

# INVESTMENT CLIMATE IN PRACTICE

INVESTMENT POLICY AND PROMOTION

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## PROVIDING INCENTIVES FOR INVESTMENT ADVICE FOR POLICYMAKERS IN DEVELOPING COUNTRIES

Are tax incentives effective at attracting investment? Or are they a waste of resources? The answer depends on the policies used and the sectors where investment is sought. This note consolidates the policy implications of the latest research by the World Bank Group's Investment Climate Advisory Services on the efficacy of investment incentives. The research finds that such incentives are ineffective where investment climates are weak, and they cannot compensate for such deficiencies. Moreover, even where incentives are effective in attracting investment, they have significant costs. When incentives are clearly ineffective, political considerations often drive their continued use. This note identifies best practices for incentive policy and administration and provides a framework for analyzing the likely effectiveness of investment incentives under different conditions and in different types of countries.

Many governments offer tax incentives to attract investment, yet policies often fail to fully assess their likely costs and potential benefits. Incentive policy should balance the higher revenues and social benefits—jobs, positive externalities, signaling effects—from (possibly) increased investment with the indirect costs of incentives (such as administrative and leakage costs) and the revenue losses from incentives given to investments that would have been made even without them.

### INCENTIVES AND THE INVESTMENT CLIMATE

Investment incentives have a mixed record. They have been associated with growth in some countries (Ireland, Mauritius, Singapore, parts of the Caribbean) but had limited impact in others (francophone Africa). The World Bank Group's Investment Climate Advisory Services recently conducted research to show the econometric evidence behind this dichotomy (see James 2009 for more details).

### SEBASTIAN JAMES

Dr. Sebastian James (sjames2@ifc.org) is Senior Investment Policy Officer in the World Bank Group's Investment Climate Advisory Services and is a taxation expert. He advises countries on the design of their tax policies and administrations, with an emphasis on improving their investment climates for economic growth.

This note benefited from contributions from Joseph Battat, Nathalie McGregor, William Mut, and Stefan Van Parys of the Investment Climate Advisory Services of the World Bank Group.

This note was developed by the Investment Policy and Promotion team of the World Bank Group's Investment Climate Advisory Services. The team advises governments on attracting and retaining investment to create jobs and foster economic growth.

In countries with weak investment climates—say, with extensive red tape on accessing land, starting a business, or exporting and importing—lowering the effective tax rate has limited impact on foreign direct investment (FDI). The average response is far more pronounced in countries with good investment climates. For example, lowering the effective tax rate from 40 percent to 20 percent raises average FDI by 1 percent of GDP for countries ranked in the bottom half in terms of investment climate—while the same change raises FDI by 8 percent of GDP for countries in the top half.

Thus tax incentives are far less effective in weaker investment climates than in stronger ones. Moreover, tax incentives should not be used in an effort to compensate for a weak investment climate. Doing so causes revenue losses because incentives do not foster additional investments in such an environment, so the benefits go to investments that would have been made anyway. Improving the investment climate is a better strategy for attracting investments.

## POTENTIAL RATIONALES FOR INCENTIVES

Governments should consider using investment incentives in three areas.

### Positive externalities

Government may use investment incentives to encourage investments that generate positive externalities (that is, when an investment creates multiplier effects and benefits far beyond the investor). Examples include:

- ❑ Investments in technology—such as research and development or high-tech industries—that upgrade worker skills.
- ❑ Infrastructure projects—such as power and roads—that encourage business growth.
- ❑ Investments that create jobs in areas with high unemployment.
- ❑ Investments in environmentally friendly technology.
- ❑ Anchor investments—those that provide multiplier effects through signaling (showing that the country is open and attractive for investment) and by creating linkages to the local economy.

Such investments can have positive, often long-term spillover effects on the economy or environmental protection, making it easier to justify spending on investment incentives.

### Public goods

To the extent possible, cash-strapped governments can use incentives to encourage the private sector to fund public goods or goods with a strong public good character (such as infrastructure). By the same token, incentives should be limited for activities unlikely to generate social benefits.

When a country's level of public goods is very low, the marginal benefit from an additional amount of public good is more than the marginal cost. Accordingly, providing investment incentives to investors who provide public goods more than covers their revenue cost. For example, investment incentives may be provided to businesses creating assets that can also be used by the public, such as a road to a plant or factory that is also available for public use, a school for children of workers that is also open to other students, or a captive power plant that provides surplus energy to the local power grid.

The goal is to compare the opportunity costs of public funds with the returns on funds used for investment incentives. And when incentives are eliminated or not used, the resources saved should be used for spending that the private sector is unwilling to cover.

### International tax competition

To be competitive, governments often offer tax incentives similar to those offered by neighboring countries. The danger is that tax competition creates a race to the bottom, with countries competing to provide more generous incentives. Countries that attract such investments may suffer from the “winner’s curse”—having given up too much in exchange for investment. Governments should work with their neighbors to curb harmful tax competition.

In addition, many investors bargain with multiple governments to secure the best incentive package, and governments generally acquiesce. Hence governments should not get carried away when competing with neighboring countries. In the short term, governments may be at a disadvantage if they do not provide tax rates as competitive as

those extended by their neighbors. But in the long term it is much better to follow an alternative approach to attracting investment—one that takes advantage of each country's unique strengths and does not involve providing competing incentives.

## BEST PRACTICES IN ADMINISTERING INCENTIVES

Incentives require governments to administer them and curb their misuse. They can impose additional costs on businesses and create opportunities for rent seeking. Hence policies are required to mitigate such problems. The following principles can help guide policymakers in such efforts.

### **Incentives should be granted automatically**

Eligibility for incentives provided by law should be based on clear criteria, not granted through special permission or certification by investment promotion agencies, ministries of trade, or other government agencies. This approach ensures prompt decisionmaking and quick turnaround times for investors—essential to attracting and retaining investment.

### **Tax incentives should be part of the tax code**

Tax-related investment incentives should be placed in the relevant tax code so that tax authorities can administer them. Some countries provide tax incentives through different statutes, and in extreme cases through individual agreements with investors. These separate laws often contradict each other, confusing investors. If tax incentives are outside tax laws, it is unclear whether the tax administration has the authority to administer the incentives. If relevant tax clauses cannot be moved to tax laws, they should at least be mirrored or copied there. Doing so unambiguously allows the tax administration to administer tax incentives and limit their abuse.

### **Incentives require adequate monitoring and control**

The tax administration should ensure that investors receiving tax incentives satisfy the requirements for them. To enable them to do so, it should be compulsory for tax returns, declarations, and relevant forms to be filed regularly for investors to receive tax benefits. Tax incentives should not be used as an excuse to avoid tax administration, information, audits, and any other compliance requirements.

### **Indirect costs of incentives should be mitigated**

Effective incentive policy requires reducing the indirect costs of providing incentives. Such costs can include:

- ❑ Distortions created by encouraging new investments that are not economically viable or that are detrimental to existing ones.
- ❑ Time and money spent by businesses lobbying for tax incentives.
- ❑ Time and money spent by businesses qualifying for and obtaining tax incentives.
- ❑ Revenue lost to illegal activity, such as from businesses that do not qualify for tax exemptions but falsify information to do so, or indirect revenue lost to businesses that do not qualify for tax incentives but use tax-exempt entities to source goods.
- ❑ Additional costs to authorities responsible for administering tax incentives.

Though these nonrevenue costs are difficult to quantify, they may greatly exceed the financial costs of incentives. Thus they should be kept in mind when formulating incentive policy.

## REFORMING TAX INCENTIVE POLICY AND ADMINISTRATION

This section advises policymakers on best practices for providing tax incentives, including needed policies and reforms.

### **The best policy option for tax incentives**

A good tax system ensures predictable revenue for government, presents a reasonable tax burden to investors, is stable, and minimizes distortions in investment decisions. There is broad consensus that a reasonable, uniform tax rate on a broad base of taxpayers is sound policy. By definition, this approach rules out tax incentives.

Imposing taxes on a broad base can be justified by the establishment of a broader, more stable revenue base. With a broader base and for a given revenue requirement, tax rates can usually be lower than with a narrow tax base. The lower tax rate reduces economic distortions. With little exclusion from the tax base, tax evasion or avoidance (by claiming to belong to an excluded category) becomes harder. As a result, lower taxes reduce incentives not to comply—further widening the base.

Last but not least, special tax provisions increase the time and cost required for the tax administration to verify claims made by taxpayers, with the additional disadvantage of the tax administration becoming a potential source of corruption.

For all these reasons, governments in developing economies should aim for a reasonable low tax rate on a broad tax base—with limited exemptions.

### The reform path for best practice incentive policy

Policymakers seeking to move toward the best approach for tax incentive policy may wish to consider the reform path suggested in Figure 1, along two distinct dimensions: tax policy and tax administration. Most countries fall somewhere in the middle of these paths, so more detailed guidance on reform is given below.

**Provide immediate relief to investors.** In the short term and for various reasons—including political—governments face pressure to act quickly to show

that they are working to increase investment and generate jobs. Reform policies can give immediate relief to investors without providing overly generous tax incentives. Such policies include:

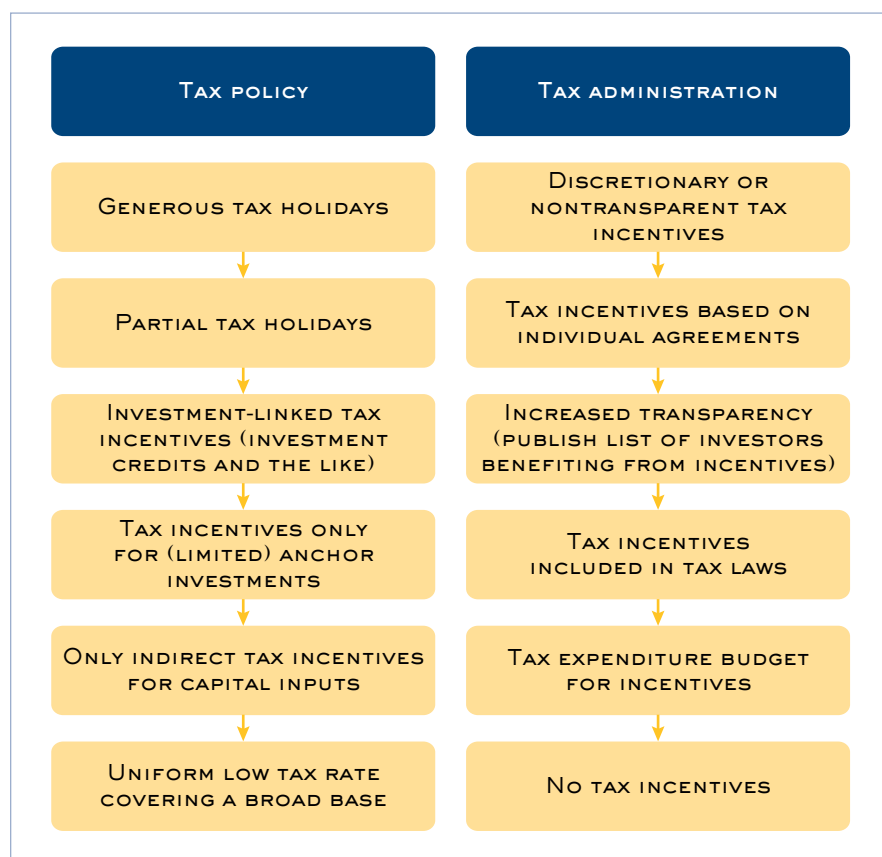
- ❑ Fostering investments in plants and machinery by lowering taxes on capital investments.
- ❑ Making incentives available automatically, signaling to investors that government is making the investment process friendlier.
- ❑ If offering new incentives, then doing so with time limits, to send a signal to potential investors that there is a limited window for benefits.
- ❑ Publicly announcing investors who benefit from incentives—increasing transparency and providing political backup.
- ❑ Pursuing a time-bound plan to reduce other barriers to investment.

**Move away from tax holidays.** Tax holidays partly or completely exempt income from taxation for a specified number of years. This is a popular but ineffective incentive for several reasons:

- ❑ It is a blanket benefit unrelated to the amount of capital invested, its growth, or its contributions to the economy during the tax holiday.
- ❑ Firms have an incentive to close and sell their businesses at the end of the tax holiday—only to reopen as a “new” investment, thus gaining an indefinite tax holiday.
- ❑ If FDI operates under double taxation agreements without tax sparing (that is, the home country respecting the incentives offered by the host country), tax holidays simply transfer tax revenues from the country receiving the investments to the country they originate from.
- ❑ Tax holidays enable firms to funnel profits, using transfer pricing, from an existing profitable company through the company receiving the tax holiday, and so avoid paying taxes on either.
- ❑ Most capital-intensive investments do not yield a profit until several years after operations start. Accordingly, tax holidays for a “startup” period of five years are ineffective.

Thus tax holidays are a blunt investment incentive. To limit their damage, tax holidays should

**FIGURE 1: REFORM PATH FOR TAX INCENTIVE POLICY AND ADMINISTRATION**



have clear end dates after which no such benefits are available. Moreover, alternatives to tax holidays can benefit taxpayers while encouraging investment. Such incentives are known as investment-linked or performance-based incentives. There are three main types of investment-linked incentives:

- ❑ **Investment tax credits** allow a fixed percentage of an investment to be deducted from taxes owed. Rules differ about credits in excess of tax liability—they may be lost, carried forward, or refunded.
- ❑ **Investment allowances** allow a fixed percentage of an investment to be deducted from taxable profit (in addition to depreciation). The value of this allowance is the product of the allowance and the tax rate. So, unlike a tax credit, its value will vary across firms unless there is a single tax rate. The value is also affected by changes to the tax rate, with a tax cut reducing it.
- ❑ **Accelerated depreciation** allows depreciation at a faster schedule than is available for the rest of the economy. This can be done in many ways, including through higher first-year depreciation allowances or increased depreciation rates. In nominal terms tax payments are unaffected, but their net present value falls and the liquidity of firms increases.

The tax benefits of tax holidays can be converted to an equivalent investment-linked incentive or a flat corporate tax rate. By properly calibrating the rates, such a conversion retains incentives for investors while eliminating the disadvantages of tax holidays. Though lowering tax rates provides a strong incentive for investment, lowering them too far is quite costly for revenue. As a result, any reform path that moves a country toward the best option should balance the competing objectives of attracting investment and protecting the revenue base.

**Develop policies for anchor investments.** Anchor investments generate multiplier effects, have significant linkages to local economies, and are often made by highly reputable firms that jumpstart investment in several areas. Accordingly, governments often woo such investors with incentive packages. But first, some basic questions should be answered.

Will the investment eventually generate additional tax revenue? Does the anchor investment provide positive externalities (such as signaling future investors and creating linkages to the economy)?

Would the investment have occurred anyway—obviating the need for incentives? Would incentives for anchor investments put existing investments at a disadvantage? Do such incentives cause leakages of tax revenue? And do they undermine the investment environment by encouraging other investors to press for similar incentives?

### **The reform path for best practice incentive administration**

Several bad practices involving the administration of tax incentives should be avoided. Some countries award incentives on a case by case basis or give investment certificates to “approved” investors, allowing them to claim incentives. These discretionary, nontransparent practices—hidden from the public—are prone to abuse and may not lead to the government’s desired outcomes. In addition, some countries provide investment incentives by executive decree and not by tax code. Even when such decrees are given by the highest authority, such as the president, this approach lacks proper checks and balances.

But even tax incentives awarded based on the law run the risk of proliferation if they are delivered by sector ministries. These ministries are not responsible for collecting taxes, so they do not bear the costs of the incentives they award. The best approach is to grant incentives based on tax laws that offer as little discretion as possible. Because tax incentives are essentially forgone revenues, to improve transparency their revenue costs should be calculated as part of the budget process. This approach enables broader discussion on the costs and benefits of incentive policy.

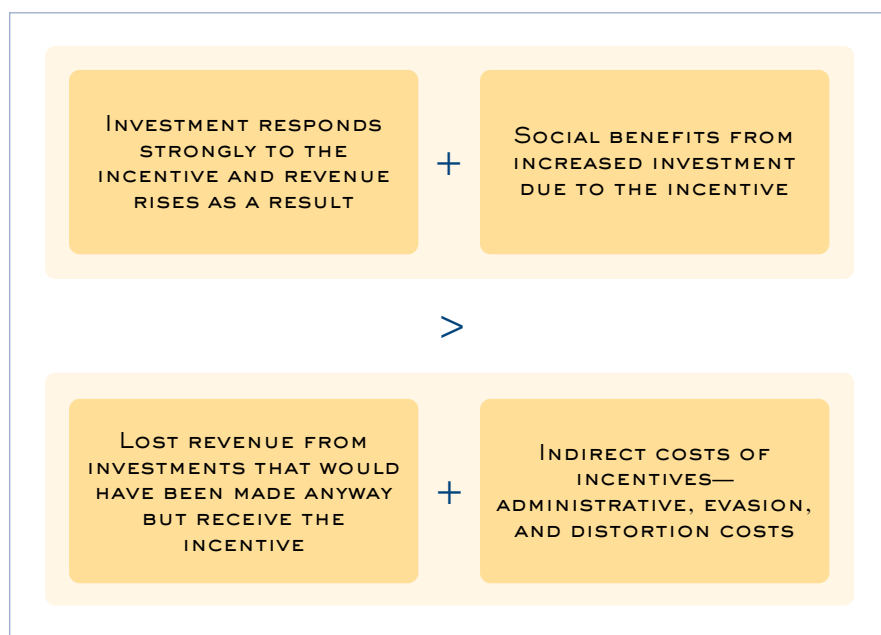
Finally, when incentives are provided it is essential that they be based on rules and not be open-ended (with strict time limits), that those benefiting from incentives file tax returns and face audits, that governments produce tax expenditure statements so that the cost of incentives is transparent, and that incentives are occasionally reviewed for their efficacy.

### **Gauging the cost-effectiveness of investment incentive policies**

A popular metric for measuring the cost-effectiveness of investment incentive policies is to calculate the dollar cost of the jobs they create, based on total tax spending. Though this approach is not very precise, it provides a ballpark figure that helps policymakers decide if the incentive was worthwhile.



**FIGURE 2: FRAMEWORK FOR FINALIZING INCENTIVE POLICY**



For example, a recent study found that the Yemeni government spent about \$6,000 for each of 8,000 jobs that investment incentives helped create—more than six times the country's per capita income (FIAS 2008). Similarly, investment incentives in Thailand cost the government 16 times the average annual wage of an industrial worker (FIAS 1999).

### RECOMMENDATIONS FOR INCENTIVE POLICY

The framework in Figure 2 provides a general guide for policymakers finalizing an incentive policy, based on country conditions and goals. For overall benefit to the country, any incentive provided should pass the test in the figure.

Using this framework and the principles outlined in this note, Table 1 summarizes desirable short- and long-term incentive policies for various types of countries.

**TABLE 1: RECOMMENDED INVESTMENT INCENTIVE POLICIES UNDER VARIOUS COUNTRY SCENARIOS**

Scenario	Short-term policy	Long-term policy
Countries with weak investment climates	Investment incentives are ineffective and therefore a waste of tax revenues. Such revenues should instead be used to provide public goods. Reforms should also be introduced to clean up the tax system.	Such countries should reduce barriers to investment by, for example, simplifying investment procedures.
Countries facing tax competition	Incentives can be used in the short-term to ensure that countries are not at a disadvantage relative to their neighbors.	Such countries should work on regional pacts to stop tax competition and promote their substantive differences (labor skills, infrastructure, and so on).
Countries seeking to diversify their economies	Such countries can use incentives linked to investment growth (investment allowances, accelerated depreciation), but for a limited period based on clear prioritization of sectors in line with FDI competitiveness.	Broader industrial policy strategies have to be followed, including a focus on sector targeting and promotion to attract investments.
Countries with unique advantages (natural beauty, natural resources)	General investment incentives to attract investments that exploit such advantages waste revenue unless they kick-start investment.	Barriers should be lowered for investments designed to exploit natural resources, improve access to land, and so on.

## LESSONS

Whatever investment incentives a government decides to offer and however it structures them, it should make every effort to ensure that they are:

- ❑ **Affordable**—forgone income should not severely undermine government revenue streams.
- ❑ **Based on evidence**—targets for incentives should be based on research that confirms they will benefit the country in ways that would not have been possible if there were no incentives.
- ❑ **Simple**—incentive administration should permit easy accessibility and eligibility determination.
- ❑ **Reviewed periodically**—investment incentives should be reviewed regularly to determine their relevance and economic benefits relative to their budgetary and other costs, including long-term impacts on resource allocation.

## CONCLUSION

Providing incentives can create risks for the investment climate and fiscal compliance. It also encourages lobbying and rent seeking. Over the long run, making the costs and benefits of tax incentives more transparent helps frame future policy. Many countries have found that the best investment incentive is providing a level playing field to all businesses through a broadly based, low, uniform tax rate and a good investment climate.

The global financial crisis has once again shed light on the need for effective fiscal policy to raise revenues for public goods while not compromising a country's attractiveness as a destination for investment or job creation. The principles outlined in this note suggest that governments take an approach that balances investment attractiveness with fiscal responsibility.

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## IN PRACTICE

The *Investment Climate IN PRACTICE* note series is published by the Investment Climate Advisory Services of the World Bank Group. It discusses practical considerations and approaches for implementing reforms that aim to improve the business environment. The findings, interpretations, and conclusions included in this note are those of the author and do not necessarily reflect the views of the Executive Directors of the World Bank or the governments they represent.

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The Investment Climate Advisory Services of the World Bank Group helps governments implement reforms to improve their business environments, and encourage and retain investment, thus fostering competitive markets, growth, and job creation. Funding is provided by the World Bank Group (IFC, MIGA, and the World Bank) and over 15 donor partners working through the multidonor FIAS platform.

