Comments on Tax Incentives

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Why are tax incentives popular ?

- Tax incentives as departure from "benchmark tax" such as tax holiday, reduced tax rates and investment allowance/credits are popular in both developed and developing economies
- In the context of global economy where tax competition has been intensified, tax incentives are more effective instruments to attract mobile capital than statutory tax rate
  - ✓ Ramsey rule of optimal taxation
- From the perspective of domestic economy, tax incentives can be used to direct scarce resources for more productive/external benefit generating sectors.
  - ✓ Industrial policy of Japan

Case for tax incentives	Characteristic
I Strong	a. Internationally particularly mobile activity
	b. Positive externalities
II. Ambiguous	a. Regional rents
	b. Unattractive location
	c. Tax cut could spark reactions in other jurisdictions
III. Weak	a. Location-specific rents
	b. None of the above

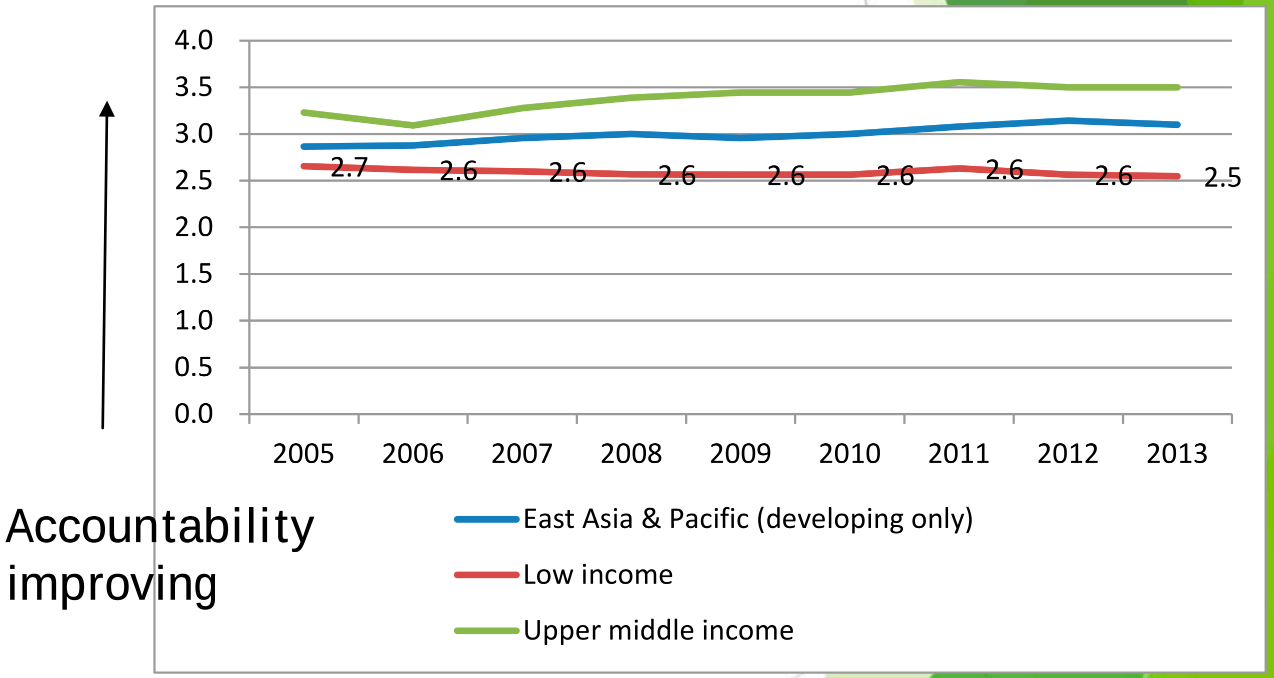
Source: Klemm(2009)

Tax incentives for developing economies

- In developing economies, tax incentives can serve as a sort of second best device to ex ante compensate (i) corruption and (ii) (ex post) hold-up

- Second best nature given weak law enforcement and lack of commitment
  - Corruption as bribery and red tape as business cost
  - Hold-up problem dues to discretionary tax or nontax burden increase after investments.
- Tax incentives as a signal of business friendly environment

CPIA transparency, accountability, and corruption in the public sector rating (1=low to 6=high)



Source:World bank

What are risks of tax incentives?

- Tax incentives can be missed to create (artificial) rent and then vested interest distorting economic activities and increasing rent seeking activities/corruption.
  - Tax incentives as hidden pork barreling/subsidy

- International tax competition could be intensified with the use of tax incentives
  - All competing countries including home and host ones can suffer from tax base erosion
  - ✓ Adequate policy instruments as tax incentives are not necessarily welfare improving

- Decisions of tax incentives may be fragmented among different line ministries within government and/or between the central and subnational governments
  - Over-spreading incentives as consequence of coordination failure
  - Tax incentives may turn out to be out of control

What are risks of tax incentives?

- Tax incentives give competitiveness advantage to certain sectors/firms as FDIs relative to others, which can cause the latter being crowded out by the former
- ✓ Ex: FDI versus domestic firms, existing firms versus new firms
- Substitution effect ⇒Net effects on investment and growth are not clear
- ✓ Evidence = low tax rate attract FDI but does not necessarily enhance overall investment.

- Tax incentives may be more favorable to less profitable investments
- Tax incentives mostly affect marginal effective tax rate applicable to zero profit project
- ✓ Production efficiency may be undermined with differentiated marginal effective tax rate.
- ✓ Statutory tax cut with base broadening rather favors profitable project

- Tax incentives will make international tax coordination more difficult
- Coordination on one dimension such as minimum statutory tax rate and definition of tax base can be offset by the strategic use of tax incentives such as preferential tax rate and investment tax credit

How to control tax incentives?

- The bottom line is that tax incentives must remain under control of the central government that initiates growth/development

- Transparency=Information disclosure can assure cost-consciousness of tax incentives to taxpayers as well as policy makers
- ✓ Tax expenditure budget
- Policy evaluation=cost and effectiveness analysis ex ante and ex post can be used to build and scrap tax incentives
- ✓ Evidence based policy decision

Box 3-1

OECD Reporting Guidelines for Tax Expenditures

- **The estimated cost of tax expenditures should be disclosed as supplementary information in the [annual] budget.**
- **...A discussion of tax expenditures for specific functional areas should be incorporated into the discussion of general expenditures for those areas in order to inform budgetary choices.**

Source: *OECD Best Practices for Budget Transparency*. 2002.

Office of Parliament Budgetary Office Canada
Federal Tax Expenditures: ***Use, Reporting and Review 2011***

Tax expenditure budget

Table 1: International comparison of range of tax expenditure budget

Country	Coverage: Types of tax	Coverage: Level of government	Classification
Australia	Personal income tax, retirement benefits tax, fringe benefits tax, business tax, excise tax.	Commonwealth government (Central Government)	By broad economic function, by type of taxpayer affected, and by the particular benchmark to which they relate
United Kingdom	Personal and corporate income tax, capital gains tax, inheritance tax, stamp duty, national insurance contributions, and VAT	Central government	By tax expenditures, by structural relief, of by relief, with tax expenditures and structural components under each tax if possible by budgetary functional category
United States	Personal income tax, corporate income tax, estate and gift taxes, and social security contributions	Federal government	By budgetary functional category.

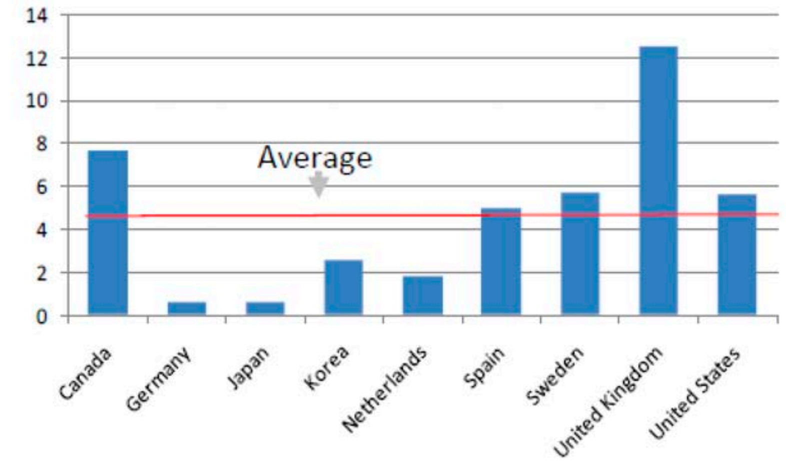
Source: Uemura(2009)   Note: Quoted from Brixi, Valenduc and Swift ed. (2003)

Office of Parliament Budgetary Office Canada
Federal Tax Expenditures: *Use, Reporting and Review 2011*

Figure 1-2

International Value of Tax Expenditures

Percent of GDP



Source: *Tax Expenditures in OECD Countries*. 2010.

Notes: Reported for 2009 calendar year, or closest period.

- Some countries publish tax expenditure budget that provides amount of tax expenditure as outlay=foregone revenue.
- The publication is to assure accountability and equal budgetary treatment between tax incentives and subsidy expenses
- With tax incentive, budgetary size of government could be larger

Policy evaluation

- Policy evaluation on tax incentives should address both ex ante prospect and ex post assessment based on logic model and quantitative target.

Table 1: Key Evaluation Questions

Ex Ante Evaluations	Ex Post Evaluations
1. What **objective** does the tax expenditure aim to achieve?	1. Is the tax expenditure still **relevant**?
2. What **market failure** is being addressed?	2. How much did the tax expenditure **cost**?
3. Is a **tax expenditure the best approach** to address the market failure?	3. What was the **impact** of the tax expenditure?
4. What economic **impact** is the tax expenditure likely to have?	4. Was it **efficient**?
5. How much is it expected to **cost**?	

Report on Tax Expenditure 2014 Ireland

- Empirical study will be of use to quantify effect of tax incentive and assess statistical significance.

$$Y_{it} = \alpha_i + \beta \times D_{it} + X_{it}\gamma + \varepsilon_{it}$$

$$\hat{\beta} = E[Y_{it} | D_{it} = 1] - E[Y_{it} | D_{it} = 0]$$

Difference in difference Study

	FDI	Pr. investment	Real growth
CIT rate	-	(-)	-
Holiday	+	0	0
Inv. allowance	0	0	0

Source: Klemm(2009)

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Implementation Guidelines for Policy Evaluation Pertaining to Special Taxation Measures

(May 28, 2010

Approved at the Interministerial Liaison Meeting on Policy Evaluation)

These Guidelines, under the framework of the Government Policy Evaluation Act (Act No. 86 of 2001; hereinafter referred to as the "Evaluation Act"), provide standard guidance for the contents, procedures, and other matters related to the evaluation of policies pertaining to special taxation measures on national tax and tax-burden reduction measures on local tax (hereinafter referred to as "special taxation measures") in order to contribute to carrying out smooth and effective evaluation of policies pertaining to special taxation measures and to provide useful information for examination work by administrative organs and for tax revision work by the government, thereby fulfilling the requirement of accountability to the public.

Two stage assessment

✓ Stage 1: Own/internal assessment By line ministries

✓ Stage 2: Check by the third party =The Administrative Evaluation Bureau of MIC

Criteria of Evaluation

- Necessity =Mission is clearly stated or not
- Effectiveness =Target value and foregone revenue are properly set or not
- Appropriateness = There are no other better means to achieve the same objective or not

Policy evaluation in Japan

点検作業

情報の充実（評価の質の向上）
国民への説明責任の向上

各府省補足説明

Own assessment

一定水準に達しているもの	4
分析・説明の内容が不十分	220
うち Necessity	128
うち Effective	220
うち Appropriate	118

After check

一定水準に達しているもの	44
分析・説明の内容が不十分	180
うち Necessity	29
うち Effective	180
うち Appropriate	27