Tax Incentives and Job Creation in the Tourism Sector of Brazil’s SUDENE Area

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Summary. — In recent decades, a significant number of developing countries have implemented fiscal incentives programs for the tourism industry as part of their regional development policies. The main objective of these programs is to increase local investment and employment, as tourism activities are labor intensive. Little evidence is available, however, to assess the effect of these policies on job creation in emerging markets. In this paper, we analyze a program of fiscal incentives introduced by the Brazilian federal government in the SUDENE area in 2002 and in which tourism firms were eligible to participate. Through a difference-in-difference estimation, we compare the change in the logarithm of local employment in the SUDENE municipalities before and after 2002 to the change in the same outcome in a group of municipalities that were not affected by the program. Although our empirical analysis does not measure the efficiency of a similar fiscal policy, it is the first one in the literature to show its effectiveness. It provides evidence that the fiscal incentives led to a substantial increase in tourism employment in the SUDENE area. We find that, over the period 2002-09, municipal tourism employment was on average 30% higher than in the absence of the intervention. This result is robust and is not the consequence of either displacement effects or job destruction in neighboring municipalities that had not been targeted by the tax incentives. We finally discuss some limitations of our analysis that might open avenues for future research in the field.

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Key words — fiscal incentives, employment, tourism, America, Brazil

1. INTRODUCTION

Tourism is one of the largest and fastest growing industries in today’s global economy, due partly to increasing globalization and disposable income (UNCTAD, 2013). In 2013, the tourism sector contributed by 9% to global GDP and in 2015 it generated (directly and indirectly) one in every eleven jobs worldwide (UNWTO, 2014, 2015). Along with the tendency to indirectly influence employment in related sectors (1 direct job in the tourism sector creates an additional 1.5 indirect jobs in the host economy), tourism caters for workers who normally have less access to the labor market, such as the young workforce, women, migrants, and rural population (UNWTO, 2014; World Tourism Organization & International Labour Organization, 2013).

Consequently, governments in emerging countries have been paying increasing attention to policies specifically targeting the tourism sector (UNCTAD, 2013). In particular, tax exemptions of various kinds are nowadays granted to support the construction or renovation of hotels, restaurants, or services catering to visitors (IADB, 2014). The ultimate objective of these programs is to tackle poverty by increasing local investments and, tourism activities being labor-intensive, local employment (Bolwell & Weinz, 2008; ECLAC, 2007; WTTC, 2012).

In spite of their extensive use, little evidence is available to assess the effectiveness of fiscal policies used by developing countries to boost their tourism sector. This paper directly evaluates the impact of a tax incentive program introduced by the Brazilian federal government in 2002 on municipal employment in the SUDENE area over the period 1998–2009.2 Touristic firms located in the SUDENE municipalities benefited from a substantial break in income tax conditionally on making new investments or engaging in expansion, modernization, or diversification projects. Additionally, pre-existing businesses in the tourism sector also received other types of income tax exemptions. Using a differences-in-differences empirical strategy, we provide robust evidence that, as a result of the 2002 tax credits, local tourism employment in the SUDENE municipalities increased by around 34% and that approximately 1 job out of 4 (45,905 units) was created by 2009.3 There are two mechanisms at play through which the assessed fiscal policy may have turned out successful. First, tax rebates conditional on investment decrease the cost of capital and, if the sector targeted is predominantly labor-intensive, can increase worker’s productivity and hence lead to job creation (World Bank & International Monetary Fund, 2015); hence, capital and labor are complementary, rather than substitute. As a matter of fact, the British Department for International Development found that the tourism sector in six developing countries is more labor intensive than non-agricultural activities, particularly manufacturing (World Tourism Organization & International Labour Organization, 2013).4 Second, tax credits directly lower the cost of capital and the real interest rate, and thereby increase investments (Feltenstein & Shah, 1995). Arbache, Teles, da Silva, and Cury (2004) show that higher investments in the Brazilian tourism sector tend to generate more employment than new capital with respect to other sectors.

The paper is organized as follows. Section 2 presents some literature to which this paper aims at contributing. Section 3

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discusses in more details the 2002 tax incentives program that was introduced by the Brazilian federal government in the SUDENE area. Section 4 introduces the data and the econometric model baseline and robust results are obtained and discussed in Section 5. Section 6 and 7 discuss potential effects of the reform in neighboring municipalities and on salaries. Section 8 concludes highlighting policy implications and limitations of our work.

2. LITERATURE REVIEW

There exist strong evidence suggesting that tax credit may be affective in attracting investments and creating jobs in developed countries. There are reasons however to expect a different outcome when similar fiscal policies are implemented in developing countries. First, the limited fiscal capacity may undermine the impact of tax-rebates and tax-holidays (Abramovsky, Klemm, & Phillips, 2014; Feltenstein & Shah, 1995). Second, the repeated use of tax incentives could lead to complex, inefficient, and largely evaded taxes on capital, resulting in little benefits and significant welfare costs (Estache & Gaspar, 1995). Third, fiscal incentives might be less effective in countries with low endowments of public goods (Van Parys & James (2010a) based on 12 Sub-Saharan countries). Finally, tax credits may not be enough to attract investments: non tax and non-economics characteristics (like political and macroeconomic instability, lack of rule of law, corruption, and administrative barriers) can further discourage potential investors (Morisset & Pirnia, 2000; Rahman, 2014; Zee, Stotsky, & Ley, 2002).

Yet, in certain cases tax breaks and tax holidays do attract new investments (Zee et al., 2002), especially in machinery, equipment, and research and development (Shah, 1995). Klemm and van Parys (2012) and Abbas and Klemm (2013) estimate a negative effect of increasing tax rates on FDI in a set of Latin American, Caribbean, and African Countries. Elasticities are found to be smaller than in developed countries.

The existing literature seems to have overlooked the potential beneficial impact that tax credits may have on the labor market in the tourism sector, especially in emerging markets. This paper is among the first ones to assess tax credits as a lever for investments and jobs in the tourism sector in an emerging market, Brazil. To our knowledge, only Van Parys and James (2010b) evaluated the effect of fiscal incentives on FDI in tourism-related activities, before. The authors however measure investment in the hotel industry at the macroeconomic level. Our analysis, instead, focuses on the firm-level impact of tax credits and therefore evaluates their employment effects at the microeconomic level.

3. INSTITUTIONAL SETTING

The Northeast region of Brazil (Nordeste) has historically lagged behind other more industrialized areas of the country, such as the Southeast region, which encompasses the states of Rio de Janeiro and Sp Paulo. Regional development policies targeting the Nordeste have been designed and implemented since the late Fifties. During the mandate of President Juscelino Kubitschek, the Superintendency of Development of the Northeast (Superintendencia do Desenvolvimento do Nordeste, or SUDENE) was established to ensure the coordination of development policies in the region. The SUDENE area covers all of the states in Northeast Brazil and some of the states of Espirito Santo and Minas Gerais. As of 2011, the area had a population of approximately 54,2 million inhabitants and generated approximately 14.3% of national GDP (IBGE, 2011; PNAD, 2011). Over the period 1995–2011, the growth rate of the area was on average 4 times larger than the national growth rate (IBGE, 2011), hinting at the presence of scope for economic development. Nevertheless, per capita GDP in 2011 was still less than half the national average (IBGE, 2011).

In 1966, the federal government allowed tax credits for hotel construction, renovation, and expansion projects at the national level. These tax incentives expired in 1985. In line with this program, in 1974 the federal government created the Northeast Investment Fund (Fundo de Investimento do Nordeste, or FINOR), a federal fund to finance investment projects specifically in SUDENE jurisdiction. According to a complicated fiscal rule, firms throughout Brazil could opt to transfer part of their income tax to FINOR and thereby become shareholders of recipient firms in SUDENE. Tourism projects qualified to receive financial support from FINOR, as well. However, by the early 1990s, significant irregularities related to corruption were observed in the management of the fund. Large amounts of resources were diverted from their initial objectives and, as a result, by the end of the 1990s, FINOR had played a very limited role in the development of SUDENE municipalities (Moreira, 2003; Campos, 2008). It was only in 2002 that tax breaks for tourism firms in the SUDENE area reappeared on the development agenda of the federal government. During 2001–02, the administration of President Henrique Cardoso undertook a new series of development regional policies to attract new investments and create jobs in the SUDENE area. The tourism activities were explicitly included in a list of sectors having priority access to several fiscal incentives. The definition of investment in the tourism sector was extended to encompass convention centers and other projects, such as tourist resorts, while previous incentives were only offered to hotels.

At the bulk of this fiscal package are three income tax credits. First, the new law allowed a 10-year, 75% income tax credit for new investments, expansion, modernization, or diversification projects in priority industries in the SUDENE municipalities. Second, a 10-year, 25% income tax credit was further granted to existing business in priority industries in the area. Finally, the SUDENE firms could benefit from a 30% rebate on taxable income if at least 45% of the latter was reinvested in project with the aim of improving the quality of facilities. Consequently, this set of new rules was likely to play an important role in investment decisions and job creation. In Brazil, income tax credits account for up to 25% of firms’ profits. Thus, the magnitude of the incentive is considerable: a 75% subtraction from income tax could imply an increase of 25% in profits, a large difference from the situation with no fiscal incentives. Note also that tax credits can be granted for new projects as well as for the expansion or modernization of existing businesses. The effect on employment was therefore likely to take place through both new investments (extensive margin) and expansion of existing activities (intensive margin). While they affected several important sectors of the economy, some evidence suggests that tourism is one of the industries that has benefited the most from the 2002 fiscal incentives in the SUDENE states. Investments in agricultural and industrial activities had already received considerable federal support through 75% income tax credit since 1998. Over the period 2013–14, instead, among more than 19 industries that
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