MENA-OECD INVESTMENT PROGRAMME

PROPOSALS ON POLICY CONSIDERATIONS IN THE USE OF INVESTMENT INCENTIVES IN THE MENA REGION

- Working Group 2 -

This report focuses on the appropriate and effective use of investment incentives in the MENA region. The policy considerations in this document were based on MENA and OECD presentations, research and preliminary discussion during the first Task Force meeting on investment incentives. They were intended to form the basis for further discussion and deliberation during working group meetings in September 2005. The following document incorporates a number of changes suggested at the 6-7 September 2005 meeting of Working Group 3 of the MENA-OECD Investment Programme.

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INTRODUCTION

1. All MENA countries offer direct and/or indirect investment incentives to boost employment, encourage the development of the private sector and improve their competitive position in today's global economy. During the past twenty years, incentives in many respects have become an important policy tool of many MENA governments to increase their share of investment in order to gain the attention of potential investors and to stay competitive with other countries offering incentives. While most international studies have shown that general economic and framework conditions, rather than incentives, are far more important in determining the size and quality of investment flows, incentives can compensate for market failures and are often seen as effective policy tools for achieving economic and social objectives.

2. Some MENA countries have multiple laws offering incentives, whose design and administration is the responsibility of separate Ministries. Responding to pressure from investors, these Ministries in many cases have made existing incentives more generous and increased the number of new incentives. Often these Ministries do not coordinate their work on incentives, with the result that the incentives often overlap, are not entirely consistent, or work at cross-purposes. Many incentives are also readily exploited by investors, as well as by those administering them.

3. Despite the popularity and widespread use of incentives in the MENA region, there generally have not been systematic reviews of the effectiveness of the various incentives offered, either by individual countries or at a regional level. In many countries, there is an absence of reliable data on actual investments made, direct and indirect benefits to the host economy and the cost of the incentives in terms of direct spending or revenue lost.

4. The Task Force is intended to help participating countries develop frameworks and analytical tools necessary to evaluate existing and proposed incentives, analyse the interaction of various incentives and improve the policy-making and evaluation structure to avoid instances where realised benefits of incentives are outweighed by their direct and indirect costs.

5. Numerous geographic, demographic, economic, socio-economic and political factors influence the effectiveness of incentive schemes. As a result, it is not possible to recommend one system of incentives for the MENA region. Nevertheless, the following broad policy considerations for tax, financial and regulatory incentives should help guide the development and design of investment incentives in the region. They are based on analysis of MENA country schemes and other studies of incentives offered by developing countries.

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GENERAL PRINCIPLES FOR CONSIDERATION

Fiscal Transparency and Policymaking

1. Ministries and agencies with responsibility for investment need to develop an overall strategy to boost investment and co-ordinate their policy making decisions. All tax and non-tax incentive policies to promote investment should be coordinated with one another, within a coherent policy framework designed to improve the investment environment.

- As incentives are just one policy tool of the Government to promote investment, these policies must be coordinated with other policies aimed at promoting the investment climate, including macroeconomic considerations, trade, tourism, industry policies and governance reforms.
- All investment incentives should be set in an overall strategy developed by the Ministries with responsibility for incentives. This will avoid the problem of competing or contradictory policy aims and legal inconsistencies. MENA countries should consider ensuring that a budgetary ceiling is set on the amount of incentives that can be granted each year depending on a number of agreed criteria that should satisfy the goals of the investment project, as a way to prevent unintended government spending or revenue loss.

2. Guidelines to measure the advantages and disadvantages of each investment incentive should be established and made transparent. MENA countries should establish guidelines to measure the advantages and disadvantages of each investment incentive and consider adopting greater transparency in the provision and delivery of incentives for investment. Guidelines should take into account the following:

- The specific goals and expected benefits of each incentive scheme should be, to the extent possible, measured and publicly disclosed in order to properly evaluate each scheme.

- Information about each incentive scheme should be published and posted on relevant Government websites, including comprehensive descriptions of each scheme, procedures and criteria for obtaining incentives, and the estimated cost of each scheme, where relevant information is available to support reliable estimates. Where practicable, case studies showing the benefits and costs of specific schemes should be developed and published.

- Both estimates of future costs of incentives and costs incurred by existing incentives should be made in order to inform and to provide policymakers with recommendations and to support ongoing capacity building to evaluate incentives.

- Incentives should, to the greatest extent possible, be rules-based and provided equally and fairly among all investors. In practice this means that administrative discretion in the awarding of incentives should be very limited and the criteria for exercising discretion are publicly disclosed. Incentives prone to abuse will require more oversight.

- All investment incentives should be identified each year in one published public document.

3. Expenditure reporting frameworks and procedures should be developed to publicly describe each incentive and report the cost of each major investment incentive where the requisite information is

available. Annual tax and non-tax expenditure reporting of the cost of incentives will help ensure proper management of public funds and reduce the scope for corruption.

Designing the Incentives Framework to Minimize Inefficiencies

4. **Investment incentives should be designed to maximise effectiveness and efficiency**. Incentives should be designed to maximise the benefits and minimise the costs of each incentive offered. To maximise efficiency, policymakers should:

- Chose the types of incentives that are most closely linked to the activity that they are meant to promote. When incentives are motivated by a need to compensate for weaknesses in the enabling environment, a more efficient outcome can be secured by tackling these shortcomings directly. Both considerations would seem to favour targeted, financial incentives over general, fiscal ones. However, this needs to be balanced against budgetary constraints.

- Avoid stacking of incentives. Offering multiple incentives (e.g. by different Ministries) tends to be counterproductive, as it increases not only program costs but also complexity, contributing to compliance and administrative costs. It also leads to unintended patterns of relief and subsidies across different investors and asset types, leading to inefficiencies in resource allocation. Furthermore, offering a myriad of incentives can create the impression that the country is compensating for a lack of a proper enabling environment for investment

- Choose incentives that can be adequately administered by programme administrators. When considering alternative incentive mechanisms, an important requirement is a workable set of rules and regulations that are understandable not just to investors, but also to those responsible for the administration of the incentive. Internal capacity of relevant Ministries should be further developed to strengthen tools and techniques to evaluate incentives.

- MENA governments should consider eliminating or phasing-out, with “grandfathering”[1], tax holidays, which are most prone to tax-planning abuse and revenue loss. For these existing incentives, a transparent approval and monitoring process should be put in place to detect potential abuse and firms should be required to file annual profit statements. Existing holidays must also be coupled with strong and transparent anti-abuse rules. Specific base protection rules include robust transfer pricing rules, thin capitalisation and controlled foreign corporation rules. Countries are also encouraged to utilise the exchange of information procedures in their double tax treaties, (Article 26 of the OECD Model Tax Convention).

5. **Duty free zones and special economic zones, where used, must be carefully designed.** Zones can be an efficient way to develop an export industry, and to minimise the costs of doing business and simplify administrative procedures in parts of a country. To ensure that zones achieve their objectives, authorities need to take into account the following considerations:

- Discrimination between companies on the basis of nationality and/or sectors should generally be avoided. Access to the zones should be based on objective criteria.

[1] Grandfathering concerns providing tax relief made available in the past to investors that previously qualified and accessed such relief.

- Adequate policies should be designed to encourage linkages between enterprises located in special economic zones and the rest of the host society. The ultimate goal should be to widen the economic achievements of the zones to the whole economy.

- Performance requirements, while sometimes justified by the presence of incentives and other subsidies, need to be carefully assessed. Performance requirements are often second-best to rethinking the generosity of other schemes.

- Where a specific regulatory environment is created for the zone, care must be taken to ensure that core labour and reporting standards together with other recognised international standards are not violated.

Evaluation and Monitoring of Incentives

6. The ability of the administering body to effectively monitor incentives should be ensured. One frequent complaint is that government agencies responsible for incentives are at a disadvantage vis-à-vis better staffed and resourced multinational enterprises. Even where this is not the case, they often lack the analytical ability to conduct in-depth impact and cost-benefit analysis of the schemes they administer. Sufficient resources must be allocated to administration of the incentives to ensure they are effectively monitored. Special macroeconomic models should be established for evaluating the effectiveness of incentives contained in the annual State budget, particularly those related to tax incentives.

7. **The costs and benefits of current and proposed investment incentives should be assessed.** MENA countries should work towards developing frameworks and capacities to analyse the costs and benefits of existing and proposed incentives. Such cost/benefit assessments would involve:

- The hoped-for direct and indirect benefits of incentive schemes need to be specified and, wherever possible, quantified.

- The effectiveness of incentives in achieving authorities' stated policy goals (e.g. additional investment, jobs and exports) should be documented.

- Estimated direct and indirect costs of the incentive (cash or cash-equivalent outlay, revenue foregone and administrative costs) must be accounted for.

- Broader-based efficiency considerations need to be taken into account. In particular, even when a scheme is found to be effective, in that benefits exceed costs, authorities need to assess whether even better results could have been obtained at a similar cost.

8. **All investment incentives should have "sunset clauses"**[2]. To facilitate monitoring and evaluation of incentives as well as curb unintended abuse, investment incentives should be introduced for a fixed period and be renewed only after evaluation and enactment of new legislation. For those incentives particularly

[2] Sunset clauses are provisions requiring the automatic termination of incentives after a specified number of years.

susceptible to abuse, such as tax holidays, the fixed period should be no longer than 5 years, beginning in the year of production.

Policy Forum and Capacity Building

9. **Establishing a regional MENA tax and incentive policy forum.** To share experience and results of studies in tax and incentive policy and promote regional co-operation, MENA countries should consider active participation in MENA-OECD policy roundtable discussions, held through both physical and electronic meetings with the results and information disseminated to all participants. Possible topics could include consideration of criteria for assessing incentives and possible policy frameworks for supporting small and medium sized enterprises and entrepreneurship.

10. **Strengthening capacity to analyse investment incentives should be a priority.** In addition to addressing the concerns about administrative ability raised above, MENA countries should further consider strengthening their analytical capacities. There is a need to develop analytical frameworks, databases and technical expertise of officials working in the incentive policy area, through national and regional programs and forums.

Specific topics could include:

- Empirical and case study analyses of linkages between incentives and investment
- Alternative incentive types and designs
- Databases for incentive analysis, simulation models to estimate the revenue cost of tax incentives
- Expenditure reporting, alternative benchmark choices and reporting practices
- Guidelines for monitoring incentives
- Anti-abuse rules
- Double tax treaty negotiation
- Exchange of information.