The role of Free Zone Incentives in Corporate Investment Decisions

By

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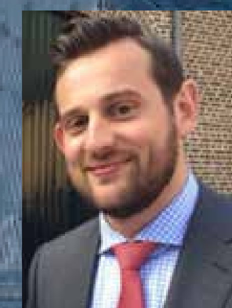

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We recently had the pleasure to provide a workshop at the first inaugural World Free Zones Organization's (WFZO) annual conference in Dubai. Our workshop and related stimulating discussion centred on some of the recent trends in FDI and addressed one of the most crucial topics for Fee Zone executives and policy-makers: the role of investment incentives in corporate investment and location selection. The article below summarizes some of the main points of our workshop.

Many Free Zones offer highly attractive investment incentive packages ranging from corporate income tax exemptions to 'one-stop-shop' investor services that facilitate corporate investment. While the former type of incentives are often qualified as 'hard' financial incentives the latter are seen as 'soft' incentives. This by no means implies that soft incentives are not important for corporate investors. In fact many corporate executives see the investor services which Free Zones can provide as a necessity given the often complex and stringent legal business environments in which they have to operate in foreign markets. 'Hard' incentives can nevertheless play a crucial role in lowering the initial investment costs for corporate investors. However, this is only successful if they address the requirements and needs of each investment, have a clear eligibility criteria and have a high level of predictability.

In order to understand the role investment incentives play and how they can be exploited as effective and efficient tool for attracting (foreign) investors to your Free Zone, it is critical to explore how investors appreciate incentives and when and how they can play a role in corporate investment decisions.

Incentives are, in most cases, not the key driver of a company's investment location decision. Depending upon the industry and type of business activities, companies explore multiple location criteria or factors before they take a final decision on where to invest. Incentives (and as such many Free Zones) are part of the overall business environment of a country or location. Incentives are often (and should be) regarded as the 'cherry on top' or 'icing on the cake' and should not be provided to fully compensate for a lack of competitiveness (i.e. in the form of low productivity, low skill levels and capabilities and experience of workers) of any country. Against this background an incentive regime and in particular, a Free Zone should emphasize the comparative advantages of a nation and cushion the negative effects of a lack of competitiveness in other areas of the business environment through incentive packages and services it offers.

Investing in foreign markets revolves around two fundamental choices that ultimately determine the location of the investment: in which market will the company invest and how will it enter this market? These choices are interrelated and depend on the interplay between unique characteristics of both the home market (i.e. push factors) and the foreign market (i.e. pull factors). In some cases, the investor selects the market first (e.g. based on strategic considerations) after which it will decide how to enter this market (e.g. exports or a joint venture). In other cases, the company first selects how it will enter a market, which determines the choice for a particular market. The outcome in both cases is similar: the company has selected a market in which it will invest by means of a particular strategy.

To enter a foreign market, a company has different "modes of entry" or "internationalization strategies" at its disposal. The choice which mode of entry the company will select depends on the envisioned location from which the company will supply the foreign market with its products or services. If it is the company's strategy to serve the foreign market from its home market, the company will most likely select exports as its mode of entry to the foreign market.

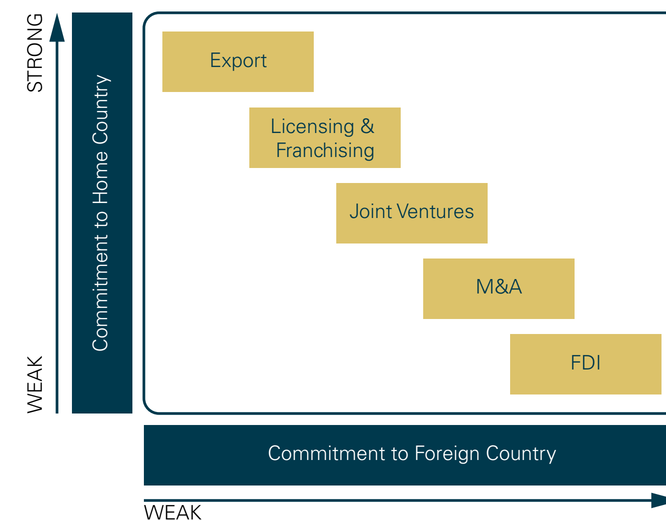
On the other hand, if the company plans to serve the foreign market from within the foreign market, for instance by co-locating a new manufacturing facility together with a distribution center, a company will opt for foreign direct investment (FDI).

Together, exports and FDI shape a spectrum based on their socio-economic commitment to their home and foreign markets. Exporting, on the one end of the spectrum has a strong commitment to the home market due to its location within the home market whilst its links with the foreign market it serves are relatively weak. On the other end of the spectrum, FDI has a strong commitment towards the foreign market as it directs capital investment into the foreign market and generates local employment opportunities.

Other modes of entry, with various levels of commitment to their home and foreign markets, are positioned in between these spectrum edges.

Examples include Licensing and Franchising, Joint Ventures, Mergers and Acquisitions (M&A).

Spectrum of modes of entry based on commitment to home and foreign country

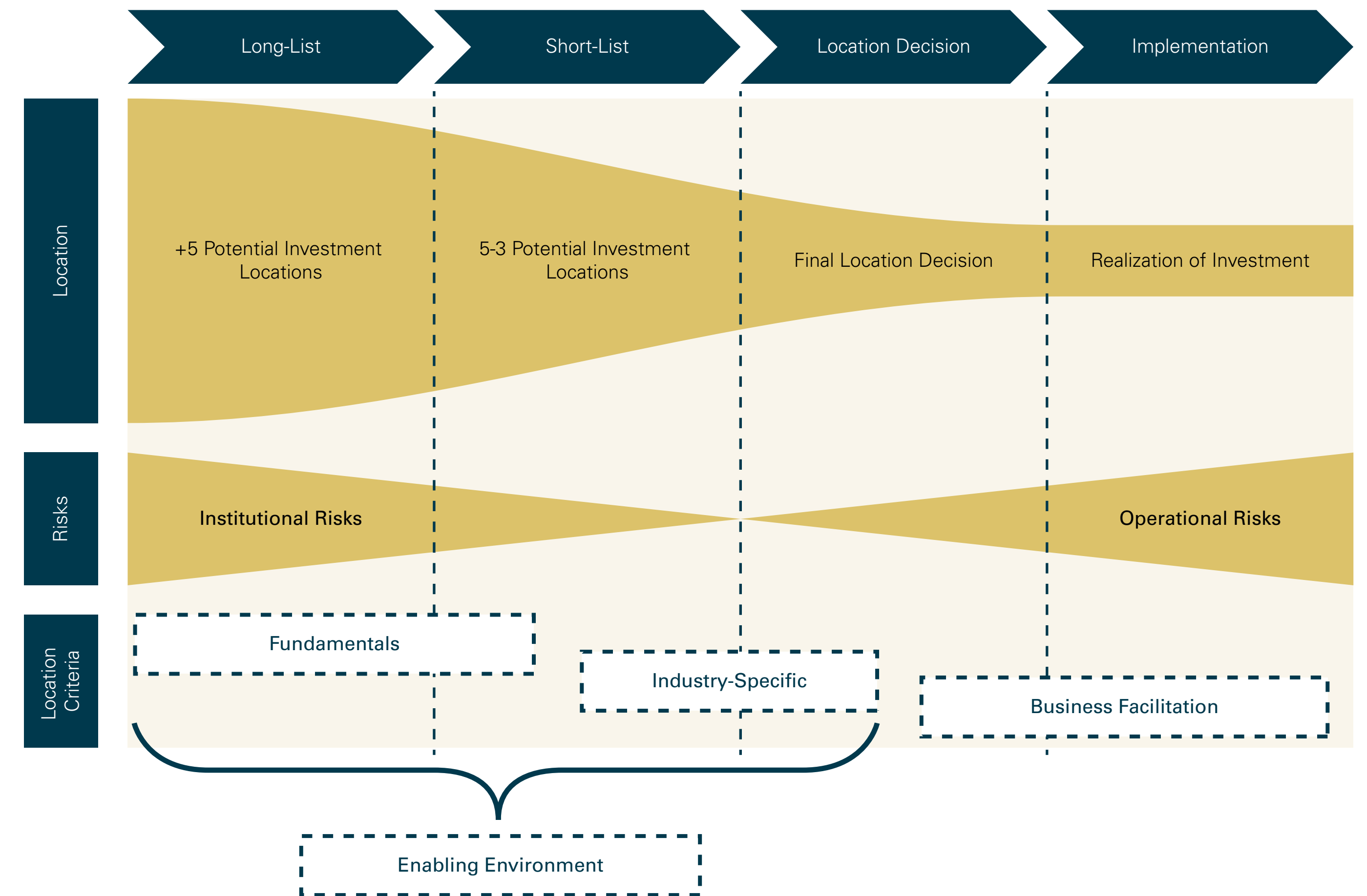


Source: Investment Consulting Associates – ICA (2015)

This implies FDI is the most risk-sensitive mode of entry due to its strong ties with the foreign market and its exposure to the business climate of this foreign market. The return on investment of the FDI project depends on balancing investment opportunities and risk levels that appear within the foreign market's business climate. In other words, the quality of the foreign market's business environment plays a key role in selecting the ultimate location for a FDI project.

This requires a thorough assessment of the competitiveness and risks of potential foreign markets where the company may realize its FDI project. This procedure is referred to as the "FDI location selection process". Companies will evaluate locations based on a number of "location criteria" or conditions of the business climate which need to be in place in order to cater specific requirements of the FDI project and mitigate investment risks.

Typical FDI location selection process



Source: Investment Consulting Associates – ICA (2015)

Risks that need to be mitigated relate to institutional risks or risks associated with the foreign country's institutional environment within which the company will undertake FDI. Examples include political stability, quality of governance, soundness of rule of law and transparency and predictability of rules and regulations. Secondly, operational risks need to be minimal in a potential investment location. Operational risks are sector-specific and could include the accessibility of natural resources, labor cost and presence of a skilled and educated labor force. Again in an ideal investment location, both institutional as well as operational risks are minimalized yielding a substantial return on investment.

In the course of a typical FDI location selection process, the focus shifts (almost) exclusively from evaluating institutional risks, which are considered more important during the initial, macro-level stages to industry-specific operational risks at a more meso-level. The number of potential investment locations will be narrowed down in accordance with the shift from institutional risks to operational risks.

The first stage of a typical FDI location selection process is characterized by a long-list based on five to ten potential investment locations, which have been selected based on a group of location criteria which is often referred to as "fundamentals". This group of location criteria reflects institutional risks such as political and social stability of the location as well as the ease of doing business and the general (institutional) business environment. The five to ten potential investment locations of which the long-list is composed of, all meet these "fundamentals". In other words, the institutional risks in these five to ten locations are acceptable and manageable compared to locations that do not feature in the long-list.

In the second stage, the long-list is narrowed down to a short-list of three to five locations. Narrowing down the long-list to the short-list reflects the shift from institutional to operational risks as the short-list is usually determined based on "industry-specific" location criteria. This group of location criteria reflects operational requirements that need to be present in the investment location to ensure the FDI project runs effectively. Location criteria on which potential investment locations are assessed relate to the industry in which the company operates as well as its motive(s) to undertake FDI. Reasons for companies undertaking FDI can be classified into four groups of motives, which, to an extent, mirror the nature of business activities and sectors with which the FDI project is associated.

- Resource-seeking FDI: ensuring (cheaper) access to and continuous supply of natural resources and raw materials.
- Market-seeking FDI: penetrating new (and neighboring) markets with products and services. Can be part of a strategy to follow key competitors, customers and suppliers and/or strategy to produce locally to anticipate on cultural differences and preferences.
- Asset-seeking FDI: obtaining strategic assets to secure the international competitive position. What is perceived as "strategic" depends on the strategy, needs and target markets of the company undertaking FDI and can be related intangible assets including technologies, innovation, skills and knowledge.
- Efficiency-seeking FDI: in order reduce operating costs and increase efficiency and productivity, firms undertaking FDI look to rationalize their existing corporate structure and search for supplies of cheaper inputs, materials and labor.

FDI undertaken with differing motives will require other operational needs in a foreign business climate.
The competitiveness of a particular location depends on the degree it is compatible with industry-specific needs.
For instance, resource-seeking FDI will put more emphasis on the abundance of certain natural resources whilst asset-seeking FDI will be more orientated to foreign markets with a highly educated labor force.

Combined, the fundamentals and industry-specific location criteria compose the so-called "enabling environment".
Only when such an attractive business and investment climate is in place, corporate investors will consider investing.
A short-list consists of several locations in which an enabling environment is present. In other words, the enabling environments of the potential investment locations are satisfactory to facilitate the needs of the FDI project as both the institutional and operational risks are alleviated and acceptable. The combination with considerable economic opportunities offers a reasonable return on investment. These ingredients are critical for a FDI project to be profitable and successful.

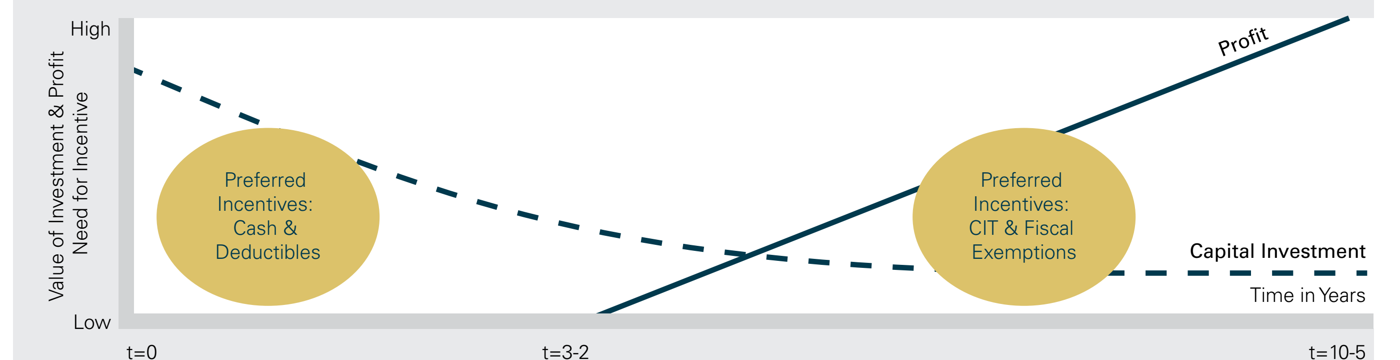
The question then remains 'does incentive packages offered within Free Zones play a role'? These come into play only after the short-list has been derived and the final location has to be decided upon. The final location decision for a FDI project is determined by so-called "business facilitation" location criteria. Examples include support from the government and assistance from an Investment Promotion Agency (IPA) and incentive packages. A short-list consists of a number of potential investment locations with similarly attractiveness and compatibility with the FDI project (i.e. "equal level playing-field"). In this case, small actions and gestures like incentives can make the difference to tilt the investment decision in favor of one particular location. In other words, incentive packages function as "icing on the cake".

Through their streamlined and simplified administrative procedures, Free Zones could mitigate institutional risks whilst their amenities, services and incentives could alleviate the more operational risks. However, as has become clear, Free Zones and particularly, their incentive packages, only appear on the horizon of corporate investors and multinationals in the later stages of the FDI location selection process.

This implies that policy-makers must design their incentive packages in line with the needs of FDI investors to cater to their specific requirements and mitigate any remaining institutional and operational risks. This applies to both the motive as well as to the life cycle of the FDI project.

- Resource-seeking FDI is much more reliant upon particular locations than FDI that has been initiated from another motive due to the scarcity of natural resources. Therefore, incentives for this group of FDI do not make much sense as natural resources are only available in a limited number of locations (e.g. minerals and oil).
- The same though to a lesser extent, is true for asset-seeking FDI. Incentives for this type of FDI do make sense in the case of a few remaining comparable locations when incentives offset expenditures related to obtaining strategic assets (e.g. R&D and training incentives).
- For market-seeking FDI, there is more motivation for incentives in the case of an equal level playing-field due to trade agreements or regionally integrated markets (e.g. EU or NAFTA) that allow more locations to compete for FDI, which can locate among similarly attractive parts of one large market. Incentives might tip the final location decision in favor of one location or another.
- In order to optimize their existing corporate structure, firms undertaking efficiency-seeking FDI are expected to compete globally. Therefore, the objective to lower the costs as much as possible explains the high appreciation of incentives of this type of investors.
- New (i.e. "Greenfield") FDI projects have a high need for capital that should finance constructing the new facility, purchasing equipment and tools and paying salaries of the first employees. As the required investment expenditures in this phase are high, FDI investors are more appreciative towards incentives that directly offset these vast capital expenditures. Examples include cash grants, investment allowances and deductibles.
- For the expansion of existing (i.e."Brownfield") FDI projects, which are up and running and are in profit, investors appreciate corporate income tax reductions and fiscal incentives for example, finance investment in their staff through the deduction of training expenditures or R & D via the deduction of research expenditures.

Appreciation of different types of incentives in the course of a FDI project's life cycle



Source: Investment Consulting Associates – ICA (2015)

Free Zones can do more in terms of economic impact analyses of investment projects in order to assess the economic impact of a project, which can be a point of departure for their communication and marketing strategy once the project has materialized. More states should be open to structurally evaluate the effectiveness and appropriateness of incentive programs and deals. This can be conducted by developing sophisticated cost benefit models and evaluation instruments as our team has done for numerous states and countries over the last couple of years.

Obviously, this must absolutely start with a coherent economic development strategy based on the known location advantages (and disadvantages) of the region, which takes into account the driving location factors of each industry and business activity. States can best achieve these goals by better understanding the site selection process and the various business criteria companies use to determine the best sites for their facilities. Incentives can only be one facet of this analysis. An economic development strategy that rests only on offering incentives is shallow and is likely to be unsuccessful.

Summing up, incentives can't turn bad location into a good one as they can't address large mismatches between the location and the business needs. An "enabling environment" in which institutional and operational risks are managed is critical. Rather, incentives can act as compensation for a lack of competitiveness in very specific areas of the business climate or when there is a short-list of similarly attractive investment locations.