Regulation and Promotion of Foreign Direct Investment in the Baltic States: Tendencies, Advantages, and Problems

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Abstract

The article analyses regulation and promotion of foreign direct investment (FDI) in Lithuania, Estonia and Latvia. There are given comparison of the main legal documents regulating the attraction and policy of FDI and differences in defining of country's image in each of the Baltic States. Also, the article provides detailed analysis of the Baltic States highlighting features that are promoting and restricting foreign direct investment. A common feature distinguishing the Baltic States from the other EU member states is a cheap skilled labour force. This factor increases the competition between Lithuania, Latvia and Estonia. However, such small economies must offer for investors much more than cheap skilled labour force as labour costs has been rising since all three Baltic countries joined the Euro zone.

Keywords: FDI policy, country branding, FDI initiatives, Baltic States

Introduction

The research of foreign capital mobility, whose origins can be traced back to the 19th century, is still relevant today. Under the present economic conditions it is important to identify the benefits of FDI for the host country and to analyse multinational companies (MNC) motives for investment. Various researches (Cooray *et al*. 2014) find that MNCs are likely to invest into economically weak countries benefiting from a low labour cost. Under the circumstances of economic recession, FDI is considered a driving force of economic growth. For this reason, most countries try to attract FDI at any cost. However, inward FDI may be determined by political decisions of the host government. Politics and policy are part of the country's governance. However, the definitions of policy and politics differ. Policy defines a decision-making process and the choices of alternatives, which are proposed in pursuance of a specific target. The goal of investment policy is to create a friendly business environment for FDI, which would positively affect a long-term growth of economic development. Thus, FDI policy should be a part of a long-term national strategy. In this way, a country gradually implements FDI policy and flexible changes with regard to its economic situation. Meanwhile, Kartasheva (2012) finds that optimal policy does not change the expectations of investors about distributions of project returns.

The others (Barros, Cabral 2002) claim that it is necessary to apply liberal foreign direct investment policies and to compete with other countries for attracting foreign capital. While multinational companies before investing compare potential countries among each other. Thus, the application of effective FDI policy might "manipulate" global corporate behaviour by appealing to favourable MNC motives for the host country. At the same time, multinational corporations reinforce their bargaining position between two or more competing countries for FDI and win "better" conditions i.e. subsidies for business startand company's performance. On the other hand, the historical experience shows that a purely liberal FDI policy turns into an anarchy and does not work when a highly developed country faces global economic downturns (Buckley, Ruane 2006; Kekic 2011). Aidt and Albornoz (2011) note that competition for FDI between countries determines welfare losses and it is not useful for a host country but for MNC. Meanwhile, Havrenek and Iršova (2010) study show that the absence of a clear fierce competition policy for foreign capital is visible the positive impact of FDI initiatives.

Sanjo (2015) research proves that under an endogenous competition policy scenario, where in the two countries which have different tax policies, the possibility of the foreign firm investing in the larger country—rather than in the smaller country—increases with the increase in the inflow of foreign capital. Kartasheva (2012) includes rules for infrastructure project selection, award procedures, support and regulation into investment promotion policies. In this way, even the regulation of FDI can be seen as a promotion policy. However, Levi-Faurand Jordan (2005) recognizes that the regulation, as well as the other political concepts, is difficult to define, since it is applied in different areas. Researchers evaluate differently degree of possible government interventions into the business and do not agree on the choice of adjustable incentives. The high level of government intervention is associated with high level of bureaucracy, which weakens the country's competitiveness in the international arena, as well as its attractiveness of FDI. Moreover, the high level of bureaucracy promotes corruption and lobbying. However, even highly regulated FDI policy opens markets for MNC companies whose activities are directed to local business development or reinvestment. According to Agrawal (1996), the regulation of foreign capital and EU agreements becomes exceptional important for competing for FDI. The author argues that this attracts FDI flows from matured EU economies to Eastern European countries and forms regulatory policy within respect to FDI.

Sirr *et al*. (2012) states that the greatest impact on attracting foreign investors has indirect incentives, especially the country's positive image is significant important. The influence of non-financial measures on inward FDI is especially emphasized. This tendency is especially evident in emerging market countries or countries in transition. These countries do not usually have a full legal base for FDI regulation and stimulation. Thus, fiscal incentives are more appropriate for them as they are easier to introduce (Ginevičius, Šimelytė 2012). In order to reduce expenditures, the state agencies very often offer direct financial incentives, instead of indirect ones. The study of scientific literature (Lim 2008; Sirr *et al.* 2012; Šimelytė 2012) reveals that promotion, as a marketing tool is equally significant in attracting FDI. Classical promotion instruments cover the creation of the country's image, the establishment of the brand of the country, investment generation and the services for foreign investments, which are provided by an investment promotion agency (IPA).

The establishment of Investment Promotion Agency (IPA) is one of the measures of FDI policy, and the promotion is a sign for MNC that the country is opened for FDI. Although, there is a shortage of scientific literature on IPAs role in attracting FDI, some studies (Anderson, Sutherland 2015) show that there is strong evidence that the presence of IPAs increases like hood of MNC locating in the host country. However, the purpose of investment support is to attract any type of FDI projects. Noailly and Ryfisch (2015) results prove that local environmental regulation and specific technological abilities in green technologies are important drivers of MNCs' green R&D location decisions. They maintain that innovation is the main driving force of economic growth, and attracting R&D investments from MNCs is high on the policy agenda of many countries. These authors advice for host country policy makers is to provide direct financial support or fiscal incentives to MNCs and implement investment promotion policies (e.g. advertising).

The purpose of the article is to assess trends, strengths and weaknesses in attracting FDI in the Baltic States, to compare conditions for granting incentives in the Baltic countries and to explore the promotion of the policy-making process, to perform the analysis of legal document that are associated with the FDI attraction, promotion and formation of the country's image.

1. Analysis of direct foreign investment legal regulation and promotion measures

"Investments are the source of an employment, knowledge and competitiveness, which determines the country's economic growth. Direct domestic and foreign investment make possible for residents of the country to earn and live better. Therefore, we aim that Lithuania would appear on the map of business investments and will strengthen the positions in international markets" it is written on the website of the Ministry of Economy. The Baltic States encourage investments as much as it is not in conflict with European Union laws, regulating state support. However, in order to attract more foreign capital, all the Baltic States apply measures to attract FDI, but do not employ targeted FDI policy. It may be noted that after Lithuania, Latvia and Estonia regained independence; foreign direct investment had a key influence on setting government targets, as foreign capital is one of drivers to stabilize the economy and ensure its growth. For this reason, one of the first laws that approved independent Estonia was Foreign Direct Investment Law (1991). Since then Estonia has began to form FDI policy, which is based on equality principal. The target of Estonian Foreign Direct Investment Law is to create a favourable climate for investments. Since then, foreign-owned firms may invest (acquire) up to 100 percent of ownership in any sector.

Since 2001, Estonia for foreign investors has began to impose restrictions in mining, energy, gas, water, railway and transport, shipping, telecom sectors. The specific incentives applied in Estonia do not discriminate local businesses and foreign investors (CommercialCode1995). Estonian initiative policy may be defined as passive liberal FDI policy. In addition, for both foreign and local capital companies funds are allocated from the national budget and the EU Structural Funds. Foreign and domestic capital companies may apply even for several support measures through the Estonian Investment Promotion Agency (Enterprise Estonia). The country quickly accepted international standards associated with FDI in the early stage of reforms and has signed bilateral agreements with its key partners: Sweden (1992), Norway (1992) and Finland (1992). This led to the development of business sectors and formation of the new sectors and the choice of streams of incoming FDI in the country. In the present, the Estonian government applies the following strategies to attract FDI: employment and economic growth; Estonia's competitiveness strategy; National Reform Programme-Estonia 2020. It implements sectorial development plans, which are closely related to the government's strategies: Estonian R&D and innovation strategy and the National Small and Medium Business Development policy, which is integrated in to the “Estonian Enterprise” policy.

These strategies, plans and policies are closely linked and complement to each other. Estonia supports investors in starting and developing business promotes exports and innovations, as well as new product development and provides the protection of intellectual capital. In addition, MNC has the same rights and obligations to the state, as well as local business firms. The conditions of establishment are not limited; the same procedure applies for MNC and for local companies. For example, 10 universities and 25 higher education institutions conduct research in electronics, mechanical engineering and metal processing areas, and are supported by the state. Estonia ensures the investors rights. Its flexible legal system and labour market are highly attractive for investors. For this reason, Estonia, employing the passive policy of investment-friendly business environment, successfully attracts FDI into R&D sector. The other two Baltic countries – Lithuania and Latvia stimulate foreign direct investments by implementing specific incentive programmes. Latvian Investment Law stimulates FDI and protects investors’ rights in the line with international standards and develops an appropriate legal framework for FDI. The law provides certain guarantees; such as to return after tax the unlimited profits, income or dividends to the investor's country. The Government of the Republic of Lithuania offers a wide range of incentives to foreign investors (table 1).

Table 1: Documents related to the promotion of foreign direct investment in Lithuania

Document	Priority	Measures to attract investment
Investment Law (1999)	Greenfield investments, investment in unfinished buildings; investment in problematic regions; investments in free economic zones, science and technology parks; investment in innovation, investments into centres of knowledge economics – clusters.	Tax incentives; staff retraining costs partially or completely covered; loans to the state (municipal) guarantee; state land leased to the investor at auction.
Free economic zone Act (1995)	In international trade, production and export of financial activities; scientific-technical progress in developing and installing companies and organizations; the creation of new jobs	For rental state land is paid a reduced up to 50per cent land tax; tax holidays; 50per cent reduced income tax rate; dividends are exempt; other tax concessions as regards under the law.
Investment Promotion2008 - 2013Programme	Development of high-tech and medium high-tech sectors, or enhancement of companies generating high value added products; employment issues.	Improving the image of the country; Design and development of investment promotion measures; flexible labour laws; favourable tax environment for businesses; rapid construction permit sand licensing; Provision of EU Structural Funds; PP network expansion
Programme of XV Government	Companies with a global and long-term growth potential; innovative and creating high added value; promoting technical and technological progress.	Not specified
Programme of XVI Government	FDI directed into the industrial sector, their efficiency and development; increasing employment; effective FDI.	Not specified
Investment Promotion2014 - 2020Programme	High-skilled jobs; high-tech and medium high-tech sectors; services, production and manufacturing companies seeking high-tech and medium-high technology and the use of high value-added product development and their export.	Next to financial create tax measures; not into favour of green field investments and its specific areas; removal of bureaucratic and administrative barriers to business; favourable tax environment for business creation; Business Control System’s simplification; liberalization of labour relations; improving the state of infrastructure.

Most frequently the Government offers tax relief, investment guarantees, support, and grants for R&D projects. Lithuanian national support is provided in accordance with Invest LT, LT +Invest, Invest LT from EU Structural funds and through fiscal incentives. The foreign capital enterprises can apply for support under the Invest LT +. Grants area warded:

- For infrastructure (with special access roads, railway tracks or improving port facilities, telecommunications, water supply and drainage systems, electricity supply, etc.);
- For the financing special training programmes for the local workforce;
- for covering project costs (land, premises and buildings for rent, joining the engineering network services input tax, for R&D and patenting services, for services on the delivery of new or existing products in new markets, as well as participation in international exhibitions and fairs, the remuneration of workers employed in the implementation of the investment project);
- for covering costs on the acquisition of tangible fixed assets(equipment, machinery, appliances and appliances purchase);- for the cost of acquisitions intangible assets (patents, licenses, software acquisition);
- For covering property, plant and development costs (in technical design, engineering install, buildings, facilities construction, reconstruction and (or) arrangements arising from the special needs).

However, support covers less than 50 per cent of the project value. Support and technical development loans are the main financial instruments to attract FDI into high-tech and medium high-tech sector. In 2011under the EU Structural Funds Programme “Assistant–3”, 724 marketing tools have been implemented, 4024 consultations were provided for business companies. During 2011 and 2012 under the “Invest LT +”programme 15 FDI projects have been attracted, their implementation created 1,545 new jobs. At the same time Lithuanian Investment Promotion agency "Invest in Lithuania” attracted 41 foreign direct investment projects with a total value of 675.1 million. These projects account for 64.1 percent of total foreign direct investment projects in Lithuania. In 2014 year 28 companies took advantages of Public enterprise “Invest in Lithuania” services and mediation have invested and created 1,800 jobs. The XVI Government of Lithuania, as XV, focuses on attracting FDI.

In current programme of the Government, in 2012-2016 periods, the main goal is an economic growth, which provides for the implementation of the active and fiscal employment policy. The programme plans to create a new FDI strategy, which is based on economic priorities. The main priority of the XVI Government, as XV, is to increase an employment and coherent approach to create job places. However, in selecting the target business sectors is formed confrontation with the previous policy. The XVI Government prioritizes industrial sectors while the XV Government gave priority to service sectors. The continuity is maintained by creating a favourable investment environment in Lithuania and enhancing investor’s confidence. Anyway, it might be noted that Lithuania still trends to form a volatile and unpredictable image of the country for investors.

However, the XVI Government of Lithuania has partially extended the investment promotion programme and supplemented it by 2014–2020 year programme of Investment Promotion and Industry Development. It states: "Especially important investment are in the services and manufacturing sectors. According to the Lithuanian Department of Statistics, in 2009, the tangible investments in Lithuania amounted to 4.5 million euro, in 2010 - 4.1 million euro, 2011 - 5million euro, but the increasing utilization of production capacity (in 2013 - 75per cent) indicates that it is necessary to increase investment in the production sector.

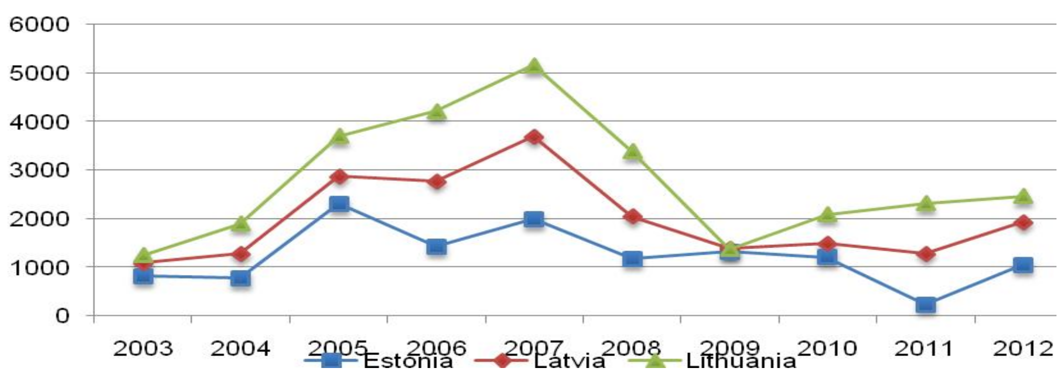

Fig. 1: Inward Foreign Direct Investments (flows), millions Euros (Source: EUROSTAT)

Latvia, adapting investment strategy of "Polaris", aims to attract invest or sand to maintain consistent growth. This strategy is intended not only to foreign investors, it focuses on public and private, as well as to foreign-funded enterprises and academic institutions. In order to receive support for investment in strategic sectors, such as R&D, investors must comply with the requirements. Lithuania, like Latvia, provides incentives for MNCs under specific requirements for investment volume. Supported are only these investors whose invested project amount into green field or brown field are not less than 5,8 million euro and 1,44 million euro investment in R&D. Lithuania supports investors establishing or enlarging existing research centres; or if the investment is with sound brand company or foreign capital is directed to high-tech. In order to attract FDI, there are proposed tax relief in three free economic zones (FEZ), four industrial parks and five research centres: “Santaros Valley” in Vilnius (IRT and life sciences),”Sunrise Valley” in Vilnius (physical sciences and technology), “Santakos Valley” in Kaunas (pharmacy and medicine, the future of energy), “Nemunas Valley" in Kaunas (agriculture), “Marine Valley” in Klaipeda (Marine Technology). Attracting investment into FEZ, there are offered tax incentives: 0 per cent on income tax during the first six years of operation and 50 per cent reduced income tax for next 10 years. It is also not subject to VAT, dividends and property taxes.

Latvia, has founded four FEZ with a well-developed infrastructure, is offering a wide range of incentives for FDI. The provisions of the underlying fiscal incentives: tax exemption sand reduced value added tax. Latvian government encourages investors by offering up to 80 percent of income tax rebate, 0 per cent of VAT, custom sand excise discounts, up to 80 per cent is reduced property tax, and there are exemptions of management, social protection and intellectual property fees. Latvia by implementing the state support programme, supports innovation, provides loans and guarantees. Both local and foreign capital investors are supported in starting a business, if it is related to the international activities and innovations. However, investors who are seeking to receive government assistance are subject to more stringent requirements than in Lithuania. For example, a company wishing to take advantage of tax incentives must commit to invest not less than 7,2 million euros over three years. They must develop new products, improve existing and substantially modernize the production process. Investors can expect 25 percent tax credits for long-term investments, which are exceeding 50 million euros, or 15 percent long-term investment, which are not exceed 50 million euros. Dual FDI incentives are provided for MNC, investing only in priority business branches.

Lithuania and Latvia trying to attract investors are applying a liberal FDI policy, with the features of regulatory FDI policy. However, in Lithuania and Latvia the flows of foreign capital are much more poorer than in Estonia, which proves that the FDI policy in these two countries is implemented not successfully or inefficiently. As analysis shows; Estonia by attracting FDI through business-friendly environment must pay more attention to the improvement of the legal system. In the current situation, companies in Estonia are facing regulatory problems and a lot of time demanding procedures. Even though not having targeted FDI policy, Estonia consists of the image of the country open to foreign capital.

2. Formation of the country's image

An effective FDI policy is unimaginable without attractive image of the country at international level. The Image of the country consists of six areas on main human perception of state: promotion of tourism, export exclusiveness, political decisions, and amount of FDI entering into the country, cultural change sand people. Image of the country, starting with branding, is created not only by marketing professionals or the authorities concerned. First of all, its forming contributes to the foreign policy, which should help to create a country’s best suited brand, slogan, and in this way introduce a country to foreign investors (Table 2).

Table 2: Branding of the Baltic States (Source: Brand for the Nation of Latvia; Everything about Nation Branding and Country Brands; Smart advertising of Lithuania)

State	Slogan
Estonia	Welcome to Estonia Smart e-solution country – small but innovative Ecological Heaven
Latvia	The land that sings
Lithuania	Lithuania is the heart of the Baltic) The Centre of Europe Lithuania is a brave country Small but sound

Estonia is seeking to attract FDI by creating an attractive image of the country in an international environment. There is established Estonian Investment Promotion Agency which is not limited on creation the image of the country, it also provides financial assistance, counselling, entrepreneurs, researchers, informs public sector about possibilities of cooperation and training (Estonian Enterprise Policy, 2007). In international area Estonia forms the image that is positively changing country. Indeed, Estonia seeks exclusivity by stressing that it is different than Lithuania and Latvia, as has old traditions of Northern Europe. It follows Lithuania, is also linking itself with the Nordic countries and the international space presenting itself as the North-East European countries with the progressive nature of typical Scandinavians. At the same time, Lithuania shapes the image of itself as a new, undiscovered country. However, in the contrast to Estonia, which has already been launched a marketing plan; Lithuania is facing with the problems of image formation. In fact, Lithuania's image is still not clear and well understood. Foreign investors, while analysing volatile image of the country, Lithuania may be treated as an unstable country in which the business development opportunities might be uncertain. According to XVI Government, it is necessary to develop and implement long-term national programme for Lithuania's image. It also aims to establish representatives abroad for public company "Invest in Lithuania”. It should be noted that Lithuania is the only one in the Baltic States having one IPA foreign office. Latvia, like Estonia, presents itself as a liberal country, which has created a favourable environment for business and willing to host foreign capital. However, Latvia's FDI policy frame work does not specify the means by which is formed a favourable environment for foreign capital. Latvia and Lithuania are still creating the country's international image.

Each of the Baltic countries, in their marketing strategy, particularly emphasizes the geographical position, high quality of life and/or lands scale, highlights the country's openness and tolerance. Especially, Lithuania distinguishes its position of a transit country, the quality of infrastructure in its marketing plan. However, Latvia, as Lithuania proposes a variety of possibilities for communication over long distances. At first glance, the Baltic countries in terms of competitive advantage are almost the same with the emphasis on similar aspects of the country's attractiveness. However, the country's image programme is able to carry out successfully only Estonia. Lithuania’s branding change forms the national character featuring volatility, unpredictability and instability. If the country's population behaviour is unpredictable, the political situation is unstable, and the legal system is rigid, it is difficult for the investor to decide whether to invest in business in Lithuania and to expand it. Latvia's image-making programme has crashed already in 2001. This may to form an opinion about the passivity of the population, unwillingness to work, laziness or a lack of creativity. Consequently, the investors who are predisposed to innovative business might to question whether it is difficult to find an appropriate workforce. Estonia, through its consistent and defined national marketing plan, highlights for the investor its permanence, pedantry and responsibility. In practice, it is noted that the main factor in forming marketing complex to attract FDI, is the degree of agencies development level (Azis 2003). However, the countries should not expect rapid foreign capital inflows if the governments, their programmes or FDI policies change too often. If IPA is focused to maintain a good image, by providing positive information through specific media, it forms a favourable investment image of the country. In some cases, the image formation is the main measure taken by the IPA in order to attract foreign direct investment. Agencies, which, from the image forming are going to investment generating measures, indicate that they are ready to accept targeted FDI.

Conclusions

A detailed analysis of the Baltic countries highlighted features that are promoting and restricting foreign direct investment. A common feature distinguishing the Baltic States from the other EU member states: is cheap skilled labour force. This factor increases the competition between Lithuania, Latvia and Estonia. Such small countries for investors must offer more than cheap labour force as labour costs are growing when all three Baltic countries joined the Euro zone.

All three countries underline their geopolitical position. Lithuania is seeking to become a transit country. There maining two positions the quality of their ports. The uniqueness of Lithuania and Estonia from other European countries–is low taxes. Estonia also among all three Baltic States has the lowest level of corruption and bureaucracy. Lithuania stands out from the Baltic countries as well as having the largest market, the growing market potential, high quality of research institutes and researchers, potential geopolitical position between East and West, good quality of roads, railway infrastructure.

There are laid down factors, which are attractive to foreign investors in Latvia:

- The fastest-growing PPP;
- qualified cheap labour force;
- expanding of Riga Airport, which is the largest airport in the Baltic countries. In addition, Latvia was awarded the highest quality rating of airports in the Baltic countries;
- direct border with Russia.

The main factors driving FDI flows to Estonia are:

- The largest PPP in the Baltic countries;
- qualified workforce is by half cheaper than in the Scandinavian countries;
- competitive product, labour and financial markets in the Baltic countries;
- the lowest level of corruption and bureaucracy;
- Maximum allocations for research and experimental development in the Baltic countries;
- simple start-up process, low taxes;
- consistent implementation of FDI attraction programme with a well-developed IPA activities;
- successful implementation of the country's image strategy;
- well-developed infrastructure, ice-free ports and ports in the highest quality in the Baltic countries.

The biggest limiting factors in attracting foreign capital-is a bureaucracy and inflexibility of the law, business putting for foreigners, complex conditions to acquire land, rent it. In addition, for the foreign investor seeking to obtain state support there are high requirements. The main impediment-not defined national priorities in the field of promotion of FDI and the changing image of the country.

Estonia has developed a scheme to attract FDI, which do not provide exceptional conditions for foreign capital enterprises, forces these companies to face the same problems as local businesses are facing. The main problems occur due high taxes, inflexible legal framework and bureaucracy. Estonia also has a workforce with inadequate level of education. The above-mentioned factors are considered key factors restricting the development of the business environment.

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