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THE EFFECT OF REGULATORY INCENTIVES ON BILATERAL FOREIGN DIRECT INVESTMENT

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Abstract. In general, the promotion of foreign direct investment (hereinafter "FDI") is considered to be one of the positive measures influencing MNCs decisions to invest in a country. Regulation is treated as a negative aspect in attracting FDI. However, regulation is employed in approving investments, managing incentives and issuing permits, which are seen as promotion tools. The authors are trying to answer the question whether promotion can exist together with regulation and have a positive effect on FDI flows. The article aims to determine the influence of regulatory incentives on inward FDI. Central and Eastern European countries have been chosen for the purpose of empirical analysis.

Keywords: foreign direct investment, FDI promotion, FDI regulation, MNCs, gravity model.

Jel classification: F21, F23, M48

1. Introduction

Recognizing the positive effects of FDI on the host country's economic development, developing countries as well as developed countries introduce incentives to attract FDI. FDI incentives framework determines business conditions for investors who move their capital to the host country. In some cases regulatory incentives play the role of disincentives in attracting FDI. The result of the implementation of FDI incentives framework, which has been especially popular for the last two decades, opened markets and increased FDI flows across countries. However, internal regulation of FDI and bulk of international investment agreements (hereinafter IIAs) caused some confusions and inaccuracies for foreign investors in the host country. The essence of IIAs is to create exclusive conditions for MNCs between the countries-contract signers. This phenomenon has spread over the world and has naturally designed a network of multinational corporations (hereinafter MNCs). Still, there are some ambiguities and arguments for the regulation of FDI. For example, liberalisation is the most common regime. However, regulation and liberalisation are two incompatible matters. Thus, the question is whether liberalisation and regulation exist in parallel or regulation is a part of liberal regime. Regulation seems like a concept too opposite to liberalization to be treated as a part of it. However, unregulated liberalism turns into anarchy. For that reason, governments intervene in the form of regulation of FDI flows. The governmental influence on inward FDI is unspecified. Anyway, according to Banga (2003), regulatory FDI incentives may increase or decrease market imperfections which can occasionally stimulate inward FDI. Moran (1998) doubts the benefit of the host country's intervention in the private sector. In some cases the consequences of intervention and regulatory FDI policy create a negative attitude towards the host country and decrease inward FDI flows. Meanwhile, it becomes more and more popular to evaluate the relationship between positive and negative FDI forces (Tvaronavičienė, Kalašinskaitė 2005; Tvaronavičienė,Tvaronavičius 2006). Thus, the model of positive FDI effects on the host country becomes less significant. Still, in the global environment, especially in emerging market countries, the liberal market model is introduced. The liberal attitude towards the global market forces governments to design FDI stimulation policy underestimating the effect of FDI on the host country. Thus, the countries, which implement unreasonable FDI promotion policy while importing FDI, suffer losses. In some business branches, these losses may be related to the positive economic evaluation, the loss of resource control, the ineffective use of resources or the shortage of reinvestments (Degutis, Tvaronavičienė 2006; Tvaronavičienė, Grybaitė 2007; Ruplienė 2009). Regulation of FDI restricts foreign capital flows from a particular country by opening market to another. Desbordes and Vicard (2009) note that historically regulatory incentive measures are

widely used during liberalisation and privatisation processes, which is the main reason why many countries introduced regulatory FDI policy, signing BITs (hereinafter bilateral investment treaties) and IIAs. The BITs are international legal commitments that guarantee the property rights of foreign investors (Manger 2008) which include expropriation clauses defining what is deemed to be expropriator behaviour and specify compensation and dispute-settlement mechanisms, such as the recourse to international arbitration courts (Desbores, Vicard 2009). Consequently, most countries introduced regulatory incentives during their transition period.

Governmental or international FDI regulation allows attracting foreign capital into targeted markets. However, the effect of trade regulation in attracting vertical and horizontal FDI is different. By employing trade barriers, governments may expect higher flows of horizontal FDI with the purpose to enlarge the market. However, Bartles (2002) and Vogel (1996) state that the governmental intervention in the market causes a negative attitude towards the country in the international arena. In that way, inward FDI flows decrease.

The article aims to determine the influence of regulatory incentives on inward FDI. The problem is that countries employ various international agreements with no regard to the consequences of implementation of BITs or IIAs. However, the scientific literature provides evidence that implementation of BITs and IIAs increases inward FDI.

2. Theoretical aspects of regulatory policy

2.1. Foreign direct investment and regulatory incentives

According to the OLI paradigm, MNCs move their activities depending on competitive advantages they would receive against local capital. Another determinant influencing the investments to the host country is choosing the right form of investment. Thus, the two factors force MNCs to take a deep look at the national and international regulation towards FDI in the host country. Under certain conditions national regulation has a higher impact on inward FDI than BITs or IIAs. The countries competing with each other offer many incentives to attract FDI. According to Fisher (2000), incentives serve to win over foreign investors who are assessing the advantages of various destinations. Designed to attract and retain FDI, incentives consist of specific measures aimed at either increasing the rate of return of a particular FDI project or reducing its costs or risks. The scope and type of incentives generally reflect the objectives and financial possibilities of host governments (Fisher 2000). Thus, regulatory incentives are important for MNCs while making decisions to invest. In some cases, regulatory incentives open the market to foreign investors treating them as local ones, or even receiving exclusive conditions for business. However, the governments providing favourable conditions increase the rate of investment in the country.

According to Levi-Faur and Gilardi (2005), like other political concepts, regulation is difficult to define as it is adopted in different areas. In conservative view, business regulation distorts the market. By contrast, socialists emphasize that FDI regulation, trade barriers and other restrictions are beneficial to the country and local business. However, the increase in the number of regulatory incentives raises doubts about effective governance. Thus, FDI attracted by employing purely liberal or regulatory FDI incentives tend to distort economic environment and force to reclaim FDIs.

Anyway, purely liberal or regulatory FDI incentives may be adopted only under perfect market conditions. Thus, there are three attitudes towards regulatory FDI policy and regulatory incentives. The first one is the “strongest” attitude which is based on the strict governmental control and disincentives towards foreign capital. For example, Bartels (2009) highlights regulatory FDI policy as the intervention of the government in private business. To speed up the MNCs decision to invest, the government may interfere in the decision-making process by offering grants, tax re-ductions or other promotion measures. FDI policy is oriented towards MNCs motives, the clash of government’s and MNCs interests which may stimulate FDI flows. However, sci-entists question at what level the government should adopt regulatory incentives. Al-Khalifa (2010) defines direct and indirect regulatory FDI approaches. Gaigo (2007) recognizes public interventions where they are absent, incomplete or inefficient. This can be seen as a requirement to (1) ensure property rights and access market, (2) correct economic externali-ties, (3) prevent abuse by monopolies, (4) increase labour standards, and (5) assure environmental protection. The assurance of property rights is especially important in attracting foreign capital.

However, the high level of governmental intervention to business leads to the high level of bureaucracy. Bureaucracy is one of the problems which diminish the attractiveness of the host country in the international market. Besides, a high level of bureaucracy often tends to increase corruption and lobbyism. According to Global Competitiveness Report (2005–2011), countries face

FDI attraction problems because of bureaucracy, corruption, inflexible legislation and tax system.

Foreign investors who move capital to the host country expecting to benefit from cheap labour force expect flexible laws towards labour. In such a case, MNCs would not move their activities to the countries applying strictly regulated legislation on labour. However, even a strictly regulatory FDI policy opens the market to MNCs which orient their investment policy towards local business investment.

The second view is based on the regula-tion and restriction targeted at FDI flows in a particular region or business sector, such as oil, air transport, etc. In that case, a strict regulatory FDI policy is adopted in respect of strategic foreign investors only. Thus, in such cases FDI regulation increases the business risk for foreign investors in the host country. Huter (2001) states that foreign capital regulation minimises risk of business development and increases possibilities of competitiveness in the host country.

The foreign investor would not be fasci-nated by the government's competitiveness pro-motion policy and regulation for competition.

The early theories of FDI state that MNCs move their capital because of market imperfection. In that case MNCs would expect benefit against the local companies. In some scientists (Mao 2006; Lim 2008; Rutkauskas *et al*. 2008; Yelpaala 2008; Miyagiwa, Ohno 2008; Rosenboim et al. 2008) view, the governmental promotion programmes tend to attract a high level of FDI. Consequently, there is a requirement to design the FDI regulatory policy of a different type which would include regulatory incentives.

Thus, the third view of FDI regulation is based on laws determining business activities in the country. In that case, the host country welcomes foreign investors and clearly determines the "rules of a game" to ensure that the equilib-rium in the market would not be broken. The clear and transparent legal and political system reduces the risks which foreign investors may face.

Table 1. The summary of previous studies on the role of regulation (Source: compiled by the authors)

Author/ year	Role of regulation	Methods	Major findings
Neumayer, Spess (2005)	The effect of BTIs on FDI flows	Econometric methods, sensitivity analysis	A higher number of BITs raises the FDI that flows to a developing country
Huigh, Cave (2005)	Regulation and promotion of investment	Case analysis of the regulatory framework for electronic communication networks in Europe	Investments in electronic telecommunications grow in regions with higher competition markets and introduced regulation framework
Cambini, Randi (2009)	Relationship between investment and regulatory regimes	Instrumental variable methods (2SLS and GMM)	Investment rate is higher under incentives regulation compared to the rate of return regulation
Desbordes, Vicard (2009)	The effect of the implementation of BITs on FDI flows	Quantitative and qualitative data on daily events, econometric methods, gravity model	Good cross-national political regulation increases FDI. The effect of BITs crucially depends on the risk sustainability of MNE when investing abroad.
Rammal, Zurbruegg (2006)	Government regulatory effectiveness and government	Stochastic methods, least square method.	Deterioration in the effectiveness and enforcement of investment regulations have an adverse effect on FDI
Karabay (2010)	Regulatory FDI policy	Game theory: optimal mechanism	Greater share of ownership ensures a higher production level in MNCs
Nitsche, Wiethaus (2011)	Investment incentives and consumer surplus	Econometric methods	Regime with fully distributed costs or a regulatory holiday induces highest investment, followed by risk-sharing and long run incremental costs regulation

However, that kind of regulation also determines exclusive conditions for foreign capital and introduces stimulation tools for FDIs. The most common incentives are fiscal and financial. Actually, fiscal incentives are more popular and, according to some scientists (Goolsbee 1997; Peters, Fisher 2004), they are more effective for attracting FDI than other. In practice, the popularity of fiscal

incentives is not based on efficiency but on the simplicity to implement them. In fact, when designing FDI policy, countries start from fiscal incentives towards FDI. As fiscal incentives are one of the active tools for FDI policy, such countries design and prepare for the implementation of active FDI policy based on competition. The laws providing for the advantages of business establishment, especially as regards MNCs, would diversify FDIs' driving forces. Thus, the host country adopting such a style of regulatory incentives would benefit from diverse types of FDI.In general, investment incentives and policies towards FDI in the country is a sign of FDI welcoming country. Furthermore, a regulatory investment incentive reduces uncertainty of the country and increases attractiveness of business environment.

2.2. The employment of BITs and inward FDI

Governments offer incentives targeted at the improvement of business environment for foreign investors. Hence, regulatory incentives promote business but do not guarantee protection in the case of expropriation or even protection of intellectual rights. Bilateral investment treaties set forth the international standards for foreign investors which are a dominant source of international law protecting FDI. According to Debores and Vicard (2009), BITs make up a mechanism for the host government to credibly commit not to expro-priate investors in the future. Manger (2008) highlights that BITs are another incentive attracting FDI. Foreign investors treat BITs as an additional determinant which makes the host country more attractive. Thus, governments seeking to attract more FDI provide national incentives along with singing BITs and IIAs. The increase in the number of BITs may be related to the growth of competition for FDI among developing countries and countries in transition. Meanwhile, Bubb and Rose-Ackerman (2007) emphasize that a country signing BIT loses a competitive advantage over another country as surplus of foreign investment is transferred to the investor's country. In that way, foreign investors benefit from moving capital to a developing country and ensure the international protection of its activities. Besides, BITs reduce political and legal risks including ethical conflicts and unemployment. Hence, the effect of BITs on FDI is controversial in scientific literature. For example, scientists Huigh and Cave (2005) analysing the aspects of regulation in electronic communication networks notice that the inflows of investments grow only in regions with higher competition markets and introduced regulation framework. Neumayer and Spess (2005) state that a higher number of BITs raises inward FDI. Salacuse and Sullivan (2005) find a positive effect only for USA BITs but not for BITs from other countries. Tobin and Rose-Ackerman (2005) discover negative effects at high levels of risk and positive effects only at low risk. Meanwhile, Hallward-Driemeier (2003) does not find any significant effect between BITs and FDI flows. Thus, these discussions lead to the assumption that BITs are a regulatory FDI incentive which stimulates FDI depending on circumstances. For example, the government signing BIT wins competition for FDI against other countries at a similar economic level. However, it lowers competition inside the country and increases the competitive advantage for the parent country. Foreign investors promoted at the national and international level gain competitive advantage over local enterprises. Such a situation is particularly common if foreign investors are promoted by the local investment law. Thus, the more BITs a country signs, the more competitive advantage it loses in the international arena. According to the research of Buss and Groizards (2008), stricter regulations are associated with a lower GDP growth. Thus, the host country signing a high number of BITs allowing the transfer of the surplus of investment to the parent country may suffer loss instead of benefit. At the same time, the high number of BITs shows that the country is ready to sign a contract on any condition with any country. Thus, a high number of BITs means that the country fiercely competes for FDI. In summary, the mechanism of a variety of incentives and institutional framework makes up the overall regulatory FDI policy which, along with a number of BITs, leads to multiple-side effects in attracting FDI.

3. Empirical model and data

In recent years, the gravity model has been widely used for estimating the bilateral FDI flows (Razin, Sadka 2007; Desbores, Vicard 2009). The original gravity model is based on the Newton's law of gravitation which was adopted for analysing human behaviour. It has lately become known as "gravity equation or model" which is widely used in social sciences (Talamo 2005). In the early 1970s gravity model was adjusted to the evaluation of bilateral trade flows. The traditional gravity variables used to evaluate the effect of regula-tion on cross-national FDI flows are the GDP of home and source countries, population growth, culture, and distance. Other scientists (Matyas 1997; Bos, Laar 2004; MacDermott 2006; Buss, Goizard 2008; Hatari, Rajan 2009; Kleinert et al. 2010), using the gravity model for evaluation of bilateral

trade or bilateral FDI flows, include more specific variables. Chou et al. (2011) confirm that a significant increase of home market size and income per person attracts more foreign investors. Desbores and Vicard (2008) discovered that a positive impact on bilateral investment without a greater income per capita has other indicators, such as good public governance and shared language. Other scientists identified that the impact of a common language (Talamo 2003; Hatari, Rajan 2009; Desbores, Vicard 2009) is not less significant than that of the distance and may be used as the indicator which determines a non-physical distance. Loungani *et al.* (2002) found out that distance is highly significant for inward FDI flows. However, informational rather than physical distance has a greater impact on making decisions on investment.

Some scientists seek to evaluate institutional indicators, such as the level of corruption and bureaucracy (Neumayer, Spess 2005), openness to trade (Talamo 2003), governmental consumption and even black market premium (Buss, Goizard 2008). Political Risk (Hatari, Rajan 2009) is highlighted as one of the determinants in evaluating MNCs decision to invest in a country, which reflects in governmental stability, investment climate, socioeconomic conditions, level of corruption and bureaucracy. Corruption and bureaucracy are widely used as the determinants influencing both inward and outward FDI flows. Many scientists (Neumayer, Spess 2005; Wei 2004; Buss, Goizard 2008; Hatari, Rajan 2009) agree that these two determinants have a strong nega-tive impact on FDI flows.

Bilateral investment treaties are among the main determinants attracting FDI in the country. Besides, BITs, IIAs, MAI are treated as promotion/regulation tools. Thus, Neuyamer and Spess (2005) choose a cumulative number of BITs signed by a developing country weighted by the share of outward FDI. However, the effect of BITs on FDI is positive for richer countries which signed a high number of BITs. Futhermore, the countries with good diplomatic relations invest more in each other (Desbores, Vicardi 2009). In that case, neither the host nor the source country loses competitive advantage in the international arena.

In general, the analysis of the previous research shows that the main influencing indicators are the GDP of home and source countries, the growth of population and the distance between them. The article involves in-stitutional indicators as well as indicators of competitiveness.

3.1. Data

The analysis aims to measure the influence of regulation on bilateral FDI flows in the Baltic States and the Visegrad countries. FDI source countries are chosen according to the amount of the whole FDI in the home country. The source countries are as follows: Finland, Sweden, Norway, Austria, Denmark, Russia, Germany, France, Italy, the Netherlands, the USA, and the UK. The survey covers the period of 2000–2010. The dependent variable is bilateral FDI flows which are measured as aggregated investment during the period of 2000–2010. The basic gravity model explanatory variables are GDP and population which are used to measure the size of economy. Usually, GDP and population are expected to be significant and positive influencing factors. Another basic factor is distance, which is measured in kilometers based on geographical coordinates of the capital cities. According to Newton's law of gravitation, two celestial bodies are subjected to force of attraction that is directly proportional to their mass and indirectly proportional to their distance (Talamo 2005). Thus, distance is expected to have a strong negative effect on bilateral FDI flows.

Other explanatory gravity variables are usually determined as institutional quality variables. However, in this article special attention is paid to the influence of regulatory incentives on bilateral flows. Thus, the model will involve real explanatory variables, such as the number of BITs signed with the main countries investors, fiscal and financial regulatory incentives. The indexes of regulatory incentives allow evaluating the application of FDI incentives in various countries under particular conditions. The highest rate is 1, which means that all possible incentives and/or promotion are adopted in all business sectors for all types of FDI. The lowest possible rate is 0. In this case incentives or promotion are not adopted in any of the business sectors. However, the minimal rate shows the employment of regulatory FDI policy. FDI regulation is understood as a partial investment incentive. For that reason, the minimal but not the lowest rate is set. The lowest rate – 0 is given when a country does not employ any incentives for any FDI type, in any business sector. Each rate is calculated as the sum of all investment incentives or promotion rates of every sector for any FDI type. The rate decreases if the incentive is applicable only for one FDI type (R&D, Greenfield or M&A). The rate decreases if the incentive or promotion is available in one or a few business sectors or applicable in some regions (see table 2). The rate of each incentive is calculated as follows:

− Not applicable – 0;

−If applicable in all cases, the rate increases by 0.025 point;

−If applicable with some exceptions, the rate increases by 0.015 point;

−If applicable only in particular cases, the rate increases by 0.01 point.

Table 2. Indexes of regulatory incentives in the Baltic States and the Visegrad countries (Source: calculation made by the authors)

	Estonia	Latvia	Lithuania	Czech Republic	Hungary	Poland	Slovakia
Fiscal regulatory incentives	0.025	0.041	0.028	0.075	0.085	0.085	0.042
Financial regulatory incentives	0.025	0.028	0.041	0.139	0.075	0.055	0.105
Promotion	0.15	0.1	0.10	0.15	0.125	0.125	0.15
BITs, IIAs, etc.	0.105	0.105	0.105	0.105	0.105	0.105	0.105
Total	0.455	0.274	0.274	0.469	0.39	0.37	0.402

Other institutional variables are obtained from Global competitiveness reports. In this case institutional variables include three variables which are supposed to have a strong negative impact: corruption, bureaucracy, political risk and market openness are expected to have a positive impact.

3.2. Data and methodology

Talamo (2005) presents a general form of bilateral trade gravity model:

$$F_{ij} = AY_iY_j / D_{ij}, \quad (1)$$

where, F_{ij} are any flows between host and source countries (i.e. migration, tourism, trade, FDI), is a constant of proportionality, Y_i and Y_j are the relevant economic sizes (GDP, GDP per capita, population), D_{ij} is a distance between capitals or economic/financial centres. In practise, a geographical distance is more often used.

The correct econometric representation of the gravity model takes the form of a triple index model (Matyas 1997):

$$\ln FDI_{ijt} = \alpha_i + \gamma_j + \lambda_t + \beta_1 \ln GDP_{it} + \beta_2 \ln GDP_{jt} + \beta_3 \ln POP_{it} + \beta_4 \ln POP_{jt} + \beta_5 \ln DIST_{it} + ... + u_{ijt} \quad (2)$$

where:

FDI_{ijt} – is the amount of FDI flows from country i to country j at time t,

GDP_{it} – is the GDP in the country i at time t,

GDP_{jt} – for country j $DIST_{ij}$ is the distance between the countries *i* and *j*.

POP_{it} – is the population of the country *i* at time *t*,

POP_{jt} – is the population of the country j at the time *t*,

α_i – is the local country effect,

γ_j – is the target country effect,

λ_t – is the time (business cycle) effect,

u_{ijt} is a white noise disturbance term.

Thus, BIT_{ijt} is a dummy variable for bilateral treatment between host i and source j countries.

The full regression formula adds both traditional and institutional variable. It includes effects of source and host countries, and time effect.

$$\ln FDI_{ijt} = \alpha_i + \gamma_j + \lambda_t + \beta_1 \ln GDP_{it} + \beta_2 \ln GDP_{jt} + \beta_3 \ln POP_{it} + \beta_4 \ln POP_{jt} + \beta_5 \ln DIST_{it} + \beta_6 \ln PIR_{jt} + \beta_7 \ln FIS_{jt} + \beta_8 \ln FIN_{jt} + \beta_9 \ln ISTQ_{jt} + \beta_{10} BTIs_{ijt} + \beta_{11} BITs_{ijt} \times \ln PIR_{jt} + \beta_{12} BITs_{ijt} \times \ln ISTQ_{jt} + u_{ijt} \quad (3)$$

where:

PIR_{jt} – is the political risk of the host country,

$ISTQ_{jt}$ – is the institutional quality of the host country.

3.3. Discussion of results

The empirical analysis began from the classical gravity model without adding other significant variable in Regression 1 (see table 3). Indexes of political risk and institutional quality of the host country were added in Regression 2. The third regression includes all variables. Surprisingly, the results in Regression 3 differ from other two. As theoretically and empirically proven, most inward FDI flows have a strong connection with GDP of the host country.

Meanwhile, the distance from the source to the host country has a strong negative impact in

Regression 1 and 2, as well as in inter-item correlation. Meanwhile, the distance from the source to the host country has a strong negative impact in Regression 1 and 2, as well as in inter-item correlation. However, Regression 3 gives opposite results. This phenomenon can be explained through the involvement of fiscal and financial incentives.

Table 3. Gravity equation (Source: calculation made by the authors)

Dependent variable ln of bilateral FDI inflows			
Variable	**Regres-sion1**	**Regres-sion2**	**Regres-sion3**
Constant	479.612	-1467.203	-3489.123
lnGDPi	0.237** (7.337)	0.198** (6.248)	0.168* (7.358)
lnGDPj	0.928* (25.487)	0.924** (25.529)	0.916 (25.572)
lnPOPi	-0.214** (1.243)	-0.214** (1.228)	-0.177* (1.247)
lnPOPj	0.113** (8.132)	-0.142* (8.149)	0.113** (8.202)
lnDISTij	-0.775 (0.058)	-0.773 (0.058)	0.767 (0.058)
lnPIRjt	-	0.863 (2459.37)	0.761 (2618.44)
lnISTQjt	-	-0.849 (8359.16)	0.719 (9233.53)
lnFISjt	-	-	0.672 (6060.12)
lnFINjt	-	-	0.701 (3217.07)
Number observa-tion	723	723	723
R	(0.753)[a]		
R Square	0.567		
Adjusted R Square	0.536	0.92	0.90
F	16.109	11.482	8.390

a. Predictors: (Constant), DISTji, POPit, POPjt, GDPit, GDPjt. **. Significance at 0.01 level, *. significance at 0.05 level.

Thus, increasing the number of incentives towards FDI lowers the significance of the distance between the source country and the host country. That means that fiscal and financial incentives do have an im-pact on making decisions on FDI. This impact is especially significant when MNCs choose the location for FDI. Another non-traditional FDI determinant is political risk which is highly related to institutional quality.The results show (table 4) that the decrease of institutional quality negatively affects political risk which is highly significant in attracting FDI (table 3). The population of the host country has a strong positive connection with bilateral FDI flows which means that the increase of population enlarges labour market. It allows recruiting "the right people for the right jobs". This is especially important for resource-seeking investors.

However, according to the results of Regression 3, the changes in the host country's labour market or population do not have a strong impact in attracting FDI. The analysis of the results provided by Regression 3 shows that the classical determinants (POPi, POPj and GDPi) of the gravity model do not have a strong effect on bilateral FDI flows which means that other determinants, such as political risk, institutional quality, fiscal and financial incentives, play an important role in attracting FDI.

In general, the result from the gravity model and inter-item correlation differs which proves that the empirical analysis based on the non-lineral model provides more exact results.

Table 4. Inter-Item Correlation Matrix (Source: calculation made by the authors)

	FDIitj	**GDPjt**	**GDPit**	**POPjt**	**POPit**	**DISTji**	**PIRjt**	**FISjt**	**FINjt**	**ISTQjt**
FDIitj	1.000	0.990	0.996	0.986	-0.926	0.773	0.485	0.555	0.626	-0.450
GDPjt	0.990	1.000	0.981	0.967	-0.940	0.838	0.531	0.662	0.613	-0.502
GDPit	0.996	0.981	1.000	0.994	-0.921	0.777	0.532	0.525	0.578	-0.499
POPjt	0.986	0.967	0.994	1.000	-0.940	0.788	0.585	0.498	0.565	-0.544
POPit	-0.926	-0.940	-0.921	-0.940	1.000	-0.877	-0.673	-0.662	-0.645	0.619
DISTji	-0.773	0.838	0.777	0.788	-0.877	1.000	0.815	0.790	0.338	-0.809
PIRjt	0.485	0.531	0.532	0.585	-0.673	0.815	1.000	0.535	0.032	-0.988
FISjt	0.555	0.662	0.525	0.498	-0.662	0.790	0.535	1.000	0.497	-0.550
FINjt	0.626	0.613	0.578	0.565	-0.645	0.338	0.032	0.497	1.000	0.004
ISTQjt	-0.450	-0.502	-0.499	-0.544	0.619	-0.809	-0.988	-0.550	0.004	1.000

4. Conclusions

The role of regulation in attracting bilateral FDI is controversial in scientific literature. The positive view in employing regulatory incentives states that a higher level of regulation attracts more FDI in the host country. However, the sceptics of FDI regulation highlight the importance of liberal regime in the country. Thus, the intervention regarding FDI flows reduces the number of investors in the host country. Others maintain that the host country can benefit from FDI regulation only in a long period of time. The authors of the article emphasize that regulation may have a positive impact on bilateral flows if it is based on the "rules of the game". Thus, fiscal and financial incentives, as well as BITs, may be treated as regulatory incentives which are employed by the host government in order to attract foreign capital. On the other hand, the high number of BITs has a negative ef-

fect on the competitiveness of the host country in the international market.

The gravity model chosen for empirical analysis is widely used in the evaluation of the flows of bilateral FDI. The main elements of the gravity model are five: GDP of source and host country, population of source and host country, and the distance between them.

The results of empirical analysis prove that regulatory incentives do have influence on inward FDI in the Baltic States and the Visegrad countries. In this case, classical elements of gravity model do not have such a great impact on bilateral FDI flows as it is emphasised in scientific literature. However, the distance between the source and the host country is one of the main factors in making decision for locating capital. The significance of distance decreases if the host country employs regulatory incentives.

In conclusion, it may be stated that regulation influences the flows of FDI in the host country. It can particularly be noticed in bilateral FDI flows. However, regulation may have both the positive and negative impact. The positive impact may be gained if the country employs local regulation incentives, such as fiscal, financial and non-financial incentives

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