TAX INCENTIVES

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I. OVERVIEW

This module examines the use of tax incentives to encourage investment and growth in developing countries. The conventional wisdom is that tax incentives, particularly for foreign direct investment, are both bad in theory and bad in practice. Tax incentives are bad in theory because they distort investment decisions. Tax incentives are bad in practice because they are often ineffective, inefficient and prone to abuse and corruption.

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Yet almost all countries use tax incentives. In developed countries, tax incentives often take the form of investment tax credits, accelerated depreciation, and favorable tax treatment for expenditures on research and development. To the extent possible in the post-WTO world, developed countries also adopt tax regimes that favor export activities and seek to afford their resident corporations a competitive advantage in the global marketplace.

Many transition and developing countries have an additional focus. Tax incentives are used to encourage domestic industries and to attract foreign investment. Here, the tools of choice are often tax holidays, regional investment incentives, special enterprise zones, and reinvestment incentives.

Much has been written about the desirability of using tax incentives to attract new investment. The empirical evidence on the cost-effectiveness of using tax incentives to increase investment is inconclusive. In some cases, it is relatively easy to conclude that a particular tax incentive scheme has resulted in little new investment, with a substantial cost to the government. In other cases, however, tax incentives have played an important role in attracting new investment that contributed to substantial increases in growth and development.

This module follows the approach of much of the recent scholarship examining tax incentives. It does not focus on the normative question of whether countries should use tax incentives. Instead, this module seeks to examine (i) the costs and benefits of using tax incentives, (ii) the relative advantages and disadvantages of different types of incentives, and (iii) the important considerations in designing, granting, and monitoring the use of tax incentives to increase investment and growth.

Role of Government. One place to start thinking about tax incentives is to consider what role governments should play in encouraging growth and development. Governments have many social and economic objectives and a variety of tools to achieve those objectives.[1] Tax policy is just one alternative. Governments use taxes to raise revenue to fund expenditures, to affect the distribution of income in a society, and to influence behavior.

All taxes distort. Taxes on income reduce returns to capital and labor. Trade taxes reduce the level of imports and exports. Taxes on consumption reduce spending. Sometimes governments use taxes to correct market failures. Tax incentives may be used to help correct market failures and to encourage investments that generate positive market externalities. Here, government officials want to distort investment decisions — they seek to encourage those investments that, but for the tax incentive, would not have been made and that may result in such benefits as transfers of technology, increased employment, or investment in less-desirable areas of the country.

As discussed below, taxes are just one part of a complex decision as to where to make new domestic investment or commit foreign investment. Governments have a greater role

[1] *See generally*, Bird, "The Role of the Tax System in Developing Countries", 7 *Aust. T. F.* 395 (1990).

than focusing on relative effective tax burdens. Governments need to consider their role in improving the entire investment climate to encourage new domestic and foreign investment rather than simply dole out tax benefits. Thus, while much of the focus on tax incentives is on the taxes imposed by government, it is also important to examine the expenditure side of the equation. Investors, both domestic and foreign benefit from government expenditures and a comparison of relative tax burdens requires consideration of relative benefits from government services.

Definition of tax incentives. At one level, tax incentives are easy to identify. They are those special exclusions, exemptions, or deductions that provide special credits, preferential tax rates or deferral of tax liability. Tax incentives can take the form of tax holidays for a limited duration, current deductibility for certain types of expenditures, or reduced import tariffs or customs duties.

At another level, it can be difficult to distinguish between provisions that are deemed to be part of the general tax structure and those that provide special treatment. This distinction will become more important as countries may be limited in their ability to adopt targeted tax incentives. For example, a country can provide a 10 percent corporate tax rate for income from manufacturing. This low tax rate can be considered simply an attractive feature of the general tax structure as it applies to all taxpayers (domestic and foreign) or it can be seen as a special tax incentive (restricted to manufacturing) in the context of the entire tax system.

Zee, Stotsky and Ley also define tax incentives in terms of their effect on reducing the effective tax burden for a specific project.[2] This approach compares the relative tax burden on a project that qualifies for a tax incentive to the tax burden that would be borne in the absence of a special tax provision. This approach is quite useful in comparing the relative effectiveness of different types of tax incentives in reducing the tax burden associated with a project.

What has changed in recent years? Tax incentives may now play a larger role in influencing investment decisions than in past years. So while tax advisors may have been correct in concluding that the past use of tax incentives has been largely ineffective, this may no longer be true. Several factors may explain why tax considerations may be more important in investment decisions.[3] First, tax incentives may be more generous than in past years. For example, the effective reduction in tax burden for investment projects may be greater than in the past as tax holiday periods increase from two years to ten years or the tax relief provided in certain enterprise zones expand to cover trade taxes as well as income taxes.

Second, the last ten years have seen substantial trade liberalization and greater capital mobility. As non-tax barriers decline, the significance of taxes as an important factor on

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[2] Zee, Stotsky & Ley, “Tax Incentives for Business Investment: A Primer for Tax Policy Makers in Developing Countries”, IMF (2001).

[3] Easson, “Tax Incentives for Foreign Investment, Part I, Recent Trends and Countertrends”, 55 *Bulletin for International Fiscal Documentation* 266 (2001).

investment decisions increase. Stated somewhat differently, investments decisions, particularly as to certain types of projects, may be more tax sensitive than in past years.

Third, business has changed in many ways. There have been major changes in firms' organizational structure, in production and distribution methods, and the types of products being manufactured and sold. Services and intangibles, such as different types of intellectual property, are a much higher portion of value-added than in past years and these factors are very mobile. Fewer firms produce their products entirely in one country. Firms contract out to third parties some or all of their production. With improvements in transportation and communication, it is not unusual for component parts to be produced in several different countries with the resulting increased competition for production among several countries.

Finally, there has been a substantial growth in common markets, customs unions and free trade areas. Firms can now supply several national markets from a single location. This will likely encourage competition among countries within a common area to serve as the host country for firms servicing the entire area.

What tax incentives cannot accomplish. While tax incentives can make investing in a particular country more attractive, they cannot compensate for deficiencies in the design of the tax system or inadequate physical, financial, legal or institutional infrastructure.

In some countries tax incentives have been justified because the general tax system places investments in those countries at a competitive disadvantage as compared to other countries. It likely makes little sense, however, to use tax incentives to compensate for high corporate tax rates, inadequate depreciation allowances, or the failure to allow companies that incur losses in early years to use those losses to reduce taxes in later years. The better approach is to bring the corporate tax regime closer to international practice rather than granting favorable tax treatment to specific investors.

Similarly, tax incentives are likely a poor response to the economic or political problems that may exist in a country. For example, if a country has inadequate protection of property rights or a poorly functioning legal system, it is necessary to engage in the difficult and lengthy process of correcting these deficiencies rather than providing investors additional tax benefits.

Tax competition and globalization. Countries no longer have the luxury of designing their tax systems in isolation. With increased mobility of capital and labor, countries must design tax systems considering the tax regimes of other countries in the region as well as international practices. Countries need to consider the tax regimes of the home countries of its major foreign investors to determine whether the tax benefits granted foreign investors are reduced or eliminated by taxes imposed by the investor's country of residence. It is also important to consider the tax regimes of other countries in the region from various perspectives: (i) that their residents may be potential investors, (ii) that they are competitors for foreign investment, and (iii) that their residents may be potential consumers of products produced in the country.

Tax competition has received increased attention, in part attributable to the efforts of the OECD and the European Union (EU). The OECD published its first report on tax competition in 1998.[4] Two year later, the OECD published a second report that identified 47 "preferential tax regimes' among its member countries with a mandate to eliminate such regimes by 2003.[5] The report also identified 35 tax haven regimes among non-member countries against which the OECD has raised the possibility of counter measures. The OECD efforts have focused on tax competition with respect to geographically mobile activities such as financial and other service activities. Whether the OECD will expand its focus to include tax competition targeted at all types of investment, such as tax incentives for manufacturing facilities, is uncertain.

The European Union took a broader approach by adopting a Code of Conduct for its member states.[6] The Code requires member states to refrain from certain types of tax competition that may affect the location of business activity within the European Union. A European Union group identified 66 special tax regimes and members were required to eliminate the tax incentives to conform to the Code. Also important in the EU, are the "State Aid Rules" that restrict or prohibit state assistance to industry.[7] The scope of the state aid prohibitions is broad enough to cover many types of tax incentives.

Finally, the World Trade Organization (WTO) will likely continue to play a role in the design and use of tax incentives. The WTO will continue to serve as a forum to resolve disputes between countries over unfair trade practices, such as those that grant prohibited export subsidies. The WTO will also likely require countries to reduce or eliminate certain types of tax incentives as a condition for admission to the WTO.

Two different views have emerged on the tax competition debate. One view contends that measures to limit tax competition are necessary to prevent a "race to the bottom" that will result in countries having limited ability to tax income from capital. This reduction in tax capacity will limit the ability of governments to fund social programs for its residents.[8]

An alternative view finds tax competition, like any other type of competition, to be good. The competition will force governments to be more efficient.[9] Some in this group seek to recast the tax competition debate as efforts by certain countries to form a "cartel" to set and maintain minimum tax rates.

Finally, in thinking about tax incentives, it is important to appreciate that there are different types of tax competition. The competition for investment may be global, among countries in a particular region, or even among states within a particular country. The

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4 OECD, Harmful Tax Competition: An Emerging Global Issue (1998).

5 OECD, Towards Global Tax Co-operation, Report to the 2000 Ministerial Council Meeting (2000).

6 Communication from the Commission to the Council: Towards Tax Co-ordination in the European Union, A Package to Tackle Harmful Tax Competition, Doc. COM (97) 495 final.

7 EC Treaty, Arts. 87-89. *See* Schon, "Taxation and State Aid Law in the European Union", 36 Common *Market L.Rev.* 911 (1999).

8 Avi-Yonah, "Globalization, Tax Competition, and the Fiscal Crisis of the Welfare State", 113 *Harv.L.Rev.* 1573 (2000).

9 Roin, "Competition and Evasion: Another Perspective on International Tax Competition", 89 *Georgetown L.J.* 543 (2001).

costs and benefits of attracting different types of investment vary greatly. Countries may seek to compete for different types of investments, such as headquarters and service businesses, mobile light assembly plants, or automobile manufacturing facilities. The effectiveness of particular types of tax incentives likely depends of the type of investment that policy makers wish to attract.

Tax cooperation. As discussed above, several international organizations have worked to improve cooperation among member and non-member countries. While the EU and the OECD have received the most attention for their efforts, organizations such as MERCOSUR and the Southern African Development Community have also considered the question of tax competition.

Regional approaches may offer a good opportunity for cooperation. A range of alternatives exists. Countries could consider proposals to harmonize capital income tax rates as a means of preventing tax competition among member countries. Countries may also consider different types of cooperation with respect to tax incentives. A group of countries could follow the European Union approach and adopt a Code of Conduct that prohibits certain types of incentives or limits the ability to adopt new incentives. Countries could also agree on a set of tax incentives that each could offer investors but require individual countries to meet certain guidelines with respect to those incentives. For example, a group of countries could agree to offer tax holidays to investors but require that holiday periods should not exceed three years. Finally, countries could agree to not allow tax holidays but allow different types of tax incentives, such as "super" depreciation or investment tax credits.

II. THE CASE FOR AND AGAINST TAX INCENTIVES

A. Convention Wisdom

Traditional advice from tax advisors. The conventional wisdom is that tax incentives often erode the tax base without any substantial effects on the level of investment.[10] Representatives of the World Bank and the IMF have traditionally advised against the use of tax incentives.[11] In some countries, the IMF has required elimination of certain tax incentive regimes as a condition of receiving additional financing.

It is not easy, however, to separate criticism of the tax incentive regimes adopted by countries from criticism of all tax incentives. Advisors have recognized that certain well-designed tax incentives targeted at encouraging investment in new machinery and investment in research and development have been successful in increasing investment.

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[10] *See, e.g.*, Shah (ed.), Fiscal Incentives for Investment and Innovation, pp. 1-30 (1995); OECD, Taxation and Foreign Direct Investment: The Experience of the Economies in Transition (1995); and United Nations, The Determinants of Foreign Direct Investment: A Survey of the Evidence (1992).

[11] Chua, Tax Incentives, in Tax Policy Handbook, pp. 165-68 (1995).

There does appear to be a shift among tax advisors from recommending against the use of tax incentives to assisting in improving the use and design of tax incentive regimes.

Review of empirical evidence. Several economic studies have examined the effect of taxes on investment, particularly foreign direct investment. While it is not easy to compare the results of different empirical studies, scholars have attempted to survey the various studies and to reach some conclusions as to the effect of taxes on levels of foreign investment. Useful surveys are included in the Ruding report,[12] Hines,[13] and Mooij and Ederveen.[14] These surveys note the difficulty of comparing the results of different studies because the studies contain different data sources, methodologies, and limitations. The studies also report different types of elasticities in measuring the responsiveness of investment to taxes.

Part of the difficulty in determining the effect of taxes on foreign investment is getting a good understanding of the different types of foreign investment and different sources of funding for foreign investment. Foreign investment consists of both portfolio and direct investment. While different ways to distinguish portfolio and direct investment exist, a common approach is to focus on the foreign investor's percentage ownership of the domestic enterprise. For example, if the foreign investor owns a greater than 10 percent stake in an enterprise, the investment is likely to be more than a mere passive holding for investment purposes. Foreign direct investment can be further divided into direct transfers from a parent company to a foreign affiliate through debt or equity contributions and reinvested earnings by the foreign affiliate.

The different forms of foreign investment are also important, as the different components might respond differently to taxes. Types of foreign investment include: (i) real investments in plant and equipment; (ii) financial flows associated with mergers and acquisitions; (iii) increased investment in foreign affiliates; and (iv) joint ventures.

The different studies have also emphasized the importance of the investor's home country's tax system in estimating the influence of tax incentives offered by the host country in attracting investment.[15] As discussed in Section III(d)_, countries generally tax their corporate taxpayers on their foreign source income under one of two alternatives: (i) the "credit" method whereby corporate taxpayers are taxed on their world-wide income and receive a foreign tax credit against their domestic tax liability for foreign income taxes paid on the foreign source income; or (ii) the "exemption" method, whereby the corporate taxpayers are generally taxed on only their domestic source income and can exempt certain foreign source income in computing their tax liability. In theory, foreign

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12 Commission of the European Communities (CEC), Report of the Committee of Independent Experts on Company Taxation (1992) (Ruding Report).

13 Hines, Tax Policy and the Activities of Multinational Corporations in Auerbach (ed), Fiscal Policy: Lessons from Economic Research (1997) and Hines, "Lessons from Behavioral Responses to International Taxation", 54 *Nat. Tax J.* 305 (1999).

14 Mooij & Ederveen, "Taxation and Foreign Direct Investment: A Synthesis of Empirical Research", paper presented at the OCFEB Conference, Tax Policy in the European Union (2001).

15 Hines, "Tax Sparing and Direct Investment in Developing Countries", (NBER Working Paper No.6728) (1998).

investors from countries that adopt the credit method are less likely to benefit from tax incentives, as the tax revenue from the favored activities may be effectively transferred to the investor's revenue service from the tax authorities in the host country. In practice, however, because foreign investors have different alternatives to structure their foreign investments, the effect of the different tax approach is likely to be relatively small.

Finally, scholars have noted that taxes may affect decision as to the source of financing rather than the level of investment.[16] Investors have several alternatives on how to fund new ventures or expand existing operations. Taxes likely play a role in the choice of whether to make new equity investment, use internal or external borrowing, or use retained earnings to finance investments.

In those cases where there has been a serious examination of the results of tax incentive regime, there are successes and failures.[17] A good review of the results of incentives is set forth in a 1996 United Nation's study.[18] The UN study concludes that "as other policy and non-policy conditions converge, the role of incentives becomes more important at the margin, especially for projects that are cost-oriented and mobile."[19] Steven Clark of the OECD reaches a similar conclusion.[20] He concludes that "Empirical work using improved data measuring FDI offers convincing evidence that host country taxation does indeed affect investment flows. Moreover, recent work finds host country taxation to be an increasingly important factor in locational decisions."[21]

Cost-effectiveness of tax incentives. Even where tax incentives succeed in attracting investment, the costs of the incentives may exceed the benefit derived from the new investment. This is difficult to substantiate, as problems exist in estimating the costs and benefits of tax incentives. One method of cost-benefit analysis is to estimate the cost (in terms of revenue foregone and/or direct financial subsidies) for each job created. For example, a 1996 study of incentives granted in the United States and in Western Europe between 1983 and 1995 found the cost of the incentive to vary from US $13,000 to over $250,000 per new job, with the cost rising steadily over that period.[22] Although the study does not give a true measure of efficiency, since it measures only the cost – and not the worth – of the jobs created, it does demonstrate the sharp rise in the cost of incentives over the past decade. The cost of jobs, however, varies widely according to the country

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[16] Auerbach, "The Cost of Capital and Investment in Developing Countries", in Shah (ed) Fiscal Incentives for Investment and Innovation (1995).

[17] *See* Chia & Whalley, "Patterns in Investment Tax Incentives Among Developing Countries", Ch. 11 in Shah, (ed.), Fiscal Incentives for Investment in Developing Countries (World Bank) (1992).

[18] United Nations, "Incentives and Foreign Direct Investment", UN Doc. UNCTAD/DTCI/28 (1996).

[19] Id. at pp. 44-45.

[20] Clark, "Tax Incentives for Foreign Direct Investment: Empirical Evidence on Effects and Alternative Policy Options", 48 Canadian Tax Journal 1139 (2000).

[21] Id. at p. 1176.

[22] UNCTAD – Incentives and Foreign Direct Investment (United Nations: New York, 1996) at pp. 29-30.

and to the industrial sector,[23] and the more "expensive" jobs may bring with them greater spill over benefits, such as technology transfer.

Role of non-tax factors. Deciding whether and where to invest is a complex decision. It is not surprising that tax considerations are just one factor in these decisions. Scholars have listed several factors that influence investment decisions, particularly those of foreign investors.[24] These include:

(1) Consistent and stable macroeconomic and fiscal policy;

(2) Political stability;

(3) Adequate physical, financial, legal and institutional infrastructure;

(4) Effective, transparent and accountable public administration;

(5) Skilled labor force and flexible labor code governing employer and employee relations;

(6) Availability of adequate dispute resolution mechanisms;

(7) Foreign exchange rules and the ability to repatriate profits;

(8) Language and cultural conditions;

(9) Factor and product markets — size and efficiency.

When scholars surveyed business executives, taxes were often not a major consideration in deciding whether and where to invest.[25] Businessmen did note that in choosing between countries in the same region, taxes were an important consideration.

Recent scholarship. The recent scholarship either acknowledges a limited role for tax incentives in correcting market failures or accepts the political realities of the continued use of tax incentives and seeks to improve the decision-making of policy makers both in the initial decision as to whether or not to adopt tax incentive regimes and the decision on the relative merits of different types of incentives.[26] This module follows this approach in seeking to discuss ways to improve the design of tax incentives and reduce the potential for abuse.

B. Advantages of Tax Incentives

If properly designed and implemented, tax incentives may be a useful tool in attracting investments that would not have been made without the provision of tax benefits. As discussed below, new investment may bring substantial benefits, some of which are not

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[23] According to a 1991 U.N. study, experience in export-processing zones (mostly in developing countries) suggests about US $5,000 per worker, though this can vary from about $1,000 per worker in textiles to more than $100,000 in the chemical industry Id.

[24] Easson, Taxation of Foreign Direct Investment: An Introduction (1999).

[25] OECD, note 11 supra.

[26] Easson, “Tax Incentives for Foreign Direct Investment, Part 2, Design Considerations”, 55 *Bulletin for International Fiscal Documentation* 365 (2001) and Zee, Stotsky & Lee, note 3 supra.

easily quantifiable. As discussed in Section III(b)__, a narrowly targeted tax incentive program may be successful in attracting specific projects or specific types of investors.

That governments often choose tax incentives over other types of government action is not surprising. It is much easier to provide tax benefits than to correct deficiencies in the legal system or to dramatically improve the communications system in the country. Also, tax incentives do not require an actual expenditure of funds by the government. One alternative to using tax incentives is to provide for grants or cash subsidies to investors. Although tax incentives and cash grants may be similar economically, for political and other reasons, it is easier to provide tax benefits than to actually provide funds to investors.

Different types of benefits. Tax incentives may yield different types of benefits. The benefits from tax incentives for foreign investment follow the traditional list of benefits resulting from foreign direct investment.[27] These include increased capital transfers, transfers of know-how and technology, increased employment, and assistance in improving conditions in less-developed areas.

Foreign direct investment may generate substantial spillover effects. For example, the choice to locate a large manufacturing facility will not only result in increased investment and employment in that facility, but also at firms that supply and distribute the products from that facility. Economic growth will increase the spending power of the country's residents that, in turn, will increase demand for new goods and services. Increased investment may also increase government tax revenue either directly from taxes paid by the investor (for example, after the expiration of the tax holiday period) or indirectly through increased tax revenues received from employees, suppliers, and consumers.

One can provide a general description of the general types of benefits of additional investment resulting from tax incentives. It is difficult, however, to estimate the benefits resulting from tax incentives with any degree of certainty. Sometimes the benefits are hard to quantify. Other times the benefit accrues to persons other than the firm receiving the tax benefits.

C. Disadvantages of Tax Incentives

1. Different types of costs associated with tax incentives

In considering the costs of tax incentive regime, it may be useful to examine four different types of costs: (i) revenue costs; (ii) resource allocation costs; (iii) enforcement and compliance costs; and (iv) the costs associated with the corruption and lack of transparency.[28]

Revenue Costs. The tax revenue losses from tax incentives come from two primary sources: first, foregone revenue from projects that would have been undertaken even if

[27] Easson, note 27 supra.
[28] Zee, Stotsky & Lee, note 3 supra.

the investor did not receive any tax incentives; and, second, lost revenue from investors and activities that improperly claim incentives or shift income from related taxable firms to those firms qualifying for favorable tax treatment.

As discussed below in Section III(b)__, policy makers may wish to target tax incentives to achieve the greatest possible benefits for the lowest costs. The goal would be to offer tax incentives only to those investors who at the margin would invest elsewhere but for the tax incentives. Offering tax incentives to those investors whose decisions to invest are not affected by the proposed tax benefit results in just a transfer to the investor (or in some instances, to the foreign investor's government) from the host government without any gain.

It is very difficult to determine on a project-by-project basis which projects were undertaken solely due to tax incentives. Similarly, it is hard to estimate for an economy as a whole what the levels of investment would be with or without a tax incentive regime.

For those projects that really would not have been undertaken without tax incentives, there is no real loss of tax revenue from those firms. Indeed, to the extent that the firms become regular taxpayers or to the extent that these operations generate other tax revenue (such as increased profits from suppliers or increased wage taxes from employees) there are revenue gains from those projects.

An additional revenue cost of tax incentives results from erosion of the revenue base due to taxpayers abusing the tax incentive regimes to avoid paying taxes on non-qualifying activities or income.[29] As discussed in Section V(b)__, this can take many forms. Revenue losses can result where taxpayers disguise their operations to qualify for tax benefits. For example, if tax incentives are only available to foreign investors, local firms or individuals can use foreign corporations through which to route their local investments. Similarly, if tax benefits are available to only new firms, then taxpayers can reincorporate or set up many new related corporations to be treated as a new taxpayer under the tax incentive regime.

Other leakages occur where taxpayers use tax incentives to reduce the tax liability from non-qualified activities. For example, assume that a firm qualifies for a tax holiday because it is engaged in a type of activity that the government believes merits tax incentives. It is likely quite difficult to monitor the firm's operation to ensure the firm does not engage in additional non-qualifying activities. Even where the activities are separated, it is very difficult to monitor related party transactions to make sure that income is not shifted from a taxable firm to a related firm that qualifies for a tax holiday.

Resource allocation costs. If tax incentives are successful, they will cause additional investment in sectors, regions or countries that would not otherwise have occurred. Sometimes this additional investment will correct for market failures. Other times, however, the tax incentives will cause allocation of resources that may result in too much investment in certain activities or too little investment in other non-tax favored areas.

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[29] See sectionV(b)___ for a discussion of different types of taxpayer abuses.

It is difficult to determine the effects of tax provisions in developed countries where markets are relatively developed. It is more difficult to determine the consequences of tax provisions in developing countries where markets do not approach the competitive models. As such, where markets are imperfect, it is not clear whether providing tax incentives to correct market imperfections will make markets more competitive.[30]

Enforcement and compliance costs. As with any tax provision, there are resource costs incurred by the government in enforcing the tax rules and by taxpayers in complying. The cost of enforcement relates to the initial grant of the incentive as well as the costs incurred in monitoring compliance with the qualification requirements and enforcing any recapture provisions on the termination or failure to continue to qualify.

The greater the complexity of the tax incentive regime, the higher the enforcement costs (as well as compliance costs) may be. Similarly, tax incentive schemes that have many beneficiaries are harder to enforce than narrowly targeted regimes. It is also difficult to get revenue authorities enthusiastic about spending resources to monitor tax incentive schemes. Revenue authorities seek to use their limited administrative resources to improve tax collection. The revenue authorities may prefer auditing fully taxable firms rather than those operating under a tax holiday arrangement.

Tax incentives also impose administrative costs on taxpayers. The administrative costs will vary by type of incentive as well as the qualification process, monitoring and reporting requirements.

Opportunities for corruption. Several recent scholars have focused on the possibility of corruption and other rent-seeking behavior associated with the granting of tax incentives. As discussed below in Section IV(a)__, there are several different approaches to providing the qualification requirements for tax incentives. The relative merits of automatic and objective approaches versus discretionary and subjective approaches are discussed in greater detail in that section.

What is clear is that the opportunity for corruption is much greater for tax incentives regimes where officials have wide discretion in determining which investors or projects receive favorable treatment. The potential for abuse is great where no clear guidelines exist for qualification.

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[30] Lipsey & Lancaster, "The General Theory of Second Best", 24 *Rev. Econ. Stud.* 11 (1956-1957).

Transparency and Tax Incentives

Howell Zee nicely adopts the transparency concepts from the anti-corruption literature to tax incentives regimes. Zee examines transparency and tax incentives along three dimensions:

Legal and regulatory dimension. That tax incentives have a statutory basis in relevant tax laws and any changes to the regime be effected through the formal amendment process;

Economic dimension. That the rationale for granting any incentives be clearly set forth and that the costs and benefits of a proposed incentives scheme be determined based on clearly stated assumptions and methodologies;

Administrative dimension. That the qualifying criteria be simple, specific and objective to minimize the discretion afforded officials that grant the incentives and to provide guidance to tax authorities charged with monitoring and enforcing the tax incentive regime.

2. ESTIMATING THE COSTS OF TAX INCENTIVES

Tax expenditure analysis. All the OECD countries and several other countries require estimates to be prepared as to the revenue impact of certain existing and proposed tax provisions. For those countries that do not have a formal tax expenditure requirement, it makes good sense to go through the exercise in deciding whether to adopt or retain a tax incentive regime.

Behavioral assumptions. All revenue estimates are based on a set of assumptions as to responses of taxpayers to particular tax law changes. In assessing the performance of tax incentive schemes, the objective is to determine the amount of incremental investment resulting from tax incentives and to be able to determine the costs and benefits associated with attracting that investment.

This requires making assumptions as to such items as: (i) the amount of investment that would have been made without the tax incentive program; (ii) the amount of "leakage" from the tax base due to taxpayers improperly claiming the tax incentives or from shifting income from taxable to related tax-exempt (or lower-taxed) entities; (iii) the tax revenue gained from either activities from taxpayers granted a tax incentive after the incentive expired or from the activities generating other sources of tax revenue.

Tax incentive budget. In many countries, the tax authorities do not have sole responsibility or discretion in designing and administering tax incentives programs. As discussed in Section V__, different government agencies, such as foreign investment agencies or ministries of international relations, have a role in designing investment regimes, approving projects and monitoring investments. These agencies' major objective is in attracting investments; they are often less concerned with protecting the tax base.

One approach that merits consideration is to set a target monetary amount of tax benefits to be granted under a tax incentive regime. This would require both the tax authorities and other government agencies to agree on both a target amount and a methodology for determining the revenue costs associated with a particular tax incentive regime.

Recent South African Legislation on Tax Incentives

South Africa has adopted a "Strategic Investment Program" as part of a larger package of tax incentives that seeks to encourage investment into South Africa from both local and foreign investors. The key features of the Strategic Investment Program include:

1. A tax expenditure budget of 3 billion rand in the form of tax allowances over a period of four years starting August 1, 2001;
2. Specification of the qualifying industry sectors that includes all manufacturing activities except tobacco and tobacco related products; computer and computer related activities; and research and development activities;
3. Specification of qualifying requirements that includes an investment in new qualifying assets equal or exceeding 50 million rand; increase production and employment within South Africa; no substantial displacement of jobs within South Africa; demonstrating long-term commercial viability; and that the project does not currently benefit from other government incentive programs;
4. Clear criteria for evaluating and scoring investment projects, a process for application and approval, and publication requirements for approved awards to ensure transparency for awarding tax incentives.

D. Sunset Provisions and Evaluation of Success of Specific Tax Incentive Initiatives

The costs and benefits of tax incentives are not easy to evaluate and are hard to quantify and estimate. Incentives that may work well in one country or region may be ineffective in another context. Tax incentive regimes in many countries have evolved from general tax holidays to incentive regimes that are more narrowly targeted.

It therefore may make sense (i) to limit the duration of tax incentive regimes to reduce the potential costs of unsuccessful or poorly designed programs by including a specific "sunset" provision as part of the original legislation; (ii) to design incentive regimes to require information reporting by beneficiaries to investment agencies and to specify what government agency has responsibility for monitoring and enforcing qualification and any recapture provisions; and (iii) to require an evaluation be made as to the costs and benefits of specific tax incentive regimes and to specify the timing of the evaluation and the parties responsible for conducting the review.

III. TYPES OF TAX INCENTIVES

A. Objectives of Tax Incentives

Countries grant special tax privileges to attract additional investment. However, if the objective were simply to increase the total stock of all types of investment, the best policy would likely be to adopt an "investor-friendly" general benchmark tax system. Tax incentives are, by definition, departures from the benchmark system that are granted only to those investors or investments that satisfy the prescribed conditions. These special tax privileges may be justified only if they attract investments that are both particularly desirable and that would not be made without such tax benefits. Thus, the first question in designing a tax incentive system is "what types of investment are the incentives intended to attract?"

B. Targeting of Incentives

Incentives may be broadly targeted; for example, all new investment, foreign or domestic, or they may be very narrowly targeted, and designed with one particular proposed investment in mind.[31]

Advantages of and Disadvantages of Targeting. The targeting of incentives serves two important purposes: (i) it identifies the types of investment that host governments seek to attract; and (ii) it reduces the cost of incentives because it reduces the number of investors that benefit.

This raises the question of whether a government should treat some types of investment as more desirable or beneficial than other types. Should a government seek to attract and target tax incentives at particular types of investments and not others, or should investment decisions be left solely to market forces? Justifiable doubt exists about the ability of politicians to "pick winners," particularly in countries making the transition

[31] For example, a Ukrainian provision favoring new foreign investment in the motor industry exceeding $50 million was introduced specifically for the benefit of Daewoo.

to a market economy. Also, there are some types of investment that, while not prohibited altogether, may not deserve encouragement in the form of tax benefits. Ideally, incentives should be given only for incremental investment; that is, for investments that would not otherwise have occurred but for the tax benefits. Even if that is not possible, targeting likely reduces the number of free riders.

One downside of a selective approach is that the more precisely an incentive is targeted, the greater the distortion it creates. This distortion takes two forms: investment decisions are changed to take advantage of incentives, thus resulting in a misallocation of resources, and competition is distorted between those firms that enjoy the incentives and those that do not.

Discretionary or Automatic Targeting. An initial question is whether the granting of tax incentives should be discretionary, or should be automatic once the prescribed conditions are met. This question is discussed in Section IV. For the reasons given there, it seems advisable to limit discretion. But if qualification for incentives is made largely automatic, it becomes necessary for the qualifying conditions to be spelled out clearly and in detail.

Foreign or Domestic Investment. In developing countries, tax incentives are primarily intended to attract foreign direct investment. An important question is whether tax incentives should be restricted to foreign investors or made available equally to domestic investors. Restricting tax incentives to foreign investors reduces the potential revenue loss. Domestic investors often have little or no real opportunity to invest elsewhere, and therefore do not need special incentives to encourage them to invest at home. However, such a restriction may be objected to on the following grounds. First, discrimination in favor of foreign investors distorts competition. It may restrict the growth of domestic enterprises, or even prevent the development of a domestic sector. It is also likely to cause resentment. Second, discrimination in favor of foreign investors is often ineffective, because domestic investors may engage in "round-tripping" to disguise domestic investment as coming from foreign sources (discussed in Section V).

New Investors. The most common form of investment incentive is the tax holiday, which by its nature, is targeted at new investors. The rationale may be that once a new investor has been "captured" its subsequent investment decisions will be made solely according to its business needs and will not be influenced, or will be less influenced, by tax considerations. In practice, restricting incentives to new investors tends to be ineffective and may be counter-productive. An existing investor that plans to expand its operations will often incorporate a new subsidiary or form a related corporation to undertake those operations such that the new entity qualifies for a new tax holiday.

Large Investments. Countries use tax incentives to attract investment -- so there often exists a view of "the more, the better". This view is reflected in provisions that restrict the granting of incentives to "large" investments, i.e., those exceeding a stipulated amount. The amount varies greatly from country to country and is sometimes further restricted to particular types of investment. Often, imposing a dollar threshold effectively limits the incentive to foreign investors, without formally discriminating against domestic enterprises. This results because few, if any, domestic investors possess sufficient capital to meet the qualifying threshold.

In principle, it is difficult to justify a qualification based on a particular threshold. It may be that two investments, each of $3 million, would be more beneficial to the host country than a single investment of $5 million. Only in very marginal cases is an investor likely to increase the size of its planned investment in order to obtain a tax privilege. Investors are more likely to change how an investment is financed or to inflate the value of the assets contributed to meet qualification requirements.

Sectoral Targeting. Many countries grant preferential tax treatment to certain sectors of the economy, or to certain type of activities. Sectoral targeting has many advantages; (i) it restricts the benefits of the incentives to those types of investment that policy makers consider to be most desirable; and (ii) it also makes it possible to target those sectors that are most likely to be influenced by tax considerations. Among the activities commonly preferred are:

Manufacturing. Several countries restrict investment incentives to manufacturing activities or provide for those activities to receive preferential treatment (e.g., China, Ireland). This may reflect a perception that manufacturing is somehow more valuable than the provision of services, perhaps because of its employment creating potential, or a view that services (with some exceptions) tend to be more market-oriented and therefore less likely to be influenced by tax considerations.

"Pioneer" Industries. Some countries adopt a more sophisticated approach and restrict special investment incentives to certain broadly listed activities or sectors of the economy. Malaysia and Singapore, for example, grant special tax incentives to "pioneer" enterprises. Generally, to be accorded pioneer status, an enterprise must manufacture products that are not already produced domestically, or engage in certain other listed activities that are not being performed by domestic firms and that are considered to be especially beneficial to the host country.

Specific Sectors. Increasingly, countries have introduced incentives narrowly targeted at particular types of investment, especially technologically advanced industries. Other common targets are infrastructure development, film production, tourism, and "offshore" financial centers. [32]

Location Incentives. Many countries provide tax incentives to locate investments in particular areas or regions within the country. Sometimes the incentives are provided by regional or local governments, in competition with other parts of the same country. In other cases, the incentives are offered by the central government, often as part of its regional development policy, to promote investment in less-developed regions of the country or in areas of high unemployment.

Employment Creation. One benefit of foreign direct investment is creating new employment opportunities and, not surprisingly, incentives are frequently provided specifi-

[32] This type of incentive may result in a country being labeled a "tax haven" under the OECD harmful tax competition initiative.

cally to encourage job creation. Policy makers could provide for tax incentives for investment in regions of high unemployment, or they could tie the tax incentive directly to employment, with the creation of a stipulated number of new jobs being made a condition for qualifying for the tax holiday or other incentive.

Technology Transfer. Foreign direct investment often results in the transfer of technology. Even critics of tax incentives concede that tax incentives may be useful to promote activities such as research and development (R&D), if only as a way of correcting market imperfections. Countries attempt to attract technologically-advanced investment in several ways: (i) by targeting incentives at technologically-advanced sectors; (ii) by providing incentives for the acquisition of technologically-advanced equipment; and (iii) by providing incentives for carrying out R&D activities.

Export Promotion. The experience of many developing countries is that export promotion, and the attraction of export-oriented investment, is the quickest and most successful route to economic growth. It is therefore hardly surprising that competition to attract such investment is especially fierce, and investment incentives are frequently targeted at export-oriented production. Additionally, incentives targeted specifically at export-oriented investment tend to be more effective than most other forms of tax incentive, due to the higher degree of mobility of such investment. However, an important factor to be considered is that such incentives may constitute an export subsidy and thus be contrary to WTO rules.

C. Forms of Tax Incentives

Designing tax incentives requires two basic decisions:- one, determining the types of investment that qualify; two, determining the form of tax incentive to adopt.

Tax incentives for investment take a variety of forms. The most commonly employed are:

(1) reduced corporate income tax rates;

(2) tax holidays (i.e., reduction of or exemption from tax for a limited duration);

(3) investment credits or allowances;

(4) tax credit accounts;

(5) accelerated depreciation of capital assets;

(6) favorable deduction rules for certain types of expenditure;

(7) deductions or credits for reinvested profits;

(8) reduced rates of withholding tax on remittances to the home country;

(9) personal income tax or social security reductions for executives and employees;

(10) sales tax or VAT reductions;

(11) reduced import taxes and customs duties;

(12) property tax reductions;

(13) creation of special "zones."

Reduced Corporate Income Tax Rates. Countries may provide exemptions from, or reduced rates of, corporate income or profits tax to particular types of activity. Some countries provide a reduced rate of tax for certain types of investment (e.g., the reduced rate for manufacturing in Ireland).[33] Other countries provide reduced tax rates for investment in particular locations or regions (e.g., the reduced rate for investment in special economic zones and other designated regions of China).

Tax Holidays. In developing countries, tax holidays are by far the most common form of tax incentive for investment. A tax holiday may take the form of a complete exemption from profits tax (and sometimes from other taxes as well), of a reduced rate of tax, or of a combination of the two (e.g., 2 years exemption, plus a further 3 years at half-rate). The exemption or reduction is granted for a limited duration.

Tax holidays can vary in duration from as little as one year to as long as 20 years. In determining the length of the tax holiday, a clear trade-off exists between the attractiveness to investors and the revenue cost to the host country's treasury. Most studies have concluded that short tax holidays are of limited value or interest to most potential investors and are rarely effective in attracting investment, other than short-term, "footloose," projects. Substantial investments often take several years before they begin to show a profit, by which time the tax holiday may have expired. Short tax holidays are of the greatest value to investments that can be expected to show a quick profit and are consequently quite effective in attracting investment in export-oriented activities such as textile production. Since that sector is highly mobile, however, it is not uncommon for a firm to enjoy a tax holiday in one country and, when it expires, to move its entire operation to another country that is willing to give a new holiday. Consequently, the benefit of the investment to the host country may be quite limited.

Tax holidays have the apparent advantage of simplicity for both the enterprise and the tax authorities. A common misperception is that, if no tax is payable during the holiday period, no formalities should be required, such as information or tax returns, and there should be no compliance or administrative costs. In practice, however, it is usually still necessary (and desirable) to require the filing of a tax return during the holiday period. In particular, if the enterprise is allowed to carry forward losses incurred in the holiday period or to claim depreciation allowances after the end of the holiday for expenditure incurred during the holiday, the enterprise will obviously need to file a return or at least keep appropriate records.

Additionally, tax holidays are especially prone to manipulation and provide opportunities for tax avoidance and abuse (discussed in Section V). Another disadvantage is that the revenue cost of tax holidays cannot be estimated in advance with any degree of

[33] This special rate is being eliminated because of EU rules.

accuracy, nor is the cost related to the amount of the investment or to the benefits that may accrue to the host country.

Finally, tax holidays exempt profits without regard to the level or amount of profits that are earned. For potential investments that investors believe will earn above market returns, tax holidays will result in a loss of tax revenue without any benefits. Because of the high return, investors would have undertaken these projects even without the availability of tax incentives.[34]

Investment Allowances and Credits. As an alternative, or sometimes in addition, to tax holidays, some governments provide investment allowances or credits. These are given in addition to the normal depreciation allowances, with the result that the investor may be able to write off an amount that is greater than the cost of the investment. An investment allowance reduces taxable income, whereas an investment tax credit is set against the tax payable; thus, with a corporate income tax rate of 40 percent, an investment allowance of 50 percent of the amount invested equates to an investment credit of 20 percent of that amount.

Investment allowances or credits may apply to all forms of capital investment, or they may be restricted to specific categories, such as machinery or technologically advanced equipment, or to capital investment in certain activities, such as research and development. Sometimes, countries limit eligibility to contributions to the charter capital of the firm. This approach may encourage investors to increase the relative amount of equity capital rather than related-party debt capital in the firm's initial capital structure.

Investment allowances and credits seem preferable to tax holidays in almost every respect: (i) they are not open-ended; (ii) the revenue cost is directly related to the amount of the investment, so there should be no need for a minimum threshold for eligibility; and (iii) their maximum cost is more easily estimated.

One objection to the use of investment allowances and credits is that they favor capital-intensive investment and may be less favorable towards employment creation than tax holidays. They may also distort the choice of capital assets, possibly creating a preference for short-lived assets so that a further allowance or credit may be claimed on replacement.

Tax Credit Accounts. Tanzi & Zee propose an interesting approach to offering tax benefits to potential investors that allows taxing authorities to determine with great certainty the revenue costs of the tax incentive program.[35] This approach provides each qualifying investor a specific amount of tax relief in the form of a tax credit account (say, for example, potential exemption for $100,000 of corporate income tax liability). The investor would be required to file tax returns and keep books and record just like any other taxpayer. If the investor determines it has $60,000 of tax liability in year one, it would pay no tax, but the amount in its tax account would be reduced to $40,000 for

[34] Tanzi & Zee, "Tax Policy for Emerging Markets: Developing Countries", IMF Working Paper No. 35 (2000).
[35] Id.

future tax years. The tax credit account has the advantage of providing transparency and certainty to both the potential investor and the government.

The tax credit account may be regarded as a sort of hybrid – a cross between a tax holiday and an investment tax credit. It resembles a tax holiday, except that the tax exemption period, instead of being a fixed number of years, is related to the amount of income earned: i.e. the exemption applies to the first $x earned. This has two important advantages: the cost of the incentive to the host government is known, and there is no strong built-in advantage for those investments that make quick profits. The tax credit account also resembles an investment tax credit in that the amount of the credit is a fixed sum: where it differs is that the amount is not determined by the amount of the investment. It consequently does not provide a preference to capital-intensive investments.

Accelerated Depreciation. As already noted, an investment credit or allowance is provided in addition to any amount of depreciation that may be claimed. The term "accelerated depreciation" generally refers to any depreciation scheme that provides for writing off the cost of an asset, for tax purposes, at a rate faster than the true economic depreciation. Many countries use some type of "declining balance" method of depreciation or other type of accelerated depreciation as part of their benchmark tax system. For those countries, however, that do not generally provide accelerated depreciation, a tax incentive can provide for deducting the cost of acquisition more quickly than would be allowed under the normal "benchmark" depreciation schedules.

The cost of accelerated depreciation, in terms of tax revenue foregone, is normally less than that of tax holidays or investment allowances/credits, since it is only the timing of the tax payable, and not the amount of tax, that is affected. That, of course, can still be a substantial benefit to established businesses that are planning to increase their investment, but in the case of most initial investments, where there may be no profit for several years, accelerated depreciation will be of no benefit.

Favorable Deduction Rules. Policy makers may influence investment by providing favorable rules for deducting certain types of expenditures. These include accelerated depreciation provisions and rules that allow the immediate expensing of capital outlays.

A somewhat different type of incentive is the double (or multiple) deduction of preferred expenditures (e.g., for re-training employees or for promoting tourism).[36]

A double deduction reduces the taxpayer's taxable income and operates in much the same manner as a "matching grant" from the host government. For example, if the taxpayer expends $1 million on training employees in new skills, it is permitted to deduct $2 million in computing its taxable income. At a corporate income tax rate of 30 percent, the host government effectively contributes an additional $300,000 to the cost of training.[37]

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36 This type of incentive is used in Malaysia and Singapore.

37 The deduction does not, of course, necessarily have to be double the amount of expenditure: it could be a 150% or 300% deduction.

Reinvestment Incentives. Some countries provide incentives for the reinvestment of profits. This can be done two ways. First, the tax liability of the enterprise itself can be reduced by allowing a deduction for the amount reinvested (or a proportion thereof) from the profits otherwise taxable. Second, the shareholder, or parent company, can be given a refund of the tax paid by the local enterprise up to a stated proportion of the amount reinvested (whether in the original enterprise that made the profit or in some other qualifying enterprise).

Whether reinvestment incentives are really effective is questionable. Once an enterprise has made its initial investment it will normally base its additional investment decisions on actual business needs, so that the incentive probably rewards the enterprise for doing what it may have done in any event. Provided the host country has a reasonably generous system of depreciation allowances, there would seem to be little need to provide any further inducement to reinvest.

Reduced Withholding Taxes. It is not uncommon for countries to provide reduced or zero rates of withholding tax as an incentive for foreign investment, either generally or to promote particular objectives such as the transfer of technology. Exemption from withholding tax is sometimes given in the case of interest on loans made at preferential rates or in the case of royalties or technical assistance fees paid in respect of technology transfers. It is also quite common for dividends paid out of exempt profits (for example, profits earned during a tax holiday period) to be exempt from withholding tax.

There is some evidence that high withholding tax rates provide a disincentive to FDI, though it is less clear that exemptions, or reductions to rates that are below the international norms, will have much if any effect on initial investment decisions. A further objection is that this form of relief actually reduces the incentive to reinvest profits (by reducing the disincentive to repatriate them).

Personal Income Tax, Payroll Tax and Social Security Reductions. Some countries accord special tax treatment to "expatriate" executives and employees, such as the granting of additional allowances (accommodation, children's education, home leave, etc.). Other countries go further and exempt certain categories of expatriate employees from income tax or payroll taxes or tax them at lower rates than other resident individuals. Concessions of this type are rarely likely to influence investment decisions, though they may be perceived by investors as one of the factors that make for a favorable investment environment.

Reductions in payroll taxes and social security contributions are also sometimes used as an incentive to invest in regions of high unemployment or to employ certain categories of workers (e.g., youths or the disabled). Such incentives are likely to be moderately effective, especially in countries where payroll taxes and social security contributions form a substantial part of the cost of employment, and they have the advantage of being relatively simple to administer.

Sales Tax Exemptions. Some countries provide exemptions from sales taxes, such as VAT, as an inducement to foreign investors. For export-oriented investment, consumption taxes are normally refunded on export. The better approach is to improve the VAT legislation, in particular by providing prompt refunds rather than by granting exemptions.

Reduced Import Taxes and Customs Duties. Customs duties increase, often substantially, the cost of imported raw materials, components and capital goods. While the taxes or duties on raw materials and components may be passed on to domestic consumers, or refunded on export, the taxes on capital goods may be less easily recovered and can add substantially to the initial cost of an investment. Exemption from customs duties and import taxes can consequently be an important factor in investment decisions. Many investors consider this type of incentive to be the most valuable type of investment incentive.

Exemptions normally apply only to imported capital equipment. Sometimes all capital equipment qualifies; in other cases, only certain categories qualify, such as machinery or technologically advanced equipment. Occasionally, however, exemption also extends to imported components and raw materials used in production, though such exemptions are usually granted only on a temporary basis. This type of exemption, especially when granted selectively to particular investors, can severely distort competition and may violate international trade rules.

Property Tax Reductions. Exemption from, or reduction of, property taxes is a common and relatively effective form of investment incentive. It has the advantage, from the granting government's point of view, that its cost is fully predictable. The relief is normally limited in duration, and its effect is much the same as a cash grant spread over a number of years. Property tax incentives are often part of more general regional development policies and are often granted by local, rather than central, government authorities.

"Zones." Countries use two types of special "zones" to attract investment: (i) duty-free zones, enjoying exemption from customs duties (and usually from VAT); and (ii) special economic zones, in which investors enjoy other tax privileges not granted in other parts of the host country. In practice, the distinction between the two types of zones is not always so clear. Investors in duty-free zones often receive other tax privileges (especially in export processing zones) and special economic zones sometimes enjoy customs privileges.[38]

Duty-free zones and export processing zones (EPZs) are intended to facilitate the trans-shipment of goods, and the processing of imported materials or components for export. Exemption from VAT and customs duty is granted on imported goods, because those taxes would normally be refunded on export. To grant additional tax privileges (e.g., tax holidays) to these activities may be inappropriate and may violate the WTO prohibition against export subsidies.

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[38] It is not uncommon for a separate "bonded" duty-free zone to exist within a special economic zone.

By contrast, special economic zones are intended to promote economic activity within a designated area, and are not restricted to exporting. They consequently should not be given favorable customs treatment.

D. ECONOMIC EFFECTS OF TAX INCENTIVES

The different types of tax incentives all share one characteristic: they reduce, or have the potential to reduce, the amount of host-country tax that would otherwise be payable. However, they do so in different ways and produce different effects.

Incentives related to profits. Some common forms of tax incentives, notably tax holidays, reduce the income tax liability related to corporate profits. Thus, only profitable investments benefit from the first seven types of tax incentives listed above. In contrast, incentives 9-12 are not related to profits tax and confer a benefit even on enterprises that have no taxable profits. [39]

Tax incentives tied to profits have the advantage in that they result in no revenue losses for those investments that turn out not to be profitable. There may be an additional advantage in that unprofitable investments are less likely to be of benefit to the host country. These types of incentives do not result in any cash outlays unlike financial incentives such as grants and low-interest loans. However, these incentives have the disadvantage in that their eventual revenue cost is difficult to forecast and may be quite substantial.

Up-front Incentives. A distinction is sometimes made between those incentives that reduce the immediate cost of the investment ("up-front" incentives), and those incentives that increase the subsequent return on the investment ("downstream" incentives). [40] Investment credits (3), accelerated depreciation (5) and reinvestment credits (7) may be considered up-front incentives for existing, profitable, enterprises. Customs duty exemptions (11), especially those granted for assets contributed to an investor's initial capital, significantly reduce the immediate cost of an investment.

Incentives that may affect homecountry tax liability. Tax incentives for foreign direct investment are sometimes criticized because the benefit of the tax foregone, or "spared", may accrue not to the investor but to the investor's home country. For those countries that use the credit method to provide relief from double taxation, any reduction in the amount of tax payable by the investor in the source country may reduce the amount of credit that may be claimed in the home country and thus increase the amount of homecountry tax payable.

The objection is probably overstated because only rarely will host country tax reductions have the effect of increasing home country tax liability. Several important capital-exporting countries use the exemption method to relieve double taxation, especially for

[39] Exemption from withholding tax (8) is profit-related in the case of dividends, but not in the case of other types of payment. Special zones (13) usually confer a package of incentives, some of which are profit-related and others not.

[40] Of course, up-front incentives also increase the subsequent *rate* of return on the investment.

income from active business. In other countries, where the investor operates in the host country through a subsidiary rather than a branch, home country tax is normally deferred (if it is imposed at all) until such time as income is repatriated to the parent company in the form of dividends, interest or royalties. Even then, an exemption is sometimes provided for dividends received from foreign affiliates, or the relevant tax treaty may contain a "tax sparing" provision that preserves the benefit of the reduction of host country tax derived from incentive legislation.

Nevertheless, potential homecountry tax liability may be a factor to consider in designing an incentives policy.[41] Exemption from taxes that are not eligible for a foreign tax credit in the home country, such as social security contributions, VAT, customs duties and property taxes (9-12), will not create a potential additional home country liability.[42] Reductions in the profit tax payable by the local subsidiary (1-6) will normally only increase home country liability (if at all) when profits are repatriated to the parent company. By contrast, reduced withholding taxes, especially on interest and royalty payments, are most likely to increase home country tax liability.[43]

IV. COMMON DESIGN ISSUES

A. ELIGIBILITY CRITERIA.

When introducing incentive legislation, one of the most important tasks is to stipulate clearly which investors, or transactions, qualify for the incentive. In particular, the following issues must be considered:

Automatic or Discretionary Entitlement. An initial question is whether tax exemptions and reliefs should be granted automatically where prescribed conditions are met, or whether these benefits should be granted only on a discretionary basis. Discretionary provisions may reduce the potential revenue cost of a tax incentive regime because it makes it possible, in theory, to restrict incentives to incremental investment and to exclude investments that might meet the prescribed formal conditions, but that are not the type of investment intended to benefit. Discretionary incentives, however, can impose significant administrative burdens. Discretionary incentives may lack transparency and may be more prone to corruption.

Tax incentives that are entirely discretionary or are completely automatic are unusual. Even where there is a high degree of discretion, the relevant legislation usually sets out the general context within which the officials may exercise discretion. Additionally, incentives that are apparently automatic frequently require some form of certification of

41 For countries in Latin America in particular, that derive a very high proportion of their foreign investments from the U.S., the ability to claim a foreign tax credit is often an important factor.

42 Except indirectly, by increasing profit.

43 Unless there is tax sparing. Reinvestment allowances or credits (7) usually operate in the same way as (normal) investment allowances or credits, but in some cases the credit is given directly to the foreign investor, which could have the effect of increasing home country liability.

satisfaction of the prescribed conditions that may call for some degree of discretion by the official charged with issuing the certification. In some countries, granting tax incentives involves a two-stage process: an automatic stage, where it is determined if the investor meets the prescribed qualifying conditions, followed by a discretionary stage where it is decided whether that investor ought to be given privileges. In other countries, what appears to be a discretionary tax privilege may in practice be granted automatically to all qualifying projects.

Apart from the risk of corruption, it may make sense to limit the amount of discretion accorded government officials. Incentives need to be predictable to influence investor decisions. The qualifying conditions for incentives should therefore be set out clearly and in detail so that potential investors may determine whether or not they qualify, or what they have to do in order to qualify, for tax benefits.

Conditions for Eligibility. Tax incentive regimes that impose specific eligibility requirements will require some form of verification to ensure compliance. Taxpayers may be required: (i) to obtain initial approval or certification; (ii) to demonstrate satisfaction of factual conditions; (iii) to obtain valuations of certain assets; or (iv) to meet certain continuing qualification requirements.

The tax system may require taxpayers to make some of these determinations even apart from the tax incentive regimes. Taxpayers must value capital investments for purposes of the general depreciation rules and must value and classify imported goods for customs purposes. Thus, tax incentives such as investment allowances, accelerated depreciation or enhanced deduction may impose little or no additional administrative burdens on taxpayers or taxing authorities. Other types of tax incentives, however, may involve substantial administrative costs for taxpayers or tax or customs authorities.

Determination of Eligibility. A further question to consider is “who determines eligibility?” Often, several government agencies participate in the foreign investment process. For example, a Foreign Investment Agency may be charged with the task of promoting and attracting investment and another government ministry (for example, the Ministry of the Economy or the Ministry of International Economic Relations) may have overall responsibility for foreign investment. In addition, other ministries, responsible for specific sectors of the economy, may participate and the Ministry of Finance may have responsibility for designing and implementing the tax regime applicable to foreign investment. These government ministries have different priorities and responsibilities. The tendency is for departments that are responsible for economic development to favor all measures, including tax incentives, which might increase the flow of investment, leaving only the Ministry of Finance to protect the interests of the treasury.

The tax administration generally makes the determination whether a particular taxpayer meets all qualifying conditions either when processing the taxpayer’s return or making the assessment for the year of qualification. The tax administration may have to verify certain facts asserted by the taxpayer and will often require information or certification from other government agencies. The respective functions and authority of the various government agencies should be clearly set forth either in the initial legislation or implementing regulations.

As tax incentives take the form of reductions in, or exemptions from, tax it is important that the tax incentive provisions are set forth in the general tax legislation, rather than in separate statutes (such as a Foreign Investment Law). This may reduce the likelihood of conflict or of overlapping provisions and increase the monitoring function of the Ministry of Finance.

B. Operational Features of Incentive Provisions

Apart from the determination of eligibility, the design of tax incentives requires careful consideration of how they will operate in practice. In particular, the following issues need to be considered.

Commencement. It is important, especially in the case of tax holidays, to establish clearly the date of commencement. The effective duration of a tax holiday depends on the point in time from which the holiday period begins to run: the later the commencement date, the more valuable the incentive. In many cases, it is a year or more after an investment has been approved before operations actually commence and often as long as five years or more before the investment begins to show a profit. An early commencement date is therefore of greatest benefit to investments that show a quick profit. Such investments, however, may not be the most desirable from the perspective of the host country. Deferring commencement increases the revenue cost of the tax incentive but may result in an increase in long-term investments that may be more beneficial to the economy.

Among the various possibilities are: (i) the date of incorporation or registration of the enterprise; (ii) the date on which production or business commences; (iii) the date on which the enterprise first receives revenue; or (iv) the year in which the enterprise first makes a profit.

If commencement is deferred until the first profitable year, it is important to make clear what this means. Is it the first year in which the business records a profit (i.e., a surplus of receipts over expenditures), or is it the first year in which it has taxable income, after allowing for the carry-forward of losses from previous years? Deferring commencement until the first profitable year may provide opportunities for manipulation, by accelerating receipts or deferring expenditures, at both the beginning and end of the period. It also requires the investor to file proper tax returns during the holiday period.

Duration and Termination. Tax holidays are, by definition, limited in duration: other types of incentives may also have a time limit, or they may be open-ended.[44] Sometimes an incentive is subject to performance requirements (e.g., maintaining a prescribed level of employment or of export sales). In such cases, the investor will

[44] Exemption from property tax, or from customs duties, for a limited duration might be regarded as a form of tax holiday, though they are usually not so described.

normally have to provide evidence each year, when it files its tax return that the conditions continue to be met.

A tax privilege may come to an end (i) on the expiry of the stipulated "holiday" period; (ii) in the event of failure to comply with ongoing qualifying conditions;[45] (iii) if the investor commits some violation that results in forfeiture of the privilege;[46] or (iv) due to a change in the relevant legislation.

Of these situations, the effect of legislative changes is the most complex. In the case of incentives with a prescribed duration, such as tax holidays, the normal expectation is that existing privileges will continue notwithstanding the repeal or modification of the legislation that granted the relief from tax. New investments will not benefit from the incentive, but existing ones will continue to do so until the expiry of the period for which the incentive was granted.[47] Where a particular incentive does not have a stipulated duration, there is no general expectation that it will continue indefinitely. However, to preserve an attractive investment climate may make it advisable to introduce some form of "sunset" provision for existing investors. In some countries, the foreign investment law may contain a guarantee against adverse legislative changes.[48] The situation can be complicated where new tax incentives are introduced to replace existing tax incentive regimes. The question then arises whether an investor may claim the new incentive or may retain the old privilege while also enjoying the benefit of the new one.

Relationship to Depreciation and Loss Rules. The interaction of tax incentives with the general provisions in the tax code such as the depreciation provisions and loss carryover provisions is of major importance, especially in the case of tax holidays, investment credits or allowances, and accelerated depreciation provisions.

Two basic questions must be considered: First, are depreciation allowances automatic or elective? Second, in what circumstances may losses be carried forward, and for how long?

1. DEPRECIATION RULES

Some depreciation systems operate on an automatic basis. Qualifying assets are written down (whether on a straight-line or a declining balance basis) to reflect the presumed depreciation and, thus, the true economic situation of the firm. The result may be a loss, or an increased loss, for the year in question. In other systems, taxpayers may claim depreciation allowances up to a maximum stipulated amount. Here, the deduction is elective and any unused allowances may be effectively carried forward.

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[45] This sometimes results in a clawback of the tax already "spared".

[46] The legislation might provide that a tax privilege is forfeited in the event of abuse.

[47] Such a principle may be found in the general law of the host country or in a bilateral investment protection treaty, but even where it is not, the withdrawal of existing privileges is likely to be a serious deterrent to potential future investors.

[48] Such guarantees, especially if not limited in time, can cause major difficulties, especially where legislative changes are in part adverse and partly more favorable.

In either case, taxpayers with insufficient profits for the year from which to deduct the depreciation allowance will receive no immediate tax benefit.[49] However, where the depreciation system is elective the benefit of the allowance can be preserved because the taxpayer will defer claiming a deduction until it earns taxable profits. The same is also true where depreciation deductions are automatic and result in a loss for the year (or enlarge an existing loss), provided that such losses can be carried forward until the business becomes profitable.

2. LOSS RULES

Most "modern" tax systems permit business losses to be carried forward and deducted from profits of future years, usually for up to 5 years and sometimes for longer,[50] though occasionally there are restrictions imposed on the amount that may be deducted in any one year. As noted above, the ability to carry forward a loss may also preserve the benefit of unused depreciation allowances. Since it may be several years before an investment produces a profit, the ability to carry forward losses is important to most new investors.

iii. Relevance to Tax Holidays

A typical tax holiday might provide for exemption from corporate income tax for a period of 5 years from the time of registration. Some investments may quickly achieve profitably and derive substantial benefit from the holiday. Other investments may make initial losses and will not become profitable until after the holiday period has elapsed. In the latter case the tax holiday will have conferred no benefit, since the firm would not have paid tax in any event. Indeed, unless losses incurred during the tax holiday period can be carried forward,[51] the tax holiday may actually be detrimental. The situation is different if the tax holiday period does not commence until the investment begins to produce taxable income.[52]

3. RELEVANCE TO INVESTMENT CREDITS AND ALLOWANCES

As noted in Section III, investment allowances and/or credits are given in addition to the normal depreciation allowances. An investment allowance reduces taxable income, whereas an investment tax credit is set against tax payable. As with tax holidays, investment allowances/credits are of no immediate benefit to investors who have no profits/tax liability against which to set them. They are useful to taxpayers only if they can be carried forward, either as an (elective) allowance or as an addition to a loss.[53]

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[49] Thus accelerated depreciation is of no value to most new investors.

[50] Carry-back of losses is permitted in some countries, but is obviously of no interest to new investors.

[51] If losses incurred in the tax holiday period can be carried forward, it means that accounts must be kept and returns filed during the holiday period.

[52] See the example set forth in the Appendix.

[53] See the example set forth in the Appendix.

C. *Matching the Tax Incentive to the Target Investment*

Tax incentives pursue a variety of objectives and take a number of forms. However, the widespread use of tax holidays suggests that little thought is usually given to choosing the forms of incentives that are most suited to achieving the desired objectives. Tax holidays are usually an inappropriate means of attracting the types of investments that are likely to be most beneficial, as well as being likely to result in unwanted distortions.

As noted in Section III, tax holidays confer the greatest benefit on short-term investments that yield quick profits. Where qualifying conditions are imposed – for example, that a minimum amount is invested, that a certain number of jobs be created, or that advanced technology be introduced – the amount of benefit conferred is largely unrelated to the cost of meeting those conditions.

For example, where countries provide tax holidays to create employment, the amount of tax saved may be only very loosely related to the number of jobs created. An investor might be also induced to hire unneeded workers to qualify for the tax reduction. In addition, regular monitoring will be required to ensure that the requisite number of jobs are maintained.

If the objective is to increase employment, then it may better to use other tools, such as exempting, or reducing, payroll taxes, allowing a double deduction for training expenses, or providing tax credits for new employees hired. Each of these incentives has its own set of problems and is also subject to taxpayer abuse. Those tax incentives, however, are tied directly to creating new jobs.

Tax holidays for introducing advanced technology similarly make little sense. First, the benefit of the holiday is unlikely related to the value of the technology introduced. In addition, the investor may be induced to adopt inappropriate or unnecessary technology to qualify for favorable tax treatment. Finally, some form of certification procedure is necessary to determine whether or not the qualifying conditions are met. More appropriate may be an exemption from customs duty on importation of particular types of equipment, an investment allowance or credit based on its cost, or a double deduction for items such as software purchases or R&D expenditures.

V. IMPLEMENTATION AND COMPLIANCE ISSUES

A. *Monitoring Compliance*

Initial Compliance with Qualifying Conditions. Some of the problems associated with determining whether an investor meets the qualifying conditions were discussed in Section IV. This determination may require:

<u>Approval or certification.</u> Some incentive provisions require initial approval or some other positive decision. For example, officials may need to determine that the investment

is in a priority sector or that prescribed employment or export targets will be met, or that environmental requirements will be complied with. Generally, tax authorities will require some form of written certification as to qualification.

Factual verification. A second type of qualifying condition requires what is essentially a factual determination, for example that the foreign participation in a joint venture exceeds a stipulated percentage, that a certain number of new jobs have been created, that a particular capital investment falls within a category qualifying for accelerated depreciation, or that imported equipment can be classified as "advanced technology." The tax authorities sometimes carry out this verification: otherwise, they can be expected to require written confirmation from the appropriate authority or department.

Valuation. A third type of condition requires a valuation of assets. For example, investors may be required to establish that the amount invested exceeds the minimum stipulated amount needed to qualify for a tax holiday, or that an investment qualifies for a tax credit of a given amount.

Monitoring Continuing Compliance. Conditions are sometimes attached to incentives that are related to ongoing performance -- for example, requirements that a given number of jobs are maintained, or that a certain percentage of production is exported, throughout the tax holiday period. Incentives of this type require continued monitoring. Although this imposes an additional administrative burden on the authorities it does have the merit of providing the host government with a reasonably accurate idea of how an investment is performing.[54] Without a formal monitoring mechanism, investors have little reason to make realistic projections as to the number of jobs that will be created, or the volume of exports that will be produced, and some studies have shown large discrepancies between investor prediction and performance. However, it is important that administrative capabilities to conduct necessary monitoring are taken into account when incentive legislation is drafted, so that unnecessary supervision is avoided.

B. Common Abuses

On-going monitoring of investments is necessary not only to ensure continuing compliance with qualifying conditions but also to detect tax avoidance or evasion. Where there is (illegal) tax evasion – for example, false claims are made in order to benefit from a tax incentive -- one would expect some penalty to be imposed and the tax privilege to be denied. Tax avoidance presents greater difficulties, since countries have different attitudes as to what constitutes avoidance, and what to do about it. Tax legislation may be interpreted literally or teleologically. For example, a tax holiday may be conditional on employing a given number of persons. In some countries an investor could legitimately make up the qualifying number by hiring "employees" with minimal duties and at low wages. In other countries, this course of action might be considered an abuse of the legislation and result in the denial or withdrawal of the tax privilege.

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[54] This is especially so in the case of investments that receives tax holidays.

The following are among the more common abuses associated with tax incentives:

Round-tripping. Round-tripping typically occurs where tax incentives are restricted to foreign investors or to investments with a prescribed minimum percentage of foreign ownership. It seems to be a common phenomenon in China, and partly accounts for the very high level of FDI in that country, as well as for the high levels of both inward and outward investment in Hong Kong. Typically, money leaves China and returns in the form of "foreign" investment from Hong Kong. Similar practices have occurred in a number of transition economies, especially in connection with the privatisation of state-owned firms, where the existing management has acquired ownership of the firm through the vehicle of an offshore company.[55]

Double dipping. Many tax incentives, especially tax holidays, are restricted to new investors. In practice, such a restriction may be ineffective and may be counter-productive. An existing investor that plans to expand its activities will simply incorporate a subsidiary to carry on the activity, and the subsidiary will qualify for a new tax holiday. A different type of abuse occurs where a business is sold towards the end of the tax holiday period to a new investor who then claims a new tax holiday. Sometimes the "new" investor is related to the seller, though the relationship is concealed. A more satisfactory approach may be to use investment allowances or credits, rather than tax holidays, so that new investments, rather than investors, qualify.

Transfer pricing. Transfer pricing has been described as "the Achilles heel of tax holidays,"[56] though it can be a problem with other forms of investment incentives as well. The tendency is to think of transfer pricing as a phenomenon that occurs internationally in transactions between related enterprises in different countries. Transfer pricing can also take place in a single country where an investor has two or more operations within a country or where the investor derives income from more than one activity. If one of those operations, or one type of income, enjoys a tax preference, profits will tend to be allocated to the preferred activity.

Transfer pricing is likely to take place where: (i) an investor undertakes two or more activities, one of which qualifies for an incentive (e.g., manufacturing, exporting) and another does not; (ii) an investor has operations in two or more locations, one of which is in a tax-privileged region and another is not; or (iii) an investor owns two or more subsidiaries, one of which enjoys a tax holiday and another does not. In each of these cases the investor will wish to allocate as much profit as possible to the tax-exempt (or tax-privileged) entity or activity. (In cases (i) and (ii) there may be only a single entity, in which case there is no transfer-pricing as such but an equivalent result is achieved through the allocation of revenues and expenditures.)

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[55] Round tripping is not always undertaken in order to meet foreign ownership requirements: often it is done to take advantage of favorable tax treaty provisions.

[56] McLure, C.E. Jr., "Tax Holidays and Investment Incentives: a Comparative Analysis", (1999) 56 *Bulletin for International Fiscal Documentation* 326, at p. 327.

The problems of monitoring transfer-pricing, especially for small or less-developed countries, are well known and do not need repeating here. The best advice would seem to be to use those tax incentives, if any are to be used, that are less prone to transfer-pricing abuses. For example, in contrast to tax holidays, investment allowances or credits provide an exemption from tax of a given amount, rather than for a given period. Consequently, artificial transfers of profits to a firm that has been granted an investment allowance or credit may result in tax liability being postponed but not eliminated.

Over-valuation. Over-valuation (or sometimes under-valuation) is a constant problem in any tax system. Tax incentives, however, may provide additional temptations to inflate the values of assets. For example, where a tax holiday is conditional upon a certain minimum amount being invested, the value of assets contributed to the new firm can be manipulated to achieve the target figure. Sometimes this is done legitimately. For example, firms may purchase machinery rather than lease property from independent lessors. Other times, however, an inflated value is attributed to the property contributed, especially in the case of intellectual property. In cases where investors also receive an exemption from customs duty for newly contributed capital no compensating motivation exists to correctly or understate the value, and no reason exists for customs authorities to pay much attention to the declared value.[57]

Abuse of duty-free privileges. As noted in Section III, a common investment incentive takes the form of an exemption from customs duty on imported equipment. A danger is that, once imported, items may be resold on the domestic market. A partial solution is to restrict the exemption to those assets that are contributed to the charter capital of the enterprise. Even so, it may be necessary to verify periodically that the assets remain in the enterprise. Another approach is to restrict the exemption to assets such as machinery (which are less likely to be resold) and to exclude items such as passenger vehicles and computer equipment.

Asset stripping and "fly-by-night" operations. Many countries have experienced problems with "fly-by-night" operators that take advantage of tax incentives to make a quick, tax-free, profit and then disappear to begin operations in some other country that offers tax privileges. This problem most often arises with the use of tax holidays and export processing zones. A further problem sometimes occurs where a foreign investor acquires control of an existing local enterprise, sometimes as part of the privatisation process, at a relatively low price. Instead of contributing new capital to modernize the enterprise, the investor strips it of its useful assets and simply disappears.[58]

Some countries have attempted to counter the "fly-by-night" problem by introducing "clawback" provisions. In China, for example, joint ventures with foreign participation enjoy a tax holiday of 2 years, with a further 3 years at half rate, but only provided the

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57 Sometimes there is a further problem. Foreign investment agencies have an incentive to boost their investment figures, so that there is almost a conspiracy between the agency and the investor to inflate the amount of the investment. It is thus important for the tax administration to be involved in the valuation process.

58 This latter problem is not necessarily linked to the availability of tax incentives, though the ability to make a tax-free capital gain is an added attraction to the assets stripper.

venture continues for a period of 10 years. If the joint venture is terminated before the end of the 10-year period, any tax "spared" must be repaid. The difficulty with such a provision is that the investor may have vanished before it is possible to claw back any of the forgiven tax liability.

Corruption. The existence of corruption can constitute a major barrier to foreign investment in a country. This does not, however, prevent foreign investors from being beneficiaries of a corrupt system. The granting of tax incentives, especially where the process involves a substantial degree of discretion, is one situation where there is a strong risk of corruption. In a recent report, one country disclosed that, of 35 foreign investment contracts that had been concluded, only 6 were untarnished by any kind of controversy.[59]

Bodies such as the OECD and the World Bank are now taking firm action to try to reduce corruption and provide assistance to countries to establish anti-corruption programs. One element of such programs should be the monitoring of foreign investment projects and, especially, the granting of investment incentives. If a tax incentive is subsequently found to have been improperly obtained then, in addition to any other legal sanctions, the privileges should be withdrawn and any tax that has been avoided should be repaid.

VI. CONCLUSION

Tax incentives can play a useful role in encouraging both domestic and foreign investment. How useful, and at what cost, depends on how well the tax incentive programs are designed, implemented, and monitored.

This module has attempted to examine the costs and benefits of tax incentives, the relative advantages and disadvantages of different types of incentives, and important considerations in designing, granting and monitoring the use of tax incentives to increase investment and growth.

No easy answers exist to the questions of whether to use tax incentives and what form these tax incentives should take. There are, however, some clear guidelines that may improve the chances of success of tax incentive programs. First, the objectives of the tax incentive program should be clearly set forth. Second, the type of tax incentive program should be crafted to best fit the objective. Third, the government should estimate the anticipated costs and benefits of the incentive program in a manner similar to other types of tax expenditure analysis. Fourth, the incentive program should be designed to minimize the opportunities for corruption in the granting of incentive and for taxpayer abuse in exploiting the tax benefit. Fifth, the tax incentive regime should have a definite "sunset" provision to allow for a determination of the merits of the program. Finally, the government should be required at a specific time to assess the success and failure of each incentive program

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[59] De la Paz,"The five that failed," BusinessWorld (Philippines), August 8, 2002, p.4.

VII. APPENDIX

Example : Tax Holidays and Investment Allowances

T Co. invests US $100 million in the year 2001. It sustains losses in the years 2001, 2002, 2003, and 2004 and thereafter shows gradually increasing profits.

Profit or loss: in each case, the profit or loss is calculated after taking into account the depreciation allowances (i.e., it is assumed that depreciation allowances are mandatory, but that they may produce, or increase, a loss).

The example considers T Co.'s results in four cases:

Case A: There is no tax holiday, but T Co. is entitled to carry forward losses for five years.

Case B: A five-year tax holiday is given, commencing in the year in which T Co. is incorporated (2001), but no losses from the holiday period may be carried forward.

Case C: A five-year tax holiday is given, commencing in the year in which sales are first made (2003); net holiday-period losses are allowed as a carry-forward.

Case D: An investment allowance of US $50 million is granted; unused allowance may be carried forward indefinitely and losses may be carried forward as in Cases A and C.

Year	Profit/loss (in millions)	Taxable income **Case A**	Taxable income **Case B**	Taxable income **Case C**	Taxable income **Case D**
2001	-5	0	0	0	0
2002	-20	0	0	0	0
2003	-10	0	0	0	0
2004	-5	0	0	0	0
2005	10	0	0	0	0
2006	20	0	20	0	0
2007	25	15	25	0	0
2008	30	30	30	0	0
2009	30	30	30	20	25
2010	35	35	35	35	35

It should be noted that Case B, the "simple" tax holiday, produces a *less* favourable result than does the "normal" regime (Case A); that is, the “incentive” actually produces a disadvantage.