

Investment policy in the European countries after their accession to EU. Lessons from the past

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Abstract

It is an open question to what extent the accession countries will be able to benefit from an increase in the quality of foreign direct investments (FDIs) that they receive due to EU membership. Although there will be some investment in new affiliates resulting in new (greenfield) subsidiaries that did not exist previously, there will also be a downgrading of subsidiaries. Transnational companies (TNCs) may divest their operations in response to better location advantages elsewhere in the EU or reduce the intensity of operations by lowering the level of competence and/or scope of their subsidiary, and shifting from truncated replicas to single activity affiliates. That is to say, sectors that were dominated by domestic capital are transferred to foreign ownership, particularly where domestic capitalists have failed to improve their competitive advantages to compete effectively with foreign firms. Indeed, in many of the Central and East European (CEE) countries, the share of foreign ownership in total capital stock is already typically much higher than in older EU member states, although with considerable variation across sectors. This paper tries to highlight the best practices in the attracting investments area for designing the best investment policy for the EU new member states.

Keywords: FDIs, investment policy, EU new member states.

JEL classifications: F21, F23, G01, G24, G38, H23.

1. INTRODUCTION

Although inward foreign direct investments (FDIs) is not the only option available to promote economic catching-up, it may be the most efficient option. FDI, however, is not a sine qua non for development. The point here is that not all affiliates provide the same opportunity for spillovers. A sales office or an assembly unit may have a high turnover, or employ a large number of staff, but the technological spillovers will be relatively fewer than, say, those from a manufacturing facility. Likewise, resource-seeking activities can be capital-intensive, but also provide fewer possibilities for spillovers than say, a market-seeking type of FDIs. Prior to economic liberalization and EU integration, transnational companies (TNCs) responded to investment opportunities primarily by establishing truncated miniature replicas of their facilities at home, although the extent to which they were truncated varied considerably between countries. The extent of truncation was determined by a number of

factors, but by far the most important determinant of truncation - and thereby the scope of activities and competence level of the subsidiary - were associated with market size, and the capacity and capability of domestic industry. There is thus a hierarchy of the quality of FDI activity in Europe which reflects the stage of industrial development.

At the "bottom" are countries that are at an early stage of transition (and furthest away from convergence with the EU norm), with a very limited domestic sector and with low domestic demand. Such countries have been host to the most truncated subsidiaries, often single-activity subsidiaries, primarily in sales and marketing, and in natural resource extraction. The most advanced economies with domestic technological capacity (such as the core EU members) have hosted the least truncated subsidiaries, often with research and development (R&D) departments. Cohesion countries (with the exception of Greece) have been in the middle (Haaparanta, 1996).

Membership of the EU has two important implications with regard to FDI. First, it allows countries that have small domestic markets to expand their de facto market size. Firms located in the EU have access to the entire EU. However, as the number of countries in the EU increases, this advantage is currently shared by 27 member countries (and in the future, possibly by the three candidate countries as of 2008 - Croatia, the former Yugoslav Republic of Macedonia, and Turkey) and even more if one includes countries that have preferential access to the single market through various lesser forms of trade agreement. Thus, this advantage has considerably less value to the accession countries than it had for the cohesion countries, and this is exacerbated by the fact that domestic firms in many of the CEE countries have little experience in dealing with competition in a market economy which further attenuates the benefits that derive from the competition effect. Second, membership suggests political, economic and legal stability. Although the absence of efficient institutions can retard the efficient accumulation and transfer of knowledge, EU accession countries are not competing with the least developed countries for FDI.

Indeed, it is a requirement for membership that candidate countries demonstrate convergence and overlap of formal and informal institutions. This acts as a location advantage vis-à-vis non-member countries with poorly developed institutions (some countries in Latin America, or the Russian Federation) but not necessarily so compared to nonmembers who are stable (for instance, some East Asian countries), or indeed relative to other long-standing EU members. Again, the greater the number of countries that are members, the less stability counts as a unique advantage to potential investors.

This paper tries to highlight the best practices in the attracting investments area for designing the best investment policy for the EU new member states, considering the main advantages of the Central and East European (CEE) region and based on the experience of the old EU member states. This is an analysis based on literature findings and based on commented statistical data for the EU and CEE regions.

Section 2 talks about the impact of the EU enlargement on FDI, Section 3 tries to underline how attractive is CEE region for investors,

Section 4 discusses about the tax policy and the alternatives to that on the emerging markets and Section 5 concludes the paper.

2. LITERATURE REVIEW REGARDING EU ENLARGEMENT ANF FDI

EU membership per se does not necessarily lead to an increase in the quality or the quantity of FDI that a country receives, and this is best illustrated by the case of Greece. In 1980, inward FDI stock per capita was \$470 (all figures in current prices) compared with \$315 and \$137 for Portugal and Spain respectively. By 2007, FDI stock per capita in Greece had grown to only \$4,740, compared with \$10,750 and \$12,138 for Portugal and Spain respectively.

To take just one example from the new member states (NMS) for comparison, Hungary's FDI per capita in 2007 was already more than double that of Greece (\$9,711). A substantial part of these flows took place before Hungary became an EU member in 2004. In this respect it is important to highlight that while EU membership may help promote FDI, we argue that the positive effects of EU membership for FDI are decreasingly important, partly because these advantages are less significant as the number of EU members increases. Furthermore, globalization and the growth of supranational agreements mean that several of these benefits are not as unique as they once were. Firms from outside the EU are no longer "forced" into EU-based production, since tariff and non-tariff barriers are fewer. It is worth remembering that a large part of the inward FDI flows from outside the EU prior to 1992 was spurred by the fear of "Fortress Europe". These fears have largely proven to be unfounded. Finally, the growth of peripheral trade and investment agreements with non-EU members also may impact on the effects of EU membership.

The effects of EU membership and the shift from the cohesion countries to the NMS by and large confirms our skeptical view of FDI flows to the cohesion and accession countries. Ex ante studies on the effects of EU membership on the shift of FDI, not unexpectedly, have found a wide range of effects. These studies are mainly simulations based on theoretical models: As early as the mid- 1990s, Galego et al. (2004) examined various aspects of the shift of FDI from the periphery to the CEE countries. Other papers (Gorg and Greenaway, 2002) examined the FDI potential of the CEE countries upon accession. Altomonte and Guagliano (2003) go beyond the cohesion countries and examine the potential of the CEE countries compared to the Mediterranean region, which can be considered as a competitor location. Clausing and Dorobantu (2005) found significant effects of key European Union announcements regarding the accession process. Garmel et al. (2008), in a growth model, predict that three quarters of capital in the NMS will ultimately be acquired by investors from the "core" member states in the long run. Ex post studies have generally found some, but no dramatic shift of FDI.

This increased competition for FDI challenges both the cohesion countries and the CEE countries. Many (but not all) of these countries have sought to compete globally on the basis of two primary location advantages: low labour costs and EU membership. As we have discussed above, EU membership is not as much of an advantage in a liberalized, stable and shrinking world where distance does not form as much of a barrier to trade and investment as it once did. For similar reasons, the cost advantage of these countries has also been dissipated in many

cases, particularly where productivity gains in China and other Asian economies have grown partly as a result of their superior technological infrastructure. Spain and Portugal have experienced some displacement of FDI or lost sequential FDI because they have not been able to develop location advantages in knowledge- and capital-intensive activities to compensate for the rising labour costs that have eroded their industrial base in low-value-adding activities, a development that also has been observed in CEE countries, where already some production activities have been shifted "further east" (World Bank, 2009).

In other words, the most obvious long-term solution for cohesion countries is to improve their location advantages in other areas, towards more science-based technological sectors. Ireland has succeeded in doing so with its focus on the IT sectors, although Portugal and Spain have so far failed to make significant moves towards more science-based sectors. Disinvestments in the cohesion countries are, of course, not happening suddenly, because although they do rely on cheap factor inputs, they are also capital-intensive. It is not immediately obvious that when TNCs begin to disinvest from the cohesion countries, thus will automatically result in increased investments in the accession countries in the same industries. In the automobile industry, for instance, the efficiency of a new Greenfield plant tends to require a relatively large minimum efficiency scale. TNCs are therefore reluctant to start out in greenfield sites, which is a further deterrent to setting up new investments in the CEE countries. Except where strong domestic sectors and specialized knowledge-based clusters exist - whether public or private - the CEE countries are unlikely to receive major inflows of FDI that are intended to supply the EU as a single market.

The lesson here for most peripheral countries is very much the same as one that development policy experts have been arguing for the developing countries: dependence on static and generic location advantages - whether drawing from the development of institutions, infrastructure, stability, or low-cost labour - is necessarily short-term and short-sighted.

The last two decades of increasing liberalization, falling transportation and communication costs, and investment in knowledge-based activities in East Asia has meant that the peripheral EU countries are no longer as attractive (although it should be noted that the lack of strong investment promoting policy enforcement in some Asian countries does provide a small window of opportunity). It is only in those sectors where "specialized" location advantages associated with higher value-adding exist that host countries can benefit significantly from TNC activity in the long run. This requires a considerable amount of government interaction and investment into tangible and intangible infrastructure. As countries reach a threshold level of technological capabilities, governments need to provide more active support through macro-organizational policies. Many of the CEE countries have the basis for creating such science-based location advantages. For instance, Poland has strengths in certain natural and life sciences, as does Hungary in electro-mechanical sectors. The Czech Republic has opted to focus on the automotive industry, given the existence of large automotive plants, while Slovakia has attracted a

number of greenfield automotive plants. Of course, adapting to such challenges is not costless, for three reasons.

First, countries need considerable resources to invest in such vertical industrial policy actions. Second, they require considerable political will and discipline, because other industries will necessarily need to be "wound down". Third, fostering new sectors requires major institutional change (Narula and Bellak, 2009). Such radical systemic change requires resources and an effective period of transition, given the inertia associated with formal and informal institutions.

There are two points of caution that need to be raised here. First, in pursuing such a strategy, the peripheral EU countries face competition not just from Asia, but also from the "core" economies of the EU, which have systematically developed strengths in technology-intensive sectors over decades, and can often out-compete weaker, peripheral economies in terms of resources, incentives and opportunities (Botman and Kumar, 2006).

Nonetheless, there are several niches and gaps in their technological competences that can be effectively exploited by the peripheral economies. Many of the CEE countries have a well-trained and skilled work force, but the availability of a large stock of suitably qualified workers does not in itself result in efficient absorption of knowledge, or in its efficient use in industrial development, especially if the level of relevant infrastructure is much lower (Bellak et al. 2009). Efficient absorption of knowledge requires the presence of institutions and economic actors, and the efficient use of markets and hierarchies, be they intra-firm, intraindustry or intra-country. This knowledge is not costless, and must be accumulated over time. Important externalities arise which impinge on the ease of diffusion and efficiency of absorption and utilization of external knowledge (Crisciolo and Narula, 2008).

Specifically, for the CEE countries, it is argued that both proactive and reactive policies are needed to achieve sustainability of FDI. Proactive policies are geared to attract FDI and therefore affect the sustainability via sectoral targeting. Reactive policies aim to make FDI more sustainable through three distinct policy channels, namely through strengthening comparative advantage, enabling firms to benefit from economies of scale, and supporting agglomeration forces. A clear gap exists between "old" and "new" member states' policies to attract additional FDI (Bellak et al., 2009). The older member states gained most by focusing on infrastructure and R&D policies. "New" member states' policies have tended to focus on reducing the share of low-skilled workers (for example by encouraging firms to restructure production and increase capital intensity) and through a reduction of labour costs via a decrease in non-wage labour costs. The fact that different policy areas are relevant in the two groups of countries opens the possibility for focused policy approaches geared to the needs of individual sectors.

The economies with the most successful technological upgrading - the Republic of Korea, Taiwan Province of China and, to a lesser extent, Brazil - allocated subsidies in a reciprocal control mechanism. That is, incentives and subsidies, whether to upgrade technologically, promote local content, expand exports or reduce import-dependence were

subject to performance standards that were actively monitored and acted to prevent government failure.

In the case of the accession countries, many have well-developed components of science and technology systems. Some are even endowed with considerable capacity in high value-adding activities such as R&D, software development and design. This has been used as a basis to attract and embed highly specialized high-competence TNC facilities. Nonetheless, one of the considerable disadvantages these countries face is the challenge of dismantling centrally planned innovation systems that are driven primarily by planners and bureaucrats rather than by demand conditions and the specific needs of firms. Foreign affiliates interact with knowledge organizations such as local universities and public research institutes, which undertake basic or applied research, produce R&D manpower and provide technical services to firms (UNCTAD, 2009).

The challenges that the accession countries face vis-à-vis developing countries are plainly easier in many ways, because membership does provide them with important location advantages. They have access to a much larger and more affluent market; valuable resources are made available by the EU to improve their basic infrastructure; they are obliged to converge their institutional arrangements with EU standards; they are protected by EU regulation and laws; and they have the political and economic clout of the EU in the areas of competition policy, trade policy, and so forth. However, they are also in the "home region" of some of the world's largest TNCs, and thus face greater and immediate competition, and cannot afford to be passive (Oman, 2000).

2.1. Effects of FDI on the host Economies

The activity of foreign owned companies profoundly changed the CEE economies. Several fields of this change were analysed by economists during the past decade. Some analyses are made based on a database of Foreign Investment Enterprises (FIEs) making a comparison to domestic firms. The highest share of FIEs in equity, value added, number of employees, sales had been reached by Hungary in the mid nineties, but was increasing in other countries as well. Labour productivity of FIEs was higher and export activity more intensive than in the case of domestic companies.

FDI can have a positive impact on productivity in the less developed economies. Majcen et al. (2009) analyse productivity changes in five CEE economies (Estonia, Poland Hungary, Slovakia, Slovenia) based on a questionnaire survey among 433 foreign subsidiary companies in 2002. They found that the higher the level of control of the foreign parent company, the higher is the subsidiary's productivity growth. Apart from that, subsidiaries with higher proportions of sales to foreign buyers experience higher changes in productivity. It is also interesting that subsidiaries in high-tech sectors show lower changes in productivity compared to firms in low-tech sectors. The authors explain this by the fact that subsidiaries in CEE are most often located in low-tech or lower value added segments of high-tech sectors.

Bijsterbosch and Kolasa (2009) also analyses the link between FDI and productivity convergence in the CEE countries. The productivity catching-up process in these countries has coincided with large inflows

of FDI, which considered to be the main vehicle for technology diffusion. The main target of FDI was financial and business services and industry (transport, food, electrical equipment). The authors build an econometric model including human capital and R&D intensity and they conclude that: 1. there is a strong convergence effect of productivity both at the country and at the industry level, 2. FDI plays an important role in this, 3. the impact of FDI depends on the absorptive capacity (proxied by human capital, innovation efforts of local firms).

Regarding the effect of FDI on industrial productivity, also the Spanish study (Elteto, 2010) showed that firms with foreign capital are more productive than domestic companies. The results proved that the presence of foreign capital is associated with a higher efficiency of labour (higher production/employees ratio). The effect of foreign capital as a determining factor was also detectable in the increase of productivity between 1991-1994.

FDI had also an effect on the regional development of the countries. In several cases, as it was mentioned before, it strengthened regional imbalances. In Poland for example regional disparities between Western and Eastern parts and metropolitan and rural areas increased with the activity of foreign firms. The already developed regions where incomes are higher and human capital is better attracted FDI (Pavlinek, 2004). In Slovakia the Bratislava region attracted approximately 70 per cent of FDI during the nineties and the situation is similar in the Czech Republic where Prague and the Western border area were the most popular locations for FDI.

Foreign investors concentrated their activity in Hungary also to the Central and Western areas in the nineties and this has changed only slowly for the years of 2000. The main reason is that the education level of the population, the availability of good human capital is worse in the North-Eastern areas. In the nineties to certain extent FDI contributed to the creation of dual economies with FIEs integrated into multinational networks with modern technology and with domestic companies with lack of capital and slow restructuring. The pattern is not so simple however, later domestic controlled companies could also successfully grow and invest abroad.

Similarly to the situation in the CEE region, FDI in Spain has mostly aimed the developed Catalonia and Madrid. FDI had perhaps the most important effect on the foreign trade of the countries. FIEs have been responsible for an increasing concentration and change of the export structure in the economies. As a consequence of the trade activity of the foreign affiliates, revealed comparative advantages of the countries changed, the role of the medium and high-tech sectors strengthened (Éltető, 2010).

This was the most apparent in the case of Hungary where the role of customs free zones hosting multinational affiliates was extremely significant. There were around a hundred industrial customs-free zones spread throughout Hungary in the end of the nineties. Investments in these zones were mainly 100% foreign-owned and greenfield investments. In 1999 for example, 43% of the Hungarian exports and 30% of the imports stemmed from customs-free zones. The EU-accession, however, modified the legislation of these zones, the companies affected could transfer their assets without VAT or customs obligations. Intra-

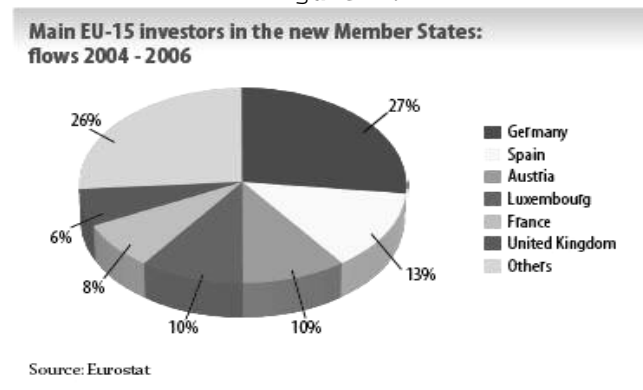
industry trade (IIT) increased with the EU in almost every branch between 1990-98. Regarding the whole manufacturing sector, mainly horizontal and vertical high quality IIT had grown. In line with the international experiences the vertical type dominated also in Hungary within intraindustry trade.

In the case of Spain, studies have found that IIT values for Spain vary between 25% and 63% depending on the product classification details used. Studies also found that the major part of Spanish IIT was of the vertical type, with low quality domination. Studies have found that IIT had been constantly growing, vertical type was more significant than the horizontal one particularly with non-OECD countries. What is more, low quality vertical IIT was greater with OECD countries and high quality vertical IIT was greater with non-OECD countries. IIT patterns thus also depend on the development level of the trade partner. Blanes-Martín (2000) also built a model to explore the determinants of Spanish intra-industry trade. They found that foreign capital penetration had a significant positive effect on both vertical and horizontal IIT. This means that the activity of foreign investment companies influenced the development of intra-industry trade between Spain and its partners.

3. HOW ATTRACTIVE IS CEE REGION FOR INVESTORS?

The majority of German, Austrian and Swiss entrepreneurs appreciate the CEE countries as being extremely attractive as sales markets and production locations - in spite of the economic crisis and the increasing role of China and India (Fig 1).

Figure 1.



Romania in particular was nominated by the business people questioned as being the third most surprisingly attractive country, after Russia and Ukraine. A recent study of CEE locations led by Horváth & Partners has come to the same and other just as interesting conclusions: today more than half of the production businesses of Austrian, German and Swiss companies are set on the mature CEE-5 markets and in the Baltic States. Over 20% of the business locations are to be found in the new EU member states Romania and Bulgaria, while the rest spread in the remaining Southern Europe (Table 1). Looking into the future we see companies primarily planning to develop their business activities in Russia and Ukraine, which are closely followed by Romania on the third place. The continuously high attractiveness of Romania consists of its interesting mixture of cheap production factors and markets that have

partially not been saturated yet, as well as of sufficient political and legal stability - advantages over several other CEE countries (Ionita and Pauwels, 2008).

The "East Way Trend" is characterized above all through the varied maturity levels of the individual regions in the CEE- economic area. The margin pressure and the competition on the mature CEE-markets like the Czech Republic, Poland and Slovakia become tougher and disparities between these areas and Western Europe as far as products, distribution, advertising and pricing are concerned seem to be in decline (Table 1).

Table 1 EU-15 outflows to the NMS in 2004-2006 (EUR bn)

Country	2004	2005	2006
Extra EU-15	160,1	268,0	285,7
Total NMS	19,1	37,5	37,2
Bulgaria	0,2	2,1	0,9
Czech Republic	-2,1	4,6	3,3
Estonia	0,1	2,1	0,2
Cyprus	0,7	2,6	2,0
Latvia	0,2	-0,1	0,0
Lithuania	0,2	-0,1	0,2
Hungary	7,8	15,2	4,3
Malta	1,5	2,6	12,0
Poland	6,6	3,0	3,5
Romania	3,0	3,1	7,4
Slovenia	0,3	0,5	0,4
Slovakia	0,8	1,6	3,0

Source: EUROSTAT, "Report EU-15 FDI in the New Member States", 2008, p. 75-89.

Location advantage, if not the biggest location advantage of the CEE-Region compared to Western Europe is the unchanged excellent ratio between productivity and costs of hired labour. Romania itself, whose industrial costs are just a bit higher than the tenth part of the costs in Germany, has therefore a significant location advantage. And so the regional labour market makes the difference in terms of location choice. The productivity of the employees, the availability of highly qualified work power as well as the costs of hired labour are considered by study carriers to be some of the most relevant location advantages.

The political events and the legal stability are ranked as being equally important, as well as the supply guarantee of utilities such as electric current, gas and water. Compared to the labour market these are factors that require a certain level of hygiene for a fluent production flow. All deriving factors make the location only marginally more interesting. If we look at the political and legal environment, we see that Romania has increasingly improved in the last few years - especially after gaining its EU member status. Several rankings that evaluate the political context and conditions, for ex. the Global Competitiveness Reports, show Romania at the middle of the classification among the CEE-states (Ionita and Pauwels, 2008).

The majority of the companies outsource their production to local firms, to take advantage of the low local costs of hired work - on the

one hand - and to avoid in advance possible quality problems - on the other. Beginning with the planning of production steps and of manufactured products in the new locations, the attention must focus on the cost reducing potential and on avoiding quality problems: companies should typically relocate the costly hired work in the production process to CEE and keep the complexity of production rather low, whereas highly standardized production processes must be conducted and highly standardized products must be obtained.

When they were questioned about finding the best location for their production businesses, the managers listed the top-management's commitment at the number one success factor. Only when the management of the company continuously assures the allocation of needed financial and human resources, the implementation of a new location can be successful. Other indispensable success factors are the studies derived from knowledge transfer (second place) to another location and professional project management within the whole construction process of the location (third place). While the top-management commitment is generally uncritical, in spite of its high relevancy - the top-management should agree on the necessity of choosing a new location - the knowledge transfer and the project management together with the management of human resources are the biggest challenges of the actual implementation.

In the present, many FDI inflows in the CEE region are concentrated in the services area. Services now constitute the largest recipient sector of FDI, accounting for about two thirds of FDI inflows worldwide, and about 55 per cent of FDI inflows into developing countries. However, very little systematic quantification and analysis are available on the policies on FDI in services. Services are generally subject to more restrictions than manufacturing and natural resources. For example, such industries as telecommunications, banking, transportation and electricity provision are often viewed by host countries as strategic or sensitive (Clausing, and Dorobantu, 2005).

Since the early 1990s developing countries have increasingly liberalized, privatized and deregulated their service industries, with a view to greater participation in the global economy. More welcoming policies on foreign direct investment have been a prominent component of this trend. National policies on FDI typically feature measures aimed at both attracting and discouraging inflows. Policies to attract FDI such as tax breaks, favourable regulatory treatment and subsidies of various sorts are usually focused on manufacturing. Meanwhile, policies restricting inward FDI are mainly concentrated in the service sector.

Almost all countries now welcome foreign investment in export-oriented manufacturing. The service sector, however, remains more restricted, notwithstanding substantial liberalization in the past 20 years. Studies of the National Bank of Austria show that FDI in services grows only when inward-oriented domestic regulations are removed, with no impact from outward-oriented barriers in the long-run. A detailed analysis by individual services sectors indicates again that cross-border trade in insurance and business services grows in response to any individual regulations being reduced, and communications and financial services are sensitive to almost all barriers. Only for

transport and construction services imports do we find no evidence of net complementarity.

As in the case of OECD countries the most heavily restricted industries are those that are highly sensitive to national security or national sovereignty considerations: telecommunications, transport, finance, electricity and media. There is also a wide dispersion in the extent of openness towards FDI in services between and within regions. The most open economies in the study tend to be in Latin America and in the economies in transition. East, South-East and West Asia tend to be more restrictive. Top seven of the most attractive CEE countries shows that Russia in on the first place, followed by Ukraine, Romania, Turkey, Poland, Belarus, Croatia.

4. TAX POLICY AND THE ALTERNATIVES TO THAT ON THE EMERGING MARKETS

In a world where an increasing number of governments compete hard to attract multinational companies, fiscal incentives have become a global phenomenon. Poor African countries rely on tax holidays and import duty exemptions, while industrial Western European countries allow investment allowances or accelerated depreciation (Table 2). This trend seems to have grown considerably since the early 1990s. These have generated considerable debate about whether governments have offered unreasonably large incentives to entice those firms to invest in their area. Still, this debate about the effectiveness of tax incentives is hardly new and has accumulated a long history.

The objective of the paper is to review the existing literature on tax policy and FDIs as well as to explore possibilities for future research. Taxes affect the net return on capital and should, at least in the mind of numerous policymakers, influence the capital movements between countries. For this reason, the early literature attempted to evaluate if a generous tax policy could compensate for other obstacles in the business environment and, thus, attract multinational companies. In the mid-1980s, the literature went one step further by exploring what kind of tax instruments should have the greatest impact on the location decision of multinational companies.

Table 2. Types of Incentives Used by Region

Region/Countries	Africa (23)	Asia (17)	Latin America & Caribbean (12)	CEE (25)	Western Europe (20)	Other Countries (6)	Total (103)
Tax holidays	16	13	8	19	7	4	67
Accelerated depreciation	12	8	6	6	10	5	47
Investment allowances	4	5	9	3	5	-	26
Import duty exemption	15	13	11	13	7	4	63
Duty drawback	10	8	10	12	6	3	49

Source: UNCTAD, *World Investment Report, 2000*, p.175.

Special attention was also given to the motivations and tax behavior of the multinational company. In recent years, the globalization process has led to the emergence of new issues. Not only have companies tended to become more mobile, but also governments have to deal with this new

dimension in the design of their national tax policy. The gradual elimination of barriers to capital movements have stimulated governments to compete for FDI in global markets as well as reinforced the role of tax policy in this process. This recent competitive trend has to be offset by the increasing pressure that governments face to harmonize their tax policies within regional (or international) agreements. A second important issue has been the recognition that tax policies of the home and host countries are interconnected and that this link influences the behavior of multinationals. There has been a great deal of evidence, especially after the changes in the U.S. tax laws during the late 1980s, that home country tax policy affects both the multinational firm's behavior and the effectiveness of tax policy in the countries where these firms operate and invest (Swensson, D., 1994).

Last but not least, there has been a growing attention to the costs associated with tax incentives - and not only to their possible benefits. Tax incentives are likely not only to have a direct negative impact on fiscal revenues but also, and frequently, create significant possibilities for suspicious behaviors from tax administrations and companies. This issue has become crucial in emerging countries where budgetary constraints as well as corruption are certainly more severe than in industrial countries.

Governments have several tax instruments that they can use to attempt to influence the effective tax rates and the location decision of multinational companies (for example, an effective tax rate in the United States of about 25% at the end of 1994 was produced by a 38% corporate tax rate combined with no investment tax allowance, depreciation rates on buildings of 4.4% and 18.6% on machinery, and a number of other assumptions about inflation, interest rates - interest is deductible, etc. Approximately the same effective tax rate was achieved in Spain with a lower corporate tax rate (35%), and lower rates of depreciation of buildings (3%) and equipment (12%). The literature has traditionally focused on the instruments linked to the corporate income tax such as tax holidays and tax allowance. Of course, these instruments are of no help to an unprofitable company and, therefore, other forms of incentives have also been widely used around the world. Exemptions from custom duties or local indirect taxes (generally to targeted sectors) do exist in many countries, even though their use has been restricted in most international and bilateral trade treaties. Outright grants are used in many industrial countries but rarely in the developing world because of their upfront costs.

Incentives will generally neither make up for serious deficiencies in the investment environment, nor generate the desired externalities. Thus, advisors often counsel long-run strategies of improving human and physical infrastructure, and where necessary streamlining government policies and procedures, thereby increasing the chances of attracting investment on a genuine long-term basis. Indeed, the importance of fundamental factors like economic conditions and political climate is underlined by the fact the most serious investors are often unaware of the full range of incentives on offer when they invest, and that they often do not consider alternative locations (Morisset and Pirnia, 2000).

Recent evidence has nevertheless shown that, when other factors such as political and economic stability, infrastructure and transport costs are more or less equal between potential locations, taxes may exert a significant impact. This is evidenced by the growing tax competition in regional groupings such as the European Union or at the subregional level within one country (the U.S.). This impact, however, has to be qualified on two important counts. First, the impact of tax policy may significantly depend on the tax instruments used by the authorities. Second, the effectiveness of tax policy and incentives is also likely to vary depending on the multinational firm's activity and on its motivations for investing abroad. For example, tax incentives seem to be a crucial factor for mobile firms or firms that operate in multiple markets because they can exploit better the different tax regimes across countries.

Foreign direct investment can provide a number of benefits to countries that need capital including higher growth, greater exports, higher wages, and greater productivity through technology spillovers to local firms. While the evidence of the impact of FDI is somewhat mixed surveys this literature and finds that the evidence indicates that FDI increases exports, sometimes increases growth (especially in developing countries with export promotion policies), has a somewhat ambiguous impact on local wages, and also has an unclear impact on technology spillovers to local firms), a big question for government officials in developing and developed countries alike is the impact of tax, regulatory, and public expenditure policies on foreign investors. An important study of foreign investment determinants found that agglomeration - measured by infrastructure quality - is an important determinant while taxes are not a significant determinant. In contrast, a growing set of studies on taxation has arisen in the public finance literature that generally find significant tax effects, though the estimated elasticity varies significantly between them depending on the data set used and whether the study is cross-sectional or panel. Given these contrasting results, it is somewhat difficult for policymakers to know what to make of this literature. In addition, a large literature in regional public economics suggests that government spending that is beneficial to investors (such as public investment in infrastructure for foreign investors) should have positive effects on investment in a region. Some more recent studies examine FDI in China and finds a positive impact of infrastructure, but they do not include a tax measure. Institutions that provide a good environment for conducting business are also important potential determinants of FDI. The level of corruption is one measure of the business environment. The impact of corruption has been studied most carefully by Wei (2000). He finds significant negative effects of corruption for several corruption definitions. This study indicates that lower taxes, lower corruption, lower government consumption spending and better infrastructure attract FDI. In elasticity terms infrastructure improvements, corruption, and taxes are of similar magnitude. The results of the paper of Timothy Goodspeed, Jorge Martinez-Vazquez, Li Zhang in 2006 indicate that lower taxes, lower corruption, and better infrastructure attract FDI. These results are robust and hold for within country variation when controlling for common year effects of FDI, and hence add strong evidence to previous cross-sectional results.

In conclusion, the adequate provision of infrastructure seems to be just as important as low taxes and low corruption in attracting FDI.

From a policy perspective, it would appear that the right approach by governments concerned with attracting foreign direct investment is to lower corruption and to keep taxes low but to maintain investment in infrastructure rather than using revenue for consumption expenditures. Keeping public revenues too low to adequately maintain or invest in infrastructure is unlikely to be a successful long run policy.

The term "aftercare" means many things. This is achieved through the development of a structured service offer that includes administrative, operational and strategic support to TNCs. Rising FDI stock in developing countries and growing numbers of established foreign affiliates present increasing servicing burdens for Investment Promoting Agencies (IPAs) but also expanding opportunities to generate follow-on investment and to foster a developmental impact. Moreover, IPAs need to be aware of the changing strategic perceptions by TNC groups of the role of their affiliates. The rise in cross-border mergers and acquisitions (M&As) also presents challenges in maintaining the profile of local affiliates within TNC groups.

The requirements for setting up and operating an aftercare unit are much the same as for any marketing activity; they include an understanding of the market and customer, a segmentation and targeting strategy, and the development of programmes and evaluation. This literature reviews a wide range of delivery options for aftercare services and the challenges involved. The challenges include establishing credibility at high levels in TNCs, moving aftercare onto a proactive footing, establishing good customer management systems and deploying capable staff backed by good Internet tools. Evidence suggests that this is a weak point in aftercare service design and delivery, and needs urgent attention. Changes in the size of FDI flows and the growing FDI stock in many economies, as well as corporate responses to changes in the international business environment, mean that attention to aftercare activity has become a priority for investment promoters in developed and developing countries. Although IPAs do not dedicate the same amount of resources to aftercare as to winning new investment, there is a sound case for investing in aftercare services in an IPA, both from the point of view of effective use of resources and ensuring maximum long-term economic impact by the TNC on the host economy. The cost of winning investments through aftercare is less than that of generating investments from new companies. The process of ensuring maximum economic impact also helps to identify key areas for policy advocacy.

Programme design, delivery and evaluation require substantial cooperation and coordination between public sector organizations at national, subnational and local levels in terms of programme development and the sharing of resources. A wide variety of models for service delivery exists, including outsourcing options. For all the reasons given above, IPAs should treat aftercare as a core function in investment promotion. It is not a stand-alone activity in the IPA, so it needs to be fully integrated with other activities and initiatives, and must be well coordinated with all the service providers within a location or country.

The analysis of the financial position of non-financial corporations and their responses to financial pressure are important elements in any assessment of the macroeconomic outlook, as firms' financial situation

can condition firms' real decisions. For example, excessive indebtedness or a high debt-service burden can have an adverse effect on investment spending, thereby contributing to deepen recessions or to delay or dampen upturns. Accordingly, understanding the way in which financial conditions affect firms' demand of productive factors - and more specifically investment, which represents 20% of euro area GDP - becomes relevant for an optimal design of monetary policy. In addition, in the context of the euro area, the knowledge of potential differences in the investment rate sensitivity to changes in firms' financial position across countries or across different types of firms is crucial for a better understanding of the impact of a single monetary policy. The analysis of the financial position of non-financial corporations and their responses to financial pressure are important elements in any assessment of the macroeconomic outlook, as firms' financial situation can condition firms' real decisions. For example, excessive indebtedness or a high debt-service burden can have an adverse effect on investment spending, thereby contributing to deepen recessions or to delay or dampen upturns. Accordingly, understanding the way in which financial conditions affect firms' demand of productive factors - and more specifically investment, which represents 20% of euro area GDP - becomes relevant for an optimal design of monetary policy. In addition, in the context of the euro area, the knowledge of potential differences in the investment rate sensitivity to changes in firms' financial position across countries or across different types of firms is crucial for a better understanding of the impact of a single monetary policy. Looking at the results of the literature (Haaparanta, 1996), we conclude that firms' financial position is important to explain their capital expenditures: indebtedness and debt burden are found to exert a negative impact on investment, while cash flow is positively linked to it. We find a certain degree of heterogeneity: firms in the Netherlands and Italy are found to be the ones with the highest marginal impact of financial pressure on investment rates, while the lowest has been found for German firms. The sensitivity of investment to changes in financial pressure has been proxied by firm indebtedness, debt burden and profitability in six euro area countries (Belgium, Germany, France, Italy, the Netherlands and Spain), which broadly represents 90% of GDP in the euro area.

A number of conclusions can be extracted from the analysis in the literature. Various types of factors have a differential and time-varying impact on the volatility of the different categories of capital flows. In fact, no single factor appears to reduce capital flows' volatility across the board. Furthermore, some factors have a conflicting impact on various types of flows. For instance, economic and political stability appears to reduce the volatility of portfolio flows but increases that of other flows; less competition in domestic banking systems increases FDI's volatility while reducing that of other flows. In addition, global factors seem to have gained importance over time as determinants of flows' volatility. All of the above poses a serious challenge for policy-makers in emerging economies trying to stabilize capital inflows. Indeed, the results suggest that, not only is it difficult to find a single policy track effective to reduce the volatility of all types of flows simultaneously, but the forces of globalization have reduced the relative importance of country-specific factors in favour of global factors that are beyond their control. However, there are some specific factors that could be effective in reducing the volatility of certain flows without increasing that of

others: inflation is robustly and positively related with the volatility of other flows; a higher volume of reserves tends to reduce the volatility of FDI; the size of the banking system in terms of assets reduces the volatility of FDI and other flows (Goodspeed, Vazquez and Zhang, 2006).

The above considerations concerning the potential impact of government responses to the financial crisis on global FDI apply to investment flows irrespective of whether their origin or destination is a developed or developing country. However, there are some issues that are particularly relevant for developing countries, both as recipients and sources of foreign investment. The challenges derive from two intertwined developments: first, the decline of investment flows due the worsening economic environment and second, government policies in response to the crisis that might have a negative impact on investment flows to developing countries.

5. CONCLUSIONS

The international financial and economic crisis of 2008-09 naturally had an effect on foreign direct investment flows in every countries but main trends were not disturbed thoroughly. FDI continues to play an important role in the economies of the examined countries, having an impact on productivity, regional structure and foreign trade.

One major concern of developing countries is how to retain existing investment and attract new FDI in times of global recession. Economic stimulus programmes can be an incentive for foreign investment, but many developing countries do not have the financial resources to successfully compete with the investment promotion packages of developed countries. Moreover, incentivesbased promotion packages for foreign investment may risk lowering social and environmental standards which would be detrimental for sustainable development. Governments have several tax instruments that they can use to attempt to influence the effective tax rates and the location decision of multinational companies (for example, an effective tax rate in the United States of about 25% at the end of 1994 was produced by a 38% corporate tax rate combined with no investment tax allowance, depreciation rates on buildings of 4.4% and 18.6% on machinery, and an number of other assumptions about inflation, interest rates - interest is deductible, etc. Approximately the same effective tax rate was achieved in Spain with a lower corporate tax rate (35%), and lower rates of depreciation of buildings (3%) and equipment (12%)). The literature has traditionally focused on the instruments linked to the corporate income tax such as tax holidays and tax allowance. Of course, these instruments are of no help to an unprofitable company and, therefore, other forms of incentives have also been widely used around the world. Exemptions from custom duties or local indirect taxes do exist in many countries, even though their use has been restricted in most international and bilateral trade treaties. Outright grants are used in many industrial countries but rarely in the developing world because of their upfront costs.

From a policy perspective, it would appear that the right approach by governments concerned with attracting foreign direct investment is to lower corruption and to keep taxes low but to maintain investment in infrastructure rather than using revenue for consumption expenditures.

Keeping public revenues too low to adequately maintain or invest in infrastructure is unlikely to be a successful long run policy. Anyhow, there seems to be a relatively clear division between investment policies of the CEE countries and of the Western European Countries of EU. While the former may gain most by focusing on infrastructure and R&D policies, in the latter group policies to reduce the share of low-skilled workers, for example by encouraging firms to restructure production and increase capital intensity and through a reduction of labour costs via a decrease in non-wage-labour costs, would attract most FDI.

The crisis, however, also provides a chance to develop and implement policies aimed at enhancing the stability of the financial system and stimulating economic growth. Various voices advocate the necessity of going beyond the mere short-term management of the ongoing crisis and of setting up the bases of sounder economic regulations, especially in banking, with more control and restriction on the activities of commercial banks, hedge funds and other financial institutions. Investment promotion agencies could play a key role in fostering aftercare policies aimed at retaining existing activities by TNCs and in implementing targeted investment promotion programmes in promising activities. In sum, for effectively dealing with the crisis and the period of major uncertainty it has opened, it is important that policymakers maintain a favourable business and investment climate and refrain from protectionist tendencies.

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