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Columbia FDI Perspectives
Perspectives on topical foreign direct investment issues
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No. 369 October 30, 2023

How to get the best deal for massive FDI incentives

by
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The US and EU offer hundreds of billions of dollars for semiconductor, electric vehicle and renewable energy projects undertaken by domestic and foreign firms. Other countries—including Canada, China, India, Japan—also grant incentives for strategic investments. A good part of enticements translates into unprecedented incentives for foreign investors. They can be as high as US$3.6 million per job (Intel's investment in Magdeburg, Germany), super-charging a global FDI incentives race.

These incentives serve several objectives: not to fall behind or regain leadership in the technology race, accelerate the green transition and/or reduce dependence on others (especially China), by expanding/locating production domestically.

FDI incentives remain controversial. This *Perspective* does *not* deal with the general desirability of granting incentives. Rather, it focusses narrowly on how countries can get the best deal for the incentives they grant to foreign investors. They do this by ensuring benefits and externalities (strengthening physical, educational, technological, relational infrastructure) beyond the investments themselves and associated jobs. (The suggestions below apply also to incentives for domestic firms.)

There are various types of incentives:

- Unconditional financial incentives (mostly grants), often preferred by investors. They can be problematic because they involve upfront cash without guarantees that projects succeed. Therefore, claw-back clauses are a must in case obligations are not met.[1]

- Unconditional fiscal incentives (e.g., tax holidays). These are less problematic (especially expenditure-based) because they typically only kick in when facilities have been built and become profitable. However, the global minimum tax-rate agreement will constrain such incentives.

Incentivized investments can create tax revenue that may compensate for the incentives granted, if investors are successful and stay long enough. But incentives should be linked, through eligibility conditions, to:

- Other incentives related to externalities and host countries' policy goals.

"Other incentives"[2] are least problematic because they involve financial and/or fiscal support for activities resulting not only in benefits for investors but also for other firms and the local economy—benefits that remain even if investors leave. Since customized incentives benefit both sides, they have a good potential to be obtainable, as seen in incentive packages granted in the past. "Other incentives" include:

- *Strengthening infrastructure*. Alabama's 1994 US$253 million incentives package to attract Mercedes included US$62 million for highway work, sewage and water improvements and a fire station. Such projects upgrade local infrastructure—benefitting the local community for good.

- *Developing talent*. Investors in cutting-edge technology projects often require highly skilled workers and, therefore, may be interested in co-establishing/expanding local vocational and degree programs. North Carolina's 2022 VinFast's incentives package included US$38 million for training. Training programs upgrade the workforce—benefitting also local firms.

- *Engaging in R&D cooperation*. Such cooperation is especially important in modern industries, with investors benefitting from local research capabilities and host countries from augmented potential for innovation. Poland requires recipients to spend 15% of grants on cooperation with local universities, leaving it to foreign affiliates to choose areas of cooperation.

- *Building backward linkages and creating an ecosystem conducive to more clustered investment by domestic and foreign firms.* Investors may wish to reduce their reliance on complex global supply chains and cut transportation costs, while suppliers can benefit from knowledge transfers and increased productivity. Supplier-development programs may be needed to identify and upgrade suppliers, and institutions may need to be strengthened, to create an attractive ecosystem, such as Silicon Saxony.

- *Contributing to the green transition.* More and more MNEs undertake climate commitments—and they will increasingly be held to them. Encouraging the implementation of such commitments includes linking incentives to the recycling of water, the use of low-carbon concrete or energy recovery—thus also helping countries meet their own climate goals. The US Inflation Reduction Act requires firms receiving incentives to have energy-efficient commercial buildings.

Governments could also stipulate that investors prioritize serving the domestic market, especially during times of crisis.

When host countries or their sub-divisions negotiate investment packages, they need to specify investors' benefits and obligations, to obtain sustainable or quality FDI. Packages may combine various types of benefits. Poland determines the size of incentives packages by assigning points for various benefits accruing to its economy.

When "other incentives"—all of which involve mutual gain—are granted, large strategic projects benefitting from a smart mix of incentives can become anchor/flagship investments with important agglomeration advantages. They can create an ecosystem and a value proposition that can attract other foreign (and domestic) investments in the same and related industries, while avoiding the risk of large projects becoming modern enclaves. INTEL's investment in Costa Rica led to additional foreign and domestic investments in electronics and medical equipment.

Supporting—or igniting—such growth poles benefits the wider economy. It requires coordination across various parts of administrations, the judicious leveraging and monitoring of incentives and finding the right balance between what is acceptable to investing firms and host countries. Only a few economies have the capacity to offer massive incentives. But if they do, they should make the most of the incentives they grant.

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[1] In 1999, the claw back clause required Siemens to return a £18 million grant after it closed a plant in Tyneside, UK.
[2] They can include regulatory incentives, not discussed here.

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