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TAX INCENTIVES FOR INDUSTRIAL DEVELOPMENT[1]

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TAX INCENTIVES FOR INDUSTRIAL DEVELOPMENT

Issues for discussion

"So far as we know, no-one has ever asked whether enterprise and investment need encouragement in the form of tax exemptions; it is simply assumed that this is the case".

Gunnar Myrdal in Asian Drama

I. INTRODUCTION - THE PROBLEM

1. Tax incentives are the most widely used form of incentive measure to promote industrial development in developing countries. This paper will consider the issues involved in designing and using appropriate tax incentives(2).

2. The primary purpose of tax incentives is to encourage private investment (both domestic and foreign) in industrial projects by raising the potential profitability of new investment. The strength of the incentive effect depends on the over-all level of taxation bearing on an industrial enterprise's profits and the thoroughness with which these taxes are collected, as well as the generosity of the concession. For foreign investors, the incentive effect may be reduced or eliminated unless the concession is covered by suitable bilateral tax arrangements(3).

3. From the Government's point of view, tax incentives can also play another useful role. They leave additional self-generated funds at the disposal of each enterprise's management. To the extent that these additional funds are subsequently reinvested in the industrial sector and not distributed as dividends, tax incentives play a role in helping mobilise finance for further industrial investment.

4. The country Background Papers show that some developing countries have had both these primary objectives in mind, as well as some subsidiary objectives.

5. The Background Papers suggest that it is difficult to evaluate the effectiveness of tax incentives. Some papers have questioned whether tax incentives were necessary to achieve the development of industry which was actually realised; this is particularly the case with import-substituting projects benefiting from other incentives such as tariff protection and assistance with financing. Other papers

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(1) For recent examinations of the subject, see UNIDO's Background Paper Tax Incentives for Industrial Development, prepared for the International Symposium on Industrial Development, Athens 1967, ID/Conf.1/B.2 (2 May 1967); and George E. Lent's article Tax Incentives for Investment in Developing Countries in the International Monetary Fund Staff Papers, July 1967.

(2) Exemptions or concessions on import duties (often included in the definition of fiscal or tax incentives) are considered in the Issue Paper on Import Duty Concessions (ID/WG/30/7).

(3) The problem of double-taxation agreements is considered in the Issue Paper on Measures to Facilitate Foreign Investment (ID/WG/30/9).

have questioned whether the effects of tax incentives can be isolated in any general evaluation of industrial progress. This last issue is examined in the Issue Paper Formulating a Programme of Incentive Measures (ID/WG/30/10).

II. SURVEY OF ISSUES RAISED

6. A whole range of issues arise in designing an appropriate set of tax incentives. This section lists as many as possible of these issues under the following headings:

(A) What form can tax incentives take?

(B) What objectives are the tax incentives expected to achieve?

(C) Have tax incentives been effective in achieving these objectives?

(D) How generous should the tax incentives be?

(E) Should they be offered only to enterprises established within a limited time period?

(F) How much do tax incentives cost in terms of revenue foregone?

(G) Can tax incentives contribute to the financing of further industrial investment?

A. The form tax incentives can take

7. Many different taxation systems are used. Most countries use a corporation tax (sometimes called income tax or profits tax) as the main instrument for taxing profits and this paper therefore concentrates on these concessions.

8. The tax incentives used take a number of different forms: (a) tax holiday, (b) accelerated depreciation allowances, (c) investment allowances and (d) cash grants. A tax holiday provides full or partial exemption from profits for a limited number of years. The most common form of accelerated depreciation is the initial allowance which increases the rate of depreciation of fixed assets in the first year at the expense of a reduced rate thereafter. An investment allowance on the other hand allows the enterprise to deduct a proportion of the investment (say 20%) in the first year, as well as depreciating the full initial cost of the investment in the normal way. Another form of incentive now used in the United Kingdom and Canada is the cash grant paid by the Government to reduce the cost of purchasing new machinery and equipment.

9. The main difference between a tax holiday and the other forms of tax incentive is that the generosity of the benefits derived from a tax holiday depends on the enterprise's ability to make profits, whilst the other measures do not. One important issue arises: which is the most effective form of tax incentive to use?

B. Objectives

10. Tax incentives have been used (i) to encourage all forms of new industrial investment, (ii) to promote investment only in priority industrial projects, (iii) to encourage a higher volume of exports of manufactured goods, (iv) to encourage new enterprises to locate in

10. **Although this list is a fairly comprehensive one, has the need to encourage modernisation of existing manufacturing facilities received enough attention in some developing countries?**

11. Where legislation has been drafted or extended so that tax incentives aim to achieve more than one objective, two further general issues arise. The first is - Are the objectives mutually consistent? Argentina found they were not when using measures to promote investment in major new industries and in the less-developed regions at the same time.

12. Secondly, is the incentive effect to achieve each separate objective as powerful as it would be if granted separately? Jamaica offers to extend the tax holiday period from 10 years to 15 years if a new enterprise locates in a less-developed region. Is the incentive effect as strong as in Iran and Pakistan, for example, where tax holidays are provided only if the new enterprise locates in a less-developed area?

13. If tax incentives are used to promote investment only in priority industrial projects, a number of issues arise. The first — which industries should be covered and what criteria should be used to select them — is the subject of another Issue Paper (No. ID/WG/30/11). The second issue — can this selective approach be adopted without discriminating between existing and new enterprises? — has been raised in the introductory Issue Paper (No. ID/WG/30/1). However, a more specific version of this issue can be discussed; that is: are the discriminatory effects of tax incentives offered on a selective basis such that they should not be used to encourage priority projects?

14. An interesting general issue arises when tax incentives (and other measures) are used to make exporting more profitable. Can tax incentives be used to promote [illegible] reducing the need to [illegible] without reducing [illegible] policy adjustments [illegible]

15. The same general issue arises when tax incentives (and other measures) are used to promote industries [illegible] less-developed regions; can tax incentives be used without [illegible] unduly interfering with the lo[illegible] For example, should incentives [illegible] of industry in areas where [illegible] structure [illegible] thereby [illegible] competitiveness of the industry [illegible] can tax incentives provide adequate and appropriate compensation for the additional costs involved?

B. Have tax incentives been effective in achieving these objectives?

16. Tax incentives are widely used as a general non-selective measure to encourage new investment in industry. In the form of accelerated

depreciation allowances, investment allowances or investment grants, tax incentives are easy to administer. However, a few developing countries also provide tax holidays for virtually all new investment in industry. Is there a danger when tax incentives are used on a non-selective basis that these benefits are seen as a permanent modification of the tax system which requires additional measures when extra incentives are required?

17. When tax incentives are used to promote selected priority projects, a distinction can be drawn between import-substituting projects and export-oriented projects. Have tax incentives been effective in promoting import-substituting projects? Many countries have found that effective tariff protection has been a more effective incentive than tax incentives, since this helps determine the level of profits before tax. Assistance with financing and pre-investment studies have also been mentioned as effective ways of promoting industrial projects.

18. The issue raised above might therefore be rephrased more provocatively to read: are tax incentives necessary to promote investment in import-substituting industries? Here it may be useful to quote a summary of the results of some opinion surveys in which businessmen were asked what role tax incentives played.(3)

19. Are tax incentives necessary to promote export-oriented industries? Many countries provide tax rebates and other measures which make the process of exporting itself more profitable for new enterprises as well as existing industries. Are further tax incentives to encourage the establishment of export-oriented industries necessary? In Korea, where the export promotion has been particularly successful, the whole package of incentives has been oriented towards encouraging the establishment of export-oriented industries.

20. Experience in encouraging industries to locate in less-developed regions of several developing countries suggests that a group of measures is often the most effective. The issue arises therefore: are tax incentives the best way of encouraging a desired locational distribution of industry, or should they be replaced or used in conjunction with other incentives such as industrial estates, assistance with finance, etc.

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(3) See George E. Lent in Tax Incentives in Developing Countries, a paper presented to the Annual Tax Conference of the National Tax Association, San Francisco, September 1968, page 8 which reads: "Opinion surveys in developing and developed countries have almost uniformly concluded that tax benefits play a relatively minor role in the formation of new businesses. Ross and Christensen, in their study of Puerto Rico's experience, found that tax exemption was not a decisive consideration for any firm, and that most firms did not even fully take it into account ....Chen-Young, in a similar survey of Jamaican firms, found that only two of the 55 firms interviewed mentioned tax incentives as an important factor influencing investment in Jamaica......Similar surveys in the United States, Argentina, Costa Rica, Nigeria and other countries confirm the limited role of tax considerations".

C. How generous should the tax incentives be?

21. The country Background Papers show that the generosity of tax incentives in the 20 developing countries studied varies greatly from one to another. This raises a fundamental issue: what factors determine the level at which tax benefits are granted in the various incentive legislations? Are the levels set determined by hunch, by copying existing legislation in other countries, by the need to compete for investment with other countries, or with other factors in mind?

22. The country Background Papers do not provide an answer to this question. However, these papers suggest that an increasing number of countries are becoming selective in the application of tax incentives. The issue arises therefore: should the generosity of tax incentives depend on the nature of the project supported? Do heavy and light industries need the same length of tax holiday?

23. What evidence there is suggests that the level of tax incentives is determined in many countries chiefly by the need to make investment in industry more profitable relative to investment in other sectors such as trade, real estate and housing. In Turkey, investment in luxury housing has been positively discouraged by taxation, whilst tax incentives were offered for industrial investment. This raises the issue: can any guidelines be established to determine the level of tax incentives required for these domestic policy reasons?

24. This raises a further issue: should the generosity of the tax incentive depend on the size or scale of investment? The revised law in the Sudan provides a tax holiday for five years plus exemption on 50% of profits earned in the following five years, if the investment exceeds S£1 million. The length of the tax holiday in Nigeria also depends on the amount invested in such a way that enterprises requiring a low initial capital investment are encouraged to expand their operations at an early date. Some countries which have restricted tax incentives to priority industries have chosen those which require large capital investments (e.g. Argentina, Mexico).

25. Some of the Background Papers point out that tax incentives have tended to favour the larger type of enterprise in which foreign investors are frequently involved. This raises a general issue: Should a system of tax incentives be designed to promote small-scale industries? Or can the objective be better achieved by reducing the rate of corporation tax on profits in the lowest ranges?

26. The level of tax incentives has also apparently been influenced by external considerations. Legislation in Jamaica enacted in 1967 which increased the length of tax holidays was made retroactive to 1963, the year in which Puerto Rico introduced more generous tax incentives. This raises the issue: Can developing countries take steps to minimize wasteful competition among themselves in granting increasingly generous tax incentives?

27. The paper on Nigeria's experience mentions that the generous tax incentives offered for investment in the less-developed regions of the United Kingdom have made it more difficult to attract British investment in Nigeria. This raises the issue: has the use of tax incentives become so widespread in developed countries that similar measures are required in developing countries to attract foreign investors?

28. The same issue applies to tax rebates and other measures used to make the process of exporting more profitable(4),(5). Have the measures taken by developed countries to make exporting more profitable reached a stage where developing countries must take similar action in order to allow their industries to compete on equally favourable terms?

D. The time factor

29. The laws of developing countries which enact tax incentives do not usually provide for the withdrawal of the benefits offered after a certain date. One exception to this general rule is India; there development rebates (initial allowances) have been offered at a higher level for industries established before a fixed date. The issue arises therefore: have most developing countries missed the opportunity to promote the development of specific projects within a limited period by restricting the period in which the benefitting enterprise must be established?

30. The answer to this question is probably not as clear-cut as it may appear at first. Those countries which identify a list of industrial projects for which incentives will automatically be granted tend to focus attention on these. Furthermore, the principal of "first come, first served" appears to be effective even in countries which have not restricted incentives to new activities (the so-called Pioneer Industries). One commentator on investment opportunities in the Central American Common Market noticed that "a large number of firms anxious to be first in believe that they will be granted these incentives along with tariff protection more readily than those who will come later"(6).

E. How costly are tax incentives in terms of revenue foregone?

31. A major consideration in selecting incentive measures is their cost and effectiveness. Bearing in mind that it is normally much easier to estimate the cost of a programme of tax incentives (at least in retrospect), it is rather surprising that attempts at such

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(4) See the Report of UNIDO/UNCTAD Expert Working Group on Incentives for Industrial Exports, November 1968.

(5) UNCTAD's Incentives for Exports in Developed and Developing Countries, October 1968 (TD/B/C.2/57)

(6) See S.L. Schreiberg, The United States Investor and the Central American Common Market, page 264 - U.S. Congress Joint Economic Committee 89th Congress 1st Session, 8-10 September 1965, (Appendix VIII).

measurement have been made in only a few countries. In Mexico, records were kept from an early date. Of the 20 developing countries whose experience is studied in the Background Papers, only a few countries provided useful data.

32. Of course, measuring the cost must have a purpose. One author has attempted to compare the cost of tax holidays and import duty concessions offered in Jamaica with the resulting benefits which industry brought to the economy(7). The issue arises: is such a cost-benefit analysis a feasible and worthwhile exercise?

33. An alternative use for data on the cost of tax incentives is to compare these costs with the cost of other incentives. The country Background Paper on Nigeria does this, it shows that of the N£.50 million cost of the total package of incentives offered between 1958 and 1968, tax incentives cost about N£6 million and import duty exemptions about N£18 million. The issue arises therefore: should developing countries collect data on the cost of their tax incentives and compare these with costs of other incentives?

F. Can tax incentives contribute to the financing of further industrial investment?

34. A wide range of techniques are available to encourage industrial enterprises to reinvest retained profits in the expansion of the existing plant or new industrial ventures. As the industrial sector grows, this potential source of savings and investment becomes increasingly important for the national economy. In the advanced countries, between 50% and 70% of new industrial investment is financed in this way.(8) Estimates by ECLA suggest the proportion had already reached between 40% and 60% in some Latin American countries in the 1950s.(9)

35. A general issue arises: have developing countries paid sufficient attention to this objective (a) in designing their system for taxing industrial profits, (b) in modifying this with incentive measures?

36. The tax system itself may encourage retained profits by taxing profits distributed as dividends at a higher rate than those retained in the business. Few of the 20 developing countries studied in the Background Papers appear to use this general system. Foreign investors may be influenced in this direction by measures which limit the volume of profits they are allowed to remit abroad in any one year.

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(7) Paul L. Chen-Young, "A study of tax incentives in Jamaica" National Tax Journal, Vol. XX. No.3 (September 1967).

(8) OECD Industrial Investment Policies, July 1965, page 21

(9) ECLA The Process of Industrial Development in Latin America page 1[illegible], (UN Sales No. 66.II.G.4.).

37. A number of developing countries have provided tax exemptions which are optional but conditional on the reinvestment of the funds saved in specified investment opportunities(10). For example, in Peru between 30% and 60% of profits can be re-invested tax free in new projects, the proportion exempted depending on the location chosen. Such reinvestment provisions cannot be effective whilst an enterprise is benefitting from a tax holiday. Instead, they should be considered as an alternative to this and other forms of tax incentive. The issue arises: can reinvestment provisions effectively replace other forms of tax incentives for promoting investment in industrial projects?

38. Another interesting example of an optional scheme is the tax credit system introduced in Brazil in 1961; the system is designed to encourage private investment in industrial projects (and more recently other types of project) in the North-east and Amazon regions. Corporations are released from income tax on up to 50% of their income tax liability, provided they place this sum on deposit for future investment in projects approved by the development agencies in these regions SUDENE and SUDAM. These deposits must then be grouped together by various owners and used to supply 25%, 50% or 75% of the capital requirements of an approved project; if the deposits are not reinvested within 3 years, they revert to the Government. By 1966, it is estimated that one-third of all corporate income tax liabilities were placed on deposit(11).

39. Other countries have introduced special legislation that has the effect of forcing enterprises to reinvest part of their profits. In the Ivory Coast, 10% of an industrial enterprise's profits must be invested in national investment certificates; the investor may use these to invest in a new local enterprise in industry and other fields or to purchase a 20-year Government bond bearing interest at 6%. In Colombia, industrial enterprises were for a time required to invest 3% of their profits in the national steel mill.

40. The issue arises therefore: have these reinvestment provisions added to the level of national savings, or merely changed the distribution of national investment? In other words, is this type of scheme more useful for achieving specific objectives than the general goal of raising the level of industrial investment?

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(10) George E. Lent in the article cited mentions The Republic of China, Costa Rica, Ecuador, Chad, Morocco, Senegal, Tunisia, Uruguay among others.

(11) See Albert O. Hirschman "Industrial Development in the Brazilian North-east and the tax credit system of Article 34/18"., Journal of Development Studies, Volume V. No. 1 (December 1967).

III. SUGGESTED ISSUES FOR DISCUSSION

41. In this Issue Paper more than any other, a very wide range of issues have been raised. In order to make the sessions devoted to this subject of maximum value, it is suggested that discussion might focus on the following issues:

To bring out the experience of countries represented at the Seminar, participants might indicate:

(a) What proportion of new industrial investment has benefitted from tax incentives in their country?

(b) Have tax incentives played a significant role in promoting this new investment?

(c) Have tax incentives played a significant role in promoting other objectives such as self-financing of further investment, location of industry, higher exports?

More general issues which might be discussed include:

(d) Should different types of tax incentive systems be used at different stages in the industrialization process?

(e) Can existing systems be improved to use tax incentives more effectively to achieve specific objectives by granting a time limit for their availability?

(f) Do developing countries in some regions need to take steps to avoid expensive and wasteful inter-country competition in the granting of increasingly generous tax incentives?

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