

Incentives analysis for promoting regional development

Descriptive analysis

January 2008

Strictly Private & Confidential



A low-angle view of a colourful dragon-shaped kite against skyscrapers in the blue sky. The picture taking in the Centre District of China symbolizes balance, control, excellence and growth

## Purpose of the study

Invest in Iceland Agency is targeting various sectors to attract Foreign Direct Investment.

Iceland presently does not offer investment incentives for FDI, except for a number of industry and activity specific support schemes.

The purpose of the study: Obtain insight in investment incentives used as a vehicle by national and regional authorities to attract FDI, and in particular to increase the attractiveness of remote areas.

For this study, IIA has defined following locations subject to research:

- 1.Traditional Europe with a focus on emerged regions such as Ireland or Wales
- 2.Hungary (South), representing a benchmark for a remote area in the enlarged EU
- 3.Canada

## Incentives differ by locations

### European Union

Within the **EU framework**, the member states determine their own incentives programs but always subject to eligible costs and maximum ceilings as set by the EU Commission.

The EU framework is based on 2 overriding principles:

- Equal treatment within a region
- All European companies operate on a level-playing field

### Canada

In Canada there is **generic national legislation** on foreign investments.

The **NAFTA framework** of rules and disciplines provides investors with a predictable, rules-based investment climate, as well as with dispute settlement procedures. Nevertheless, this framework has much less limitation than the EU framework.

This leads to **less structured and transparent** incentives system. The eligibility is determined on an ad hoc basis and is more subject to **negotiations** than it is within the EU.

## Aid can vary in definition, form and objective

- 1 Aid has many definitions. Aid can be towards - regions
  - sectors
  - projects

Incentives (regional aid) exclusively relate to stimulation of new investments

- designed specifically to attract FDI
- logic = influencing the FDI decision as an instrument of regional development.

This analysis = incentives as applicable to corporate (foreign) investment

≠ "aid" relating to the improvement of national or regional infrastructure.

≠ "artificial market mechanisms" to protect a sector or an industry segment

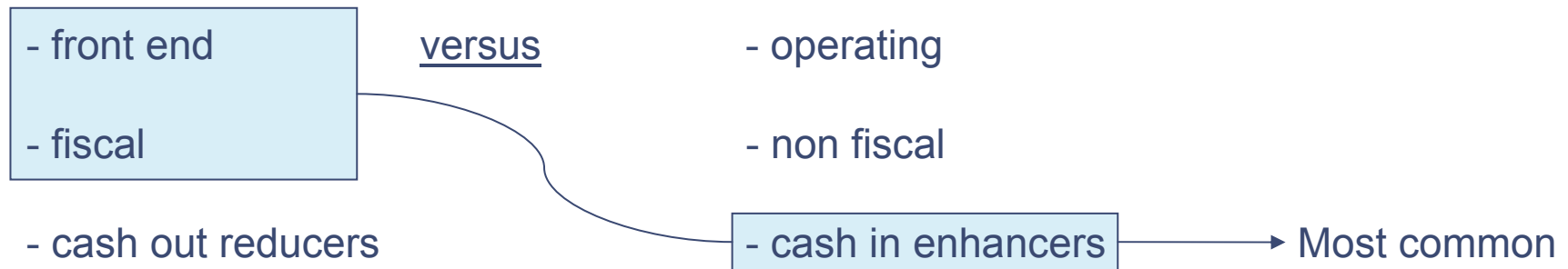
## Aid can vary in definition, form and objective

### 2 Incentives exist in numerous and various forms

- **grants**: cash, research, land cost reduction, employment, labour cost reduction, training
- **rate reductions**: interest, corporate tax, real estate tax, local tax, social security contributions
- **enhancements**: capital allowances, guarantees, infrastructure, loans
- **participations**

# Incentives are designed in different ways but with a common goal

## 3 Incentives can be categorized in several ways



## Incentives are designed in different ways but with a common goal

- 4 Incentives are - **regulated** by supra-national authorities: drivers, ceilings, allowed programs  
- **granted** by national, regional and local authorities.
- national design BUT **intensity is regionally inspired**

**Equal playing level field and avoidance of unfair competition is an adagio**

## Incentives are designed in different ways but with a common goal

5 National legislation (eg tax) - is not considered as regional aid

- has a major impact on investment decisions

## The value of incentives is often unclear

6 Incentive legislation and application is **complex**:

- **true value** not always obvious (not even the EU % of “Gross Grant Equivalent“)
- sometimes **taxed** or reducing the taxable basis for tax allowances
- mostly **capped** or mutually **exclusive**

The real value of incentives is defined by their **discounted cash flow impact**.

## The value of incentives is often unclear

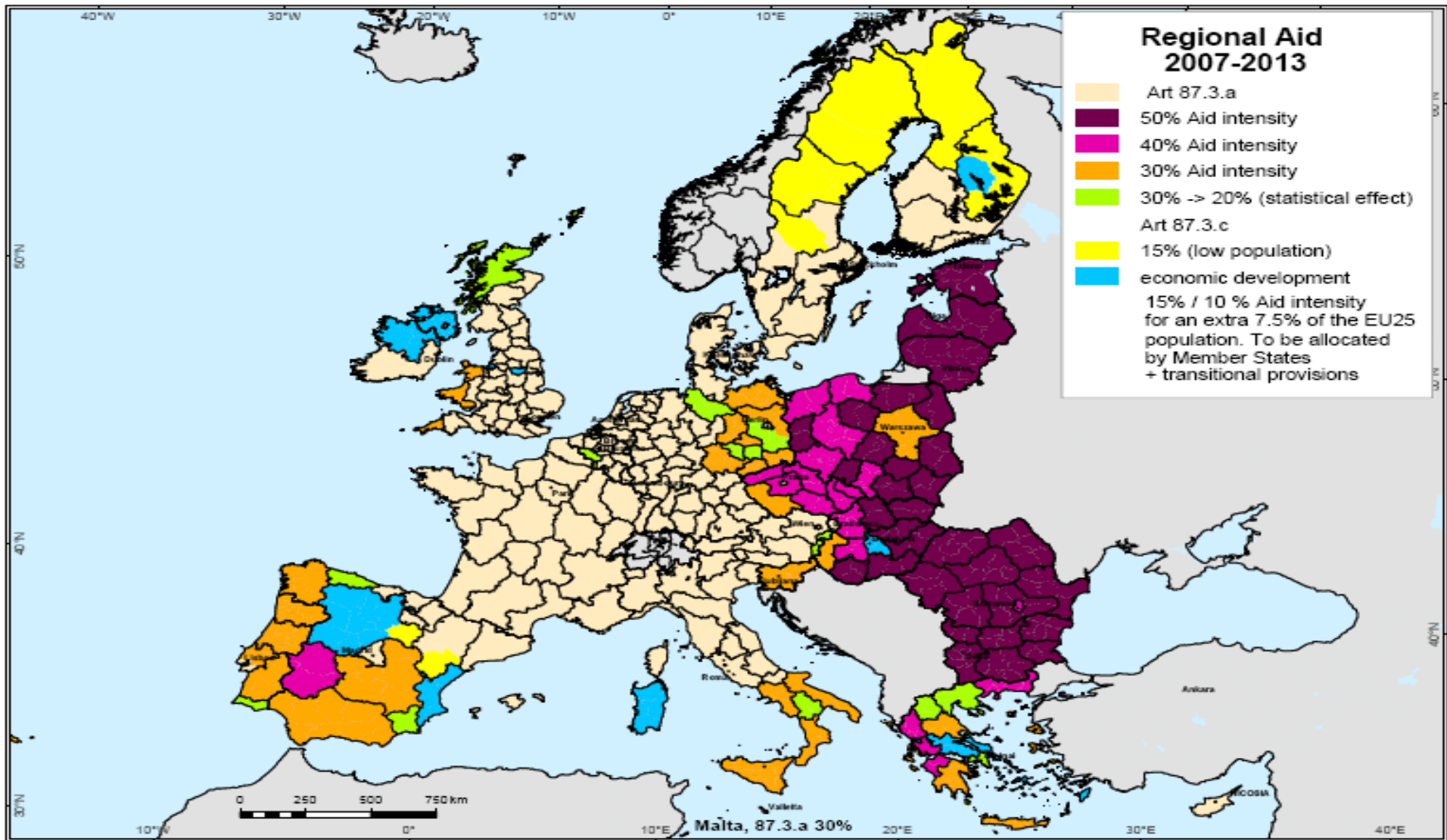
- 7 Most incentives
  - result in low absolute value
  - have a minor impact on the investment decision
- 8 Some incentives
  - result in high absolute value
  - have a minor impact on the investment decision
  - are a waste of tax payers' money
- 9 Good incentives
  - make the difference
  - have a major impact on the investment decision

## The value of incentives is highest in “underdeveloped” regions

### 10 E.U. “big packages“:

- granted in regions where GDP/capita are lowest versus EU25 average
  - i.e. new member states
  - i.e. Baltics, Bulgaria, Romania and others
- can equal 50% of GGE.

# The value of incentives is highest in “underdeveloped” regions



Based on EUROSTAT statistics of 7.4.2005 (GDP In PPS per Capita 2000-2002 Avg) / Cartography: DG COMP - G1 12/2005 / © EuroGeographics for the administrative boundaries

## The value of incentives is highest in “underdeveloped” regions

### 11 Old EU:

- mostly no relevant incentives allowed
- some regions still 10, 15%(or even 30%) of GGE

### 12 EU legislation = statutory

Canada = statutory + discretionary approach

## Incentives must bring wealth where needed

13 Main drivers of incentive package are:

- Location
- Employment
- Research content
- Fixed asset investment
- Size of the business
- Nature of the project
- Ecology
- Potential benefits for the economy
- Industry segment

## Incentives must bring wealth where needed

14 Vocation of incentives = to stimulate investments that bring **wealth** (high value added)

! 'value added' as such  $\neq$  driver of incentive packages!

Historic background: (direct) employment creation = major political driver



Historic reality: high labour cost level in western economies: no chance for success

strong knowledge base in western economies: not favoured (no budget left)

## Value of incentives depend upon the project

### 15 Impact of generic incentive packages ≈

- nature of the **investment** project



- capital intensive
- labour intensive
- know how intensive
- etc

- relationship of the elements of the **project definition**



- fixed asset investment
- employment
- research
- profit intensity
- etc

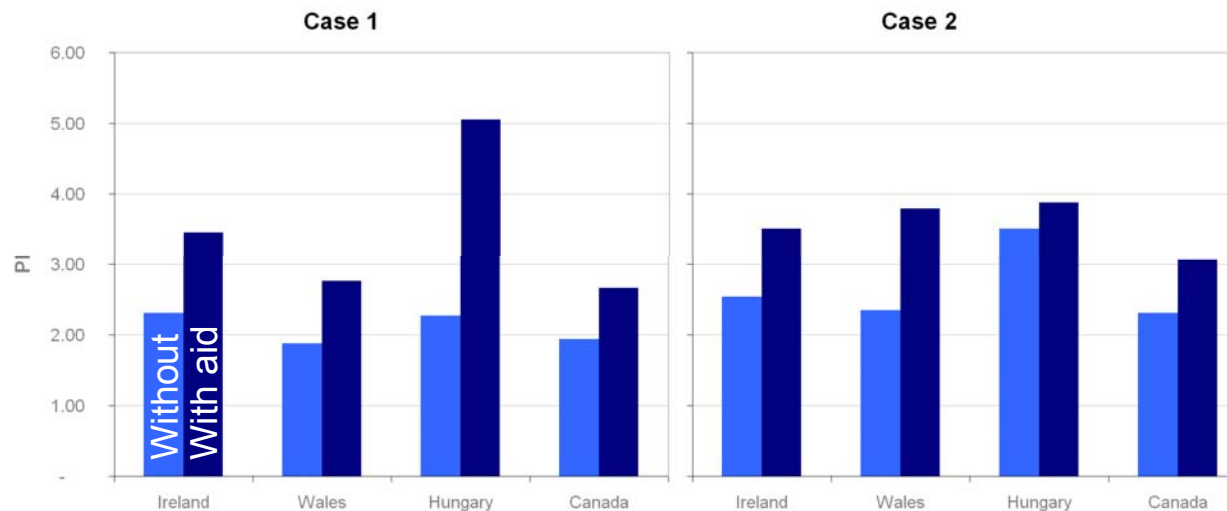
## Value of incentives depend upon the project

- 16 Cases illustrate - true impact of incentives
- real value (discounted impact on cash flow) are only indicative examples
  - differentiating impact of some packages

! Sample is not big enough and definitely not representative enough to draw conclusions!

Easy way to measure is impact on Profitability Index:

- sum of future discounted cash flows versus present net cash investment
- measures # times CAPEX is re-made over # of years of the project



# Value of incentives depend upon the project

	A	B	C	D	E	F	G	H	I	J	K	L	M	N	O	P	Q	R
1	<b>case 2</b>																	
2	<b>HUNGARY - with incentives</b>																	
3							Year 0	Year 1	Year 2	Year 3	Year 4	Year 5	Year 6	Year 7	Year 8	Year 9	Year 10	
4	EUR					2008	2009	2010	2011	2012	2013	2014	2015	2016	2017	2018	2019	
5						1	2	3	4	5	6	7	8	9	10	11	12	
6																		
7	<b>Capital Expenditures</b>																	
8	Site						731.826	-	-	-	-	-	-	-	-	-	-	-
9	Building						1.595.000	1.715.000	-	-	-	-	-	-	-	-	-	-
10	Equipment						927.960	231.990	1.159.950	-	-	-	-	-	-	-	-	-
11	<b>Total Capex</b>						<b>3.254.786</b>	<b>1.946.990</b>	<b>1.159.950</b>	<b>-</b>	<b>-</b>	<b>-</b>	<b>-</b>	<b>-</b>	<b>-</b>	<b>-</b>	<b>-</b>	<b>-</b>
12																		
13																		
14	<b>Incentives</b>																	
15	<i>Job creation subsidy</i>						4.000	196.000	196.000	244.000	-	-	-	-	-	-	-	-
16	<i>Training</i>							13.028										
17	<b>Total Incentives</b>						<b>4.000</b>	<b>209.028</b>	<b>196.000</b>	<b>244.000</b>	<b>-</b>	<b>-</b>	<b>-</b>	<b>-</b>	<b>-</b>	<b>-</b>	<b>-</b>	<b>-</b>
18																		
19																		
20	<b>Turnover</b>																	
21	Sales						-	9.777.580	15.959.590	24.530.620	35.719.810	35.719.810	35.719.810	35.719.810	35.719.810	35.719.810	35.719.810	35.719.810
22																		
23	<b>Operational Expenditures</b>																	
24	Raw material							3.754.814	7.772.467	13.342.734	20.614.521	20.614.521	20.614.521	20.614.521	20.614.521	20.614.521	20.614.521	20.614.521
25	Labour (weighted)							490.988	714.680	1.023.401	1.341.715	1.341.715	1.341.715	1.341.715	1.341.715	1.341.715	1.341.715	1.341.715
26	Power							16.658	16.658	33.317	33.317	33.317	33.317	33.317	33.317	33.317	33.317	33.317
27	Water							1.451	1.451	1,451	1,451	1,451	1,451	1,451	1,451	1,451	1,451	1,451
28	Gas							3.718	3.718	3.718	3.718	3.718	3.718	3.718	3.718	3.718	3.718	3.718
29	Transport							1.867.350	3.734.700	6.224.500	9.336.750	9.336.750	9.336.750	9.336.750	9.336.750	9.336.750	9.336.750	9.336.750
30	<b>Total Opex</b>						<b>-</b>	<b>6.134.980</b>	<b>12.243.674</b>	<b>20.629.121</b>	<b>31.331.472</b>	<b>31.331.472</b>	<b>31.331.472</b>	<b>31.331.472</b>	<b>31.331.472</b>	<b>31.331.472</b>	<b>31.331.472</b>	<b>31.331.472</b>
31																		
32																		
33																		
34	<b>Cash Flow Before Tax</b>						<b>-</b>	<b>(3.250.786)</b>	<b>1.904.638</b>	<b>2.751.966</b>	<b>4.145.499</b>	<b>4.388.338</b>	<b>4.388.338</b>	<b>4.388.338</b>	<b>4.388.338</b>	<b>4.388.338</b>	<b>4.388.338</b>	<b>4.388.338</b>
35																		
36	<b>Capital Allowance</b>																	
37	Building							-	331.000	331.000	331.000	331.000	331.000	331.000	331.000	331.000	331.000	331.000
38	Equipment							-	231.990	231.990	231.990	231.990	231.990	231.990	231.990	231.990	231.990	231.990
39	<b>Total Capital Allowance</b>						<b>-</b>	<b>-</b>	<b>562.990</b>	<b>562.990</b>	<b>562.990</b>	<b>562.990</b>	<b>562.990</b>	<b>562.990</b>	<b>562.990</b>	<b>562.990</b>	<b>562.990</b>	<b>562.990</b>
40																		
41																		
42																		
43	<b>Gross profit (with development tax allowa</b>						<b>-</b>	<b>-</b>	<b>2.972.638</b>	<b>3.032.926</b>	<b>3.218.509</b>	<b>3.705.348</b>	<b>3.705.348</b>	<b>3.705.348</b>	<b>3.705.348</b>	<b>3.705.348</b>	<b>3.705.348</b>	<b>3.705.348</b>
44																		
45																		
46	Corporate Income Tax						20,0%	20,0%	20,0%	20,0%	20,0%	20,0%	20,0%	20,0%	20,0%	20,0%	20,0%	20,0%
47																		
48	<b>Cash Flow After Tax</b>						<b>-</b>	<b>(3.250.786)</b>	<b>1.310.110</b>	<b>2.145.380</b>	<b>3.501.798</b>	<b>3.647.268</b>	<b>3.647.268</b>	<b>3.647.268</b>	<b>3.647.268</b>	<b>3.647.268</b>	<b>3.647.268</b>	<b>3.647.268</b>
49	<b>Discounted Cash Flow</b>						<b>-</b>	<b>(3.250.786)</b>	<b>1.191.009</b>	<b>1.773.042</b>	<b>2.630.952</b>	<b>2.491.133</b>	<b>2.264.667</b>	<b>2.058.788</b>	<b>1.871.625</b>	<b>1.701.478</b>	<b>1.546.798</b>	<b>1.406.180</b>
50																		
51	<b>NPV with incentives</b>																	
52	Rate							10%										
53																		
54	<b>Discounted CAPEX (with incentives)</b>						<b>-</b>	<b>3.250.786</b>	<b>1.579.965</b>	<b>796.653</b>	<b>(183.321)</b>	<b>-</b>	<b>-</b>	<b>-</b>	<b>-</b>	<b>-</b>	<b>-</b>	<b>-</b>
55	<b>PV CAPEX</b>						<b>(5.444.084)</b>											
56																		
57	<b>Discounted Cash Flow (excl CAPEX with in</b>						<b>-</b>	<b>-</b>	<b>2.770.975</b>	<b>2.569.695</b>	<b>2.447.631</b>	<b>2.491.133</b>	<b>2.264.667</b>	<b>2.058.788</b>	<b>1.871.625</b>	<b>1.701.478</b>	<b>1.546.798</b>	<b>1.406.180</b>
58	<b>PV DCF excl. CAPEX</b>						<b>21.128.970</b>											
59																		
60	<b>PI with incentives</b>																	
61	Rate							10%										
62																		
63																		

case 2 HU without incentives | case 2 HU with incentives | case 2 CA without incentives | case 2 CA with in

## National (tax) legislation can enhance incentives

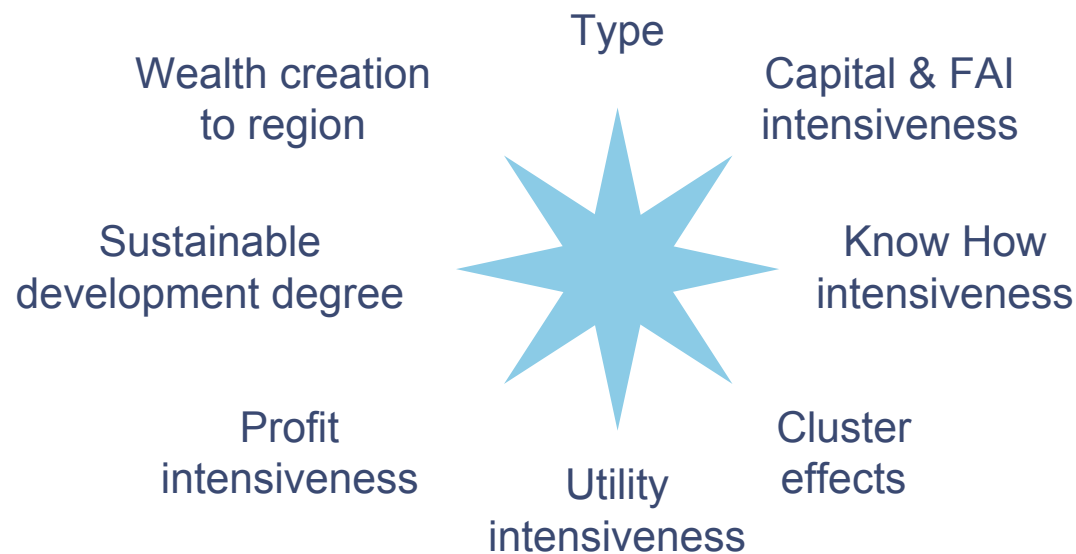
17 Deltas must be seen in combination with tax legislation and application

- Tax  $\neq$  regional incentive instrument  
= national cost component
- (incentive packages + tax) drive investment decisions

# Recommendations

Required actions to create relevant incentive packages for the regions in Iceland:

1. Define the type of investment targeted:



## Recommendations

Required actions to create relevant incentive packages for the regions in Iceland:

### 2. Define and test combinations of packages:

- cash grant
- training grants
- interest reductions
- research grants
- tax grants
- up front investment grants

## Recommendations

Required actions to create relevant incentive packages for the regions in Iceland:

3. Consider and test the packages in combination with existing or new (corporate) tax legislation:
  - testing and benchmark against national and international comparisons
  - test international legal acceptance of packages
  - define the budget impact, inclusive of ROI effects
  - define KPIs related to regional development targets