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# Incentives for Industry in Developing Countries

by Dr Heinz Ludwig, Zurich \*

**In support of their industrialisation efforts developing countries are offering a number of incentives to investors in order to compensate the latter for shortcomings and handicaps resulting from the countries' development status. Do these incentives serve their purpose?**

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Industrialisation is today a fashion in developing countries. With some, it is almost an obsession. Of motives, there are many. Rational ones: to cease being a raw material country only. To benefit from the higher profit margins of up-graded products. To save foreign currency or, by export of manufactured goods, to earn more of such currency. (So it is hoped.) To create employment, to raise the standard of living. And irrational ones: To catch up with the envied industrial countries. To enhance one's prestige among fellow-members of the Third World. And for some, to follow the example set by Russia and other East European states.

But the desire to industrialise is one thing, the capability to set up internationally competitive industries is another. Not only that factors indispensable for running industries are often missing in developing countries: expert management, manpower able to learn and willing to work regularly, sufficient capital, infrastructure. But there are positive handicaps such as small local markets, lack of quality consciousness, long distances from suppliers, time-consuming red tape in government, awkwardness in establishing export contacts. All of which tend to either prevent the coming-into being of desired industries altogether or to seriously endanger their viability should they indeed have been started.

## **Compensation for Adverse Conditions**

It is here where governments of developing countries feel called in to help. Of course, they cannot change natural or structural handicaps. They cannot, for instance, shorten the distance between London and Lomé, or vice versa. But they can compensate companies for the freight differential or they can negotiate for lower freight rates. They can, and they do, negotiate for the lowering of tariff barriers or for the duty-free entry of their industries' products into consumer countries. They can, on the local market, protect the products of new industries by tariffs, by administrative measures, by allocation of foreign currency. They can call for technical assistance from other gov-

ernments or from the World Bank, or they can engage the services of private consultants. They can apply to the World Bank or to regional development banks for grants or credits for specific projects. And they can try to encourage local private capital and enterprise, as far as there is such, or to attract foreign capital, as far as they approve of foreign participation, for the funding and financing of individual industrial projects.

Foreign governments will consider a developing country's requests for the reduction of tariffs or for assistance from the viewpoint of their own economies or from a sense of moral obligation towards the Third World. The World Bank will consider requests for grants or loans from a social cost and benefit point of view. However, local private enterprise and foreign capital will ask whether a reasonable profit can be expected for the work and for the funds which they are supposed to invest. And here, governments of developing countries are faced with the problem of how to compensate for adverse conditions and to counter-balance handicaps which they realise their new industries will encounter so as to give private enterprise and foreign capital a fair chance to succeed financially. The problem, in other words, is how to supplement or even to substitute natural competitiveness by manipulated competitiveness. To this purpose, a set of instruments has been developed by developing countries which has become known by the name of "incentives".

Now, what is common to all incentives is that they not only are meant to offer financial attractions to the entrepreneur or investor but that they definitely involve, for the Exchequer of the developing country, financial expenditure or at least the renunciation of income (e.g. tax).

## **Priority Requirements**

It is for this reason that governments of industrialising countries will be selective if it comes to the granting of incentives, and that they will have

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to be guided by a considered list of priorities. The sequence of priorities will of course vary with the necessities of the individual country but it can be assumed that the following points will be part of most priority lists:

- ☐ That the investment creates substantial employment opportunities;
- ☐ that it is apt to improve the foreign exchange position of the country by either creating exports or substituting imports, or both;
- ☐ that the investment leads to the establishment of industry in certain preferred development zones;
- ☐ that it introduces new technologies to the country;
- ☐ that it contributes to the defense of the country.

Some countries attribute priority to specific industries rather than to categories. Some consider local control of ownership an element of priority.

If an investment meets the priority requirements, it is usually declared an "approved enterprise". But even to firms within this category, the granting of incentives is often graduated according to the value which the economic establishment attaches to the project. Whether the firm has sufficient capital of its own, what part of sales it undertakes to export, what percentage the "value added" amounts to — all these factors influence the size of incentives granted. And, naturally, in estimating these factors, an element of subjectivity will enter the decisions.

Priorities and regulations for the application of incentives are usually laid down in an investment law. Details of such a law might be changed when conditions change. Thus saturation points for certain industries or certain areas might have been reached. The amounts available for incentives in a year are normally set out in the development budget after discussion within the Ministries and approval by the Cabinet and Parliament. Such budget might be based on long-term development plans. The individual allocations are administered by an Investment Authority which acts after consultation with the Ministries concerned: Trade, Industry, Finance, etc. Individual incentives in the form of credits are often decided by the Industrial Development Bank of the country.

### Groups of Incentives

Looking now at the incentives in detail, we find that governments have, during the last two decades, developed quite a set of instruments. There are six groups: Contribution to fixed capital; contributions to working capital; refunds and contri-

butions to current expenses; premiums; tax exemptions and reductions; and transfer permissions.

☐ Certain governments are prepared to contribute to the fixed capital of a new enterprise by allocating government land at nominal or very low cost; by cash grants for the construction of factory premises or the purchase of equipment; or by long-term development credits for the same purpose, bearing nominal interest only. Land, cash grants and long-term credits will vary with the importance attached to the enterprise, with the zone in which it is situated, and with its export prospects. Together, they may amount to 50 to 70 p.c. of the fixed capital required. For small factories, some governments have built standard factory compounds leasing them at low rent.

☐ Certain governments may be prepared to contribute to the working capital of a new industrial enterprise. Such contribution may, however, be confined to new firms in development zones, to factories engaged in defense work, or to exporting industries. Such export industries may obtain "directed" credits through their banks, from special government funds, to be used for financing raw material supplies, local cost of production, and export credits.

Taking together contributions to fixed and working capital, a firm building a plant in a development zone and going to produce mainly for export markets may thus require only 15 to 25 p.c. of the capital it would otherwise have to put up. Other industrial conditions being satisfactory, such incentives should have investment appeal.

☐ One would, after this, not be surprised to learn that governments of developing countries bear part of the manufacturing cost of export products, e.g. part of the direct wages. We do not know of such cases, yet. There exist, however, some incentives aimed at reducing direct cost of production and overhead expenses of local industries so as to make them more competitive on export markets. The most common one is the refund of duties paid on equipment, raw materials and components used in manufacturing products for export (drawbacks). There are reductions on port fees and inland transport tariffs as well as lower rates for power and water. Some governments contribute to the cost of training new workers. Some pay up to 50 p.c. of the research- and development cost for new products provided they are intended for export. Certain governments try to stimulate marketing efforts abroad by participating in the cost of market research, of catalogues and advertising, and of fairs and exhibitions abroad, and are even prepared to subsidise overseas sales offices of exporting manufacturers, for a few years.

□ Most important, however, from the point of view of the manufacturer, are export premiums. And as export premiums are not allowed by GATT, they are bashfully termed "indirect local tax refunds". In many cases, such premiums enable the manufacturer to offer his products abroad at a competitive price even if his cost of production, at the official conversion rate of his currency, would not leave him a profit or even cause him a loss. Export premiums are calculated according to the "value added" of the product — in other words, in proportion to the share of local labour, local materials and local overhead expenses in the total cost of the product. The higher the "value added", the higher the premium added to the official conversion rate of the foreign currency earned. In terms of local currency, export premiums can be quite substantial and may, for the balance sheet of a manufacturer mainly engaged in export, make all the difference for the result on the profit and loss account.

□ There is hardly any developing country which does not grant fiscal benefits to new industries. As taxation systems vary widely, tax concessions differ, too, but there are certain standard incentives offered by the majority of developing countries: tax holidays available to new industries for a limited period; tax reductions for company profit and/or income tax; exemption from property tax; freedom from income tax for dividends paid to foreign shareholders; increased depreciation allowances. How effective tax incentives are is doubtful. Tax rebates and large depreciation allowances yield nothing unless (and before) the firm makes a profit. But if a firm is going to make a large profit, it does not really need assistance. Only naive investors may be attracted by tax exemptions. The seasoned investor, the multinational company in particular, will take tax reliefs for granted. Each developing country offers them. Investors may compare them but will not be decisively influenced by them.

□ More important to the foreign investor is the right to freely transfer profits and to re-transfer capital whenever he desires to do so. Not that this must necessarily be his aim from the beginning. He may be quite prepared to re-invest his profits and even to increase his share in the enterprise provided the firm develops favourably. But he wants to have the feeling that he is free to withdraw his profits and perhaps part of his capital, and to transfer them if he needs the funds more urgently somewhere else. It is here where the interests of governments and those of investors may clash. The transfer of profits and re-transfer of capital requires foreign exchange, and developing countries are usually short of foreign exchange. Also, governments want to see foreign concerns extending their investment and re-in-

vesting their profits, and this might not be in the interest of the foreign firm. In some developing countries, the attitude seems to be hardening, particularly in South America, while in others, transferability is still high on the list of incentives. There are even some who add to it a guarantee regarding convertibility, expropriation, war and extended risks.

### The Cost of Incentives

What about the cost of incentives? Let us take tax exemptions, tax reductions and increased depreciation allowances first. They deprive the State of an income which it otherwise might have had — or not have had, as without these incentives, the enterprise might not have come into existence and a taxable income might not have arisen. The same could be said of the permission to transfer profits.

It is a different matter with cash grants, government loans, training allowances or export premiums. Here, money has actually to be paid out, money which comes out of the development budget. Where do the funds for this budget come from? If they come out of taxes, import levies, duties, it means that the taxpayer has to fund the bill for industrial development and foreign exchange earning. He has either to pay higher taxes or he has to forego other services of the State. And the bill can be heavy. We know of one country where the total spent on export premiums alone would have amounted — if divided by the number of families — to 8 p.c. of the average income of a family head... would it have to come out of his pocket alone. Fortunately, some countries can draw on other resources. Not that untied loans from the World Bank (or regional development banks) could be used for such purpose. Those banks will grant specific loans to new industries if they qualify for their support. But some developing countries can draw on the receipts from private development bonds placed abroad, and on donations and contributions from sympathisers and expatriates which also have the advantage that governments can afford to lose some money if an enterprise has failed.

The question may be asked why governments if they have to sink substantial amounts of money into industry, do not acquire partial or total ownership so that they can influence or control the enterprises concerned. The answer is that there are developing countries who want, and countries who do not want, to run industries. The former will themselves decide to set up a plant or an industrial complex, try to obtain funds from the World Bank, engage advisors or enlist the minority participation of a qualified foreign firm

if absolutely necessary. But they will run the industry as a state-owned enterprise. They need not grant incentives. The other group feels that it is not the job of a State to run industries. States rarely have the qualities of an entrepreneur. They want private individuals or experienced corporations to perform the task. They grant incentives to attract them. They may decide to take over and to make a capital investment only if they cannot find a qualified investor-manager, local or foreign. They will consider their investment a temporary one and try to get rid of their shares as soon as an opportunity arises.

Besides, one should not assume that incentives do not confer influence. They do, to the government as well as to its functionaries. As we said before, conditions for incentives are usually laid down in an investment law and based on priorities expressing the present policy of government. Thus government in effect influences development of industry by incentive regulations. But such regulations must leave a lot to the discretion of the Minister concerned, or of his officials. Whether a new factory is situated in zone A or zone B is an objective fact. But whether an export commitment on the part of the investor is realistic will

require sound judgement on the part of the government official, and the fixing of the "value added" of the product will always be a bone of contention between government and manufacturer.

### **Distortion of Entrepreneurial Thinking**

Now this very fact that government policy in this field can partly be expressed in regulations only, that the extent of individual incentives has to be negotiated, and that decisions often depend on opinion and judgement of government officials, has led to a very serious aspect of the incentive system. I do not think of the role bribery could play although such should not be excluded in isolated cases. I rather think of the effect of incentives on the mentality of the industrial executive. While the manufacturer in a developed country concentrates on buying at a low price, selling at a good profit, constantly cutting down on cost by improving manufacturing methods, by employing improved tools, by designing better fixtures or shortening the flow through the workshops, and by developing new models or new products, the manufacturer in an incentive-infected milieu gets more and more accustomed to thinking about what subsidies he can ask for, what premiums he may be

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able to extract, what grants he can apply for. He will spend a lot of time on working out his own estimates, and even more in driving up to government, trying to convince officials and arguing in endless meetings. This means that not only valuable time is wasted by the fight for incentives but that the entrepreneurial thinking becomes distorted and real industrial thinking is pushed into the background. Incentives are the easier road to profits. They are the enemy of efficiency.

Some shrewd manufacturers will soon have found out that full refunds, generous grants and fat premiums bring in more than savings in production cost can earn them, ingeniously as they may have been devised. Cases are known where industrialists have so successfully learned to play on incentives and their combination that the very existence of an exporting industry is dependent on the enjoyment of multiple incentives, and that the firms would simply collapse if incentives were reduced or withdrawn. This is the seamy side of manipulated competition.

#### **A Temporary Measure Only**

Have incentives served their purpose, from the point of view of governments? Have they attracted investors with industrial experience in spite of shortcomings and handicaps of developing countries? The reply is that they have, but only in combination with other "comparative advantages": accessible raw materials; qualified, or inexpensive and docile, labour. In other words: incentives seem to compensate for the disadvantages resulting from their development status, of otherwise industrially interesting countries. To prove this statistically is difficult. Most developing countries show an increased share of industrial employment over the last two decades. With some who make generous use of incentives, the increase is higher. But who could deduce from the figures whether this is solely due to incentives or whether it is

due to the power of persuasion of the country's emissaries abroad, or to the realisation on the part of investors that the country has reached a stage where it is worthwhile to have a try.

The effect on exports is more obvious. Some countries have, over a comparatively short period, shown an astonishing increase of exports of certain manufactured goods. If one takes a closer look, one will find that it was preceded by a methodical employment of export incentives and accompanied by generous "indirect local tax refunds". The question is how the old industrial countries will look at this penetration of their home and foreign markets made possible by what they would certainly consider as unwarranted subsidies. Is this system perhaps a precursor of the New International Order demanded by the Third World?

There is one aspect of the incentives which should worry the developing countries themselves. If a government grants export premiums by adding to the official rate of exchange, it performs a devaluation of its own currency although a partial one valid at the moment only for exporters. But word of it will spread and the export premium may soon be the basis for black market rates for foreign currencies and for distrust in the value of the country's own money. Governments can disregard this aspect only if they are secretly convinced that their currency is anyhow overvalued. In that case, they may also take the view that incentives are a temporary measure only, that shortcomings and handicaps may disappear once the country has found its economic equilibrium, and that then, together with a more realistic rate of exchange, there will be no need for incentives any more. An enterprise will then be able to throw away the crutches and to stand on its own feet, or it will have to close down altogether having shown that it cannot stand up to the stress of normal competition.

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