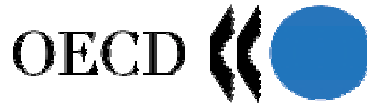

GOOD GOVERNANCE AND BEST PRACTICES FOR INVESTMENT POLICY AND PROMOTION

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Overview

Foreign direct investment (FDI) is widely recognised as a powerful engine, and major catalyst, for development, poverty-reducing growth and the global integration process. At a time when FDI levels show signs of decline and the competition among nations, particularly in the developing world, to attract more and "quality" FDI[2] becomes stiffer, promoting investment effectively has become a matter of great importance to governments all over the world. Governments recognise the need to be innovative in responding to the concerns and expectations of investors, while striving at the same time to optimise the benefits of FDI for their national economies.

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2 . It is not only governments that compete to attract FDI, foreign investors also compete among themselves to enter attractive host countries to take advantage of higher returns on investment, productive assets, locational advantages and market size.

This is indeed the *raison d'être* for such Investment Promotion Agencies (IPAs) as the "Scottish Enterprise", the "Zimbabwe Investment Centre", the "Investment Board of Thailand", the "Foreign Investment Promotion Agency of Bosnia-Herzegovina", the "Foreign Investment Committee of Chile", the "CzechInvest", the "Ghana Investment Promotion Centre", the "Saudi Arabian General Investment Authority", and likes. The number of IPAs worldwide increased substantially in the 1990s and there are presently 164 national and well over 250 sub-national IPAs.

Worldwide inflows of FDI rose from $330 billion in 1995 to $ 1,270 billion in 2000. Although this upward trend was interrupted last year by a significant decline to $760 billion according to UNCTAD, it still grows faster than other economic aggregates like world production, capital formation and trade. However, FDI is not evenly distributed among nations and the decline in 2001 has not affected developed and developing countries to the same degree. Developed countries remain the prime destination of FDI, accounting for more than three-quarters of global inflows and more than 90 percent of outflows.

Developing countries have not been able to participate as developed and certain emerging countries in the vast increase of FDI flows that has occurred in the past decade. Today, only a small portion of global foreign investment reaches them. While FDI to these countries as a whole did rise during 2000 to $240bn, their share in world FDI flows declined for the second year in a row to 19 percent compared to the peak of 41 percent in 1994. This situation highlights the need for host countries to have a broader set of policies and institutions in order to attract, absorb and maximise the benefits of FDI. In this task, home countries, multinational enterprises (MNEs), international organisations and civil society groups all have a shared responsibility.

FDI Promotion and Incentives

With liberal policy frameworks becoming commonplace and losing some of their traditional power to attract FDI, governments are paying more attention to broader measures and policy tools including investment promotion and facilitation. As foreign investors have a variety of locations to choose from, making investors aware of the opportunities, improving national image and more importantly providing an enabling environment, can often determine the attractiveness of the country as a host for a particular investment. While investment promotion strategy may influence investors' preference for a certain country, there are many other factors for foreign investors, which often have different, more complex, motives than the host country.

The main determinants of FDI include: size of markets, infrastructure, macroeconomic stability, product and labor distortions, incentives, integration schemes, methods of foreign enterprise participation, attitudes, and overall business environment. After September 11, concern over political risk has made the due diligence process more deliberate and more

competitive[3], with investors preferring to focus on less exotic, more familiar, investment destinations.

Traditionally, FDI policy has focused on establishing the regulatory and other framework conditions for market access and fair treatment of foreign investors, while investment promotion agencies (IPA) are concerned with facilitating the attraction of investment projects and maximising their benefits to the local economy. Increasingly, these areas of public action are becoming inter-connected. In addition, the role of IPAs in many countries that have demonstrated success in attracting FDI has extended to a full development agency that significantly influences policy in many associated areas (e.g. provision of infrastructure, information society strategy, training and skills development, R&D structures and linkage to industry, domestic company development, clustering, and introduction of quality systems).

FDI has to be won. Those who wait for investors to come will probably wait in vain. Those who stick to the fundamentals, realistically appraise their national FDI balance sheet, have the strategic intelligence to target the right investors, and have the promotion prowess to do so effectively and efficiently in a tailored way, will win. Offering incentives to induce investors is only one method of attracting FDI, whose effectiveness and efficiency are subject to heated discussion. There are many arguments made for and against offering foreign investors investment incentives. The incentives are essentially meant to reap the maximum benefits associated with the activities of investors e.g. knowledge, management skills, technological advantages, etc. Incentives to attract FDI, such as tax reductions, financial inducements and regulatory derogations, may be economically justified in some cases, where:

- market imperfections impede foreign investors from earning a normal return on their investments;
- there exist additional, indirect benefits -- technology spill-over and other positive externalities -- which are not be captured by private returns and may result in levels of foreign investment that are sub-optimal from the host country perspective; and
- in the specific context of developing countries, the would-be host country is constrained in its access to external finance, whereby attracting FDI becomes a strategy for financing economic growth.

However the cost-effectiveness of such incentives needs to be carefully assessed. Some may attract primarily short-term, profit-orientated or low cost-motivated FDI. Specific investment incentives may miss their targets due to the difficulty in identifying when and where expected spillovers, which would justify government intervention, will actually occur. The opportunity cost of alternative uses of public funds (e.g. education and infrastructure) has also to be taken into account.

The incentives are also widely used by some countries, adversely affected by investment relocation and disinvestment. In fact, relocation of investment from high to low-cost countries is not a new phenomenon; it has been a global trend since the late 1950s, when production of

3 . "The Global Investment Environment After September 11", Paul A Laudicina, in New Horizons for Foreign Direct Investment, OECD, 2002.

the electronics industry relocated from the OECD countries to the newly industrializing Asian economies and then relocated again to the second-tier Asian emerging economies (Malaysia, Thailand, Indonesia and the Philippines)[4]. Factor cost differentials in one era may carry the seeds of its own destruction in another as success leads to higher incomes, higher expectations, and eventually higher costs relative to other competing countries [5]. Therefore, it is questionable whether incentives only can stem the relocation and disinvestments.

In the OECD we are currently working to develop mutually agreed standards for good practices in this area. The recommendations that will eventually emanate from this work are likely to include: standards for transparency, accountability and non-discriminatory application of measures; proper procedures for weighing the benefits of attracting FDI against budget and opportunity costs; the pros and cons of tailored measures as opposed to rules-based incentives; and the appropriate degree of international policy co-ordination and exchange of information to avoid bidding wars.

Policies Matter

Clearly, countries with better policies attract the largest increases in FDI. Some countries obtain more growth for a given amount of FDI than others. While many circumstantial reasons explain this, policies make an important difference in performance. Better policies not only bring in more capital, but they tend to strengthen the foreign capital-domestic investment relationship and convince the foreign investor to reinvest its gains in the economy. Sound host country policies toward attracting FDI and benefiting from foreign presence also help mobilise domestic resources for productive investment. Indeed, as stated in the Monterrey Consensus, domestic resources provide the solid foundation for self-sustaining development.

It is no longer sufficient for a country simply to liberalise its restrictions on FDI. Most economies have already done so. Nor are investment incentives the key to success. Rather, one should consider the broader policy and institutional framework for an enabling environment for investment such as competition, taxation, financial markets, trade, corporate governance, public administration, respect for workers and environmental rights and other public policy goals. Building the capacity to formulate and implement effective policies is also a key challenge.

OECD's study on *Foreign Direct Investment for Development,* to be published later this year, shows why and how "policies matter" if countries are to reap the full rewards of open investment systems. Every aspect of host countries' economy and governance practices has repercussions for the investment climate. In light of OECD and other countries' experience, the measures at the disposal of host country authorities fall into three categories, namely improvements of the general macroeconomic and institutional frameworks; creating a

4 . The Electronics Industry: Can Manufacturing Continue in Hong Kong?, Ho-Fuk Lau and Sebastian Green, The World Economy, August 2001, Vol. 24 No.8.

5 . The Role of Government in Business Promotion: The Case of Textiles and Garments, Paul Jackson, Journal of International Development, July-August 1999, Vol 11 and No 5.

regulatory environment that is conducive to inward FDI; and upgrading infrastructure, technology and human competencies toward the level where the full potential benefits from foreign corporate presence can be realised.

FDI, Good Governance and Transparency

A system of governance that is not functioning properly can be easily be identified by various signs, regardless of the specific historic-cultural context of each country: corruption, squandering of environmental resources, loss of public confidence in the government, non-respect of constitutional rights, etc. This usually leads to sub-optimal utilisation of the country's human and financial resources. As recent OECD studies show, no country, not even the richest long-established democracies, is immune to this phenomenon.

Good governance is now recognized as a crucial pre-requisite for well functioning markets and, hence, for attractive investment conditions and a sustainable allocation of investment capital. A number of multilateral organisations, including the OECD, have reflected on the elements of good governance, and on their relation to investment for development. As the ethos and experience of these organisations vary, so, too, do their perceptions of what constitutes good governance.

The key dimensions of governance include: state of law; separation of governmental and private affairs; a judicial system with competent and independent judges who apply and enforce the law; the non-contradictory system of laws; no new laws or other parts of the legal system with retroactive implementation; and effective fight against corruption. Good governance also includes sound democratic principles in political life of a country and consultation procedures with the private sector and other civil society stakeholders to ensure that laws are consistent with practical life and compatible with the needs and possibilities of the firms and the economy in general.

Among the elements of the enabling environment that can be influenced by policies, transparency is arguably the single most important one. OECD's *Foreign Direct Investment for Development* study studies suggest that companies may be willing to invest into countries with legal and regulatory frameworks that would not otherwise be considered as "investor friendly" provided they are able to obtain a reasonable degree of clarity about the environment in which they will be operating. Conversely, there appears to be certain threshold levels for transparency beneath which the business conditions become so opaque that virtually no investor is willing to enter, regardless of the extent of the inducement.

Given the relative irreversibility of FDI, unnecessary uncertainties about legislative action and rules enforcement act as major impediments, by giving rise to risk premiums in general and by raising fears of discriminatory treatment. A non-transparent host country business environment raises information costs, diverts corporate energies toward rent-seeking activities and may give rise to outright crime such as corruption. While this weighs down on the entire host country business sector, it arguably acts as more of a discouragement to outsiders who are not privy to locally available information. All companies, domestic and foreign alike,

should be able, on an equal footing, to know in what conditions they operate and to prepare themselves sufficiently in advance, when changes are upcoming.

Transparency in government decision-making and public policy implementation is important because it facilitates governmental accountability, participation, and predictability of outcomes. To achieve transparency, there is a need for clear and enforceable rules and procedures, which are preferable to those that provide discretionary powers to government officials or that are susceptible to different interpretations. Accountability is needed to make sure that rules are actually complied with. Similarly, transparency and information openness cannot be assured without legal frameworks that balance the right to disclosure against the right of confidentiality, and without institutions that accept accountability.

What actions to take?

In this context, host country authorities may consider the following:

- Strengthen their efforts to consolidate the rule of law and good governance, including by stepping up efforts against corruption (one indicator of poor governance and a disincentive to investment), enhancing policy and regulatory frameworks (e.g. as regards competition, financial reporting and intellectual property protection) that foster a dynamic and well-functioning business sector. Such policies will benefit the climate for FDI through their effect on transparency and, *inter alia,* by bringing a larger share of the informal economy into the open, they will have important secondary effects on countries' ability to attract investment.

- Work toward increased openness to foreign trade, so as to allow the domestic enterprise sector to participate fully in emerging patterns of the global economy. This approach could be undertaken jointly with efforts at increasing business sector competition. A combined approach would allow a greater domestic and international openness to business to go hand-in-hand with safeguards against negative effects from a rise in concentration. Moreover, a successful effort at removing global and regional trade barriers makes the participating countries more attractive locations for FDI, owing to the concomitant expansion of the "relevant" market.

- Enshrine the principle of non-discrimination in national legislation and implement procedures at enforcing it at all levels of government and public administration. This implies that no special treatment would be granted to domestic enterprises under pressure from foreign entrants. However, the approach should be even-handed: efforts at attracting FDI through inducements not offered to domestic companies should equally be considered as discriminatory – except where aimed at compensating for manifest deficiencies (e.g. an "un-level playing field") in the host country business environment.

- Undertake efforts to put in place, and raise the quality of, relevant physical and technological infrastructure. The presence of such infrastructure is instrumental in attracting foreign investors, in allowing national enterprises to integrate the technological spin-off from foreign-owned enterprises in their production process, and in facilitating

their diffusion through the host economy. Allowing foreign investment in infrastructure sectors and official development assistance (ODA) may assist in these efforts.

- Implement internationally agreed environmental and core labour standards. Efforts at reducing child labour, eliminating discrimination at the workplace and remove impediments to collective bargaining are important in their own right. They also serve as a tool for upgrading the skills and raising the motivation of the labour force and facilitate linkages with foreign companies usually operating on higher standards. Additionally, a comparatively sound environmental and social environment becomes increasingly important for countries' ability to attract FDI operating on high standards.

- Carefully consider the effects of imposing performance requirements on foreign investors. Rather than justifying the imposition of performance requirements by a need to counterweight generous FDI incentives, host countries should reassess the pros and cons of incentive schemes themselves.

Challenges for Home Countries

While the brunt of the policy adjustment needed to reap the benefits of FDI for development needs to be undertaken by host country authorities, the home countries of multinational enterprises – and the developed world more generally – should also review the impact that their national policies have on developing countries. Home countries may assist the efforts of host countries by, for instance, liberalising their foreign trade regimes and their own policies for attracting FDI, exploiting the synergies between FDI and ODA, promoting public-private partnerships, and supporting capacity building and less developed countries' participation in international fora.

ODA can certainly help develop the human capacities, institutions, and governance necessary to benefit from the opportunities offered by FDI. An increasingly critical question for developing countries is how to leverage private financing with public resources, thus striving to improve synergies between ODA and FDI. Carefully targeted ODA may assist in leveraging FDI flows and creating a virtuous circle of increasing savings and investment. ODA funds could also be used to support those areas considered important to investors in determining investment decisions, particularly in less developed countries.

Another important responsibility for home countries is to curb the supply side of bribery and corrupt practices, which can undermine the effective functioning of markets. International bribery assumes many guises, but wherever the practice occurs, it inhibits economic development and distorts competition. It creates non-tariff barriers to foreign trade and investment, causes economic dead-weight losses that reduce firms' and nations' long-term competitiveness for FDI. There are estimates that in some developing countries various forms of corruption siphon away 5 to 30 percent of all public funds[6].

6 . Bribery in International Business Transactions, Wayne Hamra, Business Economics, October 2000, Vol 35 No 4.

The last few years have witnessed an unprecedented campaign around the globe to combat bribery among the originating countries as well as the receiving countries. One result is that OECD and some non-Member countries signed on 17 December 1997 the *Convention on Combating Bribery* to outlaw cross-border bribery and other corrupt practices. The OECD Convention, *inter alia,* requires countries to establish the criminal offence of bribing a foreign public official, and to have in place adequate sanctions and reliable means for detecting and enforcing the offence. The new chapter, added in June 2000, on combating corruption in the OECD Guidelines for Multinational Enterprises (which was given added importance in the 2002 Ministerial), and the disclosure and transparency chapter in the OECD Corporate Governance Principles, provide a framework that discourages foreign firms engaging in acts of bribery[7].

Corporate Responsibility for Development

The general approach to the governance and integrity problems cannot lie exclusively with regulatory, legal and judicial action by governments. Although these are very important, they are not usually precise enough to cover every conceivable business situation. Only companies are in a position to know what law and regulation mean for their operations and to translate them into management practice. Thus, their actions are as central to the effectiveness of legal and regulatory enforcement as what governments do.

Experience shows that multinationals can nevertheless play positive roles in the move toward better public governance. International business is starting to assume a role in improving public governance, with multinationals often among the best informed outside actors in host countries and able to act as role models for good governance (particularly in implementation of practices and policies related to environmental, health, safety and employee benefits). This is especially true in places where they contribute large portions of government revenues and in sectors where they are the major competitors. While business is placed in an unaccustomed role when dealing with issues where governments have primary responsibility, some leading companies have actively participated in the search for solutions.

OECD countries have launched several initiatives to promote responsible corporate behaviour. Among these instruments are the OECD Guidelines for Multinational Enterprises, which encourage a balance of responsibility between international businesses and governments. The Guidelines are recommendations addressed by 36 (OECD and non-OECD)[8]

7 No Longer Business As Usual: Fighting Bribery and Corruption, OECD, 2000, Paris

8. These include the 30 OECD Member countries, as well as Argentina, Brazil, Chile, Estonia, Lithuania, and Slovenia. The Guidelines provide voluntary principles and standards for responsible business conduct in areas such as product safety, environment, labour management, supply chain responsibilities, disclosure of major risks and competition. The recommendations express the shared values of the nations that are the source of most of the world's direct investment flows and home to most MNEs. A key value added of the Guidelines resides in the unique follow-up procedures created by governments and business. Governments of the 36 adhering countries have established a system of National Contact Points to promote the observance of the Guidelines by MNEs operating "in or from" their territories.

governments to multinationals operating in and from their countries. They are part of a broader instrument – the 1976 OECD Declaration on International Investment and Multinational Enterprises.

Evidence so far suggests that the Guidelines are making a difference. Many companies have publicly acknowledged that they use the Guidelines as a benchmark for good behavior. The Guidelines are being used to help prevent misunderstandings and promote mutual confidence and predictability between the business community and home and host societies. About twenty specific instances, where there are questions about whether or not a company has observed the Guidelines in a particular business situation, have been considered so far. Furthermore, these recommendations can be read as an approach to the Development Agenda that is now confronting the international community in areas such as technology transfer, human capital management practices, transparency, competition, and refraining from seeking exemptions from national legislation.

Best Practice Guidelines for Investment Promotion

Building on OECD Member country experience, as well as that of many developing and transition economies, the OECD and the South East Europe (SEE) Regional Roundtable for Investment Promotion have developed the "Best Practice Guidelines for Investment Promotion". They are part of our work on the Investment Compact of the SEE Stability Pact. The Guidelines do not offer a single prescription; rather they show what government commitment is needed and the scope of activity that is encompassed in the approaches of successful FDI policy and promotion in various countries.

While these Guidelines focus on smaller transition countries, the underlying principles also hold true in larger countries as well, although the motivations and negotiating positions of the investor and the host countries may be different than for smaller economies. They take into account the wide range of OECD work in the field of international investment and also draw extensively on the existing expertise and work in this field of other international agencies such as MIGA, FIAS, UNIDO and UNCTAD[9].

The twelve specific Guidelines, summed up below, provide an overall "best practice" framework for investment promotion:

(1) Establish government policy on foreign direct investment and the vision for its role and contribution to the national economic development framework.

(2) Articulate and advocate national policy on FDI among social partners and civil society as well as investors in order to create a better awareness and consensus on the aims of policy.

9. These Guidelines also draw on OECD's Istanbul Programme on Investment Promotion (2000-2010), adopted in September 2000, which is a guide to future investment promotion development.

(3)	Establish an Investment Promotion Agency (IPA) and determine the objectives and the legislative and governance structures of the agency.
(4)	Inculcate within the IPA a professional management and service culture, result-oriented ethos and innovative marketing approach in order to compete successfully in attracting new investment and to ensure satisfactory continuity of the organisation culture.
(5)	Define strategic policy options and set out the corporate strategy and marketing plan for the IPA to build competitive strength and achieve selected policy options.
(6)	Decide on incentives policy and ensure objective and regular evaluation of the costs and benefits.
(7)	Undertake a comprehensive review of skills available versus skills required by investors. Develop and implement policies to address identified gaps and thereby facilitate new investment, jobs and skills.
(8)	Ensure the provision of essential infrastructure needed by industry – industrial estates, modern factory and office buildings, utilities (electricity, gas, water), effluent treatment, drainage, telecommunications (including access to broadband networks) and different modes of transport.
(9)	Identify administrative barriers to FDI and establish a programme with clearly assigned responsibilities and target dates to remove such obstacles to investment.
(10)	Promote FDI by undertaking a comprehensive and professional marketing programme aimed at new and existing investors and by building the IPA as a credible and competent partner for investors.
(11)	Facilitate investment and service new and existing investors at all stages of the investment cycle, from start-up through to post-investment and new expansion stages.
(12)	Encourage greater integration of foreign business into the economy and the rooting of foreign investment in the country.

Progress in implementing these guidelines in the context of SEE countries is monitored through the Monitoring Process of the Investment Compact, with a particular emphasis on competitive needs, cost/benefit analysis, time limits, and measurement of the performance.

Conclusion

The implementation of investment related best practices as well as the development of international principles, codes and standards could provide guidance for and underpin

domestic reform efforts by developing countries. The main task is to build and improve the overall capacity of many developing countries to attract and absorb FDI inflows in a manner conducive to economic development.

The challenges are so great that no single institution can respond adequately to them. Against the background of the Doha and Monterrey Declarations, which identify capacity building as a priority area for international co-operation, this effort needs the co-ordinated and coherent support of international institutions and individual developed country donors in order to assist developing countries to establish transparent, broad and effective enabling policy environment for investment and build the human and institutional capacities to implement them.

In this context, the OECD has a special responsibility to share its standards and experience with as many nations as possible, building on the OECD's distinctive methodology, which relies on a peer review process, recommendations from governments with diverse perspectives and cultures, and monitoring of process. Over the past few years year, OECD's investment outreach has been carried mainly within the context of the Investment Compact of the Stability Pact, with China, Russia, Ukraine, the Caribbean and will soon extend to emerging Asian economies.

The OECD created last year the Global Forum on International Investment (GFII) as a key vehicle in its investment outreach to non-members, aimed at fostering policy dialogue and networking on globally important investment issues. The Forum was launched in November 2001 by a conference on "New Horizons and Policy Challenges for FDI in the 21st century", held in Mexico. The next GFII, tentatively scheduled for November 2002 in Asia, will focus largely on the challenge of attracting FDI in support of economic development. A later GFII conference is intended to deal with issues related to investment and good governance in co-operation with the NEPAD Initiative. We also plan a major activity with large oil-producing countries on a "beyond oil and sustainable investment" theme next year.

Working on a broad range of economic, environmental and social policy issues in a multidisciplinary context, we stand ready to share our best practices and experiences with developing countries towards the common goal to achieve sustainable investment and to achieve synergies with other multilateral organisations and relevant national agencies.