



Tax Incentives for Business Investment: A Primer for Policy Makers in Developing Countries

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Summary. — 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. This paper is primarily intended as a primer on the use of tax incentives for policy makers, especially those in developing countries. It discusses the objectives, cost-effectiveness, and transparency of implementing tax incentives; assesses the comparative merits of alternative forms of such incentives; and provides a review of the empirical literature. Its main conclusions are that the justification for the use of tax incentives should be limited to the rectification of market failures, and that the preferred form of tax incentives are those that provide for faster recovery of investment costs.

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Many underdeveloped countries have recently been competing with one another in according all kinds of tax privileges and immunities to newly established foreign enterprises in an attempt to attract foreign capital to their own territory, with adverse consequences on their ability to collect revenue. Although it can be argued plausibly that an underdeveloped country gains from the inflow of foreign capital even if the income accruing from the investments is left untaxed... it is an uncertain matter how far the total flow of capital investment from the developed to the underdeveloped areas is enhanced in consequences of such policies; and if it is not, such “beggar-my-neighbor” policies of stimulating development deprive the underdeveloped countries of revenue, without any compensating benefit. (Kaldor, 1965, p. 73).

1. INTRODUCTION

Tax incentives are a prominent feature of many tax codes in both developed and developing countries. Developed countries tend to use targeted investment incentives, generally embodied in the income tax law. Developing countries tend to use a combination of targeted and more general incentives, which may be embodied in the income tax law, the investment and other laws, or simply government decrees. Although several countries have expanded their use of tax incentives, this experience is not uniform, with some countries cutting back on such incentives, and some reintroducing them, after a period of reduced use.¹

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 (see Section 4 for a review of this evidence). An important contributing factor to this development is undoubtedly the heightened need perceived by many countries, especially in a regional context, to compete for investment in a world of broadening trade liberalization and high capital mobility. Kaldor’s eloquent words (quoted at the beginning of this paper), written four decades ago, apply equally well to the present-day situation. To these countries, tax incentives are often a visible and flexible handle for attracting investment (Surrey, 1970). Equally important in fueling the spread of tax incentives could have been the impressive economic successes of a number of Asian countries (prior to the Asian crisis) that also happened to make heavy use of such incentives, although the extent of the contribution of the incentives to

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the growth performance of these countries is unclear (Tanzi & Shome, 1992).

There are several potentially serious adverse consequences from the widespread use of tax incentives. First and foremost, they erode the tax base, either because many investments (especially highly profitable ones) would have taken place even without them, or because they are given to investments not eligible to receive them through abuse of provisions in the relevant laws and regulations by either officials or investors, or both.² Second, tax incentives distort resource allocation, as some activities are encouraged over others not because they are necessarily more economically productive, but because they have been given a tax advantage. Finally, the granting of tax incentives creates opportunities for corruption and socially unproductive rent-seeking activities.

In view of the potentially harmful effects from the spread of tax incentives, many economists have argued that to attract investment, countries should instead implement appropriate financial policies to ensure macroeconomic stability, and should pursue tax and other structural reforms to enhance competitiveness and better enable the market to efficiently allocate resources. Relatively less emphasis, however, has so far been placed on ensuring transparency of the legal and regulatory framework, as well as administrative procedures, for granting tax incentives—if they are to be granted at all. Moreover, advice on tax incentives should acknowledge pressures of tax competition for foreign direct investment (FDI) emanating from a regional or global context.

The present paper takes the realistic approach that recognizes that, regardless of their limitations, tax incentives are unlikely to be abandoned by most—especially developing—countries as policy instruments for furthering a variety of national objectives, notably for attracting/competing for FDI and/or stimulating the general level of investment. For this reason, it focuses not on the complete elimination of tax incentives, but on ways to minimize their harmful effects.

To underscore its operational orientation and to enhance its usefulness as a primer for policy makers in developing countries, the paper does not address a number of related, conceptually important but theoretically unresolved issues of taxation, such as whether capital income should be taxed at all,³ whether piecemeal advice on tax incentives in the presence of other (tax and nontax) distortions is

necessarily meaningful,⁴ and whether tax competition necessarily harms national or global welfare. Each of these issues raises a host of interesting questions that continue to occupy economists, but the literature has so far provided results that tend to be model-dependent to varying degrees.⁵ The paper also does not offer fresh empirical evidence on the effectiveness of tax incentives. On this issue, the empirical literature (reviewed in Section 4) is extensive and, as noted earlier, the evidence is inconclusive.

This paper is organized as follows. Section 2 describes the different ways a tax incentive can be defined, discusses the objectives for which tax incentives have been used, highlights the factors that bear on their cost-effectiveness, and emphasizes the importance of transparency for formulating incentive-granting laws and procedures. Section 3 provides a comparative assessment of alternative forms of tax incentives. Section 4 reviews the empirical literature on tax incentives. Finally, Section 5 summarizes the policy implications.

2. DEFINITION, OBJECTIVES, COST-EFFECTIVENESS, AND TRANSPARENCY OF TAX INCENTIVES

(a) *Definition*

A tax incentive can be defined either in statutory or in effective terms. In statutory terms, it would be a special tax provision granted to qualified investment projects (however determined) that represents a *statutorily favorable deviation* from a corresponding provision applicable to investment projects in general (i.e., projects that receive no special tax provision). An implication of this definition is that any tax provision that is applicable to all investment projects does not constitute a tax incentive. Hence, for example, a tax provision that allows the profits of a foreign-funded investment project to be taxed at half the regular CIT rate is a tax incentive; but a general reduction in the CIT rate by half—even if it is intended for a limited duration—is not.

In effective terms, a tax incentive would be a special tax provision granted to qualified investment projects that has the effect of *lowering the effective tax burden*—measured in some way—on those projects, relative to the effective

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