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Athens, 29 November-20 December 1967
Provisional agenda, item 3 (a)

Background paper

TAX INCENTIVES FOR INDUSTRIAL DEVELOPMENT

Presented by the Executive Director
of the United Nations Industrial
Development Organization

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TAX INCENTIVES FOR INDUSTRIAL DEVELOPMENT

Corrigendum

Paragraph 137, 1st sentence: Change to read as follows:

"137. It may be pointed out that the United Nations Industrial Development Organization as well as the Fiscal and Financial Branch of the Department of Economic and Social Affairs provides technical assistance to help developing countries in the design of new fiscal incentive schemes and the evaluation of existing schemes, with a view to suggesting appropriate changes."

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Introduction

1. The present study has been prepared in response to Economic and Social Council resolution 1030 A (XXXVII). Its purpose is to inform individual developing countries that wish to encourage private investment in their manufacturing sector of the various fiscal incentive schemes in operation in other developing countries, and to help them in the design, operation and evaluation of such schemes. The study draws on three principal sources: (a) the tax incentive laws of twenty-two developing countries; (b) reports of UNTA fiscal experts assigned to various developing countries; and (c) a few case studies. For various reasons, it has not been possible to draw sufficiently on the actual experience of developing countries in the implementation of fiscal incentive schemes, but it is hoped that a beginning has been made for further work in this field, particularly work related to technical assistance.

2. The study is in six main parts. The criteria determining activities eligible for tax benefits, as set out in the tax laws of selected developing countries, are reviewed and examined critically in chapter I. This is followed by a presentation of the tax incentives themselves. Those intended to encourage private investment in manufacturing industry are dealt with in chapter II. The growth of industrial output resulting from this investment may be said to be the primary objective of tax incentives. Other objectives may also be pursued, for example, influencing the location of industry, facilitating industrial financing, promoting exports of manufactures and so on. Fiscal incentives aimed at these secondary objectives are discussed in chapter III.

3. No fiscal incentive scheme can, of course, be effective without adequate machinery for its administration. The appropriate administrative set-up in selected developing countries is described in chapter IV. It must be pointed out, however, that this description is rather sketchy as the main emphasis of the study is on the economic aspects of fiscal incentives.

4. Evaluation of the fiscal incentive schemes after a number of years of operation is of utmost importance, but it is often neglected. The main considerations on which this evaluation should be based are discussed in chapter V which also includes a number of case studies.

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5. Chapter VI presents some recommendations to developing countries concerning measures they would have to adopt in order to enhance the effectiveness of their fiscal incentive schemes. These recommendations are mainly of an economic nature. They point out the need for greater emphasis on economic considerations in the design of tax incentives than is generally done, especially the need to link the selection of eligible industries to programming. Equally important is the evaluation of incentive schemes in operation by the developing countries themselves using UNIDO's assistance where necessary.

I. ELIGIBLE INDUSTRIAL ACTIVITIES

6. Nearly all the developing countries considered in this study rely on more than one criterion in selecting enterprises eligible for tax benefits. These criteria do not readily lend themselves to a systematic classification. An attempt has, nevertheless, been made to distribute them into four homogeneous groups: (a) criteria relating to broad objectives of economic development; (b) criteria specifying the favoured industrial sectors; (c) criteria relating to characteristics of industrial enterprises; (d) "pioneer" industries. It should be noted that in many countries the criteria adopted fall into more than one category.

7. This four-fold classification is based on the criteria mentioned in the tax laws. It is probable that in practice the developing countries in determining eligible activities may make use of more elaborate systems of criteria than is indicated in the tax laws. However, it is not possible to know what these systems are in the absence of appropriate case studies.

Criteria relating to broad objectives of economic development

8. Some developing countries do not identify any favoured sector or require any specific qualification from firms applying for tax concessions. The only condition for eligibility is that the applicant firms contribute to certain broad objectives of economic development of the country. The Aid to Industries Ordinance 1959 of Malta is a case in point. Concessions may be granted to firms "which will create employment, increase the national product and can be expected to carry out their project ultimately without further aid".[1] Kuwait has a similar approach: tax concessions to industrial firms are given after consideration of "the economic requirement of the country, possibilities of local consumption and exportation, the requirement of the country's social and economic development plan,"[2] and other considerations.

1/ Aids to Industries Ordinance, 1959 (Ordinance No. XXIA of 1959), Article 19.

2/ The Industrial Law, Decree No. 6 of 1965, Article 10.

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9. The law of encouragement of capital investment in Israel reflects the major problems facing the economy, namely the absorption of immigrants, reduction of the trade deficit, and proper distribution of population.3/ In Ghana the emphasis on absorption of immigrants is replaced by the emphasis on high level of employment.

Criteria specifying the favoured industrial sectors

10. Some countries such as Argentina, Brazil, India, Morocco and the Philippines grant tax concessions to specified industries that are considered to be particularly important for the country's economic development. The Brazilian Government has introduced special acts to encourage investment in such fields as heavy mechanical industry, automotive industry, agricultural and road-building machinery, metallurgical industries, ship-building, leather-tanning and the chemical industry. The favoured industries in Argentina include steel, petro-chemical (with some exceptions), pulp and paper, tanning, chemical, ceramic and glass. The Philippine Government gives different concessions to various industries through special acts. Under the Basic Industries Act sixteen industries are enumerated, and under the Cottage Industry Act twenty-one industries are covered. Separate acts cover the chemical industry, textile industry, shipping industry, export industry and so on.

11. Morocco specifies the industrial sectors that may benefit from one or several tax concessions, but at the same time broadens the scope of eligible activities by including any industry that serves the consumer market and fulfils certain conditions related to the use of local resources.4/

12. In some countries the specified sectors are further classified in priority groups. The industrial development law of Ecuador offers, in addition to the general benefits accorded to all industrial enterprises coming under the law, specific benefits to three categories of industrial enterprises. The category "Special" includes industries of high priority for the country's economic

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3/ Akiva Ilan, Tax Incentives for Industrial Development in Israel, paper prepared for CID, Tel Aviv (1966).

4/ Hints to Potential Investors in Morocco, Industrial Research and Investment Office, Rabat, pp. 5-6 (1965).

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development and which require special stimuli on the part of the State. New or existing industries, including assembly plants, that export 50 per cent or more of their production of produce goods to be used in agriculture, forestry, industry, mining or fishing, or that produce import substitutes or are felt to be sufficiently important by the Ecuadorian Government are listed in Category "A". Category "B" covers industrial activities that are likely to contribute to the economic development of the country, but which do not meet the criteria for the "Special" or "A" Categories. There are detailed lists of industries to be included in the "Special" and "A" Categories.[5/]

13. A similar approach is followed by Thailand where eligible industrial activities are also classified under three groups. Group "A" includes industries that are "vital and necessary" to the economy (34 industries). Those activities that are "less vital and necessary" are designated under group "B" (15 industries). Group "C" covers industrial activities other than those classified under groups "A" and "B" (68 industries).[6/] The list of industries included in these three categories may be modified from time to time. This, in fact, has occurred during the operational years of the tax incentive scheme. Korea favours only two priority groups; eleven activities in the first group and sixteen in the second.

Criteria relating to characteristics of the enterprise

14. Among the characteristics of industrial enterprises those most frequently considered to determine eligibility are the following: size of investment; organizational form of enterprise; source and control of capital; employment of nationals; and use of domestic raw materials.

(a) Size of investment

Some investment incentive statutes confer tax benefits only when the planned investment exceeds a specified minimum amount; this amount varies substantially

5/ Ecuador, Conway Research Inc., Atlanta, Ga., p. 109, (September 1965)

6/ Country Study for United Nations Asian Conference on Industrialization; Government of Thailand; I & NR/Ind. COMF./C.1; pp. 18-20 (1965).

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from one country to another. In Ethiopia, for example, the minimum is Eth.200,000 ($US80,000) for a newly established enterprise and Eth.400,000 ($US160,000) for an existing enterprise in expansion. In the Republic of Viet-Nam the minimum requirement is 1,000,000 piastres ($US125,000) and in the Republic of Korea it is 5,000,000 won ($US18,889). In the Republic of China (Taiwan) a minimum amount is required for exemption from customs duties on imports of machinery and equipment but none is required to qualify for tax holiday.

Sometimes a minimum amount of capital or employment of a minimum number of nationals are substitutive requirements. This is the case in Senegal: only enterprises that submit an investment programme of at least 100 million CFA Francs (about $US405,100) to be carried out in three years, or create at least 100 permanent jobs for Senegalese supervisors and workers may be approved as priority enterprises.[7/] A variation of this plan combines minimum requirements for capital and for labour, as found in some of Argentina's provincial tax incentive laws.

(b) Organizational form of enterprise

The form of enterprise (corporation, partnership or sole proprietorship) is considered by some developing countries as one of the prerequisites for granting tax concessions. China (Taiwan) allows an income tax holiday only to corporations engaged in productive undertakings that are considered to be "preferable" by the statute, but not to proprietorships of partnerships, except for those with earnings derived from exports. Also, in Pakistan the limited liability form of company is one of the requirements for eligibility.

(c) Source and control of capital[8/]

Some tax incentive laws require that a certain percentage of planned investment in industrial undertakings that seek tax concession be subscribed to by nationals. In the Philippines, for example, cottage industries must be owned and operated by Philippine citizens. In a corporation, partnership or co-operative, at least 75 per cent of capital must be owned by Philippine citizens and the same percentage of shareholders must be citizens; all members

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7/ Investment Laws and Regulations in Africa, United Nations, p. 57, Sales No. 65.II.K3, N.Y. (1965).

8/ The Status of Permanent Sovereignty Over Natural Wealth and Resources, United Nations Secretariat Publication, Sales No. 62.V.6, pp. 25-42 (1962).

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of the board of directors must also be Philippine citizens.[9/] More specific requirements are laid down in the textile act and the shipping industry act. Under the textile act individual importers of raw material for the textile industry must be Philippine citizens; in partnerships or corporations at least 60 per cent of subscribed capital must be owned by Philippine citizens.[10/] Under the shipping industry act only Philippine citizens or corporations in which 60 per cent of the subscribed capital stock is owned by Philippine citizens can avail themselves of the tax exemption.[11/]

Similarly in Nepal cottage and village industries may enjoy tax concessions if they are owned by Nepalese nationals or by organizations controlled by them. In medium-scale industries preference is given to nationals, but nationals and foreigners are treated alike in large-scale enterprises.

(d) Employment of nationals

Some tax incentive laws require an industry to employ a minimum number of nationals before the enterprise can enjoy tax benefits. India and Nepal require enterprises to employ ten or more workers in a process aided by mechanical power to be eligible. Ceylon stipulates the employment of more than twenty-five workers without reference to aid of mechanical power.[12/] Senegal, as mentioned before, accepts the employment of a certain number of Senegalese workers as an alternative for a specified minimum investment.

Some tax incentive statutes insist on a minimum percentage of nationals in total employment. Libya, for example, requires 90 per cent of the total employees to be nationals without reference to the share of the percentage in the total wage bill.[13/] Somalia does not allow an enterprise to employ more than 5 per cent unskilled foreign workers, but places no limit on the use of skilled foreign personnel. In Argentina some provincial laws that grant tax benefits to

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9/ RA 3470, approved 16 June 1962.

10/ RA 4086, approved 18 June 1964.

11/ RA 1407, approved 9 September 1955 as amended by RA 4146, approved 20 June 1964.

12/ Department of Inland Revenue, The New Tax Structure, 1965-1966, p. 37, Colombo, Ceylon, 1966.

13/ Investment Laws and Regulations in Africa, op. cit., p.45.

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industries located in certain provinces also require these industries to employ a certain minimum percentage of nationals.[14] Mexico, Panama, Trinidad and Tobago also specify certain minimum requirements of national employment.

(e) Use of domestic raw materials and intermediate products

Some countries include the use of domestic raw materials and intermediate products as one of the requirements that have to be met by enterprises applying for tax concessions. Their purpose is, of course, not only to reduce dependence on imported materials and thereby relieve pressure on the balance of payments, but also to induce increased production of domestic materials, to expand employment of labour and so on. Policies differ, however, from one country to another. The Costa Rican tax incentive law, for example, requires the use of domestic semi-finished and finished products. The Pakistan law specifies that an industry be based primarily on domestic raw materials, but such conditions may be relaxed by the Government in appropriate circumstances. In these cases, no mention is made of a prescribed minimum as to the proportion of domestic raw materials to total cost. On the other hand, Mexico requires at least 60 per cent of direct cost to be of national origin without specific reference to domestic raw materials.

"Pioneer" industrial enterprises

15. The term "pioneer industry" or "enterprise" is used to mean eligible enterprise. It is not, therefore, fruitful to read too much into it. The conditions that an enterprise must fulfil in order to be considered "pioneer" are of importance.

16. The conditions for entitlement to a "pioneer" status vary considerably from one country to another. In some countries no particular conditions are specified in the tax law. In Jamaica, for example, both "new" and "established" industries qualify for tax benefits as "pioneer industries" without specification as to conditions of eligibility.

17. In Zambia, on the other hand, in granting pioneer status the following are taken into account: capital to be invested; employment; use of local resources;

14/ F.J. Herschel, Supplementary Report to study "Tax Incentives for Industrial Development in Argentina", paper prepared for C.I.D. (1966).

competition in foreign markets; price of products; training of manpower; prospects for exports; foreign exchange earnings; and profitability.

18. There are intermediate cases between these two extremes. Sudan, for example, is somewhat more specific than Jamaica on the eligibility conditions. To qualify as an "approved industrial enterprise" an enterprise must conform to the following requirements: (1) its promotion must be in the interest of the general public; (2) it must have reasonable prospect of successful development; (3) its field of activity must not be already covered in Sudan; (4) it must have sufficient capital and managerial resources to enter upon its proposed activities.

19. The Nigerian law defines a "pioneer industry" as "an industry that is not being carried on in the country at all or not carried on in the country on a commercial scale suitable to the economic requiremen or development of the country and for which there exists favourable prospect of further development of the industry or insufficient facilities in the country to enable the industry to be so carried on and is expedient to the public interest to encourage the development or the establishment of the industry in the country".[15] This is not very enlightening. However, an enterprise in an industrial field may request that the industry be given "pioneer" status assuming, of course, that it fulfils the general conditions required. An enterprise in an industry recognized as "pioneer" may apply for the "pioneer" status. The case of Nigeria cannot be subsumed under the categories hitherto considered.

Evaluation of eligibility criteria

20. Tax concessions, like other incentives for industrial investment, should be granted to promote those sectors which are of importance for the economic development of a country, that is, priority sectors, which, in the absence of incentives, might fall short of the desirable target. The setting of sectoral targets and priorities requires programming; these targets and priorities are derived from aggregate magnitudes of the national economy. For this reason the procedure is sometimes referred to as "programming from above" or "aggregate planning". Within each sector, with due regard to targets and priorities, projects are evaluated in terms of certain criteria reflecting the objectives

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15/ Aid to Pioneer Industries Ordinance, 1952

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of a country's development. This procedure is referred to as "programming from below". Good programming practices combine the two procedures.

21. In actuality, few developing countries appear to have tried this two-way procedure with any measure of success. Planning "from above" requires a variety of statistical series which are generally not available in the developing countries. Among the countries covered by the study, Argentina, Brazil, Ecuador, India, Morocco, the Philippines, the Republic of Korea and Thailand specify certain industrial sectors in their tax laws. This might imply that sectoral priorities in these countries may be based on aggregate planning, but whether or not this is the case is not certain.

22. It is not surprising, therefore, that the vast majority of developing countries actually rely on project evaluation alone to determine the eligibility of industrial enterprises for tax concessions. Among the countries covered by the study, all, with the possible exception of those mentioned above, do so. Assuming for a moment that project evaluation is based on reasonably valid criteria, there are certain limitations to this method of programming which must not be overlooked.

23. In the first place every country makes use of more than one criterion in the evaluation of a project; however, the outcome must be acceptance or rejection of the project. The problem, therefore, is how to derive a single decision from a variety of criteria. This could be done by applying proper weights to each of the criteria in the system in order to reduce them to a common denominator. This is not easily achieved. Consider the criteria mentioned in the tax laws of the Sudan and Zambia. What should be the weights for them?

24. In the second place there are a number of effects, especially benefits, arising from the interdependence of industrial projects which are difficult to identify or to assess, yet they cannot be neglected. Thirdly, a programme based on project evaluation would result in a motley of projects in the absence of a guide for the choice of sectoral priorities and targets.

25. These are the main problems faced in the selection of beneficiary enterprises based on project evaluation under favourable conditions. It may be questioned whether the procedures actually applied in developing countries are reasonably proper. Judging by the criteria mentioned in the tax laws, there

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are good reasons to doubt that they are. Even a cursory examination shows that some of the criteria are of questionable validity. For example, the requirement of a uniform minimum capital for all qualifying enterprises overlooks the fact that industries differ from each other with respect to optimum plant size. Thus, a specified minimum capital may be appropriate for one industry but not for another. Moreover, if the specified minimum is too high, the developing countries may be deprived of certain small-scale industries which are less demanding of scarce factors, such as capital, management and technical skills. It would be desirable to differentiate, with regard to minimum capital requirement, between established enterprises and new ones which face higher risks because of their lack of experience, their unfamiliarity with markets, and so on. Only a few countries seem to pay attention to this problem.

26. In some countries, such as Morocco, Peru and Zambia tax laws insist on the use of new equipment as a prerequisite for eligibility. This may be justified in the case of export industries which face foreign competition. Opinions vary, however, as to the desirability of ruling out altogether second-hand machinery which may sometimes be used profitably in industries producing for the domestic market, provided, of course, that adequate repair services are available.

27. The definition of a "pioneer" industry or enterprise is sometimes so broad that it is of little or no help in determining the activities to be favoured. As an example, the relevant provisions of the tax law[16] of Trinidad and Tobago may be mentioned: "Pioneer industry is an industry not being conducted on a commercial scale or at all and for which there are insufficient manufacturing facilities to enable such industry to be conducted on a commercial scale; or any industry where there is favourable prospect of further development".

28. Equally vague are the criteria relating to the broad objectives of economic development. It is difficult to see how they, by themselves, can be of any use unless they are associated with more specific criteria such as those relating to the characteristics of industrial enterprises or those specifying industrial sectors. The cases of Israel, Kuwait and Malta may once again be mentioned.

16/ Aid to Pioneer Industry Ordinance, chapter 33, No. 3 (16 March 1950).

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29. It is probable, as has been mentioned before, that developing countries do not spell out in their tax laws the criteria which they actually use in the selection of eligible industries, but from general knowledge of practices in programming, it would appear that these practices are far from adequate. It is important to realize that the selection of enterprises for tax concessions, as for other policy incentives, must be related to programming, and that any progress made in the application of proper programming methods in the developing countries is likely to make an important contribution to the design of fiscal incentive schemes.

II. TAX CONCESSIONS TO ENCOURAGE INVESTMENT IN MANUFACTURING

30. The primary objective of industrial tax incentives may be said to be the growth of industrial output. This is not as obvious a statement as it seems to be as other objectives, which are referred to as "secondary", may be pursued together with the primary objective. These will be examined later.

31. Tax incentives for industrial development may be grouped, for the sake of convenience, under three headings:17/ (a) Tax concessions designed to reduce cost of imported inputs; (b) Tax concessions designed to reduce the recoupment period; (c) Concessions affecting taxes on profits.

Tax concessions designed to reduce cost

32. Among the various taxes affecting the cost of production in an industrial enterprise, customs duties on imported equipment and on materials and fuel are by far the most important. It is not surprising, therefore, that exemption from customs duties is a widely adopted encouragement measure in developing countries.

(a) Materials

The exemption policy in respect to imports of raw materials, semi-finished goods and component parts varies from one country to another depending on such factors as the availability of domestic materials, the nature of the industry for which they are intended and the degree of processing involved. Thus, the majority of developing countries when giving outright exemption on imported materials require that the imported items are not locally produced in adequate quantities or qualities.

The tax benefit may vary as to amount, or period covered, or both. In some countries such as Algeria, Nepal, Nigeria, Sudan and Zambia partial or full exemption may be granted depending on the special circumstances of each project. In other countries exemption is not uniform but varies according to different categories of industry. Thailand, for example, classifies industries into three groups depending on how "vital and necessary" they are; the exemption ranges from 100 per cent to 33.3 per cent. Ecuador and Peru adopt similar classifications.

17/ High tariffs raising the prices of competing imported goods are also used as an added incentive for industrial investment.

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In certain countries such as Pakistan no outright exemption is granted for raw materials imported by an industrial undertaking. However, duty rates are lower on raw materials required by capital goods industries than those required for consumer goods industries. Moreover, import duties vary inversely with the degree of processing.

The exemption may be permanent as in the case of Ecuador, Jamaica and Peru. On the other hand, it may be for a fixed period which may coincide with the tax holiday period, as in Guyana, Thailand, and in the case of chemical and textile industries in the Philippines. In other cases, the period of customs duties exemption may differ from the period of tax holiday as in the Ivory Coast, Nigeria, Trinidad and Tobago and some Central American countries.[18/]

Mention should also be made of tax relief from different levies on fuel and lubricants imported for use in manufacturing production. Only a few countries, however, give partial or full exemption of duties and related taxes on such items.

(b) Machinery and equipment

As the cost of imported machinery and equipment is the biggest item of capital expenditure in most industrial projects, their exemption from customs duties is particularly appropriate to encourage industrial investment. Virtually all developing countries provide full or partial exemption.[19/]

Different policies are followed with respect to imports of spare parts for exempted machinery. Malta and Nigeria, for example, may permit custom-free import of machines, yet spare parts for these machines are dutiable. Ghana and the Philippines, on the other hand, exempt spare parts along with any importation of machinery and equipment.

Tax concessions designed to reduce the recoupment period

33. Another device in the array of concessions offered by developing countries is to allow a certain deduction of expenditure on capital investment on plant

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18/ Investment Opportunities in the Central American Common Market, Central American Bank for Economic Integration, pp. 25-29, Honduras (1965).

19/ However, some countries such as India and Pakistan do not offer such an exemption. India applies favourable duties to agricultural machinery while Pakistan exempts it completely from customs duties.

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and machinery from taxable income. This would reduce the period of recoupment and, hence, the risks. There are two principal ways to achieve this. The first is to provide accelerated depreciation usually through an initial allowance. This is sometimes referred to as an interest-free loan from the Government to the taxpayer. The second device is investment allowance over and above the depreciation allowance for the normal wear and tear allowed for machinery, equipment and buildings.

34. Some developing countries offer accelerated depreciation, usually through initial allowance; others grant investment allowances, and some combine both, as shown in table 1. Morocco which is not included in the table, provides capital subsidy for industrial building, machinery and equipment.

Tax concessions affecting profits

35. Tax concessions that affect profits of an enterprise usually take the following forms: partial or full income tax holiday; relief from income tax on dividends distributed out of exempted income and deferral of depreciation deductions and carry over of losses.

(a) Partial or full income tax holiday

A partial or full income tax holiday not only increases the net return from investment, but also may reduce the pay-back period and thus the initial risk inherent in a long-range investment. In addition, it may facilitate the expansion of an enterprise through self-financing. It is understandable, therefore, that tax holidays are offered by many developing countries and are considered as one of the most important tax inducement measures to attract foreign as well as domestic capital. Some examples are given in table 2. It will be seen that some countries give full tax holiday as in the case of Ethiopia, Guyana, Nigeria, Pakistan, Puerto Rico, Republic of China, Thailand, Trinidad and Tobago and Zambia. Others give partial exemption as in the case of Ecuador, India, Israel and Sudan. Still others give tax holiday on a declining basis over a number of years, as in Argentina, Barbados and Costa Rica.

Usually, the period of exemption begins from the date of production. Some countries such as Ceylon and Guyana specify that the period starts from

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Table 1

TAX CONCESSIONS DESIGNED TO REDUCE THE RECOUPMENT PERIOD IN SELECTED DEVELOPING COUNTRIES

Country	Tax Concessions Measures	Observations
India	Investment allowance "Development rebate"	For priority industries 35% during April 1965 up to March 1975 and 25% thereafter, other industries 25% and 15% respectively.
Ceylon	Investment allowance "Development rebate"	20% standard rate. If business is an approved project or agricultural undertaking the rate is 40%
Turkey	Double depreciation rates and investment allowance	Investment allowance for regional development investment is 50%; for agricultural investment 40% and all other investment 30%, provided certain requirements are met.
Tanzania	Investment allowance	-
Guyana	Initial allowance	-
Nigeria	Initial allowance	-
Sudan	Double depreciation rates	-
Trinidad and Tobago	Initial allowance	-
Malawi	Initial and investment allowance	-
Zambia	Initial and investment allowance	-

Source: Tax Incentive Laws and Tax Codes of countries mentioned.

Table 2

INCOME TAX HOLIDAY IN SELECTED DEVELOPING COUNTRIES

Country	Full Income Tax Holiday		Country	Partial Income Tax Holiday		Country	Declining Tax Holiday	
	Period (No. of years)	Observation		Period (No. of years)	Observation		Period (No. of years)	Observation
Ethiopia	3-5	**Depending on capital invested**	**India**	...	Up to 6% of invested capital	Argentina	10	From 100% tax holiday to 10% over the holiday period
China, Republic of	5	**New and expanding enterprises**	**Sudan**	2-5	Up to 5% of profits and balance at half rates. Size of invested capital determines the period	**Barbados**	9	7 years full tax holiday, 2/3 for 8th year and 1/3 for 9th. Option (2)
Thailand	5	**New and expanding enterprises**						
Pakistan	2, 4 or 6	**Depending on location**				Costa Rica	Not to exceed ten years	Full exemption for the first half and half exemption for the second
Zambia	2-5	**Depending on nature of each enterprise**	Israel	5	Exemption from income tax but not from company profits tax			
Nigeria	2-5	Dependir on capital invested	**Ecuador**	5	12% of paid up capital for categories "Special" and "A"			
Guyana	5	**New and expanding enterprises**						
Trinidad and Tobago	5	Renewable to another 5 years						
Puerto Rico	10, 12 or 17	Depending on location						

Source: Tax Incentive Laws and Tax Codes of countries mentioned.

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attainment of production in commercial quantities. Others, such as the Republic of China consider the period to begin from the date on which the product of a new enterprise is marketed and in the case of existing firms in expansion, from the date the added equipment starts to operate.

(b) Relief from income tax on dividend distributed out of exempted income

Tax exemption may extend to dividends paid out of exempted profits. Barbados, Ceylon, Guyana, India, Israel, Jamaica, Nigeria, Puerto Rico, Sudan, Trinidad and Tobago among other countries, offer such exemption. To provide a safeguard against loss of revenue to a foreign government, some countries including Barbados, Jamaica and Puerto Rico, require that non-resident shareholders be exempted in their country of residence from the tax on dividends received.[20/]

In order to qualify for tax exemption, dividends from exempted profits must be distributed within a specified period. Some countries such as Ceylon, India, Malta and Sudan, stipulate the distribution must take place during the tax holiday. Others, such as Guyana, Trinidad and Tobago, allow tax-free dividends up to a few years (usually two years) after the expiration of the holiday period. In both cases firms wanting to take advantage of such concessions are forced to distribute dividends within the prescribed period, rather than build up reserves for self-financing. A reasonable compromise is offered by Israel which allows up to ten years after the expiration of the holiday period for dividends to be distributed tax free.

(c) Deferral of depreciation deductions

In some countries such as Ghana, Malaysia, and Trinidad and Tobago, depreciation allowances, normal as well as accelerated, on investments made during the tax

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20/ For tax treatment of foreign income and investment in capital exporting countries, see Fiscal Incentives for Private Investment in Developing Countries, O.E.C.D., Paris, pp. 15-25 (1965).

Some capital exporting countries such as France, Italy, Japan, and the United Kingdom, credit their taxpayers investing abroad for taxes "spared" by certain developing countries. Unless double taxation relief is generalized, the efforts of developing countries to encourage the flow of foreign investment may be frustrated. (For Inter-relationships of tax system of developing and capital exporting countries, ibid., pp. 45-57).

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holiday may be claimed against profits made after the tax holiday has expired. This in effect may result in an extension of the tax holiday leading to concealed tax exemption. It may be noted that in case of deferred depreciation, current profits are gross of depreciation charges. If dividends are distributed within the prescribed period so as to take advantage of the tax concession, there may be no funds available to compensate for the depreciated machinery.

(d) Carry over of losses

Corporate profits are almost as likely to be negative as to be positive. Without some adjustment for years of negative profits through loss carry-over, the tax may discourage investment in risky and uncertain fields which may be vital for industrial growth. The beneficial effects of income tax holidays and investment allowances may be lost unless liberal means for loss carry-over are simultaneously adopted.

Virtually every developing country allows for such carry-over. Some countries allow this only for a fixed period; in Mexico and Puerto Rico this period is five years; in Jamaica, six years; and in Israel seven years. Other countries, including Ceylon, Sierra Leone, Trinidad and Tobago do not specify a fixed period.

In Nigeria, for losses incurred during the tax holiday, a further extension may be given equal to the number of years in which losses are incurred, subject to a maximum period of five years.[21] It can be readily appreciated that such a procedure may open the door to tax evasion through manipulation of incomes and expenditures of the enterprise concerned so as to show tax loss in the early part of the holiday period when profits are not likely to be high. It would be advisable, therefore, to allow a grace period during which the taxpayer can select the beginning of his tax holiday period, so that the tax benefit offered will not be wasted on low or negative profits. Such an option is provided in the incentive laws of Barbados, Jamaica and Puerto Rico.

Miscellaneous tax benefits

36. Many Governments of developing countries supplement the above-mentioned tax benefits to approved enterprises with partial or full tax exemption from taxes

21/ Ordinance No. 8 of April 1958, part III, Clause 6.

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or fees on the registration of the enterprise, purchase of land for the establishment of the plant, financial transactions of the firm and sales of products. Special attention may be directed to the former concession. In most developing countries, the economic problem is more related to production, than to consumption, and the exemption of domestic sales, usually within a protected market, of approved enterprises may result in large revenue loss to the Government. The maintenance of domestic prices at a level higher than export prices has, therefore, a favourable effect on the curtailment of domestic consumption, reduction of imports, improvement of the balance of payments and protection of undue loss to Government revenue. Colombia, Costa Rica, and the Republic of China are aware of such problems and, therefore, do not extend the exemption from production and sales taxes to domestic sales.

Evaluation of tax incentives for industrial development in general

37. The nature and extent of the tax incentives offered in the form of exemption from customs duties and from income tax, investment grants, initial allowances, accelerated depreciation allowances, and the like, should be determined with due regard to sectoral priorities and the need of each sector for direct and indirect subsidies. While these needs are likely to vary from one country to another, it may, nevertheless, be useful to bring to the attention of all developing countries certain desirable tax incentive measures which have not yet been widely adopted.

38. With regard to the exemption of imported materials from customs duty, developing countries should relate the amount of exemption inversely to the degree of processing involved, as is done in developed countries. The likely effects of this on the use of domestic materials and labour are well known as are the resultant savings in foreign exchange.

39. Exemption of machinery and equipment from customs duty would appear to encourage the use of capital as against the use of labour, where these two factors of production are, in some measure, mutual substitues. By and large, however, such substitution has a limited scope in manufacturing industries and cannot be expected to provide a solution to the problem of employment in developing countries in the short run. This is not necessarily the case with equipment used in performing ancillary services, particularly transport equipment. The exemption given for imported manufacturing machinery need not be extended to such equipment, as manual labour might sometimes successfully perform the same services.

40. On the other hand, the exemption of spare parts for exempted machines and equipment is highly desirable and should be generalized. This may encourage repair of used machines, thus extending the useful life of industrial equipment and, at the same time, saving the developing countries scarce foreign exchange that they would otherwise need for replacing the old machines with new ones acquired through imports.

41. Equally, imports of fuels and lubricants for manufacturing purposes should be exempt from customs duties as this would make a reduction in manufacturing costs possible. At present, only a few countries give tax exemption for this purpose, and more countries would be well advised to grant similar concessions.

42. Investment grants are rarely provided in developing countries. Morocco is, in fact, the only country that does so among the countries covered by the study. The advantages of such subsidies are apparent: they simplify administrative procedures involved in tax exemption and provide the eligible enterprise with an outright benefit whether or not it makes a profit. Thus, benefit is particularly important for new enterprises in the initial years of their operation. The main disadvantage of investment grants is that the sacrifice in tax revenue is divorced from profits and therefore may not be compensated by a gain for the national economy. Every developing country will have to weigh the advantages and disadvantages of investment grants, depending on such factors as adequacy of tax administration and availability of public funds.

43. By shortening the recoupment period of investment, initial allowances and accelerated depreciation allowances tend to reduce the risks of non-recovery which are considerable in most developing countries. These risks are, no doubt, a major concern of potential domestic investors and foreign investors alike.

44. While initial allowances and accelerated depreciation allowances are important for industries catering to the domestic market, they are even more important for export-oriented industries. As the latter must be able to face competition in foreign markets, they may need to use up-to-date machines - and this involves more rapid obsolescence of machines than is the case with industries catering to the domestic market. For this reason, larger initial allowances and accelerated depreciation allowances should be provided for export industries.

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45. As regards income tax holidays which are widely offered in developing countries, the holiday period is generally the same for all eligible industries in a given country. Yet, industries differ with respect to their running-in periods, among other things. The steel industry, for example, has a much longer running-in period than the food industries. It is to be expected that investors would tend to favour industries which have a short running-in period. In the more advanced stages of industrialization, it will be necessary to establish industries with relatively long running-in periods. In providing tax holidays, therefore, it would be desirable to differentiate between industries as to the period for which tax holidays are granted.

46. Most developing countries offering income tax holidays provide the same exemption over the entire holiday period. At the end of this period, the beneficiary enterprises suddenly feel the full burden of the tax. This is clearly undesirable. It may be argued that beneficiary enterprises, particularly new ones, should, by the end of the tax holiday period, be able to stand on their own feet; this is, in fact, the purpose of tax concessions. But the actual picture is somewhat different from this. There have been many cases where, at the termination of the tax holiday, enterprises have either found themselves in financial difficulty or they have moved to other countries.

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III. TAX INCENTIVES FOR SPECIFIC SECONDARY OBJECTIVES OF INDUSTRIAL DEVELOPMENT

47. This chapter will review the different tax concessions aimed at achieving certain "secondary" objectives which are sometimes pursued alongside the main objective of maximizing industrial output. These objectives include: facilitating industrial financing, influencing the location of industry, promoting exports of manufactures, facilitating the transfer of technology, encouraging technical research and training, assuring the full use of existing industrial capacity. As might be expected, the importance attached to these secondary objectives varies from one country to another.

Facilitating industrial financing

48. While tax incentives are widely used by Governments of developing countries to encourage investment in the industrial sector, seldom are they designed to facilitate the financing of investment. Some investment laws, however, give special attention to this problem and provide tax concessions to encourage individuals, businesses and financial institutions to devote a greater share of their resources to industrial financing.

(a) Individuals

In India tax credit certificates are offered to individuals subscribing, on or after December 1964, to an eligible issue of equity capital or purchasing such equity shares of new industrial companies. Individuals are also exempt for five successive years from the wealth tax on equity shares in new industrial enterprises after March 1964.[22/] Recently, the tax on bonus issues has been removed and the rigours of the dividend tax have been softened with a view to reviving the capital market and increasing the flow of private savings to industry. These changes have enabled companies with large reserves to issue bonus shares, thus expanding their capital base, and consequently reducing the burden of the dividend tax.[23/] Similarly, Pakistan allows investment in new share-capital of approved industrial companies to be deducted up to 20 per cent of

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22/ Taxes and Incentives, Indian Investment Centre, New Delhi, p. 43, (1966).

23/ Report of the Industrial Development Bank of India for the year 1965-1966, Bombay, pp. 4-5 (August 1966).

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the shareholder's total income with a maximum of Rs. 12,000 ($1,600). Also, dividends up to Rs. 3,000 ($400) received from Pakistani corporations are tax-free.[24/]

In the Republic of China, purchases of registered stocks or bonds maturing in not less than three years, are deductible for income tax purposes, provided that the securities purchased relate to an industry specially designated by the Government. Another, but rather general measure, is the exemption of capital gains on investment in corporate bonds and stocks held for a period of more than one year.[25/]

A scheme was recently introduced in Ceylon by which a generous rebate is granted to taxpayers for approved investment in industry.[26/]

(b) Businesses

A number of countries give tax benefits to encourage industrial enterprises to direct part of their earnings to self-financing or to financing of other industrial enterprises. Chad, Ecuador, Morocco, Peru, Republic of China, Senegal, Somalia, Tunisia, Uruguay and some Central American countries provide tax relief for reinvested earnings in certain fields including industry.

24/ Tax in Pakistan, Central Board of Revenue, Karachi, pp. 4-17, (December 1965).

25/ Shun-Hsin Chou, Tax Incentives for Industrial Development in Taiwan, country study prepared for UNCID, pp. 2-(12)-2(14), Republic of China (Taiwan) (1966).

26/ "Approved Investment" means:

a. An investment in an approved project within the meaning of section 69 provided that:

(i) It is not an existing investment;

(ii) It is an investment in the first issue of shares or made within six years from the date of the first issue;

(iii) It is an investment in ordinary shares.

b. An investment in an undertaking or any other class of investment as is declared by the Minister of Finance by order published in the Gazette to be an approved investment.

For more detail, see The New Tax Structure, Department of Inland Revenue, pp. 22-27, Colombo, (1966).

In some cases the tax concession is subject to the requirement that the planned reinvestment be placed in a less developed area of the country.27/ A case in point is Brazil: any legal entity operating in the country may discount from its income tax, up to 75 per cent of the face value of bonds emitted by the organizations in charge of developing the Northern (Amazon Region) and the north-east areas for the purpose of obtaining resources for their operations. Moreover, to encourage investment in these two regions, enterprises can invest part of their profits tax-free. Peru has a similar provision.

By tying reinvestment of profit to purchase of bonds or to actual investment in certain areas in the same taxable year, it is intended to ensure that the new investment is financed from earnings and not from accumulated depreciation allowances or other sources. The exemption of undistributed profits, without the stipulation that it must be reinvested, would open the door wide to tax evasion.

(c) Financial institutions

Tax benefits are sometimes offered to financial institutions, particularly development banks, to encourage them to provide credit on easy terms as well as to subscribe to the equity capital of industrial projects.

Some countries give full tax exemption. In Liberia, for example, the Liberian Bank for Industrial Development and Investment is exempted from all taxes and custom duties as well as from all taxes on dividends paid by it. The Philippines exempts private development banks from payment of the gross receipt tax and income tax.28/

Other countries give only partial exemption. A part of the share capital of the Industrial Development Bank of Israel "approved investment" under the

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27/ The Italian Government, in its efforts to develop the southern part of Italy, "The Messogiorno" included such a condition for any northern firm which plans reinvestment of profits and desires to take advantage of such relief; C.A. Martellaro Economic Development in Southern Italy, the Catholic University of America Press, Washington, D.C., p. 59 (1965).

28/ Republic Act 4093 (19 June 1964).

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Law of Encouragement of Capital Investment of 1959. About 30 per cent of the bank's profits (net of the company profits tax) are exempt from income tax for a period of five years. The Banque Nationale pour le Développement Economique in Morocco is authorized to constitute certain tax-free reserves. It is also exempt from all fees and taxes on its capital, on issues of bonds, debentures and securities, and on instruments and agreements relating to its credit transactions. However, the bank is subject to the profits tax.

Similarly, the Banque Ivoirienne de Développement Industriel in the Ivory Coast, enjoys various tax holidays for a period ranging from five to ten years. The Industrial Credit and Investment Corporation of India is exempt only from income tax on dividend income received from new industrial undertakings.

Pakistan excludes from taxable income dividends received by any investment company on its equity shares. Some countries offer certain tax benefits as a subsidy intended to ease the terms on which credit is made available to industry. This is achieved, for example, by exempting interest received by the lender on money borrowed by an industrial undertaking. Thus, interest payable by an industrial undertaking in India for an approved loan from specified foreign financial institutions is tax exempt as is interest payable to a non-resident recipient for credits to finance the purchase of machinery or raw material from outside India.[29/]

Pakistan has recently changed its tax law and now provides the same concessions as India.[30/] Barbados offers a similar tax benefit, except that resident interest-receivers are exempted as well.[31/]

Influencing the location of industry

49. Although regional imbalances exist in all countries, whether they are developed or are developing, imbalances are particularly pronounced in the latter. In an

29/ Taxes and Incentives, op. cit., pp. 34-35.

30/ Tax in Pakistan, op. cit., p. 14.

31/ Industrial Incentive Act. (1963).

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effort to achieve a more balanced regional development certain developing countries provide tax incentives to encourage industrial enterprises to branch out or settle in backward areas.[32/]

50. One approach is to divide the country into a number of areas giving unequal benefits to different areas depending on their level of development. Morocco, Pakistan, Peru and Puerto Rico follow this approach. Puerto Rico is divided into three zones. Eligible industries in the "high industrial development zone" are exempted from income tax for ten years, those in the "under-developed industrial zone" for seventeen years and those located in the remaining part of the country for twelve years. Pakistan is divided into three areas eligible for a tax-holiday of six years, four years and two years respectively. However, there is no clear-cut separation between these areas; some cities and the areas within a radius of ten miles of the municipal limits are entitled to four years' tax holiday although they may be located within an area eligible for six years.

51. Some countries extend the period of tax concessions for industries moving away from congested centres. In India, for example, tax credit certificates providing relief from tax on capital gains are granted to industrial undertakings shifting from specified urban areas to other areas. Jamaica provides tax concessions for the same purpose.

52. Another approach is to give concessions only to industrial enterprises established in certain areas. For example, Iran grants new establishments a five-year tax holiday, only if they are located outside a radius of 60 kilometres from the centre of Teheran. Similarly, Argentina's central Government excludes investment located in the metropolitan Buenos Aires from any tax concessions.

53. Even where the tax incentive law is silent about location of industry, the administering agency may take the location aspect into account. In granting a pioneer certificate to an industrial enterprise, the Government of Zambia may

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32/ The use of these measures has been pioneered in developed countries. In the United States, property tax and income tax exemptions have been used by many states to attract industry. For a discussion and summary of individual states' policies regarding fiscal incentives for industrial location, see Session on _Tax Incentives to Business Location and Expansion_, Seattle, U.S.A., pp. 99-161 (1961).

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attach certain conditions relating to location. The Investment Centre of Israel is more lenient in approving investment projects in "development" areas than in other areas. In several cases investors have been asked to set up the enterprise in a development town as a condition for approval.

54. Sometimes provincial governments supplement tax incentives of the central or federal government with their own; Argentina is a good example. All provinces, with the exception of Santa Cruz, have industrial promotion laws. Some provinces indicate what industrial sectors are given priority. Others grant tax benefits only to industries that use regional inputs. The extent and duration of tax benefits vary from one province to another.[33/]

55. The extent to which the tax concession compensates for possible additional cost from locating in tax-favoured areas is very difficult to evaluate. Locating in an undeveloped area with no natural advantage to attract the investor, being far from established industrial and commercial centres, lack of auxiliary services, and so forth may be very difficult. However, in the case of Israel a considerable part of the approved enterprises were established in development areas. The relatively large share of textile and food plants supports the notion that the Investment Centre was instrumental in implementing the government policy of distributing economic activity throughout the country.[34/] Such industries may have been specially suited for these areas because a high degree of skill was not required for most workers available. These workers usually constituted new and unskilled immigrants.

56. Pakistan's experience shows that, in general, despite the tax holidays, industrialists continue to prefer urban centres such as Karachi, Hyderabad and Chittagong except where proximity to raw materials is an overriding consideration. However, the dispersal of industries to secondary centres and some isolated regions in the past six years has been stimulated by the tax-holiday system, supplemented

33/ Paper prepared for C.I.D., Industrial Location Policy and Regional Development in Argentina, (December 1966), p. 55.

34/ A. Ilan, Tax Incentives for Industrial Development in Israel, study prepared for C.I.D., p. 148, Tel Aviv (1966).

to some extent by other measures such as the preferential treatment by development banks of applicants who wish to set up industries in less development regions.[35/]

57. It is to be noted that in providing tax concessions for different regions of a country one must not lose sight of industrial priorities in each region. This may call for the provision of more favourable tax benefits for certain industries with the region.

Promoting export of manufactures

58. It is widely agreed now that developing countries cannot rely solely on their traditional exports to earn the amount of foreign exchange needed to finance their increasing imports of capital goods, materials and consumer goods that are required to achieve even moderate rates of economic growth. Export of manufactured goods will have to be expanded considerably and new lines of production will have to be initiated with a view to export.[36/]

59. Tax incentives are among the measures used by developing countries to promote export of manufactures. Virtually all countries offer full or partial exemption from export taxes on manufactured goods. In addition, some countries give special tax treatment to materials (whether imported or produced locally) used in the production process of goods destined for export and to profits arising from export of manufactures. The exemption of imported materials takes various forms. One is the drawback system by which the importer claims repayment of custom duties if the materials imported are used for the manufacture of goods to be exported. Argentina, Nigeria, Peru and the Republic of China are among the countries that have adopted such a system. Another form of exemption is deferral of custom payments by a manufacturer, upon the provision of a guarantee assuring that imported materials will be used for the manufacturing of export products. In the event that the products are sold domestically, the full taxes on imports are collected. This system is used in the Republic of China and with regard to packing requirements for export goods in Iran.[37/]

35/ Sartaj Aziz, A Study of Industrial Location Policy in Pakistan, paper prepared for C.I.D. (October 1966).

36/ A rough projection suggests that at least $US15 billion between 1960 and 1980 will have to take the form of exports of manufactures, including the value added by processing of materials. (United Nations, Economic Survey of Europe, 1960; pp. 47-48, Sales No.: 61.III.E.1.1961).

37/ Tax and Custom Regulation and Concessions to Industries, Bank Markazi, Teheran, p. 46.

60. As to locally produced materials used in the production of export goods, many countries follow either a system of exemption from domestic taxes or sales taxes, or a system of refunding such taxes if the final goods are exported. Argentina, Brazil, Ecuador, Kuwait, Saudi Arabia, and most of the Asian countries offer such concessions,38/ which, of course, are designed to relieve exporters of the burden of domestic taxation, so as to enable them to compete in the world markets.

61. Both the tax remission and the deferral of tax payments involve costly and time-consuming administrative processes. With this in view, the free zone system, which is particularly advantageous to industries producing mainly for export, is beginning to gain wide application. It is already in use in India, Panama, the Republic of China and the United Arab Republic.

62. A similar system is the bonded factory which obviates the need for payment of duties at any stage of production of export goods. The Republic of Korea introduced such a system in 1961. A form of the bonded factory system is the bonded warehouse system used in Pakistan, where excisable goods such as jute manufactures, cloth, matches and paints may be purchased by commercial exporters without payment of excise duties, provided they are held in bonded warehouses until exported.

63. Several developing countries fully or partly exempt from income tax all profits arising out of the export of manufactures. Ceylon, Colombia, Jamaica and Mexico, for example, provide full exemption for a number of years. On the other hand, the Republic of China allows a deduction equivalent to 2 per cent of export earnings in the calculation of taxable income for income tax purposes. In certain countries enterprises must export a certain minimum percentage of their total production in order to be eligible for tax concessions. Pakistan, for example, offers income tax holidays only to industrial enterprises exporting at least 30 per cent of their production. Similarly, Israel sets a minimum requirement of 50 per cent.

38/ Promotion Programmes and Limiting Factories; United Nations Economic Commission for Asia and the Far East, Bangkok; Asian Conference on Industrialisation; E/CN.77/1 and UN/Ind. Conf.IL.5; p. 59; 1965.

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Utilization of excess capacity

64. Further growth of industrial output in developing countries on a significant scale no doubt requires expansion of capacity. It may be possible, however, in the short run, to increase output by utilizing existing capacity more effectively. In many developing countries substantial proportions (in some cases exceeding 50 per cent) of installed capacity in certain industries remain idle. The reasons for this are many and they vary from one case to another. Although most of the difficulties cannot be overcome by tax concessions, these may help to overcome some of them.

65. Very few developing countries have specific provision in their tax incentive laws aimed to achieve fuller utilization of existing capacity. Tying the tax incentive to the volume and production of sales may be one way to encourage manufacturers to expand production and thereby utilize more fully their existing capacity. India is one of the few developing countries that does so. Any manufacturer in certain specified industries is entitled to tax credit certificates calculated as a percentage of excise duty payable to the central government on the excess of goods cleared during any of the five financial years - 1965-1966, 1969-1970 - over the goods cleared during a "base year".[39]

66. Another way to encourage the utilization of existing capacity is to allow additional depreciation changes for plants and machinery in case of multiple shifts. India and Pakistan are among the few developing countries explicitly allowing 50 per cent and 100 per cent depreciation charges over and above the normal allowance for double and triple shifts.

Encouraging the transfer of technology, and technical research, and training

67. As developing countries have come to regard industrialization as a means to accelerate their economic development, they have become increasingly aware of the need for technological change, technical research, and technical training, without which industrial development could not take place on any significant scale.

39/ A somewhat similar system was introduced in Canada in 1962. For a detailed discussion on the operation of the system, see R. Bird, "A Tax Incentive for Sales: The Canadian Experience", National Tax Journal, Vol. XVIII, pp. 277-285 (Sept. 1965).

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Further industrialization involving more sophisticated methods and processes of production will undoubtedly accentuate this need. Developed countries, in fact, devote vast resources for technological research and technical training, both of which enjoy government assistance and encouragement, including appropriate tax concessions.

68. Several developing countries offer special tax concessions to encourage transfer of foreign technology through licensing agreements related to patented and unpatented technological know-how. In Israel, for example, the supply of foreign know-how is considered an "approved investment" and, as such, is eligible for income tax benefits. Such benefits also apply to dividends payable out of income derived from the know-how. Moreover, the salaries of approved foreign technicians are subject to reduced income tax for a period of three years, which may be extended for another two years. Similarly, the Republic of Korea exempts from income tax and corporation tax of payments made to foreign nationals in connexion with the transfer of patents or other technological rights.

69. India has one of the most elaborate schemes to encourage transfer of technology. Royalties received by a foreign company from an Indian concern are taxed at the rate of 50 per cent as against the rate of 70 per cent applicable to other income. The same rate applies to income from technical service fees. These fees are also exempt from surtax, as are interest and royalties accruing to a non-resident company. On the other hand, the expenditure incurred by a manufacturer to acquire patent rights is deductible from profits in annual instalments.

70. To enable industrial concerns in India to attract the services of highly qualified foreign technicians at reasonable remuneration, technicians' earnings are exempted from income tax up to eight years. This applies also to foreign employees temporarily in India, serving a foreign enterprise.

71. Furthermore, foreign residents in India are allowed a rebate of up to 25 per cent of their income for educational expenses of dependent children outside of India. Travel expenses of foreign employees, their wives and children on home leave are also tax-exempt.

72. To promote scientific research the Indian tax code allows current expenditure on scientific research related to business to be deducted from profits. Capital expenditure on similar research is allowed to be spread equally over five

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consecutive years. Grants to approve scientific research associations and educational institutions, to be used for scientific research, are also adaptable.

73. Although the majority of developing countries allow all reasonable expenditure incurred by an industrial enterprise on technical training to be deducted from taxable profits like any other current business expenditure, few give special attention in their tax incentive laws related to the problem of training. In Peru instead of deducting training expenditure from gross income, an enterprise is given the option to invest part of each year's net profits in creating and developing manpower training facilities. Other countries in granting tax concessions require an enterprise to give special attention to the training of personnel without setting any standard for training programmes, or control of them.

<u>Evaluation of tax incentives for secondary objectives of economic development</u>

74. The desirability of providing incentives designed to facilitate industrial financing, to promote exports of manufactures, to foster the transfer of technology, technical research and training, and to encourage the full utilization of industrial capacity cannot be disputed. Thus, developing countries plagued with excess capacity in certain of their industries could make greater use of appropriate tax incentives tied directly or indirectly to production or sales. Also, tax incentives to stimulate technical training by industrial enterprises are likely to be of interest to all developing countries. In this connexion a positive inducement may be given to enterprises by taxing them on their wage bill unless they prove that they are undertaking their own training programme.

75. The nature of tax incentives designed to facilitate industrial financing varies from one country to another, depending on whether the intention is to encourage individuals, or businesses, or financial institutions. First, although industrial bonds and shares are sold to the public in a number of developing countries, only a few countries have security markets at present. The effectiveness of tax benefits to encourage the purchase of industrial securities by individuals will, no doubt, increase as such markets are established. Second, the channelling of business savings into self-financing is often desirable, provided that this does not prevent businesses from investing in new fields of industry when desirable. This branching off into other fields may be encouraged

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by offering tax benefits over and above those given to self-financed expansion. Third, the majority of developing countries have already established development banks which play an important role in industrial development as suppliers of finance, technical assistance, and promotion facilities. Tax concessions to these banks which are designed to increase their industrial loans or soften the terms of these loans, would be of great benefit to the economy, surpassing by far the cost in tax revenue. Equally, commercial banks could be induced by the provision of appropriate tax incentives to devote a larger share of their resources to industrial financing, assuming of course that this is desirable. Other financial intermediaries such as life and property insurance companies are potentially important sources of industrial financing, but in few developing countries are they sufficiently developed to be of importance. In all these cases, fiscal incentives could play a greater role in channeling savings into industrial investment.

76. Since exports of manufactures from developing countries at present are small, it is understandable that tax incentive schemes to promote these exports are rather simple. This does not imply, of course, that they could not be improved. In some countries, for example, eligible industrial enterprises must export a specified minimum percentage of their total production. Not infrequently, enterprises may export at a loss because they are subsidized by their domestic sales. If these sales are limited, say, for lack of domestic demand, expansion of exports would not be possible under this system. It seems advisable for countries which have adopted this system to consider relating the tax benefits to the value of exports or income from exports.

77. There is, undoubtedly, a need for more substantial tax benefits for export industries than is given at present. Reference earlier has been made to the desirability of larger obsolescence allowance for export industries. Furthermore, whether feasible tax concessions may be extended to inputs of the export-product as well as to ancillary services such as transportation.

78. Free-zone systems might greatly reduce the need for administrative procedures relating to exemption from customs duties and other tax concessions. Countries which do not as yet export manufactures on any significant scale may see no particular advantage in them, but those which emphasise export promotion would be well advised to consider the establishment of free zones

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79. By and large existing fiscal incentive schemes in developing countries encourage "traditional" exports. Yet, as has been pointed out earlier, new lines of manufactures will have to be developed if exports are to increase substantially. It would be desirable therefore to offer new export industries tax benefits over and above those given to existing industries. Once again, the determination of the new industries to be created requires careful programming.

80. It cannot be presumed, a priori, that the provision of incentives to influence location of industry is desirable as it has been presumed with regard to other secondary objectives of economic development. This is because, in the vast majority of developing countries, it is premature even to consider dispersing industrial enterprises away from the few urban centres where they are concentrated, unless the nature of the activity is such as to require location away from the centres. Even in the larger developing countries, like Argentina, Brazil and India, de-concentration with a view to the development of backward areas is a debatable issue. Under the circumstances, the wisdom of giving tax incentives for a balanced regional growth is, in most cases, highly questionable. The external and internal economies, both for the enterprise and the national economy, arising from concentration are substantial. There is no use, to give tax incentives when it is fairly obvious that no enterprise would be established in a backward area for the sake of taking advantage of the concessions offered, if the economic factors governing profitability are not there.

IV. ADMINISTRATIVE MECHANISM

Determination of eligibility

81. Developing countries generally follow two methods in determining whether a particular enterprise is eligible to receive the benefits of tax concessions offered under their fiscal systems. For the purposes of analysis, these methods may be termed: (a) non-discretionary and (b) discretionary.

82. Under the non-discretionary method tax concessions are granted to a particular enterprise upon the occurrence of a specific event, or the fulfilment of certain requirements. Some countries state the requirements in statutes specifically designed to provide tax concessions. Countries which do not have such special statutes state the requirements in their general tax laws. For example, Ceylon, India, Pakistan, and the Republic of China, among others, follow this method. In India new industrial undertakings established after 3 March 1948 are eligible for exemptions from income tax on the amount of their income equal to 6 per cent of the invested capital. Industries classified as priority industries by the Government are entitled to deduct 8 per cent of their profits from taxable income. Similarly, the Income Tax Laws of Pakistan grant a tax holiday to any industrial undertaking meeting certain requirements. The requirements relate to the use of domestic raw materials (with certain exceptions), the amount of capital invested and the reinvestment of profits. Ceylon follows a similar policy with respect to tax holiday for new industries, exports by industrial enterprises, and savings relief for approved investments. Taiwan grants income tax holiday to any enterprise that is classified as "productive" by the statute for the encouragement of investment and which also meets the encouragement criteria laid down in the same Act.

83. Under the discretionary system tax incentives may be granted only upon the determination of eligibility of a particular enterprise by an agency specifically charged with the functions. Generally speaking, such agencies are not part of the normal tax administration.

84. In determining eligible enterprises for tax incentives, developing countries that adopt the discretionary system follow one of the two procedures. Under

one procedure they entrust the granting of tax concessions to government ministries. Generally the ministries concerned are those of finance, industry, and commerce. Such is the case with Nigeria, Senegal, Sierra Leone and Tanzania.

85. Under the other procedure developing countries establish special agencies. The degree of autonomy that is granted each agency varies from country to country.

86. The agencies are of two types: (a) a single national agency which reviews all applicant enterprises; or (b) several specialized agencies, each serving a particular category of industry.

87. Countries such as Israel, Jamaica, Kuwait, Malta, Nepal and a number of countries in Africa have single national agencies; while the Philippines and Brazil have several substantive offices or executive committees each dealing with a particular industry.

88. As would be expected, the exact composition of these agencies varies from country to country. However, for analytical purposes two types of agencies may be distinguished: (1) those exclusively composed of government officials; and (2) those composed of government officials and representatives from the private sector.

89. Countries such as Algeria, Cameroon, Central African Republic, Congo (Leopoldville), Ethiopia, Kenya, Madagascar, Morocco, Nepal, and Niger have agencies composed exclusively of government officials. On the other hand, Israel, Malta, Kuwait and the Sudan have representatives from the private sector on the board of their agencies.

Evaluation and conclusion

90. The operational impact of the two systems varies. Under the first system, the legal provisions become applicable more or less automatically; the provisions are of a general nature. The same concessions are granted in an impartial manner to all taxpayers fulfilling certain conditions. It does not make a distinction between different sectors or industries or a distinction according to potential contributions to the economic development of the country. It is also easy to administer as it does not require staff specialized in different branches of economics to determine the eligibility of enterprises for tax concessions.

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91. The second system is more selective in its impact and is administratively more demanding. Under this system tax concessions are granted to individual enterprises only after their eligibility for such concessions is determined. The determination of eligibility would involve an examination of the particular circumstances of each applicant for tax concessions. On the basis of such scrutiny appropriate tax concessions are prescribed. The scrutiny has to take into account the national policy regarding the fields of industry to be encouraged and the contributions that each beneficiary would make to the country's economic development. It is administratively more demanding as proper evaluation of each potential beneficiary must be made. Such an evaluation would require the services of a staff specialized in specific branches of economics. On the other hand the second system is more equitable and flexible in its operation. In terms of national policy it is less costly as the benefits are restricted to enterprises that are judged able to contribute most to the country's economic development.

92. Neither approach is satisfactory, however, and an approach combining the desirable features of the two systems would be preferable. According to this approach the tax incentive laws or statements of industrial policy would identify the priority sectors in specific terms such as fertilizers, textiles, iron and steel. Industrial categories such as "basic", "non-basic", "essential" and "non-essential" have no real significance and are best avoided. On the other hand, within each priority sector industrial projects would be evaluated from the economic viewpoint as well as from the financial and technical viewpoint by some agency to determine their eligibility for tax benefits.

93. Project evaluation raises many problems, but this paper is not the place to discuss them. It is sufficient to mention that evaluation would require clearly defined criteria which should be as few in number as possible and yet cover the major aspects of costs and benefits of a project. Project evaluation should be as objective as possible in the sense that the eligibility criteria should leave as little room as possible for subjective evaluation. That is to say that the agency in charge of evaluation would have to have competent economists as well as technicians among its members.

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94. Few developing countries have adopted an approach similar to the one described here; it is highly desirable that the practice be generalized.

Enforcement

95. Different developing countries entrust the task of ensuring compliance with the terms under which tax concessions were offered to various governmental agencies. India relies on the Central Board of Direct Taxes, a body composed of senior officials of the revenue department. In Costa Rica the agency is a single ministry, while in the Ivory Coast it is made up of more than one ministry. In Mexico the administration is jointly under the Ministry of Finance and the Bank of Mexico.

96. The function of such agencies as the above-mentioned is to see that the terms of tax concessions are faithfully observed by the beneficiary enterprises. They also have the power to impose suitable penalties for the violation of any terms of concession. The penalties may range from simple fines to suspension or cancellation of tax concessions.

97. As would be expected various agencies use different methods of operation. For example in Ethiopia all enterprises must submit a satisfactory proof of the amount of capital invested and the date of operation. Kuwait requires every beneficiary to keep a record of exempted imports on forms specially prepared for the purpose. It requires the beneficiary to allow the Government to inspect these records and to have free access to any store or plant under the management of the beneficiary firm for verification. The beneficiary firm has to submit periodic reports or annual reports and statements that explain how the tax concessions have been used and which show the extent of the progress of the industry. It has to submit also the balance sheet and the profit and loss account for each fiscal year. In case of violations of the terms of concessions, the Minister of Finance and Industry, upon the recommendation of the Industrial Development Committee, is empowered to withdraw all or part of the concessions granted under the law.

98. A vigilance levy on the amount of tax waived is imposed by very few countries. It is highly desirable that the practice be generalized. This may facilitate the determina[illegible] of the cost of tax concessions to the treasury when an evaluation of the impact of tax benefits is undertaken by the Government.

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Country experiences

99. The problems involved in the administration of tax concessions in developing countries are well illustrated by the experiences of Nigeria and the Republic of China. The main problem is slow movement of the administrative bureaucracy in arriving at a decision to grant concessions. Sometimes the amount of time taken by the bureaucracy is so great that potential beneficiaries have preferred to forgo tax concessions.

Nigeria 40/

100. A survey of Nigeria's procedure reveals that a wide range of ministries and agencies have to be consulted to get a company declared "a pioneer" company. These consultations take a great deal of time.

101. Applications from companies for tax concessions are first processed by the staff of the Ministry of Industries, and then the Ministry of Finance is consulted. This ministry is generally reluctant to grant tax concessions because of the loss of revenue entailed. However, once an agreement is reached between the two ministries it is reviewed by the Board of Customs and Excise and the Board of Inland Revenue to determine the relevance of tax concessions to their spheres of activities. Once a final decision is reached it is published and comments are invited to determine whether or not a "pioneer" certificate should be granted to the applicant. Then the staff of the counterpart ministries in the region in which the applicant wishes to operate are consulted before recommendations are made to the Federal Council of Ministers which, after consultation with the appropriate regional executive councils, advises the Head of the Republic to declare the applicant a "pioneer company" within a pioneer industry.

102. The procedure for getting an industry declared "pioneer" is even more involved and prolonged than that of getting a company declared "pioneer".

103. From 1952 to 1961 forty-nine industries were declared "pioneer". During the same period, 155 companies had applied for "pioneer" certificates. Of these, only forty-seven companies were granted certificates. Some of the applicants had to wait for six months or as long as a year to know of a final decision. Discussions regarding import duty relief for some companies have taken as long as three years, although currently the delay is much less. The situation seems to have improved

40/ Aluko, S.A., The Incentives for Industrial Development in Nigeria, [illegible], pp. [illegible]-103.

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since 1962 as decisions are arrived at within two to six months of the receipt of applications for the tax concessions.

<u>China</u>[41]

104. In the Republic of China (Taiwan) tax remission on exports is more important as compared to exemptions and deductions from income tax under the Statute for Encouragement of Investment. A major problem involved in the administration of tax remission programme has been the specification of input-output standards. Such standards form the basis for the calculation of the amount of customs duty to be remitted.

105. Because of the cumbersome bureaucracy, it takes about six months to establish such standards where they do not exist. An application for tax remission standard for a commodity must first be sent to the Ministry of Economic Affairs. After the input-output relations have been examined the application is sent to the Committee on Tax Remission of the Ministry of Finance for further examination. Recommendations are then submitted by the Committee to the Ministry of Finance for approval. Once the Ministry approves the recommendations, a directive to the effect is issue to various offices concerned with tax administration. The offices concerned are Maritime Customs, Salt Tax Administration, Commodity Tax Administration and others. If provincial or local tax offices are involved, the directive is transmitted to them through the Taiwan Provincial Government. Such involved procedures have aroused many complaints against the tax remission programme.

41/ Chen [illegible]: The Impact of Fiscal Incentives on the Development of Manufacturing Industries in Taiwan, op. cit.

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V. EVALUATION OF FISCAL INCENTIVE SCHEMES

106. It is possible to pass reasonable judgement on the merits or deficiencies of a fiscal incentive scheme by examining its design, that is, the eligibility criteria, the nature and extent of the benefits offered and the various arrangements for administering the scheme. Equally, it is possible to suggest, on the basis of general considerations, improvements in the existing scheme so as to increase the chances of its effective application. A good deal of the suggestions that have been made in the preceding chapters with a view to enhance the effectiveness of fiscal incentives are of this nature.

107. Even more significant, however, is the evaluation of a country's actual experience in implementing its fiscal incentive scheme after it has been in operation for a long period. In this context it may be inquired (a) whether the scheme has brought about the results expected of it; (b) whether the sacrifice in the revenue is outweighed by the benefits accruing to the economy; (c) and what can be done to improve the design and operation of the scheme so as to enhance its effectiveness.

108. Incredible though this may seem, no study has yet been published by any Government of a developing country evaluating the impact of its fiscal incentive scheme on the basis of data relating to its operation. So far as can be ascertained, the Government of the Philippines is the only one to have made a systematic investigation for this purpose, but the results have not yet been published. There are two published case studies prepared by individuals relating to the experiences of Mexico and Puerto Rico in the 1950's. Both studies represent earlier attempts at evaluation. Finally, a number of case studies have been prepared by consultants for UNIDO, and the conclusions contained in some of them are briefly summarized below.

109. While it is not possible to set a rigid pattern for the way in which evaluation should be done, it may be useful to indicate the important considerations that should be taken into account:

(a) Was there a significant industrial growth in the country during the period of operation of the scheme? A negative answer would preclude, of course, the possibility that fiscal incentives could have been effective. A positive answer, on the other hand, would indicate a mere possibility that it could have been effective.

(b) Did the industries that were intended to benefit from the fiscal advantages offered show a marked trend for growth, and has this trend been more pronounced or less pronounced than that of over-all industrial growth? The former eventuality reinforces the likelihood that fiscal incentives may have contributed to industrial growth. On the other hand, a marked over-all industrial growth with the beneficiary industries lagging behind would throw doubts on the effectiveness of fiscal incentives.

(c) What are the characteristics of industrial enterprises that have enjoyed fiscal advantages at one time or another during the period of operation of the scheme? The purpose of this inquiry is to see whether these enterprises are those that should be encouraged.

(d) What is the magnitude of savings that have accrued to beneficiary industries from various tax concessions? By comparing the savings for each industrial sector to investment or profits, for example, a rough idea may be formed of what the benefits represent for the industrial sector in question. These savings are, of course, equal to the tax revenue that was sacrificed.

(e) The main purpose of the evaluation is to arrive at a comparison of revenue costs and benefits accruing to the economy, particularly its industrial branch. The estimation of the cost raises no particular difficulty, but it is of little use without a corresponding estimate of benefits. It is very difficult, on the other hand, even to form judgement of probable validity about the benefits which should be attributed to fiscal incentives as those are only one of several factors affecting profitability. All these considerations will have to be taken into account to evaluate the effectiveness of fiscal incentive schemes.

110. This approach may be supplemented by a survey of opinions held by interested businessmen as to whether the fiscal incentives provided have influenced their investment decisions. The combination of these two approaches may make it possible to identify what factors have contributed significantly to the successful operation of the scheme and what factors have impeded its success.

111. The following is a brief summary of conclusions reached by consultants who have prepared for UNIDO country studies of fiscal incentives for industrial development.

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Israel[42]

112. The expansion of industrial output in Israel [illegible] 1950's, has been very rapid [illegible] growth of industries [illegible] example, legged behind the [illegible] substantial increases [illegible] plastics, electrical equipment, ori[illegible] and [illegible] equipment. These industries [illegible] small shares of industrial output [illegible] early [illegible]

113. Investment in "approved" industrial [illegible] represented between 4[illegible] and [illegible] per cent [illegible] investment in industry. However, the number of firms [illegible] doubt because "approved" enterprises were relatively large [illegible] other enterprises. [illegible] fifteen times as [illegible] firms and employed ten times as many [illegible] enterprises. The concentration of "approved" enterprises in the larger size group was not the result of policy favouring large firms. [illegible] up to 1959 unincorporated enterprises were granted more substantial tax benefits than corporations. However, the Government policy was to encourage the production of goods that generally required large units.

114. The balance of payment problem has been uppermost in the minds of policy makers in Israel ever since this state was established. The inflow of foreign capital was encouraged by various policy measures, including tax incentives. In 1955 and again in 1959, the tax incentive law was amended so as to give greater inducement to foreign investors in preference to domestic investors. About one third of "approved" investment in the industrial sector during the period 1955 to 1962 was foreign. Although this is not a small contribution, it seems that many foreign investors preferred to invest in other fields than industry, notably real estate.

115. Another way of relieving the pressure on balance of payments is through an increase in exports of manufactures. The available data indicate that the development of industry was not export-oriented and preference was given to import substitution. During the 1950's and the early part of the 1960's, indirect

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42/ Akiva, Ilan, Tax Incentives for Industrial Development in Israel, op. cit.

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[illegible] and plastic products as against [illegible] 13/ for the industrial [illegible] as a whole. These figures illustrate the [illegible] high prices in Israeli pounds for such inputs in exports and that comparative advantages were not always properly evaluated in approval of investments.

119. The study concludes: "The available data do not permit a clear-cut answer as to whether the benefits conferred were an essential condition for carrying out the approved projects. In some cases, it was evident that approval was not required since investment was not dependent on it. However, the contribution of the incentive law towards creating a more desirable 'investment climate' together with other governmental measures may have had a beneficial influence on

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13/ The United States $1 = 3 I.L.

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The Philippines[illegible]

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[illegible]

[illegible]

(1) [illegible]

(2) [illegible]

(3) [illegible]

[illegible]

[illegible]

[illegible] the [illegible] stable exchange Program [illegible] [illegible] [illegible] fully balanced and [illegible]

[illegible]

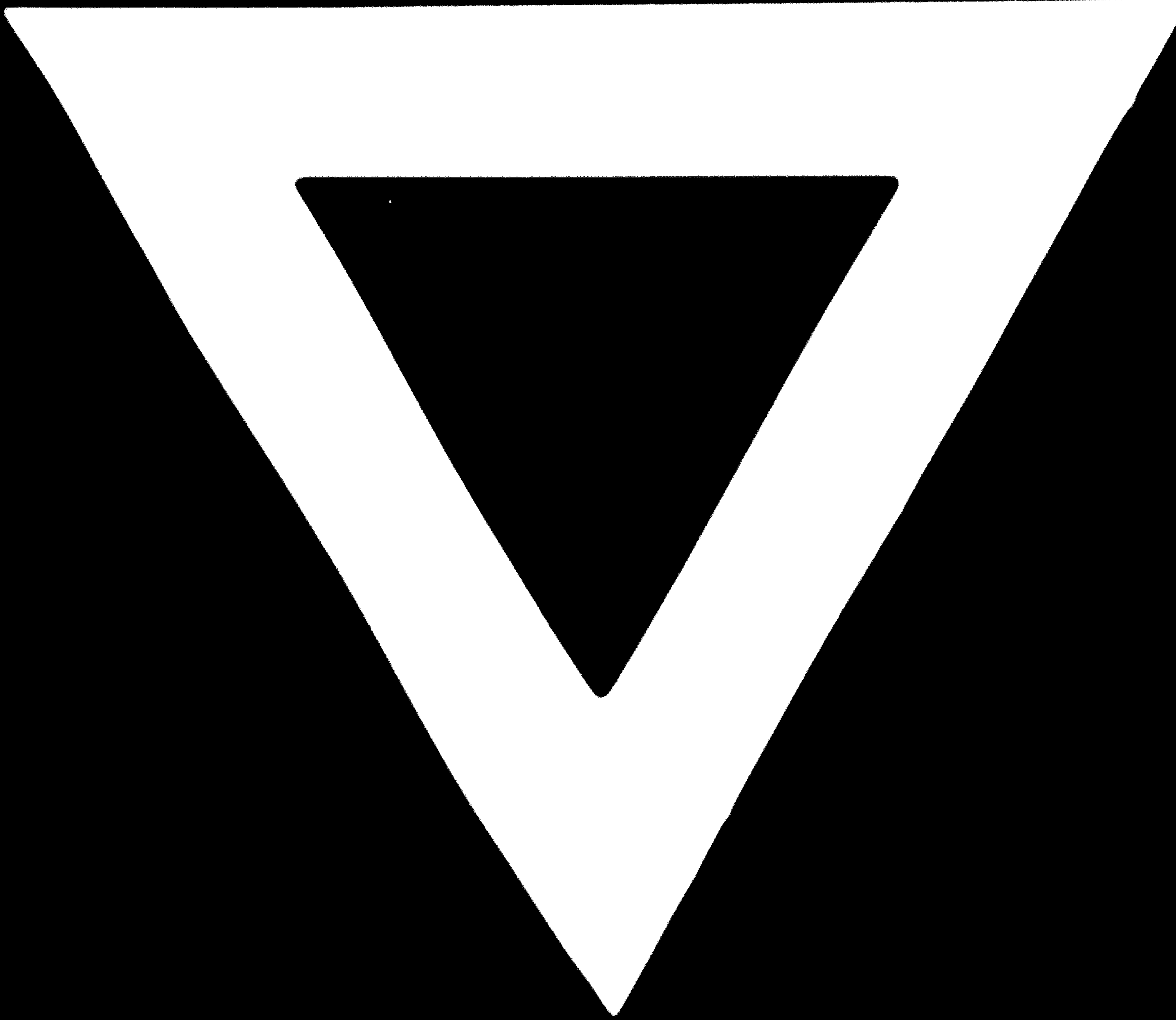
[illegible]

[illegible]

[illegible]

[illegible]

171. [illegible] while providing a number of fiscal advantages the Governments of developing countries often do not give prospective investors an indication of what all these advantages together represent and to what extent they affect the return on investment. They would be well advised to publicise their fiscal



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