Policy Competition for Foreign Direct Investment
A Study of Competition among Governments to Attract FDI

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This document reproduces the table of contents and executive summary from the above study. This study was recently published in full by the OECD in English and French.

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Executive Summary

Globalisation, and in particular the move by many developing and emerging economies in recent years to seek more actively to attract foreign direct investment, is raising policy makers’ concern that intensifying global competition among governments to attract FDI may have undesirable effects. The main concern is that global “bidding wars” to attract FDI may be producing an uncontrolled upward spiral in costly “investment incentives” that weaken public finances while introducing market distortions in the allocation of real investment, and/or that such “wars” are putting excessive downward pressure on global standards of protection of the environment and/or of workers’ rights (the so-called “race to the bottom”).

Intensifying global competition among governments to attract FDI could also, however, produce beneficial effects. These effects may include inducing governments to strengthen their economies’ “fundamentals” (e.g., by pursuing policies to enhance the supply of modern infrastructure and appropriately trained workers, by achieving greater macroeconomic and political stability, by improving long-term economic growth perspectives) which should in turn promote economic development — almost independently of their impact on FDI flows per se. Another effect may be to increase the global supply of FDI, to the benefit of investors and host economies alike.

The actual degree of global competition to attract FDI is not known, moreover, and while there is considerable evidence that such competition is widespread, involving sub-national as well as national governments both in OECD countries and in developing and emerging economies, it is difficult to predict whether that competition will intensify in the coming years.

It is against this backdrop that the present study addresses three sets of questions: (i) To what extent do governments — national and sub-national governments in OECD and non-OECD countries — actually compete with one another to attract FDI; to what extent is that competition intensifying, or likely to intensify; and what are the principal policy instruments or means by which governments compete to attract FDI? (ii) What are the effects of that competition — on FDI flows, on policy-making more broadly, and on the economy? and (iii) What are the implications for policy makers? The study addresses these questions from the dual policy perspective of enhancing economic and social development in the developing and emerging economies, and of strengthening relations between those economies and OECD Member countries.

Chapter 1 lays out the policy and conceptual issues and the working hypotheses that guide the study. Chapters 2 and 3 present the evidence. Chapter 2 looks at governments’ use of financial and fiscal incentives (“incentives-based competition”) while Chapter 3 focuses on governments’ use of “rules-based” means of competing to attract FDI — means such as environmental and labour standards, export-processing zones, international regional-integration agreements, privatisation of state-owned enterprises and strengthened judicial systems. Chapter 4 concludes with a presentation of the overall findings and policy conclusions.

Those findings and conclusions may be summarized as follows:

- Incentives-based competition for FDI is a global phenomenon: governments at all levels (national and sub-national) in both OECD and non-OECD countries engage in it worldwide.
• As barriers to international investment have fallen over the last two decades, the significance of competition for FDI has increased.

• Incentives-based competition can be intense, but the evidence — which is insufficient to draw more than tentative inferences — suggests that the competition tends to be quite intense only in particular industries (e.g. automobiles) or for particular investment projects (especially large ones) and in some industries is intense only during particular periods.

• Most incentives-based competition is effectively intra-regional, since much of the real investment for which national and sub-national governments compete is investment the investor intends in principle to locate in a particular region.

• While the evidence does not clearly point to any inexorable tendency towards global “bidding wars” among governments in their competition to attract FDI, the “prisoner’s dilemma” nature of the competition creates a permanent danger of such “wars”.

• Data on the direct financial and/or fiscal ‘cost-per-job’ of incentives received by investors in the automobile industry reveal similar orders of magnitude of that cost in OECD and in developing and emerging economies (a cost that often exceeds $100 000).

• Evidence of the effects of incentives on corporations’ real investment-location decisions, particularly for major new investment projects, is consistent with the view that the decision is normally a two-stage (or multi-stage) process in which investors first draw up a short list of acceptable sites on the basis of the economic and political “fundamentals” of alternative sites, largely irrespective of the availability of fiscal and financial incentives from potential host governments, and only later, after the short list is drawn up on the basis of the investment “fundamentals”, do investors consider — and often seek out — investment incentives, sometimes playing one government off another at this stage of their location decision. Incentives and other discretionary government policies to attract FDI can thus be decisive in investors’ location decisions, despite the much greater overall importance investors attach to the “fundamentals”.

• There is little evidence that increasing global competition for FDI over the last two decades has contributed in any significant way to the major growth of global FDI that has occurred over the same period. Rather, any relationship of cause and effect between the two phenomena appears more to work in the opposite direction: as the global supply of FDI has risen significantly, governments have intensified competition with one another to attract “their share” of that growth. (Several factors have stimulated the growth of FDI, including Europe’s Single Market and Maastricht Accords and other regional phenomena, e.g., NAFTA, as well as worldwide economic policy liberalisation and market deregulation and the globalisation of corporate activity and competition.)

• Even in the absence of global bidding wars for FDI, the distortionary effects of incentives — which tend to discriminate against smaller firms, against local firms (de facto, though rarely on a de jure basis) and against firms in sectors or types of activity that are not targeted — can be significant.

• It can be counterproductive for a government to offer costly investment incentives if the “fundamentals” of the potential investment sites within its jurisdiction fail to meet serious long-term real investors’ basic requirements, because the incentives — in addition to the distortions they inevitably introduce — will tend to attract the “wrong kind” of investor. They also tend to render the broader policy-making process more vulnerable to rent-seeking behaviour, perhaps including corruption, which can be very costly — and can even spread and become quite destructive for the
economy, for democracy and the development of a modern state, and thus for the very process of development.

- Undiscerning use of investment incentives and other discretionary policies by governments to attract FDI can have a negative effect on FDI inflows, in part because the incentive programmes and policies tend to be seen by investors as unsustainable.

- Many of the governments that are most successful in attracting FDI are also among those that best meet the requirements for good governance (requirements that include sound public finances because they lend credibility to incentives programmes in the eyes of investors, and legitimacy in the eyes of voters, by making them likely to be seen as sustainable).

- There is little evidence to support the hypothesis that intensifying competition to attract FDI induces governments significantly to enhance local supplies of infrastructure and of skilled labour; one cannot reject the hypothesis that incentives tend more to compete with than to augment the use of public resources to increase local productivity-enhancing human-capital formation and the supply of modern infrastructure.

- Whether or not induced by competition to attract FDI, policies to enhance local supplies of human capital and modern infrastructure, if successful, can nevertheless be a powerful means to attract FDI — as well as to promote economic development — if the other “fundamentals” are sound.

- While governments often “justify” providing investment incentives with the argument that they are needed to steer corporate investment to poorer areas within their economy, in practice incentives are often of limited effectiveness in this regard (though there are exceptions) and they sometimes actually reinforce inequalities instead.

- Competition for FDI among sub-national governments has been “activitated” by, but also contributes to, a broader process of reform of policy-making which includes regulatory reform, privatisation and liberalisation of trade and investment policies. In addition to strengthening market forces, this process tends to induce sub-national governments to modernise and organise themselves better, and more flexibly, to enhance the competitiveness of the economies under their jurisdiction.

- Investors often choose sites where the host government’s strategy to attract investors is part of a broader process of mobilisation around a project of social and political reform in which the government redefines its role, turning away from rigid structures and exclusive relationships with vested interest groups in favour of greater transparency, democracy and market competition. This process both enhances and is reinforced by growing exposure of local and foreign firms in the domestic market to international competition.

- Policy competition raises the delicate question of how to ensure the accountability of government officials, particularly those involved in the negotiation of discretionary incentive packages, and points up the need for governments to be able to monitor their own use of incentives. That monitoring could in turn constitute the needed basis for co-operation among governments to ensure that competition for FDI does not lead to beggar-thy-neighbour policy competition and incentives “bidding wars”.

- There is little evidence in support of the stronger versions of the “race to the bottom” hypotheses regarding governments’ defense of labour and environmental standards. The evidence cannot tell us, however, to what extent competition to attract FDI is inhibiting a socially optimal raising of those standards, and the danger of such “races” — or at least of increasing downward pressures on those
standards — always exists. There is, at the same time, evidence that competition to attract FDI can exert some upward pressure on those standards, particularly by local governments.

- Policy makers must remain vigilant to ensure that competition to attract FDI does not lower labour and environmental standards but works, if anything, in the opposite direction. Governments and society would benefit in this regard from enhanced international policy co-ordination on environmental standards, perhaps also on core labour standards.

- International regional-integration agreements can be a powerful policy tool both for attracting FDI (which requires relatively open regional agreements) and for enhancing co-operation among governments to limit the potential negative effects of policy competition — including downward pressures on labour and environmental standards as well as costly beggar-thy-neighbour policy wars and incentive wars.

- For developing and emerging economies, whose scarce financial resources often push them into a heavy reliance on fiscal incentives to attract FDI, it is important to stress the value of moving away from discretionary incentives towards greater reliance on rules-based means of attracting FDI — national and international rules that maintain or strengthen environmental and labour standards and create stability, predictability and transparency for policy makers and investors alike. A strong rules-based approach, which should include a strong and independent judiciary system, can also provide the policy transparency necessary to limit the rent-seeking behaviour that can be very damaging to development.

The prisoner’s-dilemma nature of competition for FDI creates a permanent risk of costly beggar-thy-neighbour bidding wars and downward pressure on environmental and labour standards that cannot be fully addressed by national governments in the absence of strengthened international policy co-ordination.