance material that provides detail and examples which may be useful in moving towards their fuller realization.

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PRINCIPLE 1: JUSTIFICATION

Principle 1: Justification

An incentive may be justified only if net social benefits can reasonably be expected, for reasons that are publicly articulated.

It is 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 justified only if the activities it is intended to promote generate benefits to society beyond the private gain that recipients will enjoy

Private decision making is likely to lead to too little of some activity being undertaken only if that activity generates benefits to society in addition to the private benefits it conveys to those undertaking it These social benefits could take many forms, varying across activities and countries, including: reduced environmental harm, enhanced knowledge and productivity spillovers, job creation, 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 and those to wider society. These include effects on activities that there is no policy reason to suppose are under- or over-provided, and impacts (for instance, through prices) on non-recipients. Effects on tax revenue need close attention, bearing in mind the other uses to which that revenue might be put.

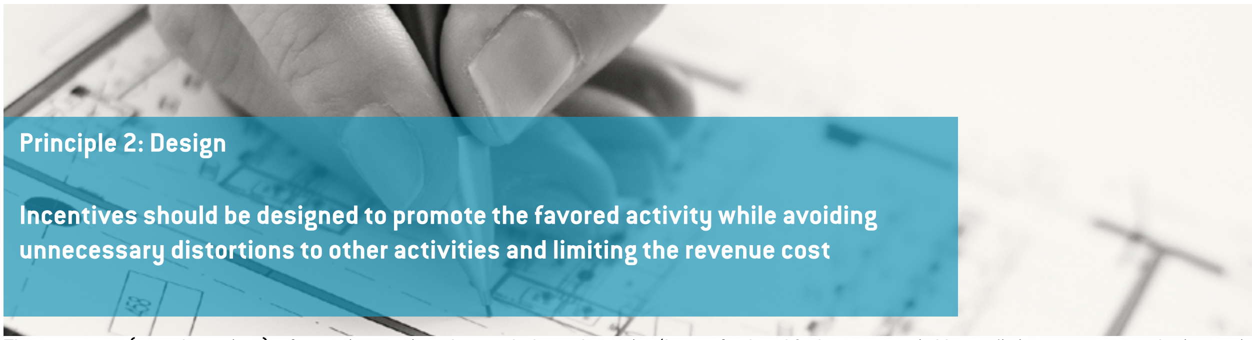
P1.3. An incentive may be justified if there is good reason to expect its social benefits to exceed its social costs—with an ex ante assessment, ideally quantified, made public

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 scope for using tax incentives to overcome non-tax difficulties is inherently 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



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 unwanted side effects, requires that any 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. The benefits of finer targeting may need to be traded off, however, against the costs of increased complexity.

P2.1. Incentives should be targeted on the expected source of social benefit, while avoiding excessive complexity

It is not always possible to explicitly condition on the favored activity (such as knowledge spillovers). But care can be taken to guard against excessively broad application (for instance by ensuring that routine product development does not qualify for any R&D preference). Greater precision in targeting can, however, mean greater complexity, and hence additional costs to the authorities of administering and/or to business of complying with the incentive provisions (with consequent risk of discouraging take-up).

P2.2. In the investment context, targeting considerations will often point to the use of cost-rather than profit-based incentives

Incentives that simply increase after-tax profit may shift resources into a favored activity, but the benefit to the investor (and revenue cost to the government) is not directly tied to increases in the activity that it is intended to encourage. They also convey the greatest benefit to the most profitable companies, which likely need the incentive least. Especially in relation to activities that are specific to a particular location—as with many natural resources—they thus present heightened risk of significant revenue being foregone with uncertain social benefit, particularly when not carefully targeted and/or not accompanied by strong governance safeguards. Profit-based incentives can also create distinct problems of control and governance.

P2.3. Unwelcome side effects should be anticipated and guarded against

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

P2.4. 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—setting an explicit date at which the incentive will be 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 by an 'incremental' incentive structure, rewarding only increases in the favored activity.

PRINCIPLE 3: INTERNATIONAL CONSIDERATIONS

Principle 3: International Considerations

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

All countries are sovereign over their own tax systems. International considerations are nonetheless an important consideration in tax policy making. 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.

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. This possibility is 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. 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 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. Where cross-border spillovers are beneficial, coordination can ensure the gains are fully realized. While most effective if adopted at global level, regional cooperation can also be valuable.

P3.4. Even looking beyond their self-interest, countries may wish to take account of the impact of their incentive policies on others

In exercising their national sovereignty, policy makers look above all to their own national interests. However, The social costs and benefits of Principle 1 could also take account of such cross-border effects (good or bad) on others, including their tax revenue.

PRINCIPLE 4: LEGISLATION

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 pose particular risks to transparency and accountability, create potential for abuse and corruption, and make the tax system more complex. Legislative and related organizational arrangements to limit these difficulties and provide clarity and certainty to taxpayers require close attention.

P4.1. Tax incentive policies should not be enacted without review, and an expression of opinion, by the ministry of finance

The design of incentives should draw on the expertise of relevant ministries and any investment promotion authority. But the role of the ministry of finance as the guardian of public revenues and the tax system is fundamentally compromised if other agencies can independently propose or enact incentive schemes. A statutory requirement that the ministry of finance review and express an opinion on any incentive scheme helps protect the integrity of the tax system.

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

To limit the risks of abuse and corruption, foster tax certainty and ease implementation costs 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 needed, make clear the reporting and other obligations on beneficiaries, minimize discretion by providing, so far as possible, for self-assessment of entitlement to the incentive (with ex post verification that all conditions have been complied with).

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

Enacting tax incentive schemes 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 approval. Parliamentary oversight, or its equivalent, is essential to limit the risks of poor policy decisions and governance problems, and to hold 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 lower rank instruments 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. Whatever the instrument by which they are provided, information on their existence and conditions should be readily available to the public.

PRINCIPLE 5: IMPLEMENTATION

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 (and may be heightened by its limited involvement at the design stage). Recognizing and managing these risks, and those of abuse and corruption, requires a tailored compliance/anti-fraud strategy and close cooperation across involved agencies.. Ex post evaluation may require information beyond that needed for monitoring and implementation by the revenue administration.

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

Other agencies (such as sectoral ministries, investment promotion bodies) may have a role in certification and checking eligibility, but the implementation of tax incentives should be under the authority of the revenue administration. For this, it should be equipped with adequate technological capacity and other tools, and appropriate legal authorities. Involvement of the revenue administration in the design of incentives will facilitate its task of implementation.

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), and include information adequate to ensure entitlement to the incentive and for the purposes of evaluation. Full due diligence, with possible recapture, is required when an incentive ends.

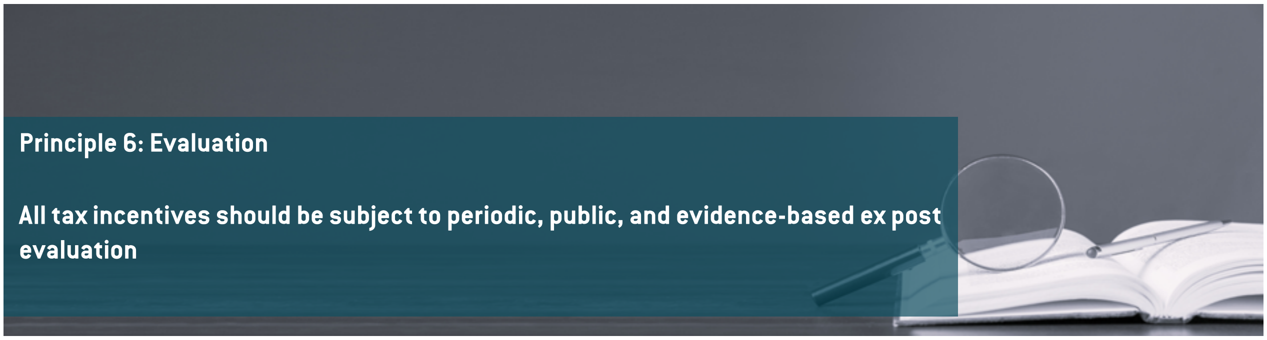
P5.3. Voluntary compliance should be supported by tailored service, assurance, and enforcement strategies

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. Clarity and timeliness in providing guidance, assistance, and information are key to voluntary compliance—and strong take-up by intended recipients. Increasing tax certainty is critical for those showing 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 sharing may need formal agreements.

PRINCIPLE 6: EVALUATION



Principle 6: Evaluation

All tax incentives should be subject to periodic, public, and evidence-based ex post evaluation

Special tax privileges require special and transparent evaluation. Tax expenditure reporting is needed to subject implicit public spending through tax incentives to the same level of scrutiny as explicit budgetary spending. Such reporting is also an essential input into the wider ex post evaluation of incentives which is needed 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 justified. This information, whose preparation should be embedded in the annual budget process, should be published regularly, along with a listing of all incentives and indication for each of how they depart from standard treatment and of their legislative basis.

P6.2 Tax expenditure reports should include broad information on the beneficiaries

Transparency is enhanced if the public has information not only on the total tax expenditure associated with each incentive but also on where that implicit spending is going. Tax expenditure reports should therefore provide information not only on the total amount of tax expenditure associated with each incentive but also (anonymized as need be) the distribution of tax benefits across recipients. Transparency should be no less than for direct spending measures, and consideration may be given to naming the largest beneficiaries.

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

Committing to an ex post evaluation of the benefits and costs that have been generated by incentives, following a timetable aligned with any sunset provisions, 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 the behavioral and external effects of incentives, and be undertaken with an intensity proportional to their likely significance

Ex post evaluation requires more than tax expenditure analysis. At a minimum, it requires reporting changes in the targeted activity and in the (preferably) measurable outcomes that the incentive was intended to affect. Fuller assessment requires forming a counterfactual as to what those outcomes would have been in the absence of the incentive. That is hard, but possibilities include illustrative calculations or comparison with appropriate control groups. 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. For such other contexts, however, they are not 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 is likely to be close to the tax rules most widely applied there.

'Activities' is interpreted broadly, to include all aspects of production and consumption. It thus includes, for example. the promotion of particular sectors, industries, regions, technologies, or workers. 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' benefits (such as increased output of some favored good) but all forms of wider social gain (such as reduced pollution, or increased opportunities for disfavored minorities and other possible welcomed distributional effects).

The aspirational nature of the principles recognizes that their full implementation may face substantial practical and, perhaps, political constraints. Each principle assumes the availability of adequate human and other resources. In many lower-income countries, however, this is not currently the case and is unlikely to change in the near term. External support, training and knowledge sharing will be critical for many countries to progress towards fuller achievement of any of the principles set out below. For brevity, this overarching point—which applies to meeting the challenges of strengthening domestic revenue mobilization more generally—is not repeated below. With such constraints in mind, the principles are nonetheless 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 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.

'Social benefit' can take many forms, and will encompass different concerns and priorities in different countries and in relation to different sectors. In low income countries, the provision of decent employment may be a primary concern; high income countries may be more focused on promoting innovation. In tourism, the emphasis may be on employment; in the technology sector, on increasing productivity. What is important is clarity on the nature of the social benefits sought, even if they cannot be fully quantified.

Reflecting this diversity of concerns, 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 done 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 impact 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 unlimited competition between them.

P1.2: 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 justified. Behavioral responses, in contrast, introduce a complex range of possible revenue effects. To the extent that the activity of interest is indeed increased and remains subject to tax, the revenue loss will be mitigated. In principle, it might even be reversed—though clear 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 social value of tax revenue for a range of African countries of 1.21.

Assessments of the impact on tax revenue should take account of all types of tax, not just that through which the incentive operates. It should also consider the full life cycle of supported projects, with appropriate discounting. For example, accelerating depreciation brings deductions forward but does not affect their total over time; the cumulative total of tax payments is unaffected, but their present value is reduced—which is a benefit to the investor and a cost to the government.

Complex incentives can be burdensome for both recipients and agencies involved in their implementation, including by distracting revenue administrations from more productive tasks. Beyond the direct costs implied, complexity may limit accessibility and uptake—particularly by smaller or resource-constrained beneficiaries—and place additional demands on administrative capacity.

P1.3: A critical test in assessing the desirability of an incentive is whether there exists good reason—preferably, quantified—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 social 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 the intended outcomes. Ideally, these would be measurable. 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. (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). This ex ante assessment should anticipate and be aligned with the later ex post evaluation (Principle 6.3), setting out the criteria by which the incentive will then be assessed. This will also enable early identification of the data required for that evaluation.

In some cases substantial preliminary work will be appropriate, including close involvement with the revenue administration. There can be significant benefits from public consultation with business, civil society, and others in so far as this can be done without creating undue expectations.

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 in making their location decisions foreign investors often attach less importance to tax than to nontax considerations (such as the quality of the infrastructure). 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: and tax incentives to promote innovation are unlikely to be effective where protection of intellectual property rights is weak, 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 promotes 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 collateral 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 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 (if the mechanism for the crediting of any input tax is working as it should) has no impact on business purchases. If the intention is to promote consumption by domestic consumers, on the other hand, a reduced rate of 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 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, and the inefficiencies consequently associated with their use 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 (expansion alone the 'intensive' margin): to increase 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 even negative, so providing a marginal subsidy) 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).

P2.2: A fundamental difficulty with profit-based incentives—such as reduced rates of taxation or outright holidays in particular sectors—is that being targeted on the favored incentive in only the most general way, they are especially vulnerable to the risk of very low 'bang for buck,' foregoing substantial tax revenue while achieving little if any change in the recipient's behavior. In relation to foreign investment, it may be a relevant consideration that the benefit of profit-based incentives may often go largely to non-citizens.

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. Conversely, however, when the activity at issue is very location-specific the risk that profit-based incentives will simply provide a windfall to investors is especially great (since they have fewer alternatives). The case for their use is then correspondingly weak, The relevant mobility here, it should be stressed, is that before the location decision is made. All investments become less mobile once investment costs have been sunk, but in order to invest in the first place investors need some assurance that the reduction in their mobility once investment has taken place will not be exploited by a higher than expected tax rate. This point is of particular importance in the extractive industries, marked by high up-front costs.

Even in relation to more internationally mobile activities, the weighing of social benefit and cost highlighted in Principle 1, the international responsibilities in Principle 3 and governance considerations may indicate the desired objectives could be better achieved through alternative, more targeted policy instruments.

Profit-based incentives can also create distinct opportunities for profit shifting (even among domestic entities). And, once conceded, the principle of setting preferential rates with little or no conditioning on behavior can also invite lobbying and pressure for similar treatment by others.

Particular governance concerns arise in relation to tax holidays. These seem 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.

P2.3: Assessing side effects requires considering how—whether legally or fraudulently—an incentive might be used to reduce tax payments other than by a real increase in the favored activity. 'Incremental' tax incentives for expenditure on, for example, R&D, might lead to legitimate deferral or acceleration of such spending in order to generate a tax saving while ultimately having little substantial effect on its overall level. One purpose in monitoring experience with incentive schemes is to provide early indication of unwanted effects, opening the way to prompt remedial action.

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 moderate its effect. For example, an incentive to use a particular form of technology, or to hire a particular class of skilled worker, may unintentionally contribute to higher prices or wages, thereby reducing the intended impact on real activity and having potentially significant distributional effects.

P2.4: The period to sunsetting should be no longer than is likely required for private costs to be recovered and for social benefits and costs to begin to be realized and assessed. The timetable should provide for a process to review the incentive as envisaged in Principle 6.

The duration of any commitment to offer the incentive should not be so long that future reforms would raise significant legal issues and/or undue competitive distortions and revenue cost. Such distortions and costs can arise as 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 effectively 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 Pillar 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: The Global Minimum Tax (GMT) of the Inclusive Framework Agreement of October 2021), which is now coming into effect, may impact incentive policies. Under the GMT rules, 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. Detailed 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 (2025). 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 neighbors that are liable to respond to their measures.

P3.3: 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.

There may be cases in which incentives (for example for reforestation) have positive spillover effects on other countries (reducing run off and erosion). Converse arguments then apply, and coordination can help to ensure that such measures are not under-provided.

P3.4: The potential importance of the cross-border impacts at issue here is clearest for larger and more advanced 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.

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: One way to ensure a pivotal role for the ministry of finance is by designating it, in the finance/budget Law (or equivalent), as the only ministry which can submit to parliament proposals governing revenue or spending.

While stressing that the ministry of finance should have a central role in the development of incentive schemes and their proposal to the legislature, this sub-principle recognizes that line ministries and other agencies may have an important role in suggesting and designing incentives (as well as in their implementation, monitoring and evaluation discussed under Principles 5 and 6). The importance of inter-agency cooperation more generally is stressed in P5.4 below. Consultations with other stakeholders can also be important at this design stage, as noted in the Remarks on P1.3.

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).

By 'self-assessment' is here meant that the incentive is made available to all those suitably qualified and meeting eligibility criteria. Instead requiring pre-approval on a project basis introduces a discretionary step at which rent-seeking may arise. Ex post monitoring and verification are of course in any case 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 from related entities facing a higher tax rate). Further examples are in Pecho and others (2024).

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 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. So too should the beneficiary's commitment to respect associated conditions and restrictions.

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 (2024).

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 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 of developing a capable tax policy unit.

Remarks on Principle 6

Ex post evaluation of an incentive—evaluation, that is, after it has been implemented—covering both social benefits and social costs, is needed to assess, and account publicly for, its success or failure.

It is also needed to inform decisions on future policies, including—but not only—the termination or reform of the incentive concerned. In deciding on either of these courses, it is 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 (as mentioned in P2.4), 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 referred to here 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).

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).

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.

Ideally, tax expenditure methodologies would be aligned across countries so as facilitate comparisons between them. There may, however, be practical and conceptual reasons for countries to adopt somewhat different benchmarks, and the priority in many countries remains to develop simple estimates according to some methodology with which they are comfortable.

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 the largest beneficiaries or projects. (Notably, the European Commission goes even further than this in relation to state aid, providing a complete repository of information on, and identifying, all recipients.)[1] There may also be sensitive groups, such as political officials or parties, whose receipt of tax incentives is of particular public interest.

In no case should transparency in relation to tax incentives be any less than that for comparable spending measures.

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, 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."[2] 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 simply 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: an assessment of outcome indicators relative to the objectives of the incentive set out in its ex ante justification. Beyond that, simple Illustrative calculations can give a sense of how plausible it is that a 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 At https://webgate.ec.europa.eu/competition/transparency/public?lang=en

2 OECD (2010, p.29) and Beer and others (2022, p.1).

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