

# Incentivising development: policy options for tax incentives

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# **Incentivising development: policy options for tax incentives**

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This paper explores the potential of tax incentives as a tool for development and the costs of their misuse. It brings together insights from research and cross-country experience to shed light on when tax incentives are most appropriate, and how to maximise their gains for development.

## Executive summary

At their best, tax incentives can encourage much needed investment into an economy, help infant industries to become competitive, and encourage investment in technology and research – all of which can boost exports, job creation, and sustainable growth. But all too often, tax incentives only benefit the businesses that receive them and at a significant hidden cost to taxpayers – they prove neither necessary nor sufficient for achieving government aims.

- ✓ In Costa Rica, the government combined extensive tax incentives with investments in skills, infrastructure and regulations to **attract large-scale investment** initially from Intel in 1996, and subsequently from other large multinationals.<sup>1</sup> These MNCs in turn had significant positive spillovers on the domestic suppliers they worked with, boosting their sales and productivity.<sup>2</sup> The country's comprehensive approach to investment promotion, alongside an increasing focus on renewable energy and sustainability, has meant that Costa Rica continues to attract investment in high-value manufacturing and technology, with FDI growing by 20% in 2023.<sup>3</sup>
- ✓ In South Korea, **targeted support to heavy and chemical industries** in the 1970s in the form of targeted lending and investment-oriented incentives contributed to the “East Asian miracle” of growth seen during this period – this support resulted in higher investment, productivity, employment, output, and exports of firms in these sectors, even after targeted support was later withdrawn. The better performance of these sectors had positive spillover effects on their buyers, resulting in their higher exports as well.<sup>4</sup>
- ✗ In the Dominican Republic, efforts to **promote the tourism sector** through tax incentives have come at a significant financial cost and analysis suggests these have had limited effect on the sector’s development.<sup>5</sup>
- ✗ In 2004, the Chinese government reduced the VAT rate on investment goods, with the aim of encouraging further investment. However, evidence suggests that this policy **did not have any significant effect** on fixed investment or productivity; instead, it encouraged businesses to shift towards greater use of capital and more capital-intensive production. The result was a reduction in employment in affected areas and average product quality.<sup>6</sup>

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<sup>1</sup> MIGA. (2006). *The Impact of Intel in Costa Rica: Nine Years After the Decision to Invest*. The World Bank Group/MIGA.

<sup>2</sup> Alfaro-Ureña, A., Manelici, I., & Vasquez, J. P. (2022). The Effects of Joining Multinational Supply Chains: New Evidence from Firm-to-Firm Linkages. *The Quarterly Journal of Economics*.

<sup>3</sup> fDi Intelligence. (2024, December 2). Costa Rica’s formula to attract foreign investment. Retrieved from <https://www.fdiintelligence.com/partner-content/6262d38c-ae23-51f9-a835-4311cd4bf017>

<sup>4</sup> Lane, N. (forthcoming). Manufacturing revolutions: industrial policy and industrialization in South Korea. *Quarterly Journal of Economics*.

<sup>5</sup> United Nations. (2018). *Design and assessment of tax incentives in developing countries: selected issues and a country experience*

<sup>6</sup> Cai, J., & Harrison, A. (2021). Industrial Policy in China: Some Intended or Unintended Consequences? *ILR Review*; Kong, D., & Xiong, M. (2021). Unintended consequences of tax incentives on export product quality: Evidence from a natural experiment in China. *Review of International Economics*.

Part of the reason for their mixed record is that tax incentives are often implemented without adequate consideration of how to maximise benefits while limiting their costs. Leveraging tax incentives for development requires clear consideration of **when** tax incentives are most appropriate and **how** to maximise their gains. Cross-country evidence suggests tax incentives:

- Can be effective in attracting new investment in countries, but only when investors are deciding between locations that are in other respects similar
- Are unlikely to be effective on their own in attracting investment to lagging regions in a country
- Require complementary policies and effective conditions to effectively support specific sectors and supplier development
- Can boost exports and R&D where there is already supportive infrastructure and skills for this

Best practice from across countries highlight the importance of continually estimating and monitoring the costs and benefits of tax incentives, allocating incentives using rules rather than discretion, designing conditions to be enforceable, and limiting institutional overlap in granting incentives.

### *In this paper*

Section 1 outlines the potential of tax incentives and the costs of their misuse. Section 2 outlines key trade-offs policymakers face in the design of tax incentives, drawing on evidence and experience from countries across the development spectrum. Section 3 outlines best practice in implementing tax incentives, and Section 4 concludes.

## 1. Tax incentives: a tool for growth or stagnation

Tax incentives can be a valuable policy tool to direct investment and drive sustainable growth. But without effective implementation, they are just as likely to be a drain on scarce public finances and a barrier to the emergence of new, competitive businesses. The difference comes down to decisions made by policymakers.

Tax incentives refer to **special tax treatment given to firms to encourage or direct investment activity**. They provide preferential tax treatment compared to national tax regimes and can range from complete tax ‘holidays’ to specific tax-deductible allowances on certain activities. Tax incentives are widespread across countries at different stages of development, used to attract foreign investment, promote certain sectors and supply chains, and support lagging regions. A study of 52 low- and middle-income countries by the OECD in 2022 found that almost 90% of these countries use some form of corporate tax exemption.<sup>7</sup>

In theory, tax incentives can help to overcome the initial costs involved in investing in a country, building supply chains and developing innovative technology. By helping firms to overcome these costs, they provide wider benefits to the economy as a whole. But they come at a significant hidden **opportunity cost in terms of revenue not collected**: the cost of these incentives is the public spending that could have been made if these taxes were collected. Evidence from Uganda, for example, suggests that tax incentives in customs and corporate income tax amount to 1% of GDP.<sup>8</sup> Evidence from 40 countries in Africa, Latin America and the Caribbean shows that revenue losses from tax holidays are associated with lower educational spending and primary education enrolment.<sup>9</sup>



*The gains from tax incentives must be weighed against their opportunity cost*

<sup>7</sup> OECD. (2022). *OECD Investment Tax Incentives Database – 2022 Update: Tax incentives for sustainable development*. OECD.

<sup>8</sup> Eissa, N., Manwaring, P., Ntungire, N., & Rauschendorfer, J. (2020). *What is the fiscal costs of tax incentives in Uganda?* International Growth Centre.

<sup>9</sup> Stausholm, S. N. (2017). *Rise of ineffective incentives: New empirical evidence on tax holidays in developing countries*. Center for Open Science.

At the same time, tax incentives can disadvantage smaller or less politically connected firms that do not receive these incentives, negatively affecting their ability to drive growth and employment.

#### Tax incentives in exchange for public benefits

Tax incentives provide preferential tax treatment to particular businesses, at the expense of public spending. As such, they are only appropriate where the businesses that benefit from these incentives offer some kind of **public benefit** in return, such as investments in green technology, research and development, and greater job creation. Without this in mind, tax incentives can easily become a tool for private gain among government officials and politically connected companies.

In practice, there has been a mixed record of their success. Tax incentives have proved valuable in promoting foreign investment in countries like Hong Kong, Costa Rica, and Singapore, and have also been used in countries like South Korea and Uganda to promote local supply chains and the development of specific local sectors. However, in a number of countries, tax incentives have not achieved their goals and instead have propped up uncompetitive firms and industries at the expense of taxpayers. Evidence from Egypt and Tunisia suggests that tax incentives offered to politically connected firms have suppressed effective competition and the potential for job creation.<sup>10</sup>

Part of the reason for their mixed record is that tax incentives are often implemented without adequate consideration of how to maximise benefits while limiting their costs. Leveraging tax incentives for development requires clear consideration of **when** tax incentives are most appropriate and **how** to maximise their gains.

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<sup>10</sup> Sy, A., Schiffbauer, M., Hussain, S., Keefer, P., & Sahnoun, H. (2015). *Publication: Jobs or Privileges : Unleashing the Employment Potential of the Middle East and North Africa. MENA Development Report.*

## 2. Designing incentives for development

### 2.1. Can tax incentives attract more investment to a country?

One of the primary uses of tax incentives by governments is to attract new – and in low-income countries, particularly foreign - investment. In India, for example, manufacturing firms that newly set up after 2019/20 are eligible for lower corporate tax rates of 15%, compared to 22%.<sup>11</sup>

#### Potential public gains from foreign investment

Foreign investment has both direct and indirect potential benefits to an economy. By injecting new capital into the economy, FDI can help to generate new jobs. At the same time, purchases by large and/or foreign firms and the knowledge and technology they share with suppliers in the economy can also indirectly contribute to employment and productivity growth.<sup>12</sup>

In theory, offering tax incentives can help to attract investment by offsetting some of the costs involved in setting up a business or newly investing in a country, particularly if the costs of business in that country are high. In many low-income countries, incentives are used to try to offset some of the investment risk associated with weaker rule of law and governance. The logic here is that the revenues lost from tax breaks given to firms will be compensated by the new investment and jobs created.

Although studies have found a consistent negative relationship between overall tax rates in a country and foreign investment<sup>13</sup>, empirical evidence on the effectiveness of tax incentives in attracting foreign investment is mixed.<sup>14</sup> There are a number of examples where incentives have been used as part of a policy package to successfully attract foreign investment.

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<sup>11</sup> PWC. (n.d.). *India: Corporate - Taxes on corporate income*. Retrieved from PWC Worldwide Tax Summaries:

[https://taxsummaries.pwc.com/india/corporate/taxes-on-corporate-income#:~:text=A%20beneficial%20CIT%20rate%20of%2015%25%20\(plus%20surcharge%20of%2010,manufacturing%20companies%20can%20be%20availed](https://taxsummaries.pwc.com/india/corporate/taxes-on-corporate-income#:~:text=A%20beneficial%20CIT%20rate%20of%2015%25%20(plus%20surcharge%20of%2010,manufacturing%20companies%20can%20be%20availed).

<sup>12</sup> Setzler, B., & Tintelnot, F. (2021). The Effects of Foreign Multinationals on Workers and Firms in the United States. *The Quarterly Journal of Economics*, 1943-1991; Godart, O. N., & Görg, H. (2013). *Suppliers of multinationals and the forced linkage effect: Evidence from firm level data*. Kiel Working Papers 1822, Kiel Institute for the World Economy (IfW Kiel); Amiti, M., Duprez, C., Konings, J., & Reenen, J. V. (2024). FDI and superstar spillovers: Evidence from firm-to-firm transactions. *Journal of International Economics*; Alfaro-Ureña, A., Manelici, I., & Vasquez, J. P. (2022). The Effects of Joining Multinational Supply Chains: New Evidence from Firm-to-Firm Linkages. *The Quarterly Journal of Economics*

<sup>13</sup> Andersen, M. R., Kett, B. R., & Uexkull, E. v. (2018). Corporate Tax Incentives and FDI in Developing Countries. In W. Bank, *Global Investment Competitiveness Report 2017/2018: Foreign Investor Perspectives and Policy Implications*.

<sup>14</sup> Van Parys, S. J. (2010). The effectiveness of tax incentives in attracting investment: panel data evidence from the CFA Franc zone. *Int Tax Public Finance*; Stausholm, S. N. (2017). *Rise of ineffective incentives: New empirical evidence on tax holidays in developing countries*. Center for Open Science.

## Case studies: leveraging tax incentives as part of a comprehensive investment promotion package

In **Costa Rica**, the government combined extensive tax incentives with investments in skills, infrastructure and regulations to attract large-scale investment initially from Intel in 1996, and subsequently from other large multinationals.<sup>15</sup> These MNCs in turn had significant positive spillovers on the domestic suppliers they worked with, boosting their sales and productivity.<sup>16</sup> The country's comprehensive approach to investment promotion, alongside an increasing focus on renewable energy and sustainability, has meant that Costa Rica continues to attract investment in high-value manufacturing and technology, with FDI growing by 20% in 2023.<sup>17</sup>

From the 1960s the **Singaporean** government used generous tax incentives to attract significant foreign investment into manufacturing and financial sectors. FDI increased as a percentage of GDP from 5% in 1965 to 225% in 2009. These incentives were managed by the Economic Development Board, a one-stop shop for investors that focused on the promotion of foreign investment and promoting spillovers to local suppliers. Over time, the government invested in infrastructure required by foreign investors and in training and education to provide a skilled workforce. With these improvements to the overall investment climate, widespread incentives were replaced with more targeted incentives to specific high-value sectors in the 1980s.<sup>18</sup> Tax incentives in the country are now tied to sectors that are projected to drive long-term growth, providing additional support for building business capabilities, R&D, and energy efficiency.<sup>19</sup>

**China** leveraged tax incentives in the 1980s – 2000s as part of a package of industrial policies aimed at attracting investment, which also included streamlined regulations and comprehensive infrastructure development in Special Economic Zones.<sup>20</sup> Foreign investors were offered lower tax rates, while tax holidays and other tax incentives were available for investors in strategic industries and special economic zones. FDI flows increased twenty-two-fold between 1983 and 1999 and by the 1990s, China was the second largest recipient of FDI globally.<sup>21</sup>

<sup>15</sup> MIGA. (2006). *The Impact of Intel in Costa Rica: Nine Years After the Decision to Invest*. The World Bank Group/MIGA.

<sup>16</sup> Alfaro-Ureña, A., Manelici, I., & Vasquez, J. P. (2022). The Effects of Joining Multinational Supply Chains: New Evidence from Firm-to-Firm Linkages. *The Quarterly Journal of Economics*

<sup>17</sup> fDi Intelligence. (2024, December 2). *Costa Rica's formula to attract foreign investment*. Retrieved from <https://www.fdiintelligence.com/partner-content/6262d38c-ae23-51f9-a835-4311cd4bf017>

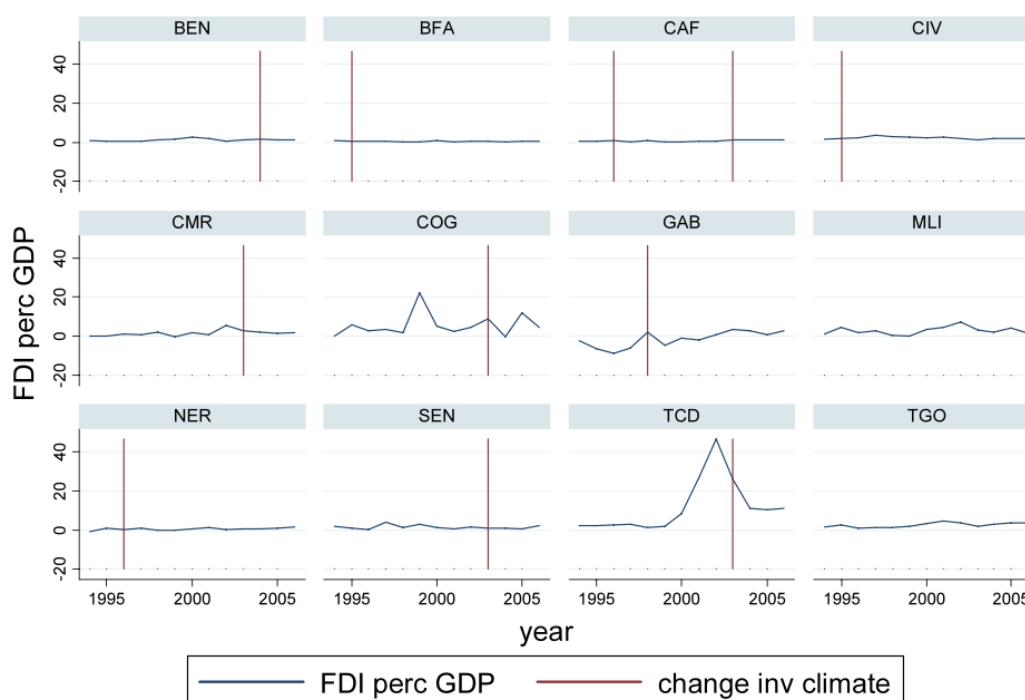
<sup>18</sup> Jun, J. (2017). *Tax Incentives and Tax Base Protection in Developing Countries*. UNESCAP; Tuomi, K. (2012). Review of Investment Incentives: Best Practice in Attracting Investment. IGC Working paper F-41003-ZMB-1.

<sup>19</sup> Valderrama, I. M., & Balharová, M. (2021). Tax Incentives in Developing Countries: A Case Study—Singapore and Philippines. In *Taxation, International Cooperation and the 2030 Sustainable Development Agenda*. United Nations University Series on Regionalism

<sup>20</sup> IMF (2015). *Options for Low Income Countries' Effective and Efficient Use of Tax Incentives for Investment*.

<sup>21</sup> Zebregs, H., & Tseng, W. S. (2002). *Foreign Direct Investment in China: Some Lessons for Other Countries*. International Monetary Fund; Zhang, K., & Song, S. (2000). Promoting exports - The role of inward FDI in China. *China economic review*.

However, many countries have not been as successful in using tax incentives to increase investment. A study of 12 CFA Franc Zone countries in Africa between 1994-2006 shows no effect of tax holidays on foreign investment in these countries.<sup>22</sup>



Graphs by country\_code

*Limited effects of changing investment climate (including tax incentives) on FDI inflows among 12 countries of the CFA franc zone between 1994-2006. Source: (Van Parys, 2010)*

Cross-country evidence suggests that in many cases, tax incentives are neither necessary nor sufficient to overcome higher costs of business and political risk in a country:

- ✗ **Tax incentives may not be necessary for FDI:** Investor surveys in low-income countries have revealed that in many cases, a large percentage (up to 98%) of investors would have invested in a country even in the absence of tax incentives.<sup>23</sup> This is particularly likely when foreign investors seek to invest in a country in order to access local markets or resources that are not available elsewhere (as opposed to 'efficiency seeking' export oriented FDI operating in competitive markets where profit margins are slim).<sup>24</sup> In countries like Ghana, for example, incentives given to mining and petroleum industries are unlikely to be necessary for investment given

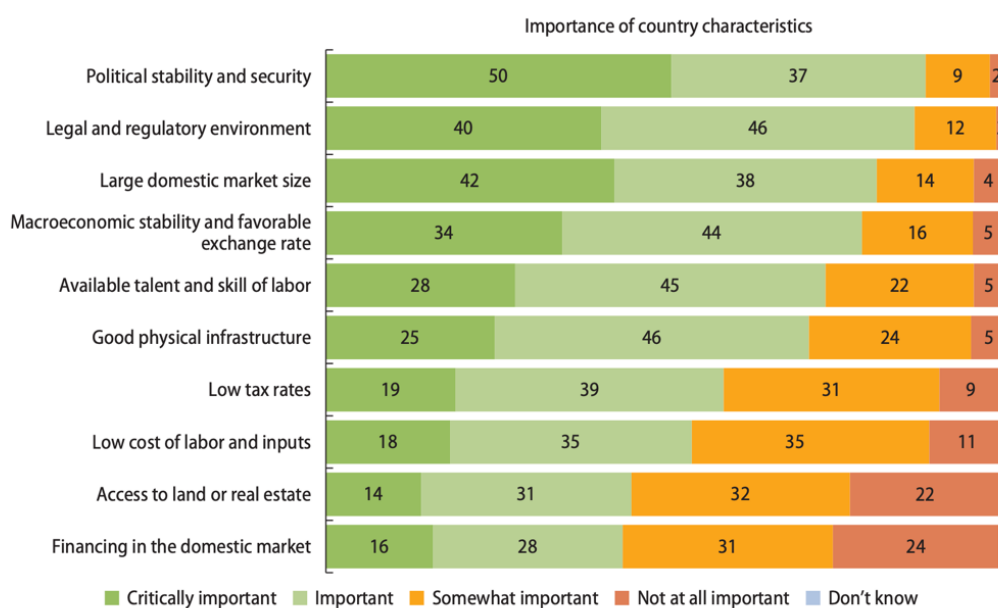
<sup>22</sup> Van Parys, S. J. (2010). The effectiveness of tax incentives in attracting investment: panel data evidence from the CFA Franc zone. *Int Tax Public Finance*.

<sup>23</sup> James, S. (2013). Effectiveness of Tax and Non-Tax Incentives and Investments: Evidence and Policy Implications. *SSRN Electronic Journal*.

<sup>24</sup> Kusek, P., Saurav, A., & Kuo, R. (2020). Outlook and Priorities for Foreign Investors in Developing Countries: Findings from the 2019 Global Investment Competitiveness Survey in 10 Middle-Income Countries. In W. Bank, *Global Investment Competitiveness Report 2019/2020: Rebuilding Investor Confidence in Times of Uncertainty*; Kusek, P., & Silva, A. (2018). What Matters to Investors in Developing Countries: Findings from the Global Investment Competitiveness Survey. In W. Bank, *Global Investment Competitiveness Report 2017/2018: Foreign Investor Perspectives and Policy Implications*.

high profits associated with their extraction.<sup>25</sup> Investors may overstate risks associated with weak institutions to bargain for larger tax incentives – to overcome this, it is important for governments to carefully evaluate what risks might affect specific business ventures and how best they can help to mitigate these. **Tax incentives may not be the most effective way to do so.**

- ✘ **Tax incentives may not be sufficient for FDI:** in many low-income countries, tax incentives are used in an effort to overcome shortcomings in infrastructure provision and the regulatory environment. But while tax incentives might be the easiest tool for a policymaker to leverage in attracting investment, it is by no means the most effective. A number of investor surveys have shown that other factors affecting the investment climate such as macroeconomic stability, infrastructure improvements, local skills, and the regulatory environment are more important in influencing investor decisions than tax rates.<sup>26</sup> In contrast with these types of interventions that help the majority of firms, tax incentives are isolated to a few firms and will reduce the revenue available to governments to make these broad-based improvements.



Source: Computation based on the GIC Survey.

Note: Multinational corporation executives were asked how important these characteristics were in their decision to invest in developing countries.

*Factors affecting investment decisions*  
 Source: (Gonzalez, Qiang, & Kusek, 2018)

- ✘ At the same time, trying to attract FDI through tax incentives often leads to a **“race to the bottom”**, where countries compete for foreign investment through tax

<sup>25</sup> Abramovsky, L., Bird, N., Harris, T., Tyskerud, Y., Weldeabzgi, A., Beyene, Y. A., . . . Keable-Elliott, I. (2018). Review of Corporate Tax Incentives For Investment in Low- and Middle-Income Countries. The Institute for Fiscal Studies

<sup>26</sup> Gonzalez, A., Qiang, C. Z., & Kusek, P. (2018). Overview. In W. Bank, *Global Investment Competitiveness Report 2017/2018: Foreign Investor Perspectives and Policy Implications*; Johnson, L., & Toledano, P. (2022). *Investment Incentives: A Survey of Policies and Approaches for Investment Incentives: A Survey of Policies and Approaches for Sustainable Investment*; Kusek, P., Saurav, A., & Kuo, R. (2020). Outlook and Priorities for Foreign Investors in Developing Countries: Findings from the 2019 Global Investment Competitiveness Survey in 10 Middle-Income Countries. In W. Bank, *Global Investment Competitiveness Report 2019/2020: Rebuilding Investor Confidence in Times of Uncertainty*.

reductions, leading to lower tax revenues with no real benefit in terms of investment promotion. Evidence from across 40 countries in Latin America, the Caribbean and Africa show that a country's tax holidays respond to those of its neighbours.<sup>27</sup> This can even happen at the sub-national level; in Brazil, for example, fierce competition between state governments for automobile investment in the 1990s came at the cost of much-needed public revenues.<sup>28</sup>

Collaboration between countries and local governments competing for investment is necessary to mitigate this threat. In Europe, for example, incentives are regulated across the European Union to limit tax competition. Lower income countries are able to offer higher incentives, while incentives on very large investments of over 100 million euros require approval from the European Commission based on justification of why such an incentive is necessary.<sup>29</sup>

- ✘ Finally, **attracting investment does not equate to more jobs created.** Without accompanying policies or conditions to promote investment in particular activities that can generate local employment, foreign investment in many low-income countries has been concentrated in extractive industries with limited opportunity for local employment generation. This has been seen in Senegal and Nigeria, for example, where generous incentives have primarily attracted natural resource extraction without commensurate gains in employment.<sup>30</sup> A study of state and local business tax incentives in the United States found that these incentives do help to boost employment by attracting firms, but that there is limited evidence of spillover effects that can drive wider economic gains.<sup>31</sup> Similarly, cross-country analysis using data from 40 Latin America, Caribbean and African countries finds that corporate income tax rate deductions and tax holidays, despite being positively associated with FDI, do not generally have a significant effect on total investment and growth.<sup>32</sup>

This may have something to do with the types of firms tax incentives attract – tax incentives are more likely to influence the decisions of more mobile firms that are sensitive to production cost differences between countries – and these firms are less likely to invest in local development if price advantages are not guaranteed in the long run.<sup>33</sup> To address this, some governments have implemented complementary

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<sup>27</sup> Klemm, A., & Parys, S. V. (2012). Empirical Evidence on the Effects of Tax Incentives. *Int Tax Public Finance*, 393-423.

<sup>28</sup> Rodrigues-Pose, A., & Arbix, G. (2001). Strategies of Waste: Bidding Wars in the Brazilian Automobile Sector. *International Journal of Urban and Regional Research*.

<sup>29</sup> Smith, B. (2021, July 29). *How Europe, India and Africa are incentivizing foreign investment*. Retrieved April 2025, from EY: [https://www.ey.com/en\\_gl/insights/tax/how-europe-india-and-africa-are-incentivizing-foreign-investment](https://www.ey.com/en_gl/insights/tax/how-europe-india-and-africa-are-incentivizing-foreign-investment)

<sup>30</sup> Tax Justice Network Africa, & ActionAid. (2015). *The West African Giveaway: Use & Abuse of Corporate Tax Incentives in ECOWAS*.

<sup>31</sup> Slattery, C. R., & Zidar, O. M. (2020). *Evaluating State and Local Business Tax Incentives*. NBER Working Paper.

<sup>32</sup> Klemm, A., & Parys, S. V. (2012). Empirical Evidence on the Effects of Tax Incentives. *Int Tax Public Finance*, 393-423; (Stausholm, 2017)

<sup>33</sup> Johnson, L., & Toledano, P. (2022). *Investment Incentives: A Survey of Policies and Approaches for Investment Incentives: A Survey of Policies and Approaches for Sustainable Investment*; Mutti, J., & Grubert, H. (2004). Empirical asymmetries in foreign direct investment and taxation. *Journal of International Economics*; Zolt, E. (2013). *Tax Incentives and Tax Base Protection Issues*. United Nations.

policies to incentives to try to maximise the wider economic benefits of new investment through supplier linkages.<sup>34</sup>

Overall, cross-country experience suggests that tax incentives are likely to play a role in investment decisions only when investors are deciding between locations that are in other respects similar. Lower tax rates have been shown to be eight times more effective at attracting investment where investment climates are otherwise good.<sup>35</sup> All else equal, tax incentives can have a significant impact – but **all else is often not equal**, and even if it is, it may not be for long.<sup>36</sup>

## 2.2. What kinds of socially beneficial activities are tax incentives best suited for?

Beyond attracting investment, tax incentives are often used to direct investment towards certain activities, sectors, and locations.

### *Local economic development?*

Many countries use tax incentives to try to spur development in less-developed regions of a country. In Vietnam, for example, progressively more generous location-based incentives are used to attract investment projects to “disadvantaged” and “extremely disadvantaged” regions.<sup>37</sup>

- ✓ In theory, tax incentives may be needed to encourage firms to overcome the initial costs of investing in a new area – which includes sourcing new supplies, training new staff and developing new markets. These are costs that the ‘first mover’ incurs but all subsequent investors benefit from – the actions of the first set of firms have a **positive spillover** or externality for all other firms.
- ✗ However, there is limited evidence on the effectiveness of using tax incentives to support local economic development. Despite large incentives given to firms in countries such as Cote D’Ivoire and Uganda to locate outside of major cities, firms continue to cluster in Abidjan and Kampala to make the most of urban connectivity and workforces.<sup>38</sup> Evidence from local government tax breaks in the United States

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<sup>34</sup> See Manwaring, P., & Rauschendorfer, J. (2020). *Making the most of investment in Uganda: the role of supplier development programmes* for more details on supplier development programmes.

<sup>35</sup> James, S. (2009). *Incentives and Investments: Evidence and Policy Implications*. World Bank.

<sup>36</sup> Mataba, K., Lassourd, T., Readhead, A., & Nikièma, S. (2023). *Revisiting Tax Incentives as an Investment Promotion Tool: Q&A for investment policy-makers*. IISD; Andersen, M. R., Kett, B. R., & Uexkull, E. v. (2018). Corporate Tax Incentives and FDI in Developing Countries. In W. Bank, *Global Investment Competitiveness Report 2017/2018: Foreign Investor Perspectives and Policy Implications*; Kusek, P., & Silva, A. (2018). What Matters to Investors in Developing Countries: Findings from the Global Investment Competitiveness Survey. In W. Bank, *Global Investment Competitiveness Report 2017/2018: Foreign Investor Perspectives and Policy Implications*.

<sup>37</sup> Förster, M. (n.d.). *Tax Incentives for Foreign Enterprises in Vietnam*. Retrieved from Vietnam Briefing: <https://www.vietnam-briefing.com/doing-business-guide/vietnam/taxation-and-accounting/tax-incentives-for-businesses>

<sup>38</sup> Tax Justice Network Africa, & ActionAid. (2015). *The West African Giveaway: Use & Abuse of Corporate Tax Incentives in ECOWAS*.

suggests that these tax breaks have limited impact on the location decisions of firms, despite costing local governments significantly in terms of revenues.<sup>39</sup>

Like using tax incentives to attract investment into a country, using them to attract incentives to a particular region is unlikely to be effective if the investment climate in lagging regions is very different from major cities: the costs involved cannot be overcome with tax incentives. Instead, addressing issues with infrastructure, skills and institutions that are affecting these lagging regions is likely to be more effective in attracting investment.

### *Supporting specific sectors?*

In a number of countries, tax incentives are used to support the development of specific industries – most commonly in manufacturing. In Nigeria, for example, tax holidays are offered for companies that produce glass, fertiliser and steel,<sup>40</sup> whilst in Ghana, 0% corporate tax rates are applied to cocoa farming.<sup>41</sup>

- ✓ The rationale behind these types of incentives is that there is some initial cost for firms investing in socially beneficial sectors that cannot be addressed through private financial markets: in other words, there is a **market failure** that is preventing production. This could include, for example, the costs of risky learning-by-doing in the initial stages of production in a country.<sup>42</sup> Tax incentives can help firms overcome this cost in the short run before they are able to become competitive, so that targeted industries can drive job creation and growth.
- ✓ There is growing evidence on the effectiveness of tax incentives and other targeted support when implemented well.

### **Case studies: tax incentives to support sectoral growth in South Korea and Romania**

In South Korea, **targeted support to heavy and chemical industries** in the 1970s in the form of targeted lending and investment-oriented incentives (including tax breaks, investment credits, and accelerated depreciation) contributed to the “East Asian miracle” of growth seen during this period. This support resulted in higher investment, productivity, employment, output, and exports of firms in these sectors, even after

<sup>39</sup> Mast, E. (2020). Race to the Bottom? Local Tax Break Competition and Business Location. *American Economic Journal: Applied Economics*, 288-317.

<sup>40</sup> Smith, B. (2021, July 29). *How Europe, India and Africa are incentivizing foreign investment*. Retrieved April 2025, from EY: [https://www.ey.com/en\\_gl/insights/tax/how-europe-india-and-africa-are-incentivizing-foreign-investment](https://www.ey.com/en_gl/insights/tax/how-europe-india-and-africa-are-incentivizing-foreign-investment)

<sup>41</sup> Abramovsky, L., Bird, N., Harris, T., Tyskerud, Y., Weldeabzgi, A., Beyene, Y. A., . . . Keable-Elliott, I. (2018). Review of Corporate Tax Incentives For Investment in Low- and Middle-Income Countries. The Institute for Fiscal Studies

<sup>42</sup> Khan, M. (2013). Technology Policies and Learning with Imperfect Governance. In J. E. Lin, *The Industrial Policy Revolution I. The Role of Government Beyond Ideology*. London: Palgrave.

targeted support was later withdrawn. The better performance of these sectors had positive spillover effects on their buyers, resulting in their higher exports as well.<sup>43</sup>

In Romania, personal income tax breaks were introduced in 2001 and 2013 for programmers with eligible bachelor's degrees working in specific IT sector codes, to support these industries. A study has shown that this resulted in higher growth of firms and industries benefiting from this incentive, with sustained positive effects on employment and positive effects on suppliers.<sup>44</sup>

- ✘ However, these types of targeted industrial policies have not always been effective at promoting the development of certain industries.<sup>45</sup> The experience of many countries in Latin America, Asia and Africa is of huge amounts of government resources spent on propping up uncompetitive firms at the expense of taxpayers. In the Dominican Republic, for example, efforts to promote the tourism sector through tax incentives have come at a significant financial cost and analysis suggests these have had limited effect on the sector's development.<sup>46</sup>

Evidence from China suggests that tax incentives and other industrial support are more effective at boosting the productivity of firms when allocated to competitive sectors, when they are more dispersed across a sector, and when they are targeted at younger and more productive firms.<sup>47</sup>

Cross-country evidence suggests that to be effective, tax incentives and other forms of industrial support need to be **responsive to the needs of firms** whilst at the same time having **effective conditions** attached. This requires:

- Where resources are stretched, focus policy on a small number of sectors close to competitive so that governments can work closely with firms and comprehensive industrial support can be effectively tailored to completely addressing barriers to competitiveness
- Government agencies that are willing and able to enforce conditions (for example, export targets) on recipient firms to help ensure they are investing in improving production – this is often not the case in many low-income countries. Without

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<sup>43</sup> Lane, N. (forthcoming). Manufacturing revolutions: industrial policy and industrialization in South Korea. *Quarterly Journal of Economics*.

<sup>44</sup> Manelici, I., & Pantea, S. (2021). Industrial policy at work: Evidence from Romania's income tax break for workers in IT. *European Economic Review*.

<sup>45</sup> Khan, M. (2000). *The Political Economy of Industrial Policy in Pakistan 1947-1971*; Krugman, P. R., Obstfeld, M., & Melitz, M. J. (2012). *International Economics: Theory and Policy*; Lin, J., & Chang, H.-J. (2009). Should Industrial Policy in Developing Countries Conform to Comparative Advantage or Defy it? A Debate Between Justin Lin and Ha-Joon Chang. *Development Policy Review*.

<sup>46</sup> United Nations. (2018). *Design and assessment of tax incentives in developing countries: selected issues and a country experience*

<sup>47</sup> Aghion, P., Cai, J., Dewatripont, M., Du, L., Harrison, A., & Legros, P. (2015). Industrial Policy and Competition. *American Economic Journal: Macroeconomics*.

imposing conditions on the support given to firms, tax incentives are often given to firms indefinitely and with no public benefit in return.

### R&D?

Particularly in high-income countries, tax incentives are used to promote research and development activities. In the UK, income from R&D patents is taxed at 10%, rather than 20%.<sup>48</sup> In South Sudan, R&D expenditures are 100% tax deductible, while in South Africa, R&D ventures are eligible for a 150% tax deduction.<sup>49</sup>

- ✓ Tax incentives aimed at research and development can help firms to overcome the **sunk costs** associated with years of research that, once it comes to fruition, will help society at large – through for example, improved healthcare or production technology. In this way, tax incentives compensate firms engaged in R&D for the costs they incur which will eventually benefit others.<sup>50</sup>
- ✓ Available evidence suggests that well-targeted incentives towards R&D can be effective in promoting investments in innovation<sup>51</sup> – in the UK, for example, R&D tax relief for SMEs has had a positive effect on research and patenting activity, with positive spillovers on R&D for similar firms.<sup>52</sup> Further evidence from the UK suggests that tax credits for R&D can boost spending on this, with every dollar lost in tax revenue generating an additional dollar in R&D spending.<sup>53</sup> In South Korea, tax incentives geared towards R&D first introduced in the 1970s have had positive effects on firm R&D expenditure and innovation in products and processes.<sup>54</sup>
- ✗ However, without **accompanying investments in skill development and infrastructure**, these incentives alone are unlikely to effectively promote research and development in low-income countries.

### Incentives for green growth

<sup>48</sup> Smith, B. (2021, July 29). *How Europe, India and Africa are incentivizing foreign investment*. Retrieved April 2025, from EY: [https://www.ey.com/en\\_gl/insights/tax/how-europe-india-and-africa-are-incentivizing-foreign-investment](https://www.ey.com/en_gl/insights/tax/how-europe-india-and-africa-are-incentivizing-foreign-investment)

<sup>49</sup> Smith, B. (2021, July 29). *How Europe, India and Africa are incentivizing foreign investment*. Retrieved April 2025, from EY: [https://www.ey.com/en\\_gl/insights/tax/how-europe-india-and-africa-are-incentivizing-foreign-investment](https://www.ey.com/en_gl/insights/tax/how-europe-india-and-africa-are-incentivizing-foreign-investment)

<sup>50</sup> Another common tool used to incentivise research and development is patents – these protect revenues of firms for the output of their research and development for a fixed period of time, to incentivise investment in R&D that will eventually benefit society at large.

<sup>51</sup> Crespi, G., Giuliadori, D., Giuliadori, R., & Rodriguez, A. (2016). The effectiveness of tax incentives for R&D+i in developing countries: The case of Argentina. *Research Policy*; Wang, K. T., Walpola, S., Zhu, N. Z., & Ulima, I. (2024). R&D Tax Incentive Reforms Around the World: The Impact on Firm Value. *European Accounting Review*; Jia, J., & Ma, G. (2017). Do R & D tax incentives work? Firm-level evidence from China. *China Economic Review*.

<sup>52</sup> Dechezleprêtre, A., Elias Einiö, R. M., Nguyen, K.-T., & Reenen, J. V. (2023). Do Tax Incentives Increase Firm Innovation? An RD Design for R&D, Patents, and Spillovers. *American Economic Journal: Economic Policy*.

<sup>53</sup> Gucer, I., & Liu, L. (2019). Effectiveness of Fiscal Incentives for R&D: Quasi-experimental Evidence. 266-291.

<sup>54</sup> Bank, W. (2024). *A Case Study on Korea's R&D Tax Incentives: Principles, Practices, and Lessons for Developing Countries*.

Increasingly governments are using tax incentives to encourage more sustainable development – particularly in high-income countries. This involves providing tax deductions for firms that invest in green sectors and technology, or that divest from ‘dirty’ sectors. In response to energy supply concerns in South Africa, for example, the government has implemented a ‘12L tax incentive’ that reduces tax burdens for firms that implement measures to improve energy efficiency.<sup>55</sup> The rationale for these incentives is that firms have to incur significant costs in moving to more sustainable production processes and sectors, but the benefits of mitigating climate change are reaped by society as a whole. Tax incentives can help compensate firms for the wider benefits of their actions.

However, these types of incentives are in the minority: a 2024 study by the World Bank found that between 2009-2020, only 3 percent of corporate income tax incentives are focused on encouraging green sectors, and another 3 percent on encouraging green processes. By contrast, 10 percent of CIT incentives encourage polluting sectors.<sup>56</sup>

### *To develop local supply chains?*

To complement efforts to attract investment, many governments use tax incentives to encourage large investors to work with local suppliers. In Rwanda, Kenya and Uganda, for example, tax incentives are offered to investors based on their use of local supplies, either in the form of reduced tax rates and tax holidays if a firm uses a certain amount of local inputs, or reduced VAT rates on certain local supplies.<sup>57</sup>

- ✓ The idea behind these incentives is to help compensate large investors for any additional costs involved in working with local suppliers, to allow local suppliers to benefit from the **positive externalities** of working with large (and in particular foreign) firms. By working with large investors and integrating into global value chains, local suppliers may be able to expand their sales and benefit from economies of scale, and learn best practices in production technology and product quality.<sup>58</sup>

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<sup>55</sup> Department of Mineral Resources and Energy, Republ. (2022). *12L Tax incentive: Turning energy efficiency into profits*.

<sup>56</sup> Kett, B., Kronfol, H., Sandoval, E. A., Schimanski, C., & Steenbergen, V. (2024). *Corporate income tax incentives to promote environmentally sustainable investment: Findings from 40 economies covered by the World Bank Corporate Income Tax Incentives Database*. International Bank for Reconstruction and Development / The World Bank.

<sup>57</sup> Republic of Kenya. (2023). *The Finance Act 2023*; Government of Rwanda. (2021). *Medium Term Revenue Strategy*.

<sup>58</sup> Arraiz, I., Henriquez, F., & Stucchi, R. (2012). Supplier Development Programs and Firm Performance: Evidence from Chile. *Small Business Economics* Bastos, P., & Silva, J. (2010). The Quality of a Firm’s Exports: Where You Export to Matters. *Journal of International Economics*; Kugler, M., & Verhoogen, E. (2012). Prices, Plant Size, and Product Quality. *The Review of Economic Studies*; Godart, O. N., & Görg, H. (2013). *Suppliers of multinationals and the forced linkage effect: Evidence from firm level data*. Kiel Working Papers 1822, Kiel Institute for the World Economy (IfW Kiel); Javorcik, B. S., & Spatareanu, M. (2009). Tough Love: Do Czech Suppliers Learn from Their Relationships with Multinationals?\*. *The Scandinavian Journal of Economics*; Spray, J. (2017). *Exports and Promoting Backward Linkages: Ideas and Lessons for the Made in Rwanda Policy*. IGC.

Stausholm, S. N. (2017). *Rise of ineffective incentives: New empirical evidence on tax holidays in developing countries*. Center for Open Science.

- ✘ However, incentives to work with local suppliers are unlikely on their own to sufficiently compensate large investors if local suppliers produce at a much lower quality than what could be imported. Evidence from Uganda suggests that in these cases, tax incentives may only incentivise less competitive firms producing for the local market to source locally.<sup>59</sup> These linkages are likely to have much less positive spillovers on productivity.
- ✘ At the same time, if local suppliers face capacity constraints, incentivising certain firms to source more locally will just displace local supply from other industries, and suppliers will not benefit from economies of scale.<sup>60</sup>

Tax incentives to support supplier development will only be as successful as complementary efforts to improve the **quality and capacity of local suppliers**.

### *To promote exports?*

In many countries, tax incentives are offered for firms engaged in exporting activities. In Uganda, for example, a ten-year tax holiday is available for companies exporting at least 80% of their production as finished goods. In many countries including Rwanda and South Korea, tax exemptions are offered on imported raw materials used in the production of exported goods.

- ✓ There may be particular barriers firms have to overcome in learning to export that, similar to developing a new sector, require short term financial support from the government. These include additional standards that need to be met, as well as costs of shipping, logistics, and marketing in a new country. By encouraging exports, these incentives help earn foreign exchange needed to achieve other government aims such as servicing external debt and importing necessary capital goods and other materials.
- ✓ By encouraging firms to export, these incentives can also help firms to learn from supplying to other markets on a global scale, raising the productivity of these firms to the point where they no longer need incentives to be able to export.<sup>61</sup>

Evidence from China suggests that duty drawback schemes which provided exporters with rebates on imported inputs in the 1980s and 90s did have a positive effect on exports.<sup>62</sup>

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<sup>59</sup> Manwaring, P. (Forthcoming ). *Buy Local, build local? Tax incentives and local content promotion*

<sup>60</sup> Manwaring, P. (Forthcoming ). *Buy Local, build local? Tax incentives and local content promotion*

<sup>61</sup> Kiendrebeogo, Y. (2020). Learning by exporting or self-selection into exporting? *Middle East Development Journal*.

<sup>62</sup> Chao, C.-C., Chou, W. L., & Yu, E. S. (2001). Export Duty Rebates and Export Performance: Theory and China's Experience. *Journal of Comparative Economics*.

- ✘ However, the effectiveness of tax incentives for export promotion requires firms that can, once initial obstacles have been overcome, be able to produce at a globally competitive level. Without this, additional support for exporting firms will be unlikely to effectively encourage firms to export and will be a continuous drain on public resources. Cross-country experience shows that in many cases, efforts to promote exports have followed an initial period of 'import substituting' support to build capabilities of domestic producers.<sup>63</sup>

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<sup>63</sup> Balassa, B. (1978). *Export Incentives and Export Performance in Developing Countries: A Comparative Analysis*. World Bank Reprint Series.

<i>Policy aim</i>	<i>The role of tax incentives</i>	<i>Potential challenges</i>
<b>Local economic development</b>	Can encourage firms to overcome the initial costs of investing in a new area	Unlikely to be effective if the investment climate in lagging regions is very different
<b>Supporting specific sectors</b>	Help overcome market failures preventing competitive production	Can be used to prop up uncompetitive industries – need to have effective conditions attached
<b>Supporting R&amp;D</b>	Help firms to overcome the sunk costs associated with research	In low- and middle-income countries, R&D activity will likely require additional investments in skill development and infrastructure
<b>Developing local supply chains</b>	Help compensate large investors for any additional costs involved in working with local suppliers	Requires local suppliers to produce (or begin producing) at the required scale and quality needed by large buyers
<b>Export promotion</b>	Help firms overcome barriers in learning to export	Requires firms that can, once initial obstacles have been overcome, be able to produce at a globally competitive level.

*Summary: what kinds of socially beneficial activities are tax incentives best suited for?*

### **2.3. What kinds of tax incentives work best?**

There are a range of different types of tax incentives that governments can employ, but these broadly take one of two forms:<sup>64</sup>

- 1) Profit-based incentives**, that directly reduce the taxable amount of profit – this includes full tax holidays or reduced tax rates

<sup>64</sup> Stotsky, J. (2024). *Tax Incentives and Investment*. Asian Development Bank.

**2) Expenditure-based incentives**, which introduce tax deductions based on specific types of expenditure. This includes tax credits or allowances that allow businesses to ‘write off’ some or all of the costs of an investment from taxes or taxable income, as well as accelerated depreciation, whereby firms can deduct more sooner from their tax obligations based on depreciation of certain types of capital in initial years.<sup>65</sup> This also includes incentives that reduce taxes paid on particular transactions, such as reduced VAT or import duties on certain items or for firms engaged certain activities.

Evidence from the United States suggests that accelerated depreciation can stimulate a similar increase in investment to reduced tax rates per dollar of lost revenue.<sup>66</sup> However, there are reasons to believe that expenditure-based incentives are likely to be a more effective option in attracting long term investment:

- ✓ By reducing tax rates for a limited period, profit-based incentives have been found to encourage greater investment in short-term projects that offer quicker returns, rather than longer term projects that involve significant initial capital outlays and where profits may not be seen for the first few years.<sup>67</sup> By reducing tax obligations based on specific (usually capital) expenditures, expenditure-based incentives have an effective condition on expenditure in-built. As such, they may be more effective in attracting longer term capital investment that cannot easily move to another location in response to tax changes.
- ✓ Profit-based incentives are also at greater risk of encouraging profit shifting: MNEs and multi-plant firms can artificially report higher profits in locations/activities where incentives are granted.

However, it is important to note that because they are applied based on specific expenditures, expenditure-based incentives require **more sophisticated record keeping** by firms and monitoring by government authorities.

At the same time, expenditure-based incentives that encourage specific types of expenditure need to be **designed carefully** to avoid unintended consequences. For example, in 2004, the Chinese government reduced the VAT rate on investment goods, with the aim of encouraging further investment. However, evidence suggests that this policy did not have any significant effect on fixed investment or productivity; instead, it encouraged businesses to shift towards greater use of capital and more capital-intensive production. The result was

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<sup>65</sup> Under accelerated depreciation, total tax liabilities remain the same in nominal terms, but deductions are made earlier, thus yielding a benefit in terms of present value.

<sup>66</sup> Ohrn, E. (2018). The Effect of Corporate Taxation on Investment and Financial Policy: Evidence from the DPAD. *American Economic Journal: Economic Policy*.

<sup>67</sup> Andriansyah, Hong, S. H., & Nam, B. (2021). *Policy Considerations in Using Tax Incentives for Foreign Investment*. AMRO.

a reduction in employment in affected areas and average product quality.<sup>68</sup> Similarly, in some countries, expenditure-based tax incentives take the form of losses carried forward, whereby businesses can write off their losses against future or past tax obligations. However, they can unfairly advantage more established firms that can benefit from carrying forward initial losses, at the expense of newer firms currently incurring extensive initial start-up costs. Given that R&D expenses are often undertaken by newer firms, this may not be the most effective way of encouraging such activity.

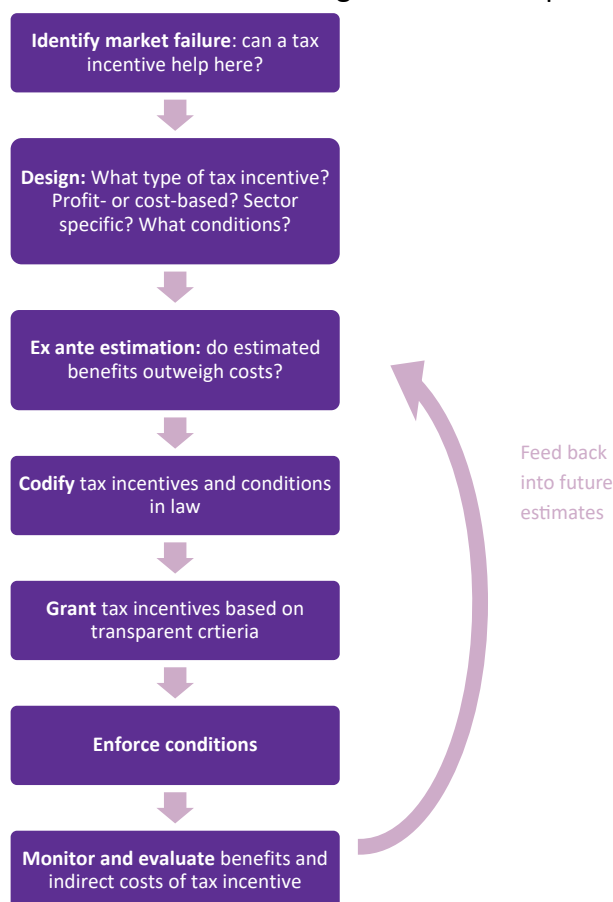
Given their potential advantages in attracting long term investment, where governments have capacity to **monitor** expenditures and to work with businesses in **identifying valuable inputs** to production, incentives should ideally target costs rather than profits.

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<sup>68</sup> Cai, J., & Harrison, A. (2021). Industrial Policy in China: Some Intended or Unintended Consequences? *ILR Review*; Kong, D., & Xiong, M. (2021). Unintended consequences of tax incentives on export product quality: Evidence from a natural experiment in China. *Review of International Economics*.

### 3. Implementing incentives

Even the best designed tax incentives can be a barrier to growth if not implemented well.



#### 3.1. Estimating and monitoring costs and benefits

Given the significant costs of tax incentives, it is critical when designing and allocating incentives for governments to assess whether the **estimated** benefits of a tax incentive outweigh its estimated cost.<sup>69</sup> Following the allocation of incentives, continued **monitoring** of outcomes is needed to verify their costs and benefits. Over time, monitoring actual responses to incentives can help inform better estimates.

- The costs of tax incentives include the **direct cost** of revenue foregone through the introduction of tax incentives,<sup>70</sup> and the **indirect costs** of market distortions these incentives introduce by giving certain firms preferential treatment: do other firms lose out on markets and opportunities to grow?

<sup>69</sup> A full cost-benefit analysis of tax incentives requires a) an estimate of direct and indirect costs of tax incentives over the period applied, b) an estimate of the value of actual or predicted benefits over a specified period e.g., in terms of employment, output, growth, and c) assumptions about the discount rate on future income to compare future gains with current revenues forgone

<sup>70</sup> The direct costs of tax incentives can also be calculated as revenue gains from the removal of these incentives, or the 'outlay equivalence': how much would be required to achieve the same effect through a subsidy? For more details, see Kronfol, H., & Steenberg, V. (2020). *Evaluating the Costs and Benefits of Corporate Tax Incentives*. World Bank.

Once the direct costs of tax incentives have been calculated, it is important for governments to **account for this in their public budget**. This helps taxpayers and government agencies to take seriously the hidden costs of incentives in terms of revenue forgone, and to make sure this is worth the benefits.

- In estimating the **benefits** of tax incentives, the key question is: what is the change in behaviour that comes from introducing incentives, and what benefits does this change create? While tax incentives may be offered to firms which go on to generate jobs and exports, it is important to distinguish *whether these benefits would have happened in the absence of tax incentives*.

Detailed assessment of benefits is particularly important because experience shows that businesses will try to benefit from tax incentives by changing their business practices on paper, without any real benefit to the economy – for example, by shifting declared income to tax exempt activities.<sup>71</sup> In Bolivia, for example, a tax credit was introduced in 1987 for exporters based on **export growth over the previous year**. In response, farmers moved their herds over the border multiple times to increase their ‘exports’ – the programme was scrapped by 1991.<sup>72</sup> Understanding firm behaviour in response to tax incentives can help design rules and conditions to prevent such abuse.<sup>73</sup>

#### *Institutional capacity for estimation and evaluation*

Estimating and monitoring costs and benefits of tax incentives requires government institutions to have both the **technical capacity** among staff to work with and analyse data, and **up to date data** to undertake detailed analysis:

- *Ex ante* estimation of costs and benefits will require data on firm behaviour as well as predictive modelling skills to estimate revenues forgone, how firms are likely to react to the tax incentive, and the changes this implies for the wider economy.
- Monitoring costs and benefits of incentives over time requires comprehensive data collection on firm behaviour and outcomes before and after the implementation of investment promotion policies, as well as on firms who are not subject to these policies, to be able to undertake effective comparisons.<sup>74</sup>
- Effective estimation and evaluation also requires staff that are sufficiently trained to identify tax avoidance strategies by firms that may limit the effectiveness of incentives.

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<sup>71</sup> IMF (2015). *Options for Low Income Countries’ Effective and Efficient Use of Tax Incentives for Investment*.

<sup>72</sup> Rodrik, D. (1993). *Taking trade policy seriously: export subsidization as a case study in policy effectiveness*.

<sup>73</sup> See Zolt, E. (2015). *Tax Incentives: Protecting the tax base. Paper for Workshop on Tax Incentives and Base Protection* and United Nations. (2018). *Design and assessment of tax incentives in developing countries: selected issues and a country experience* for more details on common ‘abuses’ of tax incentive regimes

<sup>74</sup> See Kronfol, H., & Steenbergen, V. (2020). *Evaluating the Costs and Benefits of Corporate Tax Incentives* for more details on methods for quantifying costs and benefits of tax incentives

Fortunately, much of the data needed for such analysis is often already collected by national tax authorities in the form of tax returns files by businesses. Domestic tax and customs data can provide a clear picture of investment, value-added and exports, as well as the level and types of supplier linkages between firms. In countries like Rwanda and Uganda, for example, the national revenue authority has access to detailed data on businesses' balance sheets, profit and loss statements, imports, exports, employment and items purchased/sold, through corporate income, Paye-As-You-Earn, VAT and import tax records. Together, these provide data that can be used to calculate revenues foregone from tax incentives<sup>75</sup> as well as a rich set of firm outcomes that can be monitored in assessing the effects of incentives.

In many countries, firms that receive full tax holidays do not keep accurate business records over this period, making it difficult for governments to assess the revenues forgone from these incentives and therefore to assess their costs and benefits. Best practice suggests that even when receiving full tax holidays, firms should complete and submit full tax records.

### 3.2. *Rules over discretion*

In many countries, tax incentives are offered on an ad-hoc, discretionary basis, with limited public knowledge of who receives these and why.<sup>76</sup> At the same time, the application process and procedures involved in obtaining incentives are often opaque. Not only does this limit the attractiveness of such incentives for investors by introducing uncertainty into whether they or their competitors will receive these incentives, it also makes public scrutiny and accountability of these incentives extremely difficult. Tax incentives can become a vehicle for personal gain among government officials, rather than public development.

Getting the most out of incentives offered to investors requires **transparent processes** and **rules-based criteria** for obtaining tax incentives, so that public officials and the public can have effective oversight over this process. In many countries, parliamentary approval is needed for the introduction of new incentives, which are then codified into law. By limiting the use of discretionary incentives, governments avoid introducing unnecessary advantages for particular firms that can actually harm competition and growth.

### 3.3. *Enforceable conditions*

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<sup>75</sup> See Eissa, N., Manwaring, P., Ntungire, N., & Rauschendorfer, J. (2020). *What is the fiscal costs of tax incentives in Uganda?* International Growth Centre, for example

<sup>76</sup>Waiswa, R., & Rukundo, S. (2023). *Strategic Investment Tax Incentives in Africa: The Case of Tax Holidays in Uganda*. ICTD Working Paper 161; Tax Justice Network Africa, & ActionAid. (2015). *The West African Giveaway: Use & Abuse of Corporate Tax Incentives in ECOWAS*.

While there are often conditions attached to tax incentives – on investment, exports, or employment, for example - in practice these conditions are often not enforced. Effective enforcement requires:

- Sufficient resources dedicated to auditing firms
- Empowered institutions and personnel that can retract incentives if conditions are not being met

One critical way to help ensure tax incentives are given in exchange for public benefits is to make them **time-bound**. If firms require financial assistance to set up a business or to expand into new activities, incentives can help to overcome these initial costs, but unless these firms are offering a significant public service, incentives should not be required indefinitely. At the same time, time-bound incentives allow governments an opportunity to assess the effectiveness of incentives in achieving their goals and to prevent benefits accruing to firms that are not meeting their commitments.

### **3.4. Avoiding institutional overlap**

Incentives in low-income countries are often managed by multiple government agencies and codified across different laws. In the Philippines, for example, there are at least seven different investment promotion agencies involved in granting tax incentives.<sup>77</sup> Not only does this often create unnecessary complexity and uncertainty for investors who have to work with multiple agencies, it also prevents any one agency from taking accountability for the costs and benefits of these incentives.

Streamlining this process by assigning a dedicated government agency for tax incentives can help make the process of assigning and monitoring incentives more transparent for investors and improve accountability of their use. At the same time, it can avoid a ‘race to the bottom’ even between government departments in the same country whereby agencies compete to offer incentives.

#### **Case study: addressing institutional overlap in Ethiopia**

Until recently in Ethiopia, the power to grant tax incentives was shared between several government agencies and incentives were outlined in different regulatory documents. At the same time, the Ethiopian Investment Board was granted discretionary power to approve incentives beyond those outlined in existing investment regulations, with the aim

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<sup>77</sup> <https://cbos.com.ph/understanding-the-philippine-investment-promotion-agencies/>

of attracting investment that helps support the country's development.<sup>78</sup> This complex system created confusion and misinformation on the part of investors as well as the Ethiopian Revenue and Customs Authority, the agency responsible for implementing these incentives.<sup>79</sup> To address this, new regulation was introduced in 2022 to centralise the design and administration of tax incentives with the Ministry of Finance.<sup>80</sup> Now, all other authorities must submit tax incentive requests to the Ministry for final approval.

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<sup>78</sup> Abramovsky, L., Bird, N., Harris, T., Tyskerud, Y., Weldeabzgi, A., Beyene, Y. A., . . . Keable-Elliott, I. (2018). Review of Corporate Tax Incentives For Investment in Low- and Middle-Income Countries. The Institute for Fiscal Studies

<sup>79</sup> Abramovsky, L., Bird, N., Harris, T., Tyskerud, Y., Weldeabzgi, A., Beyene, Y. A., . . . Keable-Elliott, I. (2018). Review of Corporate Tax Incentives For Investment in Low- and Middle-Income Countries. The Institute for Fiscal Studies

<sup>80</sup> Aman & Partners. (2022, August). *New Regulation on Investment Incentives*. Retrieved from <https://www.aaclo.com/insight/new-regulation-on-investment-incentives/>.

#### 4. Concluding remarks

Tax incentives have the potential to encourage investment and support socially beneficial activities that can drive job creation and growth. But while they may be relatively easy to implement and can be implemented by governments operating with limited public finances, tax incentives on their own are unlikely to be the most effective tool available to policymakers.

To achieve their aims often requires complementary investments in skills, infrastructure, and institutions. Lower tax rates have been shown to be eight times more effective at attracting investment where investment climates are otherwise good.<sup>81</sup> It also requires empowered government agencies that can assign incentives impartially and transparently and enforce conditions on incentives to ensure that their benefits are worth their significant hidden cost. Without these conditions, tax incentives are likely to become a drain on scarce public finances and a barrier to the emergence of new, competitive businesses.

Even with these conditions in place, government will need to invest in continually estimating and monitoring the costs and benefits of tax incentives, to ensure they are as effective as possible, and to work with businesses in identifying additional barriers to investment.

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<sup>81</sup> James, S. (2009). *Incentives and Investments: Evidence and Policy Implications*. World Bank.

## Recommended further reading

Abramovsky, L., Bird, N., Harris, T., Tyskerud, Y., Weldeabzgi, A., Beyene, Y. A., . . . Keable-Elliott, I. (2018). *Review of Corporate Tax Incentives For Investment in Low- and Middle-Income Countries*. The Institute for Fiscal Studies.

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