Investment incentives in other geographies

Sebastian James

In 2013, Jamaica under severe fiscal pressure agreed to undertake comprehensive tax reform and eliminated many of its generous and discretionary tax incentives for investment (Collister, 2013). On the passing of the legislation, the Minister of Justice, Senator Mark Golding said, "The Jamaican economy has not been well served by the existing regime of sector based incentives. The consensus is that such incentives may have been partly responsible for Jamaica's lackluster record of growth by encouraging the misallocation of limited economic resources in our country." He also explained that the reform would ensure that an equitable rules-based system is created for all players within the industry and not just those who have "access to ministerial decision-makers" (Latonya, 2013). Similar reform of the tax incentives as a result of losses to the treasury have been repeated in Uganda ("Uganda Budget – 'Tighten your belt'", 2014) and Pakistan (Anthony and Mangi , 2014) in 2014.

On the other hand, in the not too recent past, the Finance Minister of Grenada announced that the in order to encourage the resort group Sandals to invest in Grenada, the government agreed to waive the company's payment of corporate taxes for 25 years, place a cap on Sandals' property taxes for 25 years, waive all import duties for 25 years and waive the value added tax for 15 years on consumer goods. The minister announced that the benefits to the economy were an injection of US$100 million and the creation of 425 jobs ("Sandals investing US$100 million in new Grenada resort", 2012). In 2013, Malaysia announced new tax incentives for its RAPID (Refinery and Petrochemical Integrated Development) Complex which included tax exemptions for capital expenditure; and in 2014 year Italy put into law a tax credit for investments in plant and equipment.

These instances highlight the very justifiable confusion of the use of tax incentives around the world today. While they are being scaled down in some countries, new tax incentives are being provided in others. Even within countries one sees the gyrations in the policy across time. Indonesia for example, went from providing tax holidays to eliminating them for investments made after 1983 only to reverse its policy in 1994. It now offers tax holidays for certain "pioneer" industries. Wells et. al. (2001) show that the elimination of tax holidays in 1983 had no impact on the foreign direct investment (FDI) into Indonesia but the government felt pressured by a temporary dip in FDI in 1994 to re-introduce it.

Attracting FDI as well as encouraging domestic investments is an important goal for countries with the aim of creating jobs, bringing in new technology and skills and improving their competitiveness and access to international markets. Investment incentives, be they tax incentives that exempt companies from taxation either partially or fully, or non-tax financial incentives such as cash grants and loan guarantees, are commonly used to encourage investments. In trying to use investment incentives governments face the difficult task of

managing the budgetary implications that those measures entail. Hence there is a constant tension faced by governments on setting the appropriate tax and other policies that neither discourage investment nor hurt the government budget. It is not surprising that this results in policy dilemmas and reversals in policies related to incentives.

As demonstrated by the examples above, governments try to fine-tune their tax policy by offering incentives to encourage investments into certain sectors or, specific kinds of investments (as in the case of Malaysia and Italy above) or, into certain regions which otherwise may not happen due to market failures or, even to compete with their neighbors for investment (as the case of Grenada); at least that is the theory. In practice however, tax incentives are driven not only by economics but also politics. In many cases, politicians find it easy to announce new tax incentives so that they are seen to be pro-active in dealing with an economic downturn or unemployment. Further the costs of these decisions are non-transparent as they relate to forgone tax revenues sometime in the future. In other cases they are the result of governments acquiescing to “pressure” by large businesses as a condition to invest (James, 2009).

The tax incentives provided around the world that this chapter surveys reflect these varied situations and “pressures” faced by the government. They are provided by nearly all the governments in the world, they are numerous, are provided for not just in the tax laws but also in various other laws. As a result they are complex both in their design as well as their administration.

Tax incentives are further complicated by the fact that they change quite often as demonstrated by the case of Indonesia. As a result, providing a summary of the investment incentive schemes within a country is itself quite challenging and doing so for the whole world even more. In this chapter an attempt has been made to summarize the different kinds of incentives provided around the world and the manner in which they are administered. It is hoped that the reader will get a sense of their use as a tool for attracting encouraging investments by different countries of the world and how it has changed over time.

Most investment incentive “schemes” involve exemption or reductions from various taxes especially the income tax, the value added tax (VAT) and customs duties. These “schemes” may also include exemptions from property tax, and smaller taxes and fees such as stamp duty and registration fee, etc. Some countries may also provide cash incentives and “in kind” incentives such as free land (sometimes even free electricity!). Loan guarantees are also given to ensure that investments can get the required funding to get started. These non-tax incentives are highly complex and particularly challenging to identify and summarize. That being said, non-tax incentives especially cash incentives are much less common than tax incentives.[1] As a result this chapter shall focus on tax incentives offered under income tax, VAT and customs duty.

[1] I am not including other ‘incentives’ such as guaranteed pricing mechanisms, subsidies, etc. which are quite common in developing countries but beyond the scope of this chapter

This chapter does not analyze incentives that flow through international tax treaties that provide for special tax treatment for certain kinds of incomes that accrue to non-residents. These incentives have been increasingly in the news these days because of the spotlight on the low taxes that multinationals such as Apple, Google, and Microsoft pay in jurisdictions such as Ireland, Luxembourg and Netherlands.[2] These special provisions are basically tax incentives because they accord special tax treatment to certain kind of incomes for non-residents of certain countries. Another mechanism that is under scrutiny recently is the use of lax transfer pricing rules[3] and advance pricing agreements (APAs) as a tax incentive. An APA is an agreement between a multinational and the tax administration of a country that governs how the price (and hence income) is determined on transactions between agencies of the same multinational but across different tax jurisdictions. When an agreement allows for a disproportionate amount of income to accrue to a tax haven and hence lower the tax liability, such an agreement is seen as providing a special tax treatment to that multinational. The European Commission (EC) is investigating whether one such special treatment that the government of Ireland allegedly provided to Apple Operations International is prohibited under EC state aid rules (European Commission, 2014). A similar investigation is being launched by the EC against the government of Luxembourg where special tax treatment through APAs is alleged to have been provided to Amazon (European Commission, 2014). These special tax arrangements while important are beyond the scope of this chapter.

The chapter is organized as follows: first it summarizes the income tax incentives offered around the world. It then describes VAT incentives and their use in some parts of the world. Next, it briefly describes the customs duty exemptions that countries use and the increasing use of duty relief provided in Special Economic Zones as a tool for attracting investment. Lastly, it describes the different ways in which investment incentives are administered and their implications on uptake and governance of the incentives.

Income Tax Incentives around the world

Table 1 below shows the prevalence of the different tax incentives among the 153 countries surveyed.[4] Despite the differences in opinion on their effectiveness, the fact remains that income tax incentives in one form or the other are used by nearly all countries in the world.

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[2] The Dutch sandwich is an example of a tax avoidance mechanism provided through the Ireland tax treaty mechanism which exempts withholding tax from certain receipts from EU member states. This enables multinationals with specially designed structures to book tax that accrues to an Irish company to flow to a low tax jurisdiction such as Bermuda and Cayman Islands without paying any tax in Ireland.

[3] The double Irish is a tax arrangement that allow tax avoidance by multinationals through the use of Ireland's lax transfer pricing rules.

[4] In this survey, mining incentives have not been included as the tax regime for the mining sector is quite distinct from those of the others. Some countries do have a mining code that in many cases also govern the taxation of the mining sector, but in most cases the fiscal terms of most large mining projects are negotiated.

Table 1: Prevalence of Income Tax Incentives around the world

	Number of Countries Surveyed	Tax holiday/Tax exemption	Reduced Tax rate	Investment allowance/Tax credit	R&D Tax Incentive	Super-deductions
East Asia and Pacific	12	92%	75%	67%	83%	33%
Eastern Europe and Central Asia	17	82%	35%	24%	29%	0%
Latin America and the Caribbean	24	92%	33%	50%	8%	4%
Middle East and North Africa	15	80%	40%	13%	0%	0%
OECD	34	12%	32%	65%	76%	21%
South Asia	8	100%	38%	75%	25%	63%
Sub-Saharan Africa	44	80%	64%	77%	11%	18%

Source: James, 2014

Among the different regions around the world, except for the OECD countries, tax holidays, which exempt 100% of the taxes on income for one or more years are the most common tax incentive. Tax holidays are offered by all of the countries in South Asia. In some countries in the Caribbean, tax holidays could extend as long as 25 years ("Sandals investing US$100 million in new Grenada resort", 2012). In contrast, in the OECD countries investment allowances are the most common. Among the countries of Sub-Saharan Africa, both tax holidays and investment allowances are equally prevalent while among the Latin American countries investment allowances are the second most popular tax incentive (after tax holidays).

Tax holidays are frequently abused as companies have a common practice extending their tax holidays by re-organizing their business under a different name. Further tax holidays have the disadvantage as compared to investment-linked incentives such as investment allowances and accelerated depreciation in that the tax incentive is not aligned with growth of the business. The benefits provided by investment-linked incentives increases as the business expands and hence there is an incentive to grow.

Despite their disadvantages, governments continue to offer tax holidays. One reason for this might be the popularity of tax holidays with businesses. In addition to having the potential to extend their tax holidays through corporate reorganization, businesses might also favor tax holidays because, as compared with investment-linked incentives, there is a reduced (or even

complete absence in some countries) of the requirement to deal with the tax authorities. This exacerbates the problems associated with tax holidays because, particularly in those countries in which taxpayers are not even required to file tax returns, it becomes even more difficult for governments to administer the tax holidays.

Table 2: Prevalence of Tax holidays in 2000 v. 2014

	Number of Countries surveyed (UNCTAD 2000)	Number of countries with Tax Holidays	
		in 2000	in 2014
East Asia and Pacific	7	7	6
Eastern Europe and Central Asia	3	3	2
Latin America and the Caribbean	10	10	8
Middle-East and North Africa	4	4	4
OECD	8	6	3
South Asia	2	2	2
Sub-Saharan Africa	See Table 3 below		

Source: UNCTAD (2000) and James (2014)

Table 2 shows how the use of tax holidays has changed over time. In the year 2000, UNCTAD conducted a survey of the use of tax incentives around the world covering 50 countries ("Tax Incentives and Foreign Direct Investment, A Global Survey", 2000). This survey covered the main tax incentives including tax holidays. When comparing this with the incentives being offered today, overall, 96% of the sample of countries surveyed in 2000 offered tax holidays while 76% of them did in 2014. Hence despite their extensive use today, fewer countries offer tax holidays today than in 2000. This reduction is most marked among the OECD countries, which have mostly moved to using investment-linked incentives, reflecting an approach among those countries to more targeted and precise use of investment incentives.

When one looks only at the non-OECD countries, the prevalence of tax holidays has come down slightly from 100% in 2000 to 85% in 2014. Their use has remained unchanged in the Middle East and North Africa (MENA) region and in South Asia.

An extensive survey of incentives in over 40 countries conducted by Keen and Mansour (2009) illustrates their use in Sub-Saharan Africa. Table 3 shows that the number of countries offering

tax incentives including tax holidays has actually gone up between 2005 and 2014. What is most marked is the increase in the number of countries offering tax incentives in free zones from 17 out of 40 in 2005 to 27 out of 40 in 2014. In fact when one looks at the countries (Cameroun, Mozambique, Namibia, Senegal and Zambia) that did not provide tax holidays in 2005 but did so in 2014, they did so only for investments within the free zones. This is a feature (limiting tax holidays to within free zones) that is growing in popularity not just in sub-Saharan Africa. This is an effort driven by countries to limit the "damage" that a tax holiday may cause by confining the holiday to a geographically contiguous area (the free zone). Its use may reflect the need by countries to "target" these tax holidays to certain businesses (such as exporters) and for certain sectors. This issue is dealt with further later in this chapter when discussing free zones. Another interesting fact is that fewer countries in Sub-Saharan Africa offer tax incentives through investment codes or other sectoral laws in 2014 with more of the incentives being provided through the tax laws (research on this phenomenon on other regions of the world is pending).

Table 3: Tax Incentives in Sub-Saharan Africa 2014 vs. 2005

	Number out of 40 countries surveyed providing investment incentives	
	2005 (IMF Survey)	**2014**
Tax Holidays	27	31
Reduced CIT Rates	20	26
Investment Allowances	22	31
Free Zones	17	27
Tax Incentives provided through Investment Codes	31	23

Keen and Mansour (2009) and James (2014)

Table 2 and 3 indicate that the popularity of tax incentives worldwide has not significantly diminished over the last decade and, in Sub-Saharan Africa, has even increased.

The OECD countries while limiting the use of tax holidays increasingly use carry forward of losses as an incentive. The treatment of tax losses can be very valuable to businesses. This is because the income tax is a tax on income earned during the previous year. When the business suffers a loss in one year, no tax is owed, but when it earns a profit, tax is due. However, when one looks at the business not on a year-to-year basis but rather on a multi-year basis, losses in one year could be absorbed by profits in the other years resulting in reduced tax overall. Carrying forward of losses allows businesses to benefit from such a multi-year approach to taxing the income of a business. If there is a limitation on carrying forward of losses, it may dis-incentivize

businesses that take many years to become profitable, consequently discouraging long-gestation-period projects.

Table 4 shows the divergence between the treatment of tax losses among East Asian countries and some OECD countries. Except for three countries in East Asia that allow for tax losses to be carried forward indefinitely, the others do not allow for tax losses to be carried forward for more than six years with the most common being five years. Indefinite carry forward of losses is much more common among OECD countries; and the US and Canada allow losses to be carried forward for up to 20 years. Similarly, in the case of carry back of losses (which allow a loss in the current year to be allowed to be set-off against income of the previous year), seven of the OECD countries allow this while only Singapore and Brunei allow it among the East Asian countries. The difference in approach between the East Asian countries and the OECD reflects the use of tax incentives by the former as "signaling" devices (tax holidays sound more investor-friendly that a more generous loss carry forward), though the impact may be similar.

Table 4: Carry Forward/Back of tax losses in a selection of countries

	Number of years of Carry Forward, Carry Back of Losses		Number of years of Carry Forward, Carry Back of Losses
East Asian countries		**OECD Countries**	
Brunei	6,-1	Australia	∞,0
Cambodia	5,0	Austria	∞,0
China	5,0	Canada	20,-3
Hong Kong	∞,0	Denmark	∞,0
Indonesia	5,0	France	∞,-3
Laos	3,0	Germany(1)	∞,-1
Malaysia	∞,0	Ireland	∞,-1
Myanmar	3,0	Italy	5,0
Philippines	3,0	Japan	9,0
Singapore	∞,-1	S. Korea	10,0
Thailand	5,0	Mexico	10,0
Vietnam	5,0	Netherlands	9,-1
		New Zealand(4)	∞,0
		Spain	15,0
		Sweden	∞,0
		Switzerland	7,0
		United Kingdom	∞,-1
		USA	20,-2

Source: James (2014)

Apart from exempting 100% of income as in the case of tax holidays, some countries also provide reduced tax rates distinct from tax holidays which exempt only a part of the income from taxation. In many cases these are granted along with tax holidays with 100% of the income tax exempt for a few years and only a part of the taxes exempt for the rest of the period (when this is the case, it is included in the Table 1 under tax holiday). Brazil, for example, does not provide tax holidays but allows for a reduced rate of tax on income. Such reduced tax rates are most common among the East-Asia and Pacific countries followed by Sub-Saharan Africa region, with their use having increased in the latter group of countries in 2014 as compared to 2005 (see Table 3).

After tax holidays and reduced tax rates, investment-linked incentives such as investment allowances, accelerated depreciation, initial allowance and tax credits are the most prevalent. By design these incentives are superior to tax holidays because the incentive is linked to the size of the investment. As the benefits accruing to the investment are in general proportional to the size of the investment, the incentives of the government to encourage businesses to invest more in their business and, that of the businesses, which garner more tax benefits when they do so, are aligned.[5] As mentioned above, most OECD countries have moved away from tax holidays and towards such investment-linked incentives. Countries in Sub-Saharan Africa, which use tax holidays extensively, also use investment-linked incentives, with many countries using both kinds of incentives. Investment-linked incentives are least common among MENA countries.

Despite their advantages over tax holidays, investment-linked incentives are not without their problems as unscrupulous investors could artificially inflate the value of their investments in order to increase their tax benefits (Modi, 2004). For this reason the benefits of the investment allowance are sometimes capped. Malaysia for example uses generous investment allowances to encourage investments in manufacturing, tourism and agriculture sectors. The benefit accorded by those investment allowances is, however, capped at 60% of the taxable income and any unabsorbed allowance can be carried forward to set-off against income in other years. Furthermore, the investment allowance Malaysia grants in most cases is limited to five years.

This practice is not uncommon. In Burkina Faso for example, the investment allowance cannot reduce the taxable income to below 50% of the taxable income. In India the benefit of all incentives including the investment allowance (15% of investment made above $4 million) is limited as corporations are liable to pay a Minimum Alternate Tax (MAT) of 18.5% (20% with

[5] Critics have argued that such incentives distort the decision towards capital intensive investments which may not be optimal in some cases.

surcharge and tax earmarked for education) of the book profit (the book profit is calculated without providing for any tax benefits)[6].

Super-deductions, where deductions are allowed for more than the actual cost of certain expenses are most prevalent in South Asia and are used mainly to subsidize the cost of investments when starting a business. For example, in Thailand, businesses are allowed to deduct more than the actual expenditure on training of their employees as they are allowed to deduct 150% while the usual accounting treatment would only allow for deducting the actual amount. Such additional deductions are common for Research and Development (R&D) expenditures. South Africa and China allow businesses a super deduction of up to 150% of the actual R&D expenses while India and Malaysia allow 200% of qualifying R&D expenditure to encourage more of such activity.

With the exception of countries in the MENA region, which do not use tax incentives to explicitly target R&D, there is now much greater use of tax incentives by countries worldwide to encourage R&D expenditures. These types of incentives are especially common in OECD countries and countries in East Asia and the Pacific. China offers reduced corporate tax rates for companies that are granted High and New Technology Enterprise (HNTE) status (Deloitte 2013). Many countries are increasingly using a tax incentive or "Patent Box" that reduces the tax rate for income attributable to intellectual property. In the United Kingdom, this incentive allows for a lower rate of corporation tax of 10% (the main rate of corporate tax is 21%) calculated on profits earned from patented inventions and certain other inventions.

The use of incentives for businesses located in Special Economic Zones/Free Trade Zones/Export Processing Zones (collectively referred to as "SEZs")is quite popular across all the regions. These zones are generally contiguous areas that are outside the customs territory of the country and hence allow free movement of goods without duties and VAT. In many cases, income tax incentives are also included. For example in the case of South Korea's Incheon Free Economic Zone, large investments benefit from a tax holiday of up to 5 years over and above customs duty exemptions. Indeed, in some countries the tax holiday is limited to investments inside SEZs but not available to those outside these zones (Table 1 includes tax holidays if offered inside or outside these zones). Kenya and Tanzania for example offer a 10-year tax holiday for investments inside the Export Processing Zones but investments outside the zones are not eligible for it. In fact Tanzania replaced the tax holidays outside the zones with enhanced capital allowances.

Other SEZs do not provide income tax incentives. France's Verdon Free Zone/Port is an example, limiting the benefits to customs duty free, VAT and excise free imports as long as the

[6] The corporate tax rate for India in 2014 is 30% and when the surcharge and education tax is included it is 34%.

imported goods remain within the free zone (Foreign Investment Business Support - Incheon Free Economic Zone). If they are released outside the Free Zone, these taxes have to be paid.

Most SEZs are designed in a manner to attract export-oriented investment because they greatly reduce the procedural burden on imports which are primarily used for the purposes of exports. This makes them more attractive to exporters of those goods that have a significant proportion of imported inputs. The exemptions provided on border taxes (customs and VAT on imports) are discussed later in the chapter.

Exemptions and Zero-Rating under the Value Added Tax

Governments around the world offer incentives under the VAT which may be exemptions or zero-rating of supplies of goods or services (henceforth referred to simply as "supplies"). For those who are not very familiar with the VAT, a brief summary of this tax is useful to understand the role of incentives provided under this tax.

Only businesses registered for the VAT are allowed to charge VAT (the sales price times the VAT rate) and collect it from the buyer/purchaser. However, the amount collected is not entirely owed to the government. This is because the business is allowed to deduct the taxes it pays on its purchases from the tax it collects on its supplies/sales (input credit method[7]). As a result of this, the VAT is a tax collected on the difference between a business's sales and its purchases (which is the value added). Because the VAT-registered business is allowed to deduct all the taxes on inputs including tax paid on investments made into the business, in theory it is an investment friendly tax.

When a supply is exempt it means that no tax could be charged on its sale by the supplier. However, the supplier will continue to pay tax on the inputs into the production process (that are not exempt). In case a supply is zero-rated, then not only are sales of that supply not taxed, but all of the taxes paid on inputs to produce that supply are reimbursed to the supplier.

Not all exemptions are investment incentives in the sense that they are not provided with the aim to encourage investment. Some exemptions are part of the design of the VAT that needs to compromise between a wide coverage of the tax and administrative feasibility of collecting the tax. This will be discussed in detail later in this chapter.

The costs to businesses of complying with the VAT are non-trivial. Businesses have to keep track of sales that are exempt and those that are not. Furthermore, the taxes a business paid on purchases are calculated based on the invoices that it has been issued on these purchases; hence

[7] The 'subtraction' method is the other way to calculate the VAT, but this is rarely used.

businesses have to keep track of all the invoices paid on the inputs into the production process without which the taxes paid on these inputs cannot be deducted (from the taxes due to be paid to the government on sales). VAT returns have to be filed with the necessary information of exempt sales and regular sales and the correct tax rate applied when a business supplies both kinds of supplies (exempt supplies and the inputs that go into it are treated differently from regular supplies that are taxable). Because of the high cost of compliance of the VAT most governments do not allow businesses having sales below a certain threshold from registering for VAT and complying with the requirements to collect tax on sales and file tax returns (some countries allow these "small" businesses to register for VAT on an optional basis)[8].

Complications also arise in the operation of a VAT either because of the peculiarity of the sector, the difficulties in administering the VAT or, for reasons of public policy. Exceptions to the charging of the regular VAT may be classified under "out-of-scope" supplies where exceptions are granted for supplies that are not consumed locally (for example zero-rating of exports, international transport, etc.), merit or concessional exemptions (for example education, healthcare, charitable services, etc.) and "technical" exemptions (for example the financial sector, real estate, gambling, etc.). In the case of financial services the "technical exemption" is given because it is difficult to correctly assign value added. In the case of durable goods such as real estate which is consumed over a long period of time, computing value added is difficult and not practical. Policy makers further try to reduce the burden of the VAT on goods consumed by the poor such as bread and grains by allowing businesses to sell them free of VAT and further allow them to claim refunds on the taxes paid on inputs (zero-rating).

When certain supplies or businesses are exempt from the VAT the advantage is both the lower cost of compliance as well as[9] the benefit that they are not charged tax on the value added[10]. Producers of supplies that are zero-rated benefit even more as taxes on inputs are refunded. Producers from supplies that have inputs that are exempt also benefit from lower input costs.

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[8] As a result, such 'small' businesses end up bearing the tax on inputs as they are treated as final consumers and not allowed to claim any deduction of the taxes paid on inputs.

[9] Say a producer uses inputs into the production process of $100 which bear VAT of 20% and hence the total cost on inputs being $120. She then adds value of $30. Say the market price of the good with tax is given to be $150 (and the producer cannot affect this price). This is equivalent to a tax free price of $125, as 125 + tax of 20% of this amount which is $25 making the total price to be $150. Under the regular VAT the producer/seller would charge a tax of $25 from the buyer. The producer/seller will then be allowed to deduct $20 of tax paid on inputs to pay a net tax of $5 and keeps the difference of $125-$100-$5 = $20. If the producer was exempt, the producer will not charge any tax on sales but also cannot credit any tax on inputs, hence the producer gets to keep $150-$120=$30. In such a scenario, exemption is better than being taxed.

[10] Provided the sellers of those inputs have passed on the lower tax into the price of the product.

A comprehensive analysis of VAT systems around the world is very complex as there can be dozens of exemptions under a given VAT. Nevertheless, drawing from surveys done by PriceWaterhouseCoopers on VAT in Africa and the OECD on VAT in the OECD countries, Table 5 summarizes the principal exemptions and zero-ratings in Africa and the OECD for various kinds of supplies or sectors.

Table 5: Prevalence of VAT Exemptions and zero-ratings (Africa v. OECD)

	% of Countries in the region providing Exemptions			% of Countries in the region providing Zero-rating	
	Africa	OECD		Africa	OECD
Agricultural Inputs	50%	9%		32%	15%
Agricultural Produce	71%	6%		50%	27%
Transport	68%	24%		39%	30%
Real Estate	71%	100%		7%	3%
Education	93%	12%		18%	0%
Health/Pharma	79%	94%		29%	27%
Capital Goods	11%	0%		4%	9%
Fuel	7%	0%		0%	3%
Cultural	64%	97%		4%	27%
Finance (does not include insurance)	82%	100%		7%	6%
Mining / Petroleum	36%	0%		11%	0%
Charitable	7%	97%		4%	6%
Construction	7%	12%		0%	6%
Tourism inputs/services	18%	6%		4%	9%

Source: PWC, Overview of VAT in Africa – 2014, OECD, Consumption Tax Trends 2012 and James (2014)

All of the VAT Exemptions with the exception of Finance and Real Estate could be classified as incentives. As shown in Table 5, nearly all countries provide exemptions to the Finance and Real Estate sectors both in Africa and the OECD. The exemptions given to the cultural supplies include supplies such as books, newspapers, films, art, etc. VAT exemptions given to the agriculture sector are shown under exemptions specifically agricultural inputs such as fertilizers, agricultural implements, seeds, etc. The main purpose of these exemptions is to reduce the costs of inputs to the agricultural process. Exemptions for agricultural produce are for sales of agricultural commodities which are driven by the desire by governments to keep the agriculture sector out of the VAT.

In Africa, the most common VAT-related incentives are to the education, health, transport, culture and agriculture. Among the OECD countries, supplies related to cultural activities, the health sector and charitable contributions benefit from exemptions in most countries. Although there are therefore similar patterns, in Africa, governments provide more support to the agriculture, education, transport and mining sectors through VAT exemptions than the OECD countries. These differences – especially in education, transport and agriculture – may reflect the differences in the level of development of these sectors between these two groups of countries. Interestingly, the treatment of the health sector is quite similar.

VAT zero-rating is less common than exemptions and mainly targets the agriculture sector. This is done with the aim of reducing the incidence of the tax on the poor, especially for food items and hence lower prices on basic agriculture produce. Zero-rating for transport shown in Table 5 refers to the tax treatment of international transportation which is essentially treated as consumption abroad on which VAT is not levied. As in the case of exemptions, the treatment of the health sector on average is similar between the two groups of countries but divergent in the case of the education sector.

The tax incentives for VAT provide at least two advantages for businesses. First, they allow businesses to lower the prices they could charge to consumers; and second, they eliminate the need to comply with the administrative requirements of the VAT. However, tax exemptions and zero-rating (except in the case of "technical" exemptions), increase reporting requirements for businesses that provide a combination of standard supplies and exempt supplies. Further when these exemptions are part of a VAT chain, they cause breaks in the reporting along the chain (as those exempt are not required to collect tax and file returns). As a result, it makes the enforcement of the VAT more difficult for tax administrators.

Customs Duty Relief and Exemption Regimes

Duty exemptions as well as duty relief can be important tools to increase the attractiveness of the country as an investment destination.

Customs duty relief refers to customs regimes under which goods are imported with suspension of duty payment pending their re-exportation. The common forms of duty relief include manufacturing under bond, customs warehousing and duty-drawback regimes, temporary admissions for re-exportation in the same state, etc. Duty relief is used to reduce the cost of exports by eliminating all of the duties that go into the cost of production, thereby helping the exporters sell their products abroad.

Duty exemptions are full or partial exemptions from customs duties unrelated to exportation (Goorman, 2005). Hence they are exceptions made to the application of the ordinary customs tariff[11]. These exemptions may be stipulated under international conventions such as the Vienna Convention on Diplomatic Immunity or under regional agreements.

Table 6: Use of Special regimes for Duty Relief

	Number of Countries Surveyed	SEZ/Free Zones/EPZ/Freeport
East Asia and Pacific	12	92%
Eastern Europe and Central Asia	16	100%
Latin America and the Caribbean	25	72%
Middle East and North Africa	15	80%
OECD	33	67%
South Asia	7	71%
Sub-Saharan Africa	45	64%

Source: James (2014)

Duty relief is generally used inside enclaves called SEZs as discussed above. These enclaves have special schemes whereby inputs for the production of goods (destined for exports) can enter duty-free. If the final goods are sold in the domestic market they typically attract all of the taxes that have been suspended. As this regime is compatible with the WTO rules regarding prohibited subsides on exports (because the suspension of duties of goods on imports that are used in the production of products that are destined for exports is not treated as an export subsidy), they have become increasingly popular around the world. Table 6 shows the prevalence of the use of these regimes. They are most common in the regions of Eastern Europe and Central Asia and the East Asia and the Pacific and least common in the OECD though still used by 2/3rd of the countries.

This chapter does not provide a summary of duty exemptions provided in the countries around the world as it is very difficult to capture the various complex exemption regimes that are employed. Nevertheless, Table 7 provides a few country examples to illustrate some practices and provide a glimpse of the challenges to presenting a broader picture of these exemptions.

[11] The special treatment of imports such as Duty Exemptions and Duty Reliefs is governed by the International Convention on the Simplification and Harmonization of Customs Procedures (done at Kyoto on 18 May 1973 and entered into force on 25 September 1974), as amended by the 1999 Protocol of Amendment, also known as the Revised Kyoto Convention.

Table 7: Duty Exemption regimes – some examples

Ethiopia	Exemption of Customs Duty on import of all investment capital goods such as plant and machinery and equipment, construction materials as well as spare parts worth up to 15% of the value of the imported investment capital goods
Turkey	Exemption of Customs Duty on imported machinery and equipment for approved projects
Malaysia	Import Duty Exemption on machinery and equipment excluding spare parts and consumables
Zimbabwe	Rebate of duty on specified goods for the mining industry; materials used in preparation and packaging of produce for exports; goods imported for tourist zones; parts and materials imported for aircraft assembly; motor vehicle assembly; registered electrical manufacturer; pharmaceutical manufacturer, etc.

Source: James (2014)

This survey is intended to provide the reader with a glimpse of the kind of incentives through reduction or relief of customs duties. A more detailed assessment is beyond the scope of the chapter. Nevertheless these types of incentives are important due to their widespread use of duty relief schemes and with duty exemptions constituting sometimes 30% or even half of all the imports[12].

This chapter has to this point discussed certain common investment incentives offered in the different regions around the world. These incentives are exceptions to the general tax treatment and there are procedures for their applicability as well as reporting. This chapter will now discuss the manner in which these incentive regimes are implemented in practice.

Procedures for granting Investment Incentives

The manner in which tax incentives are provided and administered varies greatly across the world. Most notable is the use of discretionary procedures to provide tax incentives across all the regions. Though such discretionary procedures, investors can "apply" for a new tax incentive or duty exemption, typically to an agency outside the tax administration, provided they satisfy certain broad criteria. This essentially allows the government to "customize" the tax incentive to each investor. While, in theory, such "customized" solutions allow for fine-tuning of the incentives, in practice such a system is susceptible to corrupt practices, vitiates the business environment by introducing uncertainty to investors who may not get a similar "deal" as their competitors and delays the investment process. Despite these disadvantages many countries adopt such practices.

[12] Ibid v.

The discretion mentioned above is on the provision of the tax incentive (i.e. the incentive is not specified in the law or regulation but provided to investors who ask for it on a case-by-case basis). Discretion can also be on the "application" of a tax incentive that is already specified in the law. The tax incentive that the investor may qualify for may be specified in the tax law or investment code but generally given broad interpretation which requires an approval process. The "automatic" process on the other hand is when tax incentives are provided for in the tax legislation and there is not requirement to "apply" for them separate from the tax procedures. Taxpayers in this case directly claim for their tax incentives during tax filing or during importation. Discretionary tax incentives are also prone to corrupt practices as the "approval" is valuable for investors and officials administering them have the ability to refuse it. The "approval" in many cases by agencies outside the tax administration is not final because the tax administrations on their part have to comply with their own procedures to ensure that the tax incentive or duty exemption is correctly claimed. This makes the "approval" process an additional burden on investors as the process is duplicated.

Table 8: Discretion in the provision and application of Tax Incentives

	Number of Countries Surveyed	% of countries following a discretionary process for Investment Incentives
East Asia and Pacific	12	83%
Eastern Europe and Central Asia	16	38%
Latin America and the Caribbean	25	40%
Middle East and North Africa	15	40%
OECD	33	33%
South Asia	7	43%
Sub-Saharan Africa	45	82%

Source: James (2014)

Table 8 indicates all kinds of discretionary procedures in the qualification as well as the application of the tax incentives. Among all the regions in the world, countries in East Asia and the Pacific use discretionary procedures the most, followed by the Sub-Saharan African region, while the OECD countries use them the least. The heavy use of discretionary practices mostly reflects the use of investment codes where investors typically need to "apply" for tax incentives before Investment Promotion Agencies. One would expect that the OECD countries would completely do away with discretion and prefer a rule based system applicable to all investors in a transparent manner, but at least a third of these countries have some kind of discretion. In the Czech Republic for example, a business seeking to benefit from tax incentives should submit an "Investment-incentives Application" to the Ministry of Industry and Trade which could take up to 6 months to be approved. In India on the other hand no such pre-approval is required (i.e. the

application of the incentive is automatic) and taxpayers apply for their income tax incentives when they file their tax returns. In the case of duty exemptions in India on the other hand the business needs to apply to the Director General of Foreign Trade to benefit from the various government schemes. In Bangladesh tax exemptions are provided on application to the National Board of Revenue while in Senegal all tax incentives outside the tax code requires the approval of the Minister of Finance. In both of these examples (Bangladesh and Senegal) there is discretion on the provision and application of the tax incentive even though it is the tax collecting agency or the Ministry that is approving them. That being said, investors in many countries have the opportunity to seek an "Advance Ruling" with the tax authorities on their eligibility for a particular tax incentive. The "Advance Ruling" is a procedure laid out in the tax law where investors may seek a clarification from the tax administration on the application of certain tax provisions for example, whether they qualify for a certain tax incentive based on the tax administration's interpretation of the tax law. As this is a clarification on the law, it is not treated as the use of discretion by the tax administration.

A big driver of discretion regarding tax incentives is when it is granted through laws outside the tax and customs laws. In many countries it is provided through the Investment Code or Investment Law. This in most cases provides the handle for agencies outside those administering taxes to become involved with the "approval" process. As shown in Table 9, of the 47 countries in Sub-Saharan Africa that were surveyed, 30 provided tax incentives outside the tax laws, and in 93% of those 30 there was discretion in the granting of the tax incentive. However, among the countries that provided tax incentives only through the tax laws only 47% of them provided discretionary tax incentives.

Table 9: Tax Incentives through Investment Codes and Discretion in Sub-Saharan Africa

	Incentives in Investment Code	Discretionary incentives
Angola	x	x
Benin	x	x
Burkina Faso	x	x
Burundi	x	x
Cameroon	x	x
Cape Verde	x	x
Central African Republic	x	x
Chad	x	x
Comoros	x	x
Congo	x	x
DRC	x	x
Equatorial Guinea	x	x

Eritrea	x	
Ethiopia	x	
Gabon	x	x
Gambia	x	x
Guniea-Bissau	x	x
Ivory Coast	x	x
Madagascar	x	x
Mali	x	x
Mauritania	x	x
Niger	x	x
Rwanda	x	x
Sao Tome and Principe	x	x
Senegal	x	x
Sierra Leone	x	x
Southern Sudan	x	x
Sudan	x	x
Togo	x	x
Zambia	x	x
% of countries with Discretionary Incentives for countries with Investment Code		**93%**
Botswana		x
Djibouti		
Ghana		x
Guinea		x
Kenya		
Lesotho		x
Liberia		x
Malawi		x
Mauritius		
Mozambique		
Namibia		x
Nigeria		
Seychelles		x
Somalia		
South Africa		
Swaziland		x
Tanzania		
Uganda		

Zimbabwe		
% of countries with Discretionary Incentives for countries without Investment Code		**47%**

Source: James (2014)

Some countries have moved away from providing tax incentives through investment codes. Tanzania for example transferred all of the tax incentives provided through the Tanzania Investment Act to the Income Tax Act, Customs and VAT Acts. Recently, Senegal and Guinea have done the same though they retain some elements of discretion in their administration.

The need to move tax incentives from other laws into the tax laws is a critical first step in better managing the use of tax incentives. Providing tax incentives outside the tax laws by agencies not involved in the collection of taxes presents a moral hazard problem because those agencies are evaluated on how much investment is generated, and how many tax incentives are granted, but do not bear any responsibility for losses of revenue that may result. Despite those potential conflicts of interest, many countries have taken the power to administer tax incentives from the tax authorities and given those powers to investment promotion agencies on the ground that tax authorities are too conservative on granting tax incentives and not sufficiently "investor friendly". Yet, as Table 10 indicates, the impact on "investor friendliness" may be the opposite of what was intended. This is because when tax incentives are provided by the investment promotion agency, it actually increases the time it takes for investors to start their businesses.

Table 10: Discretion in granting Tax Incentives and Delay in starting a business

Countries Surveyed	Average delay in days for granting of incentives[13]	Tax incentive provided by Investment Promotion agency?
Serbia	6	No
Rwanda	10	No
Tanzania	15	No
Uganda	18	No
Jordan	21	Yes
Nicaragua	42	No
Burundi	47	Yes
Kenya	63	Yes
Guinea	80	Yes
Tunisia	95	Yes

Source: James (2014)

[13] Data from Investor's Motivation Surveys conducted by the world Bank Group; answer to the question "Approximately how many days/weeks/months were required to obtain the incentives over and above the time needed for standard registration and start-up procedures?"

Conclusion: Tax incentives are widely prevalent and reflect the desire of governments to support economic growth and provide value for the local economy through jobs, new skills and technology. Governments also provide tax incentives in order to diversify their economies and support activities that they hope will lead to new sources of growth that use untapped potential of the country. The widespread use of investment incentives indicates that governments continue to feel that these instruments are useful and effective tools. However there are indications that tax incentives are increasingly being limited in various ways. For one, countries are confining them to Free Zones to better target tax incentives and to limit their revenue impacts. Similarly, governments have attempted to target tax incentives by providing them on a case-by-case basis and only to those investments that provide the intended benefits. However, this has had unintended consequences, resulting in increasing opportunities for rent seeking as discretionary power can be misused.

Overall, the true impact of these incentives on investment is much harder to gauge. There is evidence that some tax incentives are not effective in meeting the intended goals that governments seek to achieve and their continued use, despite the evidence on their ineffectiveness, reflects the political economic realities (James, 2009). Further, there is weighty evidence to show that policies that go beyond tax incentives are more effective in encouraging investments than policies that focus narrowly on tax incentives (James, 2009). The goal is to have greater transparency on the costs as well as the benefits of the tax incentives so that taxpayers may be able to question their effectiveness and governments can in turn design better policies to encourage investment.

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