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Ted G. Telford

Heather A. Ures

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TED G. TELFORD* AND HEATHER A. URES**

I. INTRODUCTION

The world is shrinking. As technology improves exponentially and information flows at light speed, nearly every country receives an invitation to participate in the global marketplace. This invitation may be better characterized as a request, however, because countries that decline the invitation do so at their own peril. The recent decade proved the folly of economic isolationism and reaffirmed the principles of competitive advantage and supply and demand. Today, more than ever, economics and the free market system drive international relations and policy-making. Likewise, more cities, states, and countries realize that foreign investment is crucial to economic growth and social development. These bodies understand that the value of foreign direct investment (FDI) lies in the short-term benefits of job opportunities and also in technology and knowledge transfer, as well as in the resulting infrastructure improvements and supplier base development. Without FDI, entities must work their way through the technology learning curve on their own. Entities fall farther behind in their level of development and ability to attract the remedy if unable to leverage the knowledge and experience of others. Entities continue to explore new ways to compete with each other for investment opportunities in their quest for the benefits of FDI. Among other things, many locations offer "incentives" as a means to attract FDI.

* Senior Manager, Strategic Relocation & Expansion Services, KPMG LLP.
** Juris Doctor/Master of Business Taxation candidate, University of Southern California, 2001. B.A., Political Economy of Industrial Societies, University of California, Berkeley, 1997.

II. LOCATION DECISIONS

The free market system is competitive. A smaller, more accessible, and more inter-connected world creates more competitors. With an increase in customer choice, companies must seek out opportunities to become more competitive by increasing productivity while controlling costs. Few factors affect a company's productivity and cost effectiveness more than location. Location decisions are therefore becoming increasingly critical. Gone are the days when one or two executives made location decisions for their business based on a few relaxing days in a well-known destination. Prudent companies are sophisticated enough to realize the value of seeking out experts to complete in-depth comprehensive location analyses. These experts seek to understand a company's operational sensitivities and key decision factors in order to match a particular project's requirements with the location best positioned to fulfill them. Criteria for assessing locations depend on the project itself and consist of anything from airlift capacity to work council requirements.

Most companies make location decisions primarily from a qualitative perspective and secondarily from a quantitative perspective. In other words, the company must confirm the ability to operate effectively before considering cost implications. In some cases there may be marketing advantages or synergy opportunities that are great enough in a specific location to override many cost considerations. For example, a consumer products manufacturer may be required to locate within the market supplied by a company. Here, the benefits of a local presence (marketing, logistics, customer service, etc.) are key drivers in the location decision (i.e., the local presence is necessary to take advantage of market potential). In addition to market opportunities, infrastructure requirements may exist that can only be found in a limited number of locations. In this case, the total cost of doing business becomes secondary to the ability to operate effectively, competitively, and profitably. Likewise, the day-to-day operating environment ("ease of doing business") may be worth more in one location, while in another the cost advantages may be irrelevant because of operational difficulties.

Total cost becomes the next filter once the ability to operate as desired is established. Many projects are able to move to any location that can provide the basic infrastructure requirements because of the activity that will take place. For these investments, total cost and ease of doing business become the key differentiators. Governments utilize

incentives for these projects to improve their total cost environment and increase overall competitiveness.

III. INCENTIVES

From a company's perspective, incentives are tools that governments utilize to make up for the operational difficulties or cost disadvantages inherent to a particular location. There may be significant challenges related to a location's accessibility, level of development, or state of security, which would exclude it from consideration under normal circumstances. In such cases, governments often attempt to compensate a company for the additional risk and/or costs associated with operating in that location.

From the government's point of view, incentives attract investment to underdeveloped areas where job opportunities, education levels, or standards of living are lagging. While most often associated with the financial benefits made available to lure attractive investments, incentives can also take the form of non-financial benefits offered to improve a company's ability to operate. For example, governments will offer training facilities, customize permit processes or customs clearance procedures, and establish dedicated "response teams." Other benefits may include necessary infrastructure improvements.

Non-financial incentives are equally attractive because speed and flexibility are critical in most businesses. Companies want to locate where they are free to operate as they see fit and in an environment that will quickly evolve along with their needs. Governments' efforts to develop clear, simple, and flexible operating environments are characterized as non-financial incentives. In order to attract investment, a location must either disentangle its challenges or compensate the investor for dealing with them. Obviously, there are many elements outside a government's immediate control, such as higher labor costs or geographic location. Incentives can offset these higher costs or operational difficulties and make the total cost picture more competitive. In a perfect world, the ideal location would not include incentives, as they would be unnecessary. The operating environment and the total cost of doing business would be competitive enough to enable a company to operate successfully and profitably without extra inducements.

A. Incentives as Investment

Incentives are a form of government investment that expect a positive return. The government must assess the associated risks

involved and estimate the size of investment required, and then attempt to anticipate the return on investment (ROI). Most government entities have difficulty comprehending the full ROI because much of the return is non-quantifiable. Increased education, improvements in standards of living, and a location's image in the global economy as favorable are all benefits of FDI that are difficult, if not impossible, to quantify. Additionally, benefits such as these are long-range and typically not realized during the term of a particular political administration. Political decision-makers are largely tactical rather than long-term strategic thinkers, so these intangible benefits are often understated. Once the value is determined, an entity's investment in financial incentives takes the form of grants, tax abatements, deferrals, or training assistance.

Governments' understanding of incentives is not always consistent with that of potential investing companies. While incentives may attract investment to the more underdeveloped areas of a given location, the value of those incentives is too often inconsistent with the increased costs and risks a company would be exposed to in those areas. Governments typically overestimate the competitiveness of their environments and often do not understand the operational and cost requirements of direct investors. Therefore, they are unable to create or modify incentive programs to fit the unique needs of each investor. Additionally, many governments underestimate the ROI of their incentive investments. They are more concerned with short-term political ramifications. Thus, they are unable to effectively meet the legitimate needs of companies. These issues commonly result in costly incentives for the government, many of which have little or no value to the investing company.

Unfortunately, even when political decision-makers comprehend the value of offering incentives and make them available, those in positions to actually approve, grant, and administer incentive packages often do not see the logic in so doing. The concept of the government investing, rather than simply giving, is then lost as public gatekeepers frustrate the process in the name of safeguarding taxpayers' money.

B. Non-financial Incentives

Non-financial incentives are often equally as important as their financial counterparts for several reasons. With businesses running at "Internet speed," the ability to start up and begin operating quickly is critical. Also, infrastructure reliability is absolutely necessary to minimize or even eliminate down time. Companies must be able to

operate with minimal interference from government in order to maintain corporate cultural characteristics and practices that are put in place worldwide and contribute to ongoing success. Clear and simple processes are necessary to enable a company to focus on doing business rather than wading through bureaucratic quagmires. Non-financial incentives include those customized benefits offered to companies that help ensure speed, simplicity, and flexibility in doing business. A few examples of non-financial incentives include infrastructure improvements, streamlined permit and approval processes, specialized customs clearance procedures, and fast track construction permitting.

IV. EMPIRICAL EXAMPLES

A. Ireland

For several decades, Ireland has sought to attract FDI by offering extensive tax relief to potential investors. Factors aside from tax relief, however, have contributed to Ireland's success in attracting substantial foreign investment. Most notably, Ireland has become an increasingly popular location choice since joining the European Union (EU) in 1973. Because the EU claims to achieve political, economic, and monetary union, Ireland's membership provides investors with access to the entire European market. To begin, EU policy prohibits the imposition of tariffs or value added tax (VAT) on trade between EU member states. The EU's "customs duties" tax and VAT (ranging from 3.3% to 21%), however, are charged on goods imported into Ireland or other member states from non-EU countries.[1] The customs tax rate is identical for each member state. Therefore, no one nation is favored over another.

Ireland's membership in the EU provides significant non-financial incentives to foreign investors. Ireland adopted the *euro*, the EU's single monetary unit so that foreign investors will enjoy the ease of keeping a single currency when conducting business with other EU countries. Investors also gain the benefit of interacting with only one central bank for all EU member states. The EU's unified economic and monetary policy makes it easier for a country to tap into the markets of other member states, and to freely conduct business with them. Membership in the EU also provided companies located in Ireland with access to a patent approval process that is honored in all EU countries.

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1. Diarmuid Murray, *Foreign Income: Business Operations in the Republic of Ireland*, Tax Mgmt. (BNA) No. 965-2nd, at A-3 (Sept. 11, 2000).

If a company successfully locates in Ireland, it has effectively gained access to the entire European market.

The most significant financial incentive to potential investors in Ireland is tax relief offered in the manufacturing sector. For example, foreign manufacturing companies can sell or lease industrial estates below market prices from the Industrial Development Agency of Ireland.[2] Additionally, the government can apply cash grants to fixed assets, staff training, and research and development (R&D). Such grants need not be repaid. The Irish government also facilitates access to the EU market through grants for overseas sales promotion costs and market research. Most notably, through the year 2010, profits derived from the manufacture and sale of goods are subject to a corporate tax rate of only 10%.[3]

The combination of financial and non-financial incentives in Ireland coincides with dramatic economic growth, awarding Ireland the title of "Celtic Tiger" among the international community. This cannot be wholly attributed to Ireland's tax incentive policy, because in the 1980s and early 1990s, Ireland was identified by political economists as an example of developmental failure. By the year 2000, however, the combination of a highly educated work force, a fiercely nationalistic citizenry, and an entrepreneurial spirit supplemented Ireland's financial incentive policy leading to truly remarkable economic growth.

In addition to benefits such as English being the national language, a highly educated labor force, and lower wages than most Western countries, Ireland has been extremely flexible and responsive to the individual needs of both existing and potential investors to insure operational success. Processes are streamlined; experienced government officials, who clearly understand the issues with which companies deal, work directly with investors. More important, they are willing to bend accordingly in order to ensure a win-win relationship.

B. Israel

Israel's financial and non-financial incentives provide an attractive climate for foreign investors. Israel offers an exceptional location for companies engaging in international trade. Israel is located at the crossroads between three continents, and offers direct access to both the Mediterranean and Indian Seas. Additionally, Israel's labor force is comprised of highly skilled workers, who are knowledgeable of

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2. *See id.* at A-9.
3. *Id.*

Western technologies and are well-trained manual workers. Israeli wages also tend to be significantly lower than comparable European or U.S. wages. Finally, English is Israel's second language and is widely spoken throughout the country.

Currently, Israel has free trade agreements with the United States, the EU, Canada, and Turkey. Generally, these agreements abolish all customs, duties, and quantitative restrictions on goods that originate in one country and are exported to the other. Neither party may impose licensing requirements. The Israeli government retains the power to impose levies in times of national need. For example, these levies may be imposed in the event of a balance of payments or foreign currency crisis, or to prevent the risk of competitive imports and dumping.

Israel's financial incentives to attract FDI are elaborate, yet strategically designed to encourage local economic development. The country is divided into three zones, which form concentric circles around the most populated areas of the country. The best financial incentives are offered to companies planning to locate in the least developed zone, which is the outermost zone. A company wishing to take advantage of such incentives must engage in a project that benefits both the investor and the Israeli economy. In addition, it must obtain government approval for the project.

An approved enterprise is entitled to an investment grant as a percentage of the investment in the fixed assets.[4] The percentage varies according to the zone, and the least developed zone offers the highest percentage investment grant. Although the grant is not taxable, it must be deducted from assets for purposes of depreciation deductions.[5] Companies have the option to forego the investment grant and choose an income tax exemption for a varying number of years depending on the zone.[6] A company that pays dividends out of income earned during the exemption period, however, must pay taxes on these dividends at the applicable corporate tax rate.[7] All companies located in such zones enjoy preferential tax rates (ranging from 10% to 25%), lower withholding taxes on dividends (15% instead of 25%) and most notably, the higher the percentage of foreign investment the greater the tax abatement.[8]

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4. Dr. Amnon Rafael, *Foreign Income: Business Operations in Israel,* Tax Mgmt. (BNA) No. 967-3rd, at A-5 (Jan. 1, 2001).

5. *Id.*

6. *See id.*

7. *Id.*

8. Zeev Holender & Alan I. Appel, *The U.S.-Israel Tax Treaty, Bearing Two Protocols,*

Furthermore, Israel also offers grants for very specific types of R&D outlays in exchange for royalty payments to the state. The R&D plan must be approved by the Israeli government and relate to incorporating the increased know-how and keeping the financial capital in the country. Another grant is available for projects submitted by jointly-owned Israeli and U.S. firms, and encourages risk-taking in R&D projects.[9] If the project is successful, the firm is required to repay the grant in the form of royalties to the state.[10] If the project is unsuccessful, however, no repayment is required.[11] Finally, Israel encourages exporting by reimbursing up to 33% of expenses related to the marketing of exported products abroad.[12]

It is difficult to establish a direct link between incentives and economic growth in Israel. While Israel's incentives are strategically designed to promote economic development, many argue that such growth is bolstered by the receipt of substantial U.S. funds, and hindered by the ongoing Arab-Israeli conflict.[13] The high value of financial benefits available in Israel is a reflection of the perceived risks involved in doing business there and serves to compensate companies for taking those risks. Further, the high value of financial incentives helps offset the challenging and lengthy process of dealing with the government on an ongoing basis.

C. People's Republic of China

The recent boom in the Chinese economy has largely been attributable to increased international trade, a significant part of which is attracting FDI. In the 1990s, China was the most popular country in the world for foreign investment, aside from the United States.

China's current economic growth strategy is a product of its unique history. In the nineteenth century, China underwent foreign colonialism and became dependent upon the USSR in the 1950s. In the 1960s, China began a development policy of economic self-reliance because outsiders had always determined China's government structure and macroeconomic policy. By the late 1970s, it was evident that this policy only stifled economic growth, so China looked to models

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Moves Toward Ratification, 4 J. INT'L TAX'N 292, 293 (1993).

9. Rafael, *supra* note 4, at A-7.

10. *See id.*

11. *Id.*

12. *Id.*

13. *See Middle East Review of World Information*, QUEST ECONOMICS DATABASE (1998) (on file with authors).

followed by Western countries and began to open its borders. As part of a larger economic development plan, China permitted regional and local companies to engage in international trade, and began offering incentives to attract FDI.

Beginning in 1979, China established incentive zones. The purpose of these zones was to foster the development of the manufacturing sector, particularly in companies geared toward export. At the same time, significant tax legislation was enacted to encourage foreign investment in these areas. The areas are divided into Special Economic Zones (SEZs), Economic and Technical Development Zones (ETDZs), and "old urban" districts within the two former areas. Each zone provides tax abatement to investing foreigners in the form of a Chinese-foreign equity joint venture, Chinese-foreign cooperative enterprise, or wholly foreign-owned enterprise.

Financial incentives offered to foreign direct investors who locate within an SEZ or ETDZ include a lower corporate income tax rate (15%) and tax holidays.[14] The tax holiday differs according to the type of business conducted. If the company engages in productive operations, such as industry, communications, transportation, or agriculture for a term longer than ten years, that company may enjoy a five-year tax holiday. This tax holiday provides that no income taxes will be paid in the first two profit-making years, and that income tax will be half of the normal rate (i.e., 7.5%) for the following three years.[15] If the company engages in a service business and funds its operations with at least five million U.S. dollars, it may enjoy a three-year tax holiday.[16] The company would be exempt from income tax during the first profit-making year and then would be taxed at 50% the normal rate for the following two years.[17] Finally, passive source income earned by foreigners without an establishment in the SEZ is taxed at a lower rate of 10%, rather than 20%.[18]

Foreigners who invest in "old urban" districts are subject to a preferential income tax rate of 15% if they undertake a technology-

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14. Kenny Z. Lin, *Income Taxation and Foreign Direct Investment in China*, 25 INT'L TAX J. 78, 82 (1999).

15. *Foreign Income: Business Operations in the People's Republic of China*, Tax Mgmt. (BNA) No. 957, at A-21 (Oct. 14, 1996) [hereinafter *China 1996*].

16. Owen D. Nee, Jr., Deborah J. Goldstein & Lawrence H. Sussman, *Foreign Income: Business Operations in the People's Republic of China*, Tax Mgmt. (BNA) No. 957-2nd, at A-43 (2001).

17. *See id.*

18. *See id.* at A-42.

intensive project.[19] This applies if the amount of foreign investment is at least thirty million U.S. dollars, or if the project involves energy resources, transportation, or port construction.[20] Otherwise, production-oriented urban district enterprises are taxed at a rate of 24%.[21] Additionally, the municipal people's government can decide whether to exempt "old urban" district enterprises from local taxes.

As a part of China's commitment to international trade, companies that locate in incentive zones may import all machinery and equipment, raw materials, spare and component parts, and other production materials tax-free, if the product is later exported. If the enterprise uses materials or parts imported tax-free to produce goods that are sold in China, rather than exported abroad, the enterprises have to make up a proportionate amount of turnover taxes that would have been payable on the imported materials and parts.

One disadvantage to foreign investors is that if the company intends to export and receive favorable tariff treatment, it must obtain licenses subject to quotas. Additionally, different sets of laws apply to the state-operated economic sector and to the private economic sector. This makes it difficult to determine which activities require regulatory approval. Since 1994, however, the Chinese government began to establish a uniform set of laws and regulations for foreign investors to follow for project approval.

China offers a large labor market, which could support a large labor-intensive operation. Additionally, in 1996, China converted to a floating exchange rate, although its currency is still not readily convertible. In response to recent foreign criticism of China's intellectual property laws, China has strengthened and attempted to enforce its patent, trademark, and copyright laws, as well as adhere to international standards.

In China, economic development coincides with the country's plan of economic restructuring and international trade. As such, FDI plays a pivotal role in economic development, as it provides foreign capital to combat any problems with the balance of payment or foreign currency shortages. China has become a major player in the international marketplace and continues to prosper because of its policies.

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19. *China 1996*, *supra* note 15, at A-21.
20. *Id.*
21. *Id.*

V. CRITICS

Despite the growth and development experienced by many countries that have successfully utilized incentives, many still argue against using them to attract investment because they result in unfair advantages. Some claim that incentive practices favor more developed countries, as they have more to "put on the table." Empirically, this has not been the case. Countries that have had the most success with incentives include Ireland, Israel, and China. All three were considered to be "infant" countries, in terms of industrial development, when they first created and offered incentives. Typically, less-developed locations also enjoy lower overall cost structures, which require less incentives in order to make their total cost environments attractive.

Many in the business world claim that incentives only benefit larger, higher profile companies. While the higher profile companies receive more attention, locations are becoming sophisticated enough to realize the need to attract smaller investments. These smaller investments are typically less demanding on infrastructure. In order to improve, it would be necessary to establish clusters of expertise, and develop the supplier bases requisite for the "bigger fish."

The most common criticism is that the locations benefit far less than the companies they incent. There must be a win-win relationship in order for the company to operate successfully in the long-term. As discussed earlier, it is in the best interest of any company to maintain a solid working relationship with the local government and the community. If either the company or host location does not benefit from the relationship, then it will likely fail.

VI. CONCLUSION

The global marketplace, although competitive, offers vast economic opportunites. Given the current nature of the marketplace, financial incentives are crucial to a country's economic development. While many argue that offering incentives furthers the growth of already-developed countries, empirically this is hardly the case. There are too many examples of developing countries that have incorporated strategic financial incentives into their macroeconomic structure, resulting in dramatic economic growth. Incentives have caused a rapid and steep increase in FDI, producing two layers of benefit. Wage increases, reduced unemployment, increased demand for the goods of local suppliers, and the inflow of foreign capital are all short-term economic benefits. This results in a boon to the country's capital market and can ameliorate problems with balance of payments.

There are also long-term economic benefits as a result of FDI. The transfer of knowledge relating to the skills of a particular industry, and skills related to organizational structure, efficiency, and productivity are examples of such benefits. Increased FDI also enhances the foreign government's ability to raise revenue through taxation, and thus reinvest in the country's infrastructure. Such indicia of long-term economic development are the same non-financial incentives a country offers to attract FDI. This creates a domino effect, which improves the likelihood that such economic growth will be sustainable. Consequently, the effect of offering incentives can be immense, yet the first steps are very simple.