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Jurisdictional Competition for FDI in Developing and Developed Countries

This brief is based on research studying jurisdictional competition between countries and its influence on the inflow of foreign direct investments (FDI). The study compares jurisdictional competition among the developing Central and Eastern European (CEE) countries with competition among developed EU countries. As instruments of jurisdictional competition for FDI, we consider governments' efforts to improve the rule of law, corporate governance, and tax policies. The results suggest the presence of proactive jurisdictional competition via the quality of corporate governance regulation both in the CEE and the EU countries. The CEE states also attract FDI by competing in tax policies.

Introduction

The determinants of FDI inflows have been examined in numerous studies. A substantial number of them consider the influence of institutions, which are defined as particular organizational entities, procedural devices, and regulatory frameworks (IMF, 2003).

The quality of institutions is a particularly important FDI determinant for less-developed countries because poor institutional quality and weak law enforcement increase the costs of running a business, create barriers for financial market efficiency, and increase the probability of foreign assets expropriation (Blonigen, 2005).

However, governments interested in attracting FDI to boost job creation, new technologies, and tax revenues to their countries are not only concerned about the internal institutional environment. They are also competing with other countries in attracting foreign investments, engaging in what is often referred to as "jurisdictional competition". In a broad sense, this can be thought of as governments' efforts to outcompete one another in offering foreign companies more favorable institutional and fiscal conditions for capital placements.

This brief summarizes the results of a study on the jurisdictional competition for FDI among the developing CEE and among developed EU countries (Mazol and Mazol, 2021). The research explores the precondition for proactive jurisdictional competition between economies for FDI – namely, how the economic and institutional environment within a country impacts the inflow of FDI both domestically and to its neighboring states, - by using a spatial econometric approach. The brief emphasizes the difference in the FDI policy responses implemented by developing CEE and developed EU countries.

Data and Methodology

In our econometric analysis we use the FDI inward stock (i.e., the value of capital and reserves in the economy attributable to a parent enterprise resident in a different economy) as the dependent variable. The explanatory variables indicating jurisdictional competition include quality of corporate governance, rule of law, political stability, and tax policy. We employ balanced panel datasets for 26 developing CEE countries and 15 developed EU countries for the period 2006-2018. The dataset is derived from the World Bank and UNCTAD databases.

The analysis is based on a panel spatial Durbin error model (SDEM) with fixed effects (LeSage, 2014). Parameter estimates in the SDEM contain a range of information on the relationships between spatial units (in our case, countries). A change in a single observation associated with any given explanatory variable will affect the spatial unit itself (a direct effect) and potentially affect all other spatial units indirectly (a spillover effect) (Elhorst, 2014). The spatial spillover effect is viewed here as the impact of the change in the institutional or economic factor in one country on the performance of other economies (LeSage & Pace, 2009).

In our case, the direct effect is the effect on the FDI in country i of the changes in the studied instrument of jurisdictional competition in country i. The spillover effect is the change in FDI in country j following a change in the studied instrument of jurisdictional competition in country i.

Results

The results of our estimation are suggestive of a proactive jurisdictional competition in taxes among the CEE countries and in corporate governance quality both among the CEE and EU countries. Analyses of other factors (i.e., political stability and rule of law) show no significant interrelation between policy measures implemented by neighboring countries in order to attract FDI.

The precondition for the presence of proactive jurisdictional competition in a particular factor is to have statistical significance in both its direct and spillover effects (Elhorst and Freret, 2009). Such findings may indicate that policy measures in one economy trigger a policy response in a neighboring economy, which, in turn, influences the level of FDI in both countries.

***Table 1.** Estimation results of SDEM models – direct effects*

Models	CEE countries	EU countries
$\ln fdi\_pc_{lag_t}$	0.515*** (0.027)	0.664*** (0.052)
$corp\_governance_{lag_t}$	-0.025** (0.012)	0.032* (0.017)
$rule\_of\_law_{lag_t}$	0.197** (0.077)	0.199 (0.126)
$political\_stability_{lag_t}$	0.048* (0.028)	0.144** (0.061)
$tax\_rate_{lag_t}$	-0.003*** (0.001)	0.004 (0.003)
$\ln gdp\_pc_{lag_t}$	0.192 (0.137)	0.017 (0.440)
$inflation_{lag_t}$	0.001 (0.002)	0.024** (0.011)
$resource\_rent_{lag_t}$	-0.006** (0.003)	0.048*** (0.003)
$urban\_population_{lag_t}$	0.031*** (0.009)	0.026** (0.011)
$unemployment_{lag_t}$	-0.002 (0.004)	0.001 (0.007)
R^2	0.967	0.409
Number of observations	338	195
Moran I Test	0.147***	0.217***
Hausman LM Test	604.274***	533.363***

Notes: *** – significance at 1% level, ** – significance at 5% level, * – significance at 10% level. ln – denotes the logarithm of the underlying variable. lag_t – denotes lagged underlying variable by one period (year) in time. Values of *t* statistics in parenthesis. CEE countries: Albania, Armenia, Azerbaijan, Belarus, Estonia, Bosnia and Herzegovina, Bulgaria, Croatia, Czech Republic, Georgia, Hungary, Kazakhstan, Kyrgyz Republic, Latvia, Lithuania, Macedonia, Moldova, Poland, Romania, Russia, Serbia, Slovakia, Slovenia, Tajikistan, Ukraine, Uzbekistan. EU countries: Austria, Belgium, Denmark, Finland, France, Germany, Greece, Italy, Luxembourg, Netherlands, Norway, Portugal, Spain, Sweden, Switzerland. *Source:* Author's estimates based on World Bank and UNCTAD databases.

Our results for the direct and indirect response to a tax policy in CEE countries illustrate this logic. Decreasing *tax_rate* increases FDI to the CEE economy enacting this change (see Table 1), as well as to its neighboring countries (see Table 2). This finding is consistent with jurisdictional competition in taxes. That is, a reduction in domestic *tax_rate* may entail a decrease in the tax rate of a neighboring economy, resulting in a subsequent increase in FDI. (To explicitly confirm the suggested channel, further tax policy analysis would be needed). Interestingly, our results suggest that jurisdictional competition in taxes is only present among CEE economies, but not among EU countries.

In turn, an increase in *corp_governance*, a measure of corporate governance quality, increases FDI in neighboring countries both in the EU and in the CEE region (see Table 2). A possible interpretation is that an increase in *corp_governance* in one country may entail an increase in *corp_governance* in its neighboring economies, resulting in a subsequent increase in FDI. This result suggests proactive competition via corporate governance policy both among the EU countries and the CEE countries.

However, the direct effect differs between the regions. In the EU, an increase in *corp_governance* increases FDI to the EU economy in question, in line with common wisdom (see Table 1). At the same time, in the CEE region, an increase in *corp_governance* is followed by a decrease in FDI to that country.

***Table 2.** Estimation results of SDEM models – spillover effects*

Models	CEE countries	EU countries
$corp\_governance_{lag_t\_lag_s}$	0.096* (0.057)	0.130* (0.076)
$rule\_of\_law_{lag_t\_lag_s}$	-0.338 (0.432)	-0.553 (0.540)
$political\_stability_{lag_t\_lag_s}$	-0.088 (0.168)	-0.191 (0.277)
$tax\_rate_{lag_t\_lag_s}$	-0.015* (0.008)	0.006 (0.015)
$\ln gdp\_pc_{lag_t\_lag_s}$	-0.318 (0.461)	-2.940** (1.400)
$inflation_{lag_t\_lag_s}$	0.013 (0.008)	
$resource\_rent_{lag_t\_lag_s}$	0.008 (0.020)	0.056 (0.070)
$unemployment_{lag_t\_lag_s}$		-0.050* (0.028)
R^2	0.967	0.409
Number of observations	338	195
Moran I Test	0.147***	0.217***
Hausman LM Test	604.274***	533.363***

Notes: *** – significance at 1% level, ** – significance at 5% level, * – significance at 10% level. ln – denotes the logarithm of the underlying variable. Values of *t* statistics in parenthesis. $lag_t\_lag_s$ – denotes spatially lagged underlying variable (multiplied by spatial weight matrix) lagged by one period (year) in time. *Source:* Author's estimates based on World Bank and UNCTAD databases.

One potential explanation for the negative direct effect of corporate governance quality on FDI in the CEE economies is that improved corporate governance practices can block certain types of FDI, leaving behind foreign investors with a lower "threshold for corruption". This may decrease FDI to the CEE country in question. However, once the jurisdictional competition results in an improvement of corporate governance across the region, it ultimately has a positive spillover effect.

The above explanation is in line with the theory of regulatory capture (Stigler, 1971), which suggests that the decisions made by public officials might be shaped and sometimes distorted by the efforts of rent-seeking interest groups to increase their influence.

Finally, the estimates do not indicate that the other studied institutional factors, rule of law and political stability, are applied as instruments of jurisdictional competition as neither groups of countries show significant spillover effects. The results, however, show that these factors influence the FDI inflow via the direct effect. More specifically, an increase in *political_stability* positively influences the FDI inflow to the economies in question, both in CEE and the EU, while *rule_of_law* is positive and significant only for the CEE countries. If investors are not as responsive to changes in *rule_of_law* when the initial level is high, the fact that EU countries typically have a higher *rule_of_law* value compared to CEE countries might explain why this estimate is insignificant for the EU countries.

Conclusion

This brief, first, presents new evidence on the relationship between different economic and institutional factors and FDI using a spatial econometric approach; second, it analyzes the possible existence of jurisdictional competition among developing CEE countries and developed EU countries as well as its effect on FDI.

The results suggest proactive jurisdictional competition in FDI determinants such as corporate governance quality and tax rates. CEE countries competing with one another use both these instruments of jurisdictional competition, while EU countries compete only via corporate governance quality. Furthermore, foreign investors are not sensitive to the quality of rule of law in the EU countries, while this instrument is more important for the FDI inflow to CEE economies.

Our results stress that officials responsible for the FDI policy implementation should pay more attention to the policies undertaken by neighboring governments as such external policies can make their own strategies to attract FDI to their economy less effective.

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