# Foreign Direct Investment Policy and Incentives

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# Contents

## Tables



## Figures

# Preface

Foreign Direct Investment (FDI) bring about various positive externalities such as stable inflow of foreign capital, increase in employment, increase in gross national product, improvement in balance of payments and transferring multinational corporations' advanced managerial skill and technology to the host country. These positive externalities can be the main goal of FDI inducing policy.

Each host government implements various means to achieve the objectives of FDI inducing policy. The investment incentive system is gaining more and more attention recently, especially since the mid 1980s, as a typical tool for attracting FDI. As for desirable FDI policy, the devices suitable for policy objectives should be selected to maximize the positive effects of FDI in the host country's economy. If discrepancy occurs between the objectives and means, not only the implementation of policy may become inefficient, but also, the possibility of negative effects on the structure of economy may be greater.

This study presents the conceptual framework and attempts an empirical test, correlation analysis and four countries' case studies, on the strategic fit between the objectives of FDI inducing policy and its means, i.e., economic impacts and investment incentive types. This study provides an insight that there must be a distinct correlation between the policy objective and investment incentive and the host government should take these factors into consideration when applying policies to attract FDI.

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# I. Introduction

Why are so many countries competing to attract foreign direct investment (FDI)? Because each country desires to induce foreign investment and wishes to utilize positive externalities from FDI for development of the national economy. FDI bring about various positive externalities such as stable inflow of foreign capital, creating employment, increasing gross national product, enhancing the balance of payments and inducing multinational corporation (MNC)'s managerial assets, know-how, and high technologies to a host country (Buckley and Casson, 1985; Brouthers et al,. 1996; UNCTAD, 1999). These positive externalities can be the objectives of FDI attracting policy and the reason why the host country government to induce FDI.

Generally, when MNC invest their intangible assets to a host country, they have difficulties in internalizing completely, because these are too specific to a given firm. The rate of return may not fully capture the net benefit of the investment to MNC. To an extent that these intangibles generate major beneficial effects for the rest of the host economy which are not internalized by MNC, FDI need not take place at the socially optimal level. In such cases, FDI may generate sufficient positive externalities to justify the host government's compensation, i.e., investment incentives, for MNC. Furthermore, host government promotes an aggressive incentive campaign to increase attracting investment beyond the passive compensating dimension.

Recently in Korea, the Korean government began an aggressive campaign to attract FDI through maintaining investment law system and organizations relevant to investment inducement when foreign exchange reserves dropped to a dangerously low level at the end of 1997. As a result, much like that Asian countries as Malaysia, Thailand, the Philippines, and Indonesia, Korea became the only country to increase inward FDI since the outbreak of the foreign exchange crisis in Asia (UNCTAD, 1999).

The available foreign exchange reserves that once amounted to only US$8.8

billion exceeded US$74 billion at the end of 1999, and as of June 2000, surpassed US$90.1 billion. Out of the increased amount of US$39.7 billion available in foreign exchange reserves in 1998, inward FDI accounted for 13%, at US$5.2 billion, and also accounted for 41% at US$10.4 billion of the US$25.5 billion available in foreign exchange reserves in 1999. Therefore, inward FDI accounted for 24%, or US$15.6 billion, of the total US$65.2 billion increased of amount foreign exchange reserves available during the two years.

It seems that Korea's economy has escaped from the economic crisis that resulted due to the depletion of foreign exchange reserves, now that the reserves have increased over ten times the amount during the foreign exchange crisis. Accordingly, the future FDI policy should be geared to maximize such economic externalities as creating employment, advancing industrial structure, economic growth, enhancing exports and developing of outdated areas by mainly focusing on establishment of FDI policy.

As for the policies related to FDI, appropriate tools should be applied to maximize the performance of FDI policy at the national level. In the case of the Untied Kingdom (U.K.), whose primary economic goal is to relieve its unemployment rate, takes into an account of job availability firstly when it decides on the investment incentives, while Malaysia, which intends to advance its industrial structure, takes into consideration in producing high value added firms versus factors such as generating employment.

In spite of all FDIs that entered into Korea, which successfully assisted in reviving the economy, there seems to be a misfit between these FDI objectives and its means. The Korean government, facing depletion of foreign exchange reserves, regarded FDI as a tool for overcoming the economic crisis. The increasing foreign exchange reserves, i.e., increasing capital inflow in quantity approach, is highlighted as a critical aspect of government policy. However the context of newly revised investment promotion system, the new Foreign Investment Promotion Act (hereinafter "the new FIPA") replaced the old system on Foreign Direct Investment. However, Foreign Capital Inducement, still focuses at enhancing advanced industrial structure, which is the primary objective in the previous FDI policy. If discrepancy occurs between the objectives and means of policy, it gives not only inefficiency in the implementation of policy, but also there will be a greater possibility that negative effects can prevail on the structure of economy.

In this book, the argument of strategic fit between FDI policy objectives and investment incentives is presented in several steps. First, we discuss and define FDI policy and try to classify the objectives and types of investment incentive. Next, conceptual framework for following empirical analysis will be presented. Finally, empirical analyses such as correlation analysis and case studies of major countries as the U.K., Malaysia, Singapore and Korea will be conducted to test presented framework. Finally, the implications of these argument will be discussed at the end of this book..

# II. The Concept of Foreign Direct Investment Policy

## 1. Defining Foreign Direct Investment policy

FDI has gained more and more attention from many host governments as a cure for overcoming economic problems such as lack of domestic investment and high unemployment rate, unbalanced development of local area, trade deficit, and industry hollowing effect of host country, etc. In order to maximize the positive FDI impact, it is necessary for host country's government to formulate and implement FDI policy in the strategic fit concept. The first thing for the government to consider when it formulates FDI policy is to select the objective of FDI. Even if FDI is expected to produce positive effects on various economic objectives, all of the economic goals to achieve cannot be FDI policy's objectives.

This is because there can be an offsetting effect or negative economic effect when non-compatible objectives are included in the FDI policy objectives.

Therefore, the first step to consider when formulating FDI policy is to set objectives or to adjust priorities in terms of three levels of objectives, i.e., in country level; macro economic policy objectives, -- stabilization of employment, foreign exchange reserves, interest rates, improvement of balance of payments and industrial policy level; advancing the industrial structure and fostering the high-tech industry and corporate objectives; enhancing corporate competitiveness and corporate restructuring under the condition that will maximize the economic return on FDI and minimize the costs without conflict.

However FDI policy should not only mean selecting policy objectives. It should include the selection of appropriate means and preparation of a system to maximize the economic spillover effects. Policy instrument should be suited to the investment policy objectives so that the desired results can be achieved. Therefore, searching for instrument design is next step for the accomplishment of competitive FDI policy. The instrument for FDI policy can be embodied in the legal system for support when attracting FDI. The main reason a host country formulates and offers incentives is due to the difference between the real location attractiveness of host country and the degree of expectation of the MNC for desirable investment location. Generally, the motives of MNC going abroad can be to cultivate local market, attain productivity and secure natural resources, etc. So, if the host countries want to attract even more significant number of FDI, they only have to improve their investment environment conditions but unfortunately, that is not an easy job. Expansion of domestic markets, increase of productivity, magnification of technology infrastructure and development of natural resources, which are difficult to improve in the short-run, yet offering investment incentives, activities to promote investment, and providing business facilitation can be improved by providing systematic support for short-run. Especially, such investment incentives as tax reductions and government grant have direct impact on investment costs and future investor's returns. Investment incentives, due to these properties, are becoming the main stream FDI policy means in the world.

The final step, when defining FDI policy, the investment incentives should be devised to maximize the realization of investment policy objectives and to be compatible with the objectives. For example, tax reduction incentive is beneficial for the development of high value added corporations or industries, since the level of incentive is decided ex-post in proportion to the value-added that is created by a firm. In contrast, the government grant is more suitable means for investment inducement to attain such investment policy objectives as creating employment and regional development since the size of payment is fixed in the initial stage of investment.

To sum up, FDI policy includes the following three concepts. First, FDI policy is to attain economic objectives related to FDI, and is a part of all of the national economic policy objectives, but is a subordinate concept to that of national economic policy. Second, FDI policy includes establishing the means for FDI inducement to achieve economic policy goals. Finally, it also includes the problem of properly fitting together the means for policy objectives to effectively formulated FDI policy. Therefore, FDI policy can be defined as follows: *those activities that prepare suitable means for FDI inducement to select the objectives in which FDI can be applied and thus maximize its impact on the national economic.*

## 2. Classifying the foreign direct investment policy tools

The policy tools for attracting investment can be classified into investment support, investment restriction and investment enticement. *Investment support* includes the following four categories. First, various investment incentives, such as grants, tax reduction, and protection of the market by the host government. Second, providing one-stop shopping, i.e., settlement for applications as a proxy for foreign investors, matchmaking with potential joint venture of (merger and acquisition (M&A) partners, search and locate suitable sites and a proxy execute on behalf of foreign investors in regards to procedures required for factory establishment, etc. Third, investment-consulting support by advisory group and institutions such as chamber of commerce and industry, an investment research institutes and law firms. Finally, follow-up service for businesses after establishment which includes such support as helping to find things that are difficult to find, solving problems and use of an ombudsman system.

*Investment restrictions* to induce suitable foreign investment compatible to the direction of foreign investment policy can be one of the investment policy tool of host government. Investment restrictions are divided into two types of restrictions, i.e., before entry and after entry. The former is restriction on ownership structure of invested firm and the latter is on investing in business sectors. In addition, the government can exclude some industries as the object of foreign investment or restrict a foreigner's equity share by enacting a special law to protect infant industries, such as the information and telecommunications industry, electric power, and the defense industry. Government also can restrict a foreign firm's activity through the various notification, authorization, and registration systems in the establishment of a factory, environment protection, export and import procedures, marketing and procurement, even after the permission of investment. Regarding investment enticement, which include dispatching investment delegations, holding investment seminars/exhibitions, and honoring foreign corporation awards. The means for investment enticement can be included in the investment support means but are classified into enticement tools due to its indirect effects. Table 1 shows further detailed means of investment support, investment restriction and investment enticement.

Table 1. Classification of FDI policy tools

| | |
|---|---|
| Support | 1.Investment incentive system: government grant and compensation, subsidy, insurance and financial guarantee, loan, free lease of government and public assets, reduction and exemption of taxes and tariffs, permission of accelerated depreciation, market protection etc.<br>2.Supporting activities for investment promotion agency: investment supporting activities for investment promotion committee and investment promotion agency (IPA)<br>3.Investment advising: advising activities for related institutions such as research institute, chamber of commerce and industry, law and accounting firms<br>4.follow-up service system of after investment: monitoring of grievances and difficulties, establishment and operation of ombudsman |
| Restriction | 1.Restrictions on equity share and entry (business sectors of investment): restrictions on foreign investor's equity ratio and on entry to certain business sectors<br>2.Restrictions on business activities: restrictions of various authorization and permission, notification, registration, approval and conditions of establishment covering establishment of a factory, environment protection, export and import procedures, marketing and procurement etc. |
| Enticement | Dispatching investment delegation, holding investment seminars and exhibitions, honoring foreign firms and awarding, etc. |

## 3. The composition of foreign investment policy

Figure 1 indicates the relationship among the elements influencing the formulation of foreign investment policy as was explained before. A summary of the relationship among the elements of economic policy and investment policy objectives, economic policy and investment policy means, investment environment and investment policy means, and investment environment and investment policy objectives is as follows.

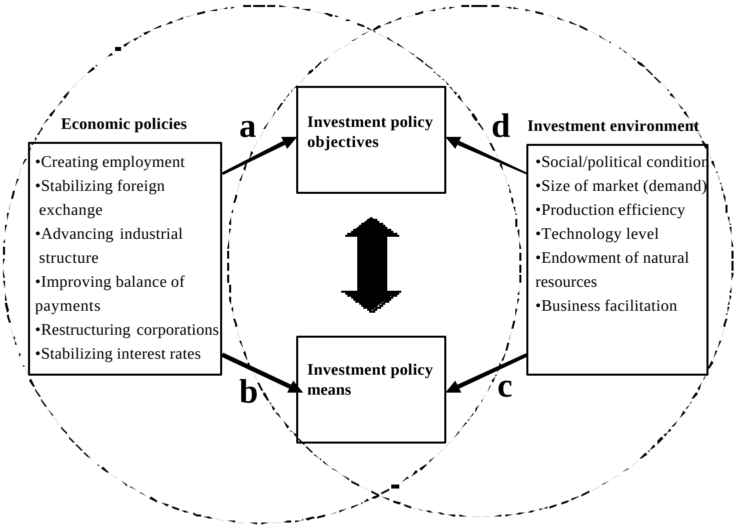
a. Economic policy and investment policy objectives: the main reason for the government inducement of foreign investment is to achieve economic development by including it policies to improve employment rates, stabilize interest rates and foreign exchange rates, improve balance of payments, performing restructuring of industry and corporate. Accordingly, foreign investment policy can be an sub-policy of national economic policy and on the same line, the investment policy objective can be one of the national economic objectives. Therefore, the investment policy cannot be established separately from the economic policy and it is restricted by the national economic policy.

b. Economic policy and investment policy means: Investment incentive systems, i.e., tax reduction or exemption, government grants, and rental fee reduction or exemption for government property, as means for attracting foreign investment, can be non-compatible with other economic policy means which is designed to attain each economic objectives. For example, granting tax reduction or exemption to a foreign investor as support means for attracting investment can be non-compatible with other economic policies established to form a sound national finance system. The investment incentive system, which supports greenfield investment, will not be helpful to an economic policy in which corporate restructuring is pursued in the M&A type. The investment policy means to attain investment policy objectives can be influenced by other national economic policies.

c. Investment environment and investment policy means: Generally, degree of investment incentives offered to foreign investors by the host government and the attractiveness of investment location of the host country, which is in inverse proportion. If a country has a well-developed consumer market or the cost of production factor is low, attracting MNC is rather easy even without the special investment incentives. On the contrary, if a nation has an unfavorable market size and production efficiency, it has to promote its location attractiveness through relatively enhanced investment incentives. The investment incentive can be not only an investment policy means but also an element composing the investment environment itself.

d. Investment environment and investment policy objectives: Among the economic policy objectives, the investment environment influences investment policy objectives when the investment policy objectives to induce and attain foreign investment are selected. As the investment environment becomes more attractive, a few restrictions are only possible in selecting investment policy objectives from among the economic objectives. While the possibility is low for a country with a high level of technology to select high-tech and enhanced industrial structure as its investment policy objectives, the possibility is high for a nation with insufficient technology and industrial foundation to select hi-tech and enhanced industrial structure as its investment policy objectives. A typical example is Malaysia, which selected advancing industrial structure as its investment policy objectives to convert its labor-intensive industry structure to a capital-intensive industry structure.

Figure 1. Concept and composition of FDI policies




## 4. Foreign direct investment policy and economic policy

### 4.1. FDI and macroeconomic policies

Foreign direct investment brings to the host country such positive externalities as the effects of a stabilized foreign exchange, economic growth, generating employment and balance of payment as well as the effects of industrial restructuring. In a country lacking foreign exchange reserves, foreign investment is actively utilized as a stable source of foreign exchange supply without the burden of principal and interest repayment. In the case for Korea, foreign direct investment contributed to the stabilization of demand and supply for foreign exchange since the foreign exchange crisis.

Foreign investment positively influences the increase of national income and economic growth. Even though there are growing concerns about FDI due to negative effects it can cause by distorting the host country's economic growth in the long run. However, various empirical analyses results show that the inflow of capital from advanced countries and technology influence on the host country's economic growth is positive. (UNTAD, 1999)

The employment generating effects of foreign investment gradually increased the importance of social, labor and welfare policies. In the U.K., as the once prosperous coal mining industry faded, the government faced a large unemployment problem. Therefore, government's prime goal for its foreign investment attraction policy was to create employment. In Korea too, the importance of job creation has grown as many domestic businesses became bankrupt since the foreign exchange crisis. A foreign investment company not only contributes to job creation for the host country by employing the host country's workers, but also creates employment indirectly by inducing related parts supplying companies, subcontractors and distributing companies to employ more workers.

The expansion of export can be an important foreign investment objectives with other macroeconomic objectives such as stabilization of foreign exchange and increase of employment. Host government also makes an effort to induce foreign investment companies, which can contribute highly to export, and also actively promote the exports of foreign companies.

### 4.2. FDI and industrial policies

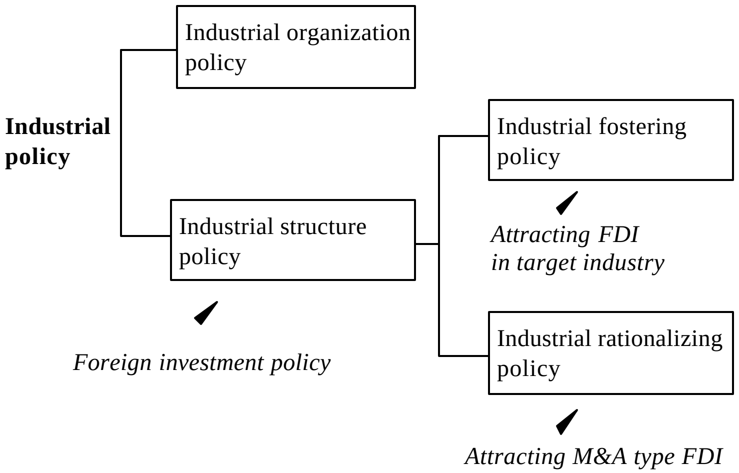
Foreign investment is closely related to industrial policies as well as the stabilization of macroeconomic indicators, e.g., foreign exchange rate, interest, employment rate and inflation. Many Asian countries, including Malaysia, Indonesia, Singapore and Korea adopted the policy to advance their industrial structures to induce foreign investment. Government policies to permit or induce foreign investment that contribute to advancing industrial structure, can selectively be a part of industrial policies. Of all of the industrial policies, foreign investment policy in particular is more related to industrial structuring policy than it is to industrial organization policy.

While industrial organization policy has competition promoting characteristic that makes market structure more efficient by interfering with intra-industry, getting rid of various barriers to entry and regulating monopolistic and oligopolistic companies, the industrial structuring policy is the distribution of intra-industry resources to convert current industrial structure to a desirable optimal industrial structure.

Industrial structure policy is divided into industrial fostering policy, which supports and develops a particular industry, and industrial rationalizing policy, which rationalizes a declining industry or restricts over-investment. If a policy, for example, is to promote a new firm's entry into promising industries i.e., target industries such as biochemical industry, semi-conductor industries and information and telecommunications industry, which are the expected high growth industries of the future, the industrial fostering policy is possible, while policy to support a corporation's exit from a declining industry or restrict a new firm's entry into an over-competitive industry or adjust business operations among existing companies is industrial rationalizing policy. Industrial rationalizing policies include firm's M&A activities, market expansion, exit system, support of technology development, support of specialized personnel and abolishing barriers to entry into a new industry.

Less developed countries (LDCs) have difficulties in technology development and high-tech acquisition due to the lack of domestic investment resources. The inducement of a MNC with high technology and advanced management techniques is effective to raise short-term competitiveness in a LDC's particular industrial area. Enabling a new foreign investment company with high-tech or technology to enter into the intra-industry and allowing it to acquire a company, although redundant, can be an applied area of FDI in the industrial structure policy dimension (See Figure 2).

Figure 2. FDI policy in industrial policy




### 4.3. FDI and corporate policies

Foreign investment capital can be used in acquiring non-performing corporations or assets. A government's corporate restructuring, which lowers a corporation's debt to equity ratio and strengthens its financial structure, is one of the foreign investment policy objectives. Corporate restructuring is corporation-wide industrial restructuring, which entails continued efforts to strengthen competitiveness and enhance corporate value by restructuring corporate structures in the areas of ownership, management control, management, business operation and financial matters in response to the change in economic environment. This is divided into intra-corporation restructuring covering withdrawal and transfer of business, reduction of production, cost saving, rationalization of personnel and making goods with high value added, and inter-corporation restructuring covering M&As, division of a corporation and strategic alliances. The policy tasks of corporate restructuring include activation of markets for M&A between corporations, maintenance of a system for exits and non-performing corporations, enhancing the transparency of corporate management to establish efficient corporate structure, improvement of management control, correction of management with borrowed money and improvement of the financial structure.

As for Korea, the need to improve corporate structure through foreign capital inducement has increased due to the deteriorated corporate management situation since the foreign exchange crisis. Corporations and the government made enormous efforts to induce foreign capital through corporations. Acknowledging the foreign capital inducements by the government and corporations are the main corporate restructuring means, as many corporations were on the brink of bankruptcy due to having a high debt to equity ratio. Foreign capital inducement increased through M&A type investments in relation to corporate restructuring, accounting for 53%, amounting to US$4.7 billion out of the total foreign investment amount of US$8.85 billion during 1998 after the foreign exchange crisis, while it accounted for only about 10% before the foreign exchange crisis. M&A type investment decreased to under 15% due to an upturn in the domestic business cycle, including stable domestic interest rates, decrease in wages, and the boom in the securities market in 1999.

# Ⅲ. Strategic Approach on Foreign Direct Investment Policy

## 1. The theoretical approaches on investment incentives

The theoretical approach to investment incentives can be explained in the terms of compensation for externalities and the infant-industry fostering policies of the host government. Corporate investment activities not only generate returns through the sale of produced goods, but also create positive externalities resulting from such factors as economies of scale, the diffusion of new knowledge, or the upgrading of labor skills (UNCTAD, 1996; 9-12). A firm, however, cannot be compensated sufficiently for generating these externalities due to imperfect market conditions, providing an essential rationale for incentives in this regard. In other words, producers cannot benefit from the externalities they generate, creating a “wedge” between private and social rates of return. It can be argued that an incentive to private investors, compensating them 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, e.g., technology and managerial expertise that often are specific to a given firm. If these intangibles are completely internalized by the subsidiary in their transfer from the parent firm, the rate of return will fully capture the net benefits of an investment, and no incentives are required. However, to the extent that these intangibles generate major beneficial effects for the rest of the host economy which are not internalized by the MNCs, FDI need not take place at the socially optimal level. Therefore a host country's government provides investment incentives in return for these positive externalities.

Also, we can explain the incentive in relation to a government's economic policies in terms of infant-industry protection. When a firm invests progressively more, production costs and productivity can be improved. However, in an infant-industry these advantages can be less reflected in an investing firm's return than in the growing industry. Tax reduction and grants thus need to be offered to these firms to compensate foreign investors for the lack of returns due to the host country's industrial policy.

## 2. Investment incentives as a means of effecting FDI policy

Dunning (1996: 56) identified four types of multinational corporation (MNC) activities: resource seeker, market seeker, efficiency seeker and strategic asset or capability seeker. Borrowing and extending from a taxonomy used by Behrman (1972), UNCTAD (1998: 91) defines these motives as economic determinants with two other FDI determinants, i.e., the host country's policy framework and business facilitation. Policy frameworkrefers to social and political stability, rules regarding entry and operations, fair competition between foreign and domestic investors; privatization policy, international agreements on FDI and a host government's attitude towards a foreign corporation. Business facilitation refers to providing facilitation services for foreign investors such as government FDI inducement activities, investment incentives, administrative support, and after-care service for foreign investors.

Dunning (1981, 1988) also did not restrict investment location advantages to their cost saving aspects including market access, i.e., input factor cost, transportation cost, communication cost, R&D, and marketing productivity. Instead, he expanded the definition of location advantages to include investment incentives, government interference, language, culture, methods of doing business, politics, and ideology. He also included investment incentives in the determinants of investment location attractiveness.

The taxation regime of a host country was listed as one of six determinants influencing foreign investment in the research of Root and Ahmed (1978, 1979) and from Leree and Guisinger (1995). Empirical results stated that American outward FDI has an inverse relationship with the host country's tax rate. This study indicates that a host country's tax reduction and exemption policy can be as much of a factor in attracting investment as direct promotional/induction activities. But Guisinger (1992) indicated that a MNC considered economic determinants such as a host country's production efficiency and market demand as the primary determinant. Walker (1966) also noted that investment incentive is less important in the investment location selection to a MNC compared to other variables, such as political and non-political variables. UNCTAD's survey of 74 investment projects of 30 MNCs across four industries including automobiles, computers, petrochemicals, and food processing, investment incentive does not determine investment location decisions alone, but rather makes an already determined investment location more attractive (UNCTAD, 1996: 43-44; UNCTAD, 1998: 103).

We can presume that investment incentive acts as an FDI determinant, but the previous empirical results are not consistent as to whether investment incentive occupies an absolute position as an investment determinant.

Despite the fact that incentives play a less crucial role in determining FDI inflows than is widely believed, the reason investment incentive maintains its significance as an investment policy instrument is because economic determinants such as wage structure and market structure are difficult to improve by government in the short-run. Investment incentive, on the other hand, is a controllable variable in the short-term, and compatible with government policy to attain investment policy objectives by improving the local investment environment as a competitive measure against rival countries. As shown in a survey of the World Association of Investment Promotion Agencies (WAIPA), at least 95 countries have implemented foreign investment promotion programs which include investment incentives (UNCTAD, 1998).

### 3. The strategic fit in FDI policy

According to Learned et al. (1969) and Quinn (1980), high corporate performance can be attained when an ideal congruence between objective and means of firms' strategy is achieved. This concept of "strategic fit," beginning with Chandler (1962), Learned et al. (1969), Andrews (1971) to Porter (1980), Thompson and Strickland (1987) has been a determining factor in the course of research and has gradually come to be viewed as a defining strategy (Barney, 1996; 22).

In accordance with the above statement, the devices of FDI policy suitable for policy objectives should be selected to maximize the effects of FDI like business strategies of firms. This book explains that procedures to establish FDI policy may be divided into the following three steps.

First, the objectives of FDI policy should be prioritized, since if the economic effects to be achieved using FDI are incompatible with each other, the overall impact will be negative. Next, suitable means of achieving investment policy objectives should be prepared. Such means should be devised within the host government capabilities in areas such as financial conditions, human resources and organizational support systems, etc., to achieve investment policy objectives. Last, a strategic fit should be designed between FDI policy objectives and means, to maximize the effects of FDI as follows.

## 4. Conceptual framework

The main economic effects of FDI anticipated by a host government typically include advancement of industrial structure, i.e., the fostering of value-added industries, enhancing exports, increasing foreign exchange reserves, creating employment, and regional development. Economic effects are generally according to their scope and point of origin as follows:

First, advancing industrial structure, enhancing exports, creating employment, and increasing foreign exchange reserves are economic effects that impact an entire nation, while regional development concerns only the locality in question.

The former are referred to as economic effects of *national scope*, and the latter, economic effects of *local scope (or sub-national scope).*

Classification according to the point of origin includes the case that the effect is determined from the time the investment originates and the case in which the effect works gradually as time goes by. Cases of the former include the creation of employment, increasing foreign exchange reserves, and regional development. Cases of the latter include advancing the national industrial structure and enhancing exports. The creation of employment, increasing foreign exchange reserves, and selection of regions for development are the economic effects whose scope is determined. These economic effects occur from the initial stage of entry by foreign investors into a host country, while the economic effects resulting from advancing industrial structure and enhancing exports achieved by a MNC's technology transfer and knowledge sharing are developed gradually in the process of a MNC's business activities. The former are called *start-up type* economic effects, while the latter, *development type* economic effects.

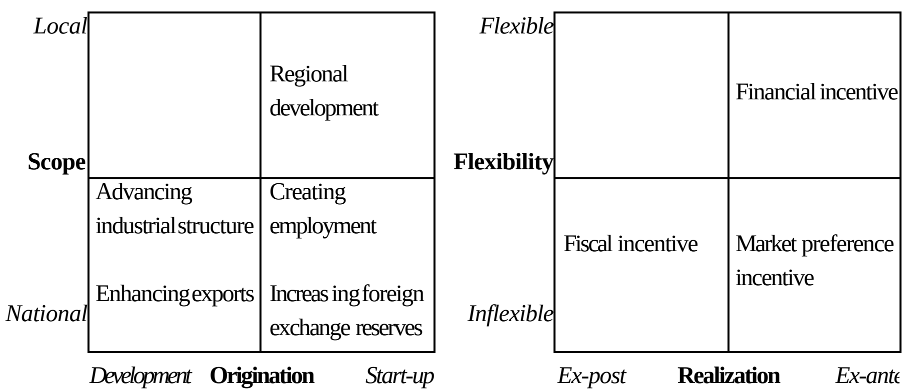
In addition to their economic effects, investment incentives can be classified as to their operational flexibility and their point of realization. First, regarding operation flexibility, fiscal incentives, e.g., reduction of the standard corporate income-tax rate, tax holidays, accelerated depreciation, and exemptions from import duties are hard to apply flexible in individual cases of investment. This is because fiscal incentives are based on laws pertaining to such subjects as taxation. Financial incentives, on the other hand, e.g., government grants, subsidized credits and government insurance at preferential rates, and market preference incentives, e.g., granting of monopoly rights, protection from import competition, and preferential government contracts, may be implemented flexibly by a local government through individual negotiations with a foreign investor. In this book, the former are referred to as *inflexible incentives* and the latter, *flexible incentives*.

In the incentive realization point of view, the financial incentives can be classified as *ex-ante incentives*, in which the extent of an incentive such as scope of government grants and preferential rates are determined in the investment decision stage or start-up stage of foreign investors, and materialize the profit to the foreign investors immediately. The market preference incentive also can be classified as an ex-ante incentive, since the extent of benefits such as the permission of market monopoly right and the demand guarantee of specific goods is decided on the incentive negotiation table between a host country's government and foreign investors. In this case, the benefit of incentive takes place and rightfully goes to foreign investors immediately.

However, fiscal incentives, which reduce or exempt corporate income tax on their returns to create value-added business activities by foreign investors, can be *ex-post incentives* in which the extent of benefit takes place after foreign investors' business performances in proportion them.

The classification of investment incentives as objectives for FDI policy, i.e., the economic effects to be achieved by a host country's government, using FDI inducements, and the means, especially incentive types, are indicated in Figure 3.

Figure 3. Relationship between objectives and means of FDI policy.



Among the incentive types, the ex-post incentive is more suitable in development type objective FDI policies while the ex-ante incentive is more suitable for the start-up type objective.

Fiscal incentives such as corporate income tax reduction take advantage in fostering high value-added firms or industries because their level of offered incentives is escalating to value-added created by a firm, that is, if the foreign investors make the more value-added activities, they can obtain the more incentives. Meanwhile, government grants are effective when the government intends to utilize the FDI to create employment and regional development. Foreign investors who are lacking investment resources may have interest in the grants offered by the host government in the start-up stage of investment proceedings. In this case, the incentive offer level is determined at the initial stage of investment and almost fixed during the entire time of investment proceedings. For example, in the case of the United Kingdom, whole grants are usually provided by local governments at three sequential times within the first or second year of investment inducement when the investor fulfills their obligations in an investment incentive contract (Fraser, 1999). The former, due to difficulties in calculating the economic effects such as contribution to enhancing exports and advancing industrial structure, adopting ex-post incentives, that is, giving the incentives when these effects occur, is a better strategy in the investment negotiations of a local government, The ex-ante incentives are better for the latter case, because the incentive determination criteria such as number of employment and selection of regional development are explicit in the start-up stage.

Flexible investment incentives are useful tools for utilizing regional economic effect while inflexible investment incentives are apt for enhancing the nationwide economic effect. Financial incentive such as grants are more flexible as tools to induce FDI in specific regions by regional governments, which are more free from national law systems than fiscal incentive. A local government's discretionary power on preferential application of tax reduction is not likely to restrict from the central government, especially in developing countries. Even in developed countries, adjustment of the national taxation system by the central government can cause an equity problem in the law system.

This book's research topic identifies that which incentives, i.e., fiscal incentives, financial incentives and market preference incentives, are appropriate as means to utilize a country's economic effect by inducing FDI, yet this book will focus on fiscal and financial incentives without market preference incentives. Market preference is not only an unusual incentive type, of which few samples have been recorded, but it also concerns the political logic of a local government more than these economic approaches. Therefore, the following hypotheses are offered:

H1: There is positive correlation between the nationwide/developing process type of attracting FDI policy objectives (advancing industrial structure, enhancing exports) and inflexible/ex-post investment incentive type (fiscal incentives).

H2: There is positive correlation between the local/start-up type of attracting FDI policy objectives (regional development) and flexible/ex-ante investment incentives (financial incentives).

# Ⅳ. Case Study on Foreign Direct Investment Policy

## 1. Foreign direct investment policy of the United Kingdom

### 1.1. FDI policy objectives of the United Kingdom

The United Kingdom (U.K.) during the 1970s focused on attracting investment in manufacturing, as domestic business conditions and the manufacturing sector contracted due to the increase in unemployment and enhanced labor disputes arising from the declining coal, steel and ship-building industries. The central government and local autonomous government's investment attraction policies put priority on employment inducing investment and investment for balancing regional development. The central government also set priority in the order of Northern Island Development Areas (DA), Intermediate Areas (IA), and focused on relieving unemployment and economic development of outdated areas (DTI 1997). As a result of continuous foreign investment inducement aimed at complementing the lack of domestic investment by foreign investment inducement, although the number of foreign investment corporations accounted for only 1.6%, the government employed 19% of the whole manufacturing sector, accounted for 28% of domestic production of total manufacturing sector, 34% of domestic gross net capital expenditure and 50% of the total exports, according to the Office of National Statistics of the U.K. Meanwhile, 40% of the foreign investment corporations ranked among the top export corporations. At the same time, foreign investment corporations recorded a 24% higher value-added rate per person, 33% higher wage level and 133% higher net capital expenditure per person compared to the purely U.K. founded corporations.

The U.K. adopted policy to increase the attractiveness of investment by creating support systems for attracting FDI i.e., the U.K. operates the most advantageous investment incentive system among the European Union (EU) members by assisting over 15% on the average in gross capital cost of foreign investors, and its corporate income tax rate is 31%, which is the lowest of all the EU members (Germany 50%, France 34% and Italy 36%). At the same time, when a corporation is operated in the form of a group, the U.K. acknowledges the loss transfer between subsidiaries, which is an advantageous system for an investor due to the reduction of the tax burden. The circumstances of U.K. investment inducement reveal competition among local autonomous governments, which reflects its historic and political situation. This arises from the fact that the U.K. has been divided into four counties: England, Wales, Scotland and Northern Island, which have such degree of autonomy of individual counties.

### 1.2. The means of FDI policy of the U.K.

The characteristics of U.K. investment incentives assume the government subsidy type, in which the scope of benefit is determined by negotiation with an investor. The type of grants can be divided into Regional Selective Assistance (RSA) that is managed by the central government and the local package by a local government. On the average, RSA accounts for 70% while the local incentive package accounts for 30% of total investment incentives. But the total incentive ratio is limited to 40% out of the total investment amount.

RSA is the incentive system introduced to solve problems of large unemployment and development of outdated region caused by declining traditional industries as coal, steel and shipbuilding. The assistance payment is used for capital costs, such as purchase cost for a factory and office of an investment corporation, construction cost, and costs of plant and machinery facility. The benefiting areas and benefiting requirements and methods follow.

The areas that benefit are Development Areas (DA) and Intermediate Areas (IA), which are considered through the mixture of unemployment rate, backwardness of the area and area that requires strategic development. Currently, the DA in the U.K. are parts of Scotland (Glasgow-ship building area), Wales (coal mine area around Cardiff and Fishguard), Northern England (Steel and coal mine area around Newcastle), Mid England (Mid Yorkshire coalmine areas) and the whole Northern Ireland. As for Northern Ireland, the entire area is added to the DA; therefore, the majority of RSA benefits can be obtained if a company invests in Northern Island (Except Belfast). Benefit requirements for companies investing in the DA and IA follows.

- An investing company should have independent economic capability or possibility of independence.
- An investing company should contribute to the creation of employment in the appropriate area and have possibility to keep over a certain level of employment.
- An investing company should contribute to the economy of the appropriate area.
- An investing company should need assistance.

The payment criterion for assistance is not determined, but will be determined through negotiations with individual investors on a case-by-case basis. In investment with large capital, such as in semi-conductors, high-tech chemicals, manufacturing and facility investment, the scale of capital investment is also considered in addition to the ability to create employment. As for the method of acquiring benefit, assistance is paid in three installment payments. Assistance is paid based on investment progress and employment level specified in the contract, but assistance can be cancelled due to sluggish investment or cancellation of investment. RSA is large in new investment, but small in added investment since the possibility to invest in other than the U.K. is low, once invested in the U.K., that makes investors lose their bargaining power in negotiation table with the host government. The sources of the assistance come almost entirely from government's budget, and partly from the EU executive committee's fund, and subsidies of various private companies. According to the U.K. government's white paper on budget expenditure (1997), it reported that every one million pounds of assistance induced 14 million pound worth of investment and created

241 jobs as spreading effects.

The local government package, differing from RSA, is an investment incentive, which a local government provides with its own financial resources, that gives benefits in the types of employment and education/training cost payment, reduction of lease fee or rent and reduction of property tax. The local package is differentiated by area, and the central government leads in having the local government provide it when possible to prevent over competition among areas. The local government package is normally related to an industrial site and factory facility. The following is the investment supporting system of the Northern Island area, which is supported as an exception.

***The support system of the Northern Island area***

- Grant on investment capital: If an investment is judged as contributing to enhancing the industrial competitiveness and being promising internationally, up to 50% of the cost for factory construction (including factory site) and equipment purchase based on the effect of employment creation are paid gratis by the Industrial Development Board (IDB) (Tax is exempted, because it is conceded as tax-free income).
- Grant on employment: This grant is paid based on newly created employment scale and it can be converted to company operating capital. The period of assistance is three years and if the employment scale is guaranteed, a grant for a three-year period can be paid at a time.
- Free assistance on operating capital: When a factory is leased, up to 100% of the leasing fee is paid for up to five year period, and interest assistance for the following seven years is available for capital borrowed from non-government institutions, while management

incentive is paid when highly competent management personnel are employed.

- Factory construction and lease: IDB charges actual cost on factory construction or sale, long-term lease of a factory that is required by a foreign investment company and provides the factory site. Up to five years, 100% of lease fee will be assisted.
- Benefits on taxation: 40% of depreciation is allowed for machinery, equipment and factory construction for the first year of business and then after, an annual 25% of depreciation for machinery and equipment and an annual 4% of depreciation for factory construction are allowed.
- Assistance for education and training of employees: By establishing a training center as a subsidiary of the IDB, employee education is supported in such areas as the preparation of training program for pre-employment, providing a training center and dispatching a technician.

## 2. Foreign direct investment policy of Malaysia

### 2.1. FDI policy objectives of Malaysia

In Malaysia, foreign investment in the 1980s contributed to its economic growth largely by using low waged labor, but it has tried hurriedly to absorb low waged workers of the surrounding countries to soothe wage increase pressure and it has been attempting to advance its industrial structure and create high value-added product in the short term due to sharp wage rises starting in the 1990s. Under the catch phrase "WAWASAN 2020" to join the rank of the developed countries, the Malaysian government is driving its foreign investment attraction policy to be focused on advancing industrial structure, enhancing firm exports and achieving national economic independence.

Above all, advancing the industrial structure is the most imminent task. Foreign investment is treated in the industrial policy dimension; therefore, investment in labor-intensive or low value-added industries is not even authorized or permitted as domestic Malaysian investment. The project, which has the capital investment per employee ratio of under M$55,000 is defined as the labor-intensive industry, and manufacturing business permit will not be granted nor offered investment incentives. In principle, Malaysia does not provide any differential incentives from a Malaysian company to foreign investment, and to the contrary, the equity ratio of a foreign investment company to induce a joint venture with a Malaysian company is not permitted. Improving the actual Malaysian industry's competitiveness is the goal of the basic FDI policies and it entails adjusting the equity ratio based on export ratio, technology level of investment project, spreading effect, value-added activity and domestic procurement of raw material.

If the export ratio accounts for over 80% of gross turnover, the foreign equity share limit is 100%, which means wholly owned subsidiary is possible if the export ratio is 51%-79%, the equity share limit is 51%-79%, the export ratio is 20%-50%, the equity share limit is 30%-51%, and if export ratio is below 20%, then maximum the foreign equity share ratio permitted becomes 30%. Production of high-tech products, however, or necessary goods in consideration of domestic market situation, mining excavation and production of goods related to ore processing are irrelevant of foreign equity limit; that is, 100% of foreign equity share is permitted. The Malaysian government postponed foreign equity limit based on export ratio temporarily and made it possible to own 100% of foreign equity irrelevant to export ratio to promote improvement of its sluggish foreign investment due to economic difficulties in Malaysia from July 31 1998 to December 31 2000. That was done to increase new investment applications during the period. In spite of the exception clause, the existing foreign equity share limit based on export ratio applies to seven fields where local production is sufficient, such as the paper packing industry, plastic packing industry, parts related to plastic injection, metal structure, printing, electroplating and iron manufacturing service, without application of the above exceptional regulation.

To promote Bumiputra native's economic independence, the government induced distribution of equity share between foreigners and local ethnic groups. The distribution ratio of equity share between local ethnic groups is indicated in Table 2, when there is a joint venture with a foreign investor.

Table 2. Compulsory distribution ratio of a foreign joint venture between local ethnic groups

| The subject of a project | Foreign equity | Equity distribution between local ethnic groups | |
|---|---|---|---|
| | | Bumiputra | Non-Bumiputra |
| Foreigner (No domestic partner) | Over 70% | Residue | - |
| | Below 70% | 30% | Residue |
| Foreigner+Bumiputra | Over 70% | Residue | - |
| | Below 70% | Residue | - |
| Foreigner+non-Bumiputra | Over 70% | - | Residue |
| | Below 70% | Residue | 30% |

## 2.2. The means of FDI policy of Malaysia

Investment incentive assumes the tax reduction or exemption. Incentive types are divided into three types; new investment, re-investment and other incentives on a case-by-case basis. Incentives for new and re-investment have originated from the Investments Promotion Act (Act 327) and Orders, and other incentives are based on special individual law. Regarding new investment, a new investor determined to be fit for granting approval can select either grant pioneer status or investment tax allowance incentive. The investor; therefore, decides which incentive is more favorable to him/her after analyzing, and the details of incentives follow.

The company that obtains pioneer status only pays 30% of the tax out of the legal income, since tax is partially exempted for this kind of company. The benefit period is five years from the production date that the Minister of International Trade and Industry (MITI) designates, and the pioneer businesses are announced as recommended goods for investment. Companies operating in the favorably treated areas, such as Eastern Malaysia (Saba and Sarawak) and the eastern region of the Malay Peninsula, only have to pay 15% of the tax out of the legal income during the period.

As for investment tax allowance, 60% of allowance benefit is provided for capital expenditure within five years from the date of investment. The allowance amount can be offset up to 70% of the legal income during the taxation year, and the balance can be transferred to the next year until total allowance is spent. The business types for investment tax allowance is separately announced as recommended goods for investment. In Eastern Malaysia and the eastern region of the Malay Peninsula, which are favorably treated areas also, 80% of allowance benefit is provided and the allowance amount is possible to off-set up to 85% of the legal income during the taxation year.

Regarding re-investment allowance, the capital expenditure for the expansion and modernization of production facilities and diversification of related goods is allowed up to 60% and the allowance amount is possible to off-set up to 70% of the legal income.

In the areas of timber, textile, machinery and engineering, investment allowance for industrial restructuring is given up to 100% of allowance benefit for the capital expenditure to implement restructuring, such as productivity improvement, spent by an existing investment company before 1990, within a specified range. Allowance for industrial restructuring needs ex-ante approvals of the MITI and Minister of Finance, and double allowances with investment tax allowance and re-investment allowance are prohibited.

Other incentives include investment encouragement incentives for national strategic projects and the high-tech industry, encouragement incentives for acquiring industrial assets rights, investment incentive for small and mid-size companies, investment incentive for enhancing industrial independence, encouragement incentive for inducing a multi-national corporation's regional headquarters and export encouragement incentive. The incentive scale is the largest for the investment encouragement incentive for national strategic projects and the investment encouragement incentive for the high-tech industry. The former, a large-scale high-tech project, is given the benefits of ten years of full tax exemption, or a 100% investment tax allowance, for capital expenditure spent within five years from the starting date of investment. As for the latter, five years of full tax exemption is given to the appointed high-tech company engaged in new technology development business or 60% of allowance benefit is given for the capital expenditure spent within five years from the investment starting date.

## 3. Foreign direct investment policy of Singapore

### 3.1. FDI policy objectives of Singapore

The transition of Singapore's foreign investment policy is closely related to its history and political environment. Singapore was a trade base of the British East India Company in 1819. It became the British colony in 1867, and was under Japanese military occupation from 1942 to 1945. In 1959, Singapore established its autonomous government and joined the Malaysia Federation in 1963 and then it became an independent nation in 1965, withdrawing from the Malaysia Federation.

The biggest economic tasks were replacing imports, promoting exports and creating employment just after its independence. Singapore, therefore, induced foreign labor-intensive industry to expand employment opportunities and encouraged policies for foreign investment companies to replace its import-oriented industry and production. At that time, Singapore accepted any foreign investors without selection in its foreign investment policy, which led to fostering a labor-intensive industry, such as fiber, textile, toys and wooden products.

The Singapore's government, starting in the 1970s, focused on the capital-intensive and high value-added industries and strengthened investment incentives; that is, pioneer status --Until 1970, 352 corporations obtained pioneer status, in which it tried to induce foreign companies with advanced technology. As a result, foreign companies accounted for 26% of the all companies, 63% of total employment, 75% of gross value-added product produced and 75% of exports in 1971. Due to the first oil price shock that occurred at the beginning of the 1970s, the Economy of Singapore experienced difficulties, but not to an extreme, and during this economic depression, the government exercised various industrial development projects. Many investment promotion tools were introduced and implemented to induce high-tech and capital-intensive industries, and post-pioneer status was given to the companies that had obtained pioneer-status to extend special benefits. During the economic depression in 1975, the manufacturing sector surpassed the commercial sector for the first time and became the largest industry. Meanwhile, means for promoting domestic companies, such as capital assistance schemes, investment allowance schemes, product development assistance schemes in addition to those for foreign company investment inducement were prepared.

From the 1980s until now, Singapore has been in the high-tech industry inducement stage. The government proclaimed that its economy was in the "Second Industrial Revolution" stage in 1981, and actively pushed forward to induce high-tech industry investment, which could obtain high value-added product without severe regulations from the MDCs when fiber, shoes and furniture were influenced by such trade barriers as high tariffs and importing quotas in the world market. The government designated the high-tech industry to produce integrated circuits, computers, industrial electronic equipment and special chemical materials, and has induced active foreign investment in those sectors.

In the meantime, the government of Singapore intends for the country to be an international business, comprehensive service center as well as fostering the high-tech and high value-added industries. The system introduced to make Singapore an international business center includes a favorable treatment system for appointing Operational Headquarters (OHQ) and tax reduction or exemption systems for Authorized International Traders (AIT), International Procurement Offices (IPO) and Authorized Oil Traders (AOT). The objectives of Singapore's foreign investment policy not only include advancing industrial structure, promoting exports and fostering the manufacturing industry, as in the introduction of new technology and processes, improvement of productivity and fostering high-tech industry, but also utilizing foreign investment for becoming an international business service center and a center for globalization.

### 3.2. The means of FDI policy of Singapore

The Singapore's incentive system tends not to be publicly implemented and is separated on a case-by-case basis by Singapore's Economic Development Board (EDB). To acquire investment benefits, an investment company should undergo EDB's screening. As for the incentives to be given to foreign companies advancement related to advancing industrial structure and creating high value-added, the categories include the pioneer status, post-pioneer status and development and expansion incentives.

Pioneer status is to reduce or exempt investors from Singapore's corporate income tax rate (the corporate income tax of 26%) for 5-10 years based on the type of goods and technology level when new technology is introduced to produce goods that are not produced in Singapore, and the loss accrued during the tax exemption period can be transferred to the period after the exemption period. If a company is authorized post-pioneer status after the pioneer status period has expired, 10% of the corporate income tax rate can be applied to the company instead of the 26% for a maximum of ten years. Development and expansion incentive can be offered when a foreign investment company undertakes a new project in an area that has large economic spread effects or expands its existing investment. A reduction of 13% of Singapore's corporate income tax rate out of the 26% of the normal corporate income tax rate is provided. The period of benefit is up to ten years.

The incentive related to promoting exports includes export of services. Export of service incentive refers to exempting 90% of export related income tax of a company that exports over 20% of its total income through services related to an overseas project exercised based on Singapore or exports products valued over 100,000 Singaporean dollars annually. The exemption period is up to ten years. A foreign company can acquire incentives even though it does not receive pioneer status or taxation support as an exporting company. When a foreign company in Singapore invests in capital facilities in approved industrial areas (manufacturing, R&D, construction and saving drinking water) within five years of the legal period, the government reduces up to 50% of the tax out of taxation amount of new investment, which is called investment allowance incentive.

The operational headquarters incentive is to assist in promoting Singapore as an international business center. When a company with an international network establishes a local corporation specifically, an operational headquarters in Singapore, and manages overseas subsidiaries, then the government applies a reduced corporate income tax rate of 5-10% for up to ten years on administrative income, interest, royalty, income resulting from foreign exchange transactions, offshore investment income and other income. The foreign withholding dividend income is also tax free for ten years.

Other tax benefits included an accelerated depreciation scheme. Instead of the usual depreciation rate (initial period-20% and every year-5-20%), annual 100% or 33.3% of depreciation can be given to the computer, automated facilities and industrial robot industries, and twenty-five years of depreciation is acknowledged for industrial buildings.

The approved foreign loan scheme is one in which withholding taxation at the source of income is reduced or exempted when over S$200,000 dollars are financed from foreign financial institutions to purchase a production facility (but only when exempted tax amount is not taxed overseas). The financial assistance is exercised by investment promoting institutions, including EDB and other related institutions, not by law, but on a large scale investment judged as necessary to economic development. The EDB decides the scale of assistance without notifying the public based on individual investment.

## 4. Foreign direct investment policy of Korea

### 4.1. FDI policy objectives of Korea

The first law related to foreign investment in Korea, which has been the benchmark of foreign investment in Korean policy, was the Foreign Capital Introduction Promotion Act in January 1960. The Foreign Capital Introduction Promotion Act, which meant FDI as the means for simple foreign capital introduction was revised as Foreign Capital Introduction Act later on, and was revised three times. The Foreign Capital Introduction Act was applied in July 1984, authorization instruction has been changed from a positive system (permitted business types) to a negative system (prohibition and limitation business sectors), and the criteria and business sectors of tax reduction or exemption are maintained.

Although the third revised act superficially indicates opening of investment business sectors, the investment objects or the scale of tax reduction or exemption have become more restrictive, considering the current legal operating practices. The objects of tax reduction or exemption had been restricted to the seven business types: businesses carrying advanced technologies, favored small and mid-size fostering businesses, investment businesses of a Korean national abroad, businesses located in a Free Trade Zone, exporting business (exporting more than specified rate of self-produced goods and when export ratio is larger than import dependence ratio plus 30%), import replacement business and large-scale investment business (A business producing an item with tariff rate under 10% as automatically approved import items, and with a one time investment amount exceeding US$10 million and as tourist hotel business with one time investment amount exceeding US$5 million), and the tax reduction or exemption scale reduced to only a five-year tax exemption from the prior five-years exemption and 50% of tax reduction for the next three years after that.

In the Foreign Capital Introduction Act Enforcement Ordinance revised in January 1990, business sectors of tax reduction or exemption objects were reduced to businesses carrying advanced technologies, businesses located in the Free Trade Zone and other businesses as specified by executive order. And, the period of tax reduction and exemption was curtailed to three years for a 100% tax exemption and 50% of tax reduction for the next two years after that, when the fourth revised Act was implemented. In the Act on Foreign Investment and Foreign Capital Introduction which was applied in April 1997, the tax reduction and exemption period again set to the level of five years at 100% exemption and 50% of tax reduction for the next three years after that, the same level as before 1984.

As the importance of FDI emerged due to overall economic difficulties, including the foreign exchange crisis and bankruptcy of badly managed companies at the end of 1997, the government formulated full-scale inducement promotion tools. In the Foreign Investment Promotion Act (FIPA) valid currently since November 1998, the business sectors of tax reduction or exemption have been extended to service industries supporting manufacturing sectors and businesses located in the Foreign Investment Zone, in addition to businesses carrying advanced technologies; and the tax reduction and exemption period has been extended to seven years at 100% tax exemption and 50% of tax reduction for the following three years after that, totaling ten years in all.

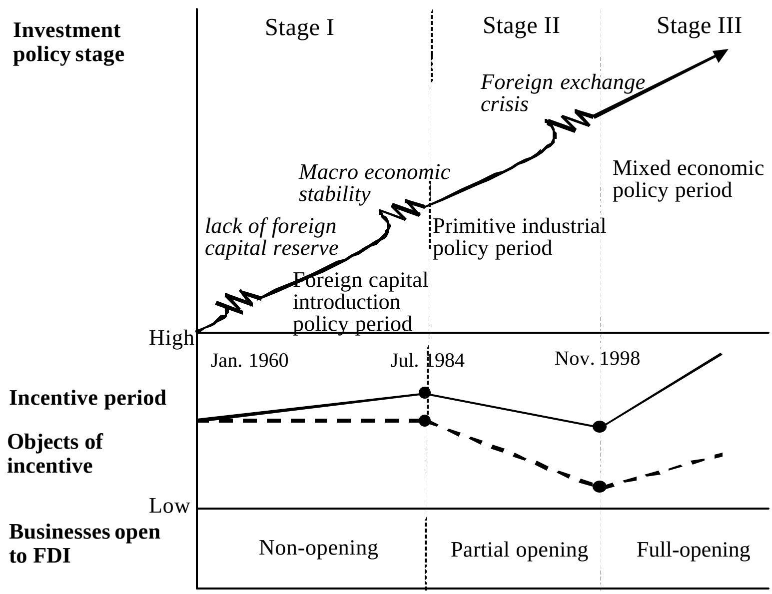
The characteristics of Korean foreign investment policy can be divided into three stages as follows.

The Korean investment policy stage, during the 60s-70s and the beginning of 1980s (before July 1987), that was marked as the first stage, can be considered to be *the Foreign Capital Introduction Policy Period*. In the beginning of 1960s, foreign capital introduction focused on commercial loans, such as commercial loans and the public loans from the International Bank for Reconstruction and Development (IBRD) rather than FDI due to the negative view on the right of foreigners to engage in management. The government permitted FDI within the range of no severe clash with the domestic industry, as it faced foreign debt burdens due to rapidly increasing commercial loans since 1965. FDI was used to foster the export industry and import replacing industry based on strategy for promoting exports for the purpose of obtaining foreign currency. Above all, investment in the export industry was authorized in the first place and joint venture principle was applied at the same time, and sole FDI was permitted only in the case of exporting all of the goods produced in Korea. During the 1970s, FDI was joined with the area of heavy and chemical industry to expand production facilities and intermediary production base, but still foreigner's participation in management was restricted. Accordingly, foreign investment ratio principle was 50:50 between Koreans and foreigners. Amid the government's attempts to induce foreign investment to the domestic industrial policy, due to instability in the international financial market, including the second oil price shock and the proclamation of debt payment default by developing countries occurred at the end of 1970s, thus the need to induce FDI emerged sharply.

The second stage, from July 1984 to November 1998, one year after the occurrence of the foreign exchange crisis, is called *the Primitive Industrial Policy Period*. The business sectors to FDI permitted change from a positive system to a negative system, and the opening wave was accelerated by setting different investment ratios by business sectors, while the uniform 50% of investment ratio limit was abolished. During the latter part of 1980s, government showed a closed attitude toward FDI as the situation of foreign exchange market grew better due to domestic and overseas economic booms. During this period, the base of investment policy was to open objects of investment, but not to give incentives to all the FDI companies. That is, business types receiving incentives were restricted (seven business sectors) to particular industry and particular area in which particular effects can be achieved. This period was one of which FDI policy mixed with industrial policy elements. Seven business sectors of tax reduction or exemption objects were restricted to only businesses carrying advanced technologies and businesses located in the Free Trade zone, and the elements of industrial policy became increasingly deeper. At the end of 1980s, the government opened investment in the manufacturing sector and in the beginning of 1990s, the service industry was also open.

The third stage, from November 1998 when FIPA was initiated to the present, is called *the Mixed Economic Policies Period*. As foreign reserves were depleted due to the foreign exchange crisis, the government expanded FDI inducement to stabilize foreign exchange. The bankruptcy that many companies' experience due to heavy debt burdens, followed as the result of sudden economic difficulties, and unemployment problems began. The government experienced three-fold difficulties of depletion of foreign exchange reserves, non-performing corporations and increase in the rate of unemployment. FDI was used to solve all of the three-fold difficulties. The government allowed FDI companies acquire domestic non-performing companies in the exit situation, which made it possible to perform corporate restructuring and relieve unemployment at the same time. The government extended investment incentive benefit periods, and opened short-term and long-term national bond markets and other bond markets, and M&A markets by which it prepared the base of M&A type investment rather than that of new factory establishment type of investment. Business sectors for investment opening were sharply extended, too. It did not open seven business sectors, such as growing of cereal grains, inshore fishing, coastal fishing, radio broadcasting, television broadcasting, coastal water passenger transportation and coastal water freight transportation. It opened 14 business sectors, including the power generation, cable broadcasting, news agency activities and wire/wireless telegraph and telephone etc. All together, only 21 business sectors were restricted among the total of 1,148 business types. The opening rate, therefore, was 99.4%. The transition of FDI policy characteristics by each stage and opened business sectors and investment incentive systems are shown in Figure 4.

Figure 4. FDI policies by stage




As for the characteristics of Korea's FDI policy related to industrial policy, the FDI policy as with industrial policy means started during the latter part of the 1980s, was not able to develop from the primitive industrial policy period into the next stage; that is, the industrial policy settlement stage, due to the sudden foreign exchange crisis. Rather, it was used as a mixed economic policy means. An improper fit, accordingly, occurred partially between objectives for investment policy and support means for it is due to the clash of investment policy objectives. Despite the fact that the grant system is effective for creating employment and regional development, and fiscal incentive system is effective for advancing industrial structure shown in the case studies of the U.K., Malaysia and Singapore, the Korean government has tried to achieve various economic goals, including advancing industrial structure. In other words, it has tried to improve not only quantity but also quality aspects of FDI by enhancing tax reduction or exemption-oriented incentive system, which has been investment promotion tools in quantity aspects for more than 40 years from 1960.

### 4.2. The means of FDI policy of Korea

The type of Korean investment incentive is the fiscal incentive system in which tax reduction and exemption is mainly offered. In addition to the tax reduction or exemption of corporate tax, income tax and local tax, there are leasing national/local government properties and a grant system, but the largest benefits of incentives for foreign investors are tax reduction or exemption incentive system. The objects for tax reduction and exemption include 97 service industries supporting manufacturing and 436 business sectors carrying advanced technologies and FDI companies located in the Foreign Investment Zone (FIZ). *Service businesses supporting domestic industry* is the service business, acknowledged as necessary to enhance the domestic industry's international competitiveness, which supports the development of other industries, including the high value-added manufacturing sector. *Businesses carrying advanced technologies* refers to that business acknowledged as being necessary to enhance domestic industry's international competitiveness, which accompanies technology that has not been developed or is at a very low level in Korea. As for the method to reduce and exempt tax, businesses carrying advanced technologies and service industries supporting manufacturing are exempted 100% of tax for seven years and for the three years following that, 50% of income tax and corporate tax is reduced. As for the business located in the FIZ, 100% of corporate tax and income tax for seven years and 50% of that for the next three years after are reduced and exempted from the date of business commencement. The income tax and corporate tax for a FDI companies are treated in the same way as tax reduction and exemption from it. Not only national taxes, but local taxes, such as acquisition tax, registration tax, property tax and aggregate land tax, are also reduced and exempted. The minimum tax reduction/exemption required by law is eight years (five years at 100%, then three years at 50%). The periods of reduction and exemption or allowance can be extended up to 15 years by the local government's ordinance and within the extended period. Tax reduction and exemption system regulated in the FIPA, which has been implemented since November 1998 has been compared with that of before amendment. Table 3 shows the comparison.

Table 3. Comparison between prior and current tax incentives

| Past | Present |
|---|---|
| **National tax**<br>Corporate tax, Income tax, Income tax on dividends<br><br>·Businesses carrying advanced technologies: reduction and exemption for 8 years (full exemption for five years, 50% reduction for the next three years)<br>·Business located in the Free Trade Zone: reduction and exemption for 5 years (full exemption for three years, 50% reduction for the next two years) | **National tax**<br>Corporate tax, Income tax, Income tax on dividends<br><br>·Businesses carrying advanced technologies, service industries supporting manufacturing, business located in the Foreign Investment Zone, business located in the Trade Free Zone: reduction and exemption for 10 years (full exemption for seven years, 50% reduction for the next three years) |
| **Local tax**<br>Acquisition tax, Property tax, Aggregate land tax<br><br>·Reduction and exemption for 8 years (full exemption for five years, 50% reduction for the next three years) | **Local tax**<br>Acquisition tax, Property tax, Aggregate land tax, Registration tax<br><br>·Minimum reduction and exemption period: 8 years (full exemption for five years, 50% reduction for the next three years)<br>·The reduction and exemption periods and rates can be determined within 8~15 years by local ordinance |

Customs, duties, special excise tax, and value added tax, with respect to capital goods imported for three years from the date of notification of FDI for the purpose of operating a business of FDI companies, are fully exempted. A foreign company can receive grants from the central and local government in relation to factory establishment and employment in addition to tax reduction and exemption. The grants are divided into assistance related to the lease national and local government properties and government grant.

The minister of Finance and Economy (MOFE) and the heads of administrative agency for national properties and local government can lease or sell national and local properties to a FDI company by free contract irrelevant of National Assets Law and Local Finance Act and FIPA (article 14), and to the FDI company related to this. The benefits of postponing payment for sale, installment payment, reduction of lease fee for national and local government properties and discount of unit price of selling are given. The rental period for national and local properties can be up to 50 years, and it can be renewed up to 50 years. The sale amount for national properties can be paid by installment payment within 20 years or the payment period can be postponed up to one year. As for the land owned by a local autonomous government, the payment date and installment payment period can be determined by its ordinance. The lease fee reduction or exemption does not apply to all regions, but applies to only lands in the Foreign Investors' Industrial Complex purpose complex, National Industrial Complex and Foreign Investment Zone. Full reduction or exemption is given to all businesses of foreign companies located in FIZ and in advanced technology business making FDI that equals or exceeds US$1 million and located in the industrial complex reserved exclusively for FDI companies (Foreign Investors' Industrial Complex). In case of manufacturing companies locating in Foreign Investors' Industrial Complex making FDI that equals or exceeds US$10 million, 75% reduction is allowed. Companies that contribute substantially to assured supply of social overhead capital, adjustment of industrial structure or financial independence of local governments, which are designated by the Foreign Investment Committee are also allowed for 75% reduction. Following businesses subject to reduction up to 50%:

companies carrying advanced technology locating in National Industrial Complex throughout the nation making FDI that equals or exceeds US$1 million and manufacturing companies making FDI that equals or exceeds US$1 million.

According to the FIPA a local government can pay the employment subsidy and education and training subsidies specified by the Act's enforcement order, if necessary, according to the instructions provided by the local government's ordinance. Considering the local government's financial independence, however, the practical effect can be small.

To induce FDI, the region where a foreign investor wants to invest can be appointed as a FIZ by a mayor or a governor through examination of the Foreign Investment Committee, if necessary. When a new industrial complex is developed, satisfying one of three cases, are qualified: foreign investments with over US$100 million involving a manufacturing business, service industries supporting manufacturing and companies carrying advanced technology; and a foreign investment company with the equity ratio of 50% and the employment size of over 1,000 employees and the foreign investment company has over US$50 million and new usual employment of over 500 employees.

When the already developed national industrial complex or a part of it or all of a regional industrial complex are appointed as a FIZ, if the investment amount is over US$30 million and the foreign investment company's new usual employment size is over 300 employees, appointment is then possible. In addition to the industrial complex, the tourist hotel businesses, international conference facilities and integrated resort businesses on Cheju Island or the areas that are specified by an executive order can be appointed as a FIZ. Tourist hotel businesses and international conference facilities should have over US$30 million in foreign investment and the integrated resort business on Cheju Island or the areas specified by the Finance and Economy minister's order should have US$50 million in foreign investment.

The characteristics of Korean investment incentives are summarized as being the restriction of the benefited industry and tax reduction/exemption oriented. The objects of national and local tax reduction or exemption have been restricted to service industries supporting manufacturing and companies carrying advanced technology, only if these have large spread effects on the related industries and create high value or have sophisticated technology. From this, anyone can see at a simple glance that investment incentives lie in advancing industrial structure. Although the conditions to designate a FIZ include investment amount, the ratio of FDI and employment size, a FIZ is designated only if a business carries out service businesses supporting domestic industries and companies carrying advanced technology, considering these conditions deferentially, not providing incentives if these conditions apply to all business types independently.

## 5. Implications from case studies

Common characteristics that emerge from the case studies on FDI policies are that the goals for investment policies are related to each nation's social, economic and political background. The U.K.'s priority on the investment policy goals lies in creating employment and economic development of outdated regions to relieve unemployment arising from declining industry, and to achieve these goals, investment incentives paying grants based on creating employment and depending on the retardation of the region, how much of an investment company's advances have been prepared. The nation that is in an inferior situation in production efficiency from high labor cost compared to other competitive investment inducing countries, increases the importance of its attractiveness as investment location by operating a grant payment system strongly and flexibly. Each local government under its own judgement offers assistance (grant) to an foreign investment company that is considered to be needed to induce within the limit of regulation of a law or flexibly pays it through negotiations between the benefactor and beneficiary, although the amount is more than what is permitted under the law.

Malaysia, which holds low waged and abundant labor forces in investment location aspect, provides selective investment incentives for foreign investment companies, and accordingly, it pursues policies to foster a high value-added industry and to increase exports. This investment environment, which is different from the U.K.'s flexible assistance payment system related to the number of created employees per dollar invested, is the foundation in settling fiscal incentive system that provides tax reduction or exemption benefits of capital-intensive and technology-intensive industries by explicit standards.

Singapore plans to become the world center of MNCs, finance, tourism, transportation, high-tech industry and business, while the nation drives the so-called "Singapore 21" program in which it tries to advance to the ranks of advanced countries by 2030. The FDI policy, accordingly, induces and supports foreign investments selectively to attain these goals. The fiscal incentives, which mainly provides tax reduction or exemption, are the main stream, and Singapore maintains a developed financial support system. The limitation of flexible operation due to codified law covering tax reduction/exemption has overcome through flexible financial support including fund loans by the EDB and investment inducing institutions.

Korean FDI policy was developed as the means for foreign capital introduction in the past, but these days it has focused increasingly on fostering particular industries and tools to overcome economic issues. The fiscal incentive system, which is tax reduction or exemption oriented, has been maintained since 1960 when the investment incentive system was established, the short-term investment policy objectives, reflected the economic situation such as acquiring foreign exchange reserves, corporate restructuring and relieving unemployment, became susceptible to a change due to the sudden foreign exchange crisis. Accordingly, the importance of foreign investment emerged, and as a result, investment inducing activities and incentives are extended. In the FIPA, although partial permission of subsidy payment and preparation for the its regulation is provided, generating employment and investment scale have been considered. Still the objects of incentives have been limited to the service businesses supporting the domestic industry and businesses carrying advanced technologies. Therefore, the foundation of Korean industrial policies, so to speak, advancing industrial structure, has been carried on. The existing incentives efficient to fostering the high value added industry and enhancing industrial competitiveness can be the policy means that differ from overcoming the foreign exchange crisis that are set as flexible short-term policy achievement goals.

As a result of analysis, each country's FDI policy was fit for achieving policy objectives as the means for investment policy linking the FDI policy objectives with each country's economic goals, although each country has a different internal and external environment. The comparison of each country's background to induce FDI, FDI policy objectives and supporting policy means is shown in the following Table 4.

Table 4. Comparison of comprehensive cases

| | U.K. | Malaysia | Singapore | Korea |
|---|---|---|---|---|
| Background to induce investment | Social/political issue: unemployment due to deteriorating traditional industries | -Labor intensive industry oriented<br>-Income difference among ethnic groups<br>"Vision 2020" | Industrial internationalization to overcome small territory and the lack of resources<br>"Singapore 21" | Improvement of economic structure is needed<br>"Economy crisis" |
| FDI policy objectives | -Generating employment<br>-Balancing development of outdated regions | -Advancing industrial structure<br>-Increasing export | -Globalization oriented<br>-Advancing industrial structure<br>-Fostering high-tech industry | -Advancing industrial structure<br>-Improving economic structure |
| Investment policy means | -Flexible assist operations by methods of payment (grant oriented)<br>-The scales of grant directly related to the number of jobs available per person | -Tax reduction and exemption oriented based on explicit standards<br>-Linking tax reduction/exemption rate with the ratio of invested capital per person | -Tax reduction/ exemption oriented<br>-Development of financial support (flexible operation)<br>-The size of tax reduction/exemption directly dependent on the level of technology | -Tax reduction/ exemption oriented<br>-Object of incentives are restricted to service business supporting domestic industry and high-tech accompanying industry |

# Ⅴ. Empirical Analysis on Foreign Direct Investment Policy

## 1. Data

These data are based on questionnaire completed by policy makers in charge of attracting FDI in each country through the Korea Trade-Investment Promotion Agency's overseas network. The data set consists of 68 samples from 68 countries: 22 countries in Europe, 15 countries in Middle East and Africa, two countries in North America, 12 countries in Central and South America and 17 countries in Asia. The period of the survey was between August 1 through August 31, 1999. The policy objectives and investment incentives were measured on five-point scale. The average creating employment, advancing industrial structure, and fiscal incentive are higher than other cases. As for descriptive statistics on investment incentives, seven countries including Argentina, Lebanon, etc., which do not have investment incentive systems are excluded from the 68 countries (See Table 5).

Table 5. Descriptive statistics of sample

| | Advancing industrial structure | | Enhancing exports | | Regional development | | Creating employment | | Increasing foreign reserves | | Fiscal incentive | | Financial incentive | | Market preference incentive | |
|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|
| Weak 1 | 6 | (8.8) | 6 | (8.8) | 5 | (7.4) | 2 | (2.9) | 18 | (26.5) | 6 | (9.8) | 18 | (29.5) | 40 | (65.6) |
| 2 | 2 | (2.9) | 6 | (8.8) | 12 | (17.6) | 8 | (11.8) | 9 | (13.3) | 6 | (9.8) | 11 | (18.0) | 11 | (18.0) |
| 3 | 10 | (14.8) | 18 | (26.5) | 21 | (30.9) | 9 | (13.3) | 19 | (27.9) | 12 | (19.7) | 13 | (21.3) | 6 | (9.8) |
| 4 | 16 | (23.5) | 21 | (30.9) | 14 | (20.6) | 5 | (7.4) | 6 | (8.8) | 15 | (24.6) | 4 | (6.6) | 3 | (4.9) |
| Strong 5 | 34 | (50.0) | 17 | (25.0) | 16 | (23.5) | 44 | (64.6) | 16 | (23.5) | 22 | (36.1) | 15 | (24.6) | 1 | (1.6) |
| N | 68 | | 68 | | 68 | | 68 | | 68 | | 61 | | 61 | | 61 | |
| Mean | 4.1 | | 3.5 | | 3.4 | | 4.2 | | 2.9 | | 3.7 | | 2.8 | | 1.6 | |
| Std. | 1.3 | | 1.2 | | 1.2 | | 1.2 | | 1.5 | | 1.4 | | 1.6 | | 1.0 | |

Note: Valid percentage of numbers are in parenthesis.

Figure 5 and Figure 6 show the highest marked investment objectives and investment incentives of samples according to the conceptual frame that was presented earlier.

Figure 5. FDI policy objectives of sample

| | | |
|---|---|---|
| *Local* | | **Regional development**<br>France, India, Indonesia, Ireland, Japan, Nigeria, Rumania, Taiwan, Thailand, U.K., U.S.A., Uruguay, Libya, Myanma (14 countries) |
| *National* | **Advancing industrial structure**<br>Bangladesh, Canada, Cote D'ivoire, Czech, Denmark, Dominican Republic, Guatemala, Hungary, Italy, India, Indonesia, Japan, Kenya, Korea, Malaysia, Morocco, Myanma, Nigeria, Norway, Oman, Panama, the Philippines, Poland, Portugal, Rumania, Saudi Arabia, Singapore, Slovenia, South Africa, Sri Lanka, Taiwan, Turkey, Ukraine, Uruguay, Venezuela, Zimbabwe (37 countries)<br><br>**Enhancing firm's exports**<br>Egypt, Germany, India, Indonesia, Myanma, Nigeria, Oman, Pakistan, Peru, Rumania, Saudi Arabia, Slovenia, South Africa, Taiwan, Thailand, Uruguay, Zimbabwe (17 countries) | **Creating employment**<br>Belgium, Brazil, Columbia, Cote D'ivoire, Denmark, Egypt, France, Germany, Greece, Guatemala, Italy, India, Indonesia, Ireland, Japan, Kenya, Lebanon, Mexico, Morocco, Myanma, the Netherlands, Nigeria, Oman, Panama, Peru, the Philippines, Poland, Portugal, Rumania, Saudi Arabia, Slovenia, South Africa, Spain, Sri Lanka, Taiwan, Thailand, Turkey, U.K., U.S.A., Ukraine, Uruguay, Venezuela, Zimbabwe (43 countries)<br><br>**Increasing foreign exchange reserves**<br>Bangladesh, Dominican Republic, Guatemala, India, Jordan, Kenya, Lebanon, Nigeria, Pakistan, Peru, Rumania, South Africa, Thailand, Uruguay (14 countries) |
| | *Development* | *Start-up* |

Figure 6. FDI policy means of sample

| | | |
|---|---|---|
| *Flexible* | | **Financial incentive**<br>Austria, Belgium, Chile, Czech, France, Germany, Greece, Guatemala, Italy, India, Japan, Morocco, Portugal, Spain, Taiwan, U.K., U.S.A. (17 countries) |
| *Inflexible* | **Fiscal incentive**<br>Brazil, Chile, Cote D'ivoire, Egypt, France, Greece, Italy, India, Indonesia, Japan, Jordan, Korea, Malaysia, Morocco, Oman, Portugal, South Africa, Sri Lanka, Taiwan, Thailand, Turkey, Ukraine, Venezuela (25 countries) | **Market preference incentive** |
| | *Ex-post* | *Ex-ante* |

## 2. Findings

In selecting political tools for FDI policy, the national financial condition can be a restriction. It is hard to adopt financial incentives. e.g., government grants, as investment attracting tools when national financial condition is insufficient for a developing country. In this book, we take account of it in empirical analysis, Pearson's correlation analysis was conducted in three groups, i.e., total samples, more developed countries' (MDCs') samples and less developed countries' (LDCs') samples. Partial correlation analysis was also conducted to control for dummy variables in Organization for Economic Co-operation and Development (OECD) membership countries. This book regards OECD membership countries as MDCs and non OECD membership countries as LDCs. As for MDCs, 27 samples belong to OECD membership country and the remaining 41 countries are adopted as LDCs' samples. Table 6 shows the summery of correlation analyses.

The result of Pearson correlation analysis, which used the whole sample, shows that the objective of advancing industrial structure has a positive correlation with fiscal incentive and the objective of regional development with financial incentive. Pearson correlation coefficients .259 and .369, which are significant at the 1 percent level and at the 5 percent level, respectively, are expected. These relationships are somewhat different between the groups of MDCs and LDCs. The relationship between the objective of regional development and financial incentive is more stronger in MDCs than in LDCs. The coefficient value in MDCs is more than three times the corresponding coefficient in LDCs. Meanwhile, the coefficient between the objective of advancing industrial structure and fiscal incentive is significant in LDCs but the corresponding coefficient becomes statistically insignificant in MDCs. In partial correlation analysis controlling for OECD membership countries, the correlation coefficients between the objective of advancing industrial structure and fiscal incentive is significant at the 5 percent level and between the objective of regional development and financial incentive is significant at the 1 percent level. The result of correlation analysis with the objective of enhancing exports, which is another regional and process developing type of policy objective, is not similar to the result of advancing industrial structure. The relationship between the objective of enhancing export and fiscal incentive is insignificant in all models.

As for other relationships between the objectives and incentives, market preference incentive caused negative effects on advancing industrial structure and on creating employment in all correlation analysis except in MDCs. In MDCs, market preference incentive is negatively correlated to the objective of enhancing exports at a 5 percent significant level. From the results we infer that the competitive restrictive policies, therefore, in which only particular companies can enter in particular markets based on a government's political preference, can hinder a firm's voluntary market entry and new investment, and can cause a decrease in employment and bring undesirable results in the industrial structure.

Table 6. Summery of correlation analyses

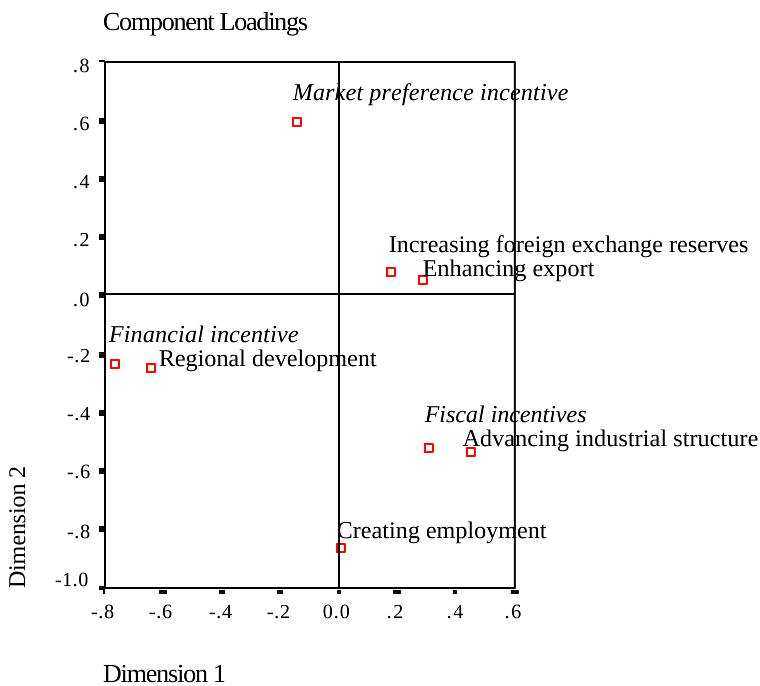
| Correlation analyses | Objectives and Incentives | Advancing industry | | Enhancing firm's export | | Regional development | | Creating employment | | Foreign exchange reserves | |
|---|---|---|---|---|---|---|---|---|---|---|---|
| Simple correlation analysis | Total | | | | | | | | | | |
| | Fiscal | .259* | (.044) | -.205 | (.113) | -.163 | (.209) | .174 | (.180) | -.028 | (.832) |
| | Financial | -.229 | (.076) | -.270 | (.036) | .369** | (.003) | .059 | (.649) | -.249 | (.053) |
| | Market | -.287* | (.025) | -.172 | (.184) | -.054 | (.679) | -.401** | (.001) | -.019 | (.886) |
| | MDCs | | | | | | | | | | |
| | Fiscal | .064 | (.777) | -.395 | (.069) | .197 | (.380) | .177 | (.432) | .083 | (.714) |
| | Financial | -.330 | (.133) | -.223 | (.319) | .723** | (.001) | .365 | (.095) | -.066 | (.771) |
| | Market | -.069 | (.761) | -.452* | (.035) | -.304 | (.169) | -.346 | (.115) | .173 | (.441) |
| | LDCs | | | | | | | | | | |
| | Fiscal | .337* | (.036) | -.161 | (.328) | -.308* | (.057) | .173 | (.292) | -.066 | (.691) |
| | Financial | -.117 | (.477) | -.033 | (.844) | .217 | (.184) | -.104 | (.531) | -.020 | (.906) |
| | Market | -.500** | (.001) | -.169 | (.308) | .083 | (.615) | -.418** | (.008) | -.089 | (.590) |
| Partial correlation analysis | Fiscal | .263* | (.042) | -.228 | (.080) | -.163 | (.212) | .174 | (.184) | -.029 | (.824) |
| | Financial | -.186 | (.154) | -.100 | (.448) | .390** | (.002) | .028 | (.833) | -.033 | (.802) |
| | Market | -.314* | (.015) | -.268* | (.038) | -.050 | (.706) | -.395** | (.002) | -.114 | (.388) |

Note: P-values are in parenthesis.

** and * indicate significance at the 1% and 5% levels, respectively.

Nonlinear canonical correlation analysis (using OVERALS of SPSS 7.5 for Windows) that can test how much a group of variables are correlated to another group of variables is also conducted to prove hypotheses (see Figure 7). The diagram of category coordinates, in which strongly related things locate closely and weakly related things locate further away, shows that fiscal incentive locates closely to advancing industrial structure and enhancing exports, while financial incentive locates closely to regional development.

Figure 7. Nonlinear canonical correlation analysis



## VI. Conclusion and Discussion

During 1998, the year following the financial crisis, FDI on the basis of delivery increased 34% at US$5.2 billion compared to the previous year, and now stands at US$10.4 billion in total, which doubled compared to 1999. The Korean government extended investment incentives to promote FDI, facing the foreign exchange crisis. In the current implemented FIPA, the range of incentives and periods have been extended. The Act provides the benefits of tax reduction or exemption to service businesses to support manufacturing industry in addition to companies carrying advanced technology and businesses located in the Free Trade Zone, and the tax reduction/exemption period was extended to ten years from eight years. Although the support means for investment inducement have been enhanced, however, the economic effects, which were expected, through FDI inducement could not be achieved easily if the supporting means and the policy objectives did not match with each other. Furthermore, the distortion of economic structure can occur as the result of investment inducement, which can lead to some kind of damage.

This book carried out case studies and a correlation analysis to find out if policy objectives and the support means fit with each other. The facts discovered are summarized as follows.

The incentives provided by each government is closely related to each country's political and economic situation and also complements any host country's location attractiveness. The U.K., whose priority falls on generating employment and regional development of the industrially and economically retarded regions, has implemented grants oriented investment incentives based on the extent of generating employment and impediments to advancing the region to achieve these FDI objectives.

The reason why the British government adopts the grant payment type of financial incentive is because this type has large inducement elements in the initial investment stage and is easy to operate flexibly. That is, the grant types incentives fit as a support means to satisfy these desires. The U.K. sets grant size flexibly on a case-by-case negotiation basis, and became the successful country to induce FDI in the world, while the fit between FDI policy objectives and supporting means is achieved.

Malaysia, contrary to the U.K., restricts the scale and range of incentives and adopts an inflexible tax reduction or exemption system as a support means since it does not have much difficulty in inducing FDI due to low wages and sufficient labor force as investment attractiveness. Accordingly, Malaysia selectively supports foreign investment companies that contribute to creating high value added industry and increasing corporate exports.

Singapore is not much different from Malaysia in the fit between FDI policies and support means, but it includes fostering finance and a business center, professing the "Centralization in the World" as the object of benefits in addition to advancing industrial structure and fostering high-tech industry. Although Malaysia and Singapore are different from the U.K. in priorities and inner environment of FDI policy objectives, they are assessed as establishing and implementing efficient investment policies, while they match the fit between investment policies and supporting means in their own way.

The results of the correlation analysis show similar results in the case studies. The positive correlation between enhancing export and fiscal incentive and between regional development and financial incentive exist according to the results. This correlation is shown more clearly, when only LDC samples were the objects in the former case, and when data of MDC were the objects in the latter case.

The countries that focus at generating employment or advancing industrial structure as their FDI policy objectives are reluctant in adopting market preference incentive that can cause negative effects by restricting competition.

Now a look at Korea's case, which has been rated as utilizing FDI successfully in overcoming the foreign exchange crisis. Do Korea's FDI policies correspond to the contents of the research results? If we relate the question to the several views currently discussed, it can be described as follows.

- First, the extension of fiscal incentive under the amended FIPA brought about the increase of FDI inducement amount.
- Second, the current system causes waste of resources through excessive competition of investment incentives between the local autonomous governments.
- Third, it is desirable to provide incentives through case-by-case negotiations.

Firstly, as for the relationship between the fiscal incentives and the results of investment inducement, the incentive is only one of FDI determinants and the impact is minimal (Waker 1965, Aharoni 1966, Lim 1983, UNCTAD 1996, 1998). The existing research results tell us that any host nation's production factor prices, market demand size and political and social stability have influence on the investment decision directly and the incentive functions are complementary. As an illustration, Malaysia, which does not provide incentives, but has high investment attractiveness compared to other competing countries, has the highest possibility of keeping the absolute amount of foreign investment at the current level, but the U.K. seems to find it hard to achieve current investment inducement performance without the assistance payment system. Tax reduction and exemption, which focuses on qualitative composition rather than on absolute amount of induced investment, is a means to support selective foreign investment policy objectives as we viewed before. Therefore, rather than the size of induced investment amount, how well the selective investment policy objectives were achieved can be appropriate for performance indicator. If investment policy objectives, in other words, lie in advancing industrial structure, the measuring stick for investment performances should be how many foreign companies that contributes to advancing industrial structure have been induced.

When we regard that this kind of logic applies to Korea, literally, it is difficult to say that the extension of fiscal incentive contributed to the increase of absolute amount of induced FDI. On the contrary, economic reform, the measures to open the economy, such as abolishing the limits on the daily range of foreign exchange rate, opening medium and long-term national bonds and bond markets, permission of aggressive M&A between the boarders, allowing layoffs in the case of M&A, abolishing the restriction of ownership of non-business properties by a foreign corporation, and the favorable change of attitude of the Korean government and its people towards FDI and foreign companies, the increase of companies for sale as M&A objects due to corporate restructuring and lowly valued investment objects can be considered to be the main reasons. Secondly, the view that the resources are wasted due to excessive competition between the local autonomous governments cannot be said to reflect reality, considering the relationship between the central government and the local governments and the extent of local government's financial independence. Korea's current incentive system designates payment criteria and scale in detail. The national tax is applied in the same way everywhere, and a local government has very limited discretion on the local tax. Although the grant payment system can be specified by a local government's ordinance to operate flexibly, rather than the tax reduction or exemption incentive, it is difficult to realize the grant system at the moment, considering the weak financial situations of the local governments.

Thirdly, there cannot be any other opinion other than the view that providing investment incentive by negotiations on the case-by-case basis is desirable, and the view is interpreted as adjusting the ranges of incentives range according to the importance of individual investment case. In the current tax reduction or exemption type incentive system, however, adjusting inventive range by case flexibly is very hard. The view to set the incentive range according to individual investment case seems to be in line with the view to increase the weight of financial incentive system among investment incentive systems. Although the grant (subsidy) system is related to investment policy goals, the central government, especially a local government's financial situation can function as a big restrictive element. In the short-run, setting tax reduction and exemption's floor and ceiling lines within a specified range rather than fixing the tax reduction or exemption rate can be a method to exercise flexible effects. There can be limits, however, in changing investment incentive range by case flexibly in a taxation system, considering that it can be incompatible with a taxation system that clearly regulates taxation regulations to avoid obscure applications of the taxation law.

Ultimately, the direction of Korea's foreign investment policy to develop and extend sound positive economic externalities continuously should lie in the consistent investment policy and fundamental improvement of investment inducing determinants. The consistency of FDI policy means the realization of clear mid and long-term investment policy goals and the fit between objectives and means. To realize the fit, the investment incentive types that occupy the largest share among investment policy means should be established in line with policy objectives. The other policy supporting means such as an investment inducing institution's supporting activity, investment counseling activity and post-management system should also be driven to attain the policy objectives. If the policy objectives lie in creating employment and advancing industrial structure, the supporting activity of an investment inducing institution should focus on greenfield investment rather than on M&A type investment. "Fundamental investment inducing determinants" should not be the investment incentive system that complements and guarantees investments performances artificially, such as with tax reduction or exemption, subsidy payment and market protection, but should be improving social policy determinants in investment attractiveness aspect by settling transparent corporate management practice and promoting sound labor relations. The improvement of investment environment also is necessary to satisfy a foreign investment corporation's desires, such as in market pursuing, production efficiency pursuing and technology transfer pursing by developing technology, fostering excellent personnel and forming efficient labor market.

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