

Analytical and Regulatory Issues in the Competition for Private Investment Between and Within Developing Countries

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1. Introduction

I first met Dr. Rangarajan sometime during 1950-53 when we were both students of Loyola College, Madras and residents of the college hostel. He was reading for his B. Com. (Honors) degree and I was reading for my B.A. (Honors) degree in mathematics. We were colleagues at the Indian Statistical Institute, Delhi in the late sixties, before he joined the Institute of Management at Ahmedabad. He and his wife Haripriya have graciously hosted my wife Nalini and myself several times.

Ranga is primarily a macroeconomist and macro econometrician while my interests have been in the microeconomics, particularly foreign trade. In his long and illustrious academic career as well as in his policy making role, particularly as the Governor of Reserve Bank of India (RBI), Ranga has brought in rigorous theoretical and empirical tools to policy analysis. I have no doubt, his support and advice as governor of RBI was crucial to the then finance minister Dr. Manmohan Singh in managing the macroeconomic-cum-balance of payments crisis of 1991, opening the insulated Indian economy to competition from the rest of the world and above all, bringing about systematic reforms. In honoring Ranga, I have chosen to write on an integral aspect of the reforms, namely the opening of the Indian economy to foreign direct investment.

* Samuel C. Park Jr. Professor of Economics Yale University. I cannot adequately thank my colleague, Alvin Klevorick, for saving me from analytical errors and for his editorial suggestions. The late S. Guhan, T.N. Krishnan and Mancur Olson, Jr. had made valuable comments on an earlier version of the paper. It was presented at the Delhi and Madras sessions of the Conference in January 1996 on "A New Institutional Approach to Development: Achieving India's Full Potential" organized by the Center for Institutional Reform and the Informal Sector (IRIS), University of Maryland at College Park, the National Council of Applied Economic Research, Delhi, the Madras Institute of Development Studies, Madras and the Institute of Management, Calcutta. My thanks are also due to my discussants Sanjaya Baru and U. Sankar and participant at these sessions. Financial support of IRIS is gratefully acknowledged.

Private capital flows to developing countries have increased dramatically in the 1990s. According to the IMF (1995, p364), net capital inflows to developing countries averaged \$28 billion during the "debt-crisis" period (1982-89). The World Bank (2000, Table 2.1) reports that total long-term private capital flows (net) to developing countries, rose from \$98.5 billion in 1990 to a peak of \$343.7 billion in 1997 and fell to \$290.7 billion in 1999. Flows of foreign Direct Investment (FDI) have consistently risen from \$24.1 billion in 1990 to \$192.0 billion in 1999. In contrast, official flows fell from \$55.9 billion in 1990 to a low of \$31.0 billion in 1996 and have since risen to \$52.0 billion in 1999. The prospects of any substantial increase in official flows (particularly concessional flows) are not at all bright. Developing countries will have to look for increasing private flows (debt, portfolio and FDI) to supplement domestic savings in financing their investment and growth.

Among the three alternative forms of private capital inflows, viz. debt, portfolio and FDI, the last is deemed most attractive to developing countries. Unlike a project financed with foreign debt, a project financed by FDI (or through portfolio investment), generates resource outflow only if the project succeeds (or if the portfolio yields a positive return) and not otherwise. Thus the investor and the economy receiving the investment share the risks associated with investment. In a debt-financed project, barring default, the borrower bears the entire risk. FDI, with its longer time horizon, is less susceptible to sudden withdrawal as compared to portfolio investment, which is highly sensitive to short-term swings in market expectations and can be withdrawn if there is an unanticipated adverse shift in market expectation.

Besides financing domestic investment, other well-known positive aspects of FDI include the possible infusion of technical knowledge into the host country and expansion of export opportunities. Borensztein et al. (1998) utilize data on FDI flows from industrial countries to 69 developing countries over the last two decades to estimate a

cross-country regression to examine the effect of FDI on growth. I have argued (Srinivasan 2000) that there are serious analytical, data and econometric problems with cross-country regressions. And findings from such regressions, including those of Borenstein et al discussed below, should be treated as suggestive and no more. Their results confirm that FDI is an important vehicle for the transfer of technology; it contributes relatively more to growth than does domestic investment. However, FDI is more productive relative to domestic investment only when the stock of human capital in the host country exceeds a threshold level. In addition, FDI increases total investment in the economy more than one for one, which suggests the predominance of complementarity effects of FDI with investment financed by other means.

In choosing among alternative opportunities, private investors (domestic or foreign) will be guided by the return and risk to their investment. Hence, it is to be expected that governments would attempt to influence the scale, location (geographical and sectoral) and other characteristics (e.g., nature of technology, skill intensity, etc.) of such investment by affecting private incentives (in particular, return and risk) to invest.

The ongoing process of globalization involving the integration of the economies of developing countries with world markets for goods, technology, and capital have increased the importance of a country's incentive system in influencing the locational decisions of transnational corporation (TNC). Moreover, countries as well as sub-national units within countries compete for attracting TNCs by offering them a variety of incentives (UNCTAD, 1996).

It is obvious, but nonetheless worth emphasizing, that unless the private returns to FDI are different from social returns in the host economy, there is no analytical justification for a government to change private incentives through public policies. Even if there are reasons to presume a wedge between social and private returns, not only is the

calculation of the wedge problematic in practice, in the strategic competition among governments it is possible that the non-cooperative equilibrium has the character of a “prisoners dilemma”, in which individually rational and non-cooperative behavior leads to an inferior outcome compared to that under cooperative behavior. Were the governments to cooperate and come to a credible agreement to limit the amount of incentives each offered, in such a cooperative equilibrium each government would gain relative to the non-cooperative equilibrium. Thus each government by having to tax less to finance the costs of the incentives offered to TNCs would make their tax-paying citizens better off, since the incentives in effect transfer reserves from citizen to foreign investors (UNCTAD, 1996).

Until the reforms initiated in 1991, the regulatory regime in India had been not particularly receptive, if not completely hostile, to FDI. Since the reforms, not only have many of the most onerous restrictions that inhibited FDI been removed, but the government welcomes FDI even in sectors, such as power, that used to be public sector monopolies. There have been several changes of central government since 1991. However, the Prime Ministers and Finance Ministers of all the governments that came to power, as well as senior officials, have participated in several gatherings of leaders of business at home and abroad to explain the reforms and to inform foreign businessmen of the vast, exciting, and profitable investment opportunities opening up in India. The ninth five year plan (1997-2002) proposes to raise foreign investment threefold from its level of \$3.2 billion in 1997-98 (Planning Commission, 1999, paragraph 1.16). In a radical departure from the past, the state governments are actively courting FDI. Chief Ministers of states ruled by different political parties, including communist-ruled West Bengal, have toured Europe and North America to persuade foreign investors of the attractiveness of investing in their states.

While the FDI proposals approved since 1991 have been substantial as compared

to the pre-reform era, India in particular, and South Asian countries in general, lag behind East Asian economies in attracting FDI. According to the World Bank (2000, Appendix 5), FDI flows to India and Pakistan in 1999 were respectively \$2.5 billion and \$400 million, amounts that are paltry in comparison to flows to neighboring countries. Such flows to the much smaller economy of Thailand after the 1997-1998 financial crisis amounted to more than \$5 billion, and Malaysia attracted \$4 billion and China received a massive \$40 billion in 1999 (ibid., appendix 5, p.154).

Given the modest flows of FDI thus far, it might seem premature to raise the possibility that the competition of India with other developing countries as well as the competition among Indian states to FDI could become "excessive" in the sense that either too much FDI is attracted to India (or to a particular state in India) relative to what would be socially optimal, or that foreign investors receive a higher return on the amount invested than what they would have earned at their next best alternative. I would argue, however, that, first of all, it takes some time for foreign investors to appreciate the fact that more than four decades of hostility to FDI have really, and hopefully irreversibly, come to an end. Second, some of the politically more difficult reforms (e.g. privatization, amendment of labor and bankruptcy laws) that will have an impact on the profitability of investment are yet to be completed. Hence, it is understandable that inflows of FDI are still modest. Third, external investors seem to be slowly realizing that Indian reforms are unlikely to be reversed in the foreseeable future and that opportunities for profitable investment in India are vast. For example, the Commerce Department of the U. S. Government has included India among the Big Ten Emerging Markets for U.S. private FDI.

Under the circumstances, it is worth looking at the nature of competition for FDI and examining whether there is any need for regulating it. In Section 2, I briefly examine the analytics of public intervention in markets for mobile capital. Section 3 is devoted to

policy implications and concludes the paper.

2. Analytics of Policy Interventions in the Market for Mobile Capital

Many of the policy questions relating to FDI arise also with regard to private domestic investment. Hence, I will use the term private investment to cover FDI as well as domestic investment. In the absence of a wedge between private and social returns to private investment there would be no need for public policy intervention to affect market-determined flows of investment. Broadly speaking, one can distinguish two sets of circumstances under which such a wedge could arise. In the first, because of one or more distortions from policies that are difficult to remove from a political perspective, private returns to investment in one jurisdiction (country or state) are lower than returns to the same investment elsewhere. In the second, a wedge between private and social returns arises from the presence of uninternalized externalities (positive or negative).

2.1 Interventions in the Context of Distortions

If some distortions are unremovable, intervention is required to offset them if the country or state is to compete for investment on comparable terms with others (to use a cliché, a 'level playing field' has to be created). The term "distortion" is to be interpreted broadly to include the effects of interventions promoting policy objectives that do not enter the profit calculus of a private investor. For example, as long as balanced regional development remains a policy objective, policy interventions would be needed for promoting investment in a region in which private returns are lower than elsewhere. Incentives have to be offered to induce private investors to invest in the region. The policy instruments used to provide such incentives are often distortionary.

There is a large theoretical literature on tax competition across jurisdictions for attracting mobile capital. While much of the early contributions assumed perfect competition in goods and factor markets, and an elastic supply of capital, recent

contributions draw on models of economic geography in a context of scale and agglomeration economies and imperfect completion (Kind at al (1999) and the literature cited therein).

In practice some interventions, whether or not they serve legitimate policy goals, usually have unintended negative side effects that are sought to be offset by yet other interventions. For example, in India, industries, including suppliers of inputs to agriculture (such as fertilizers and pesticides), were protected from import competition. Protection raised the cost of such inputs, and the adverse effect of higher cost of inputs on agricultural producers then offset through input subsidies. In the context of competition for FDI it is argued that greater incentives that India may have to offer relative to other developing countries (or one Indian state has to offer in comparison to another) should be viewed as offsetting the effect of such constraints, present in India (or that state) and absent elsewhere, that reduce the attractiveness of India (or not state) as a location for investment.

Among the well-known theoretical propositions on ostensibly offsetting interventions, there is one of wide applicability: when several distortions are present, removing a subset of them or alternatively adding one or more new ones (possibly to offset others) has ambiguous welfare consequences. Thus removing a subset could paradoxically decrease welfare if such removal accentuates the welfare-reducing effect of the remaining distortions (Bhagwati (1971)). Thus, removing restrictions on FDI (i.e. removing one distortion) while other distortions in the economy remain could, though not necessarily would, lead to welfare loss.

A celebrated example of this, is due to Brecher and Diaz-Alejandro (1977), who show that the inflow of foreign capital into a capital-intensive manufacturing industry that produces protected import substitutes in a labor-rich, capital-poor developing economy

such as India, would reduce in their case the unremoved distortion is the protection of import substitutes. However, from the argument of Brecher and Diaz-Alejandro it does not follow that the restrictions on inflows should be imposed, but only that protection of capital intensive import substitutes should be removed.

2.2 Interventions in the Presence of Externalities: The "First-Best" Environment

There is a presumption that some types of investment, such as FDI, generate positive externalities or benefits that cannot be captured and internalized by the investor. Hence, investors have to be provided with incentives. Again, economic theory suggests that each country (or state) that wishes to reap the external benefits of investment should directly subsidize it, so that at the margin the investor is indifferent between investing in India (or that state) or elsewhere, and finance such subsidy through non-distortionary taxation.

Formally this can be seen as follows. Assume for simplicity that FDI has a "public goods" aspect, for the host country or state, that generates benefits to consumers; there are no other distortions, externalities, or income distributional objectives; and competition prevails in all markets. Suppose the marginal benefit to consumer i (in India or a state) from an extra unit of FDI is MB_i , the private return to investing in India (or that state) is r , and the return to the investor, had he chosen to invest elsewhere (i.e. the opportunity cost of funds) is c . By assumption, $c > r$. Then from the perspective of the host country or state, the socially optimal amount of FDI is determined by the Samuelson rule:

$$\sum_i MB_i = c - r$$

(1)

The rate of subsidy per unit of investment is $c - r$. Assume for simplicity that c and r are independent of the size of investment I , and the $\sum MB_i$ decreases from a value above $c-r$ to values below $c-r$ as I increases from zero. Then equation (1) uniquely determines the optimal amount of investment, say I^* . The total subsidy is $I^*(c-r)$, and this has to be

financed in some non-distortionary manner.¹

The analysis that led to (1) assumes that there is no other externality or distortion beyond the external benefits to consumers from FDI and that each state or country behaves competitively,² i.e. as if it cannot influence c by its actions on the market for investible funds. Although, for simplicity, c is assumed to be a constant, nothing essential depends on this. For example, suppose c is variable, and the aggregate supply of investible funds under competition among investors is an increasing function of c . Then, for each value of c one can determine an aggregate demand for funds at that c by summing over all competing countries or states each state's demand for funds arising from (1). The resulting aggregate demand for funds as a function of c would be combined with the aggregate supply function to determine the equilibrium.

In the "first best" environment that underlies equation (1), as long as each country or state offers a subsidy that ensures that the sum of the externalities generated for its consumers by a marginal unit of investment and the return on that unit accruing to private investors equals the return to be earned in any alternative use of the funds, each country or state will attract the socially optimal amount of investment from its perspective. At the same time, the investor will be indifferent between investing in any of the countries or states competing for funds, since he will earn the same return c wherever he invests. There will be neither a need, nor an incentive, for any country or state to deviate from its optimal subsidy to attract more investment or to reduce investment as compared to the level determined by (1). Such deviations can only be welfare-reducing from the country's perspective. In particular, there will be no incentive or tendency to overbid (i.e. to offer a

¹The analysis does not assume that all states or countries have the same preferences, nor does it assume that the wedge $c-r$ is the same across states.

²For a game-theoretic (rather than a competitive market-based) analysis of the competition of host countries for FDI, see Chapter IV of the unpublished Yale Ph.D. dissertation of Kim Tan (1991). Other chapters of this interesting dissertation analyze the roles of tax holidays and establishment free trade zones in attracting FDI.

subsidy in excess of $c-r$) that the UNCTAD (1996) suggests might occur.

2.2 Interventions in the Presence of Externalities: Departures from the "First-Best" and the Possibility of a Race to the Bottom

In actuality, governments rarely ever compete for private investment with "first best" instruments at their disposal. Besides, the presence of imperfections in the market for investible funds, the presence of externalities in addition to those generated by FDI, and the possibility of other distortions cannot be excluded. In any case, even in the absence of these harsh realities, the simple rule of (1) is hard to implement in practice: at a minimum the mechanisms for eliciting 'true' marginal benefits of a public good are themselves complicated. Nevertheless, the recognition of these realities does not necessarily imply that the UNCTAD (1996) report's call for international cooperation in limiting incentives-based competition for FDI is justified.

A similar call for a collective agreement for limiting competition for mobile capital has often been made in the context of provision of public goods and of governmentally mandated standards relating to the environment, occupational safety, and conditions of work. It is argued that unrestricted competition will result in a "race to the bottom" that ends with standards that are inefficient from the perspective of the entire set of competing countries or regions.

Klevorick states the issue clearly and succinctly:

...to attract mobile resources, especially firms, governments will choose policies--for example, environmental standards, occupational health and safety standards, competition policy--that entail suboptimal requirements, which afford their citizens too little protection--whether from environmental hazards, unsafe or unhealthy working conditions, or cartel behavior. The idea is that to make its country a

hospitable location in which to do business, a government would establish lax standards to be imposed upon those it wishes to draw. The result, it is argued, is that all countries will impose standards that are much more lax than those they would set if they did not have to compete with one another for the mobile resources. In short, they will race to the bottom of the domain of standards, and the contest will be to no avail because with all countries choosing the same standard, mobile resources will have no incremental incentive to move. If only these countries could agree not to compete in the dimensions of these standards, the argument concludes, each government would choose the socially optimal level of the relevant standard, and all their populations would be better served (Klevorick (1996), pp. 459-60).

Klevorick then argues, rightly, that:

The defect upon which adherents of the view that nations race to the bottom focus actually sounds much more like the complaint of "ruinous competition" or "destructive competition" that one firm in an industry makes about another when the second has won the battle of the marketplace or the claim that competitors in an industry make when trying to justify agreements among themselves as to prices, quantities, qualities, and so on. In each case the claim is that the competitive process itself is harmful to the interests of one or more competitors and to those they serve, consumers of the product. These are claims about which most antitrust laws and competition laws are highly and justifiably skeptical (*ibid.*, p. 460).

A possible interpretation of a deleterious "race to the bottom" is that it is ...due to failures in the interactions among states, in other words, failures *external* to any one country. This interpretation suggests that repairing the market in which these countries compete would eliminate the detrimental effects, in a manner

analogous, for example, to the way in which domestic antitrust policy is meant to preserve the competitive process or regulation in the public interest is intended to remove a market failure (ibid., p. 460).

Whatever be the plausibility of this interpretation in the contexts to which Klevorick refers, it appears irrelevant to incentive-based-competition for FDI, the UNCTAD (1996) report notwithstanding.

2.3 Global Integration and the Environment

There is a fear that global integration of goods and financial markets and easing of restrictions on FDI will result in transnational corporations of rich countries seeking "pollution havens" in developing countries.^{3,4} This fear seems exaggerated: available empirical evidence does not support the view that higher profits arising from savings due to lower environmental standards are a major consideration in the locational decisions of transnational corporations. In the "Race-to-the Bottom" literature, governments are viewed as deliberately lowering environmental standards to attract capital. Klevorick (1996) suggests, however, that those who fear a race to the bottom of environmental standards, particularly those in rich countries who are critical of environmental standards in poor countries, are concerned not so much about the competition among countries as about the failure of particular governments to set and enforce a particular standard, which they--the critics--deem appropriate from their normative perspectives. Thus to concede the critics' demand for harmonizing standards at their chosen particular standard and enforcing it through international agreement is to enable them to impose their values or norms on others.

³Lawrence Summers, former Vice President of the World Bank and current Secretary of the Treasury in U.S. government was widely criticized for viewing this phenomenon as benign (see Ross and Kathryn Pertras (1993, p. 142) for a pithy quotation from Summers' internal memorandum at the World Bank.

⁴Sankar suggests that enforcement of India's stringent pollution control laws at the behest of courts is adequate to prevent India from being used as a "pollution haven."

Regardless of the empirical significance of pollution-haven seeking private investment or public-policy lowering of environmental standards to attract capital, the demand for linking market access to performance with respect to environmental protection, that is, linkage between trade and environment, has already resulted in the establishment of a committee on Trade and Environment in the World Trade Organization (WTO). Jagdish Bhagwati and I (Bhagwati and Srinivasan (1996)) have elsewhere examined in detail the merits of the case for linkage between trade and environment, and in particular whether environmental diversity detracts from the case for a liberal trading system, I will confine myself here to stating two of our main conclusions. First, the case for linkage is unpersuasive, and developing countries should resist in any future rounds of multilateral trade negotiations any and all attempts at imposing such linkage in the WTO. Second, a liberal trading system is consistent with environmental diversity so that harmonization of environmental standards among countries is not a precondition for gainful exchange in unrestricted markets.

Lowering of environmental standards is only one of many possible incentives in the competition for mobile capital. Such a competition presumes that the incentives offered materially affect the locational decisions of investors. The secretariat of UNCTAD has done a valuable service by putting together a comprehensive list of the types of incentives offered by various countries and surveying theoretical and empirical studies of the response of investment to incentives offered. Although there is no consensus in the empirical literature, most studies do not find a strong influence of incentives offered on investors.⁵

UNCTAD (1996) states flatly that "Incentives are not among the main determinants of FDI locational decisions. Nevertheless, competition among countries to

⁵ See Nordstrom and Vaughn (1999) and the literature cited therein.

attract and keep investment through incentives is strong and pervasive." The governments of India and Indian states are competing to attract FDI. Fortunately in this competition the states have recently agreed not to use tax concessions as a tool.

To sum up, the analytics of the competition for private investment suggest that, first, in the absence of a wedge between social and private returns to such investment no public policy intervention to influence investment flows is called for; second, as long as such a wedge can be eliminated with an appropriate subsidy (resp. tax) that is financed in a non-distortionary way (resp. the tax revenues are used in non-distorting ways), competition for investment will not be ruinous; if appropriately subsidizing or taxing investment is infeasible and governments attempt to attract investment through other incentives, then there is a possibility that in such a competition among states, each state could end up transferring resources from its citizens to the investors in amounts that exceed the benefits citizens derive from such investment.

3. Policy Implications and Conclusions

In the present Indian context such a deleterious outcome is possible. First of all, given the substantial differences among states in development in general and industrialization in particular, in the reformed policy environment ⁶(with the reduction, if not total elimination, of the central government's control of private investment through licensing of investment, capital goods, and raw material imports), less advanced states will wish to play an active role in catching up to the more advanced states, and the latter will try to preserve their advanced status.

Second, poor infrastructure continues to be a major constraint on growth. Much of

⁶Guhan(1980) provides an extremely insightful analysis of the policies pursued by state governments prior to the reforms of 1991. Then the central government directly controlled public sector industrial investment and through industrial licensing controlled private investment as well. His analysis anticipated some of the issues discussed in this paper.

the infrastructure is still under the control of the public sector (state and central) enterprises whose capacity to generate resources for the needed scale of investment is limited. On the one hand, there is an understandable attempt to induce private (domestic and foreign) investors to enter infrastructural industries at the earliest times so that, given the long gestation lags of such investment, supply bottlenecks do not get accentuated in the future. On the other, given the very financial vulnerability and inefficiency of the public sector enterprises at the state level (e.g., electricity boards), the central government has continued to be a part of investment contracts, even though they involve a state public sector unit and private foreign investors. Some of the problems with fast-track approvals and, most notably the need for guarantees by the Central government would not have arisen had the anticipated shortfalls in power been less severe, and had the State Electricity Boards (SEBs) been financially stronger. Guaranteeing, in effect, the rate of return on investment and thus insuring against any and all normal business risks that a private investor would otherwise face, whether the investment was in India or elsewhere, is excessive.⁷

It could be argued that given most states' budgetary situations when they compete for private investment, domestic and foreign, they cannot "transfer" resources to investors through fiscal concessions. But the transfers need not be formal fiscal concessions for them to have fiscal implications. For example, if a state agrees to purchase the output of the private enterprises at a higher than competitive price, or if it provides the enterprise with state land at a price below what such land would have fetched in the market, or if it undertakes investment in infrastructure that is in effect dedicated to

⁷ Besides the fear that SEBs would be unable to pay for the power they purchase, procedural delays as well public interest suits brought against proposed projects on environmental and other grounds have deterred the entry of foreign investment in the power sector. In 1999 and 2000, several external investors (Daewoo Power and Asea Brown Boveri, Electricite de France, National Power of the United Kingdom, and Cogentrix of the U.S. withdrew their proposed investment. (Financial Times, August 23, 2000).

the enterprise in question and for which it does not get fully compensated, the state effectively either forgoes potential revenue or incurs additional expenditure. In either case, its fiscal deficit would be higher than it otherwise would have been. Given the complex system of intergovernmental transfers among the central and state governments through the Finance Commission, Planning Commission, as well as loans from the Centre, there is ample scope for a state to shift the burden of financing its deficits to other states and the Centre. To put it in stark terms: there is a possibility that in competing for private investment, the state could transfer resources to the investor and finance the burden of the transfer only partly from taxes on its own residents and by shifting the remaining part to the other states and the Centre.

Before turning to other issues relating to FDI, some alternative policies concerning competition through fiscal incentives are worth considering. First, if indeed incentives do not significantly influence investment decisions, as the empirical evidence seems to indicate (UNCTAD, 1996), one policy response would be to do away with incentives entirely. But this is unlikely for at least two reasons. First, because no developing economy is completely free of distortions that reduce the rate of return to investment, even in the absence of any externalities associated with FDI, there will be a need to 'offset' the effect of distortions. Second, when other countries (or states) cannot be relied upon to cease offering incentives to investors, it is not in the interest of any one country or state to cease offering them. In such a context, international agreement or its domestic counterpart, inter-state agreement or alternatively central regulation, is needed to ensure that no country or state offers incentives that in fact do not influence investment.

The UNCTAD report (1996) makes several recommendations, though some of them are difficult to implement in practice. The report rightly suggests that

To be efficient, FDI incentives programmes need to work in harmony with basic

market possibilities and stimulate changes led by the competitive situation, both in a static and dynamic sense; the choice of incentive measures is also important to ensure that the same effect on investors' decisions is achieved at a minimum welfare cost for the country; the value of an incentive ought to be established, as far as possible, on the basis of objective criteria, at any rate not exceeding the value of the wedge between the private and social return of the investment. This requires not only careful policy design of FDI incentives programmes but also paying special attention to the manner in which these programmes are implemented in practice.

While recognizing that the Uruguay Round Agreement has addressed subsidies that distort international trade in goods, the UNCTAD report suggests that similar progress should be made in regulating the use of incentives in international competition for investment. It rightly recognizes that this task "is not made simpler by the fact that, in many instances, incentives competition is particularly fierce at the sub-national level." The emerging competition among Indian states is an example. The report's interim recommendations that exchange of information on and experience with FDI incentive policies among governments are undertaken and that the transparency of incentives offered be improved are both on target. Indeed, it is hard to exaggerate the importance of transparency in the process of FDI approvals in the Indian context.

Let me conclude with a few remarks on attracting FDI to infrastructural sectors. Such investments usually involve sizable chunks of capital, are lumpy, and take several years to complete, and their output is likely to be sold in regulated markets. These characteristics imply that there are likely to be few potential projects undertaken in a country within any reasonable time horizon, and a consortium, rather than a single investor, might have to be involved in financing a project. Finally, and most importantly, failing to conclude an agreement to invest and start project construction can create

shortages in the future, since most infrastructural services cannot be imported. The visibility, size, and limited number of such projects also imply that intrusion of politics into their choice cannot be easily avoided. The ENRON episode amply illustrates this.

Inviting competitive bids, evaluating them, and then awarding a contract in a way that is transparent and precludes collusion and rigging in the bidding process, requires institutional and analytical capabilities that few developing countries are likely to have. A vigilant and free press, and the transparency of procedures, would certainly help prevent political and administrative corruption in the award of contracts. It is another matter to resist pressure, not often very subtle, by foreign governments, particularly by a powerful one. For example, according to President Clinton, the United States Government announced in 1993 the establishment of a new commercial strategy focusing on the overseas markets that hold the most promise for U.S. exports and investment over the long term: "We selected ten economies, designated the Big Emerging Markets (BEMs), and designed a strategy aimed at encouraging commercial cooperation with the BEMs and helping US firms seize the opportunities the markets offer" (Letter from the President in U.S. Department of Commerce (1995), a study by the U.S Department of Commerce). The ten BEMs are: Argentina, Brazil, ASEAN (now including Vietnam), the Chinese Economic Area (China, Hong Kong and Taiwan), India, Mexico, Poland, South Africa, South Korea and Turkey. The introduction to the BEMs study states that in each of the markets

competition will be fierce. But, because many have important state sectors and because virtually all are focusing heavily on infrastructure projects that demand involvement of local governments U.S. companies will need the U.S. government at their side to win a fair hearing. What is more, because of the intensity of foreign competition and the capital demands on these economies, our competitors will be public-private partnerships in which foreign governments are providing

concessionary financing and aggressive advocacy to support their companies? efforts. If we don't do the same, we will lose not only our chance to succeed in these markets but our chance to remain the world's largest economic leader into the next century (U.S. Department of Commerce (1995), pp. 18-19, emphasis added).

The Study goes on to identify the role and policies of the U.S government in promoting U.S. interests in BEMs as follows:

There is an important role for our government to play in helping to stimulate our trade with each of the BEMs. The BEMs are unlike our more traditional trading partners, such as Great Britain or Germany. There are frequently severe barriers to entering these markets, including high tariffs, quotas and protectionist regulatory restrictions. Commercial systems, including full respect for intellectual property rights, smoothly functioning capital markets and open government procurement procedures, are often still developing or lacking altogether. In some of the BEMs, impartial legal systems are missing, too. And as noted earlier, the nature of the competition we face in these markets is dramatically different from what we have been used to.

In these markets, therefore, we can and should help American businesses in a variety of ways from securing market access, to providing financing, to supporting US companies seeking to win major projects on deals in which foreign governments are helping their firms or play an important decision-making role in awarding projects (U.S. Department of Commerce (1995), p. 22).

One would hope that a representative of the government in any one of the BEMs would not be intimidated into conceding too much when negotiating with the

representative of an American enterprise who has the representative of the U.S. government at the table providing aggressive support. It is reasonable to expect governments of major industrial countries to support their companies in their negotiations with governments in BEMs as well as in other developing countries. If, as is often the case, the foreign companies and their governments have better information about the host country and stronger analytical support, the task of the developing country's negotiators becomes even more difficult.

The fact that the competition for FDI can be counterproductive does not mean that it necessarily will be.⁸ My purpose here is simply to raise the possibility of counterproductive outcomes primarily to ensure that necessary steps are taken to avoid them. Indeed, India and Indian states need to raise investment in all sectors, including most importantly social sectors. Augmented flows of private investment into those sectors that private investors might find attractive and that the public sector is currently involved in will release public resources for use in those sectors (some social sectors in particular) in which there is no alternative to the public sector. Competition among states to make each investor-friendly and to accelerate reforms is to be welcomed and not discouraged. But the "rules of the game," so to speak, of such competition have to be well-defined, transparent, and subject to appropriate checks and balances through the political process. Otherwise there is a danger that such competition will reduce welfare all around.

⁸ The late Mancur Olson Jr. Suggested in a private communicate that, given the modest flow of FDI to India, relative to potential investment demand for sustaining an annual average rate of growth of GDP 7% or more over a long enough period of time, the possibility of counterproductive competition leading to "excessive" FDI is remote.

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