Recent Findings on Tax Incentives

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Tax Incentives and Tax Competition

- Tax incentives are often instances of tax competition, with the risk that ultimately all countries will lose
  - By attracting investment that would otherwise have gone to another—e.g. neighboring—country, tax incentives can cause adverse cross-border spillover effects on the welfare of other countries
- Moreover, tax incentives in one country might evoke strategic reactions in other countries to adopt the same policies (IMF, 2014).
  - This process can cause a race to the bottom, with ultimately all countries ending up with lower tax revenue, but with no discernible impact on the allocation of investment
- Local governments, within a single country, may compete for investment by granting local tax incentives, thus causing the same negative spillovers on other localities

Tax Competition Examples

- Systematic evidence for 40 countries in Latin America, the Caribbean and Africa shows that a country's length of tax holidays responds positively to that in its neighbors, a clear instance of tax competition (Klemm and Van Parys, 2009)

- The Finance Minister of Grenada waived the company's payment of corporate taxes for 25 years, placed a cap on Sandals' property taxes for 25 years and waived all import duties for 25 years.
  - Benefits: an injection of US$100 million and the creation of 425 jobs
  - This reflects an aggressive form of tax competition in the hotel industry in the Caribbean, whereby governments compete for the same investors

Race to the Bottom or to the Top?

- Race to the bottom
  - Evidence shows that countries compete
    - by lowering tax rates
    - by providing more attractive tax holidays (Klemm and Van Parys, 2009)
      - Thought this cannot be extended to other kinds of tax incentives
  - Fighting off one country with the other is part of a strategy followed by some private companies
    - However, in many cases the final choice is already made
  - 'Winning' countries in many cases suffer from the winners curse/buyers remorse, having given up too much
  - Only a coordinated response could avoid such a race to the bottom (Ex. agree on common minimum criteria)
- There is also evidence of a race to the top !

Tax Incentives in a Global World

- Tax regimes in other countries do matter for global business
- If a parent company resides in a country with a worldwide tax system—such as the US, Brazil, China and India—tax incentives offered by the host country may be offset by a tax liability in the home country, with no notable relief for the investor (other than perhaps deferral of tax, if granted)
  - This can make tax incentives in the host country less effective—although other provisions, such as tax sparring agreements, may nullify this effect and restore the effectiveness of tax incentives (see Zolt, 2015)
- Multinational corporations may be able to shift taxable profit out of a host country and into a tax haven or other low-tax jurisdiction through tax planning techniques:
  - The resulting low effective tax burden on such foreign investors can make tax incentives less valuable and, therefore, less effective

Social Cost Benefit Analysis of Tax Incentives

- SCBA of tax incentives requires first measuring the effects on FDI
- Subsequently, private benefits will depend on how this inflow of FDI has affected:
  - Income generation (jobs)
  - Displacement effects
  - Domestic investment
  - Productivity spillovers
- The public costs can be measured by the net revenue loss for the government—direct costs, corrected for
  - dynamic scoring effects—and
  - valued at the marginal cost of public funds
- Indirect costs

Tax Incentives Framework

The Benefits and Costs of a Tax Incentive Policy

"Net" revenue rise due to increased investment

+

Social benefits from increased investment

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Lost revenue from investments that would have been made anyway

+

Indirect cost of tax incentives (complexity, abuse, transparency, unfairness, quality..)

Social Benefits include cleaner environment, better skills, better health, etc.

How can we measure the different components and provide policy advice to governments ?

Tax Incentives and FDI

- FDI can either be:
  - resource seeking (to exploit the presence of natural resources),
  - market seeking (to penetrate a local market),
  - strategic asset seeking (to exploit local know-how or technology)
  - efficiency seeking (to exploit cost advantages in production for the world market)
- Evidence suggests that tax incentives tend to be less effective in attracting the former three types, but have the greatest salience for the last, i.e. where investment is footloose and oriented toward production for exports (Grubert and Mutti, 2004).

Tax Incentives and FDI

- Variations in tax-responsiveness between countries and regions:
  - Business agglomerations, for instance, may attract FDI due to very favorable production conditions, irrespective of the level of taxation (Baldwin and Krugman, 2004)
  - Elsewhere, investment conditions may be so weak due to poor infrastructure and weak governance that tax incentives have little relevance to location choice (James and Van Parys, 2010)

Tax Incentives and FDI

- Where tax incentives do increase FDI, domestic investment may be displaced:
  - For instance, if FDI reflects a mere transfer of ownership, or if foreign capital crowds out domestic investment.
  - Displacement reduces the effectiveness of tax incentives by mitigating the growth of the domestic capital stock
  - Displacement can also occur with employment, as new jobs created by the new investment may come at the expense of employment in other sectors of the economy

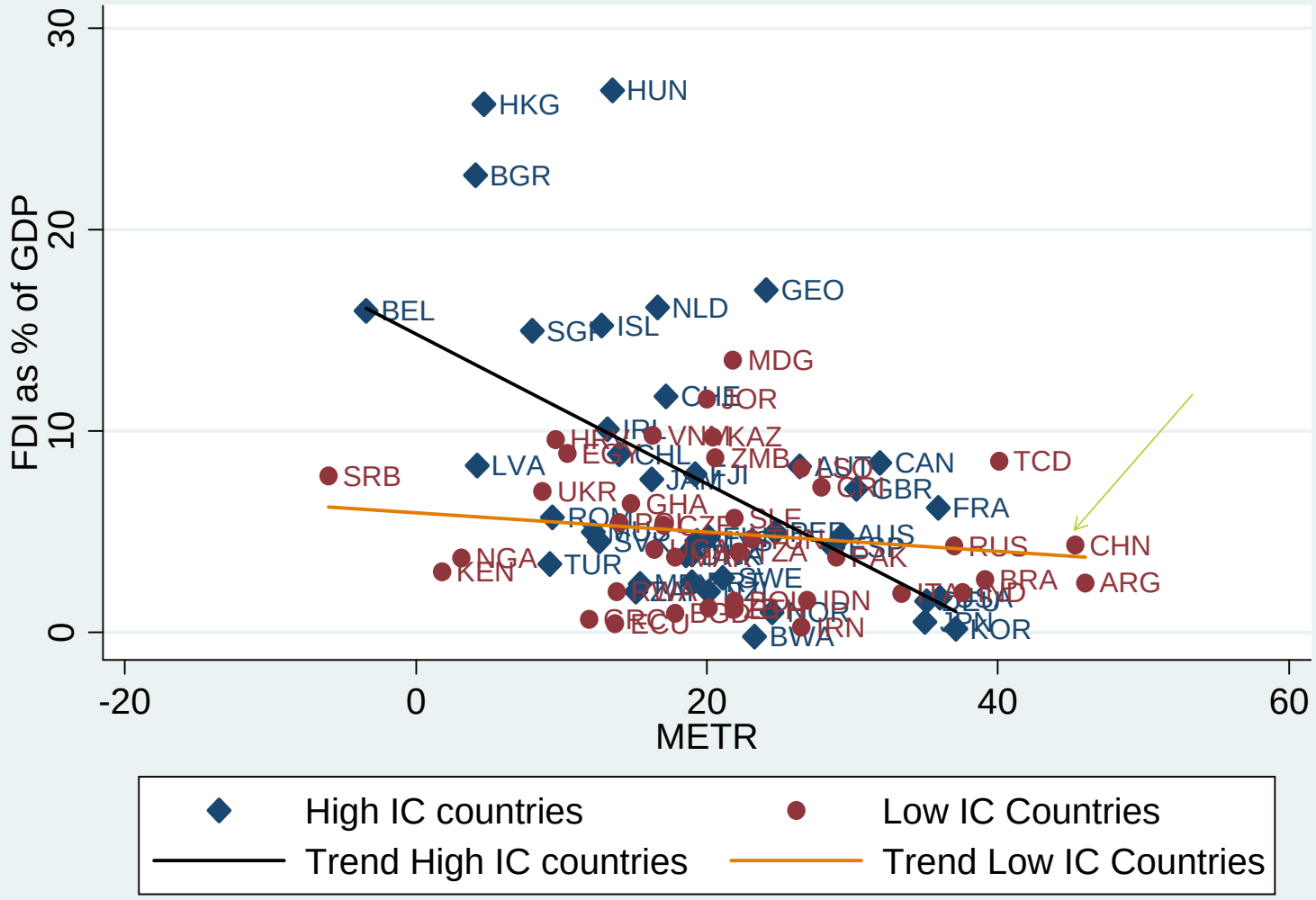
Tax Incentives Examples

- Evidence for **40 Latin American, Caribbean and African countries:**
  - the length of tax holidays systematically increased FDI inflows during 1985-2004
  - These FDI inflows did not come along with an increase in total domestic investment, nor did they increase economic growth. This suggests full crowding out of domestic by foreign capital (Klemm and Van Parys, 2012)
- Agosin and Mayer (2005) report evidence of significant displacement effects of domestic investment by FDI in **Latin America**. Displacement is less prevalent in **Asia** and **Africa**

Econometric Analysis

Research	Conclusion	Policy implication
De Mooij and Enderveen (2003), Desai, Foley, and Hines (2004)	Investments in developed countries respond strongly to incentives	Tax incentives may have been effective in generating investments in developed countries
Klemm and Van Parys (2009)	Investments in some developing countries did respond to incentives, but the elasticity was lower than that seen for developed countries.	Incentives have had a smaller effect on generating investments in developing countries
Grubert and Mutti (2003), Rolfe and White (1991), Wells (1986)	Export-oriented investments are more sensitive to tax incentives	Targeted incentives to promote exports are more cost effective
World Bank Research (Trade and Competitive)	Investments are poorly influenced by lower tax rates in countries with weak investment climates	Tax incentive policy should take into account the readiness of the environment to encourage business

Fiscal Policy Effectiveness and the Investment Climate



Source: James and Van Parys, 2009

Additional Cost of Incentives

- Distortion costs
- Time and money spent by businesses to lobby the government for incentives
- Time and money spent by businesses to qualify for and receive tax incentives
- Revenue lost to illegal activity
- Additional costs for tax authorities responsible for administering tax incentives

Political Economy of Tax Incentives

Discretionary tax incentives are popular with politicians

Tax incentives have non-transparent costs

Role of governance is critical in determining their effects

Bargaining for incentives can open a Pandora box

Tackling the Political Economy of Tax Incentives

- Increase Transparency
  - Measure the cost of tax incentives (Tax Expenditure Statements) - allows the costs to be scrutinized by the public
  - Place a budget cost estimate of tax incentives
- Reduce Discretion
  - Replace discretionary tax incentives with those that flow out of the Tax Law and overall tax system
  - Ensure that criteria is well defined
- Tighten administration - reduce leakage in the usage of tax incentives
- Periodically study the cost effectiveness - allow the public to see for themselves if incentives work

Key Policy Questions to Ask

- Would the investment come in anyway ? Does the country have any other special advantages that are important to the investor?
- Would the investment provide benefits beyond the direct investment (positive externalities)?
- Would the investment generate additional “net” tax revenue?
- Would tax incentives put existing and expected investments at a disadvantage?
- Would they undermine the investment environment by encouraging other investors to ask for similar incentives?

Key Questions

Do Tax Incentives affect Investment ?

If No, how can policy makers manage the political economy drivers?

What other obstacles should be overcome?

If Yes, under what conditions and how can policy makers manage the race to the bottom?

Would any other changes in the tax system be required?

A Policy Direction - Rationalization of Tax Incentives

- Goal – To make the tax system more transparent by eliminating distortions and discretion which creates an unequal playing field
- Avoid – (mis)use of tax incentives and, rather, focus on
  - improving investment climate, and
  - developing a competitiveness strategy to attracting new Investments
- Desired policy impact –
  - More investment in the formal sector
  - Better quality investment
  - Higher tax revenues

Key Reforms

- Increase Transparency
  - Measure the cost of Incentives (Tax Expenditure Statements)
  - This allows the costs to be scrutinized by the public
  - Place a budget on tax incentives
- Reduce Discretion
  - Replace discretionary Incentives with those that flows out of the Tax Code
  - This ensures the role of the legislature
  - Even if a 'big' deal has to be given tax incentives ensure that criteria is defined
- Tighten administration
  - Reduce leakage on the usage of Tax Incentives
- Periodically study the effectiveness
  - This allow the public to see for themselves if incentives work

Recent Reforms

- In 2013, **Jamaica** eliminated many of its generous and discretionary tax incentives:
  - -above 6% of GDP revenue foregone
  - -very little impact on growth (0.9% per year, 1990-2003, Panadeiros and Benfield, 2010)

- *"The Jamaican economy has not been well served by the existing regime of sector based incentives. The consensus is that such incentives may have been partly responsible for Jamaica's lackluster record of growth by encouraging the misallocation of limited economic resources in our country."*

Suggestions for a Reform Program

- Compile an Inventory of Incentives
- Determine how they are administered
- Measure their Costs (Tax Expenditures)
- Conduct Investor Motivation Survey – Look at the Investment side - Political Economy
- Do a Cost-Benefit analysis
- Advise on Policy to improve transparency
  - Define an Investment Policy to drive Incentive Policy
  - On Tax Policy
  - On Tax Administration

Reform Path for Investment Incentives Policy

Tax Policy	Tax Administration	Non Fiscal Incentives
Generous Tax Holidays	Discretionary/Non-Transparent Tax Incentives	Define Investment Policy
Partial Tax Holidays	Tax Incentives in Individual Agreements	Investor Aftercare
Investment linked tax incentives (Investment Credits, Allowances, etc)	Improve transparency (Publish list of investors benefiting from incentives)	Removing Regulatory Barriers
Only indirect tax incentives for capital inputs	Tax incentives in Tax Laws	Invest in Infrastructure
Tax incentives only for anchor Investments, ex-post	Tax Incentives are available without additional permission	Policy Coordination
Uniform low tax rate over a broad base	No Tax Incentives	