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Research Report

An international framework to discipline outward FDI incentives?

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Perspectives on topical foreign direct investment issues

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An international framework to discipline outward FDI incentives?*

by

Karl P. Sauvant and Clémence Boullanger**

With all developed countries and some 140 emerging markets reporting outward FDI (OFDI) stocks in 2017, the question arises what policy actions, if any, home country governments should take to support their firms investing abroad. As OFDI potentially benefits home economies by improving firms' access to markets and resources of all kinds, the challenge consists in increasing their international competitiveness and bringing capabilities back home.

Hence, all developed countries support their outward investors in various ways, including by granting specific advantages to home country firms.¹ But most emerging markets have not done so yet. Still, they face the challenge of considering policies and measures to ensure that this situation does not put their firms at a competitive disadvantage. This will lead to an escalating OFDI-incentive competition (mirroring the “bidding-wars” on the inward FDI side) that, ultimately, helps no country.

The most problematic OFDI incentives are financial and fiscal measures. These include, e.g., grants, loans, financial guarantees, and specific tax exemptions. Their proliferation raises several issues.

- An escalation of OFDI-incentive competition can lead to a misallocation of public funds and wasteful “beggar-thy-neighbor” policies. This is particularly challenging for countries with limited resources.
- The increased international competitiveness of specific firms does not always translate into positive effects in home countries, e.g., when MNEs do not repatriate earnings. Actually, the more firms internationalize through FDI, the smaller—potentially—the overlap between their global corporate interests and the national interests of the countries in which they are headquartered.
- Possibilities for abuse exist. MNEs may engage in “OFDI-incentives shopping,” as the definition of a “domestic” firm is not always clear.² Foreign firms could rout

investments through countries with generous OFDI incentives, leaving them without the desired OFDI benefits.

- OFDI incentives affect competitive neutrality, i.e., the promotion of a level playing field for competition among firms. This concern has mostly been raised in the context of state-owned enterprises (SOEs)—which possess various advantages vis-à-vis private firms—but could be extended to OFDI incentives in general. Indeed, governments distort competition in the world FDI market when introducing measures to support the international expansion of their firms, thereby placing them in a more advantageous position vis-à-vis firms from countries that do not receive the same help from their governments.

Two complementary solutions offer themselves:

- Governments supporting their outward investors should at least focus any aid on projects that directly benefit domestic economic development (as, e.g., China does).
- Discussions on an international framework for OFDI incentives should be initiated. As OFDI incentives are applied unilaterally, only a multilateral (or regional) approach can prevent governments from outbidding each other by offering incentive packages to their outward investors.

Admittedly, seeking a OFDI-incentives agreement is a long-shot, given the past failure to reach an international agreement constraining inward FDI-incentive competition. Yet, three considerations support action:

- Importantly, since most governments do not back their domestic outward investors with incentives yet, they have a self-interest in a preemptive agreement, to avoid having to join a costly incentive competition.
- Governments increasingly recognize the wasteful effects of inward FDI-incentive competition. This rationale also applies to OFDI incentives. The European Commission has begun to take action, in reference to state-aid rules and the distortion of competition.³
- Governments are beginning to address issues related to competitive neutrality and SOEs in treaties, e.g., in [Chapter 17 of the Comprehensive and Progressive Agreement for Trans-Pacific Partnership](#).

Discussions on limiting OFDI incentives could be sponsored by the World Association of Investment Promotion Agencies (with some supportive countries?), as its members should have an interest in this matter.

An international framework on OFDI incentives could emulate the “traffic light” approach of the WTO’s Subsidies and Countervailing Measures Agreement.⁴ It could first require increased transparency and eventually discipline the most harmful incentives, starting with capping specific financial incentives. However, exceptions could cover incentives encouraging FDI flows to least developed countries, sustainable FDI flows and SME OFDI.

A build-in agenda could provide for a gradual approach for emerging markets still in the process of liberalizing OFDI. This would allow these economies’ domestic outward investors to catch up with their competitors from developed countries, which typically benefitted from OFDI incentives when establishing themselves abroad.

Absent a preemptive multilateral or regional approach, all governments will eventually engage in OFDI-incentive competition, lest their firms face a competitive disadvantage. This would lead to the adoption of costly measures not necessarily benefiting domestic development—a missed opportunity.

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¹ Karl P. Sauvant et al., “Trends in FDI, home country measures and competitive neutrality,” *Yearbook on International Investment Law and Policy*, 2012-2013 (New York: OUP, 2014), pp. 3-95.

² Spain, e.g., offers financial support to investment projects involving a “Spanish interest”, without distinguishing between domestic and foreign companies: <<https://www.cofides.es/biblioteca-de-documentos/folleto-fiex>>.

³ The General Court upheld two Commission decisions that classified as prohibited state aid a Spanish tax scheme providing a specific fiscal advantage to domestic firms acquiring shareholdings in foreign companies: *Judgement of 15 November 2018, Deutsche Telekom v Commission*, T-207/10, EU:T:2018:786.

⁴ Pierre Sauvé, and Marta Soprana, “Mission impossible? The political economy of disciplines on investment incentives,” *Journal of World Trade*, vol. 52 (2018), pp. 209–228.

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