THE ROLE OF INVESTMENT INCENTIVES IN ECONOMIC RECOVERY AND GROWTH

May 27, 2021

Hania Kronfol, Private Sector Specialist
Sebastian James, Senior Economist
Agenda

Key Policy Challenges
Emerging Issues
World Bank Country Assistance and Tools
Recommendations
The advent of Covid-19 highlights four key policy dilemmas underscoring 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.
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.


While the use of incentives is widespread, they play a limited role in investor decision-making.
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).
As businesses struggle in the aftermath of Covid-19, they place a high-level of importance on tax relief efforts.

- Over half of surveyed business were receiving some form of tax relief (e.g., tax cuts, tax credits, deferred payments) by the end of 2020.
- Tax relief was cited among the most important areas of government support for businesses to address challenges of Covid-19.
- A higher percentage of smaller-sized companies considered tax relief to be critically important compared to large companies (60% v. 47%).

Note: Computation based on the October-November 2020 Investor Confidence Pulse Survey.
Revenues fell in 2020 as compared to 2019 as the lockdowns were implemented and policy measures undertaken.

There was some recovery towards the end of 2020.

However, overall revenue in 2020 was 18% below levels in 2019 in South Asia and 6% in Eastern Europe and Central Asia.

Different tax policy measures were implemented as part of the immediate Covid-19 response effort

➢ Tax incentives were part of the overall Covid-19 policy interventions.
➢ It is not clear what part of the revenue impact was the result of different policy measures but spending and revenue measures together reached between 2% and 7% of GDP.


Most of the new tax measures were temporary or targeted

- **Business Income Tax**
  - Accelerated Depreciation
  - Extend Loss Carry-Forward
  - Tax Rate reductions for Specific Sectors
  - Tax Credits

- **Personal Income Tax/ SSC**
  - Tax Exemptions
  - Tax Rate Reductions
  - Raising Thresholds for Taxability
  - Suspension of Contributions

- **Customs/VAT**
  - Rate reduction for Medical Equipment and Consumables
  - Rate Reduction for the Tourism Sector

- **Tax Administration**
  - Deferral of tax payments
  - Tax amnesty
  - Accelerating refunds
  - Lower Advance Tax Payment
  - Suspend Debt Collection
  - Suspend Audit Activities

> **Targeted sectors** were mainly hospitality or restaurants.

> **Targeted cost-based exemptions** were mainly health-related.
Governments implemented different incentives during the crisis, expanding their generosity and/or introducing new schemes

**Examples:**

- **Thailand** increased period for 50% CIT reduction by 3 years for specific industries (medical equipment manufacture)

- **Hungary** widened the applicability of the small business regime and lowered its rate

- **Russia** introduced tax exemptions for Q2 of 2020 for SMEs and Sole proprietors

- **Somalia** introduced three months tax holiday on basic commodities
“Green” incentives are becoming more common to promote the use renewable energy and advance other environmental policies

- Taxes are an important tool to increase the cost of polluting and Green House Gas (GHG) emitting activities.

- However, taxes have their limits as excessive taxes may encourage evasion and exacerbate corruption.

- Tax incentives could be used in combination with taxes to encourage activities that benefit the environment.

- In the case of renewable energy, the overall goal is to make the tax and incentive regime when applied to the power sector to equate (or encourage) the cost of using “clean” technologies as compared to polluting technologies.
Different incentive instruments are being used to integrate “green” conditions

<table>
<thead>
<tr>
<th>Share of Countries Attaching “Green” Condition to Specific Types of Corporate Income Tax Incentives</th>
</tr>
</thead>
<tbody>
<tr>
<td>Tax holiday</td>
</tr>
<tr>
<td>--------------------------------------------------</td>
</tr>
<tr>
<td>13.8%</td>
</tr>
</tbody>
</table>

Notes:** Tax holiday, Reduced CIT, Tax credit, Extended loss carry forward/backward, and/or Accelerated depreciation; Preliminary data from 41 countries (28 developing countries and 13 high-income, for 2019). Source: Calculations based on World Bank, FCI & MTI Global Corporate Income Tax Incentives Database (under development).
Tax Competition has been one of the main drivers of the fall in CIT rates, keeping corporate collections nearly flat even while PIT and indirect tax collections have increased.

Tax avoidance by MNEs using tax havens have significantly reduced the Effective Tax Rates of MNEs.

“Pillar Two” under the Inclusive Framework is negotiating an international rules-based approach to address this problem.

Currently, a global minimum tax of 15% Effective Tax Rate for large MNEs is being proposed (as per current status of negotiations).

While this would address tax avoidance involving large MNEs, it would not put to rest the issue of competing Tax incentives for attracting medium-sized businesses.
The World Bank is supporting countries adopt an evidence-based approach to incentive design and reform

32 prior actions in lending operations (2018-2021)

<table>
<thead>
<tr>
<th>Policy Action</th>
<th>No. of Countries</th>
</tr>
</thead>
<tbody>
<tr>
<td>Publish an inventory of tax Incentives</td>
<td>6</td>
</tr>
<tr>
<td>Undertake cost-benefit analysis</td>
<td>11</td>
</tr>
<tr>
<td>Removal/Reduction of tax expenditures</td>
<td>18</td>
</tr>
<tr>
<td>Publication of tax expenditure reports</td>
<td>5</td>
</tr>
<tr>
<td>Improve governance of tax incentives</td>
<td>3</td>
</tr>
</tbody>
</table>

Global Corporate Income Tax Incentive Database

- Systematically report on the availability, conditions & generosity of corporate tax incentives for countries over time
- Key objective to inform policymakers and researchers on the type, competitiveness and (fiscal) cost of corporate tax incentives offered around the world

1. Compiling inventory of CIT incentives
2. Estimating average effective tax rates
3. Estimating tax revenue foregone
The World Bank helps countries design and implement incentives strategically

- **Well-defined policy objectives**
  - Rule-based administration & strong governance
  - Is the incentive conceived to address specific & measurable policy goals?
  - Is the incentive best-suited to address the market failure/obstacle?
  - Have alternative policy instruments been considered, weighing the advantages, challenges and risks?

- **Targeted eligibility criteria**
  - Is the eligibility criteria tied to the specific policy goal?
  - It is targeting those investors likely to be swayed by the incentives?
  - Is the eligibility criteria objective and conceived to minimize distortions to competition?

- **Cost-effective instruments**
  - Is the incentive profit- or cost/performance-based?
  - Do the analytics and evidence demonstrate that the benefits outweigh the costs?

- **Rigorous M&E**
  - Are incentivised firms subject to frequent review and rigorous monitoring?

- **Clear exit policy**
  - Are there effective safeguards in place to prevent abuses through shifting of incentives?
  - Does the incentive incorporate a sunset-clause?
The crisis presents an opportunity for policymakers to advance 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
Thank You

HANIA KRONFOL
Private Sector Specialist
Finance, Competitiveness & Innovation
Hkronfol@worldbank.org

SEBASTIAN JAMES
Senior Economist
Macroeconomics, Trade & Investment
Sjames2@worldbank.org