The Economics of Foreign Direct Investment Incentives

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1 Introduction

The attitude towards inward foreign direct investment (FDI) has changed considerably over the last couple of decades, as most countries have liberalised their policies to attract investment from foreign multinational corporations (MNCs). On the expectation that foreign MNCs will raise employment, exports or tax revenue, or that some of the knowledge brought by the foreign companies may spill over to the host country’s domestic firms, governments across the world have lowered various entry barriers and opened up new sectors to foreign investment. An increasing number of host governments also provide various forms of investment incentives to encourage foreign-owned companies to invest in their jurisdiction.¹ These include fiscal incentives such as tax holidays and lower taxes for foreign investors, financial incentives such as grants and preferential loans to MNCs, as well as measures such as market preferences, infrastructure and sometimes even monopoly rights.²

Although some FDI promotion efforts are probably motivated by temporary macroeconomic problems such as low growth rates and rising unemployment, there are also more fundamental explanations for the increasing emphasis on investment promotion in recent years. In particular, the globalisation and regionalisation of the international economy appear to have made FDI incentives more interesting and important for national governments. Trade liberalisation – be it globally, through GATT and WTO, or regionally, in the form of EU, NAFTA, AFTA and other regional agreements – has led to increasing market integration and reduced the importance of market size as a determinant of investment location. Hence, even a small country may now compete for FDI if 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 liberalisation, and the internationalisation of capital markets has limited the possibilities of using exchange rate policy as a

¹ UNCTAD (2001:6-7) reports that nearly 95% of the 1,185 changes in national FDI legislation during the period 1991-2000 were favourable to foreign investors. A significant share of these changes focused on incentives and FDI promotion.
² See UNCTAD (1996) and Brewer and Young (1997) for definitions of various FDI incentives.
tool to influence relative competitiveness. This has been seen most clearly in Europe, where the Single Market Programme and the EMU have shifted the responsibility for trade and exchange rate policies from national governments to the European Commission and the European Central Bank. However, national decision-makers remain committed to promoting the competitiveness and welfare of their constituencies, and are likely to put more emphasis on those policy instruments that remain at their disposal, including FDI incentives. The fact that most others subsidise foreign investment is another important reason why more and more countries are drawn into the “subsidy game”.

There are also more substantial theoretical arguments in favour of public support for FDI than globalisation and the wish to increase local employment and growth rates in cyclical downturns. The strongest ones are based on the prospect for knowledge spillovers. Since the technology and knowledge employed by foreign firms are to some extent public goods, foreign investment can result in benefits for their host countries even if the MNCs carry out their foreign operations in wholly-owned affiliates. These benefits take the form of various types of externalities or “spillovers”. For instance, local firms may be able to improve their productivity as a result of forward or backward linkages with MNC affiliates; they may imitate MNC technologies or hire workers trained by MNCs. The increase in competition that occurs as a result of foreign entry may also be considered a benefit, in particular if it forces local firms to introduce new technology and to work harder. However, the foreign MNCs will not include these spillovers in their private assessment of the costs and benefits of investing abroad and may therefore invest less than what would be socially optimal. The motive for public subsidies to foreign investors is to bridge the gap between private and social returns, thus promoting larger inflows of FDI.

The aim of this paper is to examine whether international investment incentives can be justified on the basis of academic research on the host country effects of FDI. In particular, we discuss whether the externalities from the operations of foreign MNCs are strong and systematic enough to justify subsidising foreign investment with various fiscal and financial incentives. We also discuss some alternative policy measures available to governments that wish to benefit from inward foreign investment.

The paper is organised as follows. Section 2 discusses the determinants of where MNCs invest and introduces the arguments for international investment incentives. Since one of the main theoretical motivations for such incentives is the potential for externalities or spillovers of FDI, Section 3 summarises the evidence on such effects, focusing on the diffusion of production technology and labour and management skills from multinational corporations to local host country firms. Based on the current knowledge of spillovers, Section 4 asks whether investment incentives can be justified or not, and discusses the design of incentive policies. There is also a concluding section.