Tax Incentives: Efficient? Effective?

Victoria Perry
Fiscal Affairs Department, IMF

April 2015
ECOSOC

Background

- 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

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)

...but are they effective? Rankings by investors:

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

Efficiency is when...

- There is increased investment...
  - net of displacement of other investments
- The impact on (income from) jobs is positive...
  - but what is the counter factual?
- Spillover benefits (e.g., technology/skills transfer)...
  - but hard to quantify

…and all that exceeds...

- *Social costs* from:
  - Lost tax revenues
  - Other costs (e.g., environmental degradation)
- And consequent distortion in rest of the economy
  - Incentives lead to investments that have a lower pre-tax return than others

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)

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

Questions for the Analysis:

- 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?