

# Investment Incentives

A survey of policies and approaches for  
sustainable investment



Columbia Center  
on Sustainable Investment

A JOINT CENTER OF COLUMBIA LAW SCHOOL  
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This report was prepared by Lise Johnson and Perrine Toledano, with substantial input from Ella Merrill and Mithatcan Aydos. Nathan M. Jensen (University of Texas at Austin) also contributed to an earlier draft.

Core input to the draft report, much of which remains in this report, was provided by Sari Bernstein (CCSI), Kaitlin Cordes (CCSI), Harald Jedlicka (World Bank Group), Sebastian James (World Bank Group), Charles Krakoff (Koios Associates, Investment Consulting Associates), Hania Kronfol (World Bank Group), Jacky Mandelbaum (CCSI), Ilan Strauss (CCSI), Ivan Nimac (World Bank Group), Frances Ruane (Economic and Social Research Institute, Dublin), Yassin Sabha (World Bank Group), Ana Teresa Tavares-Lehman (School of Economics, University of Porto), and Kenneth Thomas (Center for International Studies, University of Missouri, St. Louis).

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## *About the Columbia Center on Sustainable Investment (CCSI)*

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# Executive Summary

In order to effectively harness public funds and leverage them to support sustainable development, governments have to be strategic in their use of capital. This means ensuring that government funds are used to help compensate for market failures that lead to the underproduction of public goods. It also means ensuring that government funds are not used to provide redundant support for private actors and subsidize environmentally or socially harmful activities.

To achieve these policy objectives, governments need to be careful and deliberate in their use of investment incentives. Investment incentives, which may be defined (broadly) as nonmarket advantages used to influence the behavior of an economic actor, can represent significant costs to governments. These costs have the potential to generate various public benefits such as increased employment, development and dissemination of environmentally and socially sound technology, and other positive externalities. However, investment incentives are not often tailored or implemented in ways that ensure they produce the desired outcomes, or they do so at public costs that are less than their public benefits.

Investment incentives have the potential to advance sustainable development but can also be misused, undermining their goals, and wasting public funds. This report provides an overview of investment incentives, their policy implications, and strategies for understanding and managing their costs and benefits.

## **Data Limitations on the Use of Investment Incentives**

Investment incentives have been widely and increasingly used by governments in the developing and developed world. Various studies reviewed in the report provide a picture of where and how they are used. The report, however, notes that there are significant limitations on the public availability of data on investment incentives. Largely due to the discretionary and frequently opaque nature through which many incentives are granted, it is extremely challenging to develop a complete picture of the amounts and types of incentives being awarded. Apart from rules on State Aid in the EU and efforts by some subnational entities, information regarding the use of incentives is not systematically collected or disclosed, which hinders research and analysis of associated policy issues and solutions.

## **Types of Investment Incentives**

Investment incentives can be divided into four types:

- Fiscal incentives – tax-based measures; provide exemptions from or reductions of government revenue which would otherwise be due.<sup>1</sup>
- Financial incentives – financial support that is non-taxed based. Forms include the provision of certain goods and services; transfer of funds or liabilities; transfer of funds through instruments such as grants or loans; and payments in kind.<sup>2</sup>
- Regulatory incentives – derogations from the rules and regulations of certain national or subnational rules and regulations.<sup>3</sup>
- Technical and business support incentives – advisory services provided to ease entry or support the operations of firms.

While we recognize four types of investment incentives, this report focuses on tax incentives and, to a lesser extent, on financial incentives.

### **Reasons for Using Investment Incentives**

The use of incentives might be motivated by the desire to attract or keep investment and to help ensure that the investment advances certain policy aims. More specifically, from a public policy perspective, there are four main situations providing an economic rationale for the use of investment incentives:

- Public goods

Public goods are generally defined as goods or services that benefit society. They are frequently provided free of charge and financed by direct taxation or a subsidy to private spending.

- Positive externalities

In broad terms, a positive externality is a positive effect that a particular activity has on an unrelated third party. It can occur on either the production or consumption side of things. For example, an educated population is statistically associated with lower crime, higher property value (ergo higher property tax), and better-informed voters. Governments are therefore compelled to subsidize the education industry because of all of these positive externalities.

- Credit market failures

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<sup>1</sup> James, Sebastian. 2009. "Incentives and Investments: Evidence and Policy Implications." Investment Climate Advisory Services of the World Bank Group.  
<https://openknowledge.worldbank.org/bitstream/handle/10986/27875/588160WP0Incen10BOX353820B01PUBLIC1.pdf?sequence=1&isAllowed=y>, 1

<sup>2</sup> *Ibid.*

<sup>3</sup> OECD. 2003. *Checklist for Foreign Direct Investment Incentive Policies*. 17.

Even economists couldn't agree on the nature of market failures and what measures should be taken to prevent them. Reallocation of resources or a change in the incentive structure are frequently used for addressing credit market failures.

- Private firm risk aversion<sup>4</sup>

Risk-averse private firms are frequently regarded as prioritizing the safety of their principal over the prospect of a higher return on their investment. However, companies, at least in theory, should create value for stakeholders by taking risks and reaching higher returns. The corporate tax system is frequently used to incentivize risky business decisions.

### **Effectiveness of Investment Incentives**

The effectiveness of incentives on an investor's investment decision varies based on the nature of the investor's business and its strategies. Firms seeking to enter new markets or acquire natural resources (or other resources and strategic assets), for example, appear less motivated by locational tax incentives than highly mobile, efficiency-seeking firms that seek to reduce costs for manufacturing products or producing services destined for a global market. Tax incentives may also be important for market-seeking investment if the investment decision is contingent on determining where to locate among similarly attractive platforms or similarly attractive parts of one large market. A number of studies indicate that incentives seeking to influence location decisions are relatively less important than other characteristics of a host country and are often unable to compensate for an unattractive investment climate.

### **Effectively Designing Tax Incentive Programs**

*Proper Targeting of Incentives.* A starting point for any incentive discussion needs to address the targeting of businesses for incentives. Many incentive programs target businesses that are unlikely to be influenced by incentive offers. This includes companies for which investment decisions are likely to be determined primarily based on geographic constraints, like the location of a resource deposit or an existing production facility.

Other incentives may indeed influence investment decisions but result in limited economic development benefits for broader communities or countries. For example, incentives for new businesses that displace existing businesses, investments with few linkages to other parts of the economy like sports stadiums, or investments that generate few full-time or permanent jobs for residents like film and TV production, may not be optimally targeted to encourage economic development.

*The challenge of cost-benefit analysis.* To understand whether it is strategic to use incentives in a particular country, it is necessary to assess the costs and benefits of those potential incentives.

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<sup>4</sup> See Lovallo, Dan, Tim Koller, Robert Uhlener, and Daniel Kahneman. 2003. "Your Company Is Too Risk-Averse." *Harvard Business Review*. <https://hbr.org/2020/03/your-company-is-too-risk-averse>

With respect to tax incentives, for example, governments should take stock of the direct fiscal costs of revenue losses from giving tax benefits to investors that would have invested in their absence. They should also measure incentives' indirect costs. These are more difficult to measure but can include “distortions created by encouraging new investments that are not economically viable or that are detrimental to existing ones,” as well as “time and money spent by businesses lobbying for,” “qualifying for, and obtaining tax incentives.”<sup>5</sup>

Meanwhile, the benefits from incentives can also be direct or indirect: direct benefits might include contributions to job creation, whereas indirect benefits might include effects that encourage investments in environmentally friendly technologies.

One narrow but somewhat simplistic approach to cost-benefit analysis is to assess the jobs created as a result of tax incentives. While less comprehensive than other techniques for assessing the costs and benefits of these tools, the main advantage of this type of analysis is that it may be relatively easy for a government to conduct. It also provides a rough figure that can help policymakers decide if the incentive is worthwhile. A number of country studies have shown the cost per job of investment incentives is often quite high. For instance, a World Bank Group study of a project in El Salvador found the cost of incentives per job to be US\$2,084, more than half of El Salvador's per capita Gross National Income. A method to calculate the jobs created as a result of tax incentives is presented in this report, along with other techniques for conducting cost-benefit analyses on incentive packages.

Many incentive evaluations erroneously attribute 100% of the jobs of a firm to granted incentives. However, a review of existing literature on U.S. incentive programs suggests that only 2% to 25% of investment decisions are decisively influenced by incentive packages.<sup>6</sup> Governments can build this research into evaluations: for example, the U.S. state Rhode Island provides costs-benefit analysis estimates assuming that 0%, 25%, 50%, 75%, and 100% of investments are due to the incentives offered.<sup>7</sup> Policymakers can use such estimates to further refine and apply their cost-benefit analyses.

In addition to the costs incurred and benefits provided by the granting jurisdiction, incentives can also have (“external”) impacts on other jurisdictions. Incentives might, for instance, indirectly impose costs on other jurisdictions by exposing them to investment policy “races to the bottom,” or by causing them to lose tax revenue due to transfer pricing practices. Yet incentives can also provide external benefits: incentives might be used to encourage outward investment in areas or

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<sup>5</sup> James, Sebastian. 2010. “Providing Incentives for Investment: Advice for Policymakers in Developing Countries.” *Investment Climate in Practice: Investment Policy and Promotion*. 3.

<sup>6</sup> Barik, Timothy. 2018. ‘*But For*’ Percentages for Economic Development Incentives: What percentage estimates are plausible based on the previous research. Upjohn Institute Working Paper 18-289.

<sup>7</sup> Raimondo, Gina M. 2018. “Economic Development Tax Incentives Evaluation Act: Evaluation of ‘Motion Picture Production Tax Credits’ (R.I. Gen. Laws § 44-31.2-5) Tax Years 2013 through 2015.” State of Rhode Island and Providence Plantations: Office of Revenue Analysis.

activities in which investment might not otherwise be made, generating positive spillovers in home, host, and even third countries. Many states already recognize this potential for positive and negative effects outside the granting jurisdiction: the EU rules regarding State Aid, for example, consider the effects of Member States' incentives policies on other states within the EU. Another relevant example can be found in the practice of the U.S. agency providing incentives for outward investment, which assesses the effects – both at home and abroad – of the investments it supports.<sup>8</sup>

*Administration and implementation challenges.* Incentives create a number of risks. They can encourage lobbying and rent-seeking, facilitate tax evasion, and exacerbate challenges related to the administration of the incentives scheme or program. In particular, financial incentives present unique challenges: their many policy objectives can make it hard to calculate benefits, and they tend to be administered by different authorities, come in varied forms, and may be offered on a discretionary basis, making them more apt to abuse.

Drawing from the literature and building on the discussion of the report, there are 12 guiding principles that represent international best practice for the effective design and implementation of investment incentives, with a focus on fiscal and financial tools. These are:

- 1) Incentives, both tax and financial, should only be used as focused instruments to correct market failures and as a second-best policy option after having evaluated the alternatives available.
- 2) Incentives should be part of a broader and consistent investment attraction or influencing strategy.
- 3) Incentives programs should be time-bound.
- 4) Incentives programs should be reviewed regularly to ensure that they continue to remain relevant and effective.<sup>9</sup>
- 5) Information on the processes and procedures related to incentives administration should be transparent and publicly available.

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<sup>8</sup> See, e.g., U.S. Overseas Private Investment Corporation (OPIC). 2013. “Self-Monitoring Questionnaire for Finance, Insurance, Reinsurance, and Investment Funds Projects, Form OPIC-162.” <http://www.opic.gov/sites/default/files/files/OPIC-162-FY2012-SMQ-FOR-PUBLIC%20USE.pdf>; OPIC. 2013. “Office of Investment Policy Questionnaire, Form-248.” <http://www.opic.gov/sites/default/files/files/OPIC-248-OIP-Questionnaire.pdf> Note, OPIC was replaced in 2018 by a new federal entity playing similar functions, the U.S. International Development Finance Corporation. See 22 USC §§ 9601–9689.

<sup>9</sup> While stability is important, predictable flexibility ensured by mandatory reviews is preferable to maintain effective incentives.

- 6) The process of applying for incentives should be simple and minimize discretion, and for tax incentives it should be automatic.
- 7) Incentive programs should have a statutory cap, limiting the total dollars allocated to a program.

With specific regard to tax incentives:<sup>10</sup>

- 8) As much as possible, they should be linked to investment levels, while tax holidays should be used sparingly.
- 9) They should be provided in the relevant tax code.
- 10) Tax returns, declarations, and relevant forms should be filed on a regular basis as a pre-condition for investors.
- 11) Tax expenditure statements should be prepared regularly to measure the costs of tax incentives.
- 12) Incentives are more effective when they are offered up for short time periods, as opposed to offered over a long time period. As a general rule, tax incentives offered longer than 5 years are excessively costly.

### **Reducing Incentives Competition – Regulatory Effects to Limit ‘Races to the Bottom’**

While a winning location may reap near-term benefits from securing an investment, it does so at a cost that is likely higher than it would have been absent any incentives competition. This can lead to a situation in which the offer and receipt of incentives become the norm rather than the exception, benefiting investors at the expense of general welfare. Addressing these issues, however, is a problem requiring collective action. There are treaties that address these problems and restrict the use of trade-distorting practices by making certain government support or assistance impermissible. For example, members of the World Trade Organization (WTO) may invoke several of the WTO’s “covered agreements” to discipline the use of investment incentives (both financial and regulatory) that government entities may introduce to attract investment. Outside the WTO framework, the EU has a relatively robust legal framework governing the use of incentives by EU member states.

### **Concrete Areas for Action**

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<sup>10</sup> Adapted from the United Nations Committee of Experts on International Cooperation in Tax Matters, *Secretariat Note On Agenda Item - Use Of Tax Incentives In Attracting Foreign Direct Investment*, Geneva, 18-22 October 2010. <https://docplayer.net/52303652-Secretariat-note-on-agenda-item-use-of-tax-incentives-in-attracting-foreign-direct-investment.html>



While current knowledge regarding the use of investment incentives is limited, this report seeks to lay the foundation for renewed attention to the use of incentives. Actions by individual granting jurisdictions are necessary to ensure that incentives advance identified policy objectives and that their benefits justify their costs. Collective action to rein in incentives competition is also required, as individual jurisdictions acting alone fear – often mistakenly – that they will lose out to competing jurisdictions if they curtail their use of incentives. Against that backdrop, the report identifies concrete areas for action, such as:

- increasing the transparency of investment incentives;
- transitioning to a rule-based, as opposed to *ad hoc*, system for granting incentives;
- ensuring incentives arrangements build in mechanisms for monitoring, oversight, and enforcement so that they actually advance intended policy objectives;
- building capacity to perform proper cost-benefit analyses to ensure that incentives do not dilute, eliminate, or even outweigh the potential benefits of an investment project;
- mandating regular reviews of incentive programs, with the review criteria specified prior to the implementation of the legislation; and
- including sunset clauses that cancel programs if they prove ineffective.

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# Acronyms

AoA	WTO Agreement on Agriculture
BIT	Bilateral Investment Treaty
COMESA	Common Market for Eastern and South Africa
EAC	East Africa Community
ECJ	European Court of Justice
EPZ	Export Processing Zones
EU	European Union
FDI	Foreign Direct Investment
FET	Fair and Equitable Treatment
GATS	General Agreement on Trade in Services
GATT	General Agreement on Tariffs and Trade
OECD	Organisation for Economic Co-operation and Development
OFDI	Outward Foreign Direct Investment
OPIC	U.S. Overseas Private Investment Corporation
R&D	Research and Development
SADC	Southern African Development Community
SCM	Subsidies and Countervailing Measures
SEZ	Special Economic Zones
SME	Small and Medium Enterprises
TBT Agreement	WTO Agreement on Technical Barriers to Trade
TFEU	Treaty on the Functioning of the European Union
TRIMs	Trade-Related Investment Measures
UNCTAD	United Nations Conference on Trade and Development
UNIDO	United Nations Industrial Development Organization
VAT	Value-Added Tax
WAEMU	West African Economic and Monetary Union
WTO	World Trade Organization

# Investment Incentives: An Introduction to the Main Concepts and Challenges

Governments – whether acting at the supranational, national, or sub-national level – have long used incentives (also defined as nonmarket advantages) to shape the conduct of economic actors. The use of incentives by governments can be crucial for advancing public objectives and correcting market failures caused by information asymmetries, externalities, and other circumstances. Incentives can help produce positive outcomes that the market alone may not achieve by encouraging the private sector to produce public goods, internalize and reduce negative externalities, invest in research and development (R&D), and generate economic activity and employment in undeveloped or marginalized areas.

Yet the use of incentives is also subject to criticism on the grounds that, while incentives might at times attract investments and shape investor behavior, on the whole, they distort the normal functioning of markets and result in the inefficient or suboptimal allocation of resources. For instance, the unnecessary costs to governments' budgets from the excessive use of tax and financial incentives can lead to a narrowing of the tax base and the loss of public revenue necessary to provide essential public goods and services.

Governments are apparently increasingly using investment incentives to attract and retain capital that is more and more mobile. Governments use incentives to convince investors to forgo other opportunities offered by competing jurisdictions in order to create employment, increase competitiveness, generate exports, and build tax bases. Incentives are also used to encourage already existing investments to deepen linkages with and spillovers into the host jurisdiction. In this context, governments may offer incentives for businesses to hire local employees, procure their goods and services from local providers, and invest in education and training.

In addition to those efforts aimed at bringing in, keeping, and benefiting from investments, more governments are giving incentives to encourage domestic firms to grow abroad. They may provide this support based on the assumption that outward investment can produce positive spillovers in the home country, but whether and under what circumstances such an assumption is true are important questions.

Investment incentives are now used pervasively across both the developed and developing world. These incentives are often expensive, as a percentage of government revenues, a percentage of the value of the investment being incentivized, a percentage of the country's GDP, or the cost per job created. In Rwanda and Sierra Leone, for instance, the governments have been reported to devote more than one-third of tax revenues to investment incentives.<sup>11</sup> As a percentage of GDP, estimates

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<sup>11</sup> James, Sebastian. 2013. *Tax and Non-Tax Incentives and Investments: Evidence and Policy Implications*. 25. <http://www.estimacionestributarias.com/archivos/Effectiveness.pdf>

are that Cambodia has provided tax incentives that are 5.9% of its GDP, Ghana, 5.2%, and the Dominican Republic, 3.9%.<sup>12</sup> In terms of the cost of incentives per job created by an investment project, there are examples of governments in Europe,<sup>13</sup> the United States,<sup>14</sup> Brazil,<sup>15</sup> and India<sup>16</sup> all reportedly paying more than \$200,000 in incentives per position.<sup>17</sup>

In addition to these general trends in incentives, crisis events may cause dips and spikes in absolute levels of incentives being provided, the amount of incentives relative to other government expenditures, and the types of incentives given.<sup>18</sup> Across many countries, the use of discretionary incentives seems to have spiked as a result of the tumultuous events of 2020, in which the COVID-19 crisis drove unprecedented peacetime shifts in public capital.<sup>19</sup> As governments injected public funds into efforts to support private sector activities, it is estimated that additional government

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<sup>12</sup> World Bank Group. 2018. *Global Investment Competitiveness Report 2017/2018: Foreign Investor Perspectives and Policy Implications*. (Washington, DC: World Bank).

<sup>13</sup> See, e.g., Decramer, Stefaan and Stijn Vanormelingen. (2016). “The effectiveness of investment subsidies: evidence from a regression discontinuity design.” *Small Business Economics*, 47(4), 1007–1032. <http://www.jstor.org/stable/26154683> (estimating that a subsidy program in Flanders cost roughly EU500,000 per job created).

<sup>14</sup> Thomas, Kenneth P. 2011. *Investment Incentives and the Global Competition for Capital*. (New York: Palgrave Macmillan) 4. Additionally, a deal between the US state of Wisconsin and Foxconn, which called for Wisconsin to provide roughly USD 4 billion in state and local incentives, and anticipated Foxconn would provide roughly 13,000 jobs, would involve a subsidy of over USD 300,000 per job. Originally struck in 2017, the deal was subsequently revised.

<sup>15</sup> *Id.*, 30.

<sup>16</sup> *Id.*

<sup>17</sup> For other studies on incentives per job created, see, e.g., Fabuš, M., and Csabay, M. (2018). “State aid and investment: Case of Slovakia.” *Entrepreneurship and Sustainability Issues*, 6(2), 480-488. doi:[http://dx.doi.org/10.9770/jesi.2018.6.2\(1\)](http://dx.doi.org/10.9770/jesi.2018.6.2(1));

<sup>18</sup> For studies looking at the ebbs and flows in use of incentives, and the influence of economic recessions on incentives practices, see, e.g., Hinkley, S., and Weber, R. (2021). “Incentives and Austerity: How Did the Great Recession Affect Municipal Economic Development Policy?” *Urban Affairs Review*, 57(3), 820–855. <https://doi.org/10.1177/1078087420964254>; Bartik, Timothy J. 2017. *A New Panel Database on Business Incentives for Economic Development Offered by State and Local Governments in the United States*. W.E. Upjohn Institute. <http://www.upjohn.org/models/bied/maps/ReportFinal.pdf>; Zheng, Lingwen, Warner, Mildred. 2010. “Business Incentive Use Among U.S. Local Governments: A Story of Accountability and Policy Learning.” *Economic Development Quarterly* 24(4): 325–36. doi:[10.1177/0891242410376237](https://doi.org/10.1177/0891242410376237); Reese, Laura A., Larnell, Twyla Blackmond, Sands, Gary. 2010. “Patterns of Tax Abatement Policy: Lessons from the Outliers?” *The American Review of Public Administration* 40 (3): 261–83. doi:[10.1177/0275074009340051](https://doi.org/10.1177/0275074009340051).

<sup>19</sup> See, e.g., UNCTAD. 2021. *World Investment Report 2021: Investing in Sustainable Recovery*. (Geneva: UNCTAD) (stating, on p. 116: “The drastic decrease in global FDI flows caused by the COVID-19 pandemic triggered a rise in the number of promotion and facilitation measures in numerous developing countries in 2020. At least 27 countries introduced such new policy measures.”).



spending and forgone revenue (through, e.g., tax relief) amounted to between 2% and 7% of GDP, with the percent of GDP tending to increase with the income of the country.<sup>20</sup>

Some of the COVID-19-related incentives were designed to encourage companies to invest in activities to directly combat the pandemic, such as investment in developing vaccines, treatments, and personal protective equipment.<sup>21</sup> Others were designed to help support businesses forced to close or significantly curtail operations in light of government-imposed lockdowns and other restrictions. Still, others aimed to generally ease burdens on investors and make doing business in the relevant jurisdiction easier and more profitable. Near the start of the pandemic, for example, China announced it would provide government assistance to foreign investors by simplifying approval processes for foreign investment projects, optimizing tax exemption processes for imports, and implementing special investor protections.<sup>22</sup> Additionally, some measures were designed more broadly to inject capital into the economy and, when doing so, influence investor behavior and catalyze investment into sustainable development priorities.<sup>23</sup>

While well-designed incentives offerings can be impactful in terms of enabling countries and their stakeholders to withstand and weather crises,<sup>24</sup> the use of incentives in times of crisis intensifies some of the already existing challenges and risks associated with those tools. The time-sensitive nature of crisis response can, for example, hinder cost-benefit analysis of programs or otherwise disrupt normal governance of incentives schemes,<sup>25</sup> increase opportunities for corruption and

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<sup>20</sup> IMF Fiscal Monitor, October 2020. See also “Rich countries try radical economic policies to counter COVID-19,” (26 March 2020) *The Economist*, available at: <https://www.economist.com/briefing/2020/03/26/rich-countries-try-radical-economic-policies-to-counter-covid-19>.

<sup>21</sup> See, e.g., UNCTAD. 2021. *World Investment Report 2021: Investing in Sustainable Recovery*. (Geneva: UNCTAD) (providing examples of healthcare-related investment incentives predating COVID19 as well as those adopted in response to the pandemic on pp. 141 and 142).

<sup>22</sup> UNCTAD, *Investment Policy Monitor Issue 23* (April 2020); National Development and Reform Commission, *Development and Reform of Foreign Investment (2020) No. 343*, [https://www.ndrc.gov.cn/xxgk/zcfb/tz/202003/t20200311\\_1222902.html](https://www.ndrc.gov.cn/xxgk/zcfb/tz/202003/t20200311_1222902.html).

<sup>23</sup> Vetter, David. 13 April 2020. “Use Lessons of COVID-19 to Build a Green Recovery, Say EU Ministers” *Forbes*, <https://www.forbes.com/sites/davidrvetter/2020/04/13/use-lessons-of-covid-19-to-build-a-green-recovery-say-eu-ministers/?sh=911979a43350>; Vetter, David. 16 April 2020. “South Korea Embraces EU-Style Green Deal for COVID-19 Recovery” *Forbes*. <https://www.forbes.com/sites/davidrvetter/2020/04/16/south-korea-embraces-eu-style-green-deal-for-covid-19-recovery/?sh=537c3225611d>; note also, Harvey, Fiona. 23 September 2020. “Few countries living up to Covid “green recovery” pledges – analysis.” *The Guardian* <https://www.theguardian.com/environment/2020/sep/23/few-countries-living-up-to-green-recovery-promises-analysis>.

<sup>24</sup> Wen, Jean-François. (2020). *Special Series on COVID-19: Temporary Investment Incentives*. (IMF Fiscal Affairs), <https://www.imf.org/-/media/Files/Publications/covid19-special-notes/en-special-series-on-covid-19-temporary-investment-incentives.ashx>

<sup>25</sup> See, e.g., Agnolucci, Irene. 2021. “Will COVID-19 Make or Break EU State Aid Control? An Analysis of Commission Decisions Authorising Pandemic State Aid Measures.” *Journal of European Competition Law and Practice*, <https://doi.org/10.1093/jecclap/lpab060>; Van Hove, Jan. 2020. “Impact of State Aid on Competition and

wasteful cronyism, and strengthen beggar-thy-neighbor impulses that can create a race to the bottom in terms of incentives use. Enhanced use of incentives during times of financial stress also gives rise to complex issues related to macroeconomic policy and budgetary planning and management.<sup>26</sup>

Thus, when considering the design and implementation of incentives policies, it is important to think about how those policies operate in times of relative calm and also try to develop plans for their operation in times of crisis. Additionally, insights derived from the use of incentives in times of crisis can also generate insights on incentives design more generally. This report does not focus on crisis-related incentives tools but flags it as an important subdimension that merits further specific analysis.

The pervasive use of incentives, and examples suggesting their high cost relative to their aims or benefits, raise two sets of key questions: The first asks whether and in what circumstances the benefits of incentives outweigh their costs. The second question asks what regulatory regimes exist or could be adopted to help governments ensure that their use of incentives is sufficiently disciplined and strategic to meet policy goals. The following sections will provide an introduction to these questions.

This is a stock-taking report rather than an analytical one. It provides a foundation for future research in an area that remains opaque in many respects.

The report is structured as follows:

Section 1 introduces the concept of investment incentives, examining the main types of incentives provided by governments and the economic conditions under which incentives may be used. It also discusses particular issues that arise in connection with tax incentives for foreign direct investment (FDI). Section 2 surveys diverse data sources to assess the scale of tax and financial incentives used in a variety of jurisdictions. Section 3 discusses efforts by governments to track and manage their use of incentives, focusing on cost-benefit analysis practices and efforts to structure those incentive packages to further relevant policy aims. Section 4 focuses on governance frameworks that limit “races to the bottom” in competition for investment.

The report concludes by identifying policy approaches that can be pursued to help improve and rationalize the granting of incentives and ensure that, when used, they are adequately tailored to advance long-term sustainable development.

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Competitiveness during COVID-19 Pandemic: An early Assessment” requested by the Committee on Economic and Monetary Affairs of the European Parliament (ECON Committee) and published in December 2020, [https://www.europarl.europa.eu/thinktank/en/document.html?reference=IPOL\\_STU\(2020\)658214](https://www.europarl.europa.eu/thinktank/en/document.html?reference=IPOL_STU(2020)658214).

<sup>26</sup>Hinkley, S., and Weber, R. (2021). “Incentives and Austerity: How Did the Great Recession Affect Municipal Economic Development Policy?” *Urban Affairs Review*, 57(3), 820–855. <https://doi.org/10.1177/1078087420964254>.

# Section 1: Definitions and Types of Incentives

*Investment incentives* are “targeted measures designed to influence the size, location, impact behavior, or sector of an investment project.”<sup>27</sup> These investment incentives could include full or partial exemptions or deferrals of tax charges, laws, and regulations. They may be granted to any firm operating in a particular geography or sector, or made conditional on compliance with certain obligations or targets, such as investment or hiring plans; however, generally speaking, to be considered an ‘incentive,’ they “must be tailored to specific investors or types of investors” for “specific investment projects.”<sup>28</sup> Although different sources will use slightly different definitions or criteria for incentives for data collection, reporting and regulatory purposes, this section of the report describes various types of measures that can be deemed incentives. Due to the wide range of relevant measures, Sections 2 and 3 focus more narrowly on describing the use and regulation of a subset of the larger group, namely tax and financial incentives.

## 1.1 Types of Investment Incentives

Investment incentives can be broken down into four types: (1) **tax incentives**; (2) **financial incentives**; (3) **regulatory incentives**; and (4) **technical or business support incentives**.

### 1.1.1 Tax Incentives

Tax incentives provide reductions or exemptions from general tax laws and regulations in order to induce an investment or an activity; tax incentives may make an investment more attractive by increasing an investment’s rate of return or reducing associated risks and costs through the reduction of an investment’s tax burden.<sup>29</sup> They can include:

- *Exemptions*: income excluded from the tax base.
- *Allowances*: amounts deducted from gross taxable income.
- *Credits*: amounts deducted from tax liability.
- *Rate relief*: a reduced tax rate.

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<sup>27</sup> Tavares-Lehmann, Ana Teresa, Lisa Sachs, Lise Johnson, and Perrine Toledano. 2016. *Rethinking Investment Incentives: Trends and Policy Options* (New York: Columbia University) 5.

<sup>28</sup> *Id.*, 4.

<sup>29</sup> *Id.*, 24.

- *Tax deferrals*: relief that takes the form of delay in paying tax (for example, accelerated depreciation).
- *Duty exemptions*: duty not collected on imports that in the usual course would be collected.<sup>30</sup>
- *Value-added tax (VAT) exemptions/Zero-rating*: VAT collected using a lower (or zero) rate, either on imports/production or value added.

### 1.1.2 Financial Incentives

Financial incentives include all financial support that is not taxed-based. Forms include the provision of certain goods and services; transfer of funds or liabilities; transfer of funds directly or through providing loans and guarantees; and the creation of targeted infrastructure.<sup>31</sup> They are divided in greater detail in Table 1.

**Table 1: Financial Incentives: Instruments and Examples<sup>32</sup>**

Instrument		Examples
Financial Incentives	<b>General Financing Incentives</b>  Provision of financing options primarily to defray start-up costs, but may also be offered to upgrade or stabilize an investor's operations	<b>Direct Grants and Cost-Sharing Schemes</b> <ul style="list-style-type: none"> <li>• Cash grants on proof of start-up, or after x years of operation</li> <li>• Public sector equity participation</li> </ul>
		<b>Lending Instruments and Guarantees</b> <ul style="list-style-type: none"> <li>• Soft loans</li> <li>• Interest subsidies</li> <li>• Loan guarantees</li> </ul>
	<b>Land and Infrastructure Incentives</b>  Reduced rates on and/or direct provision of land, public utilities, or transportation granted for specific investments	<b>Reduced Market Values or Direct Provision of Land</b> <ul style="list-style-type: none"> <li>• Public land or buildings sold to investors at below market values</li> <li>• Infrastructure provision such as roads, railways, harbors, telecomm</li> </ul>
		<b>Low Input Prices From Parastatals</b> <ul style="list-style-type: none"> <li>• Reduced rates on public utilities (e.g. electricity, water) and transportation</li> </ul>
	<b>Training and Employment Incentives</b>  Subsidized training programs and education commitments or subsidies to reduce investors' staffing costs	<ul style="list-style-type: none"> <li>• Job training subsidies</li> <li>• Wage subsidies</li> <li>• Exemptions from social security contributions</li> </ul>
	<b>R&amp;D Incentives</b>  Grants and lending instruments to support investments in R&D and innovation	<ul style="list-style-type: none"> <li>• Subsidies supporting R&amp;D and Innovation</li> </ul>

<sup>30</sup> For the purpose of this report, tax incentives include duty exemptions, although import duties are not properly defined as taxes.

<sup>31</sup> Tavares-Lehmann, Sachs, Johnson, and Toledano, *Rethinking Investment Incentives*, supra n26, 22.

<sup>32</sup> Provided by World Bank Group Trade and Competitiveness Global Practice, Investment Policy Team.

Only incentives that are aimed at “specific” undertakings are included in Table 1. Financial incentives do not include measures of general applicability such as government direct financing of public infrastructure that, although they might be crucial for attracting investment, are not targeted toward specific investors or investments.<sup>33</sup>

### 1.1.3 Regulatory Incentives

Regulatory incentives offer or provide derogations from generally applicable laws or regulations.<sup>34</sup> Those derogations may exempt companies from having to comply with otherwise applicable laws, regulations, or permitting requirements, or may grant them special privileges and rights.<sup>35</sup> Regulatory incentives may be bundled together, also with fiscal incentives, for instance in ‘stabilization clauses’ which exempt investors from changes to the legal framework, or as a package of incentives for investors in special industrial zones.<sup>36</sup>

### 1.1.4 Technical and Business Support Incentives

Technical and business support incentives are usually provided to reduce information asymmetries<sup>37</sup> and administrative hassles and delays; to ease access to assets, infrastructure and other resources necessary for business activities; and, to provide “aftercare” once an investor has already invested.<sup>38</sup> This particular type of incentive ensures a specific investor or type of investor has the ability to successfully maneuver a host economy and circumvent potential costs and risks that they may have encountered without the incentive’s support.

Some business-related measures might involve government-provided databases, reports, publications for the investment process or seminars, webinars, or trainings on that same topic.<sup>39</sup> Technical incentives could include government lobbying on behalf of the investor to international

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<sup>33</sup> Special Economic Zones (SEZs) were excluded from the typology here because they involve a unique mix of fiscal and non-fiscal investment instruments.

<sup>34</sup> The OECD defines regulatory incentives as incentives that seek to attract investments “by means of offering them derogations from national or subnational rules and regulation.” OECD, *supra* n3, 17. This definition, however, may not be adequately comprehensive since the power to provide such derogations might be conferred through national or subnational rules and regulations, raising the question of whether or not there is in fact a “derogation”.

<sup>35</sup> Tavares-Lehmann, Sachs, Johnson, and Toledano, *Rethinking Investment Incentives*, *supra* n26, 31.

<sup>36</sup> *Ibid.*, 32.

<sup>37</sup> Investors may not always have the information they need to make use of certain activities or services. “The costs of gathering the information or the complexity of the information may be too great, in which case improved salience of the information or support in interpreting it could stimulate investment. Investment incentives in this case may be seen by some governments as drawing firm owners’ attention to the range of potential services that their businesses could use and which ones may be profitable.” Campos, Francisco, Aidan Coville, Ana M. Fernandes, Markus Goldstein, and David McKenzie. 2012. “Learning from the Experiments That Never Happened. Lessons from Trying to Conduct Randomized Evaluations of Matching Grant Programs in Africa.” *Policy Research Working Paper 6296* (Washington, DC: World Bank).

<sup>38</sup> Tavares-Lehmann, Sachs, Johnson, and Toledano, *Rethinking Investment Incentives*, *supra* n26, 33.

<sup>39</sup> *Id.*, 34.

organizations or provision of legal and accounting services.<sup>40</sup> Provision of these types of incentives is often a central plank of the work done by investment promotion agencies throughout various stages in the lifecycle of a foreign investment in order to attract and maintain FDI, and to establish linkages between the investment and the host jurisdiction.<sup>41</sup>

These services can be divided among the key stages of a foreign investment lifecycle, as illustrated in Table 2 below.

**Table 2: Business Support/Technical Services by Stage of Investment**

Phase	Type of service
Decision phase/ Pre-investment stage/ Pre-expansion stage	Information on markets
	Information on availability of supporting infrastructure
	Information on corporate taxation and incentives
	Information on strategic partners (distribution, legal support, recruitment support, etc.) and on relevant industry or sector
Entry stage	Information on procedures and regulations for doing business in this country (company registration, permits, labour regulations, etc.)
	Facilitating company registration, licensing (work permits, import/export permits, etc.)
	Introduction to legal, accounting and other professional services
	Soft landing services (e.g. schools, housing, safety)
Implementation stage	Finding suitable sites (e.g. land, office, factory)
	Facilitating building construction
	Access to utilities and infrastructure
	Finding key staff
Operation stage/ After care stage	Complaint resolution (issues concerning tax, labour, customs, immigration, utilities)
	Information on finance
	Matchmaking (access to suppliers, buyers, finance)
	Assistance in upgrading (information on technology sources, terms of technology transaction)
	Access to utilities and infrastructure

Source: UNIDO (2011)<sup>42</sup> based on surveys of African IPAs.

## 1.2 FDI and Incentives

Because most incentive programs do not distinguish between foreign and domestic investors in attracting investors, this report also does not differentiate between incentives used to favor foreign

<sup>40</sup> *Ibid.*

<sup>41</sup> *Id.*, 35-37.

<sup>42</sup> United Nations Industrial Development Organization (UNIDO). 2012. *Africa Investor Report 2011: Towards Evidence-based Investment Promotion Strategies*. (Vienna: UNIDO).

or domestic capital. Therefore, it is not limited to FDI incentives per se. The costs, benefits, and rationales for investment incentives generally do not vary based on whether the recipients are foreign or domestic but rather on the characteristics and activities of the particular recipients (which may correlate with nationality but are not inherent to or a necessary product of it). Nevertheless, some attributes of FDI related to its role in the global economy that are relevant to analysis of the use of investment incentives.

For one, FDI may often be seen as particularly valuable because it can provide access to capital and technology unavailable in the domestic market. It is not the “foreignness” of the investment necessarily that is attractive, but the fact that the investment possesses unique strengths that can compensate for weaknesses or fill gaps in the host economy. This may especially be the case where domestic entities lack the financial resources, know-how, or supportive infrastructure necessary to meet the needs of the domestic population and be competitive in an increasingly globalized world.

FDI is a growing force in the global economy, with important policy implications for governments. Global outward FDI stock totaled US\$2 trillion in 1990; by the end of 2017, that stock was near US\$31 trillion, and at the end of 2020 it was roughly US\$39 trillion.<sup>43</sup> It is difficult to understate the importance of the multinational enterprises that are behind this growth in FDI. As just one indicator, roughly 80% of total world trade is intra-firm trade (i.e., trade between entities belonging to the same corporate family or group.)<sup>44</sup>

This growth in FDI has been enabled by technological improvements that reduce transportation costs and enhance the coordination capability of internet and telecommunications; it has also been supported by legal, regulatory, and policy shifts at the domestic and international levels. In addition to unilaterally liberalizing their economies, countries over the past two decades have concluded an unprecedented number of trade and investment treaties in which countries commit to allowing foreign individuals and entities to invest in their territories, and to permit the free flow of capital, goods, and services across borders. While the foundational documents of the World Trade Organization (WTO), including the 1994 General Agreement on Trade in Services (GATS),<sup>45</sup> involved committing to open specific sectors to foreign investors, a growing body of bilateral and multilateral agreements increasingly obligates countries to allow foreign investment in *all sectors* except those specifically excluded. Investment treaties also protect multinational firms’ abilities to transfer capital, ensuring that, once in a particular host country, investors have significant freedom to move capital in and out of that territory when launching, operating, and disposing of their businesses.

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<sup>43</sup> This data on FDI stock is from United Nations Conference on Trade and Development (UNCTAD). 2021. *World Investment Report 2021: Investing in Sustainable Recovery* (Geneva: UNCTAD).

<sup>44</sup> United Nations Conference on Trade and Development (UNCTAD). 2013. *World Investment Report 2013: Global Value Chain and Investment and Trade for Development* (Geneva: UNCTAD).

<sup>45</sup> General Agreement on Trade in Services (GATS). 15 April 1994. Marrakesh Agreement Establishing the World Trade Organization. Annex 1B, 1869 U.N.T.S. 183.



Such trade and investment agreements facilitate multinational enterprises' efforts not only to spread their activities, value chains, and cash flows across borders, but also to move those activities as conditions in host countries and markets change. As options and mobility increase for firms, it becomes more difficult for countries to get those investments (and the jobs, revenues, and positive spillovers they can generate) to "stick." Additionally, whereas competition to attract and keep firms may formerly have been largely between different jurisdictions within one country, the mobility of firms means that the field of competitors has been growing and now often crosses national borders. The increasing complexity of the corporate structures of multinational enterprises – the relationships between parent firms and their subsidiaries and affiliates, branches, and holding companies – means that incentives provided in one location can often be effectively enjoyed by a firm operating in a different location. Transfer pricing, which can be exceedingly difficult to regulate, can be used to allow firms with a presence in a low-tax jurisdiction, or where substantial tax incentives are offered, to shift revenues or profits to that jurisdiction to avoid paying taxes in a more highly taxed location. In addition to affecting the attractiveness of a particular incentive for the firm, this can also affect its fiscal cost, not only for the jurisdiction granting the advantage, but also for other locations where the firm's affiliates are sited (see Box 8).

In addition to those issues of transfer pricing, which can influence the calculation and distribution of benefits associated with a given tax incentive, the distribution of international production through global value chains can also impact whether and to what extent FDI will produce outcomes anticipated by the host country. While patterns can differ based on the firm, its place in the corporate family, and relevant industry and sector, FDI by a multinational enterprise may utilize fewer domestic inputs than a domestic counterpart, and may also repatriate, rather than reinvest, a greater share of its revenues. For instance, while efficiency-seeking FDI in services and manufacturing might be motivated to invest in maintaining and upgrading facilities and operations in the host country, revenues from FDI in extractive industries may be more likely to be repatriated after upfront capital expenditures have been made. These features and patterns will shape the nature and degree of firms' impacts on host countries, and the desirability of incentivizing those firms' investments.

FDI can provide important benefits for host and home countries (see Box 1), but it also poses challenges that can be hard to predict, identify, and manage. These issues, in turn, make it difficult for governments to identify whether, to what extent, in what circumstances, and how to incentivize such investment. Moreover, while FDI increases the complexity of calculations for the incentive granter, it provides advantages to firms shopping for incentives when deciding where to locate. Those firms can exploit the fact that a given enterprise frequently has a range of potential locations available to it, while information asymmetries regarding firms' locational decisions lead would-be hosts to compete for their business.<sup>46</sup>

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<sup>46</sup> Jensen, Nathan M. 2018. "Bargaining and the Effectiveness of Economic Development Incentives: an Evaluation of the Texas Chapter 313 Program." 29-51. *Public Choice*.



### 1.3 FDI and Motives

Firms invest abroad for four main categories of reasons:<sup>47</sup>

- **Market-seeking FDI:** firms search for new consumers of their goods or services;
- **Natural resource-seeking FDI:** firms pursue access to natural resources and raw materials;
- **Efficiency-seeking FDI:** firms seek to decrease costs of production by transferring production to locations with lower labor, environmental, or other costs or otherwise rationalizing their operations across borders;
- **Strategic-asset-seeking FDI:** firms pursue tangible or intangible assets (e.g., advanced technology owned by the target company) in order to strengthen their positioning vis-à-vis competitors.

Factors that influence *where* firms undertake this FDI include host states' **(a) general economic policy framework for FDI, (b) economic determinants and conditions, and (c) business facilitation environment**. Table 3 illustrates how these determinants – firm motives and host country characteristics – interact to influence where FDI occurs.<sup>48</sup>

**Table 3: Locational Determinants of Foreign Direct Investment<sup>49</sup>**

<b>Economic policy framework for FDI <sup>50</sup></b>
<p>Economic, political, and social stability</p> <p>Rules regarding entry and operations</p> <p>Standards of treatment of foreign operations</p> <p>Policies on the functioning and structure of markets (especially competition, Mergers and Acquisition [M&amp;A]; and corporate governance)</p> <p>Privatization policy</p> <p>Trade policy (tariffs and non-tariff barriers) and coherence of FDI and trade policies</p> <p>Tax policy</p>

<sup>47</sup> Dunning, John H. and Sarianna M. Lundan. 2008. *Multinational Enterprises and the Global Economy*. 63-78. [https://dipiufabc.files.wordpress.com/2015/06/dunning\\_multinational-enterprises-and-global-economy.pdf](https://dipiufabc.files.wordpress.com/2015/06/dunning_multinational-enterprises-and-global-economy.pdf)

<sup>48</sup> UNCTAD. 1998. *World Investment Report 1998: Trends and Determinants*. (Geneva: UNCTAD); UNCTAD. 2000. *World Investment Report 2000: Cross-border Mergers and Acquisitions and Development*. (Geneva: UNCTAD).

<sup>49</sup> Based on UNCTAD. 1998. *World Investment Report 1998: Trends and Determinants*. (Geneva: UNCTAD); UNCTAD *World Investment Reports 2010: Investing in a Low-Carbon Economy*. (Geneva: UNCTAD); Krüger, Ralf and Strauss, Ilan. "Africa Rising out of Itself: The Growth of Intra-African FDI." *Columbia Center on Sustainable Investment* 139; Dunning John H, and Lundan, Sarianna M. 2008. *supra* n47; Oxelheim, Lars and Pervez N. Ghauri eds. 2004. *European Union and the Race for Foreign Direct Investment in Europe*. International Business and Management Series. (Elsevier).

<sup>50</sup> Different types of FDI will put different weight on those various factors.

Good governance Protection of property rights (including intellectual property) Industrial and regional policies; development of competitive clusters Stable exchange rates	
<b>Economic determinants by multinational enterprise (MNE) motive</b>	
Market-seeking motive	Market size and per capita income Market growth Access to regional and global markets Country-specific consumer preferences Structure of markets Physical distance
Natural resource-seeking motive*	Land and building costs: rents and rates Access to raw materials, components, parts Access to natural resources
Efficiency-seeking motive	Cost of resources and assets listed under resource- or asset-seeking motives Availability and cost of unskilled and skilled labor Other input costs, including costs of other intermediate products and transportation and communication costs Membership in a regional integration agreement conducive to the establishment of regional corporate networks Different comparative advantages of countries Better deployment of global resources
Strategic asset-seeking motive*	Access to new competitive advantages, e.g., coming from firm-specific technological and other created assets (e.g. brand names) Access to technology, know-how, and marketing networks Country-specific assets (e.g., in the case of tourism, cultural heritage).
<b>Business facilitation</b>	
Investment promotion (image-building, actions to reduce information asymmetries) Investment incentives (tax, financial, regulatory, and other) Technical services, including: Reduction of hassle costs (related to corruption, administrative efficiency) Provision of social amenities (bilingual schools, quality of life) Provision of after-investment services Availability of “one-stop shop” services to centralize procedures and information	

*Note:* UNCTAD (1998) has the two categories of natural resource-seeking and strategic asset-seeking motives grouped together as “Resource/asset-seeking” motives.

The effectiveness of tax incentives on investors’ investment location decisions varies based on the nature of the business and its motive for FDI (Table 4).

**Table 4: Typology of FDI and Response to Tax Incentives<sup>51</sup>**

Type of Investment	Factors that drive investment	Response to investment tax incentives
Resource-seeking FDI	Location of natural resources/raw materials/low-skilled labor/agglomeration benefits	Lower response. FDI driven primarily by non-tax factors.
Market-seeking FDI	Market potential <ul style="list-style-type: none"> <li>- Market dimensions</li> <li>- Income per capita</li> <li>- Customer-specific preferences</li> <li>- Kind of goods and services to be provided</li> <li>- Competitors</li> </ul>	Lower response. Same tax system for all competitors (a level playing field) is critical. However, higher response at the regional level (such as within the EU or within the U.S.).
Efficiency-seeking FDI	Lower costs <ul style="list-style-type: none"> <li>- Mostly export oriented</li> <li>- Availability of skills at low costs</li> <li>- Close to markets</li> <li>- Low relocation costs</li> </ul>	Higher response to tax incentives. Firms are expected to compete globally, hence the lower the costs, the better their ability to compete globally.
Strategic-asset-seeking FDI	Acquiring strategic assets <ul style="list-style-type: none"> <li>- Brands and market positioning</li> <li>- Know-how</li> <li>- Technology</li> <li>- Distribution networks</li> <li>- Human capital</li> </ul>	Lower response. FDI is driven by the location of the asset. However, lower taxes on capital gains reduces the costs of the transfer of these assets.

Reproduced from James, 2013

This typology provides a starting point for the analysis of incentives. For example, as Table 4 shows, firms engaging in FDI to enter new markets or acquire natural resources (or other resources or strategic assets) appear less motivated by tax incentives than highly mobile and efficiency-seeking firms that seek to reduce costs for products destined for a global, rather than domestic, market. Industries, as well as firms within industries, can vary in their sensitivity to cost differences across locations, so this table provides a starting analytical framework for understanding when incentives are more or less effective in attracting investment.

It is also worth noting that, though incentives may have less effect on the location of market-seeking investments than they would on efficiency-seeking investments, they may nevertheless

<sup>51</sup> Adapted from James, *supra* n11.

have some influence on market-seeking investment decisions in cases where firms are deciding among similarly attractive locations or among similarly attractive regions of a single large market (such as the United States, European Union, or China). Further research could further nuance in this analysis by investigating how firms make investment decisions in the industrial sector.

Lastly, Box 1 presents investment incentives in the particular context of efforts to support *outward* FDI.

### Box 1: Outward FDI Incentives

Most attention given to FDI incentives has been focused on incentives for inward FDI, i.e. what support measures can be put in place to attract FDI, based on a broad consensus that the impacts of such investment and the flow of resources it brings to host countries tend to be positive. Until recently, less attention was paid to the impacts of outward FDI (OFDI), and some governments even applied measures to restrict or dissuade OFDI.<sup>52</sup> Arguments against exporting jobs and technology have quashed many measures to promote OFDI. However, governments have begun to adopt home country measures to stimulate outward investments, as at least some research substantiates the link between OFDI and other policy aims such as strong exports and economic growth, opportunities for job creation, and increasing innovation and technological development in the home country. Governments may also promote OFDI for other strategic and policy aims, such as to support sustainable development outcomes in host countries.

Thus, an increasing number of governments have become proactive in helping domestic companies scale up operations and reach new markets in order to compete in or serve the global arena. Indeed, many emerging economies have adopted strong support measures and spurred an exponential increase in OFDI, leading to some controversy and to concerns about competitive neutrality.<sup>53</sup>

*What types of OFDI incentives exist? How do they differ from those on the inward side?*

There are different typologies to categorize OFDI incentives/policies. The OECD has identified<sup>54</sup> three types: financial, regulatory and tax. Economou & Sauvant provide an alternative classification: (i) institutional framework; (ii) information services; (iii) financial measures; (iv)

<sup>52</sup> Sauvant, Karl P. 2008. "Outward FDI from Emerging Markets: Some Policy Issues." In John H. Dunning and Philippe Gugler eds. *Foreign Direct Investment, Location and Competitiveness, Progress in International Business Research* Vol. 2. 279-284.

<sup>53</sup> Sauvant Karl P., Persephone Economou, Ksenia Gal, Shawn Lim, and Witold P. Wilinski. 2014. "Trends in FDI, Home Country Measures and Competitive Neutrality." In Andrea K. Bjorklund ed. *Yearbook On International Investment Law and Policy 2012–2013*. (New York: Oxford University Press) 3-108.

<sup>54</sup> OECD supra n3.

fiscal measures; (v) investment insurance measures; (vi) treaties.<sup>55</sup> Here, we propose the following five categories:

#### Outward FDI Home Country Measures

Tax	Tax breaks/exemptions, rate reductions, tax deductions, loss carryforwards, deferrals, accelerated depreciation, customs benefits. <sup>56</sup>
Financial	Monetary transfers – cash or subsidies. Grants, loans (preferential access to credit and/or low interest) and even equity participation on investment projects. <sup>57</sup>
Risk-minimizing measures	Political risk insurance (PRI) and credit risk insurance. PRI protects against political upheavals, losses due to certain events such as expropriation/nationalization, war, and other conflicts, and restrictions on the repatriation of capital. Credit risk insurance relates to the failure of clients to honor their payments.
Regulatory and investment climate measures	Regulatory measures – measures including investment agreements, double taxation treaties – shaping the legal and economic investment climate in potential host countries.
Information and technical services	Information on markets and operations (economic data, information on industry and on other stakeholders – competitors, suppliers, clients, partners, entities from the scientific/technological system, global value chains, costs, skills, availability of distinct resources, identification of opportunities, other business intelligence; services such as feasibility research, legal support, skill training programs, consulting activities, international exchange programs for human resources, support to trade fairs and missions, etc.)

Probably the most critical difference vis-à-vis inward FDI policy is that home countries have less control over the host environment and associated stakeholders and locational attributes. Thus, the home country is more constrained (or even powerless) in the ability to change some of these

<sup>55</sup> *Id.*

<sup>56</sup> Tavares-Lehmann, Ana Teresa, Angelo Coelho, and Frederick Lehmann. 2013. “Taxes and Foreign Direct Investment Attraction: A Literature Review.” In Rob Van Tulder, Alain Verbeke, and Liviu Voinea eds. *Progress in International Business Research* 7. 89-116.

<sup>57</sup> UNCTAD. 2001. *Trade and Development Report 2001*. (Geneva: UNCTAD).

factors. At home, they are naturally better able to influence relevant FDI-related determinants. For example, the home country's government cannot change several relevant aspects pertaining to the investment decision and its profitability/performance (labor laws, the bureaucratic circuit to be followed, the granting of favorable or exceptional positive discrimination measures, etc.). While very influential home countries may be able to influence policy adoption in weaker host countries, they still are markedly less influential than within their own borders.

Another key difference is likely that monitoring of outcomes in third states may be especially difficult, and positive indicators in those host states may not align with the indicators of success being used in the home country. All this, together with the comparative lack of experience in the design and implementation of OFDI incentives, renders the task of conceiving and putting into practice OFDI policies more complex than what concerns their inward-focused counterparts.

#### *1.4 Do Incentives Matter for Investment Location Decisions in General?*

Several studies indicate that the role of incentives in influencing investment location decisions by both domestic and foreign investors is often limited in developing and emerging countries (Table 5) across sectors and motivations. This may be because tax incentives are often unable to compensate for unattractive investment environments marked by poor infrastructure, legal and economic instability, weak governance, and small markets.<sup>58</sup> Morisset and Pirnia thusly argue that “incentives will generally neither make up for serious deficiencies in the investment environment nor generate the desired externalities.”<sup>59</sup>

In Table 5 we summarize various studies looking at the effectiveness of incentives in terms of shaping investment location decisions. For example, World Bank Investment Climate surveys consistently find that investors do not consider incentives to have been pivotal for their investment decisions. Other studies survey investors on the factors that are most important for their investment decisions. These surveys reveal that incentives are a minor factor in firms' investment decisions.

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<sup>58</sup> FIAS showed that “for countries with weak investment climates, a lower marginal effective tax rate (METR) has limited impact on FDI. The average response is much more pronounced in countries with good investment climates. For example, having an METR of 20% instead of 40% raises FDI by 1% of GDP for countries ranked in the bottom half in terms of investment climate – while the same difference in METR has an effect eight times greater for countries in the top half. This finding implies that tax incentives are far less effective in weaker investment climates than in stronger ones.” James, Sebastian. 2013. *Tax and Non-Tax Incentives and Investments: Evidence and Policy Implications*.

<sup>59</sup> Morisset, Jacques and Neda Pirnia. 2001. “How Tax Policy and Incentives Affect Foreign Direct Investment: A Review,” in Wells et al. eds. *Using Tax Incentives to Compete for Foreign Investment*. World Bank Group, Foreign Investment Advisory Service (FIAS). 23.

**Table 5: Tax Incentives and Locational Decisions-Survey**

Author	Focus of survey	Conclusion		Did incentives influence Investment level? (share saying yes)
Investment Climate Advisory investor motivation surveys <sup>60</sup>	Burundi (2011)	Redundancy ratio for incentives (would have invested even if incentives were not provided)	77%	30%
	Guinea (2012)		92%	6%
	Jordan (2009)		70%	28%
	Kenya (2012)		61%	11%
	Nicaragua (2009)		15% (51% for non-exporting firms outside free zones)	17%
	Rwanda (2011)		98%	21%
	Tanzania (2011)		91%	8%
	Tunisia (2012)		58%	25%
	Uganda (2011)		93%	13%
FIAS <sup>61</sup>	Thailand (1999)		81%	-

<sup>60</sup> James, supra n11, 14

<sup>61</sup> Foreign Investment Advisory Services (FIAS), World Bank. 1999. *Kingdom of Thailand – A Review of Investment Incentives*. Washington, DC: World Bank.

Nathan Associates <sup>62</sup>	Mozambique (2009)		78% <sup>63</sup>	13%
UNIDO <sup>64</sup>	Covering 2000-2011, 7000 firms in 19 countries in sub-Saharan Africa <sup>65</sup>	Incentives ranked 11th out of 12 location factors; incentives also noted as a “deteriorating” factor over the previous 3 years		
Bartik <sup>66</sup>	Meta-analysis of 30 published studies in the US	Redundancy rates between 75% to 98%, with higher rates for less biased studies.		

This summary of studies combines analysis of different types of programs across countries and illustrates a general pattern of locational incentives’ inefficacy.

To glean more comparable insights on the efficacy of these programs, analysts could examine a single country’s incentive programs for how they influence firm behavior. Some of the most sophisticated work on incentives explores various national, state, and local incentives in the United States. For instance, in a meta-analysis of 30 published studies of incentives, Bartik finds “but for” percentages of 2% and 25%.<sup>67</sup> In other words, incentives were only responsible for swinging

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<sup>62</sup> Bolnick, Bruce. 2009. *Investing in Mozambique: The Role of Fiscal Incentives*. Report for USAID. In this study, a survey was conducted between November 2008 and January 2009, “interviewing senior managers at 60 companies that obtained investment approvals from [Mozambique’s] Center for Investment Promotion (CPI) in 2005, 2006, and 2007. Companies come from the three major economic regions of Maputo, Nampula, and Sofala. The survey used a “1:5 stratified random sample (with explicit substitution rules to deal with selected companies that could not be contacted), [with a] “stratification was designed to obtain a representative sample by year, region, and sector.” The geographic distribution of the interviewees led to underrepresentation of agriculture and tourism and overrepresentation of industry, construction and transport “as compared to the overall set of approved investments by CPI.”

<sup>63</sup> 47 out of 60 companies (78%) surveyed said that they did not need an income tax break to invest

<sup>64</sup> UNIDO. 2011. *Africa Investor Report 2011: Towards Evidence Based Investment Promotion Strategy*. (Vienna: UNIDO). [http://www.unido.org/fileadmin/user\\_media/Publications/Pub\\_free/AIS\\_Report\\_A4.pdf](http://www.unido.org/fileadmin/user_media/Publications/Pub_free/AIS_Report_A4.pdf).

<sup>65</sup> 64% were domestic and 36% partly or wholly foreign- owned. Local market seekers represent 89% of the domestic surveyed firms and 74% of the foreign ones; “regional market seekers with a substantial proportion of their sales exported to sub- Saharan Africa excluding South Africa,” represent 5% of domestic and 11.5% of foreign surveyed firms; and global market seekers represent 6% of domestic and 14.5% of foreign firms. The primary sector represents 4.7% of the sample, high technology manufacturing, 7.7%, medium technology manufacturing, 13.4%, low technology manufacturing, 27.5% and services, 47.3%. “At individual subsector level, the largest groups were trading firms, (16%), food and beverage manufacturers, (11%), consultancy firms (7.4%) and basic metals and metal fabrication, (6.2%).

<sup>66</sup> Bartik, Timothy. 2018, *supra* n6.

<sup>67</sup> *Id.*



between 2% and 25% of investments, and were ineffective between 75% and 98% of the time. As noted by Bartik

, the variation in these estimates is the result of research methodology – many studies seem to be biased towards finding that incentives have a positive effect on firm decisions. For example, firms that apply for expansion incentives are most likely different from firms that are not applying for incentives. Studies that compare incentive applicants relative to non-applicants as a control group are biased towards finding incentives are effective in encouraging expansion decisions.

Other research on the effectiveness has been conducted in the European Union where the State Aid regime<sup>68</sup> has improved transparency and analysis of government incentives. One study published in 2020 examined the role of EU Member States’ investment incentives in shaping investors’ location decisions. Based on literature reviews, econometric analysis, surveys, and interviews, the study concluded that:

- The existence of investment incentives will not likely cause an investor to locate its investment in a particular location; but it may be a factor that helps companies choose between a shortlist of relatively similarly situated jurisdictions.
- The absence of incentives in one jurisdiction, when other jurisdictions offer incentives, may cause an investor to reject the jurisdiction without the incentives. In other words, while an incentive may not bring an investment, the lack of an incentive may result in a jurisdiction not attracting investment.
- Investors from some home countries seem to put more weight on the offer of incentives than others.
- “The literature on the impacts of regional aid on the EU’s ability to direct investments to disadvantaged regions of the EU is reviewed in the fourth subsection. The empirical evidence suggests that aid has an impact on the decision making of small and sometimes even medium-sized firms, but there is little evidence that aid would affect the incentives of large firms.”<sup>69</sup>

The redundancy of incentives may be due to their design. For example, Jensen (2018) examines a Texas incentive program that structurally leads to the overuse of incentives.<sup>70</sup> This program allows local school districts to provide tax abatements to firms, but the school districts pass the costs of

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<sup>68</sup> For more on the State Aid regime, see *infra*, Section 2.3.

<sup>69</sup> European Commission, Directorate-General for Competition, Retrospective evaluation of the regional aid framework – Final Report (2019) 80. Accessible at:

<https://www.sheppardmullin.com/assets/htmldocuments/Retropective%20evaluation%20of%20the%20regional%20aid%20framework%20-%20final%20report.pdf>.

<sup>70</sup> Jensen 2018, *supra* n46.

these abatements to the state. These school districts not only receive the tax revenue for these investments (from the state), but they can also require additional “supplemental payments” from firms. School districts generate more tax revenues by offering abatements through these programs (by being compensated by the state along with supplemental payments) leading to the overuse of incentives. Jensen (2018) found that 85% of these firms would have been located in Texas even without this incentive program.

Another issue is that even if an incentive succeeds in attracting investment, the investment attracted may not be ideal. For example, some research on regulatory incentives found that while jurisdictions with low environmental standards might have been able to use those low standards to attract efficiency-seeking firms, the firms primarily responding to those environmental incentives were not the most competitive.<sup>71</sup>

While such studies are surely not conclusive, their results raise serious questions about the efficiency and efficacy of many investment incentives to attract or keep the investment. Given the scarcity of public capital for investments in development-driving public goods, this data points to a need to more carefully design and monitor the impact of investment incentives.

### *1.5 Behavioral Incentives*

Much of this report focuses on locational incentives: incentives provided to entice investors to come to, or stay or expand in, a particular jurisdiction. However, there are also behavioral incentives (which can be combined with locational incentives) that seek to encourage investors to modify their operations, such as by investing in R&D on different problems or at a greater scale than they otherwise would have without the incentives,<sup>72</sup> or shifting to cleaner, more environmentally sound modes of production than they would employ absent the incentives.<sup>73</sup>

When considering the use, effectiveness, costs and benefits of incentives, it is useful to distinguish between behavioral incentives and locational incentives. Studies on the effectiveness of investment incentives, for instance, often ask investors whether they would have invested in a particular location absent the incentive, or about the importance of investment incentives influencing investors’ decisions to invest in a specific host country relative to other characteristics of the host country (e.g., the quality of infrastructure, the general business climate). These studies, as noted above, often raise questions about the efficacy of locational incentives. Research on behavioral incentives, in contrast, will have different targets and ask different questions, and produce different

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<sup>71</sup> Dowell G., Hart S., Yeung B. (2000) “Do Corporate Global Environmental Standards Create or Destroy Market Value?” *Manag Sci* 46(8):1059– 1074. <https://doi.org/10.1287/mnsc.46.8.1059.12030>

<sup>72</sup> See Aiello, Francesco, Giuseppe Albanese, Paolo Piselli. (2019). “Good Value for Public Money? The case of R&D policy” *Journal of Policy Modeling*, 41(6): 1057-1076, which examines the effect of public R&D subsidies on R&D outputs (patents), as distinct from R&D inputs (e.g., expenditures, employees).

<sup>73</sup> Biffi, Sofia; Traldi, Rebecca; Crezee, Bart; Beckmann, Michael; Egli, Lukas; et al. *Environmental Research Letters; Bristol* 16, Iss. 5, (May 2021). DOI:10.1088/1748-9326/abfa4e

insights and lessons for policymakers. Analysis of behavioral incentives has, at least in some contexts, been more positive.<sup>74</sup>

Throughout this report, we seek to distinguish between research and insights on locational incentives, and research and insights on behavioral incentives. Overall, it seems that while many of the best practices regarding the use of incentives apply to both categories, locational incentives give rise to more concerns about races to the bottom and harmful competitions for capital.

## *1.6 Conditions Under Which Investment Incentives Make Economic Sense*

There are conditions under which the provision of investment incentives can be strategic. Examples of factors or situations providing an economic rationale for the use of investment incentives include providing incentives 1) for the provision of public goods; 2) to generate positive externalities; 3) to address credit market failures; and 4) to overcome private firms' risk aversion. These are discussed below. Most often, the situations in which governments may use investment incentives is a combination of more than one of those factors or situations. Yet, as Sebastian James notes, recognizing that there are economic rationales supporting the use of incentives does not mean "that incentives should be offered to correct all such market failures or anomalies."<sup>75</sup> It rather means "that there are areas where governments may consider applying further analysis to see if intervention through incentives is warranted."<sup>76</sup>

### **1.6.1 Public Goods**

When faced with the challenge of defining a policy to stimulate certain economic activities or sectors, or to attract investment, a government should always decide which policy approach is more likely to generate the most beneficial effect on the citizens' welfare. For example, there is a trade-off between spending directly on public goods and services, and spending it to provide investment incentives that can indirectly generate public goods. The marginal benefit from an additional investment in a public good is usually more than its marginal cost, especially when the supply of such public good is low. Hence, it would be beneficial to invest more in public goods. At the same time, an investment incentive can attract private investment that is beneficial to the economy. Thus, when comparing spending options, a government should consider the opportunity costs of public funds.<sup>77</sup>

For example, if a government invests in the improvement or upscaling of roads, telecommunications, or education in areas where these were previously weak, that investment will

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<sup>74</sup> See, e.g., Howell, Sabrina T. 2017. "Financing Innovation: Evidence from R&D Grants." *American Economic Review*, 107(4):1136-64.

<sup>75</sup> James, *supra* n1, 17

<sup>76</sup> *Id.*

<sup>77</sup> *Id.*

likely be more effective in attracting new investment, compared to granting the same amount of money in tax incentives to, say, a mining company in that area.<sup>78</sup>

Another issue is that the market will never supply certain public goods, or if it does, it will do so insufficiently. In such cases, one should consider whether investment incentives can efficiently address the undersupply.<sup>79</sup>

### 1.6.2 Positive Externalities

Economic activity often leads to spillover effects or positive externalities on the economy, social welfare, and environmental protection that governments want to encourage, possibly through the use of incentives aimed at fostering sustainable development. Positive externalities could be the result of:

- “investments in technology such as research and development or high-tech industries that improve workers’ productivity;
- improvements in overall access to electricity that encourage business growth;
- job creation in areas of high unemployment;
- adoption of environmentally friendly technology; and
- anchor investments, meaning those that provide multiplier effects through signaling and by creating backward linkages into the local economy.”<sup>80</sup>

For example, a 2018 report by Austin, Glaeser and Summers argues that some place-based policies can be economically efficient if targeted at high-unemployment areas.<sup>81</sup> They find that externalities associated with non-employment in certain areas can justify government intervention to create jobs. Thus, the size of the positive externalities associated with employment creation is, unsurprisingly, context-dependent, with higher returns in areas with higher unemployment.

### 1.6.3 Credit Market Failure

Governments may use financial incentives in situations where firms might be credit-constrained and therefore unable to undertake investments even if promisingly profitable. The best solution in this case would be to address inefficiencies in the credit market. Yet developing inclusive financial systems takes time and can be expensive;—and ultimately, decisions about who receives loans

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<sup>78</sup> *Id.*

<sup>79</sup> *Id.*

<sup>80</sup> *Id.*

<sup>81</sup> Austin, Benjamin, Edward Glaeser, and Lawrence Summers. 2018. *Saving the Heartland: Place-Based Policies in 21st Century America*. Brookings.

will be determined by financial institutions and not the government. While the main emphasis should remain on improving the availability and quality of term finance as part of developing financial systems, it might also be strategic for some governments to provide financial incentives, such as matching grants or subsidized loans.

First, they can partially fix the credit market failure by directly providing credit for activities that banks would not traditionally finance. Banks tend to finance activities that can be collateralized, such as the purchase of equipment. However, “they are less likely to finance consulting, training, or high-risk intangible activities such as those associated with start-ups and innovation, for which matching grants are often used.”<sup>82</sup> Second, matching grants can provide a signal of the good quality of the investment, which reduces the risks for banks to provide credit and increases the likelihood of future successful loan applications.<sup>83</sup>

#### 1.6.4 Private Firm Risk Aversion

Governments may also use financial incentives to entice risk-averse firms. These firms might avoid investing even with an expectation of high returns if high, uninsurable risk is involved. In this case, an equity market or a venture capital market would be optimal, enabling firms to share risks with investors. However, in the absence of an equity or venture capital market, financial incentives such as matching grants, equity participation, and subsidized loans can increase the expected return on the investment by lowering its price, which encourages firms to take on riskier projects.<sup>84</sup>

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<sup>82</sup> A matching grant is a very common tool used by governments in developing countries and is generally a partial subsidy “provided by a government program to a private sector firm to help finance the costs of activities to promote exports, innovation, technological upgrading, the use of business development services, and, more broadly, firm growth.” (Campos et al., 2012 *supra* n83)

<sup>83</sup> Campos, Francisco, Aidan Coville, Ana M Fernandes, Markus Goldstein, and David McKenzie. 2012. *Learning from the Experiments That Never Happened. Lessons from Trying to Conduct Randomized Evaluations of Matching Grant Programs in Africa*. Policy Research Working Paper 6296, World Bank, Washington, DC. 6.

<sup>84</sup> *Id.*

## Section 2: Global Trends in Investment Incentives

To evaluate incentives and the policies governing them, it is important to gather information on their use. Several older studies have sought to answer this question, compiling data on incentives granted by various countries worldwide over the past several decades. These include research from the United Nations Conference on Trade and Development (UNCTAD) in the 1990s covering the types and use of incentives in more than 100 countries;<sup>85</sup> a study published by the Development Centre of the OECD;<sup>86</sup> research on investment incentives in Africa by the United Nations Industrial Development Organization (UNIDO);<sup>87</sup> data on aid in the European Union by the European Competition Commission; and other information collected by academics,<sup>88</sup> the media,<sup>89</sup> and nongovernmental organizations.<sup>90</sup>

This section uses these sources to broadly illustrate patterns and practices regarding the use of tax and financial incentives over time and in different regions around the globe. We include some studies examining the use of incentives as far back as the 1990s. We include them due to the fact that they have looked at the policy tools covered by this report and in order to provide context. Nevertheless, we also note that the landscape of international economic activities has changed dramatically in recent decades. The rise of bilateral and plurilateral trade and investment agreements has liberalized the flow of goods, services, and capital across borders; those policy shifts, combined with technological changes, have resulted in the rise and expansion of global value chains. The mobility of firms and segmented nature of production likely have implications for the use of incentives and would not be fully addressed in early studies on the global use of incentives.

Another caveat when reviewing studies is that there are significant limitations in terms of what is known about incentives practice, which results from the discretionary and frequently opaque

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<sup>85</sup> UNCTAD. 1995. *World Investment Report 1995: Transnational Corporations and Competitiveness*, 298. (Geneva: UNCTAD).

<sup>86</sup> Oman, Charles P. 2000. *Policy Competition for Foreign Direct Investment*. Development Centre Studies. (Paris: OECD Development Centre).

<sup>87</sup> UNIDO. 2011. *Africa Investor Report - Towards Evidence Based Investment Promotion Strategy*. (Vienna: UNIDO).

<sup>88</sup> Thomas, Kenneth P. 2000. *Competing for Capital: Europe and North America in a Global Era*. (Washington, DC: Georgetown University Press); Thomas 2011, *supra* n14.

<sup>89</sup> Story, Louise. 1 December 2012. "As Companies Seek Tax Deals, Governments Pay High Price." *New York Times*.

<sup>90</sup> Pew Charitable Trusts. *Economic Development Tax Incentives Project*; For more information, visit <http://www.pewstates.org/projects/economic-development-tax-incentives-project-329163>.

nature through which many incentives are granted, and limited requirements to report on incentives granted or outcomes achieved.<sup>91</sup>

The figures from the EU stand out in that they provide a relatively comprehensive set of information regarding the use of incentives. This is due to requirements for member states to report subsidies and the EU's public disclosure of reported information. While EU data does not capture all incentives offered by its member states or incentives granted by the EU's institutions, its reporting requirements, their enforcement, and the public release of the information provide a degree of transparency that is unique as compared to many other regions of the world. Apart from the EU and efforts by some subnational entities, information regarding the use of incentives (e.g., what is being provided, who is granting incentives, for what type of investment to what investor, and at what aid intensity) has not been systematically collected or disclosed, hindering research and analysis of policy issues and solutions.

## *2.1 An Overview of Global Practices*

Two 2018 reports, one by the World Bank presenting findings on tax incentives offered by 107 developing countries from 2009 through 2015<sup>92</sup> and another by UNCTAD offering insights from a survey of WTO Trade Policy Reviews, provide an overview of the use of tax and, albeit to a lesser extent, other types of incentives offered by countries across the globe. Key findings on those incentives included:

- At least 75% of developing countries use tax incentives.<sup>93</sup>
- Financial incentives appear to be used less frequently than tax incentives in developing countries but seem to play a greater role in developed countries.<sup>94</sup>

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<sup>91</sup> While steps have been taken to increase transparency at the national level, significant gaps remain; furthermore, there remain major challenges in understanding the use of incentives at subnational levels. On that issue within the US, see, e.g., Hinkley, S., and Weber, R. (2021). "Incentives and Austerity: How Did the Great Recession Affect Municipal Economic Development Policy?" *Urban Affairs Review*, 57(3), 820–855. <https://doi.org/10.1177/1078087420964254>.

<sup>92</sup> World Bank researchers compiled this information in a Developing Country Tax Incentives Database, which drew from sources such as Ernst and Young's "Global Tax Guides" and the websites of investment promotion agencies. Note, this database is limited in a number of ways. It doesn't include indirect taxes such as customs duties or VAT exemptions, or other types of incentives such as financial or regulatory incentives. It also does not include incentives granted at the subnational level, nor other discretionary deals such as those agreed through specific investor-state contracts.

<sup>93</sup> World Bank Group. 2018. *Global Investment Competitiveness Report 2017/2018: Foreign Investor Perspectives and Policy Implications*. (Washington, DC: World Bank). As noted above, studies of tax incentives are likely to underestimate their use.

<sup>94</sup> See European Commission. 2021. *State Aid Scoreboard 2020*, pp. 25-27.



- The trend seems to be toward increasing in frequency and generosity of incentives. While “[almost half of all countries introduced new tax incentives or increased existing ones ... in the five-year period to 2016,” “[f]ewer than a quarter abolished tax incentives or made them less generous.”<sup>95</sup>
- Roughly 40% of developing countries offer tax incentives indiscriminately to all or most economic sectors. This means that incentives may be offered to investors in sectors and activities that are typically not influenced (or influenced primarily) by tax incentives, such as natural-resource-seeking investors and market-seeking investors.<sup>96</sup>
- Profit-based incentives such as tax holidays and preferential tax rates appear more common than cost-based incentives, notwithstanding general consensus about cost-based incentives being the better policy tool, due to the administrative challenges. (See Section 3)
- Among developing countries, tax holidays are the most commonly used tax incentive, followed by preferential tax rates. When tax holidays are granted, the median duration is 10 years.<sup>97</sup>
- UNCTAD’s survey of recent WTO Trade Policy Reviews found that roughly 80% of manufacturing incentives schemes were tied to compliance with performance requirements such as requirements for minimum capital investments, to invest in a particular location, to contribute to R&D, or to create a certain number of jobs.

In sectors that are largely efficiency-seeking, competition to attract FDI is high, leading to greater use of incentives.<sup>98</sup> Sectors seeking access to natural resources and domestic markets are less influenced by incentives. Yet many developing countries offer incentives to all sectors. Across the board, incentives do not compensate for less favorable investment climates overall.

Furthermore, those tax incentives were more effective when used to attract efficiency-seeking FDI, because these are the most motivated to lower production costs.<sup>99</sup> The World Bank report identifies a global trend towards lower taxation of “geographically mobile capital” as governments compete

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<sup>95</sup> UNCTAD. 2018. *World Investment Report 2018: Investment and New Industrial Policies* (Geneva: UNCTAD), 149. The UNCTAD study based its data on the 2018 World Bank report.

<sup>96</sup> Andersen, Maria R., Benjamin R. Kett, and Erik von Uexkull. 2018. “Corporate Tax Incentives and FDI in Developing Countries”, 76 in World Bank Group, *Global Investment Competitiveness Report 2017/2018: Foreign Investor Perspectives and Policy Implications*.

<sup>97</sup> *Id.* 75.

<sup>98</sup> *Id.* 82-86.

<sup>99</sup> *Id.* 22-26.



to attract FDI.<sup>100</sup> As countries continue to lower taxes in response to a competitor's move to attract investment, the intended effect of incentives is greatly diminished.

## *2.2 Policy Objectives and Implementation Approaches*

The 2018 UNCTAD study,<sup>101</sup> which dealt solely with developing countries, also supports what previous studies have revealed, which is that there are a number of different motives behind countries' use of incentives, including strategies that are regionally oriented; focused on developing prioritized areas or activities; or applied to support certain industries.

In middle- and high-income countries, there is an emphasis on promoting strategic sectors and high-growth activities. With some exceptions, eligibility criteria in those countries for incentives rarely discriminate between foreign and national investors. That said, in practice, foreign enterprises may be better positioned to acquire certain incentives because they can be more flexible in location choice and more apt to conduct R&D, or to invest in strategic sectors. The main types of policy objectives relate to:

- job creation/retention;
- promotion of strategic or priority sectors;
- development of human resources;
- supporting R&D and the transfer of technology;
- encouraging investment in less developed areas within a country; and
- supporting the growth of SMEs.

The incentives awarded to industries of high added-value production tend to be more substantial than those awarded to other industries. Some countries (e.g. Rwanda and Uganda) have very targeted incentives, such as those that focus exclusively on technology R&D or the growth of SMEs.<sup>102</sup> Low-income countries, on the other hand, appear more likely to adopt “specific” incentive approaches tailored to individual investors or projects. They are more likely to offer incentives on a case-by-case basis.

Countries that are loosely acknowledged to have achieved success with their investment schemes in the investment policy literature mentioned above (e.g., Austria and Czech Republic) tend to

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<sup>100</sup>See supra n93, 78. For more information: Klemm, A., and S. Van Parys. 2012. “Empirical Evidence on the Effects of Tax Incentives.” *International Tax and Public Finance* 19 (3): 393–423

<sup>101</sup> See supra n95.

<sup>102</sup> *Id.* 137.

focus on projects that prioritize (i) staff training (human resources), (ii) the diffusion of technology, and (iii) the development of lesser developed regions.

### *2.3 Investment Incentives in the European Union: State Aids*<sup>103</sup>

In the EU, some incentives are considered “State Aid,” which is defined under EU law as: (1) aid, in any form whatsoever, (2) which confers an advantage or benefit for the recipient; (3) granted by a member state or through state resources; (4) distorts or threatens to distort competition by favoring certain undertakings;<sup>104</sup> or the production of certain goods; and (5) affects or is likely to affect trade between member states. All five elements must be met for government assistance to count as State Aid (see also Box 2 below and Section 4). Those that do constitute State Aid are prohibited unless they are used for certain policy objectives and satisfy other tests, such as whether they are proportionate to their goals.

Although not all investment incentives fall within this definition, many do. Data compiled by the European Competition Commission on State Aid thus helps illustrate the use of incentives in EU Member States.

#### **Box 2: Key Concepts and Definitions in EU Regulation of State Aid**<sup>105</sup>

**Aid intensity:** Aid intensity is a measurement of aid that looks at the amount of aid as a percentage of the total investment. EU rules require the calculation of aid intensity in terms of “gross grant equivalents,” or the discounted value of the aid expressed as a percentage of the discounted value of specified eligible investment costs. Under EU regulations, the permissible level of aid intensity varies based on the economic conditions in the jurisdiction granting the incentive. The more disadvantaged states and regions are able to provide incentives at a higher degree of aid intensity than the less disadvantaged states. If an incentive is being used to support a small to medium-sized enterprise, the permissible aid intensity will rise; but if the incentive is used to support a “large

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<sup>103</sup> The information on the EU data and regime in this report is current as of the 2020 Scoreboard published in 2021.

<sup>104</sup> An undertaking is any entity (this includes legal persons, such as a company, and individuals acting as sole traders) that is engaged in an economic activity (C-303/88 Italy v Commission 1991 ECR I-1433). An economic activity is “any activity consisting of offering goods and services on a given market” (C35/96 – Commission v Italy 1998 ECR I-03851). When an organization is carrying out an activity for which it is capable of being remunerated and competing against other organizations within a market, it will be an undertaking for the purposes of State Aid. The Commission applies the undertaking test very narrowly. It does not take into account whether a fee is charged or whether the amount of profit is appropriate. Neither does it consider whether the organization has charitable aims or other social objects. Public sector organizations that have engaged in an economic activity have been found to be undertakings. (Italy v Commission, 1991 ECR I-1433).

<sup>105</sup> European Union Commission. 2012. *State Aid Scoreboard: Report on State Aid Granted by the EU Member States*. Autumn 2012 Update.

investment project” the permissible aid intensity will drop. The European Commission develops specific guidelines to determine allowed aid intensities.

**Form of aid:** States provide aid in many different forms. Aid may, for example, take the form of grants; low-interest loans or interest rebates; state guarantees; the purchase of a share-holding or an alternative provision of capital on favorable terms; exemptions or reductions in taxes; social security or other compulsory charges; or the supply of land, goods or services at favorable prices.

**Horizontal aid:** Horizontal aid is used to pursue objectives of common interest in accordance with Article 107(3) of the Treaty on the Functioning of European Union (TFEU). EU rules may permit horizontal aid even though it does not meet the definition of State Aid. It includes aid for the pursuit of environmental goals; research, development and innovation; employment and training; and support of small- and medium-sized enterprises. States granting such aid can use different tools, such as reporting requirements and claw-back provisions, to ensure that aid is used to support the intended policy objective.

**Noncrisis State Aid:** Noncrisis State Aid excludes measures aimed at supporting the financial sector, aiding recapitalization and providing impaired asset relief in relation to the financial crisis. Following EU methodology adopted in order to avoid distorting the picture of trends, the discussion in this report excludes crisis aid unless otherwise stated. The EU’s methodology for calculating non-crisis State Aid also excludes subsidies to the railway sector and aid for services of general economic interest.

**Investment aid v. operating aid:** Investment aid is “aid awarded for investment in material and immaterial assets relating to the setting up of a new establishment, the extension of an existing establishment, diversification of the output of an establishment into new, additional products, or a fundamental change in the overall production process of an existing establishment.” Operating aid is regional aid used to reduce a firm’s current expenses (e.g., tax exemptions or reductions in social security contributions). Because operating aid is not considered to be tied to new investment, job creation, or general development, it is only rarely permitted.

**Regional aid:** This category of State Aid is granted to promote the economic development of certain disadvantaged regions within the European Union. It consists of (1) investment aid granted to large companies in designated areas or, in specific limited circumstances, operating aid; and (2) investment aid to small- and medium-sized enterprises within disadvantaged regions that exceeds what is allowed in other areas. Because of its policy purpose, this type of State Aid may be allowed, subject to certain criteria. The amount of aid permitted depends on the degree to which the region is disadvantaged relative to other areas of the EU, or relative to the national average. Regional aid maps are used to determine the regions that are eligible for regional investment aid and the maximum aid intensities for those regions.

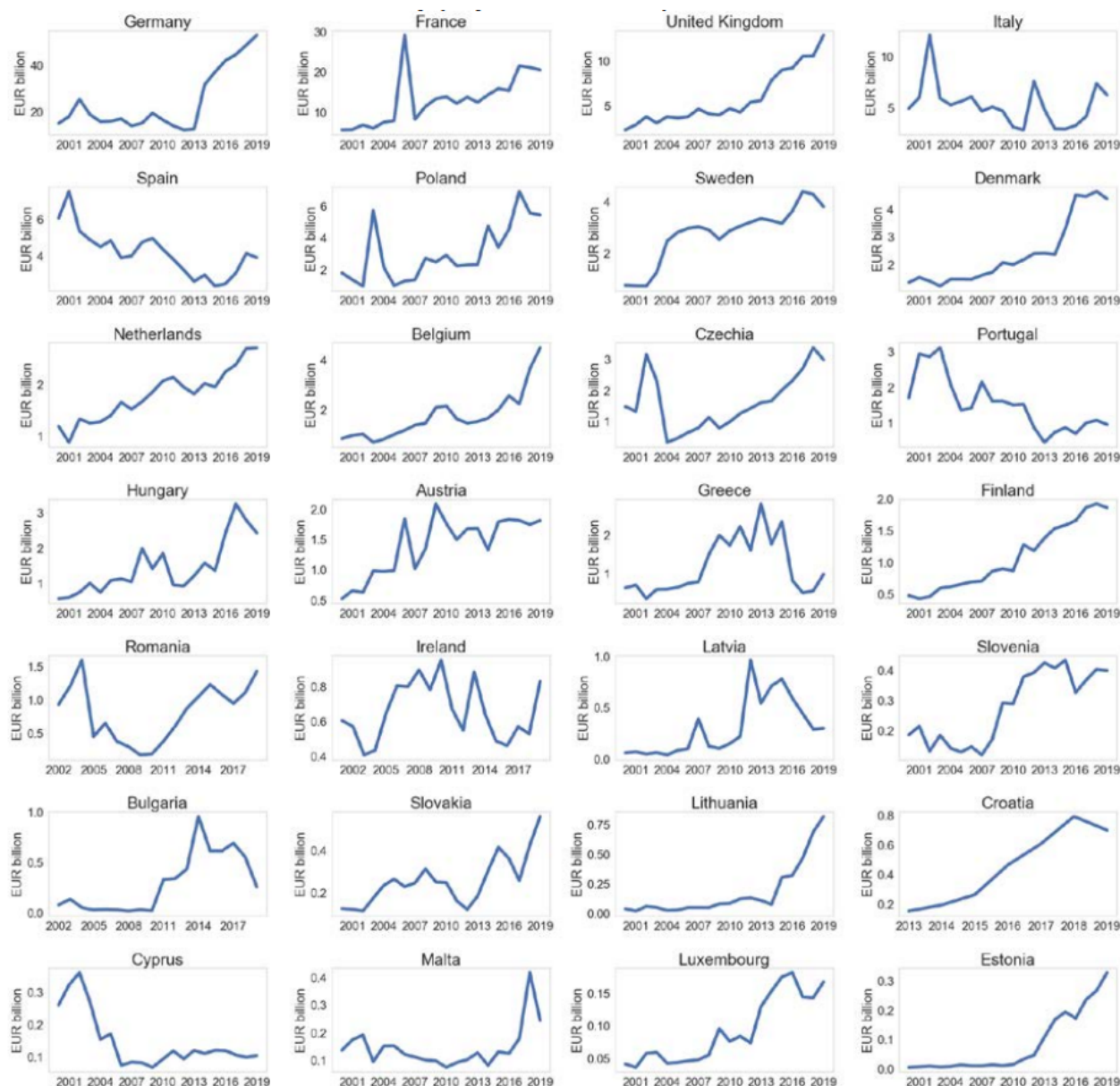
Data reported by EU member states indicates that the use of State Aid has generally decreased significantly since the 1980s, likely due to the implementation and enforcement of regulations on such aid (those regulations are described further in Section 4). Yet, since 2014, when the EU reformed its State Aid scheme, State Aid has been on the rise again in absolute terms and, generally, as a percent of GDP.<sup>106</sup> (See Figure 1). In 2019, State Aid amounted to roughly 0.81% of GDP across EU Member States.<sup>107</sup> Spending per country, and within each country over time, varies significantly. Figure 1 below shows absolute levels of spending in EU member states from 2000 to 2019, while Figure 2 shows spending as a percentage of each member state's GDP from 2009 to 2019.

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<sup>106</sup> To help the economy in the wake of the COVID-19 outbreak, the European Commission adopted the Temporary Framework for COVID-19 State aid ("Temporary Framework") in March 2020, which allows EU Member States to have State aid approved quickly by the Commission. It has been amended six times since then: First, expanding public funding opportunities for research, testing, and production of COVID-19-fighting products. Second, to enable recapitalization and subordinated debt measures; and third, to provide additional support for micro, small, and start-up businesses, as well as to encourage private investment. A fourth amendment extended the Temporary Framework's coverage once more and extended its application until 2021. The Fifth Amendment extended the Temporary Framework's application until the end of 2021, increased the amount of aid that the Commission could approve, and allowed the conversion of a limited amount of repayable Temporary Framework aid to grants. Lastly, the 6th Amendment prolonged the Temporary Framework until 30 June 2022 and has added investment and solvency support measures to aid economic recovery and raise certain aid ceilings. To accurately show historic trend, this study only examines the notion of "default" State Aid mechanism for the period preceding global Covid pandemic. Thus, potential effects of the EU's Covid recovery actions, or the Ukraine-Russia war were not addressed.

<sup>107</sup> Although this is low relative to the 1980s, when State Aid was roughly 2% of GDP, the amount of State Aid has roughly doubled since 2010. European Union Commission

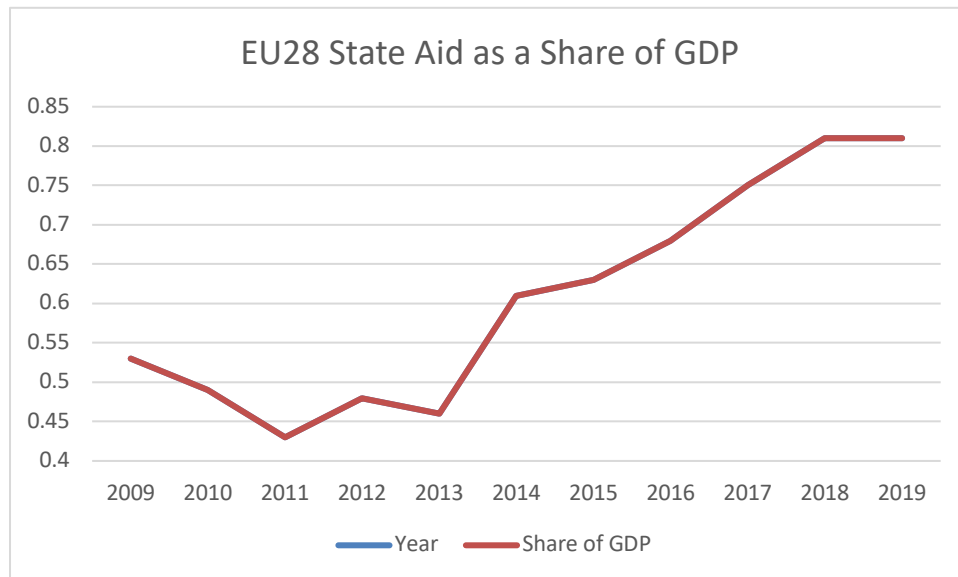
**Figure 1: State Aid Expenditure from 2000-2019, Excluding Aid to Agriculture, Fisheries, and Railways, by Member State, in EUR billion**



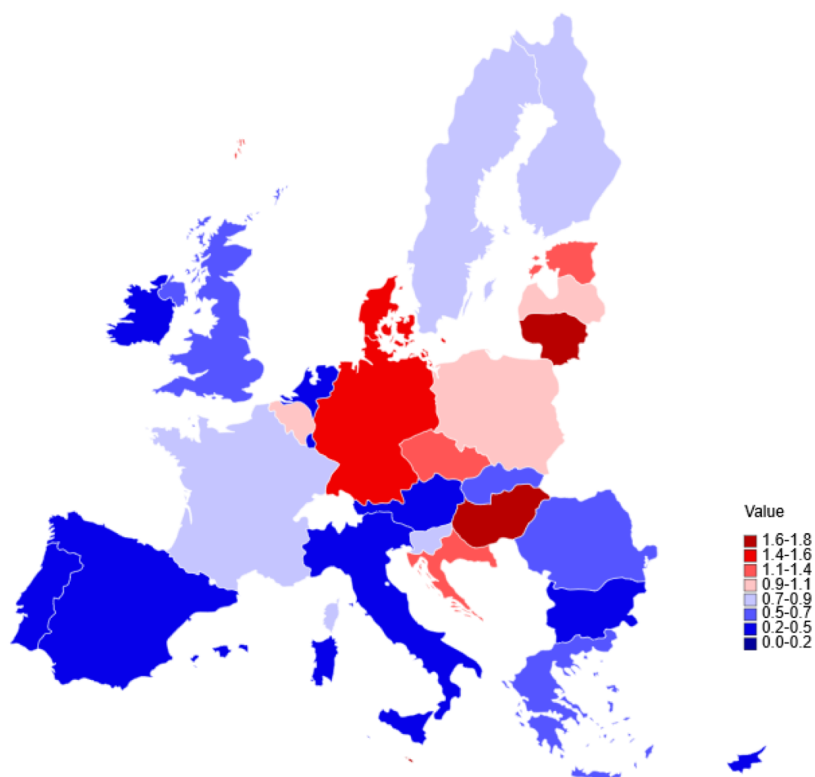
Among EU Member States, Germany has tended to grant the most. In 2019, it provided EUR 53 billion, or roughly 39% of total EU State Aid.<sup>108</sup>

<sup>108</sup> European Commission. 2021. *State Aid Scoreboard 2020*, p. 15.

**Figure 2: State Aid in the EU28 as a Percentage of GDP, 2009-2019<sup>109</sup>**



**Figure 3: Total State Aid Expenditure by Country, Excluding Aid to Agriculture, Fisheries, and Railways (as a Percent of GDP, 2019)<sup>110</sup>**

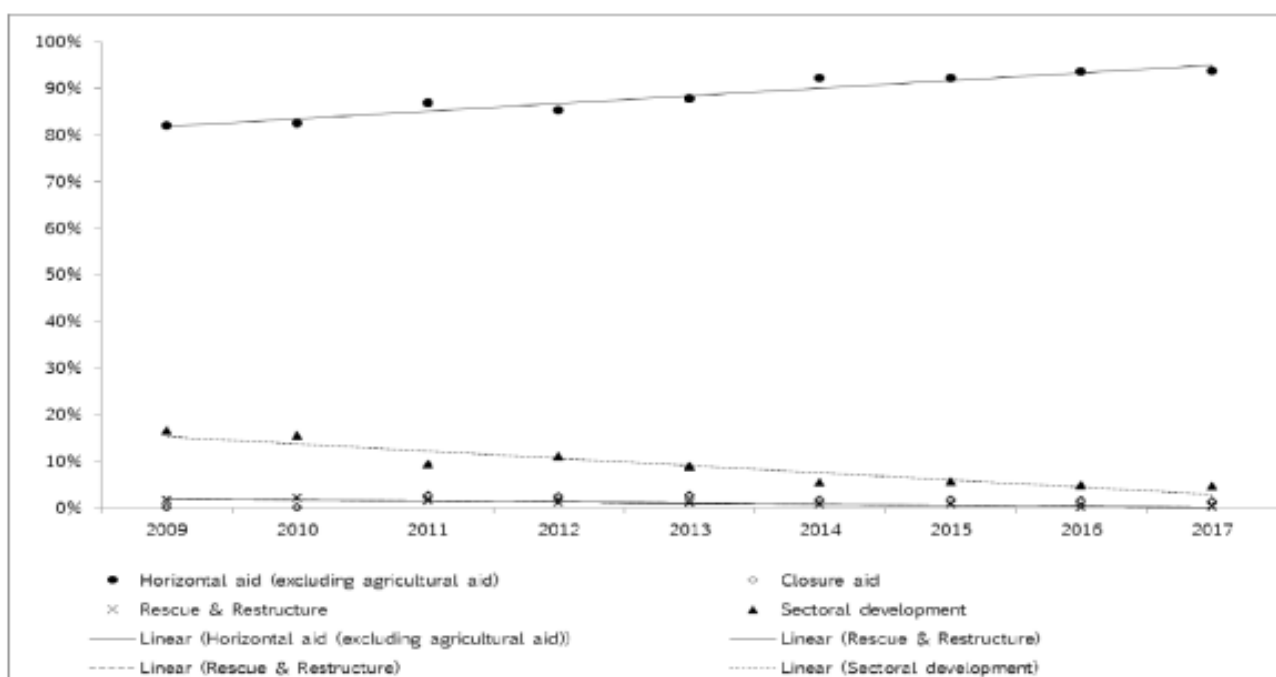


<sup>109</sup> Data is from the EU State Aid Scoreboards.

<sup>110</sup> European Commission 2021, supra n.108, 14.

Within the overall downward trend, EU rules have also produced a shift toward the use of horizontal aid (see Box 2.)<sup>111</sup> In some states, the share of horizontal aid is lower, but in only a few does it fall below 50%.<sup>112</sup> This shift toward horizontal aid reflects a greater use of incentives to address market failures and to pursue specific, previously identified goals important to the EU as opposed to more generally encouraging new or supporting existing investment in a given sector or industry.

**Figure 4: Share of Total State Aid Spending, Excluding Agricultural Aid, for Horizontal and Non-Horizontal Objectives<sup>113</sup>**



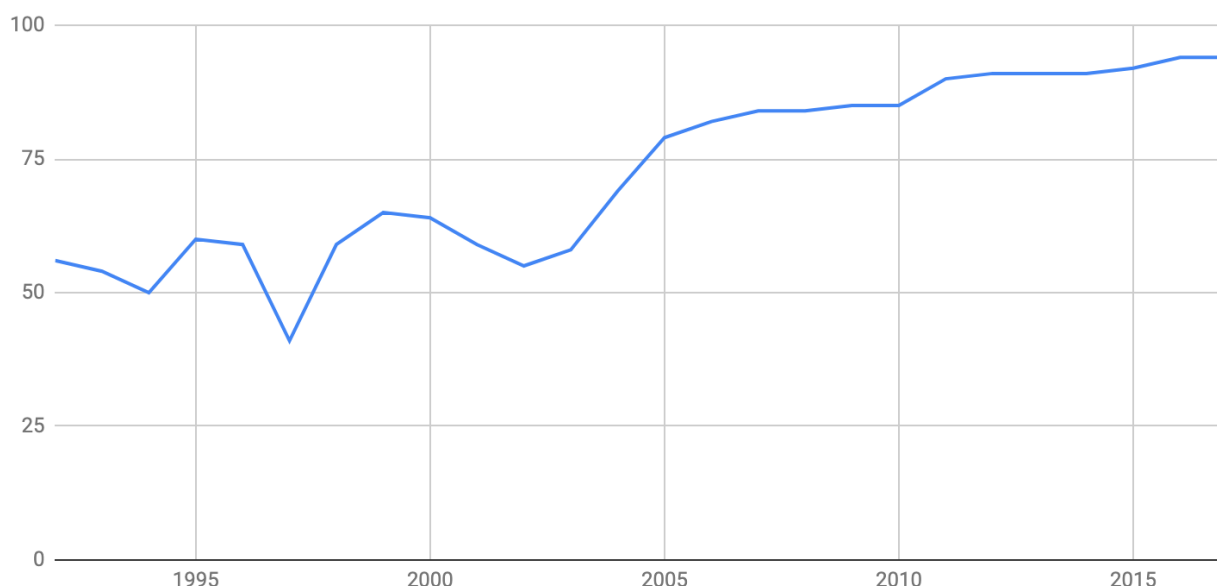
*Source: Commission services.*

<sup>111</sup> As indicated in the text, these numbers do not include crisis aid, nor aid to agriculture, fisheries, or transport.

<sup>112</sup> European Commission 2021, *supra* n.108, 8.

<sup>113</sup> *Id.*, 33.

**Figure 5: Non-Crisis State Aid for Horizontal Objectives as Percentage of Total Aid (1992-2017)<sup>114</sup>**



In terms of aims advanced by EU State Aid, environmental protection (including energy savings and promoting the use of renewable energy) has been the policy objective supported by the greatest share of State Aid over recent years.

Figure 6 shows spending on environmental aims, as compared to spending on other aims, from 2009-2019. Aid for regional development, and aid for research, development, and innovation (RDI) have tended to be policy objectives receiving the second and third most State Aid, swapping places or being in close races from year to year.<sup>115</sup> Figure 7 shows State Aid expenditures across EU Member States in 2019 per policy objective.<sup>116</sup>

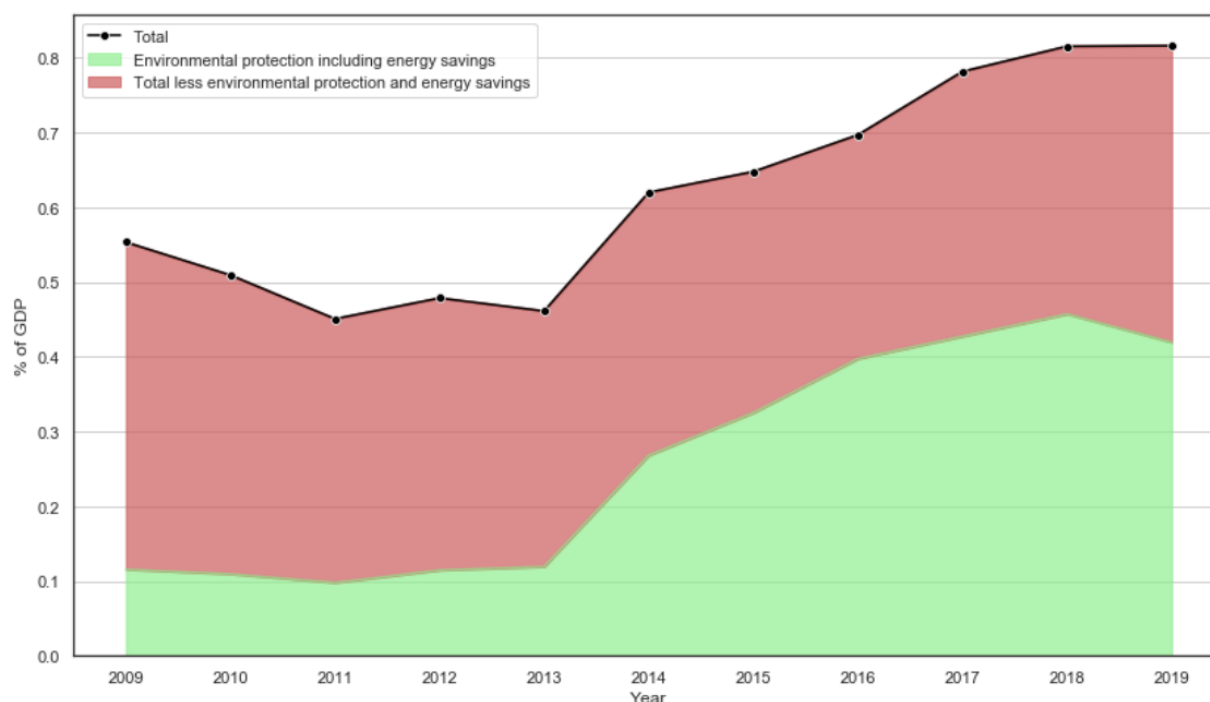
<sup>114</sup> *Id.*, Directorate-General for Competition; European Commission Competition Scoreboard 2017; European Commission Competition Scoreboard 2018.

<sup>115</sup> Compare the Scoreboard for 2019 data (RDI represented 10%, and regional development 8.5%), with the Scoreboard for 2018 data (RDI and regional development aid were each roughly 9%), and 2017 data.

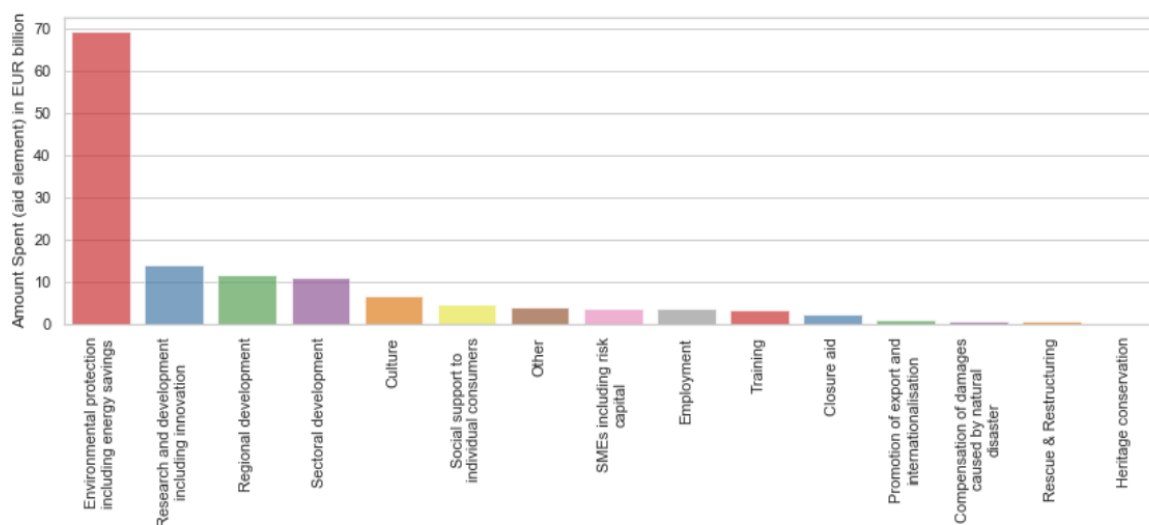
<sup>116</sup> State Aid Scoreboard 2020 (showing data for 2019).



**Figure 6: Total State Aid Expenditure, Excluding Aid to Agriculture, Fisheries, and Railways, as a % of EU28 GDP<sup>117</sup>**



**Figure 7: EU State Aid by Policy Objective, 2019<sup>118</sup>**



<sup>117</sup> *Id.*

<sup>118</sup> State Aid Scoreboard 2020.

Most State Aid provided by member states to industry and services, as shown in Table 6, is given through grants (63% in 2019 in terms of value), followed by tax exemptions (31%). Falling well behind those categories are other forms of aid, such as soft loans, equity investments, and subsidized services. Nevertheless, the type of aid instrument varies depending on the country granting the aid, as well as the type of policy objective the aid seeks to support and the market failure it seeks to overcome. Table 6 provides a snapshot of the different aid instruments used by EU Member States over a three-year period. With respect to the relationship between aid-type and objective, a greater share of State Aid for RDI, for instance, tends to come in the form of direct grants than is the case for State Aid for environmental protection.<sup>119</sup>

**Table 6: Non-Crisis State Aid to Industry and Services by Aid Instrument and Member State, Annual Average in Million Euros, 2015-2017<sup>120</sup>**

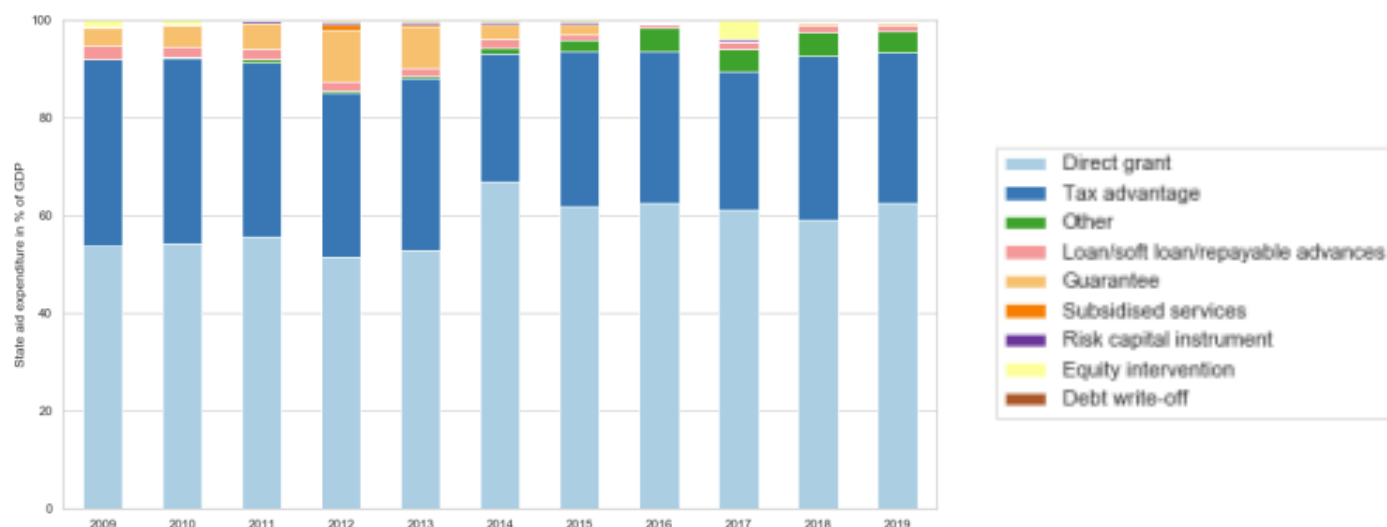
	Equity Participation	Grants	Guarantees	Soft loans	Tax deferral	Tax exemption	Total
<b>European Union (28 countries)</b>	585	63634	817	1155	9	31927	102202
<b>Belgium</b>	61	1125	0	30	0	1026	2243
<b>Bulgaria</b>	0	167	0	6	0	32	567
<b>Czech Republic</b>	0	1080	7	1	0	224	2307
<b>Denmark</b>	14	2042	0	17	0	1948	4045
<b>Germany (until 1990 former territory of the FRG)</b>	27	29549	14	156	0	9797	39591
<b>Estonia</b>	0	153	0	0	0	47	201
<b>Ireland</b>	0	368	2	7	0	74	454
<b>Greece</b>	56	476	547	0	0	0	1079
<b>Spain</b>	0	1923	10	142	0	432	2518
<b>France</b>	103	6708	0	211	1	7400	15799

<sup>119</sup> See State Aid Scoreboards covering data for 2017-2019.

<sup>120</sup> *Id.*

<b>Croatia</b>	0	217	0	8	0	31	393
<b>Italy</b>	51	2510	14	118	0	767	3706
<b>Cyprus</b>	0	107	0	0	0	7	115
<b>Latvia</b>	10	540	0	4	0	49	603
<b>Lithuania</b>	4	137	0	0	0	106	354
<b>Luxembourg</b>	0	145	0	0	0	0	169
<b>Hungary</b>	44	2023	0	7	0	159	2234
<b>Malta</b>	13	17	1	1	0	36	78
<b>Netherlands</b>	5	1414	6	62	9	386	1888
<b>Austria</b>	2	1305	8	11	0	450	1779
<b>Poland</b>	7	4123	0	13	0	843	4986
<b>Portugal</b>	10	200	0	293	0	150	813
<b>Romania</b>	1	469	2	10	0	201	1064
<b>Slovenia</b>	35	218	0	2	0	118	373
<b>Slovakia</b>	4	245	0	0	0	73	331
<b>Finland</b>	12	725	1	16	0	921	1678
<b>Sweden</b>	0	781	4	5	0	2929	3719
<b>United Kingdom</b>	126	4865	199	34	0	3722	9115

**Figure 8: Share of Total State Aid by Instruments, Excluding Aid to Agriculture, Fisheries, and Railways Between 2009 and 2019 (in %)<sup>121</sup>**



In addition to overall declines in the amount of State Aid provided since the 1980s, the “intensity” of the aid has also shrunk.<sup>122</sup> As is discussed further in Section 4, this is due to EU rules placing ceilings on permissible levels of aid intensity. Areas that are the most disadvantaged and in need of investment have the highest ceilings. The ceilings are further adjusted based on the size of the firm benefitting from the State Aid. Despite the apparent reduction in overall State Aid and in aid intensity, it is important to emphasize that State Aid does not include all types of incentives. Measures that are likely to affect trade with firms outside the EU but not with EU states, for example, would not be covered.

In conclusion, data reported by EU member states indicates that, likely due to the implementation and enforcement of regulations:

- data on the use of incentives covered by the State Aid scheme is not fully comprehensive, but is relatively robust;
- the use and intensity of non-crisis State Aid has declined in the EU since the 1980s, but has risen slightly in recent years, partly due to reforms aimed at simplifying the use of State Aid, and a significant rise in renewable energy initiatives in Member States;
- there has been a dramatic shift toward the use of horizontal aid, which now accounts for the vast majority of all non-crisis State Aid to industry and services; and

<sup>121</sup> The EU Commission, State Aid Scoreboard 2020.

<sup>122</sup> For more on the definition of aid intensity, see also Box 2.

- this shift reflects a greater use of incentives to address market failures and pursue specific, previously identified goals important to the EU as opposed to more generally encouraging new or supporting existing investment in a given sector or industry.

## *2.4 Investment Incentives in the Middle East and Northern Africa*

The economic crises triggered by the COVID-19 pandemic added to what were already pressing socioeconomic problems in parts of the Middle East and Northern Africa (MENA). Inflows of FDI into the region fell dramatically in 2020, and the OECD predicts there will be sharp increases in already high unemployment and poverty, as well as a rising risk of macroeconomic, political, and social instability in the region.<sup>123</sup>

MENA countries could attract FDI by taking advantage of their unique location, large market size, and young workforce.<sup>124</sup> In recent years, almost all governments of the MENA countries have taken steps to improve business climate and address competition for investment from emerging developing countries. Some of these measures have strengthened the capacity and role of investment promotion agencies (IPAs) in attracting investors and streamlining the start-up and expansion of investments. On the other front, tax and financial incentives are also widely used by governments in MENA, as in many developing and emerging economies, to attract private investment. A recent study from the OECD gives an overview of the different investment incentives types available in the MENA economies, the instruments used, the stated objectives of these incentives, and how they are implemented.<sup>125</sup>

According to the OECD study, MENA governments have been providing tax and financial incentives primarily to agricultural, tourism, and industrial sectors, as well as export-oriented activities and underdeveloped regions.<sup>126</sup> Investor incentives that promote environmental protection, are also common. Yet, compared to other OECD countries, there are fewer incentives for firms to use new technologies or support technology transfer and R&D activities.<sup>127</sup>

Corporate tax holidays, reduced corporate tax rates, tax deductions, and credits are the most common types of tax incentives used by MENA governments, which is consistent with trends in other developing and emerging markets. Exemptions from indirect taxes, such as import and export duties and VAT, are frequently used in addition to direct tax incentives.<sup>128</sup>

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<sup>123</sup> OECD Middle East and North Africa Investment Policy Perspectives, OECD Publishing (2021), 15.

<sup>124</sup> *Id.*

<sup>125</sup> *Id.*

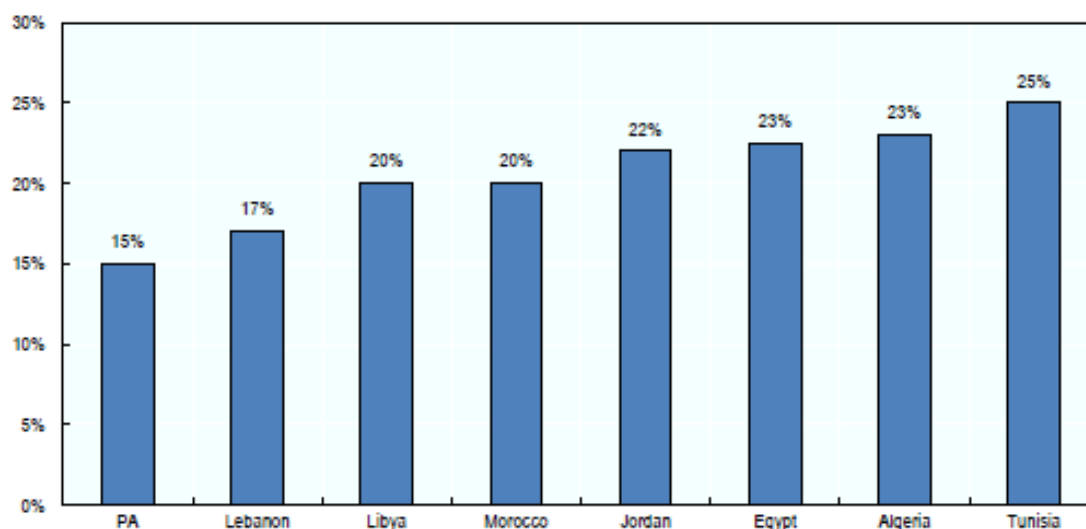
<sup>126</sup> *Id.*

<sup>127</sup> *Id.*

<sup>128</sup> *Id.*

The statutory CIT rate in MENA economies is 21% on average, with rates ranging from 15% (Palestine) to 25% (Tunisia) (Figure 9). This is slightly lower than the OECD and ASEAN average CIT rates of 25% and 23%, respectively.<sup>129</sup>

**Figure 9: Statutory CIT Rates in MENA Economies<sup>130</sup>**



*Note:* Rates as of 2020. Standard CIT figures for Algeria and Jordan show the simple average of standard rates for different sectors (excluding rates that only apply to one sector), Morocco shows the simple average of progressive rates. PA: Palestinian Authority.  
*Source:* OECD based on national legislation and (EY, 2020<sub>44</sub>).

**Figure 10: Projects Eligible for Permanent Tax Holidays<sup>131</sup>**

<i>Projects</i>	Palestine	Lebanon	Libya	Morocco	Jordan	Egypt	Algeria	Tunisia
<i>Agriculture</i>	X			X			X	

<sup>129</sup> *Id.*

<sup>130</sup> *Id.*

<sup>131</sup> *Id.* 136

<i>Export-oriented sectors or free and economic zones</i>		<b>X</b>	<b>x</b>			<b>x</b>	<b>x</b>	
<i>capital risk, offshore, and holding companies</i>		<b>X</b>		<b>x</b>				

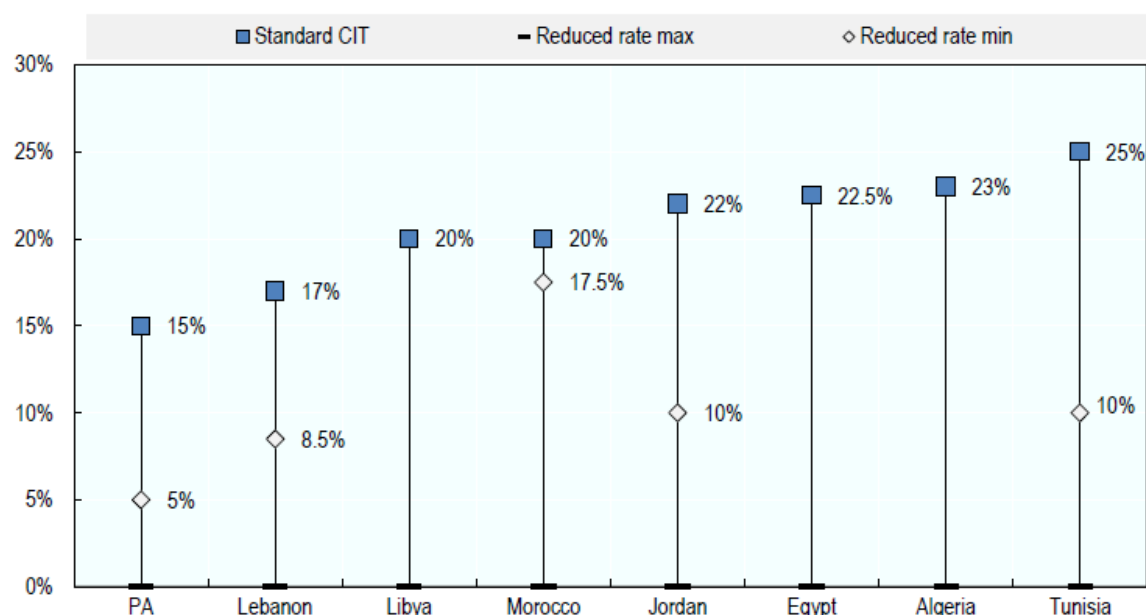
Tax holidays are granted by all MENA governments (except Palestine) based on the location of the investment, which can include underdeveloped areas and, more frequently, economic or free zones. Also, with the exception of Egypt and Libya, the majority of countries offer tax holidays based on industry, and half of them grant holidays based on specific economic activities (e.g., skills development, R&D, environmental protection). The maximum length of tax holidays (including extensions) is around 10 years in most countries, except for Jordan, which grants exemptions with a 30-year period. In comparison, tax holidays in ASEAN countries typically range from four to twenty years (including extensions), with no permanent exemptions available.

MENA economies, on average, provide more permanent exemptions and longer tax holidays (14.6 years) than Association of Southeast Asian Nations (ASEAN) countries (11 years), but they receive less FDI. This emphasizes the importance of the overall investment climate in attracting firms and raises questions about the value of broad-based, generous incentives.

Following the expiration of a tax holiday, businesses may be deemed eligible for reduced CIT rates (non-zero tax rates that are lower than standard CIT rates) in five of the eight MENA economies.<sup>132</sup>

<sup>132</sup> Palestine, Lebanon, Morocco, Jordan, and Tunisia.

**Figure 11: Statutory and Reduced CIT Rates in MENA Focus Economies<sup>133</sup>**



In general, cost-based incentives (that reduce the cost investment for business) appear less common in the MENA economies than profit-based benefits, which are the norm in most developing and emerging economies. Yet, there is a scarcity of publicly available information on these schemes, necessitating further investigation.

- Egypt:<sup>134</sup> In 2017, Egypt reformed its investment incentive regime to increase the use of cost-based incentives and reduce the recourse to tax holidays.<sup>135</sup> Investors can deduce up to 50% of investment costs from taxable income for projects in low-income areas, and up to 30% for investment in specific sectors (such as renewable energy and labor-intensive projects).
- Tunisia:<sup>136</sup> Tunisia has the most tax deduction schemes, including those for reinvesting profits in agriculture, innovative industries, and exporting businesses.
- Algeria:<sup>137</sup> Algeria provides tax deductions for investments made for research and development.

According to the 2021 OECD study, most MENA countries grant all investors accelerated depreciation of assets and loss-carry-forward schemes through the general regime. However, some

<sup>133</sup> *Id.* 136

<sup>134</sup> OECD (2020), OECD Investment Policy Reviews: Egypt 2020, OECD Investment Policy Reviews, OECD Publishing, Paris, 191–193. <https://dx.doi.org/10.1787/9f9c589a-en>

<sup>135</sup> Please see Article 11 of Income Tax Law No:91 of 2006 and Investment Law No. 72 (INVL) for more information.

<sup>136</sup> OECD MENA Report (2021), *supra* n123, at 36.

<sup>137</sup> *Id.*



countries, such as Algeria, follow a negative list approach to incentives, with over 100 sectors and activities disqualified from receiving tax benefits.

Moreover, MENA countries use financial incentives to attract investment in specific sectors, activities, and locations, though they are used less frequently than tax incentives.<sup>138</sup> These financial incentives include grants for infrastructure, staff training, land/building or equipment costs, reduced financing<sup>139</sup> for projects related to sustainable development, environmental protection or renewable energy, as well as loan guarantees and interest subsidies, which have been used in Algeria to promote tourism projects and in Lebanon to encourage businesses to relocate to underdeveloped areas.<sup>140</sup> Besides Tunisia, no legislation specifies the details of these incentives, such as the amount of funds eligible firms can receive. The eligibility requirements in most countries are also unclear.

## *2.5 Investment Incentives in (Sub-Saharan) Africa*

According to the African Development Bank, the infrastructure investment gap in Africa is estimated to be more than \$100 billion per year, and will reach \$170 billion per year by 2025, adversely affecting Africans' living conditions and the continent's global competitiveness.<sup>141</sup> Governments are eager to attract FDI that will contribute to filling this gap. Sub-Saharan African countries provide a variety of enhanced tax incentives, including accelerated capital expenditure allowances, special allowances for investments in specific industry sectors, and tax holidays ranging from three to ten years. Almost all African governments offer tax incentives to boost their manufacturing, agricultural, and industrial bases, while more advanced African economies also provide incentives to attract financial services industries. Cash grants are not common, but stronger economies such as South Africa and Nigeria still offer cash grants in addition to tax holidays – all of which require government approval.<sup>142</sup> In general, pre-qualification or pre-approval of the investor by the respective country's regulatory agency is required in all countries, and in some cases (such as Botswana, the Democratic Republic of the Congo, and Somalia), government agencies are also willing to enter into tax agreements and/or cooperation agreements for investment certainty.<sup>143</sup>

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<sup>138</sup> Libya is the only one of the MENA economies whose legislation does not specify specific financial benefits.

<sup>139</sup> Tunisia, Morocco, Egypt and Algeria

<sup>140</sup> *Id.*

<sup>141</sup> African Development Bank Newsletter Feb 2022. <https://www.afdb.org/en/news-and-events/press-releases/african-development-bank-sets-course-close-infrastructure-gap-board-approval-its-first-public-private-partnerships-strategic-framework-48875>

<sup>142</sup> KPMG, Africa Incentive Survey 2017/2018, Preface.

<sup>143</sup> *Id.* at 92.

In sub-Saharan Africa, 80% of countries offered tax holidays in 2015 (an increase from 40% in 1980), and 50% operated free zones, which did not exist 30 years prior.<sup>144</sup> In 2017, 65% of sub-Saharan countries introduced more generous incentives, and 21% removed or restricted incentives.<sup>145</sup>

Box 3 below describes the use of tax incentives in Africa to attract FDI in the extractive industry, specifically.

### **Box 3: Cost of the Pervasive Use of Tax Incentives to Attract Extractive Industries in Africa**

#### **Why are companies asking for incentives in the extractive sector?**

The extractive industry has long argued that it is a particularly risky and capital-intensive industry and therefore deserves some special tax treatment. Some of its arguments include:

- it has a long exploration period with no revenue;
- capital outlays during the development and closure phases are higher in the extractive industries than in other businesses;
- after the construction of mines, capital is captive and not transportable;
- equipment generally needs to be imported;
- extractive projects span several decades and are thus exposed to risk related to changes in political circumstances;
- commodity prices, and therefore revenues, are cyclical;
- companies must incur costs unrelated to production to obtain and maintain a social license to operate.

#### **What incentives are granted?**

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<sup>144</sup> IMF, OECD, UN and World Bank. 2015. *Options for Low Income Countries' Effective and Efficient Use of Tax Incentives for Investment: Report to the G20*. <https://www.oecd.org/tax/tax-global/options-for-low-income-countries-effective-and-efficient-use-of-tax-incentives-for-investment.pdf>

<sup>145</sup>See Andersen, Kett, Uexkul supra n96.

Generally, extractive companies receive tax incentives in the following forms; lower tax rates, reduced tax bases through special allowances; exemptions from paying certain types of taxes.

One particular regulatory incentive is also often applied by statute or agreement: stabilization of the taxes, sometimes over the life of the contract. Governments may also agree to stabilize a broader set of laws, or even all laws, affecting the project.

A 2015 study by the IMF, OECD, UN, and World Bank found that, without the tax incentives, over 90% of investments would have still taken place in Uganda, Rwanda, Tanzania, and Guinea.<sup>146</sup> Incentives were found to be one of the least important factors in influencing an investment decision in a study of 7,000 companies in 19 Sub-Saharan African countries.<sup>147</sup>

Robertson & Bredar concludes that potential impact of tax incentives in Africa is typically lesser than any other region in the world on stimulating investment, except the Caribbean.<sup>148</sup> While tax incentives may be used to encourage foreign investment in the hopes of securing technology, infrastructure, and high-skilled jobs,<sup>149</sup> the documented domestic externalities have been overwhelmingly negative in Africa due to poor implications of tax incentives and a lack of good governance.

The KPMG report surveyed 37 African countries, all of which offered some tax incentives, and 23 of which offered SEZs or Export Free Zones. Only eight included a job creation requirement as part of these incentives, and 12 included training incentives.<sup>150</sup> This is especially concerning in light of the global COVID-19 crisis, which has already strained revenues and heightened the urgent need for increased domestic resource mobilization. Yet, manufacturing incentives are found in more than a third of the 37 countries surveyed.<sup>151</sup> African countries appear to be reforming their incentive policies to include manufacturing incentives in order to attract manufacturing FDI.

Many African countries have disorganized and contradictory systems of granting various tax exemptions under multiple pieces of legislation and agencies.<sup>152</sup> For instance, there are ten different government agencies in Ghana that can grant exemptions to investors, allowing them to shop around departments.<sup>153</sup> This has resulted in a "race to the bottom," with various agencies

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<sup>146</sup> IMF, OECD, UN, and World Bank 2015, *supra* n 144, p.26.

<sup>147</sup> *Id.*

<sup>148</sup> Robertson, Fiona and Lauren Bredar. 2021. *Scoping Study: Tax Incentives*. <https://cdn.one.org/africa/wp-content/uploads/2021/05/28145051/Tax-Incentives-Lit-Review-FINAL-May-2021.pdf>

<sup>149</sup> James, *supra* n11, 24.

<sup>150</sup> See *KPMG Survey*, *supra* n 142

<sup>151</sup> *Id.* at 4.

<sup>152</sup> See Robertson & Bredar, *supra* n148, 2.

<sup>153</sup> Moore, Mick, Wilson Prichard, and Odd-Helge Fjeldstad. 2018. *Taxing Africa: Coercion, Reform and Development*. (London: Zed Books), 136.

competing to offer the lowest rates.<sup>154</sup> This “race to the bottom” problem is also seen at the regional level, where countries with similar economic conditions compete for investment and gain no additional revenue as a result of tax wars.

Also, the terms of tax incentive policies in Africa are criticized for being unclear, allowing for corruption and erosion of any tax benefit. For example, according to the Tax Justice Network, Tanzania's “Strategic Investor Status,” allows companies investing more than \$20 million to negotiate individual tax holidays.<sup>155</sup> Further, the OECD pointed out the fact that “special concessions to individual companies... have never been formally made public” with regard to the incentives in Tanzania.<sup>156</sup>

Several studies acknowledge the lack of formal reporting of tax incentives. Most countries do not keep a comprehensive list of tax exemptions.<sup>157</sup> According to World Bank data from 2015, only 21% of countries in sub-Saharan Africa estimate forgone revenue through tax expenditures on a regular basis.<sup>158</sup> Only 28 African countries reported their tax expenditures to the public once or more between 2000 and 2019, according to the Global Tax Expenditures Database.<sup>159</sup> When reporting is completed, there is still a problem with report quality, which includes the level of detail, the definitions used, the quality of estimation methods used, and the frequency of reporting.<sup>160</sup> Improving the frequency and quality of tax expenditure reporting is difficult due to weak institutions, data constraints, and limited human and financial resources.<sup>161</sup>

Further, exemptions are not always granted for economic reasons, but rather for political reasons, as a reward for loyalty or in exchange for political gaining.<sup>162</sup> In those cases, care for designing incentives effectively, for instance, by lowering costs to developing marginal mines is absent, and incentives are granted when investments would have been made anyways.<sup>163</sup> While there have been few studies on the relationship between politics and tax incentives, in Tanzania, a link was

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<sup>154</sup> Robertson & Bredar, supra n148, 2.

<sup>155</sup> Tax Justice Network Africa & ActionAid International. 2012. *Tax competition in East Africa: A race to the Bottom?* (Nairobi: Tax Justice Network Africa & ActionAid International).

<sup>156</sup> IMF, OECD, World Bank and UN Report, supra n144, 26.

<sup>157</sup> Gupta, Sanjeev, and Mark Plant. 31 October 2019. *Strengthening Revenue Performance in Africa Requires Tough Political Decisions*. <https://www.cgdev.org/blog/strengthening-revenueperformance-africa-requires-tough-political-decisions>

<sup>158</sup> Redonda, Agustin, Christian von Haldenwang, and Flurim Aliu. 2021. “Tax Expenditure Reporting and Domestic Revenue Mobilization in Africa,” in Mosquera Valderrama et al., *Taxation, International Cooperation and the 2030 Sustainable Development Agenda*. United Nations University Series on Regionalism, vol 19. [https://link.springer.com/chapter/10.1007%2F978-3-030-64857-2\\_9#DOI](https://link.springer.com/chapter/10.1007%2F978-3-030-64857-2_9#DOI)

<sup>159</sup> Global Tax Expenditure Database, [www.GTED.net](http://www.GTED.net)

<sup>160</sup> Robertson & Bredar, supra n148, 3.

<sup>161</sup> *Id.*

<sup>162</sup> Tax Justice Network-Africa & ActionAid. 2015. *The West African Giveaway: Use & Abuse of Corporate Tax Incentives in ECOWAS*.

<sup>163</sup> OECD and IGF. 2018. *Tax Incentives in Mining: Minimising Risks to Revenue*, 22.

discovered between increased political competition during election periods and increased tax exemptions.<sup>164</sup>

#### **Box 4: Snapshot of Selected Countries in Africa: How Much Revenue Is Lost as a Result of Tax Incentives?**

**Tanzania:** The Bomani Commission estimated that the government lost US\$31 million in 2006-7 and US\$52 million in 2007-8 as a result of fuel levy exemptions granted to the six largest mining companies.

**Malawi:** Tax incentives given to mining companies cost Malawi at least 8 times more than the revenues received; a loss that could cover 60% of the costs of the Ministry of Health.

**Sierra Leone:** The government has offered two iron ore mines a tax rate of 20% in place of the standard statutory tax rate of 30%. The country forewent an estimated US\$131 million in revenue between 2014 and 2016 due to this policy.

**Cote d'Ivoire:** After granting the Yaoure gold mine a five-year tax holiday, the government developed a model to assess the cost of the incentive and concluded it had foregone US\$129 million. The mine would have experienced a solid rate of return without the tax holiday.

One study pointed out that, in 2008 “tax incentives in sub-Saharan Africa [were] used more widely than in the 1980s, with more than two-thirds of the countries in the region providing tax holidays to attract investment. Such incentives not only shrink the tax base but also complicate tax administration and are a major source of revenue loss and leakage from the taxed economy.” Compounding those problems, tax incentives are often granted through special agreements negotiated behind closed doors, without the consent of or engagement with tax authorities.

Most recently, various governments have enacted laws and policies relating to renewable energy tax incentives in a variety of ways, the most notable of which are<sup>165</sup>:

(i) Investment tax incentives, (ii) production tax incentives, (iii) property tax reductions, (iv) VAT tax reductions, (v) excise (sales) tax reductions, (vi) import duty reductions, (vii) accelerated depreciation, (viii) research, development, demonstration and equipment manufacturing tax incentives, (ix) tax holidays, (x) taxes on conventional fuels.

<sup>164</sup> Therkildsen, Ole, and Anne Mette Kjaer. 2013. “Elections and landmark policies in Tanzania and Uganda.” *Democratization* 592-614

<sup>165</sup> Esther Mukami Githinji; Tax Incentives on Renewables (2021), <https://cleanenergy4africa.org/tax-incentives-on-renewable-energy/>

## Box 5: Tax Incentives in the Renewable Energy Sector in Selected Countries<sup>166</sup>

**Madagascar:** The Madagascar Tax Code of 2015 provides for the following renewable energy tax incentives:

- a. A 50% reduction in corporate income tax on investment;
- b. A VAT exemption on equipment used in the production of renewable energy. Wind power generators, hydropower generators, solar water heaters, and solar PV panels are examples of equipment; and
- c. With the exception of buildings, equipment can be depreciated at a 30% rate of net value.

**South Africa:** The South African Income Tax Act establishes a number of fiscal incentives for the renewable energy industry. Allowances for a. Energy efficiency savings (Section 12L); b. Capital allowance for renewable energy machinery (Section 12B); c. Exemption of certified emission reductions (Section 12K); d. Allowance for industrial policy projects (Section 12I); and e. A variety of tax incentives for the proposed special economic zones SEZs (Section 12R).

**Malawi:** The Malawi Customs and Excise (Tariffs) Order has been amended to include a zero-rate VAT on solar panels, solar batteries, solar inverters, solar bulbs, solar regulators, solar accumulators, and energy efficient bulbs.

**Rwanda:** The Rwanda Investment Code provides for a seven-year tax holiday for energy projects with a capacity of at least 25 megawatts. The investment must be at least \$50 million USD, with the investor contributing at least 30% of this amount in the form of equity in these sectors. A list of clean energy equipment exempt from VAT is provided by the Minister of Finance and Planning.


































**Sierra Leone:** The Finance Act establishes a three-year duty-free period for the importation of photovoltaic system equipment and low-energy or energy-efficient appliances for resale or use by third parties.

**Kenya:** The Kenya Finance Act of 2021 amends the Value Added Tax Act's First Schedule to exempt solar and wind energy specialized equipment from taxation. This came after a 14% VAT on solar equipment was imposed in 2020, making solar products unaffordable and discouraging the implementation of universal electrification. The new law puts the country back on track to achieving green energy goals.

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<sup>166</sup> *Id.*

Figure 12: Tax Incentives in the Renewable Energy Sector in Africa<sup>167</sup>

		FISCAL INCENTIVES AND PUBLIC FINANCING				
		Capital subsidy, grant, or rebate	Investment or production tax credits	Reductions in sales, energy, CO <sub>2</sub> , VAT, or other taxes	Production payment	Public investment, loans, or grants
 Algeria			•			
 Angola						•
 Benin				•		
 Botswana		•		•		
 Burkina Faso			•	•	•	
 Cabo Verde				•	•	
 Cameroon				•		
 Côte d'Ivoire				•		
 Egypt		•		•		
 Ethiopia				•		•
 Gambia				•		
 Ghana		•		•		•
 Guinea				•		
 Kenya				•	•	•
 Lesotho						•
 Libya				•		
 Madagascar				•		
 Malawi				•		
 Mali				•		•
 Mauritius		•				
 Morocco						•
 Mozambique						•
 Niger				•		
 Rwanda				•		•
 Senegal				•		
 South Africa		•		•		•
 Sudan						
 Tanzania				•		
 Togo				•		
 Tunisia		•		•		•
 Uganda		•		•		•
 Zambia		•		•		
 Zimbabwe						

<sup>167</sup> IRENA. 2015. *Africa 2030: Roadmap for a Renewable Energy Future*. IRENA, Abu Dhabi adapted from REN21 (2015)



## *East Africa*

In 2012, ActionAid and Tax Justice Network Africa reported on lost revenue by East African countries to tax incentives for foreign corporations, estimating these losses at US\$2.8 billion a year across four countries—Tanzania, Kenya, Rwanda, and Uganda.<sup>168</sup> Their 2016 report tracked new developments in tax policy in these four countries plus Burundi, and found that they are still losing between US\$1.5 billion and US\$2 billion a year.<sup>169</sup>

**In Kenya,**<sup>170</sup> the Special Economic Zone Act of 2015 increased the number of SEZs in the country. This act exempts companies within SEZs from all taxes and duties payable under the Excise Duty Act, Income Tax Act, EAC Customs Management Act, and the BAT Act. Due to the lack of transparency in the Kenyan tax regime, there is no updated number on lost revenue to tax incentives since the 2012 estimate, which was US\$1.1 billion.

Under the VAT Act 2013 and VAT (Amendment) Act 2014, Kenya offers an exemption from the VAT and import duties for supplies imported or bought for the construction of a power-generating plant or for geothermal exploration, as well as certain plant and machinery. Pursuant to the VAT acts, solar cells and modules that are not equipped with elements such as diodes, batteries or similar equipment are free from import duty and exempt from VAT; PV semi-conductor devices, including PV cells and light-emitting diodes, together with wind-powered generating sets that have already been assembled, are subject to a 5% import duty and 16% VAT; Wind engines (windmills) are free from import duty and exempt from VAT; Hydraulic turbines and water wheels are free from import duty but pay 16% VAT.

**In Tanzania**<sup>171</sup>, revenue losses from tax incentives granted in 2014-15 were estimated at US\$790 million, or 1.5% of GDP (2% was lost in 2013-14). This number does not take into account a new VAT law which will allegedly result in tax revenues of \$500 million. This VAT Act (2015) reduces the number of items and companies that are eligible for VAT exemptions. New investors in EPZs and SEZs will not be eligible for VAT exemptions. EPZs and SEZs continue to exist, and companies there are exempted for the first 10 years from paying all taxes and levies imposed by local government authorities, and from corporate income taxes. In addition, companies are granted import duty exemptions on raw materials and capital goods imported for manufacturing goods. Oil and gas investors are given special treatment. Exemptions for multinational companies engaged in natural gas and oil exploration amounted to US\$58.8 million in 2013-14. The new Tax Administration Act restricts power to the Minister to grant tax exemptions, and publishes quarterly

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<sup>168</sup> Tax Justice Network and Africa and Action Aid International. 2012. *Tax Competition in East Africa: A Race to the Bottom?* (Kilimani: Tax Justice Network-Africa; Johannesburg: Action Aid. International). [http://www.actionaid.org/sites/files/actionaid/eac\\_report.pdf](http://www.actionaid.org/sites/files/actionaid/eac_report.pdf).

<sup>169</sup> Tax Justice Network Africa and ActionAid. 2016. *Still Racing Toward the Bottom? Corporate Tax Incentives in East Africa*. <https://actionaid.org/publications/2016/still-racing-toward-bottom-corporate-tax-incentives-east-africa>

<sup>170</sup> *Id.*

<sup>171</sup> *Id.*



tax exemption reports to increase transparency, though it does not make public CIT exemptions or other exemptions granted within EPZs.

**Uganda**<sup>172</sup> has also taken steps to reduce VAT and other exemptions, but many incentives remain, notably, as in other East African countries, for oil companies. In 2015, Uganda exempted oil companies from paying VAT in the exploration and construction phases. More generally, investors located in export zones are entitled to a 10-year tax holiday, duty exemption on raw materials, and no export tax, among other exemptions.<sup>173</sup> There are also capital and depreciation allowances, and customs duty and tax exemptions. Uganda's policies are more targeted than those of Kenya and Tanzania. It offers corporate income tax holidays for certain categories of businesses, such as companies engaged in agro-processing and those exporting finished consumer and capital goods.<sup>174</sup> Through recent tax reforms, the government expects to increase tax collections by 0.7% of GDP.

**Rwanda**<sup>175</sup> introduced a new 2015 Investment Code that offers extensive tax incentives to foreign investors. Revenue loss from incentives is estimated at US\$115-176 million a year. At present, Rwanda only raises 15% of its GDP in taxes.

**Burundi**<sup>176</sup> is especially vulnerable to harmful incentives because of its position as a poor country with a small population and subsequently small tax base. Revenue loss from incentives presently offered to international and domestic companies is impossible to calculate due to the scarcity of data. However, the high fiscal deficit in Burundi in 2018 was attributed in part to weak tax collection by African Development Bank.<sup>177</sup> While incentives are currently offered through tax deferrals and duties exemptions, positive reforms have been made in recent years. In 2007, Burundi joined the East Africa Community (EAC) common market, which, in combination with the closure of certain tax loopholes, has helped increase revenues from tax collection.<sup>178</sup>

### *West Africa*

Tax holidays are the most common type of incentive in Western African countries. In 2015, ActionAid and Tax Justice Network<sup>179</sup> released a report examining corporate tax incentives and their impact on the Economic Community of West African States (ECOWAS), with a focus on four countries: Nigeria, Ghana, Cote d'Ivoire and Senegal.

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<sup>172</sup> *Id.*

<sup>173</sup> For more information, see Uganda Investment Authority. 2019. *A Practical Guide to Doing Business in Uganda*.

<sup>174</sup> *Id.*

<sup>175</sup> See *supra* n169.

<sup>176</sup> *Id.*

<sup>177</sup> African Development Bank Group. 2019. *East Africa Economic Outlook 2019: Macroeconomic developments and prospects*.

<sup>178</sup> Tax Justice Network Africa, ActionAid 2016, *supra* n169.

<sup>179</sup> *Id.*

Despite serious doubts about the effectiveness of corporate tax incentives in achieving economic goals and the costs to national budgets, the report found that they continue to be a popular policy tool in ECOWAS member states.<sup>180</sup> According to the study, Corporate tax incentives – tax reductions offered by governments to entice investment – have a significant impact on domestic revenue collection and are not required to attract foreign direct investment (FDI).<sup>181</sup> Their analyses estimate that three countries – Ghana, Nigeria, and Senegal – collectively lose up to \$5.8 billion per year.<sup>182</sup>

West African states provide both formal and off-the-books or discretionary corporate tax incentives in special deals with businesses.<sup>183</sup> For example, in Senegal, for investments exceeding 250 billion CFA francs, the government may grant a special tax and customs regime exempting the investor from the benefits of the investment and mining codes.<sup>184</sup> In Liberia, certain incentives of up to 15 years may be granted for investments exceeding USD 10 million, subject to presidential and legislative approval.<sup>185</sup>

Tax holidays are given to as many as 46% of the 40 companies surveyed in Ghana, Nigeria, and Cote d'Ivoire: 10% of businesses are exempt from paying corporate income tax entirely, while the remaining 10% pay a reduced rate.<sup>186</sup> To encourage export-led growth, a large percentage of investors receive export tax exemptions or subsidies.

West African countries tax only 10-15% of their GDP on average, compared to 25-30% for the southern African countries.<sup>187</sup> Because governments in the region continue to be strapped for cash, some have turned to VAT to make up for revenue lost due to incentives. As a result, VAT rates in West Africa are relatively high. The Union Économique et Monétaire Ouest-Africaine (UEMOA), a group of Francophone countries in ECOWAS that share the CFA currency, has set a VAT band of 15 to 20% for the French West African region. Ghana levies 17.5% VAT, while only Nigeria has managed to keep its VAT at 5%, thanks to labor union opposition to government attempts to raise it from 5% to 10% in 2007.<sup>188</sup>

ActionAid report also pointed out that tax incentives are frequently administered by multiple, uncoordinated entities in each country and are granted based on whim rather than cost-benefit

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<sup>180</sup>Tax Justice Network, Africa, ActionAid, International the West African Giveaway. 2015. *Use & Abuse of Corporate Tax Incentives in ECOWAS*, 4.

<sup>181</sup> The report noted that it is statistically impossible to accurately calculate how much the 15 ECOWAS states lose due to the granting of corporate tax incentives due to a lack of reliable and complete data.

<sup>182</sup> *Id.* If the rest of ECOWAS lost revenue at the same rate as Nigeria, the total revenue loss for the 15 ECOWAS states would be \$9.6 billion per year due to the improper use and abuse of corporate tax incentives.

<sup>183</sup> *Id.*

<sup>184</sup> KPMG, *supra* n142 at 88

<sup>185</sup> *Id.* at 81.

<sup>186</sup> Action Aid and Tax Justice Network *supra* n180 at 10.

<sup>187</sup> *Id.* at 8.

<sup>188</sup> *Id.*

analysis.<sup>189</sup> Despite years of providing generous incentives to investors, most ECOWAS countries have failed to achieve their goals of increased job creation and employment. Hence, foreign direct investment into West Africa has risen, but not in the industries that generate the most jobs, such as manufacturing. Neither corporate tax incentives nor the availability of natural resources, such as oil and gas, drive such investment.

In addition to the shared type of incentive, such as exemptions or tax holidays, many Western African countries also offer creative – and unorthodox types of incentives. For instance, in **Sierra Leone**, the government - through the Central Bank, organizes weekly non-cash foreign exchange auctions in order to improve transparency and efficiency in foreign exchange transactions and achieve a market-determined foreign exchange rate. While such auctions are primarily intended to allow the Central Bank to efficiently inject foreign exchange into the market, they also provide a window for other economic agents to sell foreign exchange at market rates.<sup>190</sup>

## *2.6 Investment Incentives in ASEAN, China, and India*

Southeast Asia outperforms the rest of the world in terms of exports and FDI inflows and has been a top destination for multinational corporations from all over the world for at least the last three decades.<sup>191</sup>

In 2019, the OECD released a study analyzing the collected information regarding incentives used in Brunei, Cambodia, Indonesia, Laos, Malaysia, Myanmar, Philippines, Singapore, Thailand, and Vietnam.<sup>192</sup> The report points out that the policy stance of national governments has had a significant impact on Southeast Asia's economic performance. Through a combination of incentives, selective liberalization, and strong investment protection guarantees, many countries in the region were early movers in welcoming FDI for its contribution to exports.<sup>193</sup>

Investment tax incentives are widely used in all ASEAN Member States and have been for a long time. Singapore was the first to move in 1967, and other countries quickly followed, including the Philippines and Indonesia in 1967, Malaysia in 1968, and Thailand in 1972.<sup>194</sup> Governments have refined and reformed their legal infrastructure over time, opening up more sectors to foreign investment and clarifying protection provisions. Currently, all ASEAN Member States provide income tax holidays. Also, tax deductions, credits or both are also used by all the members.

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<sup>189</sup> *Id.* at 4.

<sup>190</sup> KPMG, *supra* n142 at 88.

<sup>191</sup> OECD. 2019. *OECD Investment Policy Reviews: Southeast Asia*, 11. [www.oecd.org/investment/oecd-investment-policy-review-southeast-asia.htm](http://www.oecd.org/investment/oecd-investment-policy-review-southeast-asia.htm)

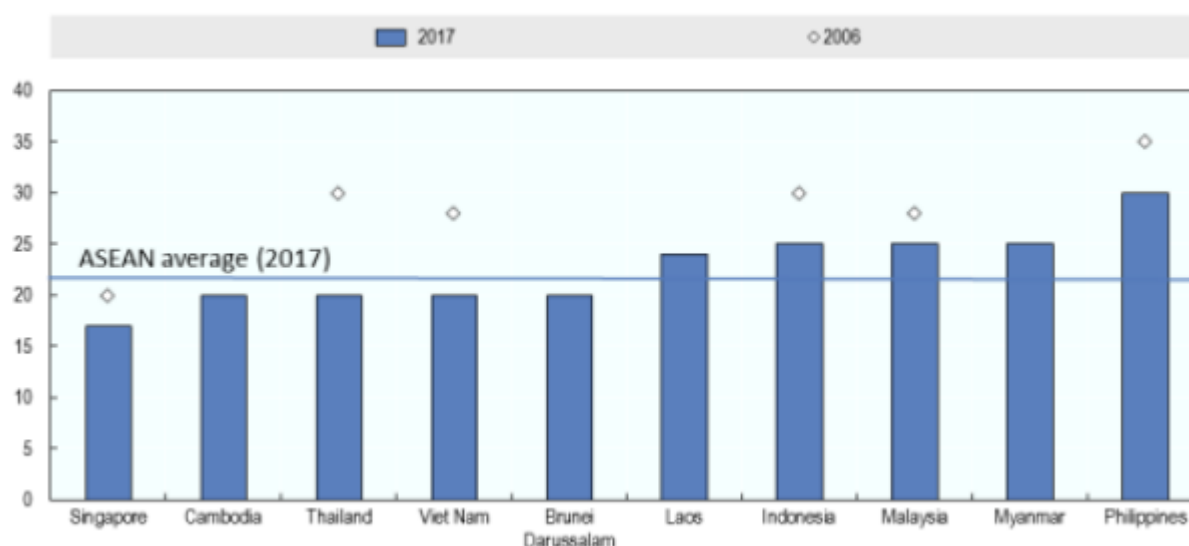
<sup>192</sup> OECD, *supra* n191, 11-12.

<sup>193</sup> *Id.*

<sup>194</sup> Thomsen, Stephen (2004), *Investment incentives and FDI in selected ASEAN countries*. International Investment Perspectives. (Paris: OECD Publishing).

Average corporate income tax rates in ASEAN are down to 23%, from 26% in 2009. This is lower than the OECD average of 25%.<sup>195</sup> In China, the statutory rate of enterprise income tax is 25%.<sup>196</sup> In India, while domestic companies are subject to tax at a basic rate of 30%, the net income of foreign companies is taxed at 40% plus the 2% or 5% surcharge, as applicable.<sup>197</sup> Thailand and Vietnam have reduced their CIT rates by 10% and 8%, respectively, since 2006.<sup>198</sup> All countries in Southeast Asia have higher contributions of corporate taxes to total GDP than the average for OECD countries (7%). Furthermore, the OECD found that, for all ASEAN countries, the difference between tax rates with and without incentives is above 10 percentage points.<sup>199</sup>

**Figure 13: Statutory Corporate Income Tax Rate (in %) <sup>200</sup>**



Corporate investors can take advantage of income tax holidays in all ASEAN Member States, with various qualifying criteria, and with the maximum number of years ranging from four, in Vietnam, to 20 years in Indonesia.<sup>201</sup> Income tax holidays are also offered in India and China; in India, investors can qualify for tax holidays for up to 20 years if they meet certain conditions;<sup>202</sup> while in China, the tax holiday for qualified enterprises (or qualified projects) can be extended to 10 years

<sup>195</sup> OECD n191, at 138.

<sup>196</sup> Ernst&Young (EY). 2019 *Worldwide Corporate Tax Guide*. <https://www.ey.com/gl/en/services/tax/worldwide-corporate-tax-guide---country-list>, 323.

<sup>197</sup> *Id.*, 695.

<sup>198</sup> *Id.*, 138.

<sup>199</sup> *Id.*, 152.

<sup>200</sup> Based on KPMG (2017), Tax Tools & Resources (database), [www.kpmg.com/Global/en/services/Tax/tax-tools-and-resources/Pages/corporate-tax-rates-table.aspx](http://www.kpmg.com/Global/en/services/Tax/tax-tools-and-resources/Pages/corporate-tax-rates-table.aspx) and official national government websites.

<sup>201</sup> OECD, *supra* n191 at 140.

<sup>202</sup> EY, *supra* n196, 696-97.

(exemption for the first five years and a 50% reduction for the next five years).<sup>203</sup> Singapore, Brunei Darussalam, and Indonesia, also have very generous tax holiday programs.<sup>204</sup> Singapore offers a maximum tax holiday of 15 years, but only for income streams derived from specific pioneering activities.<sup>205</sup>

The OECD report also shows that the cost of tax holidays in ASEAN member states reaches a considerable amount, especially compared to the other regions of the world. For instance, Cambodia, whose incentives are made up mostly of tax holidays, experiences a revenue loss of 6% of its GDP to these incentives. Vietnam and the Philippines each lose 1%.<sup>206</sup>

Complete tax holidays are also allowed in many South-eastern Asian EPZs and SEZs. China, India, and all of ASEAN Member States (with the exception of Brunei) also have SEZs, or incentives that are differentiated regionally to help underdeveloped areas. EPZs tend to offer substantial tax holidays and import duty exemptions, ergo companies can be exempted from customs duties and taxes on both exports and imports.<sup>207</sup>

On the other hand, tax deductions, credits, or both are used by all ASEAN Member States. In India, companies can get tax exemptions and deductions, if they meet certain requirements as well. In terms of the number of schemes that allow for tax deductions and credits, Vietnam has one of the most comprehensive regime in this category.<sup>208</sup> For instance, corporate income tax paid in foreign countries, as well as certain projects employing women or ethnic minorities, are eligible for tax credits in Vietnam.<sup>209</sup> Cambodia and the Lao People's Democratic Republic, on the other hand, use deduction and credit schemes much less frequently among ASEAN countries; as an alternative to tax holidays, Cambodia offers accelerated depreciation, while Lao PDR provides a tax credit on reinvested profits and certain types of losses.<sup>210</sup>

Where achieving development objectives is concerned, many of these instruments may be effective in attracting investment, but the OECD holds that they are costly when considering the forgone revenue a host state could be using to pursue the advancement of such development objectives on its own. That having been said, evidence suggests that cost-based instruments, such as tax deductions and tax credits, are preferable to profit-based instruments such as tax holidays and tax reductions. This is because instruments like tax holidays favor firms with high profits that need less government support. The most developed ASEAN countries, such as Malaysia, Singapore,

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<sup>203</sup> EY, *supra* n 196, at 139. The 5-year or 10-year tax holiday begins the tax year in which a qualifying business or project makes its first profit or generates its first business operating income.

<sup>204</sup> OECD, *supra* n191 at 140.

<sup>205</sup> *Id.*

<sup>206</sup> *Id.* at 18.

<sup>207</sup> *Id.* 39.

<sup>208</sup> *Id.* at 142.

<sup>209</sup> *Id.* Investors can also deduct income from technology transfer activities and R&D expenses from taxable income, carry forward losses from previous fiscal years, and depreciate assets more quickly for taxable purposes.

<sup>210</sup> *Id.*

and Thailand, use cost-based incentives more often than the less developed countries such as Myanmar and Cambodia.<sup>211</sup>

Tax incentives in ASEAN countries are increasingly targeted towards specific sectors, as well as, notably, specific development objectives.<sup>212</sup> While some targeted incentive policies can be quite broad (for example, they could aim to attract any or all exporters or manufacturers), some countries list incentives for a number of key sectors. Some countries use incentive instruments in a differentiated manner across sectors.<sup>213</sup> Where investment is resource specific (in the case of extractives, for example), incentives are less likely to impact an investor's decision of where to locate operations.<sup>214</sup>

Singapore, Malaysia, and Thailand use tax incentives to promote environmental protection, attract technology, and other development objectives.

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<sup>211</sup> *Id.* at 152.

<sup>212</sup> *Id.* 148.

<sup>213</sup> *Id.*

<sup>214</sup> For a closer look into resource-based development, see Lisa E. Sachs. 2013 'On Solid Ground: Toward Effective Resource-Based Development,' (2013) Columbia Center on Sustainable Investment.

**Figure 14: Extent of Tax Incentive Targeting Across ASEAN**<sup>215</sup>

	Local sourcing, SME linkages	Employment, training and skills	R&D and other strategic sectors	Green growth	High-tech	Export	Import	Head-quarter	Territorial, SEZs	Infrastructure
Brunei Darussalam		Deduction	Deduction	Deduction	Deduction		Trade tax exemption			
Cambodia						Trade tax exemption	Trade tax exemption		Trade tax exemption	
Indonesia					Tax Holiday		Trade tax exemption		Deduction, trade tax exemption	Tax Holiday
Laos						Trade tax exemption	Trade tax exemption		Tax Holiday	Tax Holiday
Malaysia	Tax holiday, reduction	Deduction	Tax holiday, reduction	Reduction	Tax holiday, reduction	Trade tax exemption	Trade tax exemption	Reduction, trade tax exemption	Reduction	Deduction
Myanmar		Deduction	Deduction			Trade tax exemption	Trade tax exemption		Reduction	
Philippines					Tax Holiday	Trade tax exemption	Trade tax exemption	Reduction	Reduction	Deduction
Singapore		Deduction	Deduction		Tax holiday, deduction		Trade tax exemption	Reduction	Trade tax exemption	
Thailand	Deduction	Deduction	Deduction				Trade tax exemption	Tax Holiday	Tax Holiday	Deduction
Viet Nam		Tax credit	Deduction		Deduction		Trade tax exemption		Tax holiday, reduction, trade tax exemption	Deduction, reduction

Finally, some incentives are targeted specifically at foreign investors. Some of the following countries offered such incentives in 2019:<sup>216</sup>

- In Vietnam, the standard corporate tax rate of 20% can be reduced as low as 10% for a 15 year period as well as additional incentives.
- In Indonesia, foreign investors in pioneer industries can receive tax incentives ranging from 50% to 100% for a period of 5-20 years.
- In China, companies can receive a number of different tax holidays, including a 5-year holiday for investments in special economic zones, and certain high technology

<sup>215</sup> *Id.* at 144. “Note: Tax holiday = total income tax exemption over defined period; reduction = income tax rate reduction over defined period; deduction = deductions of certain expenses from taxable income; tax credits = deduction of certain expenses from payable taxes (loss carried forward and accelerated depreciation also fall under this category for simplicity); trade tax exemption = exemption from import duties, export taxes or VAT.”

<sup>216</sup> *Id.*

investments can qualify for a 5-year holiday and an additional 5-year 50% reduction in corporate income taxes.

#### **Box 6: Investment Incentives for Agriculture and Agro-Processing in Africa and Asia**

A survey of incentives regimes of 19 countries in Africa and Asia<sup>217</sup> implemented by the Columbia Center on Sustainable Investment highlights the widespread implementation of tax incentives to promote investment in agriculture and agro-processing.<sup>218</sup> For example, 18 of the 19 countries offer some kind of corporate tax deductions to encourage investment. Seven countries offer a version of a tax holiday and 15 provide import duty exemptions for raw goods imported to manufacture or export agricultural products. Although financial incentives, such as loans, appear to be less common in the countries reviewed, they are still used to attract investment in both agriculture and agro-industry processing. For example, Zambia provides financial incentives for farm works and farm improvement,<sup>219</sup> while Taiwan offers a special loan program for investments in agriculture technology parks with the goal of expanding the nation's agro-industry.<sup>220</sup>

Land-related incentives, especially regarding tenure, are an additional type of incentive frequently used for the agricultural sector. Land tenure rules can affect how foreign investors view the attractiveness of a country with respect to agricultural investments. Here, too, government policies vary: for example, while Thailand allows foreign ownership of land,<sup>221</sup> many other countries prohibit this, providing instead for long-term leases by foreigners. Myanmar's newly enacted Foreign Investment Law caps long-term leases at 50 years (with possible extensions),<sup>222</sup> while Tanzania allows foreigners to engage in large-scale, long-term leases for up to 99 years.<sup>223</sup> Furthermore, because foreigners are not permitted to own land in Tanzania, the Tanzania Investment Centre established a land bank, containing over one million hectares of land to lease for foreign agricultural investment.<sup>224</sup> Such rules governing rights to use land, coupled with more traditional investment incentives, may factor into how investors view agricultural sector opportunities.

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<sup>217</sup> Asian countries include Cambodia, Indonesia, Lao PDR, Malaysia, Myanmar, Philippines, Taiwan, Thailand, and Vietnam. African countries include: Angola, Burundi, Cameroon, Ghana, Liberia, Morocco, Mozambique, Sierra Leone, Tanzania, and Zambia.

<sup>218</sup> CCSI, Guide on Incentives for Responsible Investment in Agriculture and Food Systems

<sup>219</sup> Zambia Development Agency. 2011. *Agriculture, Livestock and Fisheries*, 20. (Lusaka: Zambia Development Agency).

<sup>220</sup> Invest in Taiwan. *Preferential Loan for Investment in Agricultural Technology Park*. (last visited 5 November 2013).

<sup>221</sup> Investment Promotion Act, B.E. 2520. 2002.

<sup>222</sup> The Foreign Investment Law. 2012. The Pyidaungsu Hluttaw Law No. 21, Ch. XIV, 31-33.

<sup>223</sup> Tanzania Investment Centre. 2008. *Tanzania Investment Guide 2008 and Beyond*, 11.

<sup>224</sup> Tanzania Investment Centre. 2002. *Land and Property* - The Land Act, Cap. 113. (last visited Nov. 5, 2013).



# Section 3: Effectively Designing Investment Incentives Programs

## 3.1 The Challenges of Cost-Benefit Analyses

As Sections 1 and 2 covered, countries (and the jurisdictions within them) provide a range of incentives to different types of investors, both domestic and foreign. Whether these incentive packages make for good policy is another question altogether, and one that requires analysis of each policy's associated costs and benefits. There will, of course, be distributional and temporal implications to these costs and benefits; how costs and benefits are enjoyed or shouldered by different constituencies over time will not be uniform and should therefore be accounted for in analyses.

Governments can take steps to identify and weigh the factors required to assess the costs and benefits of incentives and then decide which strategies to adopt in order to avoid the losses from incentives. The variables presented in this section can be measured and analyzed using a variety of techniques, though it is not an easy task and is not frequently done (See Section 3.2). Box 7 below shows how the costs and benefits of incentive programs are evaluated in the U.S., presenting evidence from Pew Center's research. Box 8 addresses EU's cost-benefit analysis for the State Aid program as shown by a recent ex-post evaluation.

### Box 7: Inadequate Cost-Benefit Analyses in the United States

The Pew Center on the States' research facilitates an examination of U.S. practices in evaluating its incentive programs.

In one study,<sup>225</sup> the Pew Center reviewed 16 hefty tax incentive bills passed by U.S. States between 2007 and 2011 and researched whether (1) reliable cost estimates and (2) annual spending limits were used. The research found that:

- in only four cases were both tools used;
- five of the bills were enacted without either of these fiscal safeguards;
- in seven cases, the legislation only used one of those measures.

<sup>225</sup> The Pew Center on the States. 2012. *Avoiding Blank Checks, Creating Fiscally Sound State Tax Incentives*. (Washington, DC: The Pew Center on the States).

In another study,<sup>226</sup> the Pew Center examined whether policy makers were getting the information necessary to understand if tax incentives were delivering the expected return on investments. To that end, it reviewed roughly 600 documents from state agencies and legislative committees and interviewed 175 policy makers, agency officials and experts. It found:

- only four states – Arizona, Iowa, Oregon, and Washington – integrated evaluation of their major incentives into a policy process ensuring that incentive deals were regularly reviewed (between five and ten years);
- twelve states reviewed all major tax incentives but failed to use the data to inform policy choices;<sup>227</sup>
- thirty-five did not review all the major tax incentives or use data to inform policy choices.

The Pew Center also highlighted leading examples that could provide lessons learned for other states:

- under an Oregon law, tax credits expire every six years. Although they can be renewed, the expiration term provides policy makers and other stakeholders an opportunity to critically review and assess the desirability of renewing any or all of their incentive programs;
- in 2007, Washington began a 10-year review process for every tax incentive offered. Pursuant to that process, each year nonpartisan analysts and a citizen commission collaborate to review a group of incentives and provide recommendations to lawmakers regarding whether and how the incentives should change;
- in assessing the job creation associated with incentive deals, Louisiana took into account the effects on businesses that did not receive incentives. The finding was that some newly created jobs displaced existing positions as a result of distorted competition between the businesses that were given incentives and those that were not;

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<sup>226</sup> The Pew Center on the States. April 2012. *Evidence Counts*.

[http://www.pewstates.org/uploadedFiles/PC\\_S\\_Assets/2012/015\\_12\\_RI%20Tax%20Incentives%20Report\\_EXEC\\_SU\\_MM\\_web.pdf](http://www.pewstates.org/uploadedFiles/PC_S_Assets/2012/015_12_RI%20Tax%20Incentives%20Report_EXEC_SU_MM_web.pdf)

<sup>227</sup> Arkansas, California, Connecticut, Delaware, Kansas, Missouri, Nebraska, North Carolina, Ohio, Pennsylvania, Texas, Virginia.

- in 2010, Connecticut’s economic development agency assessed the state’s major tax credits and concluded that some were not meeting the intended outcomes, but others were beneficial and cost-effective. The review resulted in some of the incentives being eliminated.
- In 2013, Rhode Island passed legislation requiring all new incentives to be regularly evaluated. The 2018 evaluation made a number of concrete recommendations for the reform of their investment programs.
- In 2017, Pennsylvania’s General Assembly passed a bill mandating a review of incentive programs. The first review of these programs has already led to policy changes.

### **Box 8: Lessons from the Cost-Benefit Analysis of the EU State Aid, 2007-2013**

*A review of 28 investment projects that were granted EU State Aid for regional development illustrates the role of cost-benefit analysis techniques, indicating that they are being employed, but not fully or by all granting authorities, leaving projects without adequate ex-ante economic assessments or ex-post evaluations.<sup>228</sup> This review covered projects in six industries and seven member states that were carried out between 2002 and 2010. The case studies included (1) seven investment projects in the pharmaceutical industry in Ireland; (2) three investment projects in the solar industry in Germany; (3) three investment projects in the car industry in Slovakia and Hungary; (4) eight investment projects in internal business services in Poland; (5) two investment projects in the cement industry in Hungary; and (6) five investment projects in the pulp and paper industry in Spain and Portugal. Among the study’s findings are that certain agencies are more diligent about conducting cost-benefit analyses of projects and incentives offers than others, but that in no case was there actually a careful review of the “incentive effect” – i.e., whether the incentive would impact investors’ investment or locational decisions. It also determined that while some jurisdictions controlled the discretion of the granting authority to negotiate and renegotiate incentives packages, others took a more flexible approach, loosening controls over efforts to ensure that the incentives provide value for money and were used to meet intended objectives.<sup>229</sup>*

<sup>228</sup> Ramboll and Matrix. 2012. *Ex-Post Evaluation of the Regional Aid Guidelines 2007-2013*. (Luxembourg: European Commission), 8.

<sup>229</sup> Le Den, Xavier, Robert Kröber, Alessandro Ramella Pezza, Fritz Gillerke, Lukas Bresser, Matías Krämer, Usman Khan, and Jose Olivas. 2012. *Ex-Post Evaluation of the Regional Aid Guidelines 2007-2013* (Evaluation Report). Usman Khan ed.

### 3.2 Gauging the Costs and Benefits of Investment Tax Incentives<sup>230</sup>

Tax incentives have both direct and indirect costs. The direct fiscal costs of a tax incentive are the revenue losses experienced as a result of giving the tax benefits to an investor that would have invested anyway.<sup>231</sup> While direct costs are fraught with challenges, the indirect costs, which can also be substantial, are even more difficult to measure. Indirect costs include:

- the time and money spent by businesses lobbying the government for tax incentives;
- the time and money spent by businesses applying for and receiving tax incentives;
- the distortions caused by encouraging new investments that are detrimental to existing ones;
- revenue lost to illegal activity, such as when businesses that do not qualify for tax exemptions falsify information to do so, or indirect revenue lost to businesses that do not qualify for tax incentives but are nonetheless illegal.
- additional costs for authorities responsible for administering tax incentives.<sup>232</sup>

Both direct and indirect benefits are possible. The creation of jobs by investors who changed their investment decision as a result of the tax incentive is one benefit that is relatively simple to measure. Other spillover benefits can also accrue, such as:

- increasing investments in technology – such as research and development or high-tech industries – that upgrade worker skills;
- promoting investments in infrastructure projects that facilitate further economic growth;
- channeling investments to create jobs in areas with high unemployment;
- encouraging investments in environmentally friendly technology; and
- securing anchor investments – i.e., investments, those that provide multiplier effects through signaling and by creating backward linkages into the local economy.<sup>233</sup>

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<sup>230</sup> Section adapted from James, S., Tax and Non-Tax Incentives and Investments: Evidence and Policy Implications. World Bank Investment Climate Advisory Services (September 2013).

<sup>231</sup> There are three methods used for calculating tax expenditures: (1) the revenue foregone method; (2) the revenue gain method; and (3) the outlay equivalent method. James, *supra* n11 20-21.

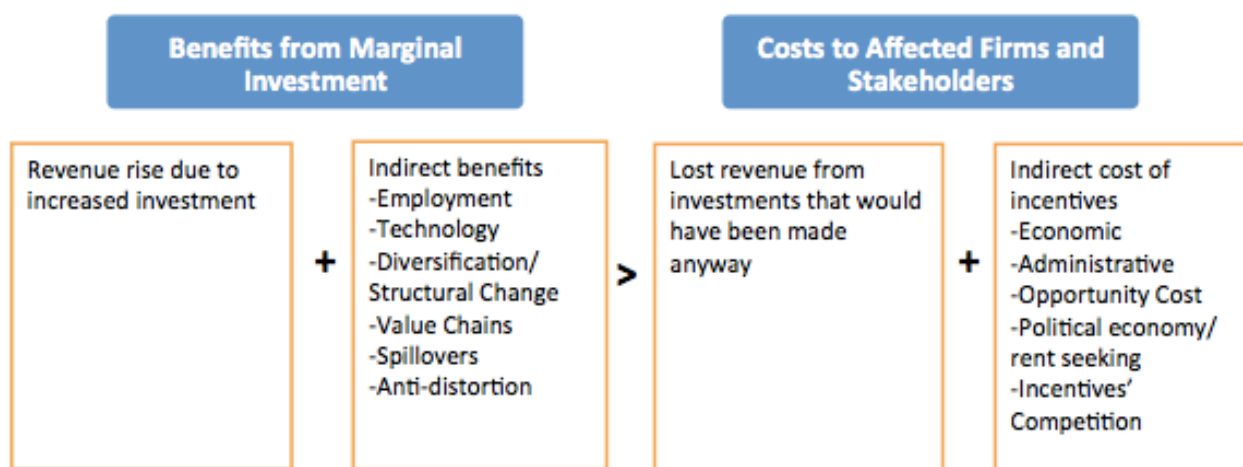
<sup>232</sup> *Id.*

<sup>233</sup> *Id.*

Although these positive externalities, like the negative ones, are often challenging to calculate, it is nevertheless important to consider them when assessing the desirability of an incentive.

Figure 15 illustrates a cost-benefit analysis examining these issues. The concept of “marginal investment is being used, and it represents the investment that would *not* have been made if the tax incentives were not provided. Using that concept to evaluate the desirability of a tax incentive, one could generally conclude that an investment incentive is beneficial if the left side of the equation is greater than the right. Governments should account for the costs both of “marginal investors” (those who would not have made the investment without the incentive) and of “infra-marginal investors” (those that would have made the investment without the incentive that they received). Note, however, that this measurement focuses only on economic costs and benefits, and does not account for other social and environmental considerations, which can alter that equation.

**Figure 15: The Basic Equation of the Cost-Benefit Analysis**



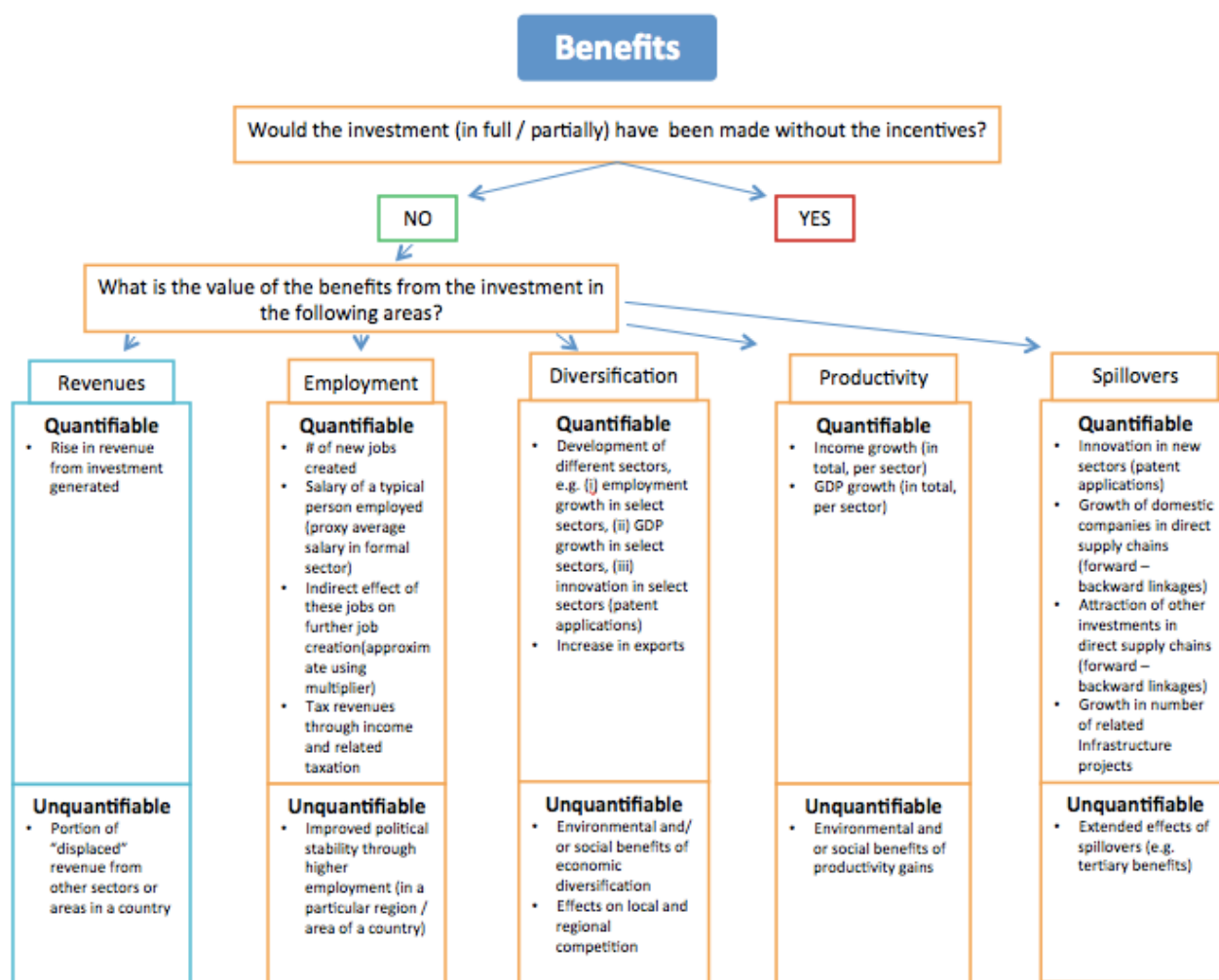
Source: Sebastian James, World Bank Group. December 2009, "Tax and Non-Tax Incentives and Investments: Evidence and Policy Implications"

One of the limitations of this cost-benefit model is that it focuses on economic costs and benefits. Incentive policies are not always considered from an economic standpoint, but rather may be dictated by other political and/or social considerations.

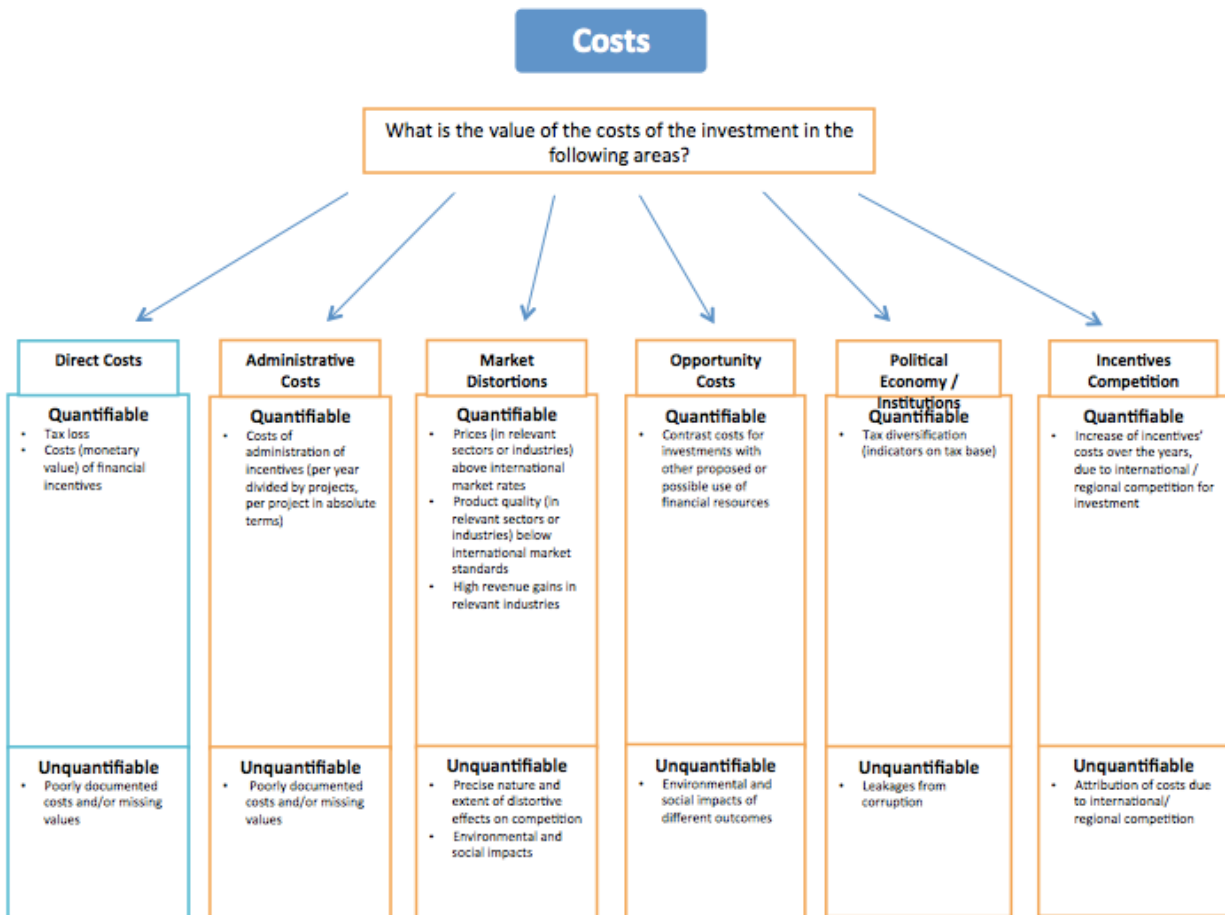
Reproduced from James, 2009

When deciding whether to offer incentives and, if so, how much to offer, governments could also take a wider range of costs and benefits-related factors into account. Figure 16 illustrates a number of these quantifiable and unquantifiable factors.

Figure 16: Framework to Assess Benefits and Costs<sup>234</sup>



<sup>234</sup> Provided by World Bank Group Trade and Competitiveness Global Practice, Investment Policy Team.



### 3.2.1 Using Jobs Created as a Measure for the Cost-Effectiveness of Tax Incentives

One narrower approach to a cost-benefit analysis is to assess the jobs created as a result of tax incentives. While less comprehensive than the analysis shown in figures 13 and 14, job creation analysis may be easier for a government to conduct. The impact of tax incentives on employment can be evaluated in a variety of ways. We suggest, at the very least, that the assessed benefits' value be restricted to jobs produced by "marginal investors" and that the assessed costs take into account the value of lost profits from investments that would have been made in the absence of incentives.

Such calculations should yield the revenue cost for each job created. There are three main ways to conduct this calculation, depending on the data that is available:

- Jobs created by marginal investors [**Benefits**]/revenue cost as measured by the percentage of non-marginal investors multiplied by the total tax expenditures [**Costs**].<sup>235</sup>
- Jobs created by marginal investors [**Benefits**]/revenue cost as measured by the actual tax expenditures incurred by the non-marginal investors [**Costs**].<sup>236</sup>
- Jobs created by all the investors benefiting from tax incentives [**Benefits**] /total tax expenditures [**Costs**].<sup>237</sup>

Though the revenue cost per job created indicator does not entirely cover all the costs or all the benefits, it provides a rough figure that can help policy makers decide if the incentive is worthwhile. Several country studies have shown the cost per job to be high. For instance, a 2013 Trade and Competitiveness study in El Salvador found the cost of incentives per job to be US\$2,084.<sup>238</sup> This was attained as the ratio between the US\$20,482,980 spent on infra-marginal investors (who would have invested anyway) and the 9,831 jobs created by marginal investors (who wouldn't have invested without them). In the case of Tunisia, it was found that the cost of tax incentives for each job created was three and a half times the per capita income.<sup>239</sup>

Another method for evaluating the jobs created as a result of incentives looks at the percentage of jobs created by marginal investors as compared to total jobs created. One caveat to the methods described above is that there are a number of practical and policy issues associated with a focus on the “marginal investor.” For one, identifying the marginal investor is a difficult exercise given that a firm seeking to convince policy makers of the usefulness of incentives has reason to declare itself a marginal investor. Some scholars<sup>240</sup> have suggested that, in order to receive more genuine and illuminating answers, rather than phrasing the redundancy question as “Would you have made this investment had you not received incentives from the host country?” it should be phrased as “Would you have made this investment had you not received incentives from the host country *assuming other countries offered the same incentives?*”

In addition, some warn that “marginal investor”-based analysis could cause negative policy signals and outcomes. More specifically, they argue that offering incentives only to “marginal investors,” for example, in order to attract a business to a site in which it otherwise would not have located

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<sup>235</sup> When we do not have the exact amount of tax incentives claimed by the investors, but we are able to find through surveys the marginal investors as well the jobs they create.

<sup>236</sup> When we do have the exact amount of tax incentives claimed by the investors as well as the jobs created by the marginal investors.

<sup>237</sup> When we do not have the exact amount of tax incentives claimed by the investors as well as the jobs created by the marginal investors).

<sup>238</sup> James, supra n11.

<sup>239</sup> *Id.*

<sup>240</sup> Guisinger, Stephen E, et al. 1985. *Investment Incentives and Performance Requirements: Patterns of International Trade, Production and Investment*. (New York: Praeger).; Thomas 2011, supra n14.



encourages companies to pit jurisdiction against each other, driving them to engage in potentially costly bidding wars. Additionally, it may effectively penalize businesses that do not shop for incentives by threatening to relocate.<sup>241</sup>

Nevertheless, identifying the “marginal investor” is at very least a useful tool for assessing the utility and efficiency of investment incentives.

### 3.2.2 Possible Extensions of the Jobs Created Methodology

Other benefits from investments, like diversification and skill development, are more difficult to measure than job creation. However, it is possible to provide similar estimated cost-benefit analyses as follows:<sup>242</sup>

- Improvement of job quality/value-add per job.

*Multiply the jobs created by the marginal investors in different categories by the salary paid to the staff in each of these categories, where the salary is the proxy of the value added.*

- Indirect creation of jobs across incentivized industries.

*Multiply the jobs created by the marginal investors by a factor that captures the indirect jobs created, which could vary by sector.*

- Creation of new skills and research jobs.

*Estimate the jobs created under different categories, including research jobs and use the same metric of the cost to create these jobs. Alternatively, for costs, estimate the revenue forgone for each of the patents that the tax incentives have incentivized.*

### 3.3 Assessing Costs and Benefits Outside the Granting Authority’s Jurisdiction

In addition to the costs and benefits for the jurisdiction providing the incentive, incentives can also have external effects. By forcing them into “races to the bottom” in investment incentives or by causing them to lose tax revenue as a result of transfer pricing practices, incentives may indirectly impose costs on other jurisdictions. However, they can also be advantageous because they promote foreign investment in fields or pursuits that might not otherwise be pursued and result in advantageous spillovers in the home, host, and even third-party countries.

There are procedures and rules for evaluating how incentives affect regions outside the jurisdiction of the grantor. As further outlined in Section 4, EU regulations on State Aid take into account how

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<sup>241</sup> The authors thank Ellen Harpel for raising these points.

<sup>242</sup> James, *supra* n11, 34

incentives granted by one member state affect other states within the EU. Another pertinent example is the U.S. Overseas Private Investment Corporation's (OPIC) policy of evaluating the effects of the investments it supports both domestically and internationally. In order to promote investments that are socially and environmentally responsible in developing nations, where such support is most likely not provided, the U.S. government established OPIC. Projects must annually show, in order to receive OPIC support, that they will not have impermissibly negative effects in the United States or cause a net loss of American jobs, as well as the degree to which they will or do have favorable effects in their host countries.<sup>243</sup>

To evaluate the impacts on the home country, the OPIC questionnaires ask for annual reports on information such as:

- whether the project has a monopoly position in the home country (or any other market);
- whether the project will, at its inception as well as throughout the course of its operations, procure goods or services from U.S. suppliers and, if so, in what amounts and from what types of suppliers (for example, whether the enterprise is minority- or female-owned, whether it is a small business, etc.);
- whether there will be remittances, including how much of it will go to the United States; and,
- whether the project will result in job losses in the United States.

To assess impacts on the host country, investment projects seeking OPIC support must complete questionnaires that ask whether the project:

- relates to activities or products that may be subject to domestic or international regulation and may be banned, phased out, or restricted due to their negative impacts on health or the environment;
- will employ men or women, skilled or unskilled labor, domestic or foreign workers, and temporary or permanent employees;
- will be situated in any environmentally sensitive area or areas of national or regional importance;

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<sup>243</sup> OPIC Self-Monitoring Questionnaire for Finance, Insurance, Reinsurance, and Investment Funds Projects. Form OPIC-162.; OPIC Office of Investment Policy Questionnaire. Form OPIC-248.

- will provide "ancillary" benefits or services not directly related to business activities, such as charitable donations or activities, scholarship programs, recreational facilities, schools, or medical clinics;
- will train workers and, if so, what percentage of workers they will train and what types of training they will provide;
- will result in restructuring that entails the dismissal of employees in the host country;
- will have human resources staff and policies, offer benefits like healthcare, and go above and beyond what is legally required under domestic law in terms of those benefits;
- will provide workers with training and, if so, what percentage of workers they will train and what types of training they will provide;
- will provide new or unusual management practices, marketing or distribution strategies, production or processing methods, or products or services as a means of transferring technology to the host nation;
- will offer technical support or training to clients, business partners, or suppliers;
- will offer instruction on international industry certifications and standards; and
- will reinvest profits back into the host nation.

This questionnaire illustrates some of the potential impacts of outward investment on host and home countries, and ways that granting jurisdictions can measure the costs and benefits of incentives encouraging such investment. Presently, however, cost-benefit analyses of incentives for outward investment appear to be conducted even less frequently than analyses of incentives used to attract inward investment.

### *3.4 Policies for Minimizing Costs and Maximizing Benefits of Tax Incentives<sup>244</sup>*

Cost-benefit analyses are crucial for helping governments evaluate the desirability of existing or potential future incentives grants or programs. Importantly, various policy strategies can shape the weight of costs and benefits. This section highlights several key considerations that governments can take into account when seeking to maximize the benefits and minimize the costs of the incentives they offer. These include reducing administrative costs and opportunities for tax evasion; carefully matching incentives to desired targets and needs; and avoiding tax holidays, which tend to be particularly wasteful incentives.

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<sup>244</sup> Adapted from James, *supra* n11.

### 3.4.1 Reduce Administrative Costs and Opportunities for Evasion Through a Broad, Uniform System

A good tax system is stable, ensures predictable revenue for the government, and minimizes distortions in investment decisions. There is broad consensus that applying tax instruments with reasonable tax rates over a broad base is sound policy. Paradoxically, that approach rules out all tax incentives.

Silvana and Baer note that in many developing countries, a tax system with few taxes, a limited number of rates for each tax, limited exemptions, and a broad base has proven much easier to administer and resulted in higher compliance than a complex tax system.<sup>245</sup> Similarly, aiming for a global tax with few exemptions, credits, rebates, or deductions, avoiding attempting to achieve too many social and economic goals, and being continuously monitored are some other recommendations made by experts for the ideal tax system.<sup>246</sup>

“Having few exemptions limits the need to verify case-by-case compliance with the conditions under which exemptions are granted. Differential treatment greatly increases information requirements for the tax administration, provides opportunities for misreporting, and complicates tax compliance requirements. Furthermore, costs and complexity of tax administration increase if the tax system is used to achieve nonrevenue goals. Tax concessions for nonrevenue objectives should be used very selectively and only after comparing their effectiveness with alternative expenditure, subsidy, or regulatory instruments that can potentially achieve the same goals.”<sup>247</sup>

That said, political economy considerations and short-term constraints may be strong forces driving countries to offer some kind of tax incentives. Moreover, some experts have argued that governments should have fewer neutral policies because not all investments are the same and some incentives may be needed to overcome obstacles and market failures.<sup>248</sup>

### 3.4.2 Match Incentives to Particular Region/Country Characteristics, Targets, and Needs

In order to be effective and help governments meet their policy goals, incentive programs should be designed to account for the needs and characteristics of the granting jurisdiction in the near and long term. Table 7 summarizes desirable short- and long-term incentive policies for countries facing a variety of conditions.

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<sup>245</sup> Silvana, Carlos and Katherine Baer. 1997. *Designing a Tax Administration Reform Strategy: Experiences and Guidelines*. IMF Working Paper. 30.

<sup>246</sup> James, *supra* n11, 28.

<sup>247</sup> Adapted from James, *supra* n11

<sup>248</sup> Dunning John H. and Sarianna M. Lundan. 2008. *Multinational Enterprises and the Global Economy*. 85-86.

**Table 7: Incentive Policies Under Various Country Scenarios<sup>249</sup>**

<b>Country Scenario</b>	<b>Short-Term Policy</b>	<b>Long-Term Policy</b>
<b>Countries with a very weak investment climate</b>	Investment incentives are ineffective and therefore lead to a waste of tax revenues. Tax revenues instead should be used to create public goods. Reforms should also be introduced to rationalize the tax system, the tax instruments, and the rates as well the tax administration.	Country should work to reduce barriers to investment and focus on simplifying investment process widely.
<b>Countries facing tax competition</b>	Incentives may be used to ensure that the country is not at a disadvantage to its neighbors. <sup>250</sup>	Such countries should work on regional pacts to stop harmful tax competition. Countries should also work on marketing the more substantive differentiations, e.g., labor, skills, infrastructure, or develop a unique selling proposition.
<b>Countries planning to diversify their economy</b>	Countries may use incentives that are linked to investment growth (investment allowance, accelerated depreciation, etc.) but only for a limited period based on clear prioritization of sectors in line with FDI competitiveness.	Broader industrial policy strategies must be followed, including a focus on sector targeting and promotion for investment.
<b>Countries possessing unique advantages (natural beauty, natural resources)</b>	General investment incentives to attract investments that exploit such advantages waste revenue, unless they kick-start investment.	Barriers should be appropriately lowered for investments designed to exploit the natural resource, access to land, good quality infrastructure, etc.

Reproduced from James, 2013

<sup>249</sup> James, supra n11.

<sup>250</sup> While such a strategy was effective in the case of Antigua, it is possible that it took investment away from its neighbors through tax competition. As a result, while Antigua gained, it is likely that this was at the cost of its neighbors. Further in the long term, it erodes the tax base creating the need to tax other sources such as labor and consumption.

### 3.4.3 Avoid Tax Holidays

In particular, tax holidays – although a popular incentive – should be avoided as they have numerous disadvantages, including<sup>251</sup>:

- “Tax holidays are a blanket benefit unrelated to the amount of capital invested or its growth during the holiday. An alternative is to set minimum capital investment **or** growth requirements to receive a tax holiday.
- Firms have an incentive to close and sell their businesses at the end of the tax holiday – only to reopen as a “new” investment, thus gaining an indefinite tax holiday.
- If FDI operates under double taxation agreements, tax holidays simply transfer tax revenues from the country receiving the investments to the investor’s home country.
- Tax holidays enable firms to funnel profits, using transfer pricing (see Box 9), from an existing profitable company through the “tax holiday” company and so avoid paying taxes on either.
- Most capital-intensive investments do not yield a profit until several years after operations start. Thus, tax holidays for a “start-up” period of five years are ineffective. Indeed, tax liabilities often kick in just about when a business starts to make a profit.”

#### **Box 9: Incentives and Investment in India: The Role of Institutions and Issue of Transfer Pricing<sup>252</sup>**

Incentives for exporters were removed by the Indian government in 2000, with the exception of those who were based in export processing zones or who met the criteria for export-oriented units. Businesses that lost their incentives quickly changed their investment behavior. Firms from the zones and export-oriented units, which were very similar, served as a control group for the study of these changes. Only the garment exporters from one Indian state (Tamil Nadu) were examined in order to compare them to other businesses.

Despite higher tax rates, companies that lost their incentives continued to invest the same amount. Similar patterns were seen in the control group, proving that the removal of incentives had no impact on investments.

In the group that lost incentives, reported pre-tax profits decreased by 50% despite hardly any changes in business metrics like sales or the percentage of exports. Incentives did not cause pre-

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<sup>251</sup> James, supra n11.

<sup>252</sup> *Id.*; James, Sebastian. 2007. *The Effect of Tax Rates on Declared Income: An Analysis of Indian Taxpayer Response to Changes in Income Tax Rates*. Ph.D. Dissertation, Harvard University.

tax profits to decrease; instead, only the amount reported did, as shown by tax audits. This suggests that investors increased their tax evasion in response to the loss of incentives. The pre-tax profits of units in the zone were also found to be significantly higher than those of units outside, even when both units were producing the same product in the same city, among investors who owned two industrial units, one inside the zone and the other outside. Thus, the profits of the unit that did not benefit from tax incentives were frequently much lower than the profits of the unit that did, indicating a diversion of profits to the tax-exempt entity, when a company had two units, one of which benefited from tax incentives while the other did not.

Therefore, tax holidays are a very blunt investment incentive, while other incentives could provide benefits to taxpayers, encouraging investment. Such incentives, known as investment-linked or performance-based incentives, include the following<sup>253</sup>:

- “*Investment tax credits*. A fixed percentage of an investment is deducted from tax liability.”
- “*Investment allowances*. A fixed percentage of an investment is deducted from taxable profit (in addition to depreciation).”
- *Accelerated depreciation*. Depreciation is permitted more quickly than is feasible for the rest of the economy. There are many ways to accomplish this, such as by raising first-year depreciation allowances or depreciation rates. Tax payments are unaffected in nominal terms, but their net present value decreases and firm liquidity rises.

#### 3.4.4 Path to Reform

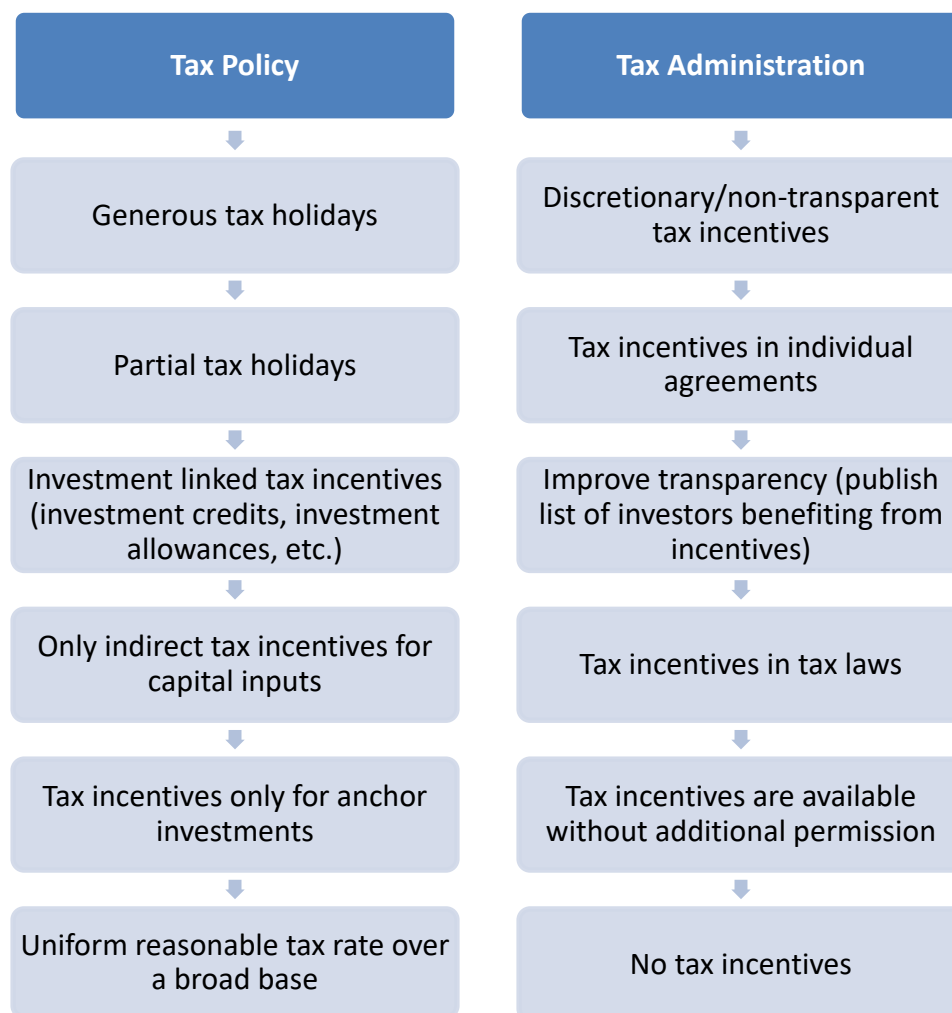
Overall, the practice of providing incentives creates many risks. Among them, it might encourage lobbying and rent-seeking, facilitate evasion, and exacerbate the challenges of administration. But there are various steps governments can take to minimize or avoid these consequences. For instance, increasing transparency on the costs and benefits of tax incentives would, in the long run, better help shape future policy. Moreover, providing a level playing field to all businesses through broad-based taxes and with reasonable rates has been the best investment incentive in many countries.

Based on these considerations, the diagram below illustrates a progressive evolution towards a sound, measured, and targeted use of tax incentives.

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<sup>253</sup> James, *supra* n11.

**Figure 17: Reform Path for Tax Policy and Administration<sup>254</sup>**



Reproduced from James, 2013

### *3.5 Policy Challenges Relating to Financial and Other Nontax Incentives*

The sections above focused on tax incentives. As compared with those types of measures, the costs and benefits of financial and other non-tax incentives can be more difficult to track, measure, and control.

Many of these difficulties with non-tax incentives are brought on by the fact that they take many different forms, such as direct grants, lower real estate prices, and exemptions from regulatory compliance. The variety of non-tax incentives can make cost calculations for them particularly difficult. It can also be challenging to calculate benefits due to their policy objectives, particularly

<sup>254</sup> Adapted from James, supra n11.



for behavioral incentives (incentives designed to encourage particular behaviors, like R&D incentives and training incentives).

As opposed to tax incentives, which are usually only granted by taxation authorities, national and subnational officials can grant numerous financial and alternative non-tax incentives as well as collaborate with other government bodies to administer such incentives, adding yet another challenge to accounting for all administered grants.<sup>255</sup>

The likelihood of abuse is also increased because the majority of financial incentives are highly targeted and may be given in a discretionary manner. As a result, it is more difficult to gather accurate data, account for rent-seeking, and consider other political economy implications. Additionally, it's possible that the political justifications for using financial incentives will prevail over their economic justifications.<sup>256</sup>

Together, these factors can complicate the process of evaluating and shaping the cost-benefit profile of non-tax incentives beyond the challenges associated with tax incentives alone.

### 3.6 Concluding Remarks on General Best Practices for Government Design of Tax and Other Incentives

Drawing from and building on the discussion in this section, the text below concludes by setting forth 10 core principles that are considered international best practice in the area of investment incentives.<sup>257</sup>

#### 3.6.1 Principles Related to the Selection and Design of Incentives

***Principle 1: Investment incentives should not be a primary economic development strategy but rather a focused policy instrument meant to correct market failures.***

Applies to: Tax and Financial Incentives

Rationale: Empirical studies and country experiences indicate that when incentives do play a role, they are most influential when investors are wavering between like options in countries with enabling environments that are conducive to investment. Due to the potential for rent-seeking, competition distortions, high opportunity costs, and a “race to the bottom” within a nation or region, the use of incentives should be calculated and cautious, and it is important to carefully consider other policy options that might be more effective in achieving the same goals. Broadly

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<sup>255</sup> *Id.*

<sup>256</sup> *Id.*

<sup>257</sup> *Ibid.*; Blomström, Magnus and Ari Kokko. 2003. “The Economics of FDI Incentives.” *International Investment Perspectives*. NBER Working Paper No. w9489. 1; Thomas, Kenneth P. 2007. *Investment Incentives: Growing Use, Uncertain Benefits, Uneven Controls* (Geneva: International Institute for Sustainable Development); OECD. 2003. *Checklist for Foreign Direct Investment Incentive Policies*.

speaking, investment incentives are often best leveraged to support the development of public goods including investments in public infrastructure projects, health facilities, education and skills upgrading, or targeted support during economic downturns.

***Principle 2: Investment incentives, if used, should only be part of broader economic development strategy.***

Applies to: Tax and Financial Incentives

Rationale: If used, incentives should only be considered one policy instrument of a larger government effort to address key investment objectives. In order to maintain investor confidence and certainty, the messaging and policies related to incentives should not be frequently changed.

***Principle 3: Investment incentives programs should be time-bound***

Applies to: Tax and Financial Incentives

Rationale: Since incentives are meant to address specific market failures, they should be designed to include sunset provisions. Tax holidays, in particular, create a community of businesses that depend on these incentives and lobby for their continuation long after the benefits for the initial period are granted. In many countries, it has been observed that tax holidays frequently continue to exist in the legal space long after their original intended duration and the time at which they would have provided any benefits would have expired. Thus, financial incentives should also have a “sunset clause.” For matching grants, sunset clauses are not needed as those grants are one-time payments. However, other financial incentives, such as loans, should have deadlines setting the expected date for outcome achievement.

***Principle 4: Investment incentives should be regularly reviewed to ensure relevance and effectiveness.***

Applies to: Tax and Financial Incentives

Rationale: Investment incentives should be regularly reviewed to determine their relevance and economic benefits relative to their budgetary and other costs, including long-term impacts on resource allocation.

When considering the role and effectiveness of incentives, governments should consider the following key questions:

- Would the investment come in anyway (even without an incentive)?
- Would the incentive put existing businesses at a disadvantage (distort competition)?

- Would the incentivized investment realize tax revenues after the incentives are exhausted?
- Does the incentivized investment provide positive externalities such as:
  - direct jobs,
  - new technology/skill upgrade,
  - Infrastructure/public goods,
  - new industry, or
  - ancillary industries?
- Does the incentive create opportunities for evasion or corruption?
- Does the incentivized investment cause negative externalities such as pollution?
- Would the incentive result in increasing demand for incentives by other investors?
- How does the incentive affect equity and the distribution of benefits?

We encourage legislators to include details on these evaluations in the design of the program, including details on who is responsible for the relevant data collection as well as the methodology that will be used for the analysis.

***Principle 5: Information on the processes and procedures, administration, management, and dispersal of investment incentives should be transparent and publicly accessible.***

Applies to: Tax and Financial Incentives

Rationale: Firms favor incentives that are transparent and easy to understand, and value certainty in incentives policy. A country's incentives regime should include practices that promote both internal disclosure (within and between government institutions) and external disclosure (to investors and the general public). Investors should have easy access to details about the different incentive programs available, the qualifications and documentation needed, the maximum awards, the award process and criteria, the duration of the award process, and the authority in charge. Information on incentives should be gathered and shared by pertinent public institutions. A centralized database should ideally contain all of the data, including beneficiary information, budgeted amounts, and incentive values.

We also encourage transparency in the individual agreements between firms and the government, as well as certification reports. States should build a public “database of deals” that includes all of this relevant information.

***Principle 6: The process for applying for investment incentives should be simple and minimize discretion. In the case of tax incentives, the approval process should be automatic.***

Applies to: Tax and Financial Incentives

Rationale: Streamlined, well-coordinated procedures help minimize both administrative costs as well as investor compliance costs. Country experiences show that automatic approval of tax incentives (i.e., investors who meet the eligibility criteria for an incentive are automatically granted that incentive) helps promote transparency and accountability, and encourages investor certainty. As opposed to granting incentives on a case-by-case basis, automatic approval is the least discriminatory and limits possibilities for bribes, so long as the eligibility criteria are objective and clearly defined, and there is the capacity to monitor and enforce compliance. Tax authorities should periodically carry out audits of cases where taxes have been claimed to minimize misuse.

***Principle 7: Incentive programs should have a statutory cap, limiting the total dollars allocated to a program.***

Applies to: Tax and Financial Incentives

Rationale: Incentive programs can become extremely costly and encourage overuse without limits on their spending. These spending caps also have a secondary benefit of requiring greater transparency in the use of incentives.

***Principle 8: Tax incentives should be linked as much as possible to investment level, and tax holidays should be used as sparingly as possible.***

Applies to: Tax Incentives

Rationale: International experiences demonstrates that tax holidays are generally less cost-effective than investment-related tax incentives like investment allowances, investment tax credits, and accelerated depreciation. They produce more deliberate motivations for growth because they are linked to the amount of capital.

Moreover, and as described in greater detail above, although tax holidays are widely prevalent, they present a range of limitations and risks.

***Principle 9: Tax Incentives should be provided for in the relevant tax code (and not in other statutes or agreements).***

Applies to: Tax Incentives

Rationale: Keeping incentives in the tax law ensures the role of the legislature and administration by the tax authority. It challenges the discretionary practice of creating individual agreements on

the provision of incentives. Additionally, with the information consolidated in one law, it increases transparency, reduces complexity (by minimizing potential confusion across multiple statutes and agreements), and motivates coordination of the relevant government agencies on the incentives offered.

***Principle 10: Tax returns, tax declarations, and relevant tax forms should be filed on a regular basis by investors as a pre-condition to benefiting from tax incentives.***

Applies to: Tax incentives

Rationale: To support monitoring and evaluation, investors should be required to file tax returns (even if the investors are receiving complete exemptions through their package of incentives). In addition to identifying the incentives that the investor is receiving, the tax form should also collect data on the approximate value of the incentives received. These values would support the collection of budgetary data and tax expenditure calculations. They would also guide tax authorities in carrying out audits of investors if automatic approval is adopted.

***Principle 11: Tax expenditure statements should be prepared regularly to measure the costs of the tax incentives.***

Applies to: Tax incentives

Rationale: The regular preparation of tax expenditure statements fosters internal accountability and sound budgeting practices. It also provides important data to assess the relative costs of incentives (e.g., as a percentage of GDP, in relation to spending on other public goods, or in relation to additional jobs provided by marginal investors).

# Section 4: Reducing Incentives Competition: Regulatory Efforts to Limit ‘Races to the Bottom’

There are several factors and trends driving the use of inefficient incentives:

- **Asymmetries in information** and inequality in **bargaining power** between governments and firms. Governments are sometimes unable to know what incentives packages competing jurisdictions are willing to give.
- **The growing use of site consultants providing information on incentives offered by different governments**, which in some markets can strengthen those asymmetries and the extractions of “rent” by firms.
- **Misalignment of costs and benefits**, with the benefit of attracting an investment being “booked” for the government officials in office at the time, but the costs often pushed off onto future governments.
- **The absence of a counterfactual** (i.e., the inability of a government to always know what would have happened if it did not grant the incentive or provide a smaller incentive package).
- **The increasing mobility of capital** making it more difficult for governments to get investments to “stick.”

While the winning location may reap near-term benefits from securing an investment, it does so at a cost likely higher than it would have been absent any unnecessary incentives competition. This can lead to a situation in which the offer and receipt of incentives becomes the norm, rather than the exception, benefiting investors at the expense of general welfare.

Addressing these issues, however, is a problem of collective action. An individual city, state, nation, or even region does not want to restrain its ability to use incentives to obtain an advantage over other competing jurisdictions, particularly if other jurisdictions have not similarly committed to restricting the use of incentives. When each actor pursues its own self-interest in the effort to attract investment, it encourages a race to the bottom detrimental to all.<sup>258</sup>

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<sup>258</sup> Thomas 2011, *supra* n14.

There are treaties that address these collective action problems and may restrict the use of trade-distorting practices caused by making certain government support or assistance impermissible. For example, members of the WTO may invoke several of the WTO's "covered agreements"<sup>259</sup> to discipline the use of investment incentives (both financial and regulatory) that government entities may introduce to attract investment. These agreements were originally aimed at addressing issues of cross-border trade and were not designed specifically to address the use of incentives to increase investment (or support outward investment). However, their rules may apply to the granting of certain subsidies, regulatory advantages, and State Aid used to attract investment. Two examples are the WTO Agreement on Trade-Related Investment Measures (TRIMs Agreement),<sup>260</sup> and the WTO Agreement on Subsidies and Countervailing Measures (SCM Agreement).<sup>261</sup> Outside the WTO framework, there are the European treaties governing State Aid. There are also other recent agreements designed to govern international investment that contain rules relevant to the use of investment incentives. These instruments are discussed in more detail below.

#### 4.1 The WTO TRIMs Agreement

The WTO Agreement on TRIMs disciplines the use by WTO members of trade-related performance requirements applied as a condition of foreign direct and, in some cases, inward investment. The context is not direct financial incentives *per se* (i.e., subsidies). Members can invoke the TRIMs Agreement to limit the performance requirements that host states seek to apply to inward and foreign investors, and this may have indirect financial implications. For example, in the *Indonesia – Autos* dispute,<sup>262</sup> Indonesia lost a case involving its attempt to condition the receipt of import duty relief and import duty exemptions for parts and components, as well as certain sales tax reductions for vehicles on the investor's satisfaction of local content requirements. Such performance requirements are widely perceived by WTO members as trade-restrictive or trade-distorting.

The TRIMs Agreement makes only a modest contribution towards disciplining performance requirements. It clarifies the application of GATT rules on national treatment and the prohibition of quantitative restrictions that arose in the *FIRA* GATT Panel Report.<sup>263</sup> The *FIRA* report involved performance requirements imposed by Canada on foreign investors. These conditions took the form of local content and export performance requirements. The GATT panel determined that Canada's local content requirements violated the national treatment obligation present in Article

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<sup>259</sup> Marrakesh Agreement Establishing the World Trade Organization, 1867 U.N.T.S. 154.

<sup>260</sup> Agreement on Trade-Related Investment Measures (TRIMs Agreement). 15 April 1994. Marrakesh Agreement Establishing the World Trade Organization, Annex 1A, 1868 U.N.T.S. 186.

<sup>261</sup> Agreement on Subsidies and Countervailing Measures (SCM Agreement). 15 April 1994. Marrakesh Agreement Establishing the World Trade Organization, Annex 1A, 1869 U.N.T.S. 14.

<sup>262</sup> Report of the Panel. 1998. *Indonesia – Certain Measures Affecting the Automobile Industry*, WT/DS/54, 55, 59, 64/R.

<sup>263</sup> Report of the GATT Panel. 1984. *Canada – Administration of the Foreign Investment Review Act* [hereinafter *FIRA*], BISD 30/S, 140.

III: 4 of GATT 1947<sup>264</sup> but that its export performance requirements did not violate GATT rules. The panel went to great lengths to emphasize that the issue before it was not Canada's sovereign right to regulate foreign investment, but instead the consistency of Canada's trade measures ("purchase and export undertakings") with GATT rules.<sup>265</sup> Nevertheless, the *FIRA* report has considerable relevance with respect to the conditions that GATT contracting parties (now WTO members) may impose on foreign investment. The WTO TRIMs Agreement, which is inspired by the *FIRA* report, has similar relevance since the primary obligations are similar, if not identical.

By its own terms, the TRIMs Agreement only applies to trade in goods and not services.<sup>266</sup> The TRIMs Agreement does not define what constitutes a trade-related investment measure. Instead, it reinforces the *FIRA* conclusion that Articles III: 4 and XI: 1 of the GATT are applicable to TRIMs.<sup>267</sup> In addition, pursuant to Article 2.2 of the TRIMs Agreement, the agreement incorporates an annex containing an "Illustrative List" of trade-related investment measures that violate Article III:4 and Article XI:1 of GATT 1994.

#### **Illustrative List**

1. TRIMs that are inconsistent with the obligation of national treatment provided for in paragraph 4 of Article III of GATT 1994 include those which are mandatory or enforceable under domestic law or under administrative rulings or compliance with which is necessary to obtain an advantage, and which require:

(a) purchase or use by an enterprise of products of domestic origin or from any domestic source, whether specified in terms of particular products, in terms of volume or value of products, or in terms of a proportion of volume or value of its local production; or

(b) that an enterprise's purchases or use of imported products be limited to an amount related to the volume or value of local products that it exports.

2. TRIMs that are inconsistent with the obligation of general elimination of quantitative restrictions provided for in paragraph 1 of Article XI of GATT 1994 include those which are mandatory or enforceable under domestic law or under administrative rulings or compliance with which is necessary to obtain an advantage, and which restrict:

(a) importation by an enterprise of products used in or related to its local production, generally or to an amount related to the volume or value of local production that it exports;

<sup>264</sup> General Agreement on Tariffs and Trade. 1947 (GATT 1947). 55 U.N.T.S. 194. Its successor agreement is the General Agreement on Tariffs and Trade 1994 (GATT 1994), 1867 U.N.T.S. 187. GATT 1994 incorporates GATT 1947. Article III: 4 sets forth the national treatment principle. National treatment together with the most-favored nation principle found in Article I: 1 of GATT 1994 make up the GATT non-discrimination obligation.]

<sup>265</sup> *FIRA* Report. para. 5.1.

<sup>266</sup> TRIMs Agreement Art. 1.1.

<sup>267</sup> TRIMs Agreement, Art. 2.1. Article XI: 1 limits quantitative restrictions (usually applied in the form of quotas).



- (b) importation by an enterprise of products used in or related to its local production by restricting its access to foreign exchange to an amount related to the foreign exchange inflows attributable to the enterprise; or
- (c) exportation or sale for export by an enterprise of products, whether specified in terms of particular products, in terms of volume or value of products, or in terms of a proportion of volume or value of its local production.

This Illustrative List constitutes the heart of the TRIMs Agreement. The TRIMs listed in paragraph 1 of the list violate Article III: 4 of GATT 1994. Paragraph 1(a) prescribes the use of local content requirements. Paragraph 1(b) prescribes the use of trade balancing requirements that in effect require the use of local content.

The TRIMs listed in paragraph 2 violate Article XI: 1 of GATT 1994. Paragraph 2(a) and 2(b) are both “trade balancing” requirements. While paragraph 1(b) “deals with internal measures that affect products after they have been imported,” “paragraph 2(a) deals with border measures affecting the importation of products.”<sup>268</sup> Paragraph 2(b) prohibits foreign exchange balancing requirements applied to limit imports.

Paragraph 2(c) is consistent with Article XI: 1 of GATT 1994. It prohibits TRIMs involving restrictions on the exportation of or sale for export by an enterprise, “whether specified in terms of particular products, in terms of volume or value of products, or in terms of a proportion of volume or value of its local production.” Paragraph 2(c) deals only with measures that restrict exports. The result, consistent with the *FIRA* decision, is that the Illustrative List does not apply to other “measures relating to exports, such as export incentives and export performance requirements.”<sup>269</sup>

Several WTO decisions have interpreted the TRIMs Agreement. A thorough examination is beyond the scope of this report, but two points bear noting: (i) In *EC – Bananas III* the panel found that the TRIMs Agreement “does not add to or subtract from” Articles III: 4 and XI: 1 of GATT 1994, but instead “clarifies that Article III: 4 may cover investment-related measures;”<sup>270</sup> and (ii) in *Indonesia – Autos* the Panel found that the TRIMs Agreement is not limited to measures applicable to foreign investment. It also applies to advantages accorded to domestic investors since they influence the treatment of foreign investment.<sup>271</sup>

<sup>268</sup> WTO Trade and investment – technical information.

[https://www.wto.org/english/tratop\\_e/invest\\_e/invest\\_info\\_e.htm](https://www.wto.org/english/tratop_e/invest_e/invest_info_e.htm).

<sup>269</sup> *Id.*

<sup>270</sup> WTO. 1997. *European Communities – Regime for the Importation, Sale and Distribution of Bananas. Complaint by Guatemala and Honduras*. Report of the Panel. WT/DS27/R, para. 7.185.

<sup>271</sup> WTO. 1998. *Indonesia – Certain Measures Affecting the Automobile Industry*. Report of the Panel. WT/DS54/R, WT/DS55/R, WT/DS59/R, WT/DS64/R, para. 14.73.

While the main focus of this chapter is on disciplining inefficient investment incentives, particularly various subsidies that states may accord investors, investment incentives do not always take the form of direct financial contributions. They can also be indirect in nature. WTO members may invoke the disciplines of the TRIMs Agreement (and Articles III:4 and XI:1 of GATT 1994) to oppose indirect financial benefits, such as import duty relief and import duty exemptions when tied to local content requirements, trade balancing requirements, and exchange balancing requirements.

#### *4.2 The WTO SCM Agreement*

The SCM Agreement governs the use of subsidies relating to trade in goods (not services). While not specifically drafted as a means to discipline investment incentives, it may nevertheless serve this function in certain circumstances. For example, one can imagine a scenario whereby a WTO member offers a financial subsidy to a foreign automotive firm to entice it to locate a factory within its territory. This type of subsidy would raise issues under the SCM Agreement.

The SCM Agreement is the only multilateral agreement containing a definition of a “subsidy.” Under the SCM Agreement, a subsidy is generally defined as a “financial contribution,” or “income or price support,” “by a government or any public body,” which confers a “benefit” on the recipient.<sup>272</sup> Financial incentives that do not meet the SCM definition of a subsidy are outside the SCM Agreement.

One important element in the SCM Agreement’s definition of a subsidy is the meaning of a “financial contribution.”<sup>273</sup> In Article 1.1(a) (1), the SCM Agreement sets forth an exhaustive list of the types of financial contributions that can be classified as subsidies. These are:

- a direct transfer of funds (e.g., grants, loans, and equity infusion), and a potential direct transfer of funds or liabilities (e.g., loan guarantees);
- government revenue that is otherwise due is forgone or not collected (e.g., tax incentives such as tax credits);

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<sup>272</sup> Agreement on Subsidies and Countervailing Measures (SCM Agreement). 1994. Art. 1.1. [hereinafter “SCM Agreement”]

<sup>273</sup> Read together, Article 1.1(a)(2) and Article 1.1(b) of the SCM Agreement provide that, in addition to a “financial contribution,” an “income or price support in the sense of Article XVI of GATT 1994” that confers a benefit will also be a subsidy. The meaning of that language and its relationship to a “financial contribution” is relevant to the scope of the definition of a “subsidy” under the SCM Agreement. WTO panels and the Appellate Body have not provided much insight into how the phrase “income or price” support should be interpreted. See the discussion in Coppens, Dominic. 2014. *WTO Disciplines on Subsidies and Countervailing Measures: Balancing Policy Space and Legal Constraints*. (Cambridge: Cambridge University Press).

- provision of goods or services (other than general infrastructure), or government purchases of goods, at non-market prices; and
- government payment to a funding mechanism, or when government entrusts or directs to a private body to carry out one or more of the three types of contributions addressed above.

Regulations (e.g., exemptions from compliance with certain environmental or technical standards) that convey an indirect benefit to firms or industries are not on that list and are unlikely to fall within the SCM's definition of a subsidy. Nevertheless, in very limited circumstances they might be prohibited under other WTO-covered agreements, such as the non-discrimination provisions in the Agreement on Technical Barriers to Trade (TBT Agreement) and in the GATT (GATT 1994).<sup>274</sup> These obligations are mentioned below.

The second core element of the definition of a “subsidy” under the SCM Agreement is that it must confer a benefit or advantage on the recipient. A “benefit” or an “advantage” is defined in relation to the normal costs and benefits occurring in the market. A benefit or an advantage is conferred if the financial contribution “places the recipient in a more advantageous position than would have been the case but for the financial contribution.”<sup>275</sup>

#### 4.2.1 Regulation of Specific Subsidies

Even if a measure falls within the definition of a “subsidy,” this does not mean that the subsidy is prohibited or restricted under the SCM Agreement. Whether and to what extent the subsidy will be regulated depends on its “specificity.” Specificity refers to whether a subsidy is available only a particular enterprise, industry, or group of enterprises or industries.<sup>276</sup> By disciplining “specific” subsidies, the SCM Agreement targets those subsidies that “cause distortions and inefficiencies in international trade and [that], therefore, should fall under an international discipline. General measures, such as the reduction of tax rates for an entire country or the creation of public infrastructure, modify the market structure in the same way for all economic operators in the market” and are not restricted.<sup>277</sup>

If a subsidy is “specific” it may fall into one of two categories, (1) prohibited subsidies, which the SCM Agreement deems to be specific and flatly prohibits; and (2) actionable subsidies, which the

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<sup>274</sup> Agreement on Technical Barriers to Trade (TBT Agreement). 1994. Marrakesh Agreement Establishing the World Trade Organization, Annex 1A, 1868 U.N.T.S. 120.

<sup>275</sup> Panel Report. 1997. *Canada – Measures Affecting the Export of Civilian Aircraft*, WT/DS70/R, paras. 9.112-9.113; Appellate Body Report. 1990. *Canada – Measures Affecting the Export of Civilian Aircraft*, WT/DS70/AB/R, paras. 157-158.

<sup>276</sup> SCM Agreement, Article 2.1.

<sup>277</sup> Luengo Hernandez de Madrid, Gustavo. 2007. *Regulation of Subsidies and State Aids in WTO and EC Law: Conflicts in International Trade Law*. Kluwer Law International, 129.

SCM Agreement classifies as actionable, but not *per se* illegal. A third category, non-actionable subsidies,<sup>278</sup> expired on Dec. 31, 1999, with the effect that such subsidies are now actionable.<sup>279</sup>

Article 3.1 of the SCM Agreement defines prohibited export subsidies as:

- Subsidies contingent, in law or in fact, whether solely or as one of several other conditions, upon export performance; and
- Subsidies contingent, whether solely or as one of several other conditions, upon the use of domestic over imported goods.<sup>280</sup>

Pursuant to Article 3.1, prohibited subsidies consist of export subsidies and import substitution subsidies. A member may challenge such subsidies without showing harm to its interests, and WTO dispute settlement is subject to tighter time limits since injury is not an issue. There is a philosophical similarity in the disciplines imposed under the SCM and TRIMs Agreement. Both agreements discipline incentives that favor the use of local goods over imported goods.

The second category (actionable subsidies) includes specific subsidies that are not export subsidies or agricultural subsidies. These subsidies are actionable in the event that they adversely affect other members, including through:

- injury to the domestic industry of another member;
- nullification or impairment of benefits accruing directly or indirectly to other members under GATT 1994; and
- serious prejudice to the interests of another member.<sup>281</sup>

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<sup>278</sup> Article 8.1 of the SCM Agreement designated, on a temporary basis, three categories of specific subsidies as “non-actionable.” These were certain measures designed to support or promote research, to assist disadvantaged regions within the territory of a Member, and to promote adaptation of existing facilities to new environmental requirements.

<sup>279</sup> SCM Agreement, Art. 31.

<sup>280</sup> SCM Agreement, Art. 3.1. Pursuant to footnote 5, certain measures falling within the scope of Article 3 are permitted if they are referred to in Annex 1 of the SCM Agreement as not constituting export subsidies. More specifically, the second paragraph of Annex I, paragraph (k) establishes a “safe harbor” for certain export credits falling within the OECD Export Credit Arrangement.

<sup>281</sup> SCM Agreement, Art. 5. Serious prejudice is defined in Art. 6. Article 6.3 clarifies that: “Serious prejudice in the sense of paragraph (c) of Article 5 may arise in any case where one or several of the following apply: (a) the effect of the subsidy is to displace or impede the imports of a like product of another Member into the market of the subsidizing Member; (b) the effect of the subsidy is to displace or impede the exports of a like product of another Member from a third country market; (c) the effect of the subsidy is a significant price undercutting by the subsidized product as compared with the price of a like product of another Member in the same market or significant price suppression, price depression or lost sales in the same market....” Serious prejudice thus includes harm in third country markets.

If the SCM does not prohibit a subsidy, or if an actionable subsidy does not cause adverse effects, it is outside the scope of the SCM Agreement.

#### 4.2.2 Remedies for Unlawful Subsidies

The SCM Agreement provides a two-track approach for addressing unlawful subsidies. Pursuant to Track One, members have the right to impose countervailing duties unilaterally in response to subsidies that cause injury to their domestic industry.<sup>282</sup> This is a fast and effective means of redress as it allows a member to countervail an illegal subsidy through national procedures and without recourse to WTO dispute settlement. Pursuant to Track Two, a member can seek multilateral redress at the WTO, where a WTO panel or the Appellate Body acting through the WTO Dispute Settlement Body, can recommend that a subsidy be removed. Multilateral redress is the only available remedy when a subsidy harms a member's exports to a third country or to the subsidizing member.<sup>283</sup>

In conclusion, it is possible that, in certain cases, an investment incentive could involve a prohibited subsidy. However, it is more likely that a case involving the WTO legality of investment incentives would revolve around:

- (i) Whether another WTO member (not the grantor or the grantee of the specific subsidy) can prove that an investment incentive causes injury to its domestic industry within the meaning of the SCM Agreement. If so, the subsidy could be “countervailable” at the national level,<sup>284</sup> or
- (ii) Whether there is nullification or impairment or serious prejudice if a dispute involves a member's exports to a third country or to the subsidizing member (or injury to its domestic industry. If so, such a measure could be capable of redress at the WTO.

#### 4.2.3 Subsidies Used by Developing Countries

The SCM Agreement included many specific rules for developing country members, most of which have now expired. Article 27.2(a), when read together with Annex VII, still permanently exempts the least developed members from the prohibition on subsidies conditioned on export performance, thus allowing them more flexibility to use export subsidies (which may not be within their means). The SCM Agreement also sets out special rules regarding countervailing duties,

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<sup>282</sup> SCM Agreement, Part V.

<sup>283</sup> Clark, Peggy A. and Gary N. Horlick. 2005. “The Agreement on Subsidies and Countervailing Measures.” In Patrick Macrory, Arthur Appleton, and Michael Plummer eds. *The World Trade Organization: Legal, Economic and Political Analysis*, Vol. 1. 687. (Springer).

<sup>284</sup> See SCM Art. 5 and Art. 11.2.

broadening the category of subsidies offered by developing country members that are deemed to be *de minimis*, and not subject to countervailing duties.<sup>285</sup>

#### 4.2.4 Notification and Review

Article 25 of the SCM Agreement requires that members disclose all specific subsidies on an annual basis. Any member may ask another for additional information about its subsidies and, if the requested member does not comply, the matter may be brought to the attention of the Committee on Subsidies and Countervailing Measures.

#### 4.3 WTO Agreement on Agriculture (AoA)

To what extent would government financial incentives applied to attract agricultural investment fall within the disciplines of the WTO Agreement on Agriculture? The legal situation is complex, further complicated by the fact that the AoA was not written as an investment agreement, but as a means to accomplish three goals: (i) increased market access for agricultural producers,<sup>286</sup> (ii) increased discipline on domestic support granted by members to their agricultural producers,<sup>287</sup> and (iii) increased discipline on export subsidies accorded agricultural producers.<sup>288</sup> Nevertheless, it is conceivable that the AoA might apply, in very limited circumstances, to certain investment incentives that a WTO member might offer to attract or retain an agricultural producer.

Why should the AoA apply while the SCM Agreement does not? Pursuant to Article 21, the AoA trumps other WTO-covered agreements dealing with trade in goods. As the AoA takes a more lenient approach to export subsidies and domestic support programs,<sup>289</sup> investment measures (to the extent that they might fall within the AoA) might receive greater protection. When the Peace Clause<sup>290</sup> was in effect, agricultural export subsidies in conformity with the AoA were not

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<sup>285</sup> SCM Agreement, Art. 27.10. For developing countries, *de minimis* is defined in its simplest form in Article 27.10(a) as less than 2% of the products value calculated on a per unit basis.

<sup>286</sup> WTO. *Agreement on Agriculture, Uruguay Round Agreement*. Part II and III. [hereinafter “AoA”] [https://www.wto.org/english/docs\\_e/legal\\_e/14-ag\\_01\\_e.htm](https://www.wto.org/english/docs_e/legal_e/14-ag_01_e.htm).

<sup>287</sup> Part IV of the AoA.

<sup>288</sup> Part V of the AoA.

<sup>289</sup> Wouters, Jan and Dominic Coppens. 2009. “An Overview of the Agreement on Subsidies and Countervailing Measures.” In Kyle W. Bagwell, George A. Bermann, and Petros C. Mavroides eds. *Law and Economics of Contingent Protection in International Trade*. (Cambridge University Press). 79-81.

<sup>290</sup> Article 13 (Due Restraint) of the AoA was popularly known as the Peace Clause. It limited the right of WTO Members, during the AoA’s implementation period, to raise the SCM Agreement in certain agricultural disputes.

prohibited or actionable, but could be countervailed.<sup>291</sup> With respect to domestic support,<sup>292</sup> green box<sup>293</sup> subsidies were not actionable and could not be countervailed. Amber box<sup>294</sup> and blue box<sup>295</sup> measures were countervailable, but were not actionable if they did not exceed 1992 levels.<sup>296</sup>

With the expiry of the Peace Clause, the situation is less clear. One view is that export subsidies that are in accord with the AoA are still legal but may be actionable.<sup>297</sup> Domestic support measures

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<sup>291</sup> Export subsidies under Article 9.1 AoA are defined as:

- (a) the provision by governments or their agencies of direct subsidies, including payments-in-kind, to a firm, to an industry, to producers of an agricultural product, to a cooperative or other association of such producers, or to a marketing board, contingent on export performance;
- (b) the sale or disposal for export by governments or their agencies of non-commercial stocks of agricultural products at a price lower than the comparable price charged for the like product to buyers in the domestic market;
- (c) payments on the export of an agricultural product that are financed by virtue of governmental action, whether or not a charge on the public account is involved, including payments that are financed from the proceeds of a levy imposed on the agricultural product concerned or on an agricultural product from which the exported product is derived;
- (d) the provision of subsidies to reduce the costs of marketing exports of agricultural products (other than widely available export promotion and advisory services) including handling, upgrading and other processing costs, and the costs of international transport and freight;
- (e) internal transport and freight charges on export shipments, provided or mandated by governments, on terms more favorable than for domestic shipments;
- (f) subsidies on agricultural products contingent on their incorporation in exported products.

<sup>292</sup> The three categories of subsidies are popularly known by the colors amber, blue and green.

<sup>293</sup> Green box measures that are considered to have no or only a minimal impact on trade. To fall within this box, subsidies must (a) “be provided through a publicly-funded government program (including government revenue forgone) not involving transfers from consumers;” (b) “not have the effect of providing price support to producers;” and (c) must be used for and meet criteria regarding specific policy purposes or objectives, including promoting food security, providing food aid, or providing support for relevant services such as R&D, extension and advisory services, and infrastructure services. Green box measures are not disciplined under the AoA. See AoA Annex 2.

<sup>294</sup> Amber box measures deemed to be highly trade distorting. Amber box measures, which include price-support subsidies or subsidies directly relating to production quantities, are generally subject to reduction commitments which were stronger for developed than developing countries. Amber box subsidies by least developed countries are not restricted. See AoA Article 6.

<sup>295</sup> Blue box measures are deemed by WTO Members to be less trade-distortive than amber box measures. Blue box measures include subsidies such as price supports that would otherwise be deemed as amber box subsidies, but that are made contingent on farmers *limiting* (as opposed to exporting or increasing) production. Such “production-limiting” conditions are considered to have less price-suppressing effects, and thus do not require control through reduction commitments. See AoA Article 6.5.

<sup>296</sup> Wouters, Jan and Dominic Coppens. 2009. *An Overview of the Agreement on Subsidies and Countervailing Measures – Including a Discussion of the Agreement on Agriculture*. 79-81.

<sup>297</sup> The application of subsidy rules to agricultural producers is complex. Article 3.1 of the SCM Agreement contains an exception whereby the AoA takes precedence with respect to export subsidies.



that are in conformity with the AoA are actionable under the SCM Agreement, but require a showing of specificity and adverse effects.<sup>298</sup>

In conclusion, certain agricultural investment incentives, in the form of the export subsidies and domestic support measures described above, might fall within the disciplines of the AoA and the SCM. The fact situation seems unlikely to occur, but the possibility does exist.

#### *4.4 The WTO Agreement on Technical Barriers to Trade*

The TBT Agreement seeks to ensure that technical regulations, standards, and conformity assessment procedures are applied in a manner that is non-discriminatory and does not create unnecessary obstacles to international trade, while assuring that WTO members have sufficient policy space to achieve legitimate objectives, such as protection of the environment, national security, consumer protection, as well as the protection of human health or safety, or animal or plant life or health.

As with the AoA, the TBT Agreement was not drafted as a means to discipline investment incentives. There are no WTO disputes arising under the TBT Agreement that involve investment incentives in the form of regulatory advantages specifically accorded foreign or national investors. Again, such disputes, while conceivable, are unlikely to arise under the TBT Agreement.

There are two distinct scenarios that could conceivably arise with respect to technical regulations applicable to investors. The first scenario would involve a WTO member agreeing to waive a domestic environmental law governing air pollution from a factory that would operate in the member's territory if a foreign investor agrees to locate the factory there. This decision would be within the national sovereignty of that member and would not involve a violation of the TBT Agreement. Such a situation is also unlikely to violate the SCM Agreement for the reasons mentioned above.

The second scenario would involve a WTO member seeking to attract investment, for example, an automotive plant, and in doing so, agreeing to waive national laws regulating automotive emission and fuel consumption for vehicles produced by that plant and sold within its territory. This scenario would fall within the TBT Agreement and would constitute a violation of the TBT Agreement if foreign automobiles had to satisfy a higher standard in order to be sold within the member's territory.

Were such a dispute to arise, it would involve a violation of the non-discrimination rules of Article 2.1 of the TBT Agreement (more specifically, the national treatment requirement), as well as a violation of the national treatment requirement present in Article III: 4 of GATT 1994. Three recent

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<sup>298</sup> Wouters and Coppens 2009, supra n296, (citing Steinberg, R.H. and Josling, Timothy E. 2003 "When the Peace Ends: The Vulnerability of EC and U.S. Agricultural Subsidies to WTO Challenge." *Journal of International Economic Law*, 6, 377-378. 369.)



Appellate Body decisions involving the TBT Agreement (collectively known as the “Trilogy cases”)<sup>299</sup> set forth the applicable rules under the TBT Agreement for determining whether there is impermissible discrimination. Assuming that foreign and domestic automobiles are like products,<sup>300</sup> the regulating member would not be permitted to accord less favorable regulatory treatment to imported automobiles,<sup>301</sup> unless it is done in an even-handed manner and the detrimental impact is the result of a legitimate regulatory distinction (such as protection of the environment or human, animal and plant life or health).<sup>302</sup> As the TBT Agreement is more specific than GATT 1994, pursuant to WTO practice, it is unlikely that the Appellate Body would subsequently examine an investment measure that is found to violate Article 2.1 of the TBT under Article III: 4 of the GATT.<sup>303</sup>

In conclusion, it is conceivable that an investment measure involving a technical regulation could fall under the TBT Agreement. If so, under the Appellate Body’s present interpretation of the TBT Agreement, it is likely that a discriminatory measure that accords less favorable treatment to foreign products, or among foreign products, would violate the TBT Agreement in cases where there is a legitimate regulatory distinction beyond economic gain.

#### 4.5 WTO General Agreement on Trade in Services

GATS<sup>304</sup> covers trade in services through four distinct “modes of supply” that are based on the location of the service supplier and the manner in which services are provided.<sup>305</sup> “Mode 3” covers trade in services through the commercial presence of a service supplier from one member in the territory of any other member. Mode 3 is, in effect, a form of foreign direct investment. As a result,

<sup>299</sup> Appellate Body Report, United States. 2012. Measures Affecting the Production and Sale of Clove Cigarettes. WT/DS406/AB/R; Appellate Body Report, *United States – Measures Concerning the Importation, Marketing and Sale of Tuna and Tuna Products*. WT/DS381/AB/R; Appellate Body Reports, United States. 2012. Certain Country of Origin Labelling (COOL) Requirements. WT/DS384/AB/R / WT/DS386/AB/R.

<sup>300</sup> In recent WTO jurisprudence (including *U.S. – Clove Cigarettes*), likeness is determined by assessing whether two products that are in competition with each other share the same tariff classification, product characteristics, end uses and consumer preferences.

<sup>301</sup> Treatment no less favorable requires a panel to determine whether the technical regulation at issue modifies the conditions of competition in the relevant market to the detriment of the imported like products.

<sup>302</sup> The Appellate Body followed this reasoning in all three of the “Trilogy cases.”

<sup>303</sup> The Appellate Body would exercise judicial economy, but the result is likely to be the same even if the reasoning would be different since GATT 1994 applies a rule – exception test that is absent in the TBT Agreement.

<sup>304</sup> General Agreement on Trade in Services (GATS). 1994. Marrakesh Agreement Establishing the World Trade Organization, Annex 1B, 1869 U.N.T.S. p.183.

<sup>305</sup> Article 1.2 distinguishes between four modes of delivery:

Mode 1: from the territory of one Member into the territory of any other Member;

Mode 2: in the territory of one Member to the service consumer of any other Member;

Mode 3: by a service supplier of one Member, through commercial presence in the territory of any other Member;

Mode 4: by a service supplier of one Member, through presence of natural persons of a Member in the territory of any other Member.

GATS is relevant with respect to the disciplines that members may impose on service-related investment incentives.

Nevertheless, two areas are carved out from the GATS, meaning that GATS disciplines, including any rules applicable to subsidies, do not apply: (i) to services supplied in the exercise of governmental authority,<sup>306</sup> and (ii) to [air] “traffic rights, however granted;” “or services directly related to the exercise of traffic rights, except as provided in paragraph 3 of this Annex.”<sup>307</sup>

Article XV of the GATS, titled “Subsidies,” contains no rules restricting the use of subsidies.<sup>308</sup> It contains little more than a mandate for continued negotiations. Other GATS provisions, however, are relevant and may have a stronger disciplining effect on investment incentives.

Article II, the most-favored nation provision, restricts a member’s ability to treat foreign investors from one WTO member less favorably than foreign investors (like service and service suppliers) from another WTO member. This obligation applies to all measures (including the provision of subsidies) and service sectors unless the government adopting the measure has listed an appropriate exemption in its List of MFN Exemptions, or unless the country involved is an adjacent country and the measure is designed to “facilitate exchanges limited to contiguous frontier zones of services that are both locally produced and consumed.”

Article XVII, the national treatment provision, restricts a member’s ability to treat foreign investors less favorably than domestic investors with respect to an investment in services. This obligation only applies to service sectors that a member has listed in its schedule. For those sectors that are scheduled, a member has the right when formulating its service schedule to negotiate an exception enabling it to grant different treatment to foreign and domestic investors. Poretti notes that “the applicability of National Treatment to subsidies is confirmed by para. 9 of GATT Document MTN.GNS/W/164, 3 Sep. 1993 ‘Scheduling of Initial Commitments in Trade in

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<sup>306</sup> GATS. 1994. Article I: 3.

<sup>307</sup> GATS. 1994. Art. 2, Annex on Air Transport Services.

<sup>308</sup> GATS Article XV provides:

1. Members recognize that, in certain circumstances, subsidies may have distortive effects on trade in services. Members shall enter into negotiations with a view to developing the necessary multilateral disciplines to avoid such trade-distortive effects. The negotiations shall also address the appropriateness of countervailing procedures. Such negotiations shall recognize the role of subsidies in relation to the development programs of developing countries and take into account the needs of Members, particularly developing country Members, for flexibility in this area. For the purpose of such negotiations, Members shall exchange information concerning all subsidies related to trade in services that they provide to their domestic service suppliers.

2. Any member that considers that it is adversely affected by a subsidy of another Member may request consultations with that Member on such matters. Such requests shall be accorded sympathetic consideration.

An omitted footnote provides that: “A future work programme shall determine how, and in what time-frame, negotiations on such multilateral disciplines will be conducted.”

Services: Explanatory Note,’ stating ‘Article XVII applies to subsidy-type measures in the same way that it applies to all other measures ...’.<sup>309</sup> Poretti further notes that:

[T]he Explanatory Note provides at para. 10 that “There is no obligation in the GATS which requires a Member to take measures outside its territorial jurisdiction. It therefore follows that the national treatment obligation in Article XVII does not require a Member to extend such treatment to a service provider located outside the territory of another Member”. The Explanatory Note clearly reduces the territorial scope of the National Treatment provision for the purpose of subsidies. Accordingly, Members are not requested to extend positive measures to services or service suppliers located outside of their territory. National Treatment nevertheless applies to foreign investment (or Mode 3 of Supply-commercial presence) in the financial services sector, regardless of the form and organization of the investment vehicle.”<sup>310</sup>

Through the application of Article XVI on market access, WTO members commit to allowing investors from other WTO members to invest in their domestic service sectors. Absent such a commitment, there is no obligation to allow a foreign firm to establish or operate a presence within its territory. Krajewski observed that subsidies do not need to be scheduled in the market access column of a member’s service schedule, even if the subsidy effectively limits market access. He also notes that if subsidies discriminate between domestic and foreign service suppliers, they need to be scheduled in the national treatment column.<sup>311</sup>

In conclusion, despite the unhelpful language in Article XV, the GATS does in fact contain a number of provisions that are relevant with respect to disciplining service-related investment incentives.

It is outside the scope of this report to analyze the effectiveness of the WTO Agreement as a means to restrict investment incentives, to evaluate the compatibility of the types of measures identified in Sections 2 and 3 of this report with the WTO Agreement, and to identify gaps in the WTO Agreement that remain to be filled. Instead, the goal of this section is to demonstrate that when viewed holistically, the WTO Agreement does provide a limited number of disciplines that may permit WTO members to discipline investment incentives, thereby limiting, at least to a certain extent, races to the bottom resulting from the use of investment incentives by the members.

#### *4.6 Treaty on the Functioning of the European Union (TFEU) and Rules on State Aid*

In addition to the global rules of the WTO, there are region-specific frameworks governing the use of subsidies and incentives, including, most notably, those used by the EU. The overarching rules

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<sup>309</sup> Poretti, Pietro. 2009. “Poretti on the GATS and Services Subsidies.” International Economic Law and Policy Blog; Poretti, Pietro. 2009. *The Regulation of Subsidies within the General Agreement on Trade in Services - Problems and Perspectives* (Kluwer Law International).

<sup>310</sup> *Id.*

<sup>311</sup> Krajewski, Markus. 2003. *National Regulation and Trade Liberalization in Services: The Legal Impact of the General Agreement on Trade in Services (GATS) on National Regulatory Autonomy* (Kluwer Law International), 84.

on State Aid are currently set forth in Articles 107 through 109 of the TFEU. These provisions are brief and provide limited guidance, so communications, guidelines, and decisions by the European Commission, as well as judgments of the European Court of Justice (ECJ), play a crucial role in elaborating the substantive content of the standards. There is now a relatively robust body of law governing the use of State Aid and providing guidance regarding when and under what circumstances it will be allowed, including with regard to support for inward and outward investment.

Through the application of these rules and guidelines, granting of State Aid by European countries has been in decline, as explained in Section 2. Constituting roughly 2 percent of GDP in the 1980s, they now are roughly 0.81 percent of GDP.<sup>312</sup>

#### 4.6.1 EU Definition of State Aid

As noted in Section 2, State Aid regulated by EU law is (Article 107(1)): (1) aid, in any form whatsoever, which confers an advantage or benefit for the recipient; (2) granted by a member state or through state resources; (3) that distorts or threatens to distort competition by favoring certain undertakings<sup>313</sup> or the production of certain goods; and (4) affects trade between member states. All four elements must be met for government assistance to count as State Aid.

***Contribution of state resources.*** Decisions of the ECJ interpreting the rules on State Aid have held that it must involve a direct or indirect transfer of state resources, or a charge on the public account.<sup>314</sup> Price and income supports not paid through public funds would consequently not constitute State Aid, nor would actions by the government directing a private body to make a payment or forgo income otherwise due.

***Advantage.*** To determine whether the recipient has been granted a benefit or advantage requires application of a market test – i.e., determining whether the same advantage would have been available under market conditions. Advantages can be granted through a wide range of

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<sup>312</sup> EU Commission, State Aid 2020 Scoreboard. 2021 Thomas 2011, *supra* n14; EU Scoreboard 2012. 7-8. These figures are limited to non-crisis State Aid. The aid to the financial sector in 2011 was 714.7 euros, or 5.5% of EU GDP.

<sup>313</sup> An undertaking is any entity (this includes legal persons, such as a company, and individuals acting as sole traders) which is engaged in an economic activity (C-303/88 Italy v Commission 1991 ECR I-1433). An economic activity is “any activity consisting of offering goods and services on a given market” (C35/96 – Commission v Italy 1998 ECR I-03851). When an organization is carrying out an activity for which it is capable of being remunerated and competing against other organizations within a market, it will be an undertaking for the purposes of State Aid. The Commission applies the undertaking test very narrowly. It does not consider whether a fee is charged or whether the amount of profit is appropriate. Neither does it consider whether the organization has charitable aims or other social objects. Public sector organizations that have engaged in an economic activity have been found to be undertakings. (Italy v Commission, 1991 ECR I-1433).

<sup>314</sup> Luengo 2007, *supra* n277; Luengo suggests, however, that the European Commission has indicated it takes a different view of this subject.

interventions, including through government participation in a company's capital; the granting of loans or guarantees; tax relief; exemptions from social welfare charges; provision of goods or services; and payment for goods and services.

**Selectivity.** The advantage must favor certain undertakings or the production of certain goods or services. Hence, subsidies that are granted to individuals, or general measures open to all enterprises, are not prohibited and do not constitute State Aid (e.g. general taxation measures or employment legislation). However, “a measure that is open to all sectors may be selective if there is an element of discretion by the awarding authorities,” and if the scheme applies to only part of the territory of a member state (this is the case for all regional and sectoral aid schemes).<sup>315</sup>

#### 4.6.2 Regulation of Specific Subsidies

Support meeting the definition of State Aid is generally considered to be incompatible with the common market of the EU and not allowed unless it is aimed at one of several community objectives or corrects certain market failures.

Article 107(2) of the TFEU lists three categories of State Aid that are always permitted, in order to achieve certain policy goals of the community. These include:

- aid with a “social character” granted directly to individual consumers, as long as it is granted without discrimination relating to the origin of relevant products (e.g., tax deductions for low-income or disabled persons, or tax benefits for the purchase of low-carbon products);
- aid to repair damage caused by natural disasters or other exceptional occurrences; and
- aid granted to certain parts of Germany to compensate for the economic consequences of the former division of the country.

Article 107(3) provides that there are several other objectives that may, in certain cases, also warrant the use of State Aid. In this case, the commission has discretion regarding whether to authorize State Aid targeting any one of these policy goals:

- Furthering economic development of areas where the standard of living is abnormally low or where there is serious underemployment as compared to EU averages (Art. 107(3)(a)).
- Promoting important projects of common European interest (e.g., construction of a power plant to provide energy to other EU members, construction of infrastructure linking EU states, the formulation of industrial standards, and environmental protection) or correcting

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<sup>315</sup> EU State Aid Scoreboard. 2018. See also for more, EU State Aid Scoreboard 2020.

a serious disturbance in the economy of a member state that affects the state as a whole (as opposed to just certain regions or sectors) (art. 107(3)(b)).

- Facilitating the development of certain economic activities or certain economic areas (regions that are economically disadvantaged relative to the state in which they are located), provided that such aid does not adversely affect trading conditions to an extent contrary to the common market (Art. 107(3)(c)).
- Promoting conservation of culture and heritage (Art. 107(3)(d)).
- Achieving other goals specified by decision of the council acting on a proposal by the commission (Art. 107(3)(e)).<sup>316</sup>

The Commission has issued guidelines specifying the criteria that must be satisfied for aid under Article 107(3) to be allowed.<sup>317</sup> The criteria include:

- contribution to a well-defined objective of common interest;
- need for state intervention: A State Aid measure must be targeted towards a situation where aid can bring about a material improvement that the market cannot deliver itself, for example by remedying a market failure or addressing an equity or cohesion concern;
- appropriateness of the aid measure: the proposed aid measure must be an appropriate policy instrument to address the objective of common interest;
- incentive effect: the aid must change the behavior of the undertaking(s) concerned in such a way that it engages in additional activity that it would not carry out without the aid or it would carry out in a restricted or different manner or location;
- proportionality of the aid: the aid amount must be limited to the minimum needed to induce the additional investment or activity in the area concerned;
- avoidance of undue negative effects on competition and trade between member states: the negative effects of aid must be sufficiently limited, so that the overall balance of the measure is positive;

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<sup>316</sup> For a useful discussion of these criteria, see Luengo 2007, surpa n277 at 346-378.

<sup>317</sup> These guidelines issued in 2013 will cover the period from 2014 to 2020; European Commission. 2013. Guidelines on Regional State Aid for 2014-2020. 2013. *Official Journal of the European Union*, 209(01).

- transparency of aid: member states, the Commission, economic operators, and the public, must have easy access to all relevant acts and to pertinent information about the aid awarded thereunder.

In addition to these overarching principles, for each of the types of potentially permissible categories of State Aid referred to in Article 107(3), the Commission and the ECJ have developed more specific guidance regarding the scope and nature of support that may be allowed.

For instance, to determine whether to authorize regional aid, the Commission has developed precise rules that specify appropriate levels of aid intensity. These levels vary based on the extent of the economic disadvantage in the targeted region as well as the size of the investment. The more severe the economic situation in the relevant region, the greater the allowed aid intensity will be. The maximum aid intensity for SMEs can be greater than it is for large firms. If the investment project is deemed a “large investment project” because it exceeds a threshold value, the maximum aid intensity is lower than the standard maximum allowed for investment support in that region and will be further lowered as the value of the investment increases. Commission guidance also provides that regional aid is generally only permitted to support establishment of a *new* enterprise or the expansion, diversification, or upgrading of an existing one. Regional aid is only rarely allowed if it is designed to cover operating expenses of an existing investment.

Application of these rules has led to the withdrawal of several investment incentives. For instance:

[T]he Commission in 2005 informally indicated to the Irish government that it would not approve a proposed €170 million aid to Intel for a €1.6 billion chip fabrication plant at Leixlip, and the Irish authorities withdrew the aid notification. ... Similarly, in 2008 an EU decision ... to open an investigation of a proposed investment subsidy of €37.4 million to steel-maker Dunaferri prompted Hungary to withdraw the aid proposal. And in 2002, the UK withdrew a proposed £17.4 million aid to Ford after the commission opened an investigation under [State Aid regulations].<sup>318</sup>

#### 4.6.3 Notification and Review

With certain exceptions, member states must notify the European Commission and seek prior approval of new State Aid they intend to grant or amendments to existing State Aid. Elements that must be disclosed in the notification include the authority granting the subsidy, the intended beneficiaries, their locations and sectors, the amount, form and source of the aid, and its objectives.

The exceptions to these requirements for prior notification and approval are for:

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<sup>318</sup> Thomas 2011, *supra* n14, 7-8 (internal citations omitted).



- State Aid covered by a “block exemption”,<sup>319</sup>
- *de minimis* aid, defined as aid to a single undertaking that does not exceed the value of 200,000 euros over a three-year fiscal term assessed on a rolling basis,<sup>320</sup> and
- individual aid granted pursuant to an “aid scheme”<sup>321</sup> that had already been notified to and authorized by the Commission.

These exceptions apply to the majority of State Aid, and the block exemption is increasingly being used by the Member States. In 2019, 1473 new block exemption measures were put in place, accounting for 95.5% of all new State aid measures. In other words, roughly 95.5% of aid provided to industry and services was granted based on programs covered by a block exemption or previously approved aid schemes.<sup>322</sup> Furthermore, Member States are now implementing large block exemptions schemes for a variety of goals.

In addition to the disclosure requirements regarding new aid and amendments to existing aid, member states must also provide annual reports to the Commission on their existing aid schemes.

#### 4.6.4 Penalties and Remedies

The Commission has significant powers to monitor compliance with its decisions and the State Aid rules. It can conduct on-site monitoring relating to existing aid programs and review whether schemes in place continue to comply with relevant rules. Then, in cases where a member state has: (1) not notified a State Aid, and that aid is later determined to be incompatible with the common market; or (2) notified the State Aid and obtained approval, but implemented the aid in a manner contrary to the decision approving it, the Commission may order the member to terminate the scheme and take all steps necessary to recover aid already granted.<sup>323</sup>

<sup>319</sup> See, e.g., Commission Regulation No. 800/2008 of Aug. 6, 2008 (establishing block exemptions for certain aids to small- and medium-sized enterprises, aids supporting R&D, environmental protection, employment and training, and aid complying with the Commission’s regional maps). In 2013, the Council adopted Regulation No. 733/2013 enabling the Commission to grant new block exemptions for aid for innovation, culture, natural disasters, sport, certain broadband infrastructure, social aid for transport to remote regions, and aid for certain issues relating to agriculture, forestry, and fisheries.

<sup>320</sup> Commission Regulation No. 1407/2013 of December 18, 2013 on the application of Articles 107 and 108 of the Treaty on the Functioning of the European Union to *de minimis* aid. This regulation does not apply to certain activities or sectors including primary production of agricultural products, fisheries, or aquaculture, export aid, or aid contingent upon the use of domestic over imported products.

<sup>321</sup> It is a tool for streamlining administrative procedures: an aid scheme has to satisfy the general conditions for state aid, it just then allows individual grants of aid to be given pursuant to that “scheme.”

<sup>322</sup> EU Scoreboard 2020.

<sup>323</sup> There are some limits on these recovery orders. Recovery need not be done if it would violate a general principle of Community Law. Decisions by the Commission regarding the compatibility of aid with the common market, as



#### 4.7 Intra-African Agreements

Various regional and economic blocks in Africa have made attempts at harmonizing their tax regimes and disciplining subsidies.<sup>324</sup>

One example is the effort toward tax harmonization in the West African Economic and Monetary Union (WAEMU). The eight members of this union have agreed on directives harmonizing various aspects of their tariff and tax regimes, including, in 2009, rules on income taxation. One recent study found, however, that WAEMU countries are granting investment incentives undermining those harmonization objectives. Whether acting through law or contract, officials in WAEMU countries are taking advantage of institutional weaknesses and gaps in the relevant rules to give investments deals that deviate from their standard tax regimes, increasing the opacity and complexity of the tax systems, and “contributing to a culture of ‘tax negotiation.’”<sup>325</sup>

The treaty establishing the five-member East Africa Community (EAC) evidences its state parties’ aims to harmonize and rationalize their investment incentives<sup>326</sup> and tax policies.<sup>327</sup> EAC member states have also recently made progress towards a “Code of Conduct Against Harmful Tax Competition” to harmonize member states’ tax incentive regimes. That code, which is yet to enter into force, aims to formalize an existing arrangement whereby each year the finance ministers of the five countries that make up the EAC meet before their budget speeches are made and discuss their budget proposals. This provides the opportunity for finance ministers to dissuade other members if they propose any new tax incentive that puts other countries at a disadvantage. The Secretariat, through a series of studies, is currently working to drive investment harmonization by unifying the incentive packages offered to investors within the member states and removing the disparity among investors.<sup>328</sup>

The Common Market for Eastern and South Africa (COMESA) also integrates regulations regarding incentives in the legal notice establishing its rules. It defines subsidies, and lists tax

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well as orders to suspend aid or recover aid provided, can be appealed to the ECJ. National courts can review whether member states have complied with procedural requirements of the State aid rules such as obligations to notify aids. They cannot, however, review compatibility of aids with the common market or Commission decisions and must annul any acts that the Commission determines constitute an unlawful grant of state aid. See discussion in Luengo 2007, *supra* n277 at 403-404.

<sup>324</sup> In addition to those described in this section, other initiatives include those by the Economic Community of West African States (ECOWAS). Outside of Africa, there have been relevant efforts by the Organisation of Eastern Caribbean States (OECS).

<sup>325</sup> Mansour, Mario and Grégoire Rota-Graziosi. 2013. *Tax Coordination, Tax Competition, and Revenue Mobilization in the West African Economic and Monetary Union*, 36. Working Paper 13/163. (Washington, D.C.: International Monetary Fund).

<sup>326</sup> East African Community. 2007. Treaty for the Establishment of the East African Community, Art. 80(1) (f).

<sup>327</sup> *Id.*, Art. 83(2) (e).

<sup>328</sup> James, *supra* n11.

incentives as among the types of financial contributions that fall within that definition.<sup>329</sup> It requires each COMESA member state to notify the other member states of any subsidies granted or maintained that directly or indirectly distort competition among countries in the common market.<sup>330</sup> It also allows COMESA to impose countervailing duties on products imported into the COMESA common market by third countries to offset the effects of subsidies granted by those countries.<sup>331</sup>

Last, the Southern African Development Community (SADC) is encouraging harmonization and cooperation among its member states, notably through Annex 3 to the Finance and Investment Protocol.<sup>332</sup> That annex, titled “Co-operation in Taxation and Related Matters,” requires state parties to, among other things:

- “endeavor to achieve a common approach to the treatment and application of tax incentives”;<sup>333</sup>
- “endeavor to avoid ... harmful tax competition”;<sup>334</sup>
- “endeavor to avoid ... introducing tax legislation that prejudices another State Party’s economic policies or activities of, or the regional mobility of goods, services, capital or labor”;<sup>335</sup>
- “ensure that tax incentives are provided for only in tax legislation.”<sup>336</sup>

Article 4 of the annex further requires the states to “develop and adopt guidelines for tax incentives in the Region” and establish a “fiscal framework for tax incentives” aiming, among its objectives, to address the effectiveness of proposed tax incentives in achieving their policy goals, and assessing costs and impacts of measures within individual states employing them and within the region.<sup>337</sup> It stipulates “good practice Guidelines to avoid harmful tax competition & cost benefit analysis to protect regional revenue.” To focus efforts towards implementing tax coordination, ministers for finance and investment of the member states endorsed the formation of three technical

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<sup>329</sup> COMESA. 2009. Council Regulations Governing the COMESA Customs Union, Art. 1, Legal Notices Number 1 of 2009, Vol. 15, No. 1. [hereinafter “COMESA Council Regulations”].

<sup>330</sup> COMESA Council Regulations, Art. 22.

<sup>331</sup> COMESA Council Regulations, Art. 23.

<sup>332</sup> SADC. 2010, April 16. SADC Agreement Amending Annex 1 (Co-operation of Investment) of Protocol on Finance and Investment. [hereinafter “SADC Finance and Investment Protocol”].

<sup>333</sup> *Id.*, Annex 3, Art. 4(1)

<sup>334</sup> *Id.*, Annex 3, Art. 4(3) (a).

<sup>335</sup> *Id.*, Annex 3, Art. 4(3) (b).

<sup>336</sup> *Id.*, Annex 3, Art. 4(1).

<sup>337</sup> *Id.*, Annex 3, Arts. 4(4) & 4(5).

working groups, one of which is the Tax Incentives Working Group, engaged in studying and developing guidelines for the governance of those measures in SADC.<sup>338</sup>

#### **4.8 International Investment Treaties**

International investment treaties are bilateral and multilateral instruments designed for the promotion and protection of international investment.

There are several connections between investment treaties and investment incentives that make these instruments relevant and important for the international governance of FDI incentives. Both investment treaties and investment incentives are instruments used by governments to attract investment and promote outward investment. Investment treaties may even be seen as one form of regulatory investment incentive, aiming to influence investment decisions by providing investors additional substantive and procedural legal protections, and restricting host countries' abilities to interfere with their investments. Both instruments, however, are also criticized as not being effective in achieving their intended goals, or if effective, being effective at too high a price, and with that price raising equity concerns, as it constitutes a transfer of wealth from the public to the private sectors.

Aside from these broad overlapping features, there are important connections between investment treaties and incentives. Investment treaties may be driving and locking in the use of incentives, but they also can and, to a limited extent already do, regulate the use of such supports.

##### **4.8.1 Investment Treaties' Role in Driving and Locking in Use of Incentives**

Investment treaties affect capital mobility and intensify competition among governments to attract more footloose capital through use of incentives. While many investment treaties only offer protection to foreign investment already within a state's borders, a growing number of them provide foreign investors with rights to enter a foreign market and establish a commercial presence there, guaranteeing the ability of investments and investors to freely transfer capital across borders. Additionally, broadly phrased definitions of "investments" and "investors" have been interpreted to protect investors and their overseas investments irrespective of whether the investor has substantial or real ties with the home country, or whether its foreign investment has made a lasting commitment to the host country. Investment treaties thus facilitate and protect the free movement of capital across borders, even where this may run counter to states' needs for long-term, stable investment that can provide a reliable tax base, employment, and other benefits.

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<sup>338</sup> Bolnick, Bruce. 2004. *Effectiveness and Economic Impact of Tax Incentives in the SADC Region*. USAID/RCSA and SADC Tax Subcommittee, Nathan Associates; Ogley, Adrian. 2006. "Study to Develop Draft Guidelines for the Application and Treatment of Tax Incentives and a Tax Expenditure Budgeting Template in SADC," unpublished study, PMTC International Limited; Himes, Susan. 2012. *Study to Develop Guidelines for the Application and Treatment of Tax Incentives in SADC*.

When incentives are granted to attract or keep this investment, investment treaties may lock them in irrespective of their efficiency or effectiveness in meeting policy goals or shifts in the needs, priorities, and resources of governments. After a government establishes an incentive program, it may wish to modify or eliminate that program if it runs into budget shortfalls, comes across new challenges and priorities, or determines that the incentives are not efficient or effective. Investment treaties, however, may limit governments' abilities to amend or remove incentive programs once in place.<sup>339</sup> Foreign investors have alleged that the "fair and equitable treatment" (FET) standard and the obligation to pay compensation if there is any expropriation of an investor's property – both of which are common obligations in investment treaties – are breached as a result of changes in incentives.<sup>340</sup>

While some awards evaluating and judging the merits of these claims have not yet been issued, others illustrate that shifts in incentives policies can give rise to state liability. In *PSEG v. Turkey*, for example, the tribunal found that the government violated the treaty's FET obligation when it apparently became concerned about, and decided to back away from, previous signals that it would provide what could have been costly financial support to a proposed energy project.<sup>341</sup> Similarly, in *Micula v. Romania*, the tribunal determined that the government breached the FET standard by removing certain incentives offered to firms in order to attract investment.<sup>342</sup>

What best explains the gravity of such a discussion is what happened after Spain changed its feed-in tariff system, which it implemented to promote renewable energy generation in the first place. In 2010, Spain began to change its renewable energy incentive regime as it was found to be no longer cost-efficient. This has prompted a number of arbitral claims alleging that such a change in the regulatory space violates the FET standard. As of September 2021, 22 arbitral decisions had been issued in what has become known as the "Spanish renewables saga," with more than 50 cases filed under the Energy Charter Treaty (ECT).

For instance, in the *RREEF v. Spain* case, in which an investment fund from the United Kingdom and Luxembourg brought a claim targeting the Spanish reforms in 2013, the tribunal found that Spain has breached its FET obligations by changing the old Feed-in-Tariff regime, as "obligation to create a stable environment certainly excludes any unpredictable radical transformation in the

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<sup>339</sup> Spain is currently being sued under one multilateral investment treaty, the Energy Charter Treaty, for actions relating to cuts in the incentives it had offered investors in order to promote development of renewable energy. Only limited information about the case is publicly available. See *Investment Arbitration Reporter*. 2013. "Spain Round-UP: Twin Energy Charter Claims Moving at Different Speeds; Arbitrator in Third Case Agrees to Hear Jurisdictional Objections First."

<sup>340</sup> Some treaties do have carve-outs for "taxation measures" which can mean that actions revising or removing fiscal incentives would not be actionable under the treaty.

<sup>341</sup> *PSEG Global, Inc., The North American Coal Corporation, and Konya Ingin Elektrik Üretim ve Ticaret Limited Sirketi v. Republic of Turkey*. ICSID Case No. ARB/02/5, Award. 19 January 2007.

<sup>342</sup> *Micula, Ioan and Viorel Micula.11 December 2013. S.C. European Food S.A, S.C. Starmill S.R.L. and S.C. Multipack S.R.L. v. Romania*, ICSID Case No. ARB/05/20, Award.

conditions of the investments.”<sup>343</sup> While the majority of the *Spanish Saga* tribunals acknowledging that the FET standard does not give the right to regulatory stability per se, the *Eiser v. Spain* tribunal went on to determine to what extent treaty protection, as well as the FET treatment provided in the ECT, could be invoked and result in a right of compensation as a result of a State's acknowledged regulatory rights.<sup>344</sup> The tribunal concluded that the FET obligation entails providing fundamental stability in the essential characteristics of the legal regime that investors rely on when making long-term investments.<sup>345</sup> The *Antin v. Spain* tribunal also adopted the *Eiser*'s approach and found that the FET standard includes a requirement to provide fundamental stability in the “essential characteristics of the legal regime relied upon by investors in making long-term investments.”<sup>346</sup> Both the *Antin* and *Eiser* tribunals concluded that, feed-in tariff regimes, as part of an incentive scheme, constitutes an essential characteristic of the legal regime relied upon by investors in making long-term investments. This approach ultimately described the policy choice of Spain in changing its incentives schemes as a treaty violation, no matter whether the said policy choice is actually found to be reasonable or economically and socially justifiable.

Even if not ultimately successful, the initiation of the cases alone can be costly for governments to defend and may have a “chilling effect” on governments, making them reluctant to change unwise or costly incentives programs. Also, the reviewed decisions tend to confirm that the ECT provides overly broad protection against regulatory changes to “investors.” No doubt, such broad protection may entail undermining the inherent police power of sovereigns, and enhancing the welfare of taxpayers of the host states.

Investment treaties can also effectively encourage the use of incentives through provisions stating that a government may only impose certain performance requirements on investors if they are imposed as a condition for the investor to obtain or receive an advantage.<sup>347</sup> Such requirements may be to procure services locally or train or employ workers.

#### 4.8.2 Investment Treaties’ Regulation of Incentives

In addition to indirectly or directly driving the use of incentives by facilitating increased capital mobility and potentially restricting changes in the relevant legal framework, investment treaties contain some provisions that can discipline their use. For one, most agreements contain

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<sup>343</sup> RREEF Infrastructure v. Spain, ICSID Case No. ARB/13/30, Decision on Responsibility and on the Principles of Quantum (30 November 2018), paras 315 and 379: unreasonable and disproportionate changes are understood as “drastic and radical change” affecting “unexpectedly” the conditions of the investments.

<sup>344</sup> *Eiser Infrastructure Limited and Energía Solar Luxembourg S.à.r.l. v. Kingdom of Spain*, ICSID Case No ARB 13/36 (Award 4 May 2017)

<sup>345</sup> *Id.*, 360.

<sup>346</sup> *Antin Infrastructure Services Luxembourg S.à.r.l and Antin Energía Termosolar B.V v. Kingdom of Spain*, ICSID Case No ARB 13/31 (Award 15 June 2018)

<sup>347</sup> 2012 U.S. Model Bilateral Investment Treaty, Treaty Between the Government of the United States of America and The Government of [Country] Concerning The Encouragement and Reciprocal Protection of Investment. 2012, Art. 8. [hereinafter “2012 U.S. Model BIT”].

nondiscrimination obligations that prevent states from treating covered foreign investors less favorably than similarly situated domestic investors or investors from third states. These provisions could restrict the use of selective subsidies that favor one or some enterprises over others. While some have argued that discrimination must be on account of nationality in order to be prohibited, cases indicate that de facto and unintentional discrimination are also actionable.<sup>348</sup>

A number of states – primarily developed countries with relatively elaborate treaties such as the U.S. and Canada – have (1) specifically carved out subsidies and grants from the scope of these obligations, (2) safeguarded measures in force at the time of the treaty’s conclusion that might be inconsistent with the nondiscrimination obligations, or (3) inserted policy-related exceptions, all of which can enable them to provide selective state supports. However, many states, mostly developing countries, have not included these narrowing provisions, and thus could be subject to claims by investors and the other state party or parties to the treaty that their subsidies are inconsistent with the investment treaties’ nondiscrimination provisions.

Some agreements more directly restrict certain types of incentives, but provide only weak, if any, mechanisms to enforce those obligations. In particular, a growing minority of investment treaties includes provisions stating that the contracting parties should not or must not reduce or fail to enforce environmental or labor standards in order to attract investment. These provisions aim to prevent countries from competing for investment by reducing regulatory burdens on investors. The 2012 U.S. Model Bilateral Investment Treaty (BIT), for instance, states:

The Parties recognize that it is inappropriate to encourage investment by weakening or reducing the protections afforded in domestic environmental laws. Accordingly, each Party shall ensure that it does not waive or otherwise derogate from or offer to waive or otherwise derogate from its environmental laws in a manner that weakens or reduces the protections afforded in those laws, or fail to effectively enforce those laws through a sustained or recurring course of action or inaction, as an encouragement for the establishment, acquisition, expansion, or retention of an investment in its territory.<sup>349</sup>

The Parties recognize that it is inappropriate to encourage investment by weakening or reducing the protections afforded in domestic labor laws. Accordingly, each Party shall ensure that it does not waive or otherwise derogate from or offer to waive or otherwise derogate from its labor laws where the waiver or derogation would be inconsistent with the labor rights referred to in subparagraphs (a) through (e) of paragraph 3, or fail to effectively enforce its labor laws through a sustained or recurring course of action or inaction, as an

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<sup>348</sup> Johnson, Lise. 10 September 2013. “Mobil v. Canada – Ratcheting Down the Scope of Treaty Reservations.” UNCTAD Investment Policy Hub: Featured Discussion.

<sup>349</sup> 2012 U.S. Model BIT, Art. 12(2)

encouragement for the establishment, acquisition, expansion, or retention of an investment in its territory.<sup>350</sup>

The model states that these obligations apply not only to investments by those foreign investors covered by the treaty, but to all investments within a host country's territory.

In contrast to other provisions in investment treaties, however, there are limited or no mechanisms for enforcing these obligations. The 2012 U.S. Model BIT, quoted above, only requires the states to consult with each other regarding issues arising under those articles,<sup>351</sup> and affirms that states may (but are not required to) “provide opportunities for public participation regarding” relevant matters.<sup>352</sup> The obligations regarding labor and the environment are neither subject to mechanisms for investor-state dispute settlement nor state-state dispute settlement.<sup>353</sup>

Moreover, the types of “races to the bottom” targeted by these provisions are only a subset of the legal and regulatory races that can occur due to countries' efforts to attract and retain mobile capital. States may, for instance, simply agree to pay investors for any additional costs they incur as a result of new environmental or labor legislation. They may also compete for capital by offering tax or financial incentives, or agreeing to provide land, infrastructure, or other resources on preferential terms. While not constituting offers to derogate from environmental or labor law, these incentives can erode states' resources, transfer public resources to private entities, and have similarly detrimental impacts on societal welfare and policy objectives.

A third way in which investment treaties regulate the use of incentives is through their provisions on regulatory transparency. These may require all levels and branches of government to disclose any laws, regulations, procedures, rulings and decisions relating to investment, as well as any relevant laws, regulations, or procedures proposed for adoption.<sup>354</sup> These obligations thus can be used to mandate disclosure of programs and grants of investment incentives. Like the rules on non-derogation from environmental and labor standards, these regulatory transparency obligations can now be found in some relatively modern agreements, but are still only in the minority of the treaties that have been concluded and, where included, are often not subject to dispute settlement.

Finally, a fourth way investment treaties might address the use of incentives is through the incorporation of standards and guidance developed by the OECD and UN on the conduct of multinational enterprises (see Box 10 below). There have been some efforts and calls to include in investment treaties obligations on firms to comply with such standards and guidelines. Noncompliance could then be relevant to a state's liability to an investor in the case of disputes

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<sup>350</sup> *Id.*, Art. 13(2).

<sup>351</sup> *Id.*, Arts. 12(6) and 13(4).

<sup>352</sup> *Id.*, Arts. 12(7) and 13(5).

<sup>353</sup> *Id.*, Arts. 24(1) and 37(5).

<sup>354</sup> *Id.*, Arts. 10(1) and 11(2).



regarding the removal of or modifications to incentives. It could give rise to claims or counterclaims or cause the investor to lose the benefits of the treaty.<sup>355</sup>

The TTIP negotiations on a trade and investment treaty had potentially offered an opportunity to regulate investment incentives more effectively, and any renewed attempts at that deal should similarly provide a platform for greater cross-border engagement on these issues. While the EU has rules restricting its member states' abilities to provide investment incentives, the U.S. largely lacks similar regulations. It thus seems likely that European states would have concerns that a new investment liberalization and protection agreement would more fully expose them to efforts by the 50 U.S. states and thousands of U.S. municipalities to outbid European locations for new projects and use incentives to encourage European businesses to relocate operations. European states and the Commission might also be concerned as to whether orders for firms to repay subsidies would be deemed to breach treaty protections such as the obligation to provide fair and equitable treatment.<sup>356</sup> Disciplines on the use of incentives in such an agreement could, however, potentially avoid or curb those cross-Atlantic battles.

#### **Box 10: International Standards on Firms' Activities Seeking and Obtaining Incentives**

International instruments address the *role of businesses* in seeking and obtaining incentives. Two examples are the OECD's Guidelines for Multinational Enterprises (the "Guidelines")<sup>357</sup> and the UN Principles for responsible contracts (the "Principles").<sup>358</sup>

The Guidelines are recommendations provided by governments to enterprises operating in or from adhering countries, which now number more than 40.<sup>359</sup> Though formally directed at *multinational*

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<sup>355</sup> SADC 2012. 55.

<sup>356</sup> As Luengo (2007, *supra* n277) notes, in some cases the doctrine of "legitimate expectations" has been used to shield an aid beneficiary from the obligation to repay funds that were later deemed to have been provided in breach of the rules on State Aid. Investment treaties are often interpreted as incorporating a similar protection for "legitimate expectations" in their obligations to provide foreign investors "fair and equitable treatment." It is outside the scope of this paper to determine whether the two concepts are coextensive, but if the investment treaty standard were interpreted to be more protective of investors' rights than the EU standard, then repayment orders could conceivably breach an investment treaty.

<sup>357</sup> OECD. 2011. *Guidelines for Multinational Enterprises*. [hereinafter "OECD MNE Guidelines"]

<sup>358</sup> Ruggie, John. 2011. "Report of the Special Representative of the Secretary-General on the Issue of Human Rights and Transnational Corporations and Other Business Enterprises." In *Principles for Responsible Contracts: Integrating the Management of Human Rights Risks into State-Investor Contract Negotiations: Guidelines for Negotiators*. A/HRC/17/31/Add.3.

<sup>359</sup> OECD MNE Guidelines, Foreword. Adhering countries include OECD members and non-members. More information is available at <http://www.oecd.org/daf/inv/mne/>



*enterprises*,”<sup>360</sup> they also represent “good practice for all” and thus generally apply to foreign and domestic firms alike.<sup>361</sup>

Relevant to the issue of incentives, the Guidelines state that enterprises should “refrain from *seeking* or *accepting* exemptions not contemplated in the statutory or regulatory framework related to human rights, environmental, health, safety, labor, taxation, financial incentives, or other issues.”<sup>362</sup> Notably, the Guidelines not only recommend against requests for certain financial, tax, and regulatory incentives, but also discourage passive receipt of those benefits.

While the Guidelines disclaim that they are “voluntary and not legally enforceable,” adhering countries have made a binding commitment to implement them and have instituted mechanisms such as the system of National Contact Points in order to promote the effectiveness.<sup>363</sup>

The second instrument, the UN Principles for responsible contracts, which was developed under the mandate of the Special Representative of the Secretary-General on the issue of human rights and transnational corporations and other business enterprises, provides recommendations to ensure that contracts between investors and states, including contracts containing incentive packages, are consistent with the state’s duty to protect human rights and the firm’s responsibility to respect them.

Principle 4 is relevant to the practice of granting regulatory incentives that provide investors with exemptions from or compensates them for changes in the generally applicable legal regime. The principle declares that states and investors should ensure that “contractual stabilization clauses, if used, [are] carefully drafted so that any protections for investors against future changes in law do not interfere with the State’s *bona fide* efforts to implement laws, regulations or policies in a nondiscriminatory manner in order to meet its human rights obligations.”<sup>364</sup> The Principles observe that stabilization clauses that could frustrate human rights include provisions freezing fiscal terms, as well as those restricting, or requiring compensation for, changes in laws relating to health, protection of the environment, labor and safety.<sup>365</sup>

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<sup>360</sup> *Id.*, I (1) (emphasis added).

<sup>361</sup> *Id.*, I (5).

<sup>362</sup> *Id.*, II(A)(5) (emphasis). The Guidelines also contain other relevant provisions, including those on transfer pricing. *Id.* at paras. 103-106.

<sup>363</sup> See OECD MNE Guidelines, Part II.

<sup>364</sup> United Nations Human Rights. 2015. *Principles for Responsible Contracts Integrating the Management of Human Rights Risks into State-Investor Contract Negotiations*. 2-13.

<sup>365</sup> *Id.*, 13.

#### *4.9 National and Subnational Efforts to Regulate Competition for Investment Through Use of Incentives*<sup>366</sup>

Thus far, we have reviewed cross-national efforts to restrain incentive competition. In many countries, subnational competition is fierce and the use of incentives is providing no national benefits in terms of investment attraction. For example, in the United States there is competition across states, and often competition between communities within a state for investment.<sup>367</sup> This process has been heavily criticized in the United States where, in a survey of economists through the University of Chicago Booth School, experts were asked if offering local tax incentives to firms benefited the United States as a whole. Only 5% agreed with this statement.<sup>368</sup> Civil society groups in the U.S., such as Good Jobs First, have attempted to document this “jobs piracy” and to encourage cities and states to sign non-aggression pacts.

Examples abound of states, provinces, and municipalities competing to attract investment outside of the United States. Countries such as Australia, Brazil, Canada, China, India, Vietnam, and the United States all have been noted for the costly bidding wars that have been conducted within their territories to attract new investment or pull investment from one part of the country to another. Some of these countries, or subnational units within them, have consequently taken steps to govern such conduct, while in others, the issue remains largely unregulated.

In **Canada**, poaching, or the use of incentives to cause an investment to move from one location to another, has driven action:

[P]oaching (usually called “piracy” in the United States) was a major problem in the 1990s, with Nova Scotia and Manitoba both losing existing call centers to New Brunswick, and Crown Life Insurance moving 1200 headquarters jobs from Toronto to Regina in 1991 with a C\$250 million provincial loan guarantee. It was in this context that the Code of Conduct on Incentives was agreed in July 1994 as part of the Agreement on Internal Trade (AIT), whose parties include the federal government, all 10 provinces, and two of the country’s three territories. The Code (Annex 607.3) explicitly prohibited relocation subsidies in Article 3, Prohibited Incentives (Internal Trade Secretariat, 1994):

‘No Party shall provide an incentive that is contingent, in law or in fact, and would directly result in an enterprise, located in the territory of any Party, relocating an existing operation into its territory.’

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<sup>366</sup> For more on these measures, see Thomas 2011, *supra* n14.

<sup>367</sup> Jensen, Nathan and Edmund Malesky. 2018. *Incentives to Pander: How Politicians Use Corporate Welfare for Political Gain* (Business and Public Policy). (Cambridge: Cambridge University Press).

<sup>368</sup> Local Tax Incentives (with participatory responses). 2015. <http://www.igmchicago.org/surveys/local-tax-incentives>.

Moreover, under Article 4, Avoidance of Certain Incentives, the governments agreed to make “best efforts” to avoid bidding wars; however, unlike Article 3, this was not legally binding.

That agreement remains in force but, according to Thomas, has had little effect: Only one complaint of poaching has been raised under the AIT, and that dispute was not resolved;<sup>369</sup> poaching of investments from one province to another has continued, albeit on a smaller scale.<sup>370</sup>

More recently, the two Canadian provinces of Alberta and British Columbia entered into the Trade, Investment, and Labor Mobility Agreement that has, since its entry into force in 2007, broadly banned business subsidies provided by all levels of government in the two provinces.<sup>371</sup>

Apart from these inter-provincial agreements, there has been increased regulation of competition by local government authorities, with eight of 10 provinces prohibiting municipalities from granting incentives.<sup>372</sup>

Thomas reports a similar story in **Australia**:

In Australia, bidding wars and poaching were also considered to be a problem for the states and territories. In 2000, South Australia offered auto parts firms A\$15,000 per job to relocate from Victoria. The following year, Victoria returned the favor by offering A\$2 million to South Australia parts maker Castalloy. Reform movements started as early as 1996, when the Community and Public Sector Union endorsed a New South Wales government initiative to end the poaching and bidding wars, and an Industry Commission report criticized state incentives and recommended that they be cut back or abolished entirely. The Industry Commission’s successor, the Productivity Commission, published further estimates of state incentive spending in 2002. Following this, five of the country’s six states (New South Wales, Victoria, Tasmania, South Australia, and Western Australia), plus the Northern Territory and the Australian Capital Territory (ACT), reached an agreement in 2003 to end bidding wars among them. In addition, the parties provide annual reports to each other on their investment attraction. Queensland was the only state that refused to go along. Stimulated in part by an A\$100 million subsidy to Fox News in Sydney, the signatories banned relocation incentives and pledged not to use subsidies for investments that were clearly coming to Australia. The three-year agreement was renewed for another five years in 2006.

While the agreement was relatively weak, in that it had no mechanisms for monitoring or enforcing the parties’ commitments, did not include all states, and did not require publication of incentives,

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<sup>369</sup> Thomas 2011, *supra* n14, 21-22.

<sup>370</sup> *Id.*

<sup>371</sup> *Id.* 24.

<sup>372</sup> *Id.* 23.

it nevertheless may have been effective. There were reports that implementation of the agreement helped reveal cases of businesses overstating offers of incentives from competing jurisdictions, resulted in a drop in the number of requests for relocation incentives, and saved the states millions of dollars.<sup>373</sup> When the agreement expired in 2011, however, it was not renewed.

In the United States, the 50 states and the municipalities within them compete fiercely for investment. And, although some states have regulations requiring the provision of investment incentives to be disclosed or restricting intra-state competition by municipalities, many do not.<sup>374</sup>

At the federal level, the constitutional doctrine of the “dormant commerce clause” may restrict the use of some investment incentives.<sup>375</sup> Additionally, federal law prevents states and municipalities from using federal funds to poach investments from other locations. Overall, however, U.S. law contains no comprehensive restrictions on inter-state or intra-state investment incentives.

#### *4.10 Summary and Trends Regarding the International, National, and Subnational Regulation of Incentives*

Table 8 compares different regulatory initiatives on the criteria of requirements, obligation of reporting, and enforcement mechanisms. The text below the table provides additional points of comparison and cross-initiative analysis.

**Table 8: Summarizing Initiatives of Supranational/Federal Governance of Incentives<sup>376</sup>**

Initiative	Requirements	Mandatory reporting?	Enforcement
WTO SCM Agreement	Restricts use of specific subsidies relating to trade in goods.	Yes	Enforcement is initiated by members unilaterally or through a complaint procedure using the WTO’s dispute settlement mechanisms.

<sup>373</sup> *Id.*, 26.

<sup>374</sup> *Id.*, 9-10.

<sup>375</sup> See, e.g., *Daimler Chrysler Corporation v. Charlotte Cuno, et al.*, 386 F.3d 738 (May 15, 2006); the original was reported at 383 F.3d 379 by the United States Court of Appeals for the Sixth Circuit and then withdrawn and vacated in part due to lack of standing.

<sup>376</sup> Thomas 2011, *supra* n14.

IIAs	Relevant provisions in articles on nondiscrimination, labor, environment, performance requirements, and transparency, but no general restrictions on State Aids or investment incentives.	No	<p>Limited mechanisms are available to challenge actions to attract investment by lowering/not-enforcing environmental or labor standards in order to attract investment.</p> <p>Some treaties permit subsidies/incentives to be challenged if discriminatory.</p> <p>Rules on transparency requiring disclosure of incentives might be subject to state-state mechanisms.</p>
EU	Comprehensive rules restricting State Aid that generally ban trade-distorting investment incentives but allow them for certain policy goals, including development of disadvantaged regions; support for research, development and innovation; employment and training; environmental protection; energy conservation; and development of renewable energy.	Yes	<p>Commission plays a significant role in enforcement. There are repayment obligations for unlawful aid.</p> <p>Other interested natural and legal persons may also bring actions to challenge decisions approving or not approving aid.</p>

Canada	<p>Provinces: Per Code of Conduct on Incentives, provinces barred from using relocation incentives and must use “best efforts” not to engage in bidding wars. All 10 provinces have agreed.</p> <p>Two provinces (Alberta and British Columbia) entered into a separate agreement banning business subsidies at all levels.</p> <p>Municipalities: eight of 10 provinces prevent municipalities from granting incentives.</p>	Yes (but reports not made public)	Code of Conduct Contains a complaint procedure. It has only been used once (in an anti-poaching claim filed by British Columbia in 1996). The dispute was never resolved, and no other poaching case has since been raised.
Australia – Inter-state Cooperation Agreement (expired 2011)	Banned relocation incentives; states pledged not to use subsidies to attract investment already coming to Australia.	Yes (but reports not made public).	Agreement did not contain any mechanisms for enforcement.

- *Main objectives of different models:* The WTO’s SCM Agreement focuses on restricting government measures that distort trade in goods between member states. The EU’s rules on State Aid are broader than those under the WTO in that they are not limited to measures impacting trade in goods, but also narrower in several ways. They only govern supports that constitute a charge on the public account and affect EU member states; IIAs generally prevent discriminatory subsidies on a broad multi-sectoral basis, and, in contrast to the EU’s rules, may also restrict use of regulatory incentives, even though such incentives do not necessarily require state resources or a charge on the public account. Subnational rules regarding investment incentives entered into by states and provinces, to the extent they exist; seem to largely be centered on combating the specific issue of poaching. Moreover, some agreements, such as the 1951 Paris Treaty and the WTO’s AoA are entirely sector-specific, while others, such as the TFEU, allow some flexibility for sector-specific rules.

- *Policy Space:*
  - Regulation of subsidies and investment incentives generally targets only those measures that are specific or selective, allowing governments to retain freedom to establish legal and economic frameworks attractive to investments more generally, and to attract investment through efforts such as comprehensive infrastructure development and education and training.
  - International regulation of subsidies by the WTO and within the EU contains various carve-outs protecting even specific and trade-distorting subsidies designed to correct market failures and advance legitimate policy goals such as promotion of development in low-income states or areas of high unemployment, investment in R&D, and investment aiming at environmental protection. Subsidies used to advance such projects can incorporate various tools, including monitoring and reporting requirements and penalties or claw-back provisions, in order to ensure that the costs of the incentives result in the desired benefits.
- *Consideration for disadvantaged areas:* Some institutions, such as those established by the WTO and the EU's rules on State Aid, contain special rules of application for states, and even regions within states, that are relatively disadvantaged, and thus might have (1) greater need to use incentives to attract investment, but (2) lesser resources to provide such incentives (particularly if they have to compete against incentive packages offered by wealthier jurisdictions).
- *Enforcement mechanisms:* The most effective rules and enforcement mechanisms are found in systems where there is some form of vertical hierarchy and an independent institution or body at or near the top of that hierarchy, capable of assessing whether rules are being complied with and awarding compensation or assigning penalties for breach. The WTO's dispute settlement system plays this role;<sup>377</sup> and within the EU, the Commission and ECJ serve these functions. The EU's system additionally allows private actors to initiate actions challenging violations of State Aid rules. At the national level, a federal or central government can establish rules and sanctions with which provinces and states must comply while provinces and states, in turn, are able to set rules governing the conduct of the municipalities within their borders. Horizontal agreements and commitments are less effective unless, as is done in the context of investment treaties, an independent body has the power to determine compliance and determine remedies.
- *Transparency:* Instead of, or in addition to, regulating the use of investment incentives, some efforts have been dedicated to promoting their transparency, requiring either ex-ante

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<sup>377</sup> With states also given unilateral rights of action via their power to impose countervailing duties.

notice (and approval), as in the case of the EU's State Aid rules, or ex-post notification, as in the case of the SCM Agreement.



# Conclusion

The use of investment incentives has relevant implications for many important issues facing us today, including tackling climate change; harnessing and leveraging the power of foreign direct investment for sustainable development; combating unfair competition harmful to consumers; limiting corruption and rent-seeking that can drain resources and wealth from the public; managing costly competition among states for investment; aligning private and public interests on issues of environmental protection, human rights, and conditions of work; addressing issues of inequality, particularly as these are exacerbated by certain crises such as the COVID-19 pandemic; and designing the transparent and workable legal frameworks that can advance those aims in a manner that is equitable and ensures appropriate accountability.

This report provides a broad overview, illustrating past and current trends in state practice relating to incentives, and the corresponding policy challenges. It also describes approaches explored to date for addressing those issues at the subnational, national, and international levels.

A fundamental issue that limits the ability to survey the use of incentives is that there is relatively little data reflecting the extent to which governments are using incentives, which types and how much they are providing, to what firms, and under what conditions.

One reason for the lack of information is that, in many countries across all regions, investment incentives are provided on a discretionary and non-transparent basis, rather than being granted automatically and openly. Moreover, they are often granted through a range of vehicles.

Governments may provide incentives through different laws, tax codes, administrative rules or decisions, and contracts. The range of incentives – which can include such diverse measures as regulatory stabilization provisions, price supports, subsidized loans, preferential tax accounting treatment, and development of dedicated infrastructure – further complicates the task of mapping the landscape of these tools.

While some studies focus on identifying a particular subset, such as tax and financial incentives, others, such as reports based on data from EU State Aid figures, only count measures that have or are likely to have trade-distorting effects in the EU common market. Thus, although the figures from the EU stand out in that they provide a relatively comprehensive set of information regarding the use of incentives due to mandatory reporting requirements and the public release of information, they leave many open questions regarding the use of incentives in that region.

While recognizing these challenges, this study nevertheless compiles research done by various bodies to at least paint a picture of currently documented trends and practices.

Early studies on incentives by UNCTAD found them to be widely used, with tax incentives being the most common and financial incentives being granted less frequently. Recent research by the World Bank, UNIDO and the Asian Development Bank on incentives identifies financial incentives as being most prevalent in developed countries, which have shifted away from tax incentives. In contrast, developing countries more commonly provide tax incentives, particularly tax holidays that do not require upfront outlays of funds from the government. Tax and duty exemptions through SEZs are used across all regions.

Data on State Aid from the EU illustrates that the type of incentive granted can also vary depending on the purpose for which the aid is given. This finding might reflect more careful tailoring of incentives programs, and a reflection of the fact that whether and to what extent a particular incentive will influence an investment decision often depends not only on the type of incentive that is offered, but also on the nature of the business and industry that is receiving it.

Indeed, for market-seeking investments, strategic asset-seeking or natural resource-seeking investments, studies commonly report that the grant of incentives does not have much or any impact on the investor's decision to invest. Efficiency-seeking investments may be more responsive to government incentives, but also may be more "footloose" and able to relocate easily once the incentives expire or better incentives are offered by a competing jurisdiction.

Understanding the utility of incentives and their impact on investment decisions is crucial as these supports impose costs on governments that not only can be substantial in absolute terms but can also potentially outweigh any direct or indirect benefit that might arise as a result of their use. Thus, to avoid wasting public resources, governments should analyze the costs and benefits of their incentive policies.

One approach highlighted in this report for calculating the costs and benefits of tax incentives is measuring the jobs created as a result of the tax incentives. This is calculated by the jobs created by marginal investors (those who would not have invested without receiving incentives) over the revenue forgone from non-marginal investors (who would have invested even without incentives). Though the revenue cost per job created does not cover all costs, or all benefits of a given incentive, it provides a rough figure that can help policy makers decide if the incentives are worthwhile.

To be cost-effective, governments should align their incentive policies with the specific characteristics of their jurisdiction, and their short-term and long-term objectives.

Beyond the actual cost of any given incentive, it is also important to highlight that they can give rise to a plethora of issues and risks, such as encouraging lobbying and rent-seeking, facilitating evasion, and creating administrative burden. Financial incentives present unique challenges compared to tax incentives as they come in varied forms and tend to be administered by different entities. In addition, as most of them involve monetary transfers, they are more prone to the risk of capture.

To help maximize the cost-effectiveness of incentives and minimize their potential risks and administrative burdens, this report offers a range of principles to guide their design and implementation:

- Investment incentives, both tax and financial, should only be used as focused instruments to correct market failures, as second-best policy options, after having evaluated the available alternatives.
- Incentives programs should be part of a broader and consistent investment attraction strategy.
- Incentives programs should be time-bound.
- Incentives programs should be regularly reviewed to ensure their relevance and effectiveness.
- Information programs on the processes and procedures related to incentives' administration should be transparent and publicly available.
- The process for applying for incentives should be simple and minimize discretion, and for tax incentives it should be automatic.
- Incentive programs should have a statutory cap, limiting the total dollars allocated to a program, similar to financial incentives.

With specific regard to tax incentives:

- They should be linked, as far as possible, to investment level, while tax holidays should be used sparingly.
- They should be provided in the relevant tax code.
- Tax returns, declarations, and relevant forms should be filled out on a regular basis as pre-condition for investors.

- Tax expenditure statements should be prepared regularly to measure the costs of the tax incentives.

In addition to taking steps within their own jurisdictions to better discipline and track the use of incentives, governments can also take steps to combat the inter-jurisdictional “races to the bottom” that can occur when they use incentives to compete for increasingly mobile capital. There are a number of initiatives at the international, national, and subnational levels that address these issues to at least some extent.

WTO Agreements, for instance, focus on restricting government measures that distort trade in goods and services between member states; the EU’s rules on State Aid are broader in that they are not limited to measures impacting trade in goods, but narrower in that, most obviously, they only prohibit incentives that affect or may affect trade among EU member states. International Investment Agreements (IIAs) generally prevent discriminatory subsidies or other preferences on a broad, multi-sectoral basis but, to date, have not been widely used to challenge incentives programs or measures. Subnational rules regarding investment incentives entered into by states and provinces, to the extent they exist, seem to be largely centered on combating the specific issue of “poaching.”

One challenge of designing systems to regulate the use of incentives is to balance rules restricting those measures against the desire to use them in order to achieve certain policy goals. For instance, restrictions in the SCM Agreement and in the EU rules on State Aid only prohibit specific or selective measures, leaving governments room to establish legal and economic frameworks attractive to investments more generally, and to attract investment through efforts such as comprehensive infrastructure development, and education and training.

In the EU, even specific and trade-distorting subsidies may be allowed if they advance certain aims such as promotion of development in low-income states or areas of high unemployment, investment in R&D, and investment aiming at environmental protection. Subsidies used to advance such projects can incorporate various tools, including monitoring and reporting requirements and penalties or claw-back provisions, in order to ensure that the costs of the incentives result in the desired benefits.

Another challenge with regulation of incentives is how to make the requirements effective. The most successful rules and enforcement mechanisms, not surprisingly, are found in systems where there is some form of vertical hierarchy and an independent institution or body at or near the top of that hierarchy capable of assessing whether rules are being complied with and awarding compensation or assigning penalties for breach.

The WTO’s dispute settlement system and the EU Commission and ECJ serve these functions, with the latter authorizing private actors to initiate actions challenging violations of State Aid rules.

Alongside those enforcement mechanisms, transparency has also been promoted with the requirement either of ex-ante notice (and approval) as in the case of the EU's State Aid rules, or ex-post notification as in the case of the SCM Agreement. Through its rules on disclosure and procedures for investigation and enforcement, the EU's framework for governing State Aid stands out as being relatively robust as compared to other efforts to regulate incentives. This, in turn, appears to have translated into reduced levels of State Aid, lower aid intensities, and a shift toward the use of horizontal aid.

In sum, while current knowledge regarding the use of investment incentives is limited, this report seeks to lay the foundation for renewed attention to the use of incentives. Collective action is required, as individual jurisdictions acting alone fear – often mistakenly – that they will lose out to competing jurisdictions if they curtail their use of incentives.

Against that backdrop, the report identifies the following concrete areas for action:

- Increasing the transparency of investment incentives.
- Transitioning to a rule-based rather than *ad hoc* and discretionary system for granting incentives.
- Building capacity and ensuring available resources for performing proper cost-benefit analyses and ensuring those analyses are systematically performed when making decisions. Incentives should not dilute, eliminate, or even outweigh the potential benefits of an investment project.
- Ensuring incentives arrangements build in mechanisms for monitoring, oversight, and enforcement so that when incentives are granted, they actually advance the intended policy objectives.
- Making sure that incentives, when used, are properly designed to meet the needs of their intended investor beneficiaries.
- Designing systems that are simple and manageable for administrators and users alike.
- Working cooperatively to restrict the use of public funds to “poach” an investment, drawing it from one location to another.
- Developing cooperative strategies to prevent disadvantaged regions with limited resources from having to compete with wealthier regions that can easily outbid them in the quest for investment.

- Preventing the excessive use of incentives such as certain stabilization clauses that create unduly inflexible legal and fiscal regimes and give rise to tensions between the interests of governments, firms, and citizens.
- Ensuring that there is policy coherence across different legal regimes, whether supranational, regional, national or subnational.

Work is and has been proceeding on each of these issues in different fora at local, national, and international levels. There are some examples of regulatory frameworks aiming to ensure that incentives are appropriately tailored to promote long-term, sustainable and inclusive growth. These could be both broadened and strengthened. Opportunities are also ripe to address these issues in the context of the ongoing global initiatives to strengthen governance of international economic activities, including tax cooperation, business and human rights, climate change negotiations, and rules on investment promotion and protection.

# Appendices

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## Appendix 1: What Is Market Failure?

A market failure is when the market does not lead to an economically efficient outcome. Externalities, imperfect information and coordination problems all lead to market failure.

**Externalities:** Externalities occur when market players do not fully pay or benefit from the consequences of their actions on other actors in society. For instance, in the case of polluting through industrial activity, market players may not have to pay for the full social cost of their actions (negative externalities). In the case of research and innovation, market players may be deprived of the full benefits of their actions (positive externalities).

**Public goods:** These are goods beneficial for society but generally not provided by the market, given that nobody should be excluded from their use. This can be the case of national defense, some types of public broadcasting, schools, and water infrastructure.

**Imperfect information:** This leads to transaction costs, agency costs, and moral hazard, which in turn lead to inefficient market outcomes. This is often the case in regulation of the market by government agencies.

**Coordination problems:** These problems occur in the field of standards setting, in transport infrastructure, or in the area of innovation.

**Market power:** Monopolies and lack of a competitive environment often drive up prices and limit supply.

**Initial risk:** High levels of initial risk with unknown benefits often lead to market failure. This is especially the case for R&D and innovation, public goods, or extractive industries. Arguments in favor of **infant industry** are often made from the above building blocks (imperfect capital markets, the ‘appropriability’ argument, or market power/scale arguments).

**Dynamic market failures:** Current market prices might discourage businesses to invest in certain branches of production even with prospects of high and sustainable rates of profit in the future. However, prices send the wrong signal because as investment proceeds and unit costs decline with increased output and external economies of scale, a country could acquire a comparative advantage in an expanding industry.

## Appendix 2: Review of Case Studies of EU Regional Aid

**Appendix Table 1:** Investment Determinants, Aid Intensities in EU Case Studies on Regional Aid 2007-2013<sup>378</sup>

	Aid amount	Aid intensity	Level of regional aid compared to RAG ceiling	Investment drivers	Incentive effect for invest. decision	Location drivers	Incentive effect on location decision
<b>Pharmaceutical industry (Ireland)</b>	Low	Low	Lower than ceiling	Rising demand, availability of new technologies, efficiency-seeking	Low	Pre-existing operations on site, availability of skilled labour force, presence of leading cluster	Low
<b>Solar industry (Germany)</b>	High	Medium	At ceiling	Rising demand, availability of new technologies, high profit margins, efficiency seeking	Low/ Medium	Pre-existing operations and availability of land at the site, skilled labour force and proximity to ancillary industries (cluster)	Medium
<b>Automotive industry (Slovakia and Hungary)</b>	High	Medium	Close to ceiling	Need to adapt to evolving demand and create new production lines for new products, efficiency seeking	Low/ Medium	Low labour costs, quality of the labour force, availability of transport infrastructure	Medium
<b>Internal business services (Poland)</b>	Very low	Low	Lower than ceiling	Efficiency-seeking through cost reduction, increased capacities and enhanced quality of services	Low	Low labour costs, quantitative and qualitative availability of labour force	Low
<b>Cement industry (Hungary)</b>	Medium	Medium	Lower than ceiling	Rising demand, efficiency-seeking	Low	Availability of raw material, geographic proximity to and accessibility of local markets	Low
<b>Pulp and paper industry (Spain and Portugal)</b>	Medium	Medium	Close to ceiling	Rising demand, need to increase efficiency to adapt to increasing competition	Medium	Pre-existing operations on site, transport infrastructure and accessibility, availability of a skilled labour force and of raw material	Low

Source: Le Den, Xavier, Robert Kröber, Alessandro Ramella Pezza, Fritz Gillerke, Lukas Bresser, Matías Krämer, Usman Khan, Jose Olivas. 2012, 154.

<sup>378</sup> Le Den, Xavier, Robert Kröber, Alessandro Ramella Pezza, Fritz Gillerke, Lukas Bresser, Matías Krämer, Usman Khan, and Jose Olivas. 2012. *Ex-Post evaluation of the Regional Aid Guidelines 2007-2013*. 154.



**Appendix Table 2: Impacts of the Investments in Terms of Regional and Employment Benefits and Externalities in EU Case Studies on Regional Aid 2007-2013<sup>379</sup>**

	Job creation	Jobs safe-guarded	Quality of jobs	Indirect jobs	Impact on R&D	Spill-over effect	Follow on investments	Cluster-specific impacts
Pharmaceutical industry (Ireland)	Low	Medium	High	Low	High	High	No	Yes
Solar industry (Germany)	High	Low	High	Medium	High	Medium/High	n/a	Yes
Automotive industry (Slovakia and Hungary)	High	Low	Low	High	Low	Low	No	No
Internal business services (Poland)	Medium	Low	Medium	Low	Low	Medium	Yes	No
Cement industry (Hungary)	Low	Low	Low	Medium	Low	Low	No	No
Pulp and paper industry (Spain and Portugal)	Low	High	Low/Medium	High	Medium	Medium	No	Yes

Source: Le Den, Xavier, Robert Kröber, Alessandro Ramella Pezza, Fritz Gillerke, Lukas Bresser, Matías Krämer, Usman Khan, Jose Olivas. 2012, 160.

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<sup>379</sup> *Id.*