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Foreign investment impact and incentive: a strategic approach to the relationship between the objectives of foreign investment policy and their promotion

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Abstract

This paper offers hypotheses and tests empirically the relationship between the objectives of foreign direct investment (FDI) policy and it results (i.e. the various types of impact of FDI and investment incentives) within a strategic fit concept. In the process, this paper demonstrates a strong correlation between specific objectives and particular incentives. Specifically, it points to a strong correlation between, on the one hand, the advancement of industrial structure and fiscal incentives and on the other, between regional expansion/development and financial incentives. The results point out how a host government should establish a coherent investment incentive system matching specific objectives of FDI policy.

Keywords: Foreign direct investment policy; Investment incentives; Strategic fit concept

1. Introduction

Most governments have introduced measures to make their countries attractive investment locations. The reasons are either to attract scarce private capital, associated technology and managerial skills or to create employment in order to achieve their development goals (Buckley & Casson, 1985; Nunnenkamp, 2004). Examples of such measures could be the liberalizing laws and regulations concerning the admission and establishment of foreign investment projects, setting up investment promotion agencies

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and organizing investment dispute mechanisms. Investment incentives are but one part of these promotional measures (Aharoni, 1966; Dunning, 1981; 1988; Loewendahl, 2001; UNCTAD, 2000; Walker, 1965; Wint & Wells, 1990). The role of incentives in promoting FDI has been the main topic of a number of studies (Cantwell & Mudambi, 2000; Lim, 1983; Loree & Guisinger, 1995; Rolfe, Ricks, Pointer, & McCarthy, 1993; Root & Ahmed, 1979; Walker, 1965; Zhang, 2001). However, the advantages and disadvantages of investment incentives have never been clearly defined.

A host government is obliged to employ investment incentives that will be both effective and precise in accomplishing its economic objectives. If it does not, the harm done would not only be limited to the inefficiency of the implementation of FDI policy. It would also create distortions in the economic structure of the host country. Thus in order to maximize the impact of incentives, the host government should establish a coherent incentive system related to specific FDI objectives. There are several studies dealing with the topic of investment incentives. None, however, consider the relation between such incentives and the policy objectives of a host government.

This paper, examines an ideal relationship between the objectives of FDI policy and investment incentives within a 'strategic fit' concept. In order to substantiate the hypotheses presented below, this paper will propose a framework of FDI policy objectives and incentives calculated to optimize the intended FDI effect. To examine the hypotheses based on collected data from 68 countries, an empirical test using multivariate correlation analysis and the optimal scaling method was conducted and the results presented.

2. Review of related literature and theories

2.1. Theoretical approaches to investment incentives

In theory, the application of investment incentives can be explained in terms of compensation for externalities by the host government to foster infant industries. Corporate investment activities generate returns through the sale of produced goods and create positive externalities resulting from various factors such as economies of scale, diffusion of new knowledge or the upgrading of labor skills (UNCTAD, 1996: 9–12). However, a private firm cannot be compensated sufficiently for generating these externalities, due to the imperfection of market conditions. In other words, producers cannot benefit from the externalities they generate such as creating a 'wedge' between private and social rates of return. It can be argued that an incentive to private investors in compensation for providing this wedge might be warranted (Pigou, 1920). The same principle applies to investment incentives for foreign investors. FDI involves more than the flow of capital. It typically entails the internal utilization of intangible assets like technology and managerial expertise, which often are specific to a given firm. If these are completely internalized by the subsidiary in their transfer from the parent firm, then the rate of return will fully capture the net benefits of an investment, and no incentives will be required. However, these intangible assets generate major benefits for the rest of the host economy that are not internalized by multinational corporations (MNCs). In return for these positive externalities the government of a host country offers investment incentives.