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Investment Policies that *Really* Attract FDI

Introduction

Foreign direct investment (FDI) leads to economic growth, and economic growth leads to poverty reduction: this line of reasoning forms the foundation of contemporary thinking about FDI.

FDI may be beneficial to the economy, but FDI flows may be very different in qualitative terms. Governments therefore face a two-fold challenge: to attract FDI and to secure benefits from these flows. There is a degree of overlap, as well as potential contradictions, between these policies. However, this paper focuses on the first challenge, i.e. how countries can really attract investment.

The first challenge has not been met in large parts of the world. The vast majority of FDI is still focused in ten developing countries which have remained much the same over the last decade.

A vast majority of countries do not even appear on the investor's map. Part of the explanation for this may be that the returns to be made in these countries are too low to be of any interest to investors. More likely, the perceived risks of investing in these countries are too high to make otherwise attractive investment opportunities worthwhile.

All stakeholders have a role to play in improving the spread of FDI over the globe. Efforts by host countries need to be complemented by efforts by home countries, donors, international organisations and businesses themselves. Civil society has a role to play in calling for policies that conform to the social and historical characteristics of the country and monitoring the implementation of policies.

What motivates investors?

Investors look for profits. For this they need large and growing markets. Thus, it should not be surprising that the countries that receive the most FDI are those with large numbers of affluent consumers. This explains why developed countries receive much more than developing ones and also why China, Brazil and a small number of other countries receive the largest share of FDI going to developing countries. Small countries can expand their markets through a regional trading arrangement that allows preferential or duty free access to other countries. This can then help to attract foreign investors.

Mexico and Turkey provide an interesting comparison. They share a similar level of productive capability: both have a young, low-cost but well trained workforce. Turkey is geographically well placed at the crossroads between Asia and Europe while Mexico also falls in the middle of two continents, North and South America. The difference is in the amount of FDI that the two countries manage to attract, as is clearly demonstrated in the graph below. The key reason behind this is that Mexico has preferential access to the vast American market and it is uniquely placed to take advantage of that market. Although Turkey has tariff-free access to the European market, it competes with many other low-cost, low-wage countries to serve that market.

While they may help, regional trade agreements are not always the answer, as the case of Turkey demonstrates. This is even clearer in sub-Saharan Africa, where low-income levels throughout the region mean that free trade even across the entire continental market would not generate enough purchasing power for multinational corporations (MNCs) interested in investing.

Percentage share of the top 10 Developing Countries recipients in total FDI inflows to developing countries

1	China	19.2
2	Hong Kong, China	16.0
3	Brazil	14.4
4	Argentina	6.5
5	Mexico	5.6
6	Korea, Republic of	4.0
7	Singapore	3.1
8	Bermuda	2.8
9	Chile	2.7
10	Cayman Islands	2.4
	Top 10 Total	76.7

Source: WIR 2001

Market size is, therefore, one constraint for countries trying to attract FDI but it is not the only factor. There are significant differences across countries in the ratio between Gross Domestic Product (GDP) and FDI. China, Brazil and Malaysia for example, receive more FDI than could be expected given the size of the market, while India and South Africa receive significantly less than could be expected. Many small countries do attract considerable FDI flows. It is not just the absolute flows that are important; relative figures such as FDI as a percentage of GDP, FDI as a percentage of world FDI are also important.

1998-2000	Share in World FDI/ Share in World GDP
China	1.3
Brazil	1.2
Malaysia	1.6
India	0.2
South Africa	0.2
Source: WIR, 2001	

In the following section, we look in more detail at the policies that are effective in attracting FDI and generating growth as a result. These policies may be divided into three 'generations': a first generation of liberalisation of investment policy, a second generation of promotion and facilitation, and a third generation of policies to enhance the investment environment[1].

First Generation: Liberalisation

The first step governments make when trying to create a more positive FDI regime is to liberalise FDI-specific investment laws. In the past, countries have imposed all sorts of restrictions on FDI, e.g.:

- Restrictions on sectors in which FDI can be made;
- 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 list were outlawed by the (TRIMs) Trade Related Investment Measures Agreement at the WTO. Developing countries were given until 2002 to comply with this agreement while least developed countries were given extra five years for implementation. Many countries have already met their TRIMs requirements and have unilaterally liberalised the other investment policies mentioned above. Exceptions remain: China maintains restrictions on the level of foreign ownership and imposes compulsory joint ventures in some sectors. India still imposes local content requirements and dividend balancing requirements for some investments.

Liberalisation of the investment regime has not led to increased flows of FDI to developing countries. On the contrary, the proportion of FDI flows to developing countries in recent years has declined. There are two broad sets of reasons for this disappointment:

- Liberalisation has taken place broadly on paper but not in practice; and
- The investment environment remains unattractive to foreign investors.

In order to tackle these problems, countries have launched policies to promote and facilitate investments.

Second Generation: Facilitation and Promotion

1. Reducing Burdensome Regulation: Foreign investors are generally required to go through a lengthy approval process with a national investment authority or agency and then acquire numerous licences or approvals with the relevant sectoral ministries, and environmental and planning agencies. This process was costly in time and effort, especially 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. Some efforts have been made to tackle this. Box I looks at the example of Zambia which has recently attempted to streamline its approval process.

The example in Box I does not imply that approval process in Zambia is now completely streamlined to reduce procedural and bureaucratic hurdles.

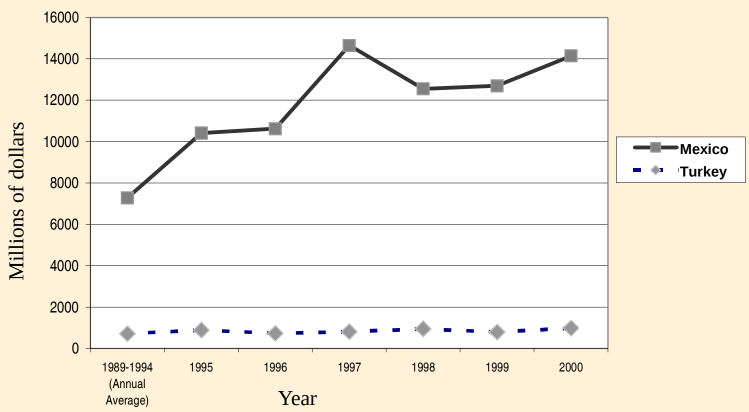
2. Promotion: Investment agencies at the national and regional levels have proliferated recently as officials have recognised that attracting investment to a country or area needs to be approached as a product to be marketed. Investors are not perfectly informed or fully rational in their decision-making. 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 (IPAs), therefore, have a vital role to play in creating awareness about a particular investment destination. There are numerous marketing strategies that IPAs can employ such as advertising in the media, targeting investors to invite to the destination, holding promotional events in other countries.

3. Investment Incentives: Investment incentives take a variety of forms. There are positive financial incentives that developed countries generally offer such as payments for each job created, access to cheap finance, loan guarantees, and subsidised utilities. The double impact of extra spending and tax revenue foregone puts a great strain on government budgets and may not be feasible in many developing countries which are under pressure to close budget deficits.

In the national interest, federal governments should restrain states and other lower levels of government from engaging in bidding wars to attract investment. At the international level, governments, motivated by the same national interest, are finding it difficult to show the same restraint that they would like states and localities to

FDI inflows to Mexico and Turkey between 1989-2000



Source: WIR, 2001

have at home. The winners in these bidding wars are the corporations.

There is no evidence that all these incentives are effective. They do not show up as being significant in studies and investor surveys rarely identify them as an important factor in influencing their decisions. These kinds of incentives are more relevant to an investor picking between states within the same country that have essentially identical economic characteristics than an investor looking at the heterogeneous developing world.

Tax breaks are the most common form of incentives. Many countries offer duty free access to imports of inputs, and tax holidays or reduced rates of corporation tax to investors, often confined to a distinct geographical area known as an EPZ (Export Processing Zone). There may also be exemptions from different kinds of local taxes where the local government is defining investment policy.

A third type of 'incentive' is lowering labour and environmental standards. This might look like a cheap way to attract investment in the short-run, but may be costly in the long-run in terms of lost development potential. Again, there is no evidence to suggest that lowering standards is an effective way to attract investment.

On the contrary, developed countries, which on the whole maintain more rigorous standards, get more investment than developing countries. They may become relevant as a bargaining chip to be used by investors who have already decided on their investment location.

One example is the heavy pressure exerted on the Malaysian government by foreign investors in the electronics sector to a proposed change in a law under which employees did not have the right to organise in the sector. In 1998, the government tried to change this law so that workers would be able to form and join unions, but they eventually succumbed to lobbying by the powerful TNCs and the law remained unchanged.

Probably, the most damaging and least successful of the incentives are the guaranteed rates of return that were offered to investors in some large-scale infrastructure projects. These distorted the incentives for investors who over-invested in physical capital. Governments, investors and the public all lost out when governments were unable to meet their obligations. One well known example is Enron's investment in the Dabhol Power Company in Maharashtra, India.

Third Generation Policies

The First and Second Generation Policies outlined above do not change the fundamental characteristics of a country as a destination for investment. Liberalising FDI policy just means allowing in investors who are already interested. Turning approved investments into realised investments again only addresses investors who have already made up their minds. Thus, it is not surprising that the implementation of these policies has not led to a significant increase in the amount of FDI flowing to developing countries.

In order to change the risk-reward ratio that investors use when considering FDI, countries have to change fundamental institutional and economic characteristics. The agenda is vast, and will take time to legislate, let alone to implement. The policies outlined below are just a few of the more prominent ones.

Governments will face another problem: sustaining the momentum for reform in the face of opposition from domestic stakeholder groups. These include employees who fear the job losses that often follow the acquisition of a domestic firm by a foreign firm, domestic producers are afraid that competition from MNCs will put them out of business, etc. In some cases, these concerns are justified and safety nets for FDI's "losers" also have to be put in place.

Changing the Risk Side of the Equation

Political Stability: This is perceived to be the key to ensuring investor confidence but there is evidence to the contrary as well. In many countries, investors have taken advantage of existing political instability. Of course, politics is an extremely sensitive subject and any perceived interference by outsiders in the political system will be treated with hostility. The suspected involvement of an MNC in the coup in Chile in 1978 sparked off a series of attempts to draw up binding multilateral guidelines for Transnational Corporations (TNCs) at the UN.

Attention to the political scene does not mean that developing countries should be influenced by multinationals politically. Investors need to be reassured of the government's commitment to the role of the private sector in the economy. This amounts to more than just the fear of expropriation of property.

Concern over expropriation was at its height in the 1970s after the spate of nationalisation that took place across the developing world at the time but there have only been a handful of expropriation cases worldwide in the last decade. Investor demands for protection and compensation for expropriation have now by and large been met in Bilateral Investment Treaties and key capital exporting countries have now signed these Bilateral Investment Treaties (BITs) with the main destination countries.

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 many investors, for example in India, where WorldTel withdrew after a few months from a joint venture with Reliance Industries for setting up of Community Internet Centres.

Corruption not only discourages investors from entering the market, it also means that investments may be channelled into monopolistic sectors where both the firm and public officials have a chance to earn rents at the expense of the consumer and the economy as a whole. A policy commitment to attract FDI may even motivate governments to tackle endemic corruption, with positive effects on the economy as a whole.

Discretion in investment policy should be minimised. Fixed criteria should be used for any approval process, particularly for large infrastructure projects and utility service providers. If officials do not have the power to take discretionary decisions, the potential for corruption is reduced.

Box I: Streamlining the Approval Process in Zambia

Companies seeking to obtain Investment Certificates to set up new businesses, expand, rehabilitate or modernise existing enterprises in Zambia are requested to complete a standard application form and submit it to the Investment Centre once the following requirements are met including payment of US$250 +Value Added Tax (VAT) at 17.5 percent Processing Fee.

The Projects Approval Committee of the Investment Board meets every month to consider applications for Investment Certificates. It is required that promoters submit sufficient detailed information to enable the Investment Centre to form an informed opinion on the project. The applications should be submitted at least a week before the consideration date. This is to enable the Centre evaluate the investment proposal before presenting it to the Board for consideration. Once an application has been approved a Certificate Fee of US$1500 +VAT is charged before collection of the Investment Certificate.

Property Rights: The protection of property rights is important to attract FDI. According to Hernando de Soto, author of *"The Mystery of Capital"*, there are $245bn worth of assets in Egypt, and $315bn in Mexico that could be turned into working capital if they were given legal title. There are probably similar assets without legal title in other developing countries.

Macroeconomic Stability: High inflation, exchange rate fluctuations, etc. can be hedged against using a variety of financial instruments. However, a sound macro environment is more conducive to both domestic and foreign investment as the risks are lower.

Changing the Return Side of the Equation

On the positive side, again, the policies that would attract investors are also policies that benefit the economy generally. Some policies remain highly controversial, in particular the liberalisation of key public services like health and education. In developing countries, these are desperately in need of finance, which has raised the question of whether private sector funds can be leveraged through public-private partnerships.

Developed countries have very mixed experience with the success of involving the private sector and are not themselves fully committed to private sector involvement. Empirical evidence is inconclusive. At the theoretical level, it is also ambiguous as to whether an incentive structure could be designed that would make corporate pressures and social objectives coincide. It would be dangerous and harmful for developing countries to become an experimental ground for untested policies.

Skill Levels/Education: Empirical evidence from numerous studies has demonstrated an extremely strong correlation between the level of education in a country and the amount of FDI that it receives. There is also, of course, a positive relationship between education and GDP. To some extent, it may be that higher income levels lead to education being provided to a larger proportion of the population. However, there would seem to be a clear policy lesson: governments can move into a rising spiral of growth and a rising stock of physical capital by raising the level of human capital.

Competition Policy: Implementation of a competition policy benefits both investors and consumers. Competition policy should be seen as a tool to regulate the entry and behaviour of powerful multinationals in the economy as well as a way to inspire efficiency gains in domestic production.

Sectoral Policies: Improving efficiency in key service sectors has significant spillover effects on the rest of the economy. The financial sector provides the clearest example. It is also the service sector in which liberalisation is most advanced in developing countries. Improving the efficiency of the banking sector should encourage domestic investment by making capital easier and cheaper to access as foreign banks have a diversified global risk portfolio. Evidence from a recent International Monetary Fund (IMF) survey suggests that foreign participation does raise the efficiency of the financial sector. The same survey demonstrates that foreign presence also contributed to the stability of the financial sector and its ability to recover from shocks[2].

Trade Policy: High tariff levels create distortions in the market and may lead to inefficiencies. The following example, one among many, illustrates this: Chile tried to encourage investment in the Tierra del Fuego region by creating a free trade zone there, while the rest of the country maintained high tariffs on electronic goods. This led to a situation in which fully assembled Japanese video recorders were being shipped to Panama where they were disassembled, brought to Tierra del Fuego, reassembled and then imported into Chile - a huge deadweight loss to the economy.

High rates of protection are justified by governments on the grounds that they allow domestic industries to build up the capacity to compete in world markets. Unfortunately, the experience in most countries is that domestic firms operating behind high tariff barriers do not have the right incentives to raise product and production standards to world levels, and so the domestic consumer loses out in terms of price and quality. As producers are consumers too, domestic industry also suffers. The use of targeted industrial policies would seem to require strong government institutions that can provide the necessary incentives for firms to export.

Conclusion

Countries and regions often see the challenge to attract FDI as a competition with other destinations. But it is not the case that investors have a limited pot of money which is fully invested and one country's gain is, therefore, at the expense of another. On the contrary, investors are looking out for more profitable opportunities. Improvements in the investment climate across countries will mean an increase in total global FDI flows.

On the other hand, the resources needed to make changes in the investment environment are huge. If attracting investors was just a matter of having an Investment Promotion Agency, countries could achieve this in a single step. In reality though, policy changes are needed across the board in all the areas identified above: political, legal and macroeconomic stability, education, competition, trade and industrial policies and probably many others. Developing country governments do not generally have the resources or the capacity to carry out these policy changes and require enhanced support from the international donor community to do so.

Home country governments, corporates, intergovernmental organisations and civil society share the responsibility with host country governments to delineate and implement these changes. Furthermore, all these stakeholders should be concerned with the implementation of laws. State-of-the-art legislation which has no hope of being implemented wastes time and resources of the already overburdened legislative systems of developing countries. Thus, time and effort should be spent on developing domestic constituencies in support of policies to strengthen the investment environment and ensure that good policies operate effectively.

Endnotes

1. Karl Sauvant, "Recent FDI trends, implications for developing countries and policy challenges", paper presented to the OECD Global Forum on International Investment, November, 2001
2. Jorge Roldos, 2001, IMF

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