OCCASION

This publication has been made available to the public on the occasion of the 50th anniversary of the United Nations Industrial Development Organisation.

DISCLAIMER

FAIR USE POLICY

CONTACT

Please contact publications@unido.org for further information concerning UNIDO publications.

For more information about UNIDO, please visit us at www.unido.org

UNITED NATIONS INDUSTRIAL DEVELOPMENT ORGANIZATION
Vienna International Centre, P.O. Box 300, 1400 Vienna, Austria
Tel: (+43-1) 26026-0 · www.unido.org · unido@unido.org

D00061

United Nations Industrial Development Organization

Distr.
LIMITED

ID/WG.30/11
6 March 1969

ORIGINAL: ENGLISH

Interregional Seminar on Incentive Policies
for Industrial Development

Vienna, 10 - 21 March 1969

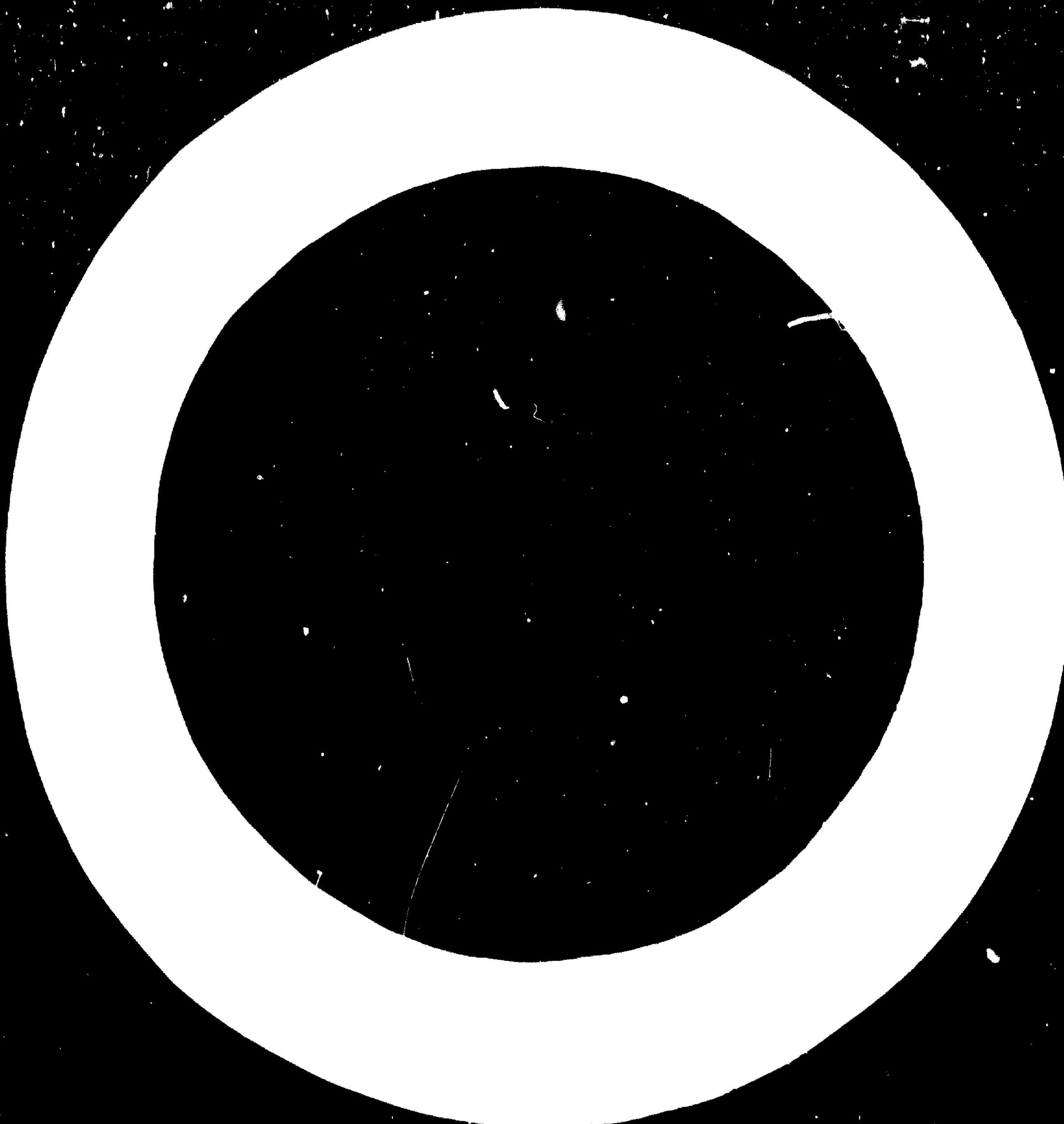
ISSUE PAPER NO. 11

CRITERIA FOR SELECTING INDUSTRIES QUALIFYING FOR INCENTIVES[1]

[1]/ This document has been reproduced without formal editing.

id.69-801

We regret that some of the pages in the microfiche copy of this report may not be up to the proper legibility standards, even though the best possible copy was used for preparing the master fiche.



CRITERIA FOR SELECTING INDUSTRIES QUALIFYING FOR INCENTIVES

Issues for discussion

"Eligibility for preferential tax treatment under investment incentive laws basically reflects a country's development strategy".

George Lent: Tax Incentives for Investment

I. INTRODUCTION - THE PROBLEM

1. Incentive measures, particularly tax incentives, are used both on a non-selective basis to encourage new industrial investment in general and on a selective basis to promote investment in approved priority projects. When formulating a programme of incentive measures, a Government needs to choose between the non-selective and the selective approach. If the selective approach is adopted, it must choose the criteria to be used to select priority industrial projects. This paper will consider the issues which arise when making these decisions.

II. SURVEY OF ISSUES RAISED

2. The selection of priority industrial projects is usually based on the type of product manufactured, and for the purposes of this paper the word "selective" is used in this sense. The selection could also be based on the size of project: i.e. small-scale industries, medium-size industries, large projects, but in this paper, this approach will be considered as a refinement of selection by types of industry.

3. The main issues raised in this paper, then, are:

(A) What considerations are involved in deciding whether to adopt a non-selective or selective approach?

(B) If the selective approach is used, what criteria can be used to select priority industries requiring incentives?

(C) What systems can be used to implement the selective approach?

(D) Criteria used to determine the level of benefits offered.

A. Choosing between a non-selective and selective approach

4. The choice between a non-selective and selective approach for granting incentive measures to industrial projects will depend on the type of measure used, the stage of industrialisation reached, and the Government's assessment of the need to stimulate interest in some priority projects but not others.

5. Some types of incentive measure are more suitable for application on a selective basis than others. Of the eight different types of incentive measure considered in the Background Papers, the three that are most frequently offered on a non-selective basis are: assistance with labour skills, assistance with land and industrial estates, and measures to facilitate foreign investment. Two other types of incentive measure (assistance at the pre-investment stage, tariff protection) are frequently non-selective in principle but selective when applied in practice. The three types of measure most frequently offered on a selective basis are tax incentives, import duty concessions, and assistance with financing. The distinction between the non-selective and selective approach may therefore not always be clear-cut. The issue arises therefore: is it useful to combine some non-selective incentives with other types of incentives applied on a selective basis to promote selected industrial projects?

6. The country Background Papers suggest that there is some tendency for countries to opt for the selective approach once a limited range of industries have been established. However, it may take some time for this point to be reached. Some countries still rely on the concept of "Pioneer Industries" or similar non-selective approaches to grant tax incentives. The issue arises, then; is there a stage in the industrialisation process when countries need to consider the selective approach?

7. There is little evidence in the country Background Papers to explain why certain countries have adopted a selective approach or why they did it at a certain stage. The issue arises: was the selective approach adopted because the Government attached special importance to the implementation of certain projects? Or was it because the potential profitability of these projects appeared low thus needing special encouragement?

8. The evidence of the Background Papers suggests that a number of different criteria and systems have been used for selecting industries benefitting from incentives, these are considered in more detail in the two following sections of this paper.

B. Criteria for selecting benefitting industrial projects

9. A wide range of criteria have been used by developing countries in an attempt to ensure that the benefitting industrial projects (a) contribute to national economic objectives, and (b) conform to sensible commercial criteria. In some cases it appears to have proved difficult to outline a mutually consistent set of national economic criteria.

1. National Economic Criteria

10. The range of national economic criteria which have been used is quite extensive; they include the following:

(a) A minimum proportion of value added in the production process;
(b) The project uses local raw materials;
(c) The proportion of imported raw materials must not exceed a given maximum proportion of total direct costs;
(d) The project will result in significant savings and/or earnings of foreign exchange (usually the gross rather than net concept is implied);
(e) The size of investment required;
(f) The enterprise includes a minimum proportion of local ownership;
(g) The project will create employment opportunities;
(h) The project has valuable "linkage effects" and will benefit from or stimulate other useful activities;

11. The issue arises: is this a complete list and can a selection of the criteria listed by successfully harmonised with the strategy and objectives of national development policies?

12. To be more specific: which of these criteria are the most important and how can special weight be given to the more important criteria? For

example, in assessing the priority for new industrial projects, can a check-list of questions be developed and points awarded (say up to 10) for each answer; should the answers to each question be given the same weight when the total points are counted or should some questions be given a special weighting?

2. National economic criteria and the Development Plan

13. In establishing a schedule of priority for investments in the industrial sector, the Government usually pays attention to such factors as the country's exchange position, the financial resources available, its raw materials and infrastructure endowments, available manpower skills, the size of the national market and the minimum size of plant which this and potential export markets will support and the likely resulting cost structure. The issue arises then: to what extent have developing countries related criteria used to select industries benefitting from incentives to national economic criteria?

14. Bearing in mind that these circumstances and objectives change as the economy develops over the years, the issue is: how frequently should these criteria be reviewed? When a new Development Plan is formulated? Or every time a national economic objective changes? (e.g. foreign exchange is no longer in short supply).

3. Commercial Criteria

15. A set of commercial criteria are sometimes included in the list. These usually have the purpose of ensuring that the project is technically sound and commercially viable. However, the fact that the commercial success of the project may well depend on the tariff protection granted has not always been recognized. The issue arises therefore: should the selection of projections include a criteria which eliminates projects where excessive protection from import competition is required?

16. Turkey has included two further commercial criteria in the case of some industries: (a) that the size of plant should be such that it can compete abroad and eventually with imports from the European Economic Community; and (b) that the technology chosen should be the most appropriate in the circumstances with this aim in mind. This raises a further issue: have developing countries paid sufficient attention to (a) the size of plant and (b) the technology chosen when granting incentives to new industries?

C. Systems used to implement the selective approach

1. Two types of approach

17. The country Background Papers suggest that two principal alternative ways of selecting priority projects can be distinguished. The first identifies in advance a list of industries which will qualify for incentive benefits; this will be called the "list of industries" approach. The second approach establishes criteria for approving or rejecting applications for a project to qualify for incentive benefits as they arise, this we will call the "selection by criteria" approach.

18. A number of developing countries have used the "list of industries" approach to encourage the implementation of industrial projects in line with their Development Plan's targets for the industrial sector. The experience of India, the Republic of Korea and Thailand suggests that this can be an effective approach, particularly (as in the case of Thailand) when some of the benefits were to be withdrawn, or (as in the case of India) reduced at the end of the Plan period.

19. Other countries (for example, Pakistan) clearly identify priority industrial projects in the Development Plan and use this as a basis for exerting some control over the selection of projects for implementation through various controls such as the licence required to import machinery and equipment; the main role played by tax incentives in Pakistan is not to direct investment into priority projects but to encourage industry to locate in the less-developed regions of the country.

20. Assuming it is decided to use incentives to direct investment into priority projects, which is the best approach? Provided the industries listed are carefully chosen on the basis of appropriate criteria, the "list of industries" approach (as adopted by Turkey, for example) has the advantage of drawing the attention of investors (domestic and foreign) to those projects. The "selection by criteria" approach may be safer in the long run but it has the disadvantage of not allowing the investor to know automatically what incentives he will be granted. This is particularly the case with incentives legislation which leaves the generosity of benefit offered either to the discretion of the administrators or the classification of the enterprise into one of the various categories.

D. Criteria used to determine the level of benefits offered

1. National economic criteria

21. Both types of approach can be refined by granting different packages of incentive benefits of varying levels of generosity to different industries or different categories of projects. Turkey has used the "list of industries" approach but varied the generosity of incentives offered according to the product produced.

22. Other countries have varied the generosity of incentives for different broad categories of industry. In Mexico, incentives were provided after 1955 for varying periods according to whether the industry was classified as basic (10 years), semi-basic (8 years) or secondary (5 years); but for various reasons (including certain general eligibility criteria), only a small proportion of new industrial investment has benefitted from incentives in recent years 1/ Korea listed various industries in the incentive legislation itself, distinguishing between heavy industries (granted 5-year tax exemptions) and light industries (granted 3-year tax exemptions).

23. The Sudan, whilst making incentives available to all types of industry, has offered more generous tax holidays for projects requiring capital investment over S£1 million.

24. The practice is also common where the "selection by criteria" approach is used. For example, to qualify for the most generous package in Ecuador under the old 1957 law, an industry had to be classified as "basic" by the Planning Board and show that imported raw materials would amount to no more than 15 per cent of the total cost of production (30 per cent if part of the output is exported). For the slightly less generous package, the proportion was 40 per cent (or 50 per cent if part of the production was exported).

25. In the arrangements proposed for the harmonisation of fiscal incentives in Central American Common Market, various packages of import duty and tax

---

1/ Ificenia M. de Navarrete, "Los Incentivos Fiscales y el Desarollo Economica de Mexico". Mexico City, 1967.

holiday exemptions were offered for three categories of industrial project. Industries producing raw materials, capital goods, or other goods drawing 50 per cent of the total value of raw materials from within the region were to be offered the most generous package. 2/ The third and weakest package offered no tax holiday or import duty exemption on raw materials until the 50 per cent use of local materials was achieved; the only import duty exemption offered was on plant and machinery.

26. A general issue arises here: is there any point in using these criteria to devise such categories of eligible industries? such systems introduce some flexibility to tailor the benefits offered according to the way the project fits certain national economic criteria but restrict the discretion of those administering the law and make the benefits much more difficult to understand.

2. Potential profitability of the project

27. An examination of the criteria used by developing countries to limit the discretion of the administration in granting incentived suggests that the generosity of the package offered is either uniform for eadh project or determined by a categorisation of industries based on national economic criteria.

28. On the other hand, the investor does not take much interest in national economic criteria; his decision is determined chiefly by the potential profitability of the project, the commercial risks involved, and (if he is a foreign investor) the risks associated with investing in a developing country.

29. Looked at from this point of view, it is clear that in principle the incentive benefits offered should ideally be granted at a level which is only just generous enough to promote the establishment of a new industrial enterprise or the expansion of an existing venture. However, the degree of risk and potential profitability of the investment will vary considerably from project to project; it may therefore be difficult for the Government to negotiate the best possible terms. This is particularly the case if the

2/ Import duty exemptions on raw materials (100 per cent for 5 years, 60 per cent for a further 3 years, 40 per cent for the last two years) and a profits tax holiday of 8 years.

Government has to bear in mind the possible threat that the investor will locate his plant in another country.

30. This apparent conflict clearly raises an important issue: should developing countries take the potential profitability of the project as well as national economic criteria into account when granting incentive benefits? Should the role and strength of incentives be designed to compensate the investor for the gains to the economy which are not reflected in the profitability of the project?

III. SUGGESTED ISSUES FOR DISCUSSION

31. In the previous section, a number of issues have been raised. In order to maximise the value of the sessions devoted to this subject, it is suggested that discussion might concentrate on the following issues:

To bring out the experience of countries represented at the Seminar, participants might indicate:

(a) Whether their country uses a non-selective or selective approach in granting incentives for new industrial investment;

(b) If the selective approach is used, is this based on the "list of industries" approach, or on the "selection by criteria" approach?

(c) On what criteria has the selection of priority projects been based?

(d) Are incentives the only policy instrument used for channelling investment into priority industrial projects?

(e) What types of incentive measure are used for this purpose?

(f) Have incentives been offered only for a limited time period after which applications will not be eligible?

(g) Has the selective approach achieved its objective of channelling investment into these priority projects?

More general issues which might be discussed include:

(h) Are incentive measures the most appropriate way of directing new investment into priority projects?

(i) What criteria should be used to select priority projects?

(j) Will these criteria change as the process of industrialisation advances, the economy develops, and different circumstances and objectives are faced?

(k) How flexible a system does a country need to take account of the different levels of potential profitability of different projects?

20. I. 72