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Chapter 3

Investment Incentives and FDI in Selected ASEAN Countries*

ASEAN is perhaps the developing country region that has been the most successful at attracting foreign direct investment and at incorporating foreign firms into national development strategies. There has nevertheless been a secular decline in investments in the region by multinational enterprises which began in some countries even before the Asian financial crisis in 1997. This trend, together with far greater investment going into China, is often cited as a major developmental challenge for ASEAN countries. Based on a review of trends and a careful analysis of FDI into the two regions, this article concludes that China represents more an opportunity than a threat to ASEAN and that, ultimately, China and ASEAN will sink or swim together.

ASEAN countries have responded to the challenge by offering incentive schemes, or expanding the use of schemes already in place. However, and in spite of the risk that incentives competition within ASEAN could degenerate into bidding wars, the evidence presented in this study suggests that while incentives have proliferated, their use has not escalated. More countries are involved, but at the same time some countries have reduced or pared down the more general incentive schemes. New, more targeted programmes focus on "strategic" sectors and seek to achieve "dynamic" gains such as human capital formation, technology transfer, industrial clusters and market access abroad. However, this runs close to "picking the winners" strategies and hence carries the usual risks that follow from discriminating between domestic economic sectors.

* This article was prepared by Stephen Thomsen, an external consultant to the Investment Division, OECD. The views expressed are those of the author. They are not necessarily shared by the OECD or by the Organisation's member countries.

The present study was prepared within the framework of the activities of the planned OECD-Asia Investment Initiative. A recent policy statement by the OECD Investment Committee proposed a checklist to aid host governments in assessing the costs and benefits of incentive policies (Annex 3.A1). It moreover made the following observation:

> *"The aim of policies for attracting FDI must necessarily be to provide investors with an environment in which they can conduct their business profitably and without incurring unnecessary risk. Experience shows that some of the most important factors considered by investors as they decide on investment location are:*
>
> - *a predictable and non-discriminatory regulatory environment and an absence of undue administrative impediments to business more generally;*
> - *a stable macroeconomic environment, including access to engaging in international trade;*
> - *sufficient and accessible resources, including the presence of relevant infrastructure and human capital."*[1]

The study takes the overarching importance of a strong enabling environment to attract FDI as a starting point. It examines how countries in the ASEAN region have capitalised on the strength of their enabling environment, and how they have attempted to build upon it to maximise the benefits of international investment by means of targeted efforts such as investment promotion, investment incentives and, in some cases, corporate tax policy. Its assessments of incentive policies take place against the background of the Checklist.

1. Foreign direct investment in ASEAN

In the 1990s, ASEAN countries were collectively among the world's largest recipients of FDI, and foreign investors have been a driving force behind the region's export-led development. The fear nevertheless is growing within ASEAN that its best days are behind it as a magnet for FDI. Inflows into the five ASEAN countries covered by this study (Indonesia, Malaysia, the Philippines, Thailand and Vietnam) peaked in 1996, the year before the Asian crisis, but some countries saw their FDI decline even before that. Foreign investment flows into Malaysia have declined in real terms almost every year since 1994. Over the past five years, all five countries have recorded diminishing inflows, and in the case of Indonesia the inward flows have even been negative since 1998[2] (Figure 3.1).

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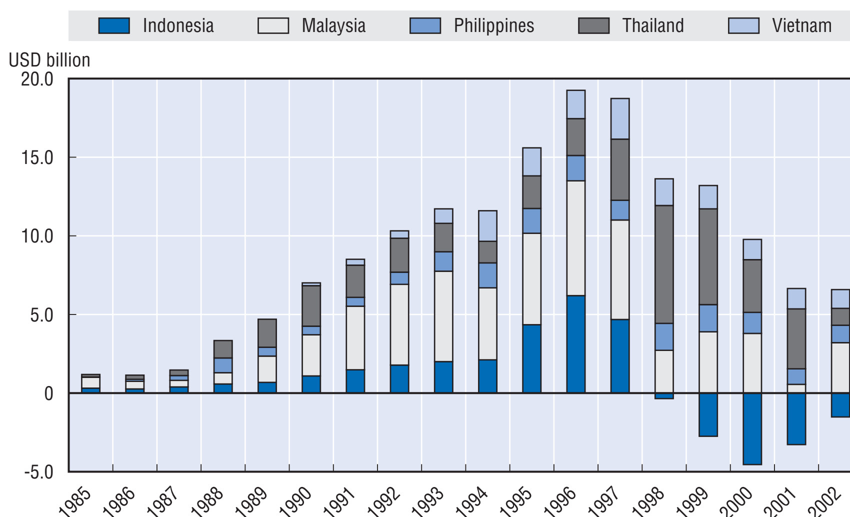
Figure 3.1. **FDI inflows into the ASEAN 5, 1985-2002**



Source: UNCTAD (2003).

Foreign investment in Malaysia began to take off in the late 1980s and early 1990s at a time when Japanese and Chinese Taipei firms were seeking offshore production platforms as a result of rising labour costs and appreciating currencies at home. In Vietnam, interest on the part of investors grew quickly in the five years following the opening up of the economy to foreign investment but has been dropping in almost each year since then as legal uncertainties and poor infrastructure and the ensuing high costs of doing business in Vietnam have discouraged investors.

Investment in Thailand grew rapidly in the year following the crisis, reflecting *inter alia* the fact that many foreign investors bought out their joint venture partners, recapitalised their affiliates and entered new sectors which had been opened up as a result of the crisis. Following this one-off event, inflows to Thailand have declined significantly. Indonesia was an early recipient of FDI, owing to its large market and abundant natural resources but, as already mentioned, has fared poorly in recent years. According to surveys of investors' intentions, foreign firms may have left Indonesia or diminished their presence in response to perceived political instability, corruption and uncertain application of legislation.

Before analysing regional FDI trends in more detail, it is worthwhile to keep in mind a few stylised facts about the ASEAN economies and their investment climates:

- ASEAN member countries are at different levels of economic development and have developed at different paces over recent decades. This affects the composition of FDI inflows, since for example investors motivated by the availability of cheap labour are normally drawn to countries in early stages of development, whereas market-seeking investors and companies in search of specific competences prefer more highly-developed economies. At present, the most highly developed ASEAN economies (measured by GDP per capita) are Singapore and Brunei, followed by Malaysia and Thailand.
- The physical characteristics of the countries in the region differ sharply. By far the largest country in terms of population is Indonesia, which could help attract market-seeking investors (though in terms of overall economic output the difference between Indonesia, Thailand and Malaysia is not so big). At the other end of the scale, Laos is not just sparsely populated but also landlocked. Several countries in the region have raw materials and minerals on their territory, but only Indonesia has them in such quantities that it is likely to have swayed foreign investors (plus Brunei, in the case of the oil industry).
- The economic growth of China during the 1990s, and this country's emergence as one of world's prime locations for FDI, fundamentally changed the economic environment and investment climate in which ASEAN countries operate.

1.1. Where does foreign investment in ASEAN come from?

Since 1995, roughly one third of FDI inflows have come each from Asia, Europe and the rest of the world, principally North America (Table 3.1).[3] The share of each source region has varied across time and among ASEAN countries. Over the period, American and European firms have tended to prefer Malaysia, followed by Thailand; Japanese firms have invested more in Thailand; and the Newly Industrialising Asian Economies outside of ASEAN have opted relatively more for Vietnam.

Some of the variation in investment patterns can be explained partly by the differing profile of investors from each region. Asian investors include a number of comparatively small enterprises seeking low cost offshore production platforms. These firms are often forced offshore by rising labour costs or appreciating currencies in their home countries and, given their limited resources, seek to minimise search costs by choosing locations in neighbouring countries or in those with which they share a cultural affinity.

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Table 3.1. **FDI inflows into ASEAN by source country, 1995-2001**
USD million; per cent

	ASEAN		Indonesia	Malaysia	Malaysia[1]	Philippines	Thailand	Vietnam
United States	24 349	17%	–1 368	5 399	8 749	2 818	4 067	459
Canada	2 836	2%	234	–114	–21	3	19	23
EU	36 528	26%	3 351	2 888	6 842	1 726	3 684	1 324
Other Europe	11 713	8%	728	67	325	97	443	493
Japan	22 151	16%	1 069	1 207	3 328	2 291	6 645	1 738
Asian NIEs[2]	11 693	8%	344	342	1 712	912	3 035	4 081
ASEAN	15 257	11%	136	2 422	6 758	1 026	3 903	2 395
Other	17 832	13%	–206	54	2 693	1 242	6 750	1 431
World	**142 359**		**4 288**	**12 265**	**30 386**	**10 115**	**28 546**	**11 944**

1. Including retained earnings.
2. Hong Kong, China; Chinese Taipei; Korea.
Source: ASEAN Statistics Yearbook 2003.

The large Asian multinationals are more likely to resemble investors from Europe and North America. Many of them pursue complex strategies of diversifying value chains across countries while at the same time supplying local markets though own affiliates. Hence they look at an array of factors including market size, openness to foreign trade, the quality of the enabling environment and the availability of domestic competences, all of which favour the more developed economies. These companies are often more interested in the quality of the labour force than in its price. This putative link between investor size and nationality and the changing patterns of investment over time in ASEAN might help to explain the changing origin of investment over time for individual ASEAN countries.

One illustrative example is Malaysia where Japanese and Chinese Taipei firms were the largest investors in the early 1990s as they sought what was then a low wage location for their offshore production. In 1990, these two countries accounted for no less than 60 per cent of approved foreign projects. Their share has since fallen almost every year and since 1998 has averaged only 17 per cent of approvals. Faced with rising labour costs in Malaysia, many of these firms chose to expand more rapidly in other countries. They have since been superseded by European and American firms – investors from the United States and Germany have represented 41 per cent of approvals since 1998 – seeking a relatively skilled workforce and access to the ASEAN market.

In the Philippines, the story is in some ways the obverse. Given its historical links with the United States, the Philippines traditionally received mostly American investment by firms seeking to supply the local market behind high tariff barriers. Since the mid-1990s when the Philippines launched

its programme of export processing zones, these zones have attracted the lion's share of investment, two thirds of which has come from Asia.

In the specific case of US based companies, support for the notion that access to local markets is an important factor driving investment is provided by the sales patterns of enterprises' affiliates in ASEAN (Table 3.2). The most populous countries have the greatest share of sales which are local and the lowest share which is exported to the United States. Affiliates in all four markets export between one quarter and one third of their output to non-US destinations, principally to the regional market.

Table 3.2. **Sales patterns of affiliates of US MNEs in ASEAN, 2001**

Per cent of total sales in each host country

Destination of affiliate sales	Indonesia	Malaysia	Philippines	Thailand
United States	3.5	25.6	n.a.	5.6
Host country	73.0	37.6	n.a.	60.2
Third markets	23.5	36.8	23.9	34.2

Source: US Bureau of Economic Analysis.

Not all of the investment in ASEAN countries comes from outside of the region: roughly one tenth of inflows into ASEAN countries originates in other ASEAN members. The share ranges from three per cent in Indonesia, 10-15 per cent in the Philippines and Thailand, to 20 per cent in Malaysia and Vietnam. In almost all cases, this intra-regional activity represents investment by firms operating from Singapore. Only in Vietnam are other ASEAN members active, notably Malaysia and Thailand.

1.2. Into which sectors does foreign investment go?

Recent direct investment into ASEAN countries has not just affected the manufacturing sector (Table 3.3). While one cannot draw strong conclusions on the basis of three years of flows, especially given net outflows from Indonesia, a look at the sectors of greatest investment since 1999 nevertheless highlights the complexity of the issue. Manufacturing is important in the case of each investor country, but often less so than other sectors. Japanese "*sogo shosha*" *trading companies* and European financial firms were major investors in ASEAN during the period. Like many investors they appear to have been driven by local and regional market considerations, including providing services to other foreign investors already in the region.

Within manufacturing, the electronics sector has been by far the most important recipient of foreign investment, which is one reason why this sector now accounts for a third of goods exports from ASEAN. In Philippine "Ecozones", electronic parts and products account for 58 per cent of all

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Table 3.3. **FDI inflows into ASEAN by sector and country of origin, 1999-2001**
USD million

	Japan	US	EU	ASEAN	Other Asia
Agriculture, fishery and forestry	–18	–4	96	71	–21
Mining and quarrying	157	707	1 178	732	21
Manufacturing	1 439	3 526	2 484	1 059	792
Construction	–267	–327	3	27	–88
Trade/commerce	2 858	1 081	1 848	181	589
Financial services	–1 862	1 507	5 858	95	915
Real estate	–415	67	–16	–231	32
Other services	489	552	335	928	587
Other sectors	116	214	1 407	366	324
Total	**2 496**	**7 322**	**13 192**	**3 227**	**3 152**

Source: ASEAN Statistical Yearbook 2003.

projects and electrical machinery another 13 per cent. The electronics industry has also been a leading investor in Malaysia, particularly around Penang. Almost 90 per cent of US manufacturing investment in Malaysia is in computers and electronic products, compared to one half in the Philippines and one third in Thailand.

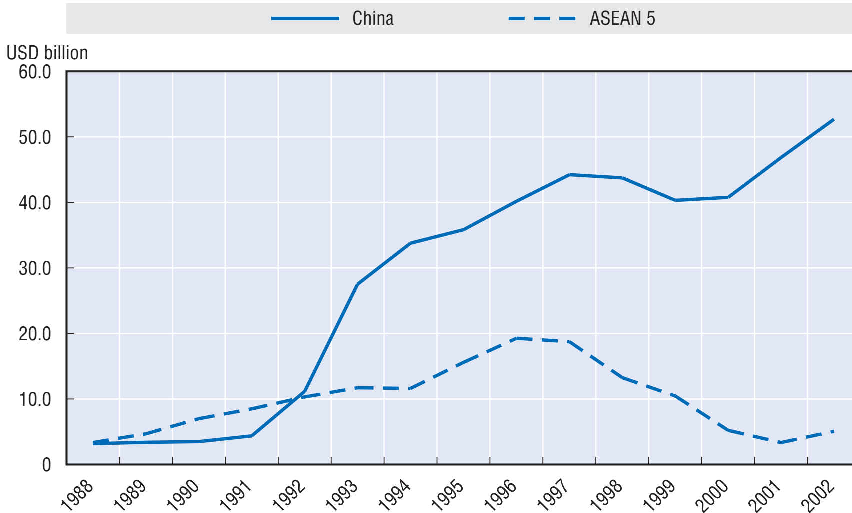
1.3. Is ASEAN losing investment to China?

"There are no doubts that China is a strong competitor for FDI not only for Vietnam but also for all ASEAN-countries", Le Dang Doanh (2002), p. 8.

The fear of losing investment to China has dominated the political discourse of investment-policy makers in ASEAN countries, to the point of overshadowing concerns about potential competition for FDI among these countries themselves. The "Chinese threat" is a frequently cited justification for incentives policies by ASEAN promotion agencies. It is a fear which has been around for a long time and was considered in detail in OECD (1999). Figure 3.2 provides what could be taken to be compelling evidence that while investment flows in the five ASEAN countries are now only a fraction of what they were in the mid-1990s, investors in China seem hardly to stop for breath.

In spite of these diverging trends, it is not obvious that the FDI boom in China has diverted investment that would otherwise have gone to ASEAN, and, even if that were the case, it is not obvious that the ASEAN countries stand to lose from these developments. First and foremost, it is only possible to "compete" for investment if investors are subject to liquidity or other quantitative constraints. Considering the overall amounts of global direct investment flows it would appear that an ASEAN country offering profitable investment prospects will receive FDI, even in the case where certain other countries offer even more

Figure 3.2. **FDI flows to China and ASEAN 5, 1988-2002**



Source: Author on the basis of UNCTAD data.

profitable opportunities. Some countries may have absolute competitive advantages (*e.g.* cheaper labour than their neighbours), but in a world of real exchange rate flexibility they are unlikely to retain them for long.

That said, within sectoral or regional niches the amount of potential investment will of course be limited. This applies, for example, to MNEs' selection of East Asian locations for regional headquarters or export platforms. Countries in the region may aggravate this problem if they focus their efforts at attracting investment on essentially the same sectors. On the specifics of China, the following observations can be made:

- Investment in China is often not a substitute for investment in ASEAN. Almost one half of FDI in China comes from Hong Kong (China) and Chinese Taipei. The investors are in many cases small and medium-sized enterprises that may not have the resources or the inclination to look farther afield. Geographical proximity and cultural affinity lower transaction costs when investing in China. In contrast, over two thirds of investment in ASEAN is from firms from OECD countries with the resources to invest in both ASEAN *and* China. These firms are not selling their assets in ASEAN in order to invest in China (Box 3.1).
- FDI is not a zero sum game, with one country gaining at the expense of all others. Investment in China can stimulate greater FDI throughout East Asia, acting like a regional magnet for investors much as Singapore has done within ASEAN.

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Box 3.1. Japanese direct investment in ASEAN and China*

Japanese firms have for a long time been among the largest investors in ASEAN and their investments in China have grown quickly in recent years. In 2002 Japanese investment flows into China reached the same level as those into ASEAN for the first time.

Surveys of Japanese investor intentions in the two areas suggest that China and ASEAN will sink or swim together. For instance, a 2001 survey of Japanese firms planning to relocate factories as a result of China's accession to the WTO were asked from where they intended to relocate. Over two thirds planned to shift production from Japan, 16 per cent from the NIEs (excluding Singapore) and only 8 per cent from ASEAN. The largest share of ASEAN production would move from Malaysia. The survey focused only on those Japanese firms planning to relocate some production, which is probably a small minority of total Japanese investors in ASEAN.

Another annual survey asks on a recurrent basis whether Japanese firms plan to expand, maintain or contract their presence in selected countries. While a higher share of firms in China plan to expand than in ASEAN, the share of firms intending to contract in either area is not significantly different, and in both areas, the share planning to contract is declining over time (except for in 1999 which appears to be an outlier).

Survey of Japanese MNEs in Asia

Where do Japanese firms plan to expand, maintain or contract their operations?

	ASEAN 4			China		
	Expand (%)	Maintain (%)	Contract (%)	Expand (%)	Maintain (%)	Contract (%)
2002	44.2	53.0	2.7	70.1	28.7	1.2
2001	51.1	46.2	2.3	76.3	23.2	0.5
2000	46.9	51.3	1.8	59.5	38.9	1.6
1999	26.6	36.2	37.2	35.5	29.0	35.5
1997	66.5	26.2	7.3	68.4	23.6	8.0
1996	74.1	17.1	8.8	75.0	19.7	5.3
1995	79.0	16.2	4.8	85.2	8.2	6.6
1994	81.3	16.9	1.8	93.1	4.0	2.9
1993	69.9	22.1	8.0	91.7	6.4	1.9
1992	57.7	27.9	14.4	81.3	15.6	3.1
1991	67.8	19.8	12.4	71.1	26.3	2.6

Note: ASEAN 4: Indonesia, Malaysia, Philippines, Thailand.
Source: Liu (2003).

As further evidence of the continuing attractiveness of ASEAN, Japanese investors are asked each year which location worldwide has been the best place to invest. In every year since 1993, China has been rated first, but the five ASEAN countries have been in the top ten locations each year since 1994.

* The survey evidence presented here is from various sources and is summarised in Liu (2003).

- Faster growth in China as a result of FDI stimulates ASEAN foreign trade. ASEAN exports to China have grown from 2 per cent of total ASEAN exports in 1993 to 7 per cent in 2001. If one excludes intra-ASEAN trade, China is now the third largest export market for ASEAN.
- Chinese firms are also beginning to invest in ASEAN: almost 1 billion US dollars (USD) since 1995. Although it is a small share of the total, it is growing. Official Chinese figures on approved FDI outflows to ASEAN show 51 projects in Vietnam over the past four years, 23 in Thailand and 9 in Indonesia. The cumulative value of Chinese investment in these three countries amounts to USD 365 million.[4]

1.4. Opportunities and challenges for ASEAN

To say that China is an opportunity for ASEAN countries does not imply that it does not impose challenges at the same time. The rise of China represents part of a long-term process of structural transformation across Asia, of which changing patterns of FDI are only one manifestation. In the mid-1980s, before the Plaza accord and the realignment of currencies, over 80 per cent of investment in Asia by OECD firms was in Singapore, Hong Kong (China) and Chinese Taipei. By 1990, their share had fallen to 50 per cent while the five ASEAN countries' share had risen from 12 per cent to 50 per cent. The appearance of China in the early 1990s meant that by 1995, each group of countries took in roughly one third of OECD investment. As stated in OECD (1999, p. 24):

> Much as the [ASEAN 5] benefited from the declining competitiveness of the [Newly Industrialising Economies, including Singapore], so too has China benefited from similar circumstances in the ASEAN economies. But while the NIEs and Japan moved successfully to higher-value added activities, certain ASEAN countries have encountered difficulties in effecting this transformation. The focus on investment diversion to China should not deflect attention from the domestic causes of this adjustment problem.

Investment incentive programmes in ASEAN are unlikely to be effective unless they assist in the adjustment process. There is some evidence that industrial policies guided by incentives are moving in the right direction. Malaysia is moving away from labour-intensive production, an area where it appears to be losing competitiveness (based on the surveys of Japanese firms mentioned earlier). The Thai Board of Investment has established an office in Shanghai for Chinese investors seeking a location within ASEAN.

2. Investment incentives in ASEAN

Foreign direct investment incentives were defined by the OECD Investment Committee as *measures designed to influence the size, location or industry of a foreign*

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direct investment project by affecting its relative cost or by altering the risks attached to it through inducements that are not available to comparable domestic investors.[5] Such incentives directed specifically at foreigners are relatively rare. In most of the cases included in this study, incentives are offered to both foreign and domestic investors, although in practice foreign firms are often best-placed to take advantage of them for a number of reasons. They are often more mobile than local firms, especially when making their first decision about whether to invest in a given location. Foreign firms are also much more likely than domestic companies to fulfil the requirements host country authorities may have defined as a precondition for incentives (*e.g.* export performance or R&D) and are also more often to be found in strategic sectors such as electronics or high technology. Thus, while some incentives are taken equally or even mostly by local firms, some are almost exclusively the preserve of foreign investors even if that is not the expressed intent of the authorities offering the incentive. The focus of the present article is on those incentives which by design or in practice apply mostly to foreign firms.

2.1. Incentives: what and how?

In theory, incentives are intended to act as an inducement to enterprises in situations where the expected societal return to an investment exceeds the risk-adjusted private one. A prime example is the situation where private investment creates spillovers which the investor is unable to internalise and hence does not value appropriately. Spillovers may include the diffusion of knowledge or technologies, human capital formation through the training of workers or enhanced access to foreign markets through the multinational enterprise (MNE).

If the intention of incentives is simply to increase the overall level of investment, particularly but not exclusively by foreign firms, then it could be argued that a uniformly low rate of corporate income tax (CIT) would suffice. But the essence of incentives is selectivity. Not all investments generate the same amount of spillovers and hence it has become the function of a number of incentive programmes to channel investment into certain sectors or areas or influence the behaviour of investors in order better to achieve national development goals. While many firms in many sectors often receive some form of promotion, the most generous incentives are offered to projects fulfilling certain specific development criteria.

Foreign investments are especially promoted because they are perceived to contribute to national development goals, often more effectively than local firms. Some of these goals are listed in Box 3.2. They tend to be part of the incentive system of all countries in this survey, although which particular goals are emphasised depends *inter alia* on the level of economic development and prior success in attracting FDI.

Box 3.2. **Rationales for offering investment incentives**

- *Priority industries:* to promote industrial policies or economic diversification.
- *Exports:* to promote export-led development and enhance access to foreign markets.
- *Employment:* to attract labour-intensive industries.
- *Regional development:* to stimulate economic activity in less developed regions.
- *Training and human capital development.*
- *Innovation and R&D.*
- *Transfer of technology and proprietary knowledge.*
- *Environmental protection:* to encourage greener production techniques, resource conservation and industries involved in waste management or providing pollution abatement equipment.

To achieve these objectives, governments resort to a range of fiscal and non-fiscal (also known as "financial") economic measures, in addition to so-called regulatory incentives (Box 3.3). Financial incentives can amount to outright grants to investors, but in most cases they relate to the free-of-charge provision of infrastructure, training or a range of commercial services by investment promotion agencies. A special kind of incentive – and from a public policy perspective, a particularly controversial one – is the selective relaxation of regulatory obstacles to investment or to the activities of a company once it has located in that country. The distinction between regulatory and other incentives can in practice be somewhat blurred. Duty exemptions on imports which serve as inputs into export production, for example, are likely to be viewed as an essential pre-condition for investing by export-oriented firms given that the producer must compete in international markets. Many developing countries prefer fiscal measures because they do not constitute a direct drain on budgetary resources.

2.2. Investment incentive schemes in ASEAN

National development goals

The countries covered by the present study have all adopted a relatively interventionist approach to development and to the role of foreign firms in that process. In earlier years, and to a certain extent still today, investment promotion coexisted with substantial restrictions on investment by foreign firms. Where foreigners could help fulfil the objectives of either import

Box 3.3. **Investment incentive instruments**

Corporate tax incentives

- Tax holidays or reduced corporate tax rates.
- Tax credits.
- Investment allowances.
- Accelerated depreciation.
- Reinvestment or expansion allowances.
- Double deduction of certain expenses for tax purposes (usually related to *e.g.* employment, exports, R&D or infrastructure).

Other tax incentives

- Personal income tax exemption on dividends.
- Exemption from, or reduction of, withholding taxes.
- Duty drawback schemes.
- Exemption from import tariffs, particularly for capital goods, equipment or raw materials, parts and inputs related to the production process.
- Exemption from export duties.
- Exemption from sales, property and wage income taxes.
- Reductions in social security contributions.

Financial incentives

- Subsidised or concessionary financing.
- Government equity participation.
- Insurance at preferential rates.
- Loan guarantees.
- Direct grants.
- Provision of dedicated infrastructure.
- Provision of training, pre-screening of potential employees.
- Preferential treatment on foreign exchange.
- Preferential government contracts.
- Protection from import competition.
- Subsidised services such as feasibility studies or product marketing.

Regulatory incentives

- Derogations from national and sub-national rules and regulations, *e.g.* social, labour or environmental standards, ethnic quotas, local equity participation.

substitution or export promotion, they were permitted to invest, although their commercial freedom was often heavily circumscribed. With gradual liberalisation, (unilaterally, regionally through ASEAN and multilaterally through WTO) restrictions on FDI have diminished to the extent that most countries maintain only a diminishing negative list of sectors closed to foreign investment and have almost completely phased out the use of performance requirements. As a result, host governments are left with investment incentives as almost the only instrument with which to influence investment behaviour.

Industrial policy has shifted from protecting infant industries (though cases of this still exist) to subsidising investments through incentives in industries which are deemed variously to be "strategic", "pioneering" or "catalytic". At the same time, most host governments also offer special incentives to any investor primarily interested in exporting or, increasingly, in locating in less developed areas. The result is a multi-tiered set of incentive schemes in which firms receive incentives according to sector, activity and location.

Across the world a large number of non-ASEAN countries encourage certain sectors or activities more than others, and many countries and regional groupings also provide incentives to firms to locate in poorer regions. However, ASEAN differs from most OECD countries in the scale and complexity of their incentive schemes. The list of promoted activities and products eligible for "pioneer" status (and hence tax allowances) compiled by the Malaysian Industrial Development Authority (MIDA) runs to 21 pages. The Investment Priorities Plan drawn up the Philippine Board of Investments (BOI) is equally detailed.

Box 3.4 outlines the broad priorities of three ASEAN countries. They take the form of general guidelines appearing on top of more concrete lists of activities eligible for promotion. Priority activities usually receive far greater incentives than those sectors which are promoted as part of a more general national development plan. The overall priorities list does not change much from one country to another; what changes is the particular emphasis given to each priority.

The nature of incentives in ASEAN

The investment incentives of each country are surveyed in Table 3.4. Several observations suggest themselves. First, many ASEAN countries have lowered their CIT rates in recent years, and the standard corporate income tax rates are now all roughly the same for large projects. It is therefore unlikely that an investor would choose one country over another solely on that basis. Second, tax holidays are a popular tool for attracting investment, for up to 10 years in some cases. (The Philippine Department of Trade and Industry reportedly lobbied for holidays up to 12 years in the wake of a failed attempt to lure a large

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Box 3.4. **Priority areas for investment promotion in ASEAN**

Vietnam

Export production; animal husbandry, farming and processing of agricultural produce, forestry and aquaculture; utilisation of high-technology and modern techniques, protection of the environment and investment in R&D; labour-intensive activities, processing of raw materials and efficient use of natural resources; construction of infrastructure facilities and important industrial production establishments; regions with difficult socio-economic conditions.

Philippines

Agriculture and agricultural products; direct involvement in technological and human resource development; public utilities and infrastructure; environmental protection and conservation; targeted industries.

Thailand

Agriculture and agricultural products; industrial zones for environmental preservation, waste water treatment and disposal of refuse, industrial waste or toxic chemicals; international distribution centres; R&D and scientific laboratories; targeted industries, including material for micro-electronics, electronic design and software; software parks.

Source: National governments.

car manufacturer to invest.[6]) Third, the same types of incentives are often made available for similar policy purposes, suggesting that there may be a good deal of imitation of policies adopted in other countries in the region.

Direct comparison of the *scale* of incentives is difficult without adequately detailed information about the *scope* of each incentive in each country. In some countries, pioneer industries include only a few activities, in others, much of the manufacturing sector. Overall, the types of incentives on offer in ASEAN appear to be highly generous in terms of tax holidays, reductions and allowances. Where available, estimates of their costs in terms of foregone fiscal revenue are provided later.

Although a comparison of incentives across ASEAN countries suggests that all five countries offer broadly similar incentives under similar circumstances, there are nevertheless qualitative differences. Of all the countries, Thailand places the greatest emphasis on the location of investment as part of a policy of regional decentralisation in order to relieve congestion in the Bangkok area and to spur growth in outlying regions. Both Thailand and Malaysia are shifting away from a previous emphasis on export promotion towards greater targeting of strategic sectors. In contrast, Vietnam,

Table 3.4. **Investment incentives in the ASEAN 5**

	Indonesia	Malaysia	Philippines	Thailand	Vietnam
Standard corporate income tax rate	(10, 15 and) 30%.	28%.	32%.	30%.	32%.
Tax reduction		"Pioneer" firms pay tax on 30% of statutory income for 5 years. Unabsorbed losses cannot be carried forward to post pioneer period. For strategic projects (*e.g.* high tech industries, R&D activities, strengthening industrial linkages and multimedia industries, full income tax exemption and/or tax relief of 5-10 years can be considered. Investors in poorer regions pay tax on only 15% of their income for 5 years.	For firms in export processing zones, 5% tax on gross income after tax holidays have lapsed. Tax credit of 25% of equivalent duties for substituting domestic for imported raw material or equipment.	50% reduction of CIT for projects located in industrial estates or promoted industrial zones (PIZs) for 5 years after the tax holiday exemption period.	Enterprises with foreign capital pay 25%, but those investments which are encouraged or promoted pay 10, 15 or 20%. In certain industries and regions, 2 year tax holiday from first profitable year and possible 50% tax reduction for two successive years. Investors satisfying a high number of investment promotion criteria shall be exempted from CIT for maximum 4 years starting from first profitable year and possible 50% tax reduction for two successive years.
Tax holiday	3 to 8 years tax holiday for new enterprises in 22 specific sectors.	Full tax holiday for 10 years for strategic projects (*e.g.* heavy capital investment, high levels of technology, or extensive linkages and with a significant impact on the economy), Operational HQ, Regional Distribution Centres and Int'l Procurement Centres. Full tax holiday for 5 years for high-tech, R&D, "strategic knowledge-based" companies and those in the Industrial Linkages Programme or investing in the MSC. 70% exemption for 5 years for some environment-related companies and approved service projects and those providing manufacturing-related services.	Pioneer projects for 6 years and non-pioneer projects for 4 years, with a possible 1 year extension for both under certain conditions. Expansion projects: 3 years (limited to incremental sales revenue/volume). New or expansion projects in less developed regions (except mining and related products): 6 years. Modernisation projects: 3 years. Exporters may receive a tax holiday for exports of new products or to new markets.	Since 12/01, tax holidays are capped at 100% of investment capital. Priority activities enjoy an 8 year exemption and other privileges according to location. Other activities are offered tax holidays by zone: *Zone 1:* 3 year exemption for projects that export 80% of total sales or that are located in industrial estates or PIZs. *Zone 2:* 3 year exemption extendable to 7 years for projects in industrial estates or PIZs. *Zone 3:* same as priority activities.	In certain industries and regions, 2 year tax holiday from first profitable year and possible 50% tax reduction for two successive years. Investors satisfying a high number of investment promotion criteria shall be exempted from CIT for maximum 4 years starting from first profitable year and possible 50% tax reduction for two successive years.

Table 3.4. **Investment incentives in the ASEAN 5** *(cont.)*

	Indonesia	Malaysia	Philippines	Thailand	Vietnam
Loss carry forward	Up to 10 years for priority sectors and in Integrated Econ. Development Areas.		10 years in Special Economic Zones.		Up to 5 years.
Investment tax allowance	In priority sectors or certain areas, reduction of taxable income by up to 30% of investment.	As alternative to pioneer status, a company may apply for an ITA which provides an allowance of 60% or 100% for qualifying capital expenditure incurred within first 5 years (10 years for R&D companies). The ITA can be offset against 70% or 100% of income in each year. Unused allowances can be carried forward until finished. Companies in certain regions will be granted an allowance of 80% of qualified capital expenditure incurred. The allowance can be used to offset against 85% of income in the year of assessment. Also reinvestment allowance (RA) of 60% of qualified capital expenditure for 15 years to be offset against 70% of income in that year, with carry forward.	Tax credits for incremental export revenue.		
Accelerated depreciation, amortisation	Doubling of depreciation in favoured zones/ sectors.	Accelerated depreciation for computer technology and environmental protection industries and, for a 3-year period, for firms for which the RA has expired.	Immediate expensing of major infrastructure investments by exporters in less developed areas (except in mining and forestry).		

Table 3.4. **Investment incentives in the ASEAN 5** *(cont.)*

	Indonesia	Malaysia	Philippines	Thailand	Vietnam
Dividend withholding taxes	15% residents, 10-20% non-residents (50% reduction in favoured sectors or zones).		10-25% on dividends remitted abroad.	10% on dividends remitted abroad; domestic intercompany dividends are partly or wholly exempt.	3, 5 or 7% on dividends remitted abroad (or 5, 7 and 10% depending on the source of the information).
Import duty and VAT exemptions	All approved projects receive full exemption for main machinery and spare parts and 50% for supplementary machinery and a 2-year exemption for raw materials. Duty drawback for goods and materials needed for exports (for companies with an export ratio over 65%), regardless of availability of comparable local products.	For goods to be exported, full exemption is normally granted on components/raw materials, provided local inputs are not available or of sufficient quality. For goods for the local market, full exemption is possible if the component is not produced locally or if there is already no duty on imports of the final product.	Exemptions of duty and VAT on inputs in certain sectors, notably exporters.	For priority activities, full exemption of import duty on machinery, regardless of location: *Zones 1 and 2:* For all investors, 50% exemption on machinery where the duty is over 10%; full exemption on raw and essential materials used in export products for 1 year. *Zone 3:* Exemption of import duty on machinery; exemption on raw or essential materials used in exports for 5 years.	Exemption for machinery and equipment and for specialised means of transport imported as part of the fixed assets of the enterprise.
Other incentives		Numerous incentives exist to promote specific sectors or areas and for *e.g.* R&D or training, SMEs, firms which increase exports.	Deduction of 50% of wages for first 5 years subject to certain conditions. Incentives for Regional Headquarters and Regional Operating HQ. Other deductions in SEZs.	In Zone 3, various deductions for transport, electricity and water costs, as well as for infrastructure and construction costs for 10 years.	Exemption from prevailing export duty.
Main government agencies offering incentives	BKPM.	MIDA, MSC.	BOI, PEZA, SBMA (Subic Bay), CDC (Clarke).	BOI.	

Source: National governments; ASEAN (1998), Fletcher (2002).

the Philippines and Indonesia still actively promote investment in labour-intensive export sectors in order to activate national pools of under- and unemployed labour.

The changing character of incentives

Of the ASEAN countries in this study, Malaysia and, to a lesser extent, Thailand were early movers in terms of investment incentives which may explain why their policies towards investment are generally more nuanced than those in the rest of the area. The case of Malaysia is shown in Box 3.5. A somewhat similar story could be told for Thailand where, since the end of 2001, the BOI has capped tax holidays at 100 per cent of invested capital. The BOI is also in the process of targeting incentives more precisely to areas where Thailand is deemed to have a competitive advantage (see Box 3.3 for a list) and has proposed guidelines for increasing the spillovers from investment in the area of technology and skills.

2.3. Incentive competition among ASEAN countries

A recent study by the OECD Development Centre suggests that "competition for FDI in the ASEAN countries has been a key factor contributing to the growth of investment incentives in the region".[7] Chia and Whalley (1995) argue that the same was true in the 1980s, but they caution that the *perception* of competition for investment is just part of the explanation for the growth in incentives.[8] The sequence of initiatives in the area of investment promotion in the region is shown in Table 3.5. Singapore moved first in this area but was rapidly imitated by other countries offering tax holidays of their own, a fact which may have encouraged it to expand its own incentives a decade later.

While the sequence of events in Table 3.5 confirms a widely held view that competition within ASEAN for investment is driving the proliferation of incentives, it is equally possible that other countries were merely following the apparently successful example of Singapore. Popularly speaking, it could be a case of "follow-the-leader" rather than "tit-for-tat". A specific example may serve to illustrate this point: in 1986, Singapore began to offer incentives for companies interested in establishing a regional headquarters. This was followed immediately – though largely ineffectually – by the Philippines in 1987, and then by Malaysia in 1990 and Thailand soon after.

Chia and Whalley (1995) argue in favour of the leader-follower explanation and consequently suggest that the best way to contain such incentives might be for the leaders (Singapore and, to a lesser extent, Malaysia) to exercise restraint. However, this argument does not necessarily convince. If incentives were offered solely to lure investors that might have

Box 3.5. **Investment incentives in Malaysia: proliferation, not escalation**

Malaysia has arguably the most developed investment promotion strategy among the ASEAN countries in this study, honed over decades to fulfil national development goals. It has generally emulated Singaporean best practices in its approach to promotion. In earlier days this reflected the fact that both countries had relatively small markets with which to entice foreign investors and hence turned more quickly towards export promotion.

If the experience of Malaysia is anything to go by, investment incentives in ASEAN are not so much escalating as proliferating: the overall incentive regime has gradually become somewhat less generous, while at the same time, promotion is being extended to new activities through a growing number of agencies.

Malaysia began to offer incentives at an early stage, primarily in the form of tax holidays to import-substituting firms. Tariff protection was also conferred, but the market was too small to allow viable infant industries to develop. The only lasting attempt to nurture a local industry has been in the automotive sector, with the Proton cars. In the late 1960s, incentives were expanded to include an investment tax credit, which was aimed both at increasing employment and at pioneer industries, including capital-intensive projects. During this period, foreign firms accounted for over one half of a manufacturing sector, which for its part represented only 13 per cent of GDP.

In the 1970s, labour-intensive and export-oriented firms were favoured, including through the creation of export processing zones which exempted firms from most of the restrictions on other investors, including ethnic hiring quotas in favour of the *Bumiputera* majority. In fact, one of the effects of Malaysia's policy of promoting foreign investment has been to provide a counterweight to the economic dominance of the ethnic Chinese minority.

In the early 1980s, the Government embarked on an industrialisation strategy based on local capital. This strategy was, however, curtailed by the recession in the mid-1980s, at which time a Reinvestment Allowance was introduced for foreign and domestic firms.

The country's real push for foreign direct investment began with the Promotion of Investments Act in 1986 which coincided fortuitously with the wave of relocation of Japanese and Chinese Taipei companies mentioned earlier. The late 1980s and early 1990s witnessed a rise in FDI into Malaysia on a scale not seen before, and not since.

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Box 3.5. **Investment incentives in Malaysia: proliferation, not escalation** *(cont.)*

It is tempting to postulate a causal link between inflows of FDI and a more active use of investment incentives over this period, but as argued in OECD (1999) Malaysia was also in the right place at the right time. To Japanese and Chinese Taipei firms it offered many advantages over other possible locations in the region: a relatively skilled and productive workforce, which was also English-speaking, good infrastructure, industrial experience, particularly in electronics, and proximity to Singapore which had emerged as the regional hub for MNEs in the electronics sector.

Whatever the reason for its success, the amount of investment Malaysia received during prompted policy makers to become more selective and targeted in their incentive policies. In the early 1990s, both the tax holiday and the investment tax allowance were made less generous for pioneer industries and their approval became more contingent on the fulfilment of certain criteria. After 1995, labour-intensive projects were no longer eligible for promotion unless they were located in certain areas or satisfied other narrow conditions.

This tightening of incentive practices in traditional parts of the economy was accompanied by an expansion in other areas: high-technology, R&D, training, industrial linkages and multimedia (the development of the latter is supported through the establishment of the "Multimedia Super Corridor"). Since 2000, the Government has offered pre-packaged or customised incentives (both fiscal and financial) for investment perceived as "high-quality" and in certain sectors deemed strategic. Incentives have also been tied less to economic performance (*e.g.* exports) and more to corporate citizenship: training, R&D, environmental protection. Incentives in these areas can still be very generous, as seen in Table 3.4.

For more traditional projects, including by domestic firms, some incentives have been retained. The Reinvestment Allowance has been expanded so as to promote industrial deepening by established firms, duty exemptions on imports have been retained, and former restrictions on foreign equity participation and on the employment of expatriates have been substantially relaxed.

Source: OECD (1999), UNCTAD (2002).

invested in other parts of the region, then it might be a viable solution. But ASEAN governments tend to view incentives as a way of managing their own development, and it does not seem likely that they will relinquish this guiding role. Furthermore, as mentioned earlier, in the competition for investment, ASEAN countries fear China as much as they do each other.

Table 3.5. **Incentive legislation in ASEAN countries**

		Act
1967	Singapore	Economic Expansion Incentives Act
	Philippines	Investment Incentives Act
	Indonesia	Investment Law
1968	Malaysia	Investment Incentives Act
1970	Philippines	Export Incentives Act
1971	Malaysia	Free Trade Zone Act
1972	Thailand	Promotion of Industrial Investment Act
1973	Malaysia	(Expansion of incentives to exporters)
	Philippines	(Amendments to earlier Act)
1975	Singapore	(Pioneer industry holiday lengthened)
1977	Thailand	Investment Promotion Act
1979	Singapore	(Investment credits scheme)
	Thailand	Industrial Estate Authority Act
1983	Philippines	Investment Incentive Policy Act
1987	Philippines	Omnibus Investments Code
1990	Malaysia	Free Zones Act
1992	Philippines	Bases Conversion Act
1994	Philippines	Export Development Act
1995	Philippines	Special Economic Zone Act

Source: OECD and national sources.

In spite of the legislative leapfrogging which began in the 1960s, most observers agree that effective competition for investments began only in the 1990s. Not only did Indonesia reinstate its incentives, but the Philippines began actively to court foreign firms. With the American bases of Clarke and Subic Bay reverting to Philippine sovereignty, the country acquired first rate facilities for exporters. At the same time, Vietnam for the first time opened up the economy to foreign investors. By the end of the decade, all ASEAN countries were participating in a contest for mobile investment.[9]

Bidding wars in ASEAN?

In an extensive cross-country survey of investment incentives, Oman (2000) finds that competition to attract investment is widespread and can be intense at both the national and sub-national level. But at the same time, he cautions against drawing the conclusion that “bidding wars” for investment are escalating. Most of the examples of an intensification of competition arise in the case of very large projects in particular sectors such as automobiles and he argues that once global restructuring has run its course in these sectors, there will be fewer of these big-ticket items up for bids.

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This finding is largely corroborated in the case of ASEAN. Anecdotal evidence in this regard is slight, but one case is frequently cited. According to a review of cases in Charlton (2003):

> In 1996, General Motors announced it wanted to build a USD 500 million car plant in Asia. The two locations that fought most fiercely for it were Thailand and the Philippines. Both countries sent in high-level negotiators. Philippines President Fidel Ramos… pitched a generous package of tax breaks and other incentives including an eight-year tax holiday followed by a 5 per cent levy in lieu of all other taxes; Ramos also offered duty-free import of machinery and equipment and government subsidies for training 5 000 workers. At the time, a high-ranking government official was quoted as saying "this is a flagship investment opportunity and we want to get it".

According to the same report, Thailand won the contest by matching the Philippine package and throwing in a 100 per cent refund on raw materials for car exports and a USD 15 million grant towards setting up a GM training institute. But such incentives do not appear as exorbitant relative to what these countries typically offer investors. Except for the specific offer of training, the incentives mentioned above are broadly in line with those in Box 3.3 for a similar category of investor. Felker and Jomo (2000) report that the Ministry of Industry offered to relax local content policies as a bargaining chip, but this too could be construed as a pragmatic *quid pro quo* for an investor concerned about its own ability to compete in export markets.

Hill (1996) offers a substantially different reading of the same case, suggesting that "the Philippines aggressively sought the project, offering many project-specific incentives, while Thailand (apparently) did not bend its rules; Thailand won owing to its superior fundamentals". With no access to deliberations either in the host countries concerned or within GM, any interpretation must remain largely subjective. The fact that Thailand won the "bidding" does not appear to be an aberration: many multinational automobile producers have chosen to locate there since the Thai market for passenger cars is five times as big as the Philippine one.

Another example of a putative bidding war is provided in Charlton (2003) in which an investment by Canon Inc. was lured away from the Philippines to Vietnam by incentives which the Philippines government could not legally match. According to the author, the Philippine Department of Trade and Industry has lobbied for changes to the Omnibus Investment Code to allow a 5 per cent gross corporate income tax and a tax holiday for up to 12 years.

The evidence presented here suggests that, except possibly for certain high-profile projects, the competition for investment is not accelerating. There is keen competition among the countries of the region, but some of

this competition concerns the search for the next "big idea", such as high-technology, high value-added services, operational headquarters, financial services, aviation hubs, industrial clusters, etc. Governments are willing to gamble substantial sums to achieve these goals, and it is relevant to ask whether it is money well-spent. But at the same time, countries such as Malaysia and Thailand do not appear to be uncritically chasing foreign investors – let alone at the expense of neglecting the more general enabling environment for investment.

2.4. The costs of incentives in ASEAN

The most pressing potential cost of incentives is the budgetary cost (mostly foregone tax revenue in the case of ASEAN) which can sometimes be substantial. Estimates reviewed below are generally in the range of one half to two per cent of GDP. The discussion which follows focuses on the potential budgetary implications of incentives, but it should nevertheless be kept in mind that incentives can affect the economy in other ways which are even harder to quantify. In particular, incentives introduce the risk of distortions in the host economy. Incentives might be cost effective in terms of encouraging investment, but if they promote a sector in which the host country has no natural comparative advantage, their long-term effect may be to make the host economy worse off.

Estimates of the budgetary costs of incentives require assumptions about what would have happened in the absence of incentives. Would the firm have invested anyway, even without the incentive package? If yes, then the full amount of the tax benefits can be considered as a cost to the host government. If not, then whatever direct and indirect taxes which are levied on that investment could be considered as a net gain to the host country's budget, ignoring any indirect impact the investment might have on the profitability of local taxpaying enterprises.

Calculating foregone tax revenues also requires an estimate of the profitability of the enterprises receiving any benefits. In cases where the investor benefits from a tax reduction, profitability is known by the tax authorities, but investors receiving a tax holiday sometimes have no reporting requirement. The extent of foregone revenue will also depend on the nature of the incentive, but since the level of incentive varies according to the sector of the investor and the location, there may be no representative case on which to base the analysis. The full revenue implications will also depend on the extent to which the host government can claw back some revenue through indirect taxation, such as on personal income or through withholding taxes. Furthermore, the revenue costs will not be constant from one year to the next or over time. In the first years of operation, an investor will have few profits which can benefit from the tax holiday, but the longer the investor has been in

the country and the longer the tax holiday, the greater will be the potential loss of revenue to the host government.

In spite of this complexity, various estimates exist of the cost of incentives for many of the countries in this survey. The best that can be done is to provide a range within which the true number might lie. The evidence presented below suggests that the budgetary implications of incentives can be significant. At an OECD Conference on FDI relations between the OECD and Dynamic Asian Economies, it was reported that "certain [representatives of Asian governments] let it be known that such subsidies can total the equivalent of up to one, or even two, per cent of GNP, which is very considerable indeed".[10]

In *Vietnam*, the Ministry of Planning and Investment surveys over 4 000 foreign investment enterprises, collecting information on their after-tax profits and the rate of corporate income tax. By grossing up each firm's profit to its pre-tax level and then applying the standard CIT, the revenue loss from corporate income tax reductions to foreign firms is estimated by the International Monetary Fund at USD 76 million in 2001.[11] This estimate is considered significantly to understate the total revenue loss from incentives in Vietnam because only a fraction of firms in the survey actually report their net profits. A further complication arises from the fact that the estimate only applies to a reduction in the CIT and does not include accelerated depreciation or other measures. If instead one compares foreign-firms in Vietnam with state-owned and collective enterprises and with domestic private and mixed enterprises (normalised by the share of each sector to GDP), the possible revenue loss is much greater, estimated at USD 224 million or 0.7 per cent of GDP and five per cent of non-oil revenues.[12]

The budgetary implications of tax incentives in the *Philippines* could be a serious political concern, not least as government revenue as a share of GDP declined from 19 per cent in 1997 to 14 per cent in 2002. Easson (2001) calculates that incentives were costing the Philippine government USD 2.5 billion in foregone revenue and other costs in 1999. In a study which covers the period before the rapid growth in investment inflows, Manasan (1988) estimates the costs of incentives in the Philippines at one per cent of GDP.

In *Thailand*, the net cost of incentives has been estimated at 0.5 per cent of GDP.[13] The Fiscal and Tax policy Division of the Thai Ministry of Finance commissioned a review of incentives in the early 1980s which provides precise estimates of the revenue foregone and generated by incentives in Thailand in 1980 (Table 3.6). The biggest source of foregone revenue was the business tax exemption. The business tax was a cascading tax levied on all inter-firm transactions which was replaced by a value added tax in 1992. Another important source of foregone revenue was the exemption from import duties. With the

Table 3.6. **Estimates of revenue implications of incentives in Thailand, 1980**
USD thousands

Category	Revenue foregone	Revenue generated	Net revenue foregone
Corporate income tax	15 531	8 778	6 753
Import duties			
Machinery	25 547	97	25 449
Raw materials	45 183	783	44 700
Total	70 730	580	70 149
Business tax			
Machinery	10 013	31	9 983
Raw materials	15 912	166	15 746
Total	25 925	197	25 728
Total taxes and duties	**112 186**	**9 555**	**102 631**

Source: Thailand (1984) cited in Halvorsen (1995), p. 429.

decline in tariff rates over time, this source of revenue loss through incentives is also likely to have diminished. In comparison, the foregone revenue from tax holidays and reductions in the CIT is relatively modest. Over one half of the foregone revenue in this area is recouped through other channels.

In *Malaysia*, Doraisami and Rasiah (2001) estimate the potential foregone revenue at 1.7 per cent of GDP in the 1980s, or 10 per cent of manufacturing value added. They suggest that while incentives may have encouraged export-oriented FDI and created employment, some incentives are likely to have been too generous and even redundant.[14]

2.5. The effectiveness of incentives

Do incentives attract more FDI?

Surveys of investment motives among multinational enterprises have a long history. In a review of the literature, UNCTAD (1992, p. 60) concluded that "surveys and other evidence indicate that the sensitivity of total foreign direct investment flows to tax and similar incentives is very low". Similarly, Chia and Whalley (1995) review some studies from the 1980s on incentives in developing countries and conclude that "tax incentives have a small or even insignificant effect on investment".[15]

It is not necessary to review the extensive literature on this topic in the present article, but certain results are particularly relevant for investment incentives in East and Southeast Asia. An early and comprehensive study of investments in developing countries by Reuber *et al.* (1973) found that the importance of incentives varied with the motive for the investment. Export-oriented firms were more likely to view fiscal incentives as an essential part of

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the calculation of whether to undertake the project. But since fiscal incentives include duty exemptions on imports which are of obvious concern to exporters, it is not clear whether tax concessions on the CIT rate were equally essential. Local market oriented firms were rarely swayed by tax concessions, but were more likely to be attracted by import protection. The study concluded that, overall, incentives did not appear to play a vital role in the investment decision.

More recently, Yeung (1996) surveyed investors in ASEAN from Hong Kong (China) and Chinese Taipei. He found that investment incentives *per se* were ineffective in attracting foreign investment. The main reason for investing was to gain a foothold in the market and to follow clients overseas. At an inter-sectoral level, he found that "the role of investment incentives is largely idiosyncratic and important only in specific industries in specific ASEAN countries".[16] These include electronics and food in Indonesia, metal manufacturing in Thailand, and miscellaneous manufacturing in Malaysia, the Philippines and Thailand.

Numerous econometric studies have attempted to distinguish between the overall rate of taxation and incentives *per se*. Root and Ahmed (1978) examined data from 41 developing countries and found that while corporate tax rates were an important determinant, complex incentive schemes and liberal exemptions had no significant impact on investment decisions. Table 3.7 presents the results of econometric studies which have focused specifically on ASEAN countries.

Table 3.7. **Studies on the effectiveness of investment incentives in Asian countries**

	Incentives	
	Not effective	Effective
Indonesia	Tanzi and Shome (1992)	
Malaysia	Tanzi and Shome (1992) Boadway, Chua and Flatters (1995)	
Philippines	Tanzi and Shome (1992) Aldaba (1994) Lamberte (1991)	Manasan (1986) found incentives to have a significant impact on the rate of return and the cost of capital
Thailand	Tanzi and Shome (1992) Halvorsen (1995), FIAS (1999), World Bank (1980)	
Vietnam	Fletcher (2002)	
ASEAN	Manasan (1988)	Aggarwal (1986) for banking and high-technology industries in ASEAN
Cross-country, Asia	Rana (1988) Fletcher (2002)	

Source: Based largely on Chalk (2001), p. 9.

It is still possible that the most recent period is not like the past and that incentives might become important as the ASEAN market becomes more integrated and multinational enterprises seek to rationalise their production accordingly. One recent study provides some evidence that incentives might have become more significant as determinants of worldwide FDI patterns for export-oriented production. Clark (2000) concludes that "empirical work using improved data measuring FDI offers convincing evidence that host country taxation does indeed affect investment flows. Moreover, recent work finds host country taxation to be an increasingly important factor in location decisions".[17] The difficulty in interpreting such studies derives not only from the problems in quantifying incentive levels but also from the need to distinguish among incentives, in particular between tax incentives and those which provide relief from domestic regulations and import duties. This latter category is often cited by investors as a significant factor.

Another way to assess whether incentives affect investment decisions is to measure the rate of return on promoted projects with and without the tax incentive. In the case of Thailand, Halvorsen (1995) finds that even without incentives, the rates of return on promoted projects would have been high enough to ensure that the investment was undertaken. He suggests that incentives in Thailand have merely provided windfall gains to projects that would have been undertaken anyway. FIAS (1999) estimates that, on average, only 19 per cent of all firms accessing the various investment incentives in Thailand were truly attracted by them.[18] This confirms the results of a study on Thailand mentioned earlier which estimated that the aggregate redundancy rate for BOI promotion activities was 70 per cent.[19]

Does eliminating incentives lead to disinvestment?

Even if some policy makers were willing to concede on the basis of the evidence presented above that incentives have little effect on FDI inflows, they would not necessarily be willing to assume that the corollary is also true: that the removal of incentives will not lead to a withdrawal by foreign investors. However, there exists an example of a country which did eliminate its incentive programme for a substantial period of time. In 1984, Indonesia reduced its rate of corporate taxation and eliminated its tax incentives for investors at the same time. According to a review of the impact of these changes:

> Abolition of tax holidays… had, at most, very slight, temporary effects on the growth of foreign and domestic investment. The main effect was to induce a large rescheduling of proposals from later years forward to 1983 to enable firms to take advantage of the double incentive of pre-tax-reform tax holidays and post-tax-reform reduced tax rates. Most of this rescheduling was in the manufacturing sector.[20]

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The holidays were reintroduced in 1996 and then dropped again, only for new incentives to appear in 2000. Tariff exemptions were maintained over the entire period. As the largest investors in Indonesia, Japanese firms complained the loudest about the repeal of the incentive programme, but they continued to invest after 1983. The decision to offer incentives again after 1996 occurred when inflows were at their peak and hence did not derive from any secular decline in inflows over time. Rather, Wells and Allen (2001) attribute the policy reversal to pressure, partly via the investment agency BKPM, from established investors – both domestic and foreign – who were keen to receive a subsidy if one was made available, and to the fact that the government was benchmarking the generosity of its schemes with those of other ASEAN countries.[21]

A second source of support for the notion that eliminating incentives will not discourage investment comes from a survey by the ASEAN Secretariat of 234 MNEs from all the major source countries for FDI in ASEAN. These firms were asked what the impact of a WTO-orchestrated reduction in local and regional incentives would be on future investment in ASEAN. The results in Table 3.8 provide considerable support for the notion that the removal of incentives will not have a great impact on investment decisions. Only in the case of Japan did some firms respond that the removal of incentives would have a large negative impact on investment, but there were just as many Japanese firms claiming it would have a large positive impact. A slightly larger share of respondents mentioned a potential negative impact than a potential negative one, but this result is driven by the responses of firms from Chinese Taipei. As mentioned in Section 1, these firms might well be smaller and hence more easily deterred by a possible adverse change in the fiscal regime.

Table 3.8. **Survey of MNEs in ASEAN concerning the potential removal of incentives**

Impact	Japan	US	Europe	Australia	Chinese Taipei	Total (%)
Large negative effect on future investment	6	0	0	0	0	7 (4)
Small negative effect	13	5	4	3	15	40 (23)
No effect	41	18	8	9	12	88 (51)
Small positive effect	15	7	3	0	3	28 (16)
Large positive effect	6	2	1	0	1	9 (5)

Source: Mirza *et al.* (1996).

3. Summary and conclusions

Investment incentives as a tool of economic policymaking have been growing in popularity. Incentive programmes are expanding partly to replace

more traditional tools of industrial policy, such as trade policies, public ownership of industrial enterprises or various impediments to foreign investment such as performance requirements. As these are gradually being negotiated away or unilaterally abandoned, one of the tools left to governments seeking to influence investor decisions is the use of investment incentives.

The growth in incentives poses new challenges for policymakers. Although the "carrot" of incentives is often seen as an improvement over the "stick" of restrictions, the use of incentives nevertheless entails certain risks. Studies tend to find that incentives have at best a marginal influence of investors' decisions. As a result, they are often ineffective, inefficient and expensive for the host country in terms of foregone fiscal revenue. The cost is likely to be even greater when countries engage in bidding wars for multinational investment.

ASEAN is perhaps the developing country region the most successful at attracting foreign direct investment and at incorporating foreign firms into national development strategies. There has nevertheless been a secular decline in investments in the region by multinational enterprises which began in some countries even before the Asian financial crisis in 1997. This trend, together with far greater investment going into China, is often cited as a major developmental challenge for ASEAN countries. Based on a review of trends and a careful analysis of FDI into the two regions, this article concludes that China represents more an opportunity than a threat to ASEAN and that, ultimately, China and ASEAN will sink or swim together.

ASEAN countries are not only important hosts to FDI, they are also among the most active purveyors of incentives for international firms seeking export platforms or access to the ASEAN market. Many of these schemes have been in operation for decades, although they have become considerably more widespread over time. Malaysia and Thailand have been offering incentives for decades, following the successful example of Singapore. Since the 1990s, they have been joined or rejoined by Indonesia, the Philippines and Vietnam.

Assessed against the background of the OECD Checklist for Foreign Direct Investment Incentive Policies (Annex 3.A1) some warning posts can be raised over recent investment incentive practices in ASEAN countries:[22]

- In some countries analysts have identified an apparent divorce between public bodies responsible for the design and the implementation of policies. Relatively few investment promotion agencies management incentives measures have a direct input into the policy-making process.
- Insufficient resources may be devoted to monitoring of incentive schemes, which is part of a broader problem of inadequate programme evaluation. When implementing agencies' resources are stretched thin, in-depth analysis of costs and benefits of policies are among the first activities to suffer.

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- In some cases too little attention may have been given to the advantages and disadvantages of individual incentive schemes. Some strategies may be more cost effective than others. Tax breaks are routinely granted, even as experience has shown that they are often not the most efficient way of addressing investors' concerns.
- Governments have been roundly criticised for not being sufficiently transparent – in some cases throughout the entire investment policy process. Some authorities have even kept their priority sectors a secret.
- The recent trend toward an increasing use of discretionary, as opposed to rules-based, policies is at risk of increasing the scope for arbitrariness, opacity and discrimination between enterprises. In more extreme cases this has also created a scope for corruption.
- Too many targets are sometimes being pursued at the same time (*e.g.* an "old" focus on export promotion may coincide with a "new" strategic-sector orientation). Such diverse objectives are not always compatible.

Moreover, incentives for investors in ASEAN have been costly in terms of foregone tax revenue. Estimates from studies reviewed below range from 0.5 to 2 per cent of GDP and it is clear that some countries in ASEAN can ill-afford to be so generous, especially when empirical and survey work suggests strongly that incentives offered by ASEAN countries, like those elsewhere, neither raise significantly investment levels in the economy nor channel effectively that investment into desirable areas. In many cases the money would probably have been better spent on enhancing the national enabling environment for investment.

In spite of the risk that incentives competition within ASEAN could degenerate into bidding wars, the evidence presented in this study suggests that while incentives have proliferated, their use has not escalated. More countries are involved, but at the same time some countries have reduced or pared down the more general incentive schemes. New, more targeted programmes focus on "strategic" sectors and seek to achieve "dynamic" gains such as human capital formation, technology transfer, industrial clusters and market access abroad. However, this runs close to "picking the winners" strategies and hence carries the usual risks that follow from discriminating between domestic economic sectors.

Bidding wars are also curtailed by the budgetary limits on what many ASEAN countries can afford to give away. There is some ambiguous evidence of bidding for certain high-profile projects but little in the way of systematic incentives competition. The article suggests instead that host governments have tended to follow in quick succession the legislative innovations arising elsewhere in the region, often in Singapore. Legislative changes have been follow-the-leader rather than tit-for-tat.

Notes

1. OECD (2003), “Guiding Principles for Policies toward Attracting Foreign Direct Investment”, *International Investment Perspectives*, OECD, Paris, pp. 98-100.
2. Gross inflows are defined as the direct investment flows by foreigners in a given location. They become negative when existing inward investors withdraw capital from the foreign-invested companies in the host economy.
3. Some investments from the rest of the world are attributed to countries like the British Virgin Islands which make it difficult to ascertain the ultimate source country.
4. Cited in Michael Vatikiotis, “Outward Bound” Far Eastern Economic Review, 5 February 2004.
5. OECD (2003).
6. *Ibid.*, p. 18.
7. Charlton (2003), p. 17.
8. Chia and Whalley (1995), p. 438.
9. In a recent APEC report, Vietnam vowed to strengthen its efforts to attract foreign companies in the future (APEC, 2003, p. 666).
10. OECD (1993), p. 26.
11. Fletcher (2002), p. 12.
12. Fletcher (2002), p. 13.
13. Chalk (2001), p. 12.
14. Quoted in UNCTAD (2002), p. 207.
15. Chia and Whalley (1995), p. 443.
16. Yeung (1996), p. 514.
17. Clark (2000), p. 1176.
18. Cited in Chalk (2001), p. 9.
19. Thailand (1984), cited in Halvorsen (1995), p. 428.
20. Wells and Allen (2001), p. 55.
21. Wells and Allen (2001), p. 29.
22. Thompsen (2004).

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ANNEX 3.A1

The OECD Checklist for Foreign Direct Investment Incentive Policies

In 2003 the OECD Committee on International Investment and Multinational Enterprises agreed on a Checklist for FDI Incentive Policies. The purpose of the Checklist is to serve as a tool to assess the costs and benefits of using incentives to attract FDI, to provide operational criteria for avoiding wasteful effects and to identify the potential pitfalls and risks of excessive reliance on incentives-based strategies. Under six categories, 20 questions are put to policy makers:

The desirability and appropriateness of offering FDI incentives

1. Are FDI incentives an appropriate tool in the situation under consideration?
2. Are the linkages between the enabling environment and incentives sufficiently well understood?

Frameworks for policy design and implementation

3. What are the clear objectives and criteria for offering FDI incentives?
4. At what level of government are these objectives and criteria established, and who is responsible for their implementation?
5. In countries with multiple jurisdictions, how does one prevent local incentives from cancelling each other out?

The appropriateness of strategies and tools

6. Are the linkages between FDI attraction and other policy objectives sufficiently clear?

7. Are effects on local business of offering preferential treatment to foreign-owned enterprises sufficiently well understood?
8. Are FDI incentives offered that do not reflect the degree of selectiveness of the policy goals they are intended to support?
9. Is sufficient attention given to maximising effectiveness and minimising overall long-term costs?

The design and management of programmes

10. Are programmes being put in place in the absence of a realistic assessment of the resources needed to manage and monitor them?
11. Is the time profile of incentives right? Is it suited to the investment in question, but not open to abuse?
12. Does the imposition of spending limits on the implementing bodies provide adequate safeguards against wastefulness?
13. What procedures are in place to deal with large projects that exceed the normal competences of the implementing bodies?
14. What should be the maximum duration of an incentive programme?

Transparency and evaluation

15. Have sound and comprehensive principles of cost-benefit analysis been established?
16. Is const-benefit analysis performed with sufficient regularity?
17. Is additional analysis undertaken to demonstrate the non-quantifiable benefits from investment projects?
18. Is the process of offering FDI incentives open to scrutiny by policymakers, appropriate parliamentary bodies and civil society?

Extra-jurisdictional consequences

19. Have authorities ensured that their incentive measures are consistent with international commitments that their country may have undertaken?
20. Have authorities sufficiently assessed the responses that their incentive policies are likely to trigger in other jurisdictions?

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