

Corporate Tax Holidays and Investment

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Abstract

Governments of developing countries commonly adopt tax holidays to encourage investment. This article evaluates the incentives provided by company income tax holidays and explains the importance of the timing of depreciation allowances in determining the effective tax rates and the cost of capital to firms considering additional investment during the holiday. If an asset is long-lived and depreciation allowances for tax purposes are accelerated, the tax holiday, by preventing depreciation deductions during periods of peak profits, may actually penalize a company for investing during the holiday. The closer the investment to the end of the holiday period, the more severe the penalty. If, instead, depreciation allowances may be deferred until after the holiday, this program of incentives is quite generous to the firm. How these sharply contrasting results may emerge is illustrated through estimation of effective tax rates and user costs of capital under tax holiday systems in Bangladesh, Côte d'Ivoire, Malaysia, Morocco, and Thailand.

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