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Investment Facilitation and Regulation in Developing Countries

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In today's world, even those living in the remotest corners of the globe, palpably feel the irreversible impacts of globalisation – both negative and positive. This fact poses numerous challenges for policymakers at all levels across countries, more particularly in the developing world. One of these challenges stems from a widespread concern that governments open up and adopt more market-friendly policy regimes and seek more actively to attract foreign direct investment (FDI). FDI is, therefore, seen as a vital source of finance and an 'engine of growth'.

Developing countries, therefore, seek FDI for the perceived benefits of backward and forward linkages, technology and skills, integration into international marketing, distribution and production networks as well as supplementing national savings. The broad policy objectives of developing countries while seeking FDI are to maximise the potential benefits and minimise the negative effects, e.g., balance of payments problems, crowding out of domestic industry, transfer pricing, abuse of market power, labour issues and environmental effects.

This paper examines the various steps developing countries initiate to facilitate benefit-maximising FDI and regulations they put in place and analyses how effective such measures have been. The paper draws, among others, from the Investment for Development (IFD) project implemented by CUTS during 2001-2003 in seven select developing countries representing diverse geographical, political, social and economic backgrounds.

Introduction

Most countries have been liberalising their policy regimes governing FDI to attract inflows. However, to make investment development-friendly, there is need for a good understanding on the policies and practices that facilitate FDI investment as well regulate them to promote development. At the outset, it would be useful to identify the key drivers of investment.

Key Drivers of Investment

Broadly, three types of investment drivers or motives have been identified:

a) Market seeking: Such investments are attracted by potential sales in host country markets. Markets that are large, growing and have the potential to access regional markets would be the most attractive.
b) Resource/asset seeking: Availability and cost of accessing raw material, other special assets and skilled and unskilled labour would be critical for making investment profitable.
c) Efficiency seeking: Efficiencies arising out of externalities, such as cost of labour, infrastructure, etc., are the key variables. Externalities or spillover benefits could be derived through regional economic arrangements (including clusters) that give rise to economies of scale and scope.

Potential Benefits

It is widely recognised now that FDI can bring huge benefits, especially to developing countries. However, these potential benefits are two-sided (box 1). Effective utilisation of FDI should comprise maximisation of its benefits and minimisation of its costs. 'Good' government regulation has an extremely important role in ensuring the effective utilisation of FDI. Developing country governments are engaged in facilitation of investment through initiation of various measures. Sometimes, specific regulations are brought into play to restrict or keep out investment from perceived sensitive sectors.

Investment Facilitation Measures

Over the past decade, developing countries have increasingly opened up their economies to FDI. Of the changes made in FDI policy in recent years, practically all have been in the direction of liberalisation (table 1).

Liberalisation: The first steps governments take when trying to create a more positive FDI regime is to liberalise FDI-specific investment laws, particularly:

- restrictions on sectors for FDI;
- restrictions on the value of the FDI;
- restrictions on the level of ownership that may be acquired;
- compulsory joint ventures with local firms;
- controls on repatriation of profits;
- export requirements;
- import restrictions; and
- local content requirements.

The last three in the above list were outlawed by the Trade Related Investment Measures (TRIMs) Agreement at the World Trade Organisation (WTO). Developing countries were given until 2002 to comply with this agreement while least developed countries (LDCs) were given extra five years for implementation. Discussions are, however, on to extend the transition period especially for LDCs. It may, however, be noted

Box 1: Potential Outcomes of FDI	
Benefits to the Host Country	**Areas of Caution**
Capital formation • FDI brings in financial capital, which is scarce in developing countries. It has the potential to add to the productive capacity or capital formation of the host country.	• FDI might not contribute to capital formation when it does not involve creation of new units, e.g., investment that comes in the form of mergers & acquisition (M&A) as against greenfield investments. • Repatriation of profits could lead to withdrawal of capital.
Balance of payments • Larger investments in the export sector can improve the current account balance and hence overall balance of payments.	• Increase in imports of inputs, remittances of royalties/ dividends abroad by subsidiaries could have a negative impact.
Growth in net domestic savings and investment • Investment can encourage setting up of new enterprises in the host country. • Foreign businesses can increase demand for domestically produced inputs. Domestic units can also be set up for processing of semi-finished products, retailing, marketing, etc.	• Foreign companies often form monopolies in the domestic market. Due to their sheer size, good quality and low cost products, they might drive out small-scale firms. • Long-drawn procedures, lack of infrastructure, etc., sometimes results in withdrawal of investments.
Transfer of technology and skills • FDI brings in new varieties of capital units and better quality of factors of production including management, which improves efficiency in the host country.	• Developing countries might not have the capacity to absorb the technology. For example, poor infrastructure, low level of education, rigidities in labour legislation and other regulations are obstacles in the Indian economy. • Some technologies may not be suitable for conditions of the host country.
Generation of employment • Investment in new sectors, setting up and expansion of business can lead to increased employment opportunities.	• Job creation may remain confined to in existing well-developed urban sectors where levels of education, training and infrastructure are high. • Small scale and rural businesses have a low capacity to attract FDI and could be left out or even forced out of business due to lack of financial resources or be compelled to use informal sources of financing.
Environmental benefits • Transnational corporations often develop environment-friendly technologies at lower costs and can induce local firms to adopt good environmental practices.	• Investors could take advantage of weak environmental legislation in developing countries, by using technologies that are cheap but harmful to the environment.
Stability in foreign inflow of funds • As compared to other international flows, FDI is stable and has the potential of ensuring a stable flow of funds to developing countries.	• Given the capacities and constraints of developing countries, free capital movements make them more vulnerable to both external and internal shocks. • Developing countries' dependence on foreign finance to cover their current account deficits also makes them financially vulnerable.
Higher export growth • If the motive of the foreign investor is to tap the export market of the host country, then it could lead to higher export growth.	• If FDI is aimed at capturing the domestic market, then it will not have much impact on the growth of exports. • Licensing conditions in the host country may restrict exports to some or all foreign markets.
Access to international markets • FDI can improve the competitive efficiency of domestic exports and hence improve market access. • International production networks offer market access to end products in any economy.	• If FDI is aimed at domestic markets only, it might not contribute to greater market access.
Source: CUTS, ABC of FDI	

that LDCs are not enthusiastic users of TRIMs. Many countries have already met their TRIMs requirements and have liberalised the other investment-attracting policies mentioned above. Exceptions, however, still remain. For example, China maintains restrictions on the level of foreign ownership and compulsory joint ventures in some sectors.

These first measures in liberalisation did not lead to increased investment flows to developing countries, which, on the contrary, declined. This has been due to:

- liberalisation taking place only on paper, not in practice; and
- the investment environment remaining unattractive to foreign investors.

In order to address these problems, developing countries then launched policies to facilitate investments.

Reducing burdensome regulation: Foreign investors were generally expected to go through a lengthy approval process with a national investment authority or agency and then acquire numerous licences or approvals with the sectoral ministries/ departments, including environmental and planning agencies. The process was costly in time and effort, where bureaucratic inefficiency required repeated trips to different offices and was exacerbated by the degree of discretion that could be exercised by officials. This increased the scope for corruption and arbitrary decision-making by officials. Developing countries streamlined the approval process whereby companies, seeking to set up new business, expand, rehabilitate or modernise, are facilitated as a 'single-window' clearance.

Table 1: Changes in National Regulations of FDI, 1992-2003

Year	1992	1993	1994	1995	1996	1997	1998	1999	2000	2001	2002	2003
Number of countries that introduced changes in their investment policies	43	57	49	64	65	76	60	63	69	71	70	82
Number of regulatory changes *Of which*	79	102	110	112	114	151	145	140	150	208	248	244
More favourable to FDI*	79	101	108	106	98	135	136	131	147	194	236	220
Less favourable to FDI**	-	1	2	6	16	16	9	9	3	14	12	24

Source: UNCTAD, World Investment Report, 2003

* Including liberalising changes or changes aimed at strengthening market functioning, as well as increased incentives

** Including changes aimed at increasing control as well as reducing incentives

Promotion: Investment agencies have proliferated at the national and regional level as developing countries recognised that to attract investment, marketing is necessary. Investors are not perfectly informed or fully rational in their decision-making. They are influenced by the stories reported in the media and may not have any knowledge about some countries at all, let alone being aware of the investment opportunities there. Investment Promotion Agencies, therefore, have a vital role to play in creating awareness about a particular investment destination by advertising in the media, targeting investors to a destination, holding promotional events in other countries, etc.

Investment incentives: These incentives take a variety of forms. Tax breaks are the most common form of incentives. Many countries offer duty-free access to imports and tax holidays or reduced rates of corporation tax to investors, often confined to a distinct geographical area *inter alia,* known as Export Processing Zones (EPZs). There may also be exemptions from different local taxes.

Lowering standards: Lowering labour and environmental standards to attract investments are sometimes resorted to by developing countries as an incentive to attract investments, as developed countries maintain more rigorous standards. This, then, serves as a bargaining chip used by investors. One example is the pressure exerted on the Malaysian Government by foreign investors in the electronics sector to change a law so that employees did not have the right to organise. Sri Lankan competition law has been diluted to exclude merger review provisions, presumably under pressure from the US, so that foreign investors find it easier to acquire local firms.

Guaranteed rate of return: Another investment incentive is guaranteeing rates of return to investors in large-scale infrastructure projects. A good recent example is Enron's investment in the Dabhol Power Company in Maharashtra, India. Even the World Bank had criticised this. Everybody is now aware how the government, the public as well as the investor lost out.

Changing the Risk-Reward Ratio

The above measures do not change the fundamental characteristics of a country as a destination for investment. There is no evidence that all these incentives are effective. They do not show up as significant in studies and investor surveys rarely identify them as important factors influencing decisions. These kinds of incentives are more relevant to an investor choosing from among the states within the same country that have primarily identical economic characteristics than an investor looking at the heterogeneous developing world.

In order to change the risk-reward ratio that investors use while considering FDI, countries have to change fundamental institutional and economic characteristics. The agenda is vast and would take time to legislate and implement. Some prominent ones are discussed below.

Political stability: This is perceived to be the key to ensuring investor confidence. Investors need to be reassured of the government's commitment to the role of private sector in the economy more than just the fear of expropriation of property. However, in many countries, investors have taken advantage of political instability as well.

Transparency and corruption: Corruption is identified in many investor surveys as a significant factor in discouraging investors, both foreign and domestic. Corruption has driven out investors, for example, in India, WorldTel withdrew after a few months from a joint venture with Reliance Industries for setting up of Community Internet Centres in favour of another better opportunity.

Property rights: The protection of property rights is important to attract FDI. Most countries, however, recognise this and chances of expropriation without adequate compensation in any country is almost non-existent.

Macroeconomic stability: A sound macro economic environment is more conducive to both foreign and domestic investment, as the risks are lower.

Box 2: Some Recent FDI Facilitation and Regulatory Measures

- Algeria, Benin, Botswana, Lesotho and Zambia are in the process of undertaking Investment Policy Reviews (IPRs) with a view to improving their investment climate.
- United Nations Conference on Trade and Development's (UNCTAD's) Programme on Good Governance on Investment Promotion and Facilitation (GGIP) assists LDCs in identifying governance-related obstacles to foreign investment and in introducing instruments and practices that promote accountability, participation, predictability and transparency in successive stages of the investment process.
- China opened its finance and travel industries to foreign investment and allowed for the first time, the establishment of educational institutions jointly with domestic investors or institutions in addition to cancelling investment approval requirements for 789 items.
- The Board of Investments in Philippines has set up three separate investment marketing desks, namely, American, European and Asian, to assist foreign investors.
- Sierra Leone issued a petroleum law offering foreign and domestic investors generous fiscal terms: a 30 percent income tax and a 6.5 percent offshore royalty.
- 2005 World Association of Investment Promotion Agencies (WAIPA) award for the best electronic investment facilitation (best practices in e-opportunity) was taken by ProInversion (Private Investment Promotion Agency), Peru.
- Djibouti introduced a new law on port operations barring foreign companies from key handling and transit operations in its international port and limiting them only to undertake stevedoring and forwarding services in conjunction with Djiboutian business partners.
- The Democratic Republic of Congo adopted an investment law reinforcing its mining code and abolishing the previous requirement to approve investment projects in an *ad hoc* manner.
- Regulation contained in Press Note 18 of the Indian Government prevents foreign companies in establishing a second or third direct investment in the 'same or allied' field without the express approval of the country's Foreign Investment Promotion Board (FIPB). A clincher to such approval was a 'no objection letter' by the existing Indian partner, who in many cases refused to extract greater exit value. New firms are likely to be free of this regulation.
- Ethiopia amended its investment law to allow private sector participation in all areas except electric power development and distribution, postal service delivery and transport using over 20 seater planes, which are solely reserved for the government.
- Pakistan introduced additional tax incentives for foreign investors and established the Pakistan Intellectual Property Rights Organisation.
- Vietnam established a Foreign Investment Bureau to attract FDI and revised the law on corporate income tax to create a fair and equal playing field for domestic and foreign companies.

Sources: UNCTAD, World Investment Report, 2004, www.dti.gov.ph, www.waipa.org. www.unctad.org, http://english.epochtimes.com

Skills level and education: Empirical evidence has demonstrated an extremely strong correlation between the level of education in a country and the amount of FDI it receives, besides its positive relationship to gross domestic product (GDP).

Competition Law: Competition law is a tool to regulate the entry and behaviour of powerful transnational corporations in the economy as well as a way to inspire efficiency gains in domestic production.

Sectoral policies: Improving efficiency in key services sectors has significant spillover effects on the rest of the economy. It is the services sector in which deregulation is most advanced in developing countries.

Trade policy: High tariff levels create distortions in the market and may lead to inefficiencies. Domestic firms operating behind high tariff barriers do not have incentives to raise product and production standards to international levels and the consumer looses out on price and quality.

Recommendations

Countries compete fiercely among themselves for FDI. Studies, however, indicate that incentives do not attract FDI to a country. Further, countries may end up hurting themselves by providing incentives, if the costs of facilitation are greater than benefits. Another pitfall of the FDI competition is that often FDI is wanted just for its own sake. Developing countries sometimes do not strategise effectively on the use of FDI, the sectors that should receive FDI and whether FDI fits into their overall development goal. Developing countries should take measures to improve their own investment environment before liberalising their FDI regimes to allow more foreign investors. Given below is a summary of the measures that could be taken to improve the investment climate of developing countries:

- define their own development priorities first and then make efforts to channelise FDI accordingly;
- implement safety nets for poverty reduction and income redistribution measures along with FDI liberalisation measures;
- put in place a regulatory structure to prevent any corporate malpractices;
- promote FDI with a potential of having deep linkages with the local economy;
- develop an investment environment, which ensures that benefits of FDI outweigh costs;
- be cautious not to open the economy to allow more FDI than it can absorb;
- disseminate information and build the capacity of its citizens on the various aspects of FDI and development; and
- conduct research and outline a clear country position on FDI before committing to any multilateral agreement on investment.

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