Policy Perspectives Paper

(PP/21-01)

Policy Considerations in Using Tax Incentives for Foreign Investment

Andriansyah, Seung Hyun (Luke) Hong, Byunghoon Nam

OCTOBER 2021

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Policy Consideration in Using Tax Incentives for Foreign Investment

Prepared by (in alphabetical order) Andriansyah, Seung Hyung (Luke) Hong, Byunghoon Nam [1] [2]

October 2021

Abstract

Many countries are facing two potentially conflicting policy priorities – supporting economic recovery and rebuilding policy space – in the post-pandemic period. Strong investment is essential to boosting the recovery momentum, but generous fiscal incentives to attract FDI could hamper the government's efforts to rebuild fiscal policy space. Meanwhile, ongoing discussion on global tax reforms will force the authorities to revisit their tax incentive system. In this context, this paper reviews the literature on tax incentives and proposes key elements for the efficient and effective use of tax incentives for FDI. The proposed elements are grouped into three pillars – design, management, and governance. Designing the tax incentives should be based on a comprehensive FDI strategy, suitable instruments and clearly defined eligibility criteria for FDI in strategically targeted sectors. Well-designed tax incentives should be implemented transparently under a life-cycle management framework with cost-benefit analysis and pre-specified sunset provisions. Good governance framework can greatly facilitate the effective and efficient design and management of tax incentives, while international cooperation can address the issues related to tax competitions and tax evasion.

JEL classification: E62, E61, H21, H25, H26, H32

Keywords: Tax incentives; Foreign direct investment; Tax exemption; Tax rate reduction; Tax allowance; Tax credit; Tax Expenditure; Cost-benefit analysis; Sunset clause; Global tax reforms

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[1] Authors' e-mails: Andriansyah@amro-asia.org; Luke.Hong@amro-asia.org; Byunghoon.nam@amro-asia.org.

[2] The authors would like to thank the participants in the AMRO Webinar on 5 October 2021, as well as the AMRO staffs who participated in the Brownbag seminar on 10 June 2021, for their comments; and Toshinori Doi, Hoe Ee Khor and Wenxing Pan for their invaluable advice and guidance. All remaining mistakes are the responsibility of the authors.

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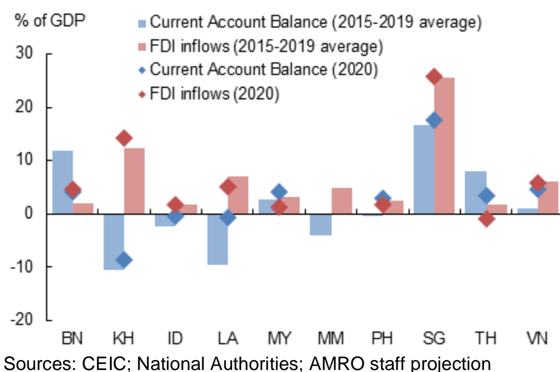
I. Introduction

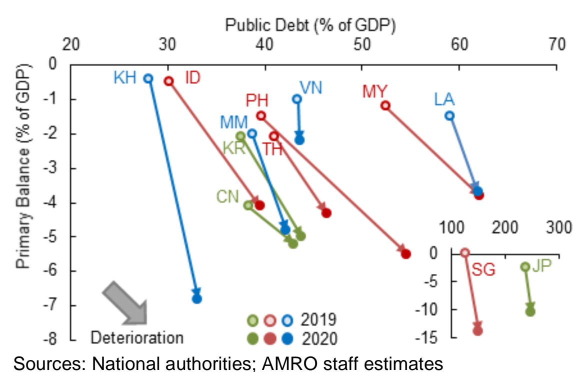
1. **Member countries face two potentially conflicting policy priorities in the post-pandemic period: continued fiscal support for robust recovery vs. rebuilding fiscal space.** Given weak recovery momentum and large uncertainty about the pandemic's evolution, substantial fiscal policy support is essential for a robust recovery, particularly encouraging investment in the strategic transition to the so-called "new normal" and enhancing long-term growth potential.[3] Some countries might be able to finance the investment from domestic savings, while other countries with relatively weak domestic financing capacity might have no choice but to rely on foreign direct investment (FDI). At the same time, governments should rebuild the fiscal policy space, which has been reduced significantly to counter the adverse effects of the pandemic on the economies. As one of the direct measures, the authorities seek various ways to improve revenue collection, including streamlining tax incentives for investments.[4]

Figure 1. Current Account Balance and Foreign Direct Investment Inflows



Sources: CEIC; National Authorities; AMRO staff projection

Figure 2. Public Debt and Primary Balance



Sources: National authorities; AMRO staff estimates

2. **Tax incentives are extensively used to attract investments, although their effectiveness remains controversial.** With gradual liberalization of FDI and shift to industrialized economic structure, ASEAN countries have adopted a wide range of investments promotion measures to nurture specific sectors (such as ICT industry), encourage specific activities (such as R&D and exports), and develop specific regions (such as Special Economic Zones). One of the most widely used promotion measures is tax incentives, and various tax incentives are being used in member countries (See Box 1 for the type of tax incentives, and Table 1 for the tax incentives implemented in ASEAN countries). Despite their wide use, however, the effectiveness of tax incentives in attracting FDI has been found to be uncertain. Many empirical studies argue that, at an aggregate level, the effectiveness of tax incentives is inconclusive or, at best marginal (See discussion in Section III).

3. **In this context, international organizations have recommended the rationalization and reforms of tax incentives.** The IMF (2021) recently recommended developing economies and low-income countries raise revenues in the post-pandemic by rationalizing profit-based tax incentives for FDI and special incentives for small and medium enterprises (SMEs). Separate from empirical studies on the effectiveness of FDI, international organizations and donor agencies have discussed how to improve the use of tax incentives, and presented guidelines for low-income and developing countries (IMF-OECD-UN-World Bank, 2015; UN, 2018, among many).

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[3] See Ekapirak and other (2020) for discussion on the characteristics of new normal.

[4] The forgone revenue has become more important in countries with tight budgetary constraints. For instance, the revenue forgone from tax incentives in Indonesia was 1.6 percent of GDP in 2019, increased from 1.5 percent of GDP in 2018 (IFPA 2020). Meanwhile, in Malaysia, the cost of incentives for the manufacturing sector was estimated to range between 0.8-1.3 percent of GDP or 6.0-8.9 percent of total government tax revenue (BNM 2017).

Table 1. Tax incentive instruments in ASEAN countries

	Income Tax Exemption	Tax Rate Reduction	Tax Allowance	Tax Credit	Trade Tax Exemption
Brunei	√		√		√
Cambodia	√		√		√
Indonesia	√	√	√		√
Lao PDR	√	√	√		√
Malaysia	√	√	√		√
Myanmar	√	√	√		√
Philippines	√	√	√	√	√
Singapore	√	√	√		√
Thailand	√		√		√
Vietnam	√	√	√	√	√

Sources: Deloitte, 2020; KPMG, 2015; National Authorities responsible for Investment Incentives (See References); AMRO staff compilation.
Note: The term "tax holidays" is loosely defined and often used to refer to general tax incentives, including tax exemption and tax rate reduction, for a certain period. Sometimes, it is narrowly defined to refer to income tax exemption in some literature. To avoid confusion, the term "tax holiday" is not used in this paper.

4. **Future progress in global tax reforms will prompt the authorities to revisit their tax incentive system.** In October 2021, the OECD/G20 Inclusive Framework on domestic tax base erosion and profit shifting (BEPS) approved a statement providing a framework for reforming the international tax rules.[5] Although the details are yet to be determined, new taxing rights for market jurisdiction and the global minimum corporate tax rate of 15 percent will affect the investment decisions of multinational enterprises (MNEs), which will in turn call for a rethinking of the tax incentive system of host countries (See Box 2 for the discussion).

5. **This paper aims to present key elements for better use of tax incentives to attract FDI based on the existing research and guidelines**. The rest of the paper is organized as follows. Section II discusses the theoretical framework in assessing the performance of tax incentives, and Section III draws lessons from existing empirical findings. Section IV proposes key elements to consider for better tax incentives, and Section V concludes.

Box 1. Type of Tax Incentives

Tax incentive instruments can be categorized by the stage and way that the instrument affects the tax amount. The instrument may reduce the actual tax amount by affecting either tax base, tax rate, or tax liability, directly or indirectly.

Table 1-1. Classification of Tax Incentive Instruments

Instrument	Description	Examples
Tax exemption	• Exclusion from tax base	• Income tax exemption for the first five years • Trade tax (VAT and customs duty) exemption for strategic imported goods
Tax rate reduction	• Reduced tax rate	• Reduced Income tax rate for the businesses in the Special Economic Zone • Reduced VAT rate in the mining sector
Tax allowance	• Deduction of certain expenses from the benchmark to arrive at tax base	• Deduction of R&D costs from taxable income • Deduction of capital investment from taxable income
Tax credits	• Deduction of certain expenses from tax liability	• Deduction of training expenses from tax liability
Tax deferral	• Depreciation of fixed assets at a faster rate • Delay in recognition of taxable income	• Accelerated depreciation of capital assets • Deferment of income tax payments for the first five years

Sources: OECD, 2010; GAO, 2013; AMRO staff compilation

[5] 10 out of 14 ASEAN+3 members (except Cambodia, Lao PDR, Myanmar, and Philippines) have participated.

In the literature, tax incentive instruments are often classified into profit-based and cost-based incentives. Profit-based tax incentives refer to instruments that directly reduce the income tax amount. Income tax exemption and income tax rate reduction fall into this category. On the other hand, cost-based tax incentives deduct certain expenses from tax base or tax liability. Tax allowance and tax credit reduce the costs related to investments. Trade tax exemption is another type of tax incentive widely used in low-income and developing countries. It can be viewed as cost-based tax incentives as it reduces the input costs related to investment. Tax deferral can be classified into either category based on whether it affects the recognition of cost or tax itself.

II. Assessment of Tax Incentives: Costs vs. Benefits

6. **This section discusses the general framework that assesses the effectiveness and efficiency of tax incentives.** Tax incentives for FDI are expected to attract more foreign investment while indirectly contributing to economic development and livelihood. On the other hand, tax incentives incur various costs: revenue costs, administrative costs, and distortion in resource allocation. Given these benefits and costs, tax incentives are evaluated to be effective if they achieve their objectives and considered to be efficient if the objectives are achieved at a lower cost. Understanding the cost and benefits associated with tax incentives would be the first step in assessing the existing tax incentives and guiding the direction towards a better incentive system.

A. Benefits

7. **Tax incentives can attract FDI that would not have been made without the incentives**. FDI has become an important source of external capital for promoting economic development, especially in low-income and developing countries with less domestic savings. Increased mobility of international companies and reduced barriers to global capital flows drive governments around the world to compete in attracting FDI into their countries. Tax incentives are expected to increase FDI into the host country by influencing foreign companies' investment decisions with tax benefits to increase the after-tax profit or reduce investment costs.

8. **The host country can also benefit from higher FDI through various channels.** First, on the supply side, an increase in FDI can induce the capital and labor inputs to related suppliers and distributors through backward and forward linkage effects. The productivity of the economy can be enhanced by adopting advanced technology, skill, knowledge, and management embedded in incoming FDI. Technology diffusion or competitive pressure on domestic firms can also stimulate innovation in the economy. Second, on the demand side, increased output, employment, and wage can raise the overall domestic purchasing power, resulting in higher consumption. FDI can also increase international trade through the expanded global value chain (GVC) participation. Third, FDI can fundamentally influence the economic structure. The host country can pursue economic diversification, balanced regional development, and institutional upgrading, by attracting FDI of interest. Lastly, fiscal revenue collection improves in the long-term. Income tax revenue from new investments can be collected after the tax incentives expire. Tax revenue from other related suppliers, distributors, employees, and consumers will also increase.

B. Costs

9. **Revenue costs**: **As exceptions to the normal tax system, tax incentives reduce the amount of tax revenue to be collected.**

- **Forgone revenue**: Tax incentives can lead to direct losses in tax revenue for the host governments in the forms of the forgone revenue that otherwise would have been collected from the activities, and the forgone revenue from projects that would have been undertaken even without any tax incentives. In the latter case, since revenue is lost without any effect on additional investment, the tax incentives are considered to be redundant.[6]

- **Lost revenue**: Additional revenue loss may arise due to the increased complexity of the tax system. In response to tax incentives, taxpayers' behavioral changes, either legal (tax avoidance) or illegal (tax evasion), tend to increase tax noncompliance, thereby reducing government revenue collection.[7] In addition, discretionary and non-transparent implementation of tax incentives, particularly granting of tax incentives, exacerbates the rent-seeking behavior of investors and corruption of public officials, reducing tax compliance and government revenue collection.

10. **Administrative costs: There are costs related to the government's enforcement of tax incentives and taxpayers' compliance.** Costs to administer complex tax clauses include granting incentives, monitoring taxpayers' compliance with the requirements, and enforcing termination or renewal of incentives. Administration costs tend to increase with the complexity of the tax incentive regime and the whole tax system, which also increases the compliance cost of taxpayers.

11. **Distorted resource allocation: Tax incentives also lead to distortions in resource allocation by affecting investment choices among sectors and activities**. With discriminatory tax treatment, more investment and labor will flow into the incentivized sectors and activities, leaving other productive sectors and activities with insufficient investment and labor. This distorted resource allocation may lower the overall efficiency of the economy, by reducing the productivity of capital and labor.

III. Lessons from Existing Literature

12. **This section summarizes the empirical findings from existing literature on tax incentives for foreign investments.** There have been extensive studies on the effectiveness and efficiency of tax incentives for foreign investments across advanced and developing countries. Some studies employ econometric models to examine the statistical significance of the impact of tax incentives in determining the FDI inflows, while some others rely on surveys and anecdotal evidence. We first review the general arguments, and then discuss the empirical studies on some specific types of FDI and tax incentive instruments.

A. Overview

13. **In general, the effectiveness of tax incentives in attracting FDI is inconclusive, particularly in developing countries.** Many empirical studies demonstrate that high corporate income tax (CIT) rates deter FDI, but most of them involve investment in OECD countries (See James (2013) and references therein). Klemm and Van Parys (2012) show by the econometric model that FDI is affected by CIT rates and tax holiday duration in developing countries, but the effects are small relative to those for OECD countries. Recently, World Bank (2017) finds that tax incentives schemes are less effective in increasing investment than a

[6] According to James (2013), redundancy ratio, defined as the percentage of investors who claim that they would have invested even without tax incentives, is mostly over 70 percent. For example, redundancy ratio is 81% for Malaysia (2014), 85% for Vietnam (2004) and 81% for Thailand (1999).

[7] Taxpayers' response to complex tax system comes in many different forms. In addition to the intended shifting of activities to those with tax incentives, abusing of tax incentives, including deliberately misreporting of their tax liabilities, tends to increase over time. Common abuses include double-dipping, round-tripping, transfer pricing, overvaluation, abusing of duty-free privileges, and "fly-by-night" operations. (UN, 2018)

simple regime with moderate CIT rates. OECD (2019) confirms that higher corporate tax rates are associated with lower FDI intensities, but higher tax incentives are not correlated with higher FDI intensities in ASEAN countries.[8] Empirically, the pure effect of tax incentives on FDI is difficult to measure because there exist many other factors considered by potential investors and many other FDI-promoting measures implemented by the host government.

14. **Tax incentives are more effective when combined with better infrastructure and investment climates.** According to surveys conducted for investors (UNIDO, 2011; World Bank, 2017), tax incentives are not among the top factors influencing location decisions. Instead, economic and political stability, transparency of regulations and legal framework, and ease of doing business matter more to investors. The survey results imply that tax incentives alone cannot attract investments and cannot compensate for deficiencies in infrastructure and investment climates (Kinda, 2018). Studies from international organizations demonstrate that countries are most likely to benefit from tax incentives with a strong investment climate, including infrastructure, availability of skills, macroeconomic stability, market access, and clear intellectual property rights (World Bank, 2017; OECD, 2015). Nonetheless, incentives often play a role in the final stage of negotiations between investors and governments of the shortlisted investment locations (Freund and Moran, 2017).

Table 2. Foreign Investors' Ranking of Importance of Location Factors

Rank	Location factors
1	Economic stability
2	Political stability
3	Costs of raw materials
4	Local markets
5	Transparency of regulation/legal framework
6	Availability of skilled labor
7	Labor costs
8	Quality of life
9	Availability of local suppliers
10	Bilateral agreements and taxation treaties
11	Incentive package
12	Export market

Sources: UNIDO, 2011

Table 3. Importance of Investment Climate Factors

Rank	Investment climate factors
1	Transparency and predictability in the conduct of public agencies
2	Investment protection guarantees provided in the country's laws
3	Ease of obtaining government approvals to start a business and to own all equity in the company
4	Investment Incentives such as tax holidays
5	Having a preferential trade agreement
6	Having a bilateral investment treaty

Sources: World Bank, 2017

15. **Targeted tax incentives are more effective and efficient, and more likely to achieve specific socio-economic development objectives.** Tax incentives could be used to target specific sectors (manufacturing, pioneer industries), activities (R&D, technology transfer, exports), and regions (less developed, SEZ) to better align with the national development plan. International organizations tend to argue for more targeted approaches in terms of sectors and activities (IMF-OECD-UN-World Bank, 2015; UN, 2018; OECD, 2019). Targeting identifies the types of investment that the host governments seek to attract, and reduce the revenue cost of incentives. Narrowly targeted incentive schemes are less difficult to enforce than broadly targeted ones. Furthermore, targeted tax incentives may leverage FDI inflows to promote and encourage economic and social spill-overs by setting specific requirements. For example, tax incentives that Malaysia, Thailand and Singapore provided to investors to foster linkages with local firms have proven effective (See OECD (2019) and references therein).

[8] OECD (2019) compares inward FDI stocks against the wedge of effective tax rates with and without incentives, which illustrates the generosity of tax incentive use. The wedge is higher for countries with lower FDI intensities (Indonesia, Lao PDR and Myanmar) and lower for countries with higher FDI intensities (Cambodia and Thailand).

B. Type of FDI

16. **Efficiency-seeking FDI is more responsive to tax incentives than market- and resource-seeking FDI**. According to the classification by Dunning and Lundan (2008), efficiency-seeking FDI exploits cost advantages in production for the global market, market-seeking FDI penetrates a local market, and resource-seeking FDI exploits the presence of natural resources. By definition, efficiency-seeking FDI is likely to respond to tax incentives that lower the production cost, while market- and resource-seeking FDI are more concerned with local demand and availability of resources. In addition, given that industries that attract efficiency-seeking FDI are often highly mobile and closely linked to the GVC, firms strategically seek the most cost-competitive locations where tax incentives can provide significant differences. In the World Bank survey results, the share of respondents rating incentives as important for their investment decision is considerably lower for market- and natural resource-seeking investors than for efficiency-seeking investors (World Bank, 2017).

17. **The effects of tax incentives are stronger for Greenfield FDI than for Mergers and Acquisitions (M&A) FDI, and for export-oriented FDI than for domestic-oriented FDI**. An empirical study by Hebous and others (2011) finds that Greenfield FDI is more sensitive to taxes than M&A FDI because the investment through M&A is sometimes a mere transfer of ownership, displacing the domestic investment, and a portion of the tax burden may be capitalized, reducing the acquisition price. Export-oriented FDI is more sensitive to changes in tax incentives than domestic market-oriented FDI because export-oriented FDI is usually motivated by efficiency-seeking behavior in the form of Greenfield FDI (James, 2013).

C. Type of Tax Incentives

18. **Profit-based and cost-based tax incentives reduce the tax burden borne by investors in different ways.** Profit-based tax incentives, such as income tax exemption and tax rate reduction, directly lower the tax amount, regardless of actual investments. The tax benefit to the company is a function of profit. On the other hand, cost-based tax incentives, such as accelerated depreciation, tax allowances and credits, deduct the investment costs from either taxable income or tax amount. Thus, the tax benefit to the company is directly related to the size of the investment undertaken.

19. **Cost-based tax incentives are generally preferable to profit-based tax incentives in terms of both effectiveness and efficiency** (IMF-OECD-UN-World Bank, 2015; World Bank 2017; OECD, 2019).

- Profit-based incentives tend to be ineffective as tax benefits are low for the projects with low profitability, while those projects with high profitability would have been undertaken even without incentives. Therefore, for highly profitable projects, tax incentives are often redundant and the host governments lose substantial revenue. The risk of tax evasion through profit shifting is also high for profit-based incentives, as firms can artificially allocate profits within the firm to plants or subsidiaries that benefit from these incentives. Some anecdotal evidence of profit shifting has been presented for developing countries, including Cambodia (UNCTAD, 2015; OECD, 2019).

- Income tax exemption is associated with additional problems. Due to the finite duration of exemption, short-term projects with low upfront investments benefit rather than long-term investments with larger capital formation and greater spill-overs. Such investment projects are known to “pack and go” or “fly by night” as firms move to another country with new tax benefits when a tax exemption expires (IMF-OECD-UN-World Bank, 2015; UN, 2018).

- Cost-based tax incentives attract investments that would not otherwise have been made by making the project profitable at the margin. They have advantages in targeting specific

activities, such as SME linkages, skills development, by attaching those requirements to incentive provisions. However, they require higher tax administration capacity, which is often lacking in low-income countries. In addition, resource allocation may be distorted as tax allowance and credits, which deduct the cost of investments from either tax base or liabilities, favor capital-intensive investment, especially on short-lived assets (UN, 2018).

Table 4. Comparison of Profit-based and Cost-based Tax Incentives

<table>
<tr><th colspan="2"></th><th>Profit-based tax incentives</th><th>Cost-based tax incentives</th></tr>
<tr><td colspan="2">Benefit</td><td>• Ineffective (if profitability is low)</td><td>• Effective</td></tr>
<tr><td rowspan="4">Cost</td><td>Redundancy</td><td>• Redundant (if profitability is high)
• Substantial/unpredictable revenue loss</td><td>• Less redundant
• Predictable revenue loss</td></tr>
<tr><td>Tax avoidance and evasion</td><td>• Prone to tax avoidance and evasion</td><td>• Less prone to tax avoidance and evasion</td></tr>
<tr><td>Administrative cost</td><td>• Low enforcement & compliance cost</td><td>• High enforcement & compliance cost</td></tr>
<tr><td>Distorted resource allocation</td><td>• Biased to short-term investment (especially, income tax exemption)</td><td>• Biased to capital-intensive investment (low employment effects)
• Preference for short-lived assets</td></tr>
<tr><td colspan="2">Other</td><td>• “Pack and go”, “Fly by night”</td><td></td></tr>
</table>

Sources: UN, 2018; OECD, 2019; World Bank, 2017; AMRO staff compilation

D. Other Issues

20. **Transparency, monitoring and evaluation, and governance are also important.** A tax expenditure, which quantifies the revenue cost, can improve the transparency of policies and the accountability of authorities. However, publishing tax expenditure regularly requires extensive knowledge and efforts from tax authorities. Monitoring and evaluating tax incentives not only ensure the effectiveness of incentives by preventing tax abuse and evasion, but also provide the host government with the opportunity to assess the performance of investment projects. Sunset clauses are also encouraged so that the host governments can reconsider whether the incentives should be continued, reformed, or repealed. Good governance requires that the government’s decision-making process, policies, and administration be transparent and subject to scrutiny and evaluation, in order to improve the accountability of authorities (IMF-OECD-UN-World Bank, 2015). The rule of law with clear eligibility criteria and a strong role of the Ministry of Finance are commonly recommended for good governance.

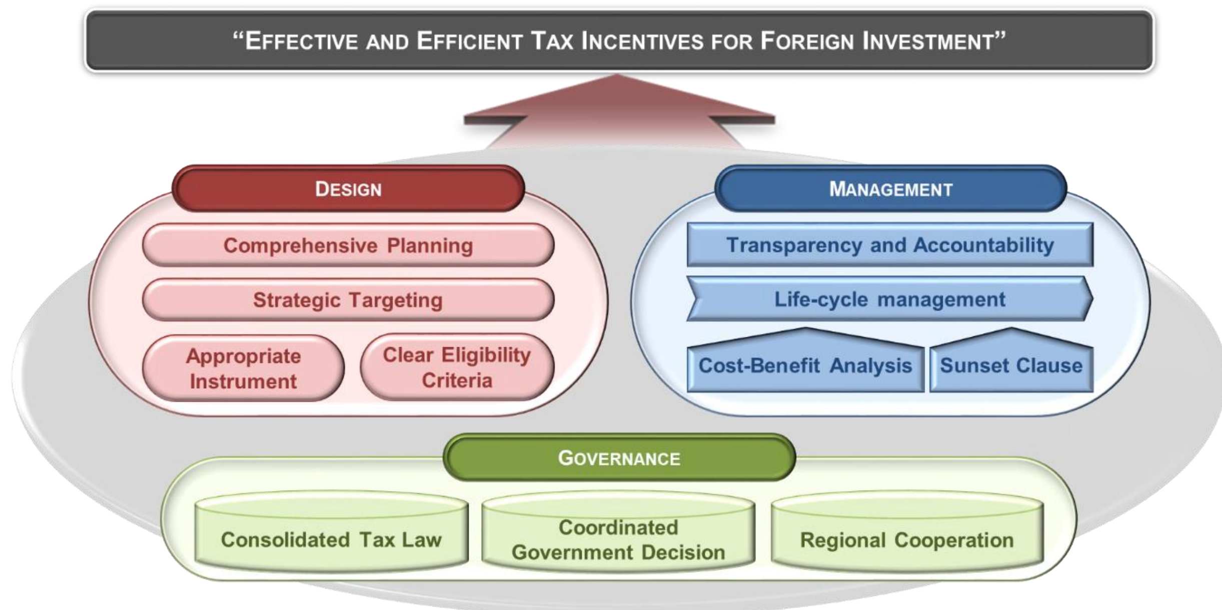
21. **Tax competition diminished the intended effects of tax incentives to attract FDI, while reducing the tax revenue of all countries.** Attracting FDIs by granting tax incentives might be deemed to be a zero-sum game. Tax competition tends to cause a race to the bottom in terms of effective tax rates. All competing countries end up with uniformly lower tax revenue with little or no actual impacts on investment decisions. International or regional tax cooperation, including information sharing, could reduce the adverse spill-over effects of tax competition.

IV. Key Elements for Effective and Efficient Tax Incentives

22. **This section discusses key elements for effective and efficient use of tax incentives to attract FDI.** Based on the discussion in the previous two sections, key elements are proposed in three pillars – design, management and governance (Figure 3). Designing the tax incentives should be based on a comprehensive FDI strategy, suitable instruments, and clearly define eligibility criteria for FDI in strategically targeted sectors. Well-designed tax incentives should be implemented transparently under a life-cycle management framework with cost-benefit analysis and pre-specified sunset provisions. Good governance framework can greatly facilitate the effective and efficient design and management of tax incentives.

23. **Given general guidelines from the existing literature, the country-specific situation should be carefully assessed for the key elements.** However good the general principles are, they are not universally applicable in practice because each country has different environments and faces different constraints. The key elements incorporate the generally accepted good practices from empirical findings, while taking into account the country-specific factors.

Figure 3. Key Elements for Effective and Efficient Tax Incentives



Sources: AMRO staff illustration

A. Design

24. **Comprehensive Planning: Tax incentives for FDI should be based on a comprehensive FDI promotion strategy.** Given FDI's significant contribution to economic development, the host country should establish a comprehensive FDI promotion strategy in line with its long-term development plan. The FDI promotion strategy should encompass various policy measures, including tax incentives and non-tax measures, to achieve its goals. All available policy options should be assessed for their relative strength and weakness in attracting FDI, and their impact on all related stakeholders should be examined carefully to facilitate the implementation of the strategy.

25. **Strategic Targeting**: **Tax incentives should have clear targets reflecting the country's endowments and strategic priorities**. Long-term development often depends on the country's endowments and strategic development priorities, which set key policy directions for the comprehensive FDI strategy. For example, some countries may aim to attract FDI that could maximize the potential of their endowments, such as large enough domestic market or abundant natural resources. Other countries may aim to attract FDI to develop specific sectors, such as export-oriented manufacturing, that are prioritized by the national development agenda. Given the negative impact on revenue, tax incentives should be used selectively and designed with clear strategic targets, which will help administer tax incentives and minimize the side-effect of tax incentives. In addition, the authorities may also consider attaching additional requirements, such as local employment, technology and knowledge transfer, to maximize the intended benefits of the targeted investments.

- **Targeting sectors and activities: Tax incentives should be used strategically to promote investment in certain sectors or activities in line with the host country's strategic priorities.** Strategic priorities may be given to promoting certain priority sectors,

encouraging activities with positive externalities, such as R&D and human resource development, or developing certain areas, such as Special Economic Zones.[9] Clearly defined policy objectives will help identify the priority sectors. For example, the employment creation motive can be supported by providing incentives to labor-intensive industries, such as manufacturing and agriculture-based industries. Manufacturing products that are not already produced domestically can be promoted by providing tax incentives to the so-called pioneer industries. Technology transfer can be boosted by targeting incentives at technologically advanced sectors.

- **Type of FDI: Tax incentives should focus on the type of investments sensitive to tax benefits**. According to the existing studies and international best practices, tax incentives are more effective for efficiency-seeking FDI and Greenfield FDI. Therefore, when a country aims to attract multiple types of FDI, tax incentives should focus more on efficiency-seeking FDI than market- and resource-seeking FDIs. For example, a country that seeks to host both efficiency- and resource-seeking FDI may concentrate tax incentives on the former, while granting less tax incentives but more non-tax measures, such as an exclusive concession, for the latter. However, market- and resource-seeking FDI could also be responsive to tax incentives under certain circumstances. For example, suppose the host country competes with other countries with similar investment environments. In that case, tax incentives can provide an additional comparative advantage in inducing FDI that would have otherwise invested in competing countries. Similarly, if M&A FDI requires sizeable additional investment to reshape or expand the existing production capacity, tax incentives can help the host country attract additional investment. In such a case, tax incentives should target the incremental investment that would not have occurred without the tax benefits.

26. **Appropriate Instrument: Choice of instruments should be based on their relative effectiveness and efficiency, considering the capacity constraints and policy environments**. Despite the higher administrative burden, cost-based instruments are generally known to be superior to profit-based instruments in terms of both effectiveness and efficiency. Therefore, countries are often advised to shift from profit-based to cost-based instruments in line with the development of their tax administration capacity. In reality, however, profit-based instruments continue to be used extensively regardless of tax administration capacity, due to their relative simplicity in administration, tax competition consideration, and intrinsic nature of targeted investments.

- **Countries with weak tax administration capacity may minimize the costs by implementing simpler profit-based instruments.** Although known to be more effective, complex tax incentive instruments could lead to excessive revenue losses if not properly administered. Therefore, a country with weak tax administration capacity needs to start with some simple instruments and adopt more complex but effective instruments over time, considering the development of its administrative capacity to properly manage the incentive system. In addition, other policy efforts should be supplemented to improve the effective and efficient use of instruments. For example, management and governance of the tax incentive system should be enhanced, as discussed in the following subsections.

- **Tax competition may force the authorities to provide profit-based incentives, especially when requested by potential investors.** Relatively generous income tax exemption is often preferred by investors weighing multiple locations. Then, host countries with similar investment environments and priorities tend to compete with each other to attract similar FDI by offering similar, if not more generous, tax incentives packages. To avoid winner's curse, cost-benefit analysis should be carefully conducted to assess

[9] These priority sectors and activities can also be combined with other policy priorities, such as inclusive growth for less-developed regions or regions with high-unemployment level.

whether the benefits of FDI outweigh the costs of tax incentives. International and regional cooperation should also be strengthened by sharing the policy concern about negative spill-overs of tax competition as the first essential step.

- **Cost-based incentives may be less effective for certain industries**. For example, low capital-intensive industries, such as software providers, platform businesses, and knowledge-based institutions, do not involve sizeable physical investments. In the absence of upfront expenses to be deducted, cost-based incentives are not attractive to these businesses. Therefore, the characteristics of target investments need to be carefully examined to determine appropriate policy options – tax incentives, direct budget subsidy, and regulatory support – based on their respective benefits and costs.

27. **Clear Eligibility Criteria: Eligibility criteria for tax incentives should be clearly defined to reduce the rent-seeking behavior of investors and the corrupt behavior of public officials.** The eligibility criteria for tax incentives should be explicitly stipulated in the law, providing a clear and reliable interpretation to potential investors, limiting ad hoc changes or discretionary implementation. Also, the scope of eligibility should be carefully set to avoid unnecessary revenue losses while effectively attracting strategically targeted FDI and activities.[10] Clearly defined and well-scoped eligibility criteria will help the responsible government agency to manage the tax incentives efficiently, reducing the risks of corruption and abuse of tax benefits. Also, the implementation of qualification requirements needs to be clearly delegated to appropriate government agencies by the law.

Box 2. Implications of Global Tax Reforms on the Tax Incentives for FDI

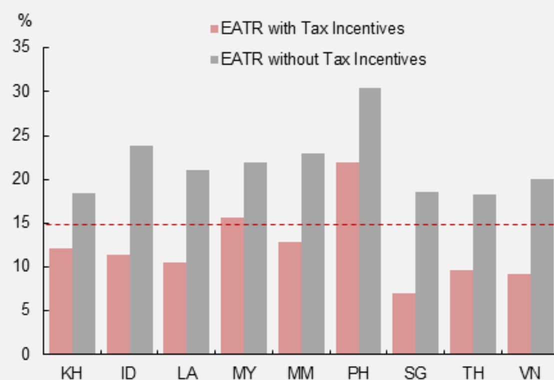
Global tax reforms are likely to influence the tax burden borne by MNEs and the tax revenue collected by host countries. Under the unified approach of Pillar 1, MNEs would pay more taxes in countries where they have more customers, even without their physical presence in those countries. However, this additional tax revenue must be compared against the loss of tax collection in other forms, if any, such as digital taxes to assess net gains. With the global anti-base erosion (GloBE) rules of Pillar 2, MNEs are subject to a minimum level of tax regardless of the tax rates of countries where they operate. Lower effective tax rates (ETRs) could be due to lower statutory rates and/or generous tax incentives, and the amount of taxes forgone due to the lower ETRs would be collected by the home countries up to the global minimum tax rate. According to Wiedemann and Finke (2015), the Effective Average Tax Rates (EATRs) of most ASEAN countries are below 15 percent if tax incentives are considered (Figure 2-1). In these countries, generous tax incentives may become less important in attracting MNEs as they need to pay the remaining taxes (up to 15 percent) to their home countries.

Table 2-1. Key Elements of Global Tax Reforms

	Pillar 1	Pillar 2
Overview	• New taxing nexus	• Global tax floor
Implication on Taxes	• Reallocation of tax revenue	• Increase in tax revenue
Scope - Basis - Revenue - Profit	 • MNE Group • ≥EUR 20 billion • ≥10%	 • MNE Group • ≥EUR 750 million • N/A
Exclusions	• Regulated financial sector • Extractives	• Gov't entities, IOs, NGOs • Pension/invest funds of MNE • Int'l shipping

Sources: OECD; AMRO staff compilation

Figure 2-1. Effective Average Tax Rates for Investment Eligible for Tax Incentives



Sources: Wiedemann and Finke, 2015

[10] In addition to attracting FDI itself, additional strategic policy objectives could be added to eligibility criteria. For example, the requirements for technology transfer, skill education, use of local supplies, and environment protection could help maximize the indirect benefits of FDI.

Global tax reforms will influence the design elements of tax incentives. First, a comprehensive FDI promotion strategy will require a more careful selection of policy measures. Given the less effectiveness of tax incentives under the global minimum tax, the host countries would rely more on non-tax promotion measures, in particular enhancing the investment environment such as ease of doing business, infrastructure developments, and skilled labor training. For example, for the efficient-seeking FDI on manufacturing exports, better connectivity and logistics may become more effective in promoting FDI, while some non-tax incentives, such as longer periods of concessions or regulatory exceptions in specific areas, can also supplement existing tax incentive tools.

Second, tax incentives should be strategically realigned to sectors, activities, and companies that will still be relevant under the new global tax regime. For example, MNEs that generate relatively small revenue (less than EUR750 million) are not subject to the global minimum tax, but they still can make significant contributions to the development of the host countries. In addition, MNEs or parts of MNEs will still benefit from tax incentives in the sectors and activities excluded from Pillar 1 and Pillar 2.

Third, the attractiveness of instruments should also be re-assessed. For the MNEs subject to global minimum tax, the instruments can be tailored to meet the company's particular considerations. For example, within the maximum amount of tax benefits available under global minimum tax, MNEs may prefer the instruments beneficial to their long-term development – such as R&D, training, and capital investments – rather than instruments with only immediate effects of the reduced tax burden. Then, cost-based incentives favorable for such activities will be more attractive than profit-based incentives.

The discussions on global tax reforms are ongoing, and many pertinent issues remain uncertain yet.[11] Considering MNEs would pay particular attention to the related discussions and optimize their decisions accordingly, the authorities should also closely communicate with existing and potential investors about when and how to re-design their tax incentives.

Box 3. Strategic Targeting in ASEAN Countries

ASEAN countries target a wide range of sectors, activities and regions with additional qualification requirements. The scope and level of sectors and activities vary across countries.

Table 3-1. Strategic Targets of Investment Promotion

	Targeted Sectors / Activities / Regions
Brunei Darussalam	• Sectors eligible for Pioneer Certificate Projects - Industries (i) expedient in the public interest; (ii) that have not been carried out on a scale adequate to the economic needs; (iii) that have favorable prospects for development - 27 industries have been declared as pioneer industries, including the manufacture of electrical industrial machinery and apparatus, manufacture of non-metallic mineral products, manufacture of radio and television equipment, manufacture of communication equipment, aircraft catering services, pharmaceutical, industrial chemical • Regions: Hi-Tech Park
Cambodia	• Sectors eligible for Qualified Investment Projects - Export supporting industry, manufacturing, construction of market and trade center - Training and educational institutes, technology or poly technology - Agriculture, tourism, infrastructure, environment, engineering, sciences services • Regions: Special Economic Zone
Indonesia	• Sectors related to Pioneer Industries - Industries that have broad linkages, provide high added value and externality, introduce new technology, and provide strategic value for the national economy. - Upstream metal, oil and gas refinery, petrochemicals, basic chemicals, pharmaceutical materials, electromedical equipment, electronics or telematics equipment, machinery, robotics components, power plant machinery, motor vehicles, vessels and trains, aircraft and supporting activities, agriculture, economic infrastructure, digital economy • Regions: Special Economic Zone

[11] For instance, the effective tax rate will be calculated annually on a country-by-country basis. However, the technical details on how the effective tax rate is calculated remain unclear and need to be agreed. This includes the details of exemptions, such as how to treat incentives that create temporary and permanent differences.

	Targeted Sectors / Activities / Regions
Lao PDR	• Sectors eligible for Incentive Certificate - (i) Industry using high and modern technology, R&D, innovation; (ii) Agriculture, agricultural processing, handicraft processing; (iii) Tourism; (iv) Education, sports, human resource development; (v) Healthcare; (vi) Infrastructure; (vii) Policy banks and microfinance; (viii) Domestic production promotion • Regions: Zone 1 (Poor and remote area with unfavorable infrastructure), Zone 2 (Area with favorable infrastructure), Zone 3 (Special Economic Zone)
Malaysia	• Sectors eligible for Pioneer Status, Investment Tax Allowance - (i) General (agriculture, agricultural processing, manufacturing, hotel, tourism, manufacturing related services); (ii) High technology; (iii) Selected industries (machinery, equipment, oil palm biomass, renewable energy); (iv) Reinvestments (resource, food processing, R&D, cold-chain) • Regions: East Coast Economic Region (ECER), Iskandar Malaysia, North Corridor Economic Region (NCER)
Myanmar	• Sectors: Agriculture (including plantation, livestock production, fishery), manufacturing, city development, infrastructure construction, airport service, transportation, power plant, telecommunication, education, health, IT, hotel and tourism, science research • Activities: Cooperation with a government organization, investments in a border region and conflict-affected area, investments across the national border and across states/regions • Regions: More incentives for underdeveloped and moderately developed regions/states, Special Economic Zone
Philippines	• Sectors and Activities preferred by Investment Priorities Plan - (i) Manufacturing (including agri-processing); (ii) Agriculture, fishery and forestry; (iii) Strategic services (IC design, creative and knowledge-based, aircraft, alternative energy vehicles, telecommunication, etc.); (iv) Healthcare and disaster risk reduction management services; (v) mass housing; (vi) infrastructure and logistics; (vii) Innovative drivers; (viii) Inclusive business models; (ix) Environment or climate change-related; (x) Energy • Regions: Pioneer incentives for less developed areas, Special Economic Zone
Singapore	• Sectors and activities: (i) Pioneer Certificate (manufacturing with high technology, qualifying services); (ii) Development and Expansion Incentive (high-value-added projects, expanding or upgrading operations, undertaking incremental activities); (iii) Incentives for internationalization (expenses for market expansion and development); (iv) Intellectual Property Development Incentive (R&D, commercialization of IP); (v) Financial sector incentive; (vi) Maritime sector incentive; (vii) Global trader program • Regions: Special Economic Zone
Thailand	• Sectors: (i) Agriculture, agricultural products; (ii) Mineral, ceramics, basic metals; (iii) Light industry; (iii) Metal products, machinery, transport equipment; (iv) Electronics and electrical appliances industry; (v) chemicals, paper, plastics; (vi) Service, public utilities • Activities - Activity-based incentives: Knowledge-based and high technology activities, infrastructure activities, activities adding value to domestic resources and strengthening the supply chain - Merit-based incentives: Competitiveness enhancements (R&D, Technology and human resources development, IP acquisition, technology training, design), decentralization, industrial area developments • Regions: Special Economic Zone
Vietnam	• Sectors: Education, health care, sport/culture, high technology, environmental protection, scientific research, infrastructure, software production, renewable energy • Activities: (i) high-tech activities, R&D; (ii) production of new materials, clean and renewable energy; (iii) production of electronic, mechanical products; (iv) production of IT and software products, digital contents; (v) agricultural products, agricultural processing; (vi) collection, treatment, recycling of waste; (vii) infrastructural works, public transportation; (viii) education; (ix) medical examination and treatment, medicines, biotechnology; (x) credit funds, microfinance institutions. • Regions: Coastal economic zones, Industrial Parks

Sources: National Authorities responsible for Investment Incentives (See References); AMRO staff compilation

B. Management

28. **Transparency and Accountability: Tax incentives should be provided and managed in a transparent manner for the predictability of potential investors and the accountability of the government**. First, comprehensive tax incentives inventories with up-to-date information should be publicly available. For example, a full list of tax incentives with legal basis, eligibility criteria, granted amount, administration process could be published and regularly updated on the government website, such as the Investment Promotion Agency. Furthermore, one-stop administrative services for interested investors would further facilitate efficient implementation and improve the investment climate. Second, tax expenditure statements should be published. Tax authorities should regularly prepare tax expenditure statements as a part of the budgetary process to assess the revenue forgone due to tax incentives, and release the reports to the public to enhance transparency and accountability with the aim of improving the use of public resources.

- **Given the administrative capacity constraints of tax authorities in developing and low-income countries, a step-by-step approach could be considered**. As a first step, a centralized inventory of tax incentives could be prepared and published, with its scope gradually increasing over time. For tax expenditure analysis, tax authorities could start by requiring the beneficiaries to file a tax return even if they are exempted from tax liabilities. The collected and consolidated information could help the authorities evaluate the revenue cost of the incentives. Starting from the largest beneficiaries by specific incentives would also help improve the management of tax incentives. For more systemic methods to publish tax expenditure, the government could seek technical assistance from international organizations.

29. **Life-cycle Management: The authorities should manage the tax incentives throughout the life-cycle**. New tax incentives should be introduced with clear eligibility criteria, based on the aforementioned comprehensive planning and strategic targeting. The tax incentives should be reviewed regularly by the responsible authority to assess their effectiveness and relevance, considering the evolving economic environment and strategic priorities. Then, ineffective or inefficient tax incentives should be modified or removed, while incentives that have already achieved the intended objectives should also be repealed.

- **The projects receiving tax incentives should also be managed throughout their life-cycle from initial grant to termination**. For the approval of the initial grant, eligibility criteria and qualification requirements should be thoroughly examined. The tax authorities could work closely with relevant government ministries and agencies that have more information and expertise in specific sectors and activities. After approval, it is essential to periodically monitor projects to avoid abuse and evasion, where proper reporting of beneficiaries is essential. When tax abuse and evasion are detected, the guilty party should be penalized based on the pre-specified legal provisions at the approval stage.

- **The government should continue monitoring and assessing the granted tax incentives, although they entail an additional administrative burden.** The management details, including the degree of scrutiny, frequency of audits, could be decided according to the authorities' capabilities and human resources.

30. **Cost-Benefit Analysis**: **Rigorous cost-benefit analysis of tax incentives should be conducted when introducing new incentives and reviewing existing incentives**. The cost-benefit analysis of new incentives would provide vital information for decision-making by comparing the opportunity costs of forgoing tax revenues which could be directed towards alternative uses of public funds beneficial to the society. Existing tax incentives should also be subject to the cost-benefit analysis to assess the need for continuation, revision, and abolition.

- **However, it is difficult to precisely measure the impact of the incentive in terms of direct and indirect cost and benefit.** A comprehensive cost-benefit analysis could be challenging for low-income countries with relatively weak tax administrative capacity and poor tax infrastructure. Even with such challenges, the cost-benefit analysis is an essential part of tax incentives management, and a less burdensome method could be used before the country's capacity can afford more complete and sophisticated methods. For example, surveys of beneficiaries would help evaluate if, and to what extent, a specific incentive is effective, and contributes to the host country's development goals.

31. **Predetermined sunset clause: Sunset clause makes tax incentives temporary in principle, mandating periodic assessment in order to assist in the decision on whether the incentives should be continued, revised, or abolished.** Deviating from the norm, tax incentives should be temporary exceptions to the regular tax system. In this regard, the sunset clause is the key to making tax incentives temporary and compels the authorities to re-evaluate the tax incentives' net benefits when deciding whether to extend the incentives. The cost-benefit analysis should be employed to ensure objective and quantitative assessment. To prevent an arbitrary extension of the sunset period and provide predictability to investors, sunset provisions should be built into the corresponding laws.

Box 4. Tax Expenditure Statements in the Philippines

The Philippines publish the tax expenditure statements as a part of budget documents, called the Budget of Expenditures and Sources of Financing (BESF). The programmed and actual amounts of tax expenditures are reported by type of tax incentives, by sector, and by Investment Promotion Agency. The total size of tax expenditure is PHP540.8 billion in 2019, which is 2.8 percent of GDP. The Philippines has implemented tax exemption, tax rate reduction, and trade tax reduction. Among them, import VAT exemption contributed 57% of the total tax expenditure. In terms of sectors, tax incentives are concentrated in manufacturing (70%), followed by services (21%).

Table 4-1. Tax Expenditure in the Philippines (PHP billion)

	2017		2018		2019
	Program	Actual	Program	Actual	Projection
Total	**422.1**	**441.1**	**471.0**	**518.7**	**540.8**
[By Type of Tax Incentive]					
1. Incentive on income tax	131.8	126.9	127.1	129.0	129.1
Income tax exemption	81.1	70.2	70.3	66.1	66.1
Special income tax rate	50.7	56.7	56.8	62.9	63.0
2. Incentives on importation	290.3	314.2	343.9	348.2	370.1
Customs duties	64.2	46.5	50.9	57.0	60.6
Import VAT	226.1	267.7	293.0	291.1	309.5
3. Incentives of cooperatives	-	-	-	41.5	41.5
[By Sector]					
1. Agriculture and Fishery	1.1	0.6	0.6	0.8	0.8
2. Economic and Low-cost housing	4.5	5.0	4.9	4.6	4.6
3. Energy	19.2	17.9	18.1	20.7	21.1
4. Manufacturing	283.9	342.8	370.0	361.1	380.8
5. Mining and Quarrying	5.8	2.6	2.6	0.3	0.3
6. PPP projects	1.5	0.7	0.7	0.7	0.7
7. Services	77.4	67.1	69.6	111.8	113.6
8. tourism	9.9	4.2	4.2	5.1	5.2
9. Unfiled	19.0	0.07	0.07	13.7	13.8

Sources: BESF FY2021, Department of Budget and Management of the Philippines.

C. Governance

32. **Consolidated tax law: Tax incentives should be thoroughly scrutinized and clearly prescribed in the law.** The design and management of tax incentives - such as eligibility criteria, tax expenditure statements, cost-benefit analysis, sunset clause - should be legislated in the form of law, rather than ad-hoc regulations to increase predictability and reduce uncertainty. Also, the roles and responsibilities of different stakeholders should be clearly specified in the legal documents to enhance management efficiency and improve accountability.

- **Furthermore, tax incentives could be consolidated in tax laws to ensure the consistency of government policies.** Consolidated tax laws would reduce the likelihood of mutually conflicting or overlapping practices, which would increase the revenue losses and limit the intended benefits. In addition, tax incentives consolidated into tax laws will enable better management with trackability. If delegation to other laws is necessary, a clear legal basis should be stipulated in relevant tax laws.

33. **Coordinated government decision: Coordination among the government agencies involved in managing tax incentives is critical.** The life-cycle management of tax incentive clauses, as well as projects receiving tax incentives, require both technical expertise in relevant sectors and fiscal consideration. Given diverse mandates of government agencies, incentives of different government agencies might conflict or overlap over certain tax incentives, failing to keep the balance between attracting FDI and safeguarding tax revenue. With technical inputs from the other line ministries, the Ministry of Finance is in the best position to assess the fiscal implications of tax incentives. To manage conflicting interests, a coordinated decision-making mechanism is often in place, such as government committee/board of relevant agencies. Also, to ensure fiscal considerations are duly reflected in the decision of tax incentives, many countries require tax incentives to be agreed (or approved) by the Ministry of Finance.

34. **Regional Cooperation: ASEAN+3 countries could cooperate to address potentially harmful tax competition and tax evasion**. Countries could start with a modest form of cooperation by agreeing on a common framework for reporting tax incentives and information exchange to encourage mutual learning. This could also enhance transparency and governance practices, and enable ex-post assessment of tax incentives. As a next step, countries could agree on a non-legally binding code of conduct not to use certain tax incentives, such as income tax exemption (for example, Code of Conduct for business taxation in EU).

Box 5. Governance for Tax incentives in ASEAN countries

In ASEAN countries, tax incentives are stipulated mostly in the laws, but not consolidated in the tax laws. The government agencies or committees that grant and manage the tax incentives vary across countries. Some countries have a single decision-making board, while others have multiple government agencies involved in tax incentives.

Table 5-1. Governance of Tax Incentives

	Main tax incentives laws	Main government agencies responsible for tax incentives
Brunei	Investment Incentives Order	Ministry of Primary Resources and Tourism
Cambodia	Amended Law on Investment, Financial Management Law, Law on Taxation	Council for the Development of Cambodia
Indonesia	Investment Law, Law on Special Economic Zones, Income Tax Law	Indonesia Investment Coordinating Board

	Main tax incentives laws	Main government agencies responsible for tax incentives
Lao PDR	Law on Investment Promotion	Ministry of Planning and Investment
Malaysia	Investment Incentives Act, Promotion of Investments Act, Companies Act	Malaysian Investment Development Authority
Myanmar	Myanmar Investment Law, Special Economic Zone Law	Directorate of Investment and Company Administration
Philippines	Omnibus Investments Code, Investment Priorities Plan, Special Economic Zone Act	Philippine Board of Investments
Singapore	Income Tax Act, Economic Expansion and Incentives Act	Economic Development Board
Thailand	Investment Promotion Act, Revenue Code	Thailand Board of Investment
Vietnam	Investment Law, Corporate Income Tax Law, Law on Export and Import Taxation	Foreign Investment Agency

Sources: OECD, 2019; National Authorities responsible for Investment Incentives (See References); AMRO staff compilation

V. Conclusions

35. **Well-designed tax incentives, managed properly under a supportive governance framework, can attract FDI, enhance spill-over benefits and reduce unnecessary revenue losses**. Empirical studies find some tax incentives are more effective and efficient than others, although the overall effectiveness is uncertain. We categorized the characteristics of widely-used tax incentives and proposed key elements of a desirable tax incentive system in three pillars – design, management, and governance. The proposed elements could provide a good reference to countries using tax incentives to attract FDI, upgrading their tax incentive system, and realigning to the new global tax regime.

36. **The government should upgrade the tax incentive system in line with the developments in the economic and policy environment**. A full assessment of the country's strengths and constraints, including endowments, economic and business structure, and administrative capacity, will help the government set the strategic targets under the national development plan. This will also help identify appropriate policy measures, but constantly evolving economic and policy environments require the government to regularly review the tax incentives for their continued relevance and effectiveness. The tax incentives should be examined and revised in this context, advancing to a more effective and efficient system by incorporating generally accepted good practices.

37. **Systematic monitoring and transparent assessment are the keys to a good tax incentive management system.** The first and most important step to upgrade the management of tax incentives is to establish a comprehensive monitoring framework, which is a prerequisite for the proper assessment of tax incentives. Centralized reporting systems and tax expenditure statements help properly assess the revenue costs incurred by tax incentives, and cost-benefit analysis provides a useful assessment framework to methodically evaluate the adoption/renewal/expiration of tax incentives. Everlasting or automatically extended types of incentives should be avoided with a predetermined sunset clause.

38. **Strong regional cooperation could enhance the tax incentive framework of each country and reduce costly tax competition and evasion**. Sharing information will help spread good practices, and coordinated policies and enhanced information sharing will help prevent cross-border tax evasions. Policy coordination to reduce tax competition among member economies will allow the members to attract more FDI at lower costs collectively.

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National Authorities responsible for Investment Incentives

Brunei Darussalam: Ministry of Primary Resources and Tourism of Brunei Darussalam

Cambodia: Council for the Development of Cambodia

Indonesia: Indonesia Investment Coordinating Board

Lao PDR: Ministry of Planning and Investment of Lao PDR

Malaysia: Malaysian Investment Development Authority

Myanmar: Directorate of Investment and Company Administration of Myanmar

Philippines: Philippine Board of Investment

Singapore: Economic Development Board of Singapore

Thailand: Thailand Board of Investment

Vietnam: Foreign Investment Agency of Vietnam

Address: 10 Shenton Way, #15-08

MAS Building, Singapore 079117

Website: www.amro-asia.org

Tel: +65 6323 9844

Email: enquiry@amro-asia.org

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