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ATTRACTING FOREIGN DIRECT INVESTMENT FOR DEVELOPMENT

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BIAC *In Response*

INVESTMENT[1] – BIAC POSITION ON INCENTIVES

[1] Here we use the term "investment" to mean foreign commercial presence. Investment in the national accounts sense of additional to capital stock may deserve to be encouraged with incentives under certain circumstances, bearing in mind the risks associated with over-investment. However, promotion of investment in the sense we are using here, i.e., facilitating the operation of business cross-border, including the removal of obstacles to it, is something that should always be a yardstick of the business friendliness of regulatory framework in a given jurisdiction/country.

Summary

Most business people would prefer to live in a world where government subsidies and incentives were unnecessary, where the policy environment is sufficiently robust and supportive. Whether in the form of a tax, grant, subsidy or another type of public expenditure, some firms receive them and some don't, often leading to a highly discriminatory situation. Those same business people would rather compete on the basis of their offerings - product or service - in terms of quality, price, availability, delivery, and support. Indeed, with regard to tax based incentives, the vast majority of business would opt for a broader base with lower rates. So, just as successive Rounds have focused on the reduction of the negative incentive of tariff protection, the long term WTO effort to develop a broad consensus regarding the elimination of subsidies, industrial and agricultural, that distort competition has been rightly supported by business.

It has been put this way by many investors.

"The most important factor in creating favourable conditions to attract foreign direct investment is good governance, i.e. clear, stable and business-friendly legislation and economic policies, which are administered in an efficient and equitable manner to provide a level playing field for all economic operators with a minimum of red tape. If such conditions prevail, no special incentives are needed to attract foreign, or indeed domestic, direct investment."

But, incentives are not necessarily undesirable. Indeed, the world turns on incentives. The world is not all sticks; there is a place for carrots. It is very important to assess the value and effect of incentives…in context.

There are often more powerful factors than cash in the package of comparative advantage being assembled by aspirant hosts. Numerous policies may be implemented by a country to attract FDI including investment in primary, secondary, tertiary education and research facilities affecting labour availability and preparation, a new road, better communication infrastructure, a more efficient port and customs facility, flexibility with regard to corporate structures, more efficient regulatory and permit processing, a more reasonable tariff regime with the elimination of costly peaks. Building business confidence is job one.

For some countries, especially in the developing world, tax policy may represent the simplest, most effective and perhaps only tool available to make their package competitive. Within the OECD environment, pressure to keep the tax burden low is economically healthy.

However, as addressed in this statement, for incentives to be effective and supporting sustainable economic growth, they must be generally available to investors – international or local, be non-discriminatory, transparent, non-trade distorting, causal or strongly-linked, proportional, temporary, have a long term orientation and be otherwise fixed within the committed business model.

The Policy Mosaic

The mosaic of assets as well as policy enablers and inhibitors is different in each polity and the quest for comparative advantage is an irresistible force. Some of those mosaics are very poor and many concessions or offsets are required to make the choice attractive, prudent and saleable to shareholders, when viewed in contrast to all the other opportunities.

However, there are strong countervailing forces. Where the investment involves access to limited natural resources, the ability to find adequate balance in the mosaic is very difficult, as the host government has disproportionate leverage over a particular contract or business model. Another polity choice is not always available to the investor.

Where domestic industry has been isolated for subsidy benefits and has developed cost structures that are not competitive outside the protected market, it is the consumer who is paying the bill. Frequently, the public is unaware of these price spreads.

And then, there is the theoretical "race to the bottom" that, fortunately, OECD research reveals is not happening.[2] Nonetheless, the government needs to be, and be perceived to be, in control of any economic development initiatives. Any effort to be secretive is counterproductive with the very polity that will benefit from increased economic activity.

The dearth of investment flowing to countries that suffer from poor governance, an absence of the rule of law and property protection, corruption and violence demonstrates that there are a number of public policies that combine to attract other peoples savings.

There are managers of risk (bankers, insurers, accountants, consultants, and attorneys) positioned between the life savings of the developed world's citizens and deployment in the developing world, as there well should be. Risk managers take a holistic view of the pluses and minuses inherent in each opportunity. Within even the most sophisticated markets, no choices of location or model are equal. There is always competition. Companies' Boards make investment choices.

Indeed, the policy mosaic differentiates even advanced economies, as to the effective functioning of the labour market, regulatory transparency, corporate governance that sufficiently protects the minority investor, environmental regulation that does not substitute prescription for innovation, a tax burden that is not excessive, a competitive environment that is not stacked against the international investor or the local entrepreneur, liberal remittance policies that enable returns to the investors and, alas, a straightforward path to exit. While incentives might not precisely offset failings of policy, they can adjust the cost base of an investment, rendering it viable.

BIAC Recommendations

Governments must ensure that whatever changes made to the mosaic in order to attract investment are effective, that is, successful in increasing economic activity without either wasting the public purse or distorting the opportunity for competition. That is, the tools applied should be:

1. Generally available
2. Non-discriminatory
3. Transparent
4. Proportional
5. Clearly causal or closely linked
6. Non-trade distorting
7. Oriented towards attracting long-term investment

[2] See generally, Foreign Direct Investment for Development: Maximising Benefits, Minimising Costs, OECD, 2002.

8. Temporary in relation to offsetting asset or policy gaps
9. Otherwise fixed within the committed business model

On this basis, to clarify the conditions, BIAC makes the following recommendations for policy makers considering incentive schemes:

- General availability is essential for creating an open atmosphere where potential investors - domestic and international and across the spectrum of industry sectors - can see the broad outlines of what is possible and know that they will be treated in a similar fashion for a similar proposition.

- Transparency underpins credibility and fair treatment. Causality and linkages that are clear make the sacrifice, or one might say investment, made on behalf of the citizens easier to understand and accept. Visible proportionality between the size of the incentive and the projected benefits will keep the pressure on minimising waste. Seeking long term investment makes benefits more publicly measurable.

- Investment incentives can have adverse welfare and efficiency effects similar to those of tariffs. Just as tariffs reduce gains from trade, so too investment incentives may reduce the gains from investment flows. Business believes that the WTO Agreement on Subsidies and Countervailing Measures (ASCM) rightly provides for the availability of investment incentives on a non-discriminatory basis, at the same time limiting their use.

- As an integral part of sustainable growth and development, we need to encourage developing countries to export and trade in a non-distortive environment. Indeed this means no subsidies solely to domestic industries but also no incentives that run counter to this thrust.

- On the assumption that political leadership will engage in continuous improvement in their particular mosaic, incentives should never be permanent, as difficult as that might be politically.

- Ideally, procedural safeguards should be included in subsidy legislation, such as a safer majority vote required to extend the subsidy. However, the assumptions for a specific business model committed during discussion with economic development representatives of the government should not be subject to arbitrary action.

- States should be cautious of fuelling an environment where FDI flows primarily to those countries with the "deepest pockets." Less wealthy states should not be precluded from the potential benefits of FDI simply because of the size of their treasuries. Additionally, smaller countries should not have a disadvantage caused by their inability to immediately off-set and absorb start-up losses from FDI. If FDI flows become contingent on bidding wars, those in most need of FDI – developing countries – will never benefit from the positive externalities it can offer. Following our nine-point path will minimise this effect.

Maximising Investment Benefits: Evaluating Trade-offs

So, differentiation, innovation and resourcefulness reign. All over the world, the conclusion that investment is "good" is prevalent, with the exception of some analysts who would attribute to the global spread of investment all the ills and failures of governance. Most commonly, investment brings jobs, better jobs and almost always better paying jobs, to a domestic economy. Jobholders

come out of the ranks of the unemployed and the informal economy to pay taxes to fund governmental priorities.

While this is rather obvious, it is often lost in speculative “concerns” about tertiary impacts. There have been volumes written analysing externalities. Most of those are positive, too. There is transfer of know-how and diffusion of technology, including environmental technologies and methods. Investors do look for local suppliers. Industry sectors do tend to cluster and investment frequently attracts upstream suppliers’ and downstream customers’ investments. Investments do stimulate trade, increasing scale with its secondary benefits. Often, there is a salutary influence on the education system where the demand for a more modern and competitive skill set is reflected in improvements in the schools. And then, there are the jobs themselves.

Do all investments bring all these benefits? Of course, they don’t. Does the absence of one or more make the corresponding investment a negative proposition? Probably, it does not. Have investments that received incentives been made that have had negative effects with regard to some elements of society? Yes, but such trade-offs or choices must be made by governments every day, and, with regard to FDI, there is ample evidence that the positive side of the ledger far outweighs the negative. A requirement that policy choice never produce negative impacts is a recipe for stasis.

Does every incentive constitute a grab for maximum cash? Certainly not. Most investments have long lives and, by their nature, represent a “participation” in the host economy, a shared interest in the policy mosaic that supports sustainable economic growth.

In Conclusion

It is good governance, and a strong domestic enabling environment - policies and infrastructure - that are most fundamental to a country’s ability to attract investment. Furthermore, to repeat, the long term WTO and GATS effort to eliminate subsidies that distort competition has been rightly supported by business, but it is not indiscriminate. Whether in the context of the Doha Development Agenda or in capitals, national or sub-national, economic growth fuelled by innovation and competition is the goal. Incentives can be a tool to accelerate the process.