Tax incentives for Investment

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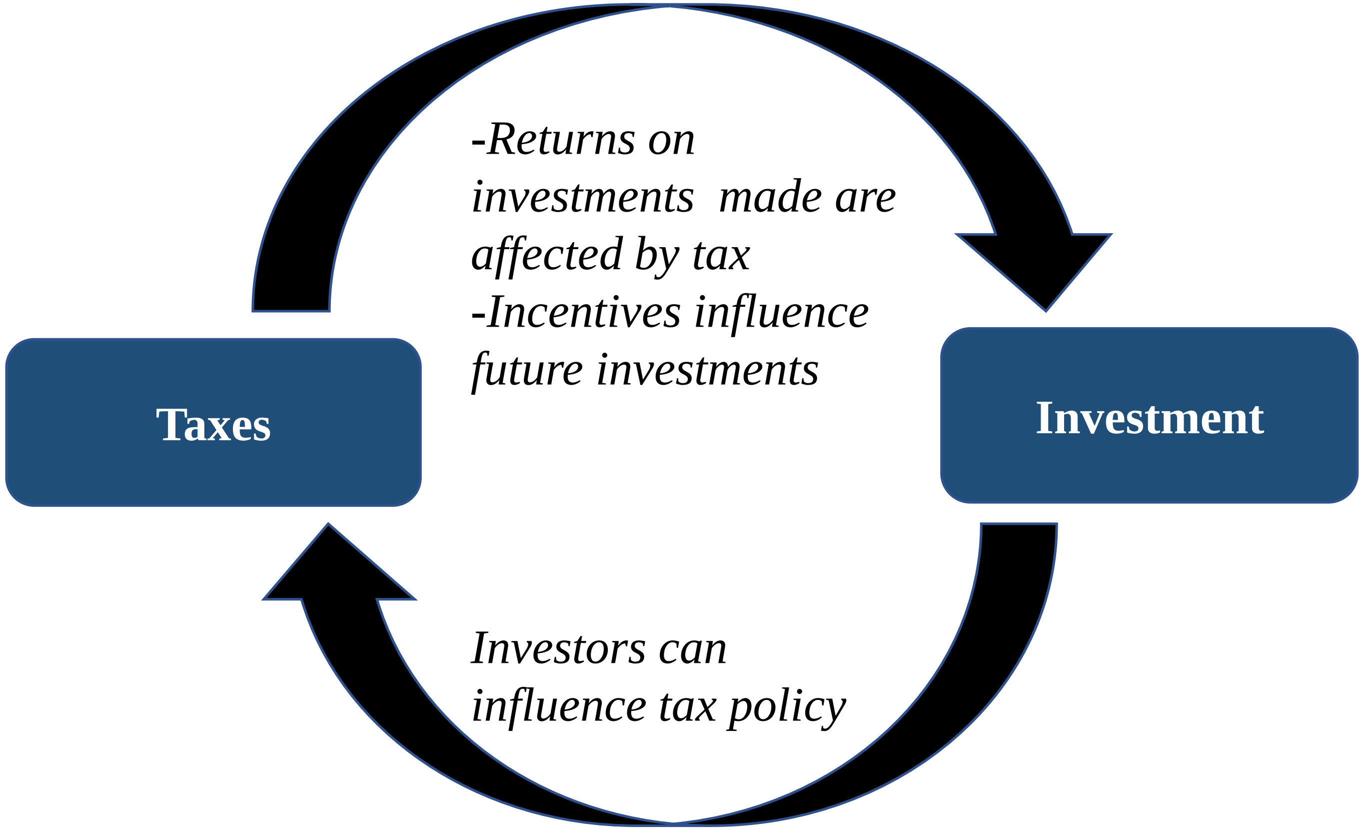
Relationship between investment and taxes



The unending debate on taxes affecting investment decisions

i. literature review finds an average semi-elasticity value of –3.72 (measuring the percentage change in FDI in response to a 1 percentage point change in the tax rate (OECD, 2007)
ii. CIT rate and tax holidays affect FDI, but not (or not robustly) total private investment or real economic growth calls for an explanation (IMF, 2009)
iii. Elasticity of foreign direct capital stock with respect to changes in the cost of capital is greater than one in developed countries (De Mooij and Ederveen, 2003) .
iv. Incentives become effective at the margin, especially for projects that are cost-oriented and mobile (UN, 1996)

Inconclusive results because you need to identify the marginal investment and compare to a situation "had there been no incentive"

It does not stop at investment

Incentive → **Investment** → **Growth**

They continue despite criticism

> ***"Despite their continuing popularity almost everywhere, tax incentives are usually redundant and ineffective: they reduce and complicate the fiscal system without achieving their stated objectives. Even to the limited extent that some incentives are effective in inducing investors to behave differently than they would have done in response to market signals, the result is often inefficient, diverting scarce resources into less than optimal uses."- ***Richard Bird

- **Developed countries use them as frequently as developing countries but these can be designed differently on the economic goals**

> ***"In developed countries, tax incentives often take the form of investment tax credits, accelerated depreciation and favourable tax treatment for expenditures on research and development. To the extent possible in the post-World Trade Organization world, developed countries also adopt tax regimes that favour export activities and seek to provide 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."***-UN

They continue despite criticism

Tax incentives worldwide

	Number of countries surveyed	Tax holiday/tax exemption	Reduced tax rate	Investment allowance/ tax credit	VAT exemption/ reduction	Research and development tax incentive	Super deductions*	SEZ/free zones EPZ/ free port	Discretionary process
		Percentage							
East Asia and the Pacific	12	92	92	75	75	83	8	83	25
Eastern Europe and Central Asia	16	75	31	19	94	31	0	94	38
Latin America and the Caribbean	24	75	29	46	58	13	4	75	29
Middle East and North Africa	15	73	40	13	60	0	0	80	27
OECD countries	33	21	30	61	79	76	18	67	27
South Asia	7	100	43	71	100	29	57	71	14
Sub-Saharan Africa	30	60	63	73	73	10	23	57	47

Source: Sebastian James, "Effectiveness of tax and non-tax incentives and investments: evidence and policy implications" (Washington, D.C., World Bank Group, September 2013).

What are tax incentives and which investments?

- **Domestic tax breaks**
- **Bilateral tax treaty withholding rates and exemptions**
- **Special recourse to alternative dispute resolution-pillar one, one time settlement?**
- **Anti-abuse provisions?**

India's experience with tax incentives

"In the corporate sector, the primary need of the hour is to infuse some confidence. The resources of this sector have to be augmented from within as well as from without, and it is therefore, necessary to provide incentives for the existing companies to plough back a larger share of their profits and also diminish the disincentive for inter-corporate investment. In this process, it seems to me necessary to make a distinction between capital intensive industries and others. The need for basic industries to grow is recognised on all hands. Therefore, selective support has to be given to these industries. I <u>am aware that all the desirable things cannot be done simultaneously. Though our present need for larger resources makes it difficult to give up any source of revenue, I am sure the changes now proposed to be made and incentives that are being provided would be appreciated and confidence would generally revive</u>."

-*Finance Minister, Budget Speech 1963-64*

"Offshore country funds are emerging as important channels for attracting foreign institutional investment particularly from non resident Indians. India made a beginning in this direction in 1989. Of late, however, there <u>are signs of diminishing interest of foreign institutional investors in off-shore India country funds. The comparative national tax structure is one of the key factors affecting the direction of international financial flow. I, therefore, propose to substantially reduce the rate of tax on dividend income received by the off-shore funds from the units of UTI or other mutual funds and on long-term capital gains from such units</u>. On dividend income the proposed rate of tax will be 10 percent as against the existing rate of 25 percent. On long-term capital gains, I propose to have the same rate of 10 percent as against the effective rate of about 45 percent at present."

- *Finance Minister, Budget Speech 1990-91*

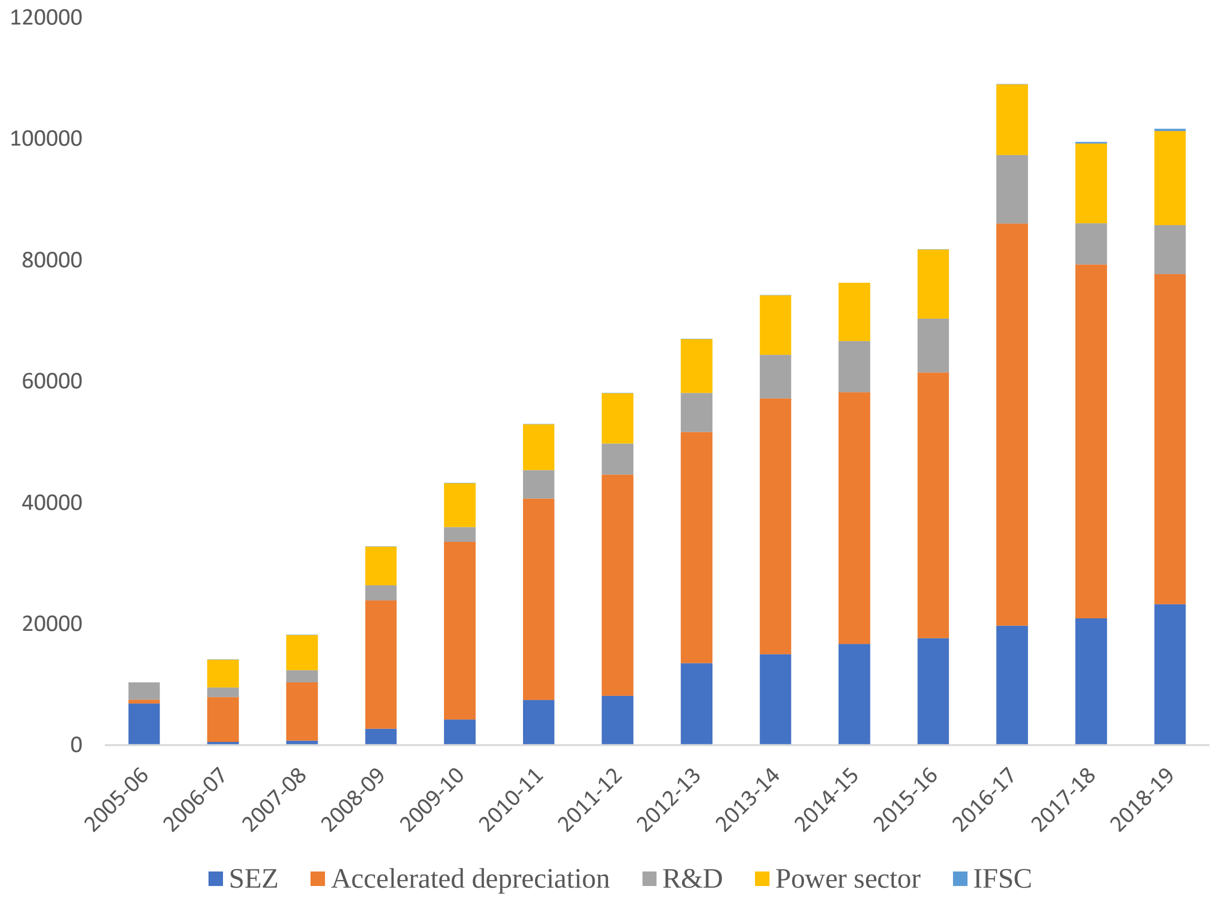
"<u>With a view to further incentivising the IFSC, I propose to further provide several direct tax incentives</u> to an IFSC including 100 % profit-linked deduction under section 80-LA in any ten-year block within a fifteen-year period, exemption from dividend distribution tax from current and accumulated income to companies and mutual funds, exemptions on capital gain to Category-III AIF and interest payment on loan taken from non-residents."

-*Finance Minister, Budget Speech 2019-20*

Incentives that continue in the ITA

- *National Infrastructure pipeline: AIF, SWF*
- *Emergence of a international financial services centre: getting around the problem of regulatory barriers*
- *Preferential treatment of capital gains from equity*

Snapshot of tax incentives in India



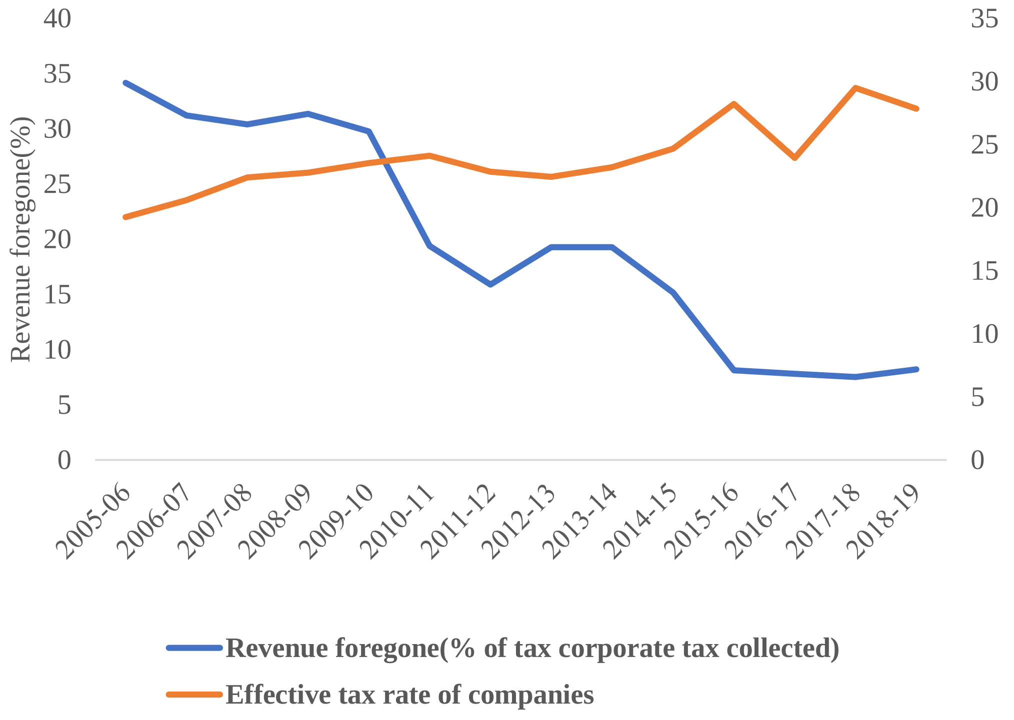
Evidence from three incentives(R&D, SEZ, backward regions)-

-The economic activity seems to have grown within the incentive regime.

-There is no clear evidence to support the conjecture that this growth in corporate activity within the incentivised activity is incremental additional activity which would not have existed if the incentive regime did not exist.

-Should the incentive such as those to power sector be removed?-context matters!

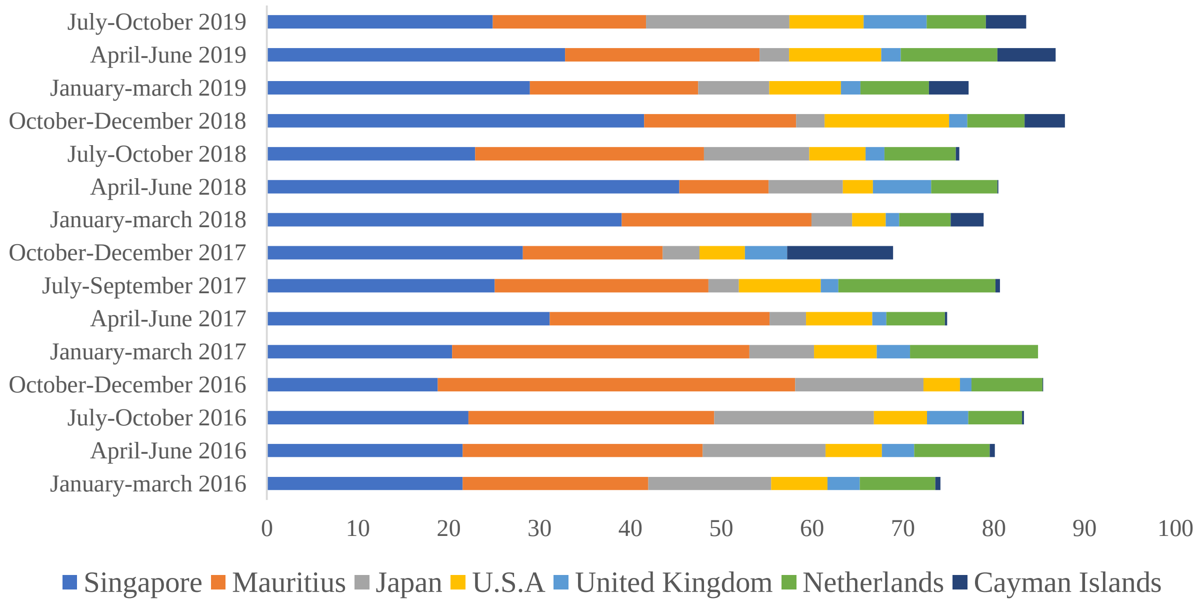
Effective tax rates of corporate taxpayers



- Over the years, the government set a sunset clause on some of these incentives such as that for developers of SEZ in 2020.
- The phasing out of the exemptions was with the idea of reducing corporate tax rates.
- This has left many foreign investors upset but the issue of to whom the incentives are to be offered i.e. <u>which investments is closely related to the economic goals?</u>

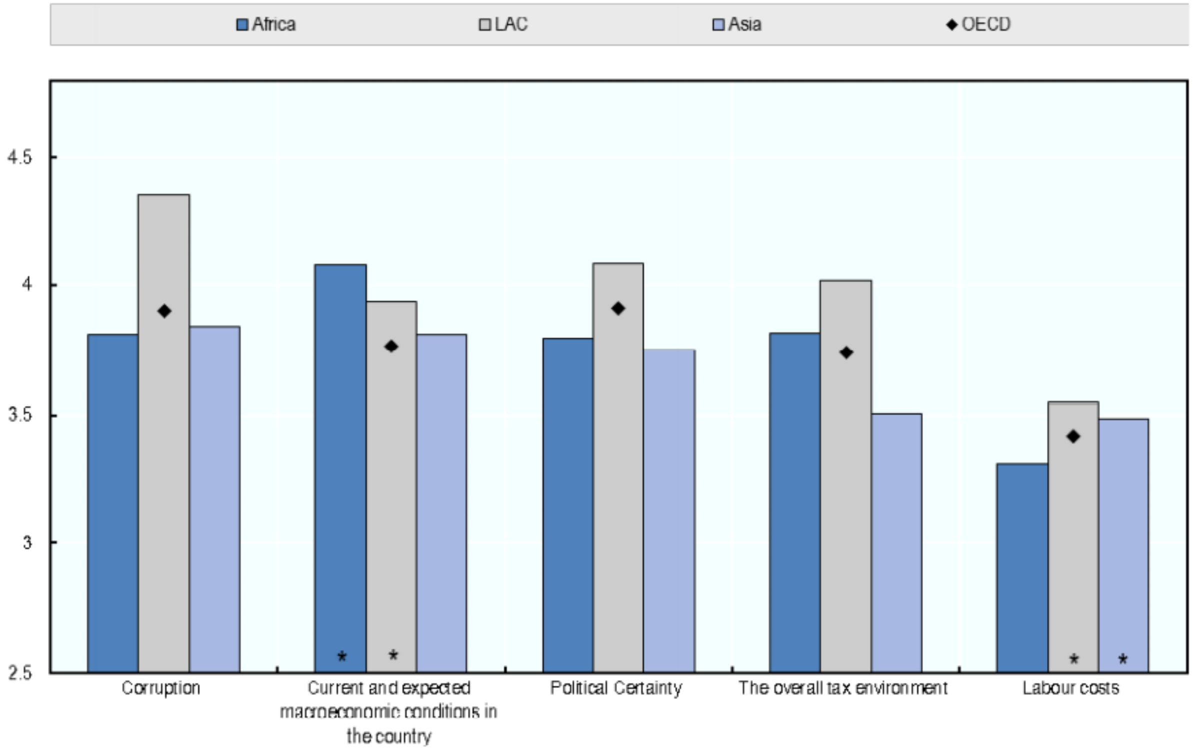
Treaties and their interplay with domestic tax rules

- **FPI, FDI- impact on exchange rate and consequences for tax**



Scourge of tax certainty

- Taxes matter?



Note: Results for the question 'Based on your experience, please assess the importance of each of the following factors for your firm's investment and location decisions. Please use a scale from 5 to 1 where 5 are extremely important and lower numbers indicate that the factor is progressively less important. If a factor is not at all important, select 1. If you have no experience or do not know, select n/a'

* denotes significance at 5%, difference between the region and OECD

Disputes and investment

- The revenue raised but not realised in currently INR 4.34 trillion and the total corporate tax revenues are INR 5.57 trillion
- Among the highest TP audits
- Cairn and Vodafone triggered many questions-source, expropriation
- APA and ARs and answer to these issues?

Concluding thoughts

- Stop non-tax incentives which may be poorly delivered and from taxpayer’s money, WTO concerns
- Other regulations must be improved and how?- labour laws should allow for contractualisation or not? For tax this is bad and for investment it is good.
- Is tax the pacifier?(second best)
- Competitive devaluations vs. tax breaks: Are taxes the substitutes for capital controls?
- Financial innovations seeking incentives-SPACs- continue and the evaluation of incentives may prove more challenging
- Influence of investors (Danzman and Slaski, 2018; Lindblom, 1977; Frieden, 1991; Strange, 1996)
- Institutional capacity, co-ordination and transparency
- No retrospective action and better DR