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POLICY MATTERS: TAX INCENTIVES FOR BUSINESS INVESTMENT

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ABSTRACT

The purpose of this paper is to analyze the effects of the use of tax incentives on business investment performance in developing and transitional countries based in best international practices and some empirical evidence. The reasons are overviewed and, the costs and benefits of introduction of tax incentives are examined. The empirical evidence of effectiveness of tax investment incentives is studied in countries such as China, India, Russia, Uzbekistan. The conclusions are drawn, and recommendations are given on further implication of tax investment incentives in countries with transition economy.

JEL CLASSIFICATION & KEYWORDS

■ H20 ■ H25 ■ BUSINESS TAX ■ TAX INCENTIVES ■ INVESTMENT ■ SUBSIDIES

INTRODUCTION

The financial crisis followed by capital drought in international markets makes tax incentives one of the main instruments to attract foreign investments in many transitional and emerging markets. However, the use of tax incentives to attract of investments is still the matter of the discussions among the policymakers. Despite the standard international tax policy advice cautions against the use of tax incentives for investment, many developing and transition countries, as well as many industrial countries continue to offer them.

According to OECD report tax incentives for foreign investment are - measures designed to influence the size, location or industry of foreign direct investment project by altering its relative cost or by altering the risks attached to it through inducements that are not available to comparable domestic investors" [1]. A broader view explaining that tax incentives confer benefits on foreign investors in the form of tax expenditures that represent a statutorily favorable deviation from the normal benchmarks of a country's tax system [2].

The study concludes that tax incentives are defined as those special exclusions, exemptions, deductions or credits that provide special credits, a preferential tax treatment or deferral of tax liability. Tax incentives for business investment are often structured through income tax systems, providing relief from corporate-level taxes on income from capital (e.g., tax holidays, reduced corporate tax rates, special corporate tax deductions, allowances and credits), and in some cases providing relief from personal income tax (e.g., imputation relief, preferential tax treatment for expatriates). They can also take form of reduced import tariffs or custom duties.

The empirical analysis of the evidence of use of tax incentives shows application this instrument in Uzbekistan for direct investments as opposed to portfolio investments and relate to real investment in productive activities rather than investment in financial assets.

Tax incentives are introduced for varying reasons:

- they are much easier to provide than to correct deficiencies in, for example, infrastructure or skilled labor;
- they do not require an actual expenditure of funds or cash subsidies to investors, and politically easier to provide than funds;
- sometimes introduced to keep up with other countries in competing for international investment.

Effectiveness of tax incentives

The cost of tax incentives are wide-ranging and include distortions to the economy as a result of preferential treatment of investment qualifying for incentives, administrative costs from running and preventing fraudulent use of incentives schemes, and social costs of rent-seeking behavior, including possibly an increase in corruption. The study evidences that revenue costs of incentives are difficult to quantify. If incentives apply only to investment that would not have taken place otherwise, the cost of direct revenue forgone would be nil. At the other side, if incentives are purely redundant and have no effect on investment then the entire tax revenue waived makes up the direct revenue cost. In practice, the true amount of direct revenue losses is likely to be between these two extremes. Even if taxes are waived on an investment that would not have taken place without incentives, there may be indirect revenues losses. If there is an increase in aggregate investment and activity, there may be revenue gains from this, such as from additional employment taxes or taxes on inputs.

Also investment tax incentives have been subject to serious tax avoidance which has added greatly to their revenue cost. Tax avoidance results, in part, from the design of the incentives and also from the difficulties tax administrations face in auditing taxpayers. The revenue forgone in transition countries as a result of the use of tax incentives to shelter domestic income from taxation may well exceed the incentives earned through legitimate FDI (recent case Starbucks in UK is good example).

The benefits of tax incentives are even harder to assess. Tax incentives are often used to achieve medium-term development objectives, which will be affected by many factors other than incentives, the research showed. Hence, in the typical case of incentives, which are aimed at boosting investment and thus economic growth, it will be difficult to know what the growth performance in the absence of incentives would have been. It is even less clear, what would have happened under another tax reform, such as a general tax cut at the same revenue cost as the incentive. Ultimately, the benefit of incentives should be assessed in terms of higher investment and growth. This can either be achieved simply by generating more investment or indirectly by initially changing the distribution of investment towards activities with higher spillovers, and then achieving higher growth as a result of these.

Any beneficial impact on investment by firms benefiting from tax incentives should be analyzed in light of the effect of aggregate investment. Crowding out of other investment may be a serious problem, because this will occur through two channels. Apart from the usual mechanisms, e.g., through capacity constraints, there will be additional crowding out, because, under a given revenue requirement, a higher tax rate on investments not benefiting from

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incentives needs to be chosen, than would be necessary if there were no incentives. Unless incentives are well-aligned to the most mobile capital, the aggregate capital stock may not increase much.

Empirical evidence of tax incentives policies

Despite to our attempts to analyze the effect of the investment tax credit, considerable uncertainty remains. Time series studies of aggregate investment using factors such as the tax credit (or other elements that affect the tax burden on capital or the “price” of capital) as explanatory variables tended to find little or no relationship, the study of R. Chirinko, S.Fazzarri, and A.Meyer showed. A number of criticisms could be made of this type of analysis, among them the possibility that tax subsidies and other interventions to encourage investment were made during periods of economic slowdown.

Firms may have a larger response on average to changes in the cost of capital during normal times or times of high growth, when they are not in excess capacity. Certainly, one might expect the response to be smaller in low growth periods.

An additional problem we met in our research is that the timing of the investment stimulus may be too slow to stimulate investment at the right time. If it takes an extensive period of time to actually plan and make an investment, then the stimulus will not occur very quickly compared to a cut in personal taxes that stimulates consumption immediately. Indeed, the stimulus to investment could even occur during the recovery when it is actually undesirable.

There is some evidence that the temporary bonus depreciation enacted in USA in 2002 had little or no effect on business investment. A study of the effect of temporary expensing by Cohen and Cummins at the Federal Reserve Board found little evidence to support for a significant effect [3]. They suggested several potential reasons for a small effect. One possibility is that firms without taxable income could not benefit from the timing advantage. Cohen and Cummins also suggested that the incentive effect was quite small (largely because depreciation already occurs relatively quickly for most equipment), reducing the user cost of capital by only about 3%; that planning periods may be too long to adjust investment across time; and that adjustment costs outweighed the effect of bonus depreciation.

A recent study by House and Shapiro found a more pronounced response to bonus depreciation, given the magnitude of the incentive, but found the overall effect on the economy was small, which in part is due to the limited category of investment affected and the small size of the incentive [4]. Their differences with the Cohen and Cummins study reflect in part uncertainties about when expectations are formed and when the incentive effects occur.

This analysis suggests that a business tax subsidy may not necessarily be the best choice for fiscal stimulus, largely because of the uncertainty of its success in stimulating aggregate demand. If such subsidies are used, however, the most effective short-run policy is probably a temporary investment subsidy. Permanent investment subsidies may distort the allocation of investment in the long run. Thus, we think these results would be useful for policy implication in developing countries.

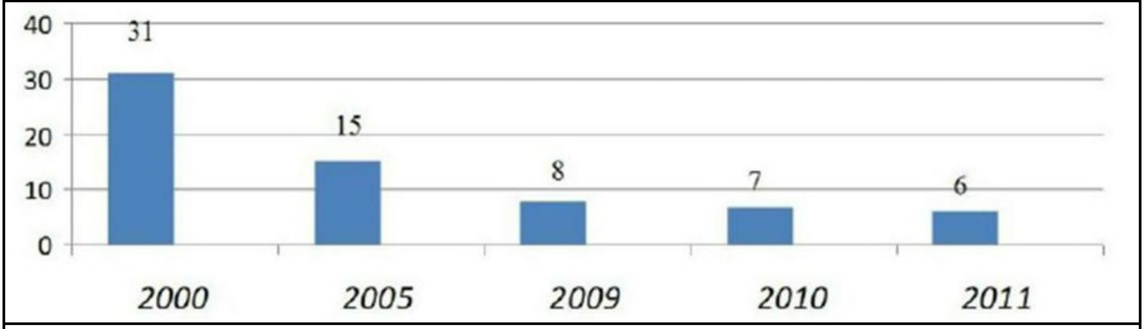
There is very little work specifically addressing tax incentives for general investment, particularly in developing countries. The little work available typically employs a descriptive or case-study approach, rather than econometric analysis, which is probably explained by the difficulty of obtaining sufficiently reliable and broad data sets. Bond (1981) finds that tax holidays lead to short-lived and small firms in Puerto Rico. Shah (1995) contains papers looking at the effect of tax incentives in a variety of countries, using different methodologies including calculations of Marginal Effective Tax Rates and business surveys. The overall conclusion from them is that tax incentives are often ineffectual, either because the particular incentives offered are not very valuable to firms or because important pre-conditions are not met, such as a relatively stable macroeconomic environment and satisfactory public infrastructure. These studies tend also to conclude that investment incentives are more effective than tax holidays. These results are, however, not fully reliable. A main weakness is that most studies focus on one country only, making it difficult to control for factors other than tax incentives.

Practices in developing countries

From a global perspective, a reduction in the base rate of corporate income tax is the most widely used fiscal incentive. However, the next most widely used tax incentives vary across developed and developing countries. In OECD countries, accelerated depreciation, specific deductions for corporate income-tax purposes, and reductions in other taxes (including state and local) are the next most widely used (in descending order). In contrast, developing countries tend to offer more tax holidays and import-duty exemptions and drawbacks after reduced base income tax rates. Among targeted incentives, those geared to promoting exports have been most effective.

In general (in both developed and developing countries) tax incentives are targeted to attract investment in specific types of activity or geographic areas. The principal targets are: i) specific sectors, notably in manufacturing, infrastructure,

Figure 1: Small business tax (fixed) reduction trend in Uzbekistan, 2000-2011



Source: N.Murodova. Mechanism improvement of state support for small businesses through tax tools in Uzbekistan. European journal of business and economics, V6/2012, pp45-47 tourism, health and transportation, and in several cases education (small businesses, manufacturing modernization, privatization are main considerations in Uzbek tax investment policy, table-1); ii) specific regions (geographic locations) which are less developed areas; iii) exports (tax incentives targeted to exports are mainly used in developing countries).

The study of China's tax incentive evidences that regimes took full shape in 1991 with the enactment of the Income Tax Law of the People's Republic of China Concerning Enterprises with Foreign Investment and Foreign Enterprises [5]. Most of the usual forms of tax incentives can be found in this law and it's Implementing Rules [6]. Some of the more important included: tax holidays and reduced rates for production-oriented enterprises, tax refunds for reinvesting profits, accelerated depreciation, and a variety of tax breaks in many geographic zones and regions as well as for advanced technology, export-oriented industries and infrastructure projects among others. Although it is debatable whether tax incentives were an important factor influencing foreign investment in China, the fact remains that China experienced a rapid growth of FDI in the following two decades – and it has been generally, if not universally, accepted by Chinese tax researchers that this can be attributed partly to the attractiveness of its tax incentive regimes [7]. Indeed, the fundamental characteristic of those regimes prior to 2008 is that they were virtually all FDI-specific. This is not the case today. Following the implementation of the Enterprise Income Tax Law of the PRC which took effect on 1 January 2008 ("the 2008 EIT Law"), the landscape of China's tax incentive regimes changed dramatically [8]. Previously, foreign investors enjoyed a variety of tax incentives that were not available to domestic investors. Under the 2008 EIT Law however, tax incentives were extended to domestic enterprises, but their scope was significantly reduced. In short, tax preferences are now restricted to supporting China's economic and, to a lesser extent, social policies in a limited range of areas, notably developing infrastructure and agriculture, promoting acquisition and innovation of technology, natural resources conservation, environmental protection, and public welfare.

Russia provides numerous investment incentives. For example, profits in the pharmaceutical industry are exempt from the federal corporate income tax. St. Petersburg allows companies to deduct capital investment from their profits for the city's share of profit taxes (Diamond and Diamond, 2006). India adopted new legislation for Special Economic Zones in 2005, with 200 approved by March 2007. As in other countries, tax breaks, labor law and regulatory concessions were the main draw (Yee, 2007).

Estonia, by contrast, maintains a low tax regime without location incentives, which were abolished in 2002. The current corporate tax rate is 22 per cent, and profits are not taxed until they are distributed (Invest in Estonia, 2007).

The United Kingdom, which reached the US$ 1 trillion level in inward foreign direct investment stocks in 2006 (U.K. Trade and Investment, 2007 provides several incentive programs. It has a regional aid scheme (known as Regional Selective Assistance or Selective Finance for Investment, depending on the region), with grants from 10 per cent to 30 per cent of the investment, depending on the severity of the regional disadvantage (Department of Business Enterprise and Regulatory Reform, 2007: file 38645). Some of these maxima will be reduced in 2011 under EU state aid rules. The U.K. actively courts film production with a 15 per cent tax credit for film-making, or 20 per cent for films with budgets below £20 million.

Japan's prolonged economic woes have led to some interest in increasing FDI in a country that has long been very selective about foreign investment. Regional governments do not have much taxing power, meaning they have little to abate (Pilling, 2004). However, depending on the prefecture or city, subsidies for new facilities or expansions have maximums ranging from ¥ 1 billion to ¥ 8 billion.

The study of tax incentives policy in Uzbekistan shows the use of mix mechanisms of tax incentives such as deductions for direct investment (especially for foreign investment) and adopting of legislation of Special economic zones (in Navoiy region and in Angren district). Very careful and selective approach is used in Uzbek tax policy making to attract investments in priority areas of development (industry).

Coming back to results of our studies, we can see investment incentives are not a marginal or geographically-limited phenomenon. On every continent, multiple levels of governments use location subsidies to try to promote investment. While some countries run low-tax regimes with few, if any, incentives, they are the exception rather than the rule. Thus, the global significance of a study of these investment supports is likely to be substantial. In addition to the examples given here, the case studies cover more countries and provide concrete examples of the widespread use of investment incentives.

Conclusion

To investors, the general features of the tax system (tax base, tax rates, etc.) are more important than tax incentives. Survey analysis shows that transparency, simplicity, stability and certainty in the application of the tax law and in tax administration are often ranked by investors ahead of special tax incentives. Tax incentives by their nature represent a revenue cost …. [and it] is wasted because the incentives go to investments that would have been made in any event" [9]. The study shows that projects would occur even if there were no tax incentives, the tax incentive is a pure windfall to them.

The practices discourage the use of special tax incentives to attract FDI and argue in favor of a reduced statutory corporate income tax rate on a broad tax base. However, pressures can mount to introduce special incentives in response to "tax competition" amongst competing states, and that policy makers can benefit from a review of design considerations to target assistance and minimize unintended revenue loss. Business leaders will always keep their pressure to maintain, restore and even increase tax incentives, even when their ineffectiveness has been demonstrated.

The most important results taken from the study of tax incentives policy to recommend on developing countries policy making can be formulated as:

- An effort worth it to try in order to simplify the country tax system, eliminate tax distortions, remove unnecessary administrative and compliance costs, increase transparency and improve government's capacity to generate revenue. This helps to improve the framework conditions and market characteristics of the country for attracting investment.
- It should be pointed out that tax relief tied to prior investment generally should be respected to not undermine policy credibility and avoid weakening the ability of government to influence investment behavior in the future.

- Countries should consider elaborating a tax expenditure report. This report not only provides information on the effectiveness and cost of tax incentives, but also helps to strengthen government finance and contribute significantly to fiscal transparency.

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