Effects of Investment Incentives on Foreign Direct Investment

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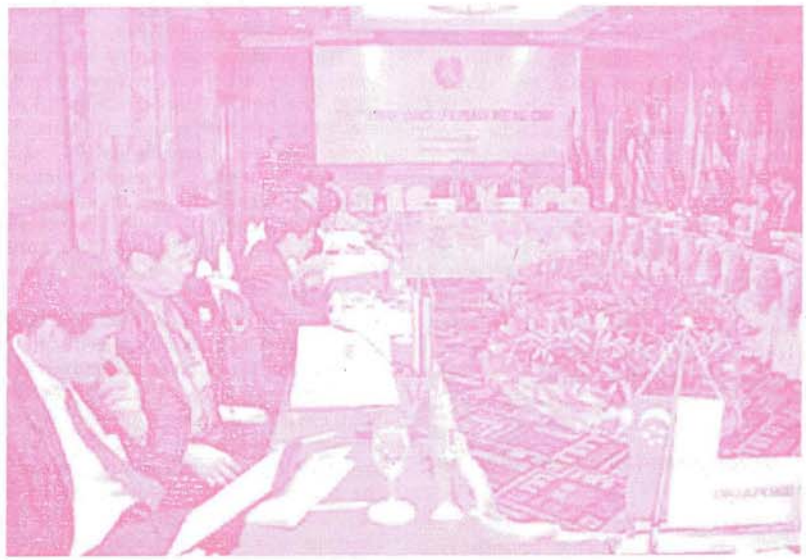
In recent decades, the robust growth of foreign direct investment (FDI) has referred to liberalization of international and regional trade. Regional integration has removed barriers to international trade and investment, at the same time; advances in telecommunications and information technology have created favorable conditions for international production networks. Today, the importance of market scale as a determinant to investment decisions has declined. Even small countries could compete for foreign capital flows if they have attractive conditions for foreign investors. Most of nations liberalizing investment policies have given various kinds of incentives to allure foreign investors. Nevertheless, the overusing incentives have triggered off new problems including their effects on FDI attraction. Moreover, incentive measures are helping transfer profits from FDI receiving countries to multinational corporations. At present, there are no quantitative studies to indicate whether the benefits from investment incentives are large enough to offset incurred costs. In developed countries, for example, the subsidy to generate a job amounts to tens of thousands of dollars. Besides, the competition between FDI receivers may lead to more profits for investors but fewer benefits to FDI receivers because they must give more subsidies. This is a special concern about healthy competition in the process of integration.

In this article, the author wishes to present beneficial and adverse effects in using incentives to attract FDI and seek opinions from researchers and managers for best solutions to this problem.



1.Forms of investment incentives

Investment incentives are economic benefits which the government offers investors to make them pour money in special fields or locations by reducing costs and risks and increasing profitability. There are some forms of incentives as follows:

- Tax incentives: they are widely applied in the world with a view to relieving tax burden to investors such as exempting and reducing tax (income tax, import and export duties), allowing tax arrears and loss transfer, giving incentives to reinvestment, allowing fast depreciation and the exclusion of certain costs from taxable amounts, etc.

- Financial incentives: they are financial supports to businesses such as the government's subsidies, preferential credit, loan guarantee, import-export credit, and so on.

- Other incentives: they include protection of production and markets, subsidized services of information, consultation, research, training and other incentives in foreign exchange rate and foreign currency balance.

2.Benefits from investment incentives

Until now, researchers do think strong economic foundation is a major factor of FDI attraction. The market scale, professional skill, infrastructure and other resources will facilitate the specialization of production; trade policies, political and macroeconomic stability are also important factors. If based on these factors, FDI is mainly used to look for markets, so incentives have fewer effects on investment decisions. We do not reject totally the value of investment incentives in spite of their small effects. Fortunately, trade lib-

Table 1: FDI in the world from 1990 to 2002 (US$bil.)

Year	1990-1995	1996	1997	1998	1999	2000	2001	2002
FDI value	225,321	386,104	478,082	694,457	1,088,253	1,492,934	735,146	534,000
Change		160,783	91,978	216,375	393,796	404,681	-757,788	-201,146

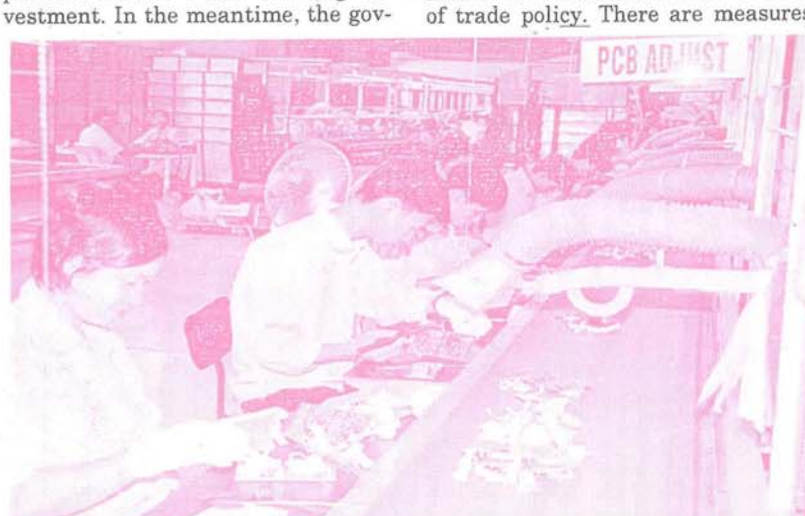
Source: International Monetary Fund (IMF) 2003 eralization and global investment have changed this picture and make incentives become important factors in international investment decisions. Investment incentives are increasingly popular, since 1990 hundreds of nations have launched a series of different incentives to attract foreign investors. Developing countries, on the whole, usually apply tax incentives due to their financial difficulties while developed ones often financial incentives because tax incentives are less versatile and tax policies must be ratified by the National Assembly. Multinational companies used to underestimate the role of incentives formerly, however, that behavior has ended now, and they recognize the role of incentives in their investment decisions. As a result, they become decisive factors to FDI flows.

Therefore, nobody can deny effects of incentives on FDI. Nevertheless, whether they are significant depends on the compensation of benefits gained for costs paid when incentives are used. Researchers and policymakers show their agreement with the government's support to foreign investors because they help the country get access to international capital flows and generate jobs to local workers. In addition, domestic companies can enhance their output value by cooperating with FDI companies, using their technologies or hiring workers who have been trained by FDI companies.

The appearance of foreign businesses has speeded up competition and forced local enterprises to innovate their old technologies and overcome their lagging. Foreign investors pay less attention to these positive effects when deciding investment. In the meantime, the government's supports to foreign investors are aimed at bridging the gap between individual and social benefits. However, these supports may distort the competition environment and cause losses to local businesses and the FDI receiving nation. The effects of FDI incentives on technological innovation and output value should be evaluated strictly. There are different opinions about these effects at the national level.

More important are capacity and motivation of local companies to receive foreign knowledge and skill. This will prove the effects of FDI incentives. Nevertheless, the government supports may help transfer benefits from the receiving countries to foreign investors although their positive effects are large. At the same time, a lot of countries are reluctant to cancel their encouraging efforts. Although it is hard to identify the incentive effects, all countries agree that the canceling of investment incentives will make one country pay for it. Incentives also create positive effects on politics because a lot of them show the government is trying its best to boost up. This is extremely important because the policymakers use many tools to enhance competition, generate jobs and increase welfare. The other reason is the structure of costs and benefits. In case of financial incentives, managers will see visible results of policies when investment projects are realized. In case of tax incentives, costs are tax loss but make no bad impact to the Treasury. Moreover, it's hard to criticize tax incentives even in the long term when the whole tax system also has certain preferences.

Policy-related problems of FDI incentives are rather similar to ones of trade policy. There are measures politically beneficial in the short run but so costly in the long run. Protectionism, for example, also helps motivate local production and generate jobs in the short run but it will be a dearly-won tool in the long run. In fact, there are a lot of similar points between trade barriers and international investment supports. In multilateral trade negotiations, countries avoid using policies which cause losses to their partners and coordinate trade liberalization between countries. It is obvious that similar behaviors should be needed in FDI competition.



3. Deficiencies of investment incentives

The opposite views to investment incentives are based on the argument that their good effects do not automatically arise but largely depend on the conditions of local companies. They will not come true unless local businesses have sufficient capacity and motivation to learn foreign companies and innovate their technologies. This shows investment incentives should be equally applicable to all foreign investors and not based on optional decisions. In addition, local companies must be given assistance so that they can increase their capacity to receive foreign technologies and skills.

Investment incentives should not be granted in the early stage, instead their positive effects need promotion at most. These activities include education and training, research and development, credit supply and cooperation between local and foreign businesses. Besides, the government is required to improve the investment climate including infrastructure and labor skill.

4. Conclusion

As mentioned above, many countries are forced to use incentives to make their local markets more attractive to foreign investors. Nevertheless, to offer effective incentives is really a complicated task, especially when the competition between FDI receivers may produce adverse effects. As a result, the optimum solution is multilateral policies between countries to build a level playing field. This is extremely important in agreements signed by regional countries. In addition, the government should give investment incentives to both foreign and local investors because local businesses also need supports to exploit good effects from FDI.■