FOREIGN DIRECT INVESTMENT INCENTIVES

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Abstract: The aim of this paper is to examine whether international investment incentives can be justified on the host country effects of foreign direct investments. In particular, we discuss whether the externalities from the operations of foreign multinational corporations are strong and systematic enough to justify subsidizing foreign investment with various fiscal and financial incentives. We also discuss some alternative policy measures available for governments to benefit from inward foreign investment

Based on the current knowledge of spillovers, we try to see whether investment incentives can be justified or not, and discusses the design of incentive policies.

Key words: foreign direct investment, incentives, multinational corporations

As most countries have liberalized their policies to attract investments from **foreign multinational corporations** an increasing number of host governments provide various forms of investment incentives to encourage foreign owned companies to invest in their countries. These include fiscal incentives such as tax holidays and lower taxes for foreign investors, financial incentives such as grants and preferential loans to multinational corporations, as well as measures like market preferences, infrastructure, and sometimes even monopoly rights.

There are some explanation about the increasing interest for investments like low growth rates and rising unemployment but it appears that the globalization and regionalization of the international economy have made foreign direct investments incentives more interesting and important for national governments.

Even a small country may now compete for foreign direct investments, given that it can provide a sufficiently attractive incentive package. At the same time, national decision – makers have lost many of the instruments traditionally used to promote local competitiveness, employment and welfare

The scope for active trade policy has diminished as a result of successful trade liberalization, and the internationalization of capital markets has limited the possibilities to use exchange rate policy as a tool to influence relative competitiveness.

Most clearly, this has been seen in **Europe**, where the Single Market program has shifted the responsibility for trade and exchange rate policies from national governments to the European Commission and the European Central Bank. Even so, national decision – makers continues to promote their competitiveness and welfare using those policy instruments that remain at their disposal, including foreign direct investments incentives.

In order to compete successfully in a foreign market a firm must possess some ownership-specific assets in knowledge, technology, organization, management, or marketing skills. Such firm has several alternative ways to claim the rents that they will yield in foreign markets, including subsidiary production, joint ventures, licensing, franchising, management contracts, marketing contracts, and turnkey contracts. Of these, subsidiary production and joint ventures involve varying degrees of foreign presence, and force the firm to decide where to locate their foreign activity.

In the past, the view was that multi national corporations are mainly attracted by strong economies based on market size and the level of real income, with skill levels in the host economy, the availability of infrastructure and other resources that facilitate efficient specialization of production, trade policies, and political and macroeconomic stability. Foreign direct investments was market seeking. Foreign investors seeking an export base were less focused on local market size and more concerned about relative cost of production, while investment incentives were seen as relatively minor determinants of foreign direct investment decisions.

In recent years the view of the importance of incentives begins to change and one indication is the proliferation of investment incentives across the world. Very few countries compete for foreign investments without any form of subsidies today. With the exception of export processing zones and industrial estates, where infrastructure and land are subsidized, developing countries are more likely to base their incentive schemes on tax holidays and other fiscal measures that do not require direct payments of scarce public funds. Direct financial subsidies are likely to have their main influence on the location decision itself, while tax holidays may well effect operational decisions for several years.

Recent econometric studies on the effects of foreign direct investments incentives, in particular fiscal preferences, suggest that they have become more significant determinants of international direct investment flows in spite of that most foreign direct investment incentives apply in particular to greenfield investments rather than foreign acquisition of existing companies.

The main reason for that is the internalization of world economy. Global trade liberalization has made easier for multi national corporations to set up international production networks, so that a larger share of output is shipped to international customers or affiliated companies in other countries rather than sold to local customers. This has reduced the impact of market size and allowed smaller countries to compete for investments that would automatically have been directed to the major markets in the past.

Regional integration has similar effects, allowing multi national corporations to supply all or several member states from a single location within the region. Incentives have also become increasingly important for national policymakers who are trying to promote local production, employment and welfare. The scope for active national trade and exchange rate policy has diminished, most clearly for present and potential European Union members, who are largely bound by decisions taken by the European Union Commission and the European Central Bank, and shifted attention to industrial policy, including measures such as investment incentives.

As a result, the incentives provided by many countries have become more generous over the years. Considering that market integration has reached further at the regional rather than global level, it is also clear that the effects of incentives are likely to be particularly strong in the competition for foreign direct investment within regions, when the initial investment decision has been taken and the investor is choosing between alternative locations in a given region.

The problem is that investment incentives are or are not likely to yield benefits that are at least as large as the costs and if those costs are justified.

Even if the foreign multi national corporation do not differ in any fundamental way from local firms, the costs of the initial investment incentive could arguably be recouped over time as the economy grows thanks to the foreign direct investment inflows. However, there are at least **two arguments** against this type of incentives. It is difficult to make reliable calculations about the expected future benefits in terms of growth, employment, or tax revenue, which is necessary to determine how large the subsidies should be. This is particularly complex in cases where foreign direct investments projects that are driven by investment incentives rather than economic fundamentals of the host country.

The reason is that these investors are likely to be relatively footloose, and could easily decide to move on to other locations offering even more generous incentives before the expected benefits in the first location have been realized.

Furthermore if foreign investors do not differ in any fundamental way from local investors subsidizing foreign direct investments may distort competition and generate significant losses among local firms.

Thus, it is hard to justify investment incentives focusing on foreign multi national corporations that do not differ fundamentally from local companies. At the same time, it should be noted that this conclusion does not rule out public policy intervention in the form of investment subsidies in situations where unemployment, insufficient investment, or weak growth are central policy problems. Instead, the policy prescription is that the problems should be addressed with policies that do not differentiate between foreign and local investors.

In the **more realistic case** where conditions for foreign firms differ from those for local firms, it is easier to motivate foreign direct investments incentives with the argument that there may be some distortion or market failure that is specific to multi national corporation production. The most obvious distortions occur if rules and regulations are biased against foreign owners. In such cases foreign direct investment incentives may well be needed to overcome the various obstacles faced by foreign investors.

Supposing there is no formal discrimination of foreign owners, controlling for this, the most common source of market failure is related to externalities or spillovers of foreign direct investment.

A firm must possess some asset in the form of knowledge of a public-good character to be able to compete in foreign markets.

If the multinational corporation cannot capture all quasi-rents due to its productive activities in the host economy, or if the affiliate increases the competitive pressure and removes distortions, the host country’s private sector can gain indirectly when productivity spills over to locally owned firms. Thus, when markets fail to reflect the social benefits of the foreign direct investment, government action can be justified to bridge the gap between social and private return for foreign direct investment projects that create positive spillovers.

The increase in competitiveness may attract further foreign investors into the country, raising national income and welfare. This motivates the host country to subsidize foreign direct investment, in competition with other host countries that see the same potential gains. Differences in country size, production costs and expected gains from foreign direct investments inflows influence each country's optimal incentive scheme.

The equilibrium distribution of foreign direct investments between countries with subsidies may well be significantly different from that without subsidies even in a perfect information setting, where each country implements its optimal incentive scheme. Foreign direct investment incentives can be expected to have a significant impact on the pattern of international investment.

Although the rationale for subsidizing inward foreign direct investments is to correct the failure of markets to reflect spillover benefits, it should be noted that neither policy making nor formal theory have focused much effort on matching the size of subsidies to the amount of expected spillover benefits. Instead, it is assumed that the spillover benefits are sufficiently large to justify investment incentives. In other words, few commentators have assessed the empirical evidence regarding spillovers in connection with this particular policy debate.

Based on the argument that foreign firms can promote economic development and growth, many countries have introduced **various investment incentives** to encourage foreign multi national corporations to invest in their market. Such incentives can mainly be justified if the foreign firms differ from local companies in that they possess some firm specific intangible asset that can spill over to local firms. In that case, the foreign investor's private benefits are lower than the social benefits and total foreign investment will fall short of the optimal amount unless various investment incentives compensate the foreign investor.

There are good reasons to remain cautious in granting incentives focusing exclusively on foreign investors. It is not easy to determine where and how spillovers will occur.

It is also difficult to calculate the value of these externalities, which is important, since national welfare will increase only if the investment incentive is smaller than the value of externality. If the subsidies are larger than what is motivated by the externalities, the host country will not only lose public revenue, but the incentives will also discriminate against local firms that may lose jobs and market shares.

Competition among governments to attract foreign direct investments may create problems. When most governments compete actively for foreign direct investments, it is difficult for any individual country to stay out of bidding contests, which effectively shift profits from the host country to multinational enterprises.

One reason is of course that strong promotion efforts show that the government is actively doing something to strengthen employment, productivity, growth, or some other policy objective.

Another reason is that some of the perceived benefits are easily observable while some of the costs are distributed over long periods of time and hard to measure. Consequently, there is a tendency to overbid and the subsidies may very well surpass the level of spillover benefits, with welfare losses as a result.

In the same way as investment incentives may be politically attractive in the short run, but costly in the long run, protectionism may also promote local employment and production in the short run at a high long run cost.

In the trade area, the path away from beggar-thy-neighbour policies has been multilateral negotiations where trade liberalization is coordinated across countries. It is clear than similar solutions would be first best also in foreign direct investment policy, in particular at the regional level. However, although several multilateral agreements include clauses on incentives and investment rules, their coverage remains limited.

In the European Union, investment incentives are in principle restricted to areas qualifying for regional assistance.

In the absence of multilateral agreements on investment, it is therefore likely that many countries will continue subsidizing foreign direct investments.

The potential for spillovers is not likely to be realized unless local firms have the ability and motivation to learn from foreign multinational corporations and to invest in new technology. Consequently, investment incentives aiming to increase the potential for spillovers may be inefficient unless they are complemented with measures to improve the local learning capability and to maintain a competitive local business environment.

This suggests first and foremost that the incentives should be rules-based and available on equal terms to all investors irrespective of industry and nationality of investor, rather than based on discretionary decisions.

The motive for supporting foreign investors, including existing investors that may consider expanding their activities, is to equalize social and private returns to investment. But there is a difference between social and private returns only if local firms are actually able to absorb some of the potential spill over benefits, and this does not occur automatically. Hence, to justify foreign direct investment incentives, there is a reason to simultaneously subsidize local firms to strengthen their capacity to absorb foreign technology and skills.

Governments should also consider their efforts to modernize infrastructure, raise the level of education and labour skills, and improve the overall business climate as parts of their investment promotion policy. These are important components of the economic fundamentals that determine the location of foreign direct investments. In addition to attracting foreign direct investments and facilitating the realization of spillovers, these policies will also promote growth and development of local industry. This, after all, is one of the ultimate goals of government intervention in general.

Foreign direct investment can play an important role in raising a country's technological level, creating new employment and promoting economic growth.

Many countries are therefore actively trying to attract foreign investors in order to promote their economic development, particularly at times when the country's domestic growth prospects appear weak. However, designing efficient incentive programs is complicated task, and the competition between host governments trying to attract foreign direct investments is likely to complicate the task further, as it tends to shift profits and welfare from the host countries to foreign multinationals.

Many countries will continue using foreign direct investments incentives as important policy tools.

The use of investment incentives focusing exclusively on foreign firms is generally not an efficient way to raise national welfare.

The main reason is that the strongest theoretical motive for financial subsidies to inward foreign direct investment – spillovers of foreign technology and skills to local industry – is not an automatic consequence of foreign investment.

The potential spillover benefits are realized only if local firms have the ability and motivation to invest in absorbing foreign technologies and skills.

To motivate subsidization of foreign investment, it is therefore necessary, at the same time, to support learning and investment in local firms as well.

Good governance in the area of foreign direct investments policy is to consider the investment incentive packages as part of the country's overall industrial policy, and make any incentives available on equal terms to all investors, foreign as well as local.

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