

## Tax Holidays: Give Them a Vacation

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The Board of Investment (BoI) encourages and promotes investment in Thailand. A principal instrument is tax holidays—temporary exemption from corporate income tax and import taxes on capital equipment, raw materials and intermediate inputs. These are granted on a selective basis, depending on size of investment, export orientation, location of the new facility, and whether the investment is in a "priority" sector.

These policies are based on a belief that, without incentives, investment in Thailand would be too small, and that particular types of investments and investors need government assistance.

### A NEW GAME: PROMOTING INVESTMENT ABROAD

BoI's most recent initiative is to promote Thai investment abroad. One proposal is to provide tax incentives for outbound investment which will be similar to those for promoting investment in Thailand. They will be targeted at "priority sectors" and at investments with high levels of Thai content.

Are BoI policies based on the view that investment in Thailand is too large or too small? Traditional support of investment in Thailand presumes there is too little. The new initiatives to promote outbound investment suggest the opposite.

Economic arguments can be found for encouraging more inbound investment than would occur as a result of market forces alone. However, under current international practices, where host countries get priority in taxing income from foreign investment, there is no economic argument for the source country to give tax advantages to residents who invest abroad. Thai investment abroad generates employment for foreigners, not Thais; and it makes little or no contribution to Thai tax revenues. Thailand itself has a large and growing need for investment in infrastructure, human capital and new technologies. Subsidies to foreign investment are not needed. In fact, Thailand would benefit from increased rather than decreased taxation of its investors abroad.

Foreign investment from Thailand is not a bad thing. It is a sign of success and of the need to adjust as Thailand loses its advantage in labor intensive products to countries such as Vietnam and China, and as liberalization and growth in these countries open up new markets. Thai investors have already demonstrated their ability to take advantage of these opportunities. BoI assistance in providing information about foreign investment possibilities might be helpful to small and medium investors. But larger Thai investors are certainly far ahead of BoI in this regard and do not need BoI's help.

BoI's role in assisting and promoting outbound investment is in need of a serious review from the perspective of Thailand's economic needs. The plans to provide incentives to such investment are symptomatic of the more general problems with excessive use of tax holidays to promote investment.

### WHAT'S WRONG WITH TAX HOLIDAYS?

***Tax incentives increase the cost of the tax system and subvert the market in guiding investment decisions.***

Taxes cause inefficiency by altering the way in which investors, savers, workers and consumers react to

market signals.<sup>1</sup> However, taxes are necessary in order to raise revenues for public purposes. The goal of the tax system, therefore, should be to do this at minimum social and economic cost. This requires low marginal tax rates. Higher marginal tax rates have much greater disincentive effects; they also subsidize evasion, thus reducing the integrity of the tax system.

Tax incentives increase the rates that must be charged to others to raise the same amount of revenue. This increases the cost of the tax system. Exemptions and discretionary tax incentives also increase variability and uncertainty in the tax system.<sup>2</sup> This increases the cost of investing and encourages rent seeking. Large foreign and domestic investors have become very good at playing this game. The remaining tax payers are the losers.

***Tax holidays have hidden and unintended effects which differ from their stated goals.***

Tax incentives are intended to assist new investments, and small and medium investors. A TDRI study<sup>3</sup> has demonstrated, however, that: a) small firms that undertake risky investments and incur losses during their early years are made worse off by BoI tax incentives, while large firms in a similar position are made better off, and b) for investments that result in positive net returns from an early stage, large firms receive much greater assistance from BoI tax holidays than do small firms. In addition, the rules, procedures and conditions for eligibility are strongly biased in favor of large, well established firms and investors.

Tax holidays are a blunt instrument. Their impact on the profitability of investments differs widely by firm and sector in the economy. The resulting effects on investment are highly arbitrary and bear no relation to any conceivable economic goal of the government.

***Tax holidays are inferior to other policies which would benefit all investors.***

Tax holidays compensate for other deficiencies of the tax system. A more direct and fruitful approach would be to correct the deficiencies themselves.

If corporate tax rates are too high, they should be lowered. This could be done at no cost by eliminating tax holidays. Lowering the overall corporate tax rate would provide a direct incentive to all investors and reduce the distortionary costs of this part of the tax system.

But corporate taxes should not be reduced too much. In an open economy like Thailand's this tax should be an important revenue raising device with respect to income paid to foreigners; and furthermore it is free. Under the laws of Thailand's most important sources of foreign investment, taxes paid here by foreign companies are credited against taxes owing in their home countries. In these circumstances, a reduction in Thai tax rates would be simply a subsidy to the treasury of the investor's home country. In addition, the corporate tax on domestic investment is really just an instalment payment on personal income taxes ultimately attributable to the companies' owners and shareholders. In a country in which personal income tax collections are not water tight, this advance tax payment is useful.

Tax exemptions on imported raw materials and intermediate inputs are necessary because import taxes are too high. This calls for a reduction in import taxes, a non-discretionary form of assistance to all investors. The reduction in duties on imported machinery a few years ago had just this effect. The same should be done for all industrial raw materials and intermediate inputs.

***Tax holidays are not transparent or accountable.***

A tax holiday is a subsidy. But since it does not result in any direct expenditure of government funds, there is never any accounting for its use or its cost to the treasury. This is the kind of program that pleases bureaucrats, since it is hidden is not subject to normal rules of budgetary accountability. Lack of transparency erodes controls and information flows that are necessary to ensure proper use of the government budget to achieve national goals.

## **WILL REMOVAL OF TAX HOLIDAYS DISCOURAGE INVESTMENT?**

Tax holidays are not necessary to ensure a continued flow of investment into Thailand. Abolishing tax holidays will permit the government to provide the two most effective tax incentives of all: greater certainty about tax liabilities and lower marginal tax rates.

Research on the determinants of investment shows tax incentives to be of little importance. Investors want to make money. If they cannot make money, tax holidays or other tax incentives are irrelevant. The fundamental conditions that determine the profitability of investment include wages and skills of the labor force, quality of infrastructure, availability of raw materials, security of property rights and certainty of the legal and political environment. If investments are profitable, investors would always prefer to pay fewer taxes. But in a stable tax environment with reasonable marginal rates, this is not a major consideration. Among fiscal concerns, low marginal rates are far more important than tax holidays.

In the mid 1980's, as part of a major tax reform, Indonesia abolished all corporate tax holidays and used the resulting revenues to reduce corporate tax rates. Predictably, there was a flood of investment approvals in the months immediately preceding the change, and an offsetting reduction in applications and approvals in the months following. But the long run growth of domestic and foreign investment did not decline—indeed it accelerated. Despite a potentially catastrophic collapse of oil revenues, which had contributed over two thirds of export and tax revenues in the mid 1980s, Indonesia's per capita growth doubled in the half decade following the reforms.

## **INTERNATIONAL COOPERATION TO ELIMINATE TAX HOLIDAYS**

Abolishing tax holidays would be good for Thailand. However, potential investors will always plead that, since some other country offers special tax incentives that are not available in Thailand, they will move their money elsewhere. This will be especially so in the new global environment. As trade liberalization continues, investors will be less constrained to locate within a particular market. Investment decisions will be based more on cost than on market considerations. Regardless of their dubious merits, it will be more and more difficult for individual governments to resist investors' pleas for special tax considerations. Tax competition will increase. This will benefit large investors ("tax bandits") at the expense of taxpayers in all countries.

The political difficulties of dealing with these tax bandits would be reduced considerably if groups of countries jointly agreed, through an investment incentives code, to place strict limits on the use of tax holidays. Just as trade liberalization is made politically palatable by pretending that tariff cuts are "concessions" offered to other countries in return for "concessions" offered by them, the countries of APEC or AFTA would benefit from an investment incentives code. Indeed, since Thailand and Malaysia are likely to proceed with unilateral trade liberalization at a much faster pace than agreed in any international negotiations, development of such a code might be of much greater value than further negotiations on trade liberalization.

## **CONCLUSION**

It is time for Thailand to give tax holidays a long vacation. They increase the cost of the tax system and subvert the market; their effects differ from what is intended; there are preferable policies, especially lowering marginal tax rates, that would be more effective and would benefit all investors; their lack of transparency and accountability makes them difficult to regulate or evaluate. New tax incentives for outward bound Thai investment would make matters even worse. Unilateral abolition of tax holidays would be the most simple and direct approach. Negotiating an investment incentives code in AFTA or APEC would be useful as well.

A more general re-examination of BoI's role in the Thai economy would also be very useful at this time.

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