Tax Incentives: Efficient? Effective?

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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

<table>
<thead>
<tr>
<th>Country</th>
<th>Countries Surveyed</th>
<th>Tax holiday/exemption</th>
<th>Reduced Tax rate</th>
<th>Investment allowance/</th>
<th>R&amp;D Tax Incentive</th>
<th>Super-deductions</th>
</tr>
</thead>
<tbody>
<tr>
<td>East Asia and Pacific</td>
<td>12</td>
<td>92</td>
<td>75</td>
<td>67</td>
<td>83</td>
<td>33</td>
</tr>
<tr>
<td>Eastern Europe and Central Asia</td>
<td>16</td>
<td>88</td>
<td>38</td>
<td>25</td>
<td>31</td>
<td>0</td>
</tr>
<tr>
<td>Latin America and the Caribbean</td>
<td>25</td>
<td>88</td>
<td>32</td>
<td>52</td>
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<td>4</td>
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<tr>
<td>Middle East and North Africa</td>
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<td>40</td>
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<td>0</td>
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<td>21</td>
</tr>
<tr>
<td>South Asia</td>
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<td>100</td>
<td>43</td>
<td>71</td>
<td>29</td>
<td>71</td>
</tr>
<tr>
<td>Sub-Saharan Africa</td>
<td>45</td>
<td>78</td>
<td>62</td>
<td>78</td>
<td>11</td>
<td>18</td>
</tr>
</tbody>
</table>

/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 counterfactual?

• 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

<table>
<thead>
<tr>
<th>Country</th>
<th>Percentage</th>
<th>Country</th>
<th>Percentage</th>
</tr>
</thead>
<tbody>
<tr>
<td>Burundi (2011)</td>
<td>77</td>
<td>Rwanda (2011)</td>
<td>98</td>
</tr>
<tr>
<td>Guinea (2012)</td>
<td>92</td>
<td>Tanzania (2011)</td>
<td>91</td>
</tr>
<tr>
<td>Jordan (2009)</td>
<td>70</td>
<td>Tunisia (2012)</td>
<td>58</td>
</tr>
</tbody>
</table>

/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 departure 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?