Tax Incentives and Tax Base Protection in Developing Countries

Joosung Jun

(Ewha Womans University, Member of ESCAP Eminent Expert Group)

*See background paper for details

Tax Incentives & Base Erosion

- Widely used in developing countries
  - Unclear benefits (investment-growth-revenue)
  - Various costs (revenue, efficiency, corruption)
- Conventional wisdom
  - Incentives effective under good **investment climat**e
  - Source of base erosion (low B/C; tax competition)
- This paper suggests
  - Alternative channels for Incentive having **base-protection** effects (esp. corporate tax base)
  - To attract **foreign investment**, incentives need to be designed considering **country-specific conditions and priorities** (rent sources, investment climate).

Benefits & Costs of Incentives

- Developed countries

  - Studies confirm that Incentives can reduce 'cost of capital' (1981-3 US tax cut)

  - But, efficiency costs of tax preferences were estimated to be large, leading to tax reforms in the 1980s, (**"low-rate-broad-base"**, 1986 US TRA)

- Developing countries

  - Efficacy of Incentives are unclear; Efficiency and other social costs seem larger; **Eliminate them?**

  - **On second best grounds**, however, incentives could possibly be utilized for protecting revenue base (rather than stimulating "investment" per se)

Tax structure & Base-broadening in Developing countries

- Tax bases are narrow

  - Tax expenditure (like advanced countries)

  - Plus, “**Evasion and Informal Activity**” (20% v. 40%)

- Corporate income tax > Personal income tax

  - Matter of “**Observability**” (manufacturing firms find it difficult to hide activity, and also to bypass use of financial sector…leaving paper trails)

  - Also, CIT doing a “backstop” role for PIT

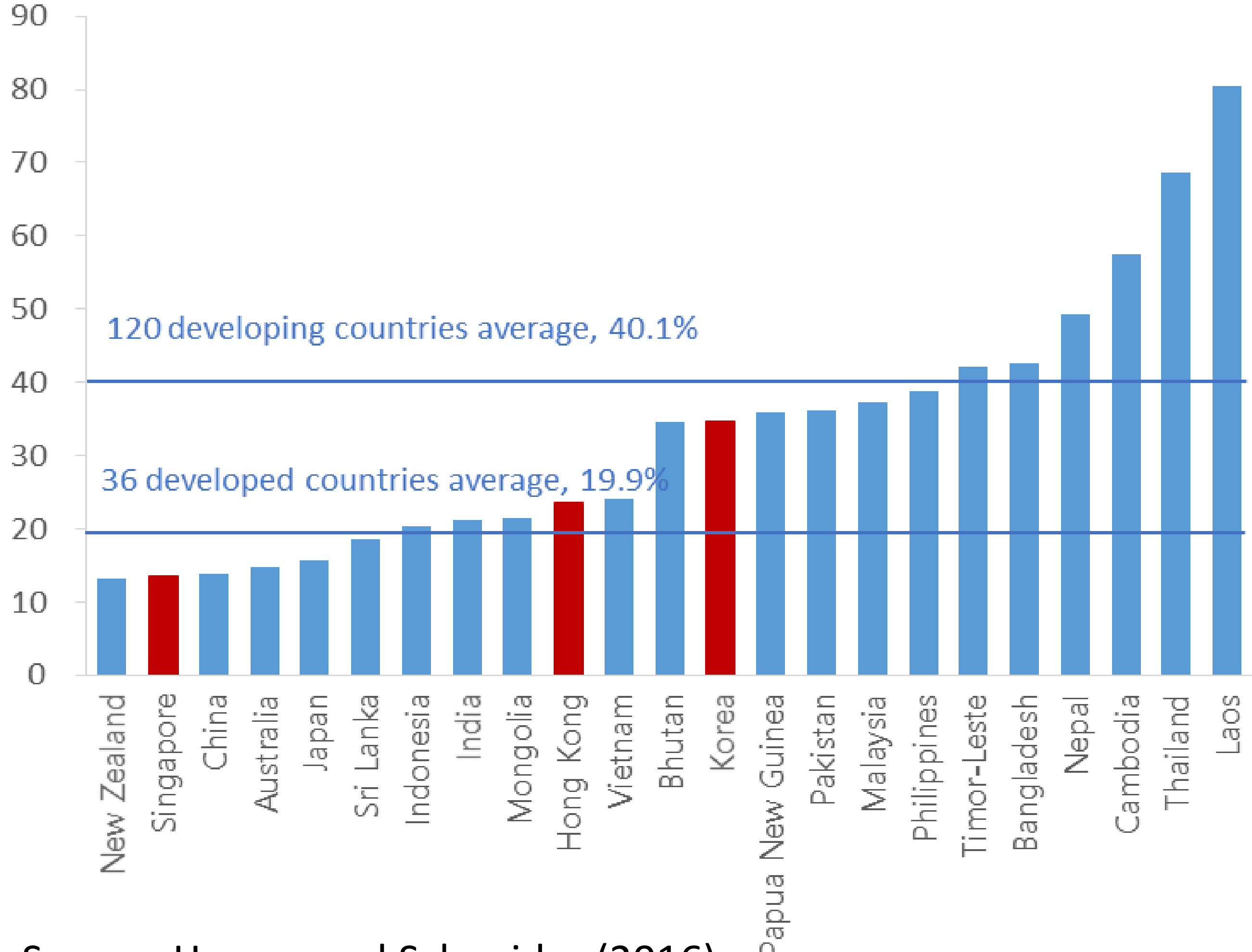
- **‘A two-tier approach’ might be useful**

  - **LR:** Policies reducing evasion and informal sector

  - **Interim period**: incentives for keeping firms in the formal sector and paying taxes

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).

Tax Incentives for Base Protection

- Large corporations

  - Account for a lion's share of revenue

  - Tax incentives for compliance purposes ("investment(?)" "being listed")

  - Nontax benefits: access to bank-loans, regulations, even discriminate against competitors

- Small firms (self-employed)

  - Incentives for staying in the formal secor (Bookkeeping, credit card usage, venture firms)

- As informal sector shrinks, cut such incentives

  - Toward the structure observed in advanced countries

Incentives for Foreign Investment

- Determinants of MNC' location choice

  - Tax incentives: visible, readily available

  - Investment climate; rent: a long-run issue

- Best practices

  - Improve climate before applying incentives? (Too simplistic; correlation may not tell enough

  - Not for compensating for deficiencies in investment climate (Why not? No investment, No revenue cost)

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

  - Tax incentives more effective when "something is missing" **at the margin. *Countries with weak investment climates can also utilize incentives**

Table 3.1 Incentive Effects by Investment Climate and Rent Potential (see paper)

	Strong investment climates	**Weak investment climates**
High rent potential	• Effective, but can be redundant	• Likely effective if properly used
Low rent potential	• Likely effective if properly used	• Ineffective but little revenue cost • Signaling effects in the long run

Hong Kong, Singapore vs. Korea

- Evidence from 'good cases'
- **Hong Kong stresses "investment climate"**

  - Simple (low-rate) tax system is part of such climate
- **Singapore 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 Competition and Coordination

- "**Race to the bottom**" related to tax incentives seems overstated; rather, "Base-erosion due to **profit shifting**'" could be a more serious issue.

  - **STRs to be in conformity** with competing countries

  - **Tax incentives (so, ETRs)** can be set reflecting **country-specific conditions** (source of rent, investment climate, presence of competitors…)

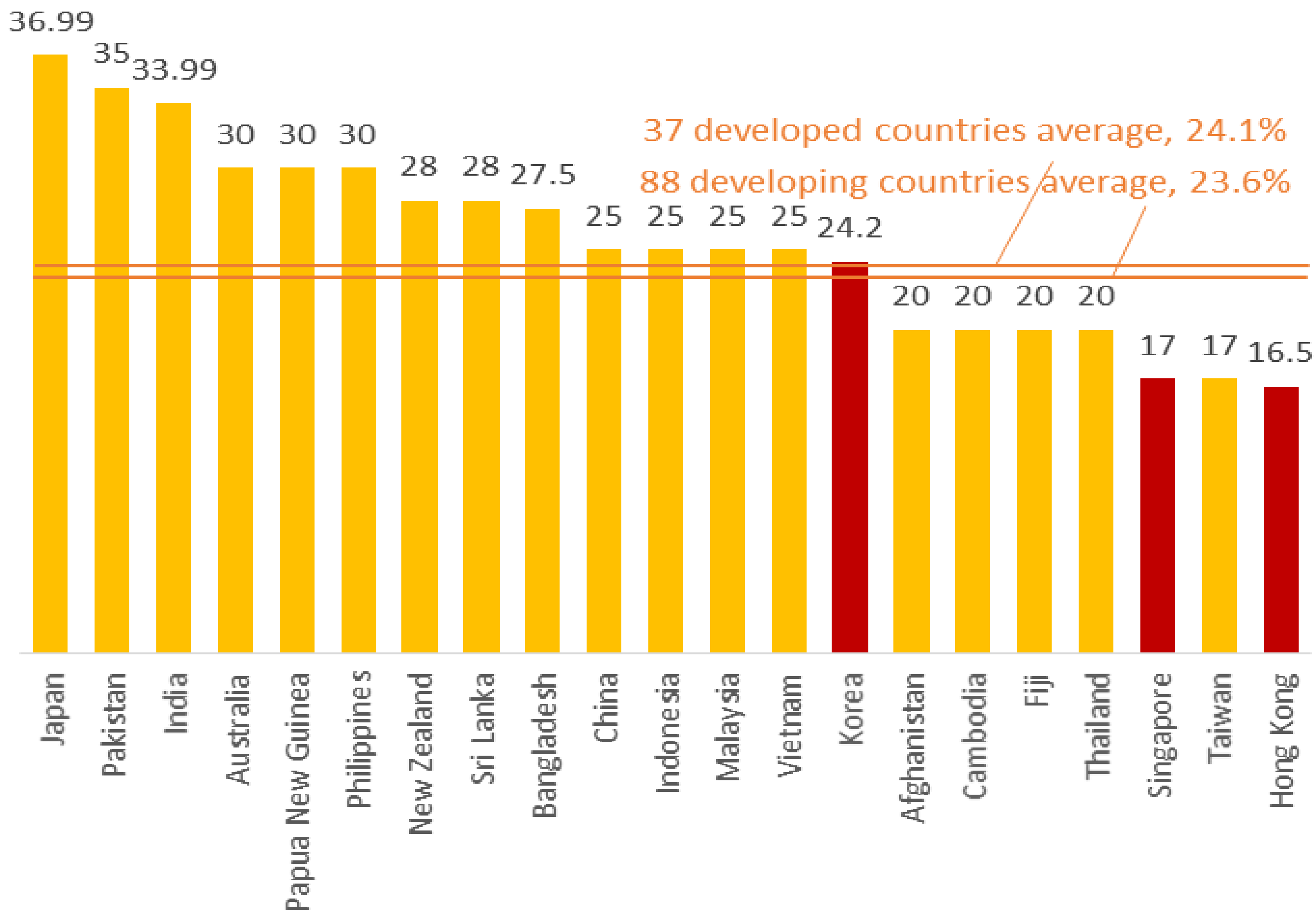
- Tax coordination not easy (political/economic structure, development stage, policy priorities)

  - Information sharing on BEPS issues

  - "Yard-stick" factors; Learning from "success cases"

Figure 5.2 Statutory Corporate Tax Rates in Selected Asia-Pacific countries, 2013

(%)



Source: KPMG; OECD Tax database.