Measures to Attract FDI
Investment Promotion, Incentives and Policy Intervention

Foreign direct investment (FDI) is attracted into countries for different reasons. At a general level, in order for a country to be more attractive to investors, there is a need to create an enabling environment by reducing so-called hassle costs. But what are these costs? A new study involving 32 developing economies indicates there exists a statistically and economically significant negative nexus between administrative costs and FDI to GDP ratio after controlling for other factors.

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II Investment Promotion

Over and above the creation of a business-friendly environment, it may be important for a potential host country to actively undertake investment-promotion policies to fill in information gaps or correct perception gaps that may hinder FDI inflows. A commonly used definition of investment promotion is “activities that disseminate information about, or attempt to create an image of the investment site and provide investment services for the prospective investors” [Wells and Wint 1990].

Any investment promotion strategy must be geared towards the following: (a) image-building activities promoting the country and its regions and states as favourable locations for investment; (b) investment-generating activities through direct targeting of firms by promotion of specific sectors and industries, and personal selling and establishing direct contacts with prospective investors; (c) investment-service activities tailored to prospective and current investors’ needs; and (d) raising the realisation ratio (i.e., percentage of the FDI approvals translated into actual flows).

Table 2 summarises the annual budgets on investment promotion by selected countries in Asia and elsewhere. As is apparent, Singapore – a major success story as far as FDI-led development is considered [Rajan 2003] – massively outspent the other countries on a per capita basis.

A case might be made for establishing a one-stop investment promotion agency (IPA) to assist in the entry and operation of FDI. The need and logic for an IPA appears to have been embraced by a number of countries, with there being about 160 nationals IPAs and over 250 sub-national ones [UNCTAD 2001]. While a one-stop investment promotion agency could facilitate FDI by lowering administrative delays and associated cost overruns, Sunjaya Lall (2000) correctly notes that
be advisable for countries to eschew selective policy intervention. As Sanjaya Lall notes:

FDI strategy is an art not a science... If administrative capabilities are not appropriate to the skill, information, negotiation and implementation abilities needed, it may be best to minimise interventions with the market: to simply reduce obstacles in the way of FDI, minimise business costs and leave resource allocation to the market... (T)here is no ideal universal strategy on FDI. Strategy has to suit the particular conditions of the country at the particular times, and evolve as its needs change and its competitive position in the world alters [Lall 2000:20-21].

III Fiscal and Financial Incentives

Countries have and will increasingly compete with each other to attract FDI by offering a number of incentives and other concessionary measures. Apart from fiscal or tax incentives, defined as “policies that are designed to reduce the tax burden of a firm” (including loss write-offs and accelerated depreciation), countries could offer financial incentives, defined as “direct contributions to the firm from the government” (including direct capital subsidies, subsidised loans or dedicated infrastructure) [World Bank 2003:Chapter 3].

Many east Asian economies have been particularly aggressive in using preferential tax treatments and other implicit and explicit subsidies to attract FDI, i.e., ‘bidding wars’ or ‘fiscal wars’. To be sure, while systematic evidence of such phenomenon is limited to specific industries (like automobiles and regional headquarters services), as Oman (2000) notes, “the prisoner’s dilemma nature of the competition creates a permanent danger of such wars” (p ii). As is apparent in the case of India and the US, the danger of fiscal wars is particularly prevalent among regions within large countries. From the viewpoint of the country as a whole, broad national codes of conduct may be useful for effective and economically rational use of such incentives.

Table 4 highlights some common tax incentives – (a) reduced corporate income taxes; (b) tax holidays; (c) investment allowances and tax credits; (d) accelerated depreciation; (e) exemptions from selected indirect taxes; and (f) export processing zones (EPZs) – and their relative merits. Tax holidays and accelerated depreciation appear to be the least desirable, while accelerated depreciation seems to be the most efficient [For an elaboration of the various tax incentives see Fletcher 2002].

As noted, tax incentives form only a part of the overall picture. Even though fiscal or tax incentives may not be available, businesses may still benefit significantly from

### Table 3: Functions of an Investment Promotion Agency (IPA)

| Image Building | Refers to the function of creating the perception of a country as an attractive site for international investment. Activities commonly associated with image building include focused advertising, public relations events and the generation of favourable news stories by cultivating journalists. |
| Investor Facilitation and Investors Servicing | Refers to the range of services provided in a host country that can assist an investor in analysing investment decisions, establishing a business, and maintaining it in good standing. Activities include investment provision, ‘one-stop shop’ service aimed at expediting approval process, and various assistance in obtaining sites, utilities. |
| Investment Generation | This entails targeting specific sectors and companies with the aim of convincing them to invest. Activities include identification of potential sectors and investors, direct mailing, telephone campaigns, investor forums and seminars and individual presentations to targeted investors. |
| Policy Advocacy | This consists of the activities via which the agency supports initiatives to improve the investment climate and identifies the views of the private sector on that matter. Activities include surveys of the private sector, participation in task forces, policy and legal proposals, and lobbying. |

### Table 2: Annual FDI Promotion Budget of Selected Countries, 1999

<table>
<thead>
<tr>
<th>Country</th>
<th>Annual FDI Promotion Budget (US$ Millions)</th>
<th>Population (Millions)</th>
<th>Per Capita Budget (US$)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Asian Countries</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Indonesia (BKPM)</td>
<td>2.8</td>
<td>207</td>
<td>0.01</td>
</tr>
<tr>
<td>Malaysia (MIDA)</td>
<td>15</td>
<td>22.7</td>
<td>0.66</td>
</tr>
<tr>
<td>Philippines (BOI)</td>
<td>3</td>
<td>76.8</td>
<td>0.04</td>
</tr>
<tr>
<td>Singapore (EDB)</td>
<td>45</td>
<td>3.2</td>
<td>14.06</td>
</tr>
<tr>
<td>Memo: Non-Asian Countries</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Dominican Republic (IPC)</td>
<td>8.8</td>
<td>8.4</td>
<td>1.05</td>
</tr>
<tr>
<td>Mauritius Export Development and Investment Authority (1996)</td>
<td>3.1</td>
<td>1.2</td>
<td>2.58</td>
</tr>
<tr>
<td>Ireland (IDA, 1999, including grants)a</td>
<td>213 (41)</td>
<td>3.7</td>
<td>57.57 (11.16)</td>
</tr>
<tr>
<td>Costa Rica (CINDE)</td>
<td>11</td>
<td>3.5</td>
<td>3.14</td>
</tr>
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Notes: a) Figures in parenthesis exclude grants

financial incentives. For instance, Singapore provides subsidies to investors that go well beyond traditional tax measures involving training, expenditure, pricing of land and utilities, and even taking rather large equity stakes in selected ventures. As with the formal tax incentives, financial incentives are likely to benefit large companies, both domestic and foreign, disproportionately. In turn, states like Singapore with strong fiscal positions can use a combination of low tax rates and aggressive fiscal incentives as competitive strategies to attract FDI vis-à-vis fiscally weak states in neighbouring south-east Asia (given that such competition tends to be largely intraregional), but elsewhere as well.

While the theoretical literature on FDI incentives is burgeoning [see the review by Devereux 1990], the empirical literature in this area is rather lagging. However, the available empirical evidence to date suggests that such fiscal incentives may be important at the margin in influencing investment decisions. Incentives are particularly useful when used essentially as signalling devices about the government’s/ country’s general (welcoming) attitude towards foreign investment and the overall business environment. Indeed, a recent OECD study suggests the existence of a two-stage investment decision process. Investors initially shortlist a set of potential host countries on the basis of economic and political fundamentals. Investment incentives play no role at this stage. It is only after the shortlist is made that investors consider and in fact seek out investment incentives before deciding where to invest (by playing off one potential host country against another) [Oman 2000]. Conversely, from the potential host country’s perspective, apart from being costly (given the tax revenues foregone as well as costs of implementation and oversight), such incentives will be least effective when used as substitutes for necessary investment-conducive policies such as disciplined macroeconomic policies, adequate infrastructural and supporting facilities, and a transparent regulatory environment.

In the final analysis, countries will no doubt continue to employ FDI incentives, not least because unilateral withdrawal of incentives as policy instruments by any single country might be potentially costly to it. However, the use of such incentives ought to be guided by certain commonsensical principles. Ad hoc, discretionary regimes which could give rise to rent-seeking activities should be eschewed. Focus should instead be on deploying a simple and predictable tax system with low rates for all investors, with there being no preference between domestic and foreign investors (i.e., uniformity). Corporate tax rates ought to be comparable to those prevailing in capital exporting countries [Moran 1998].

However, three points bear emphasising. One, complexity and uncertainty (i.e., frequent changes) in FDI-related policies (be they incentives, taxes or laws) can have a significant deterring effect on inflows. Two, beyond a signalling role, FDI incentives do not make up for deficiencies in the overall investment climate. Three, the fiscal costs of such incentives along with those of investment promotion activities noted above can be fairly burdensome and must always be kept in mind when deciding if and the extent to which such measures are to be utilised.

**IV FDI Prospects and Role of Government**

The current global environment is characterised by a general slow down in FDI inflows to developing economies, on the one hand, and the existence of a large number of investment alternatives, on the other. Specifically, there have been growing fears that FDI is being diverted from south-east Asia and other developing countries in the Asia-Pacific to China. In addition, the increased uncertainty and heightened international political and security riskiness worldwide, and cyclical concerns with regard to oversupply of certain goods and services, may preclude global FDI from growing nearly as rapidly as it did in the 1990s. A recent UNCTAD research note refers to “the most dramatic downturn of FDI inflows in history” to describe the current global investment climate [UNCTAD 2003]. The downturn has been particularly sharp in developed countries which continue to receive over two-thirds of global FDI flows (see the Figure).

Counterbalancing this pessimism is the possibility that heightened uncertainty could lead investors to consider diversifying investments geographically. The recent SARS outbreak centred in Greater China appears to have fortified this conclusion [Rajan 2003b]. However, if the hitherto peripheral countries are to benefit from this desire by foreign investors for risk diversification, they need to ensure that they have in place sound macroeconomic policies (including a “fairly valued” exchange rate) and a favourable investment climate so as to be seen as viable investment alternatives. In this regard, steps developing countries need to take to ensure an enabling business environment centre around enhancing inter-sectoral factor mobility (and especially reducing labour market rigidities), dismantling barriers to the free entry and exit of firms, relieving some infrastructural bottlenecks (roads, ports and storage), reducing other transactions costs of doing business (investment approvals, custom clearance, etc), including regulatory and legal impediments and strengthening overall governance, including strengthening intellectual property rights (IPRs) [World Bank 2003:Chapter 3].

The role of IPR regime and dispute resolution mechanism warrants mention.
While the empirical evidence regarding the impact of the quality of the IPR regime on the magnitude of FDI inflows remains uncertain, there is evidence to suggest that inadequate safeguards for protection of IPRs cause a diversion of investment from technology intensive industries (‘second-generation investments’) and more generally, from projects involving production – especially long-term investments – to activities involving distribution [Smarzynska 2002].

With regard to specific investment promotion, too many developing countries make public new policy pronouncements regarding ambitious investment and overall growth-enhancing policies but fail at the implementation stage. Done often enough this erodes the credibility of the authorities, thus making it that much harder to attract FDI. It is of little surprise then that FDI is concentrated in developed countries (largely due to cross-border merger and acquisitions activities) and a handful of developing ones, while others lag far behind.

An insufficiently recognised point is that for FDI to have a significantly positive impact on the host country it must have attained a minimum threshold of development itself [OECD 2002:Chapter 2]. Indeed, a careful examination of the empirical studies linking FDI and technological development suggests that FDI is more likely to be a significant catalyst to overall industrial development the higher the income of the host country. This in turn is often interpreted as signifying that the host country must be capable of absorbing the new technology manifested in FDI [for instance Blomstrom et al 1994:521-33]. In similar vein, another common finding is that greatest technological spillovers from FDI occur when the technological gap between local and foreign enterprises is ‘not very large’, and crowding in of FDI and technology transfer is more likely the higher the level of human capital [OECD 2002: Chapters 5 and 6; Borensztein et al 1995].

In view of the above, and at the risk of generalising, the most effective type of policy intervention appears to involve broad measures to enhance overall human capital and technical capabilities of the domestic economy on a non-discriminatory basis rather than selective intervention to maximise linkages between local firms and local subsidiaries of multinationals or technology transfer domestically from FDI.

In any event, policies such as domestic content or performance requirements, joint venture requirements, caps on foreign ownership, technology licensing, location or local employment requirements and the like have generally had mixed results at best. [For instance, see OECD 2002: Chapter 10.] There may in fact be a tradeoff in the sense that ‘artificial’ attempts to indigenous FDI activities may make the affiliate operations of multinationals less integrated with the production network of the parent to the detriment of the host country (i.e., ‘screw-driver operations’). To maximise spillover benefits from FDI on a sustained basis, host country characteristics (in terms of human capital, technological capacity, etc) must be improved. Any other policy is likely to be ineffective or short-lived at best, distortionary and detrimental at worst. [FP]

Notes

[Excellent and detailed comments by Mukul Asher enhanced the quality of the paper. Research assistance by Sadhana Srivastava is gratefully acknowledged. The usual disclaimer applies.]

Table 4: Relative Pros and Cons of Selected Types of Fiscal and Financial Incentives

<table>
<thead>
<tr>
<th>Pros</th>
<th>Cons</th>
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<tbody>
<tr>
<td><strong>Lower Corporate Income Tax Rate on a Selective Basis</strong></td>
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</table>
- Simple to administer.  
- Revenue costs more transparent.  
- Largest benefits go to high-return firms that are likely to have invested even without incentive.  
- Could lead to tax avoidance via transfer pricing (intra-country and international).  
- Acts as windfall to existing investments.  
- May not be tax spared by home country tax authorities. |
| **Tax Holidays** |  
- Simple to administer.  
- Allows taxpayers to avoid contact with tax administration (minimising corruption).  
- Similar to lower Corporate Income Tax rates, except that it might be tax spared.  
- Attracts projects of short-term maturity.  
- Could lead to tax avoidance through the indefinite extension of holidays via ‘redesignation’ of existing investments as new investments.  
- Creates competitive distortions between existing and new firms.  
- Costs are not transparent unless tax filing is required, in which case administrative benefits are foregone. |
| **Investment Allowances and Tax Credits** |  
- Costs are relative transparent.  
- Can be targeted to certain types of investment.  
- Distorts the choice of capital assets towards projects of short-term maturity since an additional allowance is available each time an asset is replaced.  
- Qualified enterprises might attempt to abuse the system by selling and purchasing the same assets to claim multiple allowances.  
- Greater administrative burden.  
- Discriminates against investments with delayed returns if loss carry-forward provisions are inadequate. |
| **Accelerated Depreciation** |  
- Similar benefits to investment allowances and credits.  
- Generally does not discriminate against long-lived assets.  
- Moves the corporate tax closer to a consumption-based tax, reducing the distortion against investment typically produced by the former.  
- Distorts locational decisions.  
- Typically results in substantial leakage of untaxed goods into domestic market, eroding the tax base. |
| **Exemptions from Indirect Taxes (VAT, Import Tariffs, etc)** |  
- Allows taxpayers to avoid contact with tax administration (minimising corruption).  
- VAT exemptions may be of little benefit (under regular VAT, tax on inputs is already creditable; outputs may still get taxed at later stage).  
- Prone to abuse (easy to divert exempt purchases to unintended recipients). |
| **Export Processing Zones** |  
- Allows taxpayers to avoid contact with tax administration (minimising corruption). |


1 For instance, see Oman (2000), Policy Competition for Foreign Direct Investment: A Study of Competition among Governments to Attract FDI, OECD Development Centre, Paris. However, to date there has not been a careful cost-benefit analysis of the EDB’s promotion activities given unavailability of data.
3 For instance, take the Local Industrial Upgrading Programme (LIUP) of Singapore’s EDB as an example. The aim of this scheme is for the multinationals to help raise the efficiency of local suppliers in stages. A large part of the success of this scheme has been due to the financial incentives offered by the EDB in the form of subsidising of training programmes by the EDB itself (OECD 2002, op cit, Chapter 10).
This conclusion with regard to fiscal incentives in East Asia is drawn by V Tanzi and P Shome (1992), ‘The Role of Taxation in the Development of East Asian Countries’ in T Ito and A Krueger (eds), The Political Economy of Tax Reform, University of Chicago Press, Chicago.

Indeed, the close nexus between host and source country tax policies is a rather under-appreciated but significant factor in determining the effectiveness of tax incentives (for instance, see Asher and Rajan 2001 and 2003, op cit).


General reasons behind this decline include continued weakness and uncertainty in global economic prospects, decline in equity markets worldwide and drop in the value of cross-border mergers and acquisition (M and A) activities.

In addition, there are acute risks in restricting FDI inflows or activities so as to promote the development of local enterprises (conventional ‘infant industry’ argument). For instance, it is often quite difficult in reality to distinguish between crowding out and legitimate competition.

References


