International Perspectives on Tax Incentives in Malaysia

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Presentation prepared for Malaysian Institute of Taxation National Tax Conference 2005 "An Effective Tax Regime, A Joint Responsibility" Putrajaya Convention Centre, Putrajaya, Malaysia, 9-10 August 2005.
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International Perspectives on Tax Incentives in Malaysia

My aim in this presentation is to provide some regional and international perspectives on the role of tax incentives in Malaysia. While I look at issues is as an economist rather than as a tax practitioner, I suspect that some of my findings and conclusions will resonate with those involved in the nitty-gritty details of tax administration and compliance.

My views are coloured by several factors. The first is my academic history during which I wore at least one hat as a public finance specialist. The second is my experience as a consultant and policy advisor, primarily to governments, on trade, fiscal and industrial policy issues. I have had the good fortune to work in Malaysia over an extended period of time from the mid-1980s until quite recently, and for an even longer time in Indonesia. Some of my most interesting and enjoyable work in this context was on the subject of tax incentives. I have also had the good fortune to work in a number of other countries in the immediate region, as well as further abroad, most recently in Africa, with considerable emphasis on South Africa, where your Prime Minister and Minister of Trade and Industry paid a visit just a couple of weeks ago.

My presentation will draw, of course, on some of my own work, but will also make use of some interesting and compelling work by others, including a former Harvard colleague from my days in Indonesia, and a team from McKinsey that has recently completed an in-depth study of the climate for foreign investment in developing and middle income countries.

Preview of Main Conclusions

Tax incentives are relatively unimportant to most investors; investors give greater weight to simplicity and stability in the tax system than they do to tax incentives.

The costs of incentives are high and generally non-transparent because of a variety of unintended effects. The costs include:

- revenue losses,
- a “race to the bottom” in tax policy through follow your neighbour policies,
- large subsidies that are either unnecessary, transferring money from tax payers to beneficiaries with no impact on investment, or result in wasteful use of investment and other resources through distortions of investment decisions,
- high administrative and/or compliance costs (another source of pure waste), and
- encouragement of rent-seeking and reduction of competition.

Playing the tax incentives game invites capture by particular industrial interests and diverts attention from more important issues in the investment environment.

In recognition of these facts, some countries are reducing their reliance on and streamlining tax incentives, paying more attention to simplifying their tax systems, and dealing more directly with underlying problems in the investment environment.

What is a Tax Incentive?

To understand their overall impact it is necessary to take a broad view of what constitutes a tax incentive, to include not only exemptions and special deductions from direct taxes, but also breaks from and/or a variety of special conditions with regard to the application of indirect taxes, including import duties. My own work in the early 1990s showed that indirect taxes had a much greater impact on investment incentives in Malaysia than did the much-more-discussed corporate tax incentives offered by the Government (Boadway, Chua and Flatters 1995b).

The Role of the Fiscal System

The main purpose of the tax system is to raise government revenues for public expenditure needs. An ideal tax system in this regard is one that is efficient, i.e. that imposes the smallest costs on the rest of the economy. An efficient tax system is one that is often described as being as neutral as possible in its effects on the allocation of investment and production in the economy. In general this requires relatively low marginal rates of taxation, especially on activities that are relatively elastic supply or demand, and a broad base.

A second desirable characteristic of a tax system is that it be equitable—that its burdens be distributed across income groups in a manner that fits with collective goals of fairness. There is much less agreement among economists and policy makers about the concept of equity than about efficiency, especially when taking account of patterns of lifetime earnings and of differences in equality of outcomes and equality of opportunities.

A third and quite distinct use of the tax system is to achieve certain regulatory goals such as discouraging socially undesirable activities whose costs are not fully captured in the market prices that motivate private decision makers, or to encourage desirable activities whose full benefits are not reflected by market prices. Positive and negative environmental impacts of private decisions are a classic case of such phenomena. The tax system certainly can play an important role here through instruments such as carbon taxes (although some countries have opted for an alternative market mechanism in the form of tradable carbon permits).

It is sometimes argued that the tax system can or should be used as an instrument to promote economic growth. Fundamentally, however, this is usually just some combination of the first and third uses described just above. Any tax system that discourages investment, whether in machines, new ideas and technologies or human capital will also stunt growth. This is one of the principal arguments for basing taxation on consumption rather than income. This can be done by increasing the importance of indirect taxation and lowering marginal income tax rates, and/or by adjusting income taxes to allow deductions or credits for savings in pension plans, provident funds, etc. If it is felt that certain types of activities generate significant growth externalities (such as R&D), then this becomes similar to the third argument—using the tax system as a regulatory device to correct for market failures. The problem here, of course, is to identify and reliably measure such externalities. As some of the examples below will show, tax policy can be seriously distorted by spurious claims about external benefits from the promotion of favoured "high-tech" type activities, and from investments by well-connected individuals and firms.

Indonesia[1]

Indonesia has been the site of two instructive and insufficiently recognized "experiments" in the use of tax incentives.

The first was in 1984 when, as part of a comprehensive tax reform, all tax holidays were abolished and replaced by what was advertised as a stable, predictable corporate tax regime with substantially reduced rates. The previous system of tax holidays was not dissimilar to Malaysia's. Applications were reviewed with respect to the economic benefits the investments might provide to the economy, as measured by certain criteria such as whether they were in a "priority sector",

[1] The material in this section is based on my own experience as a fiscal and trade policy advisor in Indonesia in the 1980s and 1990s, and on a recent paper by two of my Harvard colleagues during that period (Wells and Allen 2001).

their size, their riskiness, and their contribution to foreign exchange earnings or savings. *Ex post* analysis conducted as part of the tax reform exercise, however, showed that the screening process was not particularly successful. Economically beneficial investments were often rejected for tax holiday status, and wasteful investments were often accepted. The combination of tax incentives and capacity licensing led to further waste and reduced domestic competition. This was a reflection of both the weakness of the criteria and inherent difficulties for public sector investment boards in making such judgements.

Nevertheless, the repeal of all tax holidays was viewed with great scepticism and there were many forecasts of a collapse of foreign and domestic investment that would follow. In fact, both foreign and domestic investment grew at more or less the same, if not a slightly higher rate in the decade following the elimination of tax holidays as it had previously. Of even greater significance from a regional perspective is that over this decade Indonesia's share of foreign investment into ASEAN doubled, despite the fact that Indonesia's ASEAN neighbours continued to offer generous tax holidays.

The tax reform was one part of a larger program of fiscal, regulatory and trade policy reform aimed at reducing regulatory burdens and fiscal and other distortions on investment and production decisions. The streamlined fiscal and regulatory environment evidently was far more important to investors than the loss of tax holidays.

Despite the evidence of the success of the new tax and regulatory regime, there was constant pressure from self-interested parties for the re-institution of tax incentives. A slow-down in investment in the mid-1990s, together with increased influence of certain parties in favour of "high tech" investments and with close connections to the senior leadership of the country, provided an opportunity. In 1996 a new tax incentive law was passed, introducing a regime that was much different from the pre-1984 system. Under the new law, incentives were to be fully discretionary and were to be confined to key sectors to be defined by the government. This at least theoretically made it possible to ensure that incentives were granted only if they were necessary and if they truly met some pressing social or economic needs. The new priority sectors were never made public. The implementing team never met. Nevertheless, the law was used by the President to grant incentives to six projects, four of which were domestically owned and very closely linked to his own family.

South Africa[2]

South Africa is a resource-based economy that has undergone considerable structural adjustment over the past decade as it has opened up to the global economy after years of isolation under Apartheid and its own protectionist policies and traditions of heavy regulation. As in many other countries, policy-makers faced conflicting pressures on the use of investment incentives. Advocates of activist investment promotion advocated the use of fiscal incentives to encourage investment and channel it into what were deemed to be priority sectors and regions. The policy environment has also been flavoured by the desire to redress the balance of economic power in favour of previously disadvantaged individuals through various Black Economic Empowerment (BEE) measures.

An early attempt at investment incentives came in the form of some schemes to promote investment in poorer regions of the country. They were eventually judged to have been a failure by almost all concerned. They did very little, if anything, to stimulate additional investment in the

[2] This section is based primarily on the author's own work as an advisor to regional organizations and governments in southern Africa and most recently to National Treasury in South Africa.

target regions, they were a significant drain on the Treasury, and they were subject to considerable abuse. The programs were eventually discontinued. This experience is not very different from that of many other countries, developed and developing.

Undeterred by this failure, the Department of Trade and Industry (DTI) pushed to launch another tax incentive scheme under which it would have the power to grant investment tax credits/allowances in respect of investments in strategic industries, as judged by the Minister of the DTI. Unable to block the initiative, National Treasury insisted that the Minister not be given a blank cheque for this purpose, but rather that there be overall limits on the period of the program (four years from its commencement in 2001) and its budget, and that applications be judged on the basis of a number of criteria including project size, employment creation, industrial linkages, (lack of) displacement of existing production, etc. Applications for benefits under this Strategic Investment Program (SIP) were allocated points based on whether they

- produced a new product in South Africa,
- filled a domestic "cluster gap,"
- incorporated a high level of value-added,
- procured from SMMEs,
- provided publicly available infrastructure, and
- met direct and indirect job creation targets measured as a proportion of the amount invested.

The number of points awarded determined the size of the resulting tax allowance, ranging from 50 to 100 percent of the qualifying investment.

The SIP is now coming to an end, and the DTI is arguing strongly for an extension of its time and budget. The program has not yet been seriously evaluated, but even a cursory review of supported projects raises many questions. Despite careful analysis of the sustainability of the investments, a number of them never got off the ground, and others that did start up have already failed. A significant number of other approved projects are in protected, non-competitive upstream industries whose need for the incentives is uncertain, and whose domestic pricing has become a barrier to the development of a wide range of downstream industries. The claims about job benefits, especially indirect employment creation are difficult to verify and almost certainly exaggerated. As with the earlier failed regional incentive schemes, there appear to be serious questions about the economic value of the SIP.

South Africa has not confined itself to the income tax in designing investment incentives. In order to ease the adjustment of the motor industry to a less protected environment, the DTI introduced a Motor Industry Development Program (MIDP) in 1995.[3] The motor industry had been one of South Africa's most heavily protected and regulated industries. Protected by tariffs in excess of 100 percent and burdened by local content requirements, the industry produced a wide range of products at low scales of output and high cost. It would not (and should not) have been able to survive in that form under post-Apartheid trade policies.

The MIDP was designed to help the industry adjust and become competitive in this new environment. It comprised three principal elements:

- a gradual reduction in import duties on both vehicles and components,

[3] For more information on and analysis of MIDP see Flatters 2002 and 2003.

- an export-import complementation scheme under which vehicle and components exporters can earn tradable "Import Rebate Credit Certificates" (IRCCs) that can be used to offset duties on imported vehicles and components, and
- a duty free allowance on imported components of 27 percent of the value of vehicles produced for the domestic market.

The MIDP has had several internal reviews and has been extended twice. It now is scheduled to continue until 2012. It has been expanded to include a direct investment subsidy in the form a "Productive Asset Allowance" (PAA) that provides import duty credits equal to 20 percent of the value of qualifying investments. The industry benefits as well from a wide variety of other initiatives by national, provincial and local governments, ranging from restrictions on import of used cars to provision of infrastructure, factory facilities and special financial arrangements.

Since the program commenced, the industry has witnessed high levels of investment, increased imports of both vehicles and components and rapid growth of exports of vehicles and selected components (primarily catalytic converters and leather seat covers). On the basis of this investment and export performance, the program is widely viewed as a major success of recent industrial policy.

This assessment, and those who promote it suffer from a lack of understanding of the subtle ways in which the incentives work and therefore of the nature and magnitude of their costs. The program is essentially a disguised export subsidy paid in the first instance by the South African Treasury, and ultimately by South African vehicle consumers who pay substantially higher prices than necessary and suffer from restricted choice, especially in budget vehicles, in order to subsidize automobile and components exports. Recent estimates have revealed the magnitude of the subsidies being provided. See the following table.

MIDP Subsidies to Several Typical Investments

Investment	Subsidy Provided (% of Amount Invested)
Automobile Assembly, 1996	494%
Automobile Assembly, 2005	269%
Components Production, 1996	681%
Components Production, 2005	264%

Source: Author's estimates.

What have been the effects and the costs of these subsidies? With subsidies of this magnitude, there should be little question as to why South Africa has attracted considerable investment. And since the subsidies are largely contingent on exports, there should be even less surprise that exports have boomed.

What about the costs? For investments that would be competitive in the absence of MIDP, the subsidy is a pure rent—a transfer from South African consumers and taxpayers to the firms' shareholders. To the extent that the shareholders are foreign, this is net economic cost to South Africa. At the other extreme, for investments that are just able to earn a normal rate of return in the presence of MIDP, the subsidy represents pure economic waste—the transfer from consumers just covers the excess costs of producing in South Africa rather than elsewhere. Recent statements by senior industry stakeholders suggest that they would not continue to invest and produce in

South Africa without the subsidies, suggesting that the pure economic waste interpretation is closer to the truth. Nevertheless, almost all senior economic policy makers continue to trumpet the success of the program, pledge continued support to this sector, and announce their intent to use the MIDP as a model for other sectors.

Other Cases

There is a large and growing body of similar stories and evidence from many other countries. A recent McKinsey study reports on 14 exhaustive case studies in Brazil, China, India and Mexico, concentrating on the role of tax incentives and government regulation. They find that "the incentives used to attract foreign direct investment … are largely ineffective. Worse, they are frequently counterproductive, costing governments millions of dollars annually, protecting inefficient players, and lowering living standards and productivity" (McKinsey 2004).

Countries that got "hooked" on investment incentives got drawn into costly incentive spirals, providing incentives that often are unnecessary and when they were necessary, promoted inefficient and non-competitive investments. India continues to give unnecessary tax holidays worth $2,000 to $6,000 per worker to business-processing and IT investments. In the mid-1980s Brazil gave tax concessions that began at $50,000 to $94,000 per employee in the auto industry and quickly escalated to over $300,000 per worker, with the principal result that Brazil became saddled with an industry with high costs and enormous surplus capacity.

In their surveys of investment decision-makers McKinsey confirmed the findings of many other studies showing that investment incentives are among the least important factors for firms making strategic investment decisions. Their evidence shows, on the other hand, that investors are quite happy to accept investment incentives when they are offered, and that many companies appear to have become quite skilled at pleading for them. This is supported by a recent OECD study (Oman 2000) that finds that the auto sector, for instance has been very effective at "incentive shopping". This is consistent with the evidence from South Africa and some of the McKinsey case studies.

The Costs of Tax Incentives

The most obvious cost of tax incentives is foregone tax revenue.[4] What is missed in most discussions, however, is the fact this cost is considerable greater than the amount of the foregone revenue. To replace foregone revenues, it is necessary to raise tax rates somewhere else. Since the economic and administrative costs of most taxes generally increase with the square of the tax rate, the cost of foregone revenue is much larger than the amount of revenue foregone.

The administrative and compliance costs of most tax incentives are high. This is especially true of discretionary and tailor-made incentives, or when eligibility depends on meeting various conditions. While the administrative and compliance costs of many incentives can be reduced, this often comes at the expense of granting unnecessary incentives and/or encouraging abuse.

The existence of discretionary tax incentives encourages rent seeking. When incentives are large, the rate of return to investing entrepreneurial resources in obtaining, maintaining and increasing tax incentives can be much higher than investments in new products, cost reductions and marketing. Such rent seeking can be highly profitable to the firm, but is economically wasteful from the perspective of the national interest.

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[4] In the case of indirect taxes, the costs are often borne in the form of higher prices. The main value of an exemption from an import duty or an excise tax for a particular firm or product derives from the fact that other firms and products have to continue paying the tax or duty.

Tax incentives can have large and unintended impacts on investment decisions that are economically costly and have no obvious relationship to social or economic policy goals. The value of an income tax incentive depends in a complex way on the characteristics of individual investments, ranging from the method of finance to the gestation period and life span of the investment and time pattern of eventual earnings (see Boadway, Chua and Flatters 1995a and 1995b for the case of Malaysia). The differences in the values of incentives to different investments can have a profound impact on investment decisions. The complexity of the impact of tax incentives means that it is virtually impossible to achieve either broad neutrality or any particular economic goal. The distortionary impact of indirect tax incentives can be even larger than for direct taxes. This was certainly the case in Malaysia, at least in the early 1990s (see Boadway, Chua and Flatters 1995b).

Among the frequent unintended biases imparted to investment decisions by commonly used income tax incentives are those in favour of capital intensive projects, in favour of large projects and large established companies, against small and start-up investments and against employment creating investments (see Boadway, Flatters and Wen 1996 for the case of Thailand).

Lest there be any doubt about the economic waste that can be encouraged by investment incentives, consider the case of the South African MIDP discussed above. If the auto producers are correct in saying that their recent investments would not be viable in the absence of the incentives, a privately profitable investment of R200 million in the mid 1990s imposed an economic cost of R500 to R700 million on the South African economy—two and half to three and half times the size of the investment being promoted. Looked at another way, every BMW exported to Europe or America for $30,000 as a result of such an investment actually used up South African resources worth about $50,000, with the difference made up in the form of subsidies by South African taxpayers and consumers.

Measuring the success of investment incentives simply by the size of the investments that ensued is highly misleading.

The final cost of tax incentives is that they can distract policy makers and private sector stakeholders from tackling more important issues in the investment environment. Almost all investor surveys show that other issues are much more important than tax incentives.

Why Do Tax Incentives Continue?

There is a large body of evidence that tax incentives have little effect, if any, in attracting new and especially good new investments. The costs of incentives are high. Why do governments continue to offer them? There are several contributing factors.

Rent Seeking: Just as with import protection for domestic industries, tax incentives are costly, and yet governments continue to use them and are reluctant to “give up” this self-destructive tool when negotiating with others. A large part of the reason lies in rent seeking by a relatively narrow but well organized group of beneficiaries. Regardless of whether incentives are necessary, firms will happily seek and accept them if they are available. As observed earlier, certain industries have become quite effective in this game. When incentives become entrenched, new industries of “incentive advisors” develop and become a new source of rent seeking. While the benefits might be large and concentrated, the costs of tax incentives are spread over a much broader and more dispersed group of stakeholders—taxpayers and consumers.

Hidden Costs: Not only are the costs of tax incentives widely dispersed, they are also largely hidden and often unknown. The economic waste of inefficient and non-competitive investments that are made possible through tax incentives is not well understood. Despite its great costs, the

MIDP in South Africa is generally touted as the country's greatest industrial policy success since the end of Apartheid. The designers of the program have never attempted to assess the financial value of the incentives being provided, and even economists and policy makers who should know better have no idea of the economic costs of the program. The complexity of the impact of both direct and indirect tax incentives makes them very difficult to understand.

An Easy Policy: Countries around the world are becoming aware of the importance of creating a market friendly investment environment. Surveys and studies by international agencies (World Bank, Foreign Investment Advisory Service), accounting and management consulting companies and governments themselves are helping countries to understand the nature of the problems—inadequate infrastructure, high costs of public services, red tape, regulation of investment, labour and other markets, and corruption. The challenges are formidable, but the ability to deal with them is often weak. Pressed with the need to be seen to be doing something, one of the easiest things to do is to amend the tax laws to introduce new fiscal incentives. Passing an amendment to a tax law and granting new incentives under it is certainly much easier than reforming an entire regulatory environment, dealing with state and private monopolies and reducing red tape and corruption.

Institutional Imperatives: Not only are investment incentives relatively easy to pass, they are generally implemented by an agency (some kind of investment board) that is not responsible for the foregone revenues and that wishes to be seen to be doing something to increase investment. With an incentive regime in place, an investment board has a mission, to negotiate with potential investors. Each incentive granted is an accomplishment, regardless of the economic value of the investment created. South Africa's DTI is pleading for an extension of its Strategic Investment Program regardless of its economic value, because the budgetary costs are borne elsewhere and they need to be seen to be doing something. Overseas representatives of global companies also need to be seen to be doing something. Successful negotiations with investment boards are an obvious achievement to be reported to company headquarters regardless of whether this is actually a key issue in making an investment.

Keeping up with the Neighbours: Governments are excessively concerned with "keeping with the neighbours" in provision of tax incentives. This is easy to understand. An obvious ploy used by companies seeking investment incentives is to find a comparator country that offers "better" incentives than the one in question. The same is true of any investment board wanting to persuade the Treasury or the Prime Minister that the agency's arsenal needs to be improved. South Africa's MIDP was modelled initially after a program in Australia (although with higher tariff and subsidy rates). With the program nearing the end of its second phase, and recognizing that in the corresponding phase the Australian government phased down its tariff rate to 5 percent (the South African rate will be 25 percent at the same stage), the auto industry, with the connivance of the DTI has conveniently forgotten the Australian model and is looking to India, Brazil and other countries that give much higher rates of assistance. Regardless of the evidence that incentives are costly and of little economic value, governments and international management consultants continue to produce tables of comparative tax incentives to assist governments in their investment policy making. Academics are not immune. A recent study of the comparative impacts of tax incentive regimes in ASEAN conveniently left out Indonesia. The "problem" was that Indonesia provided no income tax incentives over the period in question and yet its investment performance completely outshone that of its ASEAN neighbours (Chia and Whalley 1996).

Lessons

I conclude with a brief summary of some key lessons.

- Tax incentives are not among the key factors in most investment decisions, especially for "good" investments. Nevertheless most investors will be happy to receive them, especially generous ones.
- The costs of investment incentives are not transparent, and are often large. An evaluation of any tax incentive requires a careful examination of these costs.
- The indirect tax system, including excises, sales taxes, import duties and preferential trading arrangements can be a very important and costly source of tax incentives.
- Tax incentives should be made as transparent as possible. As a first step all tax incentives should be included and quantified as tax expenditures annual government budgets. A review of the economic benefits and costs of all incentive programs, especially the most "successful" ones, should be part of the medium term budget cycle.
- The investment environment in almost all countries is plagued by much more important problems than the tax system. Tax incentives should not be a substitute for dealing with the real problems.
- As for the fiscal system, the best tax incentive of all is a stable regime with low rates and minimal use of exemptions, special provisions and other inducements. Simplicity and predictability are the keys. These also happen to be the main requirements for the tax system to best fulfil its primary revenue-raising function, i.e. to be an effective tax regime.

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