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Promoting Growth in the Caribbean: Tax Incentives in Theory and in Practice

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Introduction

The recent international financial crisis dealt a hard blow to the region's growth prospects, being reflected in reduced demand for financial services and tourism as well as falling remittances. This was combined in some cases with home grown macroeconomic imbalances and the need to face the costs of financial sector bailouts in other countries. Counter cyclical policy response has been limited, as countries do not enjoy sufficient fiscal space and debt levels in some of them are at worrisome levels. More recently, policymakers have indicated the need to explore the use of tax incentives in order to foster much needed private investment. This Policy Note analyzes the issues associated with the use of tax incentives and reviews the challenges faced by the region, which has had a not altogether successful experience in controlling tax expenditures.

The Policy Note is organized as follows. The first section explores the diverse nature of the Caribbean and Latin American group of countries referred to in this note: The Bahamas, Barbados, Belize, Dominican Republic, Guyana, Haiti, Jamaica, Suriname and Trinidad and Tobago. This is followed by a word of caution regarding the emphasis on factor accumulation in explaining growth, dampening beforehand any unrealistic expectations regarding growth promoting tax incentives.

A brief analytical review of the main direct and indirect tax instruments is included in section 3. Finally, while studies of tax expenditures in Caribbean economies are not infrequent, very little empirical work has been carried out in the region regarding the role of tax incentives in promoting investment and the latter's effect on growth. Section 5 will then review some country experience with provision of tax relief. A brief set of recommendations closes the document.

1. Recent economic developments in the selected group of Caribbean countries

While the Caribbean and Latin American countries included in this Policy Note share many cultural, historical, economic and geographic characteristics, they pose some striking differences as well. Most of the countries involved are island states and all are vulnerable to natural disasters. They are also small countries in terms of territory and population, though there are outliers regarding both variables. Guyana and Suriname, two countries located in South America have large if sparsely populated territories. With regards to population, the Dominican Republic and Haiti have over 10 million inhabitants each, overshadowing the rest of the countries being considered. Living standards are high in The Bahamas, Barbados and Trinidad and Tobago as measured by the UNDP's annual Human Development Report. With the exception of Haiti that borders the low-end of human development indicators, the rest of the countries' rank at the medium human development level.

Tourism, financial services and natural resources are the dominant economic activities. The Bahamas and Barbados are specialized in high-end tourism and financial services while Belize, Guyana, Suriname and Trinidad and Tobago are resource-based economies (oil and gas, minerals, agriculture and forestry). The Dominican Republic and Jamaica have strong tourist sectors as well as significant mining activity and some agriculture. Haiti is a special case as political instability and natural shocks have undermined economic performance over the past four decades.

Diversity is also a feature when considering per capita GDP. With values ranging \$17,000 to \$23,500 US dollars The Bahamas, Trinidad and Tobago and Barbados boast the highest values of per capita GDP among the emerging markets of the Western Hemisphere. At the other end of the spectrum is Haiti, with a per capita GDP of around \$830 US

dollars. Belize, the Dominican Republic, Guyana and Jamaica are low middle-income countries, in a range of \$4,000 to \$6,000 US dollars per year, while Suriname's per capita GDP will be in the neighborhood of \$9,500 US dollars in 2013.

With the exception of the Dominican Republic and to a lesser extent The Bahamas, fiscal revenue is at the high end for emerging economies, in the range of 24% to 35% of GDP for the rest of these countries. Taxes and social security systems provide the bulk of government resources although natural resources and grants represent a significant part of fiscal revenues in the cases of Trinidad and Tobago and Haiti respectively. Public expenditure is also high for emerging economies, in the range of 25% to 40% of GDP, with the exception again of the Dominican Republic where it hovers around 18%. Overall deficits for all countries will be in the range of 2% to 6% of GDP in 2013. Public Debt is a matter of concern for some countries. It is in a range of 55% to 82% of GDP in The Bahamas, Barbados, Belize and Guyana and it is especially high in Jamaica, over 140% of GDP.

The greatest impact of the international financial crisis was felt in the service oriented economies as well as those that received significant remittances from their migrants. Terms of trade shocks from higher energy and food prices compounded their stress. However even Trinidad and Tobago, an oil and gas exporter, was not immune to the crisis as it had to rescue a large financial conglomerate in 2009. This has translated in low growth, which has affected the non-resource economies for the better part of the decade.

Rigid expenditures patterns and significant deficits have meant there has been little fiscal space to finance expansionary policies domestically. High debt levels have further restricted this option except in the cases of Suriname and Trinidad and Tobago, countries that faced lesser shocks because of their resource oriented economies.

2. Growth determinants

For over half a century economists have used a sources-of-growth accounting framework to estimate the contributions to growth of changes in the labor force, in capital and in technology.

A logical extension of this analysis has been to examine the determinants of factor accumulation and innovation, including the role played by tax policy. Taxes will affect the labor force in many ways. For example a high personal income tax rate will discourage people from working while tax credits for education may encourage investment in human capital and therefore a more productive work force. The same is true regarding physical capital. Higher corporate income taxes tend to discourage additional investment while tax incentives will, all else being equal, encourage capital formation. Likewise, while tax policy cannot determine innovation it can stimulate expenditures in research and development that may lead to innovation.

It would however, be a mistake to conclude that all that is needed to increase economic growth is the right combination of tax breaks that will provide stimulus for factor accumulation. Empirical studies cited in Easterly and Levine (2001) show that factor accumulation only explains around 50% of per capita growth in OECD countries and 65% in LA countries while the rest is explained by Total Factor Productivity, a residual of which economists don't yet have an adequate understanding of (Prescott (1998)).

Without denying the importance of factor accumulation, economists have increasingly placed a greater emphasis on the role played by economic policies in setting a framework conducive for growth, productivity and innovation. An initial set of policies considered are openness to international trade, sound fiscal management and financial development. The point made is that more often than not structural reform may unleash the growth potential of a country in ways barely imagined by tax measures enacted to promote investments.

4. Features of good tax incentive systems

Tax incentives have been justified for a number of reasons in emerging economies, chief among them being the need to compensate for the existence of market failures that discourage investment¹. High capital mobility and international competition for foreign direct investment (FDI) has also led countries

to offer tax incentives as well as other enticements in an effort to land coveted investments. Lastly, tax incentives are frequently seen as an expedient way to address existing bottlenecks and limitations that make a country or sub-regions of a country, less attractive for investment and that would require lengthy structural reform.

Of the three reasons mentioned previously, possibly the most compelling justification for the use of tax incentives is the existence of positive spillover effects. Under a scenario of positive externalities, a firm will decide a level of investments that will be sub-optimal if it will not be able to reap all the benefits associated with this investment. In this case, tax incentives could be used to increase a project's profitability, inducing the firm to increase the level of investment. Examples of these investments are those located in a country's less developed regions or those that build human and physical capital that will not exclusively benefit the project's owners².

As described in Zee et al (2002) and Artana et al (2012), poorly designed tax incentives are likely to have major negative effects on the economy. They will erode the tax base, in some cases by providing tax relief to economic activities that were profitable and did not require this relief, in others due to abuses in the system by activities not eligible to receive them. This loss in tax revenue will need to be compensated, possibly by raising taxes on the rest of the economy and/or reducing expenditures. They will distort resource allocation in favor of promoted activities, which may not have been the obvious choices from an efficiency point of view. Furthermore, promoting any activity tends to affect human behavior, creating opportunities for corruption and rent-seeking behavior.

However, since tax incentives are unlikely to be abandoned by most developing countries as a policy instrument, focus should be placed on figuring ways to minimize harmful effects of tax incentives. Even in the case of market failures, the benefits to the economy should outweigh the cost associated with the introduction of tax incentives. And even then, care must be taken to design instruments that will be best for the economy.

First of all, any tax incentive scheme requires a well-functioning overarching tax system. The point is that tax incentives will only work if taxes are collected in the first place, a not so obvious fact in many countries in the hemisphere due to poor tax design and weak tax and customs administration. Efficient, client-oriented tax and customs administrations are key to collecting taxes. Tax and customs administrations should enjoy financial and administrative autonomy, and its staff should be part of a civil service that is independent of the political system. The same degree of professional skill is required of budgetary institutions, sectorial ministries and investment boards responsible for managing and overseeing any investment promotion regime. An important element of a well-designed system is the separation of those responsible for the administration of the tax benefits of projects from those responsible for selecting these projects based on objective criteria and monitoring that slippages have not occurred regarding the commitments made by investors.

The next, frequently overlooked, step of a good tax incentive system is a sustainable fiscal framework. Introducing tax incentives in countries of questionable fiscal solvency will likely not be conducive to generating quality investments, as entrepreneurs will not expect that the favorable tax treatment awarded to their investment will be sustained over time.

But what kind of tax incentives are there? The initial distinction to be made when considering tax incentives is between incentives through direct taxes - the Corporate Income Tax (CIT) - and indirect taxes (import tariffs and the Value Added Tax - VAT)³.

Corporate Income Tax Incentives

Tax incentives under the CIT target the tax rate as well as capital recovery of invested amounts. Table 1 summarizes the advantages and disadvantages of these instruments in terms of revenue and implementation costs, of the distortions they introduce in favor of tax avoidance and resource

¹ The infant industry argument was used to justify trade barriers while the nascent economic sector developed the skills, knowledge, etc. that allowed it to compete with foreign production. This argument has lost support due to the unsatisfactory performance of inward oriented development strategies vis a vis that of economies that embraced trade openness.

² Porto (2010) describes Uruguay's sophisticated investment promotion regime.

³ This is merely an analytical distinction as many investment promotion regimes (e.g. Argentina and Brazil) provide tax incentives through direct and indirect taxes. Tierra del Fuego's tax incentives can be consulted in <http://www.sub-industria.gob.ar/depyme/regimen-especial-aduanero-y-fiscal-de-tierra-del-fuego>. Manaus' regime is described in http://www.suframa.gov.br/zfm_incentivos.cfm.

allocation and in terms of transparency for the tax system. The preference is to provide tax incentives through accelerated depreciation. This alternative allows taxpayers to frontload depreciation beyond the regular schedules accepted in the tax code, in some cases even expensing the total investment amounts when the investment is made. The revenue cost associated with accelerated depreciation is bounded by the amount invested, unlike incentives that operate on profits, which are unbounded and depend on the performance of the project. Expressed from a different angle, the incentive only affects the timing of the cost-recovery and not its amount.

From the perspective of its implementation, an accelerated depreciation scheme is fairly straightforward and does not require a specific arrangement from the tax administration. Unlike other direct tax incentive schemes that favor combining profits from firms that do not enjoy tax incentives with those that do benefit from them, accelerated depreciation does not introduce any bias in terms of tax avoidance. Likewise, this alternative is transparent as taxpayers are required to file tax returns every year and it does not distort the nature of the investment to be undertaken by the firm.

Table 1
Corporate Income Incentives

	Tax Holiday	Preferential Tax rate	Accelerated Depreciation	Investment Allowance	Investment Tax Credit
Revenue cost	Unbounded	Bounded	Bounded	Bounded	Bounded
Tax avoidance	Encourages transfer of profits from firms that are not exempted	Encourages transfer of profits from firms that are not exempted	Does not encourage tax avoidance	Encourages sale and purchase of assets to claim allowance	Encourages sale and purchase of assets to claim allowance
Transparency of revenue cost	Normally do not require tax filing	Requires tax filing	Requires tax filing	Requires tax filing	Requires tax filing
Resource allocation	Tend to attract short-run projects	Tend to attract short-run projects	Does not affect life of assets. Tend to increase capital intensity	Tend to favor short term assets	Tend to favor short term assets
Administration Costs	Significant tax administration costs to monitor tax avoidance from related but non-exempted firms.	Significant tax administration costs to monitor tax avoidance from related but non-exempted firms.	Some. Usually associated with carry forwards.	Some	Some
Implementation Costs	Medium to ensure project complies with goals	Medium to ensure project complies with goals	Initially to ensure investment is made	Initially to ensure investment is made	Initially to ensure investment is made

Tax incentives provided through import tariffs, excises and VAT

Tax incentives can also be provided in the cases of import tariffs, excises and VAT⁴. This is usually done by exempting certain inputs from these taxes.

While general exemptions are easy to administer, they may entail significant revenue loss. Targeted exemptions to benefit specific industries or sectors that use these inputs will narrow the loss. However, these exemptions interfere with the desired tax neutrality in resource allocation as they provide tax

relief only to specific beneficiaries. They also pose significant challenges to tax administrations as the exempted inputs may be diverted to unintended beneficiaries. Revenue concerns, allocation distortions and enforcement costs are the three main factors that discourage the use of indirect tax incentives in most economic activities, the exception being those that are export-oriented.

The economic rationale for eliminating indirect taxes from exports is provided by the destination principle under which goods and services are taxed wherever they are consumed. The best-known example is the zero rating of VAT on exports, by which the exporter receives a tax credit for the amount of VAT paid on inputs used to produce the good or service. This implies that the tax treatment a product will receive will depend on whether it is sold in the domestic market or abroad.

While the destination principle is straightforward, its implementation can present challenges for many customs and tax administrations in developing countries. The challenge is due to the fact that indirect taxes will be reimbursed only on the amounts paid on import tariffs, excise taxes and VAT for inputs used to produce the goods and services that were exported. However, exporting firms usually produce more than one good or service, using many inputs in different proportions that may be taxed at different rates and that are sold domestically or exported.

A final mention should be made regarding Export Processing Zones (EPZ). There is widespread use of EPZ in the region to promote exports and it is not unusual that economic activities are exempt from direct and indirect taxes. While the latter is non-controversial, indirect tax incentives for export-related-activities is a violation of WTO rules and must be dismantled by 2015 for all but the poorest countries.

5. Evidence on the effectiveness of tax incentives in developing countries

In this section we begin by reviewing analytical work on tax incentives in developing countries and their impact on investment and growth. While this literature is not abundant, a further source of information on the cost of these policies is available through the tax expenditure reports

prepared by countries' Budget Offices. We examine the tax expenditures of two economies in the region: the Dominican Republic and Jamaica. As we shall see, both countries provide significant, and unaffordable, tax relief. However, the fact that there is so little to show for these tax expenditures should be taken as evidence that there is no substitute for a targeted policy or for the need for a well-designed tax system.

We will then review the aggressive tax planning behavior of the Dominican Republic's tourist sector under the understanding that it does not differ significantly with that of other countries in the region. The response of the Dominican Republic's tax administration, employing transfer pricing rules developed under the existing OECD guidelines will be described as it can easily be adapted to other Caribbean economies.

Zee et al (2002) paint a bleak picture when they review the empirical work on the effectiveness of tax incentives in developing countries: "The main messages of this research are that tax incentives can stimulate investment but that a country's overall economic characteristics may be more important for the success or the failure of industries than any tax incentive package; and even if tax incentives stimulate investment, they are not generally cost effective."

Klemm and Van Parys (2009), analyze the use of incentives as tools of tax competition, as well as their effectiveness in attracting investment in an econometric study covering 47 African, Latin American and Caribbean countries over a 20-year period⁵. While they find evidence that tax incentives provided by CIT rates and tax holidays are effective in attracting FDI, this is not the case in terms of increasing overall private investment or growth, thereby concluding that the tax incentive's "ultimate benefits for the economy may be limited"⁶

From a tax revenue perspective Nassar(2008) found that CIT competition had led to the erosion of the tax base in 15 Caribbean countries. He concluded that the widespread use of tax holidays needed to be eliminated if alternative policy proposals being considered at that time - including accelerated depreciation and tax harmonization - were to have an impact on revenue collection. Sosa (2006)

also finds disappointing results of tax incentives in terms of generating new investments and their high costs in terms of foregone tax revenue for the small island states that comprise the Eastern Caribbean Currency Union (ECCU). Chai and Goyal (2008) also study the tax incentives provided by the same group of countries and find “The costs are very large, while the benefits appear to be marginal at best. Foregone tax revenues range between 9 1/2 and 16 percent of GDP per year, whereas total foreign direct investment does not appear to depend on concessions. A rethinking of the use of concessions in the region is needed urgently”.

The Budget Office’s tax expenditure reports provide a further estimate of the cost of tax incentives in the Dominican Republic and Jamaica. The Dominican Republic had a tax burden of around 15.5% of GDP in 2010. VAT and excises are the largest revenue sources, followed closely by the income

tax and social security taxes. Tax expenditures are high, around 5.8% of GDP. Almost two thirds of this amount provides relief from VAT, in an attempt to mitigate the high adverse distributional consequences of this tax. The remaining 2.2% of GDP benefits export promotion zones, general manufacturing and the tourist sector.

In the same year, Jamaica’s tax collection reached 23.6% of GDP, with a relatively high share of income taxes in total tax receipts. Tax expenditures are high; they represented 7.3% of GDP in 2009, reflecting widespread use of tax instruments to promote economic activities. Tax incentives are grouped under four categories: Statutory Tax Expenditures, Incentives, Discretionary Waivers and Waivers on Tax Arrears. What should be clear is that this incentive system not only reduces public revenue but it ends up undermining the capacity of tax administration.

	Dominican Republic	Jamaica
Income Tax	2.9	8.7
VAT	4.3	7.1
Excises	3.5	3.2
Trade	1.0	1.7
Others	3.8	2.9
Total	15.5	23.6
Tax Expenditures	5.8	7.3

Sources: IDB CIAT Data Base, Garcimartín and Diaz de Sarralde (2012), and IDB (2010)

Tourism is possibly the most competitive sector of Caribbean countries, in spite of which most countries have awarded it with over-generous tax incentives. Tourism on average accounts for almost forty cents of every dollar of export earnings in the region, and this amount can rise to almost eighty cents in the cases of Barbados and The Bahamas. However, tourism’s share of tax revenue tends to be modest, in no small part due to aggressive tax planning (Barreix and Velayos (2013)).

In order to improve tax collection from the tourism

sector, the Dominican Republic’s tax administration (Dirección General de Impuestos Internos - DGII) launched a thorough investigation of the country’s all-inclusive hotel sector⁸. The main findings were that CIT and VAT liabilities were kept at a minimum due to three reasons: (1) reservations were handled by trading companies linked to the hotel operator but located in countries with low or no tax; (2) hotels declared daily rates to the tax administration that were lower than the operating cost per guest; (3) hotels reported permanent losses to the tax administration as well as debts to the trading companies.

⁵The Caribbean countries included in Klemm and Van Parys (2009) that are also considered in this Policy Note are Bahamas, Barbados, Dominican Republic, Guyana, Jamaica and Trinidad and Tobago.

⁶The authors offer two possible explanations for the limited impact of tax incentives: (1) tax incentives “mainly affect the ownership rather than the amount of capital in an economy” and (2) “it is possible that higher FDI crowds out domestically financed investment, with no net effect”.

⁷Chai and Goyal (2006) use the term concession instead of incentives in their study.

The DGII then designed an arm's length occupancy rate using the OECD's Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations. This rate was then used by DGII to assess CIT and VAT liabilities for 2007/2010. According to Barreix and Velayos (2010), DGII CIT assessments for 2007/2009 represented an average increase of almost 820% of previous self-assessed obligations. The comparable figure for VAT was 70% higher for 2007, 2009 and 2010. While hotels contested the tax administration's actions, the Courts ruled in favor of the DGII.

In short, tax expenditure data show that regional governments have showered economic activity with all types of tax breaks that most countries cannot afford. These tax expenditures have not led to more competitive economies and have ended up not only distorting the tax system but they have also introduced horizontal inequity between taxpayers as well. Moreover, even considering tourism, the region's most competitive sector, bad policy design combined with aggressive tax planning practices has undermined the tax system and deprived governments of revenue badly needed to finance social expenditures and infrastructure needs. The conclusion by now should be clear: tax incentives are a poor substitute for a dysfunctional tax system. Countries should consider rationalizing their tax system and eventually think about introducing a modern and cost-effective tax incentive scheme, targeted to offset negative externalities that discourage growth and the creation of quality jobs⁹.

Conclusions

The challenge posed by the international economic scenario has revived the debate regarding the need to review the policy alternatives of a group of small Caribbean and South American nations. A key element of this review is the use of tax incentives to promote growth and job creation.

The starting point of any successful tax incentive policy is a well-designed tax system. The tax system should collect the revenue required to finance government services and help fund infrastructure

needs and taxpayers should perceive it to be fair and equitable, both horizontally and vertically.

Caution with tax incentives is warranted on analytical and empirical grounds. With regards to the former, a clear and limited and limited scope of what can be accomplished with this instrument is the starting point of any successful policy initiative. Tax incentives can address negative externalities that limit investments, determine their location and discourage job creation. They cannot however be used as a *Deus ex machina* that will solve all of an economy's structural deficiencies. They are not and cannot be a substitute for structural reform.

Empirical evidence of successful tax incentive schemes implemented in developing countries is scarce and in any case discouraging. Studies carried out in developing countries including the Caribbean have found that while tax incentives may attract FDI, they have not been able to increase overall private investment or economic growth. Moreover, not only have the ultimate benefits proven to be limited, the cost in terms of foregone revenue has proven to be very high as exemplified by the small island states of the Eastern Caribbean Currency Union. Additional information on the fiscal costs of tax incentives are available in tax expenditure reports. The two countries examined in this Policy Note provided a clear picture of the difficulties of keeping tax expenditures in check as the cost of tax relief has ballooned to the 6%/7% of GDP range. The description of the aggressive tax planning behavior of the Dominican Republic's tourism sector exemplifies the questionable rationale of providing tax relief to one of the region's most competitive industries.

A good tax incentive system should provide an explicit rationale of the externality it will address and well-defined values of the variables it is expected to obtain (e.g. invested amounts, jobs, net exports, etc.). This information should be assessed by a government agency that is independent of political pressure and its reports should be available to the public. Smaller countries could consider creating a regional tax incentive scheme, administered jointly by a regional multilateral body of member states to alleviate political pressure and better resist games often played by investors on governments

⁸ All-inclusive hotels represent 69% of rooms in the country's hotel sector (Montero (2012)).

⁹ A brief description of the proposed activities in the design of tax systems and institutional strengthening of tax administrations and customs over the 2011-15 Phase IV period is presented in CARTAC (2010) Program Document.

to enhance their benefits.

Transparency should continue during project implementation. Monitoring by the tax administration and the government agencies responsible for promoting investments should also be made public. Public disclosure of project targets and their costs in terms of foregone tax liabilities should be a feature of the system. Finally, tax incentives should have a sunset clause.

In terms of implementation, the Corporate Income Tax is the instrument of choice. Job creation may warrant the use of reduced payroll taxes to finance the social security system. Similarly, location in less developed regions of a country may benefit from exemptions in local taxes. The accelerated depreciation allowance is a preferred instrument to tax rates and tax holidays and tax filing should always be required. Incentives in terms of indirect taxation should be limited to export oriented activities and are essentially covered by the destination principle of taxation under which goods and services should be taxed wherever they are consumed.

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