BETTER POLICIES FOR BETTER LIVES

Tax Incentives for Investment

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Presentation topics

- Definition of tax incentive for investment
- Rationale for tax incentives
- Types of tax incentives
- Observed targeting / qualifying criteria
- General challenges posed by tax incentives
- Challenges of profit-based incentives
- Challenges of expenditure-based incentives
- Factors influencing efficiency
- Political economy considerations

Definition of tax incentive for investment

- Possible definition:

➢ *Law or regulatory provision that provides for more favourable tax treatment of domestic or inbound investment in targeted activities or sectors, or by certain firms.*

Rationale for tax incentives investment

1. Improve the ‘international competitiveness’ of a tax system, and generally less expensive than broad-based tax relief (e.g. CIT rate cut)
2. Correct instances of market failure (e.g. R&D)
3. Support regional development goals.

- Viewed as relatively simple and easy to administer (rarely the case).
- Viewed as a net revenue raiser – assumes tax is foregone only on additional investment that results from a tax incentive (naive view).

Types of tax incentives for investment

- Tax incentives (targeted tax relief) may be provided in respect of various types of taxes – corporate income tax (CIT), customs duties, property taxes, social security contributions…
- When considering incentives that provide relief from CIT, can distinguish:
  - – expenditure-based incentives (e.g. accelerated or enhanced depreciation, investment tax credits),
  - – profit-based incentives (e.g. tax holidays, targeted preferential CIT rate).

Observed targeting / qualifying criteria

- New capital versus new and existing capital
- Equity financed investment
- Qualifying investors (e.g. foreign)
- Volume-based versus incremental expenditure
- Qualifying business sector/ activity
- Qualifying investment size
- Qualifying firm size (e.g. SME)

Challenges posed by tax incentives

- Limited behavioural response/ pure tax relief ('windfall gains') to investors.
- Significant tax administration costs.
- Unintended distortions to competition.
- Difficult to set appropriate rate of tax relief.
- Difficult to target investment – inability to draft precise/ non-complex legislation.
- Difficult to achieve desired goals - unforeseen implications of other tax rules (e.g. R&D tax credit alongside CFC-type (anti-deferral/ anti-exemption) rules).

Challenges posed by tax incentives (cont'd)

- Difficult to limit relief to targeted investments, given taxpayer efforts to mischaracterize profit or expenditure in order to qualify.
- Administrative discretion in deciding qualifying investment encourages corruption.
- Inefficiencies/ unintended outcomes with lack of co-ordination between authorities.
- Lack of policy coherence with other laws.
- Difficult to withdraw tax incentives and pressure to extend – tendency for proliferation.

Challenges posed by profit-based incentives

- Potential for significant tax base erosion.
- Difficult to target new investment.
- Tax relief is not tied/ limited to amount of investment underlying qualifying profit.
- Enables artificial conversion of taxable profit on non-qualifying investment to qualifying profit (e.g. use of non arm's-length pricing).
- Tax holiday – limited financial reporting to enable oversight.
- No relief for start-up firms in a loss position.

Challenges posed by expenditure-based incentives

- Rewards investment expenditure, not success – may encourage 'lower-quality' investment.
- May encourage short-term over long-term investment.
- Less attractive (compared with reduced CIT rate) to investments expected to generate above-normal profits.

Factors influencing efficiency of tax incentives

- Host country fundamentals – if weak, tax incentives cannot be expected to compensate.
- Eligible business activities (location specific profits vs. firm-specific profits).
- Expenditure versus profit-based incentives, and unintended tax planning opportunities.
- Carry-forward/ refund provisions (unused relief).
- Interactions with other tax provisions.
- Awareness, transparency, complexity.
- Home country treatment of foreign income.

Political economy considerations

- Ongoing pressure to introduce tax incentives – role for ‘sunset clauses’.
- Difficulties in policy co-ordination (sovereignty, relevance of tax and non-tax subsidies).
- Where promised, despite concerns, aim to avoid the most-problematic incentives.
- Need transparency, tax expenditure reporting, cost-benefit assessments (for large tax incentive programs), external/ independent reviews of tax incentive provisions and assessments.

Thank you!