Review of Investment Incentives: Best Practice in Attracting Investment

Introduction

In today’s globalized economy, few countries can remain competitive without foreign direct investment (FDI). With the potential benefits including technology transfer, employment gains, skills upgrading, and growth, it is not surprising that many governments offer investment incentives. (In this paper, the term ‘investment incentives’ will refer to policies directed at FDI, such as targeted tax breaks, as opposed to improvements in the general investment/business climate that benefit all firms).

Governments may see such incentives as a necessary measure to compete with other host countries, and to signal government commitment to an open investment environment (Moran, 1998). Support for incentives could also arise from agency problems and the comparative ease with which incentives can be enacted (Aliber, 2001; Wells & Allen, 2001). In most instances however, the efficacy of these measures are overestimated while the costs remain hidden.

Overestimation of benefits is understandable. Numerous factors are behind a firm’s decision to invest abroad with investment incentives playing a nuanced role. As noted by James (2009), countries typically pursue growth-related reforms using a combination of approaches, including macroeconomic policies, investment climate improvements, and industrial policy changes. It is therefore difficult to pinpoint the specific effect of incentives. Academic research in the area of investment determination reflects this. Some recent studies attribute an important role to investment promotion agencies (IPAs), especially in relation to targeted information provision and services. Evidence supporting targeted tax and financial incentives has been harder to find. In particular, redundancy ratios (the number of firms who would have invested without an investment) are high. For example, FIAS studies on Vietnam, Thailand, Mozambique and Jordan found rates of 85 percent, 81 percent, 78 percent and 70 percent respectively (James, 2009).

Despite this, many administrations feel that not offering incentives could put them at a disadvantage and continue to offer programs. If this is the case, it is important that any associated distortions and costs related to these tools are minimized. The paper will assist in this goal through an analysis of best practice in the area of investment incentives. It will focus on developing countries in particular, as their circumstances may be very different to those of developed. The paper will start with an overview of what investment incentives are, giving an idea of the breadth and diversity across countries. It will also look at some of the trends in incentives schemes, and the benefits and costs related to them. It will then analyze some African and other developing country case studies of ‘best practice’ tracking how the countries have implemented these programs. It will end with practical recommendations for a way forward.

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1 Although some authors such as Biggs (2007) and Oman (1999) consider tax incentives important in the investment decision, scholars generally emphasize other factors such as host market size, governance and institutions (‘fundamentals’). These include: Bevan and Estrin (2000), Goodman (1987), Saggi (2002), Moran (2005), Blöstrom and Kokko (2003), Haddad and Harrison (1993), Javorcik and Spatareanu (2006), Mallampally and Sauvant (2002), Morisset and Pirnia (2000), Nunnekamp (2002), Wells and Allen (2001), and Xu (2000). A recent study by Klemm and Van Parys (2009) looked at the effect of tax incentives and tax rates on FDI in developing countries, finding that extending tax holidays by 10 years increases FDI by only one percentage point of GDP. Moreover, according to Morisset and Pirnia (2001), tax incentives are up to eight times less effective in weaker investment climates than in stronger ones.
Box 1: The Zambian Situation

The Zambian government has recognized the importance of a good investment climate in attracting investment. It has privatized most of the previously state owned enterprises, abolished exchange controls and allows free repatriation of earnings and repayments. It has double taxation agreements with a number of European, North American, African and Asian countries, and duty free access to regional and USA markets under South African Development Community (SADC), Common Market for Eastern and Southern Africa (COMESA), African Growth and Opportunity Act (AGOA) and Cotonou Agreements.

With respect to investment incentives themselves, most date back to the Investment Act of 1993 (amended in 1996). Incentives and exemptions include:

- Buildings for manufacturing, mining and hotels receive an initial cost allowance of 10 percent and an annual 5 percent wear and tear allowance.
- Machinery for farming, tourism and manufacturing qualifies for an annual 50 percent wear and tear allowance for the first two years.
- Dividends from farming are exempt from tax for the first five years.
- Capital expenditure on farm improvements receives an annual 20 percent write-off for the first five years.
- Farm works such as stumping, clearing, prevention of soil erosion, boreholes, wells, water conservation and aerial or geographical surveys receive a 100 percent tax allowance.
- Machinery and equipment for mining and agriculture is exempt from customs duties.
- Organic and inorganic chemicals, rubber, steel and plastics can be imported duty-free.
- Custom duty on intermediate goods is 15 percent and on finished goods, 25 percent.
- Smaller sector specific fiscal incentives exist for mining, manufacturing, agriculture, tourism and energy (ZDA, 2011).
- Firms that list on the Lusaka Stock Exchange (LuSE) are subject to a reduced corporate tax rate of 33 percent, do not have to pay Capital Gains Tax and there are no restrictions on foreign ownership or shareholder levels.

While still committed to FDI development and an incentive program, the Zambian government has expressed a desire to re-assess incentive policy – to make it more cost-effective and allow it to benefit a broader spectrum of the Zambian population. This was highlighted in the 2012 budget speech which outlined the policy focus for 2012. It is commendable that the government continues to prioritize the broader investment climate. The Zambian government re-committed itself to its flexible exchange rate regime, which has proved resilient despite political uncertainty around the elections. It continues to carry out the Financial Sector Development Plan, which has increased access to financial services through the promotion of microfinance, mobile and rural banking. The government is also committed to spending 50 percent of the budget on social sectors and infrastructure, financing this through increased domestic revenues while limiting domestic borrowing to 1.3 percent of GDP. The 2012 budget also prioritizes lowering the cost of credit, accelerating business licensing, and investing in vocational and technical education. Notably, the budget dropped the corporate tax rate for banks (40 percent to 35 percent) and agriculture (15 percent to 10 percent). The Minister of Finance also explicitly noted that “the process of granting additional incentives under Section 58 of the ZDA Act provides discretion and lacks transparency, thereby creating opportunities for corruption.” He proposed removing Section 58 to strengthen revenue mobilization (Chikwada, 2012).

The new government is therefore in a good position to build off the impressive reforms that Zambia has already made, continuing to work toward best practice in incentivizing sustainable investment.

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2 K797 billion has been set aside for infrastructure.
What is an Investment Incentive?

Investment incentives are legislative measures aimed at stimulating investment. In most countries these are coordinated by a dedicated Investment Promotion Agency (IPA). The range of incentives offered is extensive and includes: tax holidays, preferential tax rates, grants, preferential loans, monopoly rights and preferential infrastructure access (Blomström and Kokko, 2003). Investment incentives can be divided into a number of broad areas, outlines of which are provided in Table 1. (A list of incentives offered by a sample of African countries is provided in Table 2):

1. A low general corporate tax rate which attracts a wide base, generally favored by small countries such as Lebanon or Mauritius.

2. Tax havens and export processing zones (EPZs), favored by countries in the Caribbean and Pacific. These have been successful in attracting FDI, though often only in mobile, global industries like banking, insurance and information technology (Morriset and Pirnia, 2000).

3. Tax holidays and tax exemptions, favored by poorer developing countries. Some developing countries also offer financial incentives in the form of government grants, subsidized credit, subsidized services, government equity participation and preferential insurance and foreign exchange rates (UNCTAD, 1997). Certain developing countries attach conditions to their tax incentives in order to achieve certain goals such as the stimulation of an underdeveloped area or attraction of foreign exchange. For instance, India offers a tax exemption on profits of firms engaged in tourism or travel, provided their earnings are received in convertible foreign currency. Angola, Brazil, Ecuador, Ghana, India, Pakistan, Egypt, Colombia, Nigeria and Thailand all offer incentives with regional development and sector-specific objectives.

A few countries have instituted measures such as loss-carry forwards, which make tax holidays more attractive for firms with long gestation periods; reduced taxes on dividends and income paid abroad; preferential treatment of long-term capital gains; and tax allowances relating to the number of employees hired (UNCTAD, 2000).

4. Investment allowances and accelerated depreciation, generally favored by industrialized countries. These have advantages in that they are targeted at the desired activity and benefits are only gained if capital investments are made. They also cause less revenue leakage than tax holidays. However, they discriminate against companies with long gestation periods and can cause distortions in high inflation environments, as borrowing becomes disproportionately attractive (Tuomi, 2009).

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3 Over 100 agencies are members of the World Association of Investment Promotion Agencies (WAIPA) which was established in 1995 for the purpose of exchange of best practices in investment ministry.

4 Corporation tax exemptions are deductions from gross income allowed in the calculation of total taxable income. They may be given at the firm level to encourage specific activities (such as investment or recruitment) or at the macro-level to encourage industrial activities and exports in specific sectors (Biggs, 2007).

5 Tax holidays are generally available for up to 5 years after an investment, but they can go up to 10 years and, occasionally, 25 years. Tariff concessions are often granted for periods of 5 to 10 years, but sometimes major projects may receive 15 to 25 years. Examples of financial incentives in developing countries include: grants for labor training during the first year of a manufacturing investment; loan guarantees from international credit sources; annual wage subsidies of up to 10 percent; and rebates up to 15 percent on the cost of electricity, water and sewage services (UNCTAD, 1997).
Table 1: Types of Fiscal Incentives, with Country Examples
(Sources: UNCTAD Policy Review Series; Biggs, 2007; Morisset and Pirnia, 2000)

<table>
<thead>
<tr>
<th>Incentive</th>
<th>Description</th>
<th>Advantages</th>
<th>Disadvantages</th>
<th>Developing Country Examples</th>
</tr>
</thead>
<tbody>
<tr>
<td>Reduced corporate tax rate</td>
<td>lower corporate tax rates</td>
<td>• distortions minimized</td>
<td>• has to be below 35% to be effective</td>
<td>All ≤ 30%: Botswana, Korea, Nepal, Nigeria, Peru, Singapore, Sri Lanka, Tanzania, Uganda</td>
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<tr>
<td></td>
<td></td>
<td>• longer benefit period</td>
<td>• rewards old capital</td>
<td>Flat tax rates: Poland, Romania, Russia, Slovakia, Uzbekistan</td>
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<td></td>
<td></td>
<td>• flat tax rates reduce confusion</td>
<td></td>
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</tr>
<tr>
<td>Sectoral incentives</td>
<td>reduced corporate tax rates for certain sectors/ activities</td>
<td>• signaling effect of government commitment</td>
<td>• may distort market</td>
<td>Botswana, Brazil, Ecuador, Egypt, Ethiopia, Ghana, Korea, Lesotho, Mauritius, Nepal, Nigeria, Peru, Philippines, Singapore, Sri Lanka, Tanzania, Uganda</td>
</tr>
<tr>
<td>Tax holidays</td>
<td>period of tax exemption/reduced tax</td>
<td>• flexible, can be used to targets certain industries</td>
<td>• discretionary approach → distortions, potential for mismanagement</td>
<td>(Years in brackets) Brazil (15), Ecuador (20), Egypt (5-20), Ethiopia (1-5), Ghana (5-10), Kenya (10), Korea (5), Mauritius (10), Nepal (5-10), Nigeria (3-5), Philippines (5), Singapore (5-10), Sri Lanka (5), Tanzania (2-5), Uganda (10), Uzbekistan</td>
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<tr>
<td>Investment tax allowances/credits</td>
<td>tax credit/ allowance for investment expenditure</td>
<td>• supports expansion in existing firms</td>
<td>• favors existing firms over start-ups</td>
<td>Ecuador (tourism), Korea (6-10%), Mauritius (anti-pollution), Mexico (19-25%), Nigeria (5-20%), Philippines (75-100%), Singapore (33-50%)</td>
</tr>
<tr>
<td>Accelerated depreciation</td>
<td>depreciation deductions are calculated over a shorter time period</td>
<td>• supports expansion in existing firms</td>
<td>• eroded by high inflation</td>
<td>Botswana, Brazil, Ecuador (5-10%), Egypt (5-10%), Ethiopia, Ghana (5-20%), Kenya, Korea, Lesotho (5-25%), Mauritius, Mexico, Nepal (5-25%), Peru (3-20%), Rwanda (5-50%), Singapore, Sri Lanka, Tanzania (25-100%), Uganda (5-20%)</td>
</tr>
<tr>
<td>Input sales tax credit</td>
<td>tax credit against input sales tax, especially on capital goods</td>
<td>• supports expansion in existing firms</td>
<td></td>
<td>Argentina, Chile, Peru</td>
</tr>
<tr>
<td>Loss carry forward</td>
<td>write-off of losses against gross profits of following years</td>
<td>• supports expansion in existing firms</td>
<td></td>
<td>(years in brackets) Botswana (5), Brazil (4), Egypt (5), Ethiopia (3-5), Ghana (5), Kenya (unlimited), Korea (3), Mauritius (unlimited), Mexico (4), Peru (4),</td>
</tr>
<tr>
<td><strong>Export/ Import Incentives</strong></td>
<td>exemption on customs duties, zero-VAT rating on exports, export marketing assistance</td>
<td>• can be used to target sectors</td>
<td>• restricted by trade treaties • dependent on capacity of customs administration</td>
<td>Botswana (duty exemptions), Brazil, Ecuador, Egypt, Ethiopia, Ghana, Korea, Lesotho, Mauritius, Mexico, Nepal, Nigeria, Peru, Philippines, Rwanda, Singapore, Sri Lanka, Tanzania, Uganda, Uzbekistan</td>
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<tr>
<td><strong>Subsidies/ Grants</strong></td>
<td>outright grants, upfront subsidies and subsidized loans</td>
<td>• flexible, can be used to target sectors</td>
<td>• high upfront costs • dependent on capacity of tax administration • open to abuse</td>
<td>rural telecommunication development: Peru, Egypt, Uganda, Nepal</td>
</tr>
<tr>
<td><strong>Regional Incentives</strong></td>
<td>grants/ tax allowances/ subsidized loans/ infrastructure provision when investing in certain regions</td>
<td>• flexible, can be used to target regions</td>
<td>• dependent on capacity of regional administration • open to abuse</td>
<td>Brazil, Ecuador, Egypt, Ethiopia, Ghana, Mexico, Nepal, Peru, Rwanda, Sri Lanka, Tanzania, Uganda</td>
</tr>
</tbody>
</table>
## Table 2: Incentives offered by a Sample of Africa Countries
(Source: IPAR, 2011)

<table>
<thead>
<tr>
<th>Burundi</th>
<th>Kenya</th>
<th>Rwanda</th>
<th>Uganda</th>
<th>Tanzania</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Corporate tax rate</strong></td>
<td>35%</td>
<td>37.5% (non-resident)</td>
<td>30%</td>
<td>30%</td>
</tr>
<tr>
<td><strong>Capital Gains Tax</strong></td>
<td>35%</td>
<td>Suspended</td>
<td>Taxed as business profit</td>
<td>30%</td>
</tr>
<tr>
<td><strong>Reductions/ exemptions</strong></td>
<td>Export of non-traditional products: 17.5%</td>
<td>EPZ: 10 year tax holiday (25% rate for next 10)</td>
<td>FTZ: 0% tax rate</td>
<td>EPZ/ SEZ: 10 year tax holiday</td>
</tr>
<tr>
<td></td>
<td>10 year tax holiday for certain firms (15% rate after)</td>
<td>Certain exemptions ranging from 20% to 40% of issued shares for newly listed companies</td>
<td>Deductions ranging from 2-7% for employing a sliding scale of Rwandans</td>
<td>25% tax rate for newly listed companies for 3 years</td>
</tr>
<tr>
<td></td>
<td>10% reduction for employing more than 100 Burundians</td>
<td>2.5% shipping reduction for non-residents</td>
<td>Export tax discounts of 3-5% for bringing minimum forex of $3-$5 million</td>
<td>Allowances for buildings for agriculture: 20% and for others: 5%</td>
</tr>
<tr>
<td></td>
<td>Leasing orgs exempt for 3 year (20% rate for next 4 years)</td>
<td>Allowance on investments greater than $230 million (outside main cities): 150%</td>
<td>Allowance on investments in Kigali: 40% and outside Kigali: 50%</td>
<td>Allowance for industrial buildings and hotels: 20%</td>
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<tr>
<td></td>
<td></td>
<td>Allowance on other qualifying investment: 100%</td>
<td></td>
<td>Allowance for commercial buildings: 5% straight line</td>
</tr>
<tr>
<td></td>
<td></td>
<td>Allowance on farm works: 100%</td>
<td></td>
<td>Allowance for plant/ machinery: 50-75% initial and an annual reduction on the balance</td>
</tr>
<tr>
<td></td>
<td></td>
<td>Certain building allowances ranging from 10%-50%</td>
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</table>
Box 2: Trends in FDI and FDI Incentives


**FDI trends:**
- Growth prospects for FDI in services (telecommunications, utilities, health) are less sensitive to the business cycle and are higher than manufacturing.
- Sub-Saharan Africa is not an investor priority (scoring only 1.6 out of a scale of 5) suggesting that more targeted approaches are necessary.
- Top investing countries: US, China, Germany, UK, France, India, Canada, Spain, Russia, and Italy.
- Top host countries: China, India, Brazil, US, Russia, Mexico, UK, Vietnam, Indonesia, Germany (see Figure 1).

**In general:**
- Competition in particular industries, such as the automotive industry, is particularly intense.
- Most incentive-based competition is effectively intra-regional, with national and sub-national governments competing for investment that an investor has already decided in principle to locate in a particular area.

**Of the countries surveyed:**
- Nearly all offer incentives that target specific sectors.
- 70 percent offer regional incentives aimed at assisting the economic development of rural or underdeveloped areas.
- 85 percent offer full or partial tax holidays or tax rate reductions for specific types of activities.
- 60 percent offer accelerated allowances, generally for investment in plant, machinery or industrial buildings, or for training, research and development.
- More than 90 percent offer export incentives.
- Of the Asia and Pacific survey respondents, 78 percent had intensified their investment targeting efforts, 39 percent had increased incentives and 61 percent had increased liberalization.
- Of the Latin American survey respondents, additional incentives are the least preferred method of investment promotion. Instead, 62 percent had intensified their investment targeting efforts and 80 percent planned to do so.
- African survey respondents are the most positive about FDI prospects, especially in areas such as agriculture, food processing, retail, wholesale and tourism. South African and Chinese greenfield initiatives are expected to form the majority of inward FDI. In comparison to other developing regions, African IPAs made greater use of incentives and less use of targeting methods.
- Central and Eastern European Survey respondents generally favored targeting and liberalization over incentives as a means to attract FDI, although some expect to make greater use of incentives.

**The Costs of Incentives Schemes**

It is important to assess both the direct and indirect costs of incentives. The most obvious cost is the redundancy rate, the lost revenue from firms that would have come regardless. This translates into a net transfer from taxpayers to investors. In their study on Indonesia, Wells and Allen (2001) calculated a redundancy rate of about 70 percent, indicating that the cost of tax holidays equaled the investment attracted. (In fact, this figure understates the true costs since some investors who were swayed by incentives receive more than would have been necessary to convince them to invest.) A recent study of the Eastern Caribbean Currency Union by Chai and Goyal (2008) not only found incentives to have a negligible effect on FDI but estimated forgone tax revenues to be in the region of 9.5 percent to 16 percent of GDP. Estimates of potential employment gains can also be highly skewed. For instance, in a US study Gabe and Kraybill (2002) found that companies receiving subsidies created 10.5 fewer jobs than projected. Two similar study by Luger and Bae (2005) and Fisher (2007) found that only 3.6 percent and 9 percent of the jobs created were due to incentives, which in the Luger and Bae case
inflated the cost per job from $5,000 to $147,463. This situation is more common in developing countries since many lack the capacity to do their own impact analyses, often relying on the projections offered by the firms themselves.

This is not the only issue however. A number of other problems can coexist with incentive programs:

1. The selectivity and lack of transparency often observed with programs increases the risk of rent-seeking. When programs are discretionary they also act as deterrents for potential investors, as the costs involved in lobbying and delays can be substantial.

2. Tax incentives tend to attract highly mobile firms, causing problems for sustainability.

3. Incentives tend to discriminate against smaller firms, against local firms on a de facto if not a de jure basis, and against firms in non targeted sectors.

4. Tax holidays and breaks generally create distortions as firms try to shift production to low-tax areas or engage in transfer pricing. Some firms even feign eligibility, a fraudulent behavior that requires costly audits to uncover. For example, in India many firms set up ‘front offices’ in regions that qualify for special incentives (James, 2009).

5. Tax holidays tend to favor existing firms over start-ups, as existing firms tend to have more immediate taxable revenue, and are able to ‘tax plan’ to minimize incidence (Biggs, 2007). If tax holidays are only granted for new investment, however, they may be biased in the opposite direction, discriminating against re-investment and investments that rely on long-lived depreciable capital (Morisset and Pirnia, 2000).

6. Tax holidays create administrative problems for tax authorities since they rarely keep depreciation and other records during the tax holiday period, which cause substantial monitoring problems when the holiday ends. Moreover, political pressure often makes it difficult to end tax holidays.

7. Tax investments that focus on equipment create inter-asset distortions between types of capital, which can be biased towards weaker investment. In Thailand, for example, firms that benefited from incentives had weaker financial ratios than those that did not (FIAS, 1999 in James, 2009)

8. Incentives compete with public funding aimed at local productivity-enhancing human capital formation and infrastructure (Oman, 1999).

9. The prisoner’s dilemma type situation caused by the proliferation of such schemes has meant that countries feel compelled to offer incentives merely to remain in the bidding process, resulting in aggregate resource inefficiency. Blömdstrom and Kokko (2003) suggest that the only workable solution to this problem is a multilateral negotiated reduction, similar to that achieved for tariffs. The current measures, such as the World Trade Organization’s Agreements on Subsidies and Countervailing Measures (ASCM) and Trade-Related Investment Measures (TRIMs), have limited coverage, mainly focusing on subsidies to individual companies.

Given all these costs, it is possible that even when incentives succeed in attracting FDI, their costs can exceed the resultant benefits. Even when this is not the case, few programs are as cost-effective as they could be. To expound this further, five case studies will be analyzed to glean lessons of best practice. Aspects of each of the following countries and projects have been deemed ‘successful’. It is therefore useful to look at the “good” and the “bad” of each program, focusing on the good that is replicable.

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6 A recent study on Jordan, Mozambique, Nicaragua and Serbia found that costs increased by about a fifth (James, 2009)

7 The TRIMs agreement prohibits the application of any trade-related investment measure that is inconsistent with Articles III (national treatment of imported goods) and XI (prohibition of quantitative restrictions on imports or exports) of the General Agreement on Trade and Tariffs (GATT). ASCM prohibits subsidies that are contingent upon export performance or the use of domestic over imported goods. The OECD did try to introduce stronger measures via its Multilateral Agreement on Investment (MAI) in the late 1990s but failed to achieve results. However, some regionally integrated areas such as North American Free Trade Agreement (NAFTA) and the EU (Code of Conduct for business taxation) have agreed on at least partial harmonization of investment measures (Blömdstrom and Kokko, 2003). Similarly, some West African countries have undertaken a joint effort to harmonize their FDI incentives within the Monetary Union of West African States.
Country Case Studies:

Singapore

It has hard to deny Singapore’s success in transforming its economy, boosting GDP and encouraging FDI. The accumulated stock of FDI as a percent of GDP rose from 5 percent in 1965 to 225 percent in 2009. Between 2005 and 2009 alone, FDI stock increased from $324 billion to $530 billion, representing a growth of 63.6 percent in five years (Healy Consultants, 2011).

Singapore’s initial low base, lack of entrepreneurial business elite, lack of natural resources and distance from large economic markets can make it a useful model for developing countries. At the same time not all of Singapore’s actions will be replicable, as compared to many developing countries it has a greater revenue pool, condensed area and stronger government capacity. Other factors making it unique are its relative authoritarian city-state nature and the fact that it never runs budget deficits.

Singapore adopted an outward based industrial strategy in 1961 starting with the establishment of an Economic Development Board (EDB) mandated with industrializing Singapore. The EDB’s budget was designed to be a one-stop agency, sorting out all investor’s requirements and focusing on ship repair, metal engineering, chemicals and electrical equipment and appliances. The EDB had four divisions: investment promotion, finance, projects and technical consultant service, and industrial facilities. It was set up as an autonomous government agency, with both a board comprised of business and other agencies, and an international advisory board of executives of major foreign companies located in Singapore. As operations became more complex over time, it started to specialize in FDI promotion, leaving other activities to other agencies (Te Velde, 2001).

Singapore experimented with tax holidays instituting the Pioneer Industries Ordinance of 1959 which reduced taxes for firms producing pioneer products. It later adapted this program, raising the minimum requisite level of sales/capital and focusing instead on upgrading the workforce. This was not the only refocus. It is generally considered that the EDB placed over-invested in the Jurong Industrial Estate and placed too much emphasis on joint ventures. Instead the EDB began to target knowledge intensive industries and encouraged firms to handle skill shortages through the recruitment of foreign workers. The EDB also introduced a Local Industry Upgrading Program (LIUP) in 1986, under which multinationals were encouraged to enter into long term supply contracts with local firms. Another skill-upgrading measure was the Skill Development Fund which was set up in 1979 by the Productivity and Standards Board (PSB) and imposed a 4 percent (later 1 percent) levy on the payroll for every worker earning less than a pre-determined amount (Te Velde, 2001).

More recently, the EDB has followed a cluster approach (a geographic concentration of interconnected firms, specialized suppliers, service providers, firms in related industries), targeting firms in the electronics/semi-conductor, petrochemicals and engineering industries. It should be noted that this approach requires strong government knowledge and capacity, a competitive environment and concurrent investment in research and development institutions. Singapore achieved this through multinational-focused infrastructure building, very low tariffs and substantial investment in training and general education (Te Velde, 2001).

There have been some missteps but Singapore’s policy can be considered broadly successful. Although some of the measures undertaken by Singapore are out of reach for the average developing country, certain key success factors are replicable: a proactive one-stop investment agency, a consistent pro-FDI stance, the realization of the importance of linkages and a supportive macro-economic environment. Flexibility in dealing with initial skill shortages and a constant review of programs are also important.

Rwanda

In the last few years Rwanda has made extensive reforms to its investment environment, moving it from position 143 to 58 in the “Ease of Doing Business” index – an achievement that led the World Bank to label it the world’s “top reformer”. Moreover, it is continuing its reform process. The Rwandan Development Board (RDB) was established in 2008 to fast track development projects and facilitate
new investment. Its establishment builds on an earlier March 2006 investment law that provides permanent residence and access to land for investors who deposit $500,000 in a commercial bank in Rwanda for more than 6 months. An initial capital investment of $250,000 qualifies the investor for tax and other investment incentives and there are no statutory limits on foreign ownership (Rwandan US Embassy, 2011).

Specific investment incentives include:
- An investment allowance of 40 percent of new or used assets if the assets are held at the establishment for at least three tax periods after the allowance is taken.
- If the investment is outside Kigali or is in a priority sector the allowance rises to 50 percent.
- All training and research expenses (not including the purchase of immovable property) are deductible from taxable profits.
- Domestic losses are deductible from profit for five periods as long as earlier losses are deducted before later losses.
- Businesses located in free trade zones and foreign firms with headquarters located in Rwanda are entitled to a zero percent corporate income tax rate OR tax free repatriation of profits OR exemption from a 15 percent withholding tax.
- Businesses that employ between 100 and 200 Rwandans are entitled to a two percent profit tax discount. If they employ between 201 and 400, this rises to five percent, between 401 and 900 to six percent, and for more than 900, seven percent. (To qualify these employment levels must be maintained for at least six months.)
- Businesses that export goods/services of between $3 million and $5 million are entitled to a three percent tax discount. If they export more than $5 million this rises to five percent.
- Companies that carry out approved micro finance activities pay a zero percent corporate income tax rate for five years from the time of approval (Rwandan Revenue Authority, 2011).

In 2008 with the help of foreign judges, the government also instituted specialized commercial courts to clear a backlog of cases. Although contract enforcement is still difficult, the establishment of the courts is a welcome reform.

Rwanda’s determination to transform its investment environment is impressive. It has undertaken numerous reforms and its incentive program is certainly generous. In fact, it is worth considering whether it is too generous and whether the same aims could not be achieved with fewer fiscal incentives and greater focus on broader development efforts.

The motive behind current Rwandan policy is certainly understandable. Rwanda is one of the most aid-dependent countries in the world, has few trained workers, suffers from poor infrastructure, and is subject to some of the world’s highest electricity rates. Given the difficulty in improving these factors in the short run, Rwanda has wisely focused on “soft infrastructure” (good governance and institutional arrangements important for private investors) (Ministry of Finance and Economic Planning, 2007). This stance and Rwanda’s reforms have resulted in some notable achievements. The average annual growth rate between 2005 and 2009 was 8.8 percent. FDI increased from $14 million in 2005 to $173 million in 2010. The question is to what extent the fiscal incentives that accompanied the Doing Business reforms were responsible for the growth or whether other factors were more influential: post conflict recovery, improved infrastructure, anti-corruption efforts and the Doing Business Reforms themselves. A number of reasons suggest the latter. For instance, although two of the priority sectors (tourism and construction) have seen an increase in projects, there has been little change in other priority sectors (such as manufacturing and agriculture).

The cost of the fiscal incentives appears to be high, with a number of studies suggesting a substantial amount foregone. A calculation by the IMF estimated it to be equivalent to 3 percent of GDP in 2006, and IPAR estimates for 2008 and 2009 are 3.6 percent and 4.7 percent respectively (see Table 3). This compares with 2.8 percent for Tanzania, 1 percent for Kenya and 0.4 percent for Uganda (IPAR, 2011).
The largest contributory category was import exemptions, accounting for 84 percent of the total foregone, while the smallest was employment incentives, which only accounted for 0.17 percent\textsuperscript{10}.

Table 3: Tax Foregone Due to Tax Incentives
(Source: IPAR, 2011, Rwandan Revenue Authority, converted to dollars using historical yearly average)

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<thead>
<tr>
<th></th>
<th>2008 Tax Foregone</th>
<th>2009 Tax Foregone</th>
</tr>
</thead>
<tbody>
<tr>
<td>Total</td>
<td>$169,882,560</td>
<td>$239,454,773</td>
</tr>
<tr>
<td>As % of Total Tax Revenue</td>
<td>34%</td>
<td>38%</td>
</tr>
<tr>
<td>As % Government Budget</td>
<td>14%</td>
<td>17%</td>
</tr>
<tr>
<td>As % of GDP</td>
<td>3.6%</td>
<td>4.7%</td>
</tr>
</tbody>
</table>

Both UNCTAD and the Foreign Investment Advisory Service (FAIS) have suggested reviewing certain of the tax exemptions and incentives. For instance, UNCTAD’s 2010 Development Driven Trade Policy Framework for Rwanda recommends making financial incentives outcome-based, targeted to development goals and designed to minimize the impact of taxation on companies’ cash flow. Moreover, the East Africa Community (EAC) of which Rwanda is a member is currently calling for more harmonization of incentive policy. If adopted, a Draft Code of Conduct against Harmful Tax Competition in the East African Community would require an amendment of existing measures that put other members at a disadvantage. Although the code does allow special consideration for underdevelopment and land-locked countries, it is not certain that all Rwanda’s current incentives would fall into this category.

Issues worth considering include:

- There may be too great a focus on tax incentives and too little on business promotion.
- Rwandan law gives the Cabinet the right to negotiate incentives with individual investors without recourse to Parliament, meaning that incentives are not subject to public scrutiny. Although the government has signaled an intention to publish these, as yet they remain unpublished (IPAR, 2011).
- There is no regular calculation of the amount foregone through tax incentives and exemptions (IPAR, 2011).
- Limiting incentives to larger investment projects can create distortions. UNCTAD and FAIS suggest that a better way to meet the country’s development objectives would be to: lower the corporate tax rate to 25 percent and the dividend withholding rate to 10 percent; allow a faster rate of depreciation on durable assets; allow unlimited loss carry-forwards; setting up a comprehensive claw-back scheme for exporters/importers; and improve administration of the Rwandan Revenue Authority (IPAR, 2011).
- FAIS also recommends limiting as many of the other fiscal incentives as possible, especially the zero percent rate on micro-finance institutions and the VAT exemption status of agriculture (FAIS, 2006).

The Rwandan case study highlights a number of ‘best practice’ factors. Transparency and monitoring of incentive systems are important, especially the inclusion of regular cost-benefit analyses in the monitoring. If certain allowances are not found to be cost effective, they should not be renewed. Ideally, the process for review should be formalized in future policy and discussed with investors, so that all parties are aware of rights and options. Given the importance of regional trade groupings, codes in agreement should also be scrutinized to see whether they could be considered prejudicial to other bloc members.

\textsuperscript{10} IPAR (2011) notes that although the number of tax payers in Rwanda has increased, this is the result of the RRA drive to register informal sector business and consists of small and medium firms not in receipt of incentives.
An In-Depth Look at Special Economic Zones: Tanzania

Economy-wide liberalization provides more benefits than do special economic zones (SEZs). Despite this, SEZs remain politically popular and in some countries have helped overcome market failure and act as catalysts for wider reform (mainly in certain Asian and Central American countries in the 1990s and early 2000s). With the possible exception of Ghana and Mauritius, however, most African SEZs have experienced low levels of exports, job creation and technology transfer.

In many ways this is to be expected. Research on SEZs underscores that success is linked to location and market size. As Farole (2011:4) notes: “Zones with proximate access to large consumer markets, suppliers, and labor tend to be more successful... Low wages, trade preferences, and fiscal incentives are not found to be correlated with SEZ outcomes. This may be, in part, because these factors are often employed as alternatives to making the hard policy choices that lead to improvements in productivity and in the investment environment.” Moreover, since China and India have integrated into global markets, it is difficult for African countries to reach this level of competitiveness, especially in manufacturing. Farole suggests that partial success may still be possible in natural resource (agriculture, tourism) and service (trading and logistics) sectors. This is supported by the evidence from Ghana and Mauritius, where they were able to capitalize on abundant endowments (agriculture, minerals and coastal position).11 They also started their programs earlier, ‘getting into the game’ before the Asian producers became dominant. For poorer countries such as Zambia, it is therefore more useful to look for lessons in similar constrained countries. As such, the Tanzanian SEZ program was selected as a case study.

Tanzania instituted an Export Processing Zone (EPZ) in 2002. In 2006 it placed this EPZ under a newly created Export Processing Zones Authority (EPZA) and established a further Special Export Zone under the Ministry of Industry, Trade and Marketing. The EPZ incentive package included exemption from forex restrictions; exemption from corporate tax for 10 years; a corporate tax rate not exceeding 35 percent for the next ten years; exemption from the payment of withholding taxes for 10 years; exemption from all local government taxes; remission of customs duty, VAT and other taxes paid for purchase of inputs; exemption from pre-shipment inspection; access to infrastructure, on-site customs inspection of goods; provision of temporary visas at entry point for key staff for a period of 30 days; and an allowance to sell up to 20 percent of produced goods in the local market. Eligibility criteria for an EPZ investment in Tanzania include: being a new investment; exporting at least 80 percent of produced/processed products; and an annual export turnover of over $500,000 for foreigners and $100,000 for local investors.

Despite these incentives, the economic contribution of the EPZ program remains insignificant in terms of the size of investments, jobs created and value of exports. By 2008, the EPZs accounted for only 6522 jobs, and 1.7 percent of total exports. Moreover, the Tanzania Revenue Authority was quoted as saying that tax exemptions cost the country about $451 million in the ten-month period running from July 2008 to April 2009 alone. This loss makes up 6.4 percent of the total 2009/10 national budget (Domician, 2009).

There are a number of reasons for the slow progress in Tanzania. Firstly, the two competing zones (EPZ and SEZ) created a confusing situation for potential investors, a situation further complicated by the fact that no regulations or governing structure for the SEZ were put in place. The importance of a clear and consistent zone policy is vital, as is a legal framework that avoids creating institutional conflict through overlapping regimes and responsibilities. Moreover, the development of the programs has not included any obvious strategic planning process, with no analysis of trade data and trends, no assessment of comparative advantage, no benchmarking and little input from investors. In successful zones, this type of assessment is done both before project implantation and on a continual basis so that policymakers can develop zone policy according to the changing needs of the private sector. As stated by Farole (2011: 158): “The ‘build it and they will come’ approach only works when there is huge pent-up demand for investing in the country/region (with or without an economic zone), which was probably the case in China and in the United Arab Emirates during the 1990s and 2000s.” Tanzania entered the SEZ market too late and without sufficient cost or scale advantages to achieve

11 Although Ghana has managed to shift to a higher growth path it is unclear how sustainable this growth will be, as it depends to a large extent on processed commodities (cocoa and timber) that are limited in their availability and face significant cyclical price fluctuations (Farole, 2011).
substantial growth in traditional labor intensive manufacturing (Farole, 2011). This highlights the usefulness of a targeted positioning strategy. Such a strategy is also important to ensure that the companies that are attracted to the zone are not disparate, and enhance both the profile and cluster effects. The zone should also be marketed only when the majority of the structures are in place as promising more than can be delivered can waste marketing resources and create negative perceptions.\(^\text{12}\)

It is also vital that zone locations are determined by commercial rather than political considerations. Placing a zone in an underperforming region requires substantially more investment in linking and supportive infrastructure than is affordable for smaller countries. FDI is attracted to regions with agglomeration benefits such as deep labor pools and knowledge spillovers. It is these spillovers that are arguably one of the most important aspects of FDI. Facilitating them should be a priority in SEZ design. This requires that policy stimulates both foreign and domestic investment in the zone. This may involve eliminating policy restrictions and high-investment requirements in some zones. (In Tanzania for example, the local firm investment minimum of $100,000 is still a barrier for most small and medium suppliers). The importance of agglomeration effects also suggest that single-factory schemes should be avoided. In comparison to other African countries, Tanzania’s share of the workforce sourced from local vocational training programs is quite high (14 percent). However, rigid labor markets seriously restrict the movement of skilled labor across firms, preventing any further spillover effects to the local economy. Allowing more labor circulation would go a long way to circulating skills and knowledge.

The Tanzanian experience also offers lessons with respect to managerial structure. Although tricky in the early stages of SEZ development, best practice suggests that the SEZ be given sufficient authority to act as a one-stop shop for investor concerns, handling customs, environmental compliance and immigration issues. If delegating authority to the SEZ is difficult, a compromise solution may be to operate under a principle of ‘automaticity’ supported by a memorandum of understanding with the relevant agencies. For example, if an applicant receives no response after a service request in Senegal, after 30 days the authorization is granted by default (Farole, 2011). Best practice also touts linking the budget of the SEZ to the revenues earned by the zone program. Together these measures allow for both flexibility and accountability.

Service provision that relies on outside factors can be particularly problematic for SEZs. Along with many other African countries, Tanzania does not have the customs resources to prevent clearance delays and uncertainties. It has made some notable improvements but problems arise whenever new staff are assigned to handle EPZ-related shipments. Improving customs and port efficiency and integrating outside infrastructure with zones is critical for success.

The Tanzanian project has had some success, mainly in linking vocational training to zone needs. In general however, progress has been slow. This is understandable given the constraints faced by a poor country with few locational advantages. The evidence continues to show that SEZs are not a short-cut to growth and that wider reforms are more reliable. If they are to be adopted in spite of this evidence, it is useful to summarize the lessons from the Tanzanian experience. Activities that are key to SEZ success include: researching competitive advantage and conducting market analysis prior to zone development; maintaining a clear and consistent zone policy; ensuring that the SEZ has authority to address investor concerns timeously; prioritizing customs efficiency; facilitating spillovers through the promotion of domestic investment and moderate labor legislation; and embarking on a targeted marketing strategy. These measures can help foster longer term growth, especially when they are eventually expanded to the wider economy. This can be seen in the next two case studies: Costa Rica and Mozal. Although the initial investment in both of these studies were in SEZs, the countries’ reforms and actions to facilitate these investments went further than just focusing on the SEZ itself.

\(^{12}\) For example, an investor in Tanzania recalled being told in 2008 that the country’s new SEZ would be ready “in three months”; he was told the same thing in 2010 (Farole, 2011).
Costa Rica: Intel

The Intel case in Costa Rica is an excellent case study in how a small country can expediently attract large scale investment through careful research, government dedication and a willingness to tailor the investment climate.

As noted by MIGA (2006: 5), “Intel's investment decision was the catalyst for a realignment of Costa Rica's competitive platform as an investment location. Costa Rica worked resourcefully and with a novel sense of urgency to enhance the country’s technical education, incentives law, regulation, and infrastructure. Over time the effects could be seen in an improved investment climate, a more focused, strategic approach to investment promotion, a developing technology cluster, and newly secured FDI projects in other targeted sectors. The Intel investment also reached far into the local community, affecting education and the country’s knowledge base, workplace standards and business culture.”

A particularly important role was played by CINDE, the official investment Costa Rica promotion agency. It adopted a number of measures that not only helped the initial investment but have also leveraged the interest it generated into further competitiveness gains.

Since Intel was too large to fit into an existing industrial park, Costa Rica allowed it to become its own free zone in a way, entitling it to receive the standard industrial park incentives that included:

- 100 percent exemption on import duties on raw materials, components and capital goods.
- 100 percent exemption on taxes on profits for eight years, and 50 percent on the following four years.
- 100 percent exemption on export taxes, local sales and excise taxes, and taxes on profit repatriation.
- 100 percent exemption on municipal and capital taxes.
- No restrictions on capital repatriation or foreign currency management.
- Fully expedited on-site customs clearance.
- Ability to sell to exporters within Costa Rica.
- Ability to sell up to 40 percent in the local market with exemption from sales tax.

These concessions, together with Costa Rica’s dedication to improving the general investment environment and constant communication with Intel executives, ‘clinched’ an agreement with Intel. Since then the government has continued to focus on promotion, with CINDE coordinating with high level agencies. For example, the Ministry of Foreign Trade (COMEX) regularly exchanges top directors with CINDE, to encourage close work on FDI attraction and export promotion. Between 1997 and 2000, a private-public sector team including the country’s President, relevant ministers, top executives of established investors and CINDE, jointly promoted the country for investment. This led to further investment from companies such as Baxter, Conair, Sawtek, Bourns, and later Abbott Laboratories (now Hospira), Western Union, P&G and Sykes, who all publicly endorsed the country in road shows across the United States (MIGA, 2006).

After studying local industry upgrade programs in Singapore, Malaysia, the Philippines and Japan, Costa Rica instituted PROVEE in 2000 to develop local suppliers and broaden its target areas from high growth to more steady industries (such as medical supply devices), a diversifying move that enabled it to better weather recessionary global conditions. Another factor which was crucial in Costa Rica’s success was its post-investment care program. It established a High-Technology Multinational Companies Committee to channel feedback from existing investors. They met with President Figueres once a month to discuss how to improve the operating environment. CINDE also created the position of Post-Establishment Coordinator in 2000 to take responsibility for policy advocacy, lobby the government for the continuous improvement of the operating environment, and help ensure investor satisfaction. This was undeniably successful: reinvestments came to represent half of total FDI flows (MIGA, 2006).

Importantly, Costa Rica also tackled a number of investment climate issues that were crucial to investor well being. For instance, the government passed the Public Concessions Law in 1998 which allowed private investors, national and foreign, to participate in the construction and operation of public works, such as roads and ports. It also transferred its customs procedures to an internet base and streamlined the permitting process, allowing for parallel permitting and deployment. With respect
to skills, it created a one-year certificate program and a one-year associate degree focused on semiconductor manufacturing and microelectronics, as well as language programs at the Technical Institute of Costa Rica (ITCR). There are always issues with developing supplier bases in small countries, as many suppliers are unwilling to invest unless they have a number of buyers and vice versa. To tackle this, CINDE tried to identify where local suppliers could be diversified and upgraded until sufficient buying power (more foreign end users) was in place to attract other suppliers.

The lessons from the Costa Rica situation are important. Its success was in a large measure due to:

- Continued government emphasis on the importance of FDI in national policy.
- The realization that competitiveness is a "moving target" and it is necessary to re-assess the environment and make adaptations.
- Involvement of the business community and the provision of post investment care - happy investors are the quickest and cheapest way to more FDI.
- An IPA with a transparent and consistent message, and sufficient resources to target suitable investors (MIGA, 2006).

MOZAL in Mozambique

The MOZAL aluminium smelter in Maputo is the largest-ever foreign direct investment in Mozambique. It has brought undeniable benefits to Mozambique\(^\text{13}\) and its location decision contains useful lessons for investment promotion, especially for poorer developing countries\(^\text{14}\). The smelter is based in the Industrial Free Zone (IFZ) zone in the Beluluane Industrial Park about 17km from Maputo city centre. (The other company with IFC status is the Mozambique Transmission Company Sarl (MOTRACO), which supplies electricity to MOZAL and Gauteng via two power lines.) MOZAL I was built during the period 1998-2000 while MOZAL II was started in 2001 and completed in 2003. Both were built and reached full production in "record-breaking time", enabling substantial savings in cost. In fact, Mozal is one of the world lowest-cost aluminium producers and capital invested per ton of added capacity is among the lowest in the western world (Wilshaw in Pretorius, 2005).

A combination of factors enabled this investment to occur. The Mozambique government’s investment law and regulatory framework\(^\text{15}\) aimed at attracting investment (especially export orientated and large projects that could facilitate SME development) through infrastructure, reductions in red tape, and fiscal concessions. Infrastructure provision was focused on the provision of cheap electricity\(^\text{16}\) and the red tape program on fast-tracking visas, work permits and customs clearance of goods. This was important since Mozambique has a limited market size and is reliant on aid flows\(^\text{17}\) (Pretorius, 2005).

With respect to infrastructure, the government privatized many port, customs and electricity supply services. As with any foreign investor in Mozambique, Moval was entitled to access domestic borrowing on the same terms and conditions applicable to Mozambican companies, and was guaranteed 100 percent remittance abroad of profits. Legislation also specified that the International Convention for the Settlement of Investment Disputes (ICSID) would arbitrate any case.

\(^{13}\) For example, Castel-Branco and Goldin (2003) estimated that the Moval project increased GDP in 2002 by between 3.2% and 5%, and an impact on the manufacturing sector ten times as large.

\(^{14}\) In October 1998 the IFC signed agreements to invest in MOZAL, under which it IFC would provide a subordinate loan of US $65 million and a senior loan of US $55 million. This amounts to 9% of total investment in MOZAL. This is the IFC’s largest-ever own account investment in Africa and reflects its confidence in Mozambique’s compliance with World Bank standards.

\(^{15}\) Article 7 of the Law on Investment No 3/93

\(^{16}\) At the time of the initial Moval investment Eskom produced electricity at a lower cost price per kilowatt-hour than Canada, New Zealand, Australia, France, USA, Portugal, Israel, Germany, UK and Japan.

\(^{17}\) In Mozambique the Investment Promotion Agency (CPI) is the body responsible for the promotion of investment and provides advisory service to Government bodies on investment matters.
Other incentive measures with respect to the IFZ include (note, IFZ rules require at least 85 percent of production to be exported):

- Allowances for the modernization and introduction of new technology, and for training.
- The regulation of labor relations in the IFZ. ( Strikes are only allowed to be called by the national or provincial union after confirmation by the IFZ Council with regard to the guarantee of minimum services, AND they require a seven day strike notice.)
- Exemptions from customs duties, VAT and Specific Consumption Tax (SCT) on the importation of construction materials, machinery, equipment, accessories, spare parts and other goods used in the IFZ.
- A ten-year 60 percent corporate income tax reduction.
- Exemption from real property transfer tax.

Although Mozal brought significant benefits to the Mozambican economy, it has underperformed in some areas, notably linkages with local suppliers. This is not surprising given the lack of capacity among local firms. Both government and investors have taken numerous steps to address this, adding new measures over the years. For instance, the 2001 Small and Medium Enterprise Empowerment and Linkages Program (SMEELP) aimed to provide skills training for local labor, encourage the use of local contractors, encourage establishment of joint ventures between foreign suppliers (mainly South Africa) and local firms, and establish systems for monitoring and reporting on the projects’ empowerment progress. Mozal and the government also tried to work together with identified potential contractors to train and educate them about the tender process. After the awarding of contracts, SMEELP offered further training in contract fulfillment, cost reduction, financial management, accounting and procurement. Moreover, mentors with experience in various areas were tasked with making regular visits to local contractors (Pretorius, 2005).

Given the scope of the problem, the SMEELP efforts are laudable (and in fact they have been recognized as such by the IFC and World Bank). Through this program, more than 25 contract packages have been awarded to SMEs, which have been trained to the degree that they are available for MOZAL operations, future projects and other local requirements (Pretorius, 2005). It should be noted however that for most of the linkages that did occur, success was driven more by Mozal managers than by government strategy (Castel-Branco, 2003 in Pretorius, 2005). Moreover, difficulties in accessing finance (stiff requirements and unpredictability) severely hampered the ability of local firms.

With respect to revenue, it is difficult to assess the impact of Mozal since so much of the Mozambican government finance is artificially bolstered by development aid. In a 2003 paper, Castel-Branco and Goldin argue that MOZAL’s impact on public revenue up to date is insignificant (given the size of some of the tax breaks). Adding on more recent secondary investment suggest a current net positive impact. Nevertheless, the long break-even period before this was achieved suggests that if public revenue is a major goal of attracting FDI, focus should be placed on climate improvements and non-fiscal measures.

All the case studies offer important lessons. By combining these with other research on investment incentives, it is possible to construct a ‘best practice’ guideline of sorts.

**Suggestions for Incentives Policy**

An ideal incentive scheme would be transparent, stable and would achieve policy objectives with a minimum leakage of tax revenue. It is suggested that prior to embarking on an incentive scheme, governments determine the role of FDI in their economy, the potential for further FDI, to what extent the regulatory framework is supportive of this potential, and what improvements could ensure its realization 18. They should then list the objectives of the incentive (i.e. the market imperfections that the incentive is designed to reduce), which can be compared to the costs of granting incentives. This comparison should then be subject to periodic review (UNCTAD, 2000).

More specific guidelines include:

18 UNCTAD has initiated a series of Investment Policy Reviews, to assist individual governments with these objectives.
1. Incentives should only be considered when the good/service has a large public good externality and it is cheaper/more efficient to provide it through this externality than directly. This would include investments encouraging environmentally friendly/research rich production or anchor investments (investments that provide multiplier effects through signaling). Moreover, with technology externalities local firms need to be willing and able to absorb the technology. As such, they need to be complemented by measures to develop human capital and competition. As noted in the UNCTAD (1995), policy should strive to create an overall attractive environment for technology transfer, including a high level of workforce mobility, a general economic atmosphere that rewards enterprises and innovation, and a dependable legal system. It also suggests institutional support for cooperative arrangements between multinationals and local learning institutions.

2. Information must be provided to potential investors in an effective and timely manner, potentially through an efficient investment promotion agency (Moran, 2005). These IPAs should not be subunits of a ministry but be either autonomous public bodies, semiautonomous agencies reporting to a ministry, joint public-private or private entities (Harding and Javorcik, 2007)\(^1\).

3. ‘Overbidding’ is often observed when countries compete for FDI. It is imperative that incentives are offered on the basis of host country requirements, not in an attempt to match those of other countries. This can result in the “winners curse” (see Box 3). Since competition is particularly prominent on a regional level, regional approaches to harmonizing concessions would limit individual country’s revenue losses (Chai and Goyal, 2008).

4. Policy aimed at infrastructure and skills is a prerequisite for any incentive scheme. An improvement in fundamentals reduces susceptibility to ‘footloose’ FDI and may well be sufficient to attract the required investment. In the words of the UNCTAD Secretariat: “Investment promotion must be seen in the context of larger development efforts” (UNCTAD, 1997: 2).

5. If incentives are being used primarily as means to market a country’s openness to investment, it is suggested that the incentive be short-term and limited. This would achieve the aim of the host country and allow the investing firm negotiators to ‘save face’ (Wells and Allen, 2001). Explicit incentives may not be necessary, however. The best commercial ambassadors are often successful and satisfied incumbent investors. As such, more FDI may be attracted if governments focus on encouraging sequential investment in current firms, through the maintenance of a stable exchange rate, a supportive environment, and perhaps the appointment of a business ombudsman to handle investor concerns (UNCTAD, 1995). This enabling environment must include fair and equitable treatment; legal protection; guarantees against expropriation; and transparency. Restrictions on entry, ownership, fund transfer and repatriation of profits and capital invested should be minimal (UNCTAD, 1997).

6. It is important that incentives are rules-based and are open to all investors regardless of nationality or industry\(^2\). A strong rules-based approach coupled with an independent judiciary, can help ensure transparency and minimize rent-seeking (Oman, 1999). It is also important that incentives are formerly incorporated into the tax code. Although it has been suggested that discretion be retained for particularly desirable projects, it is likely that discretion would either involve unnecessary democratic administration or be placed in the hands of a political figure unable to make an economic and neutral choice. Furthermore, these types of schemes will soon be prohibited by the WTO, to all but the poorest developing countries\(^2\).

7. When a country has numerous incentive codes and offers, reducing the number and converting some to guarantees can attract more investment at lower cost. This was found to be the case for the competing countries of the CFA franc zone (James, 2009). Having few exemptions also limits the need to verify case-by-case compliance.

8. Incentives should not be paid out prior to investment, but be of a type to promote activities that generate spillovers such as training, R&D and interaction with domestic firms. These are also compatible with the WTO’s Agreement on Subsidies and Countervailing Measures (Blöstrom and Kokko, 2003). Such measures could include: tax-exempt technology development funds; tax credits for R&D expenditures; tax-exemption for consulting income; and the exemption of R&D

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\(^{19}\) Harding and Javorcik (2007) found a significant positive correlation between IPA marketing efforts in foreign press and investor’s perceptions.

\(^{20}\) Some of the largest recipients of FDI (e.g. Sweden, the seventh largest recipient) do not distinguish between domestic and private investors, belying the theory that it is only foreign directed incentives that spur investment.

\(^{21}\) For example, a substantial proportion of Chinese ‘FDI’ consists of domestic funds that have been ‘round-tripped’ through Hong Kong and other territories.
cooperation and partnership agreements from competition laws (UNCTAD, 2000). Table 4 displays the cost effectiveness of some of these measures.

9. Reducing import duties on machinery and equipment can encourage linkages and technology transfer to domestic firms.

10. If investors are required to fulfill certain conditions as part of granting incentives, it is imperative that post-grant monitoring of the investment project is undertaken. It is useful to include penalties such as clawbacks for breach of contract and to backload incentives whenever possible (only pay subsidies on completion of performance goals, for example (Thomas, 2007)).

11. Investors should have recourse to and be made aware of a neutral dispute settlement mechanism for investment promotion-related quarrels (UNCTAD, 2008b).

12. The cost of the schemes should be allocated to the authority in charge of investment promotion. These authorities should produce expenditure statements so that the cost of the incentives is transparent.

13. Tax policy must aim at ensuring simplicity and stability in the tax system, especially in countries where institutional or political risk is high.

14. Tax holidays should not be used as a means to offset a high local tax rate, as the type of investment attracted by these schemes is likely to be footloose and unwilling to remain when the holiday has ended. If possible, it is always less distortionary to attract FDI through a low general corporate tax. In order to attract more long-term FDI, typically with long gestation periods, it is also advisable that firms be allowed to carry forward losses incurred during the tax holiday period. Furthermore, if a tax holiday is used, it is important that investors be required to keep records of capital expenditures and other items before and during the holiday period in order to be able to comply with the tax system following the tax holiday.

15. Investment tax credits can be preferable to tax holidays, since they target investment directly and enhance transparency by requiring the filing of tax returns. Specifying a minimum holding period would mitigate any bias toward short term assets and prevent asset resale after the credit is claimed (Chai and Goyal, 2008). It is also useful to use incremental tax credits, which are earned as a fixed percentage of qualifying investment expenditures in a year in excess of some base that is typically a moving-average base. This helps target tax relief to the incremental expenditures that would not have occurred in the absence of the credit (UNCTAD, 2000).

16. A high inflation environment negates the benefits of depreciation allowances. As such, developing countries with inflationary tendencies should avoid using such tools (Biggs, 2007).

17. Tax policy must be designed with the awareness that different measures attract different types of investors. Start-up companies prefer incentives that reduce initial expenses, such as equipment and material exemption, while expanding companies prefer ones related to profit. Manufacturing industries prefer incentives targeting depreciable assets, as they own more fixed assets than service industries (Rolfe, 1993 in Morisset and Pirnia, 2000). Furthermore, small and medium enterprises (SMEs) are far more responsive to fiscal incentives than are large multinationals (Biggs, 2007).

18. It is important that if an incentive policy is adopted, it is complemented by liberalization of outward FDI. If there are restrictions on outward FDI, domestic firms are doubly disadvantaged in that “firms must confront foreign competitors at home without a comparable opportunity to realize the benefits from their own overseas investments or from challenging competitors in their home markets” (UNCTAD, 1995: 46).

Box. 3: An Namibian Example of the Winners Curse
(Source: James, 2009)

In 2001 Ramatex, a Malaysia-based textile manufacturer, negotiated with the governments of Botswana, Madagascar, and South Africa, then decided to invest in Namibia, which offered a 20-year tax holiday, subsidized water and electricity, a 99-year tax exemption on land use, and R60 million to prepare the site (including setting up electricity, water, and sewage infrastructure). Namibia actively competed against South Africa, which offered a six-year tax holiday and subsidized land. But a year after production started, the Namibian government was having serious doubts about whether Ramatex would honor its promise of creating jobs. The factory closed in 2008 amid complaints of worker mistreatment and groundwater pollution, along with claims that the company had used Namibia only as a trans-shipment point.
Table 4: Cost Effectiveness of Various Tax Incentives
(Source: Bolnick, 2004)

Relative Cost effectiveness (RCE) is measured as the percentage decrease in the marginal effective tax rate (METR) divided by the decline in the present value of the tax. When the RCE > 1 then the incentive effect exceeds the foregone revenue (the incentives is cost effective). The benchmark case has 35% company tax and capital gains tax, declining depreciation at rates of 5%, 15% and 25% for buildings, equipment and vehicles, dividend withholding tax, loss carry forward, 10% inflation, 25% nominal interest rate, 10% duty on imported capital goods and sale of company after 10 years. The Greenfield project is assumed to be 10% land, 40% building, 40% equipment and 10% vehicles.

<table>
<thead>
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<th>METR for benchmark case</th>
<th>0% debt, green field project</th>
<th>50% debt, green field project</th>
<th>0% debt, 100% plant and equip</th>
<th>50% debt, 100% plant and equip</th>
</tr>
</thead>
<tbody>
<tr>
<td>benchmark + tax rate of 30%</td>
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<td>1.0</td>
<td>1.02</td>
<td>0.98</td>
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<tr>
<td>benchmark + tax rate of 15%</td>
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<td>0.92</td>
<td>0.98</td>
<td>0.90</td>
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<tr>
<td>benchmark + tax holiday of 5 years</td>
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<td>1.12</td>
<td>1.05</td>
<td>1.07</td>
</tr>
<tr>
<td>benchmark + tax holiday of 10 years</td>
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<td>0.88</td>
<td>0.95</td>
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<tr>
<td>benchmark + double declining balance</td>
<td>1.03</td>
<td>1.30</td>
<td>1.04</td>
<td>1.21</td>
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<tr>
<td>benchmark + 20% investment tax credit</td>
<td>1.43</td>
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<tr>
<td>benchmark + 50% initial allowance (adjustment to basis)</td>
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<td>1.30</td>
<td>1.04</td>
<td>1.21</td>
</tr>
<tr>
<td>benchmark + 20% initial allowance (no adjustment)</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>benchmark + 0% dividend tax</td>
<td>1.02</td>
<td>1.07</td>
<td>1.02</td>
<td>1.05</td>
</tr>
<tr>
<td>benchmark + 0% capital gains tax</td>
<td>1.00</td>
<td>0.81</td>
<td>1.01</td>
<td>0.84</td>
</tr>
<tr>
<td>benchmark + 0% import duty on capital goods</td>
<td>1.03</td>
<td>1.22</td>
<td>1.03</td>
<td>1.21</td>
</tr>
</tbody>
</table>

Figure 1: Top Priority Host Economies for FDI in the 2011-2012 Period
(Source: UNCTAD, 2010)
References


Foreign Investment Advisory Services (FIAS), 1999, Kingdom of Thailand: A Review of Investment Incentives, World Bank Group, Washington, DC.


Tuomi, K. 2009, Fundamentals, Tax Incentives and Foreign Direct Investment, American University, Washington, DC.


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