CORPORATE TAX INCENTIVES TO ATTRACT FDI IN DEVELOPING ECONOMIES

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CEP-GLOBTAXGOV Seminar

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Agenda

- Key frameworks and concepts
- Role of tax incentives in influencing FDI
- International Good Practices: Design and administration of incentives to attract FDI
- Emerging policy questions and recommendations
Investment incentives are only one aspect of country’s broader FDI policy and promotion framework.
The advent of Covid-19 highlights four key policy dilemmas underscoring tax incentives policy

1. securing domestic revenue | promoting private sector recovery and growth
2. providing short-term relief to businesses | ensuring long-term fiscal sustainability
3. competing on cost savings | advancing different policy agendas (environment, social equity)
4. undertaking unilateral reforms | supporting multilateral cooperation
Between 2009 and 2015, out of 155 countries, 46 percent adopted new tax incentives or made existing incentives more generous.

As of 2015, out of 107 developing countries, more than half were granting tax holidays or preferential corporate tax rates across sectors at the national level.

Note: 155 countries (103 developing countries and 52 high-income, for 2009-15).
In terms of investment location decisions, political stability and security along with a stable legal and regulatory environment are the leading country characteristics considered by investors.

Incentives are second-order considerations that come to bear at the tail-end of the decision process, when investors are wavering between similar locations.

More generous tax incentives are associated with lower corporate tax revenue

- Foregone tax revenue (tax expenditures) from the reduction in firms’ tax liability can impose significant fiscal costs on governments.
- Costs of incentives are most burdensome for lower income countries, which are already struggling with revenue mobilization.
- At the international level, there is a strong, negative relationship between the generosity of a country’s corporate tax incentives and their corporate tax revenue as a share of GDP.

Note: Authors’ calculations based on data from Anderson, Kett, and von Uexkull, and WDI, covering 109 countries (72 developing and 37 high-income, for 2009-15).
To be cost-effective, tax incentives need to be strategically designed and implemented

Well-defined policy objectives

Targeted eligibility criteria

Cost-effective instruments

Rigorous M&E

Clear exit policy

Rule-based administration & strong governance

• Is the incentive conceived to address specific & measurable policy goals?
• Is the eligibility criteria tied to the specific policy goal?
• Is the incentive profit- or cost/performance-based?
• Are incentivised firms subject to frequent review and rigorous monitoring?
• Are there effective safeguards in place to prevent abuses through shifting of incentives?

• Is the incentive best-suited to address the market failure/obstacle?
• It is targeting those investors likely to be swayed by the incentives?
• Do the analytics and evidence demonstrate that the benefits outweigh the costs?
• Does the incentive incorporate a sunset-clause?

• Have alternative policy instruments been considered, weighing the advantages, challenges and risks?
• Is the eligibility criteria objective and conceived to minimize distortions to competition?
Policy discourse on imposition a global minimum corporate tax rate raises new questions on the role of incentives in driving FDI

• How will the minimum tax influence FDI location decisions for countries at different income levels, with different economic structures, and different attraction strategies?

• How will the modality of FDI corporate taxation evolve? What are the implications for tax competition if higher-income countries are able to leverage direct subsidies to compensate? Will there be a shift to incentives focused on property taxes and social security contributions? Could we potentially see a shift to non-tax platforms to other features of the country’s investment climate to attract FDI?

• What will be the impact on SEZs which are especially widespread in the developing world as a means to attract FDI?

• Does a global minimum tax signal a broader step toward international tax cooperation and harmonization efforts?
With the spotlight on tax policy, developing countries should prioritize much-needed incentive reforms

Leverage this period of change and fiscal urgency to:

Revisit incentive policy through a holistic, evidence-based approach
• streamline incentives (eliminating redundant instruments), improve targeting, and raise cost-effectiveness

Improve incentive transparency and administration
• publish tax expenditures, emphasize monitoring and compliance, and capitalize on e-digitalization trends to automate procedures

Focus incentives on sustainable agendas and public goods
• shift policy discourse to promote a “race-to-the-top,” competing on green initiatives, innovation, and skills

Re-engage on opportunities for international cooperation
• take steps to share information on incentives, and develop common solutions to address tax evasion and profit-shifting