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Tax Incentives to Attract FDI

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TAX INCENTIVES TO ATTRACT FDI

Abstract

Fiscal incentives are an essential component of many governments' investment promotion strategies. Countries have experimented with a range of fiscal incentives in their attempts to attract Foreign Direct Investment (FDI), boost growth, diversify production and promote technological transfer. This paper reviews the different fiscal measures that countries have used to attract technology-intensive investment (including tax exemptions, tax holidays, investment allowances, accelerated depreciation, tax credits and loss relief, *inter alia*).

Based on a review of the fiscal regime in twenty-one countries, the evidence suggests that, designed wisely, fiscal incentives can indeed help meet objectives of investment promotion and diversification. However, this paper finds that developing countries have often relied on inappropriate measures, such as tax holidays and accelerated depreciation that are less suited to their needs. Fiscal incentives often focus on preferential treatment of large enterprises and multinationals, rather than smaller domestic enterprises, which may be more responsive to tax incentives. Furthermore, fiscal incentives can have unintended side-effects in relation to their objectives. This paper argues that policy-makers need to take account of the objectives and effects of tax incentives in the designing investment promotion strategies in order for fiscal incentives to achieve maximum impact.

Key words: fiscal regime, fiscal incentives, policy-makers, Foreign Direct Investment (FDI), Information and Communication Technologies (ICTs).

List of Acronyms

CT	Corporation Tax
EPZs	Export Processing Zones
FDI	Foreign Direct Investment
ICTs	Information and Communication Technologies
R&D	Research & Development
SME(s)	Small and Medium-Sized Enterprise(s)
TNC	Trans-National Corporation

Introduction – The role of fiscal incentives

Fiscal incentives are a vital component of many governments' investment promotion strategies[1]. Fiscal incentives can play an important role in attracting investment, nurturing domestic production and encouraging firms to expand supply. They can help diversify the economy and move from the heavy reliance on customs and commodity taxes often found in developing countries to greater reliance on the formal economy, including a diversified tax base (including income tax, VAT and other taxes). More directly, in fast-changing high-tech fields such as Information and Communication Technologies (ICTs), they can also encourage investment, build local capabilities and promote technological transfer. Investment in the ICT sector (domestic or foreign) can boost growth and adoption of ICTs and promote local production of ICTs.

This paper examines the different policy options open to government to drive growth using fiscal measures and seeks to assess their success (including their advantages and drawbacks) on the basis of a review of the experience of twenty-one countries[2]. What measures can policy-makers introduce to boost ICT growth? How effective are they and can they achieve their intended objectives? Policy-makers have used a range of different incentives (provisions or instruments offering preferential treatment to some activities over others) to attract investment in the broad economy, as well as specific sectors (Table 1).

Asian governments were among the first to pioneer the use of fiscal and export incentives in reduced taxes or tax waivers to specific groups of investors to build comparative advantage (Lall, various). Fiscal incentives are widely used in technology-intensive sectors with global production and supply chains, where labour-intensive developing countries seek to attract mobile capital, based on their comparative advantage. In many countries, government policy has sought to attract multinational companies with their large resources of 'hot' capital with specific subsidies and incentives.

Critics argue that this has resulted in what has been called a "race to the bottom" by some development economists in a form of 'tax competition', whereby countries undercut their neighbours in offering investors lower rates of corporation tax or preferential exemptions. This is despite the fact that large TNCs may in fact be less in need of preferential tax treatment, and are often in a stronger position for tax planning (with the option to recharge revenues between sources, countries and subsidiaries using, for example, transfer pricing). TNCS are generally less affected by the prevailing tax regime than Small and Medium-Sized Enterprises (SMEs).

[1] Investment promotion strategies refer to the broad set of incentives that many countries now offer to attract investment, including specialist contacts and assistance (often though the Investment Promotion Agency), streamlined bureaucracy, accelerated legal and administrative procedures (often also for customs procedures), tax rebates, planning permission and location incentives. Fiscal incentives are a popular package within countries' broader strategy.

[2] Comprising Botswana, Brazil, Ecuador, Egypt, Ethiopia, Ghana, Kenya, Rep. of Korea, Lesotho, Mauritius, Mexico, Nepal, Nigeria, Peru, Philippines, Rwanda, Singapore, Sri Lanka, Tanzania, Uganda and Uzbekistan, based on the UNCTAD Investment Policy Review series and other evidence from the investment promotion agencies and web-based resources.

Table 1: Principal tax incentives used by governments

Fiscal incentive/ instrument	**Definition**	**Examples**
1. a) Reduced corporation tax (CT) rates through: (i) reduced tax rate; (ii) Flat tax rates; (iii) Tax exemptions; (iv) Tax holidays. (for the economy as a whole, or for specific sectors)	Reduced rates may undercut neighbours or competitors. Flat rates are level rates of taxation across the economy. Exemptions apply the same tax rate to a reduced coverage of the taxable base. Tax holidays are an exemption/reduced rate for a specified length of time.	Worldwide, the norm for CT is about 35%. Countries with lower rates include e.g. Botswana and Korea. Countries with flat-rates now include Poland, Romania, Russia, Slovakia and Uzbekistan. Tax holidays are popular and offered by e.g. Mexico, Peru, Rwanda and Tanzania (for 5-15 years).
1.b) Tax Stability Agreement	The CT rate is fixed or 'stabilised' in advance for a predefined period.	Bangladesh, Botswana (financial services), Chile, Ecuador, Kenya (for EPZs), Peru, Sri Lanka.
2. Subsidy (or grants)	(i) A financial contribution (ii) By a government or public body within the territory of a member; (iii) Which confers a benefit For certain goals, now often used to preserve public interest in public goods.	Peru – pay phone services[1], also Universal Service Funds or Rural Telecommunication Development Funds in many countries, e.g. Egypt, Nepal and Uganda.
3. Accelerated depreciation	Allowable depreciation write-offs take into account the reducing value of assets and are deducted from the tax base on which tax liability is calculated.	Brazil, Ecuador, Egypt, Ethiopia, Ghana, Kenya (various rates, according to asset), Korea, Mexico.
4. Investment allowance*	Write-offs of investment expenditure reduce the taxable profits/tax base on which tax liability is calculated.	Widely used mainly in industrialised countries, including Japan, Korea, Mauritius. (Abolished in Rwanda).
5. Investment tax credit*	Investment tax credit may be given against the total tax bill i.e. it does not affect the amount of tax incurred/tax liability, but reduces the total tax paid.	Widely used e.g. Korea, Mexico, Nigeria, Philippines and Singapore. None in Brazil or Egypt.
6. Input sales tax credit	Tax credit is given against input sales tax. (Sales tax is similar to and often a precursor of VAT).	Many developing countries (e.g. Argentina, Chile and Peru) allow credits of sales taxes on capital goods.
7. Loss relief and carry-forward of losses.	Write-off of any given year's losses against gross profits over the following years, within a specified time limit (usually five years).	Unlimited in Kenya and Singapore. 3 years – Korea, Ethiopia. 4 years – Brazil, Mexico, Nigeria, Peru. 5 years – Botswana, Egypt, Etiopía, Ghana, Rwanda, Tanzania. 6 years –Sri Lanka

Source: Summary of measures, based on the review of countries.
* Note: Depending on the tax regime in force, tax credits differ from allowances in that they are given later, are taken into account in the calculation of the total tax liability and may have implications for cashflow (tax credits may be given in the following/later year, essentially as a tax rebate).

However, there is evidence that small enterprises are generally more responsive to tax incentives than larger firms (Coyne, 1994). Taxes play a more important role in their cost base, because they do not have the financial and human capacity to develop sophisticated tax avoidance strategies. Domestic enterprise has a vital role to play in absorbing and facilitating technological transfer and building local capabilities. Despite this, even where extensive fiscal concessions are available, many of these apply mainly to large enterprises. Fawzy (2002) notes that tax exemptions in Egypt tend to apply to Free Zone enterprises or publicly listed companies on the Stock Exchange and are enjoyed mainly by large enterprises. Incentives may not apply to small enterprises, which often account for a large proportion of domestic production in developing countries. This suggests that tax regimes may primarily focus on an audience that is inappropriate for the majority of developing countries.

It should be acknowledged that international experience from some countries indicates that fiscal incentives may have only a limited impact in some cases. Studies of whether generous tax policies can compensate for weaknesses in the commercial environment and attract TNCs have led to the broad conclusion that tax exemptions can influence some of the investors, some of the time, but are generally only marginal factors (Morisset & Pirnia, 2000). In the words of one investor cited by Morisset & Pirnia (2000), "tax exemption is like a dessert; it is good to have, but it does not help very much if the meal is not there". In a survey of Taiwanese firms, only 8% of firms rated tax incentives as the single most effective government policy for promoting technological development: last, after educating more R&D personnel (18.8%), coordinating firms to conduct joint research (18.6%), introducing new technology from abroad (17.2%) and transferring technology through government-sponsored research institutions (Lall, 2000).

Despite this, and despite some limitations to the effectiveness of fiscal incentives in promoting high-risk activities or in compensating for the lack of economic fundamentals, many countries nevertheless continue to offer extensive fiscal incentives in the belief that they are integral instruments in promoting investment (Table 2). The review of countries' different incentive schemes suggests that, by and large, countries' investment promotion strategies remain geared to attracting multinational companies. The challenge for government planners is to take the different types of players in their home market into account and to tailor fiscal incentives to the needs of their economy to maximise their impact.

Table 2: Investment Tax Incentives in Selected Developing Countries

Country	Investment Tax Credit	Accel. Deprec'n	Sectoral incentives	Export incentives	Regional incentives	Loss carry forward	Yrs Tax holidays	CT rate
Botswana	None*	Mining+ cap all.	Yes	Duty exemptions	No	5**	None	25%
Brazil	None	Yes	Yes	Yes	Yes	4	15	34%
Ecuador	In tourism	5-10%	Yes	Yes	Yes	Not avail.	20	25+15%
Egypt	None	5-20%	Yes	Yes	Yes	5	5-20	40%(32)
Ethiopia	--	Yes	Yes	Yes	Yes	3-5	1-5	35%&
Ghana	None	5-20% pa	Yes	Yes; less CT in NTE	Yes (-25/-50%)	5	5-10	30-32.5%
Kenya	None	Yes	Limited	Yes	No	Unlimited	10	30-37.5
Korea	6-10%	Yes	Yes	Yes	No	3	5	15-25%
Lesotho	None	5-25% pa	Yes	Yes	No	Not avail.	None	15-35%
Mauritius	10% anti-pollution***	Yes	Yes	Extensive	No	Unlimited	0-10	15-25-35%
Mexico	19-25%	Yes	Yes	Yes	Yes	4	None	34%
Nepal	None	5-25% pa	Yes	Yes	Yes	Not avail.	5-10	20-30%
Nigeria	5-20%	No	Yes	Yes	No	4	3-5	30%
Peru	None	3-20% pa	Yes	Yes	Yes	4	None	27%
Philippines	75-100%	No	Yes	Yes	No	Not avail.	4-5	32%
Rwanda	None$	5-50% pa	Yes	Yes	Yes	5	None	30%
Singapore	33.3/3-50%	Yes	Yes	Yes	No	Unlimited	5-10	20%
Sri Lanka	None	Yes	Yes	Yes	Yes	6	5	30%
Tanzania	None	25-100%	Yes	Yes	Yes	5	2-5@	30%
Uganda	None	5-20%	Yes	Yes	Yes	Unlimited	10	30%
Uzbekistan			Yes	Yes		Restricted	7	18%

Source: El-Samalouty (2000) and UNCTAD Investment Policy Review series.
Note: * Minister can agree reduced tax rate or favourable treatment of expense deductions case-by case
** Indefinite loss carry-forward for post-development expenditure in the mining sector.
*** Favourable capital allowances plus a 25% investment allowance on new premises, plant and machinery and computer software available in the first year.
$ Investment allowance of 30% from Law 8/97 abolished by the Income Tax Code Law 16/2005.
@http://www.investzanzibar.org/IPA_Information.asp?hdnGroupID=3&hdnLevelID=9&hdnlocaleid=1
& Ethiopia CT rate from http://www.eatic.org/media/powerpoint/eia_presentation.ppt#297,6,Slide 6

Additional information from: rhythm
www.in.kpmg.com/pdf/2003CorporateTaxSurveyFINAL.pdf

Table 3 lists the incentives that may be used for different purposes to achieve different objectives, with their advantages and drawbacks. Fiscal incentives differ in their approach (whether they are broadly-based or selective); their coverage of taxable parties; which taxes are used; and the appropriate tool or incentive. Tax incentives have different effects on economic behaviour and efficiency. Policy-makers' choice of fiscal instruments from Table 3 depends on the structure of the economy, government objectives and on the activities, companies and investors that the government wish to promote. According to how they operate, different tax incentives can have different impacts on:

- New versus existing companies;
- New versus continuing investments;
- Short-term versus long-term investments; and
- Firms with existing sales revenues versus firms with future cashflows (e.g. start-ups, with longer-term projects).

1. Corporation tax rate

The evidence suggests that corporation tax has to be substantially below the worldwide norm of around 35% for a reduced rate of corporation tax to be effective in encouraging foreign direct investment. The partner to the tax rate is the tax base, or taxable amount of revenues/income to which the rate applies – over recent years, reforms by many governments have seen lower rates of tax applied to a broader base (achieved by extending the scope of taxable income and eliminating exemptions), leaving the overall tax burden unchanged.

Advocates of lower tax rates claim that they increase entrepreneurial incentives, encourage greater economic activity and reduce incentives for tax evasion, bringing more of the informal economy into the formal, registered sphere. Critics argue that they merely result in a so-called race-to-the-bottom, with developing countries making precious tax concessions that they can ill afford to give, in order to attract investment. Of particular interest are recent reforms by Eastern European countries to introduce standard flat tax rates that are constant for all individuals and firms, regardless of levels of income or profits. The most radical version of unified flat-rate taxation introduces a single rate not just for income tax, but also for corporation tax, as with recent reforms in Romania[3], Poland[4] and Slovakia[5].

Depending on the economy's tax elasticity, introducing a ***lower*** flat rate can theoretically increase activity and thereby total tax revenue. In fact, evidence from Russia suggests that although there were initial improvements in personal tax revenues and tax compliance, there was no overall net effect on work effort or labour supply. Cutting tax rates did not necessarily lead to increases in tax revenue (Institute of Fiscal Policy, Alexander Klemm). Flat-tax rates are likely to be regressive and may do little to help redistribute income from the wealthy to poorer sections of society except indirectly, through expansion in jobs and encouraging the unemployed back into work.

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[3] http://news.bbc.co.uk/2/hi/business/4155907.stm.

[4] www.telegraph.co.uk/money/main.jhtml?xml=/money/2005/03/16/cnpol16.xml&menuId=242&sSheet=/money/2005/03/16/ixcity.html .

[5] www.economist.com/research/backgrounders/displaystory.cfm?story_id=2193836

Table 3: Selected Fiscal Measures to Promote Investment and Technological Upgrading (adapted on the basis of Morisset & Pirnia, 2000)

Tax incentive & mechanism	**Objectives**	**Coverage**	**Advantages & drawbacks (partly depend on objectives)**
1. Corporate tax instruments: *Reduced corporate tax rates (Not period – see tax holidays).*	To reduce effective tax rate (take) with waivers or reductions.	Broad coverage of profitable income -generating firms or targeted base of selected activities, sectors or firms. Does not apply to unprofitable firms.	• Tax rate has to be below global norm 35-40% for full effect; • Lower tax rates confer benefits over a longer time; • Less immediate benefits to income-generating firms; • Reductions in corporate tax rates can reward old capital more.
1a. Broad base: *Reduced corporate tax rate on all firms (e.g. Hong Kong)*	To minimise market distortions.	Broad firm base.	• Simplified system; fewer market distortions. • Perceived to be fair – affects all firms in same way. • Confers LT benefits more slowly and rewards old capital.
1b. Selective Approach: *Reduced corporate tax rates for selected activities and sectors.*	To target beneficial industries and activities of perceived advantage.	Specific targeted industries and activities; Existing firms and/or potential investors.	• Important signalling effects about government commitment and commitments to stimulate FDI; • Generally easier to implement than general reforms; • Results depend on sector choice; may distort the market.
2.Tax holidays and temporary rebates *Operate through a waiver or exempt/reduced periods for corporate tax.*	To provide support to firms in specific activities, especially new firms in their start-up phase. To encourage new investment.	Popular in developing countries with a discretionary approach. Can be used to target specific industries and activities, for existing firms and/or potential investors.	• Discretionary approach; risks introducing market distortions. • Flexible, according to government objectives; • Immediate benefits to firms/start-ups as soon as earn income; • may reward founding business start-ups, rather than ongoing investments in existing companies; and LT investments; • potential for tax planning across periods & revenue leakage; • may reward ST investments in 'footloose' industries.
3. Investment tax allowances: • accelerated depreciation; • expenditure allowances; • tax credits.	To support expansion in existing firms; To encourage long-term investment.	Widely used in industrialized countries; cover firms making investments; Generally focus on specific sectors	• Promote LT capital investments and current spending, causing less revenue leakage than tax holidays; • Promote new investment; • High inflation erodes value of annual depreciation allowances.
3a. Refundable tax allowances *Refunds from government at later date.*	As above.	Firms making investments.	• With refundable write-off allowances, investment costs and risks can be shared by government with investors. • Where non-refundable, existing companies reap benefits (supporting expansion) but start-ups must earn income first; LT projects (e.g. infrastructure) suffer cf. rapid income-earners
4. Exemptions on customs duties or local indirect taxes (e.g. EPZs)	To encourage export/import activities for TT	Generally for targeted sectors, activities, EPZs.	• Use of customs exemptions has been restricted by trade treaties • Dependent on capacity of custom/tax administrations.
5. Outright grants and upfront subsidies; subsidized loans	To facilitate establishment of business and investment.	Rarely used by DCs due to upfront costs; used for targeted sectors.	• Flexible and can directly address objectives, but depend on capacity of tax administrations and may be open to abuse.

In fact, firms' decisions to invest are based on effective tax rates, rather than the official, nominal rate of tax. The effective tax rate is the overall rate at which tax is paid when all progressive tax bands, offsets, discounts and reductions are taken into account[6]. Deductions, inflation and different sources of firm funding and financing often make the effective tax rate very different from the nominal rate. For example, Vodacom in South Africa is subject to the standard corporate tax rate of 29% on profits, but estimates that the range of direct and indirect taxes it pays on income, spectrum, revenues, licenses and sales pushes its effective tax rate up to 37%[7].

The real factor influencing firms' decisions to invest is the rate at which additional dollar of income is taxed - the effective marginal rate of tax[8]. Depending on the corporate tax regime and elasticity of tax revenues, in some cases, additional gross income may result in a decrease in disposable income (the corporate equivalent of the "poverty trap"). Effective rates can differ by sector (as, for example, in Egypt - see Table 4 below) and by funding (different tax treatment of debt interest/dividends means that firms can have different effective tax rates, depending on their financing).

Table 4: Effective Tax Rates in Egypt

Marginal Effective Tax Rate	Manufacturing (%)	Services (%)
Corporate Firm	26.4	37.3
Non-corporate firm	45	45
Corporate manufacturing firm using debt or equity finance	-26	
Corporate manufacturing firm, financed by retained earnings	50.5	
Corporate – Machinery (WB)	32.4	46.2
Corporate – Building (WB)	27.8	37.1
Corporate – Inventories (WB)	56.7	64.5
Corporate – Land (WB)	-19.3	-33.4
Corporate – Total (WB)	27.2	38.1

Source: Barents (1996) and World Bank (WB, 1995), quoted in El-Samalouty (2000).
Note: The higher effective tax rate on services reflects the higher corporate rate [40%] applied to non-manufacturing companies, versus manufacturing firms [32%]. Machinery and inventories are more highly taxed than land and buildings due to FIFO valuation (World Bank, 1995).

In general, reductions in corporation tax rate and/or period (tax holidays) are blunt instruments for attracting investment and are offered only on the basis that that "any investment is good investment". Governments will generally do better offering specific exemptions and/or tax incentives promoting targeted activities and technological transfer. Other instruments (such as the use of investment allowances and accelerated depreciation allowances to promote investment) are more focused in promoting specific activities.

[6] The effective tax rate is calculated by dividing the total amount of tax paid by the total or taxable income, to calculate the overall proportion of tax paid. This is equivalent to the rate at which the firm would be taxed, if it were taxed according to a single, constant rate, instead of progressively.
[7] "Africa – Climate must encourage healthy cycle of investment", article by Alan Knott-Craig, CEO of the Vodacom Group, p.31, the GSM Association "Mobile Tax Report", 2006.
[8] For the example of Egypt, although Egypt has lower statutory corporate tax rates in manufacturing, marginal effective tax rates in the manufacturing sector are in fact higher than in many Latin American countries and may deter investment in manufacturing (Kheir-El-Din, Fawzy & Refaat, 2000).

2. Corporation tax exemptions

Corporation tax exemptions are deductions from gross income allowed in the calculation of total taxable income, to encourage specific activities. They may be given at the firm level to encourage specific activities[9] (such as investment or recruitment). Alternatively, exemptions can be given at the macro-level to encourage industrial activities and exporters in specific sectors (over a defined/indefinite period). Depending upon the choice of sector, sector-specific reductions can confer benefits to profitable firms in the long-term, or they can reward the founding of businesses and business start-ups (including short-term investments in 'footloose' industries).

However, offering tax exemptions by sector is a discretionary approach that can promote certain sectors, but at the risk of introducing market distortions. Tax exemptions play an important signalling role, in demonstrating government commitment to key sectors (most often manufacturing and export sectors on the basis of Table 2), but risk introducing market distortions in the chosen sectors as and when government priorities change. For technology-intensive sectors, tax exemptions can be used to encourage new investment and offer immediate benefits to new firms and start-ups as soon as they begin earning income. UNCTAD's IPR of Uganda (UNCTAD, 2000) notes that tax exemptions are subject to dangers of lobbying and capture by special interest groups – ultimately, tax exemptions for specific sectors are limited by the capabilities of the policy-makers behind the choice of sectors.

3. Tax Holidays

Many developing countries offer tax holidays as one of their main incentives to attract new investment. Tax holidays were very popular with the countries reviewed, with over 75% of the sample offering some form of tax holiday, generally between 5-15 years (Table 2). For example, 'the tax holiday is the principal form of corporate tax incentive currently applied in Egypt' (El Samalouty, 2000[10]). Morisset & Pirnia (2000) note that "poor African countries have tended to rely on tax holidays and import duty exemptions"[11]. From Table 2, tax holidays are a popular element in most countries' tax incentive regime.

Tax holidays are in fact fairly blunt fiscal instruments that are not especially flexible or effective. They tend to favour established existing firms over new or start-up firms, since they open up opportunities for tax planning by existing firms with significant revenues. El Samalouty (2000) notes that, in Egypt, 'tax holiday policy will be more effective and less costly if it were restricted to well-defined and specific objectives, rather than granting holidays to over 16 activities in the current investment law. This lack of focus creates additional distortions and needlessly sacrifices government revenues'.

[9] Deductible expenses may include staff costs, depreciation, interest, legal costs, pension contributions, state insurance & taxes; investment allowances for machinery and equipment purchases; tax exemptions on capital gains; income subject to other specific taxes; or allowances for specific sources of financing, adjusting for their rates of return, relative to market interest rates.

[10] El Samalouty, Handoussa et al.

[11] Despite this general observation, the exceptions among African countries are Botswana and Lesotho, which do not offer tax holidays and Rwanda, which abolished them.

Furthermore, in some countries, tax holidays are ‘flat’ in terms of activity or sector and are defined more by the intended target location of investment[12] than by activity, to promote regional development. Examples include Egypt[13] and Ecuador. In some countries, tax holidays may be granted to state-owned enterprises through influence by special interest groups – for example, in Egypt, between 1990-1991, over half of the tax holidays awarded have gone to state-owned enterprises (IMF, 1994)[14]. The investment decisions of these enterprises are already under state planning and government control, so it is unclear why these enterprises need the further benefit of holidays to encourage them to undertake investment.

5. Depreciation, investment and capital allowances

Tax allowances and credits are likely to be more effective than tax holidays. UNCTAD’s Uganda IPR (2000) notes that depreciation and capital allowances are generally preferable to tax holidays, as they specifically encourage new investment. Morisset & Pirnia (2000) find that “industrialized countries have opted for investment allowances or accelerated depreciation”. Based on Table 2, investment allowances were considerably less popular than tax holidays, with only a third of the sample of countries offering investment allowances.

Investment allowances have the advantages of:

- Encouraging a long-term planning and approach towards investment;
- Allowances are less costly to government than tax holidays;
- Allowances are allowed as part of the regular tax code, so no separate investment incentives law is necessary;
- Allowances are less susceptible to transfer pricing manipulation and provide immediate upfront benefits to investors.

Normal depreciation allowances, along with initial investment allowances on plant and machinery, mean that, in the critical early years of a project, effective corporation tax rates can be considerably lower than nominal rates and enterprises can retain more of their cash flow and income for further investment.

However, high inflation can quickly erode the value of annual depreciation allowances, resulting in a relatively high effective tax rate on capital. This means that, for many developing countries, investment allowances are much less effective than theory might suggest. Lall & Pietrobelli (2002) observe that, in Ghana, investment allowances and tax deductible R&D expenditures “failed to evoke a significant response from the business community”. Similarly, in Malaysia, the response of the private sector to fiscal incentives was muted (Lall, 2000). UNCTAD (2000) notes the danger of special interest groups and recommends that “differential depreciation allowance rates by region or subsector should avoid selective benefits to special interest groups”.

[12] For example, Ecuador, Ethiopia, Peru and Ghana offer regional incentives according to location to promote investment across the country in regions other than the capital. In Egypt, tax holidays vary by location with a 5 year tax exemption for projects in the Old Valley; 10 year tax exemption for industrial zones, new communities, remote areas; and 20 year tax exemption for projects in New Valley.

[13] Egypt’s location-specific approach promoting regional development contrasts with the lack of sector-specificity in the tax holidays. Sector-specific incentives are only really given through preferential corporate tax rates for the manufacturing sector (Table 4).

[14] IMF (1994), Review of Egypt’s Fiscal regime.

A further disadvantage of generous tax allowances is that they can complicate tax administration and weaken tax compliance. Cumbersome and multiple procedures, rates and categories can create high rates of tax evasion, a high number of disputed cases and lengthy settlement procedures (for example, Egypt has 50 asset categories and 11 rates for depreciation write-offs). Such complicated tax schemes can result in a heavy administrative burden in tax compliance.

6. Loss relief and carry forward

In addition, losses can be tax deductible, including transfers to provisions or reserves to meet specific losses or financial commitments certain to occur. Losses may be carried forward and set off against future profits for 5 years. This can also include bad and doubtful debts are deductible (sometimes up to a limit, e.g. 5% on profits). Loss relief was very popular among the sample of countries reviewed, with over three-quarters of the twenty-one countries reviewed offering some form of loss carry-forward (Kenya, Singapore and Uganda offered unlimited loss carry-forward). Loss relief tends to reward existing firms with well-established cashflows, already incurring regular tax liabilities more than start-up enterprises.

Conclusions

This review has found that developing countries have tended to rely on tax holidays, which are a popular and common tax incentive. However, the evidence suggests that corporation tax exemptions and tax holidays are blunt tools for attracting investment. In general, governments should not rely on tax holidays as a principal form of corporate tax incentive and should use other, more focused instruments that may be used to more advantage for specific activities (e.g. the use of investment allowances and accelerated depreciation allowances to promote investment). Incentives should be tailored by priority activity and sector, as well as location to achieve more specific objectives. A sector-specific approach is likely to be most effective.

Moreover, the most common and popular tax incentives may not be achieving their intended goals. Tax incentives most often target large firms and multinationals (by accident or design). Fiscal reforms often ignore the small and medium-sized enterprises which are likely to be the most responsive to tax incentives. Furthermore, the depreciation allowances popular among governments may have only limited effect in the high-inflation environments found in many developing countries. Policy-makers need to take account of the objectives and effects of tax incentives in the designing their investment promotion strategies in order for fiscal incentives to achieve their maximum impact.

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