

Effectiveness of Investment Incentives in Developing countries

Evidence and Policy Implications

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The World Bank Group

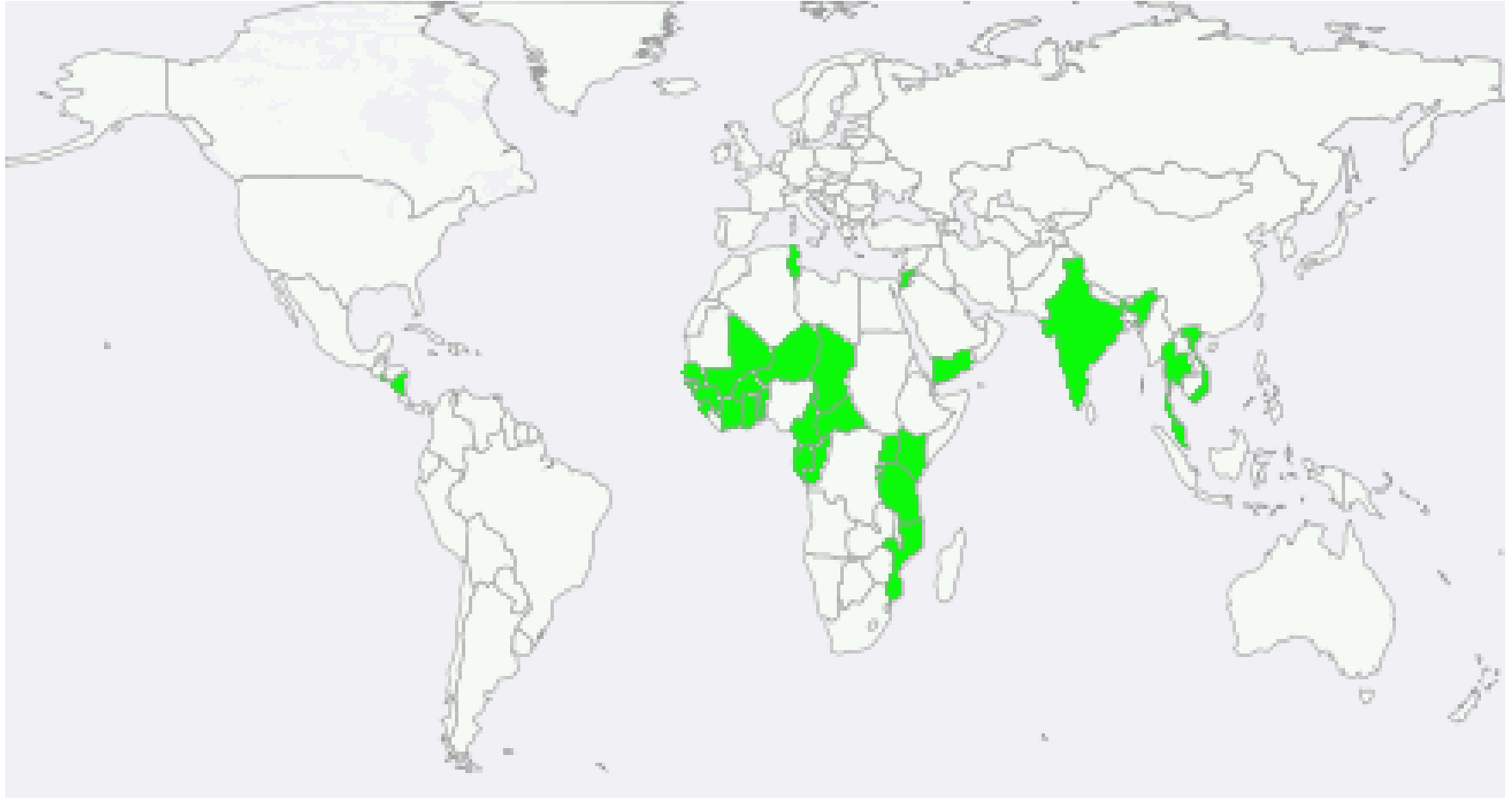
Investment Climate Advisory Services of the World Bank Group



Plan of the Presentation

- The Incentives Framework
- The econometric evidence
 - Current literature
 - Investment Climate Department research
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Incentives and Tax - Project scope

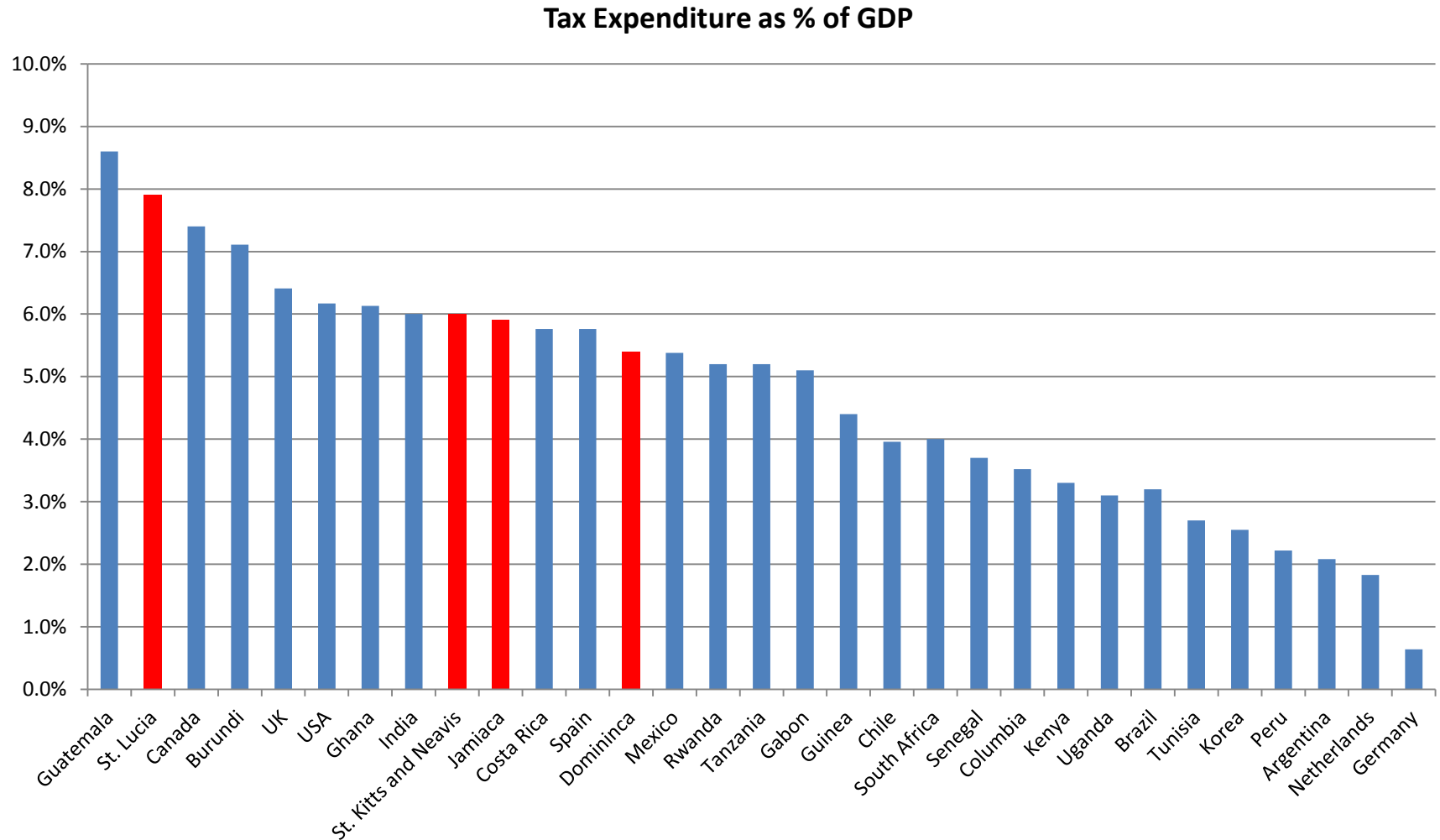


**This project studies incentives in 41 countries
across 4 continents**

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Tax Expenditures around the world



The cost of tax incentives are non-trivial in many countries including the Caribbean

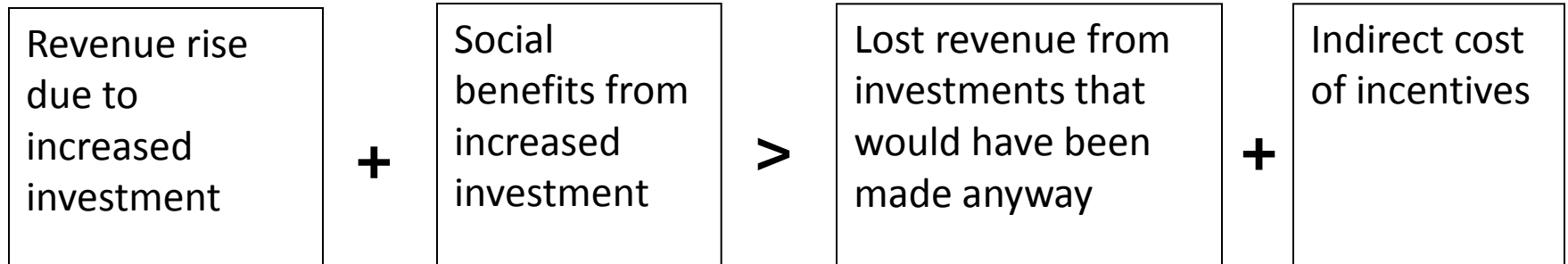
Prevalence of Tax Incentives around the World

	Number of Countries Surveyed	Tax holiday/Tax exemption	Reduced Tax rate	Investment allowance/Tax credit	R&D Tax Incentive	Super-deductions	SEZ/Free Zones/EPZ/Freeport	Discretionary process
East Asia and Pacific	12	92%	75%	67%	83%	33%	92%	83%
Eastern Europe and Central Asia	16	88%	38%	25%	31%	0%	100%	38%
Latin America and the Caribbean	25	88%	32%	52%	12%	4%	72%	40%
Middle East and North Africa	15	80%	40%	13%	0%	0%	80%	40%
OECD	33	21%	36%	64%	76%	21%	67%	33%
South Asia	7	100%	43%	71%	29%	71%	71%	43%
Sub-Saharan Africa	45	78%	62%	78%	11%	18%	64%	82%

Tax Incentives in one form or the other are prevalent in all regions of the World

Incentives Framework

The Benefits and Costs of an Incentive Policy

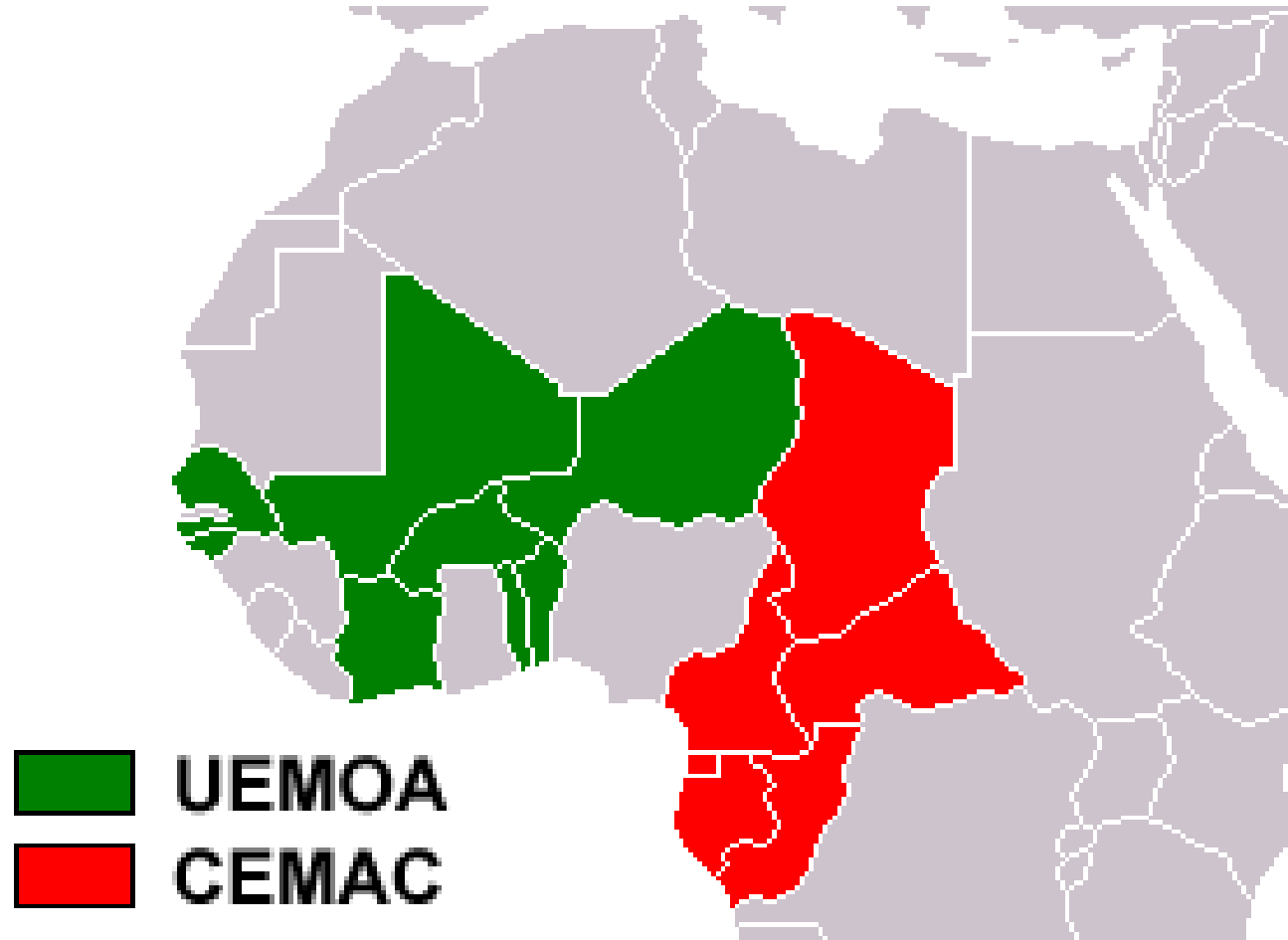


Social Benefits include cleaner environment, better skills, better health, etc.

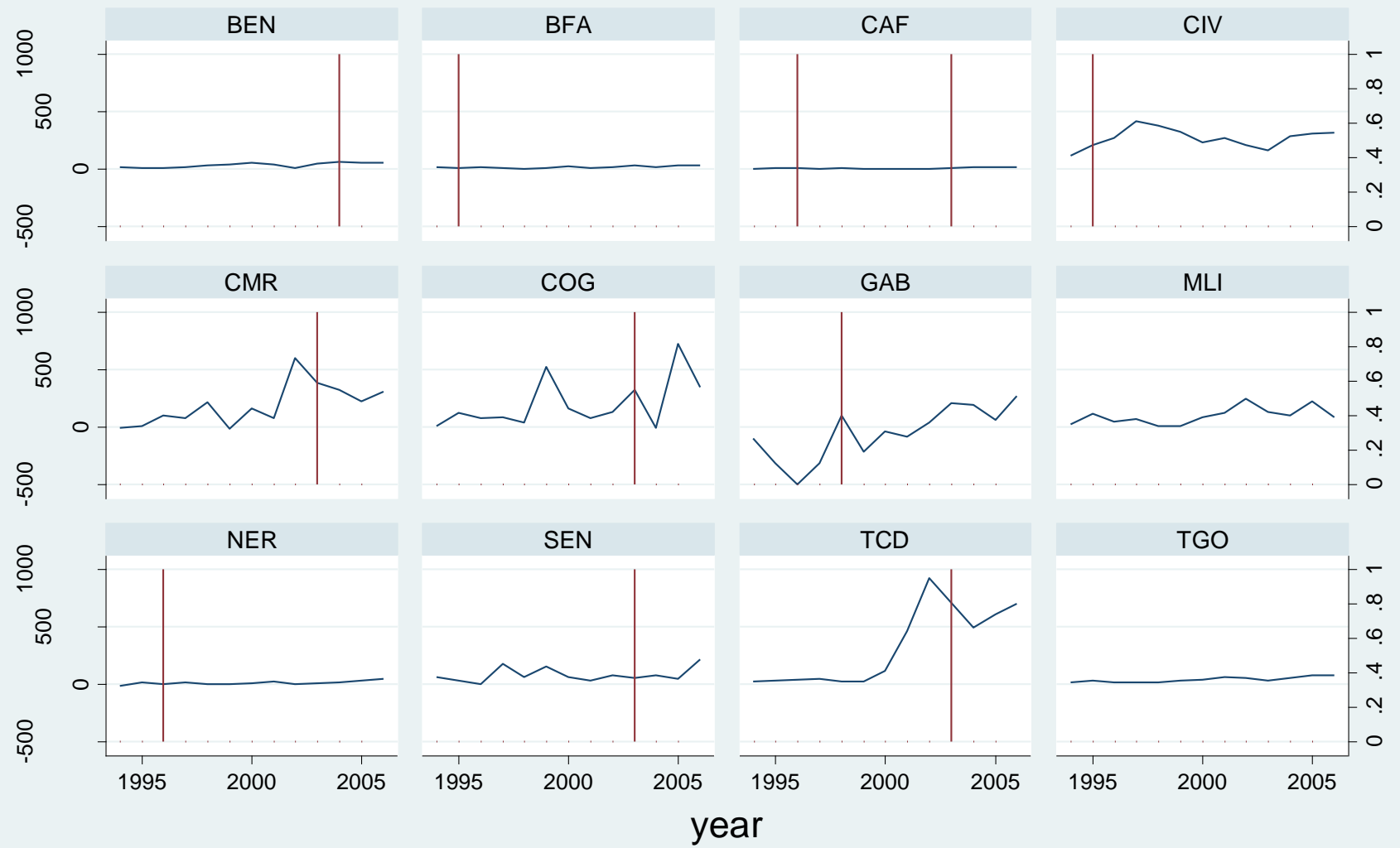
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The Effectiveness of Tax incentives in West/Central Africa



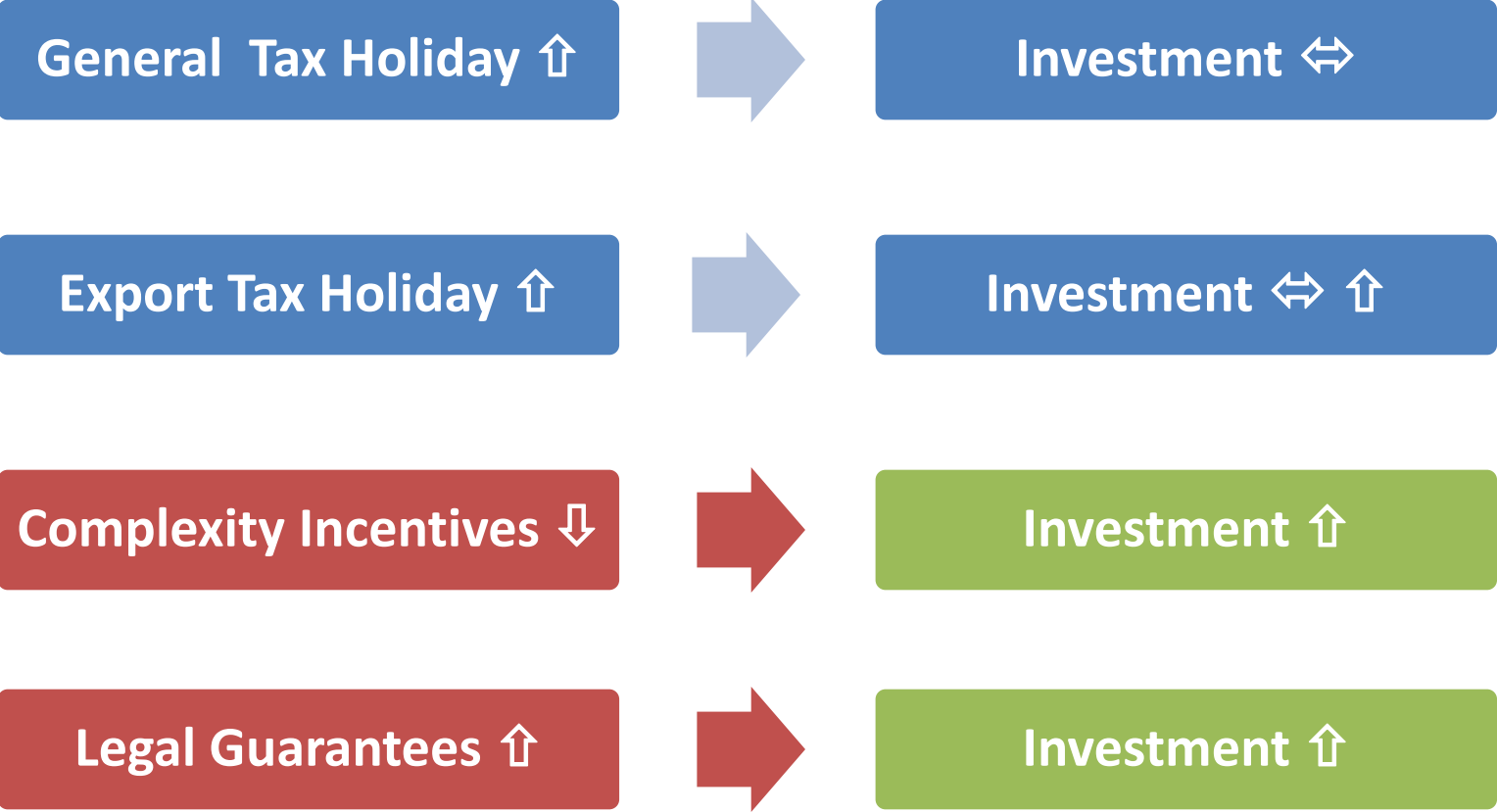
Impact of Investment Code on FDI



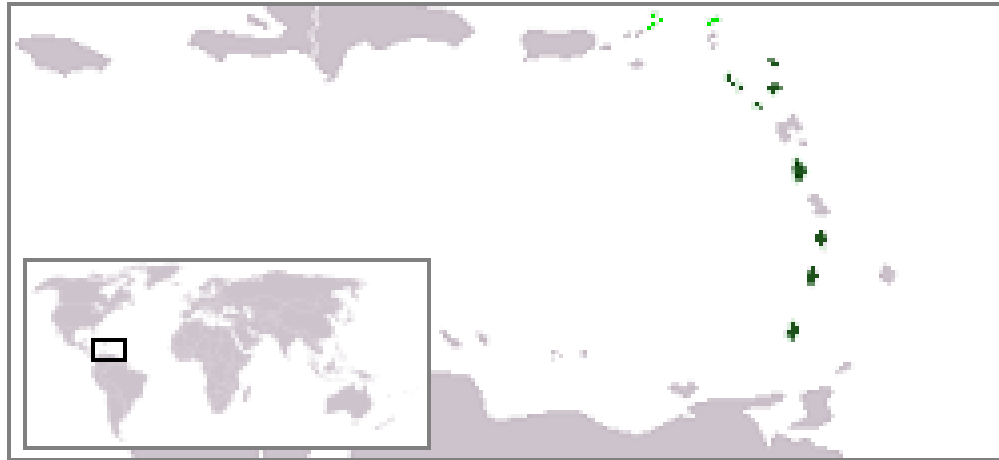
— FDI flow current USD — change inv climate

Graphs by country_code
 Source: James and Van Parys, 2009

Finding in UMEOA/CEMAC Case Study



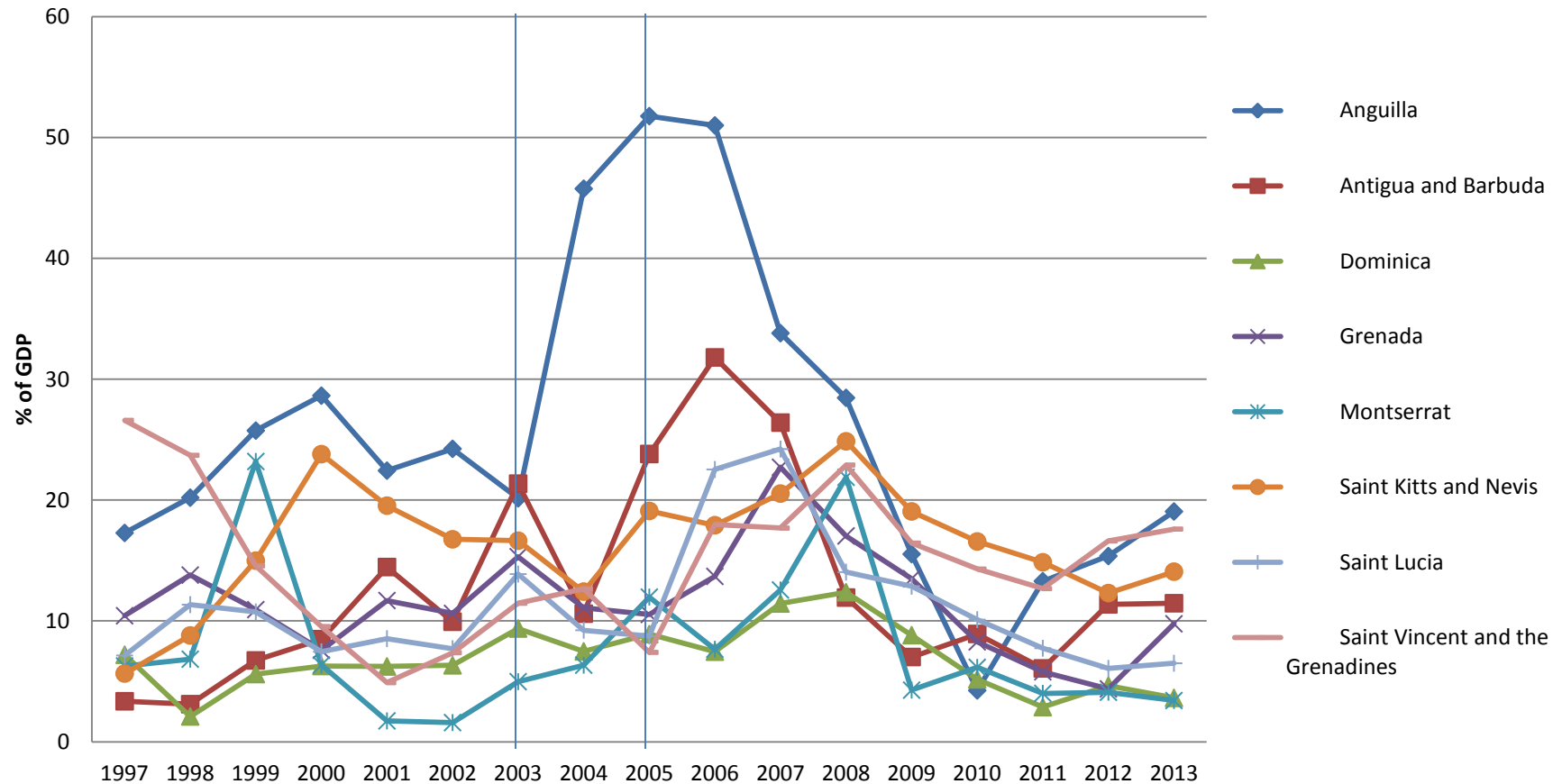
The Effectiveness of Tax incentives for Tourism Investment in the Caribbean



Organization of Eastern Caribbean Countries

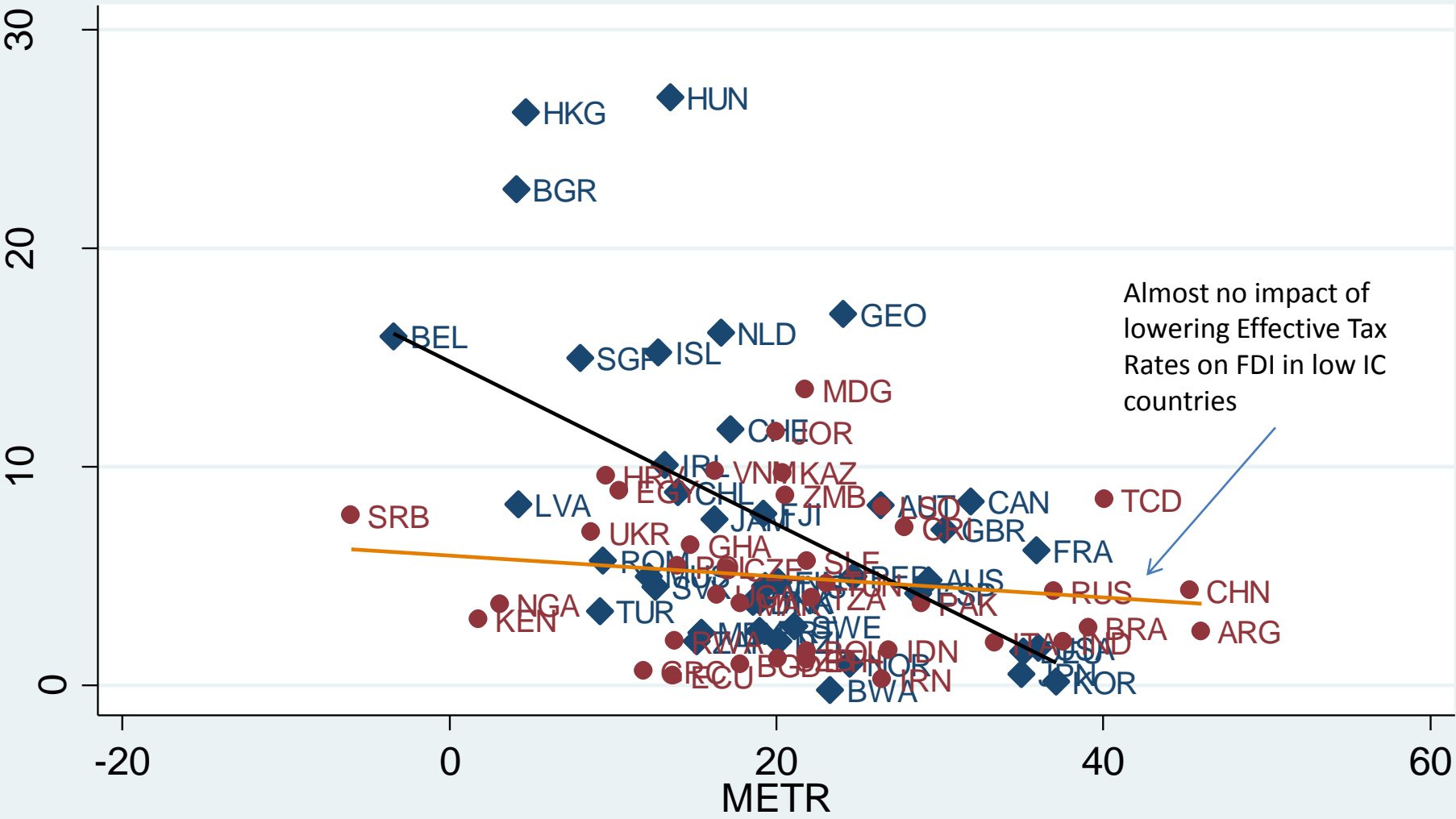
FDI inflows into the Caribbean

FDI in OECS Countries (% of GDP)



When Antigua increased the tax holiday from 5 years to 25 years in 2003 investments responded. However was this investment taken away from other countries ?

Fiscal Policy Effectiveness and the Investment Climate



◆	High IC countries	●	Low IC Countries
—	Trend High IC countries	—	Trend Low IC Countries

Source: James and Van Parys, 2009

Top inbound and outbound FDI

	Average FDI inbound (% of GDP) (2003-2012)		Average FDI outbound (% of GDP) (2003-2012)
British Virgin Islands	3564.3	British Virgin Islands	3613.5
Cayman Islands	412.3	Cayman Islands	266.7
Marshall Islands	113.5	Cook Islands	137.1
Liberia	38.8	Liberia	51.2
Luxembourg	28.1	Luxembourg	32.1
Anguilla	26.7	China, Hong Kong SAR	27.7
China, Hong Kong SAR	26.4	Belgium	13.4
Congo	21.3	Panama	11.3
Montenegro	20.6	Marshall Islands	10.3
Mongolia	19.2	Singapore	10.2
Singapore	19.1	Iceland	10.0
Sao Tome and Principe	18.0	Switzerland	9.6
Saint Kitts and Nevis	17.9	Netherlands	7.9
Belgium	15.6	Ireland	7.2
Antigua and Barbuda	15.3	Sweden	6.4

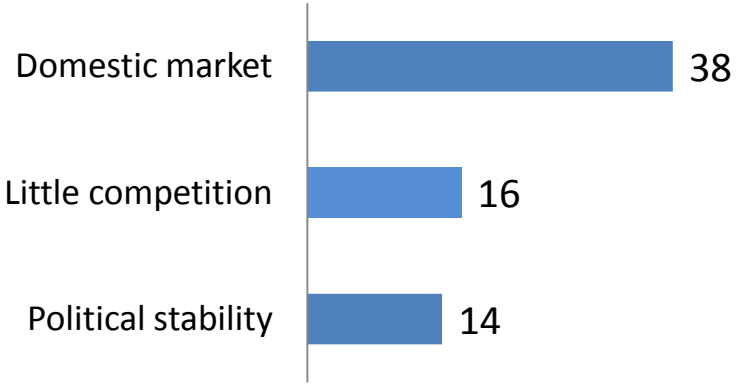
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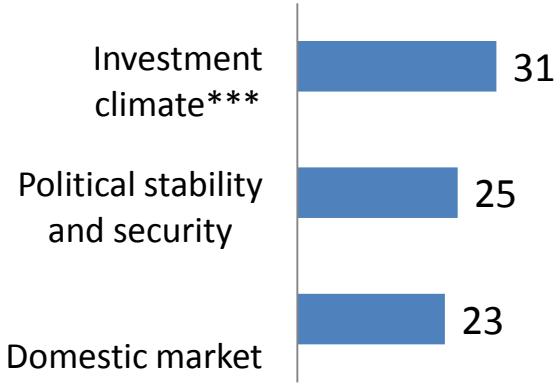
Investor Motivations to Invest

Survey asked about three most critical factors for investment decisions*
(Answer in Percent)

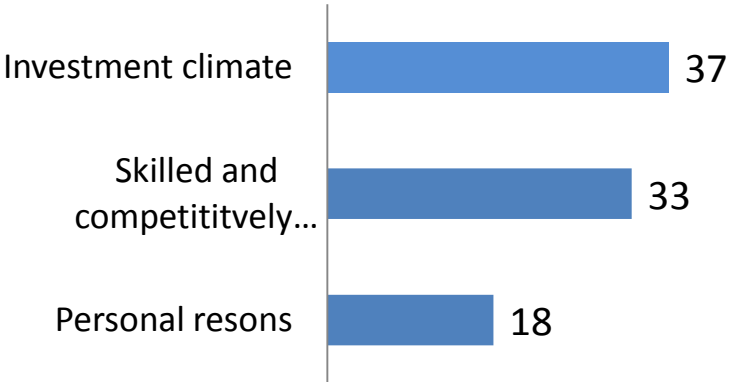
Mozambique – 60 total respondents**



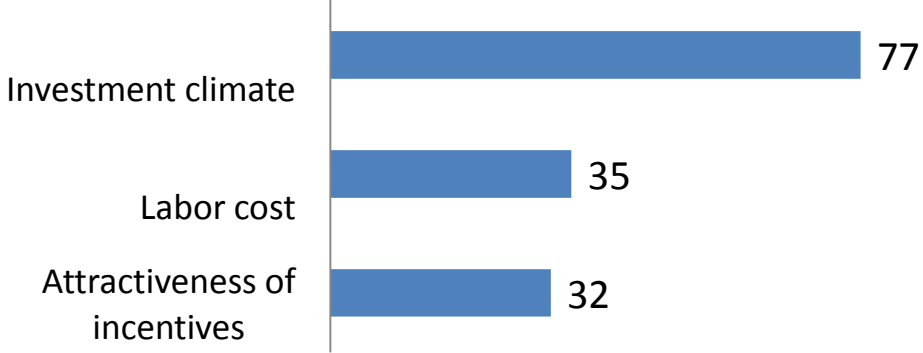
Jordan – 61 respondents



Serbia – 50 total respondents



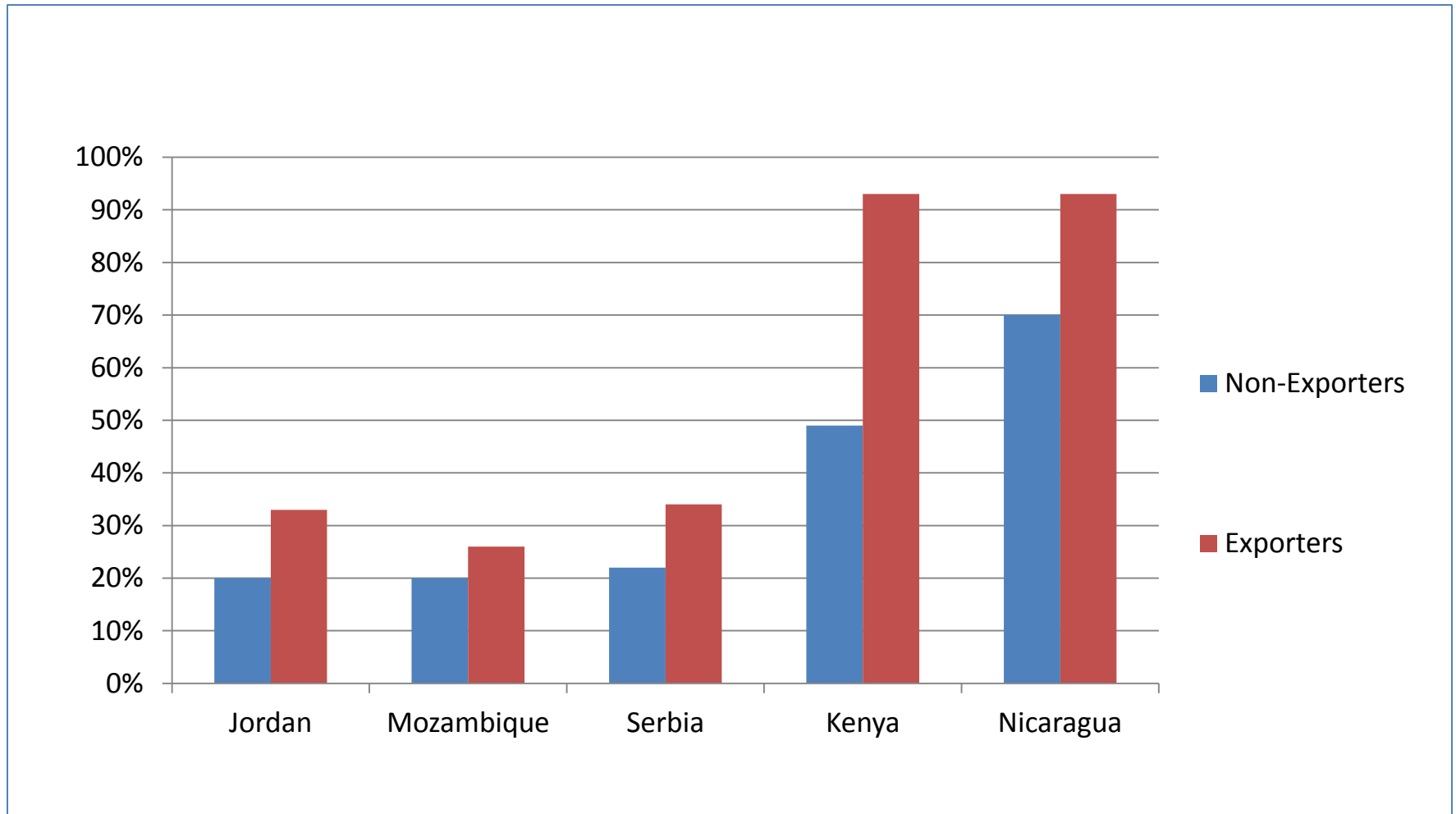
Nicaragua – 71 respondents



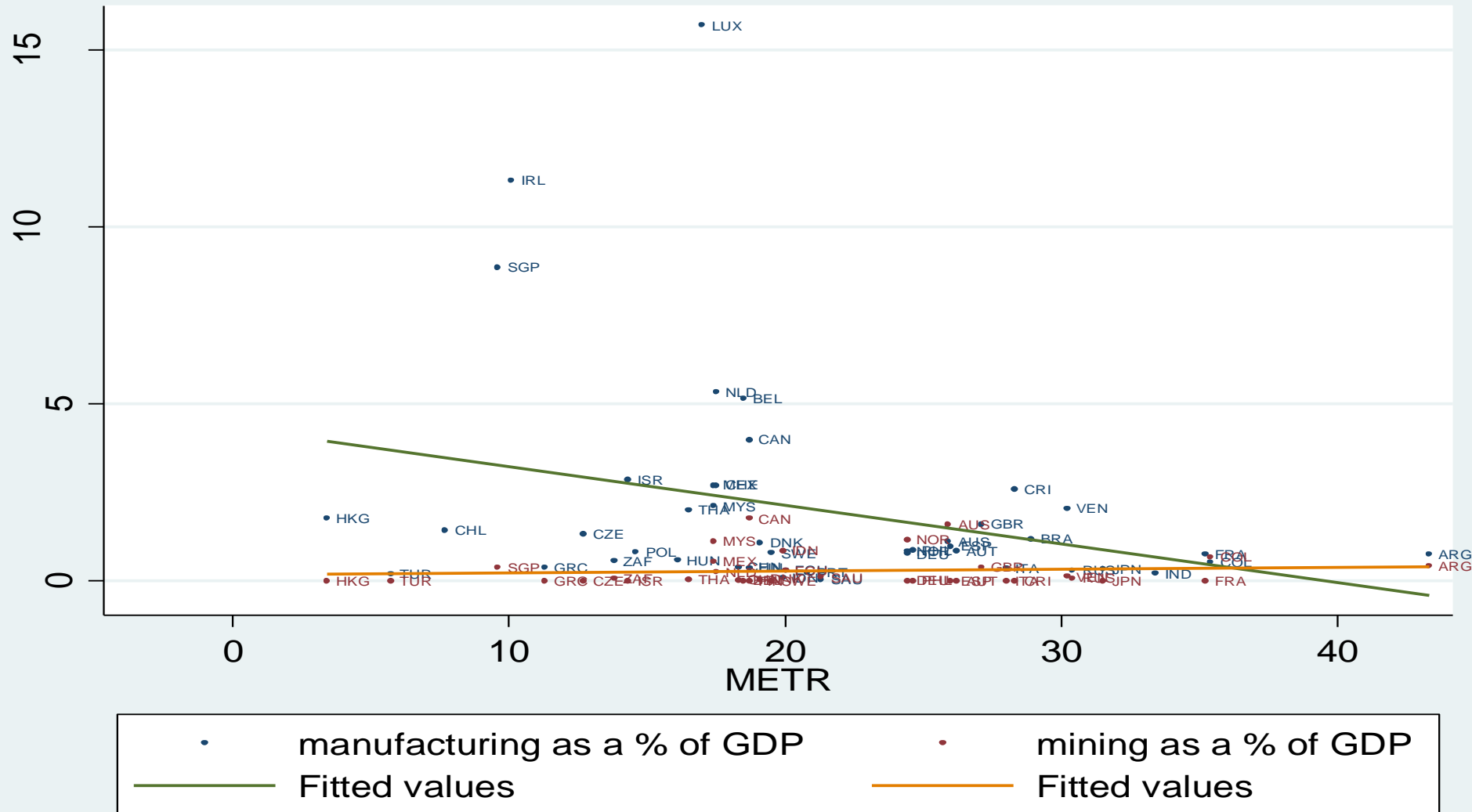
*: Open-ended question, multiple answers possible

** : Number of businesses surveyed in respective countries; ***: Includes ease of import/export, employing labor , etc.

Investors who would NOT have invested without tax Incentives



US Outbound FDI and METR in host countries



FDI in Manufacturing responds significantly but not FDI in mining which depends on the availability of the resource

Typology of FDI and response to Tax Incentives

Type of Investment	Factors that drive it	Response to investment incentives
Natural Resource/Skill-seeking FDI	Location of Natural Resources/Skills	Low response. FDI driven primarily by non-tax factors.
Market-seeking FDI	Market potential <ul style="list-style-type: none"> - Market dimensions - Income per-capita - Customer specific preferences - Kind of goods and services to be provided 	Low response. Level playing field between firms is critical (same tax system for all competitors).
Strategic Asset-seeking FDI	Acquiring Strategic Assets <ul style="list-style-type: none"> - Brands and Market positioning - Know-how - Technology - Distribution Networks - Human Capital 	Low response. FDI is driven by the location of the asset. However lower taxes on capital gains reduces the costs of the transfer of these assets.
Efficiency-seeking FDI	Lower Costs <ul style="list-style-type: none"> - Mostly export oriented - Availability of skills at a Low cost skills - Close to markets - Low relocation costs 	High response to tax incentives. Firms are expected to compete globally, hence the lower the costs, the better their ability to compete globally.

Results from Surveys

Author	Focus of survey	Conclusion	Did incentives influence Investment level? (% saying yes)
Investment Climate Advisory (FIAS)—investor motivation surveys	Malaysia (2014)	Redundancy ratio for incentives (Would have invested even if Incentives were not provided)	81%
	Guinea (2012)		92%
	Jordan (2009)		70%
	Kenya (2012)		61%
	El Salvador (2013)		37%
	Nicaragua (2009)		15% (51% for non-exporting firms outside free zones)
	Serbia (2009)		71%
	Tanzania (2011)		91%
	Tunisia (2012)		58%
	FIAS		Vietnam (2004)
FIAS	Thailand (1999)	81%	
Nathan Associates	Mozambique (2009)	78%	
Guisinger and Associates (1985)	Investment incentives and performance requirements for export-oriented firms	33%	
Reuber (1973)	FDI and market orientation	52% for export-oriented firms	
Mckinsey—MNE investment in developing economies (2003)	Business process outsourcing (BPO) and automobile sectors in India (2003)	Incentives not among top 3 factors driving location decisions	
Fortune/Deloitte and Touche (1997)	Business location study	Taxes ranked 13 th of 26 factors in importance for investments	
G-30 (1984)	Study of 52 multinational corporations covering half of world's FDI stock	Incentives ranked 7 th in importance for investments	

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Incentives and Public Goods

- Investment incentives are recommended when
 - investment assets available to general public
 - This is just another way to pay for public goods
 - investments generate positive externalities
 - Encouraging Green Technologies
 - Upgrading skills of workers
 - Anchor investments (slippery slope but have to be justified)

Tax competition

- Race to the bottom
 - Evidence shows that countries compete
 - by lowering tax rates
 - by providing more attractive tax holidays (Klemm and Van Parys, 2009)
 - Thought this cannot be extended to other kinds of tax incentives
 - Fighting off one country with the other is part of a strategy followed by some private sector
 - However, in many cases the final choice is already made
 - ‘Winning’ countries in many cases suffer from the winners curse/buyers remorse, having given up too much
 - Only a coordinated response could avoid such a race to the bottom (Ex. agree on common minimum criteria)
- There is also evidence of a race to the top !

More Regional Coordination/Harmonization of tax systems

- Countries need to avoid HARMFUL TAX COMPETITION
- There are several degrees of Tax Harmonization
 - Does not mean that all the taxes should be the same
 - Countries could agree to coordinate (EAC pre-budget meeting of Finance Ministers)
 - Countries could agree on a Code of Conduct
 - Countries could define Rules (that can be enforced) on the use of Tax Incentives (EU State Aid Rules)
 - Fiscal Union (common tax base and rates across the union)

Lessons learned on harmonizing tax incentives

- The key to success is not to be too ambitious
- Provide list of prohibited tax incentives (example, Countries shall not offer Tax Holidays longer than 10 years)
- Provide reasonable exceptions to the general strict rule of full harmonization
- Have an enforcement mechanism

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Cost of Incentives

Distortion costs

Time and money spent
by businesses to lobby
the government for
incentives

Time and money spent
by businesses to qualify
for and receive tax
incentives

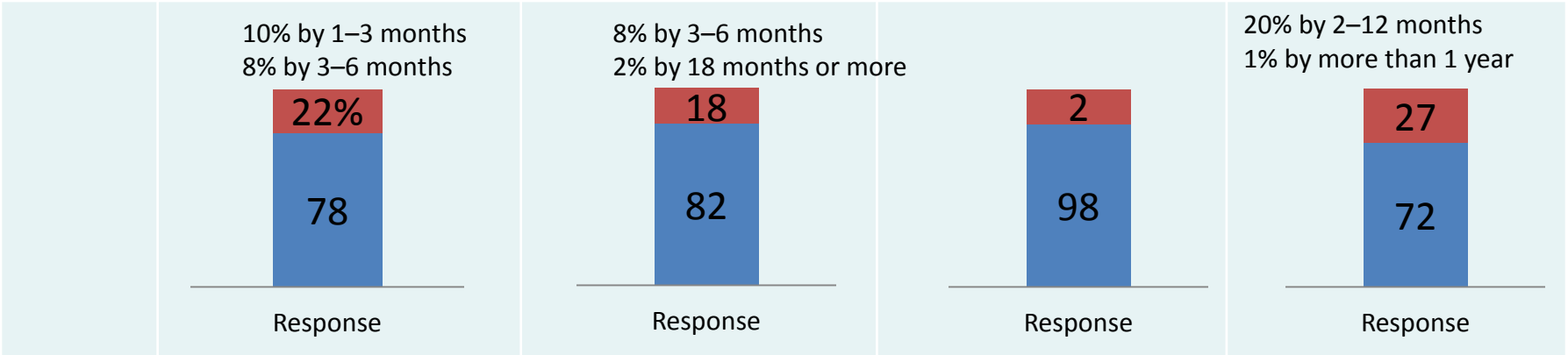
Revenue lost to illegal
activity

Additional costs for tax
authorities responsible
for administering tax
incentives

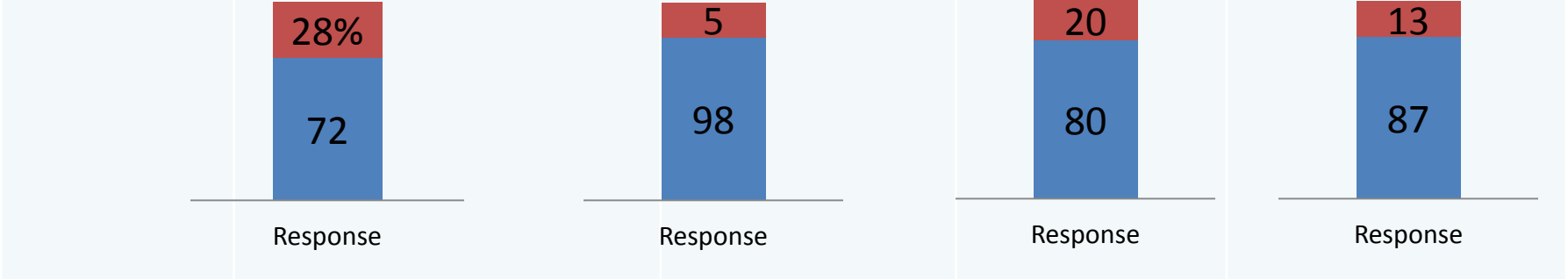
Costs of obtaining incentives

Percent	Mozambique (60 respondents)	Jordan (61 respondents)	Serbia (50 respondents)	Nicaragua (71 respondents)
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➤ **Did obtaining incentives delay project implementation?**



➤ **Did obtaining incentives add to project costs?**



➤ **What were the main additional costs?**

Additional senior management time: 18% Loss of business: 15%	Not an issue	Additional senior management time : 6% Additional consulting fees: 12%	Additional senior management time: 26% Legal fees: 24% Loss of business: 17%
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Cost v. Benefit of Tax Incentives - Jobs

Country Surveyed	Marginal Investors as a % of total Investors	Jobs Created by Marginal Investors as a % of total jobs created	(%) Jobs by Marginal Investors – (%) of Marginal Investors
Burundi	23%	19%	-4%
Guinea	8%	13%	5%
Jordan	30%	21%	-9%
Kenya	39%	42%	3%
Mozambique	22%	15%	-7%
Rwanda	2%	1%	-1%
Serbia	29%	31%	2%
Tanzania	9%	16%	7%
Thailand	19%	-	-
Tunisia	42%	35%	-7%
Uganda	7%	7%	0%

Tax given up per job created – El Salvador (\$2084); Tunisia (\$18,487); Yemen (\$5819)

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Political Economy of Incentives

Discretionary
Incentives popular
with politicians

Incentives have non-
transparent costs

Role of Governance

Bargaining for
Incentives

How to tackle Political Economy of Tax Incentives

- Increase Transparency
 - Measure the cost of Incentives (Tax Expenditure Statements)
 - This allows the costs to be scrutinized by the public
 - Place a budget on tax incentives
- Reduce Discretion
 - Replace discretionary Incentives with those that flows out of the Tax Code
 - This ensures the role of the legislature
 - Even if a ‘big’ deal has to be given tax incentives ensure that criteria is defined
- Tighten administration
 - Reduce leakage on the usage of Tax Incentives (filing of tax returns)
- Periodically study the effectiveness
 - This allow the public to see for themselves if incentives work

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Principles of Transparency of Tax Incentives

- **Make public a statement of fiscal policy objectives outlining policies of the Government in the medium term and the short term relating to taxation, expenditure, market borrowing and other liabilities, lending and investments and the key fiscal measures;**
- **Consolidate all the tax incentives that are provided either through the tax laws or otherwise**
- **Calculate the amount of revenue losses attributable to Tax Incentives, in a yearly Statement of Tax Expenditures.**
- **The Statement of Tax Expenditure shall include the largest beneficiaries of the tax incentives by individual taxpayer, sector, by specific tax provision and other criteria as required**
- **The Government shall grant tax incentives in accordance with a comprehensive policy on tax incentives, which shall lay down principles and policies for introduction or continuation of a tax incentive.**

- **The Government shall carry out periodic review of the continuance of existing tax incentives by assessing the extent to which the tax incentives could meet the stated objectives**
- **Tax incentives may be provided only through laws ratified through the law making body or Parliament**
- **Tax Incentives once provided need to be administered in a transparent manner**
- **The government shall set up a mechanism for periodic data collection, which shall be used to prepare the Statement of Tax Expenditure.**
- **Governments shall make commitments through regional agreements to avoid harmful tax competition**

Policy questions to ask on new Incentives

- Would the Investment Come in anyway?
- Would the Tax Incentive put existing businesses at a disadvantage?
- Would the Investment realize tax revenues after the tax incentives are exhausted?
- Does the Investment provide positive externalities?
 - Direct Jobs
 - New Technology/Skill up gradation
 - Import substitution
 - Infrastructure/Public Goods
 - New Industry
 - Spur Ancillary Industries
- Does the Tax Incentive create opportunities for Tax Evasion?
- Does the Investment cause negative externalities such as pollution?
- Would this result in increasing demand for Incentives by other Investors?

In general, few investments satisfy most or all of these criteria. The goal of the Government should be to improve the investment climate and make it conducive for businesses to invest and reduce their costs and make the return profitable. It may be necessary for the government to take a look at the competitiveness of the overall tax system rather than use tax incentives in specific cases to achieve the same end.

Use Better Instruments

- Use Investment linked Tax incentives rather than Tax Holidays
- If using Tax Holidays use at least partial tax holidays (i.e. 50% tax exemption rather than 100%)
- VAT incentives are redundant if the system works well
- Re-design customs incentives by product rather than by use
- Use minimum taxes

Tax Policy for SEZs

- Many countries use SEZs as a means to encourage investments especially export oriented investments
- Investments inside the SEZ are at an advantage due to the better infrastructure and simplified procedures (especially for border taxes and regulations)
- Special tax treatment especially with respect to income tax, for investments inside SEZs create an uneven playing field between investment inside the SEZs and those outside and may result in:-
 - Loss of competitiveness of investments made outside SEZs and resulting loss of investment and jobs;
 - Pressure to relocate investments from outside the SEZs to inside it to take advantage of the lower tax;
 - Resulting in loss of tax revenue because of investments now paying lower amount of tax after relocation with little additional investment;
 - Potential for tax evasion by artificially shifting profits for units outside the SEZs to those inside to take advantage of the lower tax;
 - Higher complexity of tax administration as a result of the tax incentives as well as higher cost of compliance both for business inside the SEZs and outside;
- It is recommended that the Income Tax regime should be the same for all investments whether inside the SEZ or outside.
- If any tax incentives are provided for investments inside the SEZs they should be also be made available for investments outside the SEZ

Questions

Thank You.
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