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Rethinking Investment Incentives

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The Context

Why focus on incentives?

Attracting foreign direct investment (FDI) now plays out as contests between countries and regional governments within them. Investors and consultants examine countries, negotiate with governments, and even set competing jurisdictions against each other to obtain more lucrative arrangements. They assess gains from incentives, overall investment climates, and consider factors such as domestic market size, proximity to key markets, access to raw materials and the cost and availability of skilled workers. Globalization has rendered capital the freest of all production factors to move and attracting FDI has become a geopolitical imperative on which governments can rise and fall.

The role of fiscal incentives in attracting FDI is a matter of debate. In the 1960s and 1970s, many jurisdictions offered foreign investors long-term tax exemptions. This was intended as compensation for the risks involved with poor investment climates: low institutional capacities, unstable political dynamics, poor infrastructure and largely unskilled labour forces. Policy-makers gambled that tax holidays would lure in reluctant investors and the resulting revenue losses would be balanced by the positive externalities that FDI would bring—foreign currency, jobs, up-skilling, business linkages and more. This gamble did not always play out as expected. While many economies experienced brief FDI booms, policy-makers realized that fiscal incentives did little to embed investors in the domestic economy and even less to convince them to re-invest if the wider macro-economic offering remained weak. The global investment policy community began to doubt that incentives brought net benefits—higher net tax revenues and positive externalities such as business linkages and market signalling effects. Many fiscal incentives were offered in FDI sectors where the investment would very likely have been made without them.

The challenge is not to design incentives as blunt instruments, but to match them to the economic realities of each jurisdiction, its comparative trading advantages and its immediate and medium-term sustainable development priorities.

Incentives versus the investment climate

Countries such as Canada, Ireland, Mauritius, South Korea, Malaysia and Singapore demonstrate that investment incentives can support sustainable growth. These countries have stable political climates and well-developed governance and institutional capacity. This may have allowed them to invest in the continued upgrading of their FDI credentials.

Research conducted by the World Bank Group's Investment Climate Advisory Services in 2010 suggests that in weak investment climates without accurate macro-economic data, where skilled labour is short and business establishment is hampered by bureaucratic red tape and facilitation payments, the advantage provided by tax exemptions declines. The World Bank Group found that lowering the effective tax rate from 40% to 20% raised FDI by 1% of GDP for countries ranked in the bottom half in terms of investment climate. The same change raised FDI by 8% of GDP for countries in the top half.

Tax incentives and exemptions cannot compensate for a weak investment climate. Trying to use them that way might bring governments a double revenue loss, by subsidizing investments that would have been made anyway and reducing the funds available to upgrade the macro investment environment that is critical to attracting more investment.

When should tax incentives be used?

This paper does not suggest that tax incentives should never be used. Anecdotal evidence from FDI flows over the last three decades demonstrates that tax incentives can provide a number of benefits:

- They can trigger positive externalities or multiplier benefits that go well beyond the investment: This includes investment, in infrastructure projects in energy, roads and railways, that will improve the investment climate, anchor or flagship investment projects that will signal that the investment climate is improving, ventures on environmental and other technologies that will promote research and development and build skills for knowledge-based FDI, projects based in or targeted at deprived or rural communities, ventures that have particularly strong potential to create supplier linkages in the domestic economy, and—most importantly—ventures that have the potential to crowd in domestic investors.
- They can maintain competitiveness with countries that have similar comparative advantages and trade profiles. When competitors offer tax incentives, it is difficult to not do otherwise. The challenge for policy makers is to find the balance between competing with other jurisdictions without suffering the winner's curse—giving so many benefits to the investor that returns to the host economy are compromised.
- Many governments are seeking to crowd in private capital participation in areas that were traditionally considered public goods—roads, schools, hospitals, power plants, airports, railways and railway stations, ports, water treatment plants, prisons and even public libraries. These contracts are called private public partnerships (PPPs) or, in the case of outright private capital provision, private finance initiatives (PFIs). The challenge is to design incentives that will in turn PPPs and PFIs into sustainable development triggers and increase environmental and social gains across the wider economy. This requires a sharing of risk between the public and the private sector, and incentives can play an important part of this risk sharing. Policy makers can offer incentives that will reduce the legal, political and revenue uncertainties for the investor but tie those incentives to tariffs as well as to environmental and social performance conditions over the life of the asset.
- Some experts believe that incentives should only apply to PPP projects where future revenue streams are uncertain. This is especially relevant in lower income countries where infrastructure and public services are poor and the marginal benefit from each unit of additional infrastructure or public service is more than the marginal cost. Investors are more likely to recover their investment through the project revenues, so incentives may not always be necessary. For example, an investment incentive for investments in roads there tolls or user fees might provide investors with an acceptable return on investment would be wasteful. An incentive for rural roads that would not otherwise be built might be a more worthwhile public expenditure. The challenge for policy-makers is to determine the opportunity cost of spending public funds on incentives rather than other development priorities.

Administering tax incentives

Policy makers should develop tax incentives according to the three Ts—timely, targeted and temporary:

- Stipulate by law the length of the incentive period and the entities eligible for incentives
- Administer incentives through corporate tax codes.
- If incentives are awarded through legal instruments and regulations other than corporate tax codes, these provisions should be mirrored in the tax code.
- Mandate tax authorities to administer the award and monitoring of incentives. This will lower administration costs and increase transparency as tax authorities are best placed to ensure that investors receiving incentives are eligible and provide the necessary documentation.
- Avoid the granting of discretionary incentives, whether through bilateral negotiation or certification.
- Process applications for incentives quickly, to promote transparency and reduce opportunities for abuse. One-stop-shop services for company establishment and the services of special economic zones and industrial parks are useful.

Monitor the application of incentives to guard against abuse. This would include measures to discourage the false declarations to meet incentive eligibility requirements, ensuring compliance with performance requirements including environmental and social performance, and most importantly, limiting distortions created by new investments that are not viable—or are only viable at the expense of existing projects.

Redesigning fiscal incentives

The first step in reforming fiscal incentives is to tie the administration of fiscal incentives in with tax codes and the overall corporate tax system as a whole. Well-administered tax systems that transparently gather and spend revenues for governments and are considered an acceptable burden by investors. They are a critical indicator of economic stability and ease of doing business.

Incentives should be administered by tax authorities and not by sector ministries. Incentives, like all subsidies, are foregone revenues and need to be accounted for in budgeting processes. This will generate intelligence for the wider debate on the costs and benefits of investment policies.

Governments should avoid discretionary fiscal and financial incentives. Such non-transparent practices are prone to abuse and lack the necessary checks and balances to maintain a predictable investment climate.

The next critical step would be to eliminate blanket exemptions from corporate income tax. Many countries continue to offer tax holidays and removing them or reducing their duration is a politically charged issue, but tax holidays are a blunt instrument. They do not encourage capital investment or reinject revenues into existing or new businesses. Nor do tax holidays encourage FDI providers to partner with domestic investors and do business with domestic suppliers. Rather, they can attract footloose investors who will make little effort to embed their businesses in the domestic economy, as they are likely to move to cheaper locations when the tax holiday ends.

Tax holidays also encourage firms to close their operations and reopen as “new” ventures that qualify for continued tax exemptions. This creates a large scale pattern of tax avoidance.

With the proliferation of double taxation agreements—unless tax sharing is provided for—tax holidays can encourage the transfer of tax revenues from the host country to the home state of foreign investors. Tax holidays let firms use transfer pricing—even to set up shell companies—to take advantage of tax holidays, often providing little benefit to the host country.

Tax holidays also encourage investors to channel profits through transfer pricing from profitable ventures to assets that are receiving tax holidays, and avoid paying taxes on either investment. As many investments take some time to become profitable, those tax holidays for the “first five years” become simply an administrative burden for tax authorities, who will have nothing to show for their efforts.

In designing incentives, policy makers often need to show immediate market impacts such as increased interest from foreign investors, higher private capital participation in infrastructure projects and lower rates of unemployment. Policy makers can meet these expectations through a variety of measures such as lowering (but not eliminating) taxes on capital investments in plants and machinery, making training expenses tax deductible, and making the costs of compliance with voluntary sustainability standards tax-deductible. It is also important to increase transparency and limit abuse by identifying all investors who benefit from incentives.

Incentive policies must contain be clearly time-limited. This will also simplify administration—to ensure that investors file tax returns and face audits as required and that tax authorities produce tax expenditure statements to make the cost of the incentive transparent.

Government should occasionally measure the effectiveness of incentives. The most commonly used indicator is the cost of jobs created by the tax expenditure. For example, the Investment Climate Advisory Group of the World Bank reports that in 2004, Thailand’s investment incentives costs 16 times the average annual wage of an industrial worker for every job created. In Indonesia, investment incentives cost 18 times the average wage of an industrial worker per job created, and in Bangladesh, and incentives cost 33 times the average wage of an industrial worker¹ per job created.

The case for performance-based incentives

Taxes are the most sustainable source of funds for development and the goal for policy makers is to encourage investment that benefits both investors and the host economy while qualifying tax revenues. How else are countries to reduce sovereign debt, wean themselves off foreign aid, improve sovereign risk ratings, decrease borrowing costs and improve economic stability? How can governments achieve the most fundamental step in sustainable investment—crowding in domestic investors, whether as suppliers to FDI providers, joint venture partners, or franchise holders?

Performance-based incentives provide policy makers with ways to achieve this. The options can be in the form of credits, allowances or accelerated depreciation. In sustainable development, there is increasing use of incentives in the form of loans, grants and bonds:

¹ Report of Rationalization of Tax Incentives and Consolidation of Sub-National Taxes, Fees and Charge’. World Bank Group, Washington, D.C. 2008.

- Tax credits that allow a fixed percentage of an investment to be deducted from taxable profit (in addition to depreciation).
- Investment allowances that allow a fixed percentage of an investment to be deducted from taxable profit (in addition to depreciation). The value of this allowance is usually the product of the allowance and the tax rate, so its value will (unlike a tax credit) vary among investors. The tax value is also affected by changes to the tax rate: if taxes are lowered, the value of the allowance will also be lower.
- Accelerated depreciation which provides for the on-balance-sheet depreciation of assets at a faster schedule than is available for the rest of the economy. This is most often done by allowing higher first year depreciation allowances or increased depreciation rates. While this does not affect tax payments, it helps investors increase cash flow by decreasing the net present value of assets.
- Loans were widely used during the 1990s and 2000s but have declined in importance in the EU and U.S.A. as a result of sovereign debt-related reforms. They continue to be important in the BRIC and emerging countries. While they may be easier to administer, the challenge is to ensure that the performance criteria on which eligibility was determined are indeed achieved by the beneficiaries. Loans work best as part of a package of fiscal incentives, focussing on specific performance indicators. For example, the Italian District of Apulia implemented a '13-investment-incentive' program. It included a range of fiscal incentives to all enterprises, and loans to SMEs for energy efficiency and renewable energy technology initiatives that would otherwise not have implemented. The District assumed that the energy efficiency related process improvements would make the beneficiaries even more competitive. The entire 13-incentive package is reported to have generated more than €3 billion of new investment from the beginning of 2011 to mid-2013.²
- Grants are a popular incentive but they need to be performance-driven and targeted. The use of grants as a referrals incentive is an interesting development. In Ireland, individuals who introduce an international company to ConnectIreland (a joint venture promotion initiative supported by the Irish Industrial Development Agency) are eligible for a cash reward of US\$2,000 per new job created in Ireland as a result of the facilitation. The cash reward is increased to US\$4,000 per new worker if, in a 12-month period, 30 or more "sustainable jobs" are created³.
- There is growing interest in green bonds and social impact bonds designed to guarantee investment in infrastructure and public services. Activity in this area is particularly related to providing guarantees for public private partnerships (PPPs) where the private sector is contracted to fully or partly finance, build and operate a public asset. (PPPs are in themselves controversial investments and a detailed discussion falls outside the scope of this paper.) Bonds have also been used to finance energy efficiency and renewable energy projects, with the bonds repaid from the efficiency gains enabled by the project. For example, the New Mexico Energy Efficiency and Renewable Energy Bonding Law, 2005, authorizes up to \$20 million in bonds to finance energy efficiency and renewable energy improvements in state government and school district buildings. Public entities can request an energy assessment by the New Mexico Energy, Minerals and Natural Resources Department, to determine a building's potential for energy efficiency and cost savings. If the building passes, the entity can install or enter into contracts (for a maximum of 10 years) for

² FDI Intelligence Staff Report, Apulia President takes incentive-driven Approach, June 2013. Posted at www.fdiintelligence.com

³ FDI Intelligence, Ireland introduces referral fees to boost FDI job creation, May 2013. Posted at <http://www.fdiintelligence.com/News/Ireland-introduces-referral-fees-to-boost-FDI-job-creation>

the installation of energy efficiency measures. The improvements will be financed with the bonds, which will be repaid using the associated energy savings⁴.

Performance-based incentives also make the case for equivalent incentives or flat corporate tax rates. A well calibrated, flat corporate tax rate (instead of a long-term tax holiday) can send important market signals that the investment climate and fiscal regimes are transparent and predictable. However, lowering the corporate tax rate can reduce government revenues. The objective should be to balance the competing objectives of attracting investment and ensuring the revenue base.

Performance based incentives also make the case for developing dedicated policies for anchor investments. Anchor investments serve as important market signals for lower income countries as they can be used as real time experiments to build business linkages, up-skill labour forces, establish R&D and technology partnerships via domestic academic institutions and much more. Such projects can also involve globally significant investors whose branding alone can send positive signals on the stability and maturity of the host country's investment climate. It is not difficult to empathise with policy makers who want to offer generous incentives to anchor investors. The potential returns may appear "too big to lose." In practice, anchor investments in middle and lower income countries have not always lived up to expectations.

When the domestic economy is weak, domestic businesses are not able to provide quality services, and the labour force is not adequately skilled, these projects turn out to be enclaves with little positive externalities for the domestic economy. And when coupled with tax holidays, they generate no revenue for the host government. This creates a vicious cycle—the host government has no revenues to upgrade the investment climate and this exacerbates the enclaving of FDI projects. Incentives for anchor investments can also disadvantage domestic investors by distorting markets and catering to aggressive corporate lobbies.

Moving forward

The overall recommendation of this paper is not that governments move immediately away from offering incentives—but rather that they gradually move from awarding automatic tax holidays to a mix of performance-based incentives—both fiscal and financial. This can be complemented by a flat corporate tax rate that will help create a level playing field for domestic and foreign investors.

This paper also argues that incentives should not be viewed as a form of compensation for a poor investment climate. While incentives are important determinants of FDI, what investors seek most is access to resources, access to skilled labour, ease of doing business, bankable infrastructure, a transparent and predictable fiscal code and, ultimately, opportunities to do business in the domestic market.

In implementing the recommendations made in this paper, policy makers need to remember that policy changes must be accompanied by reforms in the way taxes are administered:

- When governments award generous tax incentives, reforms should be designed as partial tax holidays for a short period of time. The challenge here will be the administration of these partial incentives, as they foster discretionary and non-transparent tax systems.

⁴ Energy Efficiency & Renewable Energy Bond Program. Website http://www.nmfa.net/NMFAInternet/NMFA_Web.aspx?ContentID=13

- When policies are implemented and partial tax holidays are replaced by performance-based incentives, tax administrations are provided with window of opportunity for reform. Investors receiving incentives need be identified and the costs and benefits of incentives must be calculated and disclosed.
- Further reforms could include performance-based incentives for selected sectors and anchor projects. Some governments also prefer to target performance based incentives for capital investments. Many European member states offered tax credits for capital investment in renewable energy projects, and on financial products engineered to deliver capital for the upgrading of student housing and retirement homes. Investment incentives can be incorporated into tax codes and the development of budgets.
- The final reform would be a uniform low tax rate for both domestic and foreign investors, levelling the playing field and eliminating the use of tax incentives altogether.

It is also important to consider the investment profile of countries in determining the best course for reform:

- When countries face aggressive tax competition, time-limited incentives enable them to compete with other jurisdictions.
- When countries seek to diversify their FDI target sectors, performance incentives linked to capital injection and expansion (such as allowances, credits and accelerated depreciation) are preferable.
- When investment climates are weak, incentives can turn out to be a waste of tax revenues which could otherwise be used to upgrade public services and infrastructure, and to improve ease-of-doing-business indicators.



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