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
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
This project studies incentives in 32 countries across 4 continents
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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.
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The Effectiveness of Tax incentives in West/Central Africa
Impact of Investment Code on FDI

Graphs by country_code

- FDI flow current USD
- change inv climate

year

Graphs by country_code
Finding in UMEOA/CEMAC Case Study

General Tax Holiday ↑

Export Tax Holiday ↑

Complexity Incentives ↓

Legal Guarantees ↑

Investment ↔

Investment ↔ ↑

Investment ↑

Investment ↑
The Effectiveness of Tax incentives for Tourism Investment in the Caribbean

Organization of Eastern Caribbean Countries
Tourism Incentives $\uparrow$ Tourism Investment $\uparrow$

Finding in OECS Case Study

Source: James and Van Parys, 2009
Fiscal Policy Effectiveness and the Investment Climate

Source: James and Van Parys, 2009
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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**
- Domestic market: 38%
- Little competition: 16%
- Political stability: 14%

**Jordan – 61 respondents**
- Investment climate: 31%
- Political stability and security: 25%
- Domestic market: 23%

**Serbia – 50 total respondents**
- Investment climate: 37%
- Skilled and competitively: 33%
- Personal resons: 18%

**Nicaragua – 71 respondents**
- Investment climate: 77%
- Labor cost: 35%
- Attractiveness of incentives: 32%

*: 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

- Personal Ties: 23%
- Peaceful, safe: 16%
- Availability of Raw Material: 14%
- Political stability: 11%
- Good Climate, Fertile Land: 10%
- Land availability: 8%
- Water availability: 6%
- Existing Investments: 5%
- Investor Friendly: 4%
- Proximity to Export Markets: 4%
- Support of Government: 2%
Importance of investment incentives*

Would not have invested but for the investment incentives

- Jordan
- Mozambique
- Nicaragua
- Serbia

* Domestic Market

* Export Market
### Results from Surveys

<table>
<thead>
<tr>
<th>Author</th>
<th>Focus of survey</th>
<th>Conclusion</th>
<th>Did Incentives influence Investment level</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Investment Climate Advisory (FIAS)—Investor motivation surveys and incentives</strong></td>
<td></td>
<td>Redundancy ratio for incentives</td>
<td></td>
</tr>
<tr>
<td>Jordan (2009)</td>
<td>Mozambique (2009)</td>
<td>70%</td>
<td>28%</td>
</tr>
<tr>
<td>Nicaragua (2009)</td>
<td></td>
<td>78%</td>
<td>13%</td>
</tr>
<tr>
<td>Serbia (2009)</td>
<td></td>
<td>15% (51% for non-exporting firms outside free zones)</td>
<td>17%</td>
</tr>
<tr>
<td>Thailand (1999)</td>
<td>Ghana (Agriculture, 2010)</td>
<td>71%</td>
<td>6%</td>
</tr>
<tr>
<td>Guisinger and Associates (1985)</td>
<td>Investment incentives and performance requirements for export-oriented firms</td>
<td></td>
<td>33%</td>
</tr>
<tr>
<td>Reuber (1973)</td>
<td>FDI and market orientation</td>
<td></td>
<td>52% for export-oriented firms</td>
</tr>
<tr>
<td>Fortune/Deloitte and Touche (1997)</td>
<td>Business location study</td>
<td>Taxes ranked 13th of 26 factors in importance for investments</td>
<td></td>
</tr>
<tr>
<td>G–30 (1984)</td>
<td>Study of 52 multinational corporations covering half of world’s FDI stock</td>
<td>Incentives ranked 7th in importance for investments</td>
<td></td>
</tr>
</tbody>
</table>

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**Note:**
- **Focus of survey** describes the main area of the survey.
- **Conclusion** refers to the redundancy ratio for incentives and the percentage of investment influenced by incentives.
- **Did Incentives influence Investment level** indicates the percentage of investment that was influenced by incentives.
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• 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!
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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

<table>
<thead>
<tr>
<th>Percent</th>
<th>Mozambique (60 respondents)</th>
<th>Jordan (61 respondents)</th>
<th>Serbia (50 respondents)</th>
<th>Nicaragua (71 respondents)</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Did obtaining incentives delay project implementation?</strong></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>10% by 1–3 months</td>
<td>22%</td>
<td>8% by 3–6 months</td>
<td>18%</td>
<td>20% by 2–12 months</td>
</tr>
<tr>
<td>8% by 3–6 months</td>
<td>78%</td>
<td>2% by 18 months or more</td>
<td>82%</td>
<td>1% by more than 1 year</td>
</tr>
<tr>
<td>2% by 18 months or more</td>
<td></td>
<td></td>
<td>98%</td>
<td></td>
</tr>
<tr>
<td></td>
<td></td>
<td></td>
<td>2% by 18 months or more</td>
<td>72%</td>
</tr>
</tbody>
</table>

| **Did obtaining incentives add to project costs?** | | | | |
| 28% | 5% | 20% | 13% |
| 72% | 98% | 80% | 87% |

| **What were the main additional costs?** | Not an issue | Additional senior management time: 6% | Additional senior management time: 26% |
| Additional senior management time: 18% | | Additional consulting fees: 12% | Legal fees: 24% |
| Loss of business: 15% | | Loss of business: 17% | |

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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

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

<table>
<thead>
<tr>
<th>Incentive framework Issue</th>
<th>Value</th>
<th>Remarks</th>
</tr>
</thead>
<tbody>
<tr>
<td>Elasticity of the Investment with respect to the Incentive?</td>
<td>LOW/HIGH</td>
<td></td>
</tr>
<tr>
<td>Contribution of the Investment to Public Goods</td>
<td>LOW/HIGH</td>
<td></td>
</tr>
<tr>
<td>Revenue Loss (Would the investment come in anyway?)</td>
<td>HIGH/LOW</td>
<td></td>
</tr>
<tr>
<td>Indirect cost of the Incentives</td>
<td>HIGH/LOW</td>
<td></td>
</tr>
<tr>
<td><strong>INCENTIVES RECOMMENDATION</strong></td>
<td>YES/NO</td>
<td></td>
</tr>
</tbody>
</table>
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.
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