

# Assessing Sustainable Development Impacts of Investment Incentives

## A Checklist

Kenneth P. Thomas  
University of Missouri – St. Louis

2009

© 2009 International Institute for Sustainable Development (IISD)

Published by the International Institute for Sustainable Development

International Institute for Sustainable Development

161 Portage Avenue East, 6th Floor

Winnipeg, Manitoba Canada

R3B 0Y4

Tel: +1 (204) 958-7700

Fax: +1 (204) 958-7710

E-mail: [info@iisd.ca](mailto:info@iisd.ca)

Web site: <http://www.iisd.org/>

Assessing Sustainable Development Impacts of Investment Incentives: A Checklist

Kenneth P. Thomas

University of Missouri – St. Louis

## About the Trade Knowledge Network

<http://www.tradeknowledgenetwork.net>

The Trade Knowledge Network is a global collaboration of research institutions across Africa, Asia, Europe and the Americas working on issues of trade and sustainable development. Coordinated by the International Institute for Sustainable Development (IISD), the TKN links network members, strengthens capacity and generates new research to assess and address the impact of trade and investment policies on sustainable development.

The overarching aim of the TKN is to help ensure that trade and investment contribute to sustainable development, with social development and the environment equitably addressed in trade and investment policies. The TKN furthers this aim by generating compelling research with clear policy recommendations and communicating those effectively to decision-makers nationally, regionally and globally.

The TKN is hosted by the International Institute for Sustainable Development, a Canada-based not-for-profit organization promoting change towards sustainable development. As a policy research institute dedicated to the effective communication of its findings, the Institute engages decision-makers in government, business, NGOs and other sectors in the development and implementation of policies that are simultaneously beneficial to the global economy, the global environment and to social well-being.

This paper is part of a larger TKN project that seeks to better understand the impacts of investment incentives on sustainable development. Other research outputs include four country case studies looking at investment incentives for the mining and quarrying industry in Vietnam (by the Central Institute for Economic Management, Vietnam), the pharmaceutical industry in Singapore (by the Singapore Institute for International Affairs), the chemical industry in Indonesia (by the Center for Asia Pacific Studies at Gadjah Mada University, Indonesia) and the tourism industry in Malawi (by the University of Malawi and the South African Institute for International Affairs). In addition, a regional study examines the effectiveness of investment incentives in attracting FDI and promoting economic growth, social development and environmental protection in Southeast Asia. The project outputs are available on the TKN website.

## About the International Institute for Sustainable Development (IISD)

<http://www.iisd.org>

The International Institute for Sustainable Development contributes to sustainable development by advancing policy recommendations on international trade and investment, economic policy, climate change, measurement and assessment, and natural resources management. Through the Internet, we report on international negotiations and share knowledge gained through collaborative projects with global partners, resulting in more rigorous research, capacity building in developing countries and better dialogue between North and South.

IISD's vision is better living for all—sustainably; its mission is to champion innovation, enabling societies to live sustainably. IISD is registered as a charitable organization in Canada and has 501(c)(3) status in the United States. IISD receives core operating support from the Government of Canada, provided through the Canadian International Development Agency (CIDA), the International Development Research Centre (IDRC) and Environment Canada; and from the Province of Manitoba. The Institute receives project funding from numerous governments inside and outside Canada, United Nations agencies, foundations and the private sector.

## Introduction

Determining the effect of investment incentives on sustainable development involves a multi-level analysis in three areas: the individual projects, the incentive policy in general and the implications of and for international agreements. Sustainable development here refers to the sustainability of the economic, social and environmental consequences of a development plan, and clearly assumes that development means more than simply economic development.

The assessment process is hindered to the extent that hard quantitative data are not available for estimating costs and benefits. The situation is bad enough in many industrialized countries, but generally worse in developing countries, due in part to less experience with investment incentives both among policy-makers and the citizenry. Assessment is further hindered by conceptual difficulties in determining whether the incentives are successful simply as incentives, let alone as policies which can affect sustainable development.

With that in mind, the checklist set out here seeks to promote the analysis of individual projects and incentive policies in terms of their success as incentives and as contributors to sustainable development. There is substantial evidence that the use of investment incentives by one country in a region diverts investment from nearby countries,<sup>1</sup> which is one reason that regional agreements on the use of investment incentives are desirable.

An important conceptual problem is determining what would have happened in the absence of the incentive (perhaps the investment would have been made anyway), which is an issue addressed in the checklist below. Research in the United States suggests drastic differences between the gross number of jobs provided by subsidized projects and the actual number of jobs that would have been created absent the incentive.<sup>2</sup> Even some of the more optimistic of these analyses estimate that less than ten per cent of apparent jobs were truly due to the effect of the incentive. Moreover, many times job creation in one jurisdiction is soon offset by job cuts at other facilities of the same company, or by cuts at other companies due to their succumbing to subsidized competition.<sup>3</sup>

Incentives can have both direct and indirect impacts on sustainable development. The direct impacts are tied to the effect of incentives in determining what investments are made. If, for instance, incentives are given to heavily polluting firms, the environmental sustainability of the investment is thereby compromised.

The indirect impacts are due to the performance requirements that are placed on the investor. Performance requirements, and possible restrictions on their use, are important because investment is not necessarily a pure gain for an economy. Foreign investors can bring in new capital, or they can borrow it on the domestic market, crowding out potential domestic investors. A multinational investor can have exemplary labour relations (fair wages, recognition of union rights, training and advancement opportunities, gender equity, etc.), or exploitative ones (low wages, high turnover, hostility to unions, no training, etc.). A foreign company can have substantial linkages with the domestic economy, thereby multiplying its potential positive impact, or it can be an enclave. For this reason, pre-entry negotiations on the conditions of investment can have a major impact on the overall results of an investment, and

---

1 Thomas (2007).

2 See e.g., Fisher (2007) and Luger and Bae (2005).

3 Thomas (2007).

governments have a strong interest in maintaining the policy flexibility to obtain the maximum benefit from it. Bilateral investment treaties, in particular, seek to freeze bargains made when an investor has its maximum bargaining power (that is, before it commits its capital) and have substantial pitfalls for host governments.<sup>4</sup>

Since many types of international agreements now have provisions affecting performance requirements, this is one area where such pacts (the WTO Agreement on Trade-Related Investment Measures [TRIMS], bilateral investment treaties [BITs], and free-trade agreements [FTAs]) are relevant for the impact of incentives on sustainable development. The other way such agreements can affect sustainable development is whether or not they have policies affecting the incentives themselves. In the European Union, the state aid rules now have provisions directly regulating investment incentives to projects over € 50 million.<sup>5</sup> In Vietnam, the central government has set limits on the incentives that can be offered by subnational governments; however, these rules had to be reinforced in 2005 when it was discovered that a number of subnational governments were exceeding their limits.<sup>6</sup>

The present work differs in important respects from earlier works such as the OECD's 2003 *Checklist for Foreign Direct Investment Incentives*. Most importantly, this methodology emphasizes not only the evaluation of incentive policy for its economic effects, but also for its effects on sustainable development. It takes as given that incentives should be available to domestic investors equally with foreign investors. In addition, there is greater attention to the evaluation of individual projects, as well as overall incentive policy. Finally, this work reflects IISD's emphasis on the preservation of policy space for host governments to maximize their benefits from investment through the use of performance requirements for investors, as elaborated in *IISD International Agreement on Investment for Sustainable Development*.<sup>7</sup>

The checklist below is designed to be used either by governments or by stakeholders. To the extent possible, the questions should be asked both *ex ante* and *ex post*. Indeed, incentive evaluation should be seen as an iterative process, with information gained from earlier incentives and programs used to benchmark later ones.

Governments, of course, will have immediate access to certain information that stakeholders may not, so for governments these questions can be used as a direct evaluation tool. However, our view is that transparency in the subsidy process is necessary for good policy to emerge and to avoid some of the inherent dangers of using investment incentives, such as corporate rent-seeking and increased opportunities for corruption. For stakeholders, achieving transparency may be difficult in some countries, but the discussion below points to the sort of questions that should be raised about individual investment projects receiving incentives, as well as a country's (or region's or city's) overall incentive policy.

---

4 Thomas (2007).

5 *Ibid.*

6 Vu *et al.* (2009).

7 Mann *et al.* (2005).

# Checklist for Assessing Sustainable Development Outcomes

## A. Individual projects:

### 1. Value for money and due diligence

What did the particular investment cost, as measured both by cost per job and the percentage of investment subsidized (aid intensity)?

How many competitors for the investment were there, and who were they? Could the investment have been received for less?

What taxes, royalties, etc., will the company pay, especially for extractive industry?

Is the company bringing in money from outside the country, or raising it on the domestic capital market?

What is the investor's track record? Does it have a history of taking the money and running?

How has it handled past disputes with host countries?

*Explanation:* One cannot evaluate a policy or a project unless you know how much it costs. It may be difficult to determine the answers to these questions. If information is available on the terms of the incentive, best practice is to calculate the present value of the support given to the investor. The answer is simple for an up-front grant, but for tax breaks or other instruments where the payments stretch out over time, it is necessary to discount the value of future payments. An excellent source of formulae for calculating the present value of a wide variety of subsidy tools is *National subsidies: A reporting manual*.<sup>8</sup> Knowing the aid intensity of the incentive is useful in comparing the project to other projects. Finding out how many other competitors were chasing the investment is also difficult: companies wish to project the aura of competition (and site selection consultants encourage them to do so), yet often they have only one location in mind all along. Whether an investment could have been attracted with fewer incentives is the most difficult to answer, and requires comparison with other projects over time.

Revenue is the other side of value for money, and is an equally important consideration. Finally, the track record of the investor on incentives, and more generally, is an important clue to likely future behaviour.

### 2. Job creation, labour relations, and technology transfer

How many jobs were created by the investment? At what wages?

Will the company train its employees to give them transferable skills?

How many management employees will be nationals, and how many expatriates? Will expatriates eventually be replaced with nationals?

Is the investor closing facilities elsewhere de facto in conjunction with this new investment? If so, how many jobs will be lost at the old facility? Would this investment have occurred without the incentive, even if other countries offered incentives?

Does the company have a history of bad labour relations?

What technology will the firm use? Are domestic firms capable of learning from the new investor?

8 OECD (1995).

*Explanation:* These questions are directed toward the economic and social benefits of the project. It is important to look beyond the gross new jobs and see if there are closures elsewhere. If there are lost jobs elsewhere in the host country, the overall benefit is lessened; if the jobs move from another country, it can be a source of political or economic tension (though perhaps addressable through regional rules on the use of incentives). If a project is based on unique features of the host country (rather than simply the fact that it has low wages), the jobs created are far more likely to be sustained over the long run. The challenge is to assess what would have happened without the incentive. Again, this requires comparison with other projects over time.

### 3. Protection of the Environment

Will the project use excessive energy or water, or cause pollution? What plans does the company have to mitigate these impacts?

Are regulatory incentives part of the package? Why were these necessary? What can be done to mitigate the harm to national environmental protections?

Does the company have a history of pollution problems?

*Explanation:* These questions address the environmental impact of the project. With the threat of global warming, it is necessary to ensure that projects are as energy-efficient as possible. Industries as diverse as silicon fabrication and golf courses are very water-intensive, and water is in short supply in many areas. The myriad forms of pollution all require minimization that is dependent on the type of project in question. One approach that is often helpful for assessing environmental outcomes is to survey the residents in the area surrounding a particular facility.<sup>9</sup>

Regulatory incentives, that is, exempting investors from existing regulations in such areas as labour relations or the environment,<sup>10</sup> should raise a red flag in terms of a project's sustainability. In addition, they usually imply a diminution of the benefits from the investment project.

## B. Incentive policy design:

### 4. General policy approach

What is overall spending on investment incentives? What guidelines does the government have for determining a "reasonable" level of incentives to provide an investor (dependent on multiple circumstances)?

Are subsidies generally available to all investors or are they discretionary? Are investment incentives available to domestic and foreign investors alike?

*Explanation:* Again, we start with the question of the cost and policies that strongly affect their cost. As always, these questions are difficult to answer, but are unavoidable if we want to analyze how well overall incentive policy works. Generally available incentives tend to be easier to administer, but in many areas of the world the trend is toward discretionary incentives, which reduces a program's cost by withholding incentives from firms which do not need them.<sup>11</sup>

<sup>9</sup> See e.g., Adiningsih *et al.* (2009).

<sup>10</sup> OECD (2003).

<sup>11</sup> Thomas (2000).

Determining what is “reasonable” is a process that must be informed by past experience and observation of other countries’ experiences.

Equal access to incentive programs for foreign investors is generally required by international trade agreements. Programs that disproportionately benefit foreign investors over domestic investors may have the perverse effect of harming the environment for domestic business,<sup>12</sup> thereby reducing the overall benefits of an incentive program.

### 5. Disciplines on sub-national measures

Are there restrictions on the ability of provincial or municipal governments to provide investment incentives?

*Explanation:* Restricting the ability of subnational governments to offer investment incentives eliminates the possibility that bidding wars among provincial or local governments for an investment coming to one’s country anyway will reduce the benefits the country will receive from that investment. Competition for investment in Canada is substantially reduced (particularly in comparison with the neighbouring United States) because almost all of its ten provinces prohibit cities from offering investment incentives.<sup>13</sup> Unfortunately, in many developing countries, the opposite is occurring, as government devolution and decentralization have led to bidding wars between states or provinces and even cities in countries as diverse as Brazil, China, and India.<sup>14</sup>

### 6. Monitoring and enforcement

Does the government require the signing of legally enforceable agreements for every project receiving investment incentives?

How much, if any, monitoring of the commitments the investor made *ex ante* will take place? This includes the amount of investment, number of jobs, wages paid and environmental impacts. Is there a government agency with the capability to do this monitoring?

What policies exist for sanctioning non-fulfillment of promised outcomes (such as clawbacks)? Will the government in fact invoke these tools in the event of non-fulfillment?

*Explanation:* These questions address the overall policy for making individual projects work as advertised. This includes having a clear legal framework for each one, followed by monitoring of commitments and lastly sanctioning of investors who do not fulfill their promises.<sup>15</sup>

### 7. Transparency and accountability

How transparent is the investment incentive process to other stakeholders, such as the community, labour unions and non-governmental organizations? Is the amount of total spending on investment incentives published? Is information on specific deals published (preferably on the Internet)?

Are there measures in place to prevent bribery of government officials with the power to grant investment incentives?

If tax holidays are used, is there sufficient oversight to prevent abusive transfer pricing?

12 OECD (2003).

13 Thomas (2007).

13 Markusen and Nesse (2007).

14 See Weber and Santacrose (2007) for further ideas on “negotiating the ideal deal.”



*Explanation:* These questions focus on the transparency of the incentive process. Secrecy is a breeding ground for poor policies, rent-seeking behaviour by investors and even bribery. Sunlight is the best disinfectant, as U.S. Supreme Court Justice Louis Brandeis said. For further ideas on how transparency can be promoted, see *The State of State Disclosure*.<sup>15</sup>

### 8. Ex post assessment

What *ex post* assessment is made of the overall outcomes of the entirety of the government's investment incentive programs? What is their contribution to economic growth, economically optimal facility location, proximity to public transport, job creation and quality, job security, social protection, energy efficiency and pollution problems minimized, versus costs of the program (incentives, administrative costs of investment promotion agency or other investment attraction method, etc.)?

*Explanation:* As with individual projects, the investment incentive program as a whole must be assessed for its contributions to sustainable development goals. Such evaluation, though costly,<sup>16</sup> is absolutely necessary to determine whether programs are effective and efficient. For example, Vietnam determined through surveying investors that its corporate tax incentives were unnecessary for attracting investment in extractive industries because the royalties the government charged the companies was so low. As a result, the government submitted a proposal for increased royalty rates to the National Assembly in 2008.<sup>17</sup>

## C. Implications of and for international agreements:

### 9. Regional agreements

Is a regional investment incentives agreement possible?

*Explanation:* Both research and experience suggest that the issue of investment incentives is one that is virtually impossible for a single government to solve on its own. The European Union has comprehensive rules on all subsidies, and specific provisions addressing investment incentives, that are backed up by monitoring and enforcement by the European Commission and the European Court of Justice.<sup>18</sup> Less comprehensive investment disciplines, such as anti-poaching rules and consultations during investment bidding wars, have been adopted with some success by Canada and Australia, and may represent a good first step on a longer road to incentive reform.<sup>19</sup>

### 10. Multilateral agreements

Have you avoided international investment agreements (such as bilateral investment agreements [BITs], free trade agreements [FTAs], or multilateral investment agreements) that restrict performance requirements, particularly those exceeding commitments of the Agreement on Trade-Related Investment Measures (TRIMS)?

15 Mattera *et al.* (2007).

16 OECD (2003).

17 Vu *et al.* (2009).

18 Thomas (2000).

19 *Ibid.*

*Explanation:* IISD has long taken the position that international investment agreements need to preserve policy space for developing countries to place legitimate requirements on investors. A full treatment is not possible here, but see *IISD International Agreement on Investment for Sustainable Development*.<sup>20</sup> This model agreement places obligations on investors and home states as well as host states, and IISD sees it as preferably being negotiated in a multilateral forum rather than bilateral or regional ones.

---

<sup>20</sup> See Mann *et al.* (2005).

## Bibliography

- Adiningsih, S., Lestari, M., Ika Rahutami, A. and Wijaya, A.S. (2009). *Sustainable development impacts of investment incentives: A case study of the chemical industry in Indonesia*. Winnipeg: Trade Knowledge Network and International Institute for Sustainable Development.
- Fisher, P. (2007). The fiscal consequences of competition for capital. In Ann Markusen (ed.), *Reining in the competition for capital*. Kalamazoo: W.E. Upjohn Institute for Employment Research.
- Luger, M. and Bae, S. (2005). The effectiveness of state business tax incentives: The case of North Carolina. *Economic Development Quarterly*, 19(4), 327–345.
- Mann, H., van Moltke, K., Peterson, L. and Cosbey, A. (2005). *IISD International Agreement on Investment for Sustainable Development*. Winnipeg: International Institute for Sustainable Development.
- Markusen, A. and Nesse, K. (2007). Institutional and political determinants of incentive competition. In Ann Markusen (ed.), *Reining in the competition for capital*. Kalamazoo: W.E. Upjohn Institute for Employment Research.
- Mattera, P., Walter, K., Farb Blain, J., and Lee, M. (2007). *The state of state disclosure: An evaluation of online public information about economic development subsidies, procurement contracts and lobbying activities*. Washington: Good Jobs First.
- Organization for Economic Cooperation and Development (1995). *Industrial subsidies: A reporting manual*. Paris: OECD.
- Organization for Economic Cooperation and Development (2003). *Checklist for foreign direct investment incentive policies*. Paris: OECD.
- Thomas, K.P. (2000). *Competing for capital: Europe and North America in a global era*. Washington: Georgetown University Press.
- Thomas, K.P. (2007). *Investment incentives: Growing use, uncertain benefits, uneven controls*. Geneva: Global Subsidies Initiative of the International Institute for Sustainable Development.
- Vu Xuan Nguyet Hong, Ngo Minh Tuan and Ho Cong Hoa (2009). *Sustainable development impacts of investment incentives: A case study of the mining industry in Vietnam*. Winnipeg: Trade Knowledge Network and International Institute for Sustainable Development.
- Weber, R. and Santacroce, D. (2007). *The ideal deal: How local governments can get more for their economic development dollar*. Washington and Chicago: Good Jobs First and University of Illinois at Chicago Center for Urban Economic Development.