FOREIGN DIRECT INVESTMENT AND REGIONAL DEVELOPMENT:
SHARING EXPERIENCES FROM BRAZIL, CHINA, RUSSIA AND TURKEY

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Overview

1. Brazil, the second largest recipient of foreign direct investment (FDI) among developing countries, and one of the world’s top ten economies, is a land of contrasts for development economists. Despite overall economic growth over the past decade, the country’s income, social and regional disparities persist, giving rise to many “Brazils”. It may be relieving to know that Brazil is not alone in facing such a colossal challenge. Not only other developing countries, but also several OECD member countries are engaged in how best to achieve balanced regional development. Income levels, unemployment and poverty rates differ widely across regions, more than between countries. Regional success and decline seem to result from physical, social and human capital to facilitate local as well as FDI.

2. For a region to be economically active and internationally competitive, its firms, institutions and people would have to make connections and alliances with partners abroad. Rapid technological change, extended markets and a greater demand for knowledge are offering new opportunities for regional development. Globalisation is increasingly testing the ability of sub-national economic areas to adapt in order to maintain their competitive edge. Performance gaps and comparative advantages vary from one region to another. Some regions that have limited access to capital accumulation and national/regional markets are disadvantaged. Those lagging behind in infrastructure investment are finding it difficult to keep up with the general trends. All countries find it more difficult to stay competitive without FDI, which sustains growth and brings at least four things of value: financial capital, management skills, technology, and access to export markets – and therefore enhance a country’s and its regions’ competitiveness in the global marketplace.

3. Although retaining and attracting sufficient FDI (not only in quantity but also in "quality") and its efficient utilisation remains clearly on top of the agendas of most countries and is an important element of the comprehensive regional development strategy, the key to successful development will ultimately be sound domestic macroeconomic and structural policies, adequate and efficient domestic savings and

¹. The views expressed in this paper do not necessarily represent those of the OECD Secretariat and OECD Member countries.
investment and human capital accumulation, supported by strong domestic institutions. FDI is not a substitute for getting domestic policies “right”. Appropriate domestic policies will help attract FDI and maximise its benefit, while at the same time removing obstacles to the dynamism and creativity of local entrepreneurship.

4. The relatively easy task is to advocate that FDI is beneficial to, and indeed a strong driver of, economic development in host countries. A few countries – essentially Japan and Korea – have been able to grow rapidly with minimal reliance on FDI. Many countries have attempted to imitate the Japanese or Korean model, but with limited success. De facto, most other fast-growing countries have relied heavily on FDI (for example Chile, China, Malaysia, Singapore, and Thailand). Most astonishingly, Ireland -despite being a relatively advanced country - has managed to grow at some 8 per cent per year for most of the 1990s due in large part to effective attraction and deployment of foreign investment.

5. It is widely recognised that FDI brings economy-wide efficiency gains through the transfer of management know-how, technology, business practice, access to foreign markets, increased employment opportunities, and enhanced social and environmental standards. It also boosts competitiveness globally. Yet, there should be no illusion: FDI cannot be the main source for solving the developmental problems in regions. It is a valuable supplement to levels of domestically provided fixed capital and other external finance rather than a primary source of finance. It cannot be allocated like state investment or official development assistance (ODA), but should be competed for and won. Therefore, the motto “policies matter” has today become even more relevant than ever, particularly at a time when global FDI flows are declining. Indeed, this was the key message that emerged from OECD’s recent report “FDI for Development: Maximising Benefits, Minimising Costs”

6. While formulating FDI attraction strategies, policy-makers should bear in mind that cost control is not a top priority for investors, according to business surveys; they are most interested in access to customers and stable economic/political environment. No amount of incentives can be a substitute for a stable economic environment i.e. stable macro policies including exchange rate policies, stability and transparency of polices towards foreign firms, an open economy free of import tariffs and export subsidies mainly designed to placate sectional interests or pursue the unattainable- so called economic self sufficiency, and policies designed to develop infrastructure and human skills. Therefore, the government intervention in attracting and maximising the benefits of FDI might be deemed necessary for the late starter regions, provided that it should be confined to the minimum level and all other efforts should be made for improving the business environment and competitiveness at a global level.

7. As practitioners in the field are well aware, investors are increasingly selective in their choice of locales for investment. They seek, inter alia, market opportunities, stability of policies, non-discrimination vis-à-vis local investors and a threshold level of human capital and infrastructure facilities. In the absence of these basic ingredients foreign investors may neither be able to meet their objectives of profit maximisation and market expansion nor would their operations promote development objectives of host countries. Integrity, transparency and accountability of governments and corporations are fundamental conditions for providing an effective investment framework. They bring huge domestic governance challenges not only for the benefit of foreign investors, but also for domestic business and society at large as well. Among the regulatory reforms, transparency of the investment-related system, the removal of corruption and bribery (one indicator of poor governance and a disincentive to investment), and sound corporate governance come up as the priority items of the agenda.

8. The nee paradigm in regional development includes actions as follows: (a) from subsidies to regional competitiveness-enhancing policies and (b) from traditional sectoral to place-based policies complemented by multi-sectoral actions. This requires innovative solutions in the governance of regional development policies, namely in institutional partnerships among different levels of government and
partnerships involving social partners and civil society. In this context, the present paper will discuss the role of FDI in regional development by looking at the investment-development nexus in a number of countries including Brazil, China, Russia and Turkey and will also attempt to draw some policy conclusions that may be relevant to Brazil’s north-west region and other countries/regions facing similar challenges.

Global and Regional Trends in FDI

9. Over the past two years the world’s financial and investment landscape has changed considerably. The surge in FDI flows and the decline in aid have transformed external finance to the developing countries. FDI flows to the developing countries rose from 0.4 per cent of the gross domestic product in the late 1980s to 2.8 per cent in the late 1990s in response to the globalisation of production and improvements in domestic policies. In virtually every region, FDI has become a driving force of globalisation and has risen relative to total capital expenditures during the 1990s. It has doubled in middle-income countries and has tripled in low-income countries. However, recently FDI flows have fallen – a situation that makes not only attracting but also retaining FDI even more important.

10. Changes in the world FDI scene are not only in terms of ups and downs in global FDI flows, but also in scope, structure, and methods of participation and in the composition of its principal actors. The scope of FDI has vastly extended from traditional manufacturing to services including information technology, finance and banking and the media. It is no more a phenomenon of big countries seeking cheap labour and raw materials in developing countries. The scene has altered with new entrants such as China, India, Brazil, Russia, Malaysia, although OECD countries still provide the bulk of worldwide FDI flows. The contractual form of foreign enterprise participation has also changed with licensing, joint ventures and franchises assuming importance along with the traditional form of FDI. These changes should be carefully considered and reflected in the strategies of governments and corporations:

- **Country policies:** More and more countries have continued to liberalise their economic policies over the last decade or two, becoming more open both to trade flows (lower tariffs, fewer quantitative restrictions, currency convertibility) and to FDI flows (fewer restrictions on which sectors are open or percentage of foreign ownership allowed, abandonment of case-by-case approval procedures, etc.). The ones that are not open are experiencing difficulties in maintaining growth.

- **Company behaviour:** More and more multinational enterprises (MNEs) are adopting integrated regional or even global strategies, using both subsidiaries and strategic allies to locate *interdependent* facilities in various countries so as to maximise their competitive edge world-wide. This is a change from the dominant behaviour of 10 or 20 years ago, when MNE subsidiaries in foreign countries were operated more or less independently of each other and were located anywhere there was a market and without regard to whether the locale offered the conditions necessary for world-competitive price and quality production.

- **Technology:** Huge improvements in international transportation and communications, combined with greater use of electronic controls and information storage and transmission, have made the opening of countries, and the change in behaviour of companies, viable and

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2. For various country experiences, use has been made of the papers presented to the OECD-China Conference on Foreign Direct Investment in China’s Regional Development (October 2001 in Xi’an, China) and the author’s earlier papers on Russia, Turkey and China including “Foreign Investment in China’s Regional Development: Prospects and Policy Challenges”, with Prof. Dr. Markus Taube, in International Investment Perspectives, No.1, 2002, OECD, and the coming FDI Policy Study of China by Kenneth Davies.
important. Changes in communication technology have drastically reduced many of the costs of locating interdependent activities in more than one location. The changes in technology, behaviour and policies reinforce and validate each other. Because of this, the world is separating into two kinds of countries: (i) those that offer competitive conditions for production, attract FDI, trade, and experience continuing increases in productivity and hence in incomes, and (ii) those that do none of these things and stagnate.

FDI in Brazilian Economy

11. Brazil has made considerable progress in facing problems that are legacy of the past. Macroeconomic stabilisation has been reinforced since the devaluation of the Real in 1999 and, for the first time in a decade, the economy was able to benefit from an export-led recovery. Nonetheless, the dependence on foreign sources of finance and thus the vulnerability to external shocks remain significant. Progress in economic stabilisation, a sweeping privatisation programme and generally improved business environment based on market reforms and outward orientation substantially increased the participation of foreign enterprises and banks in the economy in the 1990s.

12. From 1996 to 2002, Brazil received nearly $170 billion in FDI ($32.8 billion in 2000, $22.6 billion in 2001 and an estimated $20 billion in 2002). Many restrictions were lifted in the past several years to encourage foreign investors, particularly in formerly closed sectors, such as petroleum, telecommunications, mining, power generation, internal transport, and insurance to foreign investors. Credit disbursements to Brazil – direct loans, trade credit, bonds and notes – used to be larger than FDI inflows in a proportion of 3:1, up to 1995, but this scenario has changed and nowadays FDI inflows are closer to the value of total credit disbursements. Thus, FDI has virtually become the “only game in town”.

The “Two Brazils” and Regional Development Challenge

13. Although Brazil has five regions, it is in practice divided into the two: The “Brazil One” or rich Brazil, (south, south-east regions and the developed part of the middle west) and the “Brazil Two” or poor Brazil (north, north-east, and the state of Mato Grosso in the middle west including the states of Maranhão, Piauí, Ceará, Pernambuco, Rio Grande do Norte, Alagoas, Sergipe, Paraíba and Bahia. The north-east region, with a population of 47 million, rich in mineral resources, has most of petroleum and natural gas production, as well as mines of granite and precious and semi-precious stones. The San Francisco River provides electricity through several hydroelectric plants and water for irrigated fruit culture. Another sector, which provides significant boost to the region’s development, is tourism – sandy beaches and a sunny climate most of the year. Still, the economic development level of the region is far below the national average.

14. Since 1988 regional development has topped Brazil’s political and economic agenda, although the country has not been able to pursue a coherent regional development strategy. The new development policies attempt, on the one hand, to reduce the regional inequalities in income and job opportunities, while on the other aiming at improving the efficiency by the implementation of a productive structure capable of competing nationally and internationally. It may be possible to kick off a process aimed at clearly identifying, enhancing the regions’ competitiveness and comparative strengths vis-à-vis other regions and

3. While in 1993 and 1994 portfolio capital represented almost all the net private capital flowing into Latin American, since 1999 nearly 100 per cent of the net private capital flows into the region were FDI. FDI inflows into Latin America and the Caribbean are expected to fall in 2002 for the third year in a row, tumbling 27 per cent from $85 billion to $62 billion (UNCTAD preliminary estimates). The slowdown in the industrial countries may present an opportunity for Latin America and the Caribbean to attract new capital.
neighbouring countries. Rather than well-rehearsed generalities it is important to focus on some specifics, with a particular attention to the characteristics of the region because the lessons learned in this region could be relevant and disseminated to other regions of Brazil.

15. Not surprisingly, most of the FDI inflows are located in the south-east region, which receives 87.5 per cent of all assets of companies with foreign participation, while 0.6 per cent of these assets are in the middle west, 3 per cent in the north region, 4.2 per cent in the north-east, and 4.7 per cent in the south region. Although the south and north-east regions have different levels of economic development, the difference in the concentration of enterprises with foreign participation is not very significant. This occurs because the north-east has some comparative advantages in relation to the other regions, in particular, the low cost of labour and generous fiscal incentives. The transfer mechanisms are also important – through the States and Municipalities Participation Fund and Negotiated Transfers of around 4 per cent of the annual GDP. The north and north-east have benefited approximately 50 per cent of these transfers, which correspond to about 2 per cent of the GDP. Thus, these regions have become the destination of traditional industries of intensive natural resources that generates fewer added values.

16. Obviously, there is no single model of success in regional development and how foreign and domestic investment can contribute to this process. Nor is there one country that applies the optimal practice in all elements of the regional development-investment nexus. The experience suggests that in such efforts the emphasis should be on the “building blocks”, well grounded on the specific needs, comparative strengths, culture and opportunities of investment host regions/countries, rather than simply imitating practices of others, although there is certainly much to be learned from varied experiences.

China’s Uneven Regional Development and FDI

17. Last week in Shanghai China’s Ministry of Foreign Trade and Economic Co-operation announced at an OECD conference that FDI inflows to this country would exceed $50 billion in 2002, thus becoming the world’s largest destination for FDI. FDI has substantially contributed to China’s impressive economic growth since 1998 and enhanced its global competitiveness, but have these benefits evenly shared among its regions? No. That growth has been very unevenly spread, with the bulk of the investment during 1983-2001 concentrated in the eastern and southern coastal belt. In fact, the eastern coastal region accounted for 86 per cent of China’s total inflows of FDI during this period, but the central region attracted just 8.8 per cent and the western region little more than 5.2 per cent.

<table>
<thead>
<tr>
<th>Region</th>
<th>Projects (Number)</th>
<th>Share (%)</th>
<th>Contractual value (US$ million)</th>
<th>Share (%)</th>
<th>Realised value (US$ million)</th>
<th>Share (%)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Total</td>
<td>390,025</td>
<td>100.0</td>
<td>745,291</td>
<td>100.0</td>
<td>395,223</td>
<td>100.0</td>
</tr>
<tr>
<td>East</td>
<td>315,053</td>
<td>80.8</td>
<td>643,923</td>
<td>86.4</td>
<td>339,726</td>
<td>86.0</td>
</tr>
<tr>
<td>Central</td>
<td>46,713</td>
<td>12.0</td>
<td>56,521</td>
<td>7.6</td>
<td>34,693</td>
<td>8.8</td>
</tr>
<tr>
<td>West</td>
<td>28,259</td>
<td>7.2</td>
<td>44,847</td>
<td>6.0</td>
<td>20,804</td>
<td>5.3</td>
</tr>
</tbody>
</table>

Source: MOFTEC FDI Statistics.

18. The whole coastal region has been more attractive to foreign investors than are hinterland provinces because of (i) the government’s encouragement of export-oriented FDI, which favoured locations possessing easy access to ports and shipping routes, (ii) high levels of state expenditure on infrastructure, notably in the major province-level cities, and (iii) revenue-sharing agreements with the central government, which allowed them to keep a relatively large share of their tax revenue, which they were able to use to upgrade the inadequate or non-existent physical infrastructure.
19. Western and central Chinese provinces, the latecomers in the hinterland, are certainly in a disadvantageous position with regard to FDI – remote from the world markets, burdened with the remnants of a faltering state owned industry, handicapped by a reform and open door policy that has discriminated against them for at least 15 years, and possessing only a very restricted local market. In addition, there was a substantial brain drain observed during recent years when the Western region’s most skilled and entrepreneurial youth migrated to the coastal regions, where it could expect higher salaries and better living conditions. And contrary to political willingness net-capital flows have been moving from the West to the East belt, where much higher earnings could be realised, in such a way further draining the West of important resources for its own economic development.

Policy Intervention: “Go West” Strategy

20. For smaller countries or more advanced larger ones, regional imbalances can be managed. But China is a veritable giant and, despite being bound together by a strong central authority, is a country of several cultures and traditions. One challenge it has to face in this era of globalisation is to prevent its uneven growth pattern from jeopardising not only cohesion, but long-term economic stability too. The Chinese government’s response is the “Great Western Development Strategy”, launched in January 2000 – an ambitious effort to steer state investment, outside expertise, foreign loans and private capital into the regions. In fact, the government channelled $45.5 billion in 2000 to develop the west, and plans are afoot to increase that figure. But it will take more than money to make the strategy work.

21. WTO membership offers a chance for these regions to compete for new investment, including from abroad, but they will have to overcome massive infrastructure and employment problems first. On the positive side, the region does have lower costs to offer in the form of an untapped reservoir of skilled labour from former military-managed enterprises, as well as a huge mass of cheap unskilled labour. There are some research institutes and universities in provincial capitals such as Xi’an and Chengdu, abundant natural resources, with oil, gas and minerals in Xinjiang, and a strong agricultural base. In fact, Sichuan province is the main producer of rice in China. There is also great tourist potential to be tapped from such historic sites as the Silk Road, the Tibetan plateau, the archaeological digs of Liuzhaigou and the desert oasis of Turpan, where much fruit is grown. But these assets have not been enough to attract foreign investors in today’s hard and competitive global economy.

22. Obviously, given their distance from the coast, the promotion of direct export-oriented industries is hardly an option for these regions; nearby countries like Russia, Kazakhstan, Uzbekistan, Turkmenistan, Pakistan and India, may offer opportunities, not least because of their proximity, though there are one or two political difficulties that could complicate matters, like ethnic questions along some borders. A less bumpy route would be to target resource-seeking FDI from elsewhere in the world market that would integrate western China into the value chains of its eastern coast’s export-oriented businesses. This may mean relocating some investments as well as bringing in new ones and would focus on operations that do not have to be close to the final customer. Services would be an obvious option, such as accounting for the coast’s hotel businesses, or call centres and data processing. In manufacturing, attracting producers of spare parts for technology and machinery may be useful.

23. All of this presupposes a modern information technology infrastructure, which western China lacks. Moreover, the transport systems would have to be improved and inter-regional trade restrictions removed to give the inner regions a chance to supply the natural resources and labour inputs that eastern-based enterprises currently import from abroad. In the longer term it might be feasible to locate more market-oriented research and development facilities away from the east, where facilities tend to be military related. And more use should be made of the small pool of skilled labour until now absorbed in military and other state enterprises. The massive concentration of funds brought in by the government’s “Go West”
campaign should greatly improve the region’s infrastructure over the medium term, but not so the institutional and regulatory set-up.

24. China knows this well: its Shanghai Investment Promotion Agency and Yantai Investment Development Agency have been very successful out east and are no doubt seen as a model for investment promotion agencies to be created in the various western localities. Given the vastness of China, changing the FDI fortunes of all regions at the same time would be impossible. Rather, the Great Western Development Strategy could concentrate more on establishing focal points of investment, as it has started to do. Industrial districts in Xi’an, Kunming, and Luoyang, could be encouraged to become development clusters, for instance, with their greater provision of research and development and networking.

25. The main criticism directed at the “Go West” strategy at home and abroad includes the following:

- This project alone may not be enough to be able to induce substantial FDI inflows to the backward provinces. The capacity of a region with regard to FDI inflows is circumscribed by the geographical and historical setting and can only partly be shaped by government interventions. Each region can only try to enhance its particular locational advantages and try to promote development processes corresponding to the endowment. The hinterland provinces of China cannot and should not try to copy the successful development strategies of the coastal regions. Different types of FDI inflows have to be targeted. However, common denominator for promoting FDI should lie at the bottom line. Based on that, different and adaptive strategies should be taken.

- Some critics point out that increased government spending in the west will reduce the amount of money available for current social programmes, health, education and welfare, thereby aggravating the problems at another hot spot of China's contemporary development process. In the perception of some foreign enterprises, the strategy is not tackling all the main issues at stake for FDI in the region. Alternative measures must therefore be taken to enhance the attractiveness of the other provinces, in particular by investing in infrastructure, as has been done in the coastal provinces, by developing forms of inter-regional co-operation and by fostering domestic economic integration.

- The build up of a physical infrastructure will have to be complemented by an improved institutional set up of the market place. Especially the banking system will have to be modernised and freed of any “fiscal” functions it has still retained from the planned economic system. A greater availability of RMB-loans and an improved bankability of projects would be highly instrumental to attracting foreign investors, which until now shrink back from any engagement as they do not find the support by the financial system they need and are used to from ventures in other regions of the world.

- Today many western enterprises face the problem that they might find personnel willing to move to the metropolitan centres at the eastern coast. But qualified people who are willing to move for two to five years to the central or even western regions are hard to find. Local governments able to create an attractive environment to skilled labour (Chinese and expatriates) will increase the chances of their region to attract FDI.

- The promotion of direct export orientation would run counter to the regional comparative advantages of abundant resources. It rather seems to be more promising to target resource-seeking FDI, which integrate the West into the value chains of the eastern coast’s (export) businesses. This strategy seems skewed and risky. Therefore, complementary strategy, which targets market-seeking investments and bolsters local purchasing power, would be desirable.
This approach would be trying to attract investors that intend to produce for the local market and are therefore not predominantly looking at the local factor endowment.

- Government bodies both on the central as well as on the local level will have to become active. The central government is responsible for the integration of particular promotion policies in the context of the macro-economy and the national transformation process. It defines the freedom local governments have in creating their own microenvironment for FDI-attraction. In addition it can direct resources under its control into the central and western provinces in order to improve the local investment environment.

- The wealthier and more developed eastern and coastal provinces are being asked to play a major role. The government expects them to provide special subsidies and establish joint ventures with western entities. They are called upon to develop new markets and bring advanced management and innovative production styles to less-developed western enterprises. Eastern China, most prominently Shanghai, has shown some commitment to funding parts of the western development programme by signing 200 co-operative contracts with a total value of over $1.21 billion. The Chinese authorities are encouraged to continue raising the standard of investment promotion and investment approval in these regions to that prevailing in the open coastal zones, where the authorities are generally much more flexible in their interpretation of FDI laws and regulations.

- To the extent that the investment incentives available to foreign-invested enterprises are the same as those on offer to domestic enterprises, the policy of attracting capital investment to the Western and Central regions is consistent with the principle of national treatment. However, such incentives do not constitute a sufficient condition for increased investment in those regions. If the Chinese government wishes to redirect investment westward, it may prefer to put the main emphasis on improvements in the business environment there.

26. The Chinese government has much to do to correct the widening income disparities between its rich coastal provinces and the sluggish interior. But Premier Zhu Rongji has stressed that the Great Western Development Strategy was a long-term programme with a timeline of 20 to 30 years. This is a realistic assessment.

**FDI in Russia and Regional Development**

27. Russia is a vast country of 89 regions stretching across Europe and Asia, possessing spectacular wealth in exploitable natural resources, technology, a large, skilled workforce, and nearly 150 million consumers. It is a country moving towards a market system based on private capital investment and enterprise and integrating rapidly into the world economy. Indeed, it has rapidly privatised the bulk of the assets of former state enterprises (although in many cases with a lack of transparency and fairness that has created an unfortunate legacy). It has also spawned hundreds of thousands of new small and medium-sized private enterprises.

28. Among the most important reforms so far undertaken to create, not in word but in deed, a democratic rule-of-law state with a modern market economy is the re-engineering of federated relations and reform of local government, as it is virtually impossible to rule the regions from Moscow. Depending on the region investors encounter different conditions for business, different degrees of interference by the authorities. This is due on the one hand to the existing level of lawlessness that was rampant in the country.
when, in violation of the Constitution and the federal laws, the political leanings and agendas of the heads of regions and municipalities introduced various restrictions.\(^4\)

29. The Russian economy has seen an upward trend over the past three years (1999-2001), with the state consolidating its control functions, the economy expanding, and political and macroeconomic risk factors significantly reduced, despite the worldwide economic downturn and the fall in oil prices. The consolidation of the Federal Government’s authority in the regions (via the Presidential Representatives in the Federal Districts) has regional legislation into line with federal law on most issues, thereby overcoming the fragmentation of the national economic territory while reducing administrative barriers and risks.

30. However, what has been achieved to date is not in itself enough to guarantee an improvement in the investment climate and a long-term revival of the economy. Despite a general economic recovery, problems of a strategic nature remain. Until Russia sees stable growth in the output of competitive products, it will be too early to speak of a stable economic growth pattern. That applies not only to the raw materials sectors, but also to secondary industries and services. It will require massive investment into industrial plants and equipment, the widespread deployment of new technologies, and an improvement in economic management in practically all sectors of the economy. That is the real essence of the Government’s task of modernising the economy, as laid out in the Gref Programme.\(^5\)

31. Russia does not need merely to achieve high growth rates. It must also modernise the economy, ensure structural changes and actively foster global economic links in order to enhance the long-term resilience of its economic system. Modernisation of the Russian economy will result first and foremost in stable growth in domestic demand, thereby reducing Russia’s dependence on the international raw material and oil markets. However, there is still a long way to go before reaching that stage. Over the past three years, investment growth has outstripped GDP growth in relative terms; but it is difficult to say that Russia is making full use of its investment potential. Its mechanisms for transforming savings into investments are ineffective, resulting in a situation where total savings in Russia significantly exceed total capital. Sector-to-sector capital flow is also at a very low level. In terms of investment resources, there is a clear misbalance in supply and demand between the export-oriented raw materials sectors and the rest of the economy, which is in dire need of capital.

32. Yet, FDI remains a relatively marginal phenomenon in Russia. The cumulative figure for FDI in Russia from 1991 through the end of 2001 amounted to $18.2 billion, or only 5 per cent of domestic fixed capital formation. This performance may be compared with FDI in China of $46 billion in 2000 alone and more than $200 billion in the United States in 2001. The level of FDI in Russia is very low relative to other transition countries in the region as well, adjusted for population size: on a per capita basis, cumulative FDI in Russia is $15, compared to $84 for Poland, $118 for the Czech Republic and $221 for Hungary.

33. One, perhaps cynical, explanation for low level of FDI is that Russia may not really want foreign investment, and has only paid lip-service to this issue in order to gain the backing of foreign governments and international financial institutions.\(^6\) Russia’s history, not just in the Soviet period but going back

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4. “Inter-Governmental Relation Reform is priority”, Dmitry Kozak, Deputy Head of the Russian President’s Administration, in AmCham News, March-April 2002, p. 22.

5. In 2000, under President Putin, the Government published a Social & Economic Policy Programme 2000-2010 (the Gref Programme) that demonstrates an understanding of the threats currently facing the country and which offers a development strategy based on a series of social and economic reforms intended to create a liberal market economy, governed by a democratic political system. The Programme was widely endorsed by the business community in Russia, and refers to the task of improving the investment climate as one of the most important issues facing Russia today.

centuries, has been one of isolation from the West and distrust of the outside world. Many members of
today's Duma distrust foreigners per se and believe their only purpose in investing in Russia is to “rob the
country of its riches by making quick profits and shifting them abroad”. It takes time for attitudes to
change. However, there is an enlightened segment of leadership in Russia, which does not share this view,
but to the contrary, recognises that there are enormous benefits Russia can and should derive from FDI if
the enabling environment is in place.

34. The factors responsible for the comparatively low level of FDI inflows in Russia are on the whole
not different from those depressing domestic investment. Impediments to private investment, domestic and
foreign alike, are already well diagnosed. So are the remedies to rectify this situation. The key challenge is
a political willingness to tackle these problems, build the necessary capacities and move to an effective
implementation of the policy reform priorities. It is quite clear that increased levels of FDI could play a
crucial role in transforming the industrial configuration still remaining from the period of central planning
into a product of competitive forces, reducing the current excessive levels of horizontal and vertical
consolidation as well as regional market segmentation.

Federal vs Regional Governments: Implications for Investment

35. Even the relatively small amount of FDI Russia receives ($4bn in 2001) is divided unevenly
between the regions. A survey carried out by the Russian investment bank “Troika Dialog” in 2001
discovered that 10 regions attracted 83 per cent of total FDI. These included obvious places such as
Moscow and St Petersburg together with resource rich places such as Sakhalin in the Far East and Khanty-
Mansiisk in Western Siberia, which produces 65 per cent of Russia’s oil.

36. Russia lacks a clear strategic vision of how FDI could fuel its growth and modernise some of its
antiquated industries. It also needs to have an integrated approach towards investment across the often-
disconnected central government departments, the regions, and the municipalities in order to ensure that
investors would operate in an enabling environment without arbitrary government hindrance and on the
basis of market-based incentives. Significant benefits would flow from exposure to new entrants with
advanced organisational and managerial skills, particularly in the infrastructure monopoly sectors, where
deregulation is now being considered. The dominance of many large industrial firms, hitherto fairly
immune from robust competitive pressures, would also be seriously challenged.

37. The business in Russia suffers from the absence of a unified economic space and the frequent
regulatory changes, contradictory interpretation and discriminatory implementation of existing legislation
resulting from unclear and contested separation of powers. There is still a sense of uncertainty in the
relations between different levels of power. What Russia needs is a clear-cut definition of state functions,
transparency of official actions and the determination of what every level can and cannot do. President
Putin is now giving priority to restoring authority to the central government and dismantling power bases
and conflicting administrative and other structures at regional level.

38. In May 2000 he announced as a primary task to restore a common legal space in the Russian
Federation. Existing federal laws make it very difficult even for a skilled lawyer to determine which body
of government has what power and responsibilities, and what relations it can regulate and what the scope
of its interference is. The existing federal laws very often use the formula whereby simultaneously three
levels of government are responsible for compliance with federal laws: federal, regional and municipal. A
programme of administrative reform is under way, redefining the powers of the regional authorities.

7. From discussions at OECD-Russia Roundtable on Attracting Quality FDI, June 2002, Saint Petersburg.
Special presidential representatives in seven newly created federal (supra-regional) districts encompassing varying numbers of subjects of the Federation are to oversee compliance with federal law. This as yet untested new layer of authority will face very specific economic and political challenges. Whether for investors this will result in elimination of some of the differences in interpretation of laws and legislative practices (land ownership and transfer, taxation, foreign investment policy) remains to be seen.

39. The many unresolved issues in the field of inter-budgetary relations and arrangements for revenue sharing between the federal and regional governments have brought added uncertainty and changeability to the tax environment faced by investors through multiplication of seemingly irrational and incoherent taxes. Although the current policies aim to reclaim and reaffirm federal authority, relying on closed lists of taxes allowed at the different budgetary levels, many regions and local governments continue to introduce taxes that are not provided for in the federal legislation.

40. Thus, while strong federal presence seems likely to remain necessary in the near future, it should not simply take the form of increasingly rigid federal regulation, which could risk backfiring as sub-national authorities continue to seek loopholes for every restriction. A workable revenue-sharing system clearly requires consensus about its fairness in order to be genuinely effective.

41. A level playing field and a rule of law require an honest, even-handed and efficient bureaucracy and judicial system, implementing reasonable rules in a consistent and predictable manner. It also requires the evolution of a new business culture in Russia, which favours compliance, with rather than avoidance of, the rules and a system of values, which encourages productivity, and efficiency in the workplace. Such a change cannot be achieved overnight, but can be achieved over time. Failure to do so will certainly discourage FDI. However, even more importantly, it will carry a heavy political, social and economic price – continuing decline in the country's economic performance with still lower levels of new investment, higher rates of unemployment, and a growing percentage of the population living below the poverty level.

42. Seeking remedies in revisions to the legal and regulatory framework for foreign investment represents an incomplete approach, as deficiencies in this respect only form a minor part of the greater picture. The lags in structural reform and the policy deficiencies that have combined to produce an unfavourable climate for domestic as well as foreign investment need to be analysed as a whole. While it is no doubt beneficial to encourage new ideas and approaches stemming from the degree of regional diversity, policy direction should ideally ensure:

- Harmonisation of legislation and implementation practices affecting investors at regional and federal level, including a full review of diverging legislation contravening federal law as well as of existing bilateral treaties and agreements in separate areas;
- Transparency of regional administrative structures for remaining region-specific competencies;
- Transparency in the role and evolution of powers of the newly created supra-regional districts;
- Formulation of region-specific investment policy and development plans to ensure best use of regional and federal programmes and resources, including budgetary transparency of incentive packages and full elimination of extra-budgetary contributions.

43. The problems faced in Russia are in large part as relevant to most domestic investors as they are to foreign investors in the Russian economy. However, the basic difference between the two is that the domestic entrepreneur is condemned to cope with local conditions while the foreign investor is free to
choose from among competing host countries and to decide which one offers the most attractive balance of risk and opportunity for its investment. A country's success in attracting foreign investment is therefore a measure of its domestic success as well. There is today a huge pent-up interest for investment in Russia. As and when positive change occurs, foreign direct investment will dramatically increase and such investment will indeed become a motor for economic growth and prosperity in the coming years.

**FDI in Development of Turkey's South-eastern Region**

44. Turkey, the largest economy in Eastern Europe, the Balkans, the Black Sea basin and the Middle East, and the European Union’s sixth biggest trading partner, is a striking example of how a high potential country could fail to attract minimum levels of FDI to its economy. FDI flows into Turkey, with a real GDP size of about $400 billion, have rarely reached $1 billion in any one year - a fraction the level of FDI attracted to countries of comparable size and development like Argentina and Mexico. Between 1980 and 2001 foreign companies invested $17 billion in Turkey, an annual average of $850 million. The FDI inflows between 1995 and June 2002 was $9 billion, but $3 billion of this amount was due to a large licence fee paid last year by Telecom Italia to operate Aria and HSBC’s purchase of a local bank. This compares with $36 billion to Poland, $21 billion to the Czech Republic and $14 billion to Hungary over the same period.

45. To understand why Turkey’s has under-performed, one should revisit the key factors determining investment location. The location of FDI reflects the match of corporate strategy with three major location determinants: economic; political-institutional; and enabling environment. There is significant evidence that Turkey has a strong competitive position in relation to the economic determinants of investment location as it is particularly well placed compared to competitor locations due to its economic size and dynamism and quality of its labour force. But in terms of the political-institutional determinants of FDI location, Turkey has long been in a relatively weaker position. Political and economic instability, manifested as chronic inflation, fragile governments (until a few months ago), and negative attitudes towards foreign investors are major obstacles to FDI, which are compounded by a weak enabling environment for privatisation-related FDI and a total lack of effective investment promotion. There are indications that this picture may soon change thanks to the new single party government and the prospects for EU membership by early next decade.

**Redressing Regional Imbalances and South-eastern Anatolia Project (GAP)**

46. FDI’s role in enhancing Turkey’s regional development efforts is currently negligible because even the country’s more advanced regions have failed to attract much-needed foreign capital. The only realistic hope for the relatively backward eastern and south-eastern regions of Turkey is the gigantic GAP project, which is likely to produce a booming effect on private capital accumulation and entrepreneurship. The GAP, initially formulated as individual irrigation and hydropower projects on the Euphrates and the Tigris Rivers in the 1970s, is the most comprehensive integrated regional development project ever

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9. The stock of FDI in Turkey was only $300 million in 1971, and up until 1980 the average annual inflow of FDI was only $90 million. This was far less than other comparable countries, and FDI did not increase significantly for most of the 1980s. It was only with a shift in Turkey from a protectionist trade regime to export-oriented economic liberalisation in the mid-1980s that FDI increased significantly. Annual FDI flows in Turkey grew rapidly from the mid-1980s, reaching $1 billion in 1990. However, there has not been any meaningful increase for the decade since then. In other words, during the 1990s when global FDI flows boomed – exceeding the growth in world trade since 1989 – FDI in Turkey remained static.

10. The project area includes the watersheds of the lower Euphrates and Tigris Rivers and the upper Mesopotamian plains. It covers the nine provinces of Adiyaman, Batman, Diyarbakir, Gaziantep, Kilis, Mardin, Siirt, Sanciurlu and Sirnak.
attempted in Turkey to address the wide disparities in the south-east, and in recognition that strengthening this region socially and economically will benefit all of Turkey.

47. As an integrated project, in addition to dams, hydroelectric power plants, irrigation systems, it also contains industries and investments for the development of agricultural, industry, urban and rural infrastructure, communication, education, health, culture, tourism and other social services in a co-ordinated way. GAP's focus on sustainable human development builds upon the concept of integrated regional development of the GAP Master Plan of 1989, which mandated the creation of a Regional Development Administration to co-ordinate the implementation, management, monitoring, and evaluation of development related activities. The subsequent Social Action Plan of 1995 was a major step toward a greater integration of sustainable development with socio-economic and infrastructure projects.

48. The poorest cities of Turkey such as Mus, Agri, Bitlis and Bingol are all located in eastern and south-eastern region, where subsistence agriculture is still prevalent, land inequality is at large proportions, the climate is harsh, and where for the past 15 years (1985-2000) an off-and-on unrest was prevalent. About 15 per cent of all families in the nation live in the region, which in turn uses only 10.2 per cent of national income. In the region, the average income per family is $3,851, 30 per cent below the national average.

49. The difference in prosperity and income between Western and Eastern-South-eastern Turkey continues to cause the flight of manpower and capital, which hurt the development process. Internal migration data on manpower potential is truly striking. According to the 1990 census, the region's population was 9,365,000. The same data show that there were about 12,000,000 people born in eastern cities. This means that 30 per cent of the region's population (that is 3,607,000) have migrated to the west and live there. Due to both economic and political reasons, this ratio may have increased by 2 to 3 percentage points by 2000. Hence, 1 out of every 3 easterners lives outside the region.

50. Since most industries are established in the west, power generated in these regions is transmitted and consumed in the west, thus leaving little room for fostering linkages with local economy. According to Turkish Electricity Authority data, whereas the average power consumption per person in Turkey is 625 kW/h annually, this figure is 349 kW/h in the east. A speedy industrialisation related to cotton spinning and weaving has recently been taking place in the GAP region and its neighbouring cities. If this development continues power consumption may increase, but an immediate radical change is not expected to occur in this picture.

11. Sometimes the GAP is compared with the Cerrado Plain, a savannah area of central Brazil reaching into parts of Colombia. The area is huge, covering an area larger than all of Western Europe. Brazil is already an agricultural powerhouse, the world’s largest producer of rice outside Asia, among the top three producers worldwide of corn and soybeans and a leading producer of beef, tobacco and of course coffee, sugar and citrus. Credible Brazilian estimates say the area under cultivation could be expanded by up to 60 million hectares, an area equivalent to the entire plantings in corn and soybeans in the United States.

12. Within the scope of a macro economic and social development programme, the GAP Master Plan defined small and medium scale investment and socio-economic development projects ranging from educational and health infrastructure to environmental protection, irrigation systems, management development, transportation.

13. There are various historical and social reasons for the disparity in income and development between the East and the West of the country. When choosing the place or sector to make an investment, the alternative with the lowest costs and the highest return is preferred. This is the universal and constant rule of economic behaviour. The same rule was applicable to Turkey in the second half of the 19th century as the country was integrating with western capitalism. The Ottoman Empire’s process of integration with the world markets began at that time in those areas most accessible to western capitalism, that had better transportation and market followed suit. Some sections of Central Anatolia and the Black Sea regions, and all of Eastern-South-Eastern Anatolia were left behind in this capitalist expansion.

51. It is still difficult to say that investments related to GAP in manufacturing, electrical power, and mining undertaken by the state have so far produced positive effects that spread to the entirety of the region. Government incentives for underdeveloped regions too have not secured the necessary flow of investments. In this region, where population growth is much higher than the national average, production and income per capita are low. Agriculture and husbandry are on decline, and unemployment is the primary problem especially for the youth. Such an unproductive economy mainly dependent on government spending, while providing nothing more than limited sustenance of daily life for a part of the population, has also contributed to the demise of the productive activity in the region.

52. More lasting positive effects to the GAP region could come from investments in irrigation. However, the south-easterners will not fully benefit from the rents generated by these state investments. Because the south-east has the most unequal land distribution in Turkey. Despite having been targeted by successive governments for land reform programmes that were invariably undermined by local powerholders, there are still entire villages owned by individuals or families. The new patterns of land use and investments in agriculture are likely to transform the region as a whole. When production for the market begins to predominate, and large lands turn into capitalist farms by better irrigation, the capitalist farmer-agricultural labourer differentiation process will speed up. If the agro-businesses are established in cities with the help of productivity increase in agriculture, then the population that has migrated from rural areas will be used as manpower in factories. In short, as GAP investments raise the value added in agriculture, the region’s ranking on the development scale within Turkey will move up considerably.

53. Although GAP investments appear to be just regional projects, their sheer volume has ramifications for the national economy. The business volume generated by GAP investments in construction, for example, was important for large contractors based in Istanbul and Ankara. These companies that built their businesses in the Middle East and North Africa in the beginning of the 1980s, had a difficult time when these countries reduced their investments due to their declining oil income. The acceleration of investments in GAP was a big boost for these contractors. Activities at GAP continued even when the economy was in a general slump, and sustained the firms that supplied the construction sector as well as the contractors.

54. In the final analysis, the realisation of GAP’s promise for the region will largely depend on finding foreign markets and finance. The surplus generated by increased production will have to be exported. This requires the use of agricultural technologies that are at par with the world as well as the diplomatic skill not to alienate the neighbouring countries with potential markets. In today’s world, increases in agricultural productivity are possible through the use of genetic research and biotechnology. This has turned many industrialised nations that were agricultural importers into agriculturally self-sufficient countries that might even have surpluses.

55. Also, further massive investment funds will be needed. The GAP is truly exciting both as a utopia for regional development and as a process, but its cost for Turkey’s economy has not been insignificant over the past two decades. This project, which swallowed enormous government resources, has put a great strain on public finances. The total project cost is estimated at $32 billion, of which $14.8 billion have already been invested. Of this amount, $2.1 billion came from foreign sources including the World Bank and several European governments, with little private foreign investment. Unless these investments are complemented and supplemented by productive private sector investments the full benefits cannot be realised. Another possibility will be to develop cross-border investments and partnerships with countries bordering this region, although this will require a great deal of new diplomatic engineering.

56. The new Turkish government’s urgent action plan for improving conditions for FDI in line with World Bank/FIAS recommendations is an encouraging one. Reinforced with macroeconomic and political stability, Turkey’s proposed “National Development Agency” could well play a key role in reinvigorating
Turkey’s and its regions’ chances to attract new FDI. This Agency is expected to embrace, as a private sector dominated professional entity, both FDI policy and promotion functions. It will also be authorised to grant incentives and land allocation. Permit and certification processes such as company establishment, which takes months to complete and require at least 63 documents, will be simplified. Tax rates will be reduced and international accounting standards will be introduced to enable the taxation of real revenues. Last, but not least, is the elimination of unfriendly attitude towards investors, domestic and foreign alike – something easier said than done.

Policy Observations

57. Regions are not abstract entities, nor are they best understood as territorial units; they are composed of individuals, households and communities. Measures to assist people living in a region to raise their productivity and economic participation must address their needs in all three of these dimensions. Regional development initiatives should hence be tailored carefully to target the appropriate dimension. Rather than pursuit for the subsidies and incentives, a government is likely to succeed by investing in the enhancement of human capital and key infrastructure, as well as creating a favourable environment for investment and private-sector development. There are also a few additional observations, which may be of relevance to Brazil and other countries as they consider their policies towards FDI and regional development:

58. First, and most importantly, although attracting FDI can be an important element of a regional development strategy, it should be seen only as a complement to domestic investment, which will serve as the major driver for development. Sound domestic macroeconomic and structural policies, adequate and efficient domestic savings and investment and human capital accumulation, supported by strong domestic institutions are key in this regard.

59. Second, although FDI inflows into one country and region do not necessarily imply less FDI for other countries and regions, they must ultimately compete for FDI. Foreign enterprises, like domestic ones, pursue the good business environment rather than the special favours offered to induce the foreign enterprises to locate in the incentive offering regions. Special and thus transitory incentives for FDI might fail to give foreign investors long lasting interests in the host regions and would be at the risk of various types of ensuing negative side effects. Enshrine the principle of non-discrimination in national legislation and implement procedures at enforcing it at all levels of government and public administration.

60. Third, integrity, transparency and accountability of governments and corporations are fundamental conditions for a trustworthy and effective investment framework. They bring huge domestic governance challenges not only for the benefit of foreign investors, but also for domestic business and society at large as well. Among the regulatory reforms, transparency of the investment-related system, the removal of corruption and bribery (one indicator of poor governance and a disincentive to investment), and


16. A sensible approach for host countries is to presume that subsidies to FDI are not warranted, and so avoid preferential treatment of FDI relative to foreign portfolio investment or domestic investment. Deviations from such a policy would be justified only where there is clear and direct evidence of substantial positive spillovers associated with multinational production and where multinationals are unlikely to choose the optimal level of production (from the host country’s perspective) without a subsidy or other inducement.

17. This implies that no special treatment would be granted to domestic enterprises under pressure from foreign entrants. However, the approach should be even-handed: efforts at attracting FDI through inducements not offered to domestic companies should equally be considered as discriminatory – except where aimed at compensating for manifest deficiencies (e.g. an “un-level playing field”) in the host country business environment.
sound corporate governance come up as the priority items of the agenda. Policy and regulatory frameworks should be enhanced as regards competition, financial reporting and intellectual property protection that foster a dynamic and well-functioning business sector.

61. *Fourth*, exposure to effective competition on an even playing field and IPR protection is the single most important incentives for foreign and domestic companies to upgrade management and technology. The quality FDI expects quality investment policies and environment. The benefits from FDI tend to be maximised when foreign investors operate on an even and competitive playing field. This means they need to be treated just like domestic companies (“national treatment”).

62. *Fifth*, linkages between foreign affiliates and domestic firms can be of great importance to the dynamism and competitiveness of the domestic enterprise sectors – the bedrock of economic development. SMEs should be helped to become better partners as joint venture partners, suppliers or sub-contractors to foreign investors. However, it is important to emphasise that these linkages cannot be created for their own sake. Rather, the objective should be to stimulate linkages that raise the efficiency of production and contribute to the diffusion of knowledge and skills from MNEs to the local enterprise sector. Governments that understand the competition needs and priorities of MNEs can attract new investments more effectively and root them more deeply in their economies.

63. *Sixth*, ensuring policy coherence across different government departments and different levels of government is key to any successful regional development strategy. Policies intended to meet economic, social and environmental goals in the regions are made by different ministries or agencies, often with little attention to policies being developed by other entities. Thus policies pursued to achieve one objective may sometimes conflict with those adopted to meet another. In addition, sub-national governments often bear primary responsibility for implementing policies developed at the national level. To do so, they need to be able to influence policy design at the national level, and participate in decisions on how they should be implemented, including how the costs of implementation are shared. Local governments should take the lead in setting up a region-driven investment capacity building framework and the role of donors should be to support and facilitate this process. In this respect, forging stronger and result-oriented partnerships is essential between governments, multilateral organisations, businesses and civil society partners.

64. *Seventh*, rendering underdeveloped region catch-up advanced ones or breaking vicious cycles of low investment stock might require additional efforts. Central government and regional government should co-operate closely and in harmonious way in order to make their efforts bear fruitful results, which would happen only when the efforts surpass the critical mass. Advanced regions can help underdeveloped regions stand on the better position for development. Any political promotion activities or incentives, which would be necessary to jump start to attract FDI, should be terminated once the targeted development threshold has been reached and market forces can take over.

65. *Eight*, work toward increased openness to foreign trade, so as to allow the domestic enterprise sector to participate fully in emerging patterns of the global economy. This approach could be undertaken jointly with efforts at increasing business sector competition. A combined approach would allow a greater domestic and international openness to business to go hand-in-hand with safeguards against negative effects from a rise in concentration. Moreover, a successful effort at removing regional trade barriers makes the participating countries more attractive locations for FDI, owing to the concomitant expansion of the “relevant” market.

66. *Ninth*, implement internationally agreed environmental and core labour standards. Efforts at reducing child labour, eliminating discrimination at the workplace and remove impediments to collective bargaining are important in their own right. They also serve as a tool for upgrading the skills and raising the motivation of the labour force and facilitate linkages with foreign companies usually operating on
higher standards. Additionally, a comparatively sound environmental and social environment becomes increasingly important for countries’ ability to attract “quality” FDI operating on high standards.

67. **Tenth**, undertake efforts to put in place, and raise the quality of, relevant physical and technological infrastructure. The presence of such infrastructure is instrumental in attracting foreign investors, in allowing national enterprises to integrate the technological spin-off from foreign-owned enterprises in their production process, and in facilitating their diffusion through the host economy. Allowing foreign investment in infrastructure sectors and ODA may assist in these efforts. Carefully targeted ODA could be instrumental in nourishing human capital and institutions of good governance, as well as in leveraging FDI flows and creating a cycle of increasing savings and investment. It could also be used to lower political country risk. More specifically, ODA funds could be used to support those areas considered important to investors in determining investment locations, i.e. public-private partnerships in infrastructure and human capital improvement. Water and sanitation infrastructure is an obvious example of an area where better public-private partnerships could bring benefits to the developing countries.

68. **Eleventh**, multinationals have to choose carefully and investment promotion agencies (IPAs) can help to build a region’s image and attract the attention of prospective investors. IPAs are encouraged to centralise decisions on FDI regulations and promotion, co-ordinate other key government departments involved in FDI process and provide a focal contact point with private investors. Prerequisite characteristics of a successful IPA are political support and access to senior government leader, independence from other government departments and agencies, and inter-governmental co-operation and co-ordination. It is important to reinforce their policy advocacy functions vis-à-vis government so that they can be a genuine bridge between private investors and their governments.
POLICY-BASED COMPETITION FOR FDI: THE CASE OF BRAZIL

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I. Introduction

1. The general benefits of attracting foreign direct investment (FDI), and the potential of FDI as a tool for regional economic development in particular, are commonly recognised by policy makers and analysts. A recent study prepared under the auspices of the OECD Committee on International Investment and Multinational Enterprises concluded that FDI generally supports growth in developing, emerging and transition economies, irrespective of their initial state of development.

2. In the case of particularly depressed areas, savings are usually low and insufficient to finance major investment. If, moreover, local businesses are curtailed in their access to markets for borrowed funds – which is, anyway, often not the most appropriate source of finance for high-risk projects – FDI often appears as the most promising source of stable and “patient” long-term finance.

3. More highly developed areas generally have a wider choice of potential investors and sources of finance, but they nevertheless often display a revealed preference for FDI. This is founded in the fact that foreign investors tend to bring with them benefits that not every domestic investor can confer on the host economy. The benefits generally come in three different forms:

- First, foreign corporate presence invariably leads to improved trade linkages – among regions as well as internationally. Where policies in the past aimed at using foreign investors as a tool for import substitution or boosting exports, it is increasingly recognised that foreign corporate presence tends to boost both imports and exports by giving the host location better access to the investors’ global networks.

- Second, FDI may have a beneficial direct effect on domestic enterprises and markets. In particular, the OECD study identified a number of cases in which the experiences with foreign participation in privatisation have been positive, in the sense that the entry of foreign strategic investors helped improve corporate governance, introduce new technology and boost efficiency. The Brazilian privatisation programme was quoted among the examples. Foreign market entry has in many cases also had a positive effect on competition in

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1. The views expressed in this paper are those of the authors. They are not necessarily shared by OECD or the OECD Development Centre.

previously shielded markets. However, a note of caution needs to be struck here: if foreign entrants gain a dominant position in national or local markets, competition and trade policies will be challenged to ensure that they do not have opportunities to abuse their market share.

Third, foreign corporate presence is found to produce significant spillovers to the local business sector. The two areas where this channel seems to be particularly strong is technology transfer and human capital formation. Through their linkages with domestic enterprises – on recent evidence, mainly their suppliers – foreign-owned enterprises share their know-how with the local business community. As for human capital, foreign-owned enterprises tend to spin off a number of trained employees, and in many cases also managers, whose specialist skills then benefit unrelated enterprises or serve as a source of entrepreneurship in the local economy.

4. These benefits do not occur automatically: Policies matter. Surveys of investor intentions (cited by the OECD study quoted above) indicate that investors are generally concerned with the quality of the so-called “enabling environment” for investment, which covers a whole range of issues, from macroeconomic stability, to structural factors, to public and corporate governance. Two qualities that particularly seem to improve an area’s chances of attracting investment are market size and transparency.

- As for market size, it almost goes without saying that a big economy is more attractive to the enterprise sector than a small one. However, it should be noted that even a small area can make itself part of a large economy through policies of openness to trade and by pursuing regional trade integration initiatives.

- Transparency has many faces. In particular, investors have displayed great sensitivity to the respect of law, the quality of public and private governance, the pervasiveness of corrupt practices and the degree to which authorities adhere to the principle of non-discrimination.

5. That said, and while national governments are generally well advised to focus their efforts at attracting FDI largely on improving the enabling environment, regional and local authorities often support their development objectives on more targeted policies toward investment attraction. A centrepiece among these is the practice of offering investment incentives (tax reductions and other fiscal concessions, cash grants and loans, start-up assistance to investors, etc.) either generally or to attract prioritised investment projects.

6. From a general economic viewpoint, such practices may be a suitable tool for regional development when they are non-discriminatory (i.e. offer similar incentives to like classes of investors, whether domestic or foreign) and correct proven weaknesses in the domestic environment that cannot otherwise be easily addressed. Also, where local authorities aim to jump-start economic activity in a given sector, investment incentives have sometimes proved instrumental in attracting a “critical mass” of relevant enterprises. Indeed, the experiences of recent decades in both OECD countries and developing economies (notably in South East Asia) include several apparent success stories.

7. However, the use of such instruments represents a risky strategy. First, deciding how much to subsidise investment projects – and by means of what instruments – involves difficult political and economic choices. Authorities have to address these challenges and put in place appropriate regulatory and analytical frameworks – at the risk of finding themselves over-subsidising projects or creating unintended economic disturbances if they “get it wrong”. Within federal countries there is moreover a risk that

3. This is discussed in more detail by C. Oman (2000), Policy Competition for Foreign Direct Investment, OECD Development Centre, Paris.
regional authorities find themselves bidding competitively against each other (as also demonstrated by recent Brazilian experience) without ultimately influencing the direction of investment flows very much. On the other hand, competition may also serve to enhance the efficiency of capital allocation, but this advantage needs to be weighed against the budgetary cost of achieving it.

8. The remainder of this paper is organised as follows. Section II lists a number of challenges that local authorities may want to address to ensure that their incentive policies are economically sound from the viewpoint of an individual jurisdiction. Section III raises additional concerns that may arise when local authorities compete against each other. Section IV lists some concrete examples of incentive competition within the Brazilian economy. Section V sums up some of the main issues.

II. Challenges for individual authorities

9. The first question authorities will want to ask themselves is whether a policy of offering incentives to foreign investors makes sense at all. The importance of an attractive enabling environment is such that in many cases it may be more effective – and cheaper to the public purse – to pursue policies of structural reform as a way of competing for investors’ attention. However, once a decision to offer incentives has been made, the individual jurisdiction is faced with a panoply of policy concerns arise that can be clustered broadly into four categories: (i) frameworks for policy design and implementation; (ii) the appropriateness of strategies and tools; (iii) the design and management of programmes; and (iv) transparency and evaluation. These are reviewed in more detail below.

a) Frameworks for policy design and implementation

10. National authorities (or lower levels of government that have legal jurisdiction, in the case of a federal system) need to decide how much power of decision to devolve to lowest levels of government. This choice is influenced by the nature of FDI incentive strategies that are pursued. Those jurisdictions that choose general strategies, or sectoral strategies that are tied closely to general industrial policy, have less incentive to devolution than those who focus on the regional aspect of FDI attraction (or, of course, those who are bent on “chasing anything that moves”). The main advantage of giving the local level a freer hand lies in the more intimate knowledge of industries and individual investment projects that is available locally, but this comes at a risk of triggering competitive bidding and other wasteful practices within the jurisdiction.

11. The actual implementation of FDI promotion activities is in most cases left to specialised investment promotion agencies, which often enjoy a high degree of managerial autonomy and are supervised directly by domestic policy makers. However, given the diversity of incentive measures and the different levels of government involved, the main responsibility for implementing FDI incentive policies in several countries rests outside these specialised agencies, which in those cases limit themselves to an advisory and intermediary role. Regardless of the placement of the administrative and political responsibilities, it is commonly agreed that the implementation of FDI incentives should be guided by a set of clear predetermined policies communicated to the competent authorities by policy makers. High standards of accountability and disclosure vis-à-vis the general public are also helpful in creating clarity and building support for the government’s strategies.

4. This is, for example, discussed in more detail in OECD (2002), Best Practice Investment Promotion Strategies, South East Europe Compact for Reform, Investment Integrity and Growth.
12. It may, however, be difficult in practice to hold policy implementation to such high standards. In some cases, the management of incentive programmes is, for instance, made more difficult by political pressures and media speculation. It is notoriously difficult for public sector managers to negotiate with a potential investor when the contents of negotiations are at the same time being debated in the legislature or media. Also, regional or sector-specific programmes are reportedly prone to become subject to political pressures aimed at having their resources applied beyond original mandates. The result can be both ineffective incentives and the breakdown of policy-coherence in the application of FDI incentive strategies.

b) The appropriateness of strategies and tools

13. One of the most fundamental strategic choices facing policy makers offering FDI incentives relates to the economic costs of maintaining a non-level playing field. In offering incentives specifically at foreign investors, authorities depart from the principle of non-discrimination. In practice, graduated approaches range from measures that mildly favour FDI to schemes that are exclusively available to foreign entrants. In positioning themselves between the two extremes, authorities need to carefully assess the value of a maintaining a level playing field against the increased costs of making measures generally available. The costs include a direct budgetary effect and a knock-on effect via the health of the domestic business sector:

- The authorities’ choice would have to depend on a quantitative assessment of the relative merits of foreign versus domestic investment. Also, authorities pursuing general strategies would normally be more concerned about the budgetary cost of making investment incentive schemes generally available than would authorities who target their strategies toward relatively narrow sectors or geographic areas.

- Once it is known that incentives have been provided to foreign-owned enterprises, or that discretionary incentives might be available, other investors may threaten to move away (or hold back on investment as a negotiating ploy). The likely winners are the more mobile businesses that are able to gain incentives in response to such threats. The losers are businesses unable or unwilling to threaten mobility. Smaller firms, in particular, may be disadvantaged by their lack of capacity to negotiate an incentive agreement.

14. Not all types of FDI incentives are equally suited to the pursuit of different categories of FDI attraction strategies, but the relative merits of each type have to be weighed against its budgetary implications. Generally, financial incentives leave authorities with more leverage over the actions of the recipients and are therefore more suited to targeted FDI strategies. Similarly, they are easier to use in policies of compensating investors for structural disadvantages. Fiscal incentives are arguably more appropriate for policies of improving the general climate for foreign direct investment, and for foreign corporate presence more generally. However, national FDI incentive policies in many countries appear to rely excessively on fiscal incentives. The reason for this is that the up-front budgetary impact of deferred or foregone tax revenues is much smaller than the direct outlays needed for financial incentives. Authorities should heed the risk of being too sanguine about the cost of fiscal incentives. Their actions need to be guided by careful assessments of the present value of future foregone revenues.

c) The design and management of programmes

15. Minimising the dead-weight loss – i.e. the risk of paying subsidies to investment projects that would have taken place anyway – is one of the most important challenges for policy makers. This too involves a trade-off between discrimination and budgetary costs, for general FDI incentives necessarily
involve a greater risk of dead-weight losses than measures that can be applied subject to discretion. However, risk of the latter contributing to dead-weight losses as well may increase over time. A jurisdiction that has a history of offering generous discretionary FDI incentives finds it difficult to deny new foreign investors a similar degree of generosity.

16. The time profile of incentives is also important. It has often been argued that FDI incentives should not be too front-loaded. The risk is that “rent seeking” or “footloose” investors will stay only until the incentives ends (or until they are offered more by a competing jurisdiction). This is particularly the case where FDI incentives are general and transferable, such as cash payments and up-front tax breaks. On the other hand, a political willingness to commit FDI incentives up-front is often seen by investors as essential to offset the loss-making early period or as an important signalling device through which authorities make it clear that they bet on a long-term relationship.

17. To discourage investors from opting out, many incentive agreements contain “claw-back” provisions in the event investors fail to meet their obligations, including formal recovery and payback procedures. Tied to this is the existence of parent company guarantees and similar contractual arrangements that give strong assurance of limits on incentives expended. However, such contractual undertakings can be difficult to monitor unless carefully constructed, and investors may in most cases cite “market conditions” and scale down or leave before meeting their obligations under any incentive agreement.

18. Authorities may also choose to couple the offering of front-loaded incentives with demands that investors undertake certain contractual obligations (e.g. undertake subsequent investments). However, a fine balance would need to be struck. In particular, contractual obligations should generally not rise to the level of actual performance requirements, which numerous studies have concluded are counter-productive from the viewpoint of attracting and benefiting from FDI. Performance requirements as such are limited or proscribed by many international investment agreements.

19. At the more practical level, a number of jurisdictions appear to have a tendency to underestimate the resources needed for an efficient implementation. Many implementing authorities lack the data, the expertise, the special skills, and the senior management time required by incentive programmes. In particular:

- Incentive programmes are resource intensive to finance and to manage, and, in particular, most incentives are administratively burdensome. Administrative requirements and capacities need to be taken into account when any programme or piece of legislation is being considered.

- Negotiation of incentives requires special negotiating skills and expertise in the application of particular instruments. The investor will be well supported in that regard. Moreover, investors have – and expect from the competent authorities – a speed of decision-making that exceeds normal bureaucratic standards.

20. Finally, a caveat relates to the actual value of incentives to investors. First and foremost, it is one thing for governments to share the risk of an initial investment in a new location, but the investment has to make business sense without the support of public funds. The design of FDI incentives needs to be carefully considered, not only in terms of creating macroeconomic or sectoral subsidies, but with an eye to the concrete benefits to individual investors.

21. The value and costs of fiscal incentives can vary considerably depending on the investor’s circumstances and the nature of its presence in the host country (e.g. through a subsidiary or a branch).
Other important factors include the tax laws of the home country, as well as agreements – or the absence of agreements – governing taxation between the home and host countries. In fact, it has been asserted that many incentives on offer are of little relevance or interest to the investors that are being targeted. Unless an incentive package represents a meaningful cost reduction and goes directly to the firm’s bottom line, its value could be discounted despite the possible costs to the implementing authority.

d) Transparency and evaluation

22. The FDI attraction strategies should be communicated to the enterprise sector (and civil society) in a timely and transparent manner. While the implementation of strategies at the individual company level may, depending on the circumstances, necessitate an element of discretion and confidentiality, authorities have strong incentives to make their general thrust clear to investors. First, this has an important signalling effect vis-à-vis these enterprises that are relevant to strategies pursued. Second, it gives the enterprises sector at large an opportunity to inform themselves and communicate any misgivings to the relevant authorities, which need to take such information into account in the design and evaluation of their strategies.

23. Many national or local authorities already review the relevance and appropriateness of their FDI incentive strategies at regular intervals and make the results public through annual reports or other communications with the public. In addition, elected officials, for instance through parliamentary bodies, and national audit courts may choose to perform evaluations of their own. In doing so they may not wish to rely solely on the assessments of the implementing agencies. For example, they have the option of involving business sector representatives, national audit courts, the academic community and international organisations in discussions about the role of FDI incentives.

24. Conversely, if proactive communication strategies are considered as being too resource intensive for some authorities, a policy of disclosing a “minimum sufficient” amount of information to the general public could be pursued. This would allow any interested party outside the government to analyse to costs and benefits of incentive programmes, ex post if not ex ante.

25. It follows from several of the points already made that a crucial prerequisite for avoiding wasteful FDI incentives is the implementation of sound and comprehensive practices for cost-benefit analysis. The analysis does, at a minimum, need to develop an assessment of the total benefits derived from foreign direct investment projects, and of the total costs not only to the public purse but to the host economy as a whole. Doing so in practice involves numerous challenges, some of which are:

- Good, professional cost-benefit analyses and programme evaluations cost money. The latter may also require legislative authority.

- It is not always clear at what point in time cost-benefit analysis should be applied. It may for instance be done before a specific incentive “deal” is reached or after the deal has been in operation for some time. Also, the entire policy or strategy may be made subject to cost-benefit analysis. Ideally, all three categories of analysis should be undertaken, but resource limitations may in practice preclude this.

- There is no common agreement about what exactly to include in cost-benefits analysis. A number of cost-benefit models (and programme evaluation models) exist, but all of them have recognised limitations. Moreover, important provisos relate to the quality of data available and to the implementing authorities’ possible incentives to over-report the success of their activities. More specifically, this raises some additional challenges:
i) Typical quantitative methods require reliable, current data (and data collection capacity), as well as persons with the technical expertise to carry out the analysis, and to benchmark results against other jurisdictions or programmes.

ii) Those offering incentives should not be excessively dependent on investors for critical information affecting possible analysis or commitments, a determination of opportunity costs, or the monitoring and evaluation of incentive programmes.

iii) Specific problems may arise when assessing the cost of fiscal incentives. For example, the subsidies involved in the granting of investment tax credits can be so deep that corporations cannot use all their credits and are owed additional revenue back from the fiscal authorities almost indefinitely, thereby creating a very long-term and somewhat unpredictable fiscal liability.

26. Some more practical problems with monitoring programmes and investors may also present themselves. An important challenge for authorities is the complexity of the relationship between investors and authorities, which may dent their analysis and make them rely on hearsay. Agreements that make no provision for subsequent or periodic monitoring and evaluation, and the publishing of the results, can lead to a failure to perform, to a lack of accountability, and to a loss of mutual trust.

27. Unclear agreements between investors and authorities – several different authorities, in some cases – are sometimes drawn up, which are difficult to manage, monitor and enforce. In more extreme cases a general lack of clarity may expose authorities to opaque or dishonest practices by investors. For instance, incentives may invite abuses, such as aggressive tax planning techniques, transfer pricing, “round tripping”, “new firms for old” or the sale of duty-free imports. Grants or other discretionary incentives can also give rise to corruption or bribery.

III. Incentive competition

28. What are the national welfare consequences when many local governments adopt investment incentives, however individually rational? Local authorities obviously have to aim for incentives that are optimal not only from the local point of view, but which also take into account the strategic imperative to compete with other local authorities for the benefits of investment. The process of offering competitive incentives is often termed a "bidding war". This describes a situation in which it is individually rational for authorities to increase their offer of incentives to firms, but the collective effect of this competition may produce unintended consequences.

29. The consequences of competition can produce both positive and negative welfare effects. As indicated in the previous section, local welfare is affected when competition changes the level of incentives on offer. If, on the other hand, competition causes governments to increase the quality and volume of their FDI inflow through more effective and cost-efficient incentives, then the domestic effects are positive. On the other hand, in some circumstances competition may exacerbate poor incentive policies, potentially leading officials to use inefficient incentive instruments or to offer incentives that are greater than the net benefits of the investment project to the host country. In such a scenario the government will have "over-subsidised" the investment project and competition may lead to a misallocation of resources and negative domestic welfare consequences.

30. National welfare is affected when incentives cause the spatial distribution of investment to change. If competition improves the distribution – allocating investment projects to the location in which they are most profitable – then welfare is increased. If competition leads to unnecessary shifting of
investments or distorts the allocation of projects then competition might be wasteful and welfare will be reduced.

a) The potentially positive and negative effects

1) Positive effects

31. Incentive competition has been praised for encouraging the creation of business-friendly environments and facilitating the efficient allocation of investment. Indeed, in recent years there has been considerable ‘revisionist’ research on the positive effects of aggressively competitive industrial development programmes.

32. The basic argument for why competition between host economies for mobile capital is good goes back to the Tiebout Hypothesis (1956) which shows how competition among governments may ensure that taxes are efficient. Efficiency in this sense means that taxes are driven to a point at which they reflect the cost of providing public inputs, like infrastructure and trained labour, to the marginal firm.

33. In the conclusions of so-called "Leviathan models", tax competition also improves welfare because it forces government officials to reduce wasteful expenditure. Brennan and Buchanan (1980) argue that tax competition improves welfare, because the size of government would be excessive in the absence of this competition. Wilson (2001) notes that when governments spend more on incentives, they have smaller budgets for redistribution purposes, perhaps resulting in less utilisation of the political process by interest groups engaged in potentially wasteful rent-seeking.

34. Incentives may also be welfare enhancing if they lead to a more efficient spatial distribution of capital. Indeed incentives are widely used in practice for the purpose of attracting investment to underdeveloped regions. Bartik (1991) argues that even if incentives just shift jobs from one location to another, they are beneficial to the extent that they result in a concentration in relatively low-growth or high-unemployment regions. This is because the benefits of jobs created in distressed areas will exceed the benefits foregone in lower unemployment areas. The benefits of this transfer were described in Wood's (1994) and Williamson's (1997) hypothesis of the beneficial effects of international trade and movement of capital in developing countries. Fisher and Peters (1996) find mixed evidence on this issue.


2) Negative effects

35. Criticism of incentive competition can be roughly separated into two categories: basic concerns about the transfer of resources from governments to firms through incentives; and efforts at documenting the inefficiencies that can be created by them. This section focuses on inefficiencies rather than distributional concerns.

36. One of the main themes of academic literature is that investment incentives may lead to fiscal haemorrhaging and hence lower spending on public goods below efficient levels. Oxfam (2000) estimates that developing countries lose US$35 billion per year due to a competitive pressure to reduce corporate tax rates combined with the transfer of profits out of developing countries to low-tax environments. The simplest paradigm of incentive competition is summed up by Oates (1972) “The result of tax competition may well be a tendency towards less than efficient levels of … local services. In an attempt to keep taxes low to attract business investment, local officials may hold spending below [optimal] levels.” Oates concludes that in a world where every government offers incentives, the game is zero-sum from the point of view of global welfare and negative-sum from the point of view of governments. All governments would be better off having used their resources to fund efficient public investment.

37. A second argument against incentive competition is that it might cause authorities to pay too much for investment projects (i.e. the "winner’s curse" and "beggar-thy-neighbour" scenarios mentioned below) leading to inefficiently high subsidisation of international firms at the expense of the domestic economy. The risk of such outcomes is compounded by the fact that valuations of the benefits of investment projects depend on identifying and quantifying ‘positive spillovers’, which is notoriously difficult. Political pressure on governments to be seen as job winners, to send signals or to attract "landmark" investments also mitigate in favour of overbidding. The public pressure to preserve and create jobs pushes policymakers to ‘play the game’ (Wolkoff, 1992). In a similar vein, studies in Ireland have indicated that the contributions of foreign companies to Irish GDP, export and employment growth may have been exaggerated in public debate. Competitive investment incentives support industries for political rather than economic reasons. For example they tend to be offered to the most mobile producers

10. Fisher, P., and Peters, A., (1996) “Taxes, Incentives and Competition for Investment”, The Region, June 96. After analysing the returns for 16 hypothetical firms in 112 cities across 24 states, the study finds only weak support for either of these hypotheses. It concludes that “after at least a decade and a half of intense competition for investment and jobs, and the widespread adoption of pro-development tax policies and development programmes, states and cities have produced a system of taxes and incentives that provides no clear inducement for firms to invest in higher-unemployment places.”

11. The cost per job, expended in the form of direct and indirect incentives can exceed US$100,000. Indeed the Mercedes investment in Minas Gerais in Brazil involved a cost of incentives per direct job of about US$340,000, of which 92 per cent are fiscal incentives (Oman, 2000).

12. This estimate combines the cost of tax incentives and other tax measures. Oxfam (2000); Tax Havens; Oxfam Policy Papers – 6/00.


14. Biglaiser and Mezzetti (1997) investigate a model in which attracting mobile firms provides a state governor with the opportunity to engage in activities that imperfectly signal his ability to voters. They show that competition in this framework can lead to overbidding and even inefficient location.


and not to "captive" producers. This may lead to a relative over production of goods made by mobile producers. It also tends to operate as a subsidy to foreign firms.

38. Finally, incentive competition might also lead to excessive firm turnover. In the presence of incentive competition, firms may be inclined to reduce the ‘depth’ of their investment in any one location, enabling them to move more easily, and capitalise more frequently on incentive offers.\textsuperscript{17}

39. Summing up, the negative scenario is a classic "prisoner’s dilemma" situation. States are better off collectively if they limit the size of incentives offered to firms, but this co-operation is unstable because any individual state knows that it would be better off if it deviated from the coalition and lured firms by itself.

\textit{b) Efficiency overall: combining the local and national scenarios}

40. Combining the criteria for wastefulness developed for the national and the domestic dimensions, the range of possible welfare outcomes produced by competitive incentive bidding for investment can be presented in a matrix form.

\begin{center}
\begin{tikzpicture}
\matrix [draw, matrix of nodes, row sep=1cm, column sep=1cm]
{ Investment Poaching & Healthy Competition \\
Beggar-thy-Neighbour & Winners’ Curse \\
};
\end{tikzpicture}
\end{center}

The four outcomes may be categorised thus:

41. \textit{Investment poaching}. This occurs when incentives operate to enhance the efficiency of the local economy but have negative effects on national efficiency. This is for instance the case where one regional

\textsuperscript{17} Wilson (1996) builds a model in which excessive turnover is generated by the use of initial subsidies such as tax holidays, and Bond (1981) found empirical evidence pointing in this direction.
body lures an investment project from a location in which it was naturally more efficient. In such a scenario, there may also be no net employment creation and the investment could be less profitable (net of incentives) after the move. Another example relates to the case where incentives are effective in attracting firms to a particular location, but have the unintended consequence of changing the behaviour of investors. Firms could respond to greater incentives by becoming more ‘footloose’, moving between locations more frequently and engaging in ‘incentive shopping’ or rent-seeking activities.

42. **Healthy competition.** In this win-win scenario, incentives produce local efficiency, in the sense that they improve the flow of investment projects. Competition for investment also delivers nation-wide efficiency, ensuring that investment projects are matched to the locations in which their value is greatest. Incentives instruments are carefully chosen to have minimum distortion and their size is calculated to produce the maximum benefit for total welfare. In particular, this will be the case where incentives are picked to closely reflect the eventual spillover benefits to the host economy from foreign corporate presence. In this case, the country bidding the highest will *ceteris paribus* be the one where the potential efficiency gains are the largest.

43. **Beggar-thy-neighbour.** Beggar-thy-neighbour outcomes are the most potentially harmful consequences of bidding wars. They occur when the use of incentives produces both the negative nation-wide efficiency effect described above, and additional local inefficiencies. Local inefficiencies can result from poor incentive policies, implementation problems or errors in the estimation of the potential benefits from an investment project. For example, authorities might create inefficiencies by attracting a firm, which is not suited to the local area’s capabilities and natural resources. Alternatively, local inefficiencies can occur when the potential benefits from an investment project are overestimated, leading to overbidding and a net loss to the government.

44. **Winners’ curse.** This problem of systematic overbidding is a common feature in any auction of an object with an uncertain value. Even if the bidding process is nationally efficient, in the sense that the project was ‘won’ by the location in which its value is greatest, the bidding authorities may lose if they have paid too much for the investment. This scenario involves nation-wide efficiency, but local inefficiency.

c) **Options for policy makers**

45. Policymakers will wish to develop a workable policy approach that reduces the negative effects of bidding wars without preventing national or sub-national governments from pursuing legitimate industrial policy goals, such as regional development or sectoral promotion. However, in practice this often involves balancing a trade-off between conflicting policy requirements.

46. If authorities were to embark on cross-country (or cross-jurisdiction) policy action, there are essentially three options, representing three levels of ambition with regards to the objectives being pursued. In ascending order these are: (1) transparency-enhancing measures; (2) co-operation between jurisdictions; and (3) the putting in place of enforceable rules. In the case of Brazil, measures of the third kind are already in place in the form of the national government’s right to veto some kinds of incentives. The following sub-sections focus on the first two options.

1) **Transparency**

47. It has been argued that "the most effective reform would be informing citizens and policymakers what the costs and the benefits are".18 Currently, most citizens and, apparently, many policy makers do not

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18. David S. Kraybill, regional economist at Ohio State University.
know what is actually spent (on and off budget) on investment incentives. Very few national and sub-national authorities have thorough accounting practices, which quantify and consolidate all channels of business assistance. The multitude of government agencies and independent and private agencies that are involved arguably compound the opacity.

48. To some extent it is understandable that authorities have been traditionally reluctant to divulge information about their incentive packages. Governments seek to avoid the public backlash from some parts of the electorate which might be hostile to incentives, and also to avoid setting a precedent which future investing firms could use to ratchet up their incentive demands. However, and even though these considerations are to some degree legitimate, there are significant benefits available to nations that are willing to increase the transparency and accountability of their incentive payments. At a minimum, proper accounting for incentives should give a clear picture of the true level of state resources being spent on economic development, assisting governments with planning and ensuring they effectively align expenditure with policy goals.

49. Further, increased transparency across jurisdictions would increase the bargaining power of governments in incentive negotiations. Where incentive offers are opaque, the investing firm has an advantage over the bidding governments who do not know the size of each other’s bids. Firms may succeed in capitalising on the opacity of the negotiating processes. Anecdotal evidence suggests that the bidding process for some auto plants in particular has involved veritable cloak-and-dagger techniques. In some cases this allowed investors to play governments off against one another by selectively disclosing the best elements of the packages offered by each one.

50. Transparency measures may also operate to reduce the scope for corruption. Oman (2000) highlights the potential that investment competition has, particularly in developing countries, to generate graft, corruption and other rent-seeking behaviour. Greater accountability and less discretion on the part of government officials reduces the opportunity for corrupt activities.

51. In these ways, increased transparency in incentive packages has the potential to minimise the disadvantages of incentive competition described in the previous sections, whilst not greatly impinging on its positive aspects. There are several reasons to suggest that an international policy approach would be the optimal way to introduce transparency. Whereas no state receives an individual benefit from unilaterally disclosing the extent of their incentive packages to other states, there is a clear dividend from co-operation if all governments simultaneously take this step. If states have full information about each others incentive packages then they are less likely to be taken advantage of by firms playing several governments off against each other.

52. However, the downside of broad incentive disclosure should not be ignored. First, good reporting is costly. Proper assessments are a significant administrative burden and may also antagonise or discourage investing firms. Proper evaluations are difficult and subject to considerable uncertainty. Ascertaining the cost-effectiveness of incentive programmes often depends critically on whether a firm would have invested without such incentives or whether another opportunity would have arisen in its absence – which are inherently speculative questions. Moreover, evaluation errors can be costly. Negative evaluations may be used to terminate schemes and positive assessments might be discounted by opponents of incentives.

2) **Co-operation between jurisdictions**

53. The introduction of comprehensive and transparent accounting practices for incentives has the potential to increase the effectiveness of incentives and reduce wasteful expenditure. However, waste due to poor information is only one of the negative effects of bidding wars described in the previous sections. To the extent that strategic competition creates a ‘prisoner’s dilemma’ in which it is *individually optimal* for nations to offer incentives exceeding the efficient level, then no extra information will encourage governments to bring their incentive bids down. The potential effect of the prisoner’s dilemma provides a rationale for co-operation between jurisdictions.

54. Unfortunately, the nature of the prisoner’s dilemma makes co-ordination notoriously difficult to sustain. Attempts by nations, and regions within nations to form investment alliances or reduce competition have often been unsuccessful. In 1991, New York, New Jersey and Connecticut signed an agreement to stop offering incentives to businesses relocating from one state to another. However, one of the signatories broke the agreement before it had lasted a week. In 1993, the US National Governors’ Association adopted non-binding “guidelines for the de-escalation of interstate bidding wars”, but this has yet to be broadly successful. Another national example is the investment provisions in Canada’s Agreement on Internal Trade (for details see text box).

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**Box. The Canadian experience with curbing incentives competition**

Canadian policy regarding the offering of incentives to lure business investments in competition with other jurisdictions within Canada consists of two elements. The first element is the Agreement on Internal Trade (AIT) that was signed by the federal and provincial governments in 1994. Secondly, legislation in most provinces prohibits Canadian municipal governments from offering “bonuses” or firm-specific incentives to lure businesses to their jurisdiction from elsewhere in Canada. The latter element of Canadian policy may arguably have had the greater impact.

Article 607 of the AIT provides that “parties to the agreement may not discriminate against an enterprise on the basis of ownership, control or location of an enterprise within Canada. Annex 607.3 establishes a “code of conduct” on incentives which requires parties to the AIT not to offer “poaching incentives” and to make “best efforts” to avoid incentives that distort economic activity.

Canada’s AIT is not principally a tool for central influence over sub-national levels of government. Rather, the primary reason for the prohibition of sub-national incentives is a consensus amongst municipal leaders that they do not wish to compete with each other by offering investment shifting incentives, for fears of getting caught up in situations such as the “prisoner’s dilemma”. It was in response to requests from municipal leaders that provincial governments moved to outlaw “bonusing” by municipal governments. While the original intent may have been limited to not luring existing businesses from one Canadian jurisdiction to another, the practice, if not the laws, has prevented municipalities from offering incentives to attract greenfield investments from outside the country.

However, while the original consensus amongst municipal governments appears to be holding, provincial governments themselves have appeared less stringent in applying the principle. Canadian policy is therefore very much a “bottom-up” one. More recent efforts by the federal government, to strengthen the rather “soft” provisions against incentives in the AIT, have seemingly enjoyed less priority amongst provincial Ministers.

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20. On efforts to forge investment alliances among developing nations, see C.P. Kindleberger (1969) *American Business Abroad; Six lectures on Direct Investment*, Yale UP, New Haven.

55. The latent prisoners’ dilemma problem in connection with bidding wars is made particularly intractable by a couple of additional factors. First, agreements between authorities to limit incentives use are difficult to monitor because of the difficulty in accurately estimating the true size of deals offered to investors. The precise details of incentive agreements are often not made public and governments have shown a strong desire to hide or understate the actual incentives deal. Even when all the details are revealed, the actual benefit to the firm may be quite difficult to determine. They depend critically on the value attributed to the constituent elements. For example, the value of tax holidays depends on assumptions about the future profits of the firm. Similarly, the value of free or discounted land can be subjective, and benefits such as training subsidies or loan guarantees are extremely difficult to quantify. Even more difficult are calculations attributing general expenditure to specific investments. The value of setting incentive limits is diminished if it is almost impossible to accurately determine whether those limits are being adhered to.

56. Second, another concern is that business incentives come in a wide variety of different forms. Moreover, in some countries processes are informal and government agencies have considerable discretion to create *ad hoc* incentives as part of the bargaining process. With such a multiplicity of available instruments through which to confer benefits on firms, most agreements can be easily circumvented.

57. These factors make co-operation between jurisdictions inherently difficult. If any agreement is too strict then it denies the legitimate policy goals of states and will not be adhered to. If it is too weak then it will collapse under the weight of the prisoners’ dilemma, since the incentive to deviate from the agreement is strong and the cost of not deviating when others do is large.

IV. The Brazilian experience

58. Policy competition to attract investment was “activated” in Brazil by the dramatic success of the 1994 “Real Plan” in cutting inflation and bringing macroeconomic stability to the country. One reason the Plan had this effect is that conditions favourable to investment in production – and investment planning – were finally restored, and both domestic and foreign investment responded accordingly. Another reason, perhaps less anticipated, was the distributional impact of the Plan in favour of the poorer segments of the population. That distributional impact has had both sectoral and regional dimensions: demand growth has been particularly strong for lower-income as well as middle-class consumer goods, both durable and non-durable; and demand growth in the poorest regions has been higher than the national average – highlighting the consumption potential of those markets.

59. Also important have been the consolidation of the “Mercosul” regional-integration process after December 1994, when agreement was reached with Argentina, Paraguay and Uruguay to achieve a Common Market, and Brazil’s on-going unilateral policy and regulatory reforms to liberalise trade, investment and domestic competition. Average import tariffs fell from 32 per cent in 1990 to 14 per cent in 1994, for example, and privatisation of state-owned enterprises, notably in infrastructure (e.g. railroads, ports, utilities, telecommunications), has recently accounted for a quarter of all incoming FDI. All these policy changes and regulatory reforms are helping to attract FDI, as well as to promote domestic investment, which have grown rapidly since 1994. All are also thus helping to stimulate competition to attract investment in Brazil, which has indeed become very active since (and only since) 1994.

60. Trade liberalisation and regulatory reform combined with competition among sub-national governments to attract investment are having two types of effect on the location or relocation of production in Brazil. One effect involves some movement away from Brazil’s traditional industrial pole in São Paulo to other sites in the South and Southeast regions, i.e. to areas which are relatively wealthy and benefit from economies of agglomeration in technologically relatively sophisticated activities, such as automobiles and...
auto parts, electronics and telecommunications equipment. The Mercosul integration process and many of the country’s regulatory reforms (the latter often cited by government officials as needed to attract FDI in modern services) also tend to promote this effect. The other effect is a relocation of some production away from the South and Southeast altogether – sometimes involving actual plant relocations – to sites in the North, Northeast and Centre-West, notably in such traditional labour-intensive consumer goods as clothing and footwear, along with food products, beverages, hygiene and cleaning products. Proximity both to export markets in the United States and Europe and to newly expanding consumer markets in Brazil’s poorer regions, as well as lower labour costs, are important reasons for this relocation.

a) The “fiscal war”

61. The so-called auto regime, by which the Brazilian government attempted to nurture domestic car production, has been accompanied by fierce competition among sub-national governments to attract investments in this sector. That competition lies at the heart of what came to be called “the fiscal war” among the states in Brazil — and constitutes the core of incentives-based competition to attract investment in Brazil. (Thus, in Brazil as in many other countries, while sub-national governments that compete to attract corporate investment make no formal or legal distinction between the incentives they offer to foreign investors and those they offer to promote or attract domestic investment, in actual practice that competition tends to be heavily biased towards attracting FDI.)

62. A typical auto-sector investment incentives package offered by sub-national governments includes both financial and fiscal incentives, and both state and municipal governments commonly participate. The value of the fiscal incentives (commonly state sales-tax holidays and exemptions from municipal taxes) tends, however, to be much larger than that of the financial incentives (which commonly include the provision and preparation of the project site and buildings, along with dedicated infrastructure). The examples given below provide a far-from-exhaustive illustration of the packages that were offered to car manufacturers.

63. Volkswagen’s investment project in the State of Rio de Janeiro was commenced in June 1995. It was scheduled to directly create 1,800 jobs, and it benefited from financial incentives worth about US$14 million (for dedicated infrastructure) and fiscal incentives worth between US$83 and 155 million. The implied incentives cost per direct job is thus between US$54,000 and 94,000, of which fiscal incentives constituted between 86 and 92 per cent.

64. Another big auto deal occurred in 1995/96 when the state of Paraná and the municipality of São José dos Pinhais attracted an investment by Renault involving 1,500 new jobs. In return for the deal, Renault was offered a massive incentive package including a capital contribution of up to US$300 million, interest free loans and a series of local tax breaks. The government contribution also included the donation of a 2.5 million square meter site, provision of all the necessary infrastructure and utilities at the site. Renault was also to receive electricity at prices 25 per cent below market value. For the investment in Paraná, the figures suggest a total cost of incentives per direct job of about US$133,000, of which fiscal incentives constituted 88 per cent.

65. A further big deal was between Mercedes-Benz and the city of Juiz da Fora in Minas Gerais. In exchange for undertaking investment of a similar size as Renault, Mercedes-Benz secured from the state

22. Some packages also include state participation in a project’s equity — directly or via a public development fund — not so much as a financial incentive, at least for large investors with easy access to funding, but as a means to formalise the government’s commitment to the success of the project and thus serve to mitigate political risk.
and the city an equally impressive catalogue of incentives. As well as land, grants and tax breaks, the local authorities were willing to conduct extensive infrastructure development including, the construction of access roads and rail links to the plant and the development of utilities and sanitation (with lower water costs for ten years). For the investment in Minas Gerais, the figures point to a total cost of incentives per direct job of about US$340,000, of which 92 per cent were fiscal incentives.

66. In 1997 the state of Rio Grande entered the fray. The authorities privatised the local port and phone company and allocated the proceeds to pay for investment incentives earmarked for attracting car plants. Both General Motors and Ford signed deals to build new factories near Porto Alegre. According to the terms of the agreements General Motors will pay no state sales tax for 15 years. Moreover, the state government is spending around US$67 million to prepare the factory’s site, and it also lent the carmaker 254 million reais at 6 per cent interest rate (the market rate was above 35 per cent at the time). Ford reportedly obtained similar terms. The generosity of these terms gave rise to considerable political controversy within the state.

67. There are signs of a cooling in the public and political attitude towards incentives. For instance, in 1999 Brazil’s president vetoed a measure to offer 700 million reais a year in tax credits that had been offered to Ford in return for building a new factory in Bahia. Instead, the carmaker accepted a lesser, though still attractive, deal involving an annual subsidy estimated at around 180 million reais.23

b) The broader context

68. Looking beyond the auto industry per se, to the phenomenon of the relocation of production in some industries from the wealthier southern regions to the poorer northern regions, a growing mobility and readiness of firms to relocate within the country appears to have been an important factor. In that context they cite investor survey results which identify fiscal incentives and market proximity as the two most important factors, followed by labour costs, in explaining the relocation phenomenon. This evidence would seem to suggest not only that incentives are playing a key role in many investment-location decisions, but that incentives-based competition in Brazil may well remain strong, or even intensify, in the coming years.

69. While incentives-based competition is most intense at the level of state governments, and secondarily at the level of municipalities (whose governments often team up with their state government to compete against sites in other states), the federal government is responsible for the auto regime and, as such, responsible for Brazil’s most significant and elaborate investment-incentives scheme. That scheme reproduces an industrial-policy approach typical of import-substituting industrialisation, characterised by strong sectoral discrimination which effectively penalises other sectors (notably including autoparts in this case). The scheme is reproduced, and its effects greatly amplified, by state governments’ competition to attract investments in this sector.

70. The federal government is additionally responsible for incentives-based competition in Brazil today in the sense that it has avoided any attempt to limit such competition among the states and municipalities. This is true, first, because the federal government has consistently failed to apply existing legislation (notably a 1975 law) which authorises it to impose limits. It is true, secondly, because the country’s President and the legislative leadership of states in the poorer regions have agreed to block a recent initiative of the federal Senate to limit the states’ use of investment incentives. The poorer regions’ desire to use incentives to compete with the wealthier states to attract FDI thus appears to be supported by the President, and, in addition to the announced concern over possible investment diversion to Argentina, may also be an important factor behind the auto regime.

23. The Economist (1999), "Federal offences", July 29th
71. There is, in any case, broad agreement in Brazil that the loss of the federal government’s efficiency in regional-development policy was a major driving force behind the “fiscal war” among the states. In Brazil as in other countries, there is thus an important, if somewhat less than transparent, relationship between the executive authority’s use of investment incentives (and its allowance of states to use incentives) and its desire to promote development in the poorer regions by inducing investment in those regions. In Brazil more specifically, the activation of incentives-based competition since 1994 marks the culmination of a process of dissolution, underway since the mid-1980s, of the country’s relatively dirigiste import-substituting-industrialisation development strategy. That dissolution is accompanied by a process of policy decentralisation in which fiscal resources and responsibilities are transferred from the federal government to the states (and secondarily to municipalities).

72. This decentralisation process is also occurring in a broader context of regulatory reform, regional integration (Mercosul), privatisation, and trade and investment liberalisation (with the notable exception of the auto regime), all of which tend to strengthen market forces and contribute to the modernisation of the public sector. Increasingly, in other words, the logic of investment-location decisions is essentially a private one governed by cost and competitiveness criteria, rather than by political negotiations between (unelected) state and federal officials as was the case previously.

73. This new, emerging, context also induces sub-national governments increasingly to modernise and organise themselves more flexibly with a view to enhancing local competitiveness. They are learning not only how to negotiate incentives but to help investors identify investment opportunities, target potential investors, co-ordinate and professionalise their actions, and improve their own learning skills.

V. Summing up

74. The fiscal war in Brazil is hardly representative of the use of investment incentives by state governments and municipalities. Anecdotal evidence abounds of targeted investor attraction being used as a tool for regional and local economic development. There is further evidence to suggest that this has been a contributing factor to the geographic broadening of Brazil’s industrial base over the last decade. However, the fiscal war may serve as an indication of the risks that occur when sub-national levels of government pursue pro-active investment incentive strategies with little regard for the action taken elsewhere and the broader national interest.

75. It is not possible to conclude on the basis of case studies and anecdotal evidence where, on a scale from the best-case “healthy competition” to the worst-case “beggar thy neighbour” scenario, the fiscal war pitted state and local authorities. However, a reported size of individual incentive packages up to US$300,000 per job could be taken to indicate that subsidies have been paid in excess of the additional efficiency gains from reallocating plants within Brazil (hence, a case can be made for inefficiency at the national level). Moreover, the political controversy surrounding the generosity of some incentive packages would seem to imply that some quarters considered them to be exceed the benefits even from a narrowly local perspective.

76. National and state authorities in Brazil have become increasingly alert to the risks. The central government has exercised its veto over locally-offered incentive packages. Some state governments have publicly announced their retreat from the fiscal war and their determination to compete on the basis of other factors of investment promotion such as economic environment, social amenities and infrastructure. Nevertheless, state and local authorities may wish to ask themselves whether, in addition to these

24. As for example stated by the Instituto de Desenvolvimento Industrial de Minas Gerais in a communication to the OECD Secretariat.
individual actions at the central and sub-national levels, it would be helpful to put in place mechanisms for nation-wide information sharing or, even, policy co-ordination. If this were the case, the experiences from OECD countries (sub-nationally as well as internationally) could provide valuable insights.
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The Economist (1999), Federal offences, July 29.


INTERNATIONAL CONFERENCE ON REGIONAL DEVELOPMENT
AND FOREIGN DIRECT INVESTMENT IN BRAZIL

THURSDAY, 12 DECEMBER, 2002

09h OPENING REMARKS

Mr. Beni Veras – Ceará State Governor

Mr. Rolf Alter – Deputy Director, Directorate for Public Governance and Territorial Development, OECD.

Mr Esacheu Cipriano Nascimento – Deputy Minister for Regional Integration

Mr. Byron Queiroz - President of the Bank of Northeast

10h SESSION 1 CHALLENGES FOR REGIONAL DEVELOPMENT IN BRAZIL

Chairman: Mr. Mario Pezzini, Head of the Territorial Reviews and Governance Division, OECD.

Rapporteur: Mr. Osmundo Rebouças, Director and Vice-President of the Bank of Northeast, Brazil.

Speakers:

Regional Development Strategies: Enhancing Competitive Advantages and Removing Impediments to Regional Growth – Mr. Gustavo Maia Gomes, Federal Agency of Research and Planning (IPEA)

Regional Development in Brazil and the Transformative Firm: How to Make it Work – Mrs. Judith Tendler, Professor of Political Economy, Massachusetts Institute of Technology.

Panel of Experts

Regional Dimensions of Macroeconomic Policies in Brazil - Mr. Joaquin Oliveira-Martins, Department of Economic Affairs, OECD.

Regional Development in Brazilian Northeast: Meso-regions and the Federal Compact - Mrs. Mary Dayse Kinzo, Ministry of National Integration, Brazil.

The Bank of Northeast Perspective on Regional Development in Brazil - Mr. Éwerton Chaves, Bank of Northeast, Brazil.

Regional Development Tools: the Experience of the Brazilian Bank for Economic and Social Development (BNDES) - Mr. Luiz Fernando Linck Dorneles, Superintendent Regional Development Area, BNDES (National Bank for Economic and Social Development).
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<td><strong>Mrs Lamia Kamal-Chaoui</strong> - Territorial Reviews Division, OECD</td>
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<td><strong>Contribution of FDI to Regional Development Policies: Cases from Brazil, China, Russia, and Turkey</strong> - <strong>Mr. Mehmet Ögütcü</strong>, Head of the Non-Members Liaison Group and Global Forum on International Investment, OECD.</td>
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<td><strong>A New Policy for Territorial Competitiveness in Italy</strong> - <strong>Mr Tito Bianchi</strong>, Evaluation Task Force for Public Investment, Ministry of Economy and Finance, Italy.</td>
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<td><strong>Eco-tourism Clusters in Latin America: Keys for Success.</strong> - <strong>Mr. Rudolf Buitelaar</strong>, ECLAC</td>
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14h00min SESSION 3: REMOVING BARRIERS TO REGIONAL DEVELOPMENT IN THE NORTHEASTERN BRAZIL: THE WATER RESOURCES MANAGEMENT ISSUE

Chairman.
Mr. Hypérides Macedo, Ceará State Secretary of Water Resources, Brazil.

Rapporteur:
Mr. Jair do Amaral Filho, Director of State of Ceará Centre for Development Strategies, Brazil.

Speakers
The Water Resources Management as an Instrument for Sustainable Regional Development – Antônio Rocha Magalhães, Senior Consultant, World Bank Office in Brazil

Panel of Experts
The Water Resources Supply Management Policy in the Brazilian Northeastern Region. Mr. Gabriel Azevedo, World Bank
The Water Resources Demand Management in the Brazilian Northeastern Region. Mr. Larry Simpson, World Bank
The Dispute Resolution in Water Resources. Mr. Rômulo Macedo, Director of Sustainable Development Agency of Seridó Valley, Brazil.

20h30min COCKTAIL AT DRAGÃO DO MAR CULTURAL CENTER
FRIDAY, 13 DECEMBER, 2002

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<td>Promoting tourism for regional development: experience from the InterAmerican Development Bank – Mr. Jaime Mano Júnior, State Modernization, Specialist at the IDB Brazilian Office.</td>
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<td>IFC’s Experience in Supporting Investment Projects in Brazil - Mr. Luiz Antonio Funcia, International Finance Corporation.</td>
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<td>Obstacles and Advantages for a Foreign Direct Investor: the Case of MeadWestvaco - Mr. Paulo Tilkian´s, Mr. Paulo Tilkian - President of Rigesa, Brazilian subsidiary of MeadWestvaco</td>
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| 12h30min | LUNCHEON |

| 14h30min | SESSION 5. CONCLUSION: THE WAY FORWARD |
| Co-chairs: | Mr Rolf Alter - Deputy Director, OECD Directorate for Public Governance and Territorial Development |
| | Mr. Lúcio Alcântara - Newly elected Governor of the State of Ceará |
| | Reports on each individual session by all rapporteurs and co-chairs. |
| | Conclusions and follow-up actions |