INTER-GOVERNMENTAL COMPETITION
FOR
FOREIGN DIRECT INVESTMENT:

A BRIEF SUMMARY OF EXISTING RESEARCH AND PRACTICE

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Note on Research:
This document briefly summarizes nearly 30 years of cumulative research on inter-governmental competition for foreign direct investment (FDI) conducted by the author, often in collaboration with Professor Louis T. Wells, Jr., of the Harvard Business School. Much of that research has been funded by the Foreign Investment Advisory Service (FIAS) of the World Bank/International Finance Corporation.

INTERGOVERNMENTAL COMPETITION FOR FOREIGN DIRECT INVESTMENT: LESSONS FOR VIETNAM

The Market for FDI

Although no formal "market" for foreign investment exists, governments around the world increasingly behave as though there were one, analogous in many ways to product markets for goods or services. Just as businesses compete for market shares of buyers' expenditures, so too governments compete for market shares of cross-border FDI flows. Consistent with this analogy, prospective foreign investors can be characterized as "buyers", while prospective host governments that are possible sites for this foreign investment assume the role of "sellers." From this perspective, inter-governmental competition for foreign direct investment (FDI)--indeed, for local investment as well--can be analyzed in much the same way that market competition among businesses has traditionally been analyzed. In both instances, competition among prospective "sellers" for the market share of prospective "buyers" are undertaken by business and government alike through (1) price and (2) non-price differentiation.

Such inter-governmental competition for foreign investment is conducted in a highly fragmented market. For example, differences in the final destination of a prospective investors output creates at least three distinct segments—FDI oriented to serve a large domestic market in a single host country (e.g., in China), FDI oriented toward the worldwide export market (e.g., in Singapore), and FDI oriented to both domestic and export markets. In addition, differences in control over downstream market access, in relative expenditures on product and process technologies, in the pace of change in these technologies, in relative industry rankings, in capital and labor intensities—all of these fragment the market for FDI into even more distinct segments, further complicating inter-governmental competition for that investment. When a foreign investor has something special to offer—access to technology, capital, or markets—numerous governments are eager to attract its investment and offer a wide range of incentives in exchange.

Given this high degree of market fragmentation, there is considerable evidence to conclude that intergovernmental competition for FDI is especially intense when a prospective foreign investor:

- exports a large proportion of its output and is able to control the market downstream from the production site;
- employs low-cost labor and other factors of production that are easily substitutable across geographies;
- occupies a monopolistic or dominant oligopolistic position at key points in the value chain of an industry;
- utilizes a relatively "high" technology and/or requires large capital outlays to produce its output, all with few substitute sources;
- produces highly differentiated products that require large marketing and/or research and development expenditures relative to sales; and
- avoids large capital investments that once in place are difficult to liquidate or move.

Differentiation Through Pricing

In inter-governmental competition for foreign investment, various incentives are widely employed by governments worldwide to lower the effective operating and/or capital costs of prospective investors in a specific geography. By offering cash grants, tax holidays, tariff protection, tariff exemptions, and other such financial inducements, governments engage in “price” competition designed to increase their share of the available supply of foreign investment. These incentives may be targeted directly at a specific investor, or to a much broader class of investors such as those operating at a specific node (e.g., electronic components) in the supply chain of a larger targeted industry. Or these incentives may be targeted at specific behaviors to reward corporate performance as measured, for example, by an increase in exports, local R&D, or some other form of local value-added activity. These several inducements may be designed to offset or exceed the potential costs incurred by prospective investors as a result of government rules, regulations and related policies. In inter-governmental competition for FDI, the analogue of price in product markets is the value of the total bundle of financial incentives offered by government, reduced by the value of all government-induced disincentives.

There is considerable evidence concerning the impact of inter-governmental “price” competition on the location decisions of foreign investors. The general conclusion is that such competition does little to increase the overall supply of foreign investment, although it may increase the share held by a particularly aggressive government. For example, tariff and non-tariff trade barriers are particularly effective in determining the location of investments designed to supply a large domestic or common market. On the other hand, for these same investments, tax and other incentives may influence the final location within a national or regional market, but not the prior decision to enter that market. By contrast, for export-oriented investments, especially investments characterized by mobile factors of production, tax and other incentives may be more effective in determining the initial choice of investment sites. As these examples suggest, the impact of inter-governmental “price” competition on the location decisions of foreign investors varies dramatically across the highly fragmented market for FDI. This means that government “pricing” must vary with the market for FDI, and with a government’s relative market share.

While these financial incentives are central to inter-governmental competition for FDI, their relative value has declined over time and across geographies. Indeed, the net value of these financial incentives may at times be negative: Inter-governmental “price” wars can become rampant, with little balancing of relative costs against corresponding benefits. As such price wars illustrate in the extreme, financial incentives have become so globally ubiquitous across prospective host governments that they are no longer the great differentiator that they once were; to the contrary, such competition has become highly "commoditized" with very little variance in the net value of the incentives offered from one geography to the next. Moreover, these incentives increasingly violate WTO rules, which proscribe trade-related investment measures (so-called 'TRIMs') that reward minimum exports or local content in commercial transactions. All of this has led governments to pursue other forms differentiation in their competition for FDI.

Other Forms of Differentiation

In addition to “price”, governments “supplying” investment locations—just like businesses supplying goods and services--also differentiate what they are supplying through a variety of other “non-price” discriminators. These discriminators include a diverse array of government strategies.   At a minimum, governments create and promote images of an attractive business climates, and market this through media advertisements, promotional and “sales” offices overseas, and foreign missions sent in search of new investors--marketing strategies that parallel business efforts to differentiate their products from those of their competitors. In addition, governments increasingly try to reshape the geographic division of labor through "non-price" interventions designed to cluster in a specific location the labor, capital and technology necessary to add value in a targeted industry.   Occasionally, such differentiation substitutes for “price” competition; more frequently, governments try various combinations of price and non-price differentiation to attract foreign investors.

While implementing these several price and non-price strategies, governments also seek to differentiate their locations by offering different levels of “service” to prospective investors. Indeed, the structures and processes adopted by governments to interact with foreign investors are critical to that government’s competitive position in the market for FDI. To differentiate their geographies, for example, governments increasingly create “one-stop shops” and other institutional arrangements to improve “customer service” at various stages of the investors operations, from entry negotiations to the actual implementation of the terms negotiated. Management processes also influence such “customer service”. Here, investors typically value non-discrimination and transparency. And they value a government’s implementation of the terms of a contract: This is often central to a firm’s prior evaluation of investment opportunities and to that government’s success in competing for foreign investment. The failure of some government agencies to provide adequate “service” by failing to honor contractual arrangements has a strong signaling effect, leading investors to believe the terms as negotiated are not likely to be implemented fully once the firm begins operations.

The distinguishing feature of free economic zones (FEZ) and other such “one stop shops” is their packaging of government financial incentives with a wide range of other differentiators. These include public and private investments in supporting infrastructure: power, transportation, telecommunications, education, and so on. They include the targeting of key "anchor clients" around whom other investors will cluster in order to produce the desired "agglomeration effects" (such as those apparent in Silicon Valley or along Boston's Route 128). They include explicit government intervention in labor markets in order to attract or generate the workforce demanded by foreign investors. And they include a renewed attention to the quality of life enjoyed by the foreign expatriates and domestic nationals who reside in or near the FEZ. To date, such attention to quality-of-life issues has shaped the competitive strategies of only a few governments competing for FDI. That is likely to change, however, especially in those locations targeting a highly trained and thus highly mobile workforce in knowledge-intensive industries. This increased attention to quality-of-life issues promises to be the next major source of differentiation among competing locations for FDI—one of the few sources of differentiation that cannot be easily copied or "commoditized.”