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 climate
  - 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

<table>
<thead>
<tr>
<th></th>
<th>Tax Revenue</th>
<th>Personal Income Tax and Social Security Contributions</th>
<th>Corporate Income Tax</th>
<th>Consumption Taxes</th>
<th>Property Taxes</th>
<th>Border Taxes</th>
<th>Shadow Economy</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>% GDP</td>
<td>% of Total Tax Revenue</td>
<td>% GDP</td>
<td></td>
<td>% GDP</td>
<td>% GDP</td>
<td>% GDP</td>
</tr>
<tr>
<td>Developing countries average</td>
<td>24.5</td>
<td>27.1</td>
<td>14.8</td>
<td>45.4</td>
<td>2.1</td>
<td>7.2</td>
<td>39.3</td>
</tr>
<tr>
<td>Developed countries average</td>
<td>34.1</td>
<td>49.3</td>
<td>9.9</td>
<td>33.5</td>
<td>4.0</td>
<td>0.3</td>
<td>20.2</td>
</tr>
</tbody>
</table>

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 sector (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)

<table>
<thead>
<tr>
<th></th>
<th>Strong investment climates</th>
<th>Weak investment climates</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>High rent potential</strong></td>
<td>• Effective, but can be redundant</td>
<td>• Likely effective if properly used</td>
</tr>
<tr>
<td><strong>Low rent potential</strong></td>
<td>• Likely effective if properly used</td>
<td>• Ineffective but little revenue cost</td>
</tr>
<tr>
<td></td>
<td></td>
<td>• Signaling effects in the long run</td>
</tr>
</tbody>
</table>
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.