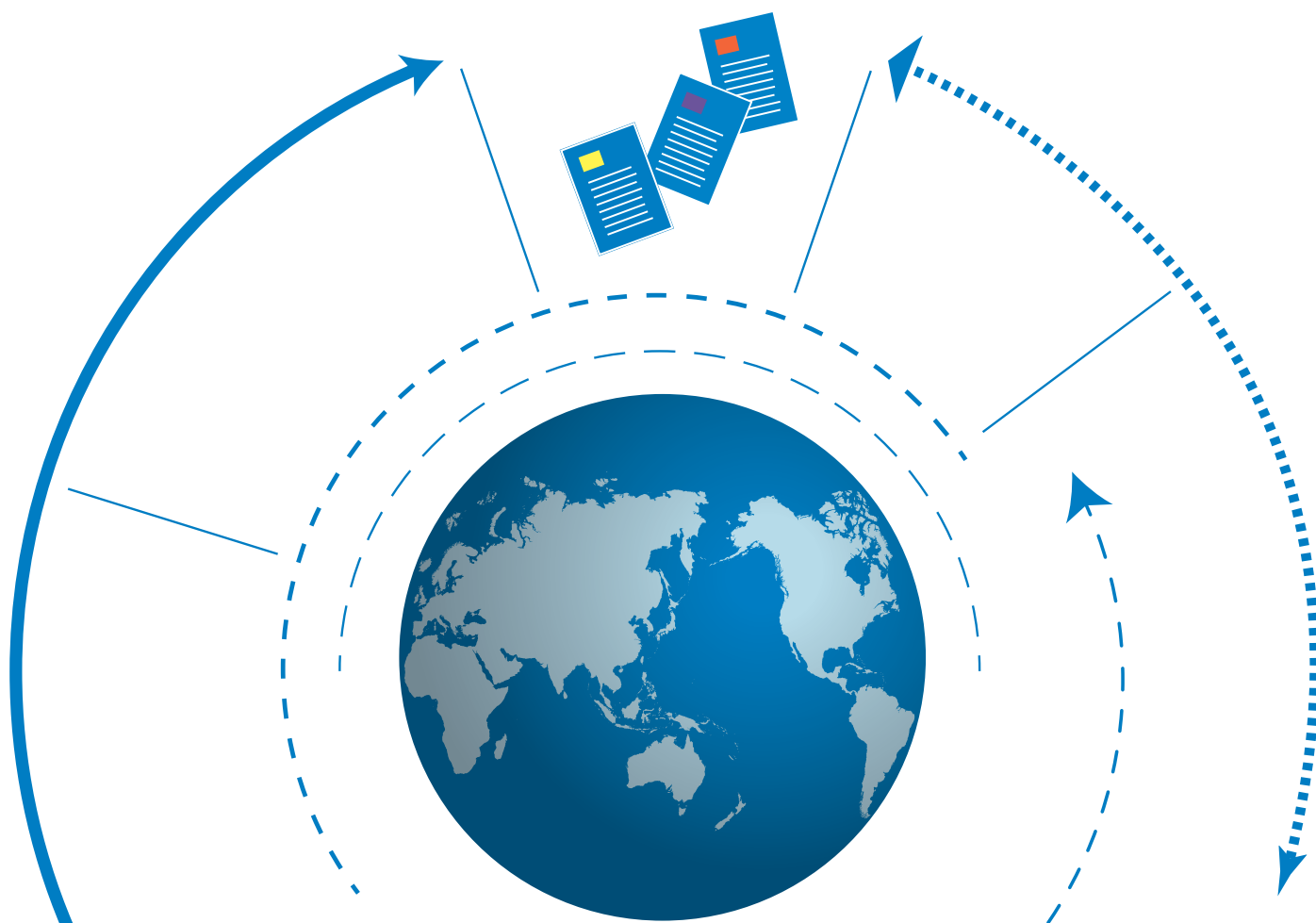




## **“Doctoring the ball”: The political economy of tax incentives for investment in the Dominican Republic**

Christian Daude, Hamlet Gutiérrez and Ángel Melguizo



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## ACKNOWLEDGEMENTS

We would like to thank Bruce Byiers, Oliver Morrissey, Carlos Scartascini, Christian von Haldenwang, Armin Schiller and participants at the DIE-GDI workshop on "The politics of taxation in developing countries" held on 24-25 September in Bonn for their helpful comments and suggestions. Flora Vever provided assistance in editing the paper.

## PREFACE

Fiscal policy can be analysed in different dimensions. There is of course a technical dimension that deals with taxes and expenditures and their effects on economic efficiency. Furthermore, recent advancements in methods and data availability have also allowed the analysis of the distributive incidence of fiscal policy from a normative as well as an empirical viewpoint. However, without considering the political economy dimension, it would be impossible to understand the tax and expenditure levels and structures that we observe in real life. Understanding how different groups influence tax and expenditure policies is essential also to assessing the forces that might oppose fiscal reform or distort fiscal policy such that it becomes a barrier rather than a tool for development.

The present paper contributes to the understanding of the use of investment tax incentives, which are widely used in developing countries to foster investment and competitiveness, not always with the desired outcomes. In particular in Central America and the Caribbean, competition to attract foreign direct investment has led towards a significant erosion of the tax base in many countries. This erosion often leads towards insufficient resources to finance public goods and services that actually enhance the citizens' livelihood, while tax exemptions are allocated according to political criteria rather than creating dynamic comparative advantages and fostering structural change. The particular case of the Dominican Republic studied in this paper illustrates some of the important ways on how interest groups shape the policy framework in their favour. Exploiting differences in different incentive schemes in terms of their governance, the authors show how interest groups have exerted pressure to preserve their privileged positions when they have control over the administration of tax benefits. However, when they could not control the mechanisms, they actually lobbied to modify the rules of the game. This has important implications in terms of the design of tax incentives, such that more transparency and budgeting tax expenditures explicitly could increase public control over these instruments.

This paper was produced as part of the OECD Development Centre work on fiscal policy in Latin America in the framework of the LAC-OECD Initiative fiscal policy pillar, a joint project of the Centre for Tax Policy and Administration and the Development Centre, supported by Spain, Chile and Mexico. We hope it contributes to developing countries' efforts to increase make fiscal policy a more effective tool of resource mobilisation for development and reform their tax and expenditure policies to narrow the multiple development gaps that still remain.

Mario Pezzini  
Director, OECD Development Centre  
January 2014

## RÉSUMÉ

Les mesures d'incitations fiscales peuvent être un outil utile pour stimuler l'investissement dans les pays en développement. Cependant, dans ces pays, les groupes d'intérêt sont souvent en mesure d'exercer une influence considérable sur sa gestion, voire sur sa conception. En suivant une approche de l'économie politique de la réforme fiscale basée sur le pouvoir nous trouvons comment les groupes d'intérêt fonctionnent dans le cadre institutionnel pour obtenir les résultats qui correspondent le mieux à leurs objectifs. Lorsqu'ils échouent, ils deviennent de puissants partisans du changement. Ces dynamiques de pouvoir ont d'importantes implications pour la conception et la gestion des mesures d'incitations fiscales dans les pays en développement.

**Classification JEL:** D78; H25; O25.

**Mots-clés:** politique fiscale, incitatifs fiscaux; économie politique; République Dominicaine

## ABSTRACT

Tax incentives can be a useful tool to stimulate investment in developing countries. However, in these countries interest groups often are able to exert considerable influence in its management, if not its design. From a power-based approach to the political economy of tax reform we find how interest groups work within the institutional framework to seek outcomes that best fit their objectives. When unsuccessful, they become powerful advocates of change. These power dynamics have important implications for the design and management of tax incentives in developing economies.

**JEL Classification:** D78; H25; O25.

**Keywords:** fiscal policy; tax incentives; political economy; Dominican Republic

## I. INTRODUCTION

*Loopholes for some mean higher tax rates for everyone else.*

The Economist. 13 July, 2013.

Tax incentives are often used in developing countries to attract foreign direct investment (FDI) and promote additional investment by domestic firms. While their effectiveness is questioned, developing countries nonetheless make use of them as they act as a substitute for a poor overall business climate (OECD, 2008). However, widespread preferential regimes weaken the tax structure by making the tax administration more complicated and preventing countries from raising their levels of taxation, creating the so-called *fiscal termites* (Tanzi, 2001). Once implemented, these systems generate significant benefits for the recipients who thus become powerful lobbyists, making their modification extremely difficult. Even if these benefits are meant to be temporary, there are strong incentives to maintain them.

Tax incentives tend to have non-transparent costs, which make their estimation difficult and increasing their social costs, underrating their impact in terms of forgone revenue. Furthermore, this opacity weakens citizens' control of the government, by masking key portions of the allocation expenditures and shifting the tax burden within society. In addition, when tax expenditures are not published, budgeted and quantified, it is difficult to evaluate their effectiveness. As formal beneficiaries have legal means to reduce their tax burden, it is in their best interest to avoid changes. In particular, our paper focuses on the formal and informal mechanisms through which economic elites are able to actively influence the administration of tax incentive schemes once they are put in place. This process of altering the rules of the game is what we refer to as "doctoring the ball" – an expression borrowed from baseball referring to when the ball is modified to put an unnatural spin on a pitch and thus create an unfair advantage.

The literature on the political economy of tax incentives, and tax policy in general, normally focuses on how key actors work *around* the institutional framework to solve conflict of interest: be they differences between organised and unorganised groups, among citizens, or between government and citizens (World Bank, 2008 and Alt et al., 2012). This paper addresses a complementary – and in our viewpoint equally relevant – aspect of the political economy of tax incentives: once enacted, vested interests have a particular motivation to keep the incentives in place and therefore we should understand how key actors work from *within* the institutional framework to seek the outcomes that better suit their objectives.

Our analysis focuses on the Dominican Republic. Despite high – albeit volatile – growth rates of income per capita in the past two decades, the country still exhibits tax revenue levels well below its potential. At around 13% of GDP, it is one of the lowest in the region. Low tax morale, or unwillingness to pay taxes, partially explains this, taking part in a vicious cycle that combines low taxation, low quality expenditure and little political legitimacy to raise taxes fairly (OECD, 2013). In particular, the tax base for firms is relatively narrow due to pervasive tax incentive schemes, but rigid – in contrast to an international trend to reduce corporate income tax (CIT) rates, it has actually increased in the past few years. This is partially the result of influence by certain groups that enables them, through legal means, to customise the tax system, shifting the burden of corporate taxation to firms unable to enjoy tax exemptions.

From a power-based approach to the political economy of these processes (Moe, 2005), we argue that stakeholders' interests influence their support or opposition to the status quo. That is, rather than responding to collective solutions, stakeholders with a position of power are likely to be self-serving. This position of power enables them to shape public opinion where it suits their objectives. In the case where the exercise of power cannot be directly exerted or influenced, considerable pressure builds to modify the system.

Specifically, we use a comparative analysis to analyse four tax incentives in the country: free trade zones (created by law 8-90), border zones (law 128-01), tourism (158-01) and industrial competitiveness (law 397-07). Our argument is that economic elites are able to influence the management (and/or design) of these incentives and, when successful, become powerful lobbyists to avoid changes. In contrast, when unsuccessful, there is significant pressure to change.

The rest of the paper is structured as follows. Section II briefly reviews the literature regarding the use of tax incentives and the political economy driving reform processes. Section III presents our case study of the Dominican Republic, including an overview of the four schemes stated above. Section IV conducts the comparative analysis while Section V concludes and explores some policy implications.



## II. A BRIEF LITERATURE REVIEW OF THE POLITICAL ECONOMY OF TAX INCENTIVES FOR INVESTMENT: AROUND AND WITHIN

Tax incentives remain the most popular measure to promote investment in both developing and industrialised countries (Boadway and Shah, 1992; Tanzi and Zee, 2000; Tanzi et al., 2008). Moreover, Klemm (2009) suggests that granting tax incentives might be used to raise the physical capital stock when the tax system is an obstacle, or there are other obstacles that can be overcome by modifying the tax code.<sup>1</sup>

In spite of their popularity, in a survey of the empirical literature focusing on FDI attraction, Blomstrom and Koko (2003) find that there are not significant improvements in welfare when extending incentives to FDI in hopes of spillover effects. This stems from the fact that local firms are able to reap the benefits because they have the ability to do so. To this end, both investors and local firms could benefit more from a stable and certain business environment and predictable tax policy (OECD, 2008).

By contrast, Keen (2001) argues that the preferential agreements can in fact be beneficial. Building on tax competition considerations, the author develops a model in which preferential regimes can have a useful purpose by restraining tax competition to particular parts of their tax system. By offering preferential treatment, countries can compete for mobile capital without holding the rest of the system, and by extension the economy, subject to harmful tax competition. This logic drove much of the legislation behind free zones (the *maquilas*<sup>2</sup>), where the race for FDI led to harmful competition between neighbours (OECD, 2013). While the empirical evidence is scarce and mixed our reading of the literature is more in line with this latter view, as we consider there is a fine line between “ring-fencing” and outright tax competition.

Nevertheless, when justifiable and applied, there seems to be a consensus that incentives should be targeted in scope and length. A first condition is that incentives should be directed toward activities that, while not originally feasible without them, are viable after benefits expire (Klemm, 2009). Second, since these schemes impose fiscal costs and administrative burdens, they should not be indefinite (Tanzi and Zee, 2000). Third, the targeting mechanism should be explicit

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1 See Boadway and Shah (1992) for an extensive theoretical treatment of tax incentives.

2 In Mexico, a *maquiladora* or *maquila* refers to manufacturing operations in a free trade zone, where factories import material and equipment on a duty and tariff-free basis for assembly, processing, or manufacturing and then export the assembled, processed and/or manufactured products, sometimes back to the raw materials' country of origin (<http://en.wikipedia.org/wiki/Maquiladora>).

from the start, and ideally be included in the budget process. Monitoring, quantifying and disclosing information regarding tax expenditures associated with these incentives is also an important factor, both from a technical and a political economy perspective (OECD, 2010a).

In any case a proper design of incentives and a rigorous evaluation of their effectiveness are necessary in order to minimise losses and opportunities for exploitation. Thus, benefits and costs must be readily available to policy makers, to which publishing of tax expenditures is a helpful way of examining costs. Transparency is also key, to which tax incentives should preferably be enacted within the tax code, as incentives given by decree or special contracts are prone to abuse and corruption (Klemm, 2009). Finally, the choice of instrument is crucial.<sup>3</sup> Here the consensus is to avoid tax holidays, since they cause rent-seeking behaviour, and focus instead on instruments that are more transparent and better at targeting investment (Tanzi and Zee, 2000). Unfortunately, the former are popular especially in developing countries since they are easy to manage.

The empirical literature is less extensive, and it tends to focus on case studies and descriptive analysis.<sup>4</sup> Klemm and Van Parys (2009) address this issue, analysing the effect of three instruments – tax holidays, investment allowances and reduced Corporate Income Tax (CIT) rates – on investment and growth for a group of developing countries. They find that tax holidays seem to have a positive effect on FDI, while investment allowances do not, though in their view this has likely to do with the type of investment being catered to. However, they do not find an overall positive impact on investment, suggesting a full crowding-out effect.

Naturally, since granting incentives is not a purely economic decision, political considerations arise. The political economy focuses on the relationship between political actors and institutions that produce a given outcome (Santos de Souza, 2013). Di John (2006) compares various approaches to understand taxation (economic, administrative and political) and concludes that introducing political economy considerations is essential to understanding tax capacity, in which interest group formation plays a central role. Groups that are bound to profit from preferential regimes naturally form a lobby to influence the design and implementation of such regimes, and to guarantee their permanence. Furthermore, once a system creates a precedent, there is considerable pressure for additional ones to emerge (Andújar-Scheker, 2005; Klemm, 2009).

Focusing on political economy aspects, Santos de Souza (2013) offers a critical political economy review of the state of tax reform in Latin America. Aside from electoral support, partisan alliances and political legitimacy and survival, three aspects concerning elite influence highlight political constraints: first, the ability of elites to influence and direct policy making or even control the tax administration; second, the organisational capacity of the business sector

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3 See Boadway and Shah (1992), Tanzi and Zee (2000), Jiménez and Podestá (2009) and Klemm (2009) for a description of the most commonly used instruments.

4 See Boadway and Shah (1992) for a broad, though less sophisticated, survey of the empirical literature.

that renders them cohesive and thus more able to effectively exert pressure (also explored by Fairfield, 2010, 2013); and third, opaque and complex tax systems facilitate exploitations by organised groups and make lobbying easier, a point also shared by von Haldenwang (2008). Therefore, in developing countries a combination of weak institutions and powerful lobbies hinder advances in tax reform. In the same line, Tanzi and Zee (2000) argue that the political setup in developing countries is less cooperative to a “rational tax policy” than in advanced countries, which results in the former having a tax system that allows them to exploit whatever options they have available. Unfortunately, this leads to highly inefficient tax systems, where the government has little political capital to raise taxes evenly. As a consequence, a preferable option is to raise taxes on corporate income, knowing firms will be compensated through incentives (Profeta and Scabrosetti, 2008).

All the references from the political economy of tax incentives normally focus on how actors work *around* the institutional framework to solve conflict of interests. That is, given a framework they will look for the best ways to exploit it.<sup>5</sup> Taxation in Central America is especially interesting. As shown by Schneider (2012), fiscal policy in El Salvador, Guatemala and Honduras can illustrate the role of underlying domestic policy structures. Elites (ranging from a unified business sector in the first case, or a quite fragmented one in the second) have succeeded in keeping taxes low and regressive. At the same time, these elites have a clear state-building project that will allow them to expand their activities and access political power.

In this line, we argue that it is equally important to understand how key actors work *within* the institutional framework; that is, how they can directly use the institutions and regulations in their own favour. The standard public-choice approach presents certain limitations to properly account for the influence elites are able to exert over policy design and implementation. In a central tenet to his power-based theory, Moe (2005) asserts that democratic institutions are often not cooperative or mutually beneficial since they involve the exercise of power.

The World Bank (2008), building on Moe (2005), argues that institutions are created and shaped by powerful interests favouring themselves, while “losers” in the bargaining game remain so. Moreover, the compensation of the latter that is central to the notion of Pareto-efficient collective bargaining is questioned since there is little incentive to compensate losers, as winners do not need them to push through their preferred reforms. “Supporters who play pivotal roles in the policy-making process, then, can use agenda control – even if they are a distinct minority – to keep reform proposals off the table, and thus to prevent change from even coming up for a vote” (Moe, 2005). We refer to this as the “capture of the mechanisms”.<sup>6</sup>

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5 Furlong (1998) explores different avenues through which bureaucracies are influenced, and how these perceive those efforts.

6 There is already an ample literature covering regulatory capture (see Stigler, 1971). However, we go beyond this framework and argue that in addition to influencing the regulatory bureaucracy, they themselves become the bureaucracy.

A similar rationale, for economic development in general, can be found in the best seller by Acemoglu and Robinson (2012). Based on several contrasting cases, nations progress when they develop “inclusive economic *and* political institutions”. While “inclusive economic institutions” have received considerable attention for a long time (those that “enforce property rights, create a levelled playing field, and encourage investments in new technologies and skills”), according to the authors, a sustainable development path also requires supportive political institutions. Conversely, “extractive political institutions” are those that concentrate power in the hands of a few, making progress inexistent (if combined with extractive economic institutions) or unsustainable. Our hypothesis of working *within* the tax legislation can be seen as a case of the latter. In other words, likewise, we strongly support the idea than the analysis of the political economy of tax incentives should consider the influence of groups of interest *around* and *within*.

Finally, our paper is also related to existing political economy approaches to the policy-making process in Latin America (see Stein et al., 2008). In this vein, the process of designing, debating and implementing policies involves the interaction of an ample set of actors (policy and legislation-makers at all levels, business associations, unions, press, civil society), in various scenarios (Parliament or the media, from public boards to private offices). Not only does this framework allow a better description of the equilibrium, but authors also stress that certain characteristics of policies, generally considered of second order, may matter as much as the contents (for example stability, coherence or focus on public interest).

These frameworks are useful to explain tax reform processes in the Dominican Republic, especially episodes concerning tax incentives. It is an interesting case, not only because the country has experienced many of these different regimes during the last three decades, but mostly because the role of groups of interest can explain partly their design, but more importantly their effects.

However, we are not the first to use this framework. To name the most relevant, Moya Pons (1992) was the first to study at length the political economy of the negotiation process of what was perhaps the most famous incentive scheme in the country, the *Ley de Protección e Incentivo Industrial*. In a similar vein, Andújar-Scheker (2005) examines the reform process in the mid-1990s, in what he describes as the second wave of structural reforms. Andújar-Scheker (2008) further develops a theoretical model of the political economy of reform, with the Dominican Republic as a study case and trade reform as the instrument. We build on these studies, plus original face-to-face interviews with government officials and private sector participants, to explore how power dynamics play out in a field characterised by important changes in the structure of the Dominican economy.

### III. THE POLITICAL ECONOMY OF TAX INCENTIVES FOR INVESTMENT IN THE DOMINICAN REPUBLIC

The Dominican Republic represents an interesting case study of the political economy of tax incentives. The country exhibits one of the highest growth rates in the region, both in per capita and overall terms, and has managed to experienced less volatility than the rest of the countries in Latin America in the past twenty years.<sup>7</sup> While growth has been somewhat accompanied by a decline in poverty, still high levels of poverty and inequality persist, and the country has not been able to consistently follow a sustainable growth path. Limited fiscal space plays an important role in this.

In general, the country exhibits low levels of tax revenues. At around 13% of GDP, it has one of the lowest tax-to-GDP ratios in the region. Compared to OECD countries, which had an average tax intake of around 34% of GDP, almost 41% of the gap is explained by a lower level of tax revenues of taxes on rents and profits. Furthermore, the country collects less than what its economic characteristics would imply, partly as a result of its tax structure (OECD, 2013).

The country has had ample experience dealing with tax relief schemes, perhaps the most famous being the system defined in law 299-68. This, however, was not the first time the country experimented with tax incentives: During autocratic rule between 1930 and 1961, a close relationship between business leaders and President Trujillo was key to enjoying benefits through a system of contracts and special concessions rather than general law (Andújar-Scheker, 2005).<sup>8</sup> This mechanism of negotiation, which preceded the creation of formal lobbying structures, dominated the relationship between business leaders and the political class for ensuing decades.<sup>9</sup>

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7 See Fanelli and Guzmán (2008) for a growth diagnostics of the country.

8 Though nominally the president only between 1930-1938 and 1942-1952, Trujillo was the de facto ruler for 31 years, from 1930 until his assassination in 1961.

9 For a primer in the political economy of incentives in Dominican Republic, see Moya Pons (1992). The author describes in detail the behind-the-scenes manoeuvring by pressure groups to affect the enactment of a custom-made incentive scheme. As opposed to the more common approach of the economic impact of incentives and the role of ISI models in the region, Moya Pons emphasises the decision-making process in both the design and execution of industrial policies for most of the 20<sup>th</sup> century.

The law was scrapped with the overhaul of the tax code in 1992, but since several bills have been enacted putting in place different tax incentives, a process that has accelerated since 2000.<sup>10</sup> Many of these systems have been passed outside the tax code, complicating the administration of the tax system and concealing beneficiaries' effective tax burden.<sup>11</sup>

We use a comparative analysis to examine how power dynamics develop when the systems managing tax incentives are captured and how it creates important barriers to change. To illustrate this, we study and compare four systems: the incentives for Free Zones, Border Zones, Tourism and Industry. Together, total exemptions to these four schemes were estimated at little over DOP 30 billion (Dominican Peso) (USD 722.2 million) for 2013, representing 20.9% of total tax expenditures, or 1.2% of the country's gross domestic product (GDP) (Table 1, Panel A). With revenue levels of about 13% of output, tax incentives for these schemes amount to almost a tenth of total tax collection. In turn, benefits granted are quite generous: Artana (2007) estimates they can amount to 50%, 65% and 84% of the value of the firm for the Free Zones, Border and Tourism schemes, respectively.<sup>12</sup>

**Table 1. Investment tax expenditures in the Dominican Republic**

*Selected regimes, 2013*

<i>Panel A. Estimated tax expenditures (as percentage of total tax expenditures)</i>					
	<b>Free Zones</b>	<b>Border Zones</b>	<b>Tourism</b>	<b>Industry</b>	<b>Total</b>
Corporate Income Tax (CIT)	47.0	1.8	2.6	-	51.4
Value Added Tax (VAT)	0.9	-	0.5	1.5	2.9
Excise taxes	1.2	0.4	-	1.3	2.8
Custom duties	80.4	1.1	3.0	0.0	84.6
Assets tax	-	-	-	76.9	76.9
<b>Total</b>	<b>10.0</b>	<b>0.3</b>	<b>0.7</b>	<b>10.0</b>	<b>20.9</b>
<i>Panel B. Estimated tax expenditures (as percentage of investment tax expenditures)</i>					
	<b>Free Zones</b>	<b>Border Zones</b>	<b>Tourism</b>	<b>Industry</b>	<b>Total</b>
Corporate Income Tax (CIT)	47.0	1.8	2.6	-	51.4
Value Added Tax (VAT)	18.6	-	10.7	31.0	60.2
Excise taxes	2.0	0.6	-	2.3	4.9
Custom duties	88.5	1.3	3.3	0.1	93.1
Assets tax	-	-	-	98.2	98.2
<b>Total</b>	<b>28.4</b>	<b>0.8</b>	<b>2.1</b>	<b>28.4</b>	<b>59.6</b>

Source: Authors' calculations based on Ministry of Finance (2012).

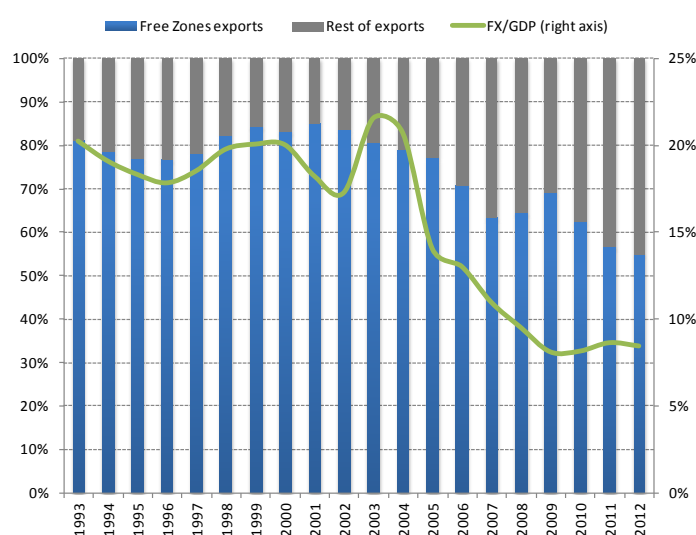
- 10 We focus on tax incentives that are aimed at productive activities and thus we are not considering other exemptions, such as on personal income tax or taxes on consumption. Ministry of Finance (2012) lists over 30 different laws that provide some sort of tax relief.
- 11 Preliminary calculations by the Ministry of Finance put the effective corporate income tax rate at well under 10%, whereas the nominal rate is 29%.
- 12 At the time of the study, the Industry scheme was not still in place. Based on the draft bill, he estimated that Industry benefits could amount up to 77% of the value of the firm.

Considering only tax incentives for investment, a different story emerges. These schemes account for almost 60% of total incentives to investment (Panel B), with the bulk being taken by the Free Zones and Industry schemes. The amounts sacrificed to Tourism are rather small, and those to Border Zones are practically negligible.

### III.1 Free Zones

Free Zones have been an important engine of growth for the Dominican Republic. These special export zones became important in the 1980s by gradually increasing their share of exports, and to a lesser extent in output, as the country was moving away from an industrialisation through import-substituting (ISI) economic model to one based on exports and services. By 1990 free zones exports amounted to over 80% of total exports, and would remain there until mid-2000s, making them an important – though decreasing – source of foreign exchange (Figure 1).<sup>13</sup>

Figure 1. Free zones share in exports and foreign exchange generation



Source: Authors' elaboration based on figures from the Central Bank of the Dominican Republic.

The development of free zones responded to an active development strategy based on three, interconnected, pillars: the diversification of the economy, the development of special economic zones, and openness to globalisation (Pozo et al., 2010). The first pillar prospered under the incentives and ISI-style protection provided by law 299-68, which defined three groups to determine the extent of benefits. The top classification (A) entailed full tax holidays for CIT,

13 The dismantling of preferential quotas under the Multi Fibre Agreement meant increased competition in the textiles sector, which comprise the lion's share of Free Zones firms. Its implementation has had a heavy impact on free zones performance (BCRD, 2006). As of 2013, free zones exports have decreased to a little over half of total exports.

custom duties and other taxes, and it was limited exclusively to exporting firms, thus establishing a proper free zone. Under this system over 300 new firms were created between 1970 and 1990.

Law 8-90, which created a protected special area for exporting firms and responds to the second pillar, governs the current structure of free zones. However, protection was not provided from outside competition, as standard in ISI models, but from *domestic* shortcomings, such as weak institutions, poor rule of law, and inadequate infrastructure (Pozo et al., 2010).

Law 8-90 took all prerogatives involving free zones from law 299-68. Granting ample powers, the scheme basically became a tax code in its own right. More importantly, it managed to survive the structural reforms of the early 1990s and the tax overhaul of 1992. Over the years, the system has proven resilient and did not suffer any major modification to either the legal background or its governing structure until 2011.

The main characteristic is a 100% exemption over the following taxes and duties:

- Corporate income tax
- Custom duties and other import charges on inputs and raw materials, equipment and capital goods and construction machinery
- Value Added Tax (VAT)
- Taxes on incorporation of companies or capital increase
- Local taxes
- Taxes on patents, assets or equity

Other benefits included tax exemptions on construction materials for employee housing, several facilities for profit reinvestment, and other preferential treatments, such as subsidised credit for free-zone firms installed in border provinces.

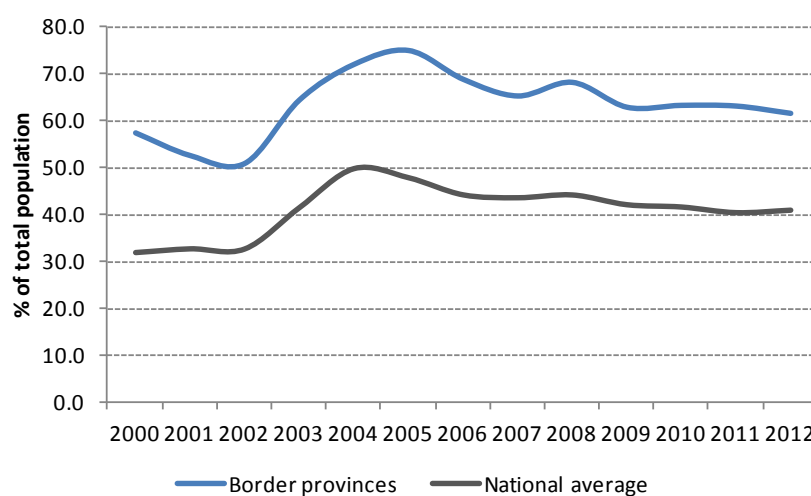
Finally, the council managing the free zones has discretionary rights to extend the maximum benefit period of 20 years, which has meant that in practice benefits are indefinite.

### III.2 Border Zones

Historically, the provinces bordering Haiti have been the least developed in the Dominican Republic. While the country in general exhibits high levels of poverty, this area has consistently stayed above the national mean, exceeding it by over 50% (Figure 2). Sparse population and inadequate infrastructure have translated into scarce development opportunities, despite the touristic potential and the dynamism of inter-border trade with Haiti. These characteristics make the border zone a high priority area.



Figure 2. Poverty levels in the Dominican Republic



Note: Refers to “moderate poverty”, according to the official poverty line. Includes two non-border provinces covered by the scheme.

Source: Authors’ elaboration based on figures from the Ministry of Economy, Planning and Development.

A tax-relief scheme exclusive for a new Special Zone for Border Development was passed in 2001. This special zone comprises the five provinces that border Haiti, plus two close-by provinces, deemed eligible due to their high levels of poverty.

As is common with special zones legislations, rather than channelling incentives toward specific sectors, this system prioritises economic activity in the area regardless of the kind. The law does specifically mention “industrial companies, agribusiness, agriculture, metallurgy, free zone, tourism, metallurgical and energy firms” to be the object of benefits, but it goes further to include “all types of businesses as permitted by Dominican laws”. In practice this has meant that along with agribusinesses and light industry, low value-added firms such as beauty parlours, motels and grocery stores also enjoy the benefits.

The most remarkable feature of the scheme, however, was that benefits applied not only to new firms, but also to *existing* ones, running counterintuitive to the rationale behind the granting of incentives.

The scheme focuses on a few key taxes and fees, on which it grants a complete holiday:

- 100% exemption on corporate income tax;
- 100% exemption of VAT;
- 100% exemption on custom duties and other applicable taxes on the import of machinery and other capital goods;
- 50% exemption of fees for use of ports and airports;
- 50% on any other taxes;

Benefits are granted for a maximum of 20 years, although they start counting five years after the enactment of the bylaws, pushing the applicability of the benefits until 2027.

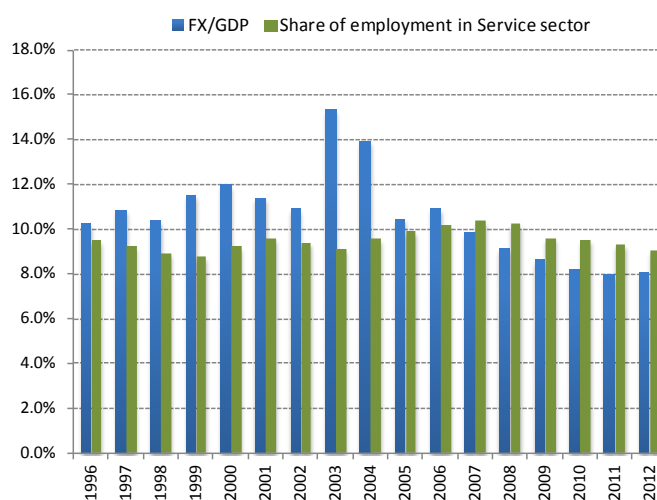
The system remained intact until 2005, when an amendment addressed three issues. First, it limited the VAT and excise taxes exemption to goods sold (or services provided) by beneficiary firms. This corrected the fact that, due to an interpretation of the law, the VAT exemption covered not only the final goods and services but also the productive process. This generated a significant gap between taxed and non-taxed activities.<sup>14</sup>

Second, only the import of machinery and other capital goods were exempted from the *comisión cambiaria*, a tax on foreign exchange transactions, while it applied to all other imports. Finally, imported goods need to be "substantially modified" in order to be able to enjoy benefits.<sup>15</sup>

### III.3 Tourism

Tourism has played a central role in the Dominican Republic, especially as the country has re-oriented itself as a service-based economy. Similar to the development of free zones, tourism took off in the 80s as the mixture of difficult external conditions, domestic crises and structural reforms changed the pattern of competitive advantages (Fanelli and Guzmán, 2008). As of today, tourism is along with free zones exports the main generator of foreign exchange and is an important employer in the country.

Figure 3. Employment and income generation in tourism



Note: Service sector excludes government administration and defence.

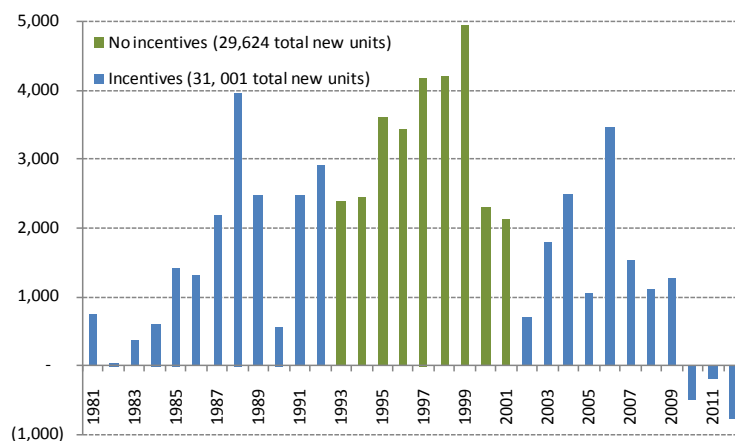
Source: Authors' elaboration based on figures from the Central Bank of the Dominican Republic.

14 The VAT rate was increased from 8% to 12% in 2001, and again to 16% in 2005, when the law was modified. As of 2013 the rate is 18%.

15 A change at the four-digit level in the Harmonised Code.

Jiménez (2007), a former minister of tourism (1996-2000, 2004-08), argues that the development of tourism can be divided into three main periods. The first incentives law of 1971 marks the first period, confining them to special areas, the *polos turísticos de desarrollo*.<sup>16</sup> This law was scrapped with the tax overhaul of 1992, when the second period starts. Tourism development progressed even in the absence of tax breaks, with almost the same number of hotel rooms built in the next decade than in the two periods governed by incentives combined (Figure 4).<sup>17</sup>

Figure 4. Net change in new hotel rooms



Source: Authors' elaboration based on figures from the Central Bank of the Dominican Republic.

A third period starts with the enactment of law 158-01, which governs the current structure of tax incentives in the sector. This law was aimed at the existing *polos turísticos* that still showed little progress, and at newly created *polos*.

Benefits are granted for a maximum of ten years for new projects. For existing projects, they cannot be older than five years in order to be able to qualify.

The instrument of choice is a tax holiday for new projects. Also, during the exemption period no new taxes or fees can be levied upon covered activities. The holiday applies, among other taxes, to:

- Corporate income tax
- National and local taxes levied on construction permits (including property purchases)

16 The law governed the overall structure of incentives, but presidential decrees delimited the *polos* where these incentives were applicable.

17 We refrain from making a direct causal relationship between these events. Strong growth in the 1990s followed structural reforms after a deep crisis in 1989-1991, where the overall conditions of the economy spurred touristic development. However, this outcome begs the question of whether the incentives were really necessary to spur development in the sector.

- Import duties and VAT on equipment, materials and movable goods
- Import of machinery and capital goods

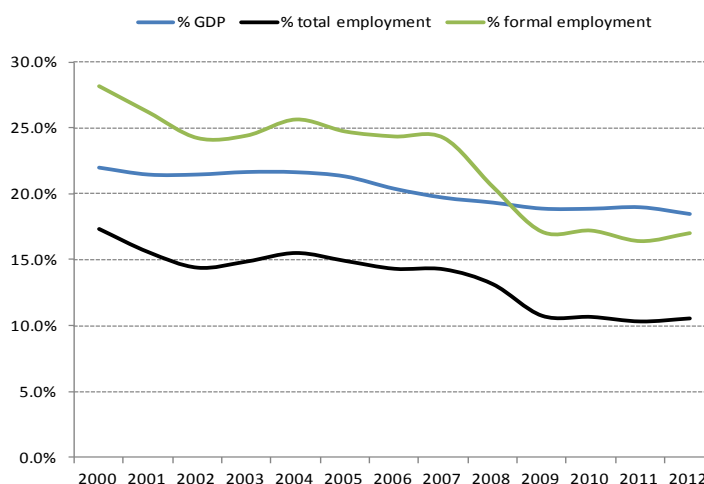
The scheme itself is not substantially different from others. Worth noting is that two sets of bylaws were enacted shortly after the law was passed, altering the scope of the scheme in two important ways.

First, benefits were expanded to *polos* not explicitly covered in the law, and to relatively more developed *polos*.<sup>18</sup> Additionally, discretionary powers were given to the governing council to determine how long a project could take before it started and thus enjoy the benefits. Second, and more importantly, the bylaws expanded benefits in two major ways. Holidays were extended to property taxes not specifically addressed in the law. Also, beneficiary activities now included the construction of apartments, villas and so forth, an implicit subsidy on second-home ownership.

### III.4. Manufacturing industry

The industrial sector is the largest one in the economy, representing close to 20% of GDP in 2012. It is the main employer in the country in terms of formal employment, and fourth overall. However, its share of GDP and job creation has been declining steadily in the past few years (Figure 5).

Figure 5. Main indicators of manufacturing



Source: Authors' elaboration based on figures from the Central Bank of the Dominican Republic.

18 These did not enjoy the full benefits however. Tax holidays on CIT were excluded if applicable to new construction of hotels, but exemptions on custom duties and other related taxes still applied if used for remodelling and re-equipment. Full benefits did apply to other activities/infrastructures covered by the scheme.

The industrial sector has been at the heart of most tax incentive systems put in place in the Dominican Republic. A long history has rendered the sector well organised and deeply experienced in lobbying and negotiation, notably through the *Consejo Nacional de la Empresa Privada* (CONEP) and the *Asociación de Industrias de la República Dominicana* (AIRD).

A new incentives scheme under the law for industrial innovation and competitiveness was passed in 2007, in a decade that saw many other tax relief systems and the passing of five tax increasing laws. The new scheme was aimed at improving the legal and institutional framework for fostering the competitiveness of the industrial sector in the country. Specifically, it centred on promoting diversification of the productive system, production linkages through industrial parks, and deeper linkages with international markets.

The main measures are:

- Creation of a special customs regime applicable to classified firms' import and export procedures;
- Exemption from collection at Customs of VAT on inputs, machinery and capital goods;
- For exporting firms: refunds for VAT and excise taxes on telecom, insurance, fuels and checks; in a proportion equal to the ratio of exports-to-total revenues
- 50% exemption of custom duties for inputs imported through the special zones and "exported" to the Dominican customs territory, for "partial processing" and subsequent re-entry to the special zone;
- A five-year grace period, under which firms can:
  - opt for accelerated depreciation for capital goods;
  - deduct from taxable income up to 50% of investment in capital goods;
  - for purposes of the asset tax, exclude investment on capital goods from the taxable base.

Interventions under this scheme are more targeted in nature, aimed mainly at improving logistics and competitiveness, and fostering innovation. For instance, not collecting VAT at Customs helped address a cash flow problem, while a provision to let firms purchase electricity in wholesale markets helps alleviate energy costs, notoriously high in the country. More importantly, benefits granted under the scheme are indefinite.

## IV. WORKING FROM WITHIN: A COMPARATIVE ANALYSIS

As can be seen, the four systems are fairly similar. Tax holidays are the most commonly used tool in incentives schemes. All systems analysed cover reliefs for VAT and custom duties, mainly those falling upon capital goods (Table 2). Goods exempted include not only machinery and capital, but also inputs and raw materials. Additionally, the Border Zones scheme grants exemption to excise taxes, and in all cases except for the Industry scheme, there is also an exemption on corporate income tax.

**Table 2. Main characteristics of incentive schemes in the Dominican Republic**

Scheme	Year approved	Targeted taxes			Length of benefits	Governing body
		CIT	VAT	Custom duties		
Free Zones	1990	x	x	x	20 years, extendable indefinitely	Public/private
Border Zone	2001	x	x	x	20 years	Public
Tourism	2001	x	x	x	10 years, each project	Public/private
Industry	2007		x	x	Indefinite	Public/private

*Source:* Authors' elaboration based on national legislation.

However, the governance mechanism offers some interesting features for analysis. In particular, it allows us to evaluate our two hypotheses: First, when elites are able to capture the policy mechanism, it remains resistant to change. Second, when unable to do so, elites will exert pressure for its modification.

Formal evidence of lobbying in the Dominican Republic is hard to come by. There are no proper lobbying firms (trade groups or sufficiently large firms carry out lobbying efforts) and there are no registration or disclosure requirements. Given its nature, lobbying often takes place under the radar (de Figuereido and Richter, 2013). Therefore, lobbying takes place mainly through two channels: publicly through the media (Andújar-Scheker, 2005) or through private meetings with key political actors (interview: Ministry of Finance, 2013).

In all cases, the governing law creates a governing body, which among other tasks is ultimately responsible for approving or denying the granted benefits. Thus deliberations are held outside the Ministry of Finance, which at most is a member of the governing body, with common

voting capabilities. In none of the cases the Ministry of Finance is head of any of the governing bodies and in the Border and Industry schemes it is not even part of it.<sup>19</sup>

The composition of the governing body is where we turn most of our focus. As we have argued, a key characteristic of the elites is the ability of not only working *around* the institutional framework, but also working *within* the institutional framework to assure the “right” decisions are taken. In this case, the practice of creating tax incentive schemes outside the tax code, and their governing body outside the Ministry of Finance or Tax Administration, has the peculiar characteristic that is harmful while being institutional. Moreover, though elites do not always have the ability or desire to capture legislation, they do have a keen interest in being close to the decision-making process as a means to ensure the greatest interaction possible with policy makers (Stein et al., 2008; interviews: Despradel, 2013; Ministry of Finance, 2013).

In three of the four schemes business groups are present in the governing structure. This is the case for Free Zones, Tourism and Industry (Table 3). Noticeably, these business groups are from the sector governed by the scheme, so individual firms stand to be evaluated partially by groups to which they have an affiliation.<sup>20</sup> Moreover, both elite groups and bureaucrats act in a cooperative way when it is beneficial to *them*, but not necessarily to the collective (Moe, 2005). Thus, the head of the council is as equally important as private-sector participation. In practice, sector ministries are the heads of council and since they are, by construction, biased toward their sectors, only the Ministry of Finance has a system-wide vision. Additionally, their success or effectiveness is measured in how well they are able to promote the sector, translating into little thoroughness when evaluating projects (interview: Ministry of Finance, 2013).

In this regard, we see that even though in most cases the public sector has a majority in the councils, the presence of sector agencies skew the balance in favour of private interests. In the Free Zones scheme, for example, the Council is comprised of four public-sector members<sup>21</sup>, five private-sector members, and the Council’s Executive Director, which has no voting rights. Similarly, in the Tourism Council there is only one private-sector member, with the rest being from the public sector and an independent environmental expert. However, it is the Minister of Tourism who heads the council and in the past they have either had ties to the sector, have nurtured political aspirations, or both (Listín Diario, 2013). This has an amplifier effect on private-sector members, where they have successfully lobbied to modify the law to expand activities eligible for benefits (interview: Ministry of Finance, 2013) and still argue for lifting remaining restrictions (Hoy, 2013b), though with some backlash (Hoy, 2006a).

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19 In all schemes, other government agencies may attend the meetings on a discretionary basis, but they do not enjoy voting privileges.

20 It also helps to create barriers to entry.

21 One public sector member is the former Corporation for Industrial Promotion (*Corporación de Fomento Industrial*), which was merged into the current *Pro-Industria*, the Industry scheme under analysis. Therefore, only three members can be considered “pure” public sector.

Table 3. Governance of incentive schemes in the Dominican Republic

	Free Zones	Border Zones	Tourism	Industry
Governing body	<i>Consejo Nacional de Zonas Francas de Exportacion</i>	<i>Consejo de Coordinación</i>	<i>Consejo de Fomento Turístico</i>	<i>Pro-Industria</i>
Public sector	Ministry of Industry and Commerce, president Ministry of Finance Corporation for Promotion of Industry* Center for Trade and Investment Promotion	Senators and Members of Congress of affected provinces Ministry of Industry and Commerce Ministry of Tourism Director-General for Border Development, president of council	Ministry of Tourism, president Ministry of Finance Ministry of Environment Ministry of Culture Deputy in Ministry of Tourism, non-voting Deputy in Ministry of Culture	Ministry of Industry and Commerce, president Ministry of Economy Center for Trade and Investment Promotion National Competitiveness Center Customs Agency Internal Revenue Directorate National Institute for Technical Training
Private sector	2 representatives of Free Zones operators, rotating 2 representatives of Free Zones business associations, rotating A representative from the Association of Exporters		A representative from Association of Hoteliers and Restaurateurs	5 representatives of the industrial sector, rotating
Other members	Exec. Director of Council, non-voting	Exec. Director of the Council's Technical Office, secretary A representative of a NGO for each province A representative of the Catholic church A representative of the Evangelical church	An expert in environmental impact	Director of Pro-Industria, non-voting
Quorum	Half plus one	Half plus one	Half plus one	Half plus one of public sector representatives, and Half plus one of private sector representatives
Voting requirements	Absolute majority	Simple majority	Simple majority	Simple majority

\* Currently Pro-Industria

Source: Authors' elaboration based on national legislations.



In the case of Pro-Industria, the industry scheme, the question of who heads the council is as equally important as the composition of the council. In the case of the latter, out of the seven public-sector members two are agencies tasked with the promotion of investment and competitiveness with the powerful *Asociación de Industrias* and *Consejo Nacional de la Empresa Privada* leading the private-sector publicly against any threats to the system (Hoy, 2006b, 2011, 2013a; El Día, 2011). Their gravitas lets them influence the latter: according to officials, private-sector members were successful in forcing the replacement of a director not deemed “from the sector”, lobbying both publicly (El Nacional, 2011) and privately (interview: Ministry of Finance, 2013). On the other hand, bureaucratic bottlenecks, a legacy from the previous entity which the new scheme absorbed, were deemed more important in this result (interview: Despradel, 2013).

On the contrary, in the case of Border Zones, the main lobbyists are the politicians, NGOs and religious leaders of the provinces covered by the scheme. This in turn generates another problem: by sitting in the Council, senators and deputies are acting as both the Legislative and Executive, a reason the system has managed to survive (interview: Despradel, 2013). In the end, there is no private-sector participant, which explains why this scheme, despite receiving fewer benefits than the rest of the systems, has been the object of increased criticism from the private sector (Hoy, 2012; La Lupa sin Trabas, 2012; Senate of the Dominican Republic, 2013). Additionally, the law has been subject to constitutional challenges, currently awaiting a ruling by the new Constitutional Court, after being upheld by the Supreme Court of Justice (SCJDR, 2005).

This in turn leads to our second hypothesis. Within the power-based framework, co-operation occurs among insiders, who use their co-operation to exercise power over others (Moe, 2005). Thus, the inability to become an insider generates a situation where change is demanded. Indeed, two events help to exemplify this.

First, the Border Zones law creates a Technical Office, which in turn has an Evaluation Commission, charged with assessing each request. In the first set of bylaws, which defined the members of the Commission, congressmen and representatives from government agencies comprised the Commission, with no participation from the private sector. In 2005 the bylaws were modified, following a modification to the law,<sup>22</sup> to include a participant of the private sector, the *Asociación de Industrias*. At the same time, the members of Congress –the most vocal lobbyists – were removed from the Evaluation Commission, though they still remain part of the Council and can override the Commission’s decisions.

Second, the ability to exert change was evident in the discussions surrounding the tax reform of late 2012. The original bill included modifications to several incentive schemes. However, only a provision to modify the Border Zones law ended in the final legislation approved by Congress, while all other schemes remained intact (interview: Ministry of Finance, 2013).

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22 The law was successfully challenged in 2007. For more details, see SCJDR (2007).

## V. CONCLUSIONS

Tax incentives for investment have been a widely used and abused instrument in the Dominican Republic. However, even if properly managed, these incentives cannot fully compensate for limitations in areas such as infrastructure, skills or institutional capacity, as argued also by Tanzi and Zee (2000) and OECD (2013). For the fiscal health of the economy and improvement of the overall productivity and competitiveness these issues will need to be addressed promptly. A proper environment (rule of law, infrastructure, and an educated labour force) would influence more than the granting of incentives. Most literature agrees that better targets and focused instruments should be emphasised when designing new schemes or reforming existing ones.

We have focused in this paper on the influence of interest groups on the main tax incentive schemes for investment in the Dominican Republic. While the role of influence groups in creating these schemes has been widely studied, we illustrate that they can also have an important role in the administration of the regime and in making it more or less open to modifications, often needed from an economic viewpoint. In this sense, our case shows that "... the winners of the democratic struggle, and who use public authority, create and design the bureaucratic institutions that fill out democratic government. Their relationships are indeed cooperative and mutually beneficial – *for them*. But they use their cooperation to impose institutions on the political losers, and indeed everyone else in society, and these outsiders are not part of the deal" (Moe, 2005).

We have also shown how the capture of incentive mechanisms has rendered the tax system rigid and unstable in the Dominican Republic, generating great inefficiencies (for example CIT rate has been fluctuating between 25% and 30% in the past years without the possibility of being permanently reduced as is the international trend). This has had the effect of subjecting the public interest to the gain of few. Therefore, there is a need to review and reform tax policy, not just from a technical viewpoint, but more importantly altering the political arrangements. A few key policy recommendations are clear: all tax expenditures should be included in the tax code, the Ministry of Finance should be the main (though not necessarily the only) actor for granting all these incentives and that the private sector cannot have deliberative power in granting incentives. Of course, consultation is welcomed as has been the case with other tax legislations, which helps assure legitimacy. Interest groups would then have again a stronger incentive to work around the system rather than within. Without more balanced and independent leadership, it would be extremely difficult to advance in these fields. More transparency in disclosing information of who has access to tax exemptions and budgeting the tax expenditures could also be tools to increase public control over these instruments.

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Authors' interviews:

DESPRADEL, R. (2013), Economic consultant.

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