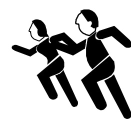
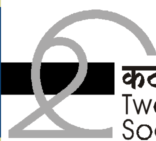
Strategising Investment for Development





#0342

Strategising Investment for Development

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Strategising Investment for Development

Published by

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LIST OF ABBREVIATIONS

ASCM	Agreement on Subsidies and Countervailing Measures
BEE	Black Economic Empowerment
BITs	Bilateral Investment Treaties
BOI	Board of Investment
BOP	Balance of Payments
CEE	Central & Eastern Europe
CS	Civil Society
CSO	Civil Society Organisation
CSR	Corporate Social Responsibility
CUTS	Consumer Unity & Trust Society
DFID	Department for International Development
EPZs	Export Processing Zones
EU	European Union
FDI	Foreign Direct Investment
FIPB	Foreign Investment Promotion Board
FTZ	Free Trade Zone
GATS	General Agreement on Trade in Services
GDP	Gross Domestic Product
GEAR	Growth, Employment and Redistribution
ICT	Information Communication Technology
IFD	Investment for Development
IGOs	Inter-governmental Organisations
IIAs	International Investment Agreements
IMF	International Monetary Fund
IPAs	Investment Promotion Agencies
IT	Information Technology
LDCs	Least Developed Countries
LEMs	Large Emerging Markets

M&As	Merger & Acquisitions
MERP	Micro Economic Reform Programme
MTEF	Medium Term Expenditure Framework
MTSF	Medium Term Strategic Framework
NAFTA	North American Free Trade Agreement
NDC	National Development Corporation
NEP	New Economic Policy
NGO	Non-governmental Organisation
NRG	National Reference Group
ODA	Official Development Assistance
OECD	Organisation for Economic Co-operation and Development
PSRP	Poverty Reduction Strategy Paper
R & D	Research and Development
SADC	Southern African Development Community
SAPs	Structural Adjustment Programme
TRIMs	Trade Related Investment Measures
TRIPs	Trade Related Intellectual Property Rights
TNCs	Transnational Corporations
UNCTAD	United Nations Conference on Trade and Development
WB	World Bank
WIR	World Investment Report
WTO	World Trade Organisation
ZFM	Manus Free Zone

PREFACE

Since 1980s and more so in 1990s, many developing countries have adopted policies to attract more foreign direct investment (FDI). This signalled a change in attitude towards FDI in many countries, which earlier had adopted import substitution policies or were outright hostile to FDI. Simultaneously FDI flows had multiplied and official development assistance flows reduced around the world in this period. At the same time, more and more developing countries have been signing bilateral investment treaties, avoidance of double taxation treaties and regional trade agreements to create a facilitative regime for FDI. All these developments indicate how important FDI has become in the global economy. A large body of literature on FDI is also in existence.

Against this background, the "Investment for Development" (IFD) project was launched in September 2001. The research project is implemented by Consumer Unity & Trust Society (CUTS), Jaipur, India, in collaboration with United Nations Conference on Trade and Development (UNCTAD), for conducting regional seminars and other technical aspects of the project and with the support of the Department for International Development (DFID), UK.

The aim of the project is to study investment policies, performance and perceptions in seven developing and transition economies. It also aims at creating awareness and building capacity of the civil society on national investment regimes and international investment issues. The seven countries in the project are: Bangladesh, Brazil, Hungary, India, South Africa, Tanzania and Zambia.

This paper has been prepared by CUTS, based on national research and advocacy policy document prepared as part of the project. The paper highlights the global and regional trends and policies in the project countries and in FDI, and the effectiveness of national policies. The paper also contains the summarised results of a survey on civil society perceptions of FDI. On the basis of the findings on these topics, the paper puts forward some recommendations and action points for policy changes to governments, civil society and inter-governmental organisations.

The finding of the project research indicates that in spite of adopting policy and regulatory changes to facilitate FDI in 1990s, the experience of the project countries with FDI is diverse. While some of the countries, such as Brazil or Hungary, received high FDI, both absolutely and relatively to their gross

national product or capital formation rates, countries from South Asia were not so successful. Further, high FDI in Brazil did not have any favourable impact on its economic growth and development. South Africa, on the other hand, was more of a source of foreign investment than a recipient of foreign investment. Domestic investment by both public and private companies, are quite low in South Africa. This has generated a debate in the country as to why the country has low investment despite having a well-developed capital market and infrastructure.

The South Asian case also illustrates how the attitude towards FDI has changed in 1990s, as both India and Bangladesh overcame strong reservations towards FDI to open up their economies. The paper throws up some suggestions that countries could take to benefit from higher FDI. Least developed countries like Bangladesh, Tanzania and Zambia need to pay special attention on strategies to reduce poverty and indebtedness. It is also important that the countries re-orient their national development strategies to promote higher growth and development, and that FDI is a part of the overall development strategy. In some countries, such as India, Bangladesh and Tanzania, greater attention needs to be paid to proper implementation of policies, and removal of bureaucratic hassles to FDI.

The project has also thrown up some ways forward for further work on investment: these could be on perceptions of FDI among different stakeholders, corporate social responsibility, in-depth sectoral strategies, more such comparative studies or on South-South co-operation on investment.

I would like to thank my colleagues at CUTS: Olivia Jensen, Rajeev Mathur, Nitya Nanda and Sanchita Chatterjee for preparing this paper. I would like to express my gratitude to Karl Sauvant, Joerg Weber, Khalil Hamdani, James Zhan and Deepali Fernandes of the Division of Investment, Technology and Enterprise in UNCTAD for their support and comments on this paper. We have benefited by comments from Laveesh Bhandari of Indicus Analytics, New Delhi, Sanjib Pohit of National Council of Applied Economic Affairs, New Delhi, and Brendan Vickers of Institute of Global Dialogue, Johannesburg. Useful comments were also received from the participants of the Investment for Development Review Seminar, on 9-10 May, 2003, in Geneva, Switzerland. Lastly, I would like to thank Roger Nellist, Freddy Bob Jones, Vicki Harris and Christian Rogg of the DFID, UK, for their valuable support on this project.

December, 2003	Pradeep S. Mehta
Jaipur	Secretary General

CHAPTER-1

Introduction

1.1 Foreign Direct Investment

Global foreign direct investment (FDI) flows have leaped by six times during 1990-2000 from roughly US$210bn to US$1.3tr. A large chunk of the flows, however, took place between developed countries. Even among developing countries, a handful of large developing countries attracted a larger share of FDI inflows than the others. This, despite the fact that since late 1980s and early 1990s developing countries have liberalised their trade and investment regimes. Till 1980s, developing countries in general and the least developed and indebted countries in particular, were largely dependent on bilateral and multilateral aid for financing their national development. Private foreign capital did not receive adequate attention or significance in most of these countries till the early 1970s.

These countries' reluctance to rely on private foreign capital had partly been due to the colonial past and partly due to perceived negative effects of FDI, such as the burden of future dividend payments on the country's balance of payments, the effects of the exercise of market power, or transfer pricing by the multinationals. There was a belief that the net outcome of FDI could be more negative than positive.

Since 1980s, there has been a growing consensus among the developing countries that the net result of FDI can be positive, though it requires careful regulation. The drop in total Official Development Assistance (ODA) flows in this period has also forced most of these countries to increasingly look at FDI as an alternative finance for development. It is considered to be a better option compared to portfolio investment, which is seen as volatile and short-lived. FDI is also being considered as an important channel for transfer of long-term private capital, technology and managerial know-how, as well as a conduit of globalisation of the economy.

Over the last twenty years or so, developing countries have not only become permissive to FDI, but competed among themselves to attract it. As a result, the period has been characterised by liberalisation of investment regimes. Restrictions on the entry and operations of foreign branches and affiliates have been considerably reduced or eliminated. Property-taking measures have

greatly diminished and investors are increasingly allowed to freely transfer their profits and capital, while guarantees of non-expropriation and free transfer of funds are generalised. Also, settlement of investment disputes through arbitration is more accepted. In simple words, conditions are conducive for a greater inflow of foreign direct investment.

The changes in national FDI policies were complemented by signing of bilateral investment treaties (BITs), an increasing number of them involving developing countries. Most of the BITs are between developed and developing countries. This, in part, reflects increasing eagerness of developing countries to adopt measures for attracting FDI. However scepticism has been expressed about the effectiveness of BITs in attracting higher FDI.

It is to be noted that commensurate with the growth in FDI inflows, economic growth rates did not increase in many developing countries. This has given rise to the debate on whether FDI has actually promoted economic development in the recent past. The focus of national policies and regulation has now shifted to facilitating FDI, which promotes economic growth and development or "quality" FDI rather than attracting FDI *per se*.

1.2 The IFD project

Given the above background, Consumer Unity & Trust Society (CUTS), Jaipur, India implemented a two-year project "Investment for Development" (IFD). The project was supported by the Department for International Development (DFID), UK and CUTS collaborated with the United Nations Conference on Trade and Development (UNCTAD) for conducting regional and international seminars, and other technical inputs. The project seeks to study investment, particularly FDI trends, policies and perceptions in select developing and transition economies, by identifying the factors encouraging or hindering FDI in these countries, identifying problems or deficiencies that exist at the national levels and designing solutions which would help countries to facilitate FDI, which would promote economic growth. The project also seeks to raise awareness and build capacities of civil society (CS) organisations, policymakers and investors on investment issues.

The selected countries in the project are: Bangladesh, Brazil, Hungary, India, South Africa, Tanzania and Zambia. The countries have been selected on the basis of their geographical location, economic characteristics, size of the economies and the level of development. The countries can be grouped into the following based on their economic characteristics: Large Emerging Markets (LEMs) – India, South Africa and Brazil; Least Developed Countries (LDCs) – Zambia, Tanzania and Bangladesh; and Transition Economy – Hungary.

The salient features of the IFD project are: Firstly, it is a comparative study of seven developing countries. The project partners prepared country reports on investment policies, performance and perceptions. These country reports were further synthesised into comparative reports. Useful comparative insights were also drawn from four regional seminars, which were as follows: Africa Regional Seminar, 18-19 October 2002, Nairobi, Kenya; Asia Pacific Regional Seminar, 24-25 November 2002, New Delhi, India; Latin America Regional Seminar, 4-5 December 2002, Sao Paulo, Brazil; and Regional Roundtable covering Transition Economies of Central and Eastern Europe and Central Asia, 5-6 May 2003, Istanbul, Turkey.

Secondly, the project involved CS organisations from the project countries in the implementation of the project in these countries. The partner organisations were Centre for Policy Dialogue (partly) and Bangladesh Enterprise Institute, Dhaka; Nucleo de Economia Industrial e de Technologia-Instituto de Economia (NEIT-IE), University of Campinas, Sao Paulo; Budapest University of Economic and Public Administration; National Council of Applied Economic Research, New Delhi; Institute for Global Dialogue, Johannesburg; Economic and Social Research Foundation, Dar-es-Salaam; and CUTS-Africa Resource Centre, Lusaka. The partners also prepared national reports for their respective countries, which contain recommendations and advocacy points for governments, CS and inter-governmental organisations (IGOs).

Thirdly, it conducted a CS perceptions survey. CS, for the purpose of the survey, was defined as representatives of non-governmental organisations, academia, trade unions, chambers of commerce and media. Their perceptions of FDI can shape policymaking processes. To gauge CS opinion on FDI, the IFD partners conducted a survey on CS perceptions in the project countries. The survey was intended to gauge the CS view on the impact of FDI on the domestic economy, the effectiveness of national investment policies and the relationship between foreign and domestic investors.

Fourthly, the IFD project has attempted to promote a dialogue between the government and CS, in each project country. Representatives of the government and CS were invited to be a part of the National Reference Group (NRG) in each of the project countries. NRGs acted as sounding boards and provided quality checks for the research output. The IFD research, including the CS perceptions survey, has also looked into the angle of promoting higher dialogue between the different groups. The project promotes greater dialogue between businesses and civil society, IGOs and governments through seminars and meetings.

Lastly, the project throws up learning for other developing countries, those with same characteristics as the project countries, as well as those which are at different stages of development. Experiences of non-project developing countries were discussed in the regional seminars and other international seminars held under the project. Learning for other developing countries is also reflected in the paper: "Synergising Investment for Development", produced under the project, and the present paper.

1.3 The Organisation of the Paper

This paper has been prepared on the basis of country papers and national advocacy policy documents, and inputs from the NRG meetings and the regional seminars held under the IFD project. It contains key results of the research and analysis, and recommendations and action points. It contains recommendations for national, regional and international level policy changes to attract beneficial investment.

The purpose of the paper is to highlight international, regional and national investment trends and policies using the IFD research as well as secondary sources of information. In the light of these policies, the paper attempts to put forward action points for three stakeholders – governments, CS and inter-governmental organisations (IGOs) – for changes in policies and practices related to FDI.

CHAPTER–2

Global and Regional FDI Flows and Performance

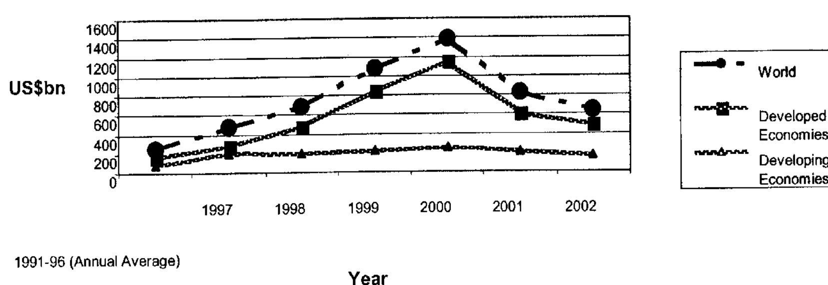
2.1 Global Trends in FDI Flows

In 2000, global FDI inflows increased by 18 percent, faster than economic aggregates such as the world production, capital formation and trade. The inflows reached a peak in 2000, plummeted by half in 2001 and by another fifth (of the 2001 level) in 2002. The fall in 2001 was the first fall in inflows since 1991 and outflows since 1992. The driving force behind the decline in flows since 2001 is a slowdown in the world economy and weak stock markets, which in turn led to a slowdown in mergers and acquisitions (M&As) activity. The decline in FDI inflows to developed countries was much sharper than that to developing ones, which experienced increasing FDI flows in 1990s. Incidentally, since 1993, FDI to developing countries as a group has been larger than aid inflows. In 2000, it was ten times larger than ODA.

Within the developing countries, however, FDI inflows have been uneven, as the next two sections highlight.

Charts I and II show that most FDI in 2001 and 2002 has flowed into developed countries and they have a larger share in global FDI than developing countries combined.

Chart I: FDI Inflows 1991-2002



Source: UNCTAD World Investment Report (WIR) 2003

Global FDI did not only increased absolutely, but also in relative terms compared to global gross domestic product (GDP) as well as gross fixed capital formation (GFCF). As a percentage of global GDP, both inward and outward FDI stock grew in 1990s. Inward stock increased by more than two times, from 9.3 percent in 1990 to 22.3 percent in 2002, and outward stock grew by more than two-and-half times, from 8.6 percent in 1990 to 21.6 percent in 2002. As a percentage of the global GFCF, FDI inflows grew from an annual average of 4.4 in 1991-96 to 12.2 percent in 2002 and FDI outflows grew from 5.0 percent in 1991-96 to 13.6 percent in 2002 (an increase of nearly 3 times of both the figures).

2.2 Regional Trends in FDI Flows

Though almost all developing countries had undertaken liberalisation measures to attract FDI in 1990s, the flows, performance and impact of FDI vary among the different regions. In this section, we examine FDI trends and performances in four host developing regions of the world: Asia and the Pacific, Latin America and the Caribbean, Africa, and Central and Eastern Europe. Generally, all the regions have experienced an increase in both absolute and relative FDI in 1990s.

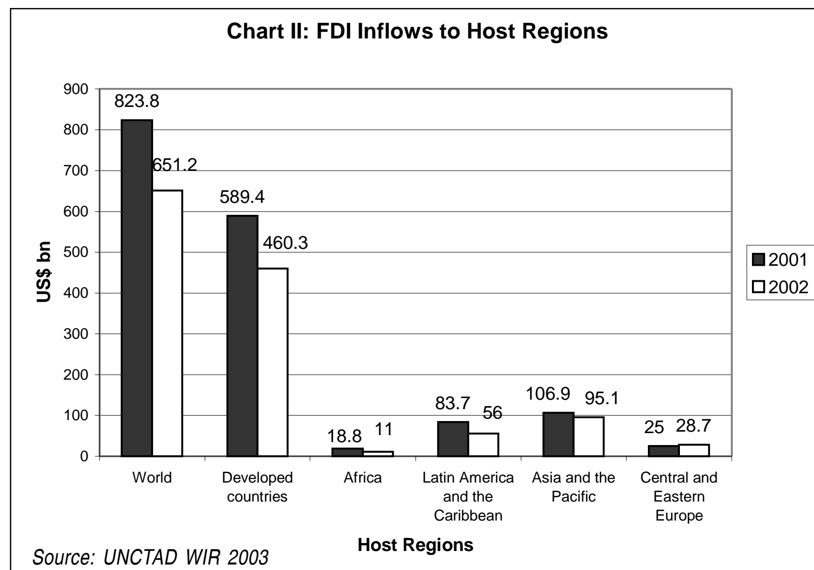
FDI flows to Asia and the Pacific were US$102bn in 2001 compared to US$134bn in 2000. In 2002, flows into this region fell (by 11 percent, to US$95bn), like other regions of the world, but the region weathered the downturn better than the others[1]. The decline was uneven across sub-regions, countries and industries.

Latin America and the Caribbean saw a tripling of their FDI inflows in the second half of 1990s. In 1999 FDI inflows to this region reached a record level of US$90bn, which was a 23 percent rise over 1998. Brazil and Argentina were the two largest recipients in this region. A large part of the inflows came in the form of M&As. Privatisation was important in Argentina, Brazil and Chile, but for the Andean Community countries, privatisation inflows remained low. In fact, the sharp increase in inflows in 1999 was due to only three major cross-border acquisitions in this region. FDI inflows to this region fell in 2002, for the third consecutive year, by a third, to US$56bn. The decline was widespread across the region and mostly concentrated in services, thus countries in which service industries are important, like Argentina, Brazil and Chile, the decline was more pronounced than in other countries of the region.

The African continent remained a small player in the global FDI game. However, the countries from the continent did not fare badly when we compare the ratio, of FDI inflows to their economic size, with other developing countries. On the

contrary, some African countries received more FDI relative to GDP than the average developing country. UNCTAD World Investment Report (WIR) 2001 reports that in 2000, FDI flows to Africa declined for the first time since the mid-1990s from US$10.5bn to US$9.1bn. In 2001, the inflows to Africa jumped from US$9bn to US$19bn but in 2002 fell again to US$11bn. As a result, the region's share in global FDI inflows fell from 2.3 percent in 2001 to 1.7 percent in 2002.

In 2002, Central and Eastern Europe (CEE) experienced an increase in FDI inflows to US$29bn, rising in 9 countries while falling in 10 others. Firms in several of these CEE countries – particularly the EU accession countries – are now cutting down activities which are based on cheap unskilled labour and expanding higher value added activities to take advantage of the educated local labour force.



A look at the relative inward FDI figures: FDI inflows as percentage of GFCF was the highest for CEE in 2002 followed by Latin America and the Caribbean, and Africa. Asia and the Pacific had the lowest FDI inflows as percentage of its GFCF in 2002. This figure indicates how important FDI has been in total investment of a country or region. In all the regions, this figure had risen in the second half of 1990s but declined in early 2000s, which also signals a slowdown of global FDI inflows. FDI inflows were nearly one-fourth of GFCF in Latin America in 1999, declined sharply in the years that followed.

Within Asia and the Pacific, FDI inflows as a percentage of GFCF rose from 6.2 in 1991-96 to 13 (an increase of about two times) in 2000 but declined to 7.2 in 2002 (a decline by about half). In Latin America and the Caribbean, FDI inflows as a percentage of GFCF increased from an average of 8.1 in 1991-96 to 25.8 in 1999 (an increase of more than three times) but by 2002, this had declined to 14.6 in 2002 (a decline by nearly half times). Within Africa, FDI inflows as a percentage of GFCF increased from an average 5.3 in 1991-96 to 11.8 in 1999 (an increase of more than two times) but declined to 8.9 in 2002 (a decline by about three-fourth times). In CEE FDI inflows as a percentage of GFCF rose by more than three times from 5.8 in 1991-96 to 18.5 in 1999 but declined by about one percentage point to 17.2 in 2002.

2.3 Trends in Large Emerging Markets and Least Developed Countries

The increase in FDI flows was spread unevenly among the different groups of developing countries in 1990s. In particular, least developed countries (LDCs)[2] received very little of the increasing inward FDI in this period. Growth in FDI inflows to the LDCs have been poor in 1990s but FDI has played an important role in overall capital formation in some of these countries as shown by their high share of FDI in GFCF[3].

Actual FDI flows into the 49 LDCs as a group increased from an annual average of US$0.6bn in 1986-90 to that of US$3.6bn in late 1990s. Even within this group, FDI flows to LDCs are highly concentrated, and interestingly in 2001, more than 90 percent of FDI inflows were in the form of greenfield investment. In 2002 inflows to the LDCs declined by 7 percent to US$5.2bn. The decline was 3 percent in LDCs in Africa and 50 percent in those in Asia and the Pacific.

Due to increasing FDI flows and declining ODA, the importance of ODA in external financial flows has been declining, though it still remains the largest component of resource flows to LDCs.

Most FDI to LDCs has been resource seeking, in sectors like oil and mining and took the form of greenfield investment. However, the share of LDCs in total FDI inflows to developing countries declined from 2.2 percent during 1986-1990 to 2.0 percent during 1996-99, because FDI to the bigger emerging economies grew faster. By large emerging markets (LEMs), we imply developing economies with considerable market size, which is defined by the purchasing power of the people. LEMs appeared to attract more FDI than LDCs both in terms of absolute numbers and in proportion of GDP as well as GFCF. LDCs received a tiny proportion of FDI from the M&As boom of late 1990s and 2000, which pushed up the level of global FDI inflows. Most M&A deals in developing

Table 2.1: FDI in LDCs and other Developing Countries		
Item	**LDCs**	**Other developing countries**
Average annual growth in FDI inflows, 1986-1999	20% 27 of the 49 LDCs experienced a growth rate of more than 20 percent. Wide variations: e.g. Burundi saw a decline of 33 percent and Cambodia saw an increase of 474 percent. Wide fluctuations in growth rates.	22%
FDI inflows as a % of gross domestic capital formation, 1997-99	8% 16 LDCs attracted more FDI as a percentage of gross capital formation than all developing countries taken as a whole.	12%
Source: FDI in Least Developed Countries at a Glance, UNCTAD		

countries were conducted in Latin America and the Caribbean with two LEMs, Brazil and Argentina, dominating the scene. Privatisation has been the main vehicle for M&A in LEMs. Privatisation FDI was also important for transition economies, particularly Hungary, and for some Asian countries. As noted earlier, M&As were not important for LDCs, the reasons being the slow pace of privatisation, poor investment climate and a general lack of attractive investment opportunities.

The next section examines the sectoral FDI trends across the globe and in the IFD project countries.

2.4 Sectoral FDI Trends

Inward FDI to developing countries falls into three broad categories: investment in the primary sector: either in the production of agricultural goods or in the extraction of minerals and other natural resources; investment in manufacturing, including, for example, the production of textiles and clothing and agro-processing; and investment in the tertiary or services sector, which includes financial services and tourism and utilities. FDI inflows to developing countries were distributed among the three sectors though some sectors received higher FDI than others.

The latest trends in FDI suggest that the share of the services sector in total FDI stock[4] amounts to 60 percent at the global level, whereas it was less than 50 percent a decade back. In contrast, the share of manufacturing in the FDI stock has declined to 35 percent in 2001 from more than 40 percent in 1990, and that of the primary sector fell to 6 percent from 10 percent in the same period. For developing countries, services account for 52 percent of the inward FDI stock in 2001 compared to 41 percent accounted by manufacturing and 7 percent by the primary sector.

Within the services sector, there was a decline in the importance of traditional activities *viz.* financial and trading services and a rise in the importance of some other activities. The finance and trading stock decreased from 65 percent of total inward services stock in 1990 to 45 percent in 2001, while that of services such as power generation and distribution, telecommunications and business services increased from 17 to 44 percent in the same period. Within the manufacturing sector two activities: chemicals and electronics account for one third of manufacturing FDI inward stock in 2001.

Of the IFD project countries, Brazil had the highest proportion of FDI coming into the services sector, at 80 percent, mainly as a result of the privatisation process. The other two large emerging markets, India and South Africa, showed mixed patterns of investment in manufacturing and services. India has seen large amounts of FDI in the telecommunication, power, oil, automobiles and information technology sectors. These are all either new industries or have just recently opened up to private investment. South Africa received most FDI in the telecommunication, energy and oil sectors, followed by food and beverages and automobiles.

In Hungary, the only transition economy in the study, investment flows were the largest in the manufacturing sector during 1990s. Investment was high in the automobiles sector and electrical products, among others. However, this pattern changed at the end of 1990s, when services dominated FDI flows and companies in the automobiles and electrical sectors relocated to other countries.

The LDCs also experienced mixed patterns of investment. For Zambia, in particular, mining constituted a large proportion of FDI, followed by tourism and agriculture. In Tanzania, investment in natural resources has been overtaken by investment in services, particularly in the telecommunication and financial sectors. FDI in agriculture has been low. Bangladesh has had most investment in gas and power, while its most export-intensive sector, textiles, has received

surprisingly little foreign investment. One problem faced by the LDCs, however, is that the proper data on sectoral FDI is lacking.

These sectoral patterns suggest that services are very important and that major privatisation efforts will attract foreign investors. However, privatisation raises a number of concerns. These will be discussed later.

Recommendations

- Good information on the sectoral distribution of FDI is needed for governments to design effective policies.
- Investment promotion should be based on the sectoral aspects of the national development plan.
- Economies are dynamic and the features that attract foreign investment will change over time. Policies need to be revised according to these trends.
- Develop sectoral incentives to encourage investment in sectors with potential such as information communications technology (ICT) in India.
- Government intervention to support technological upgrading in some sectors may be appropriate, depending on a country's level of development. In other cases, a 'hands-off' approach may be more effective. In general, governments should play a limited role in dynamic and competitive industries like IT, where regulation can inhibit growth.

CHAPTER-3

International Developments in Policy and Regulatory Changes

3.1 Regulatory and Policy Changes

Over the past decade, developing countries have increasingly opened up their economies to FDI. Of the changes made in FDI policy in recent years, practically all have been in the direction of liberalisation. (See Table 3.1: Changes in National Regulations of FDI)

These changes include:

- Minimising restrictions on sectors in which FDI is allowed;
- Removing or reducing restrictions on equity structures, caps on the proportion of foreign ownership and requirements for joint ventures;
- Reducing barriers to the repatriation of profits; and
- Lifting requirements for local content, value of imports or exports.

Table 3.1: Changes in National Regulations of FDI, 1991-2002

Year	1991	1992	1993	1994	1995	1996	1997	1998	1999	2000	2001	2002
Number of Countries Regimes that Introduced Changes in Their Investment Policies	35	43	57	49	64	65	76	60	63	69	71	70
Number of Regulatory Changes *Of which:*	82	79	102	110	112	114	151	145	140	150	208	248
More Favourable to FDI[a]	80	79	101	108	106	98	135	136	131	147	194	236
Less Favourable to FDI[b]	2	-	1	2	6	16	16	9	9	3	14	12

Source: UNCTAD, WIR, 2003

a: Including liberalising changes or changes aimed at strengthening market functioning, as well as increased incentives.

b: Including changes aimed at increasing control as well as reducing incentives.

The pace of change has varied across regions, but most developing countries now have relatively open FDI policies and there is little variation in policies between countries.

Some countries retain restrictions on industries, which are considered to be of particular national importance. In China, for example, foreign investment is restricted in sectors related to "national and economic security". In India, the agricultural sector remains closed to foreign investment, while Bangladesh does not allow investment in banking and insurance.

Some countries have implemented a "second generation" of policies to attract foreign investors. These policies have included the creation of investment promotion agencies (IPAs) and the use of other marketing techniques to promote the country as an investment location. Countries have also tried to reduce the administrative burden on foreign investors by creating 'one-stop shops', centralising the issue of licenses and permits in a single agency, while other countries have removed licensing requirements as part of their economic liberalisation strategies. A further development has been the use of incentives, such as tax holidays or tax reductions, to attract foreign investors, and the creation of export promotion zones or special economic zones in which businesses are exempt from certain national regulations and import and export tariffs. The pros and cons of investment incentives are discussed in section 3.3.

Changes in policies directly relating to FDI have been part of a general trend towards economic liberalisation and deregulation. Some of the policies associated with this shift have had an important impact on the investment environment and have encouraged investors to enter new countries. These include:

- Capital account liberalisation, which has made it possible for investors to move money freely into and out of the country.
- Exchange rate liberalisation; which has removed the disparity between official and black market exchange rates and has improved investors' incentives to export.
- Financial sector reform, including deregulating banking, opening the sector to competition and freeing interest rates. This has made it easier for investors to raise finances locally.
- Trade liberalisation, which entails opening up of their borders to trade in goods by countries, in the last decade, including all the project countries, which are all members of the World Trade Organisation (WTO). This can have opposing effects on foreign investors: on the one hand, transnational corporations (TNCs) that were serving a closed domestic market may now

face competition from imports. On the other hand, these firms may now be able to reach the larger market of the regional trading bloc.

- Deregulation, which includes reduction of red-tape and simplification of regulations, thus reducing costs for investors by governments.
- Privatisation and contracting out has opened up the sectors previously reserved by governments for foreign investors and presented many excellent investment opportunities for global firms.
- Competition, which entails had opening up to competition from foreign and domestic investors of sectors, which had high degrees of monopoly and concentration. Countries are introducing or strengthening competition laws, which will benefit competitive firms, both foreign and domestic.

Two other broad initiatives that may encourage FDI are efforts to reduce corruption and to improve transparency in developing countries. Corruption increases risks and costs for the investor, both day to day and high-level or "grand" corruption. However, once 'everyday' corruption becomes "endemic" in the system – everyone expects others to be corrupt and behave accordingly – it may be extremely difficult to eradicate it. A culture of corruption usually takes time to change. Grand corruption has often been associated with the exploitation of natural resources, and some governments and firms have been involved in recent sectoral initiatives to improve transparency in accounting and thus reduce the opportunities for corruption.

Almost all developing countries changed their policies in 1990s due to a variety of reasons, some international while others domestic. The next section discusses some of the broad reasons for the changes.

3.2 Reasons for the Changes

The reasons behind these global policy trends are both domestic and international. At the national level, macroeconomic crises prompted many of the changes and created the political will needed to follow the changes. In 1990s, many developing countries experienced severe balance of payments deficits, large government budget deficits and high inflation, which prompted thorough-going programmes of economic reforms involving the liberalisation of capital and trade flows.

Some external sectors created direct pressures. The International Monetary Fund (IMF) and the World Bank (WB) have included liberalisation commitments as conditions for their loans, notably as part of the Structural Adjustment Programmes (SAPs). Zambia, for example, embarked on capital account convertibility as part of its SAP.

Countries have also made liberalisation commitments in trade negotiations at the regional or international levels. Member states of the WTO have had to make commitments not just on trade liberalisation, but also on the protection of intellectual property rights, in the Trade Related Aspects of Intellectual Property Rights (TRIPs) Agreement, and on phasing out the use of "Trade Related Investment Measures" in the TRIMs Agreement. This Agreement prevents the use of export, import and local content controls on foreign investors by developing countries after the 2002 deadline. The other WTO agreements, which have some bearing on investment flows are General Agreement on Trade in Services (GATS) and Agreement on Subsidies and Countervailing Measures (ASCM).

FDI has come to the fore as a source of finance for development as it became more important compared to other sources. Development aid has been falling for the last two decades, although donor countries pledged an increase in aid at the United Nations, Finance for Development Conference in 2002 in Monterrey, Mexico. Inflows of commercial debt have also dropped off from the levels of 1970s and early 1980s – both governments and the Bank are conscious of the high risks involved in these commercial loans after repeated debt crises in developing countries. Furthermore, flows of portfolio investment are perceived as unstable, and sometimes undesirable, after precipitation of currency crises due to rapid investor withdrawals from emerging markets, demonstrated during the Asian Crisis, the Tequila Crisis, and most recently in Argentina. Direct investment has shown itself to be a more stable and reliable form of finance.

Recent academic thinking has drawn the attention of policy-makers to the new phenomenon of global production networks, in which firms locate their different functions in locations across the globe in order to take advantage of the competitive benefits of each place. Through FDI, developing countries can take part in these global networks, which bring with them access to rich markets, new technologies and management expertise. It is partly this new phenomenon that has shaped policy-makers views of FDI towards positive direction.

At the same time, suspicion of TNCs in governments has gradually been replaced with the view that TNCs, on balance, can benefit their host economies – a view that was based on historical experiences of colonisation, of political interference by foreign firms and exploitation of natural resources with little benefit to the host economy. However, public opinion has not always kept pace with changing opinions in governments: the public tends to be more conscious of the local-level problems and adjustment costs associated with particular investment, while governments may be looking at the bigger picture.

The last two sections have elaborated how most host economies, including the developing ones, have undertaken measures to facilitate higher FDI in 1990s. Towards the end of 1990s, however, the attention shifted to policy and regulatory measures to benefit from FDI rather than to facilitate higher FDI.

3.3 Competition for FDI among Countries

In this section, competition among countries to attract higher FDI is discussed with examples from the IFD project countries. To this end, they provide financial and fiscal incentives, undertake corporate restructuring and economic reforms, undertake investment promotion measures and, invite foreign investors to participate in the privatisation of state-owned units. Steps that improve the underlying characteristics of the investment environment will benefit domestic investors as much as foreign firms and can be regarded as healthy competition. However, the provision of incentives, which has been an important aspect of competition for FDI, is more controversial. This may create competition among countries for incentives *e.g.,* Ramatex investment in Namibia where South Africa and Madagascar were also considered as possible hosts.

Financial and fiscal incentives that are commonly used include:
- Direct subsidies to the firm for each job created;
- Exemption from import and export tariffs;
- Reduced rates of corporation tax;
- Tax holidays (tax exemption for a defined period); and
- Exemption from labour laws, such as the right of employees to organise.

The provision of incentives may be restricted to certain geographic locations, such as Export Processing Zones (EPZs), or deprived regions, or may be made available to certain types of firms regardless of their location, e.g. exporting firms. But there are doubts over the effectiveness of incentives in attracting investment if fundamental factors, like cost-levels and competitiveness compare unfavourably to other locations. It is only in cases where a number of locations meet the firm's investment criteria that incentives may tip the balance in favour of one or the other location. In some cases, it may be worthwhile to offer incentives to a key or 'first-mover' investor, which then attracts other foreign investors to the country as suppliers.

Often incentives are used to correct market failures. For example, governments often provide subsidies in the presence of external economies of scale. Incentives are also offered to compensate for deficiencies and distortions in a host country's business environment, for example, poor infrastructure and red tape.

An incentives race among host countries may lead to a "race to the top" in grants and subsidies or a "race to the bottom" in regulatory measures. This kind of race increases the risk that the cost of incentives might exceed the return to society. This is one argument against the use of incentives. Besides, it is difficult to gauge the effectiveness of incentives. Developed countries frequently employ financial incentives such as outright grants, whereas fiscal incentives are more common in developing countries due to budget constraint. Incentives have not been very successful in influencing the decision of foreign investors to invest in a country. Studies show that investment that flows into a country probably would have flowed even without the incentives[5].

There is evidence of incentives in the IFD project countries as well. South Africa and Hungary, for example, offered a variety of incentives to investors. Both the countries introduced tax holiday schemes. The scheme was phased-out in South Africa and replaced with a reduction in corporate tax rates from 35 to 30 percent of profits. Competition for FDI can also create incentives war among subnational units e.g. incentives war among the Brazilian states. The implication of this could be severe on a country's public finances.

Often countries have to remove or withdraw incentives. In Tanzania, the government was forced to remove incentives on petroleum imports for mining companies and foreign missions due to reports of abuse of the services by beneficiaries.

Often incentives help in creating a facilitative environment for investment. Fiscal and regulatory incentives helped to create an attractive investment environment in Hungary. The country provided long tax holidays, which helped to channelise profits from elsewhere in the country. This was important especially for investors planning to carry out further investment and reinvestment of profits generated elsewhere in Hungary. The other important incentive was establishment of free trade zones. However, the European Union criticised both types of incentives in accession negotiations, as they did not conform to the EU incentive structure. These incentives were eventually withdrawn by Hungary.

3.4 International Trends

In this section, we set FDI trends in the context of international developments. There have been a number of changes in the organisations and institutions that affected FDI in recent years, both directly and indirectly.

One striking phenomenon of recent years has been the explosion in the number of BITs and inclusion of clauses on investment in other agreements. There are now over 2000 bilateral treaties, almost all of which were signed in the last decade. These treaties often consolidate an existing economic relationship between two countries and contain provisions which reconfirm existing laws and practices. However, the BITs signed by the US and Canada tend to have a wider scope. They generally include the approval of investment, a wide definition of investment encompassing shares, stocks and bonds, and require 'National Treatment' (foreign investors should be allowed to invest in any sector that is open to domestic investors) and 'Most Favoured Nation Treatment' (no foreign investor should be favoured over others in admission or subsequent treatment). BITs often provide for international arbitration of disputes. Double taxation treaties are even more common than BITs and are often the first step in the consolidation of an investment relationship between two countries.

Clauses relating to investment are also becoming more common in regional trade agreements. Chapter 11 of NAFTA, the North American Free Trade Agreement, relates to investment, while the Cotonou Agreement, the Pacific Basin Charter and the Energy Charter Treaty all contain investment provisions. As regional economic cooperation seems to be a strengthening trend, it seems likely that investment provisions under these agreements will also multiply.

Several WTO agreements relating to investment were signed at the end of the Uruguay Round of trade negotiations. The GATS covers investment as one 'mode of supply' of services. Signatories made commitments to liberalise trade in services, specifying both the sector and the mode of supply. Some developing countries have opened up their borders to services investment under this agreement, for example in the area of financial services. Liberalisation under the GATS is an ongoing process, not subject to the agreement of WTO Member countries to negotiate. Many developing countries are now reluctant to make further commitments and are willing only to 'lock-in' liberalisation that has already taken place.

The TRIMs agreement forbids the use of certain import and export-related restrictions on foreign investors, while the TRIPs agreement affects the transfer of technology. These two latter Agreements have been coming into force gradually for developing country members. In the current round of negotiations, some developed countries have been pushing for negotiations on investment. However, in the Ministerial Meeting that took place in Cancun in September 2003, investment proved to be a controversial issue and members did not agree on a negotiating agenda. Developing countries expressed concerns about the

overloaded agenda and the negotiating capacity of poorer countries on new issues and whether there were any potential benefits of such an agreement for developing countries.

Governments have been involved in a number of other initiatives at the international level to address specific concerns relating to private investment, such as the Organisation for Economic Co-operation and Development (OECD) Guidelines on Multinational Enterprises. These provide a framework within which OECD governments help firms to develop their own codes of conduct and a process for resolving concerns. Further, in order to tackle corruption, OECD governments have signed on to the Convention on Bribery of Foreign Public Officials. In the aftermath of Enron's collapse, the reporting requirements for TNCs have become more stringent and corporate governance regulation are being tightened in the US and Europe. An increasing proportion of funds are being directed towards improving the environment for the private sector to operate.

Discussions on corporate social responsibility (CSR) also assume an important role in any discussion and debate on investment. There have been extensive discussions on how to enforce CSR: Should there be host country regulations? Should home countries have any role? Should codes of conduct be included in international investment agreements (IIAs)? Should there be guidelines instead, which companies would voluntarily adopt?

Recommendations

- Establish regional cooperation between countries to create awareness about the disadvantages and risks of using incentives and to discourage competition. Include clauses to constrain incentive races in bilateral, regional or international investment agreements.
- Investment promotion efforts should focus on the country's underlying strengths rather than tax or other incentives. Investment promotion agencies should be strengthened, restructured and given greater independence, where needed.
- Streamline business licensing and registration regulations and make enforcement simple and easy to implement. A one-stop-shop for investment approval is a useful step, although governments should ensure that the one-stop-shop does not become a 'many-stop' or 'full-stop' shop.
- IGOs should provide training and advice for the negotiation of international investment treaties. These negotiations are often highly complex and revolve around technical issues, with which officials from

developing countries may not be familiar. Some capacity-building for negotiation was conducted as part of the Doha Round Agenda but more extensive and continuous training is needed for countries to defend their interests in bilateral and regional negotiations.

- IGOs should support developing countries by providing legal advice and services to countries that do not have adequate financial resources or experienced personnel to take part in disputes or negotiations.
- Developing countries might benefit from a revision of the terms of existing treaties, which would allow them more flexibility, appropriate to their stage of growth.
- Strengthen and extend partnership efforts to deal with corruption, especially those forms of corruption related directly to foreign investment.

CHAPTER–4

Overview of National Experiences

4.1 Trends in FDI

The project countries differ significantly in terms of the size of the economy, per capita income and industrial structure. In terms of gross national income, India is the largest economy followed closely by Brazil, and Zambia is the smallest. However, if we consider per capita income, Hungary has the highest among the project countries, followed by Brazil and South Africa. During 1980s and 1990s, India and Bangladesh experienced a rise in the rates of economic growth, Brazil experienced a marginal increase in the growth rates with

Table 4.1: Macro Characteristics of the Project Countries

Indicators/Country		Bangladesh	Brazil	Hungary	India	South Africa	Tanzania	Zambia
Population (2002) (in millions)		136	174	10	1048	44	35	10
Surface area (2002) (Thousand sq. km)		144	8547	93	3287	1221	945	753
Population density 2002) (People per sq. km of land area)		1042	21	110	353	36	40	14
Gross National Income (2002)	*US$ bn*	48.5	497.4	53.7	501.5	113.5	9.6	3.5
	US$ per capita	360	2850	5280	480	2600	280	330
PPP Gross National Income (2002)	*US$ bn*	234	1266	130	2691	430	19	8
	US$ per capita	1720	7250	12810	2570	9870	550	770
Gross Domestic Product (2001-02)	*% growth*	4.4	1.5	3.3	4.4	3.0	5.8	3.0
	Per capita % growth	2.6	0.3	3.5	2.8	2.2	3.6	1.3

Source: World Bank World Development Report, 2004

fluctuations, while in Hungary, Tanzania, Zambia and South Africa growth rates were below 2 percent in 1990s.

Among the project countries in 1990s, Brazil had the highest inflows experiencing a rapid growth in FDI in the later half of 1990s. India and Hungary ranked as distant second and both experienced a decline in inflows in later 1990s. South Africa, on the overall, attracted less FDI than India and Hungary, with wide fluctuations. Bangladesh, Tanzania and Zambia have received low FDI of nearly the same amount. While flows increased in Tanzania and Bangladesh in 1990s, Zambia experienced a fluctuation in the flows.

Table 4.2: FDI Inflows in the Project Countries (US$mn)

Host Economy	1991-96 (Annual Average)	1997	1998	1999	2000	2001	2002
Bangladesh	8	139	190	180	280	79	45
Brazil	3,633	18,993	28,856	28,578	32,779	22,457	16,556
Hungary	2,205	2,167	2,037	1,977	1,646	2,440	854
India	1,085	3,619	2,633	2,168	2,319	3,403	3,449
South Africa	450	3,817	561	1,502	888	6,789	754
Tanzania	63	158	172	517	463	327	240
Zambia	108	207	198	163	122	72	197

Source: WIR, 2003

Table 4.3: FDI Outflows in the Project Countries (US$mn)

Host Economy	1991-96 (Annual Average)	1997	1998	1999	2000	2001	2002
Bangladesh	3	3	3	-	2	21	4
Brazil	493	1,116	2,854	1,690	2,282	-2,258	2,482
Hungary	21	433	478	252	532	337	264
India	76	113	47	80	336	757	431
South Africa	1,204	2,351	1,779	1,580	271	-3,180	-401
Tanzania	-	-	-	-	1	-	-
Zambia	-	-	-	-	-	-	-

Source: WIR, 2003

In almost all the countries, except Bangladesh, cross-border M&A activities rose in 1990s. M&A flows have been significant in Brazil, Hungary and South Africa in the second half of 1990s. FDI in Bangladesh was mostly in greenfield projects, mainly in the energy sector (gas and power) and telecommunications and cement. Outward FDI was in form of M&As for South Africa and Brazil, and to a lesser extent for India. In any case, outward FDI was lower in India than the other two countries. Outflows from Hungary are less oriented towards M&As, and from Tanzania and Zambia it is practically nil.

Inward FDI stock as a percentage of GDP was 58 percent for Zambia, 40 percent in Hungary and South Africa, and 22 percent in Brazil in 1999. For other countries, especially in South Asia, this figure was significantly lower.

4.2 Changes in Policies Related to FDI

Each project country has a different historical experience with foreign investors, and continues to use different approaches to deal with investors. However some similarities can be drawn, and study of the various national experiences with foreign investors, can provide illustrative examples for other countries. Common for all countries in the project, as is common for most developing countries, is that they have rapidly opened up their economies to foreign investors during 1990s.

This chapter highlights some of the policy changes adopted by the countries. Some of the broad initiatives are as follows:

- All the countries have undertaken significant trade liberalisation measures by reducing or removing quantitative restrictions and tariffs and getting actively involved in regional trade agreements.
- Almost all countries undertook current or capital account liberalisation.
- All countries have sought to privatise their state-run units.

Laws and regulations affecting investment are also important. The project countries modernised and revamped laws related to business and investment to bring about a facilitative investment environment, and the need to implement them effectively. The following laws were highlighted by the project countries as the ones that deserve attention:

- Labour legislation/protection with clear regulations that are implemented consistently.
- Intellectual property rights legislation that provides protection for investors while supporting the country's technological development.
- Review the system of corporate law, including bankruptcy laws, to ensure that investors have adequate legal protection.

- Design and implement competition policies that protect consumers while giving a fair deal to businesses.
- Consider laws that tax short-term capital flows in order to discourage capital flight.
- Entrench the principle of prompt and fair compensation for expropriation of investors' property in word and practice of the law.

The reasons for adopting liberalisation measures differ for different countries, e.g. impending economic crisis led Bangladesh, Tanzania and Zambia to implement structural adjustment programmes prescribed by the International Monetary Fund/World Bank (WB), whereas in South Africa, the new government, in 1994, abolished policies which promoted apartheid and adopted financial liberalisation. These incidents opened up opportunities for foreign investors to invest in these countries.

India's New Economic Policy/New Industrialisation Policy was adopted in 1991 and implemented after the country approached the IMF for a loan following a foreign exchange crisis in the country. The new policies opened the doors to foreign investors to invest in the previously restricted productive activities.

For Hungary, the watershed in policy regime was the beginning of the process of transition of the economy from a state-controlled to a market economy with the help of the Szechenyi Plan. (Refer to Table 4.4)

Table 4.4: Landmarks in Policy Changes in 1990s: The IFD Project Countries

Country	Major Reforms	Comment
Bangladesh	Structural Adjustment Programmes	WB/IMF induced policies; Vigorous trade liberalisation, economic growth and poverty reduction programmes.
Brazil	"Internationalisation" of the Economy	Significant increase in FDI inflows, especially since 1994. New constitution in 1988 made changes in the regulation of foreign capital; consitutional review of 1993 and amendments of 1995 removed restriction on foreign capital. In 1994-98, restrictions on extraction activities and on services progressively reduced.

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Hungary	COMECON[6] to Szechenyi Plan, 1992	Until 1992 Hungary was a member of the Soviet led COMECON and had a centrally planned economy. The Szechenyi Plan meant a move to market economy.
India	New Economic Policy (NEP), 1991	Liberalising FDI inflows.
South Africa	End of apartheid sanctions, 1994	Lifting of sanctions made it easier for foreign investment to flow in.
	The Growth, Employment and Redistribution (GEAR) Strategy, 1996	Two pillars: i) rapid expansion of non-traditional exports; and ii) an increase in private sector investment.
	Micro-Economic Reform Programme (MERP) and Integrated Manufacturing Strategy (IMS), 2001	Emphasises on microeconomic reforms; set out framework for SA's economic strategies.
	Medium Term Expenditure Framework (MTEF) and Medium Term Strategic Framework (MTSF), 1998	Macroeconomic policy; medium term strategic priorities.
Tanzania	Economic Recovery Programme, 1986-89	World Bank/IMF instituted adjustment programme, aimed at raising GDP and tackling inflation.
Zambia	Structural Adjustment Programme, 1991	World Bank/IMF instituted adjustment programme, which initially destabilised the economy further and led to widespread poverty.
Source: IFD Country Reports, CUTS.www.cuts.org/ifd-indx.htm		

In South Africa the new government undertook overall economic growth and development strategies, which created conditions to facilitate higher FDI in the country. Brazil undertook liberalisation policies in 1990s, which upturned the import substitution policy of the earlier decade and opened up sectors of the economy for foreign investors.

Turning to investment policies, it can be seen that while a few countries such as Tanzania and Zambia enacted or modified investment Acts to facilitate higher FDI, the others adopted related policies or enacted related Acts, which created a facilitative environment for smoother inflows of FDI. Bangladesh created its Board of Investment (BoI) through the BoI Act and adopted a new industrial policy in 1999, and Hungary adopted new investment policies, which created a framework to facilitate higher FDI. (Refer to Table 5.5)

Table 4.5: Changes in Investment Policies/New Investment Acts: IFD Project Countries			
Country	**Major Reforms**	**Year**	**Comment**
Bangladesh	Board of Investment Act	1989	Created the Board of Investment (BOI) as a one-stop service for foreign investors where they would be able to receive all the clearances.
	Industrial Policy	1999	The private sector would play an important role in the economy.
Hungary	Investment Policy	1990s	Legal framework created for foreign investors; Joint ventures with foreign companies promoted by discount of corporate income tax.
India	Industrial Policy	1991	Industrial licensing abolished for most sectors, except 18. Subsequently some more industries exempted from licensing; FDI in 34 industries eligible for automatic approval upto a foreign equity participation level of 51 percent of the paid-up capital of a company. More liberalisation in subsequent years
Tanzania	National Investment Promotion Policy Investment Promotion and Protection Act	1990	Private capital flows embraced.
	New National Investment Policy	1996	Governs all aspect of investment except the mineral sector investment.
	New Tanzania Investment Act	1997	To create an attractive commercial environment and provide incentives for inward investment. Established Tanzania Investment Centre. 100 percent foreign ownership permitted in most economic activities. Not applicable to Zanzibar, which has a separate legislation. 100 percent foreign ownership allowed in Zanzibar, except in some retail areas and tourist services.

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Zambia	Investment Act	1993, amended in 1996 and 1998	Promotes investment in productive activities; protection of investment; does not apply to banking and financial services, insurance, mining and quarrying, which have separate Acts.
Source: IFD Country Reports			

The other measures, which were important in positively influencing the investment environment, have been Acts to set up export processing zones, competition policy, sectoral policies, policies adopted by sub-national governments to facilitate FDI and, policies and legislations which simplify the administrative and regulatory set up. Some of these are discussed below.

To facilitate investment, Bangladesh enacted the Private Export Processing Zone Act in 1996, which enables private companies to set up special EPZs in selected areas, where they are allowed to import capital machinery on a duty free basis. Other measures to ensure greater transparency, predictability and labour market efficiency have been Law Reform Commission, Administrative Reforms Commission and Industrial Relations Act.

Among the measures which facilitated FDI in Brazil has been the adoption of Information Technology Law in 1993, which envisages a 15 percent reduction in industrialised products tax for producers of IT and telecom equipment, if they follow some minimum requirements for domestic production. Manaus Free Zone (ZFM), which was created in 1957, attracted investment in 1970s due to tax incentives. The 1988 constitution retains these incentives till 2013, but these lost their effectiveness due to liberalisation of 1990s. Other measures include the creation of Automotive Regime in 1990s, which provided various incentives to rejuvenate the internal market. State programmes in Brazil also played an instrumental role in facilitating FDI. The 1988 constitution increased financial powers and autonomy of the states. This led to a fiscal war among the Brazilian states.

In Hungary, the privatisation policy of 1990s favoured sales to foreign strategic investors and opened up the service sectors such as telecommunications, energy, water supply and, banking and finance, which facilitated high inward FDI to the country. FDI incentive measures in the country included state subsidies in 1990s for large-scale investment in certain high technology sectors, industrial free trade zones (FTZs) in 1982 with an aim to attract export-oriented and high technology FDI.

In India, the earlier Competition Act, the Monopolies and Restrictive Trade Practices Act, was amended initially but diluted subsequently. A new competition law has been passed but not yet put in place. However, regulators in telecom, insurance and other sectors have been instituted. India also put in place a fiscal regime for foreign investors, which accorded favourable tax treatment to foreign investors initially. Later on, foreign investors were brought at par with domestic investors and non-resident Indian investors.

In Tanzania, institutions such as Parastatal Sector Reform Commission and National Development Corporation (NDC) were created for overseeing privatisation, mobilisation and channelisation of investment to the industrial sector.

Similarly, Zambia adopted the Zambia Privatisation Act in 1992, which established the Zambia Privatisation Agency, which privatised 248 out of 280 state owned enterprises by 2000. The country also adopted a Competition Policy in 1995 that became operational in 1997.

In the next section, we discuss the implementation and effectiveness of FDI-related policies in facilitating higher FDI, and problems related to the policy regime of a country.

4.3 Effectiveness of Policies and Related Problems

The project countries have had different experiences with the implementation and effectiveness of policies. Countries in South Asia, although they have liberalised their investment regimes considerably, did not experience a considerable increase in FDI flows. Similarly, Tanzania and Zambia did not experience a dramatic increase in inflows despite taking measures to facilitate FDI, though Tanzania was relatively more successful than Zambia in this respect[7]. Again, inflows did not rise sharply in South Africa though it has a liberal regime for foreign investors and a well-developed capital market. Hungary and Brazil, on the contrary, did experience higher inflows of FDI than earlier levels.

The common problems associated with policy and law are a poor legal framework and weak enforcement mechanisms. A few of the project countries also face the problem of outdated and inadequate laws. Often investors complain about uncertainty and instability in the policy environment e.g. the Black Economic Empowerment programme in SA. (See Annexure - Box A: Why is South Africa a net capital exporter?).

A further common weakness is inadequate infrastructure. In several of the project countries, investment is discouraged by poor transport and power networks that create extra costs and risks for investors. Improving this infrastructure would not only help to attract more foreign investment, but would also encourage domestic development. However, infrastructure investments are very costly, and may be impossible for governments to make, given their large budget deficits, limited access to international financial markets and falling levels of development assistance. This has prompted some countries to look to the private sector to finance such investment.

There are also some specific problems associated with policies and implementation. In Zambia, there have been no comprehensive trade policies. Some of the project countries also face the complaint that their labour policies and regulation are investor-unfriendly: either appropriate regulation does not exist or there is problem of over-regulation. A major problem faced by the project countries is the cost of conducting business. Often, the tax structure is blamed for this. It is also seen that there is a lack of effective policies/regulation to reduce cost of investment finance to small businesses. Further, an inefficient and corrupt regulatory and institutional mechanism severely hurts a country's investment environment by slowing down or frustrating investment initiatives. (See Box 4.1: Low Fructification of FDI in India)

Box 4.1: Low Fructification of FDI in India

Several countries noted that they have a low fructification rate of approved FDI. In India, only about 20 percent of FDI approvals translate into actual investment. There is a difference between FDI approvals and actualisation in China as well, but the difference is not as stark as in India.

Analysis of determinants of FDI in India shows that there is a relationship between the rate of fructification and the size of the firm. The probability of a contract failure declines with a decline in size, but large firms might reduce FDI fructification rate. This implies that FDI has been dominated by acquisitions, with large firms being able to resist it.

The other reason for low fructification rate in India is bureaucratic hassles and red tape, though the procedural route has been simplified and made non-discriminatory in the last decade. Investors lose their initial enthusiasm after going through the investment process. As per investors' feedback, environmental clearances and legal work in the country are still the most time consuming. There are three stages of a project approval: general approval, clearance, and implementation. Of the three stages, investors found the second most oppressive. In the Indian federal structure, clearance authorities are the state governments. The gap between the central and state governments in their treatment of foreign investors undermines FDI promotional efforts of central government.

Source: CUTS (2003), Investment Policy in India: An Agenda for Action

In some countries, a change in the mindset of public officials towards foreign investment is required to implement bureaucratic reforms. The Report of the Steering Committee on Foreign Direct Investment in India chaired by N.K. Singh, Member, Planning Commission, Government of India (popularly known as the N.K. Singh Committee Report) pointed out that there is a need to change the mindset of bureaucrats in India.

Information on total FDI flows is a problem in many developing countries. Tanzania, Zambia and Bangladesh have reported problems in the measurement of inflows of FDI. Doubts are also expressed about the FDI data estimated by the WB and UNCTAD. For example, Bangladesh is unable to measure the magnitude of FDI precisely due to the problem of non-reporting. UNCTAD and the WB have estimated FDI for the country using the balance of payments accounts. However, due to difficulties involved in accounting for transactions that do not require government approval, balance of payments accounts for Bangladesh may not give a complete picture of the foreign private capital flows. A study by WB in 1999 tried to re-estimate foreign capital inflow by compiling information from alternative sources. It came out with the finding that actual FDI flow was much higher than what BoP estimates show.

Governments may also have access to very limited information about actual (as opposed to planned or approved) investment flows. There are discrepancies in the data between national and international sources, e.g. in Bangladesh on the sectoral distribution of FDI. As information may only be collected during the investment approvals process, no information on the activities and performance of foreign companies in the host country may be available, making it impossible to assess the impact of FDI on the economy. In Tanzania, for example, it was found that a large proportion of foreign companies were either not operating at the address supplied for investment approval, or were not carrying out the activities stated in the application for approval.

As mentioned earlier, some countries need to undertake vigorous investment promotion of their countries. IPAs at the national and regional levels have proliferated recently. This is the result of an increasing perception of competition among countries to attract FDI. Policy-makers have also recognised the importance of investors' perceptions in deciding where to locate a new investment. Contrary to the traditional view that investors are probably quite rational and well informed about all locations, it seems that investors are more likely to be swayed by their impressions of a country or region, which may not be based on fact. South Africa, for example, may suffer due to investor pessimism about the African continent, even though its economy has different characteristics.

Most of the project countries have an IPA. Trade and Investment South Africa (TISA) is a good example of the kinds of services offered by an IPA. TISA employs numerous marketing strategies for the country, including advertising in the media, targeting particular investors with detailed information and holding promotional events in other countries. In India, the Foreign Investment Promotion Board (FIPB) has been created with the intention of creating a single window facility for foreign investors, but investors still need to gain clearance for environmental matters, land acquisition and sectoral approvals. It should be noted that the FIPB does not play an active role in promoting the country as an investment destination in the same way as the South African Agency, TISA, for example. Again, Bangladesh, Tanzania and Zambia all have IPAs, but they are reported to be not very effective.

Within a single country, regions or states may compete with each other to attract investors. This phenomenon can be seen in the large federal countries like India and Brazil. This competition can be wasteful when looked at from the perspective of national development, and national governments should try to restrict this. If governments want to attract investment to backward regions as part of a national development plan, efforts should be coordinated at the national level.

There is little evidence to show whether investment promotion is effective when underlying determinants of investors' decisions are not favourable. Governments need to decide whether the creation of an IPA is the best use of scarce resources under these circumstances. Where an IPA already exists, its value may be increased by giving it a role in coordinating licenses and registration requirements for all relevant ministries and assisting companies in identifying suitable sites.

In the next section, we discuss the performance of countries in facilitating inward FDI.

4.4 Performance of Countries Facilitating Inward FDI

All the project countries adopted measures to facilitate inward FDI with varying degrees of success. While the South Asian countries were less successful, Brazil and Hungary were more successful in attracting FDI. South Africa had greater outward than inward FDI, being the largest source of foreign investment in Eastern and Southern Africa. Tanzania and Zambia were not much successful in facilitating inward FDI, though Tanzania fared better both in terms of policies that were in place, and FDI trends.

In Bangladesh, the potential for FDI with steady growth and improvement in the size of the market emerged only in mid-1990s. The country, however, has not been able to attract much FDI. It needs to undertake vigorous investment promotion. A way of doing so is to draw attention to its strong economic performance. The country also lacks regulatory and policy clarity, and good business environment given the already open policies that welcome FDI into infrastructure and participation in privatisation.

As noted earlier, Brazil received high FDI in 1990s. Several factors are responsible for the high propensity of FDI flows into the Brazilian economy. The historical development of the manufacturing sector has increased the presence of TNCs in it. In recent years, the privatisation programme has led to a greater presence of TNCs in the services sector, especially utilities.

Earlier, FDI inflows into Brazil were designed to serve the entire Latin American markets, as labour costs were low. However, the 'maquiladora' industries of Mexico, which took off after the emergence of NAFTA, have led to a rather large decline in the labour intensive export enclaves of Brazil.

In 1990s, Hungary received substantial quantity of FDI. The country acted as a source of cheap labour for manufacturing product exports to the richer European countries, including the EU. Hungary based TNCs thus catered to the larger regional market. Additionally, the vigorous privatisation activity, which had put up for sale earlier state-run enterprises, had also significantly contributed to the FDI inflows. Lower corporate taxes, state subsidies for large-scale investment in high-tech sectors and the ability to overcome foreign exchange risks seemed to have added to Hungary's advantages listed above.

India received lower FDI as a percentage of GDP than some other developing countries of similar size e.g. China and Brazil in 1990s. There is a lack of regulatory and policy clarity in areas such as power, water, sanitation, roads and airports. In many sectors, especially services – banking, insurance, and real estate – with liberalisation, more FDI can possibly flow in. While policy changes and regulatory clarity can lead to higher FDI inflows into India (especially through the privatisation route), policies to enhance growth are also critical.

In South Africa, earlier there was a substantial withdrawal of FDI because many companies changed their headquarters to UK and Netherlands during the apartheid regime, resulting in negative inward FDI flows. Other factors, like increasing crime and law and order problems, might have restricted FDI to much below its potential. The country should focus on general policies that enhance growth, investment, and especially exports rather than FDI related policies.

South Africa has a dominant status in Eastern and Southern Africa and has great potential for economic development given its size, resources, location and skills (which need to be improved further). But premature liberal capital account policies have contributed to capital flight and reduction in the growth potential.[8]

Detailed data for analysing FDI in Tanzania is not available for the period under study. However, with what is available one can ascertain wide fluctuations in FDI. Broadly, it seems that the realised FDI is lower than what could be achieved. Higher growth rates have enlarged the market in recent years but have not led to a significant increase in FDI inflows. It is possible that tax incentives in the region to attract FDI puts countries with infrastructure and skill-linked constraints, such as Tanzania, at a disadvantage. This may be particularly relevant now as trade barriers within the region are breaking down. For tradeables, FDI can flow to most attractive locations and cater to the region. Perceptions of high political risks add to this disadvantage of the nation.

Zambia went through major stress during 1990s with economic growth having fallen dramatically, before it recovered somewhat from the major contractionary structural adjustment and 'stabilisation' that the economy went through. The large capital flight from Zambia was also a result of this macro-economic instability. High inflation till the contractionary policies brought about severe deflation underlie these large variations. Zambia therefore is different from the countries studied in major ways – small, but with a rich resources base and significant governance failure.

Nonetheless, if we focus on 1990s alone and disregard the large fluctuations in the earlier period, potential FDI seems to be higher than what has been achieved in Zambia. Since resource seeking motive is the key driver of FDI in the country, fall in international prices of copper may have led to limited FDI inflows. As noted earlier, high inward FDI is not a guarantee to achieve higher economic growth rate. Brazil is a case in point. Some of the project countries would have to re-orient their national development strategies keeping this in mind. The next section discusses the relation between FDI strategy and overall development strategy in a country.

4.5 FDI and National Development Strategies

Until recently, most countries pursued state-centred development models that focused on the mobilisation of domestic resources, and investment by the government and, restrictions on trade and capital flows. However, the policy

orientation of many governments has changed dramatically in recent years towards a greater role for the market, including private investment. FDI can play a number of roles in a national development strategy: on the one hand, it can be seen as a source of foreign capital in the light of unstable portfolio investment flows or declining ODA. It may also be seen as a source of finance for the development of infrastructure in sectors like power generation and transport networks, when governments are unable to invest because of sizeable fiscal deficits.

For other countries, FDI is sought for transfers of technology and expertise, and access to global markets. It is this latter aim that is prevalent in the national development strategy documents, although some of the other reasons are probably implicit in government planning.

Among the project countries, not all national development strategies specifically identify FDI as a driver of growth or a contributor to poverty reduction. However, in India, the N. K. Singh Committee Report, specifically identified FDI as essential to achieving the target growth rate for the economy and recommended policy changes needed to raise FDI inflows. In Brazil, foreign investment – both portfolio and direct – has long been seen as a key driver of growth. This has motivated the policies of deregulation and privatisation, though foreign companies have played an integral part in the Brazilian economy for many decades. However, as noted earlier, economic growth rate in the country did not get a boost from higher FDI in 1990s.

In South Africa, the key policy documents have been the GEAR, MERP and IMS. These policy instruments look into all aspects of policies for growth and Black Economic Empowerment.

Hungary opened its doors to foreign investors as part of the process of its transition from a state-controlled to market economy. However, the country now feels it is time to re-look and revamp its national development strategy in view of falling FDI inflows and slower growth rate of the economy. (See Annexure – Box B: Changes in Capital Attraction Factors in Hungary)

In LDCs, comprehensive national development strategy documents have been prepared with an emphasis on the reduction of poverty. International financial institutions and bilateral donors have increasingly tried to coordinate their own efforts towards priorities defined at the national level and have supported the consultative process needed to define these priorities at the national level.

The outcome of these consultations is a Poverty Reduction Strategy Paper (PRSP), which covers important aspects of economic and social policy. These identify an important role for the private sector in raising investment rates, leading to higher rates of economic growth. For example, the Tanzania PRSP commits the government to raising private investment as a proportion of GDP. In Bangladesh, the PRSP recognised private investment as important for access to technology, the development of infrastructure and the growth of the manufacturing sector.

The contribution of FDI to the economy can be strengthened, and success rates in attracting FDI can be increased, if FDI fits into the national development strategy and is effectively regulated so as to have a positive impact on economic development. A clear idea of the way that FDI fits into the national development strategy will help countries to target their marketing efforts and will influence the design of the regulatory environment for private companies. Furthermore, a clear national development strategy will provide a foundation for governments to assess how resources should be allocated between competing uses, such as the creation of an investment promotion agency or incentives for investors.

The next section discusses the impact of FDI on the national economies given the policy and regulatory changes, and global and national trends.

4.6 The Varying Impact of FDI

FDI can have a positive impact on a country's economy by contributing to stocks of knowledge, raise the level of investment in the country and relieve foreign exchange shortages. However, FDI may also have a negative impact by crowding out domestic investment or on the current and capital accounts in the long run. It is difficult to assess the impact of FDI, as there are various studies contradicting on this, on the host developing economies.

The impact of FDI as felt by the project countries is discussed here with reference to privatisation, domestic capital formation, the effect on balance of payments, cases of investment withdrawal and sectoral experiences.

Privatisation FDI can contribute to a country's economic restructuring process by relieving government budget constraints, and often leading to sequential investment and bringing in advanced technologies. Privatisation has contributed significantly to FDI inflows in many of the project countries. Privatisation FDI was important in Hungary, South Africa, Zambia, Tanzania and Brazil but not so strong in South Asia. Privatisation FDI is a form of

acquisition. This type of FDI has contributed substantially to restructuring activities, especially in Hungary, which helped the country in its transition process. In Hungary, privatisation-led acquisitions by multinational corporations (MNCs) brought in assets like brands, skills, market share, R&D competencies and supplier networks. Even some greenfield investment started through the privatisation process as sequential investment.

The positive impact of privatisation FDI was weaker in the other project countries. In Brazil, utilities were privatised with mixed success. In Zambia, substantial privatisation was undertaken, but post-privatisation there was substantial shedding of labour. Tanzania and South Africa also experienced substantial privatisation FDI.

It is usually expected that FDI would contribute to domestic capital formation, which is the process of adding to the net physical capital stock of an economy in an attempt to achieve greater total output[9]. FDI flows contributed significantly to capital formation in Brazil and Hungary but its contributions have been much less significant in South Asia. In Brazil, FDI contributed to 31 percent of capital formation but in India, only 2 percent. In the other countries, its contribution was in the range of 8-14 percent.

FDI can also have an effect on balance of payments. Large capital inflows in short periods of time are followed by generation of profits, which could be repatriated unless the economy stimulates reinvestment from FDI. This affects the balance of payments adversely, especially if inward FDI stagnates and hidden profit transfers take place through payments for business and technical service payments. Among the IFD project countries, FDI outflows in the form of dividends and interest payments to non-residents have been significant in the case of South Africa. The country has experienced an increased presence of non-resident investment and moving of stock market listing to London by major national companies.

Brazil also faced balance of payments difficulties because of the attempt to sustain an over-valued currency in the late 1990s and the strategy to balance the growing current account deficit with portfolio investment. The current account deficit was as high as 4.4 percent of the GDP in 1999. The country could not rely on FDI to fill up the gap because FDI flows declined in the recent years.

In 1998 and 1999, Hungary's current account deficit deteriorated significantly despite the improvements in exports. It is thought that this happened due to

repatriation of substantial profits by foreign investors. Inward FDI flows to Hungary shrank in this period while outward FDI grew during this period. However, in Hungary, FDI may have contributed to reduction of current account deficits by stimulating exports. The major engines of export growth were large greenfield investment in the EPZs.

A few countries experienced cases of withdrawal by foreign investors, which may have an adverse effect on a country's employment and economic growth[10]. For example, Anglo American Corporation announced its decision to pull out of Konkola Copper Mines – the biggest mine in Zambia – in 2002. Similarly IBM, Marc Shoe and Flexitronics had moved out their manufacturing unit of Hungary. Some of the investment withdrawal cases have been due to faulty privatisation. The other reasons for withdrawal have been regulatory failure, bureaucratic and systemic delays and inefficiency, internal financial difficulties in the companies, changes in strategies of the companies, and an increase in relative attractiveness of other investment locations.

The impact of FDI on an economy can also be illustrated by looking at individual sectors. Three sector case studies were selected in each project country for an in-depth investigation. The sectors selected were the ones that were important for the country, through their impact on growth, exports, employment or other factors. Two sectors – automobiles and telecommunication – were taken up in several countries, which allowed for comparison between the countries' experiences. Other sectors were analysed individually, all yielded interesting insights. The impact of FDI on some of the sectors is discussed below.

The automobile sector has been more-or-less a success story for all the four countries that took up the case, namely, Brazil, South Africa, Hungary and India. Openness to FDI has led to increased productivity and competitiveness in the sector, although it has had a mixed impact on employment. India and South Africa have benefited from the recent liberalisation of their sectoral FDI regimes and the lifting of supply constraints, while Brazil, which has had a relatively open policy for a longer period, has benefited from restructuring at the global level. Between 1995 and 2000, the Brazilian auto sector accumulated more than US$18.6bn, making it one of the greatest recipients of FDI in manufacturing. This experience suggests that FDI in the automobile sector will benefit countries that have built up a domestic productive capacity.

The automobile sector demonstrates that a variety of policy approaches to FDI in manufacturing can be appropriate, depending on the country's level of

development. The four countries studied in this project were able to benefit from openness to FDI, but at some stages of economic development, the state may need to play an active role in supporting the growth of domestic productive capacity. At a later stage, openness can raise productivity and improve competitiveness further. Thus, policies need to be tailored carefully to suit national conditions.

One issue of concern is transfer pricing: the nature of the automobile industry with an international network of firms and suppliers makes it possible for firms to transfer profits between countries to circumvent taxes. Initiatives to tackle the problem of transfer pricing need to be pursued at the international level.

Foreign investors have also been very active in the telecommunication sector in developing countries, including the four project countries: Bangladesh, Hungary, Tanzania and South Africa. In South Africa, for example, the sector constitutes more than 7 percent of national GDP and is one of the top four FDI-earners in the country. FDI has been attracted by the shift from state-owned monopolies to deregulated markets, privatisation of state-owned companies in these countries as well as rapid technological change in the sector. FDI in telecommunication has benefited consumers, who now have higher quality services and more choice. However, the impact on prices is not always clear. In places where the market is highly competitive, prices have fallen, but where the state monopoly has been transferred to private ownership, there are concerns about the abuse of market power. In Tanzania, prices for domestic calls, which were very low before privatisation, have risen, while prices for long-distance and international calls have fallen. At the same time, the number of telephones per capita has increased.

A good regulatory system is also extremely important in the financial sector, as instability in this sector is quickly transmitted to all other areas of economic activity. In Tanzania, FDI in the sector has resulted in major technology transfers and improvements in service, but these benefits cannot be guaranteed without strong domestic sectoral policies to support them.

The power sector in India demonstrates policies that have not been successful. In India, the government tried to attract investors with incentives, but only 400MW of capacity has been added by independent power producers between 1991 and 2000, well below the government's expectations. This has, among other things, led to a series of withdrawals by foreign investors in the sector.

The state electricity board in the Maharashtra state has gone into debt as a result of the purchase agreements.

Mining has been a controversial sector for FDI. The profitability of natural resource exploitation depends on the prevailing world price for a commodity. But if the government or investor misjudges the trend in global prices, the investment may not turn out to be profitable, as was the case with copper mines in Zambia. Copper mining accounts for 70 percent of the country's export earnings and so plays a crucial role in the economy.

In Tanzania, large incentives were provided to attract investors into mining and the sector has seen some positive results: the sector has been growing at over 16 percent between 1997, when the sector was opened to FDI, and 2001, and employment and tax revenues have also gone up. The cases revealed that governments should be careful and realistic in their expectations from foreign investment in this sector. Incentives need to be proportionate to the benefits to the domestic economy and politically sustainable.

The Indian Information Technology sector is seen as a success story in terms of the growth of the sector though it is dominated by domestic firms. It has grown from US$500mn in 1994 to a sector generating over US$8bn in 2000. In this sector, the government provided an enabling environment for the growth of the sector through investments in higher education and communications infrastructure. However, it did not intervene directly in the sector and this 'hands-off' approach seems to have been the best policy.

The cement industry in Bangladesh draws attention to the importance of competition policies in relation to FDI. Foreign firms may offer efficiency and quality improvements in the short-term, but when a single large foreign investment overpowers domestic competitors, the impact of the investment should also be considered from a competition perspective, as prices may rise in the longer-term under a monopoly.

Recommendations

General

- Policies to promote competition and efficiency in the market, are important in creating an enabling environment in a host economy.
- Policies to regulate transfer pricing in intra-firm trade are necessary for creating greater accountability and transparency. The South African research highlighted the issue, and to a lesser extent, the Hungarian one has also done so.
- Policies are needed to support small and medium enterprises by providing skills based training programmes on marketing, performance assessment and management, and open up these businesses to foreign investment.
- Policies are required for supporting local businesses to upgrade technology.
- Policies are needed to encourage export oriented FDI and identify a country's potential in this area. Development of special economic zones and free trade zones, often, have proved to be helpful in this.
- Governments should reduce bureaucratic control and interference in business and investment activities, in cooperation with civil society.
- Governments should also establish effective institutional and regulatory structure to:
  a. Put in place effective intermediaries such as banks and credit institutions;
  b. Assess the impact of various investment projects by national and local governments;
  c. Make the judiciary transparent and independent.

Country Specific

- Bangladesh should improve the quality of its bureaucracy and governance, improve the law and order situation, and undertake further reforms. It should also conduct more investment promotion activities to draw attention to its growing market and increase policy clarity and transparency.
- Brazil should implement policies to promote economic growth, which can promote linkages between local and foreign firms, and foreign firms and local innovative activities. It should also promote projects, which can promote employment and training of local employees.

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- Hungary needs to adapt FDI-related policies as the country loses its low wage advantage.
- India needs to improve regulatory and policy clarity, and infrastructure. It should move ahead with its privatisation plans and undertake measures to market the country as an investment destination.
- South Africa should adopt policies to support domestic growth and exports, adopt marketing strategies to improve the image of the country as an investment destination, and reduce volatility of its currency, the Rand.
- Tanzania should improve its infrastructure and skill levels of the workforce, reduce bureaucratic red tape, and improve its method of data collection of FDI.
- Zambia needs to improve its investment environment by strengthening its institutions, increasing investment in health and education and greater marketing of the country as an investment destination.

National Development Strategy

- National governments need to take a broad view of national development and how FDI can fit into overall objectives when designing FDI policies. Generally, there is a need to define what type of FDI is needed by a country for generating economic growth and development, and in which sectors. For example, identification of niche sectors may generate greater FDI in South Africa, which would benefit its economy rather than a broad-based approach. In Brazil, preferential treatment can be given to those investment projects, which would result in higher employment and advanced technologies for promoting economic growth and development.

CHAPTER-5

The Role of Stakeholders in the Current Scenario

5.1 Civil Society Perceptions Survey

As part of the research for the IFD project, the partners conducted a survey of civil society (CS) perceptions. The views of CS about FDI and FDI policy are important because they influence the long-term sustainability of policies. FDI generates strong feelings, both positive and negative, and the survey attempted to assess these from a sample of respondents from trade unions, business associations, NGOs, religious organisations, and representatives of academia and the media. The survey also analysed whether perceptions of FDI were consistent with the data. The number of respondents of the survey in different countries is as follows:

Bangladesh	50
Brazil	11
Hungary	50
India	38
South Africa	26
Tanzania	50
Zambia	43

Their responses can be described as cautiously optimistic. Civil society has a positive view of the role FDI can play in economic development. CS organisations tend to be aware of their own country's experiences with FDI, for example, with regard to which sectors have received the most FDI, or the impact of FDI on exports and imports. In those countries where the effects have been mixed, the survey results also showed divisions.

They perceive the positive impacts of FDI as:

- It causes access to new technologies;
- It helps in introducing new management techniques;
- It brings a rise in competitiveness; and
- It is an important source of foreign capital.

This is consistent with the empirical evidence and theory, which cites technology and capital as the two main benefits of FDI.

The negative impacts of FDI as perceived by CS are:

- It can bring environmentally harmful technologies;
- It reduces profitable opportunities available to domestic investors; and
- It results out of unfair advantages of multinational firms.

Empirical evidence suggests that in some cases FDI crowds out domestic investment[12]. Evidence also suggests that the world's largest multinationals have a larger turnover than the GDP of many LDCs and possess advanced technologies and employ marketing techniques, which give them advantage over smaller companies and many small economies. Whether FDI has brought in environmentally harmful technologies to host countries, there is no conclusive evidence of this.

Further, there is less agreement among CS respondents on whether FDI:

- Increases business opportunities for local companies or
- Increases exports and reduces imports.

CS respondents also believe that:

- International investors are less concerned about issues such as the importance of civil society and are only interested in getting access to the domestic market.
- Specific policy measures can have a positive impact on the net benefits of FDI on economic development.

CS respondents view support to local businesses as an important policy relating to FDI, as is the strengthening of competition policy. In some countries, a majority were also in favour of strengthening environmental regulation, although the preference for greater regulation seemed to depend on the country's FDI history, with those countries that have had the most FDI in the past, but were less keen on extra regulation. However, in most of the countries, CS expressed support for specific government interventions and policy measures, including South Africa which otherwise has a strong positive orientation towards FDI.

The results of the survey show that developing countries' dual approach to FDI of increasingly welcoming foreign investors while imposing restrictions or requirements on their behaviour is in line with the views of CS. However, there are also some concerns that arise out of this analysis. CS tends to look at many dimensions of the impact of FDI, while policy-makers tend to focus on only the economic variables. In order to achieve broad support for FDI-promotion measures, policy-makers would benefit from consultation and cooperation with

CS representatives. Governments can also benefit by engaging CS in information collection and monitoring of firms.

5.2 Corporate Social Responsibility

Many large companies have implemented corporate social responsibility (CSR) strategies, which commit the company, its subsidiaries and suppliers, to uphold standards of conduct. Companies may also engage in social welfare projects in the regions where they operate. Initiatives involving companies include the UN Global Compact, the Equator Principles, the World Business Council for Sustainable Development, as well as a myriad of sector-level partnerships. Tri-sectoral programmes involving government, business and civil society are becoming increasingly widespread.

Issues generally dealt in CSR are observance of human rights, regulation of transfer pricing in intra-firm trade, corporate governance, proper accounting standards, maintenance of environmental and labour standards, and curbing involvement of companies in bribery and corruption.

The IFD project has highlighted concerns of civil society in this regard. Many least developed countries have weak institutions, high corruption and lack the capacity to regulate behaviour of foreign investors especially large transnational corporations. Therefore, there should be effective home country regulations to tackle this though primarily it's the host countries' responsibility to enforce CSR. Clauses on codes for regulation of business behaviour should also be included in IIAs and at least a few of them should be made mandatory. Companies, on the other hand, insist that adoption of CSR should be made voluntary.

Recommendations

- Civil Society should conduct studies and disseminate information to the public about the impact of FDI on economic and social conditions based on experience and research. It should work closely with the government to research the impact of FDI and contribute to capacity building of government officials, if possible.
- CS should inform consumers and/or shareholders about the activities of companies and the standards that they maintain. The media have a special responsibility to expose violation of laws and regulations.

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- CS should build strong alliances with other CSOs and IGOs. Share information and experience, engage in joint research and dissemination activities and work together to influence policy outcomes.
- Companies should ensure that good intentions are put into practice: appropriate CSR strategies should be implemented throughout the production chain.
- NGOs have an important role in monitoring the implementation of CSR pledges by companies at the local level. They should engage in direct dialogues with businesses.
- Governments should not look to CSR as a replacement for regulation to protect social and environmental standards. The two should be seen as complements.

CHAPTER - 6

Conclusions and the Way Ahead

The basic learning from the IFD project is that though the countries have adopted liberal investment policies to facilitate higher FDI in 1990s, not all of them have been successful in doing so. Further, higher FDI inflows do not ensure higher economic growth and development. Given the situation, developing countries should rethink their national development strategies and re-orient or restructure FDI strategies to facilitate "quality" FDI.

Moreover, countries need to re-orient their development strategies to take account of changing international economic factors e.g. growth of new kinds of FDI, effect of technological change on the information, communication, and technology (ICT) sector, growth of global production networks, change in attractiveness of certain investment locations to foreign investors etc. FDI cannot be separated from general economic development and countries need to integrate FDI strategies into national development strategies after properly defining these.

The IFD project also revealed a number of areas in which further work is needed.

1. *Civil society perceptions:* The survey conducted in the IFD project was limited in scale, but demonstrated that civil society is interested in the issue and is generally well informed. Project participants agreed that it would be valuable to deepen the study of civil society perceptions by conducting an in-depth survey of opinions in a representative sample of civil society organisations in each country. The survey could identify areas of concern to civil society and form the basis for a national information strategy on foreign investment.
2. *Sectoral strategies:* The impact of FDI varies hugely across sectors and appropriate policies need to be designed according to the specific characteristics of the sector such as infrastructure, utilities or export-oriented industries. Further, detailed studies on the impact of FDI in particular sectors of the economy would be very valuable in designing detailed policy and promotion strategies.
3. *Corporate social responsibility:* This is an issue that is currently attracting much interest in the private sector. However, the concept has sometimes been interpreted rather narrowly and could be broadened to a tri-sectoral

approach including governments and civil society organisations. Instruments like the Global Compact or the OECD Guidelines for Multinational Enterprises could also be extended to include other stakeholders.

4. *Comparative studies:* In-depth national data needs to be analysed comparatively to reveal commonalities and contrasts between countries and ensure that policy transfer between countries only takes place when the underlying conditions are the same. Country-level studies should be informed by and linked with the forefront of global research on FDI.
5. *South-South investment cooperation and agreements:* After the demise of the WTO Ministerial Meeting in Cancun in September 2003, trade and investment negotiations are expected to shift to the regional level. In this context, studies on the potential benefits of South-South trade and investment agreements would be useful.

Other issues relating to investment include: technology transfer, competition policy and law, coherence between policies, factors affecting capital absorption capacity, the role of incentives structure, causes of non-successful investments, links between official development assistance and FDI, and the role of labour mobility in international economic specialisation.

Annexure

Box A: Why is South Africa a Net Capital Exporter?

Since its transition to democratic governance in 1994, South Africa's regulatory regime has undergone significant transformation and liberalisation. There were adoption of new policies and strategies, deregulation of certain sectors, trade liberalisation and phased reform of capital controls, privatisation of airlines and telecom industries etc. In spite of all these, the country has fared poorly in the 'global beauty contest' for foreign capital. The country is in fact a net capital exporter.

There are several lines of thinking on this:

- FDI is not necessarily superior to domestic investment and thus should not be courted as an alternative to domestic investment. Though private sector domestic investment is important for the growth of the economy, it is very low in the economy. It appears that the private sector is reluctant to invest unless government spending on infrastructure increases;
- SA's inward investment is a sign of strength of its economy. The reasons:
  Firstly, the country does not have a technical shortage of capital but lacks viable projects. Its national savings are greater than national fixed investment, so there is no resource gap in the country;
  Secondly, SA's domestic capital markets are well developed. Therefore TNCs can raise their capital requirements for viable projects from the domestic market rather than from their home countries;
  Thirdly, the case of investment 'lock-out' is reported in the country. There has been a high degree concentration in virtually all the industries in SA for several decades. There are both horizontal oligopolisation and vertical integration. This leads, through tied contracts, to a 'lock-out' of any foreign investor in the main inward-oriented production, warehousing, distribution, marketing and retailing networks.
- There is unpredictability and uncertainty over government's black economic empowerment (BEE) policies, requirement of BEE partners, regulatory uncertainty and equity targets;
- The other reasons identified are small size of its market, poor economic growth, political events of the region, high crime level, shortage of skilled labour, high user cost of capital, currency instability, labour market rigidities, hidden costs, low return on investment and non-availability of readily published information on incentives schemes.

Source: CUTS (2003), Investment Policy in South Africa – An Agenda for Action

Box B: Changes in Capital Attraction Factors in Hungary

Hungary is regarded as one of the successful transition economies in Central Europe. The transition process was quick and straightforward with a high FDI in the manufacturing sector. FDI flowed into Hungary due to the following factors:

- Advantageous location in Europe;
- A sufficiently developed infrastructure network;
- Cheap and educated labour force;
- Privatisation policy;
- Generous tax holiday system;
- Industrial free trade zones

FDI inflows began to decline by the late 1990s though the stock of FDI continued to increase as most firms reinvested most of their profits. The reasons identified for the changing flows and patterns of FDI are as follows:

- The completion of the privatisation process;
- Other Central European countries were able to attract market and efficiency seeking investment while Hungarian market for investment saturated;
- Slow down of M&A activities;
- An increase in real wage costs between 2000 and 2002;
- Shortage of skilled labour;
- Withdrawal of incentives such as tax holidays and industrial free trade zones upon criticism by the European Union; and

ü Deteriorating image of the country.

It is felt that the country had to create new opportunities and fundamentals of a new and higher level of integration of the country into the international labour division system.

Source: CUTS (2003), Investment Policy in Hungary: An Agenda for Action

Endnotes

1 UNCTAD WIR 2003

2 The United Nations (UN) has designated 49 countries as LDCs – the list is reviewed every three years by the UN Economic and Social Council.

3 UNCTAD (2002). *FDI in Least Developed Countries at a Glance.*

4 Stock refers to the external financial assets (outward stock) and liabilities (inward stock) of companies, in contrast to flows, which refer to financial transactions conducted within a particular year. *(Refer to "New FDI Pattern Emerging, says UNCTAD, reshaped by services economy, new industries" UNCTAD Press Release no UNCTAD/PRESS/PR/2003/105*, 28 October 2003).*

5 UNCTAD (1996). *Incentives and Foreign Direct Investment*.

6 Economic organisation from 1949 to 1991, linking the USSR with Bulgaria, Czechoslovakia, Hungary, Poland, Romania, East Germany, Mongolia, Cuba, and Vietnam with Yugoslavia as an associated member. Albania also belonged between 1949 and 1961. Its establishment was prompted by the Marshall Plan, Comecon was formally disbanded in June 1991.

7 CUTS (2003). *Investment Policy in Select Least Developed Countries – Performance and Perceptions*.

8 In 2000, the foreign investment allowance for private residents in South Africa was raised to Rand 750,000. According to some, this has amounted to state sanctioned capital flight. Some estimates reported in the country paper suggest that since 1997 about R 17.4.

9 Collins Dictionary of Economics, *Second Edition*

10 CUTS (2003), "Investment for Development: No 7", *Quarterly Newsletter of the CUTS Centre for Competition, Investment & Economic Regulation*

11 Ministerial Declaration, World Trade Organisation, Ministerial Conference, Fourth Session, Doha, 9-14 November 2001

12 Kumar, Nagesh. (2002). *Globalisation and FDI.*

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