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TAX INCENTIVES AND DOMESTIC INVESTMENT DYNAMICS: EVIDENCE, DESIGN, AND IMPLICATIONS FROM EMERGING ECONOMIES

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Abstract: This article examines the effectiveness of tax incentives as a fiscal instrument for stimulating domestic investment, with a particular focus on emerging economies. Drawing on international empirical evidence and selected macroeconomic facts from Uzbekistan, the study analyzes the transmission mechanisms through which tax incentives influence investment decisions, evaluates heterogeneity across firm types, and discusses potential trade-offs between investment quantity and quality. The findings suggest that tax incentives can stimulate domestic investment when embedded in coherent institutional frameworks, supported by financial sector depth and administrative capacity. However, poorly targeted incentives risk generating windfall gains, misallocation of capital, and diminished investment efficiency. The article contributes to the policy debate by synthesizing empirical insights and proposing a conceptual model tailored to structurally transforming economies.

Keywords: tax incentives, domestic investment, user cost of capital, emerging economies, Uzbekistan

Tax incentives are among the most frequently applied policy tools used by governments to influence private sector investment behavior. By reducing the effective tax burden on capital, such incentives aim to increase the expected post-tax return on investment and thereby stimulate capital accumulation. In emerging economies, where domestic investment is often constrained by limited access to finance and higher macroeconomic risks, tax incentives are frequently justified as a means of accelerating structural transformation and industrial upgrading.

Despite their popularity, the effectiveness of tax incentives remains contested. Empirical research demonstrates that investment responses vary substantially depending on incentive design, firm characteristics, and the broader institutional environment. This article revisits the debate by integrating international empirical findings with stylized facts from Uzbekistan, an economy that has undergone significant tax reforms since 2019.

From a neoclassical perspective, investment decisions are driven by the user cost of capital, which incorporates interest rates, depreciation, and taxation. Tax incentives such as accelerated depreciation, investment tax credits, and reduced corporate income tax rates directly lower the user cost, shifting firms' optimal capital stock upward. In practice, however, investment responses are mediated by liquidity constraints, uncertainty, and expectations regarding policy stability.

This mechanism assumes rational profit-maximizing firms and stable institutional conditions. Deviations from these assumptions help explain heterogeneous empirical outcomes.

Empirical studies from advanced economies provide relatively strong evidence that temporary and permanent tax incentives can stimulate investment. Research on accelerated depreciation in the United States shows sizable short-term increases in eligible capital investment, particularly among firms facing financing constraints. Corporate income tax

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reductions have also been associated with higher domestic investment, although part of the response reflects timing effects rather than net capital formation.

In contrast, evidence from developing and transition economies is more mixed. In several cases, tax incentives failed to generate sustained investment growth due to weak enforcement, policy uncertainty, and limited absorptive capacity. These findings underscore the importance of complementary institutions, including financial intermediation and tax administration quality.

Uzbekistan implemented comprehensive tax reforms beginning in 2019, including a reduction of the corporate income tax rate and the introduction of investment-related tax preferences. According to national statistics, gross fixed capital formation increased from approximately 26 percent of GDP in 2018 to around 38 percent in 2022, reflecting both public investment and rising private sector activity.

Table 1. Selected Investment Indicators in Uzbekistan

Indicator	2018	2020	2022
Gross fixed capital formation (% of GDP)	26.3	33.1	38.0
Private investment share (%)	55	60	63
Corporate income tax rate (%)	14	12	12

While these trends suggest a positive association between tax reforms and investment dynamics, causality cannot be inferred directly. Macroeconomic stabilization, exchange rate liberalization, and financial sector reforms also played critical roles.

An emerging strand of literature highlights that tax incentives may increase the volume of investment while reducing its average productivity. When incentives weaken firms' screening discipline, capital may be allocated to lower-return projects. For policymakers, this trade-off raises concerns about long-term growth and fiscal sustainability.

The Uzbek case illustrates that tax incentives are most effective when embedded in a broader reform agenda. Stable macroeconomic conditions, transparent eligibility criteria, and time-bound incentives are essential to limit rent-seeking behavior. Moreover, targeting incentives toward financially constrained firms and productivity-enhancing investments can improve outcomes.

Tax incentives can stimulate domestic investment, but their effectiveness is neither automatic nor uniform. Evidence from emerging economies suggests that institutional quality and policy coherence are decisive factors. For Uzbekistan and similar economies, the challenge lies in balancing investment promotion with fiscal discipline and long-term productivity growth.

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