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Trends in Foreign Direct Investment Incentives

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Trends in Foreign Direct Investment Incentives

Judit Gergely*

1. Global Trends in FDI[1]

Global FDI inflows declined in 2002 for the second consecutive year, falling by a fifth to $651 billion – the lowest level since 1998. Flows declined in 108 of 195 economies. The main factor behind the decline was slow economic growth in most parts of the world and dim prospects for recovery, at least in the short term. Also important were falling stock market valuations, lower corporate profitability, a slowdown in the pace of corporate restructuring in some industries and the slowing down of privatization in some countries. A big drop in the value of cross-border mergers and acquisitions (M & As) had a great impact in the overall decline. The number of M & As fell from a high of 7,894 cases in 2000 to 4,493 cases in 2002 – and their average value from $145 million in 2000 to $82 million in 2002.
The global stock of FDI, owned by some 64,000 TNCs and controlling 870,000 of their foreign affiliates, increased by 10% in 2002 – to more than $7 trillion. Technology payments, mostly internal to TNCs, held steady in 2001 despite the near halving of FDI flows. Value added by foreign affiliates in 2002 ($3.4 trillion) is estimated to account for about a tenth of world GDP. FDI continues to be more important than trade in delivering goods and services abroad: global sales by TNCs reached $18 trillion, as compared with world exports of $8 trillion in 2002. TNCs employed more than 53 million people abroad.
The developed world accounts for two-thirds of the world FDI stock, in both ownership and location. Firms from the EU have become by far the largest owners of outward FDI stock, some $3.4 trillion in 2002, more than twice that of the United States ($1.5 trillion). In developing countries, the inward FDI stock came to nearly one-third of GDP in 2001, up from a mere 13% in 1980. Outward FDI

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stocks held by developing countries have grown even more dramatically, from 3% of their GDP in 1980 to 13% in 2002. However, over time, the concentration of outward and inward FDI in the Triad (EU, Japan and the USA) has remained fairly stable.

The decline in FDI in 2002 was uneven across regions and countries. It was also uneven sectorally: flow into manufacturing and services declined, while those into the primary sector rose. The equity and intra-company loan components of FDI declined more than reinvested earnings. FDI entering host economies through M & As went down more than that through greenfield projects.

Geographically, flows to developed and developing countries each fell by 22% (to $460 billion and $162 billion, respectively). Two countries, the United States and the United Kingdom, accounted for half of the decline in the countries with reduced inflows. Among developing regions, Latin America and the Caribbean was hit hard, suffering its third consecutive annual decline in FDI with a fall in inflows of 33% in 2002. Africa registered a decline of 41%; but after adjusting for the exceptional FDI inflows in 2001, there was no decline. FDI in Asia and the Pacific declined the least in the developing world because of China, which became the world's biggest host country, with a record inflow of $53 billion.

UNCTAD's Inward FDI Performance Index ranks countries by the FDI they receive relative to their economic size, calculated as the ratio of the county's share in global FDI inflows to its share in global GDP. The Index for 1999-2002 indicates that Belgium and Luxembourg remained the top performers. Of the top 20 performers, 6 are industrialized, 2 are mature East-Asian tiger economies, 3 are economies in transition and the remaining 9 are developing economies, including three from sub-Saharan Africa.

CEE again backed the global trend by reaching a new high of $29 billion in FDI inflows, compared to $25 billion in 2001. That increase masked divergent trends, however, with FDI falling in 10 countries and rising in 9. FDI flows varied across industries as well, with the automobile industry doing quite well, and the electronics industry facing problems. There was also a tendency of firms (including foreign affiliates) in several CEE countries, particularly those slated for accession to the EU, to shed activities based on unskilled labour and to expand into higher value-added activities, taking advantage of the educational level of the local labour force. Led by a surge of flows into the Russian Federation, and fuelled by the momentum of EU enlargement, the region's FDI inflows are likely to increase further. Of the two factors determining this trend, the surge of FDI into the Russian Federation seems to be more fragile in the medium and long term than the spur of EU enlargement. In the short term, however, both factors are helping overcome the impact of the completion of privatization programmes and the slowdown of GDP growth expected in some CEE countries.

1.1. FDI Liberalization Policies by Developed Countries

Attracting FDI has become a policy priority in many countries, both developed and developing. Restrictions on FDI have been substantially reduced and, as a result, FDI regimes have become increasingly similar. For governments, this has enhanced the significance of incentives as a tool for attracting investment.

Facing diminished FDI inflows, many governments accelerated the liberalization of FDI regimes, with 236 of 248 regulatory changes facilitating FDI in 70 countries in 2002. Asia is one of the most rapidly liberalizing host regions. An increasing number of countries, including those in Latin America and the Caribbean, are moving beyond opening to foreign investment to adopting more focused and selective targeting and promotion strategies.

Financial incentives and bidding wars for large FDI projects have increased as competition intensified. IPAs (Investment Promotion Agencies), growing apace in recent years, are devoting more resources to targeting greenfield investors and to amounting after-care services for existing ones.

Developed countries have been liberalizing their FDI rules and concluding bilateral and regional agreements since the 1950s. In a flurry of such activity 12 developed countries made changes to their FDI regimes in 2001 and 19 did so in 2002, with 45 regulatory changes in 2002 alone. More than 95% of the new national policy measure were favorable to FDI. They involved tax incentives (as Belgium, Canada and Ireland), guarantees (as Belgium, New Zealand and Ireland), the removal or relaxation of restriction on entry (as in Japan and Norway) and the establishment of IPAs or one-stop information centers (as in the Netherlands and Portugal).

IPAs in developed countries increased their promotion efforts, with targeting among the most frequent policy responses, according to UNCTAD's IPA survey. Remarkably, none of the agencies suggested that they offered additional incentives, unlike developing countries many of which increased their incentive packages. Japan launched a most comprehensive programme in April 2003 to double the stock of inward FDI in five years.

UNCTAD's IPA survey suggests that the United States will be the most important source of FDI during 2003-2005, followed at a distance by Germany, France, Japan and the United Kingdom. IPAs expect that FDI will be distributed fairly evenly across all economic factors – but pharmaceuticals and chemicals (including biotechnology) and services (particularly telecom) are expected to receive more attention from investors.

The survey related that the main motives for planned outward FDI in 2003-2005 were high costs of skilled labor (45%) and high taxes (37%), for example in Germany. Planned investments mainly include manufacturing projects but increasingly extend to the services sector (such as R & D and administrative and HQ functions). Preferred locations include the accession countries in CEE, but also the EU and some Asian economies, particularly China.

TNCs from the developed countries will continue to invest in EU-accession countries. They might also pay more attention to growing and lower-cost markets, such as other CEE countries, Central Asian countries and some developing economies, similar to the 1980s when countries at the EU periphery joined the Common Market. Services requiring large investments (telecom, banking and so on) are expected to account for a significant share of the EUs FDI in these regions. Automobile manufacturing, computer-related activities, medical devices and biotechnology are likely to remain important recipients. Cross-border M & As continue to be significant, but there are signs of a shift towards greenfield projects.

Experience shows that the best way of attracting FDI and drawing more benefits from it is not passive liberalization alone. Liberalization can help get more FDI. But it is certainly not enough to get the most from it. Attracting types of FDI with greater potential for benefiting host countries (such as FDI in technologically advanced or export oriented activities) is a more demanding task than just liberalizing FDI entry and operations. And, once countries succeed in attracting foreign investors, national policies are crucial to ensure that FDI brings more benefits. Policies can include faster upgrading of technologies and skills, raise local procurement, secure more investment of profits, better protect the environment and consumers and so on. They can also counter the potential dangers related to FDI. For example, they can contain anticompetitive practices and prevent foreign affiliates from crowding out viable local firms or acting in ways that upset local sensitivities.

1.2. Key National FDI Policies

National policies are key for attracting FDI, increasing benefits from it and decreasing the concerns about it. Those policies have to be seen in the broader context of the determinants of FDI, among which economic factors predominate. Policies are decisive in preventing FDI from entering a country. But once an enabling FDI regulatory framework is in place, the economic factors become dominant. Even then, the regulatory regime can make a location more or less attractive for foreign investors and for maximizing the positive development effects of FDI, while minimizing negative ones.

The best way of attracting and drawing benefits from FDI is not always passive liberalization (an "open door" policy). Liberalization can help get more FDI, but alone it is not enough. Attracting FDI in a highly competitive market for investment now requires stronger locational advantages and more focused efforts at promotion. Getting FDI in technologically advanced or export-oriented activities is even more demanding. Thus, host countries' policy and economic framework and their investment promotion activities need to be in harmony with the motives of different types (market-, resource-, and efficiency-seeking) foreign investors (see Table 1).

Having attracted foreign investors into a country, policies (see Table 1, Column I) are crucial to ensure that FDI brings more benefits. Policies can induce faster upgrading of technologies and skills, raise local procurement, secure more reinvestment of profits, protect the environment and consumers and so on. They can also help counter the potential dangers of FDI – say, by containing anti-competitive practices and preventing foreign affiliates from crowding out viable local firms or acting in ways that upset local sensitivities.

The groundwork for making markets work well – sound legal systems, clear and enforceable rules of the game, responsive market institutions, a vibrant domestic enterprise sector and the like – has to be laid down by the host country government. But even then, the strategic objectives of TNCs may not match the development goals of host governments. Policies need to bring them more in line with those goals.

The list of market failures and policy responses is long. The basic point here is that, in the real world of imperfect markets, governments have a major role. They can influence FDI in many ways with varying degrees of intervention, control and direction.

Developed countries have moved towards "market-friendly" policies – pursuing sound macro management, having stable and non-discriminatory rules on business entry and exit, promoting competition, building human capital, supporting innovation and so on. But even the most market-friendly countries have not given up promotional measures to attract foreign investors (see Table 1. Business facilitation). Several use sophisticated promotion techniques as well as large grants and subsidies to target particularly valuable investments. Countries can attract FDI in many ways. They can simply liberalize the conditions for the admission and establishment of foreign investors without doing much more. They can promote FDI inflows in general, without trying to attract particular kinds of investments – say, according to their technology content. Or they can promote FDI more selectively, focusing on activities, technologies or investors.

The economic attractiveness of a country for FDI depends primarily on its advantages as a location for investors of various types. Market-seeking investors look for large and growing markets. Resource-seeking ones look for ample natural resources. And efficiency-seeking ones look for a competitive and efficient base for export production (see more in Table 1. Motives of TNCs).

More general factors affect all prospective host economies: political stability, a sound macroeconomic framework, welcoming attitudes to foreign investment, adequate skills, low business transaction costs, good infrastructure and the like (see table 1).

Given these factors it is still useful to use promotional policies to attract investors, particularly as competition for FDI mounts and investors become choosier. How much promotion is needed depend on the kind of FDI and the basic attractions of a host economy. A large and dynamic economy needs to promote itself less than a small less dynamic one. The bulk of the massive inflows into, for example, China are not the result of active FDI promotion. And promotion can only go so far. If the economic base is weak or unstable, no amount or persuasion will attract large

and sustained FDI inflows.
The main ways countries have sought to attract FDI and the key sensitive issues that arise in IIAs are:

- *Reducing obstacles to FDI* by removing restrictions on admission and establishment, as well as on the operations of foreign affiliates. The key issue here is how investment is to be defined for liberalizing entry or offering protection (direct and portfolio capital flows may be treated differently) and what kind of control should be exercised over FDI admission and establishment.

- *Improving standards of treatment of foreign investors* by granting them non-discriminatory treatment vis-à-vis domestic or other foreign investors. The key issue here is what degree of national treatment should be granted to foreign affiliates once they are established in a host country.

- *Protecting foreign investors* through provisions on compensation in the event of nationalization or expropriation, on dispute settlement and on guarantees on the transfer of funds. A key issue here is how far the right to expropriate or nationalize extends (especially to what extent certain regulatory actions of governments constitute takings of foreign property). Another is the acceptability of the kind of dispute settlement mechanisms available to foreign investors and countries. Third is what restrictions, if any, are acceptable on the ability of governments to introduce capital controls to protect the national economy.

- *Promoting FDI inflows* through measures that enhance a country's image, provide information on investment opportunities, offer location incentives, facilitate FDI by institutional and administrative improvements and render post-investment services. Host countries do most of this, but home countries may also play a role. The key issues here relate to the use of financial, fiscal or other incentives (including regulatory concessions) and the actions that home countries can take to encourage FDI flows to developing countries.

Countries are learning that foreign affiliate activity can be influenced to enhance host country benefits only if they strengthen their capabilities. New technologies can be diffused in a host economy only if the skill base is adequate or if domestic suppliers and competitors can meet TNC needs and learn from them. Export activity can grow only if the quality of infrastructure so permits. Governments need to mount policies to build domestic capabilities, drawing on foreign affiliates and their parent firms in this effort. And again home countries can help in various ways through measures of their own. Indeed, even TNCs can try to increase the benefits to host economies.

The general trend is to reduce obstacles, create investor-friendly settings and promote FDI. But the nature and balance of policies applied by countries varies. Why? Because the cost of some governments differ in their perceptions of how best to attract FDI.
The next chapter focuses on the main types of FDI incentives and their costs and benefits.

Table 1. Host country determinants of FDI

Host country determinants	**Type of FDI classified principal economic determinants by motives of TNCs in host countries**
I. Policy framework for FDI • economic, political and social stability • rules regarding entry and operations • standards of treatment of foreign affiliates • policies on functioning and structure of markets (especially competition and M & A policies) • international trade and investment agreements • privatization policy • trade policy (tariffs and non-tariff barriers) and coherence of FDI and trade policies • tax policy	**---→Market-seeking** • market size and per capita income • market growth • access to regional and global markets • country-specific consumer preferences • structure of markets
II. Economic determinants --------------→	**-----→Resource/Asset seeking** • raw materials • low-cost unskilled labour • skilled labour • technological, innovatory and other created assets (e. g. brand names), including as embodied in individuals, firms and clusters • physical infrastructure (ports, roads, power, telecommunication)
III. Business facilitation • investment promotion (including image-building and investment-generating activities and investment-facilitation services) • investment incentives • hassle costs (related to corruption, administrative efficiency, etc.) • social amenities (bilingual schools, quality of life, etc.) • after-investment services	**---→Efficiency-seeking** • cost of resources and assets listed under B, adjusted for productivity for labour resources • other inputs, e. g. transport and communication costs to/from and within host economy and costs of other immediate products • membership of a regional integration agreement conducive to the establishment of regional corporate networks

Source: World Investment Report 2003. page 85.

2. Main Types of FDI Incentives Used by Developed Countries[4]

Incentives are any measurable economic advantage afforded to specific enterprises or categories of enterprise by (or at the direction of) a government, in order to encourage them to behave in a certain manner (UNCTAD 1996. p.3). They include measures specifically designed either to increase the rate of return of a particular FDI undertaking, or to reduce (or redistribute) its costs or risks. They do not include broader non-discriminatory policies, such as infrastructure, the general legal regime for FDI, the general regulatory and fiscal regime for business operations, the free repatriation of profits or a national treatment. While these policies certainly bear on the locational decisions of TNCs, they are not FDI incentives *per se*.

The foregoing review of trends in FDI incentives around the world shows that, in recent years, competition for FDI with incentives has been pervasive, and is even more intense in the 1990s than it had been ten years earlier. Many countries have increased their incentives with the intention of diverting investment away from competing host countries. Competition has been strong not only among governments, but also among sub-national authorities within states, including among individual cities. This has been so regardless of whether the countries involved are large or small, rich or poor, developed or developing. Not only have there been more and more countries using a greater variety of incentives to attract FDI in general, but, as countries are orienting their development and industrial strategies towards exports, technology-intensive industries and higher value-added activities, they are also increasingly using incentives to attract FDI that could contribute to these objectives specifically.

As this approach involves substantial amounts of resources and constitutes a trend that is likely to continue, it is increasingly important for policy-makers to know more about what incentives are offered by whom and where, in order to evaluate the effects of incentives on the global competition for FDI. Unfortunately, one of the main problems encountered with surveys of FDI incentives is the lack of transparency in incentives practice, particularly in the face of the widespread use of *ad hoc* incentives for major FDI projects. Similarly, overall government expenditures of FDI incentives are difficult to quantify and compare. In this respect, coordination and harmonization of efforts are necessary to improve the quality of data on FDI incentives.

The following types of FDI incentives can be distinguished:

- *Fiscal*
- *Financial*
- *Others.*

2.1. Fiscal Incentives.

The overall objective of offering fiscal incentives for FDI is to reduce the tax burden for a foreign investor. Tax-incentive schemes can be classified in different ways, depending on the tax base, like profit-, labor-, sales-, import-, export-, invested capital-, value-added or other based incentives (see Table 2).

Table 2. The Main Types of Fiscal Incentives for FDI

Profit-based	Reduction of the standard corporate income-tax rate; tax holidays; allowing losses incurred during the holiday period to be written off against profits earned later (or earlier).
Capital investment-based	Accelerated depreciation; investment and reinvestment allowance.
Labour-based	Reductions in social security contributions; deductions from taxable earnings based on the number of employees or on other labor-related expenditure.
Sales-based	Corporate income-tax reductions based on total sales.
Value-added based	Corporate income-tax reductions or credits based on the net local content of outputs; granting income-tax credits based on net value earned.
Based on other particular expenses	Corporate income-tax reductions based on, for example, expenditures relating to marketing and promotional activities.
Import-based	Exemption from import duties on capital goods, equipment or raw materials, parts and inputs related to the production process.
Export-based	a.) Output-related, e. g., exemptions from export duties; preferential tax treatment of income from exports; income-tax reduction for special foreign-exchange earning activities or for manufactured exports; tax credits on domestic sales in return for export performance. b.) B.) Input-related, e. g., duty drawbacks, tax credits for duties paid on imported materials or suppliers; income-tax credits on net local content of exports; deduction of overseas expenditures and capital allowance for export duties.

Source: UNCTAD, reference #4, page 4.

In addition, some incentives relate to the entire tax regime applying to a TNC in a host country; for example, the stabilization consists of freezing the fiscal regime at its exiting level for extended periods. This form of incentive relates generally to special regimes applying to important projects (e.g., in mining). The various types of tax incentives in a host country can have a different effect on the overall corporate tax paid by a parent company, depending on the country's tax laws and any tax treaties between the home and host countries.

Fiscal incentives continued to be the most widely used type of FDI incentive in the 1990s. This is the case for most of the main types of fiscal incentives in the table, but there are a few exceptions, especially concerning accelerated depreciation, investment and reinvestment allowances and exemption from import duties. At the same time, little has changed in the type of fiscal incentive measures available. A reduction of the standard corporate income-tax rate continues to be the fiscal incentive most widely used, followed, in declining order of importance, by tax holidays, exemptions from import duties, duty drawbacks, accelerated depreciation, specific deductions from gross earnings for-income tax purposes, investment and reinvestment allowances and deductions from social security contributions.

There are, however, significant country and regional variations:

- While reduction of the standard corporate income-tax rate is the most frequently used type of fiscal incentive for TNCs in most regions, the level of reduction varies constantly, even within the same country. The overall impact of this incentive depends, of course, on the standard tax rate in a given country (standard corporate income-tax rates usually range between 30 and 60 per cent, but lower or higher rates are often found).
- Among developed countries, accelerated depreciation and specific deductions for corporate income-tax purposes or reductions in other taxes are more prominent than exemptions from import duties and duty drawbacks, the latter incentives often being limited to special zones or regions.
- In the developing regions, by contrast, tax holidays, exemptions from import duties and duty drawbacks are the main types of tax incentives available to TNCs (after the reduction of the standard corporate income-tax rate). Tax holidays are typically available for up to 5 years after an investment, but they can go up to 10 years and, occasionally, 25 years. Tariff concessions are granted for periods usually lasting 5 to 10 years, but sometimes as long as 15 to 25 years for major projects.
- In Central and Eastern Europe, nearly 80 per cent of all countries offered reductions of the standard income-tax rate and tax holidays to TNCs. Exemptions from import duties are also important. In addition, tax-stabilization schemes have been offered by some countries as a guarantee against frequent fluctuations in their fiscal regimes during their transition periods.

Over the years – and, of course, with regional variations – fiscal incentive schemes for TNCs appear to have become increasingly specific, both in terms of the qualifying conditions attached to them and the variety of options they provide.

Among the countries surveyed by UNCTAD, less than one-third of fiscal incentives are offered to all types of FDI, with the balance, to an increasing extent, being targeted to specific types of TNC activities. According to the literature reviewed for this study, overall, the FDI purposes most frequently favored with incentives are:

- Priority industries
- Regional development (in particular in developed countries).
- Exporting. This is the most frequent objective of incentive measures in developing countries (often in the context of export-processing zones). In developing countries, export activity is rarely a target of incentive measures (other than in some special zones). (Export subsidies, such as export bounties, are now subject to discipline under World Trade Organization agreements. There is, however, scope for export incentives in the form of duty drawbacks or duty-remission schemes for imported inputs and capital equipment used in the production for export.)
- Innovation and research and development, training, employment and environmental protection, though these feature less prominently.

The underlying purpose of fiscal incentives is to reduce the effective tax rate applicable to a foreign investment, thus increasing the rate of return to that investment. However, fiscal incentives alone – and, more specifically, tax holidays – are not necessarily the most important factors influencing the effective tax rate. For instance, the inflation rate, the nominal interest rate and the accounting system used can often be more important than the standard corporate income tax rate or fiscal incentives for determining the effective corporate income tax rate of an investment. As a result, effective tax rates vary considerably across countries independently of the incentive system.

There are indicators that some efforts have been made to curtail fiscal incentives, especially selective corporate income-tax reductions and credits. Thus, for example, Indonesia abolished tax holidays in 1984; the Republic of Korea reduced barriers to inward FDI and simultaneously reduced incentives; and the Philippines as well considered the removal of tax holidays from its investment-incentives system. Some countries (e.g., Malaysia) have reduced their base-tax rate for all firms, making special incentives for TNCs less relevant.

Overall, however, it does not appear as if such efforts have led to a significant curtailment of competition through fiscal incentives.

2.2. Financial Incentives

Financial incentives involve the provision of funds directly to firms to finance new foreign investments or certain operations, or to defray capital or operation costs. The most common types include government grants, subsidized credit, government equity participation and insurance at preferential rates (see Table 3). In the 1990s, financial incentives were available to TNCs in at least 59 countries out of 83 reviewed (by UNCTAD). The range of financial incentives in these countries has also increased since the mid-1980s, although some types of financial incentives have been reduced in some regions. Thus, government grants have decreased, in Africa, Central and Eastern Europe and in the developed countries, both in absolute terms and in terms of the number of countries that offered them; subsidized loans have decreased also in developed countries.

Financial incentives, however, continue to be particularly important in developed countries, with the bulk of these incentives being aimed at industrial and regional development. In some developed countries (e.g., the Unites States), most financial incentives are granted by state, province or city authorities, and the amounts involved, if standardized by number of employees, are very high indeed. Grants are frequently used. They have the attraction of being visible measures that are relatively easy to administer. In a number of countries, grants might have to be repaid if certain conditions are not met. This feature, known as the "claw-back" provision, is usually applied to high-risk investments, such as research and development. Governments tend to be more generous with financial incentives if they expect to get most of the funds back. Aid in the form of equity participation is offered in some cases; loans at reduced interest rates and loan guarantees less frequently.

Table 3. The Main Types of Financial Incentives for FDI

Government grants	A variety of measures (also loosely referred to as "direct subsidies") to cover (part of) capital, production or marketing costs in relation to an investment project.
Government credit at subsidized rates	Subsidized loans; loan guarantees; guaranteed export credits.
Government equity participation	Publicly funded venture capital participating in investments involving high commercial risks.
Government insurance at preferential rates	Usually available to cover certain types of risks such as exchange-rate volatility; currency devaluation, or non-commercial risks such as expropriation and political turmoil (this type of insurance is often provided through an international agency).

Source: UNCTAD, reference #4, page 6.

Financial incentives appear to be less prominent in developing countries and the countries of Central and Eastern Europe, but they have increased in recent years, mainly as subsidized loans and loan guarantees and government grants. As an example, the packages of financial incentives offered to foreign investors in some low-income developing countries may include some of the following: grants for labor training during the first year of a manufacturing investment; training grants of up to 75 per cent of the investment; loan guarantees from international line of credit sources; government equity participation when required; up to 100 per cent annual contributions to the cost of training local employees; up to 10 per cent annual wage subsidies; and up to 15 per cent rebates on the cost of electricity; water and sewage services on factory premises.

2.3. Other Incentives

Some types of incentives elude easy classification, they are designed to increase the profitability of a foreign affiliate by non-financial means. Examples are subsidized dedicated infrastructure, certain subsidized services, market preferences, and preferential treatment on foreign exchange (see Table 4).
Out of 67 countries for which data were available in this respect, 59 offered various types of incentives not included in the previous categories, such as subsidized infrastructure and services and technical support. Among these countries, the overall number and range of these incentives has increased considerably between the mid 1980s and the early 1990s. Subsidized, dedicated, infrastructure and services have often been provided as part of a package of measures available for enterprises investing in export-processing zones, enterprise zones or science parks.
Typically, countries offer streamlined bureaucratic control, fiscal exemptions, prepared industrial sites and ready facilities. In addition, institutional arrangements for the provision of information, consultancy and management services, as well as training and other technical assistance at subsidized prices or no cost are increasingly becoming a common form of incentive in many countries, often focused on small firms, technology transfer and regional problem areas.

Table 4. Main Types of Other Incentives for FDI

Subsidized dedicated infrastructure	Include provision, at less-than-commercial prices, of land, buildings, industrial plants, or specific infrastructure such as telecommunications, transportation, electricity and water supply.
Subsidized services	Services offered may include assistance in identifying finance; implementing and maintaining projects; carrying out pre-investment studies; information on markets, availability of raw materials and supply of infrastructure; advice on production processes and marketing techniques; assistance with training and retraining; technical facilities for developing know-how or improving quality control.

Market preferences	Preferential government contracts; closing the market for further entry; protection from import competition; granting of monopoly rights.
Preferential treatment on foreign exchange	Special exchange rates; special foreign debt-to-equity conversion rates; elimination of exchange risks on foreign loans; concessions of foreign exchange credits for export earnings; special concessions on the repatriation of earnings capital.

Source: UNCTAD, reference #4, page 6.

In a number of developing countries and countries in Central and Eastern Europe, protection from import competition and preferential allocation of foreign exchange ahs also played an important role. For example, some countries have allowed investors to apply for permission to maintain offshore accounts in which they could hold the foreign exchange proceeds from export sales, insurance contracts and other authorized items. This makes it easier to secure investment insurance, and offers protection against the risks of local currency devaluation and non-convertibility.

Although market reforms are narrowing the scope for discriminating incentives, they remain important. They are difficult to capture in general surveys since they do not appear in budget allocations or in fiscal statements.

Different incentives may be granted *conditionally* or *unconditionally*. The former may be linked to performance requirements which in some cases can have a disincentive effect on the investment (incentives are used to compensate for this disincentive). They can be granted, financed and/or administered at all levels of government – i.e., at the supranational, national and local levels. Incentives may be granted automatically (upon compliance with certain qualifying conditions), or there may be varying degrees of discretion on the part of the administering authority to decide on the awards. Also, awards may be granted before the conditioning element has taken place, or retroactively, after the condition has been met (obviously, the choice between *ex ante* and *ex facto* awards is closely dependent on the type of incentives chosen).

As a general rule, developed countries make use more of financial incentives than fiscal ones, partly because fiscal incentives are less flexible and involve more difficult parliamentary procedures to introduce them (Commission of the European Communities, 1991). However, this pattern is reversed in developing countries, presumably because these countries lack the resources needed to provide financial incentives. Unfortunately, however, systematic comparable figures on the amounts governments spend on incentives for FDI – a key issues in the incentives-competition debate – are not available.

FDI incentives can serve a number of development purposes. At the same time, they can have distorting effects similar to trade barriers. In theory, incentives are intended to cover the wedge between social and private rates of return for undertakings that create positive spillovers, such as transfer of technology, research and development, export activity, training and backward linkages. In practice, however, the calculation of the wedge is problematic. Moreover, when governments compete to attract FDI, there will be a tendency to overbid in the sense that every bidder may offer more than the wedge. The effects can be both distorting and inequitable because the cost of incentives are ultimately borne by the public and, hence, represent transfers from the local community to the ultimate owners of a foreign investment. In such competition for FDI, the poorer countries are relatively disadvantaged. Given the "prisoner's dilemma" inherent in the competition for FDI through investment incentives, governments could collectively maximize the interests of their constituents by cooperatively agreeing to limit the amount of incentives offered.

3. Effects of Incentives on Foreign Investors' Decisions[4]

While incentives do not rank high among the many determinants cited by various theories end empirical research on FDI motivations, the impact of FDI incentives on locational choices between countries can be perceptible at the margin. This part reviews, first, the literature on the relative importance of incentives versus other determinants of FDI location, and then summarizes the evidence on the impact of specific types of incentives.

3.1. Role of Incentives in Influencing Location of FDI Between Countries

Survey data generally confirm the theoretical expectation that incentives play only a limited role, relative to other variables, in company decisions to locate FDI among different countries. For example, in an early survey of 247 United States foreign investors, only 10 per cent listed (fiscal) incentives as a condition for FDI. Similarly, in another survey of 205 companies involving 365 investments in 67 countries, investors considered that the key non-policy determinant affecting their investment decisions was maintaining market share (or expanding into new markets) in the face of tariff or exchange barriers. Among the policy elements, freedom from burdensome regulation on ownership, management and organization, non-discrimination against foreign-controlled enterprises and commitment to economic development were considered to be influential factors. But political stability, a favourable government attitude towards private enterprise and economic and financial stability were even more important factors (Robinson, 1961, cited in Galenson, 1984). Thus, the conclusion from early surveys is that other policy and non-policy variables are more important determinants that incentives in the investment-location decisions of TNCs.

Overall, the survey evidence suggests that market characteristics are among the most important locational determinants of FDI. Another important determinant involves relative production costs, mainly in the case of export-oriented offshore production; and resource availability is obviously important in industries heavily dependent on natural resources. Additional location factors, such as tariffs and other trade barriers, transport costs and exchange rates contribute in some cases to determining FDI flows. Decisions of TNCs are also influenced by political conditions and the regulatory environment in host countries. Similarly, administrative and institutional arrangements can have an impact on FDI flows because of their effects on transaction costs and on increasing or reducing uncertainty for potential investors. With respect to FDI-specific regimes, freedom of entry and establishment, national treatment, rules regarding the repatriation of funds and a number of other regulatory provisions concerning the treatment of TNCs also influence FDI location choices.

Nevertheless, when the fundamental determinants are attractive enough for an investment to be profitable and are more or less similar across alternative FDI locations, incentives appear to have an effect on investors' decisions, as regional incentives. But even then, the evidence of the impact of regional incentives has been mixed, and factors such as access to regional markets, market growth, wages and unionization have exerted greater influence than did incentives. This suggests that, as other policy and non-policy conditions converge, the role of incentives becomes more important at the margin, especially for projects that are cost-oriented and mobile.

3.2. Impact of Specific Types of Incentives

There has been little empirical research done on the effects of *financial incentives*, such as grants, capital equipment subsidies and low interest rate loans *per se*. Rather, financial incentives have often been lumped together with fiscal incentives in most analyses. Conceptually, however, there can be substantial differences between them. Many financial incentives have an immediate impact on cash flow and liquidity. In addition, they tend to have a bias towards capital intensity to the extent that they are proportional to the size of the investment, are direct subsidies to assist in purchasing capital equipment, or reduce capital costs. Also, they are not contingent on future performance. Most fiscal incentives, on the other hand, are only valuable if the investor makes a profit. Hence they tend to have less of an immediate impact on cash flow and liquidity, and are less certain.

Surveys of foreign investors that have evaluated the differential importance of financial incentives relative to other incentives have found mixed results. One study (Rolfe) found that financial incentives ranked in importance about the same level as fiscal incentives; another (Coyne), however, found that financial incentives were related at, or near, the bottom in importance among the firms in his sample.

With respect to *non-financial incentives*, the level of infrastructure development has been found to influence FDI inflows (Root and Ahmend). Another major motivation for FDI found in the past in many TNCs has been to protect and enhance their market share in a host country in the face of tariff and non-tariff barriers to trade, for example, “tariff-hopping”. The incentive effect of trade barriers, however, has received only mixed support. But effective protection has been found to be a significant determinant of the industrial composition of FDI in the United States.

3.3 Incentive Preferences by Type of Investor

Transnational corporations may respond differently to different types of incentives, depending on their strategies. A number of studies that have analyzed incentives preferences by type of investor found that export-oriented investors, seeking inexpensive labour, valued fiscal incentives (including tax holidays, duty remission and accelerated depreciation) more highly than protection of the market or other incentives. Market-seeking investors, on the other hand, valued protection of the market more often than fiscal incentives, or other incentives.

Another major study (Guisinger and Associates), despite differences in approach, reached similar conclusions. Of 36 projects oriented towards the domestic market, 23 would not have gone ahead if there had been no protection of the domestic market, while only 3 were dependent on “factor incentives”, i.e., tax rebates and duty remissions, and financial incentives. For projects oriented towards a regional common market or worldwide exports, 15 of 38 would not have materialized without factor incentives. The major difference in the findings of the two studies was that, in the latter, about one third of the projects were not dependent on incentives of any kind, compared to about 15% for the former (Reuber). This difference may have been a reflection of the reduction in tariff rates that had occurred over the twelve years between the two studies.

Using a large sample of developing countries, a subsequent study (Lecraw) found that, among the three incentive groups, changes in the tax rate had only a small effect on market-seeking TNCs while it had a much larger effect on resource-seeking and factor-seeking investors. The tariff rate, on the other hand, was found to be a significant determinant for investment oriented towards the domestic market, but not for export-oriented or natural resource seeking investment.

Other surveys of foreign investors’ preferences among a wide range of measures also distinguished between different strategies of TNCs. The first survey (Rolfe), organized by type of investors (export-oriented versus domestic market oriented, start-up versus expansion, large versus small), found that fiscal incentives fell in the middle or lower range of importance: tax holidays (ranked 5), exemption from dividend withholding tax (6), tax treaty with the United States (7), and accelerated depreciation (9). Another survey (Coyne) reached roughly the same conclusions, based on a study of 72 foreign investors in three Caribbean countries. Assurances of dividend, profit and capital repatriation ranked highly, while tax holidays and accelerated depreciation were generally ranked lowest. Both studies found significant differences in rankings depending on size, market orientation (export vs. domestic), new investment versus expansion (Rolfe), and manufacturing vs. service investment (Rolfe). Still another study (Kumar) found that export-oriented FDI in a sample of 40 countries was significantly influenced by the length of the country's tax holidays.

In the case of regional incentives, financial incentives, particularly grants, have had a greater impact on investors' locational decisions than had fiscal incentives. Studies in the United Kingdom have found that grants were a crucial factor. Investors, especially TNCs, valued the "up-front" certainty of grants over other incentives (Begg and McDowell). In Northern Ireland, grants were required to offset the region's locational disadvantages for about half of the firms; the other half would have invested without the grants (Steehan). Inward investment by TNCs in Wales was positively affected by grants (Dicken, Hill and Munday).

Finally, an increasing number of *incentive packages* has been designed to induce TNCs to profile their investment projects so as to contribute to the host country's goals in terms of export promotion, employment creation and worker training, domestic value-added and technology transfer and innovation. In practice, the most success has been achieved with incentives to export. Success on the other dimensions has been more difficult to achieve, often with different incentive packages working at cross-purposes.

When properly managed, export incentives have proven to be very effective in attracting FDI, particularly to low-wage countries in labour-intensive industries. For example, during the 1970s, the Republic of Korea set up a successful system of incentives that allowed exporters to access imported and domestically produced inputs, domestic credit and foreign exchange at world prices. A similar scheme in Taiwan Province of China gave duty remissions on imported inputs. Export-processing zones have been another way to remove anti-export biases from host economies (Balasubramanyam). The size of export-processing zones and the length of tax holidays appear to be significant in attracting export-oriented FDI to countries in the Caribbean (Woodward and Rolfe). Similarly, employment in export-processing zones has been found to be a function of United States export-oriented investment (Kumar).

A wide variety of incentives are offered for foreign investors to transfer advanced technologies; for example, tax reduction and subsidized infrastructure and land and industrial parks are used to attract research-and-development facilities (Dermer, Aydalot and Love, Cantwell). In part, these incentives have been designed to induce the development of clusters of high technology firms in one location. Governments have intervened through the creation of markets (by defence expenditures and government purchasing), research funding, educational programmes, and aid to improve infrastructure (Christy and Ironside). However, a more recent study (Vallanchain and Satterthwaite) concluded that tax incentives and financial aid did not influence the location of high technology manufacturing, while funding of enterprise zones and research parks did. It also found that labour skill levels and availability and cost were the most important factors.

4. Summary

In summary, the effects of the main incentives offered by host governments on FDI location choices between countries have proven to be difficult to separate, despite decades of research. Given all the factors that can impinge on TNC decisions, it is difficult at best to isolate the effects of just one factor, such as incentives on FDI location and characteristics. The impact of these factors on investment decisions can also differ among TNCs depending on their strategy and motivation for the investment (resource seeking, market seeking, factor seeking), size, experience, whether the investment is a new one or an expansion, and the TNCs country of origin. Nevertheless, there is overwhelming evidence to suggest that incentives are a relatively minor factor in the locational decisions of TNCs relative to other locational advantages, such as market size and growth, production costs, skill levels, political and economic stability and the regulatory framework. However, the impact of incentives is not negligible: if one country offers incentives and another does not, then, all other things being equal, foreign investors could be influenced in their locational choices between countries.

With respect to different types of incentives, fiscal and financial incentives seem to rank *pari pasu* in terms of FDI preferences. Among targeted FDI incentive packages, those geared to promoting exports have proven to be the most effective.

The experience with incentive packages suggests that, to be effective, the design of incentive programmes aimed at attracting FDI with specific characteristics not only involves careful targeting of those elements that are desirable, but, in addition, *policy coordination* at various levels of government is necessary to ensure that the incentives do not cause undesirable side effects.

There is often conflict between the goals that governments want to achieve, the incentives systems through which these goals can be achieved and the capacity of the institutions charged with implementing the incentives systems. At the same time, there is often a trade-off between incentives that are targeted to achieve specific policy goals and more general investment incentives. The more targeted an incentive, the greater its impact – but also the greater the chance that it leads to biases and distortions that impose economic costs.

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