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Chapter 3

Policies and Incentives for Attracting Foreign Direct Investment*

The present article reproduces a report approved in April 2003 by the OECD Committee on International Investment and Multinational Enterprises (CIME). The article comprises two main sections. The first section “Guiding Principles for Policies toward Attracting Foreign Direct Investment” is a statement endorsed by CIME as part of its consideration of incentive-based policies to attract FDI. The second section “Assessing FDI Incentive Policies: A Checklist” was released by CIME with the intention of providing policy makers with a tool against which to assess the usefulness and relevance of FDI incentive policies.

* The report was based on material assembled by Hans Christiansen, Principal Administrator, Capital Movements, International Investment and Services Division, OECD, reviewed and refined by CIME in the course of 2002 and 2003. The project received financial support from the UK Department for International Development.

Guiding Principles for Policies Toward Attracting Foreign Direct Investment

The present guiding principles originate from the OECD Committee on International Investment and Multinational Enterprise's 2001-2002 review of incentives-based competition for foreign direct investment (FDI).

The aim of policies for attracting FDI must necessarily be to provide investors with an environment in which they can conduct their business profitably and without incurring unnecessary risk. Experience shows that some of the most important factors considered by investors as they decide on investment location are:

- A predictable and non-discriminatory regulatory environment and an absence of undue administrative impediments to business more generally.
- A stable macroeconomic environment, including access to engaging in international trade.
- Sufficient and accessible resources, including the presence of relevant infrastructure and human capital.

The conditions sought by foreign enterprises are largely equivalent to those that constitute a healthy business environment more generally. However, internationally mobile investors may be more rapidly responsive to changes in business conditions. The most effective action by host country authorities to meet investors' expectations is:

- Safeguarding public sector transparency, including an impartial system of courts and law enforcement.
- Ensuring that rules and their implementation rest on the principle of non-discrimination between foreign and domestic enterprises and are in accordance with international law.
- Providing the right of free transfers related to an investment and protecting against arbitrary expropriation.
- Putting in place adequate frameworks for a healthy competitive environment in the domestic business sector.
- Removing obstacles to international trade.
- Redress those aspects of the tax system that constitute barriers to FDI.

- Ensuring that public spending is adequate and relevant.

The usage of tax incentives, financial subsidies and regulatory exemptions directed at attracting foreign investors is no substitute for pursuing the appropriate general policy measures (and focusing on the broader objective of encouraging investment regardless of source). In some circumstances, incentives may serve either as a supplement to an already attractive enabling environment for investment or as a compensation for proven market imperfections that cannot be otherwise addressed. However, authorities engaging in incentive-based strategies face the important task of assessing these measures' relevance, appropriateness and economic benefits against their budgetary and other costs, including long-term impacts on domestic allocative efficiency.¹ Authorities need also to consider their commitments under international agreements. The relevance and appropriateness of FDI incentive strategies should be examined at regular intervals. Transparency and accountability at all levels of governments greatly increases the success of such evaluations.

Investment incentives have effects beyond the jurisdiction that offers them, which need to be carefully considered. Some forms of competition among states for FDI may lead to sub-optimal results for all states, including waste of economic resources and social costs. OECD members and other countries adhering to the OECD Declaration on International Investment and Multinational Enterprises have undertaken commitments in this respect.² Under the instrument on International Investment Incentives and Disincentives, which is an integral part of the Declaration, they:

“... recognise the need to strengthen their co-operation in the field of international direct investment”;

“... recognise the need to give due weight to the interests of adhering governments affected by specific laws, regulations and administrative practices in this field providing official incentives and disincentives to international direct investment”;

*“... endeavour to make such measures as transparent as possible, so that their importance and purpose can be ascertained and that information on them can be readily available”.*³

Furthermore, in 1984 the OECD Council decided upon “... consultations in the framework of the Committee on International Investment and Multinational Enterprises at the request of a member country which considers that its interests may be adversely affected by the impact on its flow of international direct investment of measures taken by another member country which provide significant official incentives and disincentives to international direct investment... [T]he purpose of the consultations will be to examine the possibility of reducing such effects to a minimum.” (International

Investment Incentives and Disincentives, Second Revised Decision of the Council, May 1984.)⁴

Against this background the Committee has agreed on a Checklist for Assessing FDI Incentive Policies. The Checklist serves as a tool to assess the costs and benefits of using incentives to attract FDI; to provide operational criteria for avoiding wasteful effects and to identify the potential pitfalls and risks of excessive reliance on incentive-based strategies. The Committee also believe that careful evaluations of the Checklist and its application to considerations of investment incentives can have a positive effect in minimising potential harmful effects of incentives both for those that employ them and for other governments seeking to attract foreign investment.

OECD members furthermore consider that it is inappropriate to encourage investment by lowering health, safety or environmental standards or relaxing core labour standards. The OECD Guidelines for Multinational Enterprises, which are an integral part of the Declaration, state that enterprises should:

“... refrain from seeking or accepting exemptions not contemplated in the statutory or regulatory framework related to environmental, health, safety, labour, taxation, financial incentives, or other issues.”⁵

Notes

1. It is at the same time recognised that doing so can in practice be difficult and it requires resourceful and competent public agencies.
2. OECD members most recently reaffirmed their commitment at the 2000 *Review of the Declaration*.
3. Excerpts from Parts IV.1, IV.2 and IV.3 of the *Declaration on International Investment and Multinational Enterprises*, 27 June 2000.
4. Non-member adherents to the Declaration also adhere to the 1984 Decision.
5. The *OECD Guidelines for Multinational Enterprises*, Chapter II, paragraph 5.

Assessing FDI Incentive Policies: a Checklist

This article reproduces a document released by the OECD Committee on International Investment and Multinational Enterprises to assist national policy makers in deciding whether to apply FDI incentives. The document proposes a Checklist to assess the costs and benefits of using incentives to attract FDI, to provide operational criteria for avoiding wasteful effects and to warn against the pitfalls and risks of excessive reliance on incentive-based strategies.¹ It draws of a large body of analytical work undertaken by various parts of OECD, an overview of which is provided in Annex I. The Checklist has been developed, and needs to be considered, within the framework of the Committee's statement "Guiding Principles for Policies toward Attracting Foreign Direct Investment".²

The Checklist should not be read as an endorsement of the use of FDI incentives. It also represents a partial analysis in the sense that the viewpoint of individual jurisdictions is applied throughout. In other words, the Checklist focuses on such challenges and pitfalls as can be addressed by national or sub-national authorities acting on their own. This means that the important additional issue of competition between jurisdictions is left largely untouched. Whilst incentives competition may in some cases contribute to efficiency in the allocation of FDI, there are important risks that these benefits come at an excessive cost to the international community at large. The Guiding Principles for Policies toward Attracting Foreign Direct Investment acknowledge this risk. A similar position is taken by the social partners of the OECD, including in a recent policy statement by the Business and Industry Advisory Committee to the OECD (BIAC), which among other things opined that states should "... be cautious of fuelling an environment where FDI flows primarily to those countries with the 'deepest pockets'..."³

Moreover, the Guiding Principles also note that, even from an individual country viewpoint, incentive policies *per se* are hardly ever an optimal strategy for attracting FDI. A large body of evidence shows that investors are principally motivated by the quality a host country's enabling environment. Hence, policies to enhance macroeconomic stability, transparency, other elements of good governance, openness to trade, infrastructure and the levels of know-how in the domestic economy are all more potent tools for attracting investors. FDI incentives may in many cases at most tip the balance in favour

of one location among a group of economies that are perceived to have broadly equivalent enabling environments.

The organisation of the remainder of the article is as follows. Section I aims to establish a common ground as regards the practices that constitute FDI incentives and the outcomes that could be considered as positive or wasteful. Section II surveys and discusses the FDI incentive strategies and policy tools that are available to authorities. Section III lists some of the challenges and risks facing authorities involved in developing and implementing strategies for offering FDI incentives and synthesises the findings into a Checklist of operational criteria for policy-makers.

1. Incentives, competition and wasteful practices: what does it all mean?

Policy discussions of FDI attraction (and in many cases also the work of academic economists) tend to be fraught with confusion, largely due to an absence of a common language. Conceptually different notions such as strategies for FDI promotion, FDI incentives, policy competition and, even, bidding wars are in practice often used interchangeably. The result has been that crucial distinctions between beneficial and wasteful strategies, deliberate *versus* inadvertent resource reallocation, and legitimate self interest *versus* predatory practices have become blurred. The present introductory section aims to establish a few guiding principles for when to categorise FDI promotion strategies as “incentives”, “competition” and, crucially, “wasteful”.

1.1. FDI incentives

Policies of attracting internationally mobile investors have sometimes formally motivated targeted efforts at improving host countries’ enabling environments. Some countries have, for instance, employed particularly low corporate tax rates to attract foreign corporate presence (and induce domestic enterprises to stay). A range of other strategies has included preferential tariff regimes, the cutting of red tape, stepped-up investment in infrastructure and educational measures. Many of the latter have been targeted toward prioritised economic sectors (*e.g.* the high-tech strategies of South East Asia; the “auto regimes” of Latin America) and regions (not least in connection with “special economic zones”, “export processing zones”, etc.). Others have had as their purpose a general deepening of the capital stock through outright investment subsidies. Even though many such strategies rely for their success on a degree of foreign participation, they cannot be classified as FDI incentives.

FDI incentives, in the sense that they target or give preferential treatment to *foreign* investors, are by nature discriminatory. The definition of FDI

incentives proposed by the present document is the following: *Measures designed to influence the size, location or industry of a FDI investment project by affecting its relative cost or by altering the risks attached to it through inducements that are not available to comparable domestic investors.*⁴ Addressing policies to encourage private investment more generally is not the motivation of the present work.

Two categories of measures meet this definition, namely the so-called *rules-based approaches* that rely on discrimination (according to nationality) of investors to be stipulated by law, and *specific approaches* that tailor incentives to individual foreign investors or investment contexts. The rules-based approaches in many cases represent a relatively straightforward selective application of investment subsidies. Specific approaches, on the other hand, produce a multitude of different incentives, including specially negotiated fiscal derogations, grants and soft loans, free land, job training, employment and infrastructure subsidies, product enhancement, R&D support and *ad hoc* exceptions and derogations from regulations.⁵ The dividing line between the two categories is, however, in practice often blurred.

An important caveat relates to the practice of considering FDI incentives in isolation, since the definition of such incentives is necessarily narrow. In practice, authorities often offer incentives that are available to any enterprise not previously located in their host economy. Moreover, specific approaches are sometimes applied to enterprises already located in the host economy to encourage expansion and to discourage them from moving away. While such practices may not necessarily meet the strict definition of FDI incentives their effects are economically equivalent, and the policy challenges to which they give rise are in most cases the same.

1.2. Competition for FDI

It should be noted that the usage of FDI incentives in many cases does not imply competition between jurisdictions. Competition may be defined as situations in which authorities are induced to make available incentives or modify the FDI incentives they offer (*i.e.* by making them more generous) as a result of the incentive strategies pursued elsewhere. There would appear to be two separate, albeit interrelated, classes of competition. *Targeted competition* occurs where authorities attempt to attract individual FDI projects by means of outbidding the incentives of other jurisdictions. In doing so they normally apply specific approaches, although there have also been cases of legislation being adapted as part of a bidding process. *Regime competition* relates to the case where the overall generosity (or design) of a jurisdiction's FDI incentives is chosen in response to the incentives practices in place elsewhere. Importantly, regime competition has implications both for the design of rules-

based FDI approaches and for the amounts jurisdictions allow themselves to spend on pursuing specific approaches.

The application of FDI incentives does in most cases not involve targeted competition. It should, however, be noted that systematic and internationally comparable studies of FDI incentives are virtually non-existent, whereby any assessment must rely on case studies and anecdotal evidence. First, a fairly large share of the direct investment projects involving FDI incentives occur where investors have already formed a firm opinion of their preferred location. The issue of incentives thus mostly boils down to bilateral negotiations between investor and host authorities about how the level of risk and loss making (especially at the early phase of projects) can be diminished and about how to partition the difference between the corporate and social yield of the investment. Second, investors who have short-listed a few potential locations may shop around for the most attractive incentives packages, but the authorities of discarded locations generally do not chase the investment by topping up their incentives packages.

However, there have been cases of sharp targeted competition in recent decades. The incentives for authorities to bid against each other are particularly strong where the size of an individual project is large and where investors are relatively indifferent between alternative locations. Consequently, the bulk of the evidence of incentives competition relates to economies that are located within the same geographic area and have comparable factor endowments. Joint work by the Secretariat and the OECD Development Centre indicates that, while there are some documented cases of less developed countries being affected by direct FDI competition from mature economies, there is little evidence to suggest that this is a problem of more general concern.⁶

In some instances, targeted competition for FDI has risen to the level of veritable bidding wars, where jurisdictions not only compete, but continue raising their bids until the eventual incentives reach levels that would appear unfounded in economics. Studies have concluded that this occurs in industries where the project size is not only large, but where the expected benefits to the host economy are big enough to attract the attention of policy-makers. The benefits may come in a number of different forms, including job creation, future tax revenues and the generation of an improved (in many cases, high-tech) business environment. The bidding for such “trophy projects” appears to have been most intense in sectors such as automobiles, petrochemicals, electronics and information technology.⁷

Regime competition appears to be widespread across countries and jurisdictions. Survey responses and anecdotal evidence largely confirm that many of the jurisdictions that offer FDI incentives would prefer not to do so

and are concerned about the costs. In the words of one local politician “you can’t say no, but you can’t afford to say yes”.⁸ In a nutshell, most policy-makers feel that they would be unable to attract certain FDI projects if they did not offer an incentive package broadly as generous as the ones available elsewhere.

1.3. Wasteful strategies

The basic aim of a policy of FDI incentives (or any other strategy for attracting FDI) is to maximise the long-term benefits of foreign corporate presence. In doing so it must ensure that the benefits exceed the costs, and that the costs of achieving given goals are kept to their lowest feasible level.

The economic benefits of attracting FDI are generally twofold. First, countries with domestic savings so low that they are insufficient to finance a strategy of economic expansion (or where weak financial intermediation has a similar effect) may harness FDI as a source of external finance. This is assumed to be particularly relevant in the case of developing and emerging economies. Second, foreign corporate presence is, as demonstrated by an ample body of economic literature, generally associated with positive externalities (“spillovers”) toward the host economy.

The channels through which the spillovers operate are at least fivefold. Foreign corporate presence may 1) act as a trigger for transfers of technology and know-how; 2) assist enterprise development and restructuring, not least in connection with privatisation; 3) contribute to fuller international (trade) integration; 4) bolster business sector competition; and 5) support human capital formation in the host country.⁹ In the case of OECD countries, the first two channels are generally thought to be the most important ones. Indeed, the formal justification of many FDI incentives (“nurturing corporate clusters”, “enhancing business competences”, “attracting a pool of skilled labour”, etc.) implicitly assume that the technology-transfer channel is vigorous.

The presence (and magnitude) of such spillovers is of crucial importance if FDI incentives are to be economically justified. If spillovers were thought to be negligible, host country authorities would, in the absence of financing constraints, be better advised to pursue generic investment promotion policies.¹⁰ This observation is non-trivial for another reason: since externalities are generally thought to vary between economic sectors, FDI incentive policies will either have to discriminate between sectors as well, or take into account a certain amount of waste.

Based on the above, it appears that the criteria for characterising particular FDI incentives as being “wasteful” from the host country perspective have at least two dimensions. First, individual jurisdictions may pursue practices *vis-à-vis* investors that are inoptimal *per se*, or the

wastefulness may derive from the response to such practices by competing jurisdictions. Second, applying an inter-temporal perspective, a waste may occur up front, or it may derive from the way a given policy action influences the future “rules of the game”. The following individual criteria for wastefulness are proposed:

- *Ineffectiveness*. This is the basic case of wastefulness: the usage of FDI incentives fails to produce benefits to the host economy that exceeds the budgetary costs. This situation may arise where authorities apply faulty cost-benefit analysis (or no cost-benefit analysis at all) to their incentive programmes or where promised benefits do not materialise and conditions applied do not prevent reduced or non payment or recovery of incentives paid.
- *Inefficiency*. This is the case where incentives produce benefits that outweigh the costs, but authorities fail to properly maximise the benefits and minimise the costs. In other words, similar results might have been obtained at a lower cost, whereby the difference between the actual and the potential cost must be characterised as a waste.
- *Opportunity costs*. When the resources available to attract FDI are scarce, the issue of alternative usage of funds arises. Incentive schemes that are both effective and efficient may nevertheless be wasteful if the funds that are sunk into financing them could have been used more profitably.
- *Deadweight loss*. This term refers to the situation when:
 - ❖ Authorities find themselves subsidising investment projects that would, with the benefit of hindsight, have taken place in the absence of incentives.
 - ❖ Authorities fail to specify adequately the intended recipients and to circumscribe the application to that group only has resulted in spillover to non-target groups.
 - ❖ Authorities, in order to maintain a reasonably level playing field in their domestic business sector, feel obliged to match FDI incentives by offsetting subsidies to other enterprises.
 - ❖ Authorities, by offering particularly generous FDI incentives to some projects, effectively “raise the bar”, creating a reference point that future investors will use to demand a similar degree of generosity.
- *Triggering competition*. Long-term costs of an incentive scheme include the economic burden that arises if other jurisdictions put in place matching measures. This is of particular concern when putting in place new measures or significantly increasing the generosity of the ones already in place. Doing so without properly assessing the likely reactions of other jurisdictions can in many cases amount to a wasteful practice.

2. Choices, tools and pitfalls for policy makers

2.1. The strategies

When assessing the effect and appropriateness of FDI incentives, the position of investors and policy-makers need to be taken into account. As for investors, an array of possible motivations for investing presents the implementing authorities with multiple challenges – and with multiple risks of “getting it wrong”. Many of these are dealt with in detail in the later sections. Regarding the position of policy-makers, at least two dimensions should be considered. First, it matters greatly whether incentive schemes are operated by national or sub-national jurisdictions – *e.g.*, as is increasingly the case, by municipal authorities. Second, the purpose or policy goal that is being pursued through the FDI incentives differs greatly among host locations, not least according to their state of economic development, which may have important implications for an assessment of the value of the incentives. A few special cases are proposed below. (Most investment incentives do in actual practice involve an element of mixed strategies including several individual goals.)

- *Broadly-based FDI incentives.* Authorities may develop a simple strategy aimed at employing FDI incentives to raise the attractiveness of their host economy beyond what can be achieved by improving the quality of the enabling environment. Two distinct categories present themselves:
 - ❖ Proactive policies aimed at attracting foreign investors in general. Such strategies may aim at topping up or compounding the general advantages of the host economy’s enabling environment, for instance by making relocation easier and less costly or by seeking to cover the initial loss-making period of an investment.
 - ❖ Defensive strategies with their scope generally limited to matching the generosity of investment incentives on offer elsewhere.
- *Targeted strategies.* Most strategies for attracting FDI by means of incentives are limited in scope, in the sense that they focus on specific aspects of the host economy. The following four types of strategies appear to be commonplace:
 - ❖ Regionally oriented strategies aimed at attracting foreign enterprises to economically depressed areas or in response to the closure of another plant. National authorities may devise such strategies, or sub-national authorities may enjoy (or be granted) sufficient freedom to pursue them on their own.
 - ❖ Developing prioritised activities. One of the main examples of such strategies is the setting up (and, in the case of FDI incentives,

subsidisation) of export processing zones with the purpose of integrating the host economy close with international trade.

- ❖ Building on particular advantages. The classic example would be the attraction of labour-intensive industries to countries with an abundant workforce. Many countries have also successfully employed FDI for developing particular service activities such as tourism.
- ❖ Nurturing selected sectors. Some countries and regions attempt to use FDI as a tool for implanting whole new sectors where they have no history or of developing “priority industries” in sectors where they were not previously thought to have particular advantages. This strategy has for instance been applied to the high-tech industries and certain high-value segments of the service sectors but also in high added value projects perceived as desirable (e.g. machine tool-making, precision engineering).
- *Improvisation*. Not all FDI incentives are granted as part of concrete or targeted programmes. In fact, it has been observed that some of the most strongly publicised examples of FDI incentives relate to cases where – owing largely to the sheer magnitude of the investment projects – there was a high degree of improvisation on the part of the host area authorities.

2.2. The tools

FDI incentives are commonly divided into three categories, namely fiscal, financial, and regulatory incentives, all of which are financed (or, in the case of regulatory incentives, offered) by authorities in the host area.

The so-called **regulatory FDI incentives** are policies of attracting foreign-owned enterprises by means of offering them derogations from national or sub-national rules and regulation. While authorities may in principle choose to derogate from any regulatory practice, the onus has in practice been on easing the environmental, social and labour-market related requirements placed on investors. Such incentives are almost exclusively granted in connection with targeted strategies, or they are specially negotiated as part of the “improvised” strategies for luring large individual investment projects. It should, however, be noted that the evidence of such practices is sparse, anecdotal, and largely confined to specific sectors in non-OECD countries.

Policies of offering **financial FDI incentives** are often formally motivated by one of three considerations. First, a host area (or a site within the host area) may be perceived as being disadvantaged relative to comparable sites elsewhere, e.g. because of the stage of development in that area. In this case authorities often argue in favour of a targeted effort at assisting investors, which is construed as a policy of levelling the playing field. Such so-called “site equalisation outlays” are in many cases largely generic or available to all

companies that wish to invest in a given area, in which case they can not be considered as FDI incentives. However, the specific investment packages negotiated between authorities and, in particular, large foreign investors have often included elements such as:

- *Infrastructure subsidies.* One of the preferred ways of increasing the attractiveness of a site (or an area more generally) is by providing physical infrastructure (roads, railways, harbours) or communication tailored to meet the needs of the investors.
- *Job training subsidies.* In many cases – and particularly when investment is sought in activities that are new to the host economy – investors are faced with a shortcoming of qualified labour that authorities offer to alleviate through public or publicly-supported education programmes.

Second, authorities often argue that the costs that enterprises incur when relocating, or establishing new subsidiaries at a distance from previous sites, may hold them back from choosing the most suitable locations. According to this reasoning, it is advisable for the would-be host authorities to offer a subsidy toward meeting the relocation costs. This class of financial incentives includes:

- *Relocation and expatriation support.* Authorities may offer grants to help meet enterprises' additional capital spending and concrete relocation costs. In some cases, host country authorities also contribute toward individual members of staff's removal costs, as well as family-related expenses of expatriate members of staff.
- *Administrative assistance.* Authorities may resort to implicit subsidisation, whereby for example investment promotion agencies (IPAs) take upon themselves, as part of their competitive client service approach, to perform a range of tasks that would otherwise have fallen on the investing enterprises. Examples include preferential treatment by regulatory authorities whereby administrative impediments – such as for example the speed of obtaining permissions – are eased.
- *Temporary wage subsidies.* The start-up phase can be further supported through the temporary coverage of part of the new corporate unit's wage bill.

Third, in addition to the above two categories of FDI incentives that are generally justified by the wish to correct market imperfections and overcome transaction costs, authorities may attempt to simply reap the supposed externalities of foreign corporate presence through a policy of targeted incentives. (This applies equally to the fiscal incentives listed below, many of which are quite “blunt” and unsuited to address specific market failure.) However, since political constraints generally compel host authorities not to be perceived as handing out gifts to foreign-owned enterprises, such subsidies

tend to be tied to specific activities by investors that it seems opportune for authorities to encourage. Examples include:

- *Credits to investors.* Authorities may choose to grant soft loans or interest subsidies to foreign enterprises for the specific purpose of an investment project. Alternatively, they may ease investors financing costs by issuing loan guarantees.
- *Real estate.* There are many cases of national or local authorities selling land or buildings to foreign investors at below market values. Insofar as the real estate was not previously used, such practices are being seen by many as a virtually cost-free way of promoting investment (whereby the opportunity costs are being ignored).
- *Cost participation.* In addition to helping investors cover their start-up costs, authorities sometimes go in for the “longer haul”. In return for an opportunity to affect investors’ business dispositions, they may contribute toward marketing and developing costs and even, in some cases, ordinary operating costs. Cost participation may be direct, or it may be given indirectly via the suppliers of goods and services to the investor.

Various studies have concluded that the most commonly used inducements are **fiscal FDI incentives**. This particularly applies to non-OECD member countries, which have limited funds available for financial incentives.¹¹ Where fiscal measures are used to attract FDI into OECD countries they usually take the form of rules-based approaches, since changes in taxation in most cases require legislative action.¹² More specifically, and recalling that incentives are often offered jointly as a complex “package”, a representative list of individual fiscal incentives that are currently being offered by some jurisdictions includes:

- *Reduced direct corporate taxation.* General measures aimed at easing the corporate tax burden are used to attract foreign direct investors. These include:
 - ❖ Reduced rates of corporate income tax. Whereas a general lowering of corporate tax rates relates to the enabling environment for investment, some jurisdictions have targeted such measures at incomes from specific sources, or at income earned by non-resident investors alone.
 - ❖ Tax holidays. Under a tax holiday, qualifying “newly-established firms” are not required to pay corporate income tax for a specified time period. A variant is to provide that a firm does not pay tax until it has recovered its up-front capital costs.
 - ❖ Special tax-privileged zones. The creation of “ring-fenced” areas with low rates of corporate taxation amount to fiscal FDI incentives in the cases

where foreign-owned enterprises enjoy privileged access to operate in such zones.

- *Incentives for capital formation.* Policies of tying lower taxation to corporate investment are used by many jurisdictions as a way of conjointly attracting foreign enterprises and providing them with incentives to invest. The examples include:
 - ❖ *Special investment allowances.* Under such allowances, firms are provided with faster or more generous write-offs for qualifying capital costs. They may take the form of accelerated depreciation or enhanced deductions.
 - ❖ *Investment tax credits.* Such tax credits are earned as a percentage of qualifying expenditures and offset against taxes otherwise payable.
 - ❖ *Reinvested profits.* Some jurisdictions offer deductions or tax credits against profits that are reinvested in the host economy.
- *Reduced impediments to cross-border operation.* Companies are attracted to locations where the fiscal system imposes minimal costs on the cross-border transfer of funds, goods and services and manpower. Some of the incentives on offer are:
 - ❖ *Withholding tax.* Some countries offer foreign-owned enterprises reduced rates of withholding tax on remittances to their home countries.
 - ❖ *Taxation of foreign trade.* Reduced import taxes and customs duties (and in some cases export taxes) are sometimes used as FDI incentives – for instance where export processing zones are not accessible to domestic enterprises.
 - ❖ *Taxation of employees.* Lower personal income tax or social security reductions for expatriate executives and employees are used to make locations more attractive to foreigners.
- *Other tax reductions.* The selective lowering of any tax rate affecting the enterprise sector may be used to attract foreign enterprises. Currently, some jurisdictions use lower sales taxes and VAT reductions as an incentive; others offer foreign-owned enterprises property tax reductions. An interesting special case relates to a practice in some non-OECD countries of offering foreign-owned enterprises the option of choosing a lump sum payment in lieu of taxes, with the purpose of providing them with incentives to boost their economic activity in the host economy.¹³

3. Challenges for policy makers: a checklist

The previous sections have drawn up a quite complex matrix of potential benefits, but in particular also costs and pitfalls that policy makers embarking on an FDI incentive strategy need to take into account. Precisely because of the

complexity of the issues and the trade-offs between competing objectives, great caution is called for when, or if, FDI incentives are put in place. At a minimum it would appear recommendable that one coherent and encompassing policy should be developed in each jurisdiction. The authorities drawing up such a policy need to be well placed to take into account not just the process of attracting foreign investment, but also the overall budgetary and regulatory implications and the role of foreign direct investment in business sector development more generally.

Once policy-makers have agreed on their preferred strategies for FDI attraction, the design of the appropriate policies presents them with a further array of complex choices. Hence, to avoid negative outcomes policies guiding FDI incentives should be anchored in a strategy spelling out the measurable objectives to be pursued. (This is important not just for the sake of policy coherence, but also because the economic benefits of FDI tend to occur gradually and can be hard to verify.) By tying the incentive policies to a set of verifiable objectives, their efficiency – or wastefulness – becomes easier to evaluate. Furthermore, strategies would need to be developed with due regard to the funds available for their implementation, whereby their formulation is intrinsically linked with the budgeting process of the implementing jurisdiction.

The following subsections list some of the most crucial policy choices that need to be made and proposes operational criteria against which the relevance, quality and coherence of a policy framework can be assessed. Again, the purpose of the listing is not to recommend or prescribe courses of action. Rather, the intention is to alert policy-makers to some of the questions that present themselves when a jurisdiction embarks on a policy of offering FDI incentives. The criteria fall into six broad categories, namely *a)* the desirability and appropriateness of offering FDI incentives, *b)* frameworks for policy design and implementation; *c)* the appropriateness of the choice of strategies and policy tools; *d)* the design and management of individual programmes; *e)* transparency of procedures (*i.e.* evaluation, monitoring and follow-up); and *f)* assessing the extra-jurisdictional consequences of FDI incentive strategies.

3.1. The desirability and appropriateness of offering FDI incentives

Question 1: Are FDI incentives an appropriate tool in the situation under consideration?

Incentives are hardly ever a first-best option. Significant improvements of the enabling environment for investment (e.g. the removal of undue impediments and improvement of regulatory frameworks) can often be achieved at a low budgetary cost and should be considered.

Question 2: Are the linkages between enabling environment and incentives sufficiently well understood?

Where shortcomings in the enabling environment cannot be addressed in the near term authorities may perceive a need to rely on incentives. However, unless the incentives go some way toward correcting the concrete shortcomings, their impact on investors is uncertain.

In formulating an FDI attraction policy, authorities should start by developing a realistic view of what can, and can not, be achieved. As mentioned earlier, FDI incentives are no substitute for an attractive enabling environment for foreign direct investment. Where, as is usually the case, investors are attracted by risk-adjusted expected returns, any effort at improving the business climate or reducing risk may potentially have a similar, or larger, impact on investment than incentives. There is a danger that the practice of offering FDI incentive policies may even distract policy makers' attention from more relevant policies toward improving the business climate.

Furthermore, if a need to top up the enabling environment is perceived, it is often better met through general investment promotion strategies than FDI incentives. A policy of offering incentives selectively to foreign enterprises carries considerable risk of hurting rather than improving the domestic business environment.¹⁴

3.2. Frameworks for policy design and implementation

Question 3: What are the clear objectives and criteria for offering FDI incentives?

The relevant authorities need to establish what FDI incentives are meant to achieve, and how. In the absence of sufficient clarity about this, evaluation of the appropriateness and effectiveness of policies is impossible.

Question 4: At what level of government are these objectives and criteria established, and who is responsible for their implementation?

It should be made clear within each jurisdiction who is ultimately responsible for the formulation of policies. Other public bodies involved in the design and implementation of FDI incentives should then be accountable to this authority.

Question 5: In countries with multiple jurisdictions, how does one prevent local incentives from cancelling each other out?

Competition between jurisdictions may lead to efficiency gains when founded in genuine efforts to improve the business climate. However, a purely competitive subsidisation of enterprises often has the opposite effect. In the latter case, central authorities may have the option of encouraging co-operative arrangements between jurisdictions.

National authorities (or the lowest 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 lower 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.

The actual implementation of FDI promotion activities is in most cases left to specialised IPAs, which often enjoy a high degree of autonomy and are supervised directly by domestic policy makers.¹⁵ 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 creating clarity and building support for the government's strategies.

It may, however, be difficult in practice to hold policy implementation to such high standards. In some cases, the management of incentive programs 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.

3.3. The appropriateness of strategies and tools

Question 6: Are the linkages between FDI attraction and other policy objectives sufficiently clear?

A host of policies bear on regional and sectoral developments. It is important to ensure that FDI incentives are not granted in a way that conflicts with other objectives.

Question 7: Are effects on local business of offering preferential treatment to foreign-owned enterprises sufficiently well understood?

Policy-makers' choice will be guided by a joint assessment of the relative benefits of FDI over other sources of investment, the efficiency losses from discrimination and the budgetary costs of non-discrimination.

Question 8: Are FDI incentives offered that do not reflect the degree of selectiveness of the policy goals they are intended to support?

For instance, a jurisdiction with limited resources may be tempted to attract investment by means of fiscal concessions. It would need to consider the fact that such incentives are not particularly well suited to the pursuit of specific economic or regional strategies.

Question 9: Is sufficient attention given to maximising effectiveness and minimising overall long-term costs?

There is a risk of relying excessively on incentives that have little budgetary impact in the near term, while neglecting their longer-term effects. Also, the non-economic costs of most regulatory incentives need to be given proper consideration.

One of the most fundamental strategic choices facing policy makers offering FDI incentives does, as also mentioned in section a, relate 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 an 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 comparatively general strategies would normally be

more concerned than others about the budgetary cost of making investment incentive schemes generally available.

- 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.

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 compensation investors for structural disadvantages. 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.

3.4. The design and management of programmes

Question 10: Are programmes being put in place in the absence of a realistic assessment of the resources needed to manage and monitor them?

Even well-designed programmes may falter if adequate administrative resources are not available. FDI incentive strategies are unlikely to succeed unless the implementing authorities acquire top-level business expertise and develop sufficient capability to make quick decisions without compromising their analysis.

Question 11: Is the time profile of incentives right? Is it suited to the investment in question, but not open to abuse?

Investors' preference for front-loaded schemes has to be assessed against background of the nature and likely duration of their involvement in the local economy. While authorities will want to signal their long-term commitment, they need to guard themselves against predatory practices.

Question 12: Does the imposition of spending limits on the implementing bodies provide adequate safeguards against wastefulness?

Spending limits may include effectiveness targets (e.g. maximum spending per dollar of investment or per expected new job), a ceiling per project and a total annual budget. However, it is not always clear how effective such spending limits are in curbing waste due to inefficiencies and opportunity costs. They have to be supplemented by evaluation tools (including cost-benefit analysis).

Question 13: What procedures are in place to deal with large projects that exceed the normal competences of the implementing bodies?

Standard procedures may have to be drawn up, including a prior agreement on what branches of the executive should be involved, and what minimum level of analysis they should be expected to perform. Also, it should be decided at what point and to what degree that elected officials are to be involved in the process.

Question 14: What should be the maximum duration of an incentive programme?

Fixed duration allows for a regular evaluation of programmes assessing their continued relevance, thereby reducing a risk that FDI incentive programmes are kept alive due to administrative or political inertia. Factors such as the political cycle, the sectoral specifics of investors and the time horizon for the development of a given locality may have to be taken into account.

Minimising the deadweight loss (as indicated above this denotes the risk of paying subsidies toward 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 deadweight losses than measures that can be applied subject to discretion. However, risk of the latter contributing to deadweight losses as well may increase over time. A jurisdiction that has a history of offering generous FDI incentives finds it difficult to deny new foreign investors a similar degree of generosity.

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.

Authorities may also choose to couple the offering of front-loaded incentives with demanding 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.

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.

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 programs. In particular:

- Incentive programs 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.

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.

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.

3.5. Transparency and evaluation

Question 15: Have sound and comprehensive principles for cost-benefit analysis been established?

Cost-benefit analysis should be applied not only to individual projects, but also taking into account the overall FDI policy context. A commonly accepted methodology for cost-benefit analysis could be established and applied throughout, or alternative methods be used depending on regional and sectoral specifics. Common standards would probably have to be applied to the valuation of non-budgetary costs and benefits.

Question 16: Is cost-benefit analysis performed with sufficient regularity?

Cost-benefit analysis should preferably be performed both prior to investment projects and after a period of time. In order to ensure compliance, formal reporting requirements may have to be imposed.

Question 17: Is additional analysis undertaken to demonstrate the non-quantifiable benefits from investment projects?

A host of national strategies for attracting FDI are formally justified by the presence of non-quantifiable benefits (*e.g.* spillovers). If strategies are to be maintained over time, authorities should therefore be expected to provide *ex post* evidence of such benefits. The analysis could include a whole range of indicators, such as the likelihood of linkages with local business, the impact on value chains and the “quality” of employment.

Question 18: Is the process of offering FDI incentives open to scrutiny by policy-makers, appropriate parliamentary bodies and civil society?

Implementing authorities have incentives to sub-optimising – for instance by measuring success by the number of investment projects they attract. – so a sufficient degree of transparency around their activities must be safeguarded. Agents such as national audit courts, academics and industry itself could be involved in order to raise public and political awareness.

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.

The relevant authorities need to 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.

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

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:
 - ❖ 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 programs.

- ❖ 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 programs.
- ❖ 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.

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.

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 even give rise to corruption or bribery.

3.6. Extra-jurisdictional consequences

Question 19: Have authorities ensured that their incentive measures are consistent with international commitments that their country may have undertaken?

Certain types of incentives (notably regulatory ones) may be limited by international agreements. International commitments not directly linked with investment may nevertheless have repercussions for FDI incentives.

Question 20: Have authorities sufficiently assessed the responses that their incentive policies are likely to trigger in other jurisdictions?

There is a risk that pro-active steps toward subsidising FDI will lead to bidding wars with other jurisdictions. This risk could be particularly large where large individual projects and the ad-hoc pursuit of specific FDI approaches are involved.

The risk of triggering retaliation needs to be carefully assessed. Individual authorities are unable to take action by themselves to avoid potentially wasteful bidding wars. However, they need to take into account the responses their planned policy action is likely to trigger elsewhere. If, for instance, the predictable outcome of raising the generosity of a given FDI incentive scheme is a bout of offsetting increases in other jurisdictions then the rise will almost certainly have to be considered as wasteful. This consideration applies to all kinds of FDI incentives, but with regime competition apparently pervasive and of long duration, authorities main point for caution should arguably be the ad-hoc application of specific approaches. Some federal states have taken steps to limit the risk of such outcomes within their domestic economy. One example is Canada, the experiences of which are summarised in the text box.

Policy-makers have sometimes found that the offering of incentives invites legal challenges because the policies may be considered to be contrary to either national law or international obligations such as the WTO agreement.¹⁶ In addition, the discriminatory nature of FDI incentives implies that they may effectively distort competition, which may bring them in conflict with competition legislation and, hence, bring them under the scrutiny of national or super-national competition agencies. The most widely quoted example of disciplining investment incentives as an aspect of competition policy is the EU's rules on state aids. Articles 87, 88 and 89 of the Treaty of the European Community prohibit or limit financial or fiscal support by a government to a firm, industry or region, and in so doing limit the measures that states may use to encourage inward investment.

A special case relates to regulatory incentives. The consensus view is developing that such incentives should not be used for targeted FDI attraction, for the risk of contributing to what has been phrased “race to the bottom” and “regulatory freeze” scenarios. Such practices are discouraged by international investment policy instruments, including the OECD Declaration on International Investment and Multinational Enterprises. NAFTA’s Article 1114, for instance, includes language effectively proscribing many kinds of regulatory incentives.¹⁷

Box 1. 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.

Notes

1. FDI incentives include tax and other fiscal inducements, financial subsidies and derogations from regulation offered to foreign-owned enterprises with the purpose of making them invest.
2. An overview of other work prepared for the Committee in relation to FDI incentive policies is provided in the last section of this document.
3. "Investment: BIAC Position on Incentives", Statement by BIAC, 5 November, 2002.
4. This draws on a generic definition of investment incentives proposed by UNCTAD (1994), World Investment Report.
5. For an overview of the anecdotal evidence, see C. Oman (2000), *Policy Competition for Foreign Direct Investment*, OECD Development Centre.
6. The few cases that were documented related to countries with a relatively similar factor endowment to the mature economies, which are situated in geographic proximity to the countries with which they have found themselves in competition.
7. Examples are provided by T.H. Moran (1998), *Foreign Direct Investment and Development: The New Policy Agenda for Developing Countries and Economies in Transition*, Institute for International Economics, Washington DC. A recent further illustration is the investment car manufacturers in Central Europe, which have reportedly in some cases involved FDI incentives exceeding USD 200 000 per job created.
8. Stephen Goldsmith, Mayor of Indianapolis as quoted in J. Schwartz and T. Barret, with F. Washington, B. Fisher, and L. Rodado (2001), *Can You Top This?*
9. For a discussion, see OECD (2002), *Foreign Direct Investment for Development: Maximising Benefits, Minimising Costs*.
10. This observation is developed by M. Blomström, "The Economics of FDI Incentives" in OECD (2002), *International Investment Perspectives*, Vol. 1.
11. Other cases relate to countries in which authorities have a comparatively high degree of discretion in their application of corporate tax rules.
12. For a thorough discussion of fiscal incentives, see OECD (2001), *Corporate Tax Incentives for Foreign Direct Investment*, OECD Tax Policy Studies, No. 4.
13. A more limited scheme that may be characterised mainly as a transparency-building measure is Chile's practice of offering foreign-owned enterprises a pre-announced corporate tax rate to be held constant over the medium term.
14. This is especially a problem where there are plenty of potential investors in the domestic economy. Conversely, where domestic investors are scarce investment incentives can be made generally available at little or no additional budgetary cost.
15. 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.
16. No part of the WTO agreement bears directly on investment subsidies. However, the Agreement on Subsidies and Countervailing Measures prohibits subsidies contingent upon export performance and subsidies contingent upon the use of domestic over imported goods, which has in some cases curtailed investment incentives. Moreover, the WTO Agreement on Trade-Related Investment Measures

disciplines the performance requirements that are sometimes imposed in tandem with the offering of investment incentives.

17. The Article stipulates that "... it is inappropriate to encourage investment by relaxing domestic health, safety or environmental measures. Accordingly, a Party should not waive or otherwise derogate from, or offer to waive or otherwise derogate from, such measures as an encouragement for the establishment, acquisition, expansion or retention in its territory of an investment of an investor."

ANNEX 1

Recent OECD Work in the Area of FDI Incentives: an Overview

This Annex summarises the main distinctive findings of papers discussed at the Committee's "stocktaking exercise" in September 2001 and subsequent pieces of analytic work that have addressed the issue of FDI incentives. The following subsections are organised according to the chronology of the contributions. The overview of the findings is indicative rather than exhaustive of the large body of work undertaken by several OECD bodies in the area of investment incentives. The mentioning of work that has been reviewed and derestricted by the Committee commences by the word CIME in square brackets.

1. The CIME stocktaking exercise

1.1. General studies

[CIME] A consultant paper prepared by **Professor Magnus Blomström** discusses the overall pros and cons of offering FDI incentives.¹ It argues that the use of investment incentives focusing on foreign firms is not a recommendable strategy. The main argument in support of this is that the strongest theoretical motive for financial subsidies to inward FDI tends to be external effects such as spillovers of technology and human capital, which do not follow automatically from foreign direct investment. In other words, it is not clear that FDI has an advantage over other kinds of investment. Also, the quality of the enabling environment for investment – which affects a country's ability to attract FDI, and to benefit from it – is equally important to domestic investors. Hence, rather than proposing narrowly defined FDI policies, attractive terms to investors should be seen as part of a country's overall industrial policy and be available on equal terms to all investors, foreign as well as domestic. Incentives should, following the same logic, focus on those

activities that create the strongest potential for spillovers, including linkages between foreign-owned and domestic firms, education, training and R&D.

A report by Charles Oman of the **OECD Development Centre** emphasised the developmental impacts of FDI incentive policies.² It observes that, while there has been a global increase in FDI incentives as barriers to investment have fallen, most incentives-based competition remains intra-regional. The report draws the policy conclusion that it can be counterproductive and very costly for a government to offer investment incentives if the “fundamentals” of the potential investment sites fail to meet serious investors’ basic requirements. In fact, many of the government that have been successful in attracting FDI are also among those that best meet the requirements for good governance. Moreover, while governments often formally justify FDI incentives with a need to steer corporate investment to poorer areas within the host economy, it appears that in practice incentives are of limited effectiveness in this regard. The report recommends a broad reform of policy-making including regulatory reform, privatisation and liberalisation of trade policies (external as well as internal) as a key element in a developing country strategy to attract FDI. It further highlights the need to raise levels of accountability and transparency to limit the risk of illicit practices developing in connection with investor attraction strategies.

1.2. Fiscal incentives

A report by the **OECD Centre for Tax Policy and Administration** reviews various types of corporate tax incentives for FDI and debated some of the arguments that are often advanced for their use.³ The report considers the role of corporate taxation in a country’s tax mix, reviews the likely channels of influence of main tax incentive types and surveys empirical evidence of the sensitivity of investment to host country tax burdens. While the report stops short of policy recommendations, it nevertheless applies a cautionary view on incentives. First, it is far from clear that “general” incentives like corporate tax concessions can be used to address specific market imperfections. Second, it notes that a paucity of information in general – and not least as regards the incremental impact of tax incentives on investment decisions – makes authorities decide about tax strategies amid great uncertainty. Third, the choice of alternative tax incentives is found to be strongly dependent on specific country circumstances. For example, the findings in the report call for caution in the use of up-front tax incentives, particularly if the basic statutory corporate income tax rates in the host economy are relatively high, and if refund provisions are offered.

1.3. Regulatory incentives

[CIME] A paper provided by **Dr. Valpy Fitzgerald** reviews recent evidence relating to FDI incentives in the regulatory domain.⁴ The key issue addressed in this paper is whether competition between host countries on the basis of their regulatory regimes has any effect on the level and “quality” of inward FDI and whether such competition leads to a welfare loss to that country or internationally. The paper finds ambiguous evidence regarding the existence, effect and consequences of regulatory competition for FDI. Importantly, there is little systematic evidence in literature of a “regulatory race to the bottom” and, more generally, there appears to be no robust indication that environmental or labour standards are negatively associated with investment inflows. Conversely, while anecdotal evidence indicates that investors may be increasingly attracted to host countries with high social and environmental standards (i.e. a potential “race to the top” scenario), there is little solid research to substantiate this either.

A report published by the **OECD Directorate for Education, Employment, Labour and Social Affairs** focusing on international trade and core labour standards includes sections about the impact of FDI.⁵ The report concludes that there is no robust evidence that countries with low labour market standards provide a haven for foreign-owned firms. This finding is further supported by the fact that a sharply increasing share of FDI flows to the service sectors and affects employees with better-than-average work conditions. On the specific issue of export processing zones the report notes that national labour and industrial relation legislation is applicable to companies on the zones. However, there are some examples to the contrary, such as zones where collective bargaining and industrial action are proscribed. These zones appear to be mainly attracting investors who depend on cheap labour and move very easily to new locations. Hence, the selective lowering of labour market standards would not appear to be a sound strategy toward FDI-backed longer-term economic development.

A paper prepared for the Environmental Policy Committee’s **Working Party on Global and Structural Policies** provides a comprehensive literature review of the environmental implications of competition for investment.⁶ The paper takes stock of some existing evidence that a “race to the bottom”, “pollution havens” and “regulatory freeze” may be possible, particularly in certain resource intensive sectors, but concludes that systematic empirical evidence is still lacking. Some evidence is actually to the contrary. The private sector has in many cases showed an unwillingness to invest in countries with particularly lax environmental laws and standards, because the cost of environmental compliance is limited whereas the reputational cost of benefiting from low standards abroad can be considerable. Designated areas

for FDI such as export processing zones do, according to the paper, rarely offer lower environmental standards than elsewhere in the host economy. In some cases they even strive toward higher standards as a way of attracting highly skilled staff.

1.4. Disciplining FDI incentives

A paper prepared for the **Working Party of the Trade Committee** examines the degree to which multilateral and regional trade agreements may act to prohibit, limit or moderate the use of incentives to attract FDI.⁷ The paper surveys the following agreements: 1) the WTO Agreement on Subsidies and Countervailing Measures, which prohibits those specific subsidies that distort trade; 2) the State Aid provisions of the EU, which ban forms of governmental support that may be argued to distort competition; 3) the North American Free Trade Agreement, which restricts the use of regulatory incentives and limits the ability of governments to impose performance requirements; and 4) the APEC Non-Binding Investment Principles, where members have agreed not to reduce regulatory standards on health, safety, or environment as a means of attracting investment. However, the paper concludes that with the exception of the EU regime on state aids, no agreement imposes direct disciplines on the granting of investment incentives. Moreover, few international disputes have to date challenged an FDI incentive programme, which may be taken to indicate that the present rules are not particularly wide-ranging (or that it is difficult to successfully state a claim under them).

A paper prepared for the Committee on Competition Law and Policy's **Working Party No. 2 on Competition and Regulation** included sections dealing with "subsidies that affect location decisions".⁸ The paper cautions against trying to discipline investment incentives on the grounds that a degree of subsidised-based competition may produce efficiency gains. According to this line of argument, the presence of investment incentives ensure that the jurisdiction that expects the greatest economic benefits from a given investment project is free to secure it by topping the incentives of competing jurisdictions. However, as also noted by the paper, this finding is preconditioned on firms being mobile and incentives not discriminating on the basis of nationality. Against this background the paper advocates the use of generally available investment subsidies rather than particular FDI incentives.

2. Subsequent work on investment incentives

[CIME] A joint questionnaire exercise by the **OECD and WAIPA Secretariats** has assessed the degree to which developing countries compete for FDI by means of incentives, against each other and against the most highly

developed economies.⁹ The paper concludes that while many developing countries engage in either proactive or defensive incentive strategies aimed at attracting FDI in competition with other locations, there are few cases of them being in direct competition with developed economies. Competition mostly occurs within geographic regions and where countries are on comparable levels of economic development, which limits the scope for direct competition between mature and developing economies. Moreover, the cases of particularly sharp competition for individual investment projects appear to be limited to a few economic sectors – notably car production. [Forthcoming on OECD website.]

A recent study by the **OECD Development Centre** focuses on the policy concerns (and potential benefits) that arise from cross-border or cross-jurisdictional incentives-based competition.¹⁰ It develops a two-dimensional framework in which the discussion of potentially wasteful incentives is expanded to cover the international as well as the national dimension. The paper finds that competitive pressures between jurisdictions are in many cases a significant determinant of the generosity of investment incentive packages. However, it also observes that it is difficult to assess whether – or in what cases – the efficiency gains from competitive bidding outweigh the cost of such practices to the international system. Policy makers may nevertheless wish to put mechanisms in place to guard their jurisdictions from the possibility of sub-optimal outcomes. The paper develops a set of policy conclusions along two lines, by examining the contributions that policies of increased transparency and of a more formalised co-operation between jurisdictions can make toward minimising the downside risks.

A consultant paper prepared by **InSites Investment Counsellors** (parts of which were used as a starting point for the Committee's Checklist) addresses a range of issues related to investment incentives from a practitioner's viewpoint.¹¹ The paper reviews a large body of anecdotal evidence from some of the most highly developed OECD countries. It argues that an increasing number of investment projects put one large investor in a quasi-monopolistic position *vis-à-vis* a fragmented community of host locations. Moreover, it cites a large number of representatives and investors who consider that the scale of investment incentives is presently excessive and uses this in support of the argument that they (the incentives) have reached a level where they put the efficiency of capital allocation at risk. The paper furthermore proposes some cross-country approaches that could be applied to curb "harmful" FDI incentives. It recognises the usefulness of increased transparency in this respect, but argues that co-operation between jurisdictions probably needs to be taken further. In particular, the paper argues that policy makers should seek to agree on a "statement of basic principles" on international investment policy. It proposes a series of commitments regarding international

investment incentives, notably: the principle of transparency; the principle of non-discrimination (including national treatment and MFN); rolling back the offering of “the most harmful types of FDI incentives”; and refraining from using “harmful regulatory incentives”.

A policy statement by **BIAC** makes public views held by members of the business community.¹² The statement observes that most companies would prefer a world without investment incentives where all competition between locations would be on the basis of the quality of enabling environments – *inter alia* because incentives imply a degree of discrimination among enterprises. The policy statement acknowledges a risk of fuelling an environment where FDI flows primarily to countries with “the deepest pockets” and warns again a situation in which smaller countries could be disadvantaged because of their inability to offset and absorb start-up losses from FDI. However, BIAC also notes that investor attraction depends on a complicated policy mosaic and that the focus of the discussion should therefore be much broader than the isolated issue of incentives. The following policy recommendations are proposed to national authorities as a means of safeguarding against negative outcomes. FDI incentives should be: generally available; non-discriminatory; transparent; in proportion to the expected benefits; clearly causal or closely linked with the actual investment; non-trade distorting; oriented toward long-term investment; temporary; and rooted in a coherent business model.

Notes

1. Magnus Blomström (2001), “The Economics of International Investment Incentives”, Stockholm School of Economics [www.oecd.org/pdf/M00037000/M00037957.pdf]. Professor Blomström’s work received financial support from the UK’s Department for International Development.
2. Charles Oman (2000), “Policy Competition and Foreign Direct Investment”, OECD Development Centre, Paris [www.oecd.org/scripts/publications/bookshop/redirect.asp?pub=412000031P1].
3. OECD (2001), “Corporate Tax Incentives for Foreign Direct Investment”, OECD Tax Policy Studies, No.4 [www.oecd.org/scripts/publications/bookshop/redirect.asp?pub=232001071P1].
4. Valpy Fitzgerald (2001), “Regulatory Investment Incentives”, Finance and Trade Policy Research Centre, mimeo, Oxford University [www.oecd.org/pdf/M00041000/M00041040.pdf]. Dr. Fitzgerald’s work received financial support from the UK’s Department for International Development.
5. OECD (2000), “International Trade and Core Labour Standards”, Paris [www.oecd.org/scripts/publications/bookshop/redirect.asp?pub=222000041P1].
6. “Environmental Issues in Policy-Based Competition for Investment: A Literature Review”, mimeo [[www.ois.oecd.org/olis/2001doc.nsf/LinkTo/env-epoc-gsp\(2001\)11-final](http://www.ois.oecd.org/olis/2001doc.nsf/LinkTo/env-epoc-gsp(2001)11-final)].

7. "Regulation of Investment Incentives: The Impact of Trade Agreements", mimeo [not in the public domain].
8. "Competition Policy, Subsidies and State Aid", paper presented at the 2001 Best Practice Roundtable [www.oecd.org/pdf/M00023000/M00023892.pdf].
9. "Incentives-Based Competition for FDI in Developing Countries", mimeo [www.oecd.org/pdf/M00041000/M00041036.pdf].
10. Andrew Charlton (2002), "Incentive Bidding for Mobile Investment: Economic Consequences and Potential Responses", OECD Development Centre, Technical Paper Series [www.oecd.org/pdf/M00038000/M00038597.pdf].
11. Jon Church (2002), "The Harmful Impacts of Incentives Used to Attract Foreign Direct Investment: The Challenges Facing Policy-Makers", InSites Investment Counsellors International Inc., Ottawa, Canada, mimeo. Financial support for Mr. Church's work from the UK's Department for International Development is gratefully acknowledged.
12. BIAC (2002), "Investment: BIAC Position on Incentives", In Response, November 5th [www.biac.org/Textes/BIAC_TEXTES/BIAC_SubmissionsPDF/MNEs/FIN_BIAC_Position_on_Incentives.pdf]

Note by the Editor

International Investment Perspectives is an annual publication. Each issue includes an update of recent trends and prospects in international direct investment and provides analyses of investment policy questions of topical interest. Articles are based principally on contributions by the OECD Secretariat and committee reports which have been developed within the framework of the activity programmes of the OECD Committee on International Investment and Multinational Enterprises and the Committee on Capital Movements and Invisible Transactions. International Investment Perspectives also offers a tribune for the business, labour and civil society partners of the OECD and other external contributors.

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