Tax, Investment and Industrial Policy

Presentation for *Taxation & Developing Countries*
(a PEAKS training course)

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Overview

- Using taxation as industrial policy
- Classifying investment incentives
- WTO compliance
- Impact of incentives (some considerations)

Tax as Industrial Policy

- Trade tax incentives– (negative) protection is largely discredited, but exemptions are still used
- (Corporate/investment) tax incentives to attract pioneer sectors and encourage human capital formation (e.g. Singapore) or green innovation (e.g. R&D allowances), addressing market and co-ordination failures
- Tax incentives on their own or as part of a package (skills, R&D, infra, clustering, zones), which requires implementation capacity, strategy, consistency, etc.
- Risk of mismanagement and fiscal problems

Classification of Tax Incentives

- **Corporate tax reductions, exemptions and deductions**
  - *Low statutory tax rates, Preferential tax rates, tax holidays, others (loss-carry forward etc)*
- **Investment allowances and investment credit**
- **Taxes on dividends, interests and capital gains**
- **Taxes on inputs and imported goods**
  - *VAT exemptions, reduced duties*

WTO Compliance

- WTO rules constrain (to some extent) countries by offering certain trade-distorting incentives in order to limit trade distortionary incentives. An incentive is an implicit subsidy
- Relevant agreements
  - Agreement on Trade Related Investment Measures (TRIMS)
  - Agreement on Subsidies and Countervailing Measures (ACM)
  - Agreement on Agriculture (AoA)

Impact of Investment Incentives

- **Literature on attracting FDI** (econometric, economic, surveys, tax lawyers):
  - Main determinants are market size, economic fundamentals, resource availability, etc; but
  - But incentives can be important at margin; and
  - Tax advisors look for countries with tax treaties (DTTs etc) …
- **Revenue foregone**:
  - What would have been fiscal revenues in the absence of incentives? Static (and dynamic) counterfactuals?
- **Impact** of incentives on investment levels, investment behaviour etc.
  - Very little firm level evidence (mostly relying on first point!)
- Relation to governance, intra-state competition, corruption

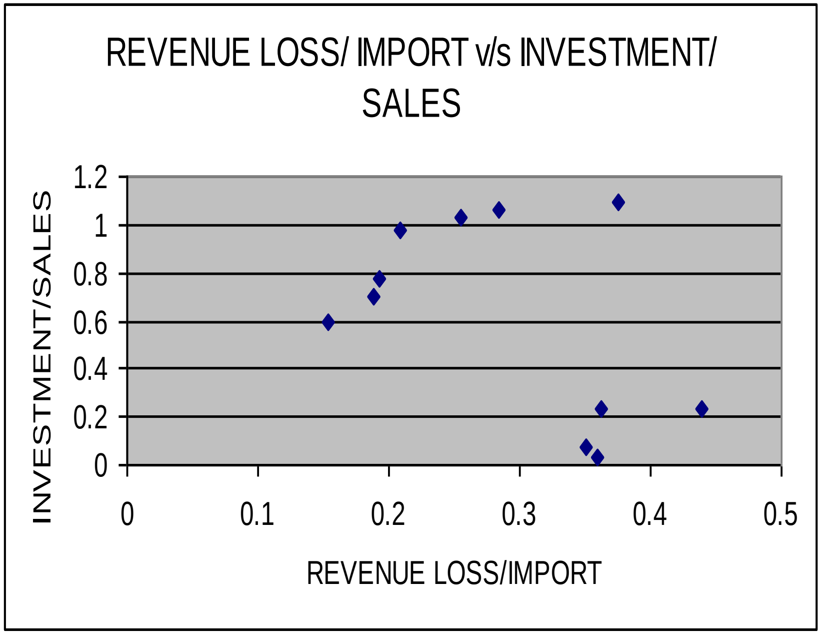
Investment Incentives
Revenue Foregone and Link with Investment

Caribbean examples of customs' revenue losses from concessions, 1991-2003 (% of GDP)

	1991-1993	2001-2003
Antigua and Barbuda	5.1	9.2
Dominica	4.2	4.3
Grenada	11.4	11.3
St Kitts and Nevis	5.8	12.2
St Lucia	5.9	5.9
St Vincent and the Grenadines	6.7	6.1

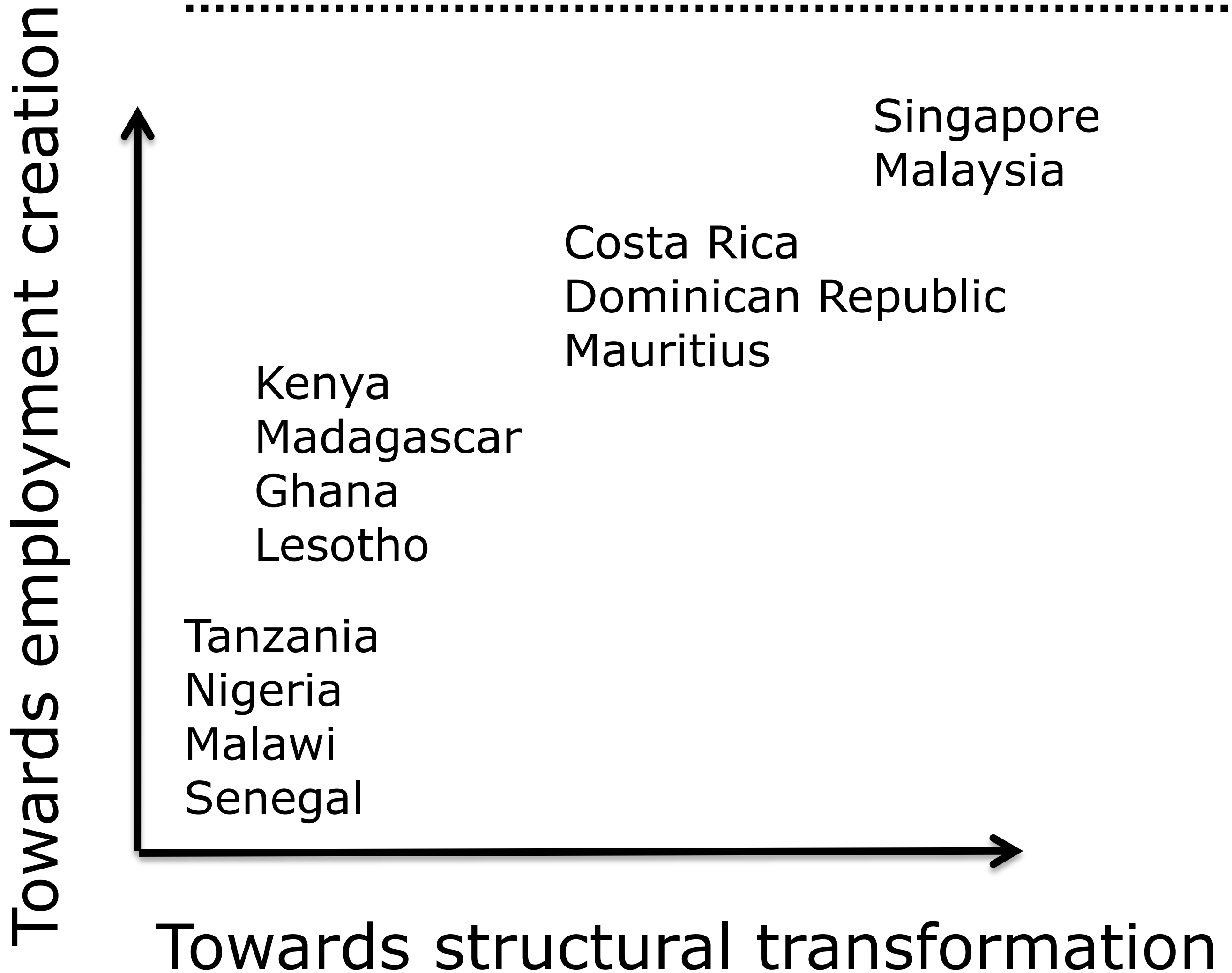
Source: Meyn et al (2008)

Firm level performance and Incentives, St Lucia



Source: CREDIT report

Impact of SEZs on Jobs and Productivity



Some Concluding Thoughts

- Tax incentives do affect investment decisions and behaviour, but there are strong doubts about whether the cost-benefit analysis is positive for host-countries

- Successful tax incentives are part of a package/strategy. Principles for successful industrial policy also apply to tax incentives

- Fiscal incentives in weak governance contexts likely to be most harmful

- But lack of good empirical studies