5

Policy Needs for Attracting FDI

5.1 Introduction

This chapter deals with the various policy needs for attracting FDI. Perhaps the most crucial one is political stability, since without a minimal level of stability and predictability in the political sphere no investor would set up facilities that have to yield their returns over the long term. However, this need not be dealt with in this study, which is mainly concerned with the economic aspects of FDI. In addition to basic stability, there is a need for a welcoming regime for FDI in particular. The need to offer stable, transparent and non-discriminatory regimes for foreign investors is universally acknowledged. [32] Both these factors are so evident that they need not be analysed at great length here. In addition, another paper for the Commonwealth Secretariat will discuss in detail the promotional aspects of FDI policy. Nevertheless, it may be useful in this context to remark on the need for efficient FDI promotion policies. Investment promotion can be an expensive proposition. Different countries show widely different degrees of success with their promotion policies. A study published by the IFC discusses how investment promotion can be done efficiently, and recommends carefully crafted and targeted strategies to attract the right kind of investor to the right kind of activities without giving excessive subsidies or mounting very expensive advertising campaigns.[33]

Many developing countries have tried to attract FDI in the past by giving large investment incentives: tax concessions or holidays or subsidising investments. Substantial econometric and firm-level research suggests, however, that the real impact of such incentives on long-term investments is negligible. Serious investors pay more attention to the underlying long-term economic situation rather than to tax concessions that run out in a relatively short time.[34] The best tax regime to attract FDI is one that offers relatively low and stable overall corporate tax rates in a context in which private investment is welcomed and facilitated, rather than one in which there are many special or discretionary concessions offered to particular investors. In other words, the real effective tax rate should be competitive, predictable and transparent, and deviations from it should be kept to a minimum to ensure that resource allocation is not distorted. It is always tempting for a particular country to offer higher incentives in order to improve its relative position vis-á-vis countries with similar economic conditions (and MNEs will not ignore a concession that is on offer). For this reason, it is tempting for their competitors to offer similar concessions. This does not raise the overall level of FDI inflows but merely imposes a large cost to the treasuries of the host economies. The only solution is to evolve regional co-operation in the design of tax incentives, while offering attractive effective tax regimes.

While the best way to ensure efficient allocation of FDI is to have the right policy framework which gives efficient signals to investors, there may be a case for targeting or promoting foreign entry into specific sectors or activities. These may offer special spillover or dynamic benefits to host countries, in terms of creating employment, transferring crucial technologies, diffusing skills or raising exports, and may not attract sufficient investment interest in the absence of special measures. Targeting economies on promotion resources and enables host countries to extract most from MNEs in terms of the special technological and other advantages that they offer. However, effective targeting requires high quality manpower in the promotion agencies and appropriate supply-side policies to ensure that the targeted investors can be attracted. As with all instruments of selective intervention, it should be handled carefully and with proper monitoring and safeguards.

5.2 Macroeconomic Policies and Privatisation

Stable and conducive macroeconomic policies are as important for attracting FDI as for ensuring healthy overall development. A relatively well-managed macro economy, with realistic exchange and interest rates, low rates of inflation and manageable external debt inspires confidence that productive investments will be able to operate properly and yield due rewards. For foreign investors particularly important are policies on the repatriation of profits and capital for foreign investors, and access to foreign exchange for the import of intermediates, raw materials and technology. Even though some high inflation countries (like Brazil) have attracted substantial FDI in the past, they also offered substantial natural resources, large markets and good growth prospects. This combination is now rare. Countries with unstable macro-policies carry risks of recession and balance-of-payments restrictions, and in a world of intensifying competition for FDI may lose investments to other countries.

One specific policy that is directly relevant to attracting FDI is the use of debt-equity swaps by heavily indebted countries, often linked to privatisation programmes. In the late 1980s such swaps were a major factor in explaining FDI in Latin America, accounting for as much as 80% of inflows in Chile in 1985-89, nearly 60% in Brazil and Venezuela, and between 20-30% in Mexico and Argentina. The privatisation of over 400 medium- and large-sized state-owned enterprises in developing countries in the period 1988-92 has generated over US $49 billion in sales, usually distributed among small or medium transactions. Privatisation accounted for about 7 percent of total FDI inflows over the same period, with marked regional variations. As Miller and Sumlinski (1994) note,

> *"During 1988-92, foreign sources provided about $18.5 billion, or 30 percent of total privatisation financing during this period. Of this amount, more than a quarter went to various Eastern European countries... However, owing to its much greater importance in overall privatisation activity, Latin America also attracted the most foreign funding, amounting to nearly two-thirds of the total... Privatisations also accounted for a substantial proportion of total FDI during this period, more than 10 percent. This figure varied considerably across regions, however, being much more important in Europe and Latin America than in other areas... In East Asia, FDI flows overall were so large that financing for privatisations, although significant, pale by comparison."* (p. 9).

Privatisation involving multinational enterprises has tended to concentrate in large scale industries, and increasingly in services, such as public utilities and banking. Among the latter, the incidence of privatisation has probably been greatest in telecommunications. In the Commonwealth area, countries with foreign equity ownership in privatised telecommunication firms include Malaysia, Pakistan, Solomon Islands and Vanuatu in Asia, Barbados, Belize, Guyana, Jamaica, St. Kitts and Nevis, and Trinidad and Tobago in the Caribbean, and Nigeria, Sierra Leone and Togo in Africa.

Privatisation programmes have been particularly successful in attracting investment flows in Latin America and the Caribbean, where the public sector had traditionally played a larger role in the economy. During the period 1990-91, the share of privatisation in total FDI inflows was 75 percent in Venezuela, 54 percent in Argentina, and 17 percent in Mexico.[35] In the Commonwealth area, Jamaica undertook a massive privatisation of some 90 percent of its state-owned enterprises, of which almost one quarter involved foreign participation; it is estimated that this programme accounted for about 40 percent of new FDI inflows to Jamaica during 1987-90.[36]

Privatisations have allowed MNEs to expand their activities in the region to sectors where their presence had previously been insignificant, such as in telecommunications and aviation. Multi-national enterprises from developing countries as well have in some cases taken part in privatisations, notably those carried out in other developing economies. Examples are the participation of Chilean firms in the privatisation of major companies in Argentina since 1991, and India's investment in Mexico.[37] The amount of FDI generated by privatisations is shown in Table 3.

In Africa, privatisation is on the policy agenda of many countries, but only a few, such as Ghana, Madagascar and Senegal, have made significant progress in this direction. A major reason for this has been the lack of a realistic assessment of the requirements needed to carry out a successful privatisation – sufficient financial and human resources, developed capital markets,[38] viable public enterprises, transparency of the process, and policy initiatives in promoting private investment. Progress has been faster in South and East Asia, though the mature stage of

Table 3: **FDI in Privatisation, 1988-92**
(US $ millions and % of total FDI)

Region	**1988**	**1989**	**1990**	**1991**	**1992**	**1988-92**
North Africa and Middle East						
FDI from privatisation	—	1	—	3	22	27
Share of FDI	—	0.1	—	0.5	1.0	0.4
Sub-Saharan Africa						
FDI from privatisation	—	14	38	3	44	99
Share of FDI	—	0.6	6.0	0.2	3.0	1.0
East Asia and the Pacific						
FDI from privatisation	—	—	—	75	302	377
Share of FDI	—	—	—	0.6	2.0	0.7
South Asia						
FDI from privatisation	—	0.1	11	4	37	52
Share of FDI	—	0.0	4.0	1.0	9.0	3.0
L. America and Caribbean						
FDI from privatisation	214	157	2,136	3,300	2,312	8,199
Share of FDI	3.0	2.0	28.0	26.0	17.0	16.0
All developing regions						
FDI from privatisation	214	172	2,185	3,385	2,717	8,673
Share of FDI	1.0	1.0	10.0	11.0	7.0	7.0
Memo item:						
Central and Eastern Europe	—	422	489	1,017	2,411	5,238
FDI from privatisation	—	39.0	34.0	51.0	41.0	43
Share of FDI						

Source: UNCTAD (1994.a)

privatising has yet to occur. Pakistan, for example, launched a massive privatisation program involving state disinvestment in banking, power generation, telecommunications and railways. Major sources of FDI were developed country MNEs, with some investment coming from Saudi Arabian and Korean investors.

In East Asia, Malaysia has led the trend, with the privatisation of the national air carrier, a shipping line, telecommunications and electricity. The sale of government assets has mainly taken place through the local stock exchange, and has involved a number of foreign multinational enterprises, although the country has statutory limitations on the share of foreign ownership of privatised assets.[39] The Philippines showed a slower progress towards state-divestiture, but a significant degree of foreign participation; it is estimated that for the period 1987-90 foreign inflows for privatisation accounted for nearly one third of total private foreign capital inflows.[40] This is by its nature a one-shot measure, and its significance to Commonwealth countries has been limited. Moreover, with increasing adjustment in developing countries in the 1990s, and the return of the debt problem into manageable proportions, the swaps lost part of their attractiveness, though it remained an important privatisation modality in some countries, particularly Brazil and Chile. The privatisation of infrastructure and related flows of FDI into BOO/BOT schemes is of growing importance in many developing countries, as noted earlier; this is taken up later.

5.3 Policies Towards the Private Sector

The most important signals that a host government can give to prospective investors is that the country welcomes private enterprise in general. These policies include general openness to market forces and the private sector, and the rapid and efficient implementation of the 'rules of the game' (legal and accounting frameworks) that govern market transactions. They may also include more specific policies to support the private sector and strengthen the supply side of private enterprises (by such measures as improving the financial system, skill base and information and technology institutions).

In general, economies that provide market-oriented environments for the private sector as a whole, with liberal conditions for entry, growth and exit, and set clear, transparent and stable

Box 2: Domestic Private and Foreign Investment

A recent report by the IFC on trends in private investment in developing countries notes that "FDI providers look for many of the same factors that influence domestic private investors."[41] It goes on to compare total private investment with FDI for 118 countries, and finds that there is a significant and positive statistical correlation between the two, suggesting that "when the investment climate is positive, both domestic and foreign investors are likely to respond." There is thus a strong complementarity between the two, and promoting local private enterprise can attract foreign investment. Given the similarity of reactions between local and foreign private investors, the attraction of FDI requires that policies be non-discriminatory (by national origin).

However, the report also notes that many countries encourage one rather than the other. In these cases the two can be substitutes for each other. This form of discrimination is increasingly uncommon, and most developing countries realise that it is not in their best economic interests to have discriminatory rules. Thus, many governments that had such policies in the past (such as Japan and Korea) have now changed their rules, partly to conform to emerging international consensus and partly to allow their own multinationals to operate more easily overseas.

rules for enterprises to follow, send positive strong signals to multinational enterprises (see Box 2). In addition, a regime that has an efficient and 'businesslike' attitude to making and implementing policies is the one most attractive to foreign as well as local firms. The economic complementarities between local and foreign firms also necessitate that both be encouraged to operate according to market forces with the minimum of government interventions in their resource allocation decisions.

5.4 Trade and Industrial Strategies

Trade and industrial strategies provide the incentive structure for manufacturing activity, and guide the allocation of resources by multinational and local enterprises. As far as trade strategies are concerned, the importance of outward oriented trade strategies is now universally accepted. There is also a consensus that they provide the best setting for multinational enterprises to operate in efficiently. While import-substitution provided the main drive to FDI in the early days of industrial development, the most sustained growth of investments in recent years has been into economies that were export-oriented. The benefits of highly interventionist, inward-oriented policies are now regarded as far outweighed by their costs to efficiency, competitiveness and dynamism. Thus, more liberal trade regimes are now accepted as the best for promoting investments, because exposure to export markets is recognised as providing the best set of signals for resource allocation and for the development of efficient practices and capabilities.

While the issue of the proper role of infant industry protection in an outward-oriented setting is still strongly debated,[42] even the proponents of industrial policy agree that the general thrust of the trade regime should be outward, and that protection should be (by the standards of 'classic' import-substitution regimes) low, very selective and limited in duration. The new GATT agreement has moved the developing world firmly towards freer trade, and the "Washington consensus" is steadily reinforcing this trend. There is thus little doubt that outward-looking policies will be the main environment for FDI policies, perhaps with a judicious role for some infant industry promotion, involving a few activities that are in the countries' future comparative advantage (which entail high 'learning' costs and create externalities, and which would not, because of the risks and costs involved, receive sufficient investment under free market conditions). The experience of the larger East Asian NIEs in attracting FDI suggests that the combination of such interventions to promote infant industries in the context of export-orientation served to attract high quality FDI in a virtuous circle of investment, growth, exports and industrial upgrading. It should also be noted that interventions to promote new activities were accompanied by a closely integrated set of measures on the supply side, to provide new skills, information and technical support, channel finance on concessional terms, and give extensive assistance with export marketing.

This sort of policy was significantly different from policy interventions in import-substituting regimes. Here protection was granted across the board and for unlimited periods, and led to widespread inefficiency. Industrial development was often spearheaded by public enterprises which lacked the human resources and autonomy to be efficient, and generally created large economic costs. Such regimes did sometimes succeed in attracting FDI, at least in the initial period, but much of the investment want into activities that were geared to small and protected domestic markets and could not become competitive in world markets.[43] The East Asian experience suggests that a very different pattern of support for private enterprise, with strong pressures to enter export markets and constantly upgrade technology and efficiency, can generate a far more desirable pattern of growth and FDI.

The scope for this sort of industrial policy is, however, much more limited now under the emerging "rules of the game". The World Trade Organisation and the multilateral institutions, and most major trading nations, would not countenance extensive protection or subsidisation that affected trade patterns. It is also very difficult to mount effective industrial policies, and there is considerable risk of 'government failure' in developing countries. Where administrative capabilities are limited and bureaucracies are not autonomous, it would be advisable to conform to liberal policies rather than to engage in the promotion of activities that will become costly drains on the economy. The growth of integrated international production also places its own limits on the exercise of industrial policy. Policies that cut off access to international markets and investment, even temporarily, may retard access to the latest technologies and so damage long-term growth prospects.

The liberalisation of trade has other advantages apart from resource allocation. It can act as a signal to the investment community of a broader process of adjustment and liberalisation towards the private sector in general. It can indicate that highly protected, inefficient activities are to be restructured or got rid of, and that resources are to move into competitive exporting or import substitution activities. It suggests that the private, including multinational, enterprises are to be accorded a freer hand in investing and operating. This seems to have been the case in Latin America. Here adjustment programmes, where accompanied by credible stabilisation of macroeconomic aggregates and by privatisation, have been successful in restoring FDI inflows. However, these flows have gone more into services and infrastructure rather than into manufacturing, reflecting the relative lag of the region's competitiveness vis a vis East and South East Asia.

In Sub-Saharan Africa, in contrast to the other regions, structural adjustment has not been able to assure the investment community of the region's attractiveness. Adjustment and stabilisation have often not been carried through fully, and implementation of reforms has been poor.[44] Deregulation has not been carried far enough, and the pace of privatisation is the slowest in the developing world. The bureaucracy retains considerable control over economic life, and there is considerable rent-seeking behaviour in many countries. The "soft infrastructure" for foreign investments – the rules of the game for foreign investors, comprising rules, regulations, accounting standards, and so on – remains unsatisfactory: this raises the costs and uncertainties of operation for MNEs relative to competing countries. In addition, political attitudes to the private sector remain ambivalent. This shows up not so much as the risk of expropriation, which is now very high and can be insured against by such agencies as MIGA, but in likely delays, constraints to growth and employment strategies and in general dealings with the government.

Even if African countries brought the rules of the game to the levels of other developing countries, there remain some structural constraints to their ability to sustain competitive investments in many manufacturing industries. These constraints assume particular importance now because of the liberal trading environment in which economic activity is to be conducted, with low levels of protection against international competition. They arise from supply side variables, in particular skill levels and weak institutional structures in many African countries,[45] exacerbated by a neglect of the physical infrastructure, which is tending to lag behind competing developing countries. Thus, despite the fact that much of Africa now offers lower wages than most developing regions, there is little movement of labour-intensive manufacturing to Sub-Saharan Africa.

The formation of regional trading blocs is often proposed as a means of, among other things, attracting FDI. Such blocs can have positive effects on the attraction of FDI to countries that do not have large domestic markets, at least as far as certain forms of investment (those not geared to serving export markets) are concerned. Apart from attracting MNEs by increasing the size of the market, regional arrangements like those being implemented in South America can allow multinationals to invest in order to rationalise existing production facilities across participating countries.[46] In fact, where domestic markets are small and fragmented by distance and poor infrastructure, regional integration may be the only way to attract domestic market-oriented investments with scale economies. This has clear significance for African countries. It must be remembered that, the whole of Sub-Saharan Africa has a market of the size of Benelux in terms of purchasing power. This is spread over enormous distances with poor interconnections in terms of transport, communication and other market links. Effective integration among groups of African countries would greatly improve their chances of securing FDI, if this were supported by improvements in physical infrastructure.

Regional blocs may have negative consequences for countries that are excluded from them. If blocs offer substantial privileges to enterprises that locate within them (say, by common tariff barriers) countries in the region that are outside the them would tend to lose FDI. This, for instance, is the risk facing countries in the Caribbean as NAFTA takes shape, and Mexico threatens to divert FDI from other developing countries in the region.

Various types of intercountry arrangements have characterised the growth of regional markets in dynamic parts of the world. Four general forms can be distinguished (in order of the degree of integration among the participants): free trade area, custom union, common market, and economic union. The major contemporary regional groupings are listed according to these categories in Appendix Table 3. Some regional arrangements, particularly the most recent ones, have been specifically designed to achieve the unification of member countries' policies towards FDI.[47] Probably the least successful efforts at economic integration have taken place in Africa and the Middle East, mainly due to wide cultural differences, and economic and political turmoil.[48] In addition, in Africa many protocols that were agreed upon to promote regional integration were not implemented, and over time non-tariff barriers have increased rather than decreased. Regional trade in Sub-Saharan Africa remains very limited, and the lack of appropriate infrastructure to permit trade and investment remains a major barrier to integration. Yet without greater integration many countries cannot offer large enough markets to attract sustained inflows of FDI.

In South East Asia, regional trade and investment have grown dynamically more as a result of income and export growth and market liberalisation rather than deliberate integration efforts. There are nevertheless several integration efforts under way. ASEAN has been going for a long time, but, because of its emphasis on planning and the public sector, has not had much tangible results. A far more ambitious effort, in the shape of the Asian Free Trade Area, is now under active consideration, and may be a reality in the next decade or two.

More limited approaches to regional integration have already been adopted in South East Asia, with the leadership role played by private enterprise. The concept of "Growth Triangles", where selected regions of neighbouring countries are formed into a quasi-union and linked by infrastructure, is catching the imagination of policy makers in South-East and East Asia. Among the main objectives of such triangles is the stimulation of FDI from participants as well as from other countries.[49] Examples are: the SIJORI Growth Triangle, set up in 1988, representing investment co-operation among Singapore, the Southern Malaysian State of Johor, and Western Indonesia's Batam Island; the Northern Growth Triangle among Northern Malaysia, Southern Thailand and Northern Sumatra in Indonesia, still in the planning stage; the Baht Zone in the border area of Thailand, Laos, Cambodia and Vietnam, also in the planning stage; the Greater South China Economic Zone which groups Hong Kong, Taiwan, parts of China and Macao, still a concept; the Yellow Sea Economic Zone including parts of China, North and South Korea, similar to the previous one.

Of these, the SIJORI growth triangle is the only one that has been going for some time.[50] It has been successful in attracting FDI in significant amounts to the Indonesia part of the triangle. The driving force has been Singapore, established reputation with the international investment community, superb infrastructure, and its pressing need for lower cost land and labour. Singapore firms have themselves invested in the less developed parts of the triangle, while a number of other investors have been attracted to those areas because of their connections with Singapore.[51] Significant FDI has also gone into Johor in Malaysia, but this was growing in any case and it is difficult to attribute it to the formation of the triangle.

Industrial policies are also important in attracting FDI. Most of the elements of industrial policy have already been noted earlier: entry, exit and growth policies, ownership requirements, labour market policies, technology support, and so on. In general, moves to market-oriented, liberal and non-discriminatory policies are associated with greater FDI inflows. However, this does not obviate the need for appropriate regulations to ensure competitive behaviour, supply-side policies to improve capabilities and competitiveness, targeted FDI promotion strategies to attract appropriate forms of foreign investment, and support for the development of small and medium local enterprises that suffer particularly from market deficiencies.

Technology import policies also fall under the heading of industrial policies. International technology markets are highly imperfect, and local firms often find it expensive and difficult to collect the information needed to identify the best sources of technology and to bargain effectively with suppliers. Multinational enterprises do not, by definition, face this problem, but developing countries often feel that the technologies transferred are not of the latest vintage (some also feel that it is too modern and so inappropriate to local tastes and factor endowments), that only operational know-how is transferred rather than the more complex and valuable design and research functions, and that the transfer is hemmed in by restrictive conditions imposed by the parent company.

Despite these arguments for government intervention, however, experience of technology policies in many parts of the developing world has shown that the best way to manage the process is not to intervene in great detail or to have rigid regulations on technology transactions. Firms should be allowed fairly liberal imports of new technologies according to their perceptions of market forces, but they should be supported by the provision of information by the government on sources and costs of technology. This is the strategy adopted by Japan and the NIEs, and it seems to have been very successful. In contrast, very stringent controls on technology imports, as exercised by India, have resulted in reducing the quantity and quality of technology inflows and in growing technology lags, and have also tended to deter FDI inflows. The pattern of recent FDI flows supports the conclusion that liberal policies on technology, which tend to go hand in hand with more liberal policies in general, serve to attract more and better foreign investments.