Geekonomics: The Use and Abuse of Tax Incentives

On a recent visit to Australia, one of us Geeks sat next to a small business owner, about to relocate to Brisbane. This businessman is a proud beneficiary of the DTI's SMEDP programme, which provides cash subsidies against new investment in machinery and land. He was approached and convinced by an investment incentive consultant to reorganise his business in a way that he could maximise his returns from the state. This included selling and then repurchasing his equipment; and moving his factory from his preferred premises, which he rented, to set-up a 'new' factory on land which he then purchased. The consultant pocketed 15% of the resulting grant and the small business owner is currently looking for ways to invest the rest in Australia.

This true story illustrates all that is bad about investment incentives: the administrative and compliance costs are high; they encourage fraud and 'rent-seeking'; they distort investment decisions; and they usually have no real impact on economic activity. Such tales are enough to keep little-Geeks up at night.

South Africa has a long and mixed history of investment incentives. It is worth retelling.

An early attempt came in the form of schemes to promote investment in poorer regions of the country. They did very little, if anything, to stimulate additional investment in the target regions and were subject to considerable abuse. These programs were eventually discontinued and nothing but empty warehouses remain.

Since that time the government has attempted two other selective direct tax incentives.

A tax holiday program was introduced in 1996. It was terminated in 1999 and replaced by a general incentive in the form of a reduction in the corporate tax rate from 35 to 30 percent. The 1999 Budget Review described this change in approach as part of a strategy to "eliminate special tax preference schemes which only benefit particular industries or narrow sector interests and which, over the long run, compromise horizontal equity."

This approach did not last long and the Strategic Investment Program (SIP) was introduced in 2001. The SIP was aimed at promoting strategic industries through an investment tax allowance and the legislation set out processes and criteria for judging applications. The program was given a four-year time horizon and a budget of R10 billion in tax allowances.

Despite careful analysis of the sustainability of the investments, a number of SIP-approved projects never got off the ground. Many that did start up have already failed. A significant number of other projects are in protected, non-competitive, capital-intensive upstream industries whose need for the incentives is uncertain, and whose domestic pricing has become a barrier to the development of labour-intensive downstream industries. Claims about job benefits, especially indirect employment creation are difficult to verify and almost certainly exaggerated.

South Africa's experience is far from unique. A recent McKinsey study on Brazil, China, India and Mexico finds that investment incentives "…are largely ineffective. Worse, they are frequently counterproductive, costing governments millions of dollars annually, protecting inefficient players, and lowering living standards and productivity". This study also confirms that investment incentives are among the least important factors for firms in making strategic investment decisions.

If all the evidence points to the fact that tax incentives have little effect, if any, on attracting new and especially good new investments and the costs of incentives are high, why do governments continue to offer them?

A large part of the reason lies in rent-seeking by a relatively narrow but well organized group of beneficiaries. Regardless of whether incentives are necessary, firms will happily seek and accept them if they are available. Certain industries have become quite effective in this game and a new industry of "incentive advisors" has emerged. While the benefits might be large and concentrated, the costs of tax incentives are spread over a much broader and more dispersed group of stakeholders—taxpayers and consumers.

Not only are the costs of tax incentives widely dispersed, they are also largely hidden and often unknown. The economic waste of inefficient and non-competitive investments that are made possible through tax incentives is not well understood.

Investment incentives are also an easy policy to implement. Passing an amendment to a tax law and granting new incentives under it is certainly much easier than reforming an entire regulatory environment, dealing with state and private monopolies and reducing red tape and corruption. Moreover, they are generally implemented by an agency that is not responsible for the foregone revenues. Each incentive granted is an accomplishment, regardless of the economic value of the investment created.

Finally, Governments are excessively concerned with “keeping-up with the neighbours”. This is understandable. An obvious ploy used by companies and consultants seeking investment incentives is to find a comparator country that offers “better” incentives than the one in question.

The investment environment in almost all countries is plagued by much more important problems than the tax system. Tax incentives should not be a substitute for dealing with such problems. As for the fiscal system, the best tax incentive of all is a stable and simple regime with low rates.

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