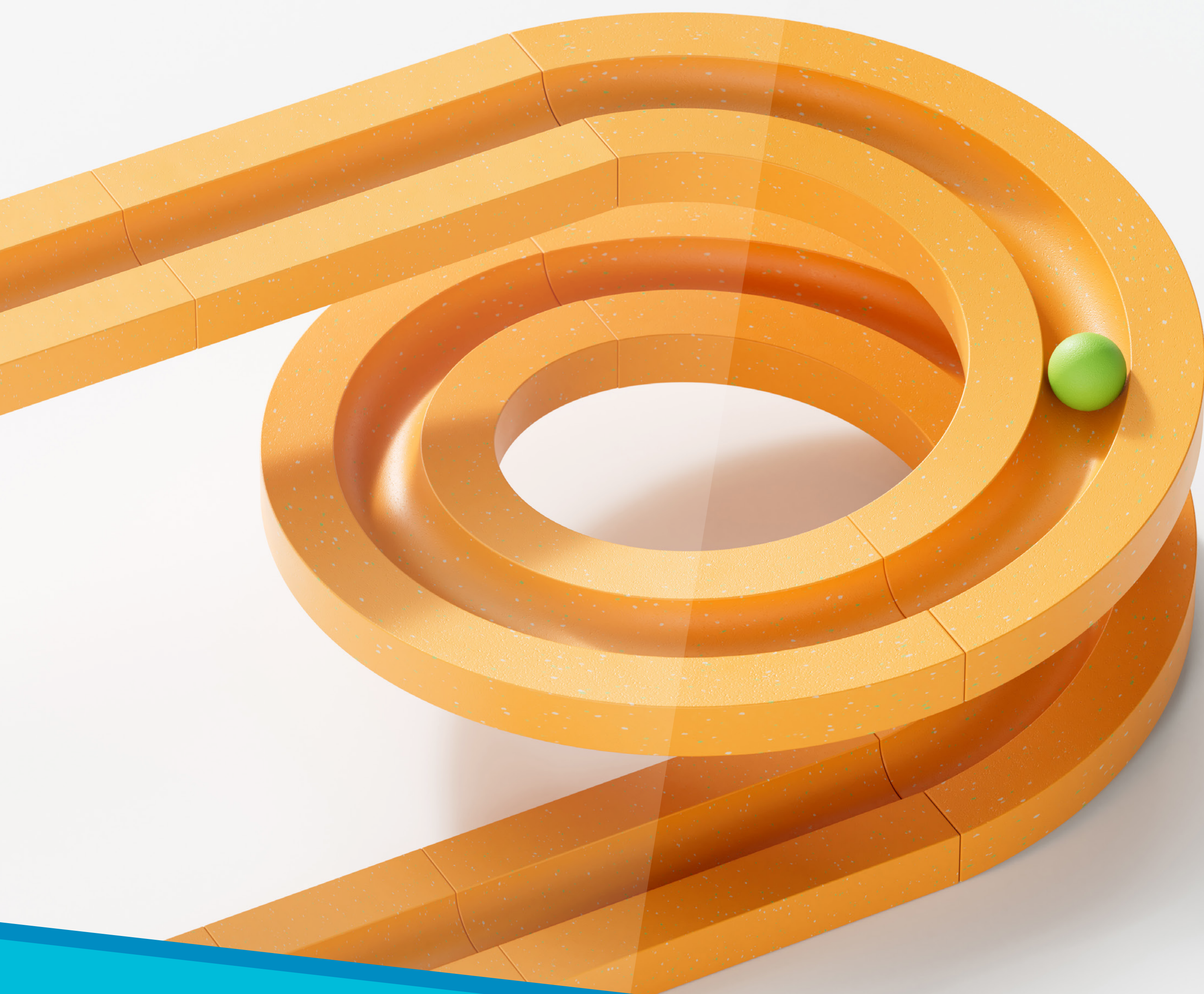
Avoiding a race to the bottom

Unlocking investments



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Introduction

Competition for investment is intensifying. Here's how to balance the use of incentives to attract investments while maximizing economic benefits.

Avoiding a race to the bottom

It is hard to overstate the importance of investment to the prosperity of countries and the global economy. In 2022, gross fixed capital formation totaled $26 trillion, or 26 percent of world GDP, and has increased by an average of 5 percent annually since 2015.[1] The reason? Countries took advantage of low interest rates following the pandemic to invest in infrastructure, sustainability, and technology, fueling investments ranging from infrastructure to the energy transition to net zero.

Yet this headline growth masks a dramatic shift. While global FDI inflows totaled $1.4 trillion in 2023, they have declined by an average of 5 percent annually since 2015 as jurisdictions—countries, regions, states, provinces, and municipalities—pivot to domestic direct investment (DDI).[2] The reasons for this shift are numerous, from a desire to retain intellectual property closer to home to an effort to avoid the kind of global supply-chain disruption experienced during the pandemic, taking advantage of automation to make high-labor-cost countries more competitive, avoiding the environmental impact of cross-continent shipping, and managing the changing global tax landscape.

But jurisdictions remain aware of the unique benefits of FDI in facilitating knowledge sharing through technology transfer, human-capital development, and collaborative R&D, while ultimately building competitive advantage to fulfil economic goals such as diversification, jump-starting new industries, or promoting social welfare. As a result, efforts have been ramped up around the world to attract greater foreign and retain domestic investment, with incentives surging 77 percent to $45 billion in 2022.[3]

This eagerness to attract capital—particularly in a competitive environment in which global FDI has fallen[4,5]—risks creating a "race to the bottom" dynamic as jurisdictions offer escalating incentives in the hope of attracting investors. This article examines the evolution of global incentives aimed at attracting investments, highlighting two approaches for changing the current dynamic.

While the article primarily addresses avoiding a race to the bottom through incentives, jurisdictions must concurrently prioritize enablers of long-term competitiveness, from doing business within specific jurisdictions to the accessibility of raw materials and production components at competitive prices, the availability of qualified talent, preferential access to export markets through free-trade agreements, or export logistics infrastructure.

By thoughtfully balancing investment incentive programs and enablers of competitiveness, jurisdictions can create exceptional environments that sustainably attract and retain investors.

1 "World Bank" Data Bank - accessed January 9, 2024.
2 "UNCTAD" Global Investment Trends Monitor, No. 46 accessed January 20, 2024.
3 Alex Irwin-Hunt, "US's incentives largesse remains no match for FDI rivals," fDi Intelligence, March 29, 2023.
4 World investment report 2023, July 5, 2023.
5 "UNCTAD" Global Investment Trends Monitor, No. 46 accessed January 20, 2024.

How incentives became critical investment enablers

Governments have shaped a competitive incentives landscape; in 2022, the US government enacted five- and ten-year packages totaling $780 billion in tax credits and cash incentives for renewable energy, semiconductors, green transport, and manufacturing under the CHIPS and Science Act and the Inflation and Reduction Act (IRA).[6] Similarly, the European Green Deal provides more than $500 billion in incentives for investments in renewable energy, green transport, and manufacturing,[7] and the Made in China 2025 industrial policy offers $300 billion for semiconductors, green transport, and manufacturing.[8]

These incentives target attracting foreign and retaining domestic investment specially to fuel the development of strategically significant sectors such as electronics. In fact, nearly half of all greenfield FDI in 2022 was in the renewables and electronics industries, both of which saw double-digit growth.[9]

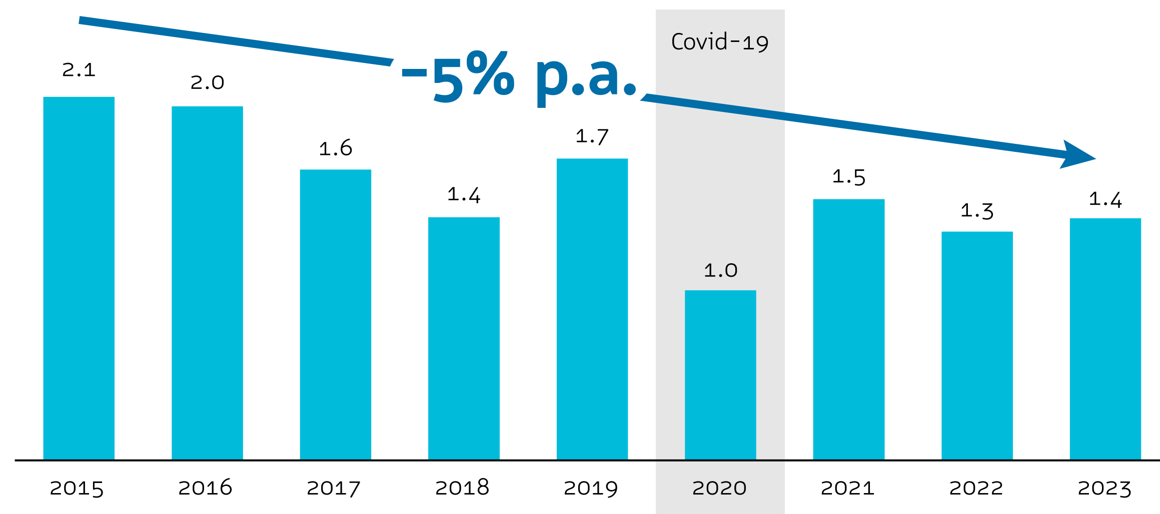
However, the competition for FDI is more intense given the cross-border knowledge transfer role it plays and the global decline it has been experiencing. Even before the COVID-19 pandemic, global FDI inflows were falling, from $2.1 trillion in 2015 to $1.4 trillion by 2023 (Exhibit 1).[10,11]

6 “Inflation Reduction Act (IRA) summary: Energy and climate provisions,” Bipartisan Policy Center, August 4, 2022.
7 “The European Green Deal: Striving to be the first climate-neutral continent,” The European Commission, accessed January 8, 2024.
8 Keith Bradsher and Paul Mozur, “China’s plan to build its own high-tech industries worries western businesses,” New York Times, March 7, 2017.
9 Alex Irwin-Hunt, “The 2022 investment matrix,” fDi Intelligence, February 1, 2023.
10 World investment report 2023, July 5, 2023.
11 “UNCTAD” Global Investment Trends Monitor, No. 46 accessed January 20, 2024.

Exhibit 1

Foreign direct investment has declined globally by 5 percent per annum since 2015.

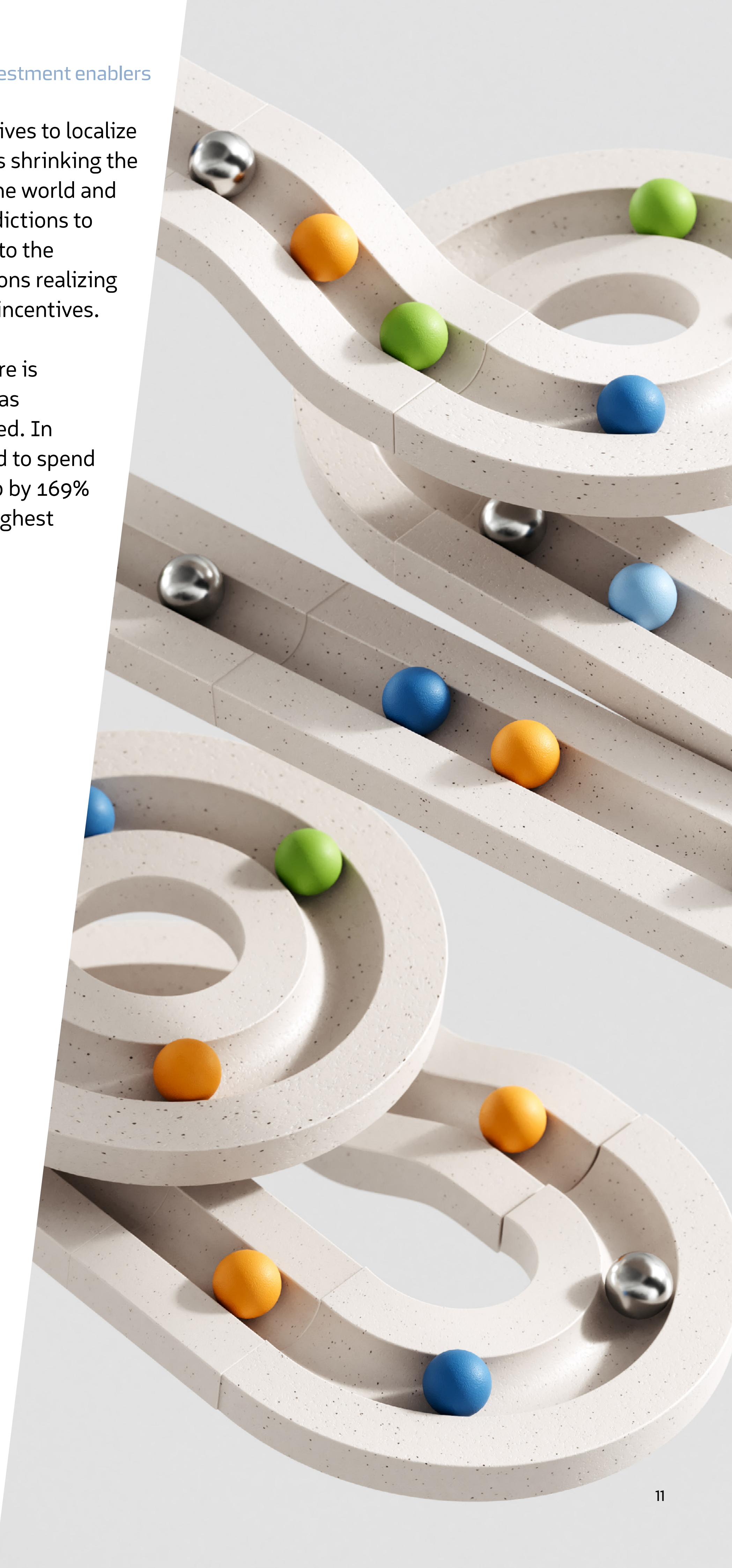
Global foreign direct investment inflows
2015–23, $ trillion



Source: World investment report 2023: Investing in sustainable energy for all, United Nations Conference on Trade and Development (UNCTAD), July 5, 2023. UNCTAD, Global Investment Trends Monitor No. 46

This wave of unprecedent incentives to localize industries by major economies is shrinking the capital available for the rest of the world and indirectly pressuring other jurisdictions to keep up, posing a risk of a “race to the bottom” dynamic with jurisdictions realizing less economic benefits for their incentives.

The effect of this indirect pressure is evident through indicators such as incentive spending per job created. In 2022, jurisdictions are estimated to spend $69,000 in incentives per job, up by 169% from the previous year and its highest level since 2010.[12]



12 Alex Irwin-Hunt, “US’s incentives largesse remains no match for FDI rivals,” fDi Intelligence, March 29, 2023.

Taking a more balanced, comprehensive approach

The risk of intensifying competition for investments is that jurisdictions may overspend on incentives—a counterproductive outcome that could divert resources from other economic priorities, subsidize businesses that are not sustainable in the long term, and increase the potential for moral hazard incidents by investors. Counteracting these risks demands a two-part approach (Exhibit 2).

The levers and tactics within these two broad strategies are not one-size-fits-all—jurisdictions can implement combinations depending on their circumstances and the investors they want to attract, with the mix and intensity depending on existing capabilities, acute needs, and capacity.

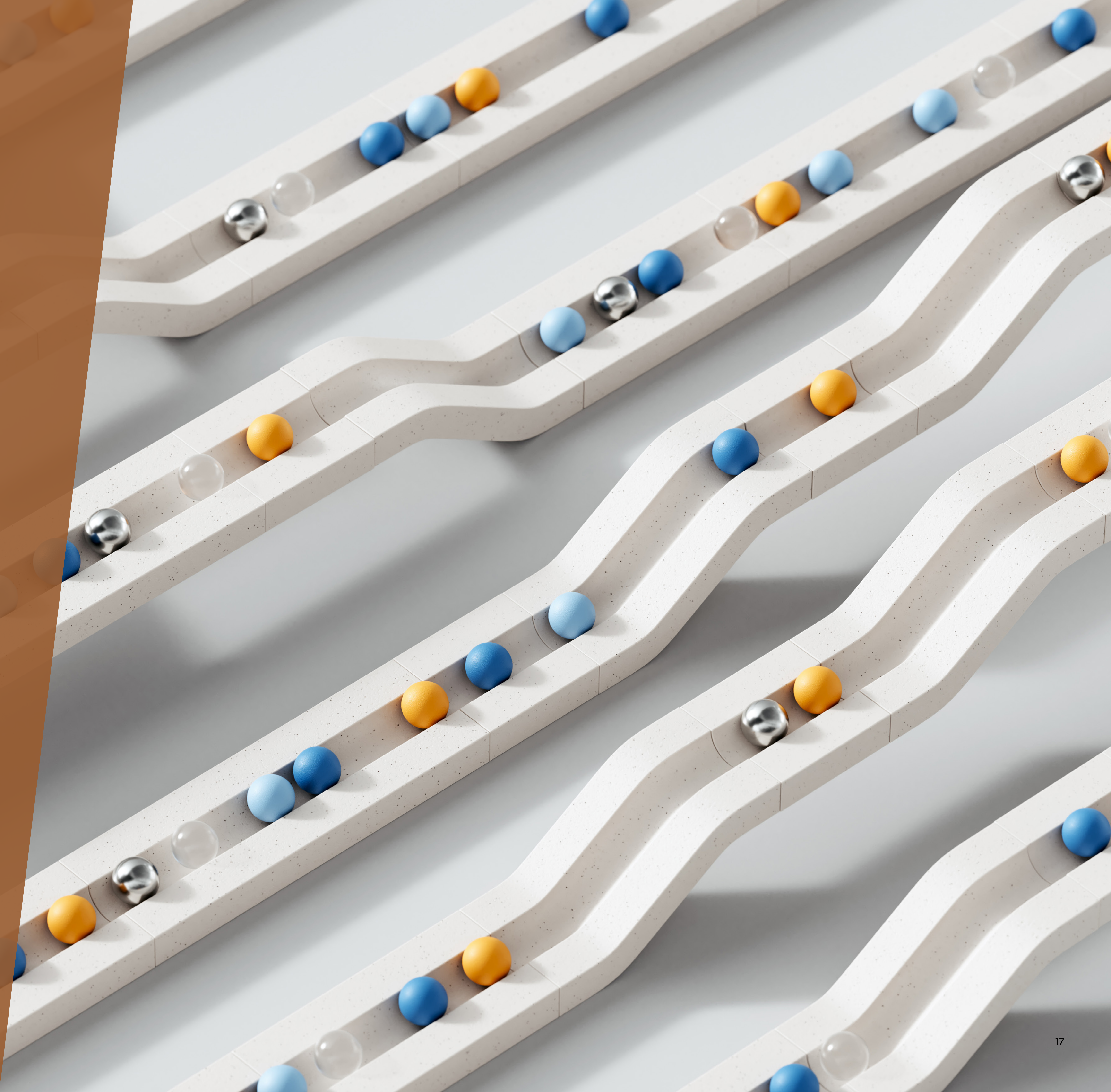
Exhibit 2

To avoid the 'race to the bottom,' decision makers may consider two main levers.

Lever	Sub-lever	Tactics
1 Optimize spending on incentives	**1a** Minimize total incentive spend	Create transparency on target IRR
		Foster competition
	1b Optimize the mix of support packages	Optimize the mix of cash vs. non cash incentives
		Leverage non-monetary support
		Offer preferential access to local and global demand
	1c Implement guardrails to reduce spending leakage	Protect jurisdiction interest in case of investor failure to meet obligations
		Avoid moral hazards
2 Maximize and sustain economic impact	**2a** Ensure efforts are sustained	Support projects that are competitive on an operating cost basis
		Invest in local ecosystem to deepen the competitiveness
	2b Maximize desired economic outcomes	Develop clarity on most critical economic objectives
		Align monetary mechanisms with most critical objectives
		Track and evaluate impact of support allocated to investment

Optimize spending on incentives

Optimal spending can be achieved by minimizing incentive spending, optimizing the mix of support packages, and implementing guardrails to reduce leakage.



Minimize total incentive spending

One tactic to minimize incentives is for jurisdictions to align with investors up front on an internal rate of return (IRR). In particular, decision makers could consider elements such as the maturity of the local ecosystem and the jurisdiction's global reputation among investors compared with its competitors. One best practice is using a shadow model, which enables a comprehensive view of a project's profitability, stress-test assumptions, and helps leaders evaluate the appropriate level of incentives. Decision makers can also use the model to compare the cost of doing business in their jurisdictions against competing locations and refine their assessment of the incentives that will be required.

Encouraging competition among investors is another way to limit total incentive spending, and it can give jurisdictions the benefit of selecting the optimal deal. This posture puts jurisdictions in a more active role, reaching out to prospective investors selected according to criteria such as their financial positions, propensity to invest, and prominence. However, jurisdictions need to maintain transparency with investors throughout the process to protect their reputation as thoughtful global partners. Jurisdictions can also use auction dynamics: setting an upfront target price or level of financial support and allowing private-sector investors to compete for the opportunity. This competitive bidding process is most appropriate when the host jurisdiction and its investment opportunity are exceptionally attractive and have multiple potential candidates. The process is often used for projects in telecommunications infrastructure, renewable-energy implementation, public-private partnerships, and mining.

Optimize the mix of support packages

Different value-transfer levers (for example, cash grants and tax exemptions) have distinct effects on a jurisdiction's budget, which makes the precise mix of the support package critical. For example, jurisdictions tend to prefer—and commonly offer—deferred-tax incentives such as full or partial exemptions on corporate taxes, import customs, and value-added taxes. These incentives are preferable because the corresponding fiscal revenue is generated only because of the investment.

Such incentive packages also contribute significantly to the profitability of projects. In contrast, jurisdictions often offer cash grants for capital projects as a last resort because they create immediate fiscal pressure. Between these two extremes—the deferred-tax incentives and the cash grant—jurisdictions can customize their packages from a menu of incentives. Jurisdictions can then use scenario analysis to assess the effect of different combinations of value-transfer levers on project profitability and governments' fiscal goals.

For example, Morocco sought to expand its export industries by creating a support package heavy on noncash incentives. One enticing proposition for long-term investors in the Tangier Free Zone was five tax-free years followed by a preferential corporate tax rate of 8.75 percent instead of 30 percent. The package also waived the value-added tax on products imported in the Free Zone, provided an income tax allowance of 80 percent for the first 15 years of the investment, and offered subsidies for the development of human capital.[13]

13 Incentives and free zones in the MENA region: A preliminary stocktaking, MENA-OECD Investment Programme, December 14, 2004.

Jurisdictions may also consider nonmonetary incentives that still have a direct financial impact, such as discounts on locally available, high-value business inputs such as energy, land, and raw materials. Offering a low and stable cost of energy is a common incentive for jurisdictions with a natural cost advantage for energy production. For instance, China's low energy prices in its Southwest provinces—$0.05 per kilowatt-hour, thanks to extensive hydropower infrastructure—have positioned the country as a cost-competitive jurisdiction globally. This cost advantage translates into competitive pricing for industries that rely on energy as a significant input, such as aluminum production. Similarly, Norway's hydropower assets give it the most competitive energy prices in Europe.[14]

Finally, jurisdictions can provide preferential access to growing local demand, if possible. This could include guarantees for centralized demand from entities such as state or national governments and large private-sector players.

Implement guardrails to reduce spending leakage

Minimizing resource leakage and generally protecting jurisdictions' interests are critical for optimizing government spending. At a basic level, jurisdictions want to ensure investors fulfill their economic obligations in areas such as job creation and production volumes, which requires specifying parameters and tying incentive disbursements to milestones or project schedules.

One risk is that investors could reap excessive financial gains from guaranteed purchasing volumes. Jurisdictions can avoid this outcome by requiring investors to participate in a minimum percentage of competitive bids for which they receive invitations, which helps jurisdictions avoid accidentally fostering anticompetitive outcomes.

In addition, boundaries can be set such that investors' bids must be within a limited distance of the most-competitive bids. This ensures the beneficiary does not artificially inflate prices to maximize its financial gains. Incentives can be reduced if the beneficiary fails to comply with the pricing cap. To be sure, these requirements would need to have a claw-back clause so incentives could be trimmed if investors fail to meet them.

14 Paul Waldie, "Norwegians, shocked by rising hydro bills, change old habits and rethink what to do with oil wealth," The Globe and Mail, February 3, 2023.

Maximize and sustain economic impact

The second strategy is to maximize sustainable economic impact from investment. Specifically, jurisdictions should ensure investments are sustainable over the long term and maximize desired economic outcomes. This requires attracting investments with operating costs allowing them to remain competitive and for decision makers to prioritize investment in local ecosystems to enhance their jurisdictions' competitiveness. Crucial to this effort is clearly articulating the top economic objectives, aligning investment incentives around them, and implementing systems to track, measure, evaluate, and refine economic impact.

Ensure efforts are sustained

Whether incentives help projects be more globally competitive or provide initial capital investment, one of the most important objectives is to ensure projects can become and remain competitive. That requires approved projects be competitive on operating costs in the long term, especially with respect to the cost of core inputs such as raw materials, energy, and labor.

Jurisdictions can use tools such as the shadow model to assess projects' operational sustainability. This analysis can be conducted independently of the investor, accounting for both operating and capital costs and comparing them against global benchmarks. They can also invest in local ecosystems to further enhance their competitive position in targeted industries. For instance, jurisdictions may partner with investors on development programs aimed at strengthening local suppliers or attracting complementary global suppliers for highly complex inputs. Collaborating with investors on vocational training programs can also help create a local pipeline of talent, ensuring a skilled workforce that bolsters an investment's prospects. To further boost competitiveness, jurisdictions may explore additional investment opportunities in adjacent industries or develop R&D centers with existing global investors.

Consider Morocco's automotive ecosystem, which now produces about 8 percent of Europe's automotive imports.[15] Using the Tangier Free Zone incentives, Morocco attracted more than 150 suppliers to contribute essential components and services to major automotive manufacturers operating in the country, such as Renault and PSA Peugeot Citroën. The country's localization efforts have created a highly integrated domestic value chain, with local suppliers providing around 60 percent of the value of vehicles manufactured in Morocco.[16] The country also established dedicated state-of-the-art training centers to develop skilled workers who can meet the needs of the automotive industry, and it subsidizes human-capital development with $500 to $3,000 per person per year for the automotive industry.[17]

Maximize desired economic outcomes

Achieving sustainable economic impact demands jurisdictions define clear economic objectives to track progress and against which to evaluate impact. First, they can articulate the most critical economic objectives, aligning stakeholders around priorities such as economic diversification, growth, supply chain resilience, and social welfare. Once these economic goals are defined, jurisdictions can set KPIs to measure progress and then develop frameworks for measuring progress, weighting objectives according to their position on the priority list.

How these elements work together will differ between jurisdictions. For instance, the IRA in the United States is focused on supply chain resilience and growing the localized portion of strategic industries. France decided to focus investment-attraction efforts on job creation and growth in strategic sectors such as technology, defense, energy, and agriculture. This made the number of jobs created or preserved pivotal, especially for jurisdictions within the country that are suffering from high rates of unemployment.

15 Economic and market report: EU automotive industry full-year 2018, European Automobile Manufacturers Association, February 2019.
16 Alex Irwin-Hunt, "A Moroccan manufacturing boost," fDi Intelligence, December 23, 2020.
17 Ruben Brekelmans et al., The automotive cluster in Morocco: Competitiveness and recommendations for future growth, Harvard Business School, May 8, 2015.

The next step is to allocate both monetary and nonmonetary support. Specifically, jurisdictions may preallocate support packages toward attracting investments that fulfill the agreed-upon economic objectives to streamline the process of allocating resources for individual investments and maximize the impact of their spending. This involves regularly monitoring and evaluating the outcomes of investments against KPIs to determine whether to take corrective action.

Consider the KPIs developed by Singapore's Economic Development Board. One of them is fixed-asset investment commitments, of which the country drew $16.5 billion in 2022.[18] Job creation is a particularly critical KPI because the board oversees industries accounting for more than a third of Singapore's annual GDP and has a mandate to help create good jobs for Singaporeans. Another KPI is government incentives for companies that invest in Singapore: their value, the number of companies that use them, and their effectiveness.[19]

18 "EDB attracted S$22.5 billion in fixed asset investment commitments in 2022 amidst a challenging business environment," Singapore Economic Development Board, February 9, 2023.
19 "Singapore Economic Development Board (EDB)," Investment Monitor, accessed January 9, 2024.

Conclusion

In this article, we have presented a comprehensive approach to unlocking investment.

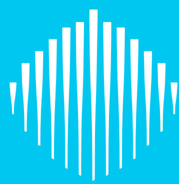
The race to the bottom is real, but not inevitable. Minimizing total incentive spending, optimizing the mix of cash and noncash support, reducing leakage with guardrails, ensuring that efforts are sustainable, and maximizing the desired economic outcomes are all ways to move beyond the current dynamic. The next steps are up to the leaders steering the economic trajectories of their jurisdictions.

About the Authors

This article is a collaborative effort by Rima Assi, Sélim Jeddi, Gannate Khowailed, Andrew Pickersgill, and Yassir Zouaoui, representing views from McKinsey's Social, Healthcare, & Public Entities Practice.

Rima Assi is a senior partner in McKinsey's Dubai office, where **Sélim Jeddi** and **Yassir Zouaoui** are partners. **Gannate Khowailed** is a consultant in the Cairo office. **Andrew Pickersgill** is a senior partner in the Toronto office.

This report has been designed by Elena Yaropolova.



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