# Tax Policy and Investment

Nada O Eissa
Georgetown University, NBER & IGC

3rd Economic Growth Forum
Kampala, Uganda
August 22, 2019

# Outline

1. Basics
   - *i.* Definitions and tradeoffs
   - *ii.* Tax Incentives in Uganda
   - *iii.* Evidence on the impact of tax incentives
2. Tax Policy for Investment
   - *i.* Design
   - *ii.* Governance
3. Welfare Framework: Marginal Value of Public Funds
4. A Plea

# Basics

- A tax incentive is a provision that confers preferential (tax) treatment to an individual business, class of businesses or sector relative to the tax system

- A form of *tax expenditures*: public spending administered through the tax system

## Tradeoffs

- Attract capital and jobs, induce competition and raise productivity in domestic markets and ultimately improve standards of living

*but*

- Highly inefficient [distort resource allocation and incentivize rent seeking], opaque, create uncertainty

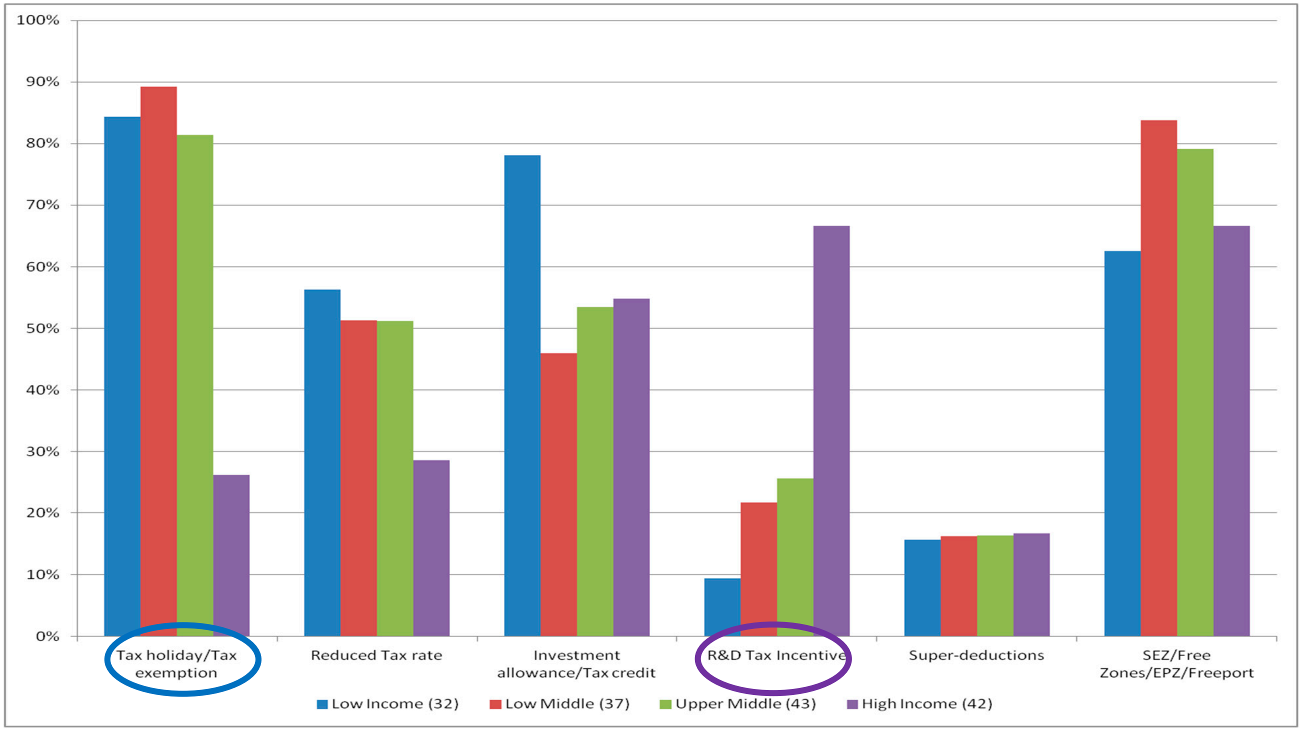
# Context: Uganda

- *Very Costly*: Tax incentives cost taxpayers UGX 900b-1,300b or 1 – 2% of GDP *annually*

| | 2011/12 | 2012/13 | 2013/14 | 2014/15 |
|---|---|---|---|---|
| | | | | |
| | | | | |
| Exempted Income | 70.5 | 142.6 | 150.6 | 101.9 |
| VAT | 607.5 | 398 | 544.5 | 115 |
| International Trade | 434 | 570.8 | 584.2 | 666.4 |
| **Total** | **1112.2** | **1111.5** | **1279.3** | **883.4** |
| | | | | |
| Share of Total Revenue | 17.9 | 15.5 | 15.9 | 9.1 |
| **Share of GDP** | **1.9** | **1.7** | **1.9** | **1.2** |

- *Wide Coverage*: agribusiness, tourism and hospitality, sports and education, steel and textile industries
- *Different Forms*: Tax exemptions/holidays to accelerated depreciation; can be discretionary

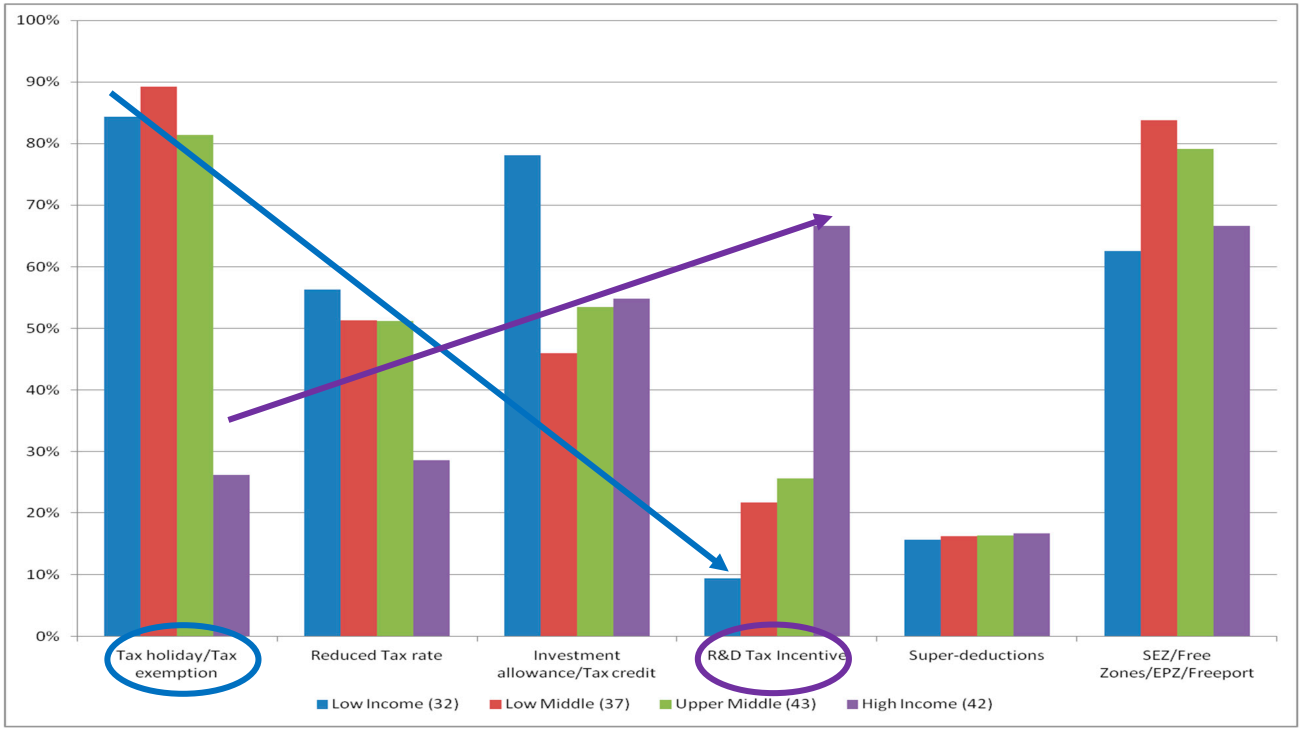
# All countries [developed, developing and emerging economies] use tax incentives




/1 Figure shows the percent of countries in each of four income groups that have the indicated incentive. The sample size per income group is denoted between brackets.

Source: IMF(2014)

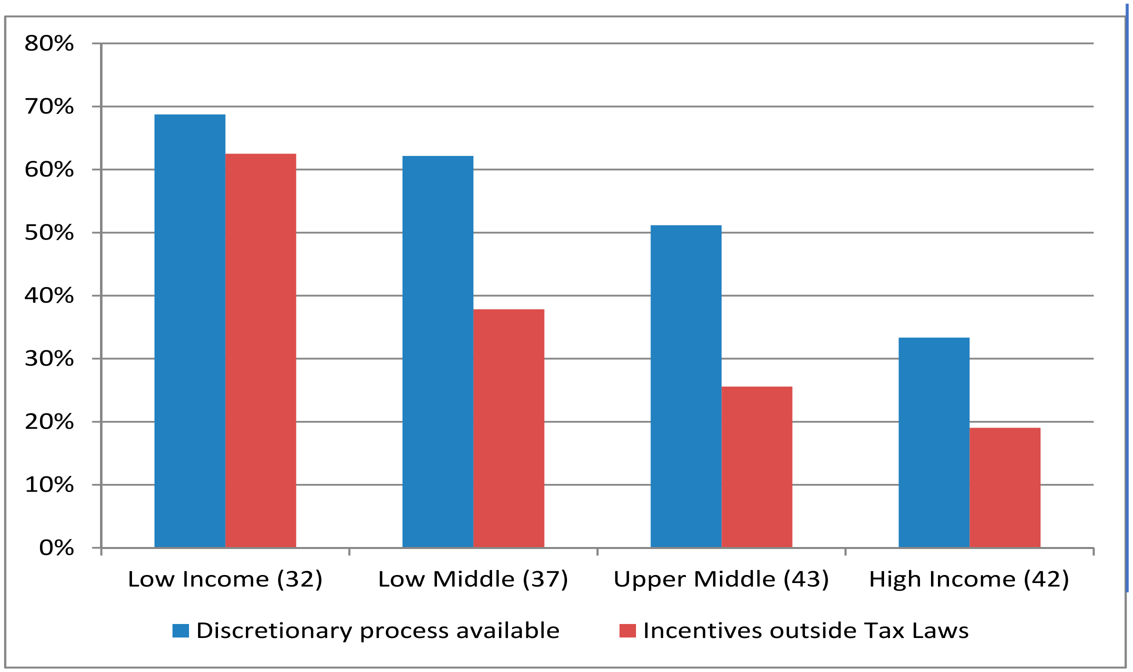
...but the form differs across countries by income. Uganda is not very different from comparable countries.




/1 Figure shows the percent of countries in each of four income groups that have the indicated incentive. The sample size per income group is denoted between brackets.

Source: IMF(2014)

# High-income countries also much less likely to use discretionary incentives



# Evidence from surveys suggests tax incentives are not a useful tool

Tax incentives *dominated* by other factors, like stable macro and regulatory environment, infrastructure, governance and rule of law [WB Business Climate]

- SSA company survey [7K/19 countries]: tax incentives 11th out of 12 factors

- 90% of investment benefiting from incentives is inframarginal, would have taken place even in the absence of incentives [Investor surveys, IMF 2014]

| | | | |
|---|---|---|---|
| Burundi (2011) | 77 | Rwanda (2011) | 98 |
| El Salvador (2013) | 37 | Serbia (2009) | 71 |
| Guinea (2012) | 92 | Tanzania (2011) | 91 |
| Jordan (2009) | 70 | Tunisia (2012) | 58 |
| Kenya (2012) | 61 | Uganda (2011) | 93 |
| Nicaragua (2009) | 15 or 51 /2 | Vietnam (2004) | 85 |
| Mozambique (2009) | 78 | Thailand (1999) | 81 |

/1 Percent of affirmative answers to the question if an incentive was redundant;

/2 51 percent for non-exporting firms outside free zones.

Source: James (2014)

# But, watch what people do, not what they say!

## Types of Analyses

*i.* Case studies
*ii.* Effective marginal tax rates
*iii.* Econometric analyses

*Evidence on developing countries is thin and ambiguous*

Evidence that taxes matter [Chen *et. al.* 2019, Abbas & Klemm 2014] and evidence that their overall impact on investment is nil [Klemm and Van Parys 2012]

# Tax Policy for Investment

- Design
  - *Tax instrument*
    - firm profits: grant special treatment to business income

      [tax holidays/exemptions, preferential rates]

    - cost of capital: reduce input cost/investment expenses/wedge between different types of capital

      [targeted allowances, tax credits, accelerated depreciation]

  - *Targeting*
    - project/sector provides well-defined *social* benefit

# A Welfare Framework for Evaluating Tax Incentives

- Marginal Value of Public Funds ($MVPF$): ratio of the ***marginal*** benefit to the ***marginal*** cost of the policy

$$MVPF = \frac{\text{"}benefit\text{"}}{\text{"}cost\text{"}}$$

- The $MVPF$ answers the question: which policy allows the government to achieve a societal objective (say, create high-wage jobs) at the lowest resource cost.

# A Welfare Framework for Evaluating Tax Incentives

- The $MVPF$ can be written as

$$MVPF = \frac{1}{1 + FE}$$

where $FE$ is the *fiscal externality* from the tax incentive; the impact of any behavioral response induced by the policy on the government's budget outlays

- $\left.\begin{array}{c}\text{newly employed workers; higher wages for workers;}\\ \text{productivity gains for competing firms (spillovers)}\end{array}\right\} MVPF > 1$

- $\left.\begin{array}{c}\text{inframarginal or displaced investment}\\ \text{(to the tax-preferred sector)}\end{array}\right\} MVPF < 1$

# Conclusions and A Plea

- Some policy recommendations are fairly straightforward
  - Opt for tax instruments that affect cost of capital rather than profits
  - Rules over discretion
  - Well-specified and measurable outcomes and monitoring
  - Granting power should be narrow and generally with MoF

# Conclusions and A Plea

- But to choose within the class of tax incentives that satisfy the criteria, we need to estimate the *fiscal externality*
  - estimating the set of possible impacts of the policy, and most critically distinguishing between investments undertaking because of the policy from those that would have occurred regardless
  - *i.e.,* we need data.

# Public Investment Management Performance and Policy Implementation

Kenneth Mugambe- Director Budget, MoFPED

Economic Growth Forum III

22nd August 2019

# State of Uganda Public Investment

1. Uganda is estimated to lose up to $300M annually due to inefficiencies in spending which must be addressed for increased rate of capital accumulation and envisaged significant positive social-economic transformation (World Bank 2017).

2. NDP I midterm review concluded that projects performance was unsatisfactory.

3. However, last two years absorption capacity has improved to 89.3% for externally financed projects and 95% for GoU projects.

4. Various reforms are underway to improve returns from Public Investment.

# Key challenges identified in EGF I

- Varying sources of project information leading to unreliable data for decision making; requires **an Integrated Bank of Projects**
- Weak legal framework: **Policy and Regulation surrounding PIMS**
- Insufficient counter part funding and budgetary allocations: Requiring rigorous compliance **to multiyear commitments project provision in the PFM Act, 2015 VS available MTEF**
- Inadequate Project Implementation capacity: **Requiring all MDAs to prioritize specialized training for public investment management**

# Key challenges identified in EGF I

- Poor Coordination among implementing Agencies, **requiring alignment of processing such as joint planning,stregtheing SWGS operation for related projects, joint monitoring, etc.**
- Supply driven projects & distortionary off-budget support; **which requires harmonization with Development Partners**
- Limited options for Infrastructure Investment financing, **which requires exploring all sources of infrastructure financing including PPPs, blending, bonds, etc.,**

# Recommended policy actions from EGF I (2017)

- Streamline project selection, preparation and appraisal before projects are approved for financing- **Done**
- Strengthen MDAs absorption capacity to implement projects through specialized training for Public Investment Management (PIM)- **Underway**
- Amendment of PPDA **Act-Underway**
- Fast-track creation of the integrated Bank of projects to align project information and create a reliable source data for decision making- **Phase one complete commencing on phase two**

# Recommended policy actions from EGF I (2017)

- Establishing the existing Government commitments through undertaking an annual stock flow and activating the asset management module  on the IFMIS. Leading to maintaining of acquired assets- **Annually**

- Streamlining PIMS in existing laws through development of PIMS policy and sector specific manuals- **Underway**

- Partnering with existing institutions such as Makerere University, UMI, Uganda service college to assist in PIMS capacity building- **Collaboration has commenced.**

| Action | Implementation | Score (1 = no progress, 2 = some progress, 3 = action achieved) |
|---|---|---|
| Streamline project selection, preparation & appraisal before projects are approved for financing | – Institutionalised the Development Committee: reviews projects inline with the Budget Cycle,<br>– Established standardised appraisal manuals, methodologies and guidelines,<br>– Put in place national parameters and commodity specific conversion factors used in appraisal | 3 |
| Strengthen MDAs absorption capacity through specialized training for PIM | – Continuous capacity building in project preparation and appraisal e.g. over 400 officers already trained across government,<br>– Partnership with local universities/Institutions to streamline PIMs training in the country. | 2 |
| Amendment of PPDA Act | **Amendments to the PPDA Act and New Regulations for Complex** and Strategic procurements are before the Finance Committee of Parliament for approval | 2 |
| Create the IBP to align project information and create reliable source data for decision making | Launched **The Integrated Bank of Projects (IBP**), an online repository of projects – however, not fully accessible by the public as yet. | 3 |

# Special Economic Zones for Uganda

MATTHIEU TEACHOUT

# What are SEZs ?

No clear consensus over exact definition and delimitation of SEZs, EPZs, Free Zones… (Farole, 2011)

For this talk, SEZs = industrial parks

(geographically delimited area)

+

incentives

(different regulatory and fiscal environment)

# Why SEZs?
# The success of Chinese SEZs…

- First 4 SEZs in China established in 1979
- 2500 SEZs today, half of the world
- Impressive statistics (Zeng, 2010):
    - 30 million jobs (4% of national employment)
    - 50-60% of exports
    - 45% of FDI


# Another perspective on Chinese SEZs

SEZs were a vector to transition from closed and centralized economy to open market economy

- Not clear if success of SEZs due to zones themselves or transition to market economy (revealed previously latent comparative advantage of China).
- Not many countries today resemble China in the 1980s.

Mixed experience in other countries:

- Average growth of SEZs similar to country growth (World Bank, 2017 using nightlight data from SEZs in many countries)
- Many case studies about mixed results/failures (e.g. India, Latin America), especially in Africa (Farole, 2011; Zeng, 2016)

# Benefits of industrial parks and SEZs

**Industrial Parks:**

- Building infrastructure and bundling public services in one place is cost-efficient
  - (Steenbergen and Javorcik, 2017, IGC paper on Kigali Special Economic Zone)
- Agglomeration economies
  - Lower transport costs (goods and labor)
  - Technological spillovers and lower information frictions (developed later in presentation)
  - Benefits from coordination and proximity (collective reputation, access to finance…)

**SEZs:**

All of the above + SEZs provide incentives … in general to attract FDI (more productive, more export-oriented, more jobs)

→ ***How important are incentives to attract FDI?***

# The role of fiscal incentives

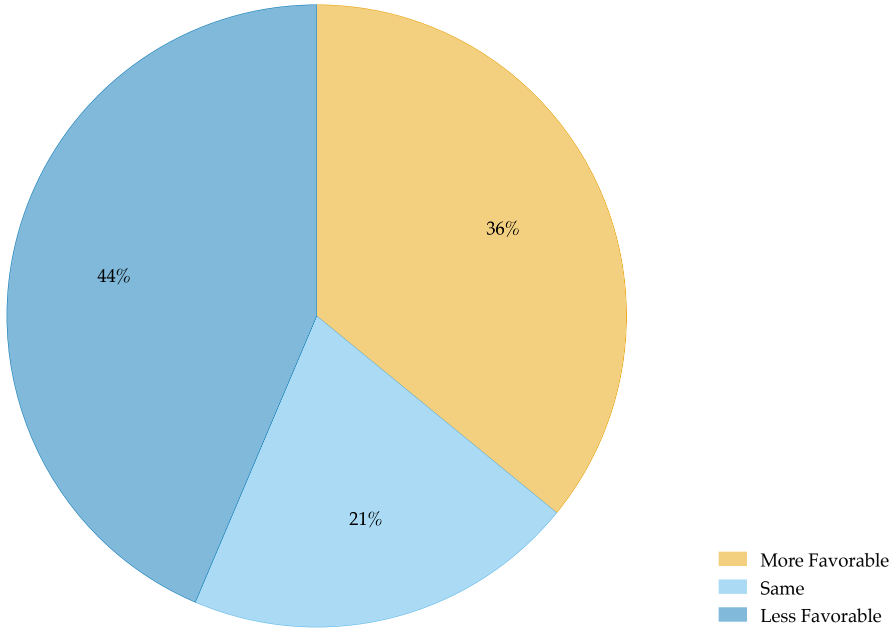
**Are fiscal incentives working?**

- Don’t play a role in explaining performance of SEZs or attracting FDI (World Bank, 2017; Farole, 2011)
- Incentives may not be most important factor in investors’ decisions (see next slide and Klemm and Parys, 2012)
- Will not compensate for other problems with business climate

**Foregone tax revenues!**

# Fiscal incentives don't seem to be most important factor for choice of destination

Were fiscal incentives in Myanmar more/less favorable than competing destinations you considered?




Source: Survey of FDI, Myanmar

# Business climate

One stop shop in the zone, streamlined procedures… have positive impact on SEZ performance (Farole, 2011 + next slide)

**Lessons from Thilawa SEZ, Myanmar**

- Autonomy of agents from line ministries in one stop shop:
  - Speeds up process
  - Allows to change mentality one agent at a time

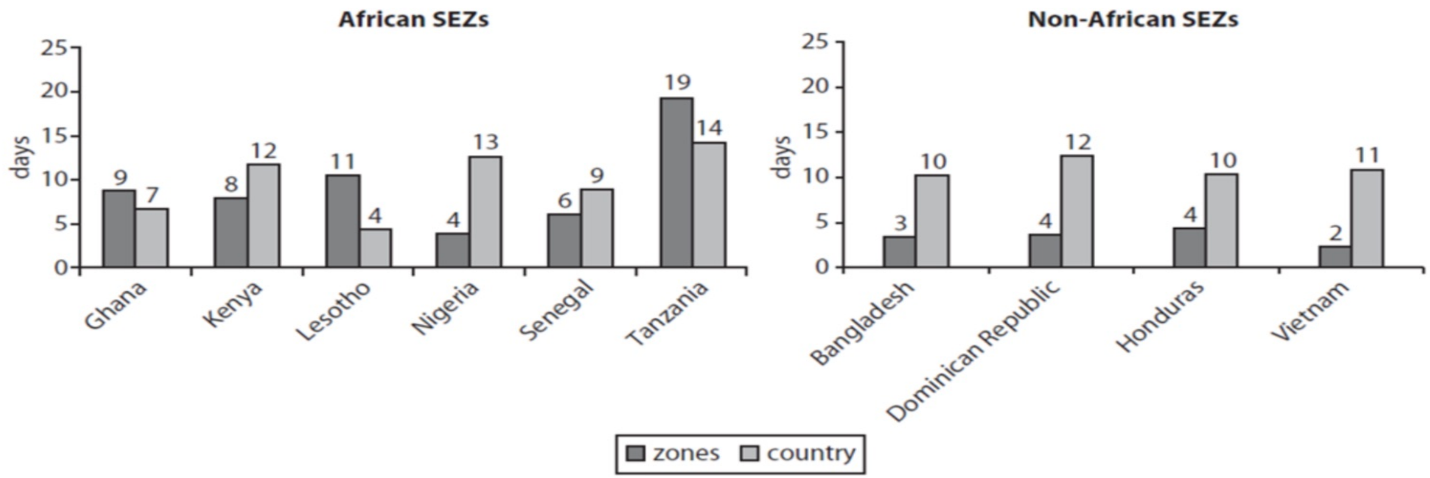
**<u>What are the main barriers that prevent firm growth and discourage foreign investors from entering?</u>**

**Towards a country and objective specific approach**

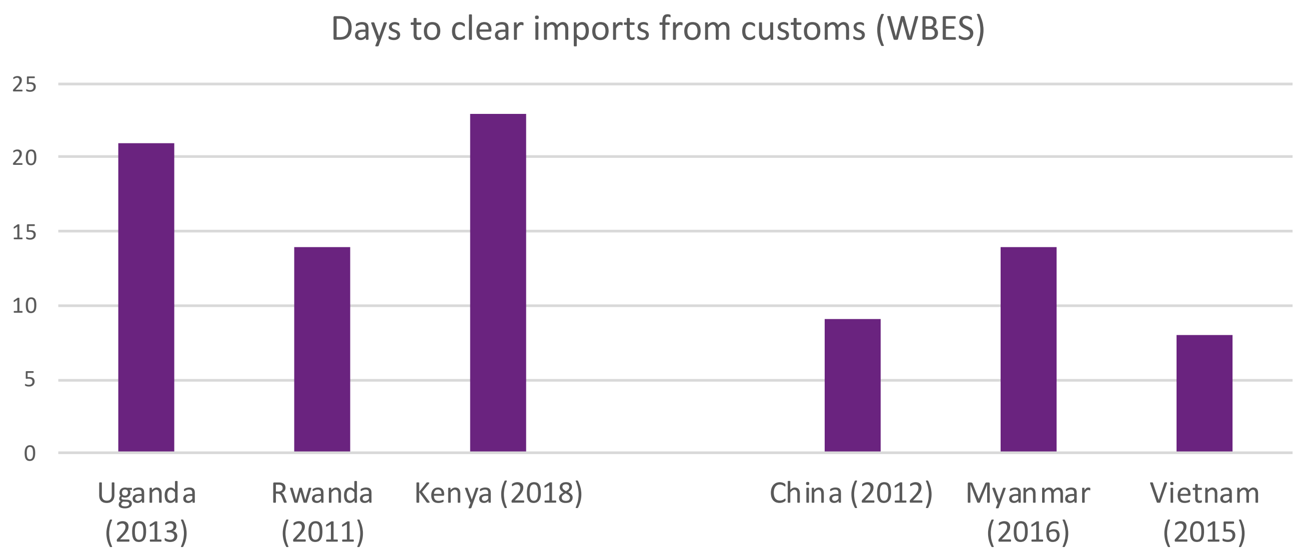
- Need analysis of current state of industrialization and exports, type of investors targeted, international benchmarking…

Easier to implement reforms in small delimited area and expand later on.

# Average time needed for imports through major seaport to customs clearance (days)




*Source:* Farole 2011.



# A framework for SEZ policy

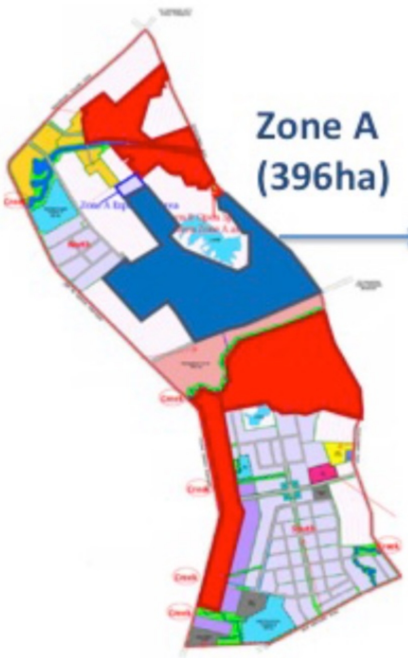
**Cost-benefit analysis:**

- Feasibility studies: **is there significant demand for SEZs or industrial parks?**
  - **LOCATION:** SEZs as placed-based policy, revitalize left behind regions
  - … but zones far from big cities have low probability of being successful!
    - World Bank, 2017
    - All 4 initial Chinese SEZs were close to Hong Kong, Macao and Taiwan
- PL statement: Economic contributions +/– Costs/Revenues (see WIR, 2019)
- SEZs may be costly (including foregone revenues), other less costly policies to create jobs?

Expected benefits of SEZs and appropriate policies to attract FDI can be unknown ex-ante.

→ **Start small!** From Chinese SEZs: *"cross the river by feeling the stones"*

# Plot Map of Thilawa SEZ Zone A



Zone A
(396ha)

# Monitoring and Evaluation

In short term, evaluate performance of SEZs:

- Investment, exports, jobs…
- Investors and workers sentiment and perceptions

Why?

- Feeds cost-benefit analysis before expanding further
- Allows to identify and adjust policies that work/don't work
- Evidence-based approach for policies to be scaled up to the rest of the economy

How? (Thilawa SEZ, Myanmar)

- Admin data (software): firm reports submitted online.
- High frequency surveys (done by text messaging for workers)

# SEZ policy in the medium/long-run

Don't want SEZs to be ***offshore assembly lines***

- Import inputs, export output
- Access to cheap unskilled labor supply
- Profit repatriation in home country
- Move once another country offers better incentives/lower trade costs

→ Very limited benefits

Spillovers

1. Knowledge and technology spreading outside the zone
2. Vertical spillovers/backward and forward linkages
   - LCUs (Steenbergen and Sutton, IGC policy note, 2017)
3. Worker training and movement
   - Guillouet, Khandelwal, Macchiavello and Teachout, IGC project in Myanmar

**Government *facilitates* spillovers**

**Identify and promote spillovers: M&E Again!**

# Summary of recommendations

1. **Work on business climate more than fiscal incentives**

- **Evidence that financial incentives are not most important factor for FDI promotion**
  - Current set of incentives for free zones in Uganda (income tax, import duties…) similar to FDI incentives (in zones) in other countries.
  - In medium-run, evaluate efficiency and rationalize current set of incentives given under Free Zones Act and other laws.
- **What are the main barriers/market failures that prevent growth of private sector?**
  - Analysis of markets, international comparison of business climate, measure main grievances of current investors and cost of these grievances: need to identify priorities!

# Summary of recommendations (II)

2. **Start small and expand**
    - Cost-benefit analysis, make sure there is demand from private sector, carefully choose locations, avoid the reputation vicious cycle.
    - Difficult to know optimal SEZ policy ex-ante, may need iteration.
    - **Interaction of Industrial Parks under UIA and Free Zones under UFZA**
        - Agencies with comparable objectives

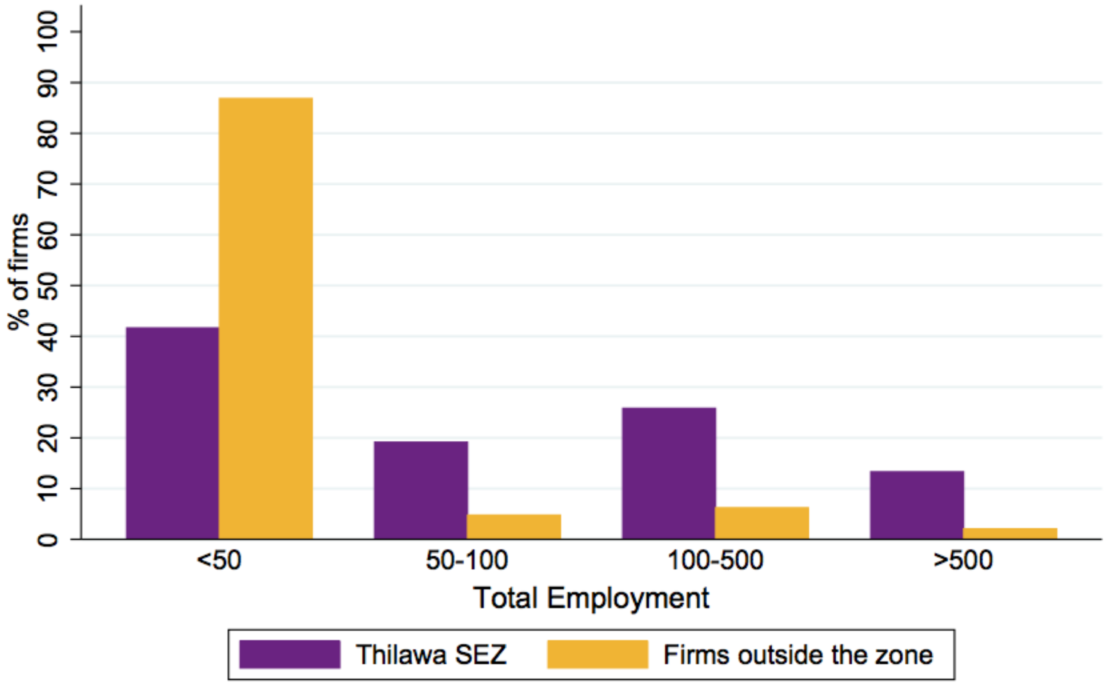
3. **Implement monitoring and evaluation**
    - Systems of data collection and management to be put in place at low cost (for government and private sector)
    - Some form of accountability on performance
    - Policy experimentation: determine policies to be implemented at larger scale

# Thank you

Readings:

- Special Economic Zones in Africa: Comparing Performance and Learning from Global Experience, Farole, 2011
- Special Economic Zones, Progress, Emerging Challenges and Future Directions, ed. Farole and Akinci, 2011.
- Special Economic Zones: Lessons from the global experience, Zeng, PEDL synthesis paper, 2016.
- Special Economic Zones: An Operational Review of Their Impacts, World Bank, 2017.
- World Investment Report, Special Economic Zones, UNCTAD, 2019.

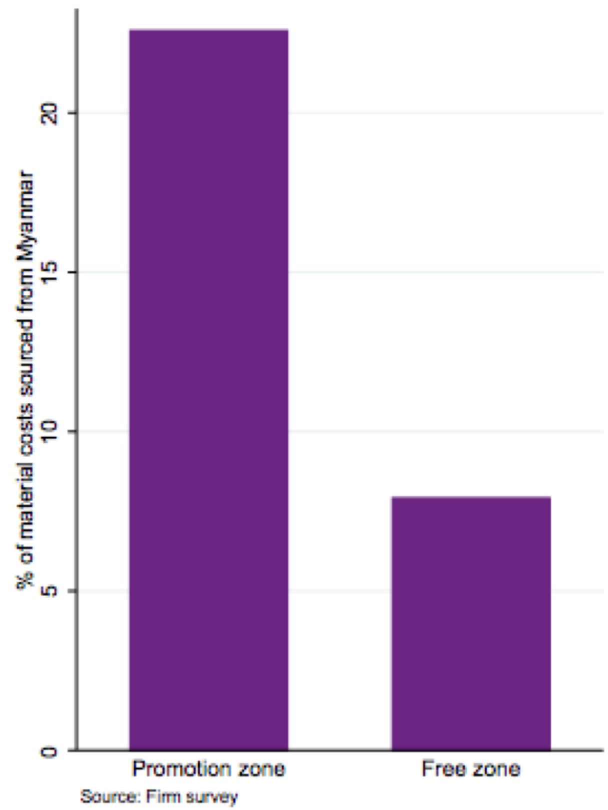
# M&E in Thilawa SEZ, Myanmar




Source: Quarterly Employment Reports and 2016 World Bank Enterprise Survey

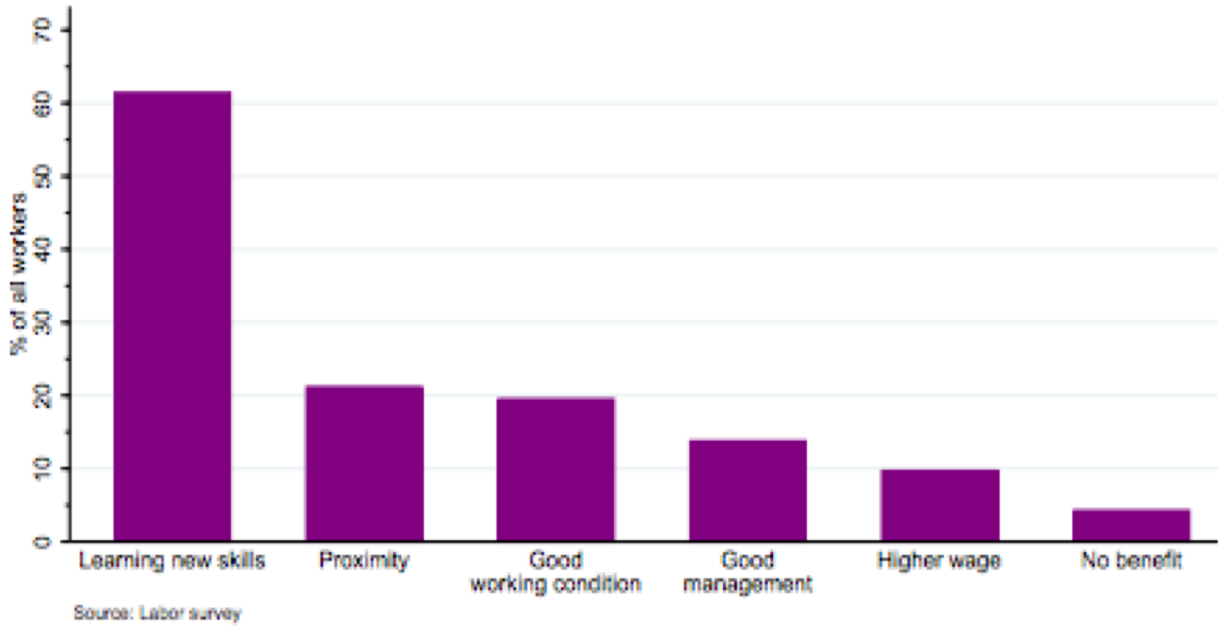
# M&E in Thilawa SEZ, Myanmar

% of material costs sourced domestically



# M&E in Thilawa SEZ, Myanmar

Most important benefits of working in the Thilawa SEZ for domestic workers



# M&E in Thilawa SEZ, Myanmar