

Tax Incentives in Cambodia, Lao PDR, and Vietnam

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I. Introduction	3
II. Conceptual Issues.....	3
A. What are Tax Incentives?.....	4
B. Arguments For and Against Tax Incentives.....	4
C. Types of Tax Incentives and their Relative Merits	6
III. Tax Incentives in Cambodia, Lao PDR, and Vietnam.....	8
IV. Evidence on the Effects of Tax Incentives	11
A. International Evidence	11
B. Estimated Effects in Cambodia, Lao PDR, and Vietnam	12
V. Conclusion	16
References.....	17
Text Tables	
1. Relative Pros and Cons of Different Types of Tax Incentives	7
2. Tax Incentives in Selected Southeast Asian Countries.....	9
3. Vietnam: Selected Tax Burdens by Sector, 2001	13
Figures	
1. FDI in the Mekong Region, 1990-2000.....	14
2. FDI and Tax Incentives.....	15
3. FDI and Standard Corporate Tax Rates.....	15

I. INTRODUCTION

A high rate of investment has long been viewed as a possible key to economic growth. Consequently, many countries offer special tax incentives to promote investment. These incentives include, for example, tax holidays for new firms, tax credits for new investments, and exemptions from import duties on inputs. Advocates of such incentives argue that they promote investment and jobs, while opponents contend that they are not effective, have high revenue costs, distort investment, facilitate corruption, and make the tax system complicated and untransparent. To investigate the validity of these opposing views, several studies have examined the empirical effects of tax incentives.¹ Few studies, however, have conducted analyses of the effects of tax incentives in the lower Mekong region (Cambodia, Lao PDR, and Vietnam), where tax incentives are a prominent feature of the tax system. This paper attempts to fill this void by examining the effects of tax incentives in these countries on revenue and foreign direct investment. It does this via several means, including an examination of tax revenue and enterprise-level data in Vietnam, regional FDI trends, and regional cross-country relationships.

Although data limitations prevent strong conclusions, the findings in this paper partly confirm other results in the literature. Specifically, this paper finds some support for the conclusions that tax incentives can be costly and are rarely the most important determinant of investment. Moreover, while low rates of taxation may promote investment, no evidence is found for the notion that complicated regimes of discriminatory tax incentives are more effective in promoting investment than simple tax regimes with low, uniform rates of taxation.

The rest of this paper is organized as follows. Section II discusses several preliminary conceptual issues, including the definition of a tax incentive, the general arguments for and against tax incentives, and the various types of tax incentives. Section III briefly describes the tax incentive schemes in Cambodia, Lao PDR, Vietnam, and neighboring countries. Section IV examines the likely effects of tax incentives, first by reviewing the existing empirical literature and then by examining some of the existing data in the countries of the lower Mekong region. Section V concludes.

II. CONCEPTUAL ISSUES

Before turning to a specific discussion of tax incentives in Cambodia, Lao PDR, and Vietnam, it is useful to first discuss several conceptual issues, including the definition of a tax incentive, the general arguments for and against tax incentives, and the various types of tax incentives.

¹ For reviews of this literature, see Zee, Stotsky, and Ley (forthcoming) and Wells and others (2001).

A. What are Tax Incentives?

This paper defines a *tax incentive* as any tax provision granted to a qualified investment project that represents a favorable deviation from the provisions applicable to investment projects in general.² Thus, the key feature of a tax incentive is that it applies only to certain projects. For example, a provision that sets the corporate income tax (CIT) rate for foreign-invested enterprises (FIEs) at half the rate that applies to domestic companies would constitute a tax incentive, but a provision that simply sets a low CIT rate for all firms would not constitute a tax incentive. By defining tax incentives in this way, the discussion is restricted to the effects of differential taxation of investment projects, avoiding broader issues of the optimal design of the entire system of investment taxation.³

B. Arguments For and Against Tax Incentives

Supporters of tax incentives most commonly argue that they are needed to increase investment, which in turn will create jobs and other social and economic benefits.

In considering the soundness of this argument, it is important to remember that tax incentives are primarily about *differential* taxation of investment. Thus, tax incentives will generally increase investment only if the more tax-sensitive projects receive the more favorable tax treatment. While such investment-enhancing differential taxation is possible in theory, in practice it can be very difficult for political processes to correctly select such projects. Indeed, experience shows that in many cases it is the most profitable projects, which would have been pursued even in the absence of incentives, that are most likely to receive incentives, rather than the more tax-sensitive ones.⁴

Similarly, tax incentives are often given to investments from countries, such as the U.S. and U.K., that provide their businesses with foreign tax credits for taxes paid overseas.⁵ Thus,

² See Zee, Stotsky, and Ley (forthcoming) for a more comprehensive discussion of tax incentive definitions.

³ There is a large literature on the optimal taxation of investment income. In a small, open economy, the high mobility of capital may argue for relatively light taxation of investment, since domestic labor will in this case bear a large burden of the tax and direct taxation of labor may be more efficient. Even in this case, however, a moderate corporate income tax may be desirable for at least two reasons: (1) to take advantage of other countries' foreign tax credits and (2) to preclude the avoidance of labor income taxes via the transference of wage income into corporate income.

⁴ See, for example, Halvorsen (1995).

⁵ Typically, such tax credits are only provided up to the amount of taxes that would have been due had the income been earned in the home country. Thus, for example, U.S. companies typically receive credits on their US taxes for taxes paid in foreign countries up to the amount of taxes that would have been paid if the foreign income had been taxed at US rates. Japan offers its companies similar foreign tax credits but also has "tax sparing" agreements with many countries that allow businesses to retain the benefits of tax incentives offered in other countries.

these incentives may not significantly reduce the investment's overall tax burden, since, for example, lower Vietnamese taxes may be offset one-for-one by higher taxes in the U.S. (since the U.S. company will claim lower tax credits on its U.S. taxes for foreign taxes paid). As a result, such tax incentives provide no incentive to increase investment. Rather, they result only in a transfer of revenue from the Vietnamese government to the U.S. treasury, necessitating higher taxation on other, more tax-sensitive projects to make up for the lost revenue.

Thus, while it is possible that tax incentives will increase overall investment, this is not obviously the case. Indeed, they may well reduce investment if they necessitate higher tax burdens on others projects, discouraging the latter's implementation. Similarly, tax incentives may result in a significant loss of revenue if they are concentrated on investment projects that would have occurred even in the absence of the incentives.

A similar argument that is often made in favor of tax incentives is that, if a country's neighbors offer tax incentives, then it must also offer them to remain competitive. To the degree that offering tax incentives makes a country's investment climate more favorable, this argument may have some force, especially if taxes have more important effects on investment decisions within regions than across regions, as some recent evidence suggests (Wells and others, 2001). However, as noted above, it is not clear that regimes of complicated, discriminatory tax incentives are more effective at enticing investment than simple regimes with moderate, uniform tax rates. Moreover, even if tax incentives are more effective in attracting investment *within* a region of similar countries, they may still be ineffective in attracting investment to the region as a whole, since this may be determined more by non-tax characteristics that differ markedly from other regions. In this case, tax incentives may result in a "race to the bottom" in which all countries in the region lose revenue with little additional investment to show for it, and the region would benefit from a coordinated reduction of tax incentives.

Some also support tax incentives on the grounds that they will shift investment to industries or areas that are deemed to be more desirable, either because of redistributive concerns (e.g., incentives for investment in poor areas), positive spillovers (e.g., incentives for high-tech industries that may transfer technology to the rest of the economy), or a desire for economic diversification. In some cases, these may be sound rationales for tax incentives. However, these rationales are also subject to the same criticism that it may be difficult for political processes to correctly identify such spillovers.

If tax incentives are not limited to addressing such spillovers and other market failures, then they will generally result in inefficient distortions of investment. For example, suppose that the standard CIT rate is 33 percent, but that a certain sector (call it Sector A) is given a tax incentive that reduces its effective CIT rate to 10 percent. Suppose also that the marginal investment in Sector A has a before-tax (after-tax) return of 10 (9) percent and the marginal investment in other sectors has a before-tax (after-tax) return of 12 (8) percent. Then, investors will choose to invest in Sector A, even though other sectors have a higher return to society. In this way, tax incentives can reduce the efficiency of investment.

In other cases, tax incentives may not be the first-best mechanism for achieving the desired objective. For example, if the objective is to assist the poor in rural areas, it may be more efficient and effective to provide direct transfers to the poor, improve their education and health care opportunities, or invest in the area's infrastructure (such as roads), rather than providing tax incentives. Similarly, tax incentives are often justified on the grounds that they are a means to relieve the burden of high CIT rates, intrusive or corrupt tax administrations, or other problems associated with the tax system. In these cases, the first-best solution would be to address the underlying problem directly.

Another argument against tax incentives is that they can exacerbate governance and corruption problems. Such problems are especially severe when tax incentives are granted on an *ad hoc* basis without clear rules and regulations, since this may provide opportunities for officials to obtain kickbacks or political favors in exchange for granting tax incentives.

To the degree that tax incentives add complexity to the tax code, they may also increase administrative costs.

In sum, tax incentives may distort investment, reduce revenue, and increase corruption and administrative costs; however, they may be useful in some cases, such as to promote tax-sensitive investments or to address market failures and equity concerns. In the latter cases, an important question to ask is whether tax incentives are the most cost-effective means of achieving the desired objective.

C. Types of Tax Incentives and their Relative Merits

Tax incentives can be broadly separated into several major categories: (1) reduced CIT rates, (2) tax holidays (no taxes for a period of time), (3) investment allowances and tax credits (reductions in taxes that are based on the amount of investment and are *in addition* to normal depreciation) (4) accelerated depreciation (allowing businesses to write-off depreciation more rapidly), (5) exemptions from indirect taxes such as import tariffs on inputs, and (6) export processing zones (special zones for exporters; enterprises in the zones are typically exempt from all indirect taxes and, in some cases, all direct taxes).

Table 1 summarizes the primary pros and cons of each type of tax incentive. On balance, the various considerations argue most strongly against the use of tax holidays and most strongly for the use of accelerated depreciation schemes. As Table 1 notes, tax holidays are more intransparent, create multiple distortions, and are very susceptible to abuse and tax avoidance strategies. To a somewhat lesser degree, many of these same criticisms apply to tax allowances and credits, preferential CIT rates, indirect tax exemptions, and export processing zones. In contrast, accelerated depreciation schemes are relatively transparent, are less susceptible to abuse, and result in fewer distortions.

Table 1. Relative Pros and Cons of Different Types of Tax Incentives	
<i>Advantages</i>	<i>Disadvantages</i>
1. Lower CIT rate	
<ul style="list-style-type: none"> • Simple to administer. • Revenue costs are more transparent. 	<ul style="list-style-type: none"> • Largest benefits go to high-return firms that are likely to have invested even without incentive. • Invites tax avoidance through high-tax enterprises shifting profits to low-tax ones via transfer pricing (intracountry and international). • Acts as windfall to existing investments. • Unlike specific benefits, may not be tax spared by home country tax authorities.
2. Tax holidays	
<ul style="list-style-type: none"> • Simple to administer. • Allows taxpayers to avoid contact with tax administration (which may be important if it is complex or corrupt). 	<ul style="list-style-type: none"> • Same as lower CIT rates, except might be tax spared. • Attracts short-run projects. • Invites tax avoidance through the indefinite extension of holidays via creative redesignation of existing investment as new investment. • Creates competitive distortions between old and new firms. • Revenue costs are not transparent unless tax filing is required, in which case administrative benefits are foregone.
3. Investment allowances and tax credits	
<ul style="list-style-type: none"> • Can be targeted to certain types of investment with highest positive spillovers. • Revenue costs are more transparent. 	<ul style="list-style-type: none"> • Distorts choice of capital assets in favor of short-lived ones, since a further allowance is available each time an asset is replaced. • Qualified enterprises may attempt to abuse the system by selling and purchasing the same assets to claim multiple allowances. • Greater administrative burden. • Discriminates against investments with delayed returns if loss carry-forward provisions are inadequate.
4. Accelerated Depreciation	
<ul style="list-style-type: none"> • All of the benefits of investment allowances and credits. • Does not generally discriminate against long-lived assets. • Moves the CIT closer to a consumption-based tax, reducing the distortion against investment typically produced by the regular CIT. 	<ul style="list-style-type: none"> • Some administrative burden. • Discriminates against investments with delayed returns if loss carry-forward provisions are inadequate.
5. Exemptions from Indirect Taxes (VAT, import tariffs, etc.)	
<ul style="list-style-type: none"> • Allows taxpayers to avoid contact with tax administration (which may be important if it is complex or corrupt). 	<ul style="list-style-type: none"> • VAT exemptions may be of little benefit—under regular VAT, tax on inputs is already creditable; outputs may still get taxed at later stage. • Prone to abuse—easy to divert exempt purchases to unintended recipients.
6. Export Processing Zones	
<ul style="list-style-type: none"> • Allows taxpayers to avoid contact with tax administration (which may be important if it is complex or corrupt). 	<ul style="list-style-type: none"> • Distorts locational decisions. • Typically results in substantial leakage of untaxed goods into domestic market, eroding the tax base.

Sources: Adapted in part from Chalk (2001) and Zee, Stotsky, and Ley (forthcoming).

III. TAX INCENTIVES IN CAMBODIA, LAO PDR, AND VIETNAM

Tax incentives schemes in Cambodia, Lao PDR, and Vietnam share similar characteristics with each other (see Table 2 for details). All three countries offer investors tax holidays of up to 8 years (although these are more rare in Lao PDR), reduced CIT rates, investment allowances or accelerated depreciation, and special exemptions from import duties and other indirect taxes. All three countries also focus these incentives especially on foreign investors, exporters, and investments in poor regions.

Such tax incentives are similar to those employed by other countries in the region (Table 2). Indonesia, Malaysia, the Philippines, and Thailand all offer similar incentives, although the details differ somewhat in each country. The one major exception in the region is Hong Kong, which offers few special incentives but instead taxes corporate income at a low, unified rate of 16 percent, almost half the typical standard rate in the region.

Table 2. Tax Incentives in Selected Southeast Asian Countries

	Cambodia	Hong Kong	Indonesia	Lao PDR	Malaysia	Philippines	Thailand	Vietnam
Standard CIT Rate 1/	20 percent	16 percent	Progressive rates: 10, 15, 30 percent	Greater of 35 percent or 1 percent of turnover	28 percent	32 percent	30 percent	32 percent
Dividend withholding taxes	Taxed at relevant CIT rate; creditable against CIT.	None.	15 percent: residents; 10-20 percent: nonresidents (50 percent reduction in favored sectors/zones).	10 percent; creditable against CIT.		10-25 percent on dividends remitted abroad.	10 percent on dividends remitted abroad; domestic intercompany dividends are partly or wholly exempt.	3, 5, or 7 percent on dividends remitted abroad.
Tax Incentives:								
Sectors qualifying for incentives (not exhaustive)	Hi-tech, export, tourism, infrastructure, energy, rural development, environmental protection.		Exports, hard-crop plantations, mining, businesses in remote areas.		Corporations in manufacturing, agriculture, tourism, and various other activities may receive “pioneer” status.	Exporters	Exporters, various other industries.	Exporters, agricultural processors, certain locations.
Tax holidays	Up to 8 years.		3 to 8 year income tax holidays for new enterprises in 22 specific sectors.	Negotiable but rare.	5 year tax holiday on 70-100 percent of statutory income (10 years for companies of national/strategic importance).	3-8 year income tax holidays.	3-8 year income tax holidays.	Up to 8 years.
Reduced CIT rates	9 percent after end of holiday for favored projects.			20 percent: foreign investors; 15 percent: companies in lowlands; 10 percent: companies in remote areas.	3 percent: offshore companies in Labuan. 10 percent: foreign fund management companies.		Enterprises in investment promotion zones get 50 percent reduction of CIT for 5 years.	25 percent: foreign investors; 10, 15, and 20 percent for 10+ years when certain are criteria.

Table 2. Tax Incentives in Select Southeast Asian Countries (continued)

	Cambodia	Hong Kong	Indonesia	Lao PDR	Malaysia	Philippines	Thailand	Vietnam
Investment allowances and credits			Reduction of taxable income by up to 30 percent of investment in priority sectors.		Investment allowances of 60-100 percent of qualifying capital expenditure.	Tax credits for purchases of domestic breeding stocks and genetic material, as well as for incremental export revenue.	Allowance of 25 percent for investment in infrastructure.	If profits reinvested for 3 consecutive years, a portion or all of CIT may be refunded.
Accelerated depreciation	Immediate expensing of plant and equipment investment financed from reinvested profit		Doubling of depreciation rates in favored zones/sectors.		Accelerated depreciation of computer, technology, and environmental protection investments.	Immediate expensing of major infrastructure investments by export enterprises in less developed areas.		
Import duty and VAT exemptions	Import duty exemptions for promoted investments		Exemptions and reduced import duty and VAT rates on inputs in certain sectors, esp. exporters.	Reduced import duties on inputs: 1 percent—foreign investors; 0 percent—exporters.	Exemptions and reduced import duty and VAT rates on inputs in certain sectors, esp. exporters.	Exemptions and reduced import duty and VAT rates on inputs in certain sectors, esp. exporters.	Exemptions and reduced import duty and VAT rates on inputs in certain sectors, esp. exporters.	Exemptions from import duties and VAT in certain sectors.
Export processing zones						After tax holidays lapse, enterprises in these zones pay only 5 percent tax on gross income.		Various additional incentives apply in these zones.
Other			Loss carry-forward extended to 10 years for companies in favored zones/sectors.	Investors can negotiate for special incentives on a case-by-case basis.	Double deduction of certain expenses (e.g., R&D, training).	Additional 50-100 percent deductions for labor expenses for export projects above a certain capital/labor ratio.	Dividend distributions during holidays are tax exempt.	

Sources: Chalk (2001) and PriceWaterhouseCoopers (2001).

1/ Higher rates apply in some cases to industries engaged in natural resource extraction.

IV. EVIDENCE ON THE EFFECTS OF TAX INCENTIVES

The desirability of tax incentives is primarily an empirical issue—if they significantly increase investment, especially those with positive spillover effects, and effectively achieve other efficiency and equity objectives, then tax incentives may be useful. If they do not, then they may simply distort investment and result in large revenue losses. Only an examination of the empirical data can determine which of these two characterizations is most accurate. Unfortunately, in Cambodia, Lao PDR, and Vietnam, very little research has been done in this area, owing in part to a lack of data. However, some insights into the effects of tax incentives can be gleaned by examining the existing research on other countries. Some insights can also be gleaned from a direct investigation of the existing data in the lower Mekong region.

A. International Evidence

The international evidence on the effects of tax incentives is mixed. Many studies have examined the effects of tax incentives using various econometric techniques and investor surveys. However, these studies yield somewhat inconclusive and contradictory results due in part to data limitations. For example, it is often difficult to determine whether the measured effects are truly due to the tax variables or to omitted variables that are correlated with tax changes (such as trade liberalization or increases in transparency). The choice of tax variables can also be problematic since the true effective tax rate in a country depends on complex interactions between statutory rates, depreciation regimes, loss-carry forward provisions, inflation, and other variables. Nonetheless, a few preliminary conclusions regarding tax incentives can be made from this literature.

Overall, the evidence suggests that taxes can have important effects on investment. Several recent literature reviews conclude that CIT rates significantly affect both domestic and foreign direct investment.⁶ Hines (1999), for example, contends that the consensus view is that each 1 percentage point reduction in the corporate income tax rate increases FDI by roughly 2 percent.⁷

However, there is little evidence that complex tax incentive schemes are any more successful than simple CIT regimes that focus on taxing all forms of investment at low, uniform rates, such as Hong Kong's regime. The relative effectiveness of special tax incentives such as tax holidays and differential tax rates has not been well studied in large cross-section or panel data. However, several country-specific studies have concluded that special tax incentives have not been cost-effective. For example, Estache and Gaspar (1995) find that extensive tax

⁶ For a review of the effects of taxation on domestic investment in the U.S., see Hassett and Hubbard (1997); for a review of the effects on FDI, see Hines (1999), Zee, Stotsky, and Ley (forthcoming), and Wells and others (2001).

⁷ This corresponds to a tax elasticity of -0.6 and a CIT rate of 30 percent.

incentives in Brazil resulted in significant revenue losses compared to the investment generated. Similarly, Boadway, Chua, and Flatters (1995) find that tax holidays in Malaysia were of little value for the target firms, and Halvorsen (1995) finds that rates of return in supported projects in Thailand were so high that they would have occurred even without incentives.⁸

Studies also find that taxes are generally not the most important factor affecting investment. For example, in a study of 45 countries, Wei (2000) finds that reducing the level of corruption from that of Mexico to that of Singapore would have approximately the same effect on FDI as a reduction in the CIT tax rate of 30 percentage points. Similarly, surveys of investors have generally found that the tax system is significantly less important than a country's basic economic and institutional environment (OECD 1995, Wunder 2001). Wunder (2001), for example, finds that, in a survey of 75 Fortune 500 companies, only 4 identify tax factors as being the most important variable in their investment decisions.

B. Estimated Effects in Cambodia, Lao PDR, and Vietnam

Few studies have specifically examined the effects of tax incentives in the Mekong region. This is due in part to the scarcity of relevant data, especially in Cambodia and Lao PDR. Nonetheless, the availability of some basic data does allow for some broad observations.

First, the revenue cost of tax incentives may be substantial. In Vietnam, the revenue cost of CIT incentives can be estimated directly from the Ministry of Planning and Investment's survey of foreign-invested enterprises (FIEs). This survey covers 4,139 FIEs and details each FIE's after-tax profit and CIT rate, among other variables. By grossing up each FIE's profit to its before-tax level and then assessing tax at the standard CIT rate of 32 percent, the revenue lost from preferential rates can be estimated. Using this methodology, the revenue loss in 2001 is estimated to be US\$76 million (D 1.1 trillion).

This estimate, however, probably significantly understates the total revenue loss due to tax incentives, since not all firms report in the survey (only 808 firms report either profits or losses in 2001, although this probably includes the largest taxpayers). In addition, this estimate only takes into account the effect of reduced CIT rates, ignoring the effects of accelerated depreciation and other measures that reduce the taxable profit base.

An alternative method of costing the CIT incentives for FIEs is to compare CIT payments from FIEs to payments by other sectors. Such comparisons are made in Table 3, which shows tax payments by state-owned enterprises, domestic private enterprises, and FIEs as a share of each sector's GDP. One can see that value-added and special consumption tax payments by FIEs are not markedly different from those made by state-owned enterprises. However, CIT

⁸ Bernstein and Shah (1995) find similarly small effects of incentives in Mexico, Pakistan, and Turkey, and Wells and others (2001) find that tax incentives in Indonesia have done little to spur investment.

payments are substantially lower. While this may partly reflect lower profitability by FIEs, it is likely that most, if not all, of this discrepancy is due to preferential tax treatment of this sector. Under this assumption, the revenue cost of FIE tax incentives can be calculated by estimating how much additional CIT would be paid by FIEs if these payments equaled 8.1 percent of their GDP (an average of the rate for the state-owned and domestic private sectors). Using this methodology yields an estimated revenue cost in 2001 of US\$224 million (D 3.3 trillion, or 0.7 percent of GDP, or 5 percent of total non-oil revenues). This represents about 23 percent of non-oil CIT revenue, which means that the CIT rate could probably be unified at around 22 percent with no loss of revenue if these tax incentives were phased out.

This estimate may, however, overstate the revenue loss if part of the investment would not have occurred in the absence of the tax incentives. On the other hand, this estimate may understate the total revenue loss from tax incentives since it only relates to the preferential treatment of FIEs relative to domestic enterprises and ignores the cost of the extensive incentives that are given to domestic companies. Absent further data, it is impossible to say with any certainty which one of these effects dominates; however, these simple calculations do indicate that the revenue cost of tax incentives may be substantial.

Table 3. Vietnam: Selected Tax Burdens by Sector, 2001

(As a share of each sector's GDP, unless otherwise noted)

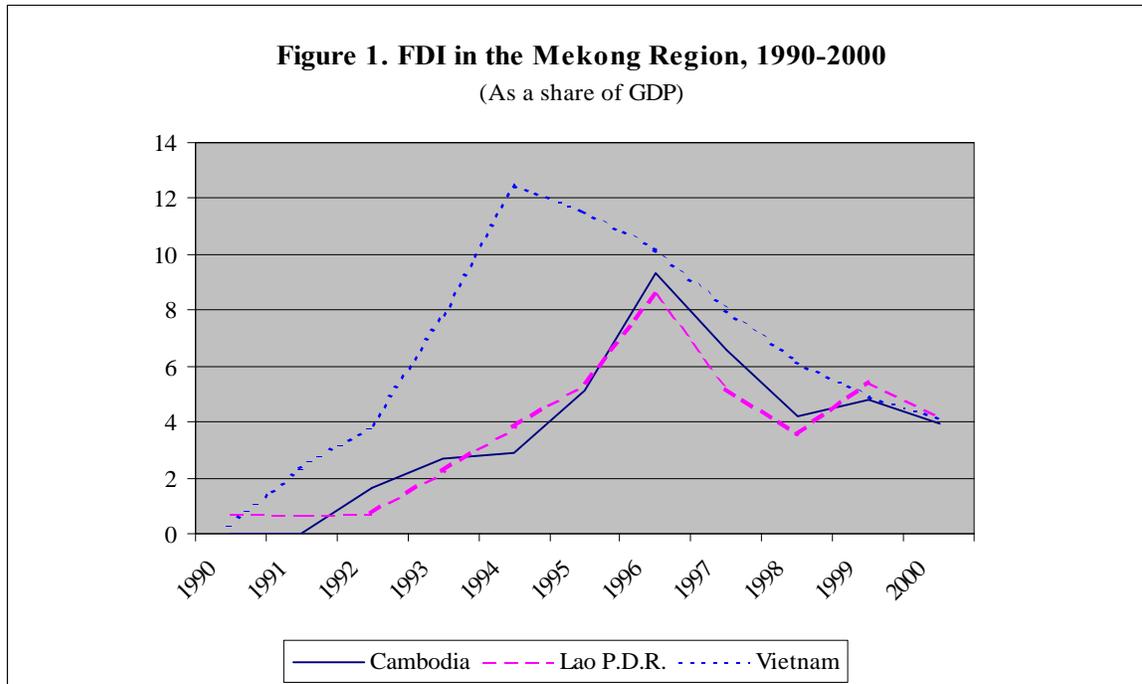
	State-owned and collective enterprises	Domestic private and mixed enterprises	Foreign-invested enterprises
Value-added tax (VAT)	2.8	8.0	3.6
Corporate income tax (CIT)	8.4	7.8	2.9
Special consumption tax (excises)	2.1	0.2	2.3
Memo items (in trillions of dong):			
Estimated revenue loss due to preferential CIT incentives 1/	3.3
Sector's GDP 2/	226.8	38.6	63.5

Sources: General Statistical Office (2002); Ministry of Finance data; and author's estimates.

1/ Assumes that, without incentives, FIEs would make CIT payments equal to 8.1 percent of their GDP, the average rate between state-owned and domestic private enterprises.

2/ Based on official data.

Have these incentives substantially increased FDI? Empirically, it is difficult to untangle the effects of tax incentives from the many other factors affecting FDI. However, it is worth noting that tax incentives have been in place in Cambodia, Lao PDR, and Vietnam since the mid-1990s, yet FDI has been declining during this period in all three countries (Figure 1). Certainly, part of this decline is due to the Asian financial crisis of 1997-99 and other country-specific factors; nonetheless, this decline provides little support for the notion that tax incentives have significantly boosted FDI. This result is also not surprising given that many FIEs do not record profits in their first years of operation and therefore benefit little from tax incentives. For example, of the firms that report earnings in Vietnam's survey of FIEs, just less than half reported a profit in 2001.

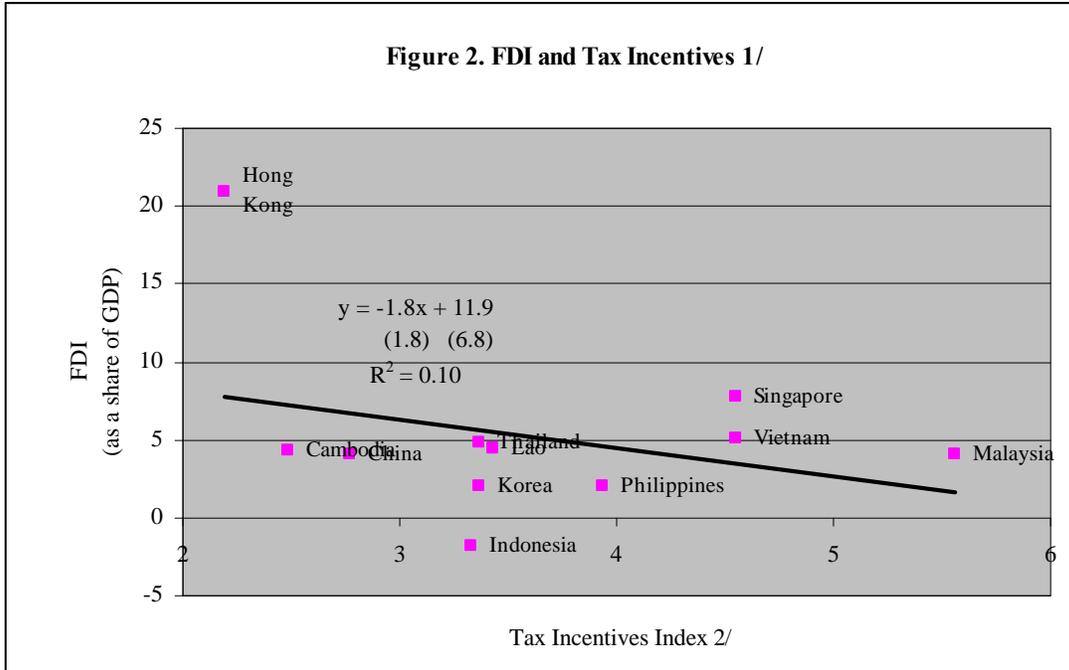


Source: World Bank (2002).

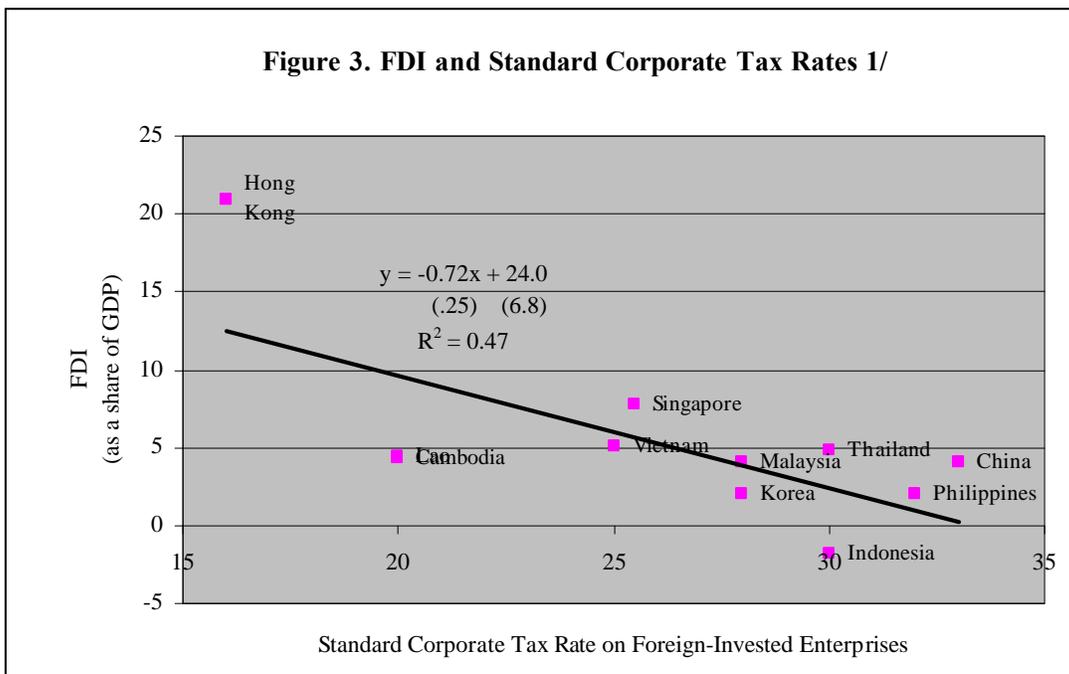
Regional cross-country evidence also provides little support for the notion that special tax incentives have attracted significant FDI. For example, figure 2 plots FDI as a share of GDP against a “tax incentives index” for several East Asian countries,⁹ revealing little evidence of a positive relationship.

However, regional cross-section evidence does indicate that low standard CIT rates may have a positive effect on FDI. Figure 3 plots FDI against the standard CIT rate for FIEs in several East Asian countries, revealing a statistically significant negative relationship. This finding is consistent with other cross-sectional studies (Hines 1999) and supports the argument that excessive CIT rates can deter investment. It also lends some support to the notion that simple, uniform, and transparent tax regimes with low or moderate rates (like that of Hong Kong) are more effective in promoting investment than complicated regimes of distortionary tax incentives. However, it should be noted that this empirical result is highly dependent on the extreme case of Hong Kong, which has both the highest level of FDI and lowest CIT rate; excluding Hong Kong, the relationship is much weaker and statistically insignificant.

⁹ This index, constructed by the author, is calculated as the natural log of the number of lines in each country’s “tax incentive” section of PriceWaterhouseCoopers’ *Corporate Taxes 1998: Worldwide Summaries* (1998). While this is clearly a rough summary measure, it does provide some indication of the extent of tax incentives in each country.



Sources: IMF (various years); PriceWaterhouseCoopers (2001); World Bank (2002); and author's estimates.
 1/ FDI is the average of 1998-2000 (the longest series available for all countries) from IMF (various years), except for Cambodia and Lao PDR, which is not available and taken instead from World Bank (2002); tax incentive index is the natural log of the number of lines in the description of tax incentives in PriceWaterhouseCoopers tax summaries for 1998, except for Cambodia and Lao PDR, which are for 1999 (1998 is not available). Standard errors are in parentheses of regression.



Sources: IMF (various years); PriceWaterhouseCoopers (2001); World Bank (2002); and author's estimates.
 1/ FDI is the average of 1998-2000 (the longest series available for all countries) from IMF (various years), except for Cambodia and Lao PDR, which is not available and taken instead from World Bank (2002); tax rates are as of January 1, 1998. Standard errors are in parentheses of regression.

V. CONCLUSION

In sum, while the evidence on tax incentives in the Mekong region in this paper is not conclusive, it does tend to confirm several previous findings: (1) Tax incentives can be costly; in the case of Vietnam, the cost may be in excess of 0.7 percent of GDP; (2) Tax incentives do not appear to be the primary determinant of investment; (3) There is little evidence that discriminatory tax incentives do a better job of promoting investment than simple, uniform regimes with low to moderate rates of taxation; indeed, if anything, the evidence indicates that the latter is preferable; and (4) If tax incentives are to be used, accelerated depreciation is likely to be more efficient and have fewer drawbacks than tax holidays.

Recently, there have been efforts to scale back tax incentives in the lower Mekong region, as witnessed by movements to amend the Investment Law in Cambodia and equalize treatment of foreign and domestic enterprises in Vietnam. The high administrative and revenue costs of tax incentives, the lack of evidence that they have been effective, and their potential for facilitating tax avoidance and corruption all indicate that such efforts may be beneficial. Although further study of specific proposals would be useful, it is possible that such reforms may enhance the investment climate in the region by making the tax system simpler, more transparent, and more predictable.

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