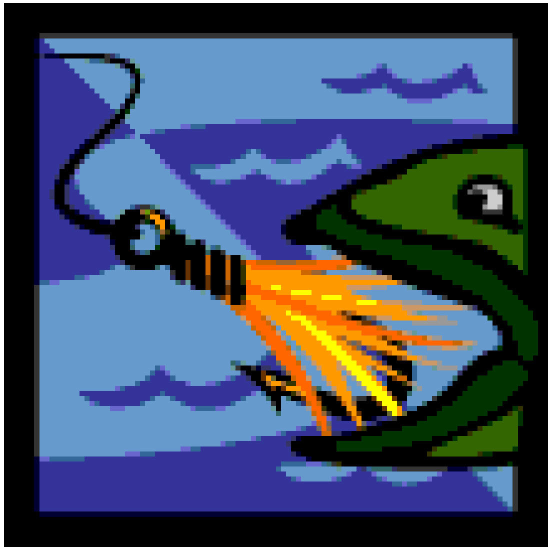
The Use of Tax Incentives to Promote Business Investment



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The Problem

"The puzzle which now has to be posed to the reader is a simple one. It was shown that fiscal incentive schemes are widespread and popular in developing countries and that their impact on their major policy target, the level of investment, is either slight or unknown. Why should schemes whose impact is either slight or unknown be so widespread and popular in developing countries?"

Shah and Toye, 1978

"The use of tax incentives is widespread even though the available empirical evidence on the cost-effectiveness of such incentives in stimulating investment is highly inconclusive."

Zee, Stotsky, and Ley, 2002

"Incentives work only if certain pre-conditions are met, and provided the correct design is chosen. However, even then, the benefits remain doubtful if their costs are taken into account. Moreover . . . some incentives are successful at increasing FDI, but . . . additional FDI crowds out other investment, so that aggregate investment and growth do not improve."

Klemm, 2009

Perplexing Paradox

Although popular and pervasive, most of the time targeted incentives to stimulate investment are both costly and ineffective

- Tax rates too low or too poorly enforced?
  - → Not an effective fiscal tool
- Destructive competition?
  - → Race to the bottom
- Political and corporate pressure?
  - → Non-economic decision
- Not critical criteria for making investments
  - → Other factors much more important

Costs of Tax Incentives

- Erode tax base because incentives either unnecessary or mistargeted
- Create economic inefficiency through distortion of resource allocation
- Increase administrative burden on tax authorities
- Provide opportunities for rent seeking and corruption

→ Without increasing investment

Political Imperative of Tax Incentives

- Dismal performance of tax incentives widely understood by fiscal policy decision makers and supporting technocrats, but must demonstrate taking initiative to political leaders
- No action interpreted as low priority
- Easiest way to appear proactive and responsive to political concerns is to promote tax incentives because they can be enacted quickly and are highly visible
- Underlying structural problems take much longer to address and benefits are realized under subsequent administrations
- Enactment of tax incentives facilitated by dueling power centers with different objectives and metrics for success, often contradictory, for example Ministry of Planning and Investment or Investment Promotion Board vs. MoF
- End result: will most likely have tax incentives….

General Guidelines

- Identify primary constraints to increasing investment so can address in parallel to enactment of tax incentives
  - Hard infrastructure?
  - Soft infrastructure?
  - Complementary factors of production?
  - Availability of inputs, access to markets?
  - Political and social stability?
- Sometimes justified to mitigate market failures
  - Maximize transparency, minimize discretion, include sunset provisions, establish baseline conditions, evaluate results
  - Faster recovery of investment costs (investment allowances, tax credits, accelerated depreciation) most effective
  - Reducing CIT rate, especially tax holidays, least effective
  - Indirect tax incentives very prone to abuse and export processing zones susceptible to considerable leakage