

## CHAPTER V

### SUMMARY AND CONCLUSION

The purposes of this study have been to review features of the tax incentives and income tax regulations in Malaysia, Singapore and Thailand, and to measure the combined effect of investment incentives on the incentives to invest in business fixed capital in the three countries. The study has also aimed at making regional comparisons of the relative strengths of the incentive packages offered in these countries, so that these may provide evidence as to the degree of which tax-related measures are being used to induce an inflow of foreign capital. The net fiscal costs of granting tax incentives in terms of revenue loss have not, however, been covered by the present study. To accomplish the latter two purposes, the rental cost of capital measure was utilized as the basic framework for calculations.

As is evident from Chapter III that all the three countries under study have, like most developing countries, relied quite heavily on tax incentives for encouraging and attracting private investment. Various forms of tax incentives have been adopted, which include accelerated depreciation, investment tax credits or investment allowances, expansion reinvestment allowances, exemption from or reduction in import duties and business (or sales) taxes on imported capital goods. In addition to these devices, all the three countries award income tax holidays to certain pioneer (or promoted) enterprises during which the profits of these enterprises are exempt from corporate income tax for a specified period.

The effects of these tax benefits to investors were then incorporated into the rental cost of capital framework. The results of the

calculations for each individual country indicate that numerous elaborate tax incentive programs (as distinct from the generally available incentives) have been used to provide incentives to capital investments in various sectors or regions of the country and that the resultant differential incentives may have an impact on the allocation of capital resources between sectors. If investment exhibits some elasticity with respect to the cost of capital, a lowering of the cost of capital (which may result from special incentives) in the promoted sector relative to the non-promoted or less-promoted sector should lead to the mobility of capital into that sector. The significant finding to be concluded for the within-country comparisons was that the special incentive programs in all three countries had a significant impact on the relative rental cost between regions or industries. The calculated indexes reveal that the difference in the cost of capital goods between a firm which operates with generally available incentives and a firm which operates in the sector receiving the most attractive incentives was 136 per cent (the percentage by which the cost of the former exceeded that of the latter) for Malaysia, 38 per cent for Singapore and 42 per cent for Thailand. This pattern of cost differences may well indicate to a certain extent that capital might have been diverted to the sectors or industries receiving greater incentives.

When comparative merits of alternative forms of tax incentives, viz. between the income tax holiday and investment allowance, are concerned, while it may be argued that the tax holiday is more significant when income tax rates are high than when they are low and that it may be more attractive if the firm is expected to realize large profits during the holiday period, the finding of the study does point to the conclusion that the tax holiday was questionable in that its value to the approved firm was partly offset by the possibility of a carry-forward of unused depreciation

allowances to years beyond the period that would be covered by the tax holiday. This relative disadvantage of pioneer incentive will even more be significant in times of inflation that may induce an increase in the discount rates, and when the holiday extends over a longer period. Notwithstanding the relative disadvantage, tax holidays represent the most important form of tax incentives in the three countries.

With regard to the relative attractiveness of the level of incentives among the three countries, the results reveal that the relative absence of indirect taxes, the liberal depreciation allowances and the generous investment allowance in Singapore make this city state the most attractive in terms of the rental cost of capital, thus indicating the most generous incentive scheme - both generally available and selectively available incentives - among the three countries. For the other two countries, the full depreciation for plant expenditure in Malaysia is used to explain why the capital cost under universal incentives in that country is lower than the capital cost in Thailand. However, the special incentive programs in the two countries may be concluded as having approximately equal value. If the tax consideration is crucial in investment decisions of foreign firms, then according to our estimates, other things being equal, foreign firms are expected to view Singapore as the most preferred location into which they would put their capital investments. The comparative conclusion for Malaysia and Thailand cannot exactly be made since both countries seem to provide foreign investors with tax incentives which are fairly competitive, and, moreover, since no exact information on the maximum or average level of exemption from customs duty are available for firms other than export producers in Malaysia. Thus, based on the information on tax incentives employed in this study, there is no outright conclusion to be arrived at as to either one of the two countries offers special incentives which are more attractive than the other.

It should be noted that the actual levels of the rental cost indexes in each country would be affected by alternative assumptions regarding the presence of debt financing of an investment project, the rate of economic depreciation, the nominal rate of interest and start-up losses experienced by a new firm. The study has assumed the case where the hypothetical investment project in each country is all equity financed, so that the relevant rate of discount is the rate at which the firm can lend. If alternative sources of financing are taken into consideration, the differential rates applying to the sources of financing of capital expenditures must be taken account of accordingly. Apart from this, the calculation of the rental cost index has not directly incorporated the rate of economic depreciation, which is specific to each firm, into the framework of measurement. The rate of economic depreciation was introduced in calculating the effective tax rate under the tax holiday, but was hypothetically set equal for all countries. Moreover, the study has also made as its assumption an ongoing firm which remains profitable so that the tax benefits can be absorbed immediately against taxable income at the time the investment is made. If this assumption is relaxed as may be the case for a new firm that is experiencing start-up losses in the early years of operation, the losses incurred and depreciation allowances must be carried forward until they are fully deducted from taxable income. For a new firm which has insufficient chargeable income, the value of rapid depreciation for tax purposes is less attractive than cash grants which are received immediately. The same argument may equally well be applied to the case where the firm is granted investment allowance which has to be set off against taxable income.

Certain limitations to the use of the rental cost of capital index should also be mentioned. Firstly, in interpreting the value of



the index, one should be aware that the index says nothing about the underlying cost of physical equipment and structures, and the cost of putting that equipment in place. The index may have the same value for two countries, or successive periods in the same country, yet the underlying cost of capital could be quite different. The index may then be more appropriately used as a measure focusing on the marginal investment decision of firms. Secondly, while the rental cost of capital framework can be used to quantify and measure the effects of investment tax incentives on the cost of capital to the firm, the rental cost measure has not incorporated a number of incentives such as the deductions for operating costs of an investment project (for example, electricity and transportation costs), incentives to other factor inputs and financial incentives. Although some of these incentives do not affect directly the cost of capital investment of any single firm, they may contribute significantly to the firm's overall profitability which, in turn, influences the incentives to invest. Hence, the investment tax incentives examined in Chapter IV should strictly be viewed as incentives to capital investments only. Each country under study has a complex array of tax-related and non-tax incentives directed towards special industries and sectors of the economy. If attempts were made so that the whole incentives could be taken full account of, the net impact of these biases would be far from clear. Thirdly, the rental cost index only describes how the cost of capital is affected by tax-incentive measures, but does not predict the response of firms to the incentives offered. The actual response of firms depends on how closely they adhere to profit-maximizing behaviour.

Whether the provision of investment tax incentives in developing countries has been really effective in stimulating industrial investment is somewhat controversial and requires extensive empirical research.

The use of tax concessions presupposes that investors undertake investments which they would not otherwise have undertaken. This, in turn, assumes that the tax consideration is crucial in investment decisions. If investment exhibits negative relationship with the cost of capital (that is, it responds positively to the tax incentives offered), there is good reason to expect that incentives limited to particular industries or sectors will be effective in diverting capital to such industries or sectors. Since the granting of investment incentives not only involves revenue loss to government but also affects the allocation of resources in an economy, the problem is then to have tax incentive devices designed as efficiently as possible so that detrimental investment effects can be minimized. Taking this consideration in mind, the big problem for developing countries lies in how to select investment projects to be eligible for promotional privileges. In principle, the investment projects which should be chosen must be projects which pay for themselves in generating additional growth to the national economy, or projects which have high external economies or economic linkages.

To render effective provision of investment tax incentives, governments of developing countries should take cognizance of the national growth, development objectives, emerging economic trends and factor endowment of the country. Basically, the design and use of investment incentives in developing countries are to serve four main purposes : to compensate for the effects of market imperfections; to reinforce development objectives; to provide stimulus to investment; and to compete for foreign investment.<sup>1</sup>

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IMG Consultants Pty.Ltd, and the Industrial Management Co.Ltd., "Study on Fiscal Implications of Investment Incentives and Promotion Efficiency," a report prepared for Fiscal Policy Office, Ministry of Finance, Bangkok, November 1984, p.138.

The design of the most efficient incentive system and the awarding of tax incentives to both potential and existing investors should therefore be made so as to achieve the four stated purposes, while bringing into line with reforms in the country's fundamental policies towards minimizing and/or removing distortions in the system.<sup>2</sup> Moreover, the incentives should only be provided for a limited period, especially for the latter three purposes, since the excessive awarding of incentives might be questioned on efficiency grounds and leads to excess costs both to government and consumers. For government, it is deemed as poor policy to make long-run commitments to tax subsidies, especially where it is hoped that there will be a declining need for such subsidies in the future.

Although there is no practical distinction between domestic and foreign investments in terms of eligibility criteria and the types and extent of incentives offered, from the national viewpoint, the role of tax incentives to foreign investors differs from that of incentives to domestic investors. While the latter merely involve transfers between the government (which loses revenue) and the investor (who gains), tax incentives granted to foreign investors reduce the whole country's share in the profits earned by foreign capital. This loss must therefore be compensated for by the gains from additional capital influx that leads to the gains for domestic factors of production to which the foreign capital gives rise in the form of increased earnings. The tax incentives may be helpful in directing foreign capital into such uses as are advantageous to the host country, and should be linked to domestic value added.

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For a comprehensive treatment of issues involved in designing the most appropriate tax incentive system in developing countries, with special reference to Thailand, see IMC Consultants Pty.Ltd. and the Industrial Management Co.Ltd., *ibid.*, pp.137-145.

Moreover, they should be designed to encourage reinvestment and permanent operation.

The effective use of tax incentives to the foreign investor is dependent upon the tax system that prevails in the foreign investor's home country. If the home country taxes its foreign-earned income at its own rate while giving a foreign tax credit, lower taxation by the developing country merely results in a transfer to the other country while leaving no advantage to the investor who repatriates profits. If effective incentives are to be granted to the foreign investor, the developing country needs the cooperation of the investor's home country. This necessarily calls for the negotiation and conclusion of either tax deferral or tax-sparing arrangement.<sup>3</sup> Under tax deferral, the foreign investor can enjoy the tax incentive, more specifically, the income tax exemption, only in so far as his earnings are not remitted back to the home country. Tax deferral not only serves to attract foreign capital to the developing country but also exerts a continuing incentive to reinvest earnings there. Under most double taxation agreements, countries of residence (i.e. home countries) accord the so-called tax-sparing credit. Under this provision, the home country would extend a full matching credit, upon repatriation of profits, for the tax paid in the developing country even though a lesser or no tax is paid under the incentive arrangement. While the tax-sparing credit helps render effective incentive to the foreign investor, it, however, lacks the incentive for reinvestment.

A final point which deserves to be mentioned is that, while the investment tax incentives in developing countries are likely to be effective

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<sup>3</sup> A good deal of information concerning tax deferral and tax-sparing arrangement is obtainable from Richard A. Musgrave and Peggy B. Musgrave, Public Finance in Theory and Practice, Ch,36, p,812.



in diverting domestic investment resources to the tax-subsidized activities, they may or may not figure predominantly in foreign investors' location decisions. In practice, investment decisions are made on the basis of several factors that contribute to the overall investment climate which, as the eclectic theory may suggest, include such determining factors as input prices, quality and productivity, infrastructure, ease of doing business, and political and economic stability. One should not, therefore, rely solely on the relative attractiveness of tax incentives across countries when one attempts to assess the value of investment incentive systems which may affect location decisions of foreign firms.