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EU – China and the Non-transparent Race for Inward FDI

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Abstract

In this paper it is argued that the restructuring following the stiffer competition stemming from increased global integration will trigger a race between countries to attract inward foreign direct investment (FDI). It is further argued that this race consists of last minute efforts and tailor-made packages designed by governments and their agencies to temporarily improve their country's otherwise inferior profile. This race is non-transparent and the factors used to compete for inward FDI (the 'elements' of the race) deviate from those of long-term efforts to develop a favourable investment climate and improve productivity, as well as medium-term efforts, such as lowering corporate taxes. The paper elaborates on the research problem of properly understanding the drivers of inward FDI in the absence of data on the elements of the non-transparent race. It also addresses the economic policy problem following from this race with a scenario where a large share of global FDI ends up in China, putting the cohesion of the EU at stake and triggering a regional race within China.

Key words: Inward FDI, China, European Union, investment-diverting policies

JEL: E61, F15, F21, F23, F36, F42, G18, G34

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1. Introduction

During the last three decades, we have witnessed profound changes in the global economic map. We have seen increased openness to inward foreign direct investment (FDI) as a result of a considerable revision of investment regimes in a positive direction. Figures for 2004 show that 85 per cent of 271 regulatory changes undertaken that year by 102 countries were favourable to foreign direct investment (FDI) (UNCTAD, 2005). We have also seen strong regional policy coordination, as in the case of the EU. The increase of the number of member countries to 27 in January 2007 and the completion of the first round of the European Economic and Monetary Union (EMU), with 12 original member countries (hereafter, “EMU countries”) having a common currency and central bank, constitute important progress in terms of economic, monetary and political integration. Moreover, we have seen the re-appearance of a new major global player, China. Taken together, the new economic map will make the competition for inward FDI stiffer, and special investment patterns will develop. One such pattern – the non-transparent race for inward FDI – will be discussed in this paper.

The developing economies have managed to attract an increased share of global inward FDI. After a global peak in 2000, FDI-flows decreased by almost 35 per cent over the following five years. However, in this period the developing economies gained - in terms of FDI “market shares” - almost 17 percentage points and reached 36 per cent, the highest share since 1997[1] whereas the developed economies lost slightly more than 20 percentage points (a drop from 80 per cent to 59 per cent). (See Figure 1).

INSERT FIGURE 1 HERE

A point of departure for this paper is that increased economic integration fosters increased competition that calls for a restructuring of global industries. Economic activities (e.g. production) are moving to sites that can provide them with the best conditions. During the last decade, China has, to an increasing extent, attracted FDI which had previously materialised in the developed world. Until recently it had the status of being the low-cost manufacturing platform for the world's largest companies. But statements from the Chinese leaders in 2007 made explicit that China from now on will opt for inward investment in knowledge-intense production. There also seems to be an interest by global firms to move R&D into China. A survey (UNCTAD, 2005) for the time span 2005-2009 shows that the most attractive prospective R&D location for these firms is China (61.8 per cent) followed by the United States (41.2 per cent) and India (29.4 per cent). Members of the European Union are found to be less attractive: the UK is ranked number five (13.2 per cent) followed by France (8.8 per cent) as number seven and Germany (5.9 per cent) as number eight. The result, however, is much tougher for the small European countries with, for instance, Ireland and Sweden receiving just 1.5 per cent of the responses in the survey. Hence, there are reasons for concern among policymakers in the EU.

[1] Based on figures from UNCTAD 2006.

Today, the EU countries in general, and the EMU countries in particular, do not have much leeway to make themselves look attractive by using the macroeconomic situation to their best advantage (Oxelheim and Ghauri, 2004). With a common monetary policy and shrinking space for autonomous fiscal policy, the EMU countries all look equally attractive from a macroeconomic point of view. Moreover, the UNCTAD (2005) survey, referred to above, reported low interest for the EU-countries, particularly the small, peripheral ones, whereas China was found to be by far the most attractive investment location (85 per cent of global FDI experts and 87 per cent of global transnational corporations expressed this view). Considering the structure of China, the inflow of FDI may trigger a race between its different regions. In this perspective, it may be worth mentioning that the survey reports prospects for a dramatically increased use of investment policy measures.

In this paper, we argue, based on global historic analogies, that policy-makers in the EU countries, as a response to the prospects of losing knowledge-intense FDI to China, will fight for inward investment using “grey” measures. A general ban on such measures will, however, give rise to a *non-transparent* race for inward FDI with economic and research policy consequences. This race will use means that deviate from transparent long-term efforts aimed at improving productivity and the general investment climate in order to attract investment. These means are also different from the transparent ones used in the competition for investment in a medium-term perspective, such as, for instance a general lowering of corporate taxes.

The non-transparent race can appear in many forms and does not necessarily start with a government taking the initiative. In recent years, we have seen a race in which the initiative comes from individual companies, demonstrating some resemblance to blackmailing. For instance, in 2005 General Motors (GM) urged -

under threat of closure - a number of production plants in Europe to compete with each other and to convince GM which of them deserved to survive. Saab's production site in Trollhättan (Sweden) had to compete with GM's production site in Rüsselsheim (Germany) for the production of the third generation of GM's middle range cars.

The GM case saw all kinds and levels of governments, authorities and labour unions involved in offering different incentives in a package aimed at boosting the chances of their site surviving. Hence, although GM's headquarters urged the subsidiaries to demonstrate their future ability, this ability was strengthened in a non-transparent way by incentives and efforts provided by many other stakeholders. For instance, some days before the decision was to be taken, the Swedish prime minister travelled to GM's European headquarters to meet with its top-management team. This was not a courtesy trip, but was undertaken to provide a last set of offers to tip the decision in favour of production in Trollhättan. The German chancellor, Gerhard Schröder, at that time almost declared "industrial war"; promising to do *all* he could to bring the production to Rüsselsheim. Hence, we already now see indications that with a stiffer investment climate, i.e. with China attracting a large share of global FDI flows, the cohesion of the EU may be threatened. The non-transparent race may also appear in a form where companies ask up front what a government can offer in order to win the competition for their cross-border investment as, for example, in Slovakia 2005 (Blomberg, 2005).

This paper elaborates on the research problem of properly understanding the drivers of inward FDI in the absence of data on the elements of the non-transparent race. It addresses the economic policy as well as research policy problems following from this race with a scenario where the bulk of inward FDI ends up in China, putting the cohesion of the European Union at stake. In the absence of other than anecdotal evidence, we here discuss the non-transparent race for inward FDI with a normative lens.

Although we focus on the non-transparent race at the governmental level we acknowledge that the race for inward FDI is a multilevel issue. In a regional context, the authorities may try to attract inward FDI to the regions that are then the target of the non-transparent race at the country level. Once a country has successfully managed to attract FDI there may follow a race at the sub-regional or local government level (of particular interest to China) that, perhaps, ends up in a race at the city level.

The paper is organized as follows. In Section 2 we provide some stylized facts about the FDI balance between the EU and China and in Section 3 we discuss the background to the race for FDI. Section 4 deals with the different incentives of the non-transparent race for inward FDI. In Section 5, the costs and benefits of the race are presented. Section 6 discusses the regulatory body adopted by the EU and the WTO aimed at preventing a race from developing. Finally, Section 7 provides concluding remarks.

2. Inward FDI: Some Stylized Facts for China and the EU

In 2005, China became the number three recipient of inward FDI in the world, after the United States and the UK (Figure 2). China's market share increased in the early 2000s and reached about 8 per cent in 2005 (12 per cent with Hong Kong included). Admittedly, the potential measurement error may be large and as reported in the UNCTAD FDI/TNC database may amount to a divergence of about 80 per cent, as in the case of the US investment in China in 2002 (USD5.2 billion reported by Chinese authorities as compared to only USD924 million reported by US authorities). This error, however, often refers to contracted versus actual FDI, which is illustrated in Table 1. In any case, the FDI flow figures for China should be interpreted with caution. Stock figures – when available - are even harder to interpret. India is often mentioned as increasing its inward FDI and as a major competitor to China. However, India managed to attract far smaller flows and had a market share of less than 1 per cent of global inward investments in 2005.

INSERT TABLE 1

In 2004, the EU faced a new and tough reality. First, the EU experienced a close to 50 per cent decrease of FDI inflows compared with 2002. Second, the EU was surpassed by the developing world for the first time in terms of inward FDI (USD233 billion and USD216 billion, respectively, out of a global total of USD648 billion). China, Hong Kong/China, Korea and India attracted close to 50 per cent of the inflows to the developing world. EU lost shares in a shrinking market.

INSERT FIGURE 2

Increased market shares for China can to, a large extent, be explained by, for example, low labour costs and large market potential. However, Chinese authorities may themselves participate in the non-transparent race; they are certainly taking part in the transparent race. Actually, a major institutional reform took place as early as in 1979 when specific policy preferences to attract FDI were designated. These policies later led to the first establishment of Special Economic Zones and to a later opening of coastal provinces for inward FDI. In this context, the Guangdong province (a top recipient of inward FDI) became the designated showroom (Ng and Tuan, 2001).

Chinese FDI policies have changed over time and differ from one region to another. Reflecting different stages of the economic reform process, we see regional variations expressed in the creation of Special Economic zones, Coastal Economic Zones and Central Reform Testing Zones. These policies have also given foreign investors preferential tax treatment (tax rates and tax holidays) to stimulate cooperation between multinational companies and local enterprises (Ng and Tuan, 2001). A beneficial tax rate for foreign direct investors is still offered. The Chinese deregulation and opening up to inward FDI was experimental in design and gradual in terms of its sequencing, following the Chinese proverb “for unfamiliar rivers, touching the stone at the river bed is the best strategy to cross the river” (Child, 2001). Part of the efforts devoted to attract inward FDI to China has been spent on creating an investor-friendly investment environment in structural dimensions: a “hard” dimension regarding physical infrastructure, a “soft” one involving administrative infrastructure, and a third dimension containing socio-economic factors (Li and Li, 1999; Lu and Tsai, 2000). Sovereign wealth funds may also play an important role in the future transparent competition for inward investment (acquired instead of attracted), containing missing pieces for Chinese knowledge creation.

Hence, China has been involved in a transparent race that may explain some of the increase of 19.4 per cent in actual utilised FDI in 2005 compared with the previous year (www.fdi.gov.cn). China’s active participation in attracting inward FDI may increase the probability that they will also join the non-transparent race.

Moreover, the propensity of China to get involved in the non-transparent race will increase with stiffer competition for knowledge-intensive production.

In addition, we argue that an increasing share of global flows of knowledge-intensive FDI to China will trigger an intra-EU race for FDI as well as a regional race in China when it comes to the decision about the end destination for inward investments. The restructuring process within the EU will take time, and some governments will be tempted to take shortcuts to gain an improved market position. They will find new ways to convince foreign investors to opt for their country by the use of non-transparent incentives. It is a matter of not only attracting new investments but also relocating existing investments from one place to another.

For example, in 2000, the German tyre manufacturer, Continental, moved its production from a small village in Sweden to Portugal. An artificially low production cost – subsidised by the EU to the amount of EURO50 million – caused a painful plant closure with about 500 lost jobs in one EU country at the expense of the emergence of a new production location and new jobs in another EU country. In 2002, Ford received in a similar way about EURO20 million as regional support to expand its production of Volvo car engines in Wales. As a result of the expansion, Ford decided to close down its production in another EU country, which happened to be Sweden also in this case. In both these examples there may just as well have been non-transparent incentives provided by the host country governments.

3. Background to the Non-transparent Race for Inward FDI

During most of the post-World War II period up to the 1980s, inward FDI flows were seen with a certain amount of scepticism. This negative view was often a result of a mistake made by governments inviting only selected firms to invest in their country. Despite the fact that the selected firm was most often at the leading edge of technology and management skill, the mere procedure of inviting only *one* firm in a particular sector meant that many countries missed most of the benefits from inward FDI and ended up leaving them disappointed.

The playing field for FDI changed substantially during the 1980s. From a historical perspective, the expansion of FDI during this decade had its parallel in the trade expansion of the 1950s and 1960s. While the international trade expansion was fuelled by multilateral trade liberalisation, the FDI expansion was, to a large extent, prompted by the global abolition of capital controls. In the 1980s, borders were opened up and inward FDI flows were in most countries no longer restricted. Economic integration increased, stimulated by increased financial integration[2]. Governments started to realise the benefits that may accrue to them and saw suddenly FDI inflows as the remedy for many domestic problems.

The regulatory changes differed substantially between countries with respect to timing, activities of supervisory authorities and content of external and internal de-regulative measures. Among the external measures, the abolition of capital controls and a general opening up for inward FDI were the most important ones. Within the group of internal measures, the relaxation of limits on activities in which different firms may engage, and the rules that discriminate against foreign-owned firms deserve to be mentioned in this context.

Once the deregulation had opened up the way for FDI, several structural forces fuelled its growth. Increased regionalisation (EU, NAFTA, etc) and the “outsider’s” fear of increased protection and discrimination, maturing markets for international

[2] From a conceptual point of view the two forms of integration are overlapping, since they both include FDI. From a causal point of view it can be claimed that the financial integration was triggered and made inevitable by the increased internationalisation of firms.

mergers and acquisitions (M&A), and the increasing role of services, which at the beginning of the 2000s accounted for 50-55 per cent of total FDI outflows from most major source countries, are the most prominent examples of these forces (UNCTAD 2005). Globalisation and regional integration, on the one hand, and technological and commercial know-how of MNEs on the other, transformed the relationship between governments and MNEs from a position of confrontation to one characterised by openness and bargaining over investments.

At the beginning of the 1990s there was no global institution committed to this task of supranational supervision, though the OECD, the IMF, the World Bank and the GATT were all potential candidates for this role. The EU, however, did assume the role of supranational authority in a regional framework. Extensive efforts have been made to control competition for inward investment among the EU members. The question is, then, to what extent have these efforts been sufficient to curb a movement towards increased competition between EU member-states for inward FDI without having the competition transformed into a non-transparent race? It is, therefore, a delicate task to nail down those governments that have participated in the race, pretending, for instance, that the sale of an under-priced building to the investing company was just a bad business deal. The task becomes even more delicate when non-transparent incentives are used as ingredients of the race.

3.1 EU and China as a trigger for a new race

In the 1990s, a veritable ‘race’ for inward FDI was visible as a means to solve the problem of growing unemployment (Oxelheim, 1993; Oxelheim and Ghauri, 2004). Governments started to elbow out their competitors by attracting inward FDI with the use of economic equivalents of anabolic steroids. Since some of the incentives used were non-transparent, the net effect of the race and the magnitude of the repercussions (to the extent they have already accrued) are seldom reported. The fierce competition for inward investment created losers as well. Frustrated governments that were not willing to compete with the same means, or were unsuccessful in the race, may have considered retaliation by imposing restrictions on capital movement. The closer to the end of the political mandate, the greater the temptation. Despite periods of temporary increases of restrictions there is no evidence that this early version of the race actually triggered a wave of re-regulation (Oxelheim 1996).

The losers blamed governments of successful host countries for their own failures. In this respect we can once again see a parallel in international trade. This time we have a parallel in the Omnibus Trade Act (1988) that granted US authorities the right to bilateral negotiations with representatives of countries that, according to the US view, engaged in unfair trading practices, hence triggering a retreat from a multilateral to a bilateral world. In a global recession, there will be many interpretations about what is “fair” or not.

In a world of perfect financial integration, expected real returns will be the same on projects that are identical except for currencies and jurisdictions. The international purchasing power parity and the international Fisher parity both prevail. The EU is moving in that direction; with – at the end of the process - one currency adopted by all member states and one policy for all. Hence inside the EU, perfect monetary and political integration will prevail. In such a world, where regulatory barriers have been removed, taxes harmonised, takeover defenses dismantled, economic policymaking coordinated, accounting principles and disclosure norms harmonised, and transactions cost suppressed to a minimum, there is little left for individual governments to use in a competition for inward FDI in accordance with the

EU regulatory body. However, if we broaden the scope and look into the grey area, i.e., accept non-transparent incentives as well, we may identify five categories of incentives for the politicians to package in a selective or tailor made fashion rather than in a general policy framework.

The incentives we are addressing in this paper could also be put in a policy context as part of an investment-diverting policy. According to the Lisbon declaration, the EU polices should, at an aggregate level, be *investment creating.* They should aim at improving the competitive power of the EU region, boost productivity and efficiency. Investment in the EU then comes as a response to new opportunities and improved attractiveness. However, investors from outside the EU may see some of these EU-policies as *investment diverting*. Policies adding to this view are, for example, anti-dumping rules strengthening the outsiders' view of the EU as "Fortress Europe". Governments in individual member countries may then pursue their own investment-diverting policies. Some policies, for example, local content rules, will signal that if you do not produce in a particular market you will not get access to it. Other policies will work as incentives aimed at convincing the outsider to produce in a particular country by pointing at an "artificially" low production cost – for example made possible through subsidies - as compared to what can be achieved elsewhere.

We rest this paper on the assumption that in an integrated region like the EU there will remain some acceptable incentives to be used by governments to lure inward FDI, but in this setting, we claim that the temptation to use old or to invent new forms of non-transparent incentives will be great. Moreover, in the race China's huge exchange reserves may increase the probability of making the option of a high knowledge-content of FDI into China come true through the investments of Sovereign Wealth Funds. Stiffer global competition will fuel financial creativity and engineering aimed at circumventing regulations and standards or disguising the abusive use of incentives. Hence, we expect to see a non-transparent race characterized by the key words: targeted firms and tailor-made incentive packages.

4. The Elements of the Non-transparent Race

A strand of literature has analysed the dependence of FDI upon location attractiveness (Vernon, 1966; Caves, 1971; Dunning, 1977, 1988, 1995, 1998, 2000; Buckley and Casson, 1976; Hymer, 1976; Rugman, 1980; Baldwin and Krugman, 2001; Ghauri et.al. 2004). Government policies, both from home and, more importantly, from host markets, play an important role in forming the location advantage, expressed as the "L" in the "OLI" paradigm (Dunning, 1977, 1988, 1995, 1998, 2000; Aharoni 1966; Aliber 1970, Buckley and Ghauri, 2004). What constitute the non-transparent race are efforts by the government to improve the L advantages of the OLI configuration by a typical "last-minute" use of non-transparent incentives.

The incentives (or elements of the race) given to foreign firms to invest in a particular country may be grouped into five major categories: 1) subsidies and tax packages, 2) looser interpretations of international agreements, 3) home country biased consumers, 4) cyclical and geographical features, and 5) information advantages and agglomeration support. The incentives can be characterised as inherent, such as language advantages, or created, such as subsidies. They may also be distinguished by whether or not they have a benchmark position. Some types of information advantages are examples of incentives that have a benchmark position, since they vanish when a country reaches the information efficiency of the rest of the world. Subsidies belong to the group of incentives that lack a benchmark position, since the upper limit of what a country can offer is very diffuse. Incentives within categories 1-3, in general, and the created ones in particular, lend themselves to the non-transparent race.

We have so far only mentioned policies for attracting inward FDI. However, in a world of high and growing interdependence these policies often accompany policies for domestic investment. Policies favourable to domestic investment very often also attract inward FDI. Similarly, policies that make domestic investment unattractive often discourage inward FDI. They encourage outward FDI as home companies and residents look abroad for better uses of their capital. Moreover, a successful campaign from the government in country A to look attractive may result in an out-location of investment from country B to country A. A substitution relationship between outward FDI and investment at home has been found for Schumpeter industries, whereas a complementary relationship has been reported for Heckscher-Ohlin industries (Braunerhjelm and Oxelheim, 2000; Braunerhjelm et al, 2005).

4.1 Subsides and tax packages

The first group of incentives for attracting inward FDI in a non-transparent way consists of different kinds of subsidies. Some of the incentives in this category may be seen as inherent, at least in a phase of transition, or rather inherited from the pre-integration period. These are common in political economies (like the Nordic countries) that are characterised by a high level of political involvement and a high average tax burden (as percent of GDP). Hence, by directing investment to such countries, the corporation may get free access to infrastructure, while an investment in other countries may be connected with high fees for the use of highways, telecommunications, etc. Governments may use these incentives in marketing campaigns in a transparent way to attract inward investments. However, they can also choose to create new incentives by subsidising improvements in infrastructure.

Among the traditional created subsidies to be used in the non-transparent race we delineate the following five categories: a) grants; b) tax concessions; c) soft loans d) equity participation; and e) warranties.

The non-transparent character of the incentives used by governments to attract inward FDI forces us to rely on anecdotal evidence. Table 2 helps us to understand the extent to which different governments have used subsidies in some industries.

INSERT TABLE 2

Using the automotive as well as the electronics, chemicals and semiconductors industries as examples, we show in Table 2 that the race was stiff already in the 1990s. The trend indicated above – to the extent a trend in a non-transparent area can be identified - supports the observation that the size of incentives has increased over the last three decades (Thomas, 1996; O'Malley, 2000). Despite the formal adherence to the principles of "national treatment", the incentives offered at state (South Carolina – BMW, Alabama – Mercedes, etc) and local levels in the United States and at the regional and national levels (France – Toyota, United Kingdom – Ford, etc) in the EU seem to provide evidence in this regard.

Grants (excluding supranational grants) in their reported and transparent forms were in the 1980s and the early 1990s the most important components of total subsidisation used by the EU and EFTA countries (Austria, Germany, Iceland and Portugal are exceptions). They were particularly used to subsidise capital formation. Table 3 shows that grants employed by most EU member states in the early 2000s.

INSERT TABLE 3

Subsidies are used very differently in the OECD countries, most of them for sub-sector specific purposes (not shown in Table 3). For instance, the EU average for 1986-88 (excluding supranational support) for sub-sector-specific purposes was 65.4 per cent of total industrial subsidies, based on figures from CEC (1990). The region-specific support came second, amounting to 15.6 per cent. The average for the EFTA countries (SITC 2 and 3) for 1984-1987 was 42 per cent. Region-specific and other general support came next, totalling about 20 per cent each (see EFTA 1998). Switzerland exhibited the highest figure of all European countries for research and development subsidies (33.9 per cent of total industrial subsidies). Denmark was at the top in terms of environmental subsidies (5.8 per cent), while the Netherlands was the country that devoted the largest share of subsidies to small and medium-sized enterprises.

Tax concessions are tax-code provisions that favour some sectors or economic activities, such as capital formation, over others. Although international comparisons are of limited value in this context due to incommensurability of data, the relative use of this form of subsidy is known to have been relatively high in the United States and in Germany. The relevance of taxation politics to the location decision process of MNEs has fuelled a great debate. Those in favour claim that they encourage operational efficiencies by constraining excess and ensuring government policies that are responsive to citizens' preferences (Ellis 1999). They also argue that competition provides the most efficient means to the end of harmonisation of tax rates and provisions. Those against tax competition argue that it results in economic distortions in the locations of FDI and deterioration of the welfare state (Hendricks 2000). Tax incentives used in the non-transparent race are those given to individual targeted firms. Due to their non-transparent character reports about their potentially distorting effect have not been published.

As regards the use of tax incentives in general policy-making and how to cope with this, the EU Code of Conduct on Business Taxation emphasises tax coordination (EU-COM 1997, p. 564), while earlier reports (The Ruding Report 1992) recommended harmonisation of tax systems within the EU. The principal assumption underlying the Code is that the competitive tax position of all countries is equal. This clearly ignores the fact that there is great disparity among the 27 Member States, both on economic and geographical levels. Moreover, without some form of tax-coordination within the EU, there may also be a destructive tax competition, a ‘race to the bottom’, that would undermine the long-term sustainability of Europe’s welfare structures.

Consider the case of Ireland: Since the 1950s Ireland has adopted a policy of attracting FDI through tax incentives. Until 1982 Ireland granted a full tax holiday to all new sales made by a foreign manufacturing company. Since 1982, however, companies have been entitled to an automatic preferential corporate tax rate of 10 per cent on all manufacturing profits, regardless of the location where these profits have been generated. Profits derived from manufacturing and qualifying services enjoyed a rate of 10 per cent until the end of 2002. Thereafter, Ireland agreed with the EU commission for a corporate tax rate of 12.5 per cent to apply to all trading activities (agreement reached July 22, 1998). The special tax rate (10 per cent) has been widely recognised as one of the main factors inducing MNEs to locate in Ireland (O’Malley 2000; O’Connor 2001).

Soft loans comprise loans from the government to the private sector at terms more favourable than those obtained on the open market. The use of this form of subsidy has been relatively high in, for example, Denmark, France and Japan. In Japan most soft loans have been offered to small and medium-sized firms. Table 3 shows that the use of loans as an investment incentive is very common.

Government *equity participation* involves subsidy to the extent that the rate of return demanded by the government falls below that demanded by private capital markets. Among the EU and EFTA countries, the relative use of this form of subsidy was, in the 1980s, by far the greatest in Austria (See EFTA 1987 and 1998; CEC, 1990; Ford and Syker, 1990). The use of this form of incentive can easily be disguised within the (pretended) frame of a joint venture.

Governments may also offer *guarantees/warrantees* on loans as a form of subsidy. This has particularly been the case in Iceland, France and Sweden. Incentives contributing to a lower cost of capital of the potential investor will work as a trigger for FDI, as pointed out in an OLI-framework by Oxelheim et al (2001). To the extent that this lowering is conditioned by a subsidy or other cost-reducing incentives from a particular country, the case for inward investment to that particular country is improved.

4.2 Looser interpretations of international agreements

Here we find two kinds of policies aimed at reducing the production costs by lowering requirements put on the producing firms. The incentives are typically created as part of the non-transparent race. One of these is the lowering of the requirements put on the labour environment; i.e., *social dumping*. The case often referred to here is the move of Hoover (the producer of vacuum cleaners) from France to Scotland.

Moreover, some may argue that this is not a result of governmental policies but rather of labour union policies. A kind of social dumping was used in the GM case mentioned previously. Labour unions started to offer (or to compete in a semi-transparent way by offering) more working-hours for an unchanged wage in a last minute effort to convince GM not to close down their respective factories.

The second alternative is the lowering of the bar for the environmental responsibility of the firm, i.e. *environmental dumping.* This may also appear as firms of new EU member countries are granted the “non-transparent” permission to catch up with corporate environmental responsibility at a slower pace than otherwise requested (Lundan, 2004).

4.3 Nationalism and home-country biased consumer

The third group contains incentives that work via some kind of support to home-country biased consumption. The incentives may be used in a more or less non-transparent way. These incentives provide a soft alternative to traditional trade barriers. Instead of imposing a tax on imports, consumption of goods and services produced domestically are subsidised. One way of doing this, which requires no outright payments from the government, is to play on nationalistic feelings. This stick approach has been used for years but often for capital account reasons. The former Russian president Boris Jeltsin urged the Russian people to buy goods produced in Russia. For a foreign producer of goods intended for the Russian market this turned into an incentive to move production to Russia in order to gain access to the Russian market. The stick will, of course, only have an effect on companies that are keen to get access to a very big market or to a market of great importance to the company’s profitability. In the United States, “made-in-America” or “made-in-the-USA” campaigns are good examples of national campaigns that forced Japanese automobile firms to invest in the United States. It is easy to imagine that the nationalistic argument may be used as an implicit stick, i.e. from a statistical point of view in a non-transparent way.

4.4 Cyclical and geographical factors

The two remaining categories are primarily not designed to be used in the non-transparent race. The fourth kind of incentives include inherent geographical advantages, such as differences in business cycles and seasonal patterns, and other such differences that will remain even as integration becomes more or less perfect. The availability of up-to-date infrastructure is a major factor that attracts FDI to a market. A number of authors have studied this phenomenon to explain why certain markets become the primary choice for FDI projects by MNEs (see e. g. Dunning 1986; Morris 1988; Buckley and Ghauri 1999b; Ghauri et.al. 2004). Most of these studies report that MNEs invest in markets that have up-to-date infrastructure as regards transportation and communication. The incentives in this group are mostly inherited and need to be marketed in order to become true drivers of inward investment. Finland, as a country in the periphery of EU, may attract inward investment by translating its geographical position into “the gate to Eastern Europe”. Similarly, deviations in terms of business cycles and seasons may be translated into incentives.

4.5 Information advantages and agglomeration support

The fifth group of incentives is associated with information in general and with transparent competition for inward investment. It contains more marketing-oriented arguments like a low degree of investment bureaucracy, a high level of education and broad competencies, rich agglomeration, etc. The argument with a potential use in the non-transparent race is related to the language of the host country. Language plays a role in attracting inward FDI (Ghauri et.al. 2004). For instance, the difficulty of the Chinese language may be used to trigger inward investment in China even though the country may be integrated in all other dimensions. The Chinese government may also “help” foreign firms to realise the necessity of being present in China by imposing rules or a *praxis*, for instance, that all consumer information should be written in Chinese. Governments may turn a language disadvantage or the classic Chinese practice of *guangxi* into a case for attracting (or pushing) a foreign investment.

5. The Costs and Benefits of Attracting FDI

What then can a host country do in order to boost it chances to attract a targeted firm? The question leads to two sub-questions: First, what constitutes a successful policy in an integrated world? Appropriate liberalization policies appear to be a necessary precondition for attracting FDI. However, changes in the economic and market conditions are also necessary. What may then tip the opinion in favour of a particular host country is the addition by the government of that country of an incremental flavour to boost the attractiveness. Between two equally endowed locations, the non-transparent incentives may make the difference. The second question is then: Can anything be achieved by government policies to attract FDI?

The major reasons for welcoming inward FDI at the government level is that FDI brings: 1) spill-over of technology; 2) spill-over of management skills; 3) capital flows with no debt-servicing obligation attached; 4) new domestic jobs; and, finally, 5) additional production capacity. We may here note that the first two benefits, which are often achieved in an agglomeration context, confront governments with a delicate problem.

There is also a cost side of inward FDI for the host country, although most researchers seem to agree that benefits of inward FDI exceed costs (McDermott 1989; Oxelheim 1993; Buckley and Ghauri 1999a). A problem in calculating the cost is to evaluate the opportunity cost in terms of the value forgone by using the money on incentives rather than on direct measures to improve productivity, efficiency and knowledge creation. When the estimated value of offered incentives amounts to USD3.4 million per job created, as shown in Table 2 for the case when Dow was attracted to Germany in 1996, this concern seems relevant (Lowendahl 2001). Perhaps there was also a social and/or signal value from the 2000 jobs created as a response to an incentive package amounting to USD6.8 billion that should be included in the cost-benefit analysis to properly understand the logic of German politicians in this particular case. The cost/job when South Carolina managed to attract BMW may to some also seem high. However, ten years later, when the number of jobs has actually increased ten times, the initial cost/job may seem reasonable.

To what extent can positive effects from the use of incentives be expected to accrue to the host country? The answer to this question is not easy and clear-cut. For the company the uncertainty is a matter of the duration of the offer. On the cost side, the company has to be sure that the incentive offered, for example, a subsidy on interest rate, is not withdrawn prematurely. Otherwise, the company may end up with negative returns for the investment and run the risk of being out-competed, causing capital waste.

The new type of political risk does not reflect the general behaviour of politicians (Oxelheim 1996), but rather a relative-risk *vis-à-vis* competitors.

Management knows that the government is inclined to provide non-transparent incentives since it has been offered some and invested based on them, but the management is uncertain about the package that the government has offered its competitor or what other countries offer it. Hence, though a firm gets a very beneficial package from politicians it may be out-competed by another firm that has received an even better package. The new version of political risk thus becomes a transparency issue.

Within the balanced-budget framework, the only constraint on the use of incentives connected to outright costs (in a tax-harmonised world) is the availability of fiscal resources. In the EU-context, the taxation issue is still a national one, though there are forces working in favour of taxation becoming an issue for the EU (Andersson et al, 2007). However, harmonisation efforts are geared only to the tax rate and base. By giving priority to subsidies for attracting inward investment, in the short term, some other tax-financed projects may have to be postponed. In the longer term, however, more resources may become available with the potential expansion of the tax-base that the new inward investments will cause. In an integrated world, access to global savings is free and governments may find it tempting to finance subsidies through loans, making the upper limit of their efforts to attract inward FDI a subtle question.

For governments of host countries, it is of crucial importance that firms that have been targeted and attracted deliver all that is expected from them. If not, it is essential to have contracts stating a repayment of incentives received. Moreover, the host country A's government always runs the risk that some other countries, B and C, bid for the same kind of investment and offer an even better package to the competitors of the attracted firm. This will render these firms a lower cost of capital and a good chance to out-compete the firm attracted by country A. This is part of what is called the race to the top of incentives. However, for the government of a host country there is a risk that an over-generous subsidy may signal future problems in the host economy and, hence, repress rather than attract inward FDI.

From a global or regional welfare point of view, the race is often claimed to have an adverse effect. The incentives may divert production from country A, with the most efficient production conditions, to the less efficient country B. At first glance, this might leave the region as a loser and the host country B as a winner. However, over a longer period, the production conditions in host country B (who managed to attract the investment) may improve as a result of the attracted FDI. Efficient production may emerge and offer country A (to the extent it has kept its efficiency intact) stiff competition from which, eventually, the entire region will benefit.

6. The EU and WTO: The Regulatory Framework

In the previous sections, we have found evidence of a non-transparent race for inward FDI inside the EU as well as on a global scope. How well is the existing regulatory body equipped to prevent the race from emerging? In this section we will see what legal forces are currently in place to hinder the transparent race. The non-transparent part of the race is by definition harder to regulate.

6.1 The EU regulatory framework

As European countries are increasingly becoming “FDI friendly,” they can, based on the historical record be put into three groups according to their eagerness to attract FDI. Group one that has constantly and proactively sought to attract FDI includes UK, Ireland, the Benelux countries and Spain. The second group that was traditionally unwelcoming to FDI and has recently become “FDI friendly” includes France, Portugal, Greece, the Scandinavian countries and the new EU members from Eastern Europe. The third group that is still rather “unfriendly” to attract FDI includes Germany and Italy (Oman 2000).

The EU policies to control state subsidies, or “state-aid,” are spelled out in the original Treaty of Rome in two articles. These articles deal with a general ban on fiscal and financial subsidies to industry as a whole. There is no direct reference to subsidies to attract FDI. There are three basic types of EU rules on government subsidies: rules to limit “strategic” subsidies to a particular sector, “horizontal” subsidies to small and medium-sized enterprises (SMEs), and “assistance” to poorer regions. However, some exceptions have been allowed for “state aid” to SMEs and poorer regions. As a result, governments of EU member-states are not allowed to give any incentives to attract FDI except for projects in “least-favoured” regions. The status of “least-favoured” or “development” regions, however, is to be determined by the EU. To qualify for this, the *per capita* GDP has to be no more than 75 per cent of average EU *per capita* GDP (Santos 2000, Hendriks 2000, Oman 2000).

For the “least-favoured” regions, governments can provide up to 50 per cent of the value of an investment project’s fixed assets; for the “development areas” the aid is limited to 20 per cent of the value of the project’s fixed assets. If governments want to give “aid,” they have to apply in advance, and it is up to the Commission to decide whether a particular project is eligible for this “aid” or not. This type of development assistance to less favoured regions has, thus, been the only financial incentive allowed by the EU to attract FDI. For example, 80 per cent of all “Greenfield” FDI in Ireland received such “aid” (Oman 2000, p. 58).

However, despite these regulations - and in addition to what has been previously noted - there are signs of increased competition for inward investment in the form of a considerable increase in the number and range of activities of national investment promotion agencies within the EU. A number of these agencies are now opening their offices abroad and are proactively seeking to recruit projects from their neighbouring countries. We have also mentioned in Table 2 a number of inward FDI projects in the EU where incentives have played a role. Examples are as Hyundai's 1996 semi-conductor investment in Scotland, where the British government reportedly paid about USD190,000 per job directly created by the project; Ford-VW's investment in the automobile industry in Portugal in 1996 offering 5000 new jobs, which received an investment package of USD265,000 per job; and VW's investment in Lower Saxony to save 2,300 jobs, that reportedly received about USD180,000 per job (Oman 2000, p. 59).

While the fundamental freedoms of the EC Treaty do not distinguish between general and specific tax measures that have discriminating or restrictive effects, this distinction is paramount in the area of state aid law under Article 87 EC (Schön 1999). Article 87(1) prohibits aid that distorts or threatens to distort competition 'by favouring certain undertakings or the production of certain goods'. Most investment agencies in Europe thus claim that although the competition for FDI is fierce, it has not led to bidding wars (Oman 2000, p. 60). In some countries, for example the new EU members, tax concessions have been more important than financial incentives to attract FDI. The danger of tax incentives to attract FDI led the EU council to adopt a code of conduct in December 1997. The adoption of stiffer regulations may act in a perverse way and fuel the development and use of non-transparent incentives.

6.2 The Code of Conduct

According to the code of conduct, member states agreed not to use 'harmful' tax measures and to roll back existing harmful measures (OECD 1998). The Commission also reduced 'less favoured' regional investment incentives (from 75 per cent to 50 per cent) and 'development areas' incentives (from 30 per cent to 20 per cent). Efforts were also made to increase the coherence between individual governments' aid programme with EU's own regional assistance programme. The Code of Conduct attempts to deal with situations where 'potentially harmful' tax measures are 'unfairly' competitive by virtue of 'a significant effect on the location of business activity'. It follows that where potentially harmful tax measures amount to state aid, a Commission enforcement action against a member state in the European Court of Justice is possible. Despite the fact that the Code is not legally binding, it mentions the possibility of Commission enforcement (Bratton and McCahery 2001).

Under the Code of Conduct, a member state can continue to assume a competitive posture with the introduction of an across-the-board tax reduction that benefits both existing businesses and potential investments. This stance aligns itself with the State aid rules, in that specific tax measures are subject to the rules, whereas general tax measures are not. The Code furthermore permits that member states should not be restrained from introducing a reduction in business taxes to stimulate the competitiveness of the domestic business environment.

6.3 WTO Rules

The GATT had no FDI issues on its agenda but exclusively trade issues. With the emergence of the WTO in 1995 the scenery changed somewhat. WTO requires that member states should make their regulations conform to WTO rules. The subsidies or incentives have to follow the WTO Agreement on Subsidies and Countervailing Measures (SCM Agreement). All pre-operational investment incentives are considered subsidies and are prohibited according to SCM. Some subsidies, for example, “Production Subsidy,” are not prohibited but are “actionable” and are subject to challenge in case they cause adverse effects on the interests of another WTO member. However, the WTO only regulates subsidies in the goods sector and the SCM Agreement is not easily applicable to all kinds of investment incentives, in particular location incentives (UNCTAD 2002, p. 209).

As the WTO only deals with “trade”, the granting of incentives in the pre-production period - and not for trade of goods - creates problems in the measurement of adverse effects for other member states. By the time production and trade/exports have started, incentives given to attract investment have often ended. Moreover, even if contested, the WTO settlement is not likely to “undo” or change investment that has already been made. Although countervailing duties can be imposed, this can only be done if another member state can determine that there are subsidised imports coming into its market (from that particular investment), that this is harmful to its domestic industry and that there is an established link between the subsidised imports and the “harm.” However, although there is a provision in the SCM Agreement that a state may be asked to withdraw tax holidays given to attract FDI and perceived inconsistent with the provision of SCM Agreement, there is no mention of repayment of subsidies/incentives (WTO/DS126/RW, Article 21.5, 21 January 2002).

7. Concluding Remarks

In this paper, we have outlined the non-transparent race for inward FDI. We have emphasized that many forms of investment incentives exist today despite the efforts by the EU and the WTO to reduce their importance. We argue that governments will increasingly rely on the use of five categories of incentives to attract inward FDI in order to reduce unemployment, obtain access to important technology, and encourage management spill-over effects. We find that three of these categories are well-designed for use in the non-transparent race.

The incentives used in boom times will be predominantly soft, i.e. of a quality rather than a quantity character aimed at enhancing general productivity of a country by improving, for instance, the quality of its educational system and infrastructure without offending too many of the other member countries. However, one triggering mechanism for a stiffer race even in boom times is the appearance of China on the global map as an attractive production site, combined with the need for a restructuring of European industries following the introduction of the Euro. In times of recession and asymmetric shocks to particular EU-countries, fuelled by nationalism, the use of non-transparent incentives, such as cash-flow related activities, for example, the offering of grants and loans under favourable conditions, is likely to increase and stiffen the race. The worst-case scenario is that the race becomes so strong that it threatens the cohesion of the entire EU. For China, there is a need to attract new investments implying new jobs to replace the jobs lost in the restructuring of the state-owned enterprises (SOEs) in order to avoid social unrest. This insight may make the race between Chinese regions fierce.

Here, there is a challenge to all policy-makers involved. In case of a non-transparent race in its most extensive form, there is risk that nations with “losing” governments will try to protect themselves by re-imposing capital controls. Such an action will at least temporarily hinder the outflow of capital to China. The re-regulation may be contagious and trigger a general wave of re-regulation making the global welfare take a giant leap backwards. To prevent this scenario from coming true, the creation of a strong supranational institution with the task of supervising the race and equipped with enforcement power has to be given the highest priority among global policymakers.

The challenge to researchers is to model the determinants of the FDI flows – be it in a New Economic Geography or an OLI context - while paying attention to the non-transparent incentives of the race as put forward in this paper. In the risk management context, the new kind of political risk emerging from the race calls for further analysis and theory development. The unwillingness of companies as well as of governments to reveal information about agreements and to provide data to the empirical testing will constitute a barrier to a full understanding of the cross-border investment process.

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UNCTAD (2006) *World Investment Report 2006*, Geneva

Table 1 Contracted and Realised Investment from European Union into China 1990-2005

Year	Number of Projects		Contracted FDI Value		Realised FDI Value	
	EU	National Total	EU	National Total	EU	National Total
1990	82	7273	22422	659611	14735	348711
1991	163	12978	75939	1197682	24562	436634
1992	763	48764	96360	5812351	24297	1100751
1993	1726	83437	318176	11143566	67124	2751495
1994	1464	47549	562958	8267977	153769	3376650
1995	1582	37011	741977	9128153	213131	3752053
1996	1167	24556	675922	7327642	273706	4172552
1997	1040	21001	422882	5100353	417115	4525704
1998	1002	19799	593938	5210205	397869	4546275
1999	894	16918	409566	4122302	447906	4031871
2000	1130	22347	885516	6237952	447946	4071481
2001	1214	26140	515284	6919455	418270	4687759
2002	1486	34171	450693	8276833	370982	5274286
2003	2074	41081	585432	11506969	393031	5350467
2004	2423	43664	836189	15347895	423904	6062998
2005	2846	44019	1153071	18906398	519378	7240569

Source: MOFCOM FDI statistics

Table 2 Estimated incentives for automotive, electronics, chemicals and semiconductor FDI projects – Inward FDI (selective) in the US and the EU member states, 1980-2000.

Date of package	Country of project	Investor	Amount per job (US$)	New jobs/investment
Automotive – USA				
1980	United States	Honda	4,000	
1983	United States	Nissan	17,000	1,300 jobs
1983	United States	Mazda-Ford	14,000	3,500 jobs
1985	United States	GM Saturn	27,000	3,000 jobs
1985	United States	Mitsubishi-Chrysler	35,000	2,900 jobs
1985	United States	Toyota	50,000	3,000 jobs
1986	United States	Fuji-Isuzu	51,000	1,700 jobs
1993	United States	Mercedes-Benz	170,000	1,500 jobs/US$300m
1994	United States	BMW	79,000	1,900 jobs/US$800m
1997	United States	DaimlerChrysler	100,000	3,500 jobs/US$750m
1998	United States	Toyota	69,000	2,300 jobs/US$1.2bn
1999	United States	General Motors	60,000	3,800 jobs/US$500m
2000	United States	Honda	105,000	1,500 jobs/US$400m
Automotive – Other				
1985	United Kingdom	Nissan	54,000	2,700 jobs
1992	Portugal	Ford-Volkswagen	255,000	1,900 jobs/US$484m
1993	Hungary	GM	300,000	213 jobs/US$64m
1997	Germany	Volkswagen	180,000	2,300 jobs
1998	United Kingdom	Ford	138,000	500 jobs
Electronics, chemicals and semiconductors				
1993	United States	Intel	120,000	2,400 jobs
1994	United Kingdom	Samsung	30,000	3,000 jobs/US$89m
1995	United Kingdom	Dupont	201,000	100 jobs, US$128m
1995	United Kingdom	IMR	63,400	>0 jobs/US$3.17m
1995	United Kingdom	Siemens	51,000-190,000	1,500 jobs/US$1.1bn
1996	United Kingdom	Hyundai	190,000	
1996	United Kingdom	LG	48,000	6,100 jobs/US$320m
1996	Germany	Dow	3,400.000	2,000 jobs/US$6.8m
1997	United States	Shintech	500,000	250 jobs/US$125m

Source: Compiled from; UNCTAD (1995), Moran (1999), Oman (2000) and Loewendahl, (2001).

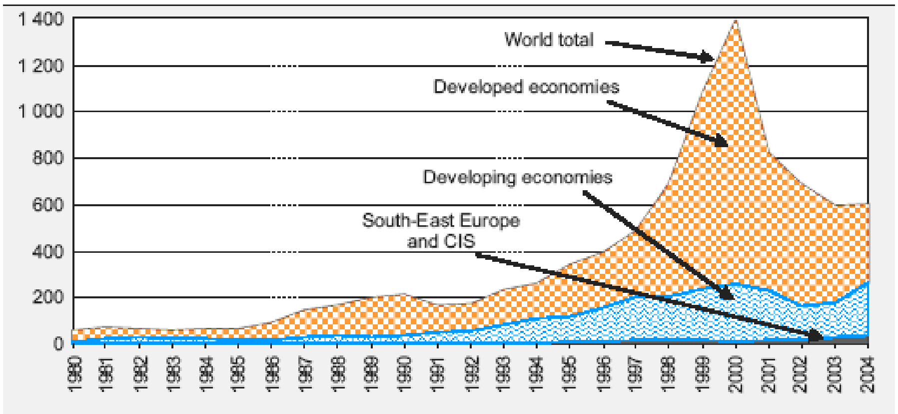
Table 3 FDI Business Incentives in the EU in 2000

	Investment Capital		Regional Development			Job Creation		Corporation Tax Incentive	Labour Costs Tax Incentive
	Grant	*Loans*	*Grant*	*Loans*	*Tax*	*Grant*	*Tax*		
Austria		●	●			●			
Belgium	●		●	●	R				
Denmark		●	●			●			R
Finland	●	●			R				
France	●		●			●	D	R	R
Germany	●	●	●	●	D				
Greece	●	●	●	●		●			
Ireland	●		●		D	●		R	
Italy		●	●	●	D	●	D		R
Luxembourg			●					R	
Netherlands			●			●			
Portugal	●	●	●	●			E	E	R
Spain			●	●	R			R	R
Sweden			●	●		●		R	R
UK	●	●	●	●		●			
New Members									
Cyprus								R	
Czech Republic	●	●	●			●		E	
Estonia									
Hungary	●		●		R	●		E	
Latvia								R	
Lithuania									
Malta		●						E	
Poland									
Slovak Republic								E	
Slovenia			●					R	

Source: Compiled from EUBIR (2001)

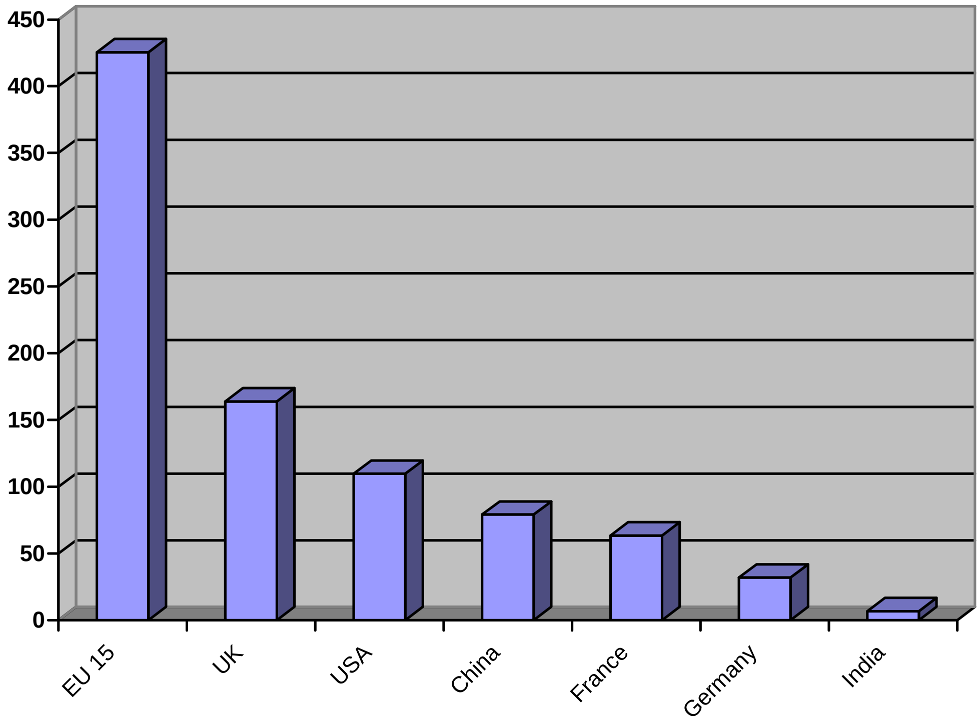
Notes: D – Tax deductible; E- Exemption; R- Reduced rate.

Figure 1 FDI Inflow, global and by groups of economies, 1980-2004 (Billions of USdollars)



Source: UNCTAD, FDI/ TNC database (www.unctad.org/fdistatistics)

Figure 2 World FDI inflows, 2005 (Billions of USDollars)



Source: The Economist Intelligence Unit, 2006