Columbia Center
on Sustainable Investment
A JOINT CENTER OF COLUMBIA LAW SCHOOL
AND THE EARTH INSTITUTE, COLUMBIA UNIVERSITY

Columbia FDI Perspectives
Perspectives on topical foreign direct investment issues
No. 279 June 1, 2020
Editor-in-Chief: Karl P. Sauvant (Karl.Sauvant@law.columbia.edu)
Managing Editor: Marion A. Creach (marion.creach@sciencespo.fr)

Leveraging corporate tax incentives to attract FDI: design and implementation considerations[*]

by
Hania Kronfol[**]

In the face of fierce global competition for inward FDI, countries increasingly rely on tax breaks to lure investors. However, empirical evidence suggests that tax incentives influence investors' location decisions only marginally. At best, they bear on the final stage of the site-selection process, when investors are wavering among like options, and after considering other competitive features, such as political stability, regulatory quality and market opportunities. [1]

All too often, policymakers overestimate the role of tax incentives in swaying investors and, in turn, their projected benefits, translating to a windfall for firms at the expense of lost tax revenue for governments. Beyond the budgetary implications, tax incentives carry other costs and risks, including rent-seeking, tax evasion, high administrative burdens, market distortions, and retaliatory behavior spurring a "race-to-the-bottom." The stakes are especially high in developing countries where fiscal, legal and institutional challenges are more pronounced.

Therefore, governments face a stiff policy dilemma: how can they design and implement incentives strategically, in a manner that maximizes their value for money and minimizes the risks? Here are some guidelines:

- Use tax incentives sparingly to address identified market failures. The purpose of granting tax incentives should be clearly defined. Is the primary objective to create more jobs, promote the absorption of foreign technology or diversify the economy through investment in new sectors? Once the objective is articulated, policymakers should identify the underlying barriers and market failures (e.g., underinvestment in public goods, skills mismatch or incomplete information to link foreign firms and domestic firms); evaluate whether tax incentives can effectively change investors' behavior to address these barriers and failures; and assess whether tax incentives are optimal, considering other measures (e.g., legal or regulatory changes, broader reform of the tax system or direct government investment in public goods). Even when tax incentives are suitable interventions, they are most effective when implemented within conducive investment environments characterized by enhanced connectivity and institutional efficiency, as well as stronger legal protections and streamlined business regulations.

- Directly link incentives to defined policy objectives. Developing countries, in particular, rely on profit-based tax incentives, such as tax holidays and corporate income tax reductions, for FDI promotion. These instruments generally do not result in cost-efficient outcomes as they confer a blanket benefit, often based on upfront granting mechanisms, rather than actual investor performance. Instead, governments should consider shifting to merit-based incentive instruments, such as investment allowances, tax credits and accelerated depreciation. These tools have the advantage of directly tying incentives to targeted outcomes, e.g., by providing allowances for R&D expenditures or tax credits for staff training programs.

- Target investors strategically. Policymakers first need to prioritize the type and quality of FDI they seek to attract, and then identify the subset of investors that are most responsive to incentives. Developing cost-efficient incentive schemes largely rests on identifying which type of investors ultimately decide to invest in one country over another because of tax incentives. Globally, incentives are more influential in attracting efficiency-seeking FDI, which is export-oriented, since such investors are mainly driven by competitive cost advantages in host countries, as opposed to natural resource- or market-seeking FDI.[2] Also, a more detailed analysis of country-level data on the profitability of firms with and without incentives can help distinguish the types of sectors and characteristics of investors that are more sensitive to possible gains from incentives.

- Rigorously evaluate the costs and benefits. An ex-ante analysis paired with a monitoring and evaluation framework during and post-implementation would provide critical data to consider the performance of incentives policy. A key input into this evaluation are estimates of tax expenditure, i.e., the tax revenue that would have been collected in the absence of incentives. These data, paired with information on the targeted outcomes and the responsiveness of investors, can help reveal how the costs compare to the benefits, and inform whether the incentives need to be revised or phased out.[3]

- Promote transparency and rule-based administration. When implementing incentives policy, institutional coordination, bureaucratic effectiveness and transparency matter—not only to sustain accessible and streamlined systems, but also to reduce opportunities for discretion and to ensure a level playing field for firms. Information on tax incentives should be publicly available in a user-friendly format, and tax expenditure estimates incorporated into the budgetary process.

Generally, regional and multilateral arrangements are needed. While challenging to implement, more policy emphasis should be placed on promoting cooperation among governments to curb harmful incentives' competition. The [EU state aid framework](), for example, requires approval for qualifying subsidies across member countries. Bolstering transparency by sharing information across countries on incentives policy and reforms are important first steps, as governments in parallel look to adopt more strategically designed, evidence-based programs.

---

* **The *Columbia FDI Perspectives* are a forum for public debate. The views expressed by the author(s) do not reflect the opinions of CCSI or Columbia University or our partners and supporters. *Columbia FDI Perspectives* (ISSN 2158-3579) is a peer-reviewed series.**

** Hania Kronfol (hkronfol@worldbank.org is a Private Sector Specialist in the Investment Climate Unit of the World Bank Group, where she leads analytic and advisory projects on investment policy and promotion. The author wishes to thank Roberto Echandi, Peter Kusek and Tuan Minh Le for their feedback on an earlier draft. She is also grateful to Lisa Sachs, Ana Teresa Tavares-Lehman and Kenneth Thomas for their helpful peer reviews.

[1] Ana Teresa Tavares-Lehmann et al., eds., *Rethinking Investment Incentives: Trends and Policy Options* (New York: CUP, 2016).

[2] Maria R. Andersen, Benjamin R. Kett and Erik von Uexkull, "Corporate tax incentives and FDI in developing countries" in World Bank, *Global Investment Competitiveness Report 2017/2018: Foreign Investor Perspectives and Policy Implications* (Washington DC: World Bank, 2018).

[3] Hania Kronfol and Victor Steenbergen, "Evaluating the costs and benefits of corporate tax incentives: Methodological approaches and policy considerations," *FCI In Focus*, World Bank, 2020.

For further information, including information regarding submission to the *Perspectives*, please contact: Columbia Center on Sustainable Investment, Alexa Busser, alexa.busser@columbia.edu.

Most recent *Columbia FDI Perspectives*

- No. 278, Karl P. Sauvant, 'A G20 Facility to rekindle FDI flows,' May 18, 2020
- No. 277, Peter Muchlinski, 'Regulating multinational digital platform enterprises: The case of Uber,' May 4, 2020
- No. 276, Carolina Arriagada Peters, 'Investment aftercare matters,' April 20, 2020
- No. 275, Karl P. Sauvant, 'Enabling the full participation of developing countries in negotiating an Investment Facilitation Framework for Development,' April 6, 2020
- No. 274, Marta Soprana, 'Outward FDI and a global compact on home-country investment incentives,' March

23, 2020

All previous *FDI Perspectives* are available at http://ccsi.columbia.edu/publications/columbia-fdi- perspectives/.