Tax Incentives and Tax Base Protection in Developing Countries

Joosung Jun
(Ewha Womans University, ESCAP Eminent Expert Group)

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Tax Incentives – Base Erosion?

- Widely used in developing countries, but
  - Unclear benefits (investment-growth-revenue)
  - Various costs (revenue, efficiency, corruption)
  - Subject to tax competition; Culprit for base erosion?
- Suggested **Best Practices**
  - Get rid of them! **Simplify the tax system**
  - Incentives effective under good **investment climate**
  - Worry about a **"race to the bottom"**
- Clear merits, but some of them are too simplistic / unrealistic; Costs seem overstated, benefits understated

This paper suggests

- **Cases for tax incentives,** on 2nd-best grounds
- **Incentives can be used for base-protection purposes** (countries under evasion pressure)

  - Tax incentives designed to keep firms from shifting into informal sector

  - Ineffective 'investment' incentives; just subsidy? (support tax-paying firms along with non-tax benefits)
- **Incentives for foreign investment can be better aligned**

  - Improve investment climate? Time/budget (Under good climate, tax incentives could be redundant)

  - Bad climate? Still room for ***marginal*** incentive effect
- Discuss **"good" cases: Singapore-Korea**

Channels for Base Erosion

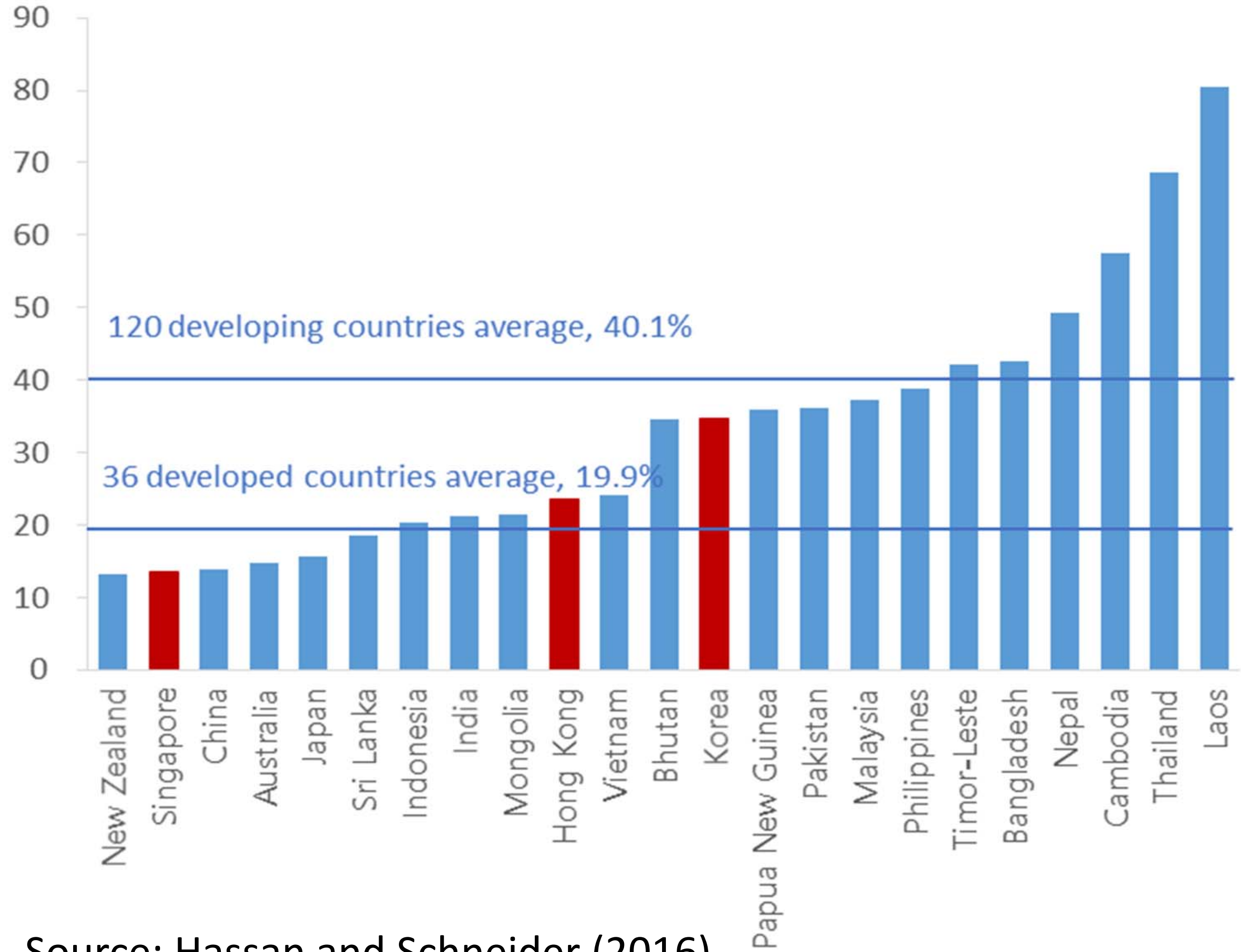
- **Traditional:** Tax distorts behavior (LS, S, I)
  - Focus on "***efficiency costs***"

  (Tax reforms toward "low-rate-broad-base")
- ***"Compliance"*** **is important for LDCs**
  - Base shift into **the informal sector**
  - Base shift between **PIT and CIT**

  (Second-best approach to protecting base; "Tax incentives" can be part of plan)
- **International capital mobility**
  - Tax competition: **investment incentives**
  - Profit shifting (Transfer pricing): **STR differentials**

Appendix 1. The Informal Sector in Developing and Developed Countries, 2013

(% GDP)



Source: Hassan and Schneider (2016).

Table 2.1 Tax Structure in Developing and Developed Countries, 2013

	Tax Revenue	Personal Income Tax and Social Security Contributions	Corporate Income Tax	Consumption Taxes	Property Taxes	Border Taxes	Shadow Economy
	% GDP	% of Total Tax Revenue					% GDP
Developing countries average	**24.5**	27.1	**14.8**	45.4	2.1	7.2	**39.3**
Developed countries average	**34.1**	49.3	**9.9**	33.5	4.0	0.3	**20.2**

Source: IMF, *Government Finance Statistics*; Hassan and Schneider (2016).

Base protection in Developing C

- **Lower Revenue & Narrower Base** than DC

  - Revenue / GDP (24.5% vs. 34.1%)

  - **Informal Sector** (20% vs. 40% of GDO)

  - CIT is more important than PIT (**Observability)**

- **CIT doing a "backstop role" for PIT**
- **Subsidize tax-paying firms**

  - Access to bank-loans, change regulations (even to the extent of discriminating against competitors)

- **Incentives to reduce evasion/informal activity**

  - Use of financial services (credit card); being listed

  - Bookkeeping burden; loss-offsetting

Incentives for Foreign Investment

- **Determinants of MNC's location choice**

  - Tax incentives: visible, readily available

  - Investment climate; rent potential: a long-run issue

- **Best practices?**

  - Improve climate before applying incentives? (takes time/fund; correlation does not tell whole story)

  - Do not use incentives to compensate for deficiencies in investment climate (Why not? See next slide)

- **"Marginal" vs. "inframarginal"** effects

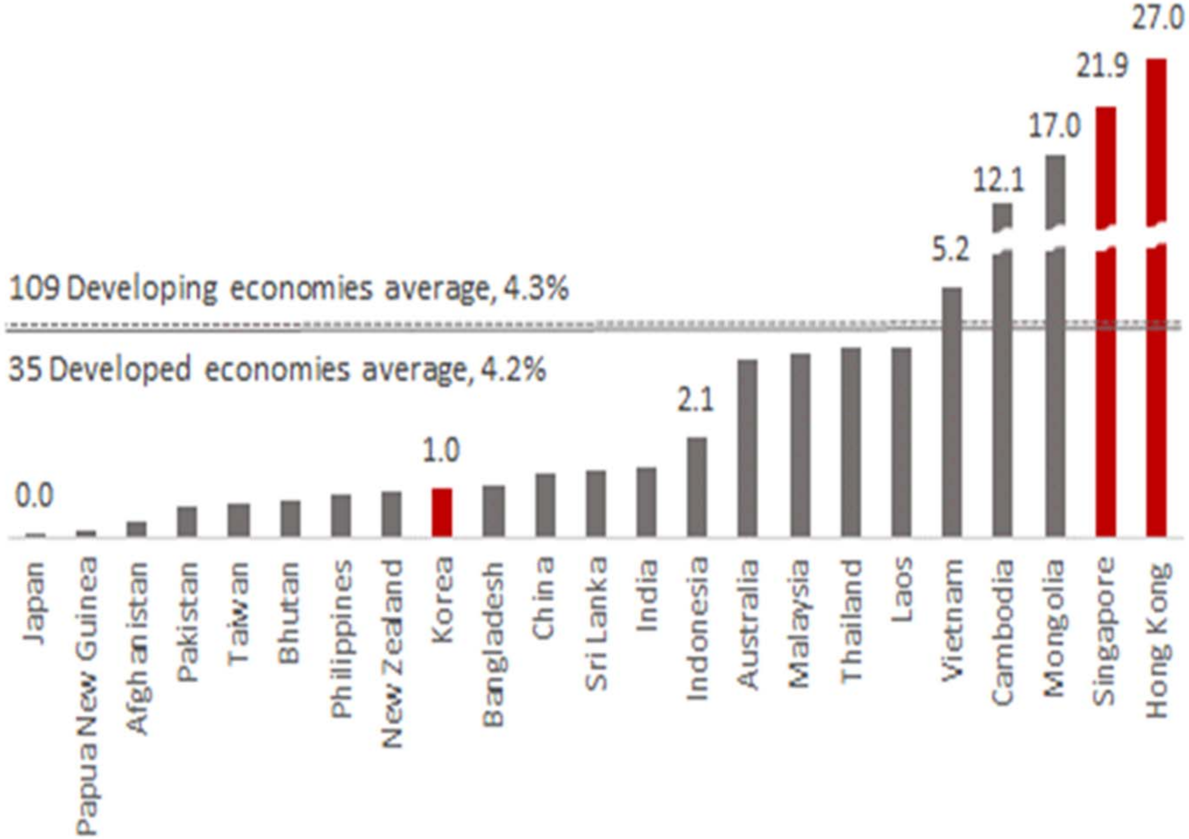
  - Tax incentives more effective when "something is missing" **at the margin.** (*Countries with weak investment climates or low-rent potential)

Incentive Effects by Investment Climate and Rent Potential

	Strong investment climates	Weak investment climates
High rent potential	• Effective, but can be redundant (infra-marginal subsidy)	• Possibly *compensating* effects at the margin
Low rent potential	• Possibly *compensating* effects at the margin	• Ineffective but little revenue cost • Signaling effects in the long run

FDI Inward Flows in Selected Asia-Pacific Countries, 2013

(% GDP)



Source: UNCTAD database

Hong Kong, Singapore vs. Korea

- Evidence from 'good cases'; but contrasting
- **Hong Kong: stresses "investment climate"**

  - Simple (low-rate) tax system is part of such climate
- **Singapore: has adjusted incentive level as its investment climate improves (to avoid 'redundancy' of incentives)**

  - FDI has been important; incentives matter, but..
- **Korea: less favorable investment climate - focused on domestic firms that pay more taxes than foreign firms**

  - FDI has a minor role; Incentives appear "ineffective"
- **Country-specific conditions and priorities!**

Tax Rate Structure

- **Statutory corporate tax rate to be in conformity with international standard**

  - Base-erosion due to **profit shifting**

- **Effective tax rate can be adjusted by tax incentives**

  - **Race to the bottom? Room for tax incentives,** reflecting **country-specific conditions** (sources of rent, investment climate, competitors…)

- **PIT-CIT rate differentials: source of B.Shifting**

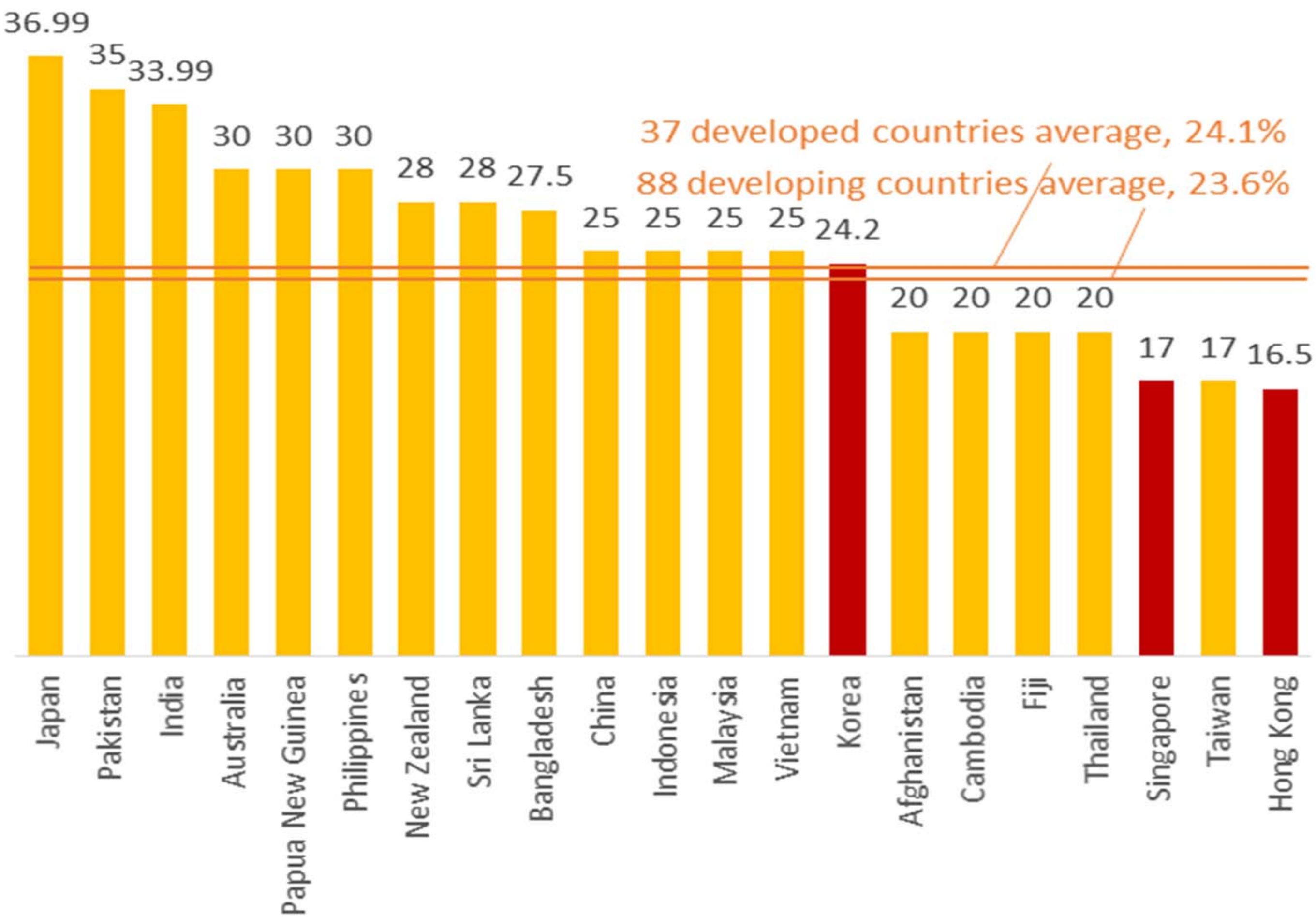
  - Downward pressure on CIT; Gap is widening

Tax Coordination

- **Tax coordination - welfare gains but not easy**
  - Political/economic structure, development stage, policy priorities are different
  - Information sharing on best practices, BEPS…
  - Nominal, *yard-stick* factors: Statutory rates
- **Regional forums** involving stakeholders
- **Taxpayer's perspective (vs. Authorities)**
- **LDC perspective (vs. Advanced)**
  - Compliance vs. efficiency
  - Benefit taxation vs. Ability to pay
  - Political factors (e.g. horizontal equity)

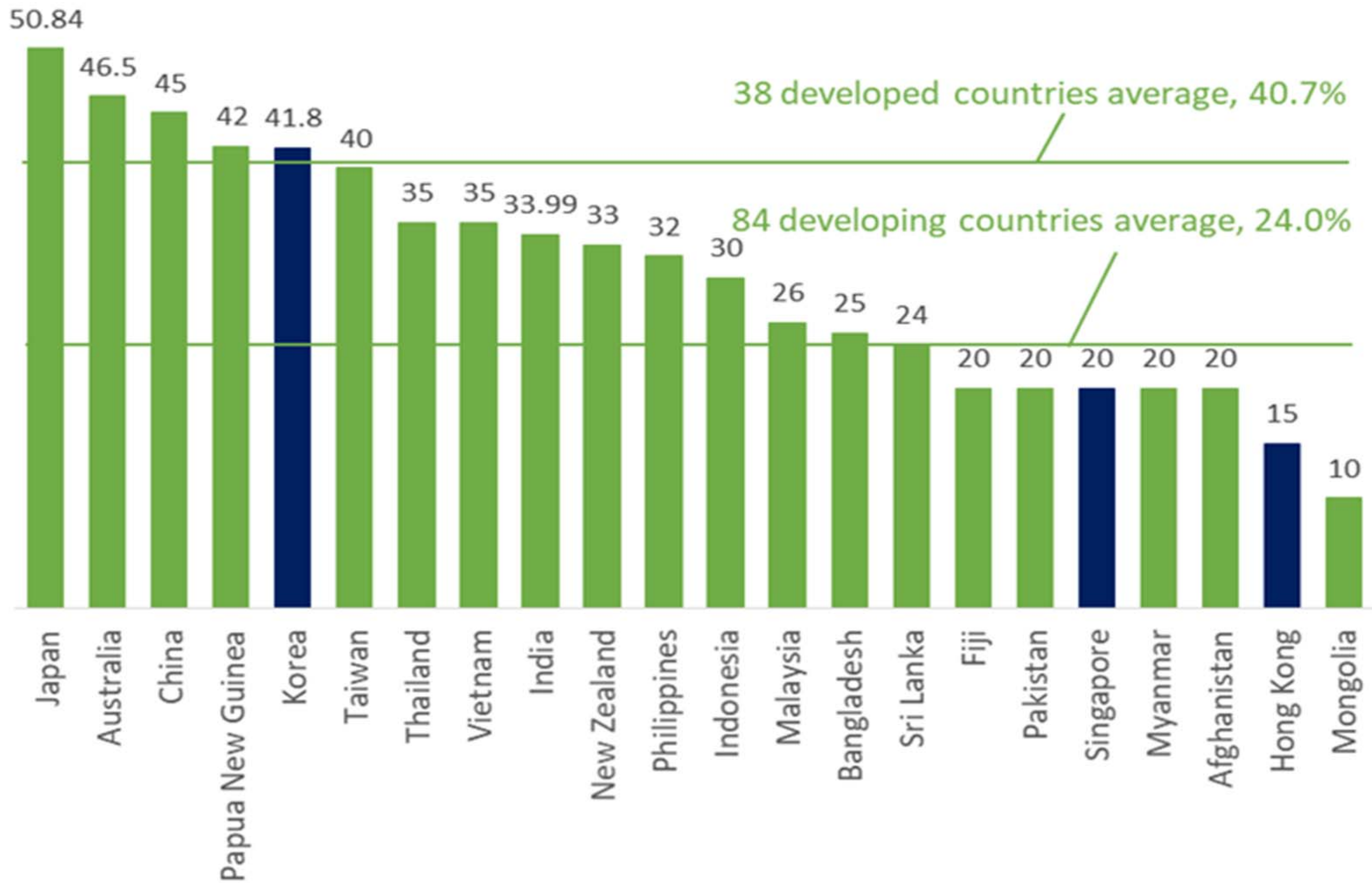
Statutory Corporate Tax Rates in Selected Asia-Pacific countries, 2013

(%)



Personal Income Tax Rates in Selected Asia-Pacific countries, 2013

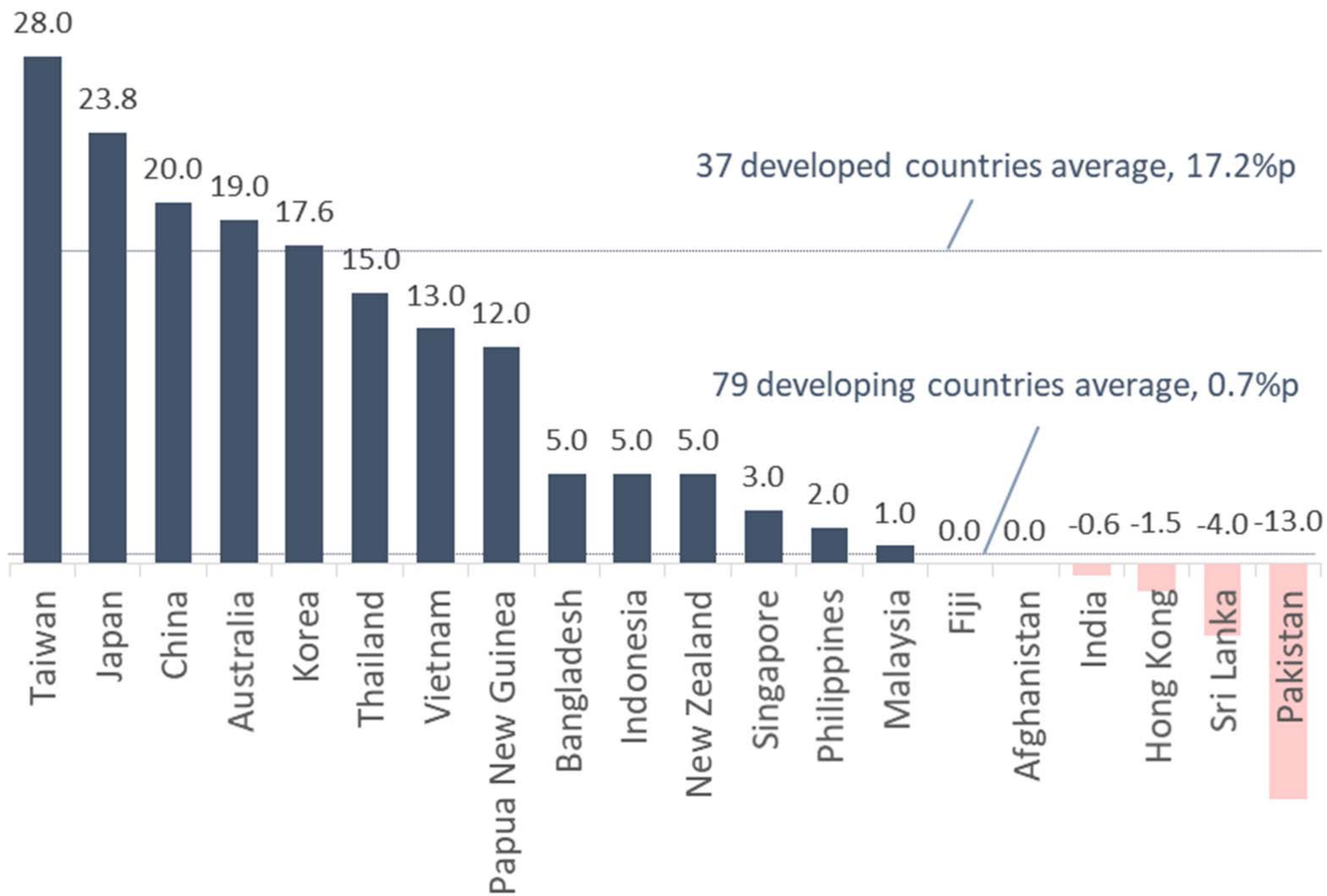
(%)



Source: KPMG; OECD Tax database.

PIT vs. CIT Rate Differentials in Selected AP Countries, 2015

(%p)



Source: Author's calculation based on KPMG and OECD.

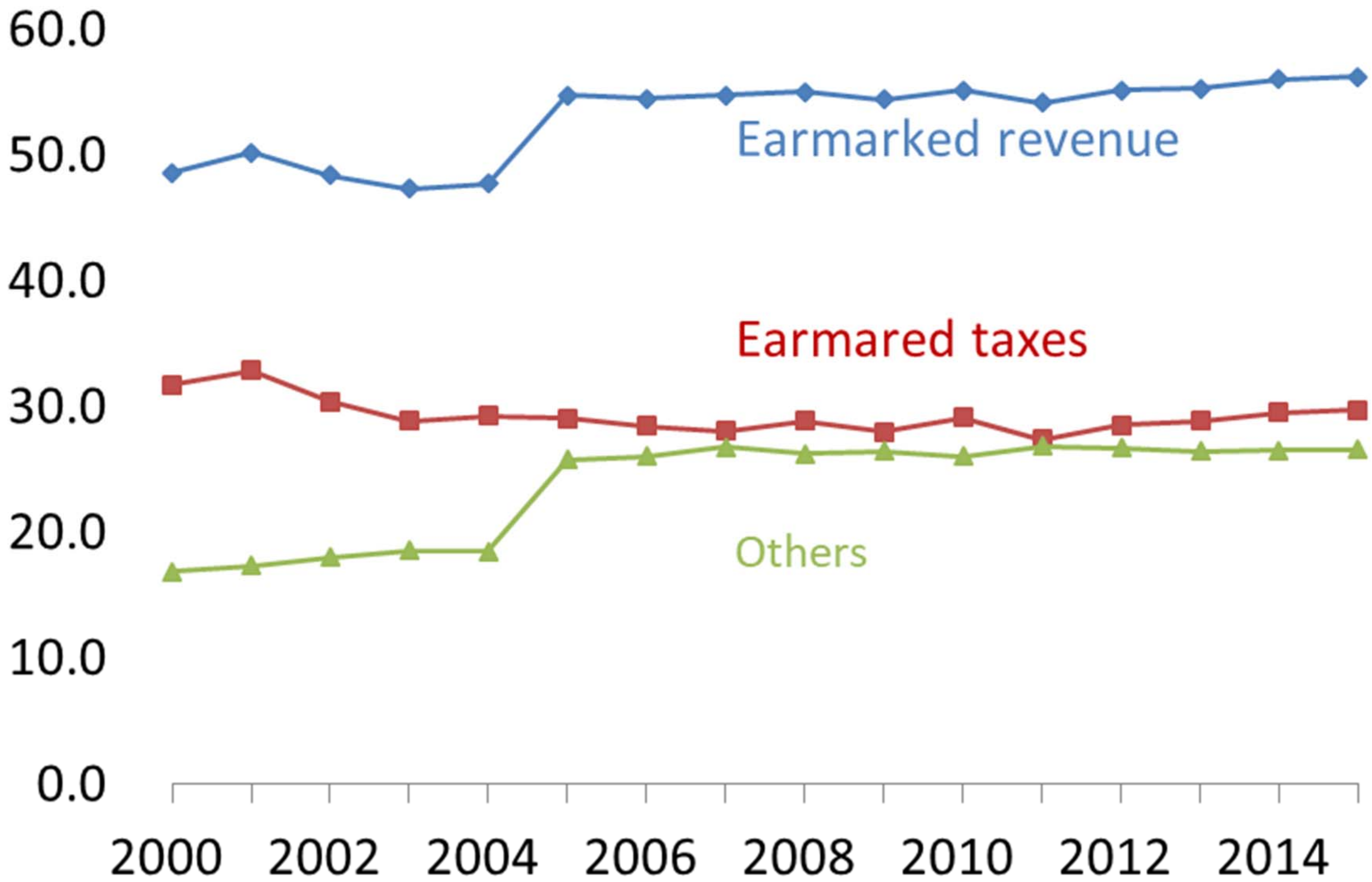
Further Topics for EEG (16:15~)

- **Singapore vs. Korea**
- **Linking Tax-Expenditure (earmarking)**
  - Benefit principle / Compliance purpose
  - Stable revenue source for localities?
  - Rent-seeking among agencies
- **MP and FP: Quasi-fiscal activities of CB**
  - Directed loan vs. (ex-post) monetization
- **Taxation of financial services: easy but risky**
- **Policies to reduce cash economy; corruption**

Linking Tax and Expenditure

- Earmarked taxes have been important source of tax revenue in LDCs (About 17% (35%) of revenue from such taxes, Korea)
- But, T&E linkage is mostly loose and not based on benefit rationale
  - Earmarked funds are inframarginal; mostly used for compliance purpose
- Revenue effect: Targeted area or Overall level
  - Flypaper effect vs. fungibility of money
- Rent seeking among agencies

Earmarked Tax Revenue, 2000-2015, Consolidated Central Gov. (% of Total)



Taxation of Financial Sector*

- **Attractive source of tax revenue**

  - Gross receipts

  - Financial transactions

- **Tax may discourage use of financial sector**

  - Lead firms to operate instead in the cash economy

  - Portfolio investments shifting abroad to avoid

- **Compromise?**

  - BEPS

  - Regional coordination

Monetary Policy & Fiscal Policy*

- **Quasi-fiscal activities of central bank**

  - Directed loan (vs. monetization)

  - Monetary stabilization bonds

- **Nominally sound fiscal position**

  - Fiscal discipline: rule vs. discretion

  (spend within revenue; “effective” budget deficits)

- **QE or Inflation Tax**

  - LDC debt crisis in the 1980s

  (monetization of budget deficits)

  - QE is a luxury (US, Japan)

Rents and Corporate Governance

- Profits (taxes) are highly **concentrated**
  - 62/191 firms (0.01/0.04%) – 41.1/19.2% of tax
- **Mobile vs. Immobile rents**
  - Return on entrepreneurial efforts vs. locally "embedded" (linked to government, affiliates, etc.)
  - Foreign ownership 33%; Samsung elect. 49.7%
- Rent subject to managerial diversion
  - less mobile? (Korean firm data: corporate governance affects the effects of tax-induced rents on firm value - extent of rent diversion)

Shadow Economy and Tax Revenue, 2013

Source: IMF, *Government Finance Statistics*; OECD, *Revenue Statistics*; Hassan and Schneider (2016).

Policies to reduce evasion

- Encourage firms to list on the stock exchanges; Link corporate tax base more closely to accounting profits reported to shareholders
- Subsidize use of credit cards (cash receipts)
- Presumptive value-added taxes at reduced rate, to pull more firms into the formal sector
- Presumptive tax (corporate plus VAT) on any sales to an unregistered firm
- Tie social benefits (UI, SS) more closely to reported income under the personal tax. This converts a tax into a user fee