The importance of defining corporate income tax incentive objectives in order to enhance their effectiveness

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Abstract

For the state budget any tax relief means tax revenue not received. Thus, on one hand, every tax relief provides support to a definite group of tax payers; on the other hand, it makes the tax administration process more complicated and costly. Corporate income tax relief is a tool to ensure economic competitiveness, attract new investments, correct market shortcomings and achieve social goals. Often, these incentives can significantly reduce the budget revenues, in particular – in case when more and more new relief incentives are introduced. In certain circumstances, such incentives do not function as an effective instrument for achieving economic and social objectives, and the benefits acquired are not adequate to the amount of resources spent on the administration of these incentives. In geographically and numerically small countries like Latvia, the opportunities of tax element (object, subject, rates, incentives, etc.) usage as a tax instrument for the regional development are not addressed. This paper will assess the efficiency of income tax relief incentives in Latvia in the given economic conditions while taking into account their economic and social significance at the current moment and will attempt to forecast the potential impact on the business environment incentives, if tax reliefs are differentiated for different regions of the country to stimulate the disadvantaged ones.

Evaluation of tax incentives has been developed in international practice and methodology. The guidelines worked out by Organization of Economic Cooperation and Development (hereinafter – the OECD) and International Monetary Fund (hereinafter – the IMF) will be taken into account in this report (OECD 2010; Klemm, Van Parys 2009).

Keywords: tax incentives, taxation, revenue, expenditure

Introduction

Tax incentives can be defined as any deviations from the laws of the general tax system established by the country; they envisage a decrease of the tax burden or a more favorable tax treatment to a taxpayer (or a taxpayer group) provided the taxpayer (or the taxpayer group) corresponds to certain statutory characteristics defined by the tax legislation (income levels, economic activity, region).

Proper application of tax incentives can significantly increase the country's competitiveness in the field of investment attraction, as investors choose the country with the most favorable tax policies for enterprises in order to acquire a bigger share of profits, which would facilitate a faster return on investment. The actuality of this issue in their scientific research have been emphasized both by economists in Russia: Arhipceva L.M., Gorbova N.S., Libman A.M., Karasjev V.I. and by such recognized experts as Zodrow G.R., Mieszkovski P., Oberender P., Cachej M., Feld L.P., Gordon R.H. as well as by many others.

In international practice, a broader term – "tax expenditures" – is used to denote tax relief – respectively, the expenses resulting from the existence of tax relief (income foregone). By "Tax expenditure" are understood any legal or regulatory provisions or practices that reduce or defer tax payments to a taxpayer group compared to the standard rate of tax. Since tax expenditure is not actual budget expenditure, the amount of expenses will be notional, or relative, assuming evaluation of the charges in general (ESAO 2010; OECD 2010).

Tax expenditures can take different forms: the exemptions in the taxable amount, tax-free base part (such as non-taxable minimum), reduced rates, deferred tax payment or a reduction in tax liability.

Tax incentives may have different objectives, the most important of them being: compensation for the high rates in certain categories of taxes, increasing the competitiveness of a country in the field of taxation, and what is the most important – the attraction of new investments. Tax relief is a rational response to tax competition, since they allow implementing a competitive tax system for mobile capital by applying higher rates for the rest of the capital. Corporate income tax incentives are introduced to meet social objectives as well to support certain economic sectors or to promote economic activities in specific regions. Some other factors why tax incentives exist are the following: correction of market shortcomings, promotion of income redistribution, economic stimulation of certain sectors and regions as well as reducing the administrative burden. This paper aims to evaluate the adaptation practices of tax incentives in Latvia and define the primary criteria for the classification of the objectives and their potential impact on the business environment incentives if tax reliefs are differentiated for different regions of the country with the aim to stimulate the depressive regions.

Factors determining the need of corporate tax incentives

One of the key factors for business development is the attraction of new investments; therefore, so many of corporate income tax incentives are designed to encourage investment in a particular business sector or a region, or in the national economy as a whole. In this case, it is necessary to balance tax incentives with the potential return on investment. Investors' attitude towards the amount of the tax burden depends on the available risk-return opportunities – the more attractive they are, the fewer objections there are against a higher tax burden. Similarly, in addition to the tax rates, the complexity of tax law and administration is also an issue for investors, especially, when compared with tax policies in other countries. Overly complex tax policy will increase investors' costs and reduce their interest in investing. It should be noted that a higher tax burden for investors is acceptable in case of positive business climate, favorable market, geographical location, and other favorable factors.

The stability of tax policy is extremely important for investments, as all too often reforms, even if they are simple and clear, cause investors to become uncertain about their future. Good tax policy principles apply also to tax incentives, including their transparency and predictability. In making their decisions, investors must rely on the stability of certain tax incentives before making larger investments.

Tax incentives are often considered a simple solution to the problems of tax policies, as these incentives are relatively easy to incorporate in the draft budget, which seemingly does not require extra costs, unlike the development of infrastructure, human resource training or other programs that promote investment. However, these benefits can often significantly reduce the budget revenues, since they can be used by companies outside the specific target group as well, which does not contribute to further attraction of investment.

The government, regularly assessing the effectiveness of tax incentives and lifting them in case of poor efficiency, should not at the same time jeopardize investors' long-term plans, since repealing of tax incentives, even if they have turned out to be faulty, undermines the credibility of government policies thus reducing its capability to leave a positive impact on investors' behavior in the future.

Once tax policies permit tax incentives, before introducing them the potential costs and benefits must be estimated, as it is essential to know whether the goals will be achieved and whether the costs involved will not be too high. It should also be noted that apart from income foregone, the introduction of incentives may incur also other costs, such as an economic distortion caused by establishing more favorable treatment of a certain investment group, increased administrative costs in order to prevent unintended scheme encounters, additional social costs or an increase of corruption.

In general, the corporate income tax incentives are judged by the lost revenue method (means that do not become part of the budget). However, as far as possible, their effects on the economy as a whole, which is not always a fully identifiable figure, should be examined as well (OECD 2006; Klemm 2009).

When deciding on a place of business start-ups, it is important not to considering the territory which offers a lower rate of corporate income tax, but rather the one which offers a lower effective rate of corporate income tax, which is determined by taking into account the corporate income tax incentives.

In Latvia there has continuously been one of the lowest effective corporate income tax rates in the EU (since 2004). During the period from 2002 to 2008, the average effective corporate income tax rate in Latvia was 10.3%. The effective rate is calculated by taking into account company income, interest payments, rent for the land, dividends, and insurance payments (EU 2010).

As shown by the international practice, the corporate income tax affects business investment plans, as it reduces the return on investment. In view of the global tax competition, corporate income tax also has an impact on business site selection. The corporate income tax rates should be proportionate, since the capital is among the most mobile and flexible means of production. However, a significant impact on the investment is left also by the overall business environment, including public infrastructure and labor quality level, which in turn have a positive impact on budgetary expenditure, which may be implemented thanks to tax revenues, including the corporate income tax.

Tax economists Libman, A. M. (2004), Zodrow, G. R., Mieszkovski, P. (1986) and Oberender, P., Cachej, M. (1997) in their scientific publications note that there exists a fairly common belief that the most efficient and less harmful to competition is a tax system, which combines a broad base and low rate. It should also be noted that the efficiency of incentives for achieving the objectives declines at a lower rate. However, tax systems worldwide are designed with various exceptions and limitations, by implementing various tax incentives. The idea that territorially and numerically small countries do not need to differentiate the taxation components: rates and tax incentives according to the level of development of the regions, leads to the situation when regions further away from the capital, practically do not develop. It is not profitable for entrepreneurs to invest in areas with poor infrastructure, if they do not meet support of the government. An expert of Finance Academy under the Government of Russian Federation Arhipceva LM (2004) indicates to possible solutions how by supporting public investment into regions, businesses can be activated in the regional areas; meanwhile she indicates that the administrative functions need to be reinforced. In the authors' point of view, in Latvian conditions a more effective solution is feasible by setting lower corporate tax rates and higher tax reliefs in depressive regions. This would facilitate the development of entrepreneurship in these regions and contribute to application of tax policy as an instrument in the processes of corporate financial management.

Classification of corporate income tax incentives according to their objectives

For analytical purposes, the existing corporate income tax incentives in Latvia can be divided into: incentives pursuing economic objectives in order to encourage business, industrial development and investment attraction; temporary support measures during the crisis period (for banks and companies) by establishing time-limited incentives; corporate income tax incentives for industries to support (agriculture, airlines, shipping, financial sector) envisaged to implement the national policy interests by means of the tax policy; regional incentive goals – the development of a territory; and social objectives in the form of support for disabled workers or support for donation.

Variety of objectives points to several conclusions: corporate income tax allowances are not focused on one goal; a wide set of goals in itself makes it difficult to evaluate the effectiveness of incentives; the interaction of the objectives and overlapping of aid makes targets less clear; support only to certain sectors of industries raises the issue of the specific situation of these industries in relation to the policies of the respective branch.

On the other hand, various preferential allocations take into account the needs of the industry sectors and the tax burden is set more appropriately for the particular situation.

Relatively, corporate tax incentives may be grouped as following:

- incentives to encourage investment;
- support during the crisis period;
- incentives for industries;
- incentives for social objectives.

Incentives to encourage investment

There are different corporate income tax incentives to encourage investment, and their importance and economic efficiency are high. Analyzing the EU countries' experience in the application of this incentive, the most extensive practice could be found to exist in Belgium, where the tax allowance for investment is set at 3% – 30% of investment costs, by providing special incentives 12.5% – 22.5% for the write-off of those fixed assets in which investments have been made. Another important feature is the tax incentives for investment in research and development, which in Belgium are set at 33.9% of the amount invested. As for small and medium companies – the relief depends on the amount of taxable income and ranges from 24.98% – 35.54%; moreover, the company can reduce the taxable income by 13,250EUR a year for each employee working in the research sector.

In certain regions of France until 31 December 2009, newly established companies were granted a tax exemption for the first 23 months, gradually reducing the incentives to 75%, 50% and 25% in each of the successive 12-month periods with the following total limit – the tax deduction could not exceed EUR 200,000 in the period of three years. In France the tax relief for research and development accounts for 30% of the amount spent on research and development if it does not exceed 100 million EUR, while the excess amount is applied a 5% preferential rate. Higher relief rates are received by companies which have never been granted tax relief, or have not received it in the last 5 years. In France there are also special arrangements for new innovative small and medium-sized companies with 50% of private capital. By a new company is understood a company not older than eight years; moreover, it must be carrying out a research project and development-oriented activities, whose expenses are at least 15% of the total costs. If these conditions apply, the company receives full relief from the tax base for the first 3 years and 50% exemption for the next 2 years.

In the Netherlands tax incentives are provided for investments in fixed assets ranging from 2,200EUR to 245,000EUR a year, determining a deduction of 25% of the value of the inputs, as well as to energy saving investments determining a deduction of 44% of the amount of the investments, depending on the type of investment.

Although in Latvia corporate income tax incentives for investments already exist, since 1 January 2011 the regulation on **Tax credit on the initial long-term investments within the framework of tax-assisted investments** has come into force, which envisages that a taxable person is entitled to a tax credit for initial long-term investments made within the framework of tax-assisted investments:

1. 25% of the total initial long-term investment amount up to 49.8 million euro (35 million LVL);
2. 15% of the part of the total initial long-term investment amount which exceeds 49.8 million euro (35 million LVL).

Tax credit applies for the taxation period in which the assisted investment project has been completed. If the calculated tax for the given taxation period is less than the estimated tax credit, the taxpayer may reduce the assessed tax in the future taxation periods by the unused part of the tax credit until the tax credit is fully used, but not more than for the subsequent 16 taxation periods in chronological order. However, when implementing tax-assisted projects, tax credit is granted only for specific sectors which would put other sectors in an unequal position.

More than half of the economic potential (67% in 2009) and more than the third of the population are concentrated in the capital of Latvia and its surrounding region (the Latvian example); the rest of the economic indicators and the population density are quite low. Meanwhile, evaluating the national policy in the application of tax incentives for regional development of the territories, it must be concluded that Latvian practice is unsatisfactory as in respect to corporate tax incentives it only provides *Preferential investments* *in fixed assets in specially assisted areas when acquiring fixed assets used in specially assisted areas.* The relief provides that persons doing business in specially assisted areas, when acquiring fixed assets, apply a coefficient increasing the value of fixed assets from which the tax depreciation is calculated (as a result the person includes in the expenditure an amount larger than the actual cost of the fixed asset). The coefficient shall apply in the range from 1.3 to 2. Thus, a significantly higher value than the asset's acquisition cost is written off as depreciation of fixed assets. Affected by the global crisis, in year 2009 compared to 2008, this exemption dropped by 62%, reflecting the decline of the region's economic activity during the crisis.

So far, the most significant of the investment encouraging incentives introduced in Latvia has been the possibility to cover the losses of the taxation period and transfer the losses within a group of companies. As a result of the economic crisis, in year 2009, compared to year 2008, the amount of this relief increased by 18% This incentive is important also in order to give full effect to the second most important investment encouraging incentive – the accelerated asset write-off procedure, since the taxpayer has the opportunity to cover the taxation year losses (which have been significantly increased by the depreciation write-off procedures during the first taxation years after the asset purchase) from the next tax year's profit (earlier for five taxation periods, now – eight). The amount of both the above mentioned exemptions accounted in Latvia in 2009 for 92.34 million EUR or 55% of all tax incentives. Similar incentives for fixed asset depreciation write-offs are applied in Belgium, Finland, France and Germany.

It should be noted that accelerated write-off of fixed order does not change the total amount of the deduction, but rather postpones them. The main benefit is the obtained time in value of money. Initially, there is no benefit from it to non-profitable investments since the deductions will be taken into account only in the years to come. The amount of this relief in 2009 compared to 2008 year, in Latvia has decreased by 65%, which shows that with the decline in business activity, the value of the purchased assets has shrunk significantly as well.

This paper does not address the incentives concerning SEZ, since in Latvia they are terminated until year 2017.

The production encouraging incentive by purchasing new manufacturing process equipment envisages applying a value increase coefficient, which was 1.4 in year 2007, 1.3 – in 2008 and has been 1.5 since 2009.

As a result of the economic crisis, incentive investments in fixed assets in specially assisted areas have decreased in comparison with year 2008, suggesting economic activity decline due to the crisis.

Support during the crisis period. Allowances for provisions for doubtful receivables have been introduced to support businesses during the crisis period, when in the light of the economic situation in the country, taxpayers are facing liquidity problems due to the failure of their counterparty to pay timely for the delivered goods and services. Therefore a possibility has been provided for corporate taxpayers, under certain conditions, to defer income tax payments for three years for provisions for doubtful receivables, without increasing the taxable income at the time of the stock up of these provisions. The special provisions for doubtful debts accumulated during the taxation period will not exceed 20% of the taxable income.

Incentives for industries. Tax incentives for industries have been designed to stimulate the development of certain sectors (shipping, air transport, agriculture). The agricultural sector received the greatest amount of relief to industries in Latvia in 2009 – the total volume amounted to 10.67 million EUR while there were only four tonnage tax payers in the country in 2009.

The impact of support investments in publicly traded securities on the 2009 Budget revenue was -3.84 million. EUR but this relief effect on budget revenues may be different year over year, as, for example, in 2008 it created a positive effect of 0.85 million EUR. The support for the investments in publicly traded securities was originally created to support the local stock markets; however, along with the accession to EU, this provision was substantially extended by applying this support to all securities publicly traded in the European Union or the European Economic Area, and it no longer meets the original purpose – to support only the local securities markets. Meanwhile, a general support for the purchase of securities is not necessary.

Incentives for social objectives. One of the biggest incentives for social objectives has been tax credit for donors, which has been used by 1,306 companies, gaining relief of 13.37 million EUR. Most of the donated funds have been usually diverted to sports. This is a corporate income tax relief whose amount has decreased significantly due to the crisis – more than twice. In 2009 the credit for the donated sums was received by eight companies – public companies with state shares and their subsidiaries; and the total amount of the tax credit was 3.13 million. EUR. Thus, in fact, the state spending policies are realized through these donors.

The total effect of the incentives on the budget of 2009 was -167.53 million EUR, or 60% of the actually collected corporate tax revenues.

The assessment of the economic efficiency of the four tax relief goals (incentives to encourage investment, support during the crisis period, incentives for industries and incentives for social objectives) brings to conclusion that the most significant corporate tax incentives have been designed to encourage investment.

To avoid the adoption of counterproductive tax incentives, not to complicate the system and to monitor and restrict the fiscal impact of incentives, it is necessary to regularly review the effectiveness of tax incentives in Latvia. Regular assessment of tax relief is being done in most developed countries. In the following years it would be appropriate to set the corporate income tax exemption limit against the corporate income tax revenue or against the volume of GDP of the country, as well as to set the annual allowable growth rate of tax relief and tax credit. For example, Poland is planning to establish that the amount of tax incentives for year 2011 shall not increase by more than 1% (plus inflation figures). Initially, the tax exemption limit level may be determined on the basis of the current situation by removing some less efficient incentives.

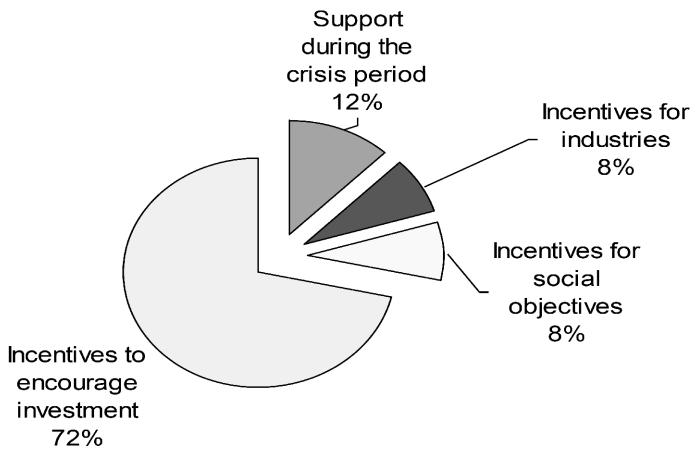
Table 1: The amount of applied corporate income tax incentives in Latvia (EUR)

Incentive	Amount 2007	Amount 2008	Changes %	Amount 2009	Changes %
Incentive for purchasing new production technology equipment	14 796 151	35 232 127	138%	19 647 148	-44%
Incentive for investments in fixed assets in specially assisted territories	1 612 529	2 161 458	34%	820 928	-62%
Incentive for investments in Free Ports and Special Economic Zones	3 939 211	2 193 290	-44%	4 318 607	97%
Possibility to cover the losses of the taxation period by transferring the losses within a group of companies	57 256 496	57 538 790	0%	67 924 485	18%
Accelerated fixed asset write-off procedure	111 824 929	69 858 239	-38%	24 420 887	-65%
The tax rebate for agricultural land	1 940 888	1 401 458	-28%	614 234	-56%
Tax relief for agriculture on the amounts paid in the form of development subsidies	8 185 338	12 817 310	57%	10 027 995	-22%
Support for the financial sector for publicly traded securities	746 786	-782 249	-	3 810 160	-
Tax credits for donors	36 592 397	28 375 061	-22%	13 336 391	-53%
Tax credits to associations corporations, etc. of the disabled	39 198	26 939	-31%	21 783	-19%
The tax relief for royalty-free transfer of computing facilities	1 279	983	-23%	1 282	30%
The tax relief for the production of deposit copies	783	1 633	109%	1 427	-13%
Other discounts whose impact has been calculated at the level of forecast				22 579 819	-

Zdroj: LR Ministry of Finance data

Adoption of new incentives should be regulated because there is a tendency for the number of incentives to increase. Unwelcome is a situation where certain incentives have existed for a long period of time, and their effectiveness and further existence have not been evaluated. Meanwhile, fixed-term relief allows to review the usefulness of all the incentives automatically and to choose from

Picture 1: The proportional division of corporate income tax incentives in Latvia in 2009 in accordance with the objectives



Source: LR Ministry of Finance data

the most urgent and appropriate ones. Fixed-term, or terminated, incentives would also resolve issues related to unexpected changes in tax policies.

Taking into account the fact that the corporate income tax incentives are budget revenue forgone, when introducing tax incentives, it would be necessary to determine what results they are aimed to achieve: macroeconomic, political, or business results. If the corporate income tax incentives account for around 60% (tab.1) of the actually collected corporate tax revenues during a year, then – for balance – it would be necessary to think about stable, economically efficient and sustainable corporate income tax revenue sources. For this purpose, for tax incentives should be set two objectives defining the following as primary:

Macro economical – by precisely defining sectors of the economy supported by the state

Political – by linking incentives to the regional development of territories

Corporate income tax relief is an instrument to ensure economic competitiveness, attraction of new investments, and correction of market shortcomings and achievement of social goals. These incentives can substantially reduce corporate tax payment.

When introducing tax incentives, it would be necessary to determine whether concrete political and macroeconomic objectives will be achieved as a result of the introduction of a particular tax relief. In addition, when preparing policy planning documents, there should be clearly defined priority sectors of the economy as well as a tax policy stimulating the economic development of regional territories.

The analysis shows that the economic objectives of tax incentives are broadly focused on the support of investments in all sectors. However, there is lack of focus on the strategic objective for Latvia – the international competitiveness.

The above mentioned diversity of the objectives, the interaction of the incentives and overlapping of aid makes CIT incentive effects on the economy and the strategies of reaching the targets less focused. Incentives that can be used simultaneously (for instance, accelerated fixed asset write-off procedure and production encouraging tax relief when purchasing new technological equipment) create a double incentive to certain categories of assets.

The idea that territorially and numerically small countries do not need to differentiate the taxation components: rates and tax incentives according to the developmental level of the regions, leads to the situation when regions further away from capital, practically do not develop. Setting lower corporate tax rates and higher tax reliefs in depressive regions regional support could be effectively dealt with on national level by the help of the tax policy as an instrument.

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Důležitost definování daňových pobídek pro daň z příjmů právnických osob s cílem zvýšit jejich efektivnost

Pro státní rozpočet všechny daňové úlevy znamenají výpadek příjmu z daní. Na jedné straně tedy všechny úlevy na dani poskytují podporu určité skupině daňových poplatníků, na straně druhé to činí správu daňových procesů komplikovanější a nákladnější. Úleva na dani z příjmů právnických osob je nástrojem k zajištění ekonomické konkurenceschopnosti, přilákání nových investic, opravení tržních nedostatků a dosahování sociálních cílů. Tyto pobídky mohou často významně snížit rozpočtové příjmy, zejména v případě, kdy je představováno více a více nových úlevových pobídek. Za určitých okolností takovéto pobídky nefungují jako efektivní nástroj k dosahování ekonomických a sociálních cílů a získaný užitek není přiměřený zdrojům použitým na správu těchto pobídek. V geograficky a numericky malých zemích, jako je Lotyšsko, nejsou možnosti daňových prvků (objekt, předmět, míry, pobídky atd.) používané jako daňové nástroje pro regionální rozvoj řešeny. Úkolem tohoto dokumentu bude posoudit efektivnost úlev na dani z příjmů právnických osob v Lotyšsku za daných ekonomických podmínek, při současném zohlednění jejich ekonomického a sociálního významu v danou chvíli a pokusit se předpovědět potenciální dopad na pobídky v podnikatelském prostředí, jestliže daňové úlevy jsou diferencované pro různé regiony země, aby stimulovaly ty regiony, které jsou zaostalé.

Vyhodnocení daňových pobídek bylo vyvinuto v mezinárodní praxi a metodologii. Pokyny vypracovala Organizace pro hospodářskou spolupráci a rozvoj (dále jen OECD) a Mezinárodní měnový fond (dále jen IMF) a budou vzaty v úvahu v tomto dokumentu (OECD 2010; IMF 2009).

Klíčová slova: daňové pobídky, daňové příjmy, výdaje

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