Effectiveness of Investment Incentives in Developing countries

Evidence and Policy Implications

TEPAV and World Bank Group Workshop

on

Attracting and Retaining Investments – The Role of Investment Climate

Sept 20, 2010, Istanbul

Investment Climate Advisory Services of the World Bank Group

IFC International Finance Corporation World Bank Group

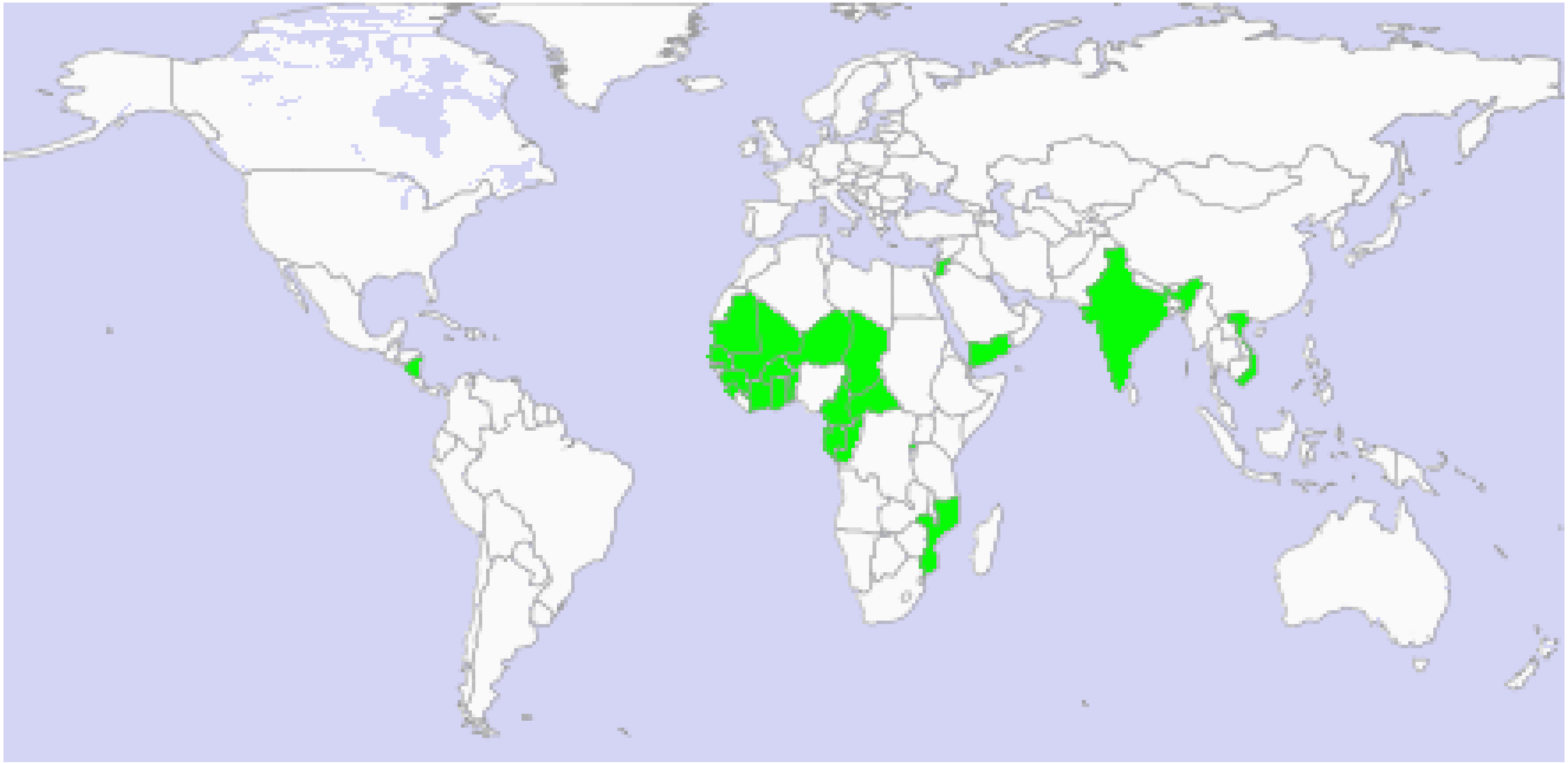
MIGA World Bank Group Multilateral Investment Guarantee Agency

THE WORLD BANK

Plan of the Presentation

- The Incentives Framework
- The econometric evidence
  - Current literature
  - Investment Climate Department research
- The survey evidence
  - Previous surveys
  - Investment Climate Advisory’s surveys
- Incentives for Public Goods
- Cost of Incentives
- Political Economy
- Policy advice

Incentives and Tax - Project scope



This project studies incentives in 32 countries across 4 continents

Plan of the Presentation

- The Incentives Framework
- The econometric evidence
  - Current literature
  - Investment Climate Department research
- The survey evidence
  - Previous surveys
  - Investment Climate Advisory’s surveys
- Incentives for Public Goods
- Cost of Incentives
- Political Economy
- Policy advice

Incentives Framework

The Benefits and Costs of an Incentive Policy

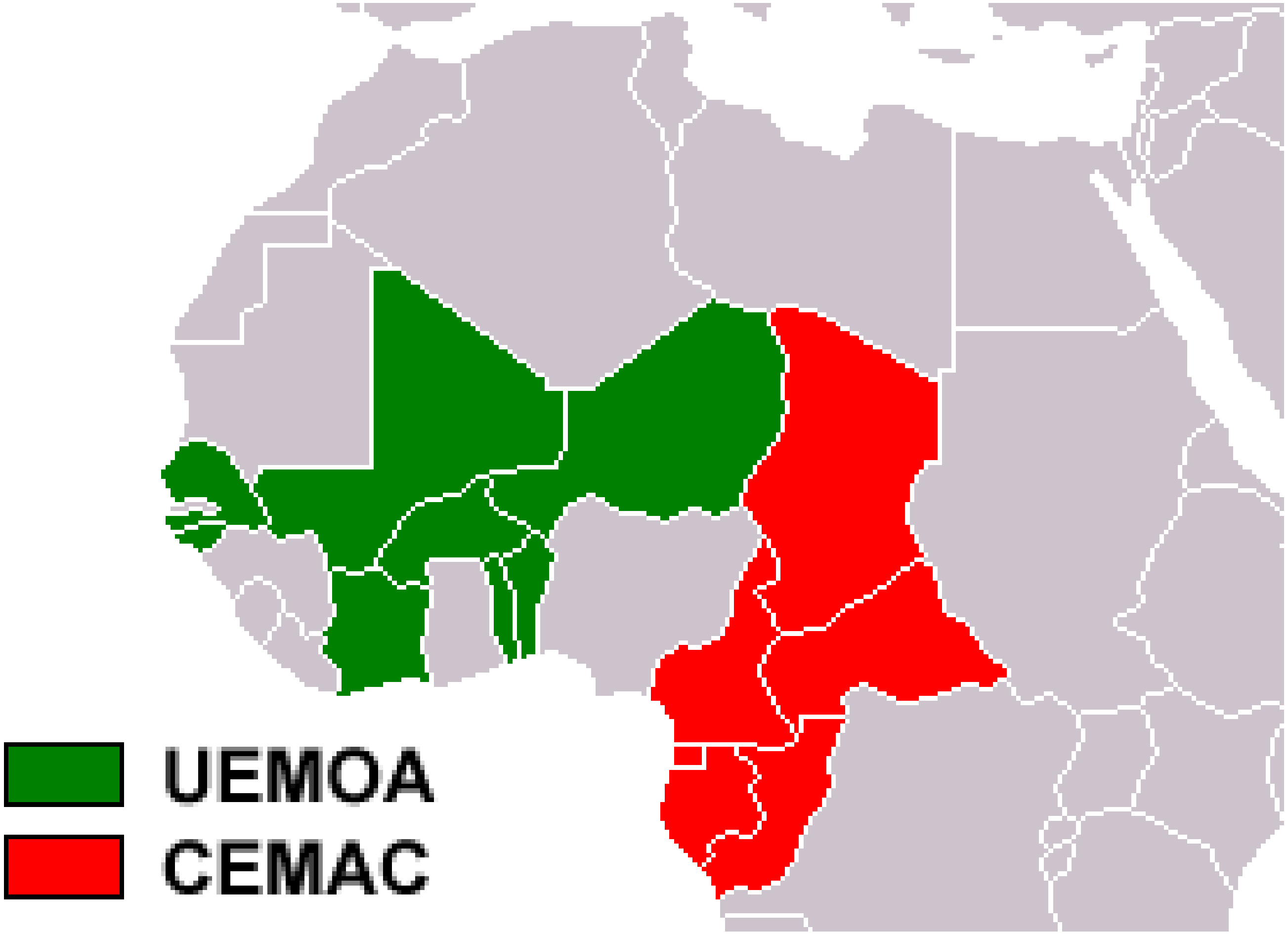
Revenue rise due to increased investment **+** Social benefits from increased investment **>** Lost revenue from investments that would have been made anyway **+** Indirect cost of incentives

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

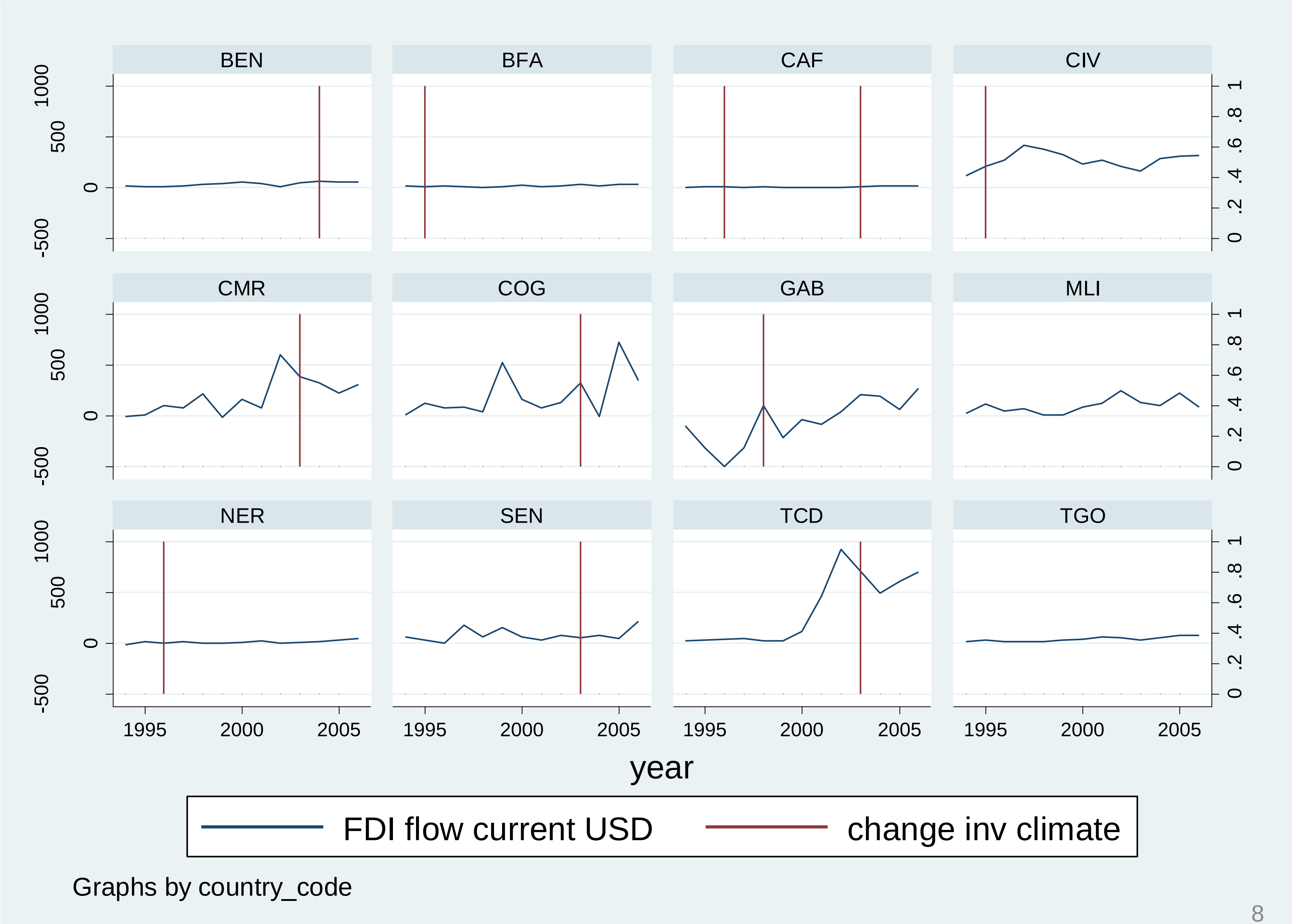
Plan of the Presentation

- The Incentives Framework
- The econometric evidence
  - Current literature
  - Investment Climate Department research
- The survey evidence
  - Previous surveys
  - Investment Climate Advisory’s surveys
- Incentives for Public Goods
- Cost of Incentives
- Political Economy
- Policy advice

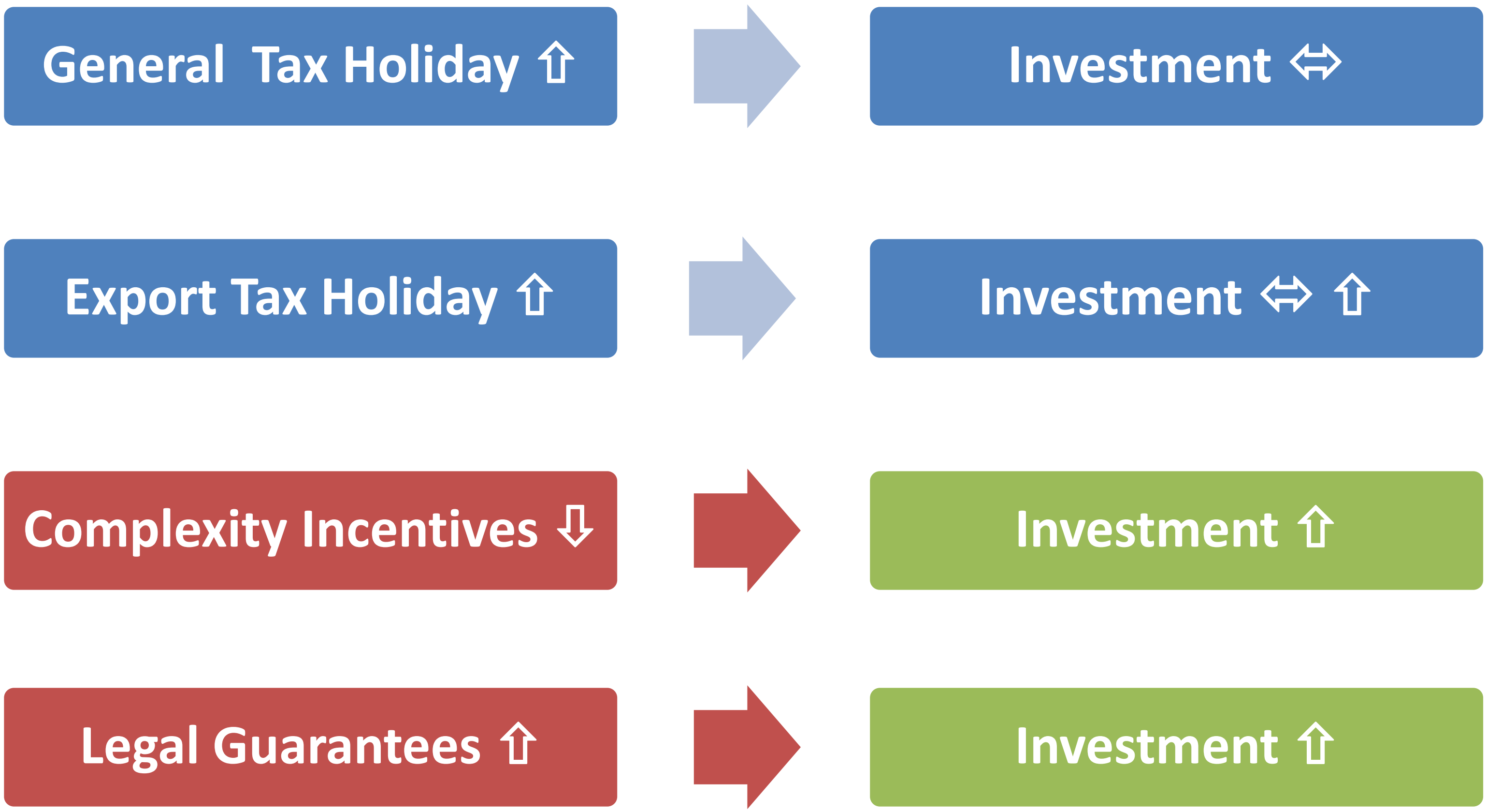
The Effectiveness of Tax incentives in West/Central Africa



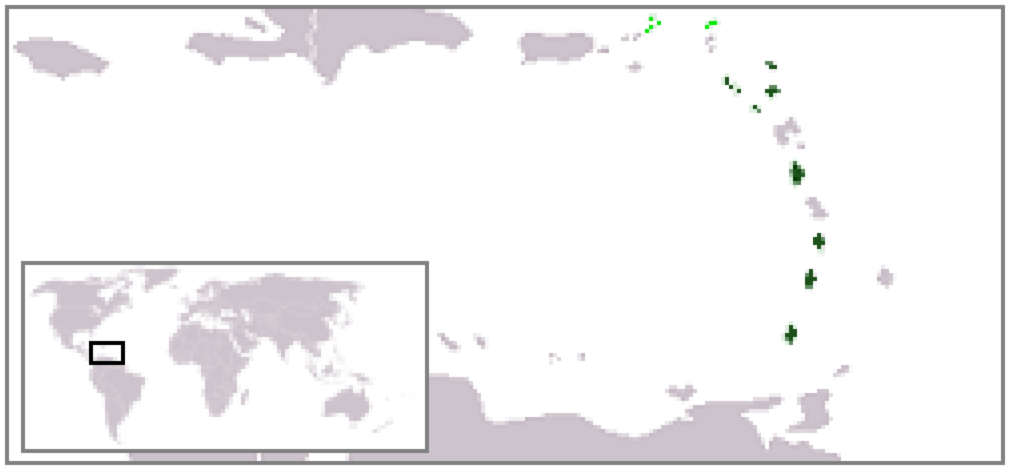
Impact of Investment Code on FDI



Finding in UMEOA/CEMAC Case Study



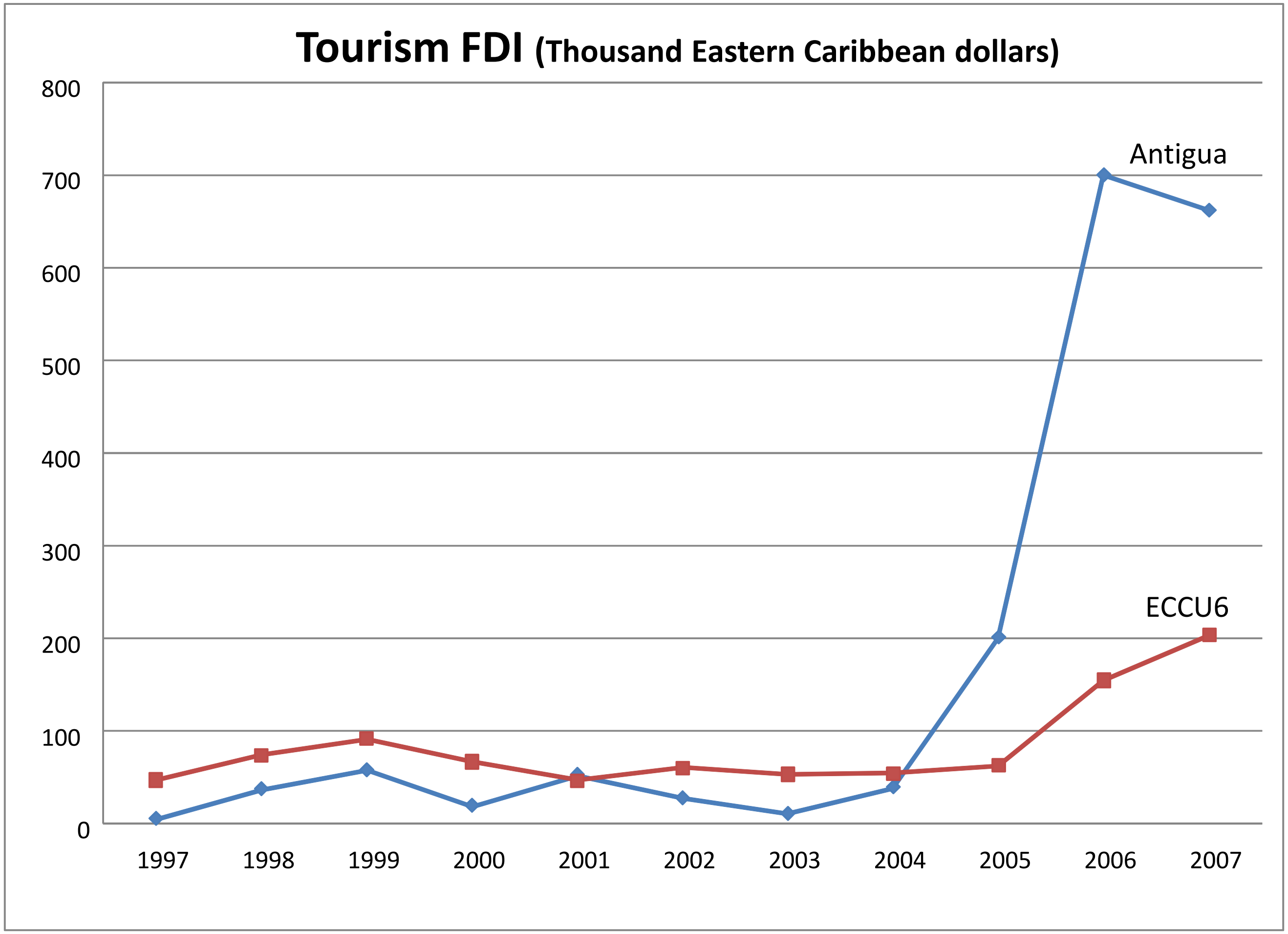
The Effectiveness of Tax incentives for Tourism Investment in the Caribbean



Organization of Eastern Caribbean Countries

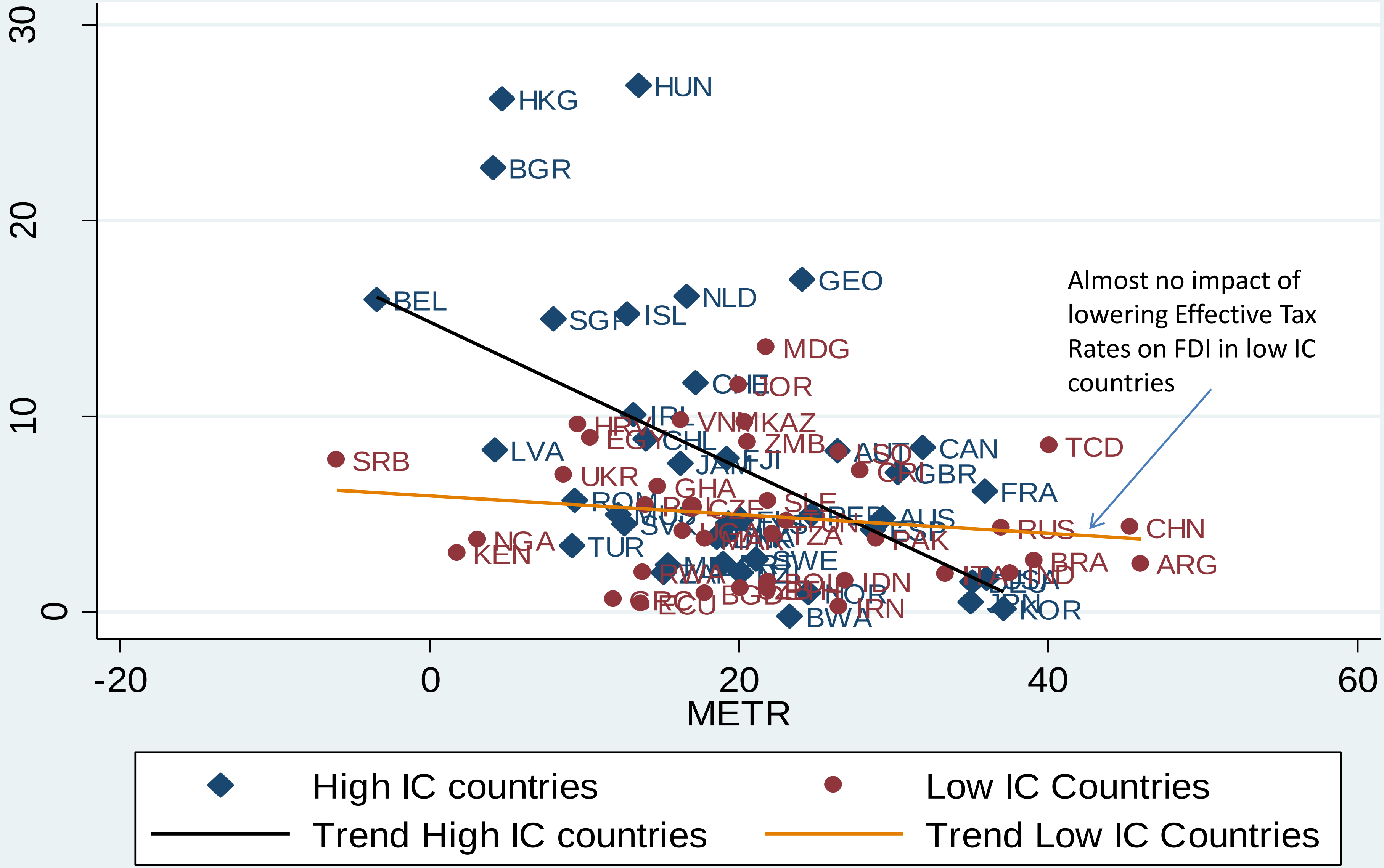
Finding in OECS Case Study

Tourism Incentives ⇧ → **Tourism Investment ⇧**



Source: James and Van Parys, 2009

Fiscal Policy Effectiveness and the Investment Climate

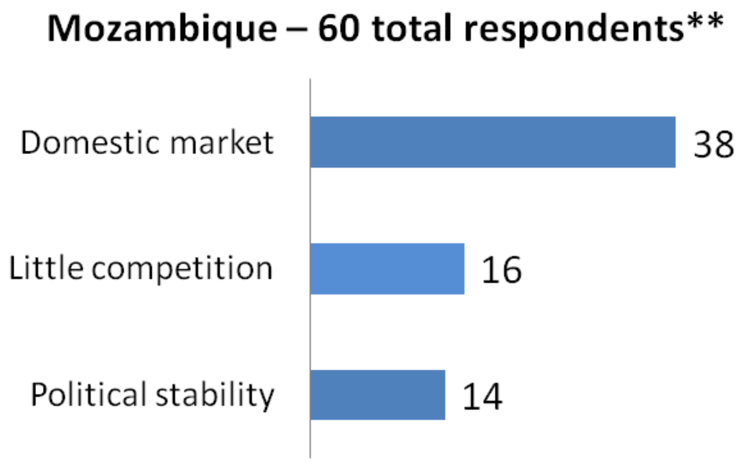


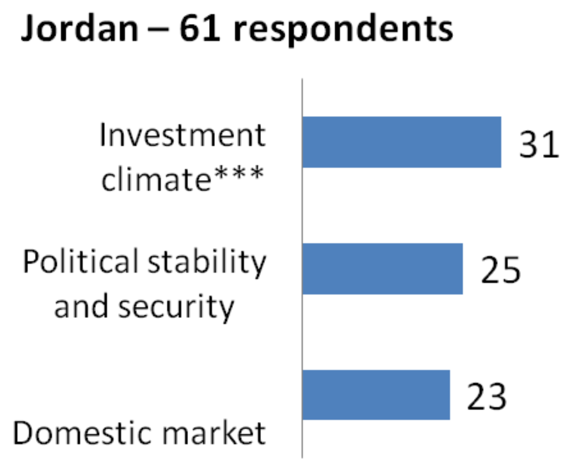
Plan of the Presentation

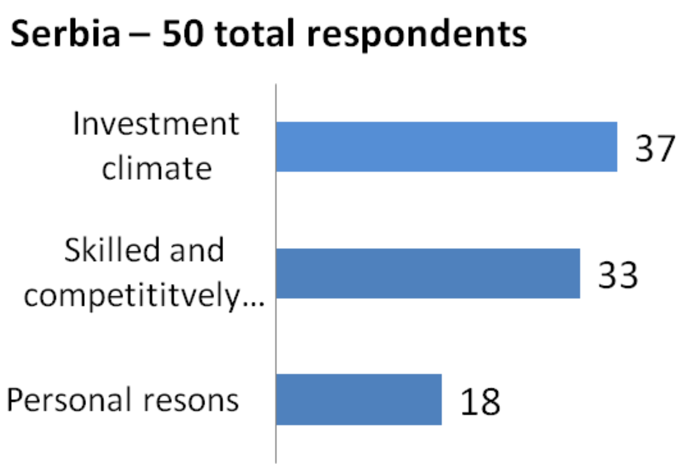
- The Incentives Framework
- The econometric evidence
  - Current literature
  - Investment Climate Department research
- The survey evidence
  - Previous surveys
  - Investment Climate Advisory’s surveys
- Incentives for Public Goods
- Cost of Incentives
- Political Economy
- Policy advice

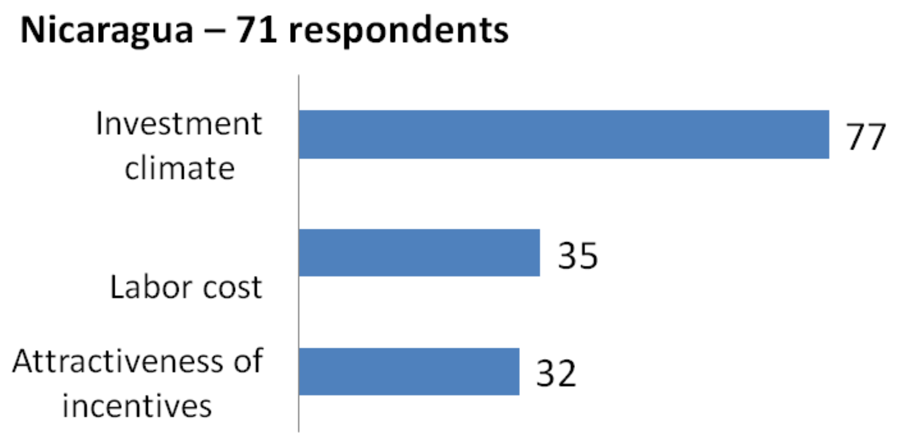
Investor Motivations to Invest

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



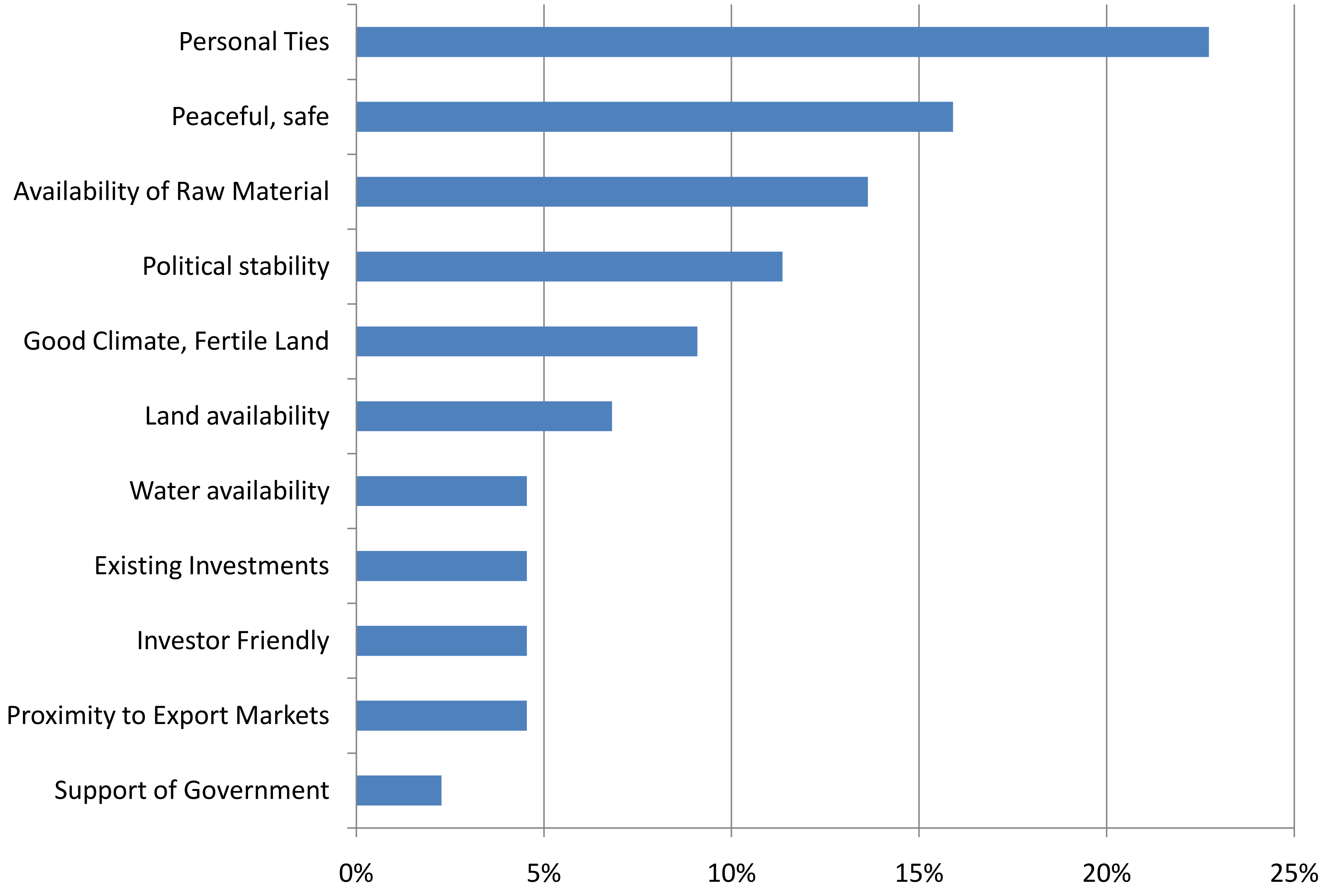




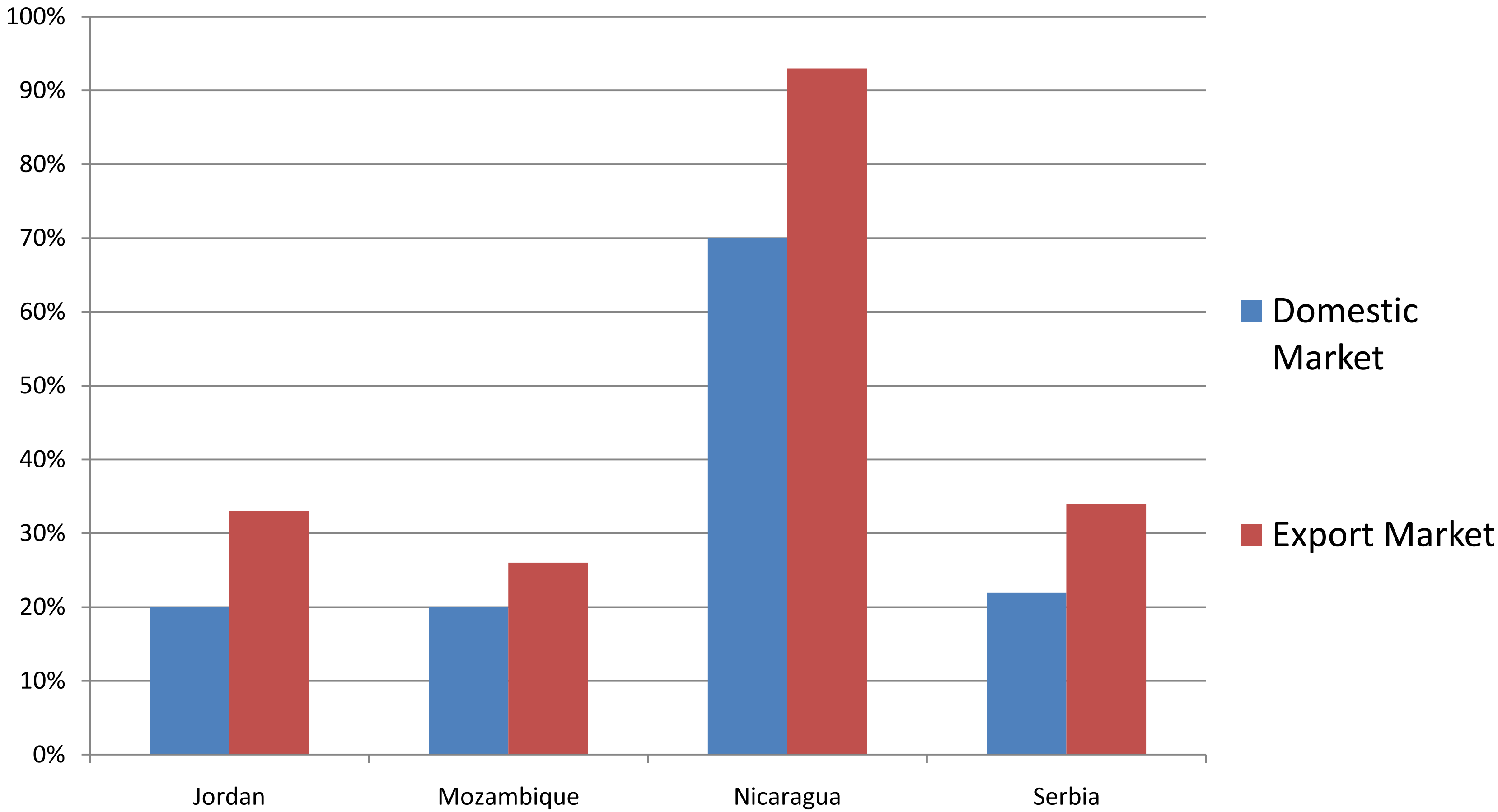


*: Open-ended question, multiple answers possible
: Number of businesses surveyed in respective countries; *: Includes ease of import/export, employing labor , etc.
Source: Investment Climate Department, 2009

Investors' motivation to Invest in Agriculture in Ghana



Importance of investment incentives*



Would not have invested but for the investment incentives

Results from Surveys

Author	Focus of survey	Conclusion		Did Incentives influence Investment level
Investment Climate Advisory (FIAS)—Investor motivation surveys and incentives	**Jordan (2009)**	**Redundancy ratio for incentives**	**70%**	**28%**
	Mozambique (2009)		**78%**	**13%**
	Nicaragua (2009)		**15% (51% for non-exporting firms outside free zones)**	**17%**
	Serbia (2009)		**71%**	**6%**
	Thailand (1999)		**81%**	
	Ghana (Agriculture, 2010)		**69%**	
Phu et. Al. (2004)	Vietnam		85%	
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—Multination corporation 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 13th of 26 factors in importance for investments		
G–30 (1984)	Study of 52 multinational corporations covering half of world's FDI stock	Incentives ranked 7th in importance for investments		

Plan of the Presentation

- The Incentives Framework
- The econometric evidence
  - Current literature
  - Investment Climate Department research
- The survey evidence
  - Previous surveys
  - Investment Climate Advisory’s surveys
- Incentives and Public Goods
- Cost of Incentives
- Political Economy
- Policy advice

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 (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 !

Plan of the Presentation

- The Incentives Framework
- The econometric evidence
  - Current literature
  - Investment Climate Department research
- The survey evidence
  - Previous surveys
  - Investment Climate Advisory's surveys
- Incentives and Public Goods
- Cost of Incentives
- Political Economy
- Policy advice

Cost of Incentives

Distortion costs

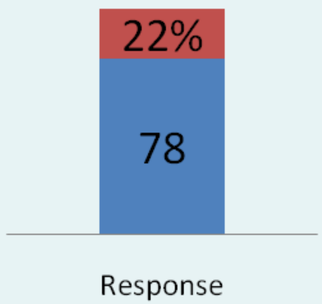
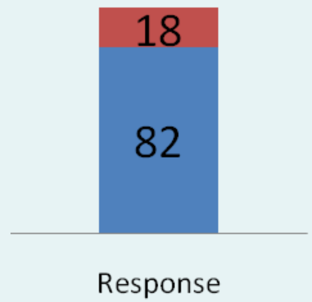
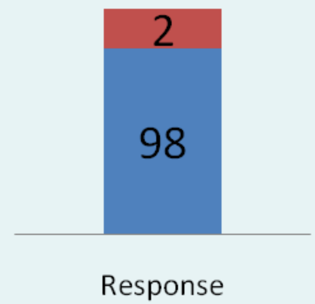
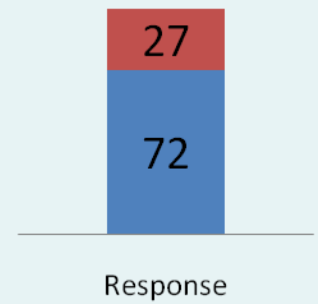
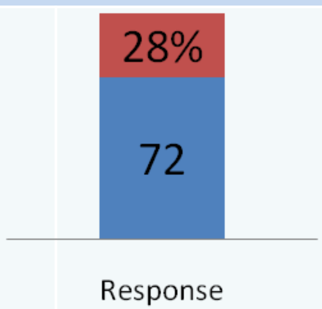
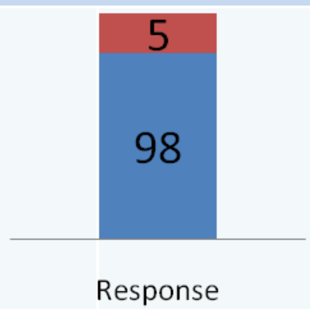
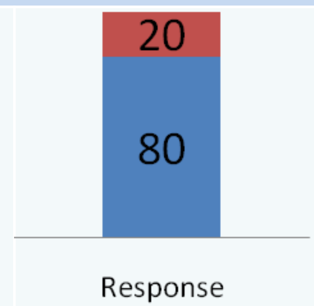
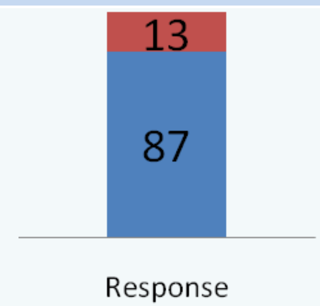
Time and money spent by businesses to lobby the government for incentives

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)**
➢ Did obtaining incentives delay project implementation?				
	10% by 1–3 months 8% by 3–6 months 	8% by 3–6 months 2% by 18 months or more 		20% by 2–12 months 1% by more than 1 year 
➢ 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%

Plan of the Presentation

- The Incentives Framework
- The econometric evidence
  - Current literature
  - Investment Climate Department research
- The survey evidence
  - Previous surveys
  - Investment Climate Advisory's surveys
- Incentives and Public Goods
- Cost of Incentives
- Political Economy
- Policy advice

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
- Periodically study the effectiveness
  - This allow the public to see for themselves if incentives work

Plan of the Presentation

- The Incentives Framework
- The econometric evidence
  - Current literature
  - Investment Climate Department research
- The survey evidence
  - Previous surveys
  - Investment Climate Advisory's surveys
- Incentives and Public Goods
- Cost of Incentives
- Political Economy
- Policy advice

Policy questions to ask

- Would the Investment come in anyway ? Does the country have any special advantages that are important to the investor ?
- Does the Investment provide benefits beyond the direct investment (positive externalities) ?
- Will the Investment generate additional tax revenue ?
- Would Incentives put existing investments at a disadvantage?
- Does it cause leakage in tax revenue ?
- Does it undermine the investment environment by encouraging other investors to ask for similar incentives ?

Policy Prescription

Incentive framework Issue	Value	Remarks
Elasticity of the Investment with respect to the Incentive?	LOW/HIGH	
Contribution of the Investment to Public Goods	LOW/HIGH	
Revenue Loss (Would the investment come in anyway?)	HIGH/LOW	
Indirect cost of the Incentives	HIGH/LOW	
INCENTIVES RECOMMENDATION	YES/NO	

Reform Path for Investment Incentives Policy

Tax Policy

- Generous Tax Holidays
- Partial Tax Holidays
- Investment linked Tax Incentives (Investment Credits, Investment Allowances, etc)
- Only indirect tax incentives for capital inputs
- Tax Incentives only for Anchor Investments
- Uniform low tax rate over a broad base

Tax Administration

- Discretionary/Non-Transparent Tax Incentives
- Tax Incentives in Individual Agreements
- Improve Transparency (Publish list of investors benefiting from incentives)
- Tax Incentives in Tax Laws
- Tax Incentives are available without additional permission
- No Tax Incentives

What about Non-Tax Incentives ?

- Governments tend to go out of their way to attract the big foreign investment
- However, there is scope for increasing size of existing investment ?
- Investor ‘aftercare’ would help policy makers understand what barriers limit existing investors
- Non-Tax Incentives such as
  - Improving investment climate by,
    - Removing regulatory barriers to investment
    - Invest in infrastructure that increases the productivity of the investments
  - Provide co-ordination between ministries and departments that help investments set-up quickly and easily
  - Some countries provide direct subsidies to investors based on certain targets, such as jobs. This brings out unambiguously the costs.

Questions

Thank You.
sjames2@ifc.org