Making Investment Work for Developing Countries

Monographs on Investment and Competition Policy, #9

0110

कट्स CUTS

Making Investment Work for Developing Countries

Monographs on Investment and Competition Policy, #9

कट्स CUTS

Making Investment Work for Developing Countries

Monographs on Investment and Competition Policy, #9

Published by:

कट्स ✠ CUTS

CUTS Centre for International Trade, Economics & Environment
D-217, Bhaskar Marg, Bani Park
Jaipur 302 016, India
Email: cuts@cuts.org
Website: www.cuts.org

Researched and compiled by:

Olivia Jensen
with assistance from Ritu Lodha

Layout by:

Mukesh Tyagi
CUTS, Jaipur

Printed by:
Jaipur Printers P. Ltd.
Jaipur 302 001

ISBN: 81-87222-49-2

#0110 SUGGESTED CONTRIBUTION Rs.20/$5

CONTENTS

Foreword

This publication is another in our series of monographs on investment and competition policy intended to introduce related topics to a wide audience. This monograph will also serve as a reference point for those interested in the complex and sometimes controversial relationship between foreign direct investment and development.

One of the dominant themes in the last quarter of this century has been the process of globalisation and the progressive international economic integration of the world economy. The movement is widening international flows of trade, finance and information and creating a single integrated market.

The liberalisation of capital flows has been at the heart of the globalisation phenomenon, creating opportunities for developing countries suffering from severe capital constraints, but at the same time threatening to destabilise or even retard their progress towards engaging in world markets on a more equal footing.

Global capital flows are not, of course, a new phenomenon. But the value and nature of these flows are. Huge multinational corporations now spread their activities across the world in global production networks, concentrating activities in different countries according to local production costs and capabilities.

On the one hand, this allows developing countries to benefit from their own competitive advantages of abundant labour and low wages. On the other hand, this could make it more difficult for them to move into an upward spiral of technological upgrading and growth. In the effort to attract greater quantities of FDI, developing country governments have sometimes forgotten the importance of the nature and quality of the capital inflows.

Whether FDI really contributes to development depends crucially on the investment environment of the host country. The investment environment is the product of economic and institutional factors. Well designed and implemented policies, both directly and indirectly related to FDI, can shape the investment environment to maximise the gains of investment.

This monograph identifies some of the policies that developing country governments can use to make investment work towards their national developmental goals, stimulating growth and contributing to the reduction of poverty.

Jaipur
November 2001

Pradeep S Mehta
Secretary General

I. Introduction: Prioritising investment

Developing countries are severely constrained in their access to finance for investment, investment that is vital to generate growth. Many of these countries suffer under the huge burden of repayment of external debt to international lending institutions as well as deficits on the current account of the balance of payments. In the context of declining overseas development aid flows, developing countries have fewer and fewer ways to gain access to external sources of financing.

Internally, governments find it hard to overcome huge budget deficits that have built up over time, and a history of low growth rates and poverty, with the implication of low levels of domestic savings, mean that domestic resources that can be leveraged for investment are also very limited.

In these circumstances, attracting investment from the private sector has understandably become a policy priority in many countries, developed as well as developing. Efforts have been focused on attracting foreign direct investment (FDI) by transnational corporations (TNCs) rather than portfolio investment in the shares of domestic companies.

FDI is differentiated from portfolio investment as it involves a transfer of management control to a foreign firm and it is generally thought that it contributes more to development through positive spillovers of various kinds than portfolio investment does.[1]

At present, developing countries attract only a small proportion of global FDI flows. In 1998, developing countries accounted for only 24 percent of global FDI inflows. Further, these flows are highly concentrated towards certain countries.

- Developing Asia received $106bn of the $208bn that flowed to developing countries as a whole, of which $40bn went to China alone.
- Brazil attracted $31bn in investment, a third of the total flow to Latin America and the Caribbean.

1 See, for example, UNCTAD World Investment Report, 1997, Chapter III

- The 48 Least Developed Countries (LDCs) attracted $4.5billion in 1999, only 0.5 percent of global FDI inflows, and 2.2 percent of the total flow to developing countries.

The limited volumes of these flows and their perceived value have ignited fierce competition between countries and even between regions of the same country to attract FDI flows. In the race to tempt investors, countries have often abandoned screening and regulatory procedures, throwing their arms wide open to any and all investments.

However, FDI has associated risks as well as benefits. It will only lead to fruitful, balanced growth in the host economy under certain conditions.

Governments have to ensure that these conditions are in place if they are going to make investment work towards their own development goals rather than just generating profits for the foreign company.

These conditions cover broad features of the political and macroeconomic environment. Policies of stability and transparency in particular will have positive effects on growth and development, not just through the FDI channel but also directly. They also cover investment-specific policies. In this respect, governments should aim not for deregulation, but good regulation.

The impact of FDI on investment in a host country depends on a variety of conditions. It will, for example, be different in countries with abundant savings and other forms of capital than in countries without enough capital relative to their investment needs or demands. It also depends on the financial and other aspects of the behaviour of foreign affiliates such as:

- their mode of entry (greenfield or merger/acquisition);
- the activities they undertake, and whether these are already undertaken in the host economy;
- Sources of finance for FDI (reinvested earnings, intra-company loans or equity capital from parent companies); and
- the impact on the activities of domestic companies.

This paper seeks to identify the advantages and the risks associated with FDI and to pinpoint those policies that get the balance right between appealing to investors and drawing out the maximum benefit from those investments.

1. Why do firms engage in FDI?

(a) Investor motivations

There are many reasons why firms choose FDI over other kinds of investment. A few critical ones are outlined below.

1. Markets. Many foreign investors are seeking opportunities to sell in overseas markets. These investors are likely to be attracted by the potential for sales in domestic markets of the countries in which they are investing. Markets that are large and growing will therefore be most attractive.
2. Production platform. Some investors set up overseas facilities specifically to serve regional export markets and to provide a platform for production and sales. An example is the Japanese auto factories in the UK and Mexico which provide platforms for sales in the European and North American markets.
3. Resources. Some investors' overseas activities are aimed at obtaining access to critical resources not available or available only at higher cost in their own markets. Low cost natural resources and labour continue to attract a significant number of investors. For certain commodities, competition is based entirely on price and therefore lower input prices are crucial for firms to retain profitability.
4. Efficiency gains. TNCs may enter a country to gain access through linkages to know-how in local industry clusters. Positive spillovers may occur only within the cluster which TNCs may try to benefit from either through merger or acquisition or informal strategic alliances. Such clusters are much more common in developed countries than developing countries. However, the software industry in Bangalore, India might be one example of a developing country cluster.

Global trade in services is expanding rapidly and foreign direct investment is one of the four ways that trade in services can take place, as defined in the General Agreement on Trade in Services signed at the WTO As countries expand their commitments under the GATS, FDI for service provision will make up an increasing part of FDI to developing countries as a whole.

Numerous investor surveys have been carried out by private companies and agencies like UNCTAD.

- In Africa, the main attractions for FDI are market-related, notably the size and growth of the local market, and access to regional markets [UNCTAD/ICC survey conducted Nov 1999-Jan 2000, WIR 2000].
- In China and India, the greatest attractions are the size of the domestic markets [AT Kearney survey, April 2001, Business Line 06/04/01].

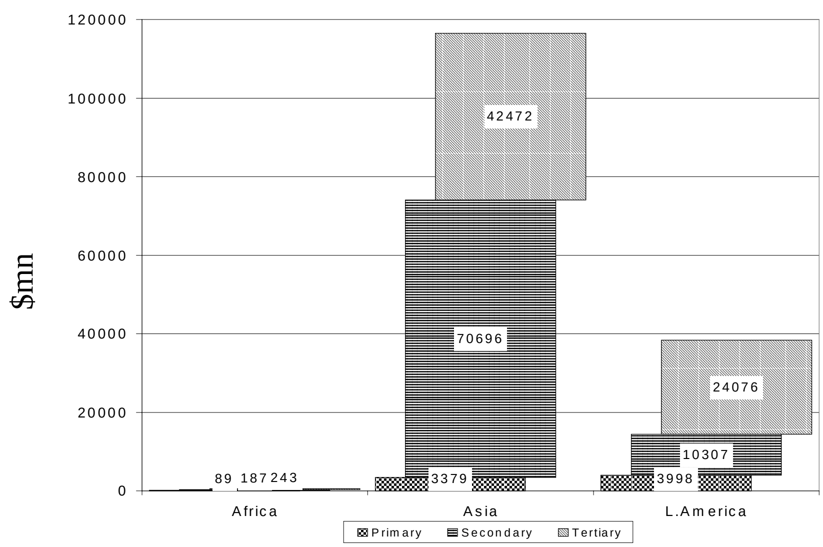
- In Latin America, investment has been attracted by profitable opportunities from privatisation. Most new investment inflows go into non-tradable service and manufacturing industries producing mostly for the domestic markets.

(b) Recent trends

Opening markets and knowledge-based production are creating both opportunities for firms to expand and the competitive pressure for them to do so. A portfolio of locational assets, i.e. production and management facilities across a range of sites, allows firms to combine their mobile resources, such as management skills and ability to organise production, with the immobile advantages of particular locations. Another recent phenomenon is the increasing propensity of firms to engage in strategic alliances, joint ventures and collaboration for R&D.

The pressures of the global, knowledge-driven economy have led firms towards corporate strategies of deepening economic integration across countries. This involves a shift away from stand-alone, relatively independent foreign affiliates, towards integrated international production systems. Any part of the chain of value addition can be located abroad, with foreign units increasingly specialised according to their function. This may help some countries with specific assets such as software skills to attract more investment.

FDI inflows by sector, 1997



2. Potential Benefits of FDI

FDI can make a valuable contribution to growth and development in national economies, particularly in a rapidly globalising world. Trade and investment flows are complementary phenomena that together help developing countries to integrate into the world economy. The benefits from FDI include:

- Overcoming the domestic investment gap. Low incomes and low savings rates mean that there are limited resources within the national economy available for investment. However, investment is desperately needed for growth. FDI can close this gap by providing an outside source of financing for investment. The inflows are more stable and easier to service than commercial debt or portfolio investment. In distinction to other sources of capital, TNCs invest in long-term projects, taking risks and repatriating profits only when the projects yield returns.
- Raising the productivity of labour and capital. Investment in capital (plant, machinery etc.) raises the productivity of labour, and so raises the quality of employment as well as the sustainable growth prospects for the economy as a whole. Economies of scope and scale and managerial efficiency can raise the productivity of all production inputs.
- Generating employment. The creation of new productive facilities means more jobs in the economy. As many developing countries face unemployment rates of 20 percent and over, as well as underemployment problems, the creation of new opportunities is very valuable. Employment, like investment, will have a multiplier effect on the economy and stimulate a dynamic growth cycle.
- Easing the balance of payments constraint. Many developing countries face a severe balance of payments constraint, with imports exceeding exports. Foreign investment constitutes an inflow on the capital account and therefore allows the economy to sustain the deficit on the current account without devaluing the currency or introducing austerity measures.
- Raising exports. A large investment by an export-oriented TNC can make a considerable difference in a small economy. This is one of the main reasons that developing country governments try to attract FDI through the creation of Export Processing Zones. The growth of exports itself offers benefits in terms of technological learning, realization of scale economies, competitive stmulus and market intelligence.
- Access to technology, tangible and intangible. For an economy to climb the quality ladder, technological upgrading is crucial. Technical inefficiency and obsolescence can severely handicap the quality of developing country products and ability to cope with new demands. Embodied technology may be too expensive to license, while 'know-how', the ability to use embodied technology, is just as important and much more difficult to transfer. The

location of productive facilities by TNCs may provide a window for this type of technology transfer. The transfer of technology may have positive spillover effects outside the individual subsidiary firm for other local firms.

- Access to markets. Knowledge about the nature and the way to gain access to the lucrative markets of the rich countries is in short supply in many developing countries. TNCs can offer a direct route into the heart of these markets without the need to build up new chains for distribution and sales for new and established production lines. Where affiliates are integrated into TNC networks, they can develop capabilities to service the regional or global system in specific tasks across the entire spectrum of corporate functions.
- Access to management skills and marketing resources. These two factors are in particularly scarce supply in developing economies, where as TNCs have these factors in abundance because of their size and reach. Brands, in particular, take time and resources to build, but they form a central element of any global sales strategy. Brands are largely controlled by TNCs so FDI is one way for developing economies to 'leap-frog' the process of brand-building.

Among the other advantages of FDI are cheaper and easier access to finance which TNCs enjoy because of their global reach, possible benefits to the environment as TNCs may have better access to and knowledge of environmentally sound technologies. Consumers are likely to benefit from increased inflows of FDI which should reduce prices and increase choice in consumer goods markets.

3. *Problems associated with FDI*

At the same time as FDI offers many potential benefits for the host economy, it also poses some real risks for the economy. These include:

- Impact on domestic investment. If FDI can lead to a reduction in domestic investment, this does not just mean that the total increase in investment is less than the value of the FDI, but may also have implications over the longer term by reducing the capabilities of domestic firms.
- Impact on domestic competition. FDI and in particular M&As are likely to have a negative impact on the level of competition in the domestic market. This may lead to restrictive businese practices and abuse of dominance.
- Impact on the balance of payments. The trade deficit can be a real constraint for developing countries. If investors import more than they export, FDI can end up worsening the trade situation of the country.
- Instability. Volatility is associated more with portfolio capital flows. In FDI, investment in physical assets is fixed, but profits from investments are as mobile as portfolio flows and can be reinvested outside the country

at short notice. Swings in investor confidence may have knock-on effects on the real domestic economy of the host country.
- Transfer pricing. This refers to the pricing of intra-firm transactions. Pricing that does not reflect the true value of products entering and leaving the country may result in a drain of national resources. Countries may lose out on tax revenue from corporations as they are able to juggle their accounts in such a way as to avoid their tax liabilities.

FDI can and does make an important contribution to development in number of ways, provided certain conditions are met with respect to:
- The nature of the projects which are undertaken;
- The timings of these projects;
- Controlling the volume of capital flows.

The recent trend amongst countries to liberalise investment policies in all respects may not allow them to reap the full benefits from investment. In countries like Taiwan and Korea, targeted investment policies placing requirements on investors enabled them to move up the skills and technology ladder. They and other successful newly industrialised countries also controlled the amount of investment in particular sectors, time periods and the balance between direct investment and portfolio investment.

Other tendencies that may be harmful to the interests of developing countries are the 'race to the bottom' in reducing regulations on firms and the 'race to the sky' of offering positive incentives for firms to invest in a particular country or regions. In these circumstances, even the country that wins the investment has to pay a heavy price.

The discussions above have highlighted both costs and benefits of FDI at the theoretical level. But whether these benefits actually accrue to developing countries is an empirical question. The sections below attempt to address the actual impact of FDI on host economies.

II. Analysis: Benefits

1. Increasing investment

Investment by TNCs does not necessarily lead to an increase of the same amount in the economy as it may 'crowd out' domestic investment. Because of their size, reach and reputation, TNCs have access to cheaper capital (i.e. at lower interest rates) than most firms in developing countries. They are therefore able to snap up profitable investment opportunities that domestic investors would have made if they had had the chance. The box below examines the empirical evidence on the effects of FDI on total domestic investment.

Does FDI lead to increased Investment?

The final impact of FDI on the host economy depends on the effect that the FDI has on domestic investment. The effect may be

- Crowding in (CI), in which case the presence of the TNC stimulates new downstream or upstream domestic investment;
- Neutral (N), in which case one dollar of investment by a TNC leads to one extra dollar of investment in the host economy;
- Crowding out (CO), where the foreign investment displaces domestic investment that would have taken place in the absence of the TNC.

Many studies have been conducted to test the impact of FDI on overall investment in host economies. The UNCTAD World Investment Report 1999 found the following results:

1976-1985	No of countries	Long-term effect
Africa	12	CI
Asia (excluding W. Asia)	8	CI
West Asia	4	N
Europe	3	CI
Latin America and Caribbean	12	CO
1986-1996		
Africa	12	CI
Asia (excluding W. Asia)	8	CI
West Asia	4	CO
Europe	3	CO
Latin America and Caribbean	12	CO

The results demonstrate a CI effect for South, East and South-East Asia and Africa, where the majority of developing and least developing countries are located. However, these results have been challenged by other studies. Manuel Agosin and Ricardo Mayer (University of Chile, Santiago) took a sample of 32 countries in Africa, Asia, Latin America and the Caribbean. They found less positive effects, especially for Latin America and the Caribbean where no countries recorded a positive effect

1970-1996	Effect		Effect		Effect
Africa		**S.America/C'bean**		**Asia**	
Cote d'Ivoire	CI	**Argentina**	N	**Korea**	CI
Ghana	CI	**Brazil**	N	**Pakistan**	CI
Senegal	CI	**Colombia**	N	**Thailand**	C
Gabon	N	**Costa Rica**	N	**China**	N
Kenya	N	**Ecuador**	N	**Indonesia**	N
Morocco	N	**Mexico**	N	**Malaysia**	N
Niger	N	**Peru**	N	**Philippines**	N
Tunisia	N	**Bolivia**	CO	**Sri Lanka**	N
Central African Republic	CO	**Chile**	CO		
Nigeria	CO	**Dominican Republic**	CO		
Sierra Leone	CO	**Guatemala**	CO		
Zimbabwe	CO	**Jamaica**	CO		

Crowding out may also take place because TNCs have privileged access to skilled personnel, again because of their reputation and size. They can thus raise entry costs for local firms, or deprive them of the best factor inputs. Foreign firms are usually able to attract top graduates at the expense of local firms.

Unless there is complete crowding out, FDI still increases total investment. Furthermore, TNCs may bring management and other skills to the operation of the firm that will allow it to operate more efficiently than if the investment had been made by a local firm. However, this may hinder the development of indigenous management expertise which can be important for development over the long run.

It is also important to distinguish between crowding out potentially efficient domestic enterprise from affiliates gaining ground on inefficient local firms that are not competitive. One of the greatest benefits of FDI can be a boost to inter-firm competition in a sector, leading to the exit of inefficient enterprises and the raising of efficiency in others. Without such a process, the economy can lack dynamism and flexibility, and lose competitiveness over time, unless competition between local firms in domestic market is intense or they face international competition.

The development of domestic enterprises is an important objective of most developing countries. Crowding out can harm the development of the domestic enterprises by adversely affecting learning and growth by local firms in competing activities. It takes the form of fostering incipient learning in domestic vis-a-vis foreign firms. FDI can abort or distort the growth of domestic capabilities in competing industries when direct exposure to foreign competition prevents local enterprises from undertaking lengthy and costly learning processes.

Foreign affiliates also undergo learning locally, to master and adapt technologies and train employees in new skills. However, they have much greater resources to undertake this learning, and considerably more experience of how to go about learning in different conditions. In these cases, "crowding out" can be said to occur if potentially competitive firms cannot compete with affiliates at a given point in time.

Linkages

Technology transfer leads to benefits, not just for the recipient firm, but through spillovers to other firms. Firms diffuse technology to suppliers, customers and other institutions with whom they have direct dealings. The extent of these benefits depends on the strength and breadth of these networks.

The most obvious type of linkages is sourcing, the purchase of inputs, components and services. A company's choice of supplier depends upon:

- Cost, quality and reliability of products;
- Access to local information, business practices;
- Ability to develop relations of trust.

TNCs already have strong linkages with suppliers outside the host country. They are reluctant to sever these links, especially for demanding inputs or long-established technical connections. However, this can change over time as the new affiliate learns about local capabilities. Governments can help firms overcome this information gap.

Evidence on linkages points to two conflicting trends:

1. Technological upgrading leads to intense efforts to improving the local supply base, e.g. the Mexican automobile industry.
2. TNCs are engaging in more intra-firm (international) sourcing, turning away from local suppliers.

More comprehensive research is being conducted by UNCTAD on the nature and extent of these linkages.

Policy implications

Governments can encourage linkages by improving the capabilities of local suppliers through supply-side policies such as cost-sharing grants and loans to SMEs to purchase equipment and training and requirements for foreign investors to assist local technology upgrading such as:

- Provide local suppliers with standardised blueprints for machinery, parts etc.
- Engage technical experts for local firms
- On-the-job training for subcontractors
- Prepare material specifications for inputs
- Inspect final products from local suppliers
- Provide access to measuring instruments, specialised tools etc. to their suppliers.

2. *Raising the productivity of labour and capital*

The productivity of labour rises with an increase in capital as each unit of labour produces greater output with an additional unit of capital. An increase in productivity means that wages can rise without the economy losing competitiveness. Productivity is extremely low in many developing countries and the economy can only be competitive by keeping wages low. In a sense, low productivity countries can be considered 'high wage' because so much more labour is needed to produce one unit of output.

In order to move out of the low productivity–low wage trap and move into a positive economic development cycle, developing countries have to focus on improving productivity. For this, injections of capital are necessary, be they from foreign or domestic sources. FDI may also raise the productivity of labour more directly through training and skill development.

FDI can raise productive efficiency within and across economies. Their size, reach and attributes allow TNCs to exploit economies of scale and improve efficiency through specialisation and planning in the production process. Units can be organised around specialised tasks, while management expertise will also allow resources within the firm to be allocated and coordinated in a highly efficient manner. The competitive pressures acting on these global firms mean that the efficiency incentives for them are particularly strong. This may be in contrast to domestic firms in developing countries that have existed in a highly protected environment, shielded from both domestic and foreign competition.

3. *Generating & raising the quality of employment*

The quantitative effects of FDI on employment in a host country take place through several routes:

- Directly by setting up new foreign affiliates or expanding existing affiliates
- Indirectly by stimulating additional employment in suppliers and distributors (depending on the intensity of local linkages).
- In the medium-term, employment can also rise through multiplier effects from the new income generated by FDI or through the increased demand stimulated by improved efficiency and restructuring of competing firms.
- Where FDI takes the form of a merger or acquisition, it can still increase employment by restructuring firms that might otherwise have become sick or bankrupt.

The qualitative impacts of FDI on employment are:

- Wages: Foreign affiliates generally pay higher wages than domestic firms in similar activities. The difference is more marked in industries that demand higher levels of skills, technology and marketing and in export-oriented activities that need to ensure consistent quality and timely delivery.
- Job security: foreign affiliates tend to offer greater job security because of their size, competitive strength and need for stable workforce. However, 'footloose' investment attracted by low wages may move to other countries so jobs may be insecure over the medium-term.
- Other conditions of work: working conditions in foreign affiliates are generally better than in local firms. In particularly large and visible TNCs tend to comply with local and international standards and even with the labour standards in their home countries.
- Skills: TNCs may upgrade employee skills in host countries by investing in training. Generally TNCs induce or support local suppliers to train workers to meet their quality standards and influence local competitors or unrelated firms to emulate their training practices. TNCs react to the availability of skills by raising the technological content of their investments, contributing to further learning and skill creation.

In general, the more efficient the labour markets and the higher the skill levels in a host economy, the greater the chances of attracting FDI associated with high employment quality and good training practices. Upgrading skills has been observed, for example, in the auto-supplier industries in Mexico.

Skills imparted to workers in their new jobs might also be transferable to other activities when they change jobs. A suitable combination of wages and skills may lead to higher value-added jobs being located in manufacturing foreign affiliates established under simple integration strategies.

4. Access to technology

The most important contribution that host developing countries desire from TNCs is in the area of technology. Almost by definition, developing countries lag behind developed countries as regards the generation and application of technology. The same goods are produced in developing countries with technologies that are outdated in developed countries and some goods are not produced at all, because the technological know how is not available in developing countries. Even where similar technologies are used, developing country enterprises tend to use them less efficiently because they lack the requisite skills and capabilities.

TNCs can bring modern technologies some of which are not available without FDI, and they can raise the efficiency with which existing technologies are used. They can adapt technologies to local conditions, drawing upon their experience in other developing countries. They may, in some cases, set up local R&D facilities. They can upgrade technologies as innovations emerge and consumption patterns change. Moreover, they can stimulate technical efficiency in local firms, suppliers, clients and competitors, by providing assistance, acting as role models and intensifying competition.

FDI makes three sorts of technological contributions to host countries:

- It can introduce a new technology not previously in use in the domestic economy and therefore, lead to the production and consumption of a novel commodity.
- Foreign investment with a technological component usually requires the introduction and development of new skills needed to operate the technology.
- Domestic innovation depends on number of ideas that are available in the economy; thus the introduction of a new idea increases the stock of ideas and stimulates domestic innovation.

There are circumstances in which it is difficult to obtain technology in any other way except through FDI. Licences may be too costly for developing country firms or the option to license may not be available at all. Firms enjoying monopoly rights over intellectual property may engage in anti-competitive practices such as cross-licensing only to other TNCs. Under these circumstances, FDI will be the only means of obtaining the desired technology.

However, FDI recipients are at a disadvantage: the foreign company will attempt to obtain the maximum return in a situation in which it has strong bargaining power based on its exclusive ownership of knowhow and patents. How much the company gains in “monopoly rents” (returns over and above what the firm would earn if it was not a monopoly but rather one player among others) depends on the ability of the host country to regulate the abuse of dominance by the TNC player.

The bargaining strength of the developing country will depend upon its own technological know-how and capacity to engage in reverse engineering, the industrial and technology policy of the government and its ability to enforce such a policy. Countries’ ability to engage in reverse engineering is diminished by the TRIPS Agreement which protects IP in process as well as products.

The bargaining between host government or potential partner and the intending foreign investor takes place over a number of factors such as terms and conditions of investment, including local content, the transfer of R&D activities as part of FDI, and the technology to be transferred. Heightened awareness about the importance of new technologies for economic growth has contributed to wide reaching changes in national policies on FDI.

Economies that have been most successful in building up domestic technological capabilities are those that have had highly selective FDI regimes such as the Republic of Korea, Singapore and Taiwan. Korea relied heavily on licensing and other forms of acquisition of technology from TNCs, while Singapore focused on attracting FDI in specific industries. Taiwan made active use of both vehicles.

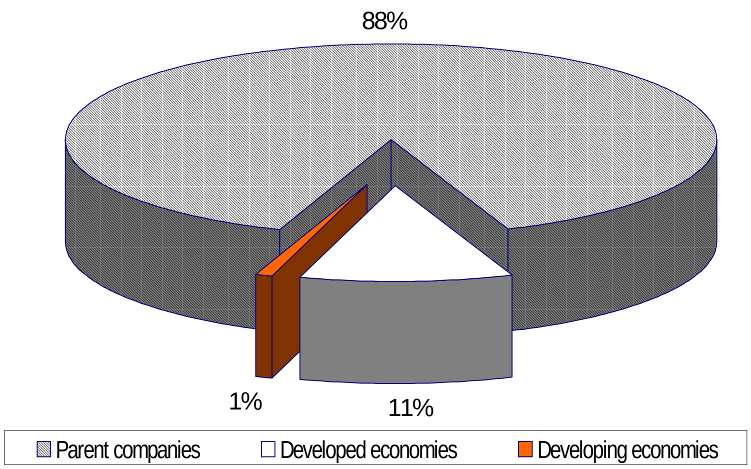
Do foreign firms engage in R&D in developing countries?

The higher the level of technological activity that the TNC carries out in the host country, the greater the positive spillovers for the economy. The level of technological activity varies hugely. The table below gives indications of the nature of technology transfer that takes place under different host country conditions. The diagram demonstrates how little 'high' level technology transfer takes place to developing countries. While it would therefore not be realistic for most developing countries to aim for a 'high' level of technology transfer, they can at least aim to move from out of the 'low' category.

Level of transfer	Type of transfer	Characteristics of host economy and nature of interaction with parent firm
High	Medium-term product/process applied development; R&D facility located with manufacturing facilities	High degree of interaction with local firms/ technical institutes; technical information flows between the parent firm and affiliate
Medium	Short-term innovation; adaptation and improvement of existing technologies	Technology transfer is mainly embodied in capital goods; training for assembly and quality management; some contact with local firms
Low	Technology and engineering support for manufacture; production-related skills and capabilities	Demand small, skill base low, no significant local suppliers; quality control is basic; limited training for local shop-floor and supervisory staff

R&D expenditure by US TNCs

Recorded R&D expenditures by foreign affiliates of US TNCs, 1994, percentage



The graph above demonstrates how little R&D is in fact conducted by TNCs outside their home country in other developed countries, let alone in developing countries. With only 1 percent of R&D expenditure by US TNCs taking place in developing countries, it is clear that without strong incentives, both positive and negative, firms are unlikely to conduct much technology transfer to their subsidiaries in developing countries.

5. Access to markets

Since many services can only be delivered to foreign markets through FDI, in such cases FDI has no adverse trade effect on production and may have positive trade effects on consumption by inducing new exports of machinery and other services. The probability that market-seeking investment may reduce the recipient country's welfare is much lower than in the tariff-hopping investments made during the import substitution period.

III. Analysis: Problems

1. Impact on the balance of payments

Most developing countries are balance of payments constrained because of high input requirements and debt repayments. A deficit on the current account, an excess of imports over exports, may create instability and will put pressure on the currency. This deficit must be financed through capital inflows if sustainable growth is to be achieved in developing countries. In the context of declining levels of Overseas Development Assistance, capital in the form of FDI has become increasingly important.

The impact of FDI on the balance of payments may be examined at the level of the individual investment or at the national level. The impact of the individual investment on the balance of payments depends on the proportion of inputs that are imported and the destination of the end product. In order to stop FDI worsening the balance of payments situation, countries impose conditions on trade-related investment measures. However, many of these have been outlawed by the Agreement on Trade Related Investment Measures Agreement at the WTO.

Measures outlawed by TRIMs

Measures which are inconsistent with the principle of national treatment:

- Local content requirements: where a corporation must use a certain value or volume of locally produced goods.
- Import balancing: where a corporation must export goods to balance the value of goods imported by that corporation.

Measures that are inconsistent with the principle of elimination of quantitative restrictions:

- Import limitation: the limitation of imports by relating their level to export levels or local content requirements.
- Foreign exchange limits: the limitation of access of a corporation to foreign exchange in relation to the foreign exchange generated by its exports.
- Export limitation: the limiting of a corporation's exports related either to a share of total production or to the type of product exported.

Some specialists in international economics have denied that developing countries are balance of payments constrained and should therefore be concerned with foreign exchange implications of FDI or other foreign capital inflows. This analysis was based on a theoretically legitimate but empirically erroneous economic doctrine that held sway in the 1990s in the international financial institutions. In its extreme form the doctrine states that in a world of free capital movements, the balance of payments of a country does not matter, as it is a purely statistical phenomenon with no significance for the real economy. Thus according to this doctrine, the government need not concern itself with the state of the balance of payments.

This view is based on the fundamental precepts of conventional welfare economics which suggest that, under certain assumptions, if all economic agents seek to maximize their own profits or utility this will achieve the best possible allocation of economic resources. Any government intervention in these circumstances will simply lead to distortions and reduce national welfare.

However, a number of the implicit assumptions of this theory that the "balance of payments does not matter" do not hold in real world. The theory was fatally undermined by events, such as the Mexican financial crisis of 1994. In December 1994 the Mexican government was obliged to float the peso which led to a huge forced devaluation as individuals and financial institutions, including domestic ones, began to withdraw their portfolio capital from Mexico. This led to a financial crisis of gigantic proportions, which threatened not only Mexico but also the entire international financial system. An unprecedented loan of US$50bn from the IMF was required to resolve this crisis.

It is generally agreed that the main reason for the crisis was that, after a point, the financial markets were no longer willing to regard the state of Mexico's current account deficit as a mere irrelevance, but rather percieved it to be an indicator of fundamental economic disequilibrium.

Financial liberalisation financed Mexican consumers' buying spree abroad. The net result was that the foreign exchange inflows were being used to finance imported consumer goods, rather than investment. This contributed to massive current account deficit, reaching 8 percent of GDP in 1994, greater than what it was in 1982 at the outset of the debt crisis. Other financial crises in Asia and Latin America show conclusively that a balance of payments deficit can have calamitous effects on the real economy.

The implications for the current and prospective balance of payments of any FDI project must therefore be carefully considered by developing countries if they are to avoid another "lost decade."

The question may be raised, why are advanced countries not faced by balance of payments problems of the kind, despite the fact that by and large they allow entry to any and all FDI?

There are a number of explanations for this:

- Assuming more or less free capital flows, as is the case now, an advanced country is able to finance its current account deficit more easily by borrowing if necessary from abroad. Most developing countries do not enjoy this kind of access to global financial markets.
- Developing countries are more vulnerable to external and internal shocks. An example of the former would be sharp changes in the terms of trade, a situation often experienced by developing countries with a restricted range of exports of primary commodities.
- Developing countries undergo huge structural changes during the course of development, a process that inevitably generates winners and losers and may give rise to social and political strife, which in turn often creates economic and financial instability. In such circumstances, developing countries may be completely cut off from global financial markets so they are unable to fund a current account deficit.

2. Instability

In addition to the short and longer-term balance of payments implications of specific FDI projects, similar concerns also arise in relation to aggregate flows of FDI and the stock of FDI. The conventional wisdom is that the stock and flows of FDI are generally a stable form of foreign longer-term capital inflows because they involve "brick and mortar" and therefore, unlike portfolio investment, require a longer-term commitment on the part of the investor.

This received wisdom has, however, been cast into doubt in the context of liberalised financial markets involving, among other things, the introduction of new financial instruments such as derivatives, and the expansion of existing ones, for example hedging. These developments have greatly blurred the distinction between FDI and portfolio investment with respect to the relative stability of these flows. A World Bank study acknowledges this point:

> "Because direct investors hold factories and other assets that are impossible to move, it is sometimes assumed that a direct investment inflow is more stable than other forms of capital flows. This need not be the case. While a direct investor usually has some immovable assets there is no reason in principle why these cannot be fully offset by domestic liabilities. Clearly, a direct investor can borrow in order to export capital, and thereby generate rapid capital outflows. "

Profit remittances and profits retained by the subsidiary in the host country are significant components of FDI flows. These are highly volatile and indeed can be just as volatile as portfolio investment flows, especially during an economic crisis. In specific instances, the volatility of profit remittances may come to dominate the degree of fluctuation of total FDI flows. Moreover, to the extent that some of the recorded FDI may represent profits reinvested in portfolio or other assets, these can be liquidated and shifted abroad relatively quickly in response to changes in local interest and exchange rates and economic and political uncertainty. Therefore the old presumption that FDI flows are less volatile than portfolio investment may no longer hold.

Unless FDI flows are 'permanent', in the sense that neither profits nor principal are repatriated, higher FDI flows lead to a greater risk of fragility in a country's current account position and thus also in its exchange rate. Both of these factors will increase the currency risk of the FDI and lead to the increased probability of repatriation or hedging through the foreign exchange market.

The effects of volatility in capital markets caused by large and rapid outflows of foreign capital can be seen clearly in the Asian crisis that began with the devaluation of the Thai baht in 1997. The flight of foreign investors from Korea, Thailand, Indonesia etc. had a huge impact on the real domestic economies of these countries causing growth to plummet, unemployment to soar. This experience should be read as a cautionary tale by other developing countries that are opening up their capital markets.

Over the longer term, success in attracting FDI flows should increase domestic incomes and costs, thus reducing the rates of return offered to foreign investors. This will not only reduce the size of FDI reinvestment flows but will also lead to a greater inducement to shift investments to other lower cost locations. Countries can retain investment and jobs only if technology and skills are upgraded. They will then be able to attract more sophisticated production.

3. Transfer pricing

Transfer pricing relates to the way in which prices are established for intra-firm transactions of goods, services, know-how and intellectual property. With the internationalisation of production processes, an increasing amount of trade crosses borders within corporate networks, especially between parent firms and their foreign affiliates. The prices at which such items are transferred determine the outcomes for both parties and therefore the flow of resources between countries. By over-valuing the goods coming into the country and under-valuing the goods being exported, inaccurate transfer pricing can worsen the balance of payments position as well as restricting the tax base of the countries involved.

In theory, a properly calculated transfer price distributes profits reasonably between the parties according to value addition and therefore the countries concerned will receive fair shares of the tax revenues from these profits. All countries have an incentive to promote fair transfer pricing frameworks so that they do not lose out on tax revenue. For developing countries, corporation tax constitutes a larger part of the tax base than in developed countries so where profits are declared is even more important for them. However, many developing countries do not have the administrative framework in place to codify and enforce regulations governing transfer pricing by TNCs adequately. An unfair or opaque transfer pricing regime can also put off potential investors.

Developing countries can deal with this issue by implementing legislation that has wide international acceptance, both by governments and by firms. For implementation to be effective, there should be a system of penalties that target deliberate manipulations by firms to avoid tax liabilities.

4. Impact on competition in domestic markets

An increasing proportion of FDI is accounted for by mergers and acquisitions (M&A). The share of M&As in world FDI flows has been rising, and reached 83 percent in 1999. The proportion of M&As in flows to developing countries is lower, at around 30 percent. M&As, defined as the acquisition of more than 10 percent equity share, involve a transfer of ownership from domestic to foreign hands and does not create new productive facilities.

M&As therefore raise particular concerns for developing countries, such as the extent to which they bring new resources to the economy, the denationalisation of domestic firms, employment reduction, loss of technological assets and increased market concentration with implications for the restriction of competition.

Concerns over the effects on competition are aggravated by the size of many of the firms involved whose turnovers now exceed the GDP of many middle-income countries. To take just one recent example, the takeover of Mannesmann, the German telecommunications company by Vodafone AirTouch of the UK was a $200bn deal that came to 6 percent of the GDPs of the two countries combined.

Developing countries are understandably concerned that the takeover of domestic firms by these international giants will allow firms to engage in anti-competitive practices and abuse of their dominant market positions. This points to the pressing need for developing countries to strengthen their domestic competition policies and laws.

Research conducted by UNCTAD for the World Investment Report 2000 revealed that the benefits of FDI through M&As are lower and the risks of negative effects are greater than for greenfield investment, especially at the time of entry and over the short term. UNCTAD research revealed the following conclusions:

- FDI through M&As correspond to a smaller productive investment than greenfield as the financial resources do not necessarily go into increases in the capital stock;
- FDI through M&As is less likely to transfer new or better technologies than greenfield investment;
- FDI through M&As does not generate employment at the time of entry into the host economy, and may lead to lay-offs as the acquired firm is restructured.
- FDI through M&As can reduce competition, and may be used deliberately to reduce or eliminate competition.
- Over the longer term, cross-border M&As are often followed by sequential investments that do increase the capital stock;
- They may also lead to transfers of technology, especially where the acquired firms are restructured to increase the efficiency of their operations.

IV. Policy: trends & recommendations

For most developing countries, the priority is to attract financial resources for development to overcome domestic gaps between savings and investment and between inflows and outflows on both the capital and current accounts of the balance of payments.

Developing countries, in part at their own initiative and in part at the behest of donor agencies like the World Bank and the IMF, have liberalised their national investment regimes. They have abandoned regulations and controls in an effort to attract investors. Of the 1,035 FDI regulatory changes between 1991 and 1999 in over 100 countries in all regions, 974 went in the direction of facilitating FDI inflows. There are now fewer investment-specific laws and certain provisions have been moved to general business and commercial laws.

The box below identifies some recent trends.

- Reduction/replacement of performance requirements with incentives
- Removal of limits on foreign equity participation
- Removal of minimum investment controls
- Removal of compulsory joint venture requirement
- Opening new sectors to FDI e.g. services and infrastructure
- Privatisation programmes open to foreign investors
- Reduction in control restrictions (although these remain for large investments and strategically important sectors)
- Relaxation of restrictions on entry of professional personnel/ management
- Relaxation of foreign exchange controls

However, in many cases, the liberalisation of the foreign investment regime has not led to big increases in the level of FDI inflows. Investor surveys confirm the fact that size and growth rates of markets and conditions of production are more significant criteria for investors than labour and environmental regulations, for example.

China, which has been the leading developing country in attracting FDI throughout the 1990s, and which attracted more than $40bn in 1999, maintains restrictions on FDI. Foreign investment in the service sector is still largely restricted, and in manufacturing, foreign exchange balancing requirements and local content requirements are imposed on firms.

These points demonstrate that countries should focus on providing an attractive investment climate. During this process, they should replace burdensome regulation with 'good regulation,' in other words, regulation that has a demonstrable positive impact on a country's development aims. This could include maintaining restrictions on capital flows, especially portfolio and currency flows, maintaining screening procedures and impact assessments prior to establishment for major projects, restricting investment in key strategic sectors and encouraging or requiring firms to follow good standards (labour conditions, environmental standards etc.) in the operational phase.

1. Creating an enabling environment

The phrase 'enabling environment' has been coined by international bodies to encompass the package of legal, political, social and economic factors that make a country an attractive destination for investment.

(a) Stability and transparency

Social and political stability in a country is almost a *sine qua non* for investment. Countries that are experiencing civil strife and political upheaval are unlikely to be considered attractive destinations for investment. However, the relationship between investment and political stability is complex: there are cases in which foreign companies operating in developing countries may be involved in fostering instability for commercial gain. Despite such cases, a steady policy-making environment is conducive both to investment and development.

Transparency in decision-making is another important issue. Investors seeking sites for long-term investment in major production capabilities to serve regional and global markets attach great importance to the predictability of the operating environment of their chosen investment sites. Integral to this issue is the degree of transparency of policy choices and the accountability of policy makers. Investors also value highly a transparent and reliable legal system.

A system based on incentives negotiated on a deal-by-deal basis may appeal to some investors as well as to some government officials. However, the possibilities of arbitrariness and corruption mean that most investors will profit more, in the long run, from the stability, transparency and predictability of a rules-based approach to FDI policy.

On the other hand, developing countries do not need to bind themselves permanently to a particular set of policies. The key to attracting FDI is timely review and constant monitoring of results, and the ability to change policies and adapt them to new circumstances. At the same time policies should not be changed arbitrarily or too frequently as investors attach importance to stable regimes. There should be stable economic and political conditions. A country has to have positive economic conditions, an established and reliable political system and a reasonably transparent operating and legal environment.

(b) Macroeconomic policies

Within the context of a stable and transparent economic and regulatory environment, the main determinants of investors' locational decisions are broad macroeconomic factors, notably the size and growth rate of the market and the costs of production. Governments should therefore implement sound macroeconomic policies that will help in themselves to achieve development objectives as well as helping the country to attract FDI.

Sound management of the state budget, stimulating demand while controlling inflation, well designed incentives in the fiscal system, appropriate spending priorities etc. will all contribute to raising domestic incomes and thus sustainable growth in the national economy.

(c) Role of the government in the economy

Governments all over the world have embarked on extensive programmes of privatisation. There has been widespread privatisation in service industries such as telecommunications, transportation, power generation and financial services as well as in primary and secondary markets. Many of these investment opportunities are open to foreign investors. The profitable business opportunities created by privatisation have been a major pull factor for FDI in some countries, particularly in Latin America.

Privatization can have positive indirect effects on FDI, too, by improving the government's financial position. A large proportion of revenues generated by privatisation in developing and emerging economies has come through FDI. This can lead to reductions in tax rates or create extra resources for providing incentives. Privatisation of utilities and infrastructure can lead to better performance for the economy as a whole. Compared with public owners, foreign investors usually insist on greater efficiency in the operations in which they invest.

In strategically important industries, governments can keep "golden shares" in privatised companies in order to be able to preserve essential strategic interests; golden shares have been used to veto undesirable changes in ownership and control of the privatised company.

(d) Trade policy

The trade regime in a host economy may encourage enterprises, local and foreign, to invest in developing local capabilities. A highly protected regime, or a regime with stringent constraints on local entry and exit, discourages technological upgrading, isolating the economy from international trends. Liberalising the trade regime will spur competition in the economy, forcing domestic firms to improve efficiency.

However, this does not imply that all trade barriers should be lifted immediately. Countries may well want to maintain protection to allow domestic industries in key sectors to achieve a certain scale before opening up to competition in the world market. 'Infant industry' considerations, as these are known, suggest that some protection of new activities can promote technological learning and deepening. This applies to foreign affiliates, as well as to local firms. A strongly export-oriented setting with appropriate incentives provides the best setting for rapid technological upgrading.

Regional trade agreements enlarge the potential market for investors and can therefore act as an investment magnet. Small, isolated economies can overcome their disadvantages in respect to market size by entering into such agreements. These agreements can enhance market transparency and, if they link national currencies, lower the costs of cross-border transactions. The need for a TNC to establish a local presence is particularly strong if an integrating area sets up high common external tariffs; but even low external barriers to trade can be a powerful magnet in expanding regional markets.

Regional initiatives may take the form of free trade areas, customs unions etc. depending on the level of cooperation that regional countries can agree on. Efforts to improve regional infrastructure networks, for example, roads or electricity, can also lure foreign investors by easing access to markets. Regional free trade agreements increasingly include provisions for free investment.

Policy Focus: Trade and Investment liberalisation

Countries need to engage in international investment and trade. However, countries should maintain some safeguards and control the pace of liberalisation. Selective liberalisation measures may be appropriate when targeting export-oriented FDI:

- EPZs, which confine liberalisation to certain locations;
- Bonded-warehouse and duty buy-back systems, which exempt export-oriented industries from domestic tariffs;
- Gradual tariff phase-outs over a period of time to allow domestic capacity to develop;
- "Trade neutrality" policy, which aims to eliminate situations in which exporters buy imported inputs above the world price but can only sell output at the world price.

(e) Competition policy

Competition policy and law are central to ensuring the effective operation of the market. They serve two essential ends: efficient allocation of resources and consumer welfare. Without competition policy, there is a danger that firms will engage in abuses of dominance and restrictive trade practices in markets that have recently been opened up to private business. Competition law is needed both to assess the competitive impact of mergers and acquisitions by foreign firms and to control the behaviour of foreign firms that are established in the host country.

TNCs enjoy commercial advantages because of their size and geographical reach over domestic firms, for example in access to and cost of capital. This allows them to make acquisitions more easily than domestic firms and may result in the concentration of market power. As countries have phased out their foreign investment screening procedures, competition law becomes increasingly important as a way to prevent harmful concentration in product markets. Developing countries cannot rely on the competition authorities of home countries to assess the impact of a merger or takeover in the host country.

TNCs may also have market dominance because they enjoy monopoly rights over intellectual property. This may be a patent on a particular piece of technology or a powerful brand name. Competition policy and law are needed to ensure that these firms do not abuse their position of dominance in the market.

At present, many developing countries do not have and do not appreciate the value of competition law to control the power of TNCs. This is likely to change over time, and developed country governments should provide support and technical assistance to countries designing and implementing competition policies.

2. Investment policy

(a) Positive incentives

The box below summarises the main positive incentives used by national, regional and local governments to attract FDI.

Fiscal	• Reduction in the rate of income/corporation tax an investor or a particular class of investors must pay • Tax holidays, on national or subnational taxes e.g. local sales tax • Exemptions from import duties or duty drawbacks • Accelerated depreciation allowances • Investment and reinvestment allowances • Specific deductions from gross earnings for national income tax purposes • Deductions from social security contributions
Financial	• Grants • Loans and loan guarantees These incentives are usually targeted to specific purposes e.g for labour training, wage subsidies, donations of sites/facilities, subsidies on utility charges or provision or subsidisation of dedicated high-quality infrastructure
Rules-based	Examples of these include: • Modifying rules on workers' rights • Modifying environmental standards • Greater protection for intellectual property rights

FDI incentives are useful only to the extent that they succeed in attracting investment to one country away from another. They will not create entirely new flows of FDI. Countries are prone to engage in a 'race to the sky,' offering investors more and more attractive financial incentives, or in a 'race to the bottom,' reducing the regulatory requirements on firms. Engaging in this type of competition almost inevitably means that even the country that 'wins' the investment has paid too high a price for it. Competition on investment incentives raises the distinct possibility that every country – big or small – could be worse off than if each were to refrain from the use of FDI incentives altogether.

One way in which a country may be able to attract FDI without across-the-board liberalisation is to create specific export processing zones (EPZs). In these areas, businesses are offered a combination of reduced tax rates, tax holidays, subsidies (based on number of jobs created/value of the investment etc.) and reduced regulation. The box below provides some examples of conditions for corporation in EPZs.

Selected export processing zones in selected developing economies: some features, latest year

Economy	Number and type of zones	Main types of incentives	Total estimated employment	Labour laws/ Labour organisation
Bangladesh	2 EPZs, 4 EPZs under construction	10-year tax holiday, duty-free imports and exports	2.2.m	EPZs exempt from Industrial Relations Ordinance
Brazil	1 EPZ	Tax and duty free	N/A	Constitution guarantees workers rights
China	6 SEZs, 34 ETDZs*	Duty free imports and exports, tax rebates	18m	Single trade union (ACFTU)
India	7 EPZs	5-year tax holiday, duty free imports	N/A	Labour laws apply
Kenya	15 EPZs	x10-year tax holiday, duty-free imports	3,000	Exempt from Factories Act and Industrial Registration Act
Namibia	3 EPZs	Unlimited tax holiday	N/A	Moratorium on strikes and lock-outs
Sri Lanka	6 EPZs	10-20 year tax holiday	90,000	No trade unions present
Zimbabwe	7 EPZs	5-year tax holiday, duty-free imports and exports	6,000	Labour laws apply

* SEZ = Special Economic Zone; ETDZ = Economic and Technological Development Zone
Source: UNCTAD, WIR 1999

If two countries are competing for a unique major investment, cooperation is unlikely, as the parties are competing for single prize. On other hand, if the objective is to attract a stream of projects of a particular type, it may be possible for countries to come to an understanding to limit the degree of competition so as to reduce the danger of overbidding. In this countries will attract some investments without paying too high a price in incetives.

However, governments should guard against a race to the bottom in their policy competition, as this would, ultimately, harm their longer-term development efforts. In a highly competitive world market for FDI, "best practices" in this respect by one government rapidly become "benchmarks" for all governments. Benchmarking among governments is particularly important in a regional context.

(b) Bilateral Investment Treaties

BITs contribute to the establishment of a favourable investment climate between two countries by providing assurances and guarantees to investors. They can attract investor attention to a particular country as well as building investor confidence in countries which have previously not attracted much investment. BITs have proliferated at a great rate, with 158 nations now signatories to almost 1900 treaties.

BITs generally provide for:

- 'Fair and equitable' treatment for foreign investors in terms of applications for investment approval, admission and promotion as well as general rules and regulations;
- Specific provisions on expropriation and non-commercial losses and compensation for the same;
- Dispute settlement mechanism. This may be take the form of investor-state or state-state settlement. Experience in developing and developed countries demonstrates that investor-state settlement can have unexpected harmful effects, for example in cases brought by US companies against the Canadian and Mexican government under the NAFTA rules.

BITs fall into one of two broad models. The model that is generally applied by the US contains provisions on the right of investors to establishment except in certain specified sectors. The second model which tends to be used by European countries, deals only with the treatment of the investor and investment after establishment. In general, it is in the interests of developing countries to sign BITs that take the latter form. This gives them scope to pursue industry-specific development strategies, including the protection of 'national champions' in key strategic sectors, and special treatment for infant industries as they build up capacity.

Further important considerations with regard to BITs involve the definition of investment used. In the recent BITs signed by the US, a very broad definition of investment has been used in which 'investment' encompasses shares, stocks and other forms of equity participation, debentures, loans, intellectual property rights, revenue-sharing contracts etc. Given the potentially harmful impact of the volatility of capital market flows, developing countries should insist, where possible, on a narrow definition of investment that excludes, for example, portfolio investment and short-term contracts.

There is little evidence to demonstrate that BITs actually stimulate the flow of FDI into the countries that sign them. Developing countries should therefore consider very carefully the extent to which their development policies may be constrained by the provisions of such an agreement before entering into it.

(c) Investment promotion

Beyond the liberalisation of regulatory frameworks, more and more countries also give more attention to pro-active policies to attract FDI. Typically, incentives are only one of the tools that government use to attract FDI.

Most countries have established investment promotion agencies whose purpose is precisely to attract FDI and look after foreign affiliates once they are established. Many countries particularly in Africa, still suffer from a negative image and so the marketing role of an investment promotion agency can be extremely important. IPAs can speed the bureaucratic procedures required of firms when they set up, and also play a facilitating role between the firms and the bureaucracy after the investment has taken place.

Many countries have also taken positive steps to market themselves as an attractive investment. They are promoting high standards of treatment, providing legal protection and guarantees. They have set up investment promotion agencies that fulfill a dual role:

- Acting as a 'one-stop shop' for investors to deal with regulatory and administrative requirements.
- Change or modify investor perceptions of the country by attending and organising investor 'fairs' and by distributing materials.

There is insufficient evidence on whether these efforts have been successful. It is clear that for many developing countries, a 'perceptions gap' undoubtedly remains. Reducing regulations is likely to improve the efficiency of resource use in the economy.

3. Targeted policies

(a) Technology policy

Policy focus: Technology
1. Attracting TNCs to specific high-technology industries like computers and computer components, software development or biotechnology. 2. Offering incentives to existing investors to move into more complex technologies and to increase or upgrade the technological R&D undertaken locally. This involves both upgrading all factor inputs that TNCs need and giving targeted incentives to launch new functions by existing affiliates or to attract technology-incentive sequential investment. 3. Developing industrial parks with high quality infrastructure to attract high technology investors. Governments can either develop these parks itself or it can grant incentives for private developers. 4. Attracting TNCs into natural resource processing and inducing greater local value added in resource-based exports. This strategy can lead not only to increased domestic value added but also to considerable technology transfer. 5. Using TNCs present in a country to attract investment by their suppliers overseas. 6. Changing the competitive environment and the existing incentive structure to promote the use of world-class technologies and management methods. 7. Improving domestic human resources through training. Governments can place a training requirement on investors to raise the quality of the labour force within the firm or provide resources for training outside the firm. 8. Collecting, organizing and disseminating information about technical, research and training facilities in the host country. 9. Improving technology access for local enterprises, by providing information on foreign and local sources of technology.

(b) Labour policy

Based on their primary objectives with reference to employment, government policies can be grouped in two: those related to employment creation and those related to employment and skills upgrading. These can be further divided into those, which work directly, and those, which work indirectly to influence FDI. The former typically includes policies that explicitly focus on FDI and are in the domain of investment-promotion agencies. Most policies, however, work indirectly by enhancing the labour market environment and institutions, industrial relations, and the skills quality and mix of human resources. They include, for example the measures available under trade, industrial, competition and infrastructure policies.

Policies for human development are the groundwork. Basic education ensures that the population is not only employable and mobile, but is also able to take in new skills and responsibilities. The best way to attract FDI in skill-intensive industries and activities is to develop a high quality human resource base. This determines its productivity and capability to learn on the job. If governments are interested in upgrading employment, one avenue to consider is to institute and implement equal wage policies and to give incentives to firms to retain workers.

To upgrade the quality of labour force, governments have several options:
- Government can rely on public education system. They can launch schemes to provide specific forms of training for activities they wish to promote.
- Governments can initiate public-private training partnerships to complement publicly funded training.
- Governments can foster employee-training programmes by companies including foreign affiliates.
- Governments undertake surveys among affiliates and supplier firms to ascertain their current and projected training needs, and register the skill requirements of prospective investors.
- Governments can rely on private institutions for certain purposes.

POLICY FOCUS: EMPLOYMENT
Employment Creation
1. Target employment-intensive FDI through proactive market-friendly policies or selective intervention. Governments can try to attract FDI: • In industries that are labour intensive (e.g. garments), • In industries that have strong linkages to the local economy • In particular regions with high unemployment or underemployment 2. Fiscal incentives, e.g. tax deductions or preferential loans linked to the number of jobs created 3. Minimum wages graded by district can be used to encourage job creation in unemployment black -spots. 4. Creation of industrial parks providing high quality infrastructure for firms.
Employment Quality
1. Implement public-private training partnerships to upgrade skills 2. Encourage foreign affiliates to implement training programmes, for example by offering double deduction on taxes for training costs or penalising firms that do not offer training. 3. Carry out skill audits (surveys of firms' current and projected training needs). 4. Governments can consider opening selected areas of educational training to FDI e.g. management courses, but should can impose national or international quality standards. 5. Foster good industrial relations by providing frameworks for communication between employers and unions for collective bargaining to take place within the context of national norms and institutions and offering arbitration mechanisms.

(c) Environmental policy

POLICY FOCUS: ENVIRONMENT
Admission and Establishment
Countries should not lower environmental regulations governing investment in large-scale and pollution-intensive industries. As well as the harmful impact on the environment, studies have shown that other factors are more important in FDI locational decisions. Governments can: 1. Conduct pre-establishment screening of investment on environmental grounds 2. Require that TNCs provide their corporate environmental policy statements and records when making an investment application 3. Require corporations to conduct an Environmental Impact Assessment
Operation
1. Governments should introduce or reform existing policies to ensure that regulatory and market incentives encourage environmentally sound production and consumption. These can include: 2. Pricing policies that more accurately reflect the value of environmental resources 3. Consultation and cooperation with stakeholder groups. 4. Developing strategic EIAs to cover whole regions as well as specific projects. 5. Requiring all new investments to have a closure plan. 6. Requiring firms to employ the cleanest technology that they have 7. Providing a duty drawback or concession for capital goods related to environmentally sound technology 8. Granting accelerated depreciation for clean technology capital goods 9. Encouraging investment in industries that involve improvements to the environment e.g. waste-to-energy plants and construction of sanitary landfills.

V. Conclusion

FDI offers great potential to contribute to the developmental objectives of poor countries. But by abandoning screening and monitoring altogether, countries risk harmful effects on their economies and societies. Excessive and restrictive regulation should be replaced with 'good regulation.'

The primary way for countries to attract beneficial investment is to ensure that an 'enabling environment' is in place and that the macroeconomic fundamentals are right. These efforts will not just attract extra investment, but will stimulate sustainable growth and poverty reduction.

Raising the quality of infrastructure and resources, especially the human resource base, will in turn reflect on the quality of the jobs created and the diffusion of technology in the economy. This will allow the economy to move into a continuous cycle of technology upgrading and endogenous growth. Integration into the world economy will support this process.

Government regulation has an extremely important role to play in guiding and shaping investment flows and their impact on the economy. Both before and after entry, the impact of the investment should be assessed and set-up and operational guidelines should be designed accordingly. In terms of technology transfer and employment creation, governments can impose specific requirements on TNCs. In labour and environment issues, governments should maintain their national standards.

Liberalising the national investment regime should not mean that the government shirks its responsibility to its citizens to pursue sustainable development. Active policy-making and thoughtful regulation becomes all the more important as the economy begins to open up to foreign capital flows. Corporations engage in FDI in order to make profits – they cannot be expected to prioritise developmental concerns. This is the responsibility of governments, and they must design investment policy accordingly.

CUTS' PUBLICATIONS

Monographs on Investment and Competition Policy

1. **Role of Competition Policy in Economic Development and The Indian Experience**
   Competition and efficiency are the guiding principles of the liberal economic order. Any healthy competition must have rules that the players should follow. This is more so when the players are business organisations and their activities will have a larger impact on the society. This monograph examines the role of an effective competition policy in economic development from the Indian perspective.
   (32pp #9908 Rs.15/$5)

2. **FDI, mega-mergers and strategic alliances: is global competition accelerating development or heading towards world monopolies?**
   Foreign Direct Investment, mergers, amalgamations and strategic alliances are the rules of the present day global economy. However, the crucial question is whether the movement of capital leads to further development and welfare of the society or the growth of monopolies. The monograph sheds light on the main contours of the global competion and its implication for the consumers. (24pp #9909 Rs. 15/$5)

3. **Competition Regimes Around the World**
   In this paper, an attempt has been made to comply briefly, the current state of Competition Law in some select countries, on which information is readily available. The paper steers clear of any value judgements on the design and implementation of the Competition Law in the countries covered herein. (40pp #2002, Rs.20/$5).

4. **Globalisation, Competition Policy and International Trade Negotiations**
   This paper maps out the issues concerning multilateral competition policy, from southern perspective. It concludes that there is a need for a realistic assessment of the Extent to which developing countries would be able to control MNCs under the disciplines of competition law.
   (38pp #2003, Rs.20/$5).

5. **Trade, Competition & Multilateral Competition Policy**
As the title suggests, this monograph clarifies the areas of interaction between trade and competition through case studies, and shows that such interactions are on rise. It also highlights efforts being taken for a multilateral competition policy after Second World War in form of Havana Charter till the present happenings at the World Trade Organisation. It further points out the provisions in various agreements of the WTO acquis, which have the elements of competition. Most importantly, the paper brings forward the debate vis-à-vis multilateral competition policy that is currently taking place at various fora. It analytically points out the hindrances in such a policy and highlights the need for a multilateral competition policy. (36p #0005, Rs.20/$5).

6. **All About Competition Policy & Law**
This monograph meant for advance learner, deals with various elements of competition law and policy in comprehensive manner. It describes about various restrictive business practices (RBPs) at the market place. It further clarifies what are competition law and policy, their elements and how they can be used to curb various kinds of RBPs. It further draws out interface of competition policy with economic development, poor and foreign investment. Finally it describes the genesis of competition law/ policy and in which direction it is moving. (70pp #0006, Rs.20/$5).

7. **All About International Investment Agreements**
This briefing kit for the general reader provides an overview of recent trends in the proliferating number of bilateral and regional investment agreements. The kit highlights the key issues in these agreements and considers past initiatives and prospects at the multilateral level.
(64pp #0102, Rs.20/$5)

8. **Competition Policy & Law Made Easy**
This publication meant for the activists, aims at generating minimum amount of awareness on competition law and policy. It could be helpful for a common person to identify anti-competitive practices in the market place and take action to rectify the same.
(36pp. #0109, Rs.20/$5)

For more details, visit our website at www.cuts.org.

कट्स CUTS

CUTS Centre for International Trade, Economics & Environment
D-217, Bhaskar Marg, Bani Park, Jaipur 302 016, India
Ph: 91-141-220 7482, Fx: 91-141-220 7486
Email: cuts@cuts.org Website: www.cuts.org