The worst form of tax incentives: CIT exemptions

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Introduction

• COVID-19 crisis ➔ Economic crisis

• Adoption of some tax policies to deal with these effects: tax deferrals, tax credits, tax reductions, and even tax exemptions, etc.

• Crisis recovery: competition for attracting capital ➔ decrease in statutory tax rates, especially for Corporate Income Tax (CIT), narrower taxable base resulting from additional deductible costs such as the Allowance for Corporate Equity (ACE) or accelerated depreciation rules, or tax credits for multiple purposes (research and development, employment, green transition…)

• Among all these instruments, tax exemptions are the most widely used: the GTED identifies 1,613 CIT exemptions (see Redonda et al., 2021)
Introduction

• Tax matters for FDI (Djankov et al., 2010; Feld and Heckermeyer, 2011)
• However, the effectiveness of tax incentives in attracting FDI appears less convincing in empirical studies
• Tax incentives increase FDI, but these additional investments crowd out other investments cancelling the aggregate effects of tax incentives on investment and growth (Klemm and Van Parys, 2011)
Related literature

• Zee et al. (2002) and Klemm (2010) provide a qualitative overview of the design of tax incentives especially in developing countries

• Zee et al (2002) argue that exemptions are the worst cost-effective tax incentive. For them, incentives that allow faster recovery of investment costs such as tax credits and accelerated depreciation should be preferred.

• Klemm (2010) provides a set of criteria to evaluate tax incentives regimes: efficiency, transparency, predictability and stability. The author stresses that the impact of tax incentives in terms of equity is rarely studied

• However, this equity consideration concerns individuals (capital owners) as in Gravelle and Zimmerman (1984)

• Boadway and Keen (2010) argue that commodity prices boom significantly increases the profitability of extractive industries justifying a progressive tax regime and avoiding costly renegotiations
Contribution

• The purpose of this paper is to appreciate the design of tax incentive
  regimes, captured through Investment Code or Act in 44 African
  countries

• Following Djankov et al. (2010), we compute the Effective Average Tax
  Rate (EATR) of a representative firm with and without investment tax
  incentives

• We appreciate the redistributive power of the national general tax code
  and of the tax incentive regime by measuring the variation in the EATR
  when the gross profitability of the firm increases

• We build a web application that allows the user to systematically estimate
  the EATR for a firm based on our methodology when information
  about the tax system are available.
Methodology

• We considered TaxPayerCo, the representative firm in Djankov et al. (2010): a mid-size firm, which produces and sells locally ceramic flowerpots. It operates in the most important city of the country and is liable to taxes charged at the local, state/provincial, and national levels.
• We consider the first 5 years of exploitation as in Djankov et al. (2010):

\[ EATR = \frac{\sum_{t=1}^{5} \frac{T_t}{(1 + d)^t}}{\sum_{t=1}^{5} \frac{S_t - C_t - I_t'}{(1 + d)^t}} \]

• where \( T_t, S_t, C_t, \) and \( I_t' \) denote respectively the sum of taxes, turnover, total cost, and investments in year \( t \). The parameter \( d \) is the discount rate.

• We consider four main tax instruments: CIT and its eventual minimum alternative, which is usually a tax on turnover at a low rate; customs duties; and employer lump-sum contributions.

• We appreciate the total tax payment under the standard tax law and the main tax incentives regime for the considered representative firm.

• There are three types of CIT incentives: reduced rate, tax exemption, and exceptional depreciations or tax credits.
Results: The profile of EATR under the standard tax system and tax incentives regime

A. Senegal (CIT credit)

B. Morocco (Complete CIT exemption)

C. Mali (Reduced CIT rate)

D. Namibia (Reduced CIT rate)
Results: Countries’ profiles based on General Tax Code and Investment Code

![Venn Diagram showing the distribution of countries based on progressivity and regressivity in General Tax Code (GTC) and Investment Code (IC).]
Results: Tax incentives and regressivity – Investment tax code
Discussion: tax credits as best practice

• The advantage of tax credit is to insure the progressivity.

• In addition, in some cases, tax credits can provide an equivalent decrease in the EATR for a given firm, that is a firm with a given before-tax profitability.

• To confirm this result, we make two simulations. The result for Djibouti is presented opposite:
Discussion: Comparing tax expenditures by type of tax incentive

• From the GTED, we notice that CIT expenditures are greater in countries, which provide tax credit

• That illustrates another undesirable feature of CIT exemptions: They are poorly followed by the tax administration and their associated revenue losses remain largely ignored

• In some cases, tax exempted firms do not even fill their statements

• By contrast, CIT credits involve fully the tax administration, and they are provided when investments are done.

• Such a difference explains why CIT expenditures are lower with CIT exemptions than with CIT credits.
Conclusion and policy implications

• Based on 2020’s tax information, we compute the EATR of a representative firm with and without investment incentives for 44 African countries.

• We then appreciate the EATR profiles as the gross profitability of firms increases and assess whether tax systems assure progressivity.

• Under tax incentive regimes, 20 out of the 44 countries present a regressive EATR profile, with 75% of these countries using tax exemption as incentives.

• Our results provide evidence of the importance of estimating the effects of tax incentives on firms’ activity in developing countries.

• We assert that tax credits are a better alternative to tax exemption as they are easy to follow, do not induce regressivity, and in some cases generate the same level of generosity as with exemptions.

• In addition, tax credits reinforces the taxing power of the Ministry of finance (MoF).