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Tax Incentives

Using Tax Incentives to Attract Foreign Direct Investment

The increasing mobility of international firms and the gradual elimination of barriers to global capital flows have stimulated competition among governments to attract foreign direct investment, often through tax incentives. This Note reviews the debate about the effectiveness of tax incentives, examining two much-contested questions: Can tax incentives attract foreign investment? And what are the costs of using them?

As more and more governments have tried to attract multinational companies and enhance the associated technology spillovers, fiscal incentives have become a global phenomenon—from tax holidays and import duty exemptions to investment allowances and accelerated depreciation. Although hardly new, this trend appears to have strengthened since the early 1990s.

At first glance the impact of tax incentives on foreign direct investment appears ambiguous. Over the past few decades time-series econometric analysis and numerous surveys of international investors have shown that tax incentives are not the most influential factor for multinationals in selecting investment locations. More important are such factors as basic infrastructure, political stability, and the cost and availability of labor. Both analysis and surveys have confirmed that tax incentives are a poor instrument for compensating for negative factors in a country's investment climate.

But that does not mean that tax incentives have no effect on foreign direct investment. It is no coincidence that in 1985–94 foreign direct investment grew more than fivefold in tax havens in the Caribbean and South Pacific. And Ireland's tax incentives have been recognized as key in attracting international investors over the past two decades. Moreover, in recent years there has been growing evidence that tax rates and incentives influence the location decisions of companies within regional economic groupings, such as the European Union, North American Free Trade Area, and Association of Southeast Asian Nations. Similarly, in the United States incentives can play a decisive role in the final location decisions of foreign companies once the choices are narrowed down to a handful of sites with similar characteristics. So, more accurate would be to say that tax incentives affect the decisions of *some* investors *some* of the time.



Box The pros and cons of tax holidays

1 Tax holidays are among the most widely used incentives, especially in developing countries. In 1995, according to the United Nations Conference on Trade and Development (UNCTAD 1995), as many as 67 countries offered this incentive. Tax holidays provide benefits as soon as a company begins earning income, while the benefits of a lower corporate tax rate accrue more slowly and over a longer time. But tax holidays benefit primarily short-term investments, typical of “footloose” industries in which companies can move quickly from one jurisdiction to another. They also tend to reward the founding of a company rather than investment in existing companies, and to discriminate against investments that rely on long-lived depreciable capital. And they can lead to erosion of the tax base as taxpayers learn how to evade taxation of income from other sources. For all these reasons fiscal experts have generally been highly critical of tax holidays.

Other evidence emerging around the world suggests that tax incentives have a more apparent effect on the composition of foreign direct investment than on its level. Indeed, most governments use tax policies to attract particular types of investment—or to change conduct—rather than to increase the overall level of investment. A recent study found that large foreign companies—such as those in the automobile sector—are generally in a better position to negotiate special tax regimes and thus to extract rents from host governments (Oman 2000).

These new findings have reenergized the debate about the effectiveness of fiscal incentives. Two main questions have held the attention of researchers: What kind of tax incentives are likely to have the greatest impact on the investment location decisions of multinational companies? And which companies or what kinds of investment are likely to be the most sensitive to tax changes?

Which tax instruments work?

In using tax instruments to attract foreign investors, many governments rely on a targeted approach. In developing countries favoring such an approach, a popular tax incentive is a reduction in the corporate income tax rate, through

tax holidays or temporary rebates for certain types of investment or companies (box 1).

Another targeted approach used in many countries, especially in the industrial world, is to allow fast write-offs of investment expenditures—for all investments or for those that the government wants to promote—through tax allowances or credits.¹ Investment tax allowances promote new investment rather than giving windfall gains to owners of old capital, as a reduction in corporate tax rates does. Still, investment tax allowances have limitations and drawbacks, especially for projects with long gestation periods and in unstable macroeconomic environments. Moreover, they pose management difficulties for tax administration and require well-developed accounting systems.

A few countries have chosen a nontargeted approach: lowering the effective corporate tax rate for all firms while providing limited or no incentives. Small economies such as Hong Kong (China), Lebanon, and Mauritius have typically chosen this option. International investors look favorably on a country offering a low statutory tax rate, especially one well below the international norm of 35–40 percent. A low corporate rate signals that the government is interested in letting the market determine the most profitable investments. But this approach can reduce tax revenues, at least during a transitional period (in the longer run the simplicity of the tax system may attract more investors, increasing the tax base and thus compensating for the initial reduction).

Finally, an extreme approach has been to simply eliminate taxes for all investors or for specific ones. Countries that have become tax havens generally suppress all direct income taxes and rely on indirect consumption and employment taxes. Other countries have limited the incentives to export-oriented activities in specific areas known as export processing zones. These extreme approaches have had mixed results, especially when the aim was to attract sustainable, high-value-added investment projects. These regimes have also been increasingly contested by OECD countries and multilateral organizations because they have often been associated with suspicious capital flows.

What firms respond?

The effectiveness of tax incentives is likely to vary depending on a firm's activity and its motivations for investing abroad. Growing evidence shows, for example, that tax incentives are a crucial factor for mobile firms and firms operating in multiple markets—such as banks, insurance companies, and Internet-related businesses—because these firms can better exploit different tax regimes across countries. Such strategies may explain the success of tax havens in attracting subsidiaries of global companies—and the spending by multinationals on economists and accountants to justify their transfer prices, designed to suit their tax needs. Similarly, tax rates generally have a greater effect on the investment decisions of export-oriented companies than on those seeking the domestic market or location-specific advantages, because such firms not only are more mobile but also operate in competitive markets with very slim margins.

What are the costs of tax incentives?

Since tax policy appears to have some effect on the location decisions of multinational firms, especially within regional markets, there is a risk that governments will “race to the bottom” with competitive tax incentives. Such competition has already started in some regions, most notably in Asia. The concern is that countries may end up in a bidding war, favoring multinational firms at the expense of the state and the welfare of its citizens. This risk has pushed governments to try to harmonize their tax policies under regional or international agreements (box 2).

Beyond the risk of a bidding war, tax incentives are likely to reduce fiscal revenue and create frequent opportunities for illicit behavior by companies and tax administrators. These issues have become crucial in developing countries, which face more severe budgetary constraints and corruption than do industrial countries.

There is no doubt that tax incentives are costly. The first and most direct costs are those associated with the potential loss of revenue for the host government. In Tunisia, relatively successful in attracting foreign direct investment, the fiscal costs associated with the incentive regime amounted to almost 20 percent of total

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Regional efforts to harmonize tax policies

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Recent efforts to harmonize tax systems have been launched in both the industrial and the developing world. In the European Union, for example, member countries are discussing more stable, predictable, and transparent tax rules. As a first step, in December 1997, member states adopted a code of conduct for business taxation, agreeing not to introduce “harmful” tax measures and to roll back existing harmful measures. Similarly, several West African countries have been working to harmonize their tax incentives for foreign direct investment in one unified investment code within the Monetary Union of West African States.

These efforts have been slow, and the political and economic challenges remain great. And as capital and companies become increasingly mobile, and investment environments increasingly similar, the temptation to use tax incentives to attract foreign direct investment will certainly increase.

private investment in 2001. In 1996 the U.S. state of Alabama paid Mercedes Benz a subsidy of US\$200,000 per employee, while Germany paid Dow Chemical an astounding US\$3,400,000 per employee (Moran 1998). The question in such cases is whether the new investment would have come to the country if it had offered lower incentives or none at all. If the answer is yes, free-rider investors benefit while the treasury loses, and the economy reaps no net gains. These examples illustrate the need to clearly evaluate the welfare implications of tax incentives, both at the level of the firm and globally.

Tax incentives also have many other, less obvious costs. Because they influence the investment decisions of private companies, they can distort the allocation of resources. And they can attract investors looking exclusively for short-term profits, especially in countries where the basic fundamentals (such as political and macroeconomic stability) are not yet in place.

Another problem with incentive measures relates to the cost and difficulty of administering them effectively. Incentive regimes generally impose a large administrative burden, so they must be more than marginally effective to cover the costs of their implementation and produce a net benefit. Discretionary regimes, which rely

on case-by-case evaluations, are especially difficult to administer. These regimes result in delay and uncertainty for investors, which can increase the cost of investment. They have also led to significant corruption, effectively screened out desirable investments, and undermined sound policymaking and the development of competitive markets. Nondiscretionary regimes, which grant incentives to any company meeting clearly stated requirements, are easier to implement. These regimes generally involve such incentives as investment tax credits, accelerated depreciation, and subsidies linked to indicators that can be easily measured (exports, technology imports, skilled labor).

A few governments, such as those of Ireland and Singapore, have had marked success with targeted tax incentives. But many more have failed to attract foreign direct investment with such incentives, explaining why the recent trend has been to eliminate and streamline tax incentive programs. These moves appear to be sensible ones, since multinationals appear to give greater weight to simplicity and stability in the tax system than to generous tax rebates, especially in an environment with great political and institutional risks (see Ernst & Young 1994).

New challenges

The debate about the impact of tax incentives on foreign direct investment is far from over. So far the benefits appear uncertain, while the costs are large. Nevertheless, old questions will lead to new answers, and new questions will arise.

The emergence of global companies will have a significant impact on government revenues. These companies are likely to be more sensitive to tax incentives, because they will be better able to exploit them by transferring their activities from one country to another. Indeed, the Internet could increase tax competition by making it much easier for multinationals to shift their activities to low-tax regimes that are physically far from their customers but virtually only a mouse-click away. As *The Economist* (2000, p. 5) commented, “many more companies may be able to emulate Rupert Murdoch’s News Corporation, which has earned profits of US\$2.3 billion in Britain since 1987 but paid no corporation tax there.”

Notes

This Note is based on Wells and others (2001).

1. These allowances take three forms: accelerated depreciation, which allows companies to write off capital more quickly for tax purposes than for accounting; investment expenditure allowances, which permit companies to write off a percentage of qualifying investment expenditures from their taxable income; and investment tax credits, which allow companies to reduce taxes paid by a percentage of their investment expenditures.

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