TAX INCENTIVES

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Sixth IMF-Japan High-Level Tax Conference
For Asian Countries in Tokyo

April 7, 2015

Context

- Request to IOs from G20 Development Working Group for a paper on “Options for low income countries’ effective and efficient use of tax incentives for investment”

- Professional consensus has been against incentives—but increasingly common!
  - 1980: less than 40% of LICs in sub-Saharan Africa offered tax holidays , none had free zones
  - 2005: over 80% offered tax holidays and 50% FZs

Scope

- An ‘incentive’ is a departure, favorable to the taxpayer, from the general tax rules
  - Many forms and objectives
- Focus on those related to investment—and within that, on business income taxes
  - Though VAT, tariff and PIT incentives can be important
- And only on national level incentives
- Incentives are found in many other countries too
  - And many of the same lessons apply

Prevalence

Incentives are widespread

	Countries Surveyed	Tax holiday/ exemption	Reduced Tax rate	Investment allowance/	R&D Tax Incentive	Super-deductions
East Asia and Pacific	12	92	75	67	83	33
Eastern Europe and Central Asia	16	88	38	25	31	0
Latin America and the Caribbean	25	88	32	52	12	4
Middle East and North Africa	15	80	40	13	0	0
OECD	33	21	36	64	76	21
South Asia	7	100	43	71	29	71
Sub-Saharan Africa	45	78	62	78	11	18

/1 Number of countries in percent of total in the group

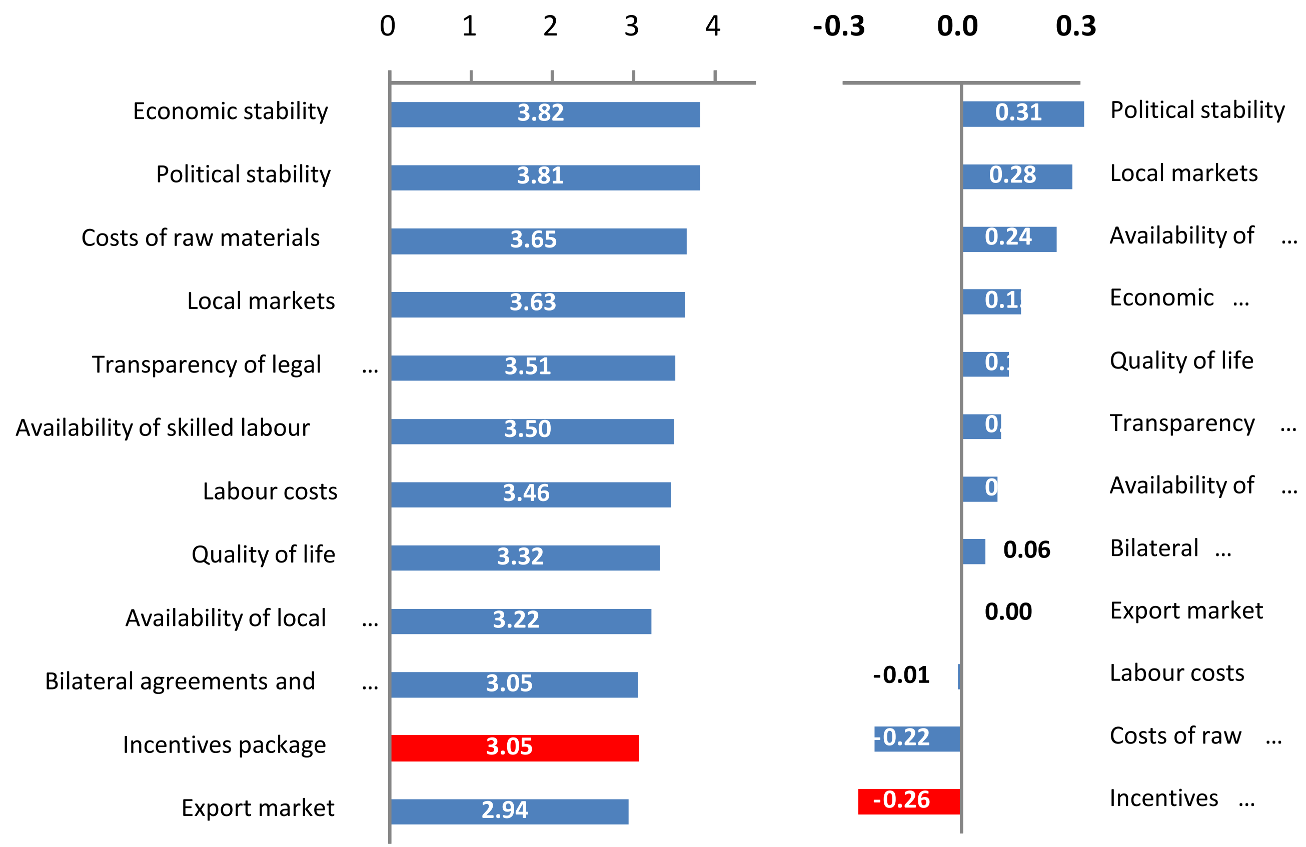
Source: James (2014)

When are incentives desirable?

When the social benefits, from…

- Increased investment…

Effects on Investment: Survey evidence



Source: UNIDO (2010)

…and econometric evidence

- Is that taxes do affect FDI
  - Mainly for location choices/greenfield
- But less marked for developing countries
- Host country tax systems matter
  - Host taxation without deferral reduced value of incentives
  - As does availability of other tax avoidance devices
- BEPS may make incentive issues more important

When the social benefits, from…

- Increased investment, including displacement of other investments
- Impact on jobs
  - But what is the counter factual?
- Spillover benefits
  - Hard to quantify

…exceed the social costs, from

- Lost tax revenue…

Redundancy can be high

Burundi (2011)	77	Rwanda (2011)	98
El Salvador (2013)	37	Serbia (2009)	71
Guinea (2012)	92	Tanzania (2011)	91
Jordan (2009)	70	Tunisia (2012)	58
Kenya (2012)	61	Uganda (2011)	93
Malaysia (2014)	81	Vietnam (2004)	85
Nicaragua (2009)	15	Thailand (1999)	81
Nicaragua (2009)	51 for non-exporting outside free zones	Mozambique (2009)	78

/1 Percent of affirmative answers to the question if an incentive was redundant

Source: James (2014)

…exceed the social costs, from

- Lost tax revenue
  - Which needs to be weighted by the marginal value of public spending
- Consequent distortion in rest of the economy
  - Incentives lead to investments that have a lower pre-tax return than others

PRINCIPLES FOR THE USE OF TAX INCENTIVES

Design

Types of incentive

- Cost-based, such as enhanced depreciation

Are generally to be preferred to

- Profit-based, such as holidays, reduced rate

because they:

- – Target investment itself
- – Have less risk of simply giving a windfall to profitable projects

Economic zones

- Many types
  - Export processing, SEZs fro domestic markets too
- Often non-tax benefits
- Widely seen as important in several countries in Asia
  - E.g. Work on China
- But wider experience mixed
  - No discernible impact on growth in India
  - Much experience of risks to revenue

Eligibility criteria

- Many types, each with their own risk. Eg
  - For foreign investment: But round tripping?
  - For large investments: But meet commitments?
- 'Strategic sectors'
  - but is government good at guessing?
- Critical to:
  - Target incentive closely today objectives
  - Consider alternative means to those ends

Governance

Transparency

- Legal:
  - Clear legal basis, preferably in tax law
- Economic:
  - Clear, public rationale
  - Ex post assessment; tax expenditure analysis a minimum
- Administrative:
  - Eligibility criteria clear and verifiable
  - Clear, open decision-making process

Authority to grant

- Often several agencies involved
  - Investment Promotion Agency, Ministry of Economy, line ministries
- Coordination critical
  - Possibly through inter-departmental committee
- Ultimate authority to grant national-level incentives should be with Minister of Finance

Administration

- Risk of complexity

Country	Average delay in days for granting of incentives	Tax incentive largely discretionary?
Serbia	6	No
Rwanda	10	No
Tanzania	15	No
Uganda	18	No
Jordan	21	Yes
Nicaragua	42	No
Burundi	47	Yes
Kenya	63	Yes
Guinea	80	Yes
Tunisia	95	Yes

Source: James (2014)

- Importance of on-going monitoring
  - Including through filing
- Enforce termination

Reform

Why is it so hard?

- Have observers understated the benefits of incentives?
- Lack of transparency
  - Costs often unclear – alleged benefits can be easy to point to, losses more nebulous
- Incentives create vested interests
  - Easier or the few who gain a lot to lobby for than for the many who each lose a little to lobby against
- And they create precedents for more incentives

Examples

- Jamaica: Removed many discretionary incentives in 2013
- Egypt: began phasing out holidays in 2005 – inward FDI doubled
- Mauritius: Aligned EPZ with rest of economy and removed incentives (except for small businesses)

Regional coordination

- Some efforts (SADC, EAC, WAEMU, Central Am.)
- But not easy: to be effective, need to cover…
  - Full range of instruments
    - E.g. If agree to eliminate invectives, may compete on general CIT rate
  - Wide enough range of countries
- …and incentive of each is to remain outside

Practical tools

Tax expenditure reviews

- Measure revenue foregone, usually without allowing for
  - Investment responses, implying overestimation of revenue cost
  - Avoidance opportunities created, implying underestimation
- A first step in evaluating incentives
  - Require company level data
  - Including for holiday firms (and, ideally, related companies)
- Increasingly common (though often crude)?
  - India, Malaysia, Nepal, Pakistan,Philippines, Sri Lanka

Quantifying effects on incentives to invest

- Impact depends on ‘effective’ tax rates, which reflect not just statutory rate, but details of base

- This impact can be complex…
  - E.g. Holiday firm may wish to delay investment
  - Interest deductibility plus accelerated depart ion can already mean a subsidy at the margin

- But methods to estimate are now routine

Concluding

Questions

- How common are positive/negative experiences with incentives?
- Are some types more effective than others?
- What are the obstacles to reform?
- What might help to overcome them?