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Policy Competition for Foreign Direct Investment

Daniel Chudnovsky and Andrés López*

7.1 Introduction

Fierce competition has arisen among developing as well as developed countries to attract increasing volumes of foreign direct investment (FDI). This new attitude in developing countries is part of the broad change towards market-friendly policies, as barriers and regulations are dismantled and intense competition for FDI is taking place at national as well as sub-national levels. This chapter addresses the global and regional dimensions of such competition. Section 7.1 addresses the main issues regarding policy competition for FDI. Section 7.2 describes the logic of the competition and the existing empirical evidence on its effects. Section 7.3 deals with the existing multilateral disciplines on investments. Section 7.4 considers the regional dimension of FDI policy competition, analyzing the cases of the European Union and Mercosur. Section 7.5 presents concluding remarks.

7.2 Policy competition for FDI: empirical evidence and policy debates

The inflow of market-seeking investments is largely determined by the size, growth rate and perspectives of the host market. Natural resources and/or labor force are relevant in resource-seeking, export-oriented investments. However, multinational corporations (MNCs) seem to be increasingly involved in so-called ‘strategic-asset’ seeking investments, in which the relevant locational advantages are related to the physical, communications and technological infrastructure, the skills of the labor force, and so on. Economic and political stability and a sound regulatory framework seem to be necessary but not sufficient preconditions to guarantee a steady flow of FDI when the above-mentioned locational advantages are lacking (see UNCTAD, 1992, and Jun and Singh, 1996).

There is a broad consensus that incentives do not rank high among the main determinants of FDI inflows, as they are essentially unable to attract...
investments to regions or countries which lack other location advantages such as an attractive domestic market, natural resources, or a skilled labor force. Nonetheless, when potential locations share common ‘fundamental’ attributes, incentives may influence investment decisions. Thus, incentives attract investment to specific sectors, regions or countries where it otherwise might not have occurred (Aranda and Sauvant, 1996, and UNCTAD, 1994).

The main theoretical rationale for investment incentives is to correct the failure of markets to reflect spillovers. If an investment creates spillovers that cannot be fully captured by the investing firm, a gap emerges between private and social returns. Incentives venture to close that gap. Incentives can also be granted to offset the effects of other policy interventions such as performance requirements (PRs) which MNCs must accept as a gateway to invest in a certain host country. Moreover, for countries in which there is a dearth of FDI, incentives can be a way to attract ‘pioneer’ investors. If this policy succeeds, a sort of ‘demonstration effect’ could arise, fostering additional, self-sustaining FDI flows. PRs such as local content, export commitments, research and development (R&D) expenditures, and job creation have been extensively, though not exclusively, used by developing country governments. In principle, they are designed to ensure that the operations of foreign firms are in tune with the policy objectives of the host country.

Incentives as well as PRs are primarily defended by those who consider that market forces do not lead to the socially desirable amount or composition of FDI, do not prevent FDI from having deleterious effects on host countries’ development objectives, and/or fail to align private and social returns of investments. In turn, orthodoxy questions the efficacy of incentives and is generally hostile towards PRs. Incentives could be useful to promote regional development, to correct market failures, or to realize positive externalities, but in most cases they are seen by the orthodoxy as a ‘second best’ solution. The orthodox criticism is even more virulent regarding sector- or firm-specific incentives policies, as these entail a ‘distortion’ of the resource allocation that ‘free market forces’ would produce. The World Trade Organization (WTO) has accepted incentives only under very stringent conditions to correct market failures, such as when a country is trying to deal with structural problems in a certain region. Incentives are also seen as an important source of distortions in the international allocation of investment resources. In this regard, the orthodox view argues that developing countries are at a disadvantage when investment incentives are in place, as they skew investment and trade in favor of countries with ‘deep pockets’ to afford such incentives. Even if an adequate incentive could be granted, its costs would surely surpass potential benefits due to the lack of detailed knowledge, the burden of monitoring tasks and the scope of rent-seeking activities. In turn, PRs are seen as ‘second best’ solutions, whose outcome is uncertain and which lead to rent-seeking behavior. In general, orthodox models tend to underline that PRs are welfare-reducing. It has also been stated that the