Synergising Investment *with* Development

CUTS-C-CIER

कट्स CUTS
Twenty Years of
Social Change
1984 to 2003

#0343

Synergising Investment *with* Development

CUTS – C-CIER

कट्स CUTS

Synergising Investment *with* Development

Published by:

कट्स CUTS

CUTS Centre for Competition, Investment & Economic Regulation
D-217, Bhaskar Marg, Bani Park, Jaipur 302 016, India
Ph: +91-141-220 7482, Fax: +91-141-220 7486
Email: c-cier@cuts.org, Website: www.cuts.org

Acknowledgement:
This report* is being published as a part of the Investment for Development Project, with the aim to create awareness and build capacity on investment regimes and international investment issues in seven developing and transition economies: Bangladesh, Brazil, Hungary, India, South Africa, Tanzania and Zambia. It is supported by:

DFID Department for International Development, UK

UNCTAD

Citation:

CUTS, 2003, Synergising Investment *with* Development

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

ISBN 81-8257-016-6

Country reports are also available with CUTS

#0343 SUGGESTED CONTRIBUTION INR50/US$10

CONTENTS

List of Tables

List of Boxes

List of Charts

LIST OF ABBREVIATIONS

CUTS	Consumer Unity & Trust Society
CMM	Capability Maturity Model
COSATU	Congress of South African Trade Union
DFID	Department for International Development
EPZs	Export Promotion Zones
FDI	Foreign Direct Investment
GDP	Gross Domestic Product
IFD	Investment for Development
IMF	International Monetary Fund
IPO	Initial Public Offering
IT	Information Technology
LDC	Least Developed Country
LEM	Large Emerging Market
M&As	Mergers and Acquisitions
MIDP	Motor Industry Development Programme
MNC	Multinational Corporation
NAACAM	National Association of Automotive Component and Allied Manufacturers
NAFTA	North American Free Trade Agreement
NGOs	Non governmental Organisations
OLI	Ownership-Location-Internalisation
RMGs	Ready-made Garments
SEI	Software Engineering Institute
SoEs	State-owned Enterprises
TNC	Transnational Corporation
UNCTAD	United Nations Conference on Trade and Development

IFD Project Partners

Bangladesh Enterprise Institute
Bangladesh

Nucleo de Economia Industrial e da Technologia-NEIT
Instituto de Economia
University of Campinas
Brazil

Budapest University of Economic Sciences and Public Administration
Hungary

National Council of Applied Economic Research
India

Institute for Global Dialogue
South Africa

Economic and Social Research Foundation
Tanzania

CUTS Africa Resource Centre
Zambia

Acknowledgements

During the implementation of this project, significant contributions were made by country researchers, partner organisations, members of the Project Advisory Committee, CUTS staff and many outside experts. It is difficult to list them all but some need special mention.

PROJECT ADVISORY COMMITTEE

Arvind Mayaram, *Government of Rajasthan, Jaipur*
Diana Tussie, *FLASCO, Buenos Aires*
Farooq Sobhan, *BEI, Dhaka*
John Gara, *Commercial Justice Reforms Programme, Kampla*
Karl Sauvant, *UNCTAD, Geneva*
M. Sornarajah, *National University of Singapore*
Mohan Kaul, *CBC, London*
Richard Eglin, *WTO, Geneva*
Roger Nellist, *DFID, London*
Sanjaya Lall, *Oxford University, Oxford*
Sabina Voogd/Myriam Vander Stichle, *SOMO, Amsterdam*

PARTNERS' STAFF AND RESEARCHERS

Bangladesh
Atiqur Rahman

Brazil
Gustavo Rocha Britto
Mariano Laplane

Hungary
Miklos Szanyi

India
Sanjib Pohit
Shalini Subramanyam
Soumya Srinivasan
Suman Bery

South Africa
Brendan Vickers
Garth Le Pere

Tanzania
Flora Kessy
Flora Musonda
HKR Amani
Lorah Madete
Rose Aiko
Samuel Wangwe

Zambia
K.S. Sajeev
Stephen Muyakwa
Gideon Mudenda
Frywell Chirwa

OTHER EXPERTS

Ananya Raihan, *CPD, Dhaka*
Andres Lopez, *CENIT, Buenos Aires*
Aradhana Agarwal, *ICRIER, New Delhi*
Atiur Rahman, *BIDS, Dhaka*
Biswatosh Saha, *XLRI, Tatanagar*
Christian Rogg, *DFID, London*
David On'golo, *Spellman & Walker Co.Ltd, Nairobi*
Freddy Bob-Jones, *DFID, London*
James Zhan, *UNCTAD, Geneva*
John Dunning, *University of Reading, UK*
Joerg Weber, *UNCTAD, Geneva*
Juma Mwasacha, *Tanzania Ambassador to France*
Kalman Kalotay, *UNCTAD, Geneva*
Khalil Hamdani, *UNCTAD, Geneva*
Laveesh Bhandari, *Indicus Analytics, New Delhi*
Oliver Saasa, *University of Zambia, Lusaka*
Peter Muchlinski, *Kent Law School, Kent*
Rakesh Basant, *IIM, Ahmedabad*
Sebastian Morris, *IIM, Ahmedabad*
Trudi Hartzen Berg, *TRALAC, Stellenbosch*
Vicky Harris, *DFID, London*

CUTS STAFF

Eric Kalimukawa
James Chansa
Hilda Fridh
Manleen Dugal
Nitya Nanda
Olivia Jensen
Pranav Kumar
Pradeep S. Mehta
Rajeev Mathur
Sanchita Chatterjee

PREFACE

In the last two decades, facilitating inward foreign direct investment (FDI) has been high on the agenda of policy changes in many developing and transition economies. Policymakers expected that FDI inflows would bring new technologies, know-how and thus would contribute to higher productivity and competitiveness of domestic industries, which in turn would foster economic growth and development. Often policymakers have done so by following the advice of multilateral development agencies like the World Bank and International Monetary Fund. In fact, some of the countries have tried to attract FDI by offering generous incentive packages. They justify the incentives by saying that foreign affiliates generate externalities though various studies have concluded that incentives are not quite effective in facilitating FDI.

Despite the fact FDI now occupies an important place in national economic policies, there is no conclusive evidence to show that FDI has brought in know-how and increased competitiveness of domestic industries in developing countries. The empirical results show that there are productivity spillovers from FDI through foreign affiliate–local supplier linkages in upstream activities. However, there is no indication of spillovers occurring within the same industry. In other words spillovers from FDI are more likely to be vertical rather than horizontal in nature.

This report, Synergising Investment w*ith* Development, has been prepared as part of a seven-country two-year project "Investment for Development" implemented by Consumer Unity & Trust Society (CUTS) with the support of the Department for International Development (DFID), UK, and in collaboration with the UNCTAD.

The report brings out common and country specific findings, from case studies on each of the seven countries. In each country, three sectors that are or could be important for facilitating and maximising benefits from FDI, have been chosen. The findings of the case studies indicate that *inter alia* generally a facilitative domestic policy environment has been a pre-condition for higher inward FDI. In terms of employment generation, FDI produced a mixed result. In case of large countries like Brazil, India and South Africa, FDI created more jobs but domestic companies experienced job losses. However, in case of LDCs – Zambia, Tanzania and Bangladesh – the result is a little different: jobs were created by the foreign affiliates and there was no significant impact on domestic industries since these are not well developed in the LDCs. So the jobs that were created were a net addition to their economies.

Further, the case studies show that the developing countries have become more competitive in the world market with higher FDI inflows. In the case of the LDCs, FDI has induced modernisation of some sectors. For example, in Zambia, the privatisation of mines by selling stakes to TNCs improved their operations substantially in terms of injecting advanced technology and capital. There have been improvements of productive capacities of the mines, which have led to higher production.

The report also includes the results of a survey on civil society perceptions of FDI carried out under the project. The survey aimed to gauge the opinion of the respondents on positive and negative aspects of FDI, the relationship between FDI and domestic investment, and the policy measures that should be adopted to maximise benefits from FDI. The respondents of the survey were representatives of trade unions, business chambers, non-governmental organisations, religious organisations, academia and media. Overall, the survey results show that in all the countries civil society is significantly positively oriented towards FDI.

CUTS would like to thank Rakesh Basant and Sebastian Morris of Indian Institute of Mangement, Ahmedabad for working on this report in the initial stages and Laveesh Bhandari of Indicus Analytics, New Delhi, India for adding value and finalising it. I would also like to thank my colleagues at CUTS: Pranav Kumar and Nitya Nanda for doing further work on this report. Further acknowledgements are due to other colleagues: Rajeev D. Mathur and Sanchita Chatterjee for providing critical comments and adding value to the report. We have also benefited by comments from Peter Muchlinski of Kent School of Law, UK and Sabina Voogd of SOMO, Netherlands on various versions of this report.

December 2003 — Pradeep S. Mehta
Jaipur, India — Secretary General

CHAPTER-1

Introduction

Foreign Direct Investment (FDI) essentially deals with the expansion of productive entities (firms) across international boundaries. As firms expand, they bring with them many tangibles and intangibles – capital, machinery, technology, managerial talent, brands, products and processes being some of the most important ones. Other intangibles, such as cultural aspects, are also considered to be intimately tied with FDI by many scholars. As firms bring in all the benefits, they also cause the host economies to incur some costs, the most important being the repatriation of surplus of profits.

Given the variety of effects involved with FDI, it has generated strong feelings in many countries. The supporters of FDI consider the gains in employment and, as a result, on growth, to far outweigh any potential pitfalls. Those inimical to FDI consider the potential costs, such as repatriation of funds, cultural 'invasion', etc., to far outweigh any potential economic benefits.

The picture painted by the literature on FDI is far from clear in terms of the 'net' benefits. The trading firms of the colonial days, the exploitation of natural resources, the meddling in the political environment of host countries, etc., have been documented by historical evidence. Modern economic history has, however, shown in many different ways the advantages that foreign direct investment brings with it, e.g., the experience of the South East Asian countries with FDI.

Given the contradictory findings, the question that arises is "What is civil society's view on FDI?" Civil society's views are important also because they play an important role in shaping the long-term orientation of the common people. These, in turn, affect the shape and structure of a country's policy towards FDI.

This paper has been prepared under the "Investment for Development" project, which is a two-year, seven-country project implemented by Consumer Unity & Trust Society, Jaipur, India, with the support of the Department for International Development (DFID), UK, and in collaboration with the United Nations Conference on Trade and Development (UNCTAD).

The countries in the project were chosen so as to highlight a variety of experiences. Diversity in economic characteristics, geographical spread, and the size of the economy were some of the key factors. In addition, CUTS' networking strength also contributed to the choice. There are, therefore, three groups of countries: Large Emerging Markets (LEMs) - India, South Africa and Brazil, Least Developed Countries (LDCs) - Zambia, Tanzania and Bangladesh and a transition economy, Hungary. Though Hungary has a much higher per capita income than the other project countries, its study throws up useful insights on the characteristics of FDI, not only in transition economies, but also the development process, in general.

The objective of the paper is to identify sensible and sustainable policy measures. Sustainable policy measures receive widespread public support; an understanding of the views of civil society becomes important in that respect as well. Thus the paper includes the results of a survey on civil society perceptions of FDI. Knowledge of cases in a range of sectors also helps us identify the direction that sensible economic policy, in general, and FDI policy, in particular, should take. The paper contains case studies of investment polices and trends in three sectors for each country. It is based on the papers prepared by the country researchers in the seven countries and the secondary data available from many different sources. [1]

The important questions that are dealt with in this part of the study are: How have experiences of the countries been? How have specific industries/sectors been affected by FDI? Have these experiences been positive? Have there been gains for specific sectors? This paper synthesises these issues based on the papers on the seven above-mentioned project countries.

Broadly, the paper seeks to explore three interrelated questions:

1. How are countries trying to increase FDI?
2. What have been the actions adopted by countries and how have they fared?
3. What has the general impact of FDI been?

Answering these questions requires us to have a good understanding of FDI. However, we find that though there is a very elaborate theoretical framework for understanding FDI, it has some gaps that make it difficult for us to derive policy prescriptions purely from theory. This has further necessitated answers based on empirical analysis of the project countries.

The task, therefore, is two-fold – to find and report about FDI in developing countries. Given the complex relationships and determinants, we try and separate the two tasks. Much of the empirical exercise conducted is reported in the Annexure. This paper, instead, concentrates on the description of the factors, the conditions in the project countries and, most importantly, the findings on how those are related to actual FDI.

The rest of the paper is divided into seven chapter. Chapter 2 summarises the key determinants of FDI by way of a brief literature summary. Chapter 3 discusses FDI trends in the project countries. It also discusses the role of FDI in these countries. Chapter 4 discusses the results of the civil society survey . Chapter 5 contains discussions on case studies on selected sectors in these countries. Chapter 6 analyses the experience of the project countries in the context of changing policy and economic environment of 1990s and raises some questions about the role of FDI in the emerging international economic situation. Chapter 7 contains conclusion and recommendations.

CHAPTER-2

What Affects FDI[2]

FDI can, essentially, be seen as the expansion of firms across borders. A firm would only expand from its base (home country) if it expects to generate high enough surpluses for it to justify investing across large distances. If a firm generates enough surpluses from any other means (such as exports) then it need not invest. In other words, FDI only occurs when there is no other means of international economic interaction that can be expected to generate higher surpluses.

This section first identifies the three broad motives that justify any type of international economic interaction. If only at least one of these three motives is met, FDI is a possibility. However, for FDI to fructify, other factors, internal and external, also have to be present for the firm. These factors can best be put together by the Ownership-Location-Internalisation (OLI) framework, which is discussed in subsection 2.2.

2.1 The Three Broad Motives of International Economic Interaction

Broadly, three types of motives have been identified: (a) market-seeking; (b) resource/asset-seeking; and (c) efficiency-seeking. These are briefly discussed below.

Box 2.1: Type of FDI Classified by Motives of Transnational Corporations and Principal Economic Determinants in Host Countries

A. Market-seeking

Depends upon:

- Market size and per capita income
- Market growth
- Access to regional and global markets
- Country-specific consumer preferences (e.g., importance of/exposure to foreign brands)
- Structure of markets (presence of competition, or incumbent monopolies)

B. Resource/Asset seeking *Depends upon:* • Raw materials • Low-cost unskilled labour • Skilled labour • Technological, innovatory and other created assets (e.g., brands) • Physical infrastructure (presence of ports, roads, power, telecommunication)
C. Efficiency-seeking *Depends upon:* • Cost of resources and assets • Other input costs, e.g., transport and communication cost to/from and within the host economy and costs of other intermediate products • Membership of a regional integration agreement conductive to the establishment of regional corporate networks
Source: Adapted from UNCTAD (1998), p 91.

The importance of different location specific determinants varies according to motives Box 2.1. *Market-seeking investors* are likely to be attracted by potential sales in host country markets. Consequently, markets that are large, growing and that can be used to access regional markets will be most attractive.

If *resource/asset-seeking* is the prime motive, availability and cost of accessing raw materials, other specialised assets, skilled and unskilled labour would be critical for making investment profitable.

Firms may also invest in a country to benefit from *efficiencies* arising from externalities (*efficiency seeking*). Here, the efficiency of resource use is critical. Costs of labour, infrastructure, etc., will be the key variables here. Externalities/spillover benefits could be derived through regional economic arrangements (including clusters) that give rise to economies of scale and scope.

These potential benefits are two-sided. As long as there is no existence of monopolies, host countries and their residents gain as well. This is presented in Box 2.2.

Box 2.2: Potential Benefits of FDI	
Benefits to Host Country	**Areas of Caution**
A. Market-seeking	
• Training and skill enhancement • Employment opportunities • Greater range of products • Lower prices of products	• Exploitative, if monopoly in essential items • Gains are maximum when competition exists in product markets
B. Resource/asset seeking	
• Training and skill enhancement • Employment opportunities • Reduces waste of human and physical resources	• Can be exploitative if monopoly in factor markets • Long term contracts combined with monopoly
C. Efficiency-seeking	
• Utilisation of inherent strengths of host country • Overall productivity gains	• Policies and incentives such as subsidies tend to neutralise the gains to the economy
Investment, employment, technology and skill improvement occur in all cases. Of these, technology and skill improvements also spread throughout the economy over a period of time.	

However, even if a country possesses the resources and the market or efficiency advantages, it does not imply that FDI will actually occur. Take, for instance, the case of a country that has a very good market for Black Cola. It does not imply that a transnational corporation (TNC) will invest in that country. It could have a long-term contract with a domestic producer who could be manufacturing it under licence. Alternatively, it could simply export Black Cola to the country. Similarly, take the case where a country has a very good human resource-base to produce software. That does not necessarily imply that a TNC will have a resource-seeking investment in that country. It could merely contract out the software development to a firm from the host country and purchase the final software.

OLI discusses the conditions under which foreign investment takes place.

2.2 The Ownership-Location-Internalisation (OLI) Framework

FDI comes under many different forms. Joint ventures, subsidiaries and branches are some of the most well-known forms. According to the OLI framework, the presence of ownership-specific competitive advantages in a firm, location-specific advantages of host economies and superiority of intra-firm transactions (internalisation) over arm's length transactions results in FDI.

- *Ownership-specific Advantage* – The firms that have acquired some firm-specific capability sometimes find that they must operate through a foreign subsidiary, in order to fully exploit that competence. For example, advantages based on proprietary technology or brand names may compensate for additional costs of establishing production facilities in a foreign economy. In fact, they can overcome the "foreign" firm's disadvantages vis-à-vis local firms arising out of "distance costs and the relative lack of familiarity".
- *Location-specific Advantage* – The firms establish a subsidiary in a foreign country to take advantage of a large market, lower cost structure or a superior infrastructure of that country.
- *Internalisation Advantage* – The firms find greater benefits in exploiting both ownership and location advantages by internalisation, rather than arm's length transactions. Such advantages may arise due to imperfections in the market for assets and inputs, especially those relating to technology and management. These imperfections may not only involve significant transaction costs but may also reduce the suitability of the ownership advantages (e.g., patents, etc.) that the firm may have. Such imperfections are likely to be more significant in earlier phases of the product/technology/ industry life cycle.

It can be seen that the first and third conditions are firm-specific determinants of FDI and essentially influence the probability and extent of investing abroad. The second set of conditions is location-specific and has an influence on the location of FDI. It is the location-specific conditions that the host country governments can possibly influence in order to attract FDI.[3] Consequently, various policy instruments can be used to enhance the location-specific advantages of the host countries.

Box 2.3: Imperfections in the International Capital Markets – Another Form of Localisation?

It has been argued that the pattern of FDI is determined by exchange risks and the market preferences for holding assets denominated in selected currencies. *Ceteris paribus*, capital can flow from countries with low interest rates to those where foreign-exchange-risk-adjusted interest rates are high. Thus, when due to interest rate differentials, returns on foreign investment (corrected for expected foreign exchange depreciation) are higher than that on domestic investment, enterprises invest abroad. Exchange rate fluctuations can also influence FDI inflows. The basic idea is that depreciation of the host country currency will give foreign enterprises the ability to outbid domestic firms because of the increased value of their capital. This may lead to inflows in various forms: expansion of production operations, entry into new foreign markets, reinvestment of earnings or consolidation of market power through mergers and acquisitions (M&As) activity, etc. On the other hand, exchange rate volatility may impede FDI, as it increases uncertainty regarding the returns to investment. Some empirical evidence suggests that, as compared to exchange rate levels, volatility of exchange rate is a more important concern for FDI inflows, though not uniformly across all countries (UNCTAD, 1993).

This explanation is highly dependent upon the relative differences in the exchange rates and volatilities between home and host countries. Arguably, these determinants, therefore, be subsumed under the OLI framework.

The key advantage of the OLI framework is that it broadly identifies all the factors that matter. In that sense, this is also a serious disadvantage. Moreover, this framework does not reveal which factors matter more.

As a consequence, policy makers cannot gain much from studying the OLI. Since the possible policies and actions are boundless, we need to focus on a few things that matter the most. The importance of this project should be seen in this light. By focussing on a range of developing countries spread over four continents, with different economies and levels of development, it seeks to empirically determine which factors matter and which ones more.

2.3 Cross-country Comparisons of FDI Inflows: the Role of Structural and Policy Variables

While all the project countries can be characterised as developing, except for Hungary, which is a transition economy, they are disparate in terms of population size, per capita income, levels of economic development, their political economy and their policies towards FDI. Therefore, before we can answer the question "How successful have these countries been in attracting FDI?", we need a prior structure wherein to study the determinants of FDI that are empirically grounded.

We know that broadly FDI seeks markets, resources and/or efficiency, and when other conditions are present, these occur in different forms. One possible way of studying it is to differentiate between *structural* and *policy* factors. Structural factors are considered here to be those that are inherent to the host economy/country and are not affected directly by policy. Policy-related factors, on the other hand, are those that can be altered or changed by policy.

Structural factors capture market size and growth (market-seeking), natural resource endowment (resource-seeking) and efficiency of production (efficiency-seeking), etc. It is difficult to get information on well-defined variables that directly capture these factors. However, it is possible to derive good proxies for the same. National income, its growth and per capita incomes are used to arrest the size of the market and its growth. Since a direct measure of natural resource endowment is not available, reliance on imported manufactured products is used as an indirect measure for resource seeking possibilities.[5]

Three factors (pointed out below) account for a very large part of FDI across the world:

- market size (as a variable capturing market seeking potential);
- growth of the market (once again apprehends market seeking possibilities); and
- natural resource endowment (a variable to capture the resource-seeking potential).

Thus, market-seeking possibilities arising from a large economy and the natural endowment-based resource-seeking turn out to be key structural determinants of inward FDI. The remaining unexplained variation is, to a large extent, due to policy differences and other qualitative differences across countries.

The role of these structural factors can be even more prominent in specific countries. For example, areas that serve regional markets can be more attractive for "market-seeking" FDI than what can be predicted on the basis of the market size of that country alone. Note that a large part of the variation in FDI is explained by the structural factors. This is evidence enough that FDI is primarily a function of the nature of the economy. This insight cannot be over-emphasised.

The analysis outlined above can also be used to predict the quantum of FDI inflows that can be expected in the project countries, given their market size, growth and natural endowments, as defined above. These reflect the structural potential of the economy to attract FDI. Good and bad policy can have a positive or negative impact on this *inherent* potential. In a subsequent section, we will analyse the observed flows of FDI in the light of these structural factors. This will help in the assessment of the relationship between the potential and actual inflows of FDI, and how policy initiatives can impinge on this relationship. However, before we can do that, we need to have a better understanding of FDI in the selected countries, and also their economic and socio-economic conditions.

2.4 Structure of Economies and Investment Policies

This section analyses a range of issues, related to FDI determinants and policies for each of the project countries. To do so, first, the key motives for an international economic interaction and FDI, in particular market, resource and efficiency objectives must be revisited. The various conditions highlighted in this section all tie into these three motives.

Chart 2.1 compares how each of the seven countries studied performs with respect to the individual determinants. A higher ranking implies that the country has a relatively strong performance in that respect and vice versa. For instance, in the market size criteria, Brazil, Hungary, South Africa and India perform stronger than Bangladesh, which, in turn, performs stronger than Tanzania and Zambia.

Chart 2.1: A Summary							
A. Market-seeking							
Variables	**Bang-ladesh**	**Brazil**	**Hungry**	**India**	**South Africa**	**Tanz-ania**	**Zambia**
Market size	**2**	**1**	**1**	**1**	**1**	**3**	**3**
Market growth	**2**	**1**	**1**	**1**	**1**	**3**	**3**
Regional markets	**1**	**2**	**1**	**3**	**1**	**3**	**3**
B. Resource/Asset-seeking							
Raw materials	**3**	**3**	**3**	**3**	**2**	**2**	**1**
Low cost unskilled labour	**2**	**3**	**3**	**2**	**2**	**2**	**3**
Skilled labour	**2**	**1**	**1**	**1**	**1**	**3**	**3**
Specific knowledge assets	**3**	**3**	**3**	**2**	**3**	**3**	**3**
Infra-structure	**3**	**2**	**1**	**2**	**2**	**3**	**3**
C. Efficiency-seeking							
Costs of resources	**2**	**1**	**1**	**1**	**1**	**3**	**3**
Index: 1. Highly Favourable 2. Favourable 3. Less Favourable 4. Negative 5. More Negative 6. Info Not Available							

Overall, we find that Hungary has the most 'attractive' conditions for the various FDI motives, followed by South Africa, India and Brazil. More importantly, we find that conditions in Zambia are the weakest, in terms of the range of motives for which FDI may occur. However, it does score the highest in terms of the natural resources for the size of its economy.

A relatively poor performance on the above aspects, however, should not be taken to imply that there is no scope for FDI, only that attracting greater FDI will be more difficult. Recall that we have found that these factors, at best, explain about half of the variation in FDI. Another half is affected by policy-related and other factors, to which we now turn.

Chart 2.2 summarises the policy-related and other conditions that prevail in the project countries. As is true for any summary, it does not give the whole picture, but it broadly identifies the performance with respect to the various policy and structural factors studied. In the chart higher ranking implies positively stronger actions and vice versa.

As the chart shows, Hungary has the strongest *relative* conditions and policies. Note that this is a relative presentation. As seen previously, countries have been converging in terms of their FDI-related policies and other non-FDI policy-related factors have, therefore, become the determining factors to differentiate those countries.

Chart 2.2: A Summary

D. Relative Conditions and Policies

	Bang-ladesh	Brazil	Hungry	India	South Africa	Tanz-ania	Zambia
Economic stability	2	4	2	2	2	4	4
Liberal FDI policies (1)	2	2	2	2	2	2	2
Trade blocks	4	2	2	4	2	4	4
Tax breaks & subsidies	2	2	2	6	6	6	2
Perception of capital cost & exchange risk	4	4	2	4	4	6	6
Perception of political and other risks	5	4	2	4	4	5	5

Index: 1. Highly Favourable 2. Favourable 3. Less Favourable 4. Negative 5. More Negative 6. Info Not Available

Take, for instance, Hungary, which shows the most favourable conditions and policies. It performs significantly better than India, which is not a member of any trade block and has relatively higher exchange and other risk perceptions. This is despite the fact that India has shown similar liberalism in its FDI-related policies.

Given this overview of conditions and policy, we now move on to studying how FDI has actually been occurring in the project countries. Therefore, in terms of both FDI motives and relative conditions and policies related to it, Hungary scores the strongest.

CHAPTER-3

Quantum, Patterns and Contribution of FDI in Project Countries

3.1 Trends in FDI

This chapter summarises the patterns of FDI inflows in the project countries. Global trends in FDI are related to the trends in growth, world trade and the differential growth rates of countries. Therefore, these variables are discussed below. Only the key findings are highlighted here.

Chart 3.1: FDI Inflows in US$mn

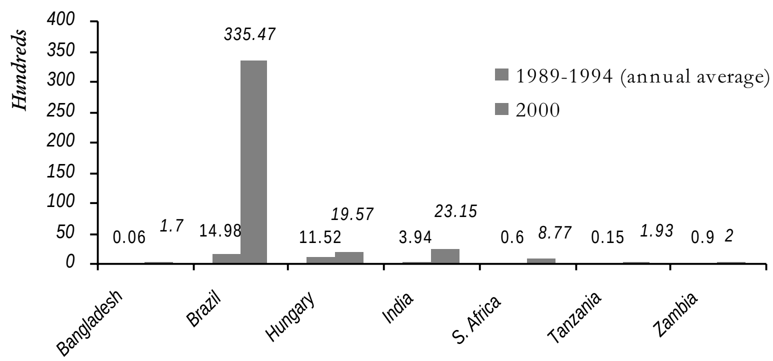


Chart 3.2: Inward Stock of FDI in US$mn

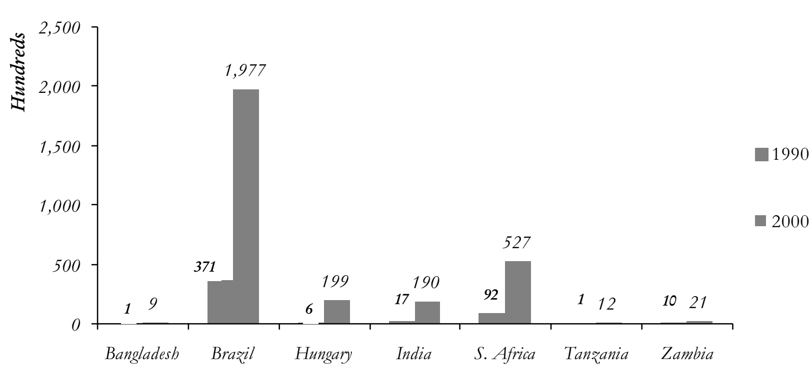
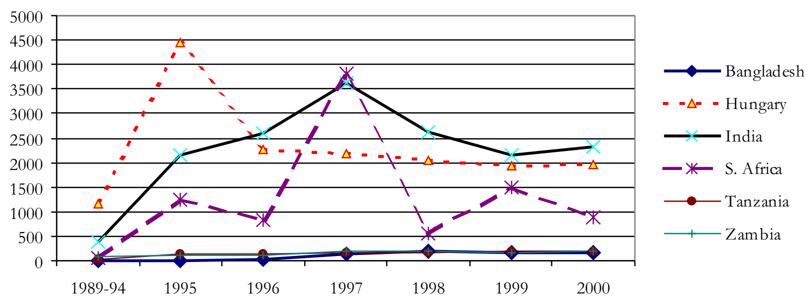


Chart 3.3: Yearly Variation in Inward FDI



- There have been significant fluctuations in the flow of FDI to various countries studied. Countries that obtain larger amounts tend to have lower fluctuations. This lumpiness in FDI is natural, as one large investment project can suddenly and temporarily shoot up the overall level of investment.
- Sources of FDI are becoming plural, as firms from more and more countries invest abroad. The dominance of US is on the decline, as Europe, Japan and many East Asian countries are becoming important sources of FDI.
- As most countries became both hosts and sources, FDI became more akin to 'trade' with both outflows and inflows.
- Structural adjustments, privatisation and liberal FDI policies have resulted in large FDI flows in the services sector. Privatisation has been one of the most important causes of FDI in recent years. FDI is crucial to globalisation of the service sector.
- FDI cannot be expected to solve the problem of under-investment in developing economies by itself. As such, there is really no case for the optimism that FDI *per se* can solve the problem of under-investment in the LDCs, though, on the whole, the share of FDI inflows to these countries has gone up in 1990s.
- There are significant inter-regional variations in FDI. In 1990s, Africa had the slowest growth in FDI, and Latin America and the Caribbean (starting from historical lows after the debt crisis) had significantly high growth rates. East Asia, of course, had the highest growth in FDI.

Overall, the information suggests that market-seeking has been the key driver for recent investment. This is followed by natural resource-seeking in the African countries and Bangladesh, in a limited way and efficiency-seeking in countries like Brazil, Hungary, India and South Africa.

3.2 Role of FDI in Project countries

Apart from contributing to the up-gradation of knowledge, foreign investment can serve two broad purposes, namely, raise investment and relieve foreign exchange shortages. Insofar as these are among the key factors influencing growth in developing countries, FDI has the potential to become an important vehicle of growth. Unless FDI affects national savings, it can either raise domestic investment, provide additional financing for pre-existing current account deficit or achieve some combination of the two.

3.2.1 FDI and Privatisation Initiatives

Privatisation policies have contributed significantly to FDI inflows in many of the project countries. In this subsection we pool together evidence from the country reports on the relative contribution of privatisation in attracting foreign investment.

In India, as part of the liberalisation process, the list of industries reserved for the public sector was reduced from 17 to 6. However, the privatisation of SoEs has been extremely slow. Although estimates are not available, unlike in many other developing countries, (especially in Latin America and Eastern Europe), FDI inflows into India have not been driven by privatisation policies and sale of SoEs to foreign investors. This is despite the fact that foreign financial and technical collaboration was made mandatory for all private sector entrants bidding for a license as operators in the telecommunications sector.

The links between the privatisation process and FDI inflows have not been very strong in Bangladesh as well. The level of privatisation achieved has been modest. Although international tender was called for privatisation of many SoEs no foreign investor ultimately invested. However, the government has offloaded its shares of different companies, mainly to foreign firms, through the stock market. Besides, opening up of the energy sector has resulted in significant FDI inflows in this sector, especially for natural gas.

Unlike, India and Bangladesh, the privatisation process in Zambia has made significant progress. By the year 2000, 248 out of 280 SoEs had been sold. The major sales have been of the copper mines. It is not known, however, if the major buyers in these deals were foreign firms. Due to massive shedding of labour in the post-privatisation period, the political commitment to privatise the infrastructure sector is on the wane. This has added to the uncertainties regarding the liberalisation process and the associated FDI inflows.

There is a strong FDI-privatisation link in South Africa; much of the FDI into the country over the past few years has been in the form of acquisitions by foreign firms of SOEs. Till the end of 2001, about US$2.7bn have been raised through the privatisation of the SoEs, mainly from international equity partners. The country has approximately 312 remaining parastatals, many of which are subsidiaries of large SOEs in the telecommunications, power, transport and armaments sectors.

The privatisation-FDI link seems to be even stronger in Hungary. During 1991-2000, about 41 per cent of the total FDI inflows into the country came through the privatisation process. Typically, many of these sales were made to firms in the developed countries, which had co-operative links with the SoEs. Even some greenfield investment started in the privatisation process. Privatisation led acquisitions by TNCs sought extant assets like brands, skills, market share, R&D competencies and supplier networks. In this sense most of the privatisation investments remained embedded in the local economy. Most greenfield investment on the other hand was seeking relatively cheap labour.

Privatisation has been an important source of FDI inflows in Brazil as well, mainly in the financial services and utility sectors. In the second half of 1990s (1996-99) privatisation related inflows constituted about 26 per cent of the total FDI inflows. About 80 per cent of the privatisation related foreign investment was in the service sector. These were mainly in those sectors, which were part of the privatisation programme, like sanitation, telecommunications, financial and business support services.

Privatisation programme in Tanzania has been going on for some time now. Between 1992 and 2001, 326 companies have been divested. Of these only about 4 per cent were bought completely (100 per cent) by foreign entities. Another 58 per cent (190 out of 326) were sold to joint ventures between local and foreign investors. According to some estimates, privatisation proceeds accounted for a third to half of the FDI inflows into Tanzania between 1992 and 1998. This was essentially due to the privatisation of public utilities.

3.2.2 FDI, Cross-Border Mergers & Acquisitions and Greenfield Investment

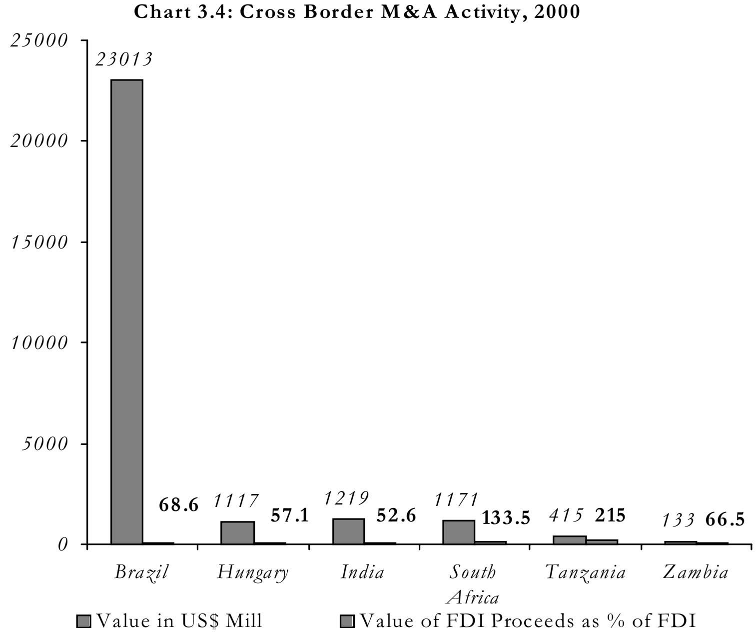
FDI flows can result in new capacity creation through greenfield investment or through M&As where existing capacities/assets are acquired. Cross-border M&A activity has been on the rise in recent years. The project countries are not an exception to this trend, except for Bangladesh where this activity does not seem to be very significant In terms of value of transactions, the second half of 1990s have seen significant transfer of assets through M&As in Brazil, Hungary and South Africa. This trend is picking up in India.

It is interesting to note that in the year 2000, for all project countries (except Bangladesh) the value of M&As was at least as much as 53 per cent of the value of FDI flows. In general, during the 1990s, M&A activity has been a significant source of FDI in Brazil, Hungary, South Africa and Zambia. This tendency was also significant for India but to a limited extent. Tanzania and Bangladesh, especially the latter, have not experienced significant cross-border M&A activity. For Tanzania, however, this activity picked up suddenly in the year 2000.

Alternative estimates show that cross-border M&As have been a very important mode of FDI into India in recent years. During 1991-98, about 38 per cent of the FDI made by TNCs came in to finance acquisition of equity stakes in existing enterprises. In fact, the share of pure technology collaborations with foreign firms has declined drastically in 1990s; technology licensing is now mostly accompanied with equity participation.

No detailed information is available for Hungary regarding the relative role of different modes of FDI. Insofar as privatisation was the key element of FDI, M&A activity seem to have dominated with very few greenfield investment.

Chart 3.4: Cross Border M&A Activity, 2000



As in Hungary, detailed information is also not available for Zambia. But anecdotal evidence suggests that most foreign investment was for take-overs of privatised state enterprises; greenfield investment was very few. The situation was somewhat similar in Brazil. Due to the privatisation policy, the share of M&A activity vis-à-vis greenfield investment rose sharply in the late 1990s. In 1996 the share of cross-border M&As in total FDI was only about 45 per cent which rose to 86 per cent in 1998. This is much higher than the ratio in the developing countries (41 percent), South and South East Asia (33 percent) and even Latin America (56 per cent).

In South Africa also inward investment has increasingly taken the form of M&As, largely as a result of state leveraged deals and the privatisation of state assets. During 1994-99 period, about 64 per cent of the total inflows were a result of cross-border M&A activity.

Interestingly, FDI in Bangladesh was mostly in greenfield projects mainly in the energy sector (gas and power), telecommunication and cement.

Greenfield investment (fully owned subsidiaries and joint ventures) has dominated as a mode of entry in Tanzania as well. While the role of cross-border M&A has increased in recent years, (essentially due to the privatisation policy), its share was no more than 10 percent during the 1990s. About 61 per cent of the FDI projects approved were joint ventures indicating willingness of potential investors to form partnerships with local private investors. The joint venture route was more pronounced in transport (80 percent), mining (72 percent), telecommunication (70 percent) and housing (88 percent) sectors.

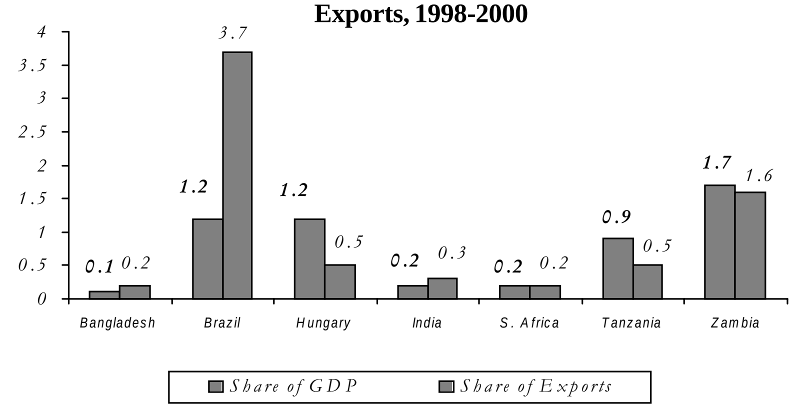
Cross-border M&A activity undertaken by firms in the project countries has been significant mainly for South Africa, Brazil and to some extent India. It may be recalled that while India did not show very high outward FDI flows, the other two countries showed significant FDI flows out of their countries. But the estimates seem to suggest that a significant amount of outflows from all three countries are being used for M&A activity. In contrast, the outflows from Hungary are less oriented towards M&A activity. Firms in the remaining three countries (Bangladesh, Tanzania and Zambia) do not undertake M&A activity outside their national boundaries.

3.2.3 FDI, Domestic Capital Formation, Gross Domestic Product and Exports

FDI flows contribute significantly to capital formation in Brazil and Hungary. FDI's contribution to capital formation is very low in the two south Asian economies, India and Bangladesh. FDI inflows contributed as much as 31 percent of Brazil's capital formation in 1999. This contribution was only about 2 percent for India. Its contribution to the capital formation in the remaining countries was in the range of 8-14 percent. Only in South Africa and to an extent Hungary, outward FDI flows have been significant vis-à-vis the country's capital formation.

Certain interesting patterns emerge when we standardise the stock of FDI by the GDP of each country. Inward FDI stock, as a percentage of GDP was as high as 58 percent for Zambia in 1999. Even for Hungary and South Africa this proportion was close to 40 percent. This reflects a significantly high penetration of TNCs in these economies. This percentage was significantly lower for other economies, except Brazil where the percentage was close to 22 in 1999. The "transnationalisation" of the economies India and Bangladesh was particularly low.

Chart 3.5: Share of World FDI to Share of GDP and Share of Exports, 1998-2000



Is the share of project countries in global FDI flows any different from their share in world output, employment and exports? The share of FDI inflows to Zambia in global FDI flows is about 70 percent more than their share in the world GDP. The shares of Brazil and Hungary in global FDI are also higher than their share in GDP, but only by about 20 percent. Except for Tanzania for which the shares in global GDP and FDI flows are roughly the same, in all other project countries, their share in GDP is significantly more than in FDI flows. The share of Hungary in world employment is about 20 percent lower than their share in FDI flows. For Brazil, the shares are about the same but for other countries, the employment shares are significantly more than the shares in FDI. In general, the shares in FDI are lower than the shares in exports for the project countries. Brazil and Zambia are the only exceptions, the former having

Chart 3.6: Share of World FDI to Share of GDP and Share of Employment, 1998-2000

a significantly larger share in FDI than in exports. Does this mean that FDI can potentially be more export oriented in countries other than Brazil and Zambia?

As has been mentioned earlier, these ratios can be affected by the size of the economy; but what these shares do reveal is that for their share of World GDP, exports and employment, FDI levels have been high in Brazil, Hungary, and Zambia. Therefore, relative to their size of the economy, FDI has been high. But what it implies for further FDI is discussed in the next section.

3.2.4 FDI and Balance of Payments

The outflows in the form of dividends and interest payments to non-residents have been significant in the case of South Africa. This has become important because of the increased presence of non-resident investment in South Africa and the movement of some major national companies to London. Over the past 50 years, South Africa has almost always recorded a surplus on the trade account but a deficit on the current account.

In Brazil, an attempt to sustain an over valued currency in the late 1990s and the strategy to balance the growing current account deficits with portfolio investment led to fast deterioration of the external accounts. Portfolio and FDI flows were crucial to finance the balance of payments deficits after the 1998 crisis. In fact, the FDI/current account ratio was as high as 106 percent in 1998-99. However, the costs of financing the deficit by portfolio capital have become prohibitive after the Asian and local market crises in late 1990s. The current account deficit was as high as 4.4 per cent of the GDP in 1999. Since then FDI inflows have declined in recent years, trade account surpluses are key to overcome the current account deficits.

The Hungary experience brings out sharply the links between capital flows and balance of payment situation. In 1998 and 1999, Hungary's current account deficit deteriorated significantly despite the improvements in exports and the domestic economic situation. Foreign capital was blamed for this crisis as it withdrew form Hungary and also repatriated substantial profits. While the inward FDI shrank, outward FDI grew during this period. Thus net inflow of capital ceased to cover deficits of the trade balance. Interestingly, the privatisation policy had preferred the foreign investors precisely to perform this balancing role.

The key point is that large capital inflows in short periods of time are bound to be followed by generation of profits that may be repatriated unless the economy is able to stimulate their reinvestment in the local economy. Such trends affect the balance of payments situation even more adversely in conditions when inward FDI is stagnating and hidden profits transfers are taking place through payments for "business and technical service payments". Both these conditions prevailed in Hungary. The data on Hungary showed that the outflows were more pronounced for bank deposits and portfolio capital than for FDI that was less volatile. Even portfolio profit transfers were more pronounced than FDI related profit transfers. Thus, growing volumes of inward and outward capital/ income transfer pose a potential threat to macro economic stability that may need to be actively corrected through macro-economic policy.

There is also some evidence from Hungary to show that FDI projects contributed to reduce the trade deficits. Initially, while the new projects were being set up, increased imports of machinery etc. deteriorated the trade balance but subsequently rapid export growth contributed to reducing the trade deficit. The major engines of export growth were large greenfield investment in the EPZs.

In India the average foreign investment inflows during 1993-2001 were more than 20 times the average levels during 1985-91. However, this sharp increase in the level of foreign investment did not result in a large capital account surplus due to the offsetting declines in the net aid flows and deposits by the non-resident Indians. The Reserve Bank of India followed the policy of accumulating foreign exchange. This meant that current account deficits remained low and foreign investment inflows did not augment domestic savings to augment domestic investment rates.

CHAPTER-4

The Civil Society Survey

Under the IFD project, a national survey on civil society perceptions was conducted in the project countries. The aim of the survey was to gauge the perceptions of civil society on the positive and negative aspects of FDI, the relationship between FDI and domestic investment, and measures adopted by governments to facilitate FDI. Questionnaires were sent to potential respondents from a range of organisations such as trade unions, business associations, NGOs, religious organisations and, representatives of the academia and the media. The respondents were asked to provide their responses on a number of issues related to FDI policy and performance. The results of the survey are presented in the sections that follow. The number of respondents in the project countries is as follows:

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

4.1 Why Civil Society: a Discussion

Developing countries typically follow a dual approach in their FDI policy. On the one hand, they increasingly welcome FDI, and, on the other, they tend to put in place certain restrictions or constraints in their operations. This dual policy, it appears, has public support as the civil society respondents tend to welcome FDI but are in favour of certain interventions that would prevent them from functioning in a completely free manner.

Moreover, given the heterogeneity in levels of development of developing countries – and the asymmetry in their characteristics and economic conditions, - objectives would tend to vary widely among developing countries. It is neither feasible nor desirable to formulate an inventory of development objectives that was applicable to all developing countries. At the same time, it is interesting to note that concerns related to FDI are broadly similar across a wide range of countries.

Globalisation and interdependence have opened new opportunities. Some countries have successfully adapted to the changes and benefited from globalisation, a contributory factor being their openness to FDI. But, has openness to FDI actually helped the overall development of these countries or their 'integration' in a sustainable way into the global economy? In order to help developing countries to prevent and overcome any negative effect of economic globalisation, there is a need for governments to form development policies, taking into account their own social, human and environmental dimensions. The orientation and participation of civil society can play an extremely important role in the process of policymaking.

Unlike policy-makers, economists, and industry associations, civil society tends to look at many non-economic dimensions as well. For any broad consensus to be achieved, countries need to take into consideration the views of the representatives of civil society. The key lies in their credibility and ability to affect long-term public opinion. Sustained and long-term improvements in FDI policy can be achieved, if there is a consensus among the general public on policies.

There is a need for governments, therefore, to interact with civil society, and engage them in a dialogue in a constructive, structured and organised way. Civil society, therefore, should be involved in the decision-making and monitoring processes of FDI on the international and national levels.

4.2 Comparison of the Results of the Civil Society Survey

Overall, the civil society survey results demonstrate that, in all the countries, civil society is positively oriented towards FDI. More importantly, a comparison among the country experiences shows that civil society is aware of its own country's experiences. Countries that have had a positive experience with certain aspects of FDI show high agreement levels. Take, for instance, responses from the survey in India on whether FDI enhances exports. FDI in India has been less oriented towards exports and more towards domestic products (see Investment Policy in India- Performance and Perceptions). Consequently, less than half the civil society respondents from India agree that FDI enhances exports. FDI in South Africa did not have a negative impact on imports, thus a low agreement among the South African respondents on this query.

Table 4.1: Positive Aspects of FDI – Percentage of Civil Society Respondents in Agreement							
	Bangl -adesh	**Hungary**	**India**	**Tanz -ania**	**Brazil**	**South Africa**	**Zambia**
FDI brings in valuable new management techniques	84	90	89	70	100	100	74
FDI is a valuable source of foreign capital	82	60	89	80	100	100	59
FDI brings in valuable new technologies	88	92	82	92	82	96	85
FDI increases access to world market	85	82	61	76	55	100	76
FDI increases the competitiveness of national economy	85	90	79	73	73	100	62
FDI helps enhance export	76	72	47	76	64	100	56
FDI makes up for insufficient domestic investment	68	80	56	48	45	88	67
FDI helps reduce import	58	53	34	41	45	65	32

Overall, in all the countries studied, the import reduction impact is not considered to be an important one by most respondents. In all the countries under consideration, the least proportion of the respondents is in agreement on this. It should be noted that international evidence on import reduction and FDI is also lacking.

As evidence and theory both have shown, technology and capital are the key contributions of FDI. Civil society perceptions on this are in line with the theory and evidence. However, there is less agreement among the respondents on its other potential advantages such as making up for lack of domestic investment, competitiveness and access to world markets.

A majority of the civil society respondents in South Africa are in agreement on the positive aspects of FDI. Significantly, the respondents in Brazil and India tend to have a lower agreement on the positive aspects. Both Brazil and India are large markets, with a strong domestic manufacturing base. The marginal impact of FDI on such factors had been lower in these countries. We also find that the respondents in Tanzania respond in a manner similar to Brazil and India.

Table 4.2 shows civil society perceptions of some potential negative aspects of FDI. It finds that, overall, civil society respondents in all the countries have lesser agreement on the negative aspects than the positive ones. However, there are significant inter-country differences in the civil society responses on this account.

Table 4.2: Negative Aspects of FDI – Percentage of Civil Society Respondents in Agreement

	Bangl -adesh	Hungary	India	Tanz -ania	Brazil	Zambia	South Africa
FDI brings in environmentally harmful technologies	38	28	39	38	18	11	23
FDI reduces the profitable opportunities available to domestic investors	47	60	33	50	45	73	27
Foreign investors are only interested in getting access to domestic markets	58	46	72	47	55	55	23
FDI results out of unfair advantages of multinational firms	65	58	38	45	27	79	31
Foreign investors do not care about impact of their investments on civil society	62	56	45	57	45	71	23

As may be expected, most respondents, in general, perceive that foreign investors do not care about their impact on civil society. In the case of India and Brazil, perceptions of this are weak. There is a very low agreement on this among the South African civil society respondents. The South Asian respondents also largely agree with the perception that investors are 'only' interested in gaining access to domestic markets. However, most respondents from other countries do not agree with this view.

The experiences of Hungary and, to a lesser extent, Tanzania with FDI also may have contributed to the responses from these two countries, the respondents are in greater agreement on the negative aspects. Overall, the responses suggest that negative perceptions are the least in South Africa, followed by Brazil. For the rest of the countries, civil society perceptions are negative. Overall, the respondents in Zambia are in lesser agreement with either the positive or negative aspects of FDI.

Table 4.3: Measures to Increase the Benefits of FDI – Percentage of Civil Society Respondents in Agreement

	Bangl-adesh	Hungary	India	Tanz-ania	Brazil	South Africa	Zambia
Support local businesses to upgrade technology/gain access to finance etc.	91	84	86	98	100	100	61
Strengthen environmental regulation	77	88	81	93	0	54	61
Introduce/ strengthen competition policy	89	64	83	100	67	65	50
Strengthen sectoral regulation	66	58	83	97	17	38	50
Strengthen labour legislation	69	40	76	98	17	4	50
Strengthen intellectual property rights legislation	88	63	95	90	33	69	85

Therefore, there is a significant concern related to the negative aspects in most countries among the respondents. Given the concerns, it is but natural that respondents would have views on the role that the government should play. Many queries related to the direction that government policy should take were asked. The responses are reported and discussed below.

Apart from Hungary and India, in all the countries, there is a strong agreement on the potential policy action that would support the strengthening of domestic businesses. There is less agreement on the necessity of strengthening environmental regulations, e.g. the Tanzanian, Brazilian and South African civil society respondents are not much in support of this measure. This could also be the result of strong environmental regulations already in place in countries such as Brazil.

Table 4.4: Restrictive Measures on Foreign Investors – Percentage of Civil Society Respondents in Agreement

	Bangl-adesh	Hungary	India	Tanz-ania	Brazil	South Africa	Zambia
Impose requirements on firms to: Create jobs	84	84	89	95		46	70
Employ local managers	80	54	75	97		62	74
Transfer technology	91	82	86	94		73	76
Source supplies from local firms or impose local content norms	71	78	68	94		38	65
Export from the economy	80	53	85	94		46	47
Balance foreign exchange impact	62	38	47	88		12	74
Transfer skills and know-how to local subsidiary firms	94	88	80	100		69	59
Transfer skills and know-how to local non-affiliate firms	63	62	67	81		38	70
Train local technical and managerial manpower	94	92	87	97		100	47

As has been discussed in the other parts of this paper, the gains from FDI can be most significant when there is a high level of competition. Competition prevents FDI from extracting monopoly rents and repatriating them. Another aspect of competition is that counter-balancing forces are present in the economy that could prevent exploitation. Strengthening of competition policy gets the largest affirmative responses in all countries.

The survey responses from South Africa, Brazil and Tanzania show lesser agreement for greater government intervention, than the other countries.

Generally, most civil society respondents, except for the South African ones, are in favour of imposing certain requirements on FDI. Of the countries studied, the Tanzanian and Indian civil society respondents are mostly in favour of specific government interventions. Curiously, most South African civil society respondents, who have greater positive orientation towards FDI than the other countries, also call for many specific interventions and policy measures.

Employment and technology-related requirements receive the most support in all the countries studied from a majority of civil society respondents. Within this class of interventions, those related to the training of local employees receive the strongest support from the respondents. Overall, the respondents in India are in favour of greater government actions to increase the net benefits of FDI to the economy, than the other respondents. In Brazil, the responses show greater variation and are highly issue-specific. Significantly, balancing requirements for foreign exchange outgo receive the least support from the respondents.

In sum, therefore, the civil society responses reveal that there is a perception that foreign direct investment plays an important role in the development of host economies.

CHAPTER-5

Findings of Case Studies

Under the IFD project, investment policies, performance and perceptions in the selected sectors in the project countries were studied. Each country has case studies of three sectors. The sectors include auto, power, mining, telecom, textiles, cement, and also include services such as the financial and tourism sectors. Generally the sector that received the highest FDI flows, either actual or approved, was chosen. Sectors were also chosen on the basis of current and expected future importance for the particular country's economy by the partner organisations[4]. Automobile and telecom make up the main comparative studies because most of the countries have chosen these, which reflects the importance of these sectors in the FDI picture of the project countries.

5.1 Enabling Environment

The findings of the case studies across several sectors in the seven countries show that everywhere the domestic policy environment has preceded the inflow of FDI. In this section the experience of the project countries in creating an enabling environment for particular sectors is discussed. In Brazil, in all the three sectors – telecommunication equipment, pharmaceuticals and automobiles – a large part of total foreign investment was attracted by incentive policies and mechanisms. In general, these policies do not make any distinction between domestic and foreign companies. In the case of telecommunication equipment, the main policies are the Information Technology Act, the Programme of Support for Investments on Telecommunications and the Fund for Technology Development. Similarly, in the case of pharmaceuticals, the New Intellectual Property Law was a strong reason for FDI attraction during 1990s in the sector.

In South Africa, as part of its plan to attract foreign investment, the government, in 1995, replaced its previous strategy of developing a local motor vehicle manufacturing industry under the seven year Motor Industry Development Programme (MIDP). MIDP was introduced to make SA’s automotive industry globally competitive. MIDP abolished all local content requirements of the previous programme, lowered tariffs on imported vehicles and components, established a duty-free allowance for original component equipment imports, which offset import duties on components and vehicles through import rebate credits earned from exports, and established a higher duty-free allowance for low cost vehicles.

Table 5.1: FDI and Government Policy Instruments		
Country	**Sectors**	**Government Policy Instruments**
Brazil	Telecommunication equipment	• The New Information Technology Act • Programme of Support for Investments on Telecommunications
	Pharmaceuticals	• The New Intellectual Property Law
South Africa	Autommobiles	• Motor Industry Development Programme
India	Information Technology	• The Electronics and Computer Software Export Promotion Council, 1988 • National Task Force on Information Technology and Software Development, 1998 • Software Technology Park Scheme • FDI up to 100 percent is allowed in various categories.
Tanzania	Mining	• Introduction of a competitive mining policy and an equally competitive mineral legislation • Review and streamlining of tax regulations on mining activities
Bangladesh	RMG and Textiles	• Provides many incentives and support to the export-oriented industry • EPZ provides an opportunity for the foreign investors as well.
Zambia	Mining	• Privatisation of mines through FDI

In Hungary, the impact of FDI became favourable when the transition process gained momentum in 1990s. The Hungarian Government supported the creation of linkages of foreign firms with the local ones. Despite the change in government, preferences for FDI in privatisation policy remained in place. As a consequence, the Hungarian manufacturing industry became dominated by foreign companies. Also, major service industries, like electricity, water supply, telecommunication, and the banking sector received large quantity of foreign investment.

In India, the success of the IT sector has been attributed to the role played by the government in providing an enabling framework. India now has a liberal policy for FDI in the telecom sector. FDI up to 100 percent is allowed in various categories of this sector. Under the new Indian auto policy announced in March 2002, the government has permitted 100 percent FDI in the automobile and component sectors, under the automatic route. In the power sector too, the new policy permits 100 percent foreign equity and repatriation of profits, without any export obligations.

In the case of three LDCs also – Bangladesh, Tanzania and Zambia – the overall liberalised environment has been important for attracting FDI. The RMG sector of Bangladesh, the mining sectors of Tanzania and Zambia received substantial quantity of FDI, following the policy changes undertaken by the governments of these countries since early 1990s.

5.2 Technology Transfer

Host countries often associate inflows of FDI with a wide variety of benefits, the most common of which is transfer of modern technologies. According to the case studies of the seven countries involving several sectors, FDI appears to have a positive impact on the technology transfer and it demonstrates better technologies to local firms. This is more evident in the case of the three LDCs – Bangladesh, Tanzania and Zambia.

In Bangladesh, FDI in RMG had a stronger impact on technology upgradation by local firms and the revenue of the government. The development of the telecom sector, particularly in cellular phone services, is basically propelled by foreign investment and collaboration from Malaysia and Norway. The impact of FDI in the telecom sector is quite evident. It has improved the communication network of the country.

In Zambia, the privatisation of the mines through FDI, by way of TNCs investing in mines, revised the mining sector which was stagnating in the absence of international capital and technology. There have been productive capacity improvements in the mines, which have led to production increases.

Similarly, in Tanzania, FDI in the mining sector has gradually expanded the areas of exploration and mining. The banking and telecom sectors have also benefited from FDI, in terms of technology transfer.

In the case of the three large developing countries – India, Brazil and South Africa – the influx of FDI in the automobile and telecom sectors has resulted in their modernisation. In India, it was way back in 1986 that Texas Instruments, a US-based TNC, had set up a software development centre in Bangalore, to tap the qualified workforce available in the vicinity. Subsequently, a host of other TNCs began to follow the footsteps of Texas. Today, the Indian IT sector is said to be one of the most competant in the world. Indian software companies cater to the needs of large TNCs in the developed countries, which outsource their software requirements from India.

In South Africa, FDI in the telecom sector has had a positive impact on technology transfer. South Africa is the telecom giant of Africa. It ranks 23rd in telecom development and is the 14th largest Internet market in the world.

FDI in the automobile sector has brought new and advanced technology in all the three countries. The automobile sector was one of the largest recipients of FDI in Brazil. As a result, the competitive gap between Brazil and the developed economies, with regards to products and productive facilities and processes, has been reduced. Today, most of the big automobile TNCs have their production base in South Africa. The automobile industry is one of South Africa's biggest exporters. Its automotive industry is increasingly acquiring a global reputation for quality, as illustrated by a recent award to BMW South Africa for outperforming plants in Europe, USA and other regions.

In India too, the automobile sector has emerged as an important driver of the economy. Although the automobile industry in India is nearly six decades old, until 1982, it had only three manufacturers – Hindustan Motors, Premier Automobiles and Standard Motors, which ruled the motor car industry. Owing to low volumes, it perpetuated obsolete technologies and was out of line with the global industry. At present, the Indian automobile sector is growing fast, with support from economic reforms that have taken place since 1991 and FDI inflows.

In Hungary, the transition from centrally planned to market economy was greatly enhanced by FDI as it played an important role in the privatisation process. Thus, it had a positive impact on the restructuring of the state-owned sector directly.

5.3 Job Creation and Job Loss

FDI is often attracted with the idea that it would result in economic growth, which, in turn, would create jobs. However, empirical evidence from the project findings shows that FDI results in more job-shedding (especially in the domestic sector) than creation. In other words, net job creation is either low or negative in most of the cases. This phenomenon is quite evident in the case of the three large developing project countries. LDCs: Bangladesh, Tanzania and Zambia have not experienced any loss in jobs, as there were hardly any local firms in existence before the economies were opened up to foreign investment.

The South African automotive industry is one of the largest employers in the country. There have, however, been several job losses in the sector over the past few years, most dramatically in the component industry. According to the National Association of Automotive Component and Allied Manufacturers (NAACAM), employment in the component industry has gone down from 89000 in 1996 to 58500 in 2001. In the telecom sector, according to the labour union, COSATU, Telkom, South Africa's national telecommunications operator, shed 25000 jobs during its exclusivity period, with another 10000 job cuts are envisaged post-IPO; which is almost a third of the company's total labour force. There has been severe job-shedding in food, beverages and agro-processing sectors as well. This could be attributed to factors such as a decline in consumption, the impact of M&As, the use of less labour-intensive technologies, outsourcing of services or the increasing use of unregistered casual labour.

In Brazil, there has been a loss in jobs in both the telecom equipment and automotive industries. In the telecom equipment sector, there was a loss of 3800 jobs in domestic companies but in foreign ones, 11700 were created. In the automotive sector, as per the data of the National Statistics and Census Institute's Annual Industrial Survey, there has been a significant increase in the number of TNCs, but the number of jobs has gone down. Between 1996 and 1999, more than 15000 jobs were shed in the vehicles sector alone. In auto parts too, there was a shedding of more than 8000 jobs. The exception is the pharmaceutical industry, where, both in TNCs and domestic industries, jobs were created. In the period between 1996 and 1999, about 9400 jobs were created in the sector, of which about 5800 were by TNCs.

The Indian IT sector showed a trend contrary to that of the manufacturing industry. The Indian companies have grown along with TNCs and a number of jobs were created.

In Hungary, the adjustment efforts undertaken for its transition resulted in the winding-up of activities and a loss of jobs. Both foreign and state-owned firms had to scale back previous activities to the size and structure that fitted the new market-oriented production patterns. Foreign firms did downsizing more ruthlessly than the local ones.

5.4 Growth of Local Industries

While attracting foreign investment, host countries do expect that besides bringing in new technology and know-how, FDI inflows will also contribute to an increase in productivity and competitiveness of domestic industries. There is no conclusive evidence from the project research, except for a few exceptions which shows that FDI, in reality, increases the competitiveness of domestic industries, like the Indian IT sector. However, the empirical results show that there are productivity spillovers from FDI through contacts between foreign affiliates and their local suppliers in upstream activities, but there is no indication of spillovers occurring within the same industry. In other words, spillovers from FDI are more likely to be vertical, rather than horizontal, in nature.

Findings of the case studies of the seven countries also reveal more or less similar results. In the telecom equipment sector of Brazil, during 1996-99, the number of domestic companies dropped from 241 to 219, while the number of foreign companies doubled. In the case of the automotive industry of Brazil, the increasing presence of foreign companies proved to be disadvantageous for domestic capital. According to Sindipecas' data, in 1994, the share of domestic companies in the capital, sales and investment in the sector was 51.9, 52.4 and 52 percent, respectively. With the increase of M&As by TNCs and the consequent deepening of the concentration and denationalisation process and the different competitive performances shown by these two groups of companies, this share dropped to 26.5, 27 and 14.5 percent, respectively.

In South Africa, the automotive industry had become extremely competitive in the last decade. However, global pressures, together with the recent appreciation of the Rand and rising input costs, had forced a number of local components companies to close down shop or scale back, as well as shed jobs. In certain sub-sectors of the agro-food complex, foreign TNCs effectively displaced South African companies, closed them down or converted them into warehouses. The dairy industry was a case in point; a strong European presence had led to the import and warehousing of subsidised EU produce, rather than fully utilising the local production capacity. The 'crowding out' of domestic firms may have meant fewer linkages of foreign firms with the economy and no technological learning from FDI.

The two exceptions to the above-mentioned trend are the IT sector of India and the pharmaceutical industry of Brazil. After the entry of foreign companies, a number of Indian companies engaged in computer hardware started to spin-off their software divisions. Despite the entry of most leading MNCs in India for software development, the industry is still dominated by domestic companies and talent. The top six software companies in India, ranked either on the basis of overall sales or turnover, are domestically owned.

The Indian software exporting companies themselves are sufficiently global in their outlook. As many as 212 Indian software companies have either subsidiaries or branch offices overseas. Nearly 32 Indian software companies have received Software Engineering Institute (SEI) USA's Capability Maturity Model (CMM) Certification. Six of them have reached Level 5 of this certification scheme, a distinction, which has been awarded, only to 12 companies world-wide.

The pharmaceutical industry of Brazil has also seen a growth in domestic industries. There are a large number of middle and big domestic companies. The number of domestic firms has increased from 618 in 1996 to 673 in 1999. These companies accounted for a gross value of production of about US$2.8bn. On the other hand, 61 foreign companies generated about US$4.9bn in the same year.

CHAPTER-6

An Assessment of FDI Flows

As we have shown in the earlier chapters, a large part of the variation in FDI is explained by structural factors. Given this evidence, one should not proceed on a premise that "there are no limits to FDI". Instead, it is important to understand that, given the characteristics of each specific country, there would be some 'limits' to FDI that can be expected. This comparison allows us to identify for each country the specific positives and negatives that affect FDI.

However, the bulk of the details is not reported here and the reader can refer to the country reports. What are of more interest are the specific insights that we are able to derive. We have chosen a central theme for each country around which the discussions take place. There are many factors that need to be changed or strengthened in each of the countries to prioritise and provide a structure to policy reform. The idea, therefore, is to put forth one or two central themes around which changes could occur in the project countries.

6.1 Bangladesh could Attract more FDI

The potential for FDI, with steady growth and improvement in the size of the market, emerged only in mid-1990s. As such, today there is a potential for substantially more FDI than the current level of about US$170mn. Thus, Bangladesh can do with a lot more improvements in FDI-related policies, including promotion. It needs to draw attention to its strong economic performance to attract FDI. This is especially so since FDI tends to show bandwagon effects. The relatively high and sustainable economic growth of Bangladesh, based, *inter alia,* on exports, has not yet drawn the attention of source countries and firms.

Given the fact that TNCs can make efficiency gains through investment in garments where labour cost are very low, restrictions on FDI to enter this sector need to be re-evaluated. It may be recalled that exports from Bangladesh have grown rapidly in recent years, providing indirect evidence for potential of efficiency-seeking FDI in those sectors where exports are high. Garments is one of the most important sectors in that category. Besides, opening up of banking, insurance and financial sectors may attract more FDI into this emerging market. While infrastructure was seen as a factor resulting in non-implementation of approved FDI proposals, it is not clear whether infrastructure is the key reason for Bangladesh not attracting FDI according to its potential. Political risks are seen to be still high, but a good growth for some more time should make the economy more creditworthy in the eyes of the international agencies.

Overall, Bangladesh can attract a lot more FDI by bringing about regulatory and policy clarity in the business environment, given its open policies that welcome FDI into infrastructure and participation in privatisation. In Bangladesh, with a weak entrepreneurship but strong growth factors, given the commitment to not allow the Taka to be overvalued, FDI in export industries can further the growth effort. Higher growth will, in turn, enhance the potential of FDI.

6.2 History, Macroeconomic Policies, Regional Markets and Privatisation Drive FDI in Brazil

In the case of Brazil, except for a brief period in late 1980s and early 1990s, the actual FDI inflows have always been larger than the 'potential'. Several factors are responsible for the high FDI flows into the Brazilian economy. The historical development of a strong manufacturing base is an important factor. Brazil, like much of Latin America, has been open to capital movements and has had liberal FDI policies for a long time. Indeed, except for short periods, Brazil has been open on the capital account. Brazil's economy diversified a great deal during the two world wars, because of the spurt in demand brought in by the wars. The immediate post-war import substitution also contributed to its industrial diversification. In the sixties and the seventies, as Brazil opened itself to TNCs, a process of dependent development of Brazilian industry (but with high growth rates) took place (Evans, 1983). This rapid growth and diversification, in a period when TNCs were allowed in liberally, was the key reason for the high FDI stock in Brazil.

Much of the highly profitable and strategic segments of industry were occupied by TNCs – drugs and pharmaceuticals, automobiles, electrical and electronic goods, lifestyle products like cigarettes, etc. The public sector dominated oil distribution, refining and many other utilities. Domestic private companies, which had links with TNCs, dominated older industries like textiles, cement, and in retail trade and distribution. A factor that allowed such deep penetration by TNCs was, besides the technological and organisational superiority, their financial advantages, at a time when domestic abilities were not as advanced.

The liberalisation of the nineties followed the fiscal and macroeconomic non-sustainability of the late eighties. TNCs, already present in the manufacturing sector, are now entering the services sector as well. Such large volumes of FDI lead to income payments abroad, but not generation of export revenues. Until a well-functioning, all-American preferential trading arrangement emerges, TNCs and their international marketing networks are an important option for realising greater exports.

Earlier FDI inflows into Brazil were designed to serve the entire Latin American markets, as labour costs were low. The 'maquiladora' industries of Mexico, which took off after the emergence of NAFTA had led to a rather large decline in the labour intensive, export enclaves of Brazil. Thus, Brazil did not have the advantage of a Mexico-type regional market. Despite this, since mid-1990s, FDI inflows into Brazil have been high. The active privatisation of both regulated and other industries, along with the withdrawal of the state in the face of a handicapped and much weakened domestic private sector , has been a large contributor to this FDI. That much of the flows have taken the form of mergers and acquisitions results from the fact that FDI has been pulled in, to a large extent, by major policy (not limited to foreign investment) and regime changes rather than by growth in the market as such.

Broadly then, in Brazil, big investment came along with vast income outflows. FDI continues to come in areas that are not likely to improve the long-term balance of payments. The leverage point does not lie in FDI-related policies *per se,* but primarily in broader processes. These have to do with two areas . One of them is strengthening of the domestic economic base of international agreements and labour market issues that will make Brazilian output (manufacturing, agriculture and services) more competitive internationally. The other one includes macroeconomic and other measures that can reduce capital flight and raise domestic investment rates.

6.3 Hungary is Using FDI to Re-integrate, Privatise and Cater to Regional Markets

In the 1990s, Hungary received high FDI inflows probably reflecting bandwagon effects and its status as an emerging economy in Eastern Europe and the special significance of Germany, France and Austria, re-establishing their hierarchical relationship with Hungary.[6] Besides its own markets, Hungary, as a source of cheaper labour for manufacturing product exports to the richer European countries is an important factor . Hungary-based TNCs cater to the larger regional markets. Additionally, the vigorous privatisation activity, which has put on the block its vast earlier state-run enterprises, has also significantly contributed to the FDI inflows. In the near absence of a local capitalist class of substance and strength, much of the privatisation of state-owned enterprises (SoEs) would have to take the form of FDI. Lower corporate taxes, state subsidies for large-scale investment in high-tech sectors and the ability to keep books of account in foreign currencies in Export Promotion Zones (EPZs), and to overcome foreign exchange risks, seem to add to Hungary's advantages listed above. However, it is not clear whether all of these measures are sustainable.

6.4 Growth-oriented Policies and Regulatory Clarity are Critical for India

India is another country which, relative to its predicted FDI, could have attracted a lot more during 1980s and early 1990s. The gap between its potential and actual flows, which had been very large in the eighties, due to severe restrictions, have now narrowed down, as these restrictions gave way in the early nineties. Post-1995, for a short period, FDI inflows showed a spurt. After late 1990s, however, actual flows came down a bit, though remained at a higher level compared to 1980s.

Indeed, if the current lack of regulatory and policy clarity in areas like power, water, sanitation, roads and airports can be overcome, increases in FDI are possible. It may be recalled that privatisation-related FDI inflows have not been as high in India as in many other project countries. Similarly, there are many sectors, especially services – banking, insurance and real estate – where, with liberalisation, more FDI can possibly flow in. With the industrial growth downturn since 1998, FDI potential may well have fallen. But, a significant increase may even now be possible, if the lack of policy and regulatory clarity that restricts private investments, in general, is overcome.

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. These will enhance the potential of the country to attract FDI. Many believe that the rate of growth of the economy can be enhanced significantly through a better policy mix. Enlarging the market size is critical for India to be in the same league as China.

6.5 Growth-oriented Macro-policies are Needed in South Africa

In the case of South Africa, the realised FDI has been much below the "potential". As mentioned, our FDI figures are net, rather than gross, and there was a substantial 'retirement' of FDI, because many companies changed their headquarters to UK and Netherlands, as the apartheid regime gave way, resulting in negative inward FDI flows. Since then, other factors, like increasing crime and law and order problems, would have restricted FDI too much below its potential. In South Africa, the focus should not be so much on FDI-related policies as much as on more general policies which enhance growth, investment, and especially, exports.

Apart from these, a few other issues may need to be sorted out. South Africa is the only one among the project countries that has restrictions on TNCs in some sectors regarding local borrowing, hiring of minimum number of local employees, ownership of immovable property and maintaining a capital base. Besides, there is evidence of significant regulatory uncertainty in the services sector. It is important for the policy makers to ascertain the extent to which such restrictions and uncertainties have impeded FDI inflows and take corrective action.

South Africa has a dominant and focal status within the region and has a great potential for economic development, given its size, resources, location and skills (which, of course, need to be improved). But, premature liberal capital account policies have contributed to capital flight and a reduction in the growth potential.[7] Besides, social unrest too has taken its toll. Thus, apart from a few FDI policies referred to above, overall growth and development policies are important.

6.6 The Tanzania Case Requires Further Exploration

A comparison of the potential and actual flows of FDI into Tanzania is very difficult, as information required for assessing the potential is not available. 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 the 'tax-break' competition in the region to attract FDI put 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 tradables, FDI can flow to most attractive locations and cater to the region. Perceptions of high political risks add to this disadvantage of the nation.

6.7 Zambia Exemplifies a Case of Governance Failure

Zambia went through major stress during the nineties, 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, underlies these large variations.

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. Since resource-seeking is the key driver of FDI here, a fall in the international prices of copper would also have led to limited FDI inflows in the country.

More important than FDI policies, the larger issues of governance need to be dealt with.

In many African countries, and more so in Zambia, the problem is a more basic one, of the country lacking the structure to retain capital within the economy. Inappropriate stabilisation programmes, and especially, structural adjustment, that assume the existence of an ever ready private sector, have further contributed to the problem.

CHAPTER-7

Conclusion and Policy Recommendations

The last section analysed FDI inflows into the project countries vis-à-vis their potential and identified a few elements that could have led to these gaps. This section views the key insights from the synthesis of the seven project countries in the context of 1990s, when, worldwide, a liberal policy agenda had become acceptable. The insights are, however, also drawn from the experiences of other countries.

The decade of 1990s, which is also the period of this study, is remarkable in many ways. The period from about late 1980s to mid-1990s saw many LDCs substantially liberalising their economies and attempting to 'globalise'. In many countries, these changes were linked to the 'stabilisation' programmes of the IMF and the World Bank. In the East Asian economies, there were attempts to globalise, after a very successful period of exports-led growth from 1960s and 1970s that had come from within these economies.

Thus, today, in the depressionary situation, globalisation is facing significant difficulties. But, the liberal agenda of privatisation, increased foreign investment, both direct and portfolio, and increased openness on both trade and capital flows continues to be actively sought and pushed, with some significant reversals, such as the re-imposition of capital controls in Malaysia. High expectation of large FDI inflows in such a scenario may be misplaced.

With practically no exception, nearly all countries turned towards the liberal agenda. In most of them, prior state failure (of varying degrees) had been significant and was an important contributory factor. The benefits were then perceived as being automatic – an increased access to foreign savings to raise the already high investment rates even further and, hence, of the prospects for higher growth and greater share of the world market. The ease of repatriating funds and low tariffs have been identified as some of the key enabling factors.

7.1 Role of Policy Liberalisation in Attracting FDI

The debt crisis of the early 1980s, which had severely affected the Latin American countries, reduced the share of LDCs for almost a decade that followed. Virtually all countries had become distinctly open to FDI in the 1990s. In some countries, such as India, the change from highly restrictive policies to very open regimes has been dramatic. Indeed, today, among LDCs, there is a veritable ‘incentive competition’ that has come about as LDCs vie with one another, through tax and fiscal concessions and other incentives, to attract FDI and multinationals.

However, we have seen that net flows of private capital in the developing countries have been rather small. FDI has had a share of around 20 to 25 percent LDCs, as a whole, if the special case of East Asia is kept aside. As such, there is really no case for the contention that FDI, *per se,* can solve the problem of investment though FDI shares of LDCs, as a whole, have gone up in 1990s.

In the project countries, structural adjustments, privatisation and liberal FDI policies have resulted in large FDI flows, particularly in the services sector. Privatisation has been one of the most important causes of FDI in recent years. Among the project countries, except in India and Bangladesh, privatisation has been quite significant and has resulted in private flows, especially foreign flows. In all the project countries, cross-border M&A activity has enhanced the privatisation process, Bangladesh being the only exception. FDI is crucial for globalisation of the services sector, it being one of the most important among non-tradeable sectors.

Besides, in many of the project countries, post-adjustment, fiscal stability seems to have been achieved, at the expense of compressing public expenditure, at a time when public services are either deteriorating or are not growing rapidly enough. A tight monetary policy may have been good for controlling inflation, but may have reduced investment through a credit squeeze. Slower rates of domestic investment often result in lower FDI inflows.

Most importantly, the fluctuations in private capital inflows still need to be recognised. Fluctuations in FDI flows into LDCs have been high; countries with smaller volumes of FDI have experienced larger fluctuations in FDI inflows. Significant dependence on FDI to bridge the investment gaps in such a scenario can be quite problematic. A fact that is not generally admitted, or even recognised, is that in inward capital movements to LDCs that have typically followed growth or liberalisation on the capital account, or both, have, after a while, reversed in many cases. Overall, however, FDI can raise domestic investment, provide additional financing or achieve some combination of the two. This, however, is only possible given the ‘correct’ internal economic conditions.

The experience of the project countries suggests that market-seeking has been the key driver for recent investment inflows. This is followed by natural resource-seeking in the African countries and Bangladesh, and in a limited way, efficiency-seeking in countries like Brazil, Hungary, India and South Africa. The policy focus should, however, be on efficiency improvement and market growth. Besides, where resource-seeking possibilities exist, policy constraints for efficient utilisation of these resources by domestic and foreign entities are critical. Market-seeking preferences are also met when countries are well integrated with the others in the region.

Apart from the two South Asian economies, India and Bangladesh, the other nations are rapidly getting integrated with the regional economic systems. While such integrations can create a potential for FDI inflows due to market creation, other features (e.g., skills, infrastructure, etc.) may be required to become a hub for FDI to cater to local markets. *Prima facie*, while South Africa, Hungary and Brazil seem to be equipped to take on this role, Tanzania and Zambia are not very attractive in this respect. The role of infrastructure is critical even for countries like India and Bangladesh, which are not yet a part of an integrated regional market where export-intensive FDI can potentially be attracted. Thus, factors like infrastructure generate positive externalities for both market and efficiency-seeking FDI.

Overall, there is not much difference in the FDI-specific policies adopted by the project countries. All the countries have liberalised these policies to a higher or lower degree. Only marginal improvements may be necessary, as FDI policies are already liberal. Some of these have been highlighted in the context of specific countries in the last section.

In general, policy liberalisation on this front seems to be desirable, except for the full capital account convertibility. As of now, capital account seems to be fully convertible only in Zambia. Tanzania plans to do so soon, while policies are very liberal in other countries, especially in South Africa. The move to full convertibility needs to be cautious and requires to be preceded by maturing of capital markets and establishment of regulatory structures.

Growth-oriented policies with high rates of domestic investment will go a long way in attracting FDI. Since privatisation and infrastructure provision is critical in many respects, regulatory clarity is critical for attracting both domestic and foreign capital. In the absence of such clarity, investment may not flow in even where market/structural potential exists.

The civil society survey has shown that the respondents are largely positively oriented towards FDI in all the countries studied. However, it does have certain specific concerns related to FDI's contribution to the economy. These concerns are reflected in its orientation towards having some constraints in the functioning of FDI firms. Civil society perceptions, it appears, have been shaped by a combination of the current economic climate of greater liberalisation and openness in economic policy and, perhaps more importantly, on the actual experiences of their countries.

Consequently, studying the experiences across countries has two advantages. Firstly, it allows us to better appreciate the concerns of civil society. Secondly, it enables us to draw important policy conclusions directly from specific experiences, rather than from abstract theories.

Civil society plays an important role in shaping public opinion in the long run. An understanding of what its perceptions are and how they are likely to evolve will also better enable us to gauge public opinion. Inasmuch as public opinion shapes long term economic policy, it also allows us to assess the directions in which policy is likely to evolve in a range of countries. In other words, sensible and sustainable policy is one that takes into consideration the ground realities of the sector and in the country. These 'realities' not only include the economic conditions and international business environment, but also public opinion.

The objective of this paper, as mentioned, is to recommend policy that is sensible, sustainable and will allow FDI to maximally contribute to the progress of the host countries. The experiences of specific sectors in the different countries have yielded a rich set of insights. We find certain policies that have a positive impact, those that have a negative impact and another set that is not likely to have had any impact.

7.2 Policy Recommendations

1. The governments should interact closely with civil society. This will: (i) enable a better appreciation in the public of the many facets of policy formulation, and (ii) enable the government to rate public opinion in a better way.
2. Provide an enabling environment for better and more efficient economic activity. The enabling environment includes: (i) education, (ii) infrastructure, (iii) good governance, and (iv) reduction of crime. (*e.g. Indian software industry, tourism in Zambia*)
3. Low government intervention allows private efforts to flourish. These could be through international firms or domestic entrepreneurial initiatives (*e.g. Indian IT industry, tourism and agro-processing in Zambia*)

4. FDI contributes the most in an open environment; trade liberalisation allows countries to maximise long term gains. However, in the short term, countries should expect a negative impact on domestic industry (*e.g. telecom in Brazil, cement in Bangladesh*)
5. Openness in trade, however, is a two-way street. If, for instance, Bangladesh were to open its borders to Indian cement imports, without an opening of Indian imports to (say) Bangladeshi textiles, then the gains will not occur. (*e.g. cement in Bangladesh*)
6. Short run opportunities can be used to create long term strengths with the help of FDI (*e.g. RMG in Bangladesh*)
7. Even in the presence of infrastructure and ground-level constraints, a policy of openness to FDI can create economic strengths (*e.g. Zambian agro-industry*)
8. Better marketing networks are a two-way street. While they offer high export opportunities, they also may lead to greater imports. However, the net effect is likely to be positive. Trying to have dual policies – encouraging exports and limiting imports – is not likely to yield long-term gains (*e.g. Brazilian telecom, South African food and beverages sectors*).
9. Many inequalities remain in international trading arrangements, and these are strongest in the agriculture sector. These inequalities (such as limits on imports in developed countries, subsidisation of developed country exports, etc.) negatively impact liberal policy formulation in developing countries. Developed countries would do well to appreciate that their dual policy of openness, when it suits them, and controls, when it does not, not only harm their credibility, but also have a strong negative impact on developing countries (*e.g. South African food and beverages sector*).
10. In some sectors, such as finance, good regulation is a necessary condition for not only FDI to be successful, but also for sustainable growth. A government devoting more efforts to good regulation is likely to yield more FDI than creating specific policies aimed at attracting FDI (*e.g. financial sector in Tanzania*).
11. Gains from privatisation have also been documented, but these gains are the most when public sector monopolies are not converted into private sector ones. Breaking up large public sector organisations into more than one competing entities is a good route. (*e.g. mining in Zambia*)
12. High level of incentives may attract FDI, but it also generates negative domestic concerns about the overall benefit of FDI. (*e.g. mining in Tanzania*)
13. Complementary sectors and activities have to be functioning properly, before FDI can be expected to make a strong positive impact. (*e.g. power production and distribution in India, telecom inter-connectivity in Bangladesh*)

14. Advice from international experts should be taken, but it should also be in line with ground level realities. Civil society and domestic experts should be incorporated in policy formulation that is more in line with the conditions in a country. (*e.g. power production in India*)
15. FDI has a positive impact across the economy, such as in complementary sectors. (*e.g. Tanzanian Telecom*)
16. Un-competitive domestic base would tend to lose out in the presence of greater FDI. All available evidence would support the view that economies are better served if reallocation of productive capacity towards more productive sectors occurs. Civil society should be able to appreciate that re-allocation of resources is an integral part of economic growth. (*e.g. Brazilian telecom manufacturing sector, South African auto industry*)
17. Transfer-pricing practices of the TNCs that limit host government abilities to gain tax revenues also create a negative perception towards FDI in the eyes of civil society. These are unethical and sometimes illegal too. Both developed and developing countries need to co-ordinate their activities to limit such practices. (*e.g. Brazilian auto industry*)
18. If given a relatively free hand (not prevented by many rules and regulations), greater economic openness generates its own 'pull' for greater FDI, thereby benefiting all. In large markets, merely opening up of the economy will lead to greater FDI (*e.g. Brazilian and Indian auto industry*)

Annexure

Box 1: Host Country Determinants of FDI

Host Country Determinants	**Type of FDI classified by motives of TNCs and principle economic determinants in host countries**
I. Policy framework for FDI • Economic, political and social stability (macro-economic policies) • rules regarding entry and operations of foreign enterprises, including performance requirements • standards of treatment of foreign affiliates • policies on functioning and structure of markets (especially competition and M&A policies) • international agreements on FDI • privatisation policy • trade policy (tariffs and NTBs) and coherence of FDI and trade policies • macro-economic policies affecting exchange rates, costs of capital • tax policy (national and state) *II. Economic determinants* • see opposite column *III. Business facilitation* • investment promotion (including image-building and investment-generating activities and investment-facilitation services) • investment incentives • hassle costs (related to corruption, administrative efficiency, etc.) • social amenities (bilingual schools, quality of life, etc.) • after-investment services	*A. Market-seeking* • market size and per capita income • market growth • access to regional and global markets • country-specific consumer preferences (including importance/ exposure to foreign brands) • structure of markets (degrees of contestability) *B. Resource/asset seeking* • raw materials • low-cost unskilled labour • skilled labour • technological, innovatory and other created assets (e.g. brand names), including as embodied in individuals, firms and clusters • physical infrastructure (ports, roads, power, telecommunication) *C. Efficiency-seeking* • cost of resources and assets listed under B, adjusted for productivity for labour resources • other input costs, e.g. transport and communication cost to/from and within host economy and costs of other intermediate products • membership of a regional integration agreement conductive to the establishment of regional corporate networks

Source: Adapted from UNCTAD (1998), p 91.

Box 2: Potential Role of Certain Determinants of FDI in Project countries							
Variables	**B'desh**	**Brazil**	**Hungary**	**India**	**S. Africa**	**Tanzania**	**Zambia**
A. Market Seeking							
Market size Important	Less	Important	Important	Important	Important important	Not important	Not
Market Growth	Limited	Important	Important	Important	Important important	Not important	Not
Regional markets	Not Important	Limited Import?	Important	Not Not	Important	Not Important	Not Important
B. Resource /Asset Seeking							
Raw materials	No	No	No	No importance	Limited	No?	Important
Low cost unskilled labour	Yes, some	No	No	Yes, some sectors	May be in some sectors	Some sectors?	No
Skilled labour	Limited	Yes	Yes	Yes	Yes	No	No
Specific knowledge assets	No	No	No	Yes, in some sectors	No	No	No
Infra-structure	No limited	Yes,	Yes limited	Very limited	Yes,	No	No
C. Efficiency Seeking							
Costs of resources	Limited	Yes	Yes	Yes	Yes	No	No
D. Impact of Policies and Other Conditions							
Economic stability	Positive, not critical	Negative	Positive, important?	Positive	Positive	Negative	Negative
Liberal FDI policies (1)	Yes	Yes	Yes	Yes	Yes	Yes	Yes
Privatisation policy	Yes, not critical	Yes	Yes, critical	Yes, critical	Yes, critical	Yes	Yes, critical
Trade blocks important	Not creation	Market creation	Market important	Not creation	Market important	Not important	Not
Competition policy	No law	Not known	Positive?	Positive	Positive	Not known	Not known
Tax breaks & subsidies	Important	Important	Important	Not important	Not important?		Important for sectors

Capital cost & exchange risk	Positive, not significant	Not clear significant	Not significant	Positive, significant	Positive, not significant?	Not clear	Not clear
Political and other risks	High	Moderate	Low	Moderate	Moderate	High	High
Notes: 1. On the basis of the available information, it is difficult to derive a ranking of project countries in terms of the relative ease with which foreign entities can enter, operate and exit from these economies. A large variety of dimensions are relevant to figure out how liberal a country is vis-à-vis its FDI related policies (see chart 2.2).							

Endnotes

1 Useful comparative insights were also drawn from the four regional seminars: Africa seminar, 18-19 October, 2002, in Nairobi, Kenya; Asia Pacific, 24-25 November, 2002, in New Delhi, India; Latin America,4-5 December, 2002, in Sao Paulo, Brazil; and Transition Economies of Central and Eastern Europe and Central Asia, 5-6 May, 2003, Istanbul, Turkey.

2 The discussion in this section draws heavily from UNCTAD (1998).

3 One can argue that location specific conditions also influence market imperfections and therefore cost of transactions and internalisation.

4\. In other words, the choice of the sector was based on available information, an interactive process between CUTS and the country team, as well as perceptions of the country experts.

5 Provides details of the model and discusses the estimation results.

6 The figures according to the UNCTC /UNCTAD based on OECD and other survey data that go beyond the balance of payments flow data used in this analyses, show much higher inflows.

7 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 a state sanctioned capital flight. Some estimates reported in the country paper suggest that since 1997 about R 17.4 bn have left the country.

Bibliography

Aliber, R Z (1993), *The Multinational Paradigm*, Cambridge, Massachusetts, The MIT Press.

Anon (2001), "A Review of Macroeconomic Scenario, Investment Policies and Regulatory Framework in Bangladesh", Centre for Policy Dialogue and Bangladesh Enterprise Institute, Dhaka.

Julie A; Dhawan, Sonali; Bagri, Uttam; Gupta, Vivek; (1998), "FDI Flows in Asia", Term paper, Course on Multinationals in the International Economy Indian Institute of Management Ahmedabad.

United Nations Conference on Trade and Development (UNCTAD) (1998), *World Investment Report 1998: Trends and Determinants*, United Nations.

UNCTAD (1993), *Explaining and Forecasting Regional Flows of Foreign Direct Investment*, United Nations.

Various Country Reports produced under the *Investment for Development* project by Consumer Unity & Trust Society (CUTS). www.cuts.org/ifd-indx.htm

ISBN 81-8257-016-6

कट्स CUTS

CUTS Centre for Competition, Investment & Economic Regulation
D-217, Bhaskar Marg, Bani Park, Jaipur 302 016, India
Ph: 91-141-2207482, Fax: 91-141-2207486
Email: c-cier@cuts.org, Website: www.cuts.org