EMERGING ECONOMIES TRANSITION

OECD Global Forum on International Investment

New Horizons for Foreign Direct Investment

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Global Forum on International Investment

New Horizons for Foreign Direct Investment

OECD

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ORGANISATION FOR ECONOMIC CO-OPERATION AND DEVELOPMENT

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FOREWORD

It is increasingly recognised that, within the right policy setting, foreign direct investment (FDI) is a powerful engine for sustainable growth and integration of nations at different levels of development into the world economy. Governments in all continents now actively seek FDI, and the international community has intensified efforts to assist less developed countries in this process. Hence, as we enter into the 21st century, and despite the overall decline in FDI flows in 2001, opportunities for reaping the full benefits of inward direct investment and achieving a better world for all remain high in the long run. Today FDI is needed more than ever to achieve sustainable development and poverty reduction.

At the same time, this observation poses new challenges. Host and home governments need to move beyond the traditional policy of liberalising FDI. They must embrace a broader set of policies for an enabling environment for investment: respect for workers and environmental rights, competition, taxation, financial markets, trade, corporate governance, public administration, and other public policy goals. Building the capacity to formulate and implement these policies has become an equally important and pressing challenge. Developing policy frameworks to ensure that multinational enterprises contribute to development goals and capacity building also remains a priority issue on the international agenda.

The OECD's Global Forum on International Investment (GFII) held its inaugural conference "New Horizons and Policy Challenges for Foreign Direct Investment in the 21st Century" in Mexico City, 26-27 November 2001. The conference provided a unique platform for an open and inclusive dialogue on emerging investment issues among government authorities in charge of investment policy and other stakeholders including multilateral organisations, the private sector, trade unions and NGOs. The GFII is one of eight "Global Forums" created in 2001 within the framework of the OECD's Centre for Co-operation with Non-Members. The aim of these Forums is to deepen and extend relations with a larger number of non-OECD economies in fields where the OECD has particular expertise and global dialogue is important.

This publication highlights the major conclusions that emerged from the conference and offers a selection of papers presented by experts and revised in light of deliberations. The book includes analyses on recent FDI trends and prospects, as well as ways of maximising the benefits of FDI for development. It also examines lessons learned in OECD Members and other countries, governments' responsibilities in FDI policies, corporate responsibility initiatives and the role of multilateral organisations in capacity building for FDI in host countries.

In our increasingly interdependent world, OECD has a responsibility - and an enlightened self-interest - to share its standards and experience with as many nations as possible. Policy dialogue with non-OECD countries and other partners and contributions to sustainable development are among OECD's central priorities. I am personally committed to further these objectives through the Global Forums and other OECD programmes.

Donald J. Johnston
Secretary-General

PREFACE

Foreign Direct Investment (FDI) has performed an essential role in the development strategy of our countries by acting as a catalyst in the production and the generation of employment and as a vehicle for the transfer of technology. FDI contributes to capital formation, the expansion and diversification of exports, increasing competition, providing access to state-of-the-art technology and improving management systems.

FDI has played a key role in the economic development of Mexico. It is present in a great variety of economic activities, and in all regions of our country. Mexico's efforts to improve its foreign investment regulatory framework has allowed us to become the second largest FDI recipient in Latin America and the third among all developing countries, averaging $12 billion per year since 1994. During difficult economic times, where global investment is declining, Mexico provides a positive contrast.

Mexico was honoured to host and co-organise the inaugural conference of the OECD Global Forum on International Investment (GFII). I am convinced that this event has contributed to enhance dialogue among Member and non-Member policymakers, representatives from international organisations, the private sector, trade unions and non-governmental organisations, on the policy challenges for FDI in this new century.

Important issues were raised during the discussions in the plenary session as well as in the panels. We hope the messages that came out of the GFII will contribute to the work conducted by other international organisations, such as the World Trade Organisation (WTO), and in particular the United Nations Conference on Financing for Development.

However, we must look at this GFII conference as only the beginning of a series of discussions regarding the importance of FDI. We are convinced of the benefits of continuing inclusive dialogue that began with this GFII event, as there is a constant need to address the complex challenges related to international investment and its contribution to development.

Luis Ernesto Derbez
Minister of Economy
Mexico

Acknowledgements

This book reflects the outputs from the inaugural conference of OECD's Global Forum on International Investment. It has been conceptualised and produced in the OECD Directorate for Financial, Fiscal and Enterprise Affairs by Mehmet Ögütçü and France Benois. Substantial inputs were received from Pierre Poret. Professor Balasubramanyam of Lancaster University provided academic counsel throughout the preparation process.

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INTRODUCTION,

William Witherell,
Director, Financial, Fiscal and Enterprise Affairs, OECD

The title for this conference is "*New Horizons and Policy Challenges for Foreign Direct Investment (FDI) in the 21st Century*". I hope that the outcome will make clear that the word "new" in the title is justified – that the international investment policy scene is a dynamic one, with important developments that need to be taken into account by all interested parties: host and home countries, multinational enterprises and their providers of finance, representatives of the workers, NGOs and the multilateral organisations.

We are fortunate to have speakers highly qualified to help us identify emerging trends and policy challenges and to evaluate alternative approaches. But it is the active participation and the open discussions between conference participants, which produce the open and inclusive dialogue that we hope will be the trademark of this and future events of the OECD Global Forum on International Investment (GFII). It is our hope that the discussions and conclusions of this conference will contribute to the forthcoming UN International Conference on Financing for Development, scheduled to take place in Mexico, in March 2002.

Many of us in the international investment community feel the need to come together to exchange information, views and ideas on emerging issues in an open and inclusive dialogue. This Forum aims to provide such a platform for all stakeholders and players in the field of international investment. The GFII and seven others, created in 2001, aim at deepening and extending relations with non-OECD members and other dialogue partners in fields where the OECD has particular expertise. Our aim in doing so has been to create venues for discussing issues that require global solutions. This inaugural conference of the GFII represents an important step in this direction.

The high interest in this Forum is evidenced by so many of you making the effort to participate, many travelling long distances to do so. This suggests to me that most if not all present would agree that FDI is now needed more than ever, particularly in the current juncture of the world economic slowdown and the international drive to advance the development and poverty reduction agenda. Indeed, I would argue, FDI is not only a mainstay of development; it also contributes to an environment conducive to international peace and solidarity as well.

Many countries are making efforts to attract more FDI. Increasingly, FDI has been recognised as a powerful engine and a major catalyst for achieving development, poverty-reducing growth and global integration process. Unfortunately, many low-income countries have not benefited from the international investment surge. They have lagged behind in terms of pursuing policies and institutions conducive to their integration in the world economy. Indeed, some areas of the world have been excluded from any of the benefits of globalisation. Intensified efforts are hence needed to foster FDI worldwide. This is especially important for countries and continents such as Africa, which so far have attracted little FDI.

The new technologies, managerial practices and financing techniques of business operations have considerably changed the environment and decision-making process for international investment. At the same time, larger FDI flows also create new challenges to policy makers in host countries, in particular to preserve the capacity to pursue — in a non-protectionist and non-discriminatory way — its own social and environmental objectives.

But we believe that, in general, the best response to this challenge lies in strengthening the environmental and social safeguards, rather than in limiting FDI flows and foregoing the economic benefits that these carry with them. Ensuring that foreign and domestic investment policies and national environmental and other relevant policies remain mutually supportive raises new challenges for governments. A rethinking of some traditional approaches to FDI is underway.

It is no longer sufficient for a country simply to liberalise its restrictions on FDI - most have already done so. Nor is offering expensive tax and other incentives the key to success. Rather, attention should be given to a broader set of policies and institutions, starting with the provision of national treatment, reduction of bureaucratic red tape and a fair and predictable tax system, but including such other policy areas as education, public and corporate governance, the rule of law, anti-corruption, competition policy, property rights, sanctity of contracts, protection of intellectual property, and so on.

A related challenge is how best to maximise the benefits of FDI in ways that do not deter the investment flows in the first place. This requires a better understanding of the various effects of FDI - both positive and negative – and how they work. A number of the speakers will present the latest analyses addressing aspects of this issue. It will be evident from the discussion, I believe, that in developing an enabling environment that will enhance the location's attractiveness to foreign investors, a country will also be adopting those policies and creating those institutions that will help it maximise the net benefits of FDI and of domestic investment as well.

Host countries are not alone in this endeavour of capacity building; home countries, companies, multilateral organisations and civil society groups all share responsibility. There is an acute need to work together in an effective and coherent way towards FDI capacity building in host countries, whether bilaterally, regionally or through multilateral organisations such as the OECD, the World Bank Group, WTO, UNCTAD or other relevant regional/international organisations. International co-operation and the sharing of experience can help all our governments to learn from each other what the "best practices" in the field of FDI are.

For its part, the OECD is actively engaged in open dialogue and experience sharing beyond its membership. Since its creation, the OECD has been at the forefront in developing "rules of the game" for international investment and multinational enterprises.

Today, six non-member countries (Argentina, Brazil, Chile, Estonia, Lithuania and Slovenia) have adhered to the OECD Declaration on International Investment and Multinational Enterprises, a political agreement providing a framework for co-operation on a wide range of investment issues. As a counterpart to their commitments under this instrument, non-member adherents participate in related OECD work. The adherence of Israel, Latvia, Singapore, and Venezuela is in the process of being negotiated as of this date. Our 2001 Ministerial Council Meeting has called on the OECD to invite other interested non-member countries to adhere to the Declaration.

The need for co-ordination and participation of many donors and international institutions in the field of international investment is particularly important. The World Bank, UNCTAD, UNIDO, IMF, Inter-American Development Bank, European Commission are all represented at the conference, and I

feel there is a great deal of synergies to be achieved among us in our future work on foreign direct investment.

In this respect, the OECD welcomes the results of Doha and pledges its full support for follow-up work in the context of the WTO. Together with other international partners, we will contribute to deliberations on how multilateral organisations could help promote FDI in support of sustainable development.

As we enter into this dialogue we should bear in mind several international events to which this meeting could contribute. The first, which is rapidly approaching, is the UN International Conference on Financing for Development that will take place in Mexico in March 2002. Second, the recent Doha Conference has raised the prospect of negotiations on FDI commencing in the WTO in several years if the necessary consensus can be achieved. The issues discussed during the two days of this inaugural conference of the OECD Global Forum on International Investment will be very relevant to both of these processes. It goes without saying that the OECD will continue its efforts to foster open and inclusive dialogue on international investment issues with all the relevant stakeholders.

SYNTHESIS OF CONFERENCE DELIBERATIONS

Plenary Session – New Approaches and Opportunities for Development.

In launching the discussion, the Plenary Session Chair, ***Mr. William Witherell*** of the OECD, stressed that FDI was needed "more than ever". FDI is recognised as a powerful engine and major catalyst for development, poverty-reducing growth, and the global integration process. The Chair regretted, however, that many Developing Countries and Least-Developed Countries had received only small amounts of FDI. This situation highlights the need for host countries to have a broader set of policies and institutions in order to attract investment and to maximise the benefits of FDI. In this task, home countries, multinational enterprises, international organisations, and civil society organisations have a shared responsibility.

Mr. Hernando de Soto of the Institute for Liberty and Democracy focused his presentation on the importance of "property rights" and the Rule of Law. In his opinion, trust is "the enabling environment for investment" and is an internal task of developing countries. Mr. de Soto presented the results of several studies he had conducted on the "underground economy in the developing world" that showed that the assets of poor citizens are not as low as they are believed to be. The challenge, therefore, is to bring those assets from the "extralegal" sector into a more inclusive legal property system in which they can become more productive and generate capital for their owners.

To illustrate this challenge, the speaker presented the experience of a Latin American country [Peru] when its government tried to sell the national telephone company. The company had been valued on the local stock exchange at US$53 million, but the government had been unable to sell it to foreign investors due to the company's title to many of the assets. In order to solve this problem, a legal team created both a title of the company's assets and a dispute settlement procedure, which gave legal certainty to third parties. Three years later, the same telephone company was sold at 37 times its previous valuation in the stock exchange. In concluding his presentation, Mr. de Soto stressed the importance of "thinking and focusing on law".

In his presentation, *Recent FDI trends, implications for developing countries and policy challenges*, ***Mr. Karl Sauvant*** of UNCTAD explained that before the tragic events of 11 September, UNCTAD had calculated an expected decline of world FDI flows in 2001 of 40 per cent. This decline is related to the slow-down of the world economy and to the sharp drop in mergers and acquisitions (M&As) activity, but is expected to be further accentuated as a result of the above-mentioned events. These events increased the level of uncertainty, which will probably make some companies put planned investment on hold. The impact is likely to be uneven, affecting specific sectors and host countries in different ways.

The decline in M&A's activity is likely to be more significant, (but the underlying determinants of M&As still suggest that this mode of FDI entry will continue on an upward trend in the longer run). Other possible impacts of the accentuation of the economic slowdown could be the relocation of

certain facilities in order to reduce costs, and modifications to regulatory regimes in order to attract FDI through the liberalisation of some sectors. Having explained the recent trends in FDI, Mr. Sauvant underlined the need to restore confidence among consumers and investors, and proposed some responses to the decline in FDI.
The first response should be investment promotion (through three different "generation" policies).

- *First generation policies:* the liberalisation of FDI flows and the opening-up of sectors to foreign investors.

- *Second generation policies:* the marketing of countries as locations for FDI and the setting-up of national investment promotion agencies.

- *Third generation policies:* The targeting of foreign investors at the level of industries and clusters, and the marketing of regions and clusters with the aim of matching the locational advantages of countries with the needs of foreign investors.

The second response to the decline in FDI would be the optimisation of the benefits from FDI (capital inflows, employment, information, technology and knowledge transfers, access to international markets, competition). These benefits do not, however, accrue automatically. In order to reap the full benefits of FDI, there is a need to promote linkages with the domestic economy. Such linkages are a positive approach and a "win-win-win" situation, because they have potential benefits for foreign affiliates, local firms and host countries.

In concluding his presentation, Mr. Sauvant mentioned some lessons learned from "best-practices" in linkage promotion (political commitment; collaboration with the private sector; selectivity; focus on the upgrading of local supply capacity; identification of areas of intervention, such as matchmaking, information, technology, training, and financial assistance) and emphasised the need to focus on polices because "policy matters".

Paul Laudicina introduced the results of a survey conducted by the AT Kearney's Global Business Policy Council "to inquire about post-September 11th investment intentions and attitudes of Global 1,000 senior executives". [The participant senior executives came from 17 countries and 14 specific industries]. The events of September 11th had an impact around the world, increasing the investment community's reluctance to expand (in particular to conduct M&A's transactions) and affecting consumer confidence. The main findings of the survey are listed below:

- More than nine out of ten CEOs are more negative about global economic conditions today compared to a year ago, and none feel more positive.

- Almost one out of three CEOs has a more negative outlook of the United States as an investment location.

- China experienced a positive shift in investor outlook over the survey period, with close to 15 per cent of executives reporting more positive perceptions of it.

- On future investment plans, 64 per cent of the CEOs intend to maintain approximately the same levels of future foreign investment as planned. However, a greater percentage of executives are inclined to reduce investments rather than to increase them.

- Geopolitical considerations have re-emerged as important factors affecting senior executive FDI calculations.

The conclusion of the survey is that "executives express increased pessimism and uncertainty about the state of the global economy. Nonetheless, they have adopted a "steady-as-you-go" approach toward the implementation of their already substantially reduced plans for investments abroad".

The first panelist, ***Ms. Olivia Jensen*** of Consumer Unit & Trust Society, India, focused on the strategy implemented by South Africa in order to attract FDI flows, and on its results. The panelist explained that, in spite of South Africa's "third generation" policies, it had not been able to attract the desired levels of FDI. This can be explained by the lack of confidence as a result of crime rates, AIDS, and regional instability. Regarding the Indian case, the panelist explained that India is conducting a gradual liberalisation process, but a significant amount of restrictions still remain.

Such restrictions exist in agriculture (where there is no FDI), in telecommunications, and in textiles (reserved to small-scale industries). Other relevant factors in the Indian case are bureaucracy and the slow pace of reform (whose agenda encounters resistance from civil society and domestic business). In concluding her presentation, Ms. Jensen recommended that countries: develop clear views on the kind of investment they want to attract (focusing on quality and not only on quantity); set strategic targets; co-ordinate policies across different branches; and build political consensus in their domestic constituencies.

Mr. John Evans, of the Trade Union Advisory Committee to the OECD, presented *The Trade Union Perspective.* At the beginning of his presentation, Mr. Evans mentioned the competition for FDI, and in particular the delocation of investment. To illustrate this subject, he referred to a press article, which mentions an investment in [Mexico] [one country] which delocated to [China] [another country] because of the low costs in the latter. The panelist also stressed the need for the respect of core labour standards, and for good governance consistent with both good economic performance and good export performance. Consistency is therefore the main policy challenge, and could be achieved through: a skilled labour force, productivity, good infrastructure; a "race-to-the-top" (as opposed to a "race-to-the-bottom").

Furthermore, Mr. Evans identified some messages to be conveyed to the United Nations Conference on Financing for Development: There is a need for an effective legal structure (to bring workers from the informal sector into the main stream of society) and for social safety nets; Official Development Assistance (ODA) is a priority for Least-Developed Countries; international rules (property rights) and respect of human rights are needed; on this last issue, he mentioned the issue of Burma. In closing, Mr. Evans referred to the "User Guide" to the OECD Guidelines on Multinational Enterprises, prepared by TUAC, and in particular, to the worldwide implementation of those Guidelines. He called for immediate action in the present situation because of the pressure on standards and on conditions.

The main topic discussed in the presentation by ***Mr. Ernesto Stein***, of the Inter-American Development Bank, was whether the benefits of FDI for the host countries depend on the manner in which FDI is attracted to a country. Mr. Stein's presentation focused on the factors influencing FDI location, and placed special emphasis on the role played by the quality of host-country institutions as a determinant of the location of FDI. He mentioned several variables such as the extent of bureaucratic red-tape, political instability, corruption and the quality of the legal system, and their relationship with other variables like attitudes toward the private sector, the living environment, inequality, the risk of terrorism, etc.

Mr. Stein took a closer look at FDI flows in Latin America to see how it compares with other regions in terms of success in attracting FDI, to identify the countries that have been more successful in this regard, and to trace where FDI flows to Latin American countries originate. He also explored the role of institutional variables as determinants of the location of FDI, using a large number of variables

drawn from several different sources (e.g. Kaufmann's government indicators, data and empirical strategy, gravity models, explanatory variables, ICRG variables).

Finally, Mr. Stein concluded that the quality of institutions has a positive effect on FDI. In particular, he stressed that market-unfriendly policies, excessive regulatory burden, and lack of commitment on the part of the government seem to play a major role in deterring FDI flows.

Mr. Jorge Roldos of the International Monetary Fund outlined the most important structural changes in the financial systems of emerging markets and their effects. FDI and portfolio investment have increased the foreign ownership and control of emerging markets' banking systems. Some factors that explain the increase in FDI in emerging markets' banking systems are the globalisation of the financial services industry and the removal of barriers to entry in several of these countries. A number of recent studies of the efficiency and the stability effects of foreign bank entry have also been conducted.

Foreign bank entry can contribute to the efficiency of the banking system through improved evaluation and pricing of credit risks and enhanced availability of financial services (there is empirical support for emerging markets but not for mature ones). Foreign bank entry can also contribute to the stability of the banking system through improved diversification, a stable credit and deposit base, and parental support (although there is broad empirical support for the first two factors, this is unclear for the last one). The panelist stressed that the growing presence of foreign banks has raised some policy issues – such as cross-border supervision and regulation, banking system concentration and systemic risks, and social safety nets – that require attention.

Panel A – Benefits of FDI for Development: Country Experiences

Chaired by ***Mr. Neil Roger*** of the World Bank Private Sector and Foreign Investment Advisory Services, and reported by ***Mr. Jan Schuijer*** of the OECD, this Panel focused on the role of FDI in promoting development and poverty alleviation.

Mr. Luis De la Calle Pardo, Mexican Vice-Minister for International Trade Negotiations, spoke about *The importance of FDI in the Economic Development of Mexico*. Mr. De la Calle divided his presentation into two specific issues: i) the benefits of FDI, and ii) the challenges for the future. On the first point, Mr. De la Calle stressed the preferential access that Mexico has to 850 million consumers in 32 countries through its large network of international agreements. Mexico already has in place 11 Free Trade Agreements (FTAs) and has negotiated 19 Bilateral Investment Treaties (BITs). In addition, Mexico is negotiating BITs with three more nations: the United Kingdom, Japan and Israel. The importance of Mexico's participation in international organisations such as the OECD was also highlighted.

Mr. De la Calle explained how trade and investment openness have benefited Mexico:

- Mexico is the 8th largest exporter in the world and the largest in Latin America
- Export activity is the main source of Employment in Mexico
- Mexico is the third-largest FDI recipient among developing countries.
- Since NAFTA, the annual average of FDI received by Mexico has more than tripled.

- More than 20 per cent of formal employment is located in FDI firms. FDI has allowed employees to be incorporated into the formal labour sector of the economy, which, in fact, enhances their quality of life.

- Employment growth rate in firms with FDI is higher than the domestic average. To date, FDI firms have created half of all new jobs generated in Mexico.

- Firms with FDI pay better than the domestic average (around 50 per cent higher).

He affirmed that Mexico is certainly an attractive destination for FDI: around 84.6 per cent of FDI comes from the United States, 10.3 per cent from the European Union, 2.8 per cent from Canada, and 2.3 per cent from other countries.

On the second point, "challenges for the future", Mr. De la Calle explained that even when 94 per cent of Mexico's exports have duty-free access by 2003, there will be decreasing returns of market access. In this regard, Mexico could have to attract investment of better quality to compensate. In addition, Mexico has to face hard competition. Its main competitors come from Asia and Latin America (Chinese Taipei, Korea, China, Brazil).

Mr. De la Calle concluded that only by maximising its fundamental comparative advantages will Mexico be able to deepen the benefits of economic openness. That is to say, Mexico should take advantage of its young population, privileged geographic position and network of FTAs to become an investor in human capital, modernise its infrastructure, and diversify trade in order to address the relative preferences.

Finally, the Panel found that it is very important that FDI be a catalyst of added value in the export processes of a country. In order to attract FDI the return-risk combination should be enhanced by seeking to decrease costs and giving legal security and predictability to investors and their investments.

Ms. Melek Us, Director General of Foreign Investment, Turkey, introduced her paper *Removing Administrative Barriers to FDI: Particular case of Turkey,* by discussing the weaknesses and strengths of Turkey and the actions taken by the government to transform Turkey from an economy lacking competition and efficiency, into an attractive destination for FDI. By establishing ambitious programmes to dismantle administrative barriers, and setting immediate measures to promote investment, Turkey is now becoming a stronger economy. All of these measures are based on a comprehensive dialogue between the government, the private sector, academics and other interested parties.

FDI and its Impact on Employment and Social Policies: The Malaysian Experience was the theme of ***Mr. Govindasamy Rajasekaran***, Secretary General of the Malaysian Trades Union Congress. Mr. John Evans of TUAC delivered his presentation since Mr. Rajasekaran was unable to attend. Focusing on the case of Malaysia, the impact of FDI on many elements of labour policies was emphasised. First, it was stressed that even if FDI does help to create jobs, it does not automatically lead to a better standard of living for workers.

The limits of FDI to growth were explained. While the large inflow of foreign investment can be effective in reviving the economy, it is not a long-term solution to economic development. It has to be accompanied by domestic developments such as the transfer of technology to local firms, the development of local production capacity and sourcing of inputs, and the development of local human

resources. For a country with a small population like Malaysia, inviting labour-intensive foreign investment creates a tight labour market that threatens to increase labour costs.

It was concluded that:

- In Malaysia the birth and growth of trade unions are severely restricted.
- Multinational enterprises, mainly from OECD countries, exert a great deal of pressure on the Government to successfully ensure that independent industrial unions are not permitted.
- Respect for freedom of association is central to the attainment of economic development and sustainable growth.
- Trade Unions play an essential role in the development process by achieving a sustainable distribution of income and wealth.
- Productivity, growth, and development all depend upon a generalised perception that the labour market is equitable.

Ms. Anabel Gonzalez, Director of the Costa Rica Investment Board (CINDE), introduced the topic *Key Drivers for Investing in Costa Rica: the Intel Case.* First, Mrs. Gonzalez gave a general description of Costa Rica: location, area, population, GDP, exports, imports, and amount of FDI. Then she explained the criteria used by Intel to select the country to establish its plant. These include stable economic and political conditions, adequate human resources, a pro-business environment, logistics and manufacturing lead time, and a fast-track permit process. In this selection process, Costa Rica competed with many developing countries, in particular with Mexico and Brazil. Although all three countries met the criteria mentioned above, Costa Rica was selected because of two important elements: negotiating tactics and specific concessions. Intel is now Costa Rica's major exporter, generating more than 2,000 jobs, and using around 300 local suppliers.

Finally, Ms. Gonzalez explained the key factors used by Costa Rica to attract investment:

- Investment promotion is made along with the participation of strategic partners e.g. MNEs, universities.
- Key drivers include political and social stability, economic openness and liberalisation, receptive investment environment, people, improved infrastructure, strategic location and a proactive attitude.

Following Intel's lead, many other multinationals have set up business in Costa Rica, including Procter and Gamble, Abbott Laboratories, Western Union, Sykes, McGhan Medical, Narda, and Teradyne.

Mr. Jacques Morisset, the World Bank's Lead Economist and Programme Manager for Africa, made the presentation *Foreign Direct Investment in Africa: Policies also Matter*. He stressed that the capacity of African countries to attract foreign direct investment (FDI) is mainly determined by their natural resources and the size of their local markets. In his presentation, Mr. Morisset showed this argument is supported by the apparent lack of interest of transnational corporations (TNCs) in African countries that have attempted to implement policy reforms.

Mr. Morisset said that it has been argued that reforms in many African countries have been incomplete, and thus have not fully convinced foreign investors to develop activities that are not dependent on natural resources and aimed at regional and global markets. His presentation was aimed at identifying African countries that have been able to attract FDI by improving their business climate, adopting proactive policies and reform-oriented governments. He concluded that over the past decade, several African countries have attempted to improve their business climate in an effort to attract foreign companies. To improve the climate for FDI, an econometric analysis indicated that strong economic growth and aggressive trade liberalisation can be used to fuel the interest of foreign investors.

Beyond macroeconomic and political stability, African countries that have been successful in attracting FDI focused on a few strategic actions such as:

- Opening the economy through trade liberalisation reform
- Launching an attractive privatisation programme
- Modernising mining and investment codes
- Adopting international agreements related to FDI
- Developing a few priority projects that have a multiplier effects on other investment projects
- Mounting an image-building effort with the participation of high political figures, including the President.

Panel B – Government Responsibility: Beyond Traditional FDI Policies.

Mr. Wesley Scholz, Director of Investment Affairs at the United States Department of State, chaired the Panel B Session. In launching the discussion, Mr. Scholz said that the new trends and developments need to go beyond traditional Foreign Direct Investment Policies and take a broader perspective as to the interaction of related policy tools. The Rapporteur in Panel B was ***Mr. Rogelio Arellano Cadena*** from the Mexican Delegation to the OECD.

Mr. Vudayagi N. Balasubramanyam, Professor of Development Economics at Lancaster University, England, made a presentation on the *Need for a broader policy approach to FDI and effective implementation*. In his presentation, Mr. Balasubramanyam addressed two interrelated issues of concern to developing countries: the factors that determine FDI flows and the preconditions for the efficient utilisation of FDI in the development process.

He discussed the main determinants of FDI: size of markets, infrastructure, macroeconomic stability, product and labour market distortions, incentive schemes, integration schemes, methods of foreign enterprise participation, attitudes, and business environment. He also analysed the necessary preconditions for the efficient utilisation of FDI in the development process. Mr. Balasubramanyam identified four propositions related to the efficacy of FDI:

- FDI is not a panacea for the development problem; it is a catalyst of growth and development.

- The type of trade policy regime in place influences the allocative efficiency of FDI.

- Competition in the market place is an essential precondition for the effective utilisation of FDI.

- Incentive packages and various sorts of regulations imposed on foreign firms may not always be conductive to their efficient operation.

The second presentation *Home country perspectives*, was made by ***Ambassador Marino Baldi***, State Secretariat for Economic Affairs, Switzerland. Mr. Baldi said that traditional policies and measures for attracting or promoting inward investment could, at the utmost, play a complementary role. They do not by themselves attract FDI. It should always be borne in mind that investors make their investment decisions on the basis of economic considerations. In other words, FDI goes to countries where investors can expect a reasonable return on capital, and such returns depend primarily on market opportunities, along with sound economic policies and a transparent and predictable legal framework. Instead of concentrating on measures that are at the most, second-best options, host and home countries should focus their efforts and activities on shaping a pro-business environment in recipient economies and on improving the long-term functioning of markets.

The third presentation, *Making FDI and financial-sector policies mutually supportive* was made by ***Mr. Pierre Poret***, Head of Division of the OECD Directorate of Financial, Fiscal and Enterprise Affairs. Mr. Poret argued that the development of a sound and efficient banking and financial sector is widely recognised as an important ingredient of an effective system of resources allocation and robust growth within national economies. It has also proven to be a key condition for ensuring orderly capital account liberalisation.

A solid domestic infrastructure for banking services and capital markets are among the parameters considered by investors when they decide on the location of their investments. An important trend in world FDI flows in recent years has been the strong orientation of FDI towards the services sector. More than half of OECD countries' FDI involves the service sector. Banks and other financial institutions accounted for a very high share of these investments. But only a small part of OECD countries FDI outflows is directed to developing countries – largely concentrated in a few countries in Latin America and Asia. This suggests that there is significant under-exploited potential for many other countries around the world to catch up.

Russian Experience Regarding the Impact of Competition Policy on FDI Flows was the subject of the presentation made by ***Dr. Nataliya Yacheistova***, Advisor to the Minister for Anti-monopoly Policy & Support of Entrepreneurship, Russia. Ms. Yacheistova talked about the general view of FDI in Russia. She pointed out that until recently the volume of FDI in Russia had been moderate. FDI into fixed capital dramatically declined during the last decade. But at the beginning of 2000, positive tendencies emerged. In 2000, FDI inflows increased to U.S.$4.26 billion. In the first half of 2001, FDI inflows to Russia increased by 40 per cent as compared with the first half of the previous year. The three leading foreign investors in the Russian economy are Germany, the United States and Cyprus. It is important to note that the biggest investment projects are concentrated in the oil and gas sectors.

Ms. Yacheistova recognised that the most important remaining problems faced by foreign investors in Russia are the following:

- Complicated tax system

- Infringement of investor rights in bankruptcy procedures

- Infringement of intellectual property rights
- Contradictory and insufficiently transparent legislation
- Weak court system
- Corruption
- Weak banking system
- High administrative barriers
- Inadequate accounting system.

The Russian anti-monopoly authorities are now playing an important role in supporting general governmental policies directed at creating an attractive investment climate in Russia.

In her presentation, *Foreign Investment in South Africa*, ***Ms. Maliza Nonkqubela*** showed that South Africa's economy is at present the largest in Sub-Saharan Africa. It is around four times larger than those of the rest of Southern Africa. Since South Africa's transition to democracy in 1994, the economy has undergone major transformations, including:

- Signing up with the WTO and the consequent extensive phasing down of import tariffs.
- Commitment to a sound macroeconomic policy in the form of growth, employment and redistribution frameworks, which has resulted in the stabilisation of key macroeconomic variables, such as inflation, budget deficit, and interest rates.
- The completion of Free Trade Agreements (FTA) with the European Union and the Southern African Development Community (SADC), qualification for preferential tariff access in terms of the unilateral U.S. Africa Growth and Opportunity Act (AGOA) as well as ongoing negotiations with respect to an FTA with MERCOSUR.

These policy measures have led to steady economic growth, strong export growth and the attraction of FDI from a wide range of countries. The policy message that Trade and Investment South Africa (TISA) wishes to see from the OECD conference is that there should be a more informed evaluation of emerging market economies in general, and promising African economies in particular. Undue Afro-pessimism should not lead to irrational investment decisions. TISA feels that South Africa has not attracted as much FDI as its economic fundamentals justify.

In his presentation, *Trade Policy and FDI Linkages*, ***Mr. Michael Gestrin***, Administrator of the OECD Trade Directorate showed that economies that are open to trade and investment have grown faster than closed economies. FDI is one, but not the only, mechanism to increase economic growth. If policy-makers focus on just trying to attract FDI to an economy with an environment that is unfavourable to domestic investment and private enterprise, the results are likely to be less favourable with respect to the long-term development of the economy. The enabling framework for FDI consists of rules and regulations governing entry and operation of FDI. Although open FDI policies are a necessary condition, a wide range of other policies and linkages affect FDI decisions. These include government measures that influence institutional effectiveness, infrastructure and skill endowments, and macroeconomic and political stability. They also involve policies towards private enterprises in

general: tax, labour market, environment, public administration, financial sector, foreign trade and exchange rate policies.

The final presentation of Panel B, *FDI and Environment*, was made by ***Ms. Aimée T. Gonzales***, Senior Policy Adviser, WWF International. Ms. Gonzales showed that FDI policies need to pay more attention to the broad set of regulatory and institutional frameworks conductive to an enabling environment for FDI. These include the protection of labour rights and the environment. She also recognised that FDI produces benefits, but it also produces environmental problems. Ms. Gonzales made a reference to the mining industry and its environmental impact. Although the mining industry is dwarfed by other industry sectors – annual raw metal production is estimated at US$93 billion – mineral exploration and extraction can have a strong impact on the natural environment and neighbouring people. Several investigations showed that mining affects the environment and associated biota through the removal of vegetation and topsoil, the displacement of fauna, the release of pollutants into the air and water, and the production of mine overburden.

The way private enterprises are governed and behave, both domestically and internationally, is important for economic development. In recent years, there have been an increasing number of corporate voluntary initiatives regarding environmental and social issues. Corporate codes of conduct cover broad range of issues, such as environmental management, human rights, labour standards, nature, consumer protection, competition, science and technology. A lot still remains to be done in environmental matters.

Panel C – Capacity Building for FDI in Host Countries.

Panel C was chaired by ***Mr. Carlos García Fernández***, Director General for Foreign Investment of the Ministry of Economy, and the Rapporteur was ***Mr. William Nicol***, Head of Division of the OECD Development Co-operation Directorate.

Mr. Richard Newfarmer, of the World Bank's Economic Advisor Policy and Prospects Group, made the first presentation of this Panel on *Improving the Investment Climate: New Policies and Institutions.* In his presentation, Mr. Newfarmer focused on the importance of the theory that suggests that raising the Total Factor Productivity (TFP) is more important than capital accumulation, and FDI contributes positively to growth, especially by raising TFP. Mr. Newfarmer demonstrated that with the establishment of stable macroeconomic policies, removing policy-induced barriers to entry and competition, creating a positive investment climate, eliminating corruption, and investing in education, countries can obtain the most TFP from FDI. He placed special emphasis on creating infrastructure and using proactive policies. He stressed the importance of FDI entry seeking, linkage creation, and technology networks.

In the second presentation, *International investment agreements and instruments*, ***Mr. Carlos García-Fernández***, Director General for Foreign Investment of the Ministry of Economy, explained the recent trends of FDI and stressed how during 2000, FDI world flows maintained their increasing trend, registering in that year a total amount of US$1,270 billion (growth of 18 per cent compared to 1999). Mr. García pointed out that in the context of economic globalisation, mergers and acquisitions (M&As) were the most important vehicle for the expansion of FDI flows. Three factors have been crucial to this expansion: 1) liberalisation of investment regimes, 2) technological process, and 3) corporate strategies.

However, Mr. García raised the following questions: Are we on the right path? What can we learn from the experiences of countries involved in FDI liberalisation? Where should we move? What

lessons can be learned from the MAI? Are governments working properly in the interest of both investors and society? Mr. García then outlined the most important investment instruments worldwide, such as the Bilateral Investment Treaties (BITs) and the relevant investment instruments in international agreements and organisations such as the OECD, APEC, Andean Community, CARICOM, MERCOSUR, and the FTAA. Furthermore, Mr. García emphasised that at the WTO, ministers recognised the case for a multilateral framework to secure transparent, stable and predictable conditions for long-term cross-border investment.

Finally, Mr García stressed that, at this point in the time, there is a patchwork of Regional and Bilateral Instruments on Investment that regulate FDI flows. It is difficult, however, to predict the outcome of the WTO, and it is necessary to agree international standards on investment as has been done in trade. This would create legal certainty and stability.

In his presentation, *The benefits of FDI in a Transitional Economy: The case of China*, ***Mr. Yasheng Huang***, Associate Professor at Harvard Business School, explained the importance and benefits of China's accession to the WTO. He mentioned that the most important benefit of WTO membership is that it will attenuate the inefficiencies of domestic financial and economic institutions. WTO accession is likely to promote internal reforms in three ways: 1) Chinese leaders today are facing a stark choice between socialism and nationalism, but China has created many profitable business opportunities for foreign firms; 2) a likely effect of WTO membership will be improved efficiency in China's service sector. As regards reforms in the banking, insurance, wholesaling, retailing and telecommunications sectors, WTO accession will force China to open its doors to the most efficient foreign service providers; 3) Finally, the third likely effect of WTO membership is that China will become more institutionally integrated into the global economy. So far, the open-door policy has increased China's economic integration. Examples of this are the increasingly large share of GDP that is traded on the world market, and the large portion of the capital formation that comes from foreign sources.

Ms. Patricia Francis, President of Jamaica's Promotions Corporation and President of the World Federation of Investment Promotion Agencies, spoke about *FDI Linkages with Local Enterprise Development*. In her presentation, Ms. Francis explained that since many developing countries have begun to search for ways to increase the benefits from FDI, one of the ways is through increased backward linkages between foreign controlled companies and local firms. In the process of promoting linkages, many countries have recognised that protectionist policies and local content programmes, previously used to force foreign companies to buy local inputs, do not work well in the changing international environment.

Studies on the Jamaican economy showed that whereas FDI can greatly assist in technology-sharing among other things, the real adaptation of these technologies is done in large part by local firms who then localise these technologies to improve their efficiency – a process known as "innovation". It is when partnerships are formed between the suppliers of capital (TNCs) and those best able to localise its use (Jamaican Firms) that capital's marginal productivity increases and stimulates company development, which places the economy on the optimum growth path. These partnerships also reduce the net cost of capital to both TNCs and Jamaican firms.

In presenting *FDI, Official Development Assistance and Capacity Building: Prospects and Policy Challenges,* ***Mr. William Nicol***, Head of Division, OECD Development Co-operation Directorate, stressed that international investment rules at bilateral, regional, and multilateral levels can play a key role for the purpose of improving the legal environment for FDI worldwide as a complement to domestic reforms. However, investment rules alone are not enough to ensure that all countries attract a greater proportion of the increasing flows of FDI. The main determinants of international investment

flows in a given country are market size and structure, macroeconomic and political stability, level of infrastructure, labour skills, etc.

An improved legal framework should be developed together with measures aimed at creating a supportive business framework that would maximise the potential that countries have for attracting FDI. This enabling environment for FDI should include good governance, effective justice systems, respect for the rule of law, etc. Not only does it make a country more attractive to FDI inflows, but it also helps it to absorb the flows in a more productive way. In this context Mr. Nicol explained that it is crucial to identify what appropriate assistance could be envisaged to ensure that developing countries exploit their full potential by attracting more capital flows and consequently increase their economic growth.

As a first step, developing countries could receive assistance on two fronts: on the one hand, assistance should aim at identifying the key requirements for increasing their attractiveness as investment locations and the key bottlenecks that frustrate domestic policies to this end. On this basis, assistance could then be directed at building capacity to: 1) regulate domestic markets in order to attract investment; 2) identify and deal with obstacles to ordinary market functioning, e.g., competition policy. On the other hand, developing countries should receive assistance to negotiate international investment rules effectively, and to transpose the results of negotiations into domestic laws and regulations.

Finally, in his presentation, *Corruption is a Barrier to FDI*, ***Mr. Luis Bates***, from Transparency International, explained that one of the main problems is the abuse of government's position. He also addressed the problem of public and private corruption, even in the case of transnational bribery. An example of the consequences of such practices is the difficulty of applying rules that could be significantly reduced through government modernisation and the legitimisation of institutions and all public workers. He stressed that the current position of Latin America is weakened by extreme corruption, mainly due to political, ethical, and economic factors.

Panel D - Initiatives for Corporate Responsibility and Economic Development

Mr. Steve Canner, Vice-President, U.S. Council for International Business chaired the Session. In launching the discussion, Mr. Canner pointed out that OECD Guidelines for Multinational Enterprises contribute to the responsible conduct of companies. The Chair also stressed that, with a few rare exceptions, commerce and investment are the main causes of environmental problems. The OECD recognises that FDI could have both good and bad effects. That was certainly one of the reasons the GFII was set up: to discuss how business and enterprises could contribute to sustainable development.

In his presentation on *Trade Union Perspective*, ***Mr. Jim Baker***, Head of the Multinationals Branch, International Confederation of Free Trade Unions, explained the implications of corporate social responsibility in economic development. Economic development is based on the notion that development should be both economic and social, and in this way, will produce the most for nations and communities. Corporate social responsibility should therefore be carried out in a way that encourages that kind of development. It could, however, discourage or be irrelevant to it, because there are many different ideas and examples of how economic development really takes place. The main problem is the respect of minimum labour standards, and that corporate social responsibility must be considered in the context of the competitive pressure to violate workers' rights.

Corporate social responsibility cannot, however, be expected to replace the responsibility of governments, because it cannot completely fill the void created by governments that are incapable of protecting the rights of their citizens. The impact of corporate social responsibility will not be felt in countries where governments effectively protect labour standards. Mr. Baker also stressed the

importance of encouraging good industrial relations policies, allowing workers the opportunity to have global collective bargaining agreements, or providing the space for workers to organise trade unions without fear. The OECD Guidelines for Multinational Enterprises and the unilateral codes of conduct, offer a great opportunity for governments to be relevant to the social needs of the global economy, contribute to real social and economic development, and guarantee the rights of workers.

In the second presentation, *Corporate responsibility and Competitiveness*, ***Mr. Enrico Massimo Carle***, Chairman on Investment and Multinational Enterprises, BIAC, stated that corporate social responsibility has to do with voluntary measures that a company takes to develop good management systems. These, in turn, enhance a company's ability to sustain their franchise and build a record of sustained growth, by engaging positively with the societies in which they operate. Thus, the decision by a company to adopt a certain code of conduct will depend on the objectives of the individual company and the relative value added each code can offer. However, Mr. Carle stressed that the behaviour of an enterprise is the most important indicator of its commitment to good business practices. He also explained that an increasing number of companies are communicating to the public their good management systems (implementation of practices and policies related to environmental, health, safety and employee benefits), in contributing to economic development.

Mr. Carle pointed out that the OECD Guidelines for Multinational Enterprises serve as an important benchmarking tool for companies as they develop their internal management systems, and that this is the main reason for BIAC and its member organisations to continue the promotion of the OECD Guidelines. The Guidelines are a voluntary tool to improve the climate for foreign direct investment and sustainable growth, and to encourage a balance of responsibility between international business and governments. Nevertheless, there are limits on what should be expected from company performance. Companies cannot substitute for governments in building the policy mosaic, that is, the co-ordinated legal framework and basic infrastructure, needed to establish fully the conditions for economic growth. Good public governance, an adequate education system, and training in basic skills are essential to attract FDI and trade.

In closing, Mr. Carle concluded that it is very important that policy-makers keep in mind that the benefits of all the instruments and codes should be the implementation of effective management systems within companies. Governments and business alike need to be sure that policy decisions in these areas enhance, and do not inhibit, the benefits of trade and investment.

In the third presentation *Corporate Social Responsibility: Are the investors the solution or the problem?*, ***Mr. Raj Thamotheram***, Senior Adviser, Socially Responsible and Sustainable Investment, Universities Superannuation Scheme Ltd., began by asking "Are investors the ones who are interested in corporate governance and corporate social responsibility part of the problem or part of the solution when they come to invest in emerging markets?" His answer covered the following four points:

- How different investors have very different agendas. Governments who wish to mobilise resources need to understand that different investors respond to different drivers, and then choose who they want to work with most.
- How – by responding to the developing interest in corporate governance and corporate social responsibility by investors – you can encourage those major investors who are wary of emerging markets.
- Who needs to do what, focusing on what OECD and non-OECD governments can do.
- And finally, why institutional investors are not the cure.

For the first point, the speaker explained that there is a range of investors, each with differing interests, for example insurance companies, which generally hold stock for longer than active managers, and shorter than pension funds, or pension funds which typically might hold stock for several years. These kinds of investors have very different interests, so who should governments and inter-governmental bodies like the OECD, listen to most carefully? Pension funds and other institutional investors should get this recognition because pension funds are the most patient sources of capital, and the beneficiaries of funded pension funds make up a significant percentage of society, especially in some OECD countries.

For the second point, Mr. Thamotheram considered, in general terms, that if governments help ensure that companies meet benchmark standards on corporate governance and corporate social responsibility, this will encourage a more positive approach from potential investing institutions.

For his third point, he stressed that OECD governments need to send clearer signals to the public that they want investors to be responsible and active long-terms owners. He also considered that governments can be supportive of companies that adopt good practice standards in corporate governance and corporate social responsibility. This is as important for OECD governments as it is for non-OECD governments, as illustrated by the positive experience of the UK Government in this regard.

In answer to his last question, the panelist explained that governments couldn't expect institutional investors do their work. Both OECD and non-OECD governments need to encourage companies to adopt benchmark standards of good practice on corporate governance and corporate social responsibility issues, and encourage investors to be responsible and active shareholders.

In his presentation, *Do Corporate Responsibility and Private Initiatives Work for Development: An OECD Perspective*, ***Mr. Pierre Poret***, OECD Head of Division, pointed out that responsible business conduct by multinational enterprises (MNE) can help countries reap the full benefits of international direct investment for development. Private initiatives for corporate responsibility are efforts by companies to develop and maintain internal control systems that allow them to comply with market, regulatory and other legitimate expectations. Mr. Poret mentioned the importance of the recent OECD Study, *Corporate Responsibility—Private Initiatives and Public Goals*, which includes initiatives for codes of corporate conduct setting forth commitments in such areas as labour relations, environmental management, human rights, consumer protection, competition, disclosure and fighting corruption. The countries adhering to the OECD Guidelines want to use them as a framework to reinforce private initiatives for corporate responsibility.

Mr. Poret explained, with some illustrations, that the approach of the Guidelines is not one of regulation, but rather one that favours co-operation and the accumulation of expertise in order to enhance further the benefits of international investment. Private initiatives for corporate responsibility raise significant challenges from a developing country perspective, and can occasionally have "unintended consequences", and he underscored the need to proceed carefully with corporate responsibility initiatives and to have adequate knowledge of local conditions. The code emerged as a result of what is now an infamous case of unintended consequences of NGO activity, in this case, in response to the revelation that children were involved in the production of soccer balls in Pakistan. As a result of NGO activity, soccer ball suppliers in Pakistan were instructed to stop employing children immediately, which they did. However, since many of the children had been brought in from surrounding areas to work in factory-type situations, they ended up on the streets without caretakers or family supervision.

The notion of corporate social responsibility is not meant to be a substitute for the responsibility of other stakeholders, particularly states themselves. Governments have the responsibility of ensuring a favourable environment for business, through provision of such services as law enforcement, appropriate regulation, and investment in the many public goods and services used by business. And businesses, beyond their core objective of yielding adequate returns to owners of capital, are expected not only to obey the various laws applicable to them, but also to respond to the societal expectations that are not written down as formal law.

During the debate on corporate social responsibility, fiduciary was identified as being the main goal of enterprises. On the concept of "corporate social responsibility" itself, one panelist made reference to a study that says that such a concept was brought by "non-democratic NGOs". In response to this, another panelist stressed that corporate social responsibility is in the interest of investors themselves and, in particular, that the OECD Guidelines are a co-operative approach to governance and regulation. There was also some debate on the timeliness of introducing the OECD Guidelines into the WTO; although arguments diverged, participants did not seem to consider this an appropriate idea.

In his presentation, *Codes of Conduct in Support of Development?*, ***Mr. Herbert Oberhänsli***, International Chamber of Commerce (and Manager, Economic and International Relations, Nestlé, SA) recognised that corporate social responsibility (CSR) is not a recent creation, but has always been inherent to enterprises´ competitiveness and long-term success. He also pointed out that, in order to improve their contribution to development, companies need to be focused, to think and act on a long-term basis, and to use dialogue rather than guidelines. In talking about the experience of the company he represents, he stated that low wages are not a factor in attracting investment, and explained how his company, which is present in many developing countries, has operated on the basis of trust and on dialogue with suppliers (farmers), workers, employees, trade unions, customers and governments, with a view to finding common interests.

An NGO perspective on the benefits and costs of FDI and on the role of codes of corporate conduct was provided by ***Mr. Brett Parris***, of World Vision, Australia, in *FDI and Corporate Codes of Conduct in National Development Strategies: Costs, Benefits and Policy Options*. He affirmed that FDI should be evaluated in an economic and social cost-benefit framework, taking into account appropriate shadow prices, discount rates and distributional weights. The context of the evaluation should be the country's own development strategy, including goals such as social development, poverty reduction and industrial restructuring. Moreover, he elaborated on the benefits and costs of FDI by multinational enterprises in developing countries, with a focus on evidence about costs in areas such as: FDI and technological spillovers; FDI and trade policy; FDI, Transfer Pricing and Tax Avoidance.

On the ability of codes of corporate conduct to modify corporate behaviour, the panelist identified three important factors: what is included in the codes, what is left out, and, most importantly, how they are promoted, monitored and enforced. On the role of codes of conduct, Mr. Parris said that they can go so far towards ensuring social benefits from FDI, but there is a need for a sound institutional environment with democracy, with competent, honest bureaucracy and judiciary, and laws to protect the environment and workers' rights. He stressed that codes of conduct can help better performance but they cannot replace a legal and political framework.

In the *Role of multinational enterprises in economic and social development of energy-rich transition countries*, ***Mr. Fikret Pashayev***, Deputy Head of Department, Ministry of Foreign Affairs, Azerbaijan, focused on the role of FDI in newly-independent energy-rich transition countries in the Caspian Sea region, and in particular on the Azerbaijani experience in the last decade. He explained some of the reforms undertaken by his country, with a particular emphasis on liberalisation, private sector

development, and transformation into a market-oriented system. Furthermore, the panelist explained some of the reasons why Azerbaijan has been able to attract important levels of FDI (rich oil and gas reserves in the Caspian Sea basin; good investment opportunities; skilled labour force at competitive costs; long-term market potential; global competition in oil industry). In closing, Mr. Pashayev referred to the contribution of multinational enterprises to the development of his country.

There was a discussion about the growing number of initiatives on corporate social responsibility. It was said that all initiatives have something to offer, and that the OECD Guidelines have a particular role to play, as they cover an extensive range of topics. One panelist stressed the need to focus on dialogue more than on initiatives, while another pointed out the importance of focusing more on the behaviour of the company and on the improvement of the situation, rather than on which code has been adopted. There was disagreement among panelists on the issue of cost-benefit analysis of proposed FDI that had been introduced by one of the panelists.

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REPORTS BY PANEL CHAIRS

Panel A - Benefits of FDI for Development: Country Experiences, *Mr. Neil Roger*

The discussion confirmed that the desirability of foreign direct investment as such is no longer an issue. All countries covet FDI. It was noted that, at Doha, 140 countries had, for the first time, agreed on the need for a multilateral framework to foster FDI. If there are concerns on FDI, these tend to relate to attendant issues. Particular mention was made of its impact on the economic development of a country and the position of workers: how could benefits be maximised and advantages more widely shared? For many countries, however, the primary concern is to attract FDI in the first place; maximising its benefits is almost a luxury question to them.

Even if we do want FDI, it seems that, as a world community, we are still not good at obtaining enough of it. Countries tend to see one another as competitors for a limited pool of investable resources. On the other hand, it was noted that there are abundant resources, which could be invested, but are not, because attractive projects are lacking. This suggests that the fear of competitors among investment promotion agencies is a bit of a red herring and that, if a country is attractive enough, and tells the world so, investors will come.

But how can a country be made attractive as a venue for FDI? Potential investors tend to compare risks with potential rewards, and to invest where the trade-off is the most favourable. Throughout our discussion, many "reward-generating" factors were cited. To mention only the most important:

- The proximity of a large market, facilitating just-in-time deliveries;
- The presence of a young and well-educated labour force;
- Lack of cumbersome administrative procedures, which convey hostility to investors;

- A trustworthy rule of law;
- Free-trade agreements with major markets, giving the country a gateway position for investors to these markets;
- A good infrastructure;
- Macroeconomic and political stability;
- Trail-blazing by a major investor (e.g. Intel´s investment in Costa Rica was followed by dozens of other IT companies).

Two country cases (Mexico and Turkey), were presented, both of which, superficially, seemed similarly attractive to FDI: their potential as a gateway to a major market (the U.S. and the EU), bolstered by free-trade agreements, good infrastructures, and young well-educated workers. Yet Mexico has proven a far greater success as an FDI venue than Turkey. This shows that even if a country does many things right, this will not be enough if other factors are neglected. Unlike Mexico, Turkey does not enjoy macroeconomic stability. A recent study has concluded that its administrative barriers cost the economy more than it presently receives in FDI. And Turkey is unlucky enough to be situated near a politically unstable region, the Balkans. Indeed, policies matter, as a speaker expressed it. The cases of Mali and Mozambique were mentioned, both of which have attracted more FDI than many other, larger African countries. Why? Because Mali and Mozambique pursued the right policies: an attractive privatisation programme, a modern and working mining law, accession to international agreements, an open economy.

Countries should be alert to the ephemeral nature of some advantages. For example, Mexico will lose its preferential access to the U.S. under NAFTA once the FTAA is in place.

Last, but not least, if a country is to attract investors, and especially the "big fish" (we were told of Costa Rica's successful wooing of Intel), it needs a strong and visible commitment from its top officials. The smaller countries, especially, have to ensure that they are seen and heard. Advice was given on the way to use news media contacts for this purpose. It is essential to build long-term relationships with the media. Indeed, the big reward, in the form of a major investor like Intel, may be years in the making.

How can a country ensure that the potential benefits of FDI to its economic development are realised? The optimistic view is that FDI has a proven record as a generator of economic growth, jobs and regional development, Mexico being a case in point. While this view was not contested, three kinds of qualifying observations were made.

The first was that foreign-invested sectors tend to stand out as export-oriented "islands" that are not sufficiently interwoven into the larger economy: "backward linkages" to the domestic sector are insufficiently developed, and as a result the economy benefits below its potential.

The second qualification concerned the impact of FDI on the host country's workers. The surge of FDI into Mexico has not stopped real wages in this country from declining. In some countries, like Malaysia, foreign-invested enterprises have employed immigrant workers on a large scale, and these are the first to suffer when business turns bad, as demonstrated during the 1997/1998 Asian crisis. Many countries have no social safety nets. Some restrict workers' rights of association in order to attract investment. Malaysia was again mentioned as an example, but China deserves a special mention here, as this country is not "handicapped" by free trade unions or a vocal and critical civil society. Fears were expressed that China's emergence as a competitor for FDI may tempt other countries in the region to restrict trade union activity.

The final qualification related to the quality of legislation. It is one thing to have all the right laws on your law books, but quite another to ensure that these laws are implemented and that they are understood by those who implement them. An enormous effort in capacity building in this area will be required. The "Doha Development Agenda" will do just that. This must also be a key issue on the Finance for Development Agenda. This Agenda should include a study of how official development assistance (ODA), which tends to flow to those countries that receive little FDI, can be used to build this kind of institutional capacity.

Panel B – Governments' Responsibility: Beyond Traditional FDI Policies, *Mr. Wesley Scholz*

Recognising that FDI flows are a key variable to face the global economic downturn, panelists in this session discussed both traditional and so-called new policies to attract and promote FDI. The main ideas that emerged from the discussions are:

- Sound macro policies and a market-oriented approach, including competition, regulatory reform, safeguard of intellectual property rights and the rule of law to build up trust, are fundamental to facilitate FDI flows;
- In addition, government, enterprises, and society as a whole can favour FDI flows and their positive impact on the economy through public and corporate governance;
- The need for a multilateral framework on investment was another of the issues discussed. Though views differed as to the WTO being the Organisation to handle investment rules, there was consensus that such rules needed to be balanced, taking into account developing country needs. Here, the role of capacity building and support for infrastructure development in LDCs was also pointed out;
- In this regard, the codes of capital movement and the Declaration of International Investment have been important steps that OECD countries have undertaken to liberalise investment flows;
- During the session it was also stressed that investment incentives are inefficient, creating distortions and even discriminating against domestic firms. However, there were no consensus on an international agreement, or domestic instruments, to regulate such incentives;
- Finally, taking into account society expectations, including the protection of the environment and basic labour rights (as is done in the Guidelines for Multinational Enterprises), would also facilitate the maximisation of FDI benefits.

Panel C - Capacity Building for FDI in Host Countries, *Mr. Carlos Garcia Fernandez*

One of the major routes by which FDI benefits development is the transfer of technology.

- Technology is a major determinant of growth.
- What capacities are needed to ensure that the transfer of technology actually takes place?
- We need to look at the transfer of technology from parent to subsidiary companies, from demonstration effects, from labour turnover, from vertical linkages. But we also need to know more about these mechanisms.

How can technology and productivity benefits be maximised?

- A stable macroeconomic climate.
- Remove policy barriers (e.g. tariffs) that devalue the benefits of FDI.
- Strengthen the investment climate (property rights, protection of intellectual, etc).
- Invest in education.
- Proactive policies – entry seeking (e.g. through strengthening competition), linkage creation, technical networks. But we need to learn how to replicate good country experiences.

Institutions are important – as the analysis of FDI in China shows

- Fragmentation of markets (product, financial) reduce "economic mass" and attractiveness to FDI – so policies to promote integration are very important.
- Full benefits from FDI require equal actions at the domestic level – there are important complementarities between the foreign and domestic sectors that need to be exploited, and FDI provides a stimulus to move ahead on the domestic scene. Otherwise, biases will limit benefits.

Capacities to develop and use investment agreements are now a key part of the FDI architecture.

- Investment agreements (bilateral, international) are important for the rules of the game and for strengthening business certainty – by focusing on legal protection, dispute settlement, liberalisation commitments.
- Bilateral investment agreements are important stepping-stones to broader international ones.
- Investment is already addressed in the WTO (via TRIMs, TRIPs, GATS), and " modalities" are to be addressed post Doha – so should WTO be the place to discuss an international framework for investment? If so, it will be important to bring in the development dimension from the outset.
- Doha has a major development and capacity agenda. But past lessons show how important it will be to raise and manage the financing needed for this capacity-building agenda.

Linkages with the domestic sector are critical to realising the full benefits of FDI.

- Earlier approaches to ensure such benefits (e.g. tariffs, local content requirements, joint ventures, etc) were not successful.
- But we are now realising the importance of upgrading the local supply chains, modernising industry, and strengthening productivity to reduce costs and improve quality.

ODA and FDI are largely unconnected – can we pull them together to strengthen capacity building initiatives?

- Many lessons – for governments, for donors, for the private sector – are being learned from past experience.
- We need to take a more systemic, strategic and comprehensive approach, based on partnerships of all stakeholders, shared responsibility, and accountability.

- We also need to distil key messages from OECD, World Bank, etc. work on how FDI contributes to poverty reduction and set these out in political and strategic ways to mobilise funding for capacity building. We need to convince donors, and some governments, of this need.
- This is all the more important today in light of the major shortfalls that exist in mobilising financing for development (the subject of the March 2002 Conference in Monterrey on this theme) and in light of the major capacity building agenda resulting from Doha.

Corruption devalues the benefits of FDI – and major capacity building initiatives are needed at all levels – governments, institutions, enterprises and individuals

- From Klitgard, we know that corruption is a function of monopoly, opacity, and discretionary powers. We need to build institutions and capacities that tackle all of these.
- Weak institutions are a major problem at all levels of government – national and municipal – and in the judiciary as well as in "line" Ministries.
- We need to look at strengthening transparency and reducing discretionary powers in both public and private sectors – by strengthening the role of market forces and codes and standards for both financial and corporate government, and by implementing ethics and integrity codes in the public and private sectors.

Panel D - Initiatives for Corporate Responsibility and Economic Development, *Mr. Steve Canner*

The Global Context: Benefits and Costs of FDI

- FDI can be of major benefit to developing countries (through technology spillovers, positive influence on labour conditions, capacity building, etc.)
- OECD and World Bank analyses tend to show that trade and investment are not a race to the bottom, and seldom the root causes of poverty, and that countries open to trade and investment grow faster (which, in turn, ensures more resources for governments to provide public goods and services)
- One panelist felt it was important to undertake proper cost-benefit analyses of proposed investments and their impact
- Whether FDI is beneficial does not just depend on the characteristics of a particular investment or company, but on local economic circumstances and government policies ("Policies Matter").

What Do Enterprises Seek?

- Enterprises are engaged in trading and investing, and, to do this, seek out market environments with a stable business environment including rule of law, protection of intellectual property rights, enabling infrastructure – in essence good public governance.
- Fiduciarity is the first goal of enterprises.
- Corporate social responsibility is not a recent invention, but has always been inherent to enterprises´ competitiveness and long-term success.

How Efficient are Corporate Responsibility Initiatives?

- Usefulness of codes depends on what they cover, what they omit, and how they are implemented and monitored.
- CSR initiatives can have unintended consequences: problems can arise from well-meaning initiatives (such as what happened in the case of the production of soccer balls in Pakistan). This underscores that there can be no one-size-fits-all approach.
- Hence, all codes and initiatives (UN Global Compact, Sullivan Principles, etc.) have something to offer.
- The OECD Guidelines have a particular role to play because they cover a comprehensive range of topics (labour, environment, human rights, corruption, tax, etc.), but also because of their implementation by governments through national contact points.
- But, ultimately, what counts is not whether or not a company has adopted a code, but how the company internalises the code to impact company performance in the field of corporate social responsibility, beyond its legal obligations.

Where do the Responsibilities of the Different Actors Lie?

- CSR initiatives can be useful as an adjunct to a sound legal environment, provided by governments in host and home countries.
- Mutual dependence exists between enterprises and the societies in which they operate: a business sector cannot prosper in a failing society, and a failing business sector inevitably detracts from general well-being.
- CSR cannot be expected to replace government: private initiatives cannot be expected to work if public governance and other parts of the system work poorly.
- States have the responsibility of ensuring a favourable environment for business, through provision of such services as law enforcement, and investment in public goods and services.
- Because the OECD Guidelines for Multinational Enterprises are an expectation of governments, governments have an important role to play in their promotion. One panelist singled out raising the awareness of pension fund managers as an opportunity for promotion.

CHAIRMEN'S CONCLUSIONS

Co-chairs, Juan Antonio García Villa, Vice-Minister of Regulations and Foreign Trade Services, Luis de la Calle Pardo, Vice-Minister of International Trade Negotiations, and William Witherell, Director, OECD, summed up the deliberations of the Conference as follows:

FDI is needed more than ever….

There was consensus on the importance of sustained FDI flows in the current juncture of the world economic slowdown. FDI is a powerful engine for achieving the international community's reinvigorated development goals, particularly reducing poverty.

FDI should be strongly linked to local enterprise development and not be confined to small enclaves. An important challenge is to bring the less developed countries, particularly in parts of Africa and Asia, into the fold of countries that benefit from FDI inflows.

Policies matter…

It was agreed that with the current uncertainty surrounding short-term economic prospects and FDI, it is all the more necessary to get the conditions right for the forces that have driven the surge in FDI over the last decade to reassert themselves, and for reaping the full benefits of existing FDI.

The benefits of FDI do not accrue automatically, and are not uniform across sectors and countries. Policies and institutions matter. Experience shows that governments need to go beyond traditional liberal FDI policies. They need to pay more attention to the broad set of regulatory and institutional frameworks conducive to an enabling environment both for foreign investment and domestic entrepreneurship. These include the prevalence of rule of law, more transparent administrative practices, effectively combating corruption, good corporate governance, sound competition policy, as well as protection of labour rights and the environment.

Mexico is a case in point. Its reform efforts are paying off: FDI flows have been very robust, and they have been increasing in spite of the global economic slowdown.

Forging new partnerships for capacity building

Building necessary capacities is key to the coherence of policies and their effective implementation. It was agreed that there was a need to establish strong and new partnerships to contribute to the domestic capacity-building efforts in FDI host countries. These partnerships should include host and home countries, multinational enterprises, international organisations and civil society groups. They need to be turned into relevant and effective action. For its part, the OECD remains committed to making this Global Forum on International Investment and its other initiatives open to non-Members and other stakeholders for expertise sharing and broad-based dialogue.

Input to UN Financing for Development and other multilateral organisations

This publication of the results of the Forum are intended as an input into the preparatory process of the UN Conference on Financing for Development that will take place in Mexico in March 2002. They could also be fed into the investment work that is taking place in other multilateral organisations.

CHAPTER I

SETTING THE TRENDS

Recent FDI Trends, Implications for Developing Countries and Policy Challenges,

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FDI plays a growing role in the globalisation process and touches more and more countries, generating both challenges and opportunities. The scope of activities by transnational corporations (TNCs) has never been greater. UNCTAD estimates that today more than 60,000 TNCs control some 800,000 foreign affiliates worldwide. Over the past 15 years, the number of countries receiving an annual average of more than $1 billion of FDI increased from 17 to 51, almost half of which are developing countries. In 2000, global FDI flows reached the unprecedented level of $1.3 trillion. Growth rates of FDI exceeded those of other economic aggregates, such as GDP, capital formation or international trade.

FDI flows are not evenly distributed, however. In 2000, more than three-quarters ($1.0 trillion) of global inflows went to the developed countries. Inflows to Central and Eastern Europe increased by 9 per cent (to $27 billion, representing 2 per cent of world inflows). Although flows to developing countries also rose by 8 per cent (to $240 billion), the share of this group of countries in world FDI flows declined for the second year running, to 19 per cent, as compared to the peak of 41 per cent in 1994.

Turning specifically to recent developments among developing countries, the trends diverge. In contrast to the experience in most other parts of the world, inflows to *Africa* (including South Africa) declined in 2000 (for the first time since the mid-1990s), from $10.5 billion to $9.1 billion. As a result, the share of Africa in total FDI flows fell below 1 per cent. The decline was mainly related to two countries: South Africa and Angola. In the former country, fewer privatisation and M&A deals caused the slow-down, while in the latter, inflows in the petroleum sector declined.

After tripling during the second half of the 1990s, FDI flows into *Latin America and the Caribbean* also fell in 2000, by 26 per cent, to $86 billion. This was mainly a correction from 1999 – when FDI inflows to the region were greatly affected by three major cross-border acquisitions of Latin American firms – rather than a shift in the underlying trend. Privatisation slowed down in 2000, but continues to be important as a factor driving inward FDI. In terms of sectors, FDI into South America was mainly in services and natural resources, while Mexico continued to receive the largest share of inflows in manufacturing as well as in banking.

In *developing Asia*, FDI inflows reached a record level of $143 billion in 2000. The greatest increase took place in East Asia; Hong Kong (China), in particular, experienced an unprecedented FDI boom, with inflows amounting to $64 billion, making it the top FDI recipient in Asia as well as in developing countries. There are several explanations for this upsurge in inflows. First, it reflects a recovery from the economic turmoil of the recent past. Second, TNCs planning to invest in mainland China have been "parking" funds in Hong Kong (China), in anticipation of China's expected entry into the WTO. Third, the increase reflects a major cross-border M&A in telecommunications, which alone accounted for nearly one-third of the territory's total FDI inflows. Fourth, there is an element of increased "round-tripping" of capital flows into, and out of Hong Kong (China). FDI flows to China, at $41 billion, remained fairly stable, while those to South-East Asia (ASEAN-10) remained below the pre-crisis level. The sub-region's share in total FDI flows to developing Asia continued to shrink, and stood at 10 per cent in 2000, as compared with over 30 per cent in the mid-1990s. This was largely due to rising inflows into other countries in the region and significant divestments in Indonesia since the

onset of the financial crisis. South Asia witnessed a drop in FDI inflows by 1 per cent over the previous year. India, the largest recipient in the subcontinent, received $3 billion.

Prospects for 2001

For the first time in a decade, FDI flows are set to decline in 2001. According to projections released just before the tragic September events in New York and Washington, world FDI flows are expected to drop by 40 per cent this year, to $760 billion. This would represent the largest relative decline in the past three decades.[1] Nevertheless, the level of flows in 2001 is still expected to be higher than that in 1998, and also higher than the 1996-2000 average.

The projected decline in FDI is primarily the result of a decline in the value and number of cross-border mergers and acquisitions (M&As). Conversely, the significant increases in FDI flows in 1999 and 2000 – by about 50 per cent and 18 per cent, respectively – were partly driven by a number of mega deals (deals worth over $1 billion) of M&As, as represented, most prominently, by the $200 billion acquisition of Mannesmann (Germany) by VodafoneAirTouch (United Kingdom) in 2000. The decline in M&As – both cross-border and domestic – is related to the slowdown in the world economy. The prices of shares, for example, which in 2000 were used to finance more than half of all cross-border M&As, fell significantly, when measured in terms of the exchange of stocks. A lull in the consolidation processes in certain industries through M&As (e.g. telecommunications, automobiles) also plays a role.

The parallel path of FDI flows and cross-border M&As is more pronounced in developed than in developing countries, partly because most FDI in the latter countries is greenfield investment. Hence, FDI flows are expected to decrease significantly in developed countries, from $1.005 trillion in 2000 to an estimated $510 billion in 2001, i.e. by 49 per cent. In the case of developing countries, the decline is estimated to be 6 per cent, from $240 billion to $225 billion. Decreases in FDI inflows are expected in both Latin America and developing Asia. As a result, the share of developing countries in world FDI inflows may rise to 30 per cent – after a number of years of steady decline – higher than the share attained in 1998. FDI inflows in Central and Eastern Europe are expected to remain stable in 2001.

The impact of 11 September

In light of the principal determinants of FDI flows, the tragic events of 11 September may further accentuate the projected decline in 2001. The most important economic determinants of FDI are related to market size and market growth. Due to a weakening of demand in some of the world's largest economies, these variables have already had a sobering effect on FDI. To the extent that the events in the United States accentuate the economic slow-down, it would lead to a further decline of FDI flows. Moreover, the higher level of uncertainty, in particular due to increased political risk (risk associated with war and terrorism), may induce some companies to adopt a "wait-and-see" position and put planned investment on hold until they gain a better comprehension of the longer-term impact of the events in the United States.

The impact is likely to be uneven, however, affecting various industries as well as markets in different ways. Industries that may be particularly negatively affected include transportation services, aeroplane

[1] FDI inflows declined in 1976 (by $6 billion or 22 per cent), 1982 (by $12 billion or 17 per cent), 1983 (by $7 billion or 13 per cent), 1985 (by $3 billion or 5 per cent) and 1991 (by $47 billion or 23 per cent).

manufacturing, insurance and financial services, and tourism; this would affect their capacity to invest abroad. The level of economic growth furthermore varies considerably by country. TNCs may continue to expand in markets that are still growing at a decent pace or have the potential to do so.[1]

An accentuation of the slow-down in the economy would add to the competitive pressure in many industries, forcing companies to enhance their cost-efficiency. Faced by more severe price-driven competition, some TNCs may choose to relocate certain production resources to low-cost producing countries; in this case there may be some redistribution of FDI flows towards developing countries and transition economies. Such restructuring may have a longer-term impact on the production systems of TNCs.

The immediate impact of the crisis on stock markets will probably accentuate the current decline in M&As. A sharp drop in share prices after the events of 11 September may further reduce the purchasing power of acquirers as shares are used to finance the acquisitions of target firms. On the other hand, as the prices of specific companies become lower, this may trigger new M&As, as happened at the time of the Asian financial crisis. Whereas cross-border M&A activity in the short term is likely to be further dampened, the underlying determinants of M&As still suggest that this mode of FDI entry will continue on an upward trend (UNCTAD, 2000).

Hence, to the extent that the tragic events in the United States accentuate the world economic slowdown, and to the extent that FDI flows tend to be pro-cyclical, this is likely to lead to a further decline in FDI, beyond the forecasted 40 per cent decline. Total FDI flows in 2001 may even approach the 1998 level of less than $700 billion. It is still too early, however, to tell whether the 11 September events will have more than a short-term effect on FDI. The longer-term implications depend on how extended the present heightened level of political uncertainty will be and, especially, on the reduced level of demand in the world economy. The key policy challenge is to help restore confidence among consumers and investors in order to contribute to a quick recovery of economic growth and thereby FDI. The concerted actions among developed countries to counter the economic slowdown, notably through expansive fiscal measures and a lowering of interest rates, are likely to play an important role to this effect.

Evolving policies to promote FDI

The decline of FDI flows may lead countries to step up their efforts to attract FDI and to try to secure greater benefits from FDI received. FDI promotion policies are gradually evolving. In the *first generation* of investment promotion policies, countries simply liberalise their enabling frameworks for FDI to attract more investment. This continues to take place throughout the world. UNCTAD data show that, in 2000 alone, out of some 150 FDI regulatory changes made by 69 countries, 98 per cent were in the direction of creating a more favourable environment for FDI. While such (in a sense passive) liberalisation is important to attract much desired investment, it is usually not sufficient in the increasingly competitive world market for FDI. Consequently, in the *second generation* of investment promotion policies, countries actively "market" their countries as locations for FDI. This approach, which typically includes the setting up of national investment promotion agencies, has been widely adopted by developed as well as developing countries. To illustrate, the World Association of Investment Promotion Agencies, created as recently as 1995, today has more than 110 members. The *third generation* of investment promotion policies takes an enabling framework for FDI and a proactive approach towards attracting FDI as a starting point. It then proceeds to target foreign

[1] For example, several telecommunications companies, like Ericsson and Motorola, have recently announced significant increases in their investments in China in the coming years.

investors (in accordance with a country's developmental priorities) at the level of industries and firms, and seeks to meet their specific locational needs.

A targeted approach is not only becoming more important to face up to the growing competition in the area of investment promotion, it is also desirable from the perspective of achieving efficient use of scarce resources. Targeting may furthermore help policy makers to improve their understanding of corporate strategies and of the specific locational assets and liabilities that characterise their host countries. An "honest" assessment of the ability to meet the requirements of specific investors is important in deciding what activities and firms to target. No one-size-fits-all formula can be applied. Instead, the approach has to take the specific circumstances of each country into account. Targeting is an ongoing process and needs to be adapted to, and develop with, the evolving objectives (employment generation, promotion of competition, generation of exports, technology inflow or upgrading of the domestic enterprise sector) and locational capabilities of countries.

Linking FDI to the domestic enterprise sector

The increased attention paid to investment promotion activities suggests that the advantages FDI can offer are now quite widely acknowledged. In addition to capital inflows, FDI can lead to transfers of technology and know-how, improve access to international markets, and spur competition. However, such benefits cannot be taken for granted. Countries need to ensure an appropriate framework in key policy areas. One important area that, in this context, has so far received relatively little attention relates to supply linkages between foreign affiliates of TNCs and local firms.

Promoting linkages is potentially a win-win-win proposition. Benefits may accrue to foreign affiliates, and local firms as well as to the host countries in which they are based. *Foreign affiliates* may seek to use local suppliers in a host country to reduce costs, increase flexibility and expand sales. Outsourcing and sub-contracting raise the need for inter-firm linkages. In fact, supply-chain management has become critical for the competitiveness of many firms. A manufacturing firm spends on average more than half its revenues on purchased inputs. In response, some TNCs have organised special development programmes in host developing countries to assist potential or existing suppliers. The experience from various companies illustrates how companies in different industries and host countries can actively support suppliers to upgrade their technology, productivity, and ability to compete internationally.

Local firms can benefit by becoming part of global production networks of TNCs, through increased sales and from productivity-enhancing information and knowledge transmitted from foreign affiliates. Linkages constitute the strongest channel for diffusing skills, knowledge and technology from foreign affiliates to local firms and institutions.

Host countries can benefit when linkages contribute to the upgrading of domestic enterprises and as foreign affiliates become more firmly embedded in the host economy. For developing countries, the formation of backward linkages, through which foreign affiliates purchase parts, components, or services through various forms of outsourcing or subcontracting arrangements, assumes particular importance.

The extent to which foreign affiliates forge linkages with domestic suppliers (as opposed to, say, using imports), however, is determined by the cost-benefit ratio of such efforts, as well as by differences in firm-level perceptions and strategies. The most important factors are related to corporate strategy and the availability of supply capacity. A lack of efficient domestic suppliers is a common obstacle to the creation of linkages, particularly in developing countries. Building on the basic self-interest of firms in

backward linkages, policy-makers in host countries therefore have an important role to play in influencing the willingness of foreign affiliates to use local suppliers. In particular, they can address specific obstacles to the linkage formation process by raising the benefits and/or reducing the costs of using domestic suppliers. For example, TNCs may be unaware of the availability of viable suppliers, or they may find it just too costly to use them as sources of inputs.

Drawing on the experience of a wide range of countries, a menu of specific measures can be considered to promote linkages. These measures pertain to the provision of information and matchmaking; encouraging foreign affiliates to participate in programmes aimed at upgrading the technological capabilities of domestic suppliers; establishing training programmes in partnership with foreign affiliates for the benefit of domestic suppliers; and various schemes to enhance domestic suppliers' access to finance.

A few countries – Costa Rica, the Czech Republic, Ireland, Malaysia, Singapore and the United Kingdom, for example – have, often with considerable success, set up comprehensive linkage development programmes involving a combination of different policy measures and targeting selected industries and firms.

Indeed, well-targeted government support can tilt the balance in favour of more linkages and thereby contribute to knowledge transfers from TNCs that can foster the development of a vibrant domestic enterprise sector. As laid out in more detail in the *World Investment Report 2001 (UNCTAD, 2001)*, linkage promotion policies need to be consistent with and embedded in a broad range of policies that support enterprise development and FDI promotion. The starting point for an effective linkage programme is a clear vision of how FDI fits into the overall development strategy and, more specifically, a strategy to build production capacity. The vision has to be based on a clear understanding of the strengths and weaknesses of the host economy and of the challenges it faces in a globalising world.

A linkage programme should, in particular, address the competitive needs of domestic enterprises and the implications these have for policies, private and public support institutions, and support measures (including skills- and technology-upgrading). It is advisable for policy-makers that choose this approach to "start small" (perhaps with a pilot scheme) and to build policy monitoring, flexibility, and learning into the programme. The need for starting small is all the greater when resources are scarce. Moreover, it is essential for any programme to seek close collaboration with the private sector, both foreign affiliates and domestic suppliers, in design and implementation.

Governments can act as facilitators and catalysts and ensure that private institutions have the incentives and resources needed. They can be particularly proactive in the following key areas of linkage formation: information and matchmaking; technology upgrading; training; and access to finance. The range of measures that can be taken in each of these areas is wide. Their principal purpose is to encourage and support foreign affiliates and domestic firms to strike up and deepen linkages. Specific choices depend on the results of earlier consultations with existing support institutions and relevant programmes in the public and private sectors, as well as with key stakeholders on the specific needs of an industry or set of firms. Governments could also encourage participating foreign affiliates to agree to a coaching and mentoring arrangement with promising local firms.

Linkage programmes can only work if they are networking effectively with efficient intermediate institutions providing support in skill building, technology development, logistics and finance. These include standards and metrology institutes, testing laboratories, R&D centres and other technical extension services, productivity and manager training centres and financial institutions. These can be public or private. It is also important that linkage programmes work closely with relevant private

associations – chambers of commerce and industry, manufacturers associations, investor associations and so on. Trade unions and various interest groups are other important stakeholders. Finally, it is important to have a monitoring system in place to evaluate the success of a programme. Often, in a learning-by-doing process, a programme needs to be adjusted and refined as experiences accumulate and situations change. The system could include benchmarks and surveys of users.

In conclusion

With FDI stocks in countries having accumulated rapidly while new FDI flows are declining, it becomes all the more important to make greater efforts to attract new FDI and increase the benefits from existing foreign affiliates. Strengthening linkages has an important role to play here, and policy-makers can help to form such linkages. In addition, firms around the world can be encouraged to study the experience of some of their competitors in strengthening their supplier linkages, with a view to emulating them for their own corporate systems. As is often the case, the best results can be reached through close public-private collaboration.

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The terrorist attacks of September 11th 2001 will undoubtedly exert a major force on the contemporary global economy, including on future foreign direct investment (FDI)[1] flows.

Overview of Global Foreign Direct Investment

Throughout the 1990s, foreign direct investment flows quintupled, increasing at an average compounded annual growth rate of 17 per cent. Over a trillion dollars were invested abroad in 2000, compared to $203 billion in 1990. Apparently resistant to the volatility of the global capital markets, global FDI flows did not decrease during the '94 Mexican peso crisis, or during the '98 Asian financial crisis. However, after a veritable bull market decade for cross-border productive capital, UNCTAD estimates that flows in 2001 will drop by approximately 40 per cent from the previous year's levels. This would represent the first drop in FDI flows since 1991, and the largest over the past three decades.

This projected decline in cross-border investment is not expected to affect developed and developing countries to the same degree. FDI flows to developed markets are expected to drop by 50 per cent of their 2000 figure, while developing countries should see much more moderate decreases of approximately 6 per cent. The halving of FDI flows to developed markets in 2001 will mainly be the consequence of a sharp decline in cross-border mergers and acquisitions (M&As).

As of September, cross-border M&As stood at about only one third of its total value in 2000. Megadeals (cross-border mergers or acquisitions exceeding US$1 billion) stood at 30 per cent of their total value in 2000. Given the negative effect of the September 11th tragedy on global capital markets, these figures are not expected to increase significantly before the end of the year. In fact, the total projected value of FDI in 2001 – approximately US$760 billion – will revert to the level of global FDI flows observed in 1998.

In addition, the composition of FDI flows for 2001 will follow more closely the configuration of global FDI in the pre-merger and acquisition boom years of the mid-90s (1995-1997). The similarities in overall composition are evident both in terms of distribution of flows among developed and developing markets, and in the percentage share of M&A FDI versus other types of flows, such as greenfield investment. Now that the M&A boom of 1998-2000, which drove the acceleration of FDI growth, has subsided, future FDI growth rates will probably return to the more modest levels of the early 90s.

Despite the nearly universal negative CEO outlook on the global economy compared to one year previously, two out of three senior executives still express their intention to invest abroad at

[1] Foreign direct investment (FDI) includes investment in physical assets, such as plant equipment, in a foreign country. Holdings of 10 per cent equity, or more, in a foreign enterprise is the commonly accepted threshold between direct and portfolio investment as it demonstrates an intent to influence management of the foreign entity. The main types of FDI are acquisition of a subsidiary or production facility, participation in a joint venture, licensing, and establishment of a greenfield operation.

approximately the same levels as already planned for this year. Negative views of global economic prospects increased dramatically over the eight-month period since February 2001.

Flash Survey

More than nine out of ten CEOs are now more negative about global economic conditions compared to a year ago, and none feel more positive. In contrast, in February 2001 only 35 per cent felt more negative and 24 per cent indicated having a more positive outlook for the global economy than they did a year before. CEO business outlook had been turning increasingly negative prior to the September 11th terrorist attacks on the United States compared to January 2000, when positive sentiment reached a high watermark and only 9 per cent of executives foresaw more negative prospects for the global economy. Senior executives' pessimism about the global economy is mirrored by their considerably more gloomy view of the United States.

In June 1999, over a third of senior executives believed that the United States, already the pre-eminent choice for investors, had increased in attractiveness as a preferred investment destination. In stark contrast, almost one out of three CEOs now has a more negative outlook of the U.S. as an investment location. The survey results also indicate that three out of four senior executives view a delayed U.S. economic recovery as the primary factor that could influence the implementation of their investment plans this year. Sixty-four per cent of CEOs intend to maintain approximately the same levels of future foreign investment as planned.

In addition, 16 per cent of executives intend to actually increase their investments, and 20 per cent plan cuts in FDI. Despite the encouraging number of executives hoping to hold steady on their investment plans for this year, for the first time since the FDI Confidence Index began probing investor attitudes a greater percentage of executives are inclined to reduce investments than to increase them. Three-quarters of respondents indicated that "first-time" outward investment would probably be destined for developing countries, with one-fourth declaring their intention to invest in new destinations in the developed world, no change from the pattern revealed in the last FDI Confidence Index assessment in February 2001.

China – Business as usual?

China is the single major economy to experience a positive shift in investor outlook over the survey period, with close to 15 per cent of executives reporting more positive perceptions of the Asian giant. This continues a trend of consistently improved investor outlook toward China over the past two years. Executive bullishness on China is, no doubt, based in part on expectations that the country will be among the few to maintain high levels of growth next year, spurred further by its entry into the World Trade Organisation. Despite the reduced growth prospects for the world and slowing Chinese exports, Beijing's massive $18 billion fiscal spending programme for 2002 will help sustain economic growth levels well above those of other large economies for the near term.

China's FDI inflows totalled US$40.8 billion in 2000, the second highest level among developing economies[1]. China is expected to register approximately US$41 billion in inflows for 2001, an

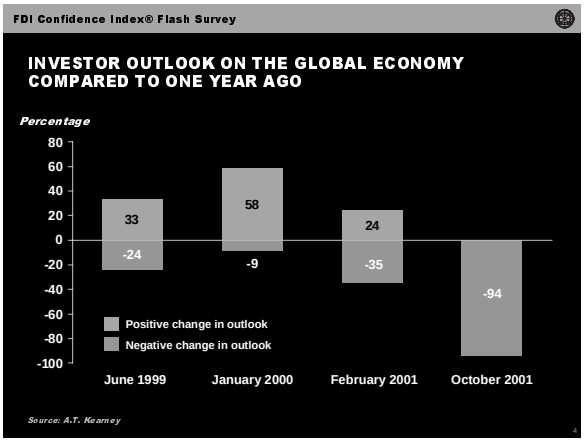
[1] China was displaced by Hong Kong as the developing economy attracting the largest inflows of FDI in 2000. However, Hong Kong's FDI outflows (US$63 billion) nearly equalled its inflows (US$64 billion), which, according to the UNCTAD, suggests that much of this capital is probably "transit FDI", stationed temporarily in Hong Kong before being invested in China and other destinations in Southeast Asia.

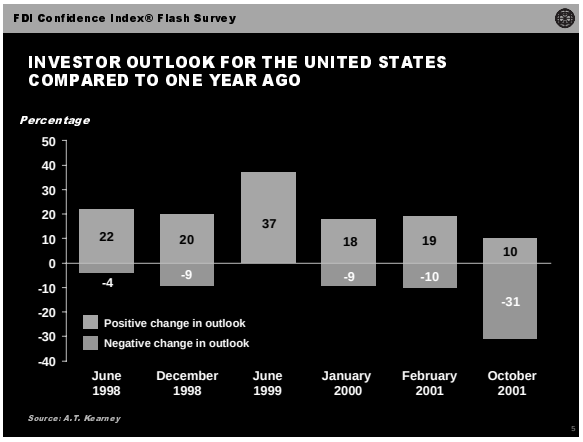
achievement all the more remarkable given the sharp contraction in global FDI flows expected for 2001. Despite this very impressive showing, the escalating tensions in Central Asia and the prospect of major instability in the region could dampen investor enthusiasm for China. China borders Afghanistan, Pakistan, and India. Much of the Chinese government's fiscal stimulus package is centred on developing infrastructure in the western part of the country, but instability on its border could threaten to reduce spending programmes and efforts to attract foreign investment to inland regions.

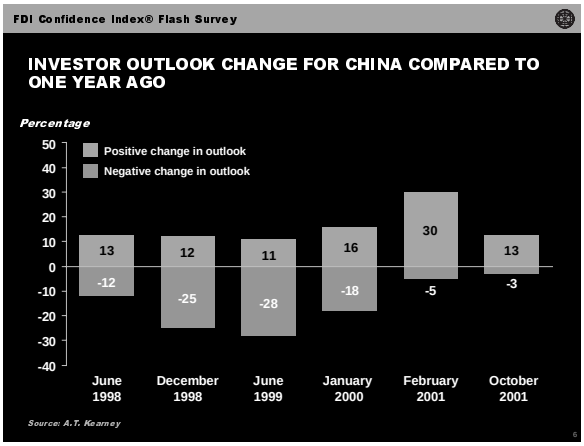
Drivers of FDI decision-making

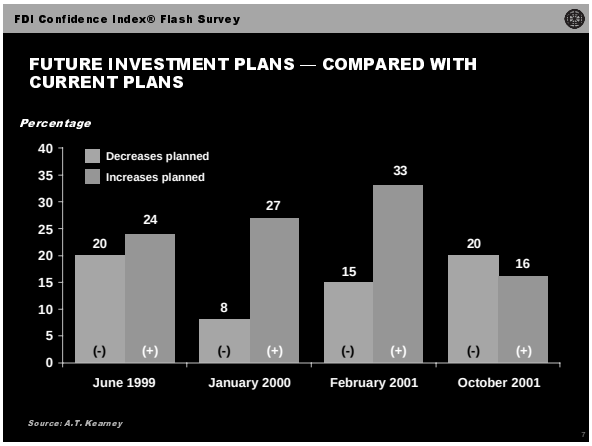
In addition to the overwhelming importance corporate investors attach to the U.S. economic recovery, CEOs indicate that the relative health of the European economy will also be a principal driver of future FDI decision-making, with one half of all senior executives citing Europe's economic performance as a chief concern. These drivers are still the most important determinants of FDI, as has consistently been reflected in past surveys. Geopolitical considerations have re-emerged as important factors affecting senior executive FDI calculations. The possibility of ongoing terrorist attacks and military counter-measures generate further investor uncertainty and concern over the global business environment.

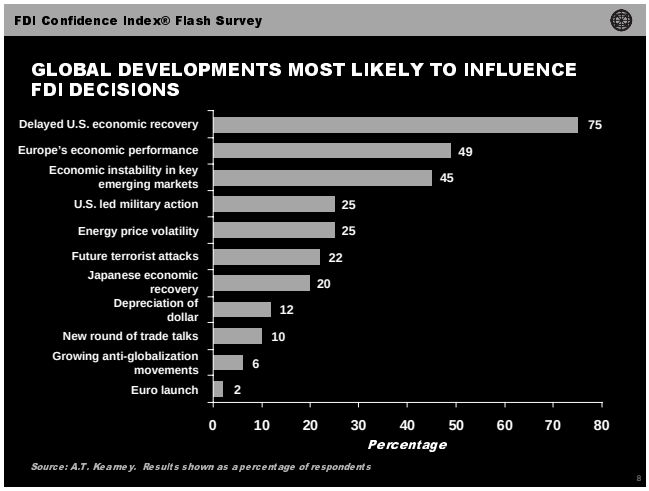
Of all executives, those from the Americas are, not surprisingly, most concerned about the prospect of repeated terrorist attacks, ranking it as their third most significant concern after the pace of a U.S. economic recovery and emerging market instability. Increased geopolitical concern may help explain why only one in ten executives cited major new trade round talks as an important factor influencing their investment calculations. Japan's chronic macroeconomic under-performance, of concern to investors the world over in the past, is now exclusively a principal concern to Japanese investors. The dampening impact that the events of September 11th have had on the anti-corporate/anti-globalisation movement perhaps explains why chief executives do not cite these movements as of major concern.











Conclusions

In the aftermath of September 11th and the U.S. declared war on terrorism, executives express increased pessimism and uncertainty about the state of the global economy. Nonetheless, they have adopted a "steady-as-you-go" approach toward the implementation of their already substantially reduced plans for investments abroad. Execution of this commitment to sustained FDI flows will hinge fundamentally on the state of the U.S. and European economies and the stability of key emerging markets. The U.S. investment environment sustained a record fall-off in levels of investor confidence, while China continues to increase its relative attractiveness to corporate investors.

As investors continue to absorb and react to the consequences of September 11th, geopolitical considerations will once again manifest themselves as important factors to consider when investing in a world perceived as inherently less stable and predictable.

The events of September 11th will exert an impact on both the volume and the direction of future FDI flows. The extent of the impact will become more evident as the jolt to the US economy is absorbed, and if no such further jolts heighten consumer anxiety. In 1998, the global financial crisis dampened investor enthusiasm for certain emerging market FDI deals – a so-called, “flight to quality”.

At the start of last year, this trend had run its course and investors were ready to return to at least the big emerging markets with robust growth opportunities (400 million new consumers of $10-$25 000

income range will be added to the world's population in emerging markets over the next four years, 200 million of whom will be in China alone). The inexorable corporate surge for new markets, greater scale, and geographic diversification will continue to fuel FDI flows.

The global roots of major MNCs are now so well-established and so integral to corporate profitability that there is no real strategic retreat from the world possible for those who have embraced it over the past 100 years – we now have some 60,000 parent companies with 800,000 foreign affiliates around the world. Nonetheless, this will not be a "business-as-usual" climate.

Concern over political risk will make the due diligence process more deliberate and more competitive. Investors – at least for a period of time – may focus on the "near-abroad" taking comfort in less exotic, more familiar, investment destinations.

Local partners – providing market know-how and local brands – will not only provide the usual benefits to large investors, but particularly to those more anxious to protect against an anti-Western, global-branding backlash.

There will be a much more competitive environment:

- Effective investment promotion will, more than ever, need strategic intelligence to help find the right investor and to locate, understand and reach his strike zone or sweet spot.

- This market intelligence will need to fuel more effective and efficient investment promotion activities. Those who wait for investors to come will probably wait in vain.

On the other hand, those who stick to the fundamentals, realistically appraise their national FDI balance sheets, 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. Even in this period when FDI flows to emerging markets will decline by 6 per cent, portfolio investments are down 77 per cent and bonds and loans (which provided net inflow to emerging markets of $20 billion in 2000) are expected to transform to net outflows of comparable volumes in 2001. FDI will continue to provide ballast to national economies.

The Secret of Non-Success,

Hernando De Soto,
President, Institute for Liberty and Democracy, Lima, Peru[*]

The Property Systems of the Developing World Exclude the Poor From Capitalism

Imagine a country where the law that governs property rights is so deficient that nobody can easily identify who owns what, addresses cannot be systematically verified, and people cannot be made to pay their debts. Consider not being able to use your own house or business to guarantee credit. Imagine a property system in which you can't divide your ownership in a business into shares that investors can buy, or where descriptions of assets are not standardised.

Welcome to life in the developing world, home to five-sixths of the global population. These people's plight underlines a paradoxical reality: capitalism was supposed to be the answer to global under-development, but here it never had a chance. It hasn't even been tried. In a capitalist economy, all business deals are based on the rules of property and its transactions. Third World property systems, however, exclude the assets and transactions of 80% of the population, cutting off the poor from the economy as markedly as apartheid once separated black and white South Africans.

Why is this important: Conventional macro-economic reform programs have ignored the poor, assuming they have no wealth to build on. Big mistake. My research team and I have recently completed several studies of the underground economy in the Third World, and they prove that the poor are, in fact, not so poor. In Peru the poor's assets are worth an estimated $90 billion – 11times the value of equities on the Lima stock exchange and 40 times the sum of all foreign assistance to the country since World War II. In Mexico the estimate is $315 billion – seven times the worth of Pemex, the national oil company.

The problem is that the poor and lower middle class are not allowed to use their assets in the same way that wealthier citizens do. And one of the biggest political challenges is to bring those assets from the "extralegal" sector into a more inclusive legal property system in which they can become more productive and generate capital for their owners.

Third World governments have already proved they can reform bad property arrangements, at least for the rich. In 1990, for example, the Compañia Peruana de Teléfonos was valued on the Lima stock exchange at $53 million. The government, however, could not sell CPT to foreign investors because of problems with the company's title to many of its assets. The Peruvians put together a hotshot legal team to create a legal title that would meet the standardised property norms required by the global economy. Documents were rewritten to secure the interests of third parties and create confidence that would allow for credit and investment. The legal team also created enforceable rules for settling property disputes that by-passed the dilatory and corruption-prone Peruvian courts. Three years later, CPT entered the world of liquid capital and was sold for $2 billion – 37 times its previous market valuation. That's what a good property system can do.

[*] This article was originally published in Time Magazine, 16 April 2001, and formed the basis of Mr. De Soto's presentation at the conference.

But how to determine what the poor really own so that their assets can be legally titled and the potential capital trapped; inside can be released? Nine years ago, I was invited by the Indonesian Cabinet to offer advice on identifying the assets of the 90% of Indonesians living in the extralegal sector. I was not expert on Indonesia, but as I strolled through the rice fields of Bali, a different dog would bark as I entered a different property. The dogs did not have to graduate from law school to know which assets their masters controlled. To determine who owned what, I advised the Cabinet to begin by "listening to the barking dogs." One of the ministers responded, "Ah, *jukum adat* – the people's law."

The history of capitalism in the West is a story of how governments adapted the "people's law: into uniform rules and codes. Ownership represented by dogs, fences and armed guards is now represented by records, titles and shares. The moment Westerners were able to focus on the title of a house and not just the house itself, they achieved a huge advantage over the rest of humanity. With titles, shares and property laws, people could suddenly go beyond looking at their assets as they are (houses used for shelter) to thinking about what they could be (security for credit to start a business).

Through widespread, integrated property systems, Western nations inadvertently created a staircase that allowed their citizens to climb out of the grubby basement of the material world into the realm where capital is created.

The poor are not the problem we think they are, but the solution of their own plight. The time is ripe to take the definition of property away from conservative legal establishments and put it in the hands of politicians committed to this view.

Foreign Direct Investment and Poverty Reduction,

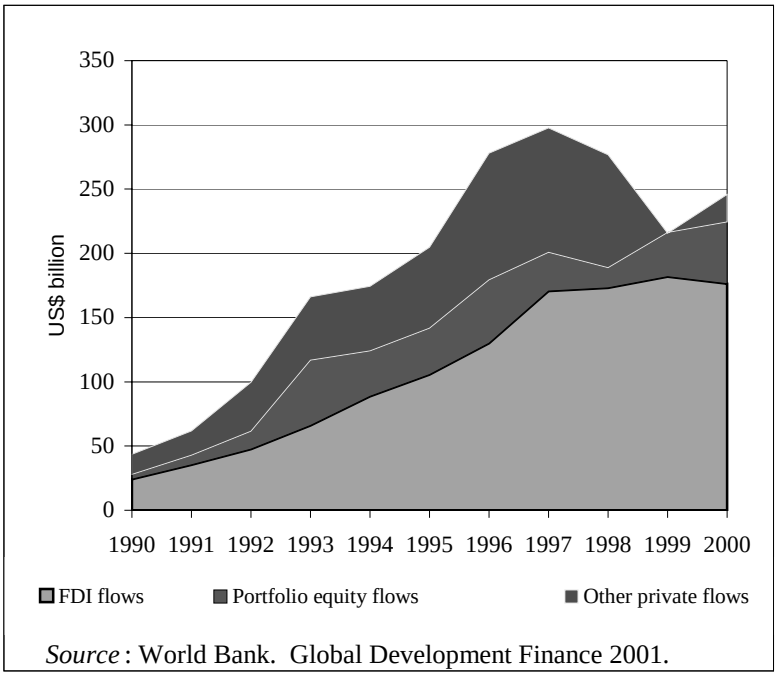
Michael Klein, Carl Aaron and Bita Hadjimichael,
World Bank

The last decade of the 20th century saw major shifts in the size and composition of cross-border capital flows into developing countries. Foreign direct investment now swamps all other financial flows. The question remains as to whether foreign direct investment supports sound development, and in particular, whether it contributes to poverty reduction.

Main Trends

Changes in cross-border financial flows – the rise of FDI. Major shifts in the size and composition of cross-border capital flows into developing countries show that net debt flows have become less and less important, portfolio flows have become firmly established, while foreign direct investment (FDI) now swamps all other financial flows. (Figure 1).

Figure 1: Net Long-Term Private Resource Flows to Developing Countries, by Type of Flow, 1990-2000

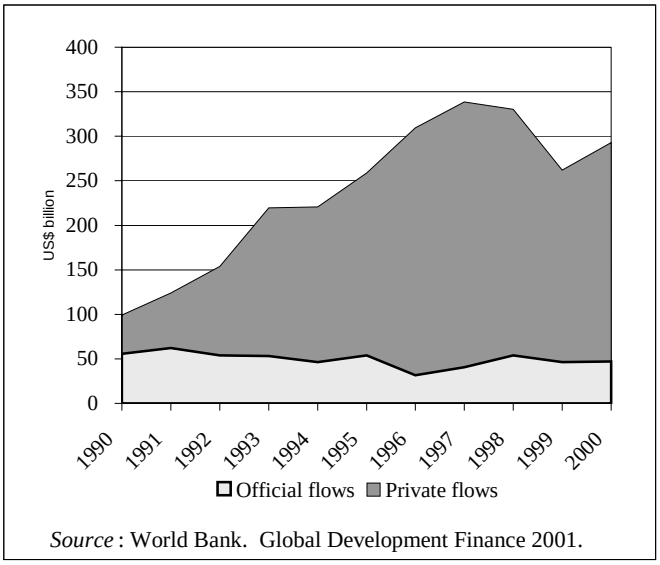


Source: World Bank. Global Development Finance 2001.

At the same time, following the collapse of communism in Eastern Europe and the former Soviet Union, official aid flows to developing countries have declined somewhat in absolute terms. In relative terms they have shrunk from roughly 56 per cent of total net resource flows to about 16 per cent (Figure 2).

Two key questions arise from these trends. First, how can shrinking aid flows be best used to support the goal of poverty reduction? Second, does foreign direct investment support sound development, and in particular, does it contribute to poverty reduction?

Figure 2: Total Net Long-Term Resource Flows to all Developing Countries, by Type of Flow, 1990-2000



Source : World Bank. Global Development Finance 2001.

FDI, growth, and poverty reduction. FDI is a key ingredient for successful economic growth in developing countries. This is because the very essence of economic development is the rapid and efficient transfer and adoption of "best practice" across borders. FDI is particularly well suited to effect this and translate it into broad-based growth, not least by upgrading human capital. As growth is the single-most important factor affecting poverty reduction, FDI is central to achieving that goal.

FDI and the quality of growth. Beyond promoting growth, FDI has other potentially desirable features that affect the quality of growth and assist with poverty reduction. First, it helps reduce adverse shocks to the poor resulting from financial instability, as illustrated during the recent Asian crisis. Second, relative to other forms of promoting private sector investment, FDI helps improve corporate governance. In particular, it is not easily subject to asset stripping that may render the distribution of property rights more unequal. Third, contrary to popular criticism, FDI can help improve environmental and labour standards, because foreign investors tend to be concerned about reputation in markets, where high standards are seen as desirable. Finally, FDI generates taxes that support the development of a safety net for the poor. Many foreign investors also invest substantially in community development in areas where they operate, and thus in the safety net for that particular area. Very importantly FDI can help improve the management of the social safety net, particularly service delivery to the poor, for example, water supply.

Pre-conditions for successful FDI. To achieve these positive outcomes for poverty reduction, the environment in which foreign investors operate needs to be "right". Otherwise, popular criticism of various forms of exploitation practiced by foreign investors may well be justified. The existence of an equal and competitive playing field without special protection for foreign or domestic investors is crucial. The regulations governing foreign investors need to be reasonable • not unduly burdensome and not arbitrary.

FDI – no panacea but an integral part of the poverty reduction toolkit. Those who believe that the current distribution of assets and incomes in the world needs to be rendered drastically more equal will not easily share this positive appraisal of the impact of FDI on poverty reduction. FDI will, indeed, not automatically reduce income inequality. Neither will FDI deal with all dimensions of

poverty. It will mainly promote growth and thereby reduce income poverty. However, there appear to be few other basic policies that promise to do systematically more for improving the material well-being of the poor. The key alternative approaches that might direct more of the fruits of growth to the poor are government-led programmes that improve social safety nets and explicitly redistribute assets and income. But these are not alternatives to sensible growth-oriented policies. They are complements. Growth is needed to fund these programmes. Moreover, the delivery of social services to the poor – from insurance schemes to access to basic services such as water and energy – can clearly benefit from reliance on foreign investors. However we may look at it – among the tools available – FDI remains among the most effective in the fight against poverty. Hence, the wide agreement among analysts as to the usefulness of FDI, including prominent critics of "growth-first" policies such as Joseph Stiglitz, the former Chief Economist of the World Bank (Stiglitz, 1998b).

The potential of FDI for poverty reduction

FDI and growth

Cross-border transfer of best practice and acceleration of growth. The key to economic development is the transfer and adoption of best practice across borders. Before the industrial revolution, it took some 350 years for income per capita to double in Europe (Crafts, 2000). As the industrial revolution accelerated in the 19th century, it took the lead country, Britain, over 60 years to double per capita income. Towards the end of the 20th century, several rather diverse countries managed to double per capita income in just about 10 years — including, for example, Botswana, Chile, China, Ireland, Japan, and Thailand. Such rapid growth is now possible for those developing economies that are able to import and imitate technical and organisational innovations from the world's leading countries. Growth of this rapid type makes it possible for the first time in history to propel people from poverty to a reasonably comfortable life within a single lifespan. Indeed, it is this possibility of near-term poverty eradication that gives rise to both hope about the possibilities and frustration about the shortcomings in the fight against poverty.

FDI — the key mechanism to transfer best practice across borders. Best practice may be transmitted across borders by various mechanisms. Foreign buyers of exports may provide the demand for upgrading, as well as some level of technical assistance to domestic firms (Lim and Fong, 1982; Johansson and Nilsson, 1997). Imported capital goods may embody improved technology. Technology licensing allows countries to acquire innovations. Expatriates transmit knowledge. Yet arguably the most effective means of transferring best practice is FDI. Foreign investment tends to package and integrate elements from all of the above mechanisms. A few countries, essentially Japan and Korea, have been able to grow rapidly with minimal reliance on FDI. Many countries have attempted to imitate the Japanese or Korean model, but with limited success. *De facto*, most other fast-growing countries have relied heavily on FDI (for example Chile, China, Malaysia, Singapore, and Thailand). Most astonishingly, Ireland — despite being a relatively advanced country – has managed to grow at some 8 per cent per year for most of the 1990s due in large part to effective attraction and deployment of foreign investment. This is not to say that FDI is all it takes to achieve rapid growth, but it appears that FDI is a key ingredient.

Many studies show that FDI tends to raise productivity in the recipient economy (Annex 1). Clearly, the key mechanism is the adoption of managerial and technical best practice from abroad. There are many ways of raising productivity, ranging from better worker training, *via* improved management methods, to deployment of advanced technology. Yet it appears that no study explicitly tests which mechanism for the cross-border transmission of best practice performs best, and under what circumstances. However, a few studies have investigated whether firms with foreign investors raise productivity more than other

firms. To the extent that such studies show that foreign-owned firms outperform domestic ones, this suggests that they constitute the better overall mechanism to improve management and technology. For example, foreign investment has raised the productivity of small and medium-sized firms in Venezuela more than that of domestically-owned firms (Aitken and Harrison, 1999). In the Czech Republic, foreign-owned firms out-performed joint ventures with foreign partners, which in turn out-performed locally-owned firms (Djankov and Hoekman, 1998). In Africa, firms with majority foreign ownership perform better than others (Ramachandran and Shah, 1997).

The role of FDI in the domestic diffusion of best practice. The ultimate impact of foreign investment on domestic growth depends not only on the performance of foreign-owned firms, but also on the diffusion of new practices throughout the economy. Several studies show that effective diffusion is possible, and works, for example, through subcontracting arrangements. A study of Malaysia documents that subcontracting for foreign firms helped almost double the productivity of domestic supplier firms (Batra and Tan, 2000).

Overall, the diffusion of best practice in the domestic economy depends on the way domestic markets work, irrespective of the nationality of owners. Surprisingly, the way in which markets really work at the firm level only became a matter of detailed empirical economic analysis during the 1990s. As usual, the most detailed studies are for the United States and are summarised in Caves (1998). A recent series of studies have, however, also tackled markets in developing countries, particularly Africa.[1] The general picture is as follows. All markets or individual sectors consist of a mix of small and large firms. A large number of SMEs (small and medium-sized firms with up to 500 employees) tends to account for the majority of employment. Among such small firms turnover is high. Between 5 and 20 per cent enter and exit the market each year. Typically, new entrants are a little more productive than those leaving the market. A few firms grow and become large. Large firms tend to be most productive, last longest, and pay the highest wages (Caves, 1998; Tybout, 2000).

In growing economies, the average size of a firm increases, and with it productivity and wages. This reflects a more sophisticated division of labour, characterised by complex subcontracting arrangements and industrial "clusters" or effective cities, which are, after all, the most efficient business "incubators". Larger firms tend to be at the apex of subcontracting chains. Similarly, larger firms are often key to the development of clusters (Iqbal and Urata, forthcoming). Larger firms provide credit to subcontractors as well as technical assistance. Particularly where financial markets are not very well developed, and where politically-not-well-connected firms are rationed out of the market, large firms may constitute the key channel to access credit. There is thus a clear symbiosis between large firms and SMEs, with the one dependent on the other.

How does FDI come into this picture? Typically, foreign entrants are larger and more productive than domestic firms in developing countries. They tend to produce higher quality goods and services, and export relatively more. By relying on foreign investment, countries can "import" such larger, more productive firms and stimulate productivity improvements throughout the economy. *De facto*, countries can use such foreign firms as catalysts that allow them to leapfrog stages in the development of local firms. FDI can thus speed up the structural shift in the economy that allows a country to catch up with advanced economies. From this perspective, sound policies that support FDI are also among the best ways to develop domestic small and medium-sized companies.

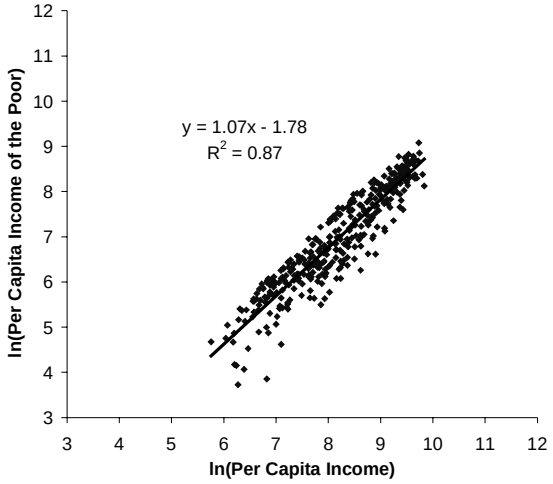
[1] The Regional Programme on Enterprise Development of the World Bank's Africa region is among the most sophisticated of such study programmes.

FDI and poverty reduction.

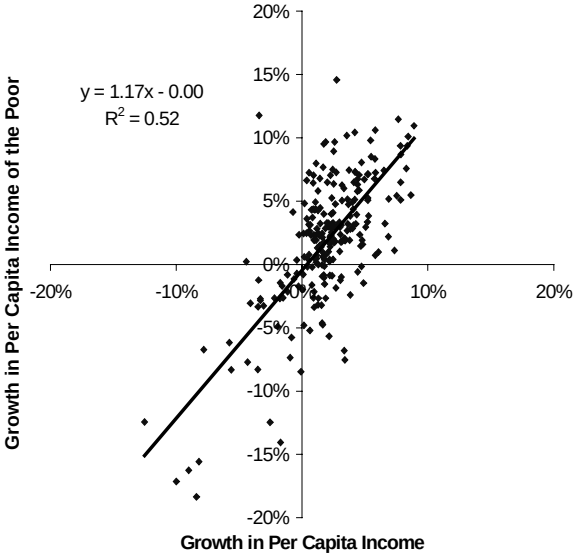
Growth and poverty reduction. Economic growth remains a necessary ingredient for poverty reduction. Recent studies suggest that growth tends to lift the incomes of the poor proportionately with overall growth (Dollar and Kraay, 2000). FDI as a key vehicle to generate growth is thus a most important ingredient for poverty reduction.

Whether the potential for domestic diffusion of best practice can be exploited depends on the absorption capacity of the host economy. Adequate levels of education and infrastructure are required to fully benefit from FDI (Borenzstein, De Gregoria and Lee, 1998), as well as competition in domestic markets (Bromstrom and Kokko, 1996).

Figure 3: Growth and the Poor Levels (in Logarithm)



Growth Rates



Source: David Dollar and Aart Kraay, 2000, "*Growth is Good for the Poor*", Development Research Group, World Bank, p. 41.

FDI and the quality of growth. While on average growth benefits the poor, there are a number of countries where this has not happened (World Bank, 2000c). There is no clear recipe for translating growth into poverty reduction for all country cases. Different countries may well require somewhat different approaches to ensure that growth leads to poverty reduction (World Bank, 2000c). In the following it is argued that FDI can actually do more than just generate growth. FDI has the potential to improve the quality of growth by:

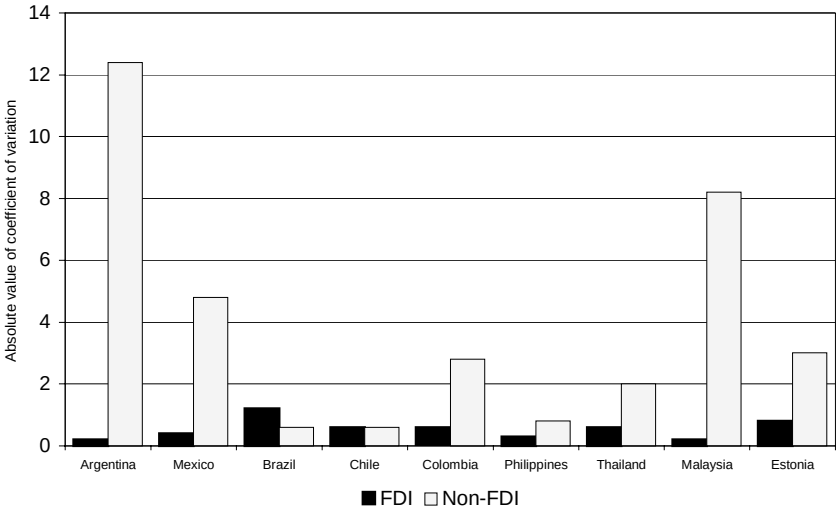
- reducing the volatility of capital flows and incomes
- improving asset and income distribution at the time of privatisation
- helping improve social and environmental standards
- helping improve social safety nets and basic services for the poor.
- FDI thus also belongs in the toolkit for poverty reduction in countries where simple reliance on "trickle down" does not work.

Protecting the poor from bad investment decisions and financial volatility. While foreign investment can be critical for rapid growth, critics fear that the gains from productivity improvements are transferred abroad. This is not the case, however, when foreign investors operate under competitive conditions. Under such conditions foreign investors can only expect to obtain a normal return on capital. As in any competitive market, some will make big profits and others small ones or losses. On average, they will tend to earn just the cost of capital. Indeed, overall, countries face a relatively competitive market for foreign investment. For example they have the choice to import capital *via* bank lending and import technology *via* licensing – the Korean strategy. The net cost would be interest payments plus license fees. Alternatively, countries can attract foreign investment and allow payment of dividends. Already in the 1970s the all-in-cost of one strategy compared to the other appeared quite similar, adjusted for the extra risks assumed by foreign equity investors (Vernon, 1977).

FDI is thus not robbing poor countries. Any strategy that imports funds and technology from abroad requires payments to foreigners — unless pure charity is involved. And rapid development without importing best practice from abroad is not possible. What distinguishes foreign investment from other ways of funding development is not that it is more costly, but the incentive structure for foreign investors. Foreign investment is equity investment. Shareholders gain when projects or firms are successful. They lose when projects or firms fail. Creditors, on the other hand, often look towards taxpayers to cover them when projects fail. This is clearly the case when credits are guaranteed by governments. It is also often the case when systemic crises lead to bail-outs of banks, as during the Mexico crisis of 1994/5 and the Asian crises of 1997/8. By definition, foreign investment will not lead to a debt crisis. Debt relief will never be an issue. By the same token, taxpayers in poor countries are not going to suffer from bad decisions made by foreign direct investors, because losses will be absorbed by the foreign equity investors.

For the recipient country, the risk profile with FDI is thus better than with debt. By the same token, foreign investors have a better incentive to evaluate projects. Once they have made their evaluation, they consequently tend to stay with an investment more consistently than other types of investors. All this is reflected in the stability of foreign investment flows compared to debt and portfolio flows. FDI flows are clearly most stable (Figure 4). Given that the poor have suffered disproportionately during currency and financial crises (World Bank, 1999), reliance on FDI helps protect the poor from the impact of volatility in international financial markets.

Figure 4: Volatility of Capital Flows - FDI is more stable 1990-1997



Source: World Bank. 1999. Global Development Finance, p. 55.

a. A notable exception is Brazil, where the FDI variablility is higher owing to a surge of FDI in 1996-97 associated with privatization.

FDI exposes investors to significant risk, which might imply that they shy away from poorer, more turbulent countries (Box 1). Yet FDI is much less concentrated on a few countries than other private capital flows. FDI is not much more concentrated than the population of the recipient countries (Table 2).

Among different types of private cross-border financial flows, FDI is thus the least volatile, the most available to poor countries, and the least likely to saddle taxpayers in poor countries with unbearable debt service obligations. Among private financial flows, FDI is thus most conducive to promoting sensible development for the poor.

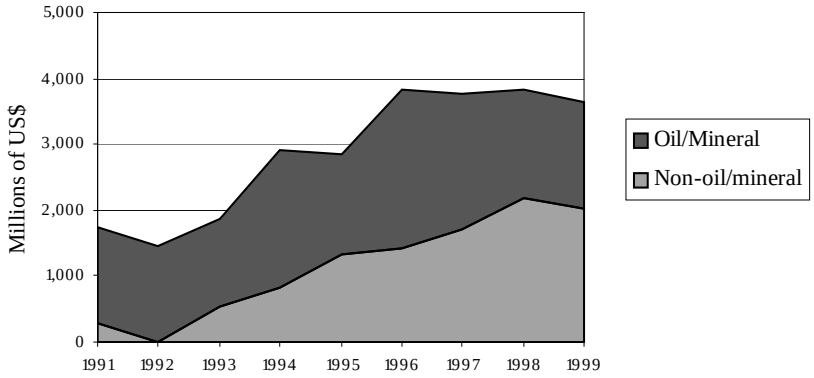
Improved corporate governance. FDI brings with it the superior incentives of equity investors who try to make sure they invest sensibly. Among forms of cross-border equity investments, FDI is also clearly the most efficient form of equity in countries with weak corporate governance rules and practices. Portfolio equity investment by minority shareholders in such countries faces severe risks of expropriation by insiders. For example, voucher privatisation to dispersed shareholders in countries such as the Czech Republic or Russia has led to inefficient asset stripping, whereas foreign direct investment in countries like Hungary and Poland led to strong productivity increases (Djankov, 2000).

Companies that are owned and controlled by foreigners have improved their productivity more than those under dispersed ownership, and the distributional implications have also probably been more benign. Asset stripping, and other forms of *de facto* expropriation of minority shareholders under schemes like voucher privatisation, have tended to lead to a concentration of ownership in the hands of relatively few "oligarchs". In comparison, foreign ownership appears to have led to less unequal ownership among nationals. In addition, dispersed minority shareholdings in firms owned by reputable foreign companies tend to be less plagued by *de facto* expropriation of minority shareholders. All in all, in countries with weak corporate governance rules and practices, foreign investment leads to higher productivity, and thus higher wages than experienced in companies owned by dispersed minority owners. At the same time, the distribution of assets among nationals would tend to be more equal. On balance the "oligarchs" benefit less and the workers more.

Box 1: Foreign Direct Investment in Africa

FDI inflows to Sub-Saharan Africa have traditionally gone to resource-based sectors. Sub-Saharan African countries, in general, have not been able to attract FDI due to their small market size, poor infrastructure, political uncertainty, corruption, and restrictive policies toward foreign investment. However, several African countries have recently improved the environment for foreign investment and have managed to attract FDI inflows toward activities in non-resource-based sectors. During 1991-94 only 21 per cent of FDI inflows to Sub-Saharan Africa went to countries that were not major exporters of oil or minerals. The share of FDI inflows to these countries rose to about 49 per cent in 1995-1999 (Figure 5).

FIGURE 5: FDI in Sub-Saharan Africa



Source: World Bank, Global Development Finance 2001.

Countries such as Mozambique, Tanzania, and Uganda, which receive most of the FDI inflows in agriculture, light manufacturing, and utilities, saw sharp increases in FDI inflows in 1995-1999. In Lesotho, FDI has been undertaken to service the market in neighbouring South Africa through the Lesotho Highlands Water project (Table 1).

Table 1: FDI Flows in selected fast-growing African countries, 1991-94 and 1995-99

	1991-94		1995-99	
Country	**Millions of US$**	**Ratio to GDP (per cent)**	**Millions of US$**	**Ratio to GDP (per cent)**
Lesotho	11	1.4	252	27.1
Mozambique	29	1.3	156	4.7
Tanzania	21	0.4	157	2.1
Uganda	37	1.1	170	2.7
Total	97	0.9	734	4.1

Note: Data are annual averages.

Source: World Bank, Global Development Finance 2001.

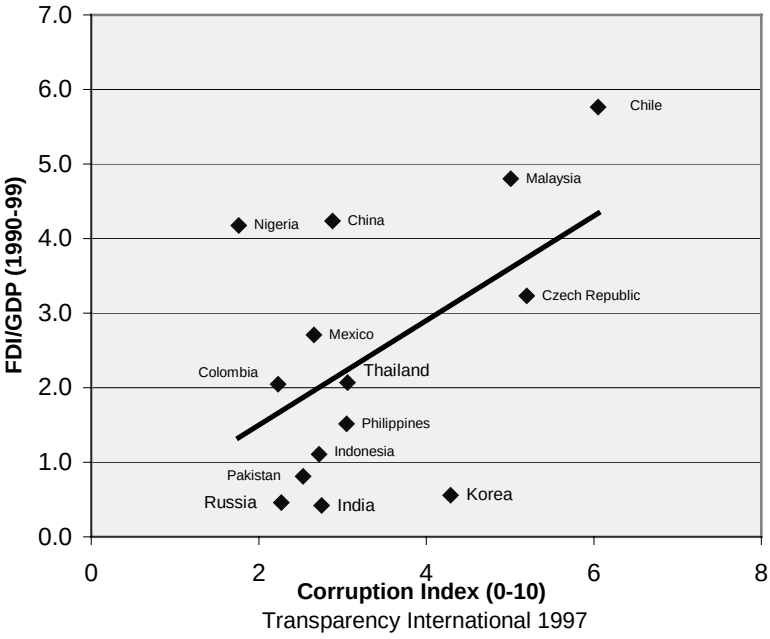
Table 2. Pattern of private financial flows in developing and transition economies [a], 1994-1999 (percentage OF TOTAL for all developing countries)

		FDI inflows		Portfolio equity		Bonds		Bank and trade-related lending		Population
Rank	Economy	1994-98	1999	1994-98	1999	1994-98	1999	1994-98	1999	1999
1	China	29.60	21.31	11.99	10.83	4.20	2.59	8.34	9.58	24.59
2	Brazil	10.58	17.96	10.74	5.6á9	6.16	10.54	31.69	55.31	3.30
3	Mexico	8.05	6.48	7.07	3.28	11.60	22.09	8.87	-31.43	1.91
4	Argentina	4.58	12.97	2.75	1.17	15.97	31.44	4.30	0.14	0.73
5	Poland	3.19	4.00	2.14	2.09	1.36	4.31	0.41	-5.20	0.77
6	Malaysia	3.13	0.85	4.86	1.51	3.58	2.93	5.29	-1.63	0.45
7	Chile	3.00	5.07	1.09	0.05	1.89	3.39	6.03	-6.67	0.30
8	Indonesia	2.54	-1.51	7.34	3.69	4.27	-5.73	2.44	20.91	4.07
9	Thailand	2.46	3.42	3.13	7.33	4.88	-5.34	4.07	18.72	1.22
10	Russian Federation	2.17	1.82	4.17	1.87	7.30	0.00	2.71	0.66	2.89
11	Colombia	2.11	0.63	0.53	0.07	2.82	4.85	4.03	-4.83	0.83
12	Venezuela, RB	2.09	1.75	1.65	0.19	0.25	0.53	1.19	0.98	0.47
13	Korea, Rep.	1.97	5.13	9.11	36.06	18.53	-5.56	1.47	53.12	0.92
14	Hungary	1.82	1.07	2.34	1.72	1.13	2.38	0.81	-6.91	0.20
15	Peru	1.80	1.08	3.73	0.84	-0.34	-1.00	1.01	-4.34	0.49
16	India	1.76	1.19	7.89	3.78	2.74	-4.42	0.43	2.03	19.63
17	Czech Republic	1.33	2.80	0.30	1.45	0.51	0.69	4.09	3.55	0.20
18	Philippines	1.21	0.32	3.15	1.22	3.32	15.31	0.01	-0.10	1.51
19	Nigeria	1.08	0.55	0.02	0.00	0.00	0.00	-0.99	0.56	2.44
20	South Africa	1.02	0.76	5.15	11.19	0.00	0.00	-0.07	0.05	0.04
21	Vietnam	0.99	0.58	0.44	0.00	0.00	0.00	0.27	2.98	1.53
22	Kazakhstan	0.71	0.87	0.03	0.00	0.29	-0.79	0.94	-0.34	0.30
23	Egypt, Arab Rep.	0.67	0.59	2.14	1.60	0.00	0.39	-0.75	0.60	1.22
24	Romania	0.64	0.57	0.03	0.00	0.66	-2.68	1.19	-1.35	0.43
25	Turkey	0.59	0.43	2.37	2.32	2.00	12.66	2.93	-14.72	1.26
26	Panama	0.53	0.01	0.09	0.00	0.34	1.50	-0.04	-1.07	0.06
27	Pakistan	0.49	0.20	1.82	0.00	0.33	-0.29	0.93	1.98	2.66
28	Azerbaijan	0.47	0.28	0.00	0.00	0.00	0.00	0.04	-0.33	0.16
29	Ecuador	0.44	0.38	0.00	0.00	-0.07	-0.08	0.32	-1.04	0.24
30	Trinidad and Tobago	0.43	0.41	0.00	0.00	0.08	0.90	-0.28	0.57	0.03
	Total above	91.45	91.97	96.07	97.98	93.81	90.63	91.68	91.80	74.83
	Top 20	85.49	87.65	89.15	94.06	90.18	79.00	86.14	104.52	66.96
	Top 10	69.30	72.36	55.28	37.53	61.22	66.23	74.16	60.40	40.22

Source: World Bank, Global Development Finance 2001.
a. Top thirty recipients of FDI inflows.

In some ways, this is a special case of the more general notion that foreign investment tends to not to go together with corrupt practices. This is not because owners and managers of foreign companies are a superior breed of people. Indeed, there are a number of examples where foreign investors are accomplices in corrupt practices, or where they work in countries that rank low on corruption indices, particular investors in the extractive industries – whether they themselves are associated with corrupt practices or not. As a rule, however, it appears that corrupt environments impose excessive costs of doing business, which foreign companies tend to avoid (Drabek and Payne, 1999; Smarzynska and Wei, 2000). In a similar vein, where corporate governance is weak, foreign investors will not invest unless they themselves have effective control. Hence, the correlation of FDI with relatively less expropriation of minority shareholders and with less corruption (Figure 6).

Figure 6: Corruption and FDI Inflows in Developing Countries



Source: World Bank, GDF 2001; Transparency International 1997 Corruption index.

Foreign companies have the ability to walk away from corruption precisely because they are less beholden to local vested interests, including governments, than domestic companies. The often deplored erosion of sovereign power due to the ability of foreign companies to choose their preferred domicile is thus revealed to be a positive trait in this case. More generally, the arms-length relationship that foreign investors have with government, where playing fields are even and competition prevails, allows foreign investors to provide opportunities to domestic employees or domestic entrepreneurs that might not have been open to them otherwise. Not being beholden to vested interests and domestic politics as much as locals, foreign investors can and do, for example, open up employment opportunities for women, who might otherwise not have found similarly well paying jobs — notwithstanding the low level of their wages.

Better social and environment standards — race to the top. Many critics of FDI allege that multinational companies tend to locate production in countries or regions with low wages, low taxes and weak environmental and social standards. They argue that FDI thus contributes to a "race to the bottom", where countries are forced to lower their standards so as not to lose investment and jobs. It is certainly true that these features of the business environment play a significant role in the decisions of multinationals. However, these items are all just part of the cost side of a business. In the end it is not costs that matter, but profits. Foreign investors balance cost considerations with others that determine the productivity of operations in a particular country.

Overall, FDI flows to places where the net profitability is highest, not where costs are lowest. This is reflected in the basic fact that some three-quarters of FDI flows to developed countries and not to low-cost developing nations. Among OECD countries, the experience of Canada and Switzerland is of interest in this regard, because in these two countries labour and capital can move freely across provinces with different tax regimes. Studies suggest that firms and individual taxpayers take the tax burden into account, but that other factors such as the state of infrastructure and other available services are even more significant factors for location decisions (OECD, 1998). Numerous studies suggest that special tax incentives are not the key to attracting FDI, but that the presence of business opportunities is much more important. Business opportunities are in turn enhanced by the rule of law, the quality of a country's labour force, its infrastructure, and so on.

The other side of the coin is that FDI will only flow into countries with low productivity when wages and other costs are low enough to offset the productivity disadvantage. By the standards of developed economies foreign investors in developing countries pay low wages. Relative to local wages, however, they tend to pay high wages, because foreign companies tend to be more productive than local ones (Graham and Wada, 2000; Mazumdar and Mazaheri, 2000).

The first round effect of greater foreign investment is often to raise wages of relatively highly-skilled workers in developing countries. This would increase inequality there. Over time, as productivity improvements spread in the recipient economy, other people benefit and incomes again become more equal than they would otherwise have been. In time, FDI thus helps improve income growth in low-wage countries. To this extent FDI actually helps equalise the global distribution of incomes. For developing countries FDI thus creates a race to the top.

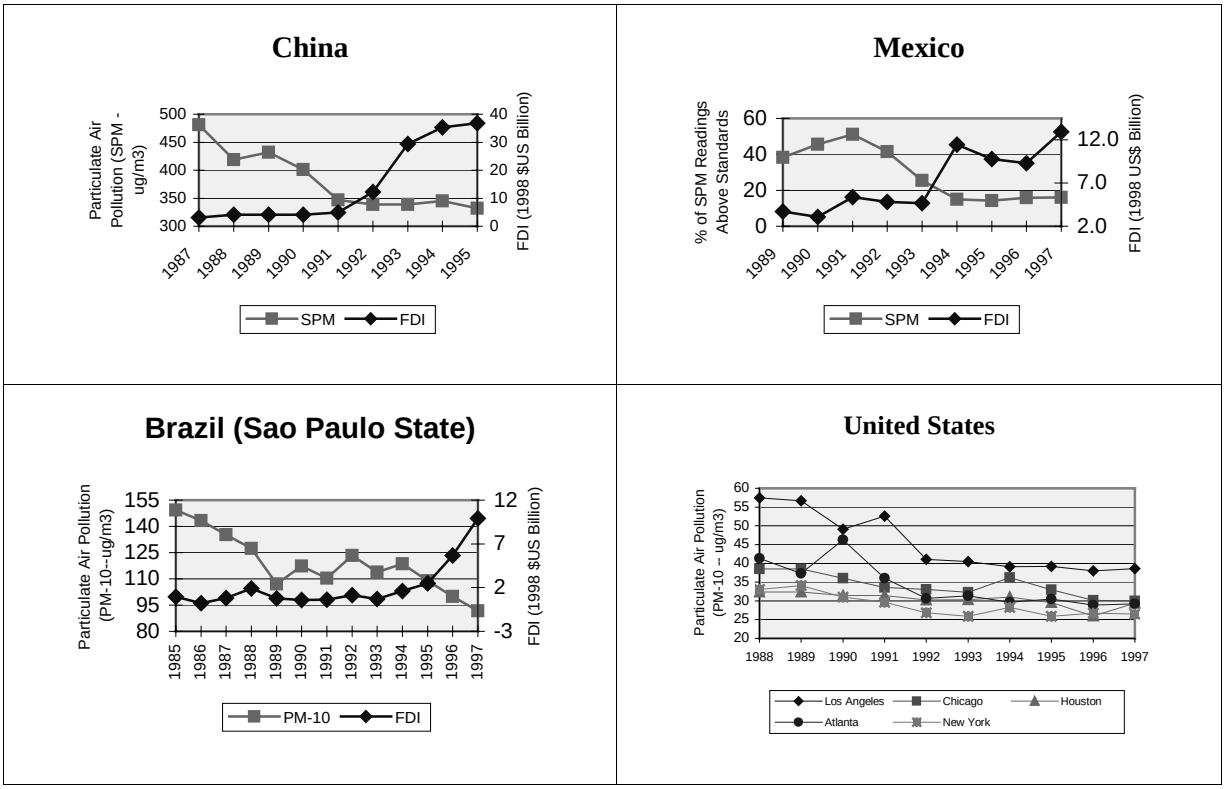
For advanced countries the situation is somewhat different. There, the move of companies to low-wage locations places downward pressure on the wages of relatively low-skilled workers. Only better training and upgrading of jobs will help these workers improve their relative income position. Hence the distrust and dismay with which many workers in developed countries regard "globalisation". Such dismay is a sign that growth that redistributes incomes towards the less well off – as FDI tends to do across countries – easily runs into political constraints, regardless of how many people feel strongly that we need a more equal world. Arguably, the relative downward pressure on the incomes of workers in high-income countries has been one of the major factors behind the disruption of globalisation in the beginning of the 20th century (O'Rourke and Williamson, 1999).

FDI can also create a race to the top for environmental and social standards, for example labour standards in developing countries. Again, this is not because managers of multinationals are particularly nice people. A number of detailed cases show that some foreign companies have operated with weak environmental and safety procedures or allowed the labour force to be treated badly by international or by developed country standards. In this they rarely behave worse than is the general practice in the recipient country (Box 2). However, foreign investors can afford to observe better standards than domestic firms, due to higher productivity. Particularly large foreign firms are now increasingly pressured by various civil society groups to improve their environmental and labour practices. When foreign companies sell in competitive markets in rich countries it is relatively easy to boycott them, because consumers can switch to competitors at low cost. Hence, large multinationals have a strong interest in preserving their reputation, and over time they tend to be a force for raising standards in developing countries (Oman, 2000).

Box 2: Racing to the Bottom?

The 'race to the bottom' hypothesis has been tested in a recent study that analyzes air quality trends in the United States and the three largest recipients of foreign direct investment among the developing countries – China, Brazil, and Mexico. The evidence shows that instead of racing toward the bottom, major cities in these countries have experienced significant improvements in air quality (see figure 7). The improvements in the developing countries have occurred in an era of economic liberalisation, industrial growth, and rapid expansion of foreign investment flows, thus contradicting the concerns that free trade and capital flows tend to erode global environmental standards. Furthermore, the reductions in air pollution in Mexico City and Los Angeles have occurred despite the fact that these are dominant industrial centres most strongly affected by the North American Free Trade Agreement.

Figure 7: Urban air pollution and FDI in China, Mexico, and Brazil, and air pollution in U.S. metropolitan areas, 1985-1997



Evidence from numerous studies suggests that an environmental "race to the bottom" is unlikely for the following reasons:

- Pollution control costs matter to factory owners and managers, but they are generally not a critical factor in location decisions;
- Where regulations are weak or absent, NGOs and community groups pursue informal regulation (threat of social, political or physical sanctions) to convince polluters to compensate the community or reduce pollution;
- At the national level, governments display a tendency to tighten regulation as incomes grow;
- Local businesses control pollution because abatement reduces costs; and
- Due to the scrutiny of consumers and environmental NGOs, multinational firms generally adhere to OECD environmental standards in their developing-country operations.

Source: Wheeler, 2001.

The key to the whole debate is that the race to the top regarding wage levels or environmental or social standards requires improved productivity. Otherwise higher wages and higher standards are not affordable. FDI is key here, because it tends to be among the more rapid ways of enhancing productivity and — when subject to effective competition — foreign investors will pass the resulting benefits to the host country *via* higher wages and/or better standards.

Social safety nets and service for the poor. While FDI has many features that help generate growth and raise wages and standards, it does not *per se* redistribute income towards the very poor. Social safety nets for the very poor and redistribution of assets and incomes towards them tend to require either important charitable activity or government intervention — not-for-profit intervention in both cases.

Foreign investment can often be important for creating the pre-conditions for such intervention. Foreign investors, by virtue of their productivity, can help generate the tax revenue required to fund assistance to the poor through their own tax contributions, and indirectly by stimulating growth and thus broadening the tax base. They also often spend significant resources on community development in the areas that they operate in, so as to demonstrate that they are "good citizens", and they make important charitable contributions.

In addition to helping fund services for the poor, foreign companies are often particularly well suited to actually delivering services to the poor, because foreign direct investment combines the superior performance incentives of equity investors with advanced managerial and technical competence.

For example, the search for better service provided by private, often foreign, investors has characterised the worldwide shift to private provision of infrastructure during the 1990s. Foreign investors in telecommunications, electricity, and water have brought more and improved service to millions of households, including poor ones. Foreign investors do not shy away from serving poor or remote customers. The key to reach the poor is simply opening up entry into service provision by private companies.[1]

Pre-conditions for Beneficial FDI

Openness to foreign investment is a strategy that has many potential benefits for poverty reduction. As has been pointed out, many countries have indeed been able to reap many of these benefits. However, the benefits do not flow quite automatically. Foreign investors are fallible, just like other people, and they need to operate under the right conditions to bring out the good side of FDI. Otherwise they might be tempted to indulge in corrupt and socially detrimental activities just as domestic firms do. Examples of such behaviour figure prominently in criticisms of FDI.

Even and competitive playing field. Most importantly, the benefits from FDI tend to be maximised when foreign investors operate on an even and competitive playing field. This means they need to be treated just like domestic companies ("national treatment"). In addition, competition, free entry, customer choice and free exit, should determine who gains and who loses. In particular, foreign investors trying to service the domestic market of the host country should not be protected from import competition. China would in many ways appear the exception to the rule. A lot of foreign investment went into the country despite a less than perfect policy environment. In the case of China, however,

[1] Issues of private participation in provision of infrastructure services for the poor were dealt with at a recent conference "Infrastructure for Development: Private Solutions and the Poor," sponsored by the Public-Private Infrastructure Advisory Facility (PPIAF) and the UK Department for International Development. For background papers, see http://www.ppiaf.org/ppiandthepoor/presentations.html.

the special relationship of key provinces that received a large part of foreign investment – Guangdong and Fujian with Chinese communities outside the mainland – did much to make up for existing distortions in the playing field. Moreover, China could clearly enhance the contribution of foreign investment through further policy reform (OECD, 2000).

Exposure to effective competition on an even playing field is the single most important incentive for foreign and domestic companies to upgrade management and technology. Existence of significant market power risks reducing the incentives of foreign investors to improve productivity and to exploit consumers or workers in captive markets. Free entry is also the key to establishing effective linkages between foreign investors and domestic buyers or suppliers that help diffuse best practice in the economy.

Domestic capability to exploit FDI. While a competitive and even playing field creates incentives to upgrade productivity throughout the economy, countries also need domestic actors capable of responding to these incentives. Various studies suggest that higher quality of the labour force and infrastructure in a country helps exploit the potential benefits from FDI (Borenzstein, De Gregorio and Lee, 1998; Caves, 1999; Djankov and Hoekman, 1998; Mody and Wang, 1997). Key policy responses will often be measures to improve education and infrastructure. In addition, foreign investors will themselves invest in upgrading domestic capability, for example *via* on-the-job training or the creation of physical infrastructure, for example by mining companies.

Adjusting environmental and social standards. Finally, as globalisation gradually leads to the establishment of more international standards for environmental and social aspects of foreign investment, governments need to adjust their own policy design to fit into the evolving world of norms. If they do not adjust their own norms, foreign investors may be forced to stay out of reputational concerns or they may face too much competition from domestic firms not subject to stringent norms. On the other hand, tougher standards have costs, which domestic firms may not be able to afford. In that case domestic activity could suffer or be driven into uncontrolled or corrupt "informality". Analyses of how governments should position themselves to help match the drive for better corporate responsibility with effective growth at home are becoming increasingly important.

Prudent management of windfall gains from natural resources. Unsurprisingly, as for any investment, a basic prerequisite for successful foreign investment is a stable macroeconomic environment that allows investors to plan. A particular issue here are policies to deal with windfalls resulting from natural resources. Such windfalls resulting from oil, gas and mining projects have very often not lead to prosperity in the exporting country (Auty, 1993; Gelb, 1988; Sachs and Warner, 1995). Large inflows of foreign exchange tend to raise the real exchange rate of an economy and thus render many non-mining activities unprofitable, the so-called "Dutch disease". In addition, the existence of large windfall gains provides the incentive for many vested interests and new players to lay a hand on the gains in more or less legal ways. Corruption easily thrives under these conditions and scarce entrepreneurial talent is often diverted from productive pursuit to devising scams. The result is that in many cases windfalls have not benefited the poor and have even hurt them.

In many developing countries foreign investors manage the extraction and sale of minerals or fuels. Due to the problems sketched above, such foreign investment in enclave projects has often not been associated with growth and poverty reduction in the host country. The key for improvement is how to manage the windfalls better. This would require prudent macroeconomic policies to prevent excessive exchange-rate appreciation, and policies that minimise the opportunities of insiders for corruption. Countries that have been able to manage resource booms relatively well, albeit by no means perfectly, include Botswana, Chile, Indonesia, Malaysia, Mauritius, Mexico and Oman.

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Foreign Direct Investment in India and South Africa:
A Comparison of Performance and Policy,[1]

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Introduction

India and South Africa are both large emerging economies with great potential for growth. However, neither country receives a significant amount of foreign direct investment, especially in comparison to other large emerging markets like China and Brazil. There is a feeling in government as well as civil society in the two countries that they are being unfairly neglected by foreign investors. This paper seeks to identify some of the reasons for this poor performance and offers some tentative policy recommendations that might help to address their problems.

Overall performance

India and South Africa together account for a tiny proportion of world FDI flows. In 2000, South Africa received around $0.9bn while India received $2.3bn. Table 1 shows how these flows have varied in recent years.

Table 1: India and South Africa FDI inflows

US$mn

	1989-94	*1995*	*1996*	*1997*	*1998*	*1999*	*2000*
South Africa	60	1,241	818	3,817	561	1,502	877
India	394	2,144	2,591	3,613	2,614	2,154	2,315

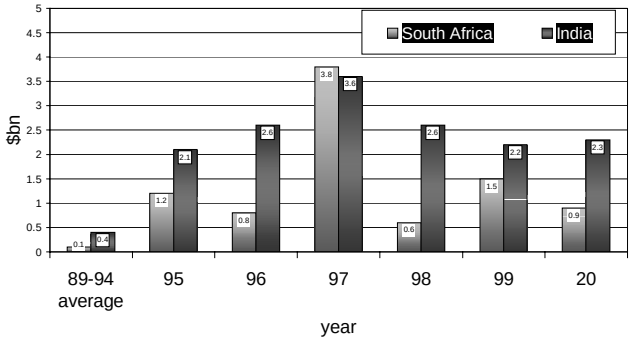
Source: World Investment Report 2001, UNCTAD

The table shows that both countries have managed an impressive increase in FDI inflows since the early 1990s, but strong sustained year-on-year increases have not been achieved. In a regional context, South Africa receives a very large proportion of Africa's FDI flows along with three other countries, while India again performs disappointingly coming after Thailand and Vietnam in the Asian ranking.

Both countries were hit by the contagion of the Asian crisis in 1997/8 as investors shunned developing markets. This trend will now be exacerbated by uncertainty brought on by the September 11 terrorist attacks and the overall downturn in the world economy. The graph also clearly demonstrates the erratic pattern of flows into South Africa. The key reason has been the faltering momentum of the government's privatisation programme, itself a victim of the shrunken telecommunications market. The transfer of assets from state-owned Telkom to the private sector in 1997 has not been followed with the sale of further shares of public sector assets as had been planned. India's FDI performance was flat during the second half of the 1990s, disappointing hopes that the gradual liberalisation of the economy would stimulate a steady rise in investor interest.

[1] *This paper draws on the reports prepared by Biswatosh Saha, Indian Institute of Technology, Kharagpur, and Brendan Vickers, Institute for Global Dialogue, South Africa, on India and South Africa, respectively, both 2001, for the "Investment for Development Project" being carried out by the* Consumer Unity & Trust Society *(CUTS).*

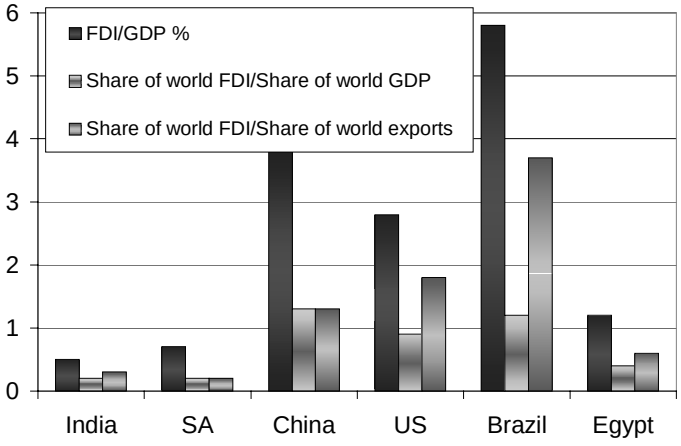
Graph 1: India & South Africa FDI inflows 1989-2000



Source: World Investment Report 2001, UNCTAD

Straight comparisons of the volumes of flows do not, of course, take into account the main determinants of FDI, the size of the market and the degree of outward orientation of the economy reflected in the volume of exports. Graph 2 shows how India and South Africa compare with selected other countries in terms of the relationship between FDI and GDP and FDI and exports.

Graph 2: India, South Africa & other countries: Comparative FDI Indices



Source: World Investment Report 2001, UNCTAD

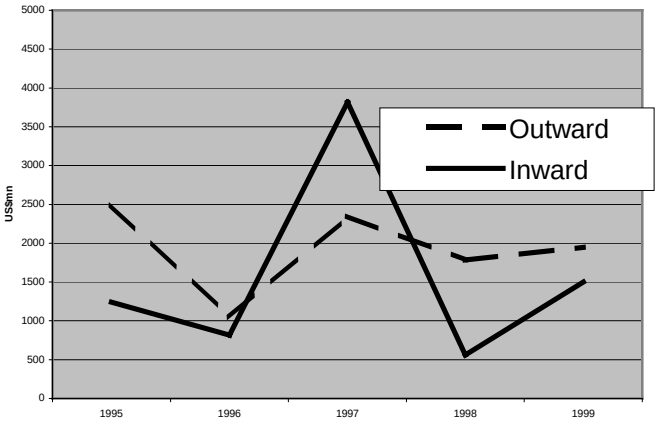
With scale and outward orientation taken into account, it is apparent that India and South Africa still perform comparatively badly. India receives FDI equal to below 0.5 per cent of GDP, while South Africa received 0.7 per cent of its GDP in FDI in 2000. The ratio between each country's share of world FDI and share of world GDP, and share of world FDI and share of world exports is well below 1 per cent in India and South Africa, demonstrating that they receive much less FDI than their importance in the world economy would justify.

In most developing countries, one of the key perceived benefits of FDI is a stable foreign capital inflow, creating a surplus on the capital account of the balance of payments to make up for a deficit on

the current account. The net balance of FDI inflows against outflows is therefore expected to be strongly positive. While this is certainly the case for India, where FDI outflows are still negligible, it is not the case in South Africa where domestic businesses have been expanding rapidly, particularly into the Southern African region.

Graph 3 shows that there have been net outflows of FDI from South Africa in several recent years, placing a greater strain on the country's foreign currency reserves. Although FDI inflows exceeded outflows in 2000, this was because the outflows fell even more drastically than the inflows during this period, rather than because inflows picked up.

Graph 3: Inward and Outward Flows of FDI, South Africa



Source: World Investment Report 2001, UNCTAD

Looking at the overall capital account, South Africa has recorded a surplus every year since 1994, accounted for by large but highly volatile portfolio flows. These have plummeted recently as a result of regional instability and other factors, reinforcing the need for FDI as a more stable form of financial flow. India records a healthy surplus on the capital account, with portfolio flows around the same volume as direct investment flows in 1999-2000 and 2000-2001.

Role of FDI inflows in the economy

Typically, countries seek FDI not just as a form of finance but for the unique combination of factors that it can provide. Among these are 'know how', technology and managerial skills, and access to global markets. These benefits of FDI are difficult to assess but will vary significantly from sector to sector depending on the capabilities of workers, firm size, and level of competitiveness of domestic industry. The extent to which FDI contributes to the Indian and South African economies in these ways is not investigated here, but policy-makers in both countries acknowledge that the potential benefits of FDI are significant.

The fundamental contribution of FDI to the economy should be to add to capital formation. However, this cannot be taken for granted. In South Africa, inward investment has increasingly taken the form of mergers and acquisitions rather than greenfield investment, largely as a result of the government's privatisation programme. Table 2 shows the breakdown of FDI between types for the 1994-1999 period.

Table 2: Types of FDI into South Africa 2000

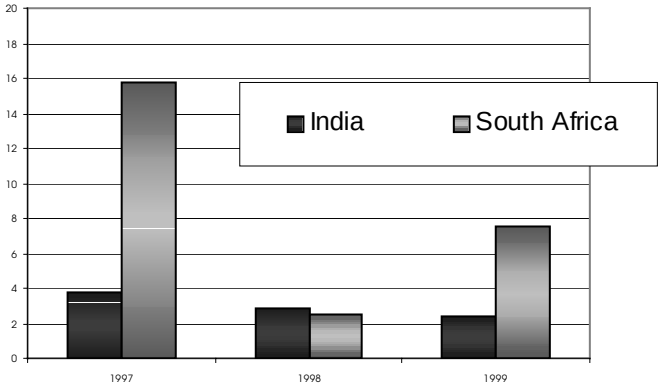
Type of FDI	*US$bn*
Mergers & Acquisitions	774.7
Expansion	570.10
New	413.82
Intention	339.50
Investment	15.50
Disinvestment	-93.50

Source: BusinessMap online South Africa FDI database.

In India, the story has been somewhat similar, although M&As have not been driven by a privatisation drive, or "disinvestment" as this is known in India. According to the estimates of CMIE (Centre of Monitoring Indian Economy), about 50 per cent of the 2000-01 inflow of FDI was accounted for either by foreign partners buying out their Indian subsidiaries or public holdings in joint ventures. ("Excess focus on FDI cannot take the economy too far," P Vinod Kumar, *Financial Express*, 02/11/01). Analysis by Saha estimates that between 1991 and 1998, about 40 per cent of FDI financed the acquisition of equity stakes in existing enterprises. (Biswatosh Saha, 2001). This means that the contribution that FDI makes to capital formation is probably much lower than the total inflow figures suggest.

This is confirmed by the fact that in both countries, FDI accounts for only a small proportion of gross domestic capital formation (GDCF). Graph 4 shows that in India, the public sector and the domestic private sector account for almost all of the country's capital formation. Indian policy-makers hope that FDI can compensate for falling levels of public sector investment in the economy. Thus increases in FDI flows that were achieved during the 1990s did not raise the GDCF rate as a proportion of GDP during this period; the rate remained around 23 per cent from 1993-4 to 1999-2000. Rates of capital formation in the manufacturing sector actually declined during this period. In South Africa, the proportion of FDI in GDCF has fluctuated widely, reaching 7.6 per cent in 1999.

Graph 4: FDI as a percentage of gross fixed capital formation



Source: World Investment Report 2001, UNCTAD

An examination of investment flows by sector reveals more about the kind of FDI that is entering the two countries under examination.

Table 3: Sectoral distribution of committed FDI in South Africa 2000

Sector	***US$ m***
Food, Beverages and Tobacco	440.3
Motor and Components	361.3
Professional Services	351.7
Telecom and IT	204.7
Mining and Quarrying	208.2
Textiles, Leather and Footwear	114.6
Hotel, Leisure and Gaming	98.8
Transport and Transport Equipment	73.6
Financial Services	54.7
Media, Print and Publishing	29.9

Source: BusinessMap online South Africa FDI database

Table 3 shows that the bulk of investment in South Africa could be classified as resource-seeking (the food, beverage & tobacco and mining & quarrying sectors) or market-seeking (telecommunications and professional services etc.) The trends for India provide an interesting contrast.

Table 4: Sectoral distribution of approved FDI in India 1991- 2001

Sector	*$mn*
Metals industry	3.0
Power	7.8
Oil refining	5.1
Computer software	1.2
Telecommunications	11.1
Transportation industry	4.0
Chemicals	2.6
Food processing	1.8
Financial services	2.4

Source: Saha 2001

Throughout the 1990s, the sectors that attracted the most interest in India for foreign investors were fuels (taking power and oil refining together), which account for 28 per cent of the total, telecommunications, accounting for another 20 per cent, and transport, with over 7 per cent of the total. These are all industries in which the main draw for the investor is the large domestic market. Drugs, textiles, and other export industries received only very small amounts of FDI during this period.

Policy setting

Despite, or perhaps because of, the difficulties that both countries are having in attracting a steadily-rising stream of FDI, attracting more FDI has become a preoccupation of policy-makers and it is seen as vital to meet growth targets in the coming years.

In India, the relevant macro policy context is defined by the "First Generation" of reforms that were brought in during the early 1990s after the balance-of-payments crisis and IMF rescue package of 1991. These reforms included the liberalisation of industrial policy, which had consisted of an intricate web of licenses and permits, along with the opening up of capital markets and of the trade regime. These reforms achieved some of their objectives, including restoring equilibrium to the balance of payments and bringing down inflation. However, the impact on the real interest rate has been

marginal, investment has not risen, and the economic growth rates of 7-8 per cent that were achieved between 1994 and 1997 and were thought to have ushered in a new high growth phase for the economy have not been sustained. The most prominent failure has been the privatisation programme, as only two businesses have been transferred to the private sector over the course of the decade.

The key current economic policy document for the medium-term is the Tenth Plan that was put together by the Planning Commission in 2001. This envisages a growth rate of 8 per cent, fuelled largely by a rise in FDI. The document also outlines the Second Generation of reforms that include the transfer of assets to the private sector and the introduction of competition to more markets. However, these plans have met with stiff political resistance and look unlikely to be implemented in the near future.

In South Africa, the key policy document is the GEAR – Growth, Employment and Redistribution – strategy, which was formulated in 1996. The GEAR strategy identifies a rapid expansion of non-traditional (non-mineral) exports and an increase in private sector investment (generated largely in the form of FDI) as the engines of economic growth. Thus FDI is central to the government's medium- and long-term economic goals. GEAR estimates that gross domestic investment has to increase from 20 to 26 per cent to achieve target growth rates, requiring capital inflows equivalent to 4 per cent of GDP. This is expected to crowd in domestic investment and contribute to a rise in exports.

The stated goals of the South African government are to stimulate growth and job creation and reduce inequalities in the economy. However, the macroeconomic priorities that the Government is following are reducing inflation and bringing down the budget deficit, effects that may, at least in the short-term, clash with the stated goals. The Government is currently facing considerable criticism because the key goals of sustained growth and job creation have not been met, even though the bulk of the policy initiatives that were envisaged have been implemented.

Investment Policy Overview

South Africa

The country has undergone a thoroughgoing liberalisation of FDI policy in recent years. 100 per cent foreign ownership is allowed across sectors; there is an automatic approval process for investments, and a large number of Bilateral Investment Treaties with both developed and developing countries have been signed that provide for investor protection, dispute settlement, national treatment and most favoured nation treatment for foreign investors.

South Africa also has an active investment promotion agency known as TISA (Trade and Investment South Africa) that supports inward and outward investment missions and actively promotes the country as a destination for investment through a network of officials located in South African embassies in 48 countries.

Until recently, the South African government rejected the use of incentives to attract foreign investors. Industrial Development Zones, as South Africa's equivalent of export processing zones are known, allow duty-free imports and provide good infrastructure and 'world-class' management, but do not provide tax breaks. IDZs have been created in relatively under-developed regions to try to spread the positive effects of investment geographically. However, investors have not shown the expected level of interest in these zones and the lack of incentives – in contrast to those offered in other countries – is cited as one of the possible reasons.

South Africa has now introduced a wide range of schemes and incentives that are available to both foreign and domestic investors. These include preferential access to credit, tax breaks related to job creation or technology transfer, etc. In addition, South Africa has recently introduced policies to encourage the development of SMEs and equitable growth:

- Public-private partnerships (innovative forms of co-operation between the public and private sectors) are being introduced to provide a range of services at the municipal and regional levels.
- Industrial clusters are being supported through the incentive schemes mentioned above along with improved infrastructure. It is hoped that these will lead to spillovers of technology and skills as well as reducing regional inequalities.

In many ways South Africa has a state-of-the-art investment policy. Apart from the clustering and public-private partnerships policies that are being adopted in the most advanced economies and are based on the latest models of economic growth, the country also has a clear and detailed framework for targeting investors. Six sectors have been identified as priorities for investors from the U.S., while investors from Belgium, France and Switzerland are targeted for the chemicals and pharmaceuticals industries, for example. The causes of South Africa's comparative failure to attract investment must therefore lie outside investment policy per se. Some possible causes are discussed later in this paper.

India

In India, investment policy may be considered a meso- or micro-level issue as policies usually apply at the sectoral level or tailored on a case-by-case basis. Requirements and incentives are defined by the Government, either at the federal, state, or even municipal level, leaving significant scope for discretion on the part of policy-makers. This makes the policy environment enormously complicated and although it may mean that the country is able to judge each investment on its own merits, opacity and unreliability in the system may also be scaring off investors.

Despite a general shift toward liberalisation of the investment regime in India, the Government maintains ceilings on the level of foreign ownership permitted in many sectors. The table below summarises these ceilings. Levels of ownership and the range of sectors have been extended gradually from 1991, when 49 per cent ownership by foreigners was allowed for the first time.

There have been numerous proposals to allow 100 per cent investment across a range of sectors but these have met resistance from various interest groups both within and outside the government, leading to a high degree of inconsistency and unpredictability in the investment environment. Resistance has come from foreign investors with a foothold in the country as well as from domestic industry.

Table 5: Sectoral Investment caps in India

Sector	*Cap %*	*Sector*	*Cap %*
Telecom basic/cellular	49	Broadcasting	20-49
Telecom ISPs	74	Advertising	74-100
Telecom manufacturing	100	Oil refining (state-owned refiners)	24
Private banking	49	Marketing	74
Finance companies	100	Upstream	51-100
Insurance companies	26	Power	100
Domestic airlines (but not by foreign airlines)	40	Mining	74-100
Roads and ports	100	Trading	51-100

Source: Economic Times 20/09/01

In recent months, for example, the Government proposed opening up the retail sector to foreign ownership, but the proposal was withdrawn under political pressure from opposition parties on the grounds that it would undermine the viability of small retail units. Resistance is found within the Government too, for example in relation to the liberalisation of the telecommunications sector. In June 2001, the Cabinet proposed that 100 per cent foreign ownership be permitted in this sector, but the Communications Ministry later quashed the proposal.

India maintains a range of requirements on FDI including local content requirements, export requirements, dividend balancing, and import limitation, which are decided on a case-by-case basis for large investments. These are outlawed by the TRIMS (Trade Related Investment Measures) Agreement at the WTO and will therefore have to be withdrawn before the 2002 deadline. Other measures include requirements for technology transfer and minimum investment requirements. The latter are being considered for the first time because of the rush of relatively small investments in the software sector that are thought to be less stable and therefore less desirable than the larger-scale investments that the country has received in the past.

The Federal and State governments have offered a number of incentives to draw in investors. Of these, the most infamous are the guaranteed rates of return that were offered for investors in large infrastructure projects such as power generation. These policies are widely considered to have been very ineffective, if not counterproductive, from the point of view of investors and domestic stakeholders alike, as the case of Enron's investment in the Dabhol Power Company amply demonstrates. The Maharasthra State government was committed to making payments to the company whether or not power was purchased from the DPC, but when the State's finances went into the red, the State government was both unwilling and unable to keep up the payments. This controversy has now been overtaken by Enron's bankruptcy, but it remains an interesting case showing the dangers of unrealistic guarantees.

The Government has made efforts to streamline approvals for FDI by allowing some automatic approvals, but the process for the rest remains lengthy and onerous. The following categories of investments require approval applications, and it can be seen at a glance that they cover a large proportion of potential investors:

- Investment in certain sectors (defence, aerospace, tobacco, alcohol, drugs and pharmaceuticals, etc);
- Investment in the manufacture of items reserved for the small-scale sector;
- Where the investor has a previous joint venture or tie-up in India; and
- Cases that involve the acquisition of shares of existing Indian companies.

The Foreign Investment Promotion Board conducts the initial approval process. Once the investment has been approved, the investor is then required to acquire approvals and fulfill the bureaucratic requirements of the relevant sectoral ministries such as the Ministry of Energy or the Ministry of Communications as well as environmental and planning approvals. The government is considering replacing the FIPB with a 'Foreign Investment Implementation Authority', which would provide a range of follow-on services for investors, in particular assisting them in securing the required extra approvals. This might help to raise the disappointing 50 per cent fructification rates (actual investments compared to investments approved) that India currently achieves.

The Investment Environment

In South Africa and India, as in all countries, investment policies are only a small subset of the economic, social, and political characteristics that affect the investments that a country attracts. In the case of South Africa, the liberal investment policy regime has not been sufficient to attract investors. Some possible reasons for the comparative lack of success are explored below. In India, other policies exacerbate the restrictions and difficulties imposed by investment policies.

South Africa

Investor surveys have shown that current investors tend to be satisfied with the investment environment and express their intentions to make further investments. The Chairman of Daimler Chrysler, for example, which has invested heavily in new plant in South Africa, has given South Africa resounding commendations as an investment destination. However, potential investors cite a number of reasons for their reluctance to invest in the country, which include:

- Stagnant market reflected in low economic growth rates
- Uncertainty/lack of confidence reflected in low rates of domestic savings, domestic investment and the recent listings of several South African companies on foreign stock exchanges (e.g. Old Mutual, Anglo-American Corporation, South African Breweries and Digital Data are all listed on the London Stock Exchange)
- Regional instability. In particular, the events in Zimbabwe have coloured investors' perceptions of the whole region and undermined trust in property rights.
- High crime rates. This has a negative psychological effect as well as raising the costs of doing business.
- Lack of political will. While the current ANC government is committed to economic growth driven by the private sector, the South Africa Communist Party and COSATU (Confederation of South African Trade Unions), which form part of the ruling coalition, oppose the privatisation programme and openly reject the role of the private sector in some areas of the economy. Until now, the promise of growth and employment has kept these parts of the coalition behind the government, but the apparent failure of policy to fulfill expectations is fuelling dissent. This may make it difficult for the government to continue with its policy programme.
- Quality of the workforce. Investors have expressed some concern about the skill levels in large parts of the workforce, but the more immediate problem is the AIDS pandemic that affects a large proportion of the economically active sections of the population. The scale of the problem is coupled with the government's perceived failure to take the necessary radical policy steps to deal with it.
- Labour policy. South Africa has strong and active unions that have high status in the country because of their role in the overthrow of the apartheid regime. Opposition of organised labour is likely to create a major roadblock to future privatisation while strikes continue to create disruption in the economy.

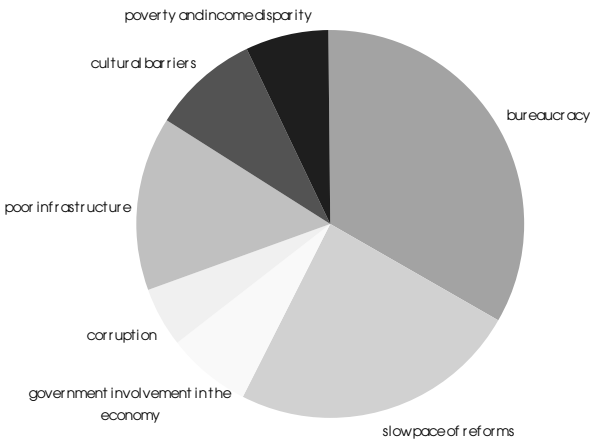
This long list demonstrates that South Africa will have to take a much broader approach to improving the investment environment if it is to attract higher FDI flows. In particular, policies to tackle AIDS and crime would be extremely valuable in themselves, as well as having positive knock-on effects on investment. Another priority for South Africa, given its significant outward investment flows, is to

take a regional approach to attracting investment. The government is already pursuing this. The South African Development Community (SADC) is developing a Finance and Investment Protocol for co-operation on financial matters that will take account of the different levels of economic development in the member countries. A Working Group will be drafting the protocol over the next few years.

India

The positive perception held by current investors in South Africa provides a stark contrast with India where many high-profile investors have withdrawn after difficult experiences. WorldTel, Congentrix and Enron provide just a few examples. In India, as in South Africa, other factors outweigh the importance of investment policy *per se* in determining whether investors come – and stay – in the country. The graph below shows the negative aspects of the Indian economy in the eyes of foreign investors.

Graph 5: Investor perceptions of problems in India



Source: AT Kearney, 2001

The most commonly cited problems – bureaucracy and the slow pace of reforms – could be tackled by the government. However, it seems to be difficult for the leadership to gather the political momentum needed to design and implement the necessary reforms. Among the most urgent reforms that are needed in the Indian economy are the reform of the labour laws and the reform of the Small-Scale Industries policy. India's labour laws are incredibly restrictive; even companies that are on the verge of bankruptcy are not allowed to lay off workers. This inhibits economic restructuring and efficient allocation of labour in the economy and makes it very difficult even for good managers to improve the efficiency and productivity of their businesses. Efficiency-seeking mergers and acquisitions, whether by foreign or domestic firms, are stifled by the policy.

Policies to support small and medium-sized enterprises (Small-Scale Industries or SSIs in India) were motivated by the wide geographical spread of the productive units of the sector and by its capacity to generate employment. SSIs were defined by a maximum level of investment and certain sectors, including potential key export sectors like textiles, were reserved for SSIs. This created a highly distorted set of incentives for managers as successful SSIs were prevented from growing because of the investment caps, while poorly performing companies were kept in business. It also discouraged foreign investment in the reserved sectors.

The most disappointing performance has been in the government's privatisation programme. Almost half of India's productive assets remain under state control and a large proportion of these are key infrastructure assets. Many of these public sector companies are generally less efficient than their private counterparts. For example, India's state-owned electricity companies lose 40 per cent or more of their power compared to 10 per cent for private distributors. Government budget constraints mean that levels of investment in infrastructure are totally inadequate, discouraging both foreign and domestic investment.

There are numerous others complications and contradictions in Indian policy which justify investors' objections to bureaucracy in India. Regulations governing power and telecommunications, in particular, are complex and often inconsistent. One of many examples of internal policy contradictions can be found in the civil aviation sector: FIPB approved an investment by a foreign airline in the domestic market but the national civil aviation authority refused to grant a license for the foreign company to operate.

The state of property markets, currently closed to foreign investment, also suppress efficiency in the economy. Currently, as many as 90 per cent of land titles in the country are under dispute of some form, and high stamp duties give India the highest property prices in relation to income in Asia. Simply changing the investment regulations to allow FDI in real estate would clearly not be adequate to draw foreign investors into property development in India.

Conclusion

India and South Africa are two excellent examples of countries with enormous economic potential that do not achieve the rates of investment that they need to realise this potential. In both cases, determined policy reform by the governments could make a huge difference. But as the preceding discussion demonstrates, it is not investment policy on its own that matters. Rather, it is the investment environment taken as a whole. In general, the same policies that would help to raise domestic investment, create the right incentives for managers, reduce distortions and raise efficiency in the economy would be the same ones that would attract more FDI. Policy coherence also stands out as a pressing need in both countries to reduce the current incidence of contradiction and confusion. Furthermore, governments will need to fill in policy gaps where bureaucratic discretion and *ad hoc* decision-making takes the place of a clear and consistent regulatory environment.

In both countries there are significant groups in the public sector and in civil society that oppose further economic reforms. If policies are to be effectively carried through from paper to practice, governments will have to spend time on winning over these groups and creating a strong domestic constituency in favour of reform. The public has much to gain from increased foreign investment governed by an adequate regulatory regime but their views are often coloured by the negative publicity that surrounds particular cases. Providing balanced information to civil society and encouraging an open national debate on investment issues would help to create the necessary pressure for beneficial reform.

A Trade Union Perspective,

John Evans,
Secretary General, Trade Union Advisory Committee to the OECD (TUAC)

The subject of this conference is not just the impact of foreign direct investment. It is part of a much wider discussion on the rules that will govern globalisation. The lessons that TUAC has drawn from the events of recent years, including the experience of the MAI and the Seattle and Doha WTO Ministerial meetings, is that global markets need governance. Global corporations need effective counterweights through civil society, through unions, and through effective regulation.

If the global market is to be socially sustainable and not lead to negative investment competition and the fear of a "race to the bottom", these rules have to cover social concerns. They also have to cover environmental concerns. This is particularly true in the current situation where there is likely to be fiercer competition to attract foreign direct investment on the one hand, and a growing public backlash against what are perceived to be the negative effects on the other.

In discussions with our membership within TUAC, it is clear that the recent increase in the international mobility of capital is being used to shift the balance of power against our members. A study of U.S. companies by Cornell University in 2000 showed that two-thirds of those facing organising drives by trade unions threatened to relocate to another country. This compares with only one-third of companies using such a threat ten years ago. It should be pointed out, however, that only 5 per cent of companies actually carried out their threat and moved. Nevertheless, the perceived impact is the same whether the threat is real or not.

This recalls the situation in Britain in the 1980s when "globalisation" was used by the then government as a term to argue that UK industrial relations had to adapt to a stereotype of "East-Asian" standards where trade unions were restricted or illegal. Some years later the then Korean Labour Minister told me that the Korean government was cracking down on trade unions because otherwise the Korean *Chaebols* would move to Scotland and Wales where labour was "more flexible"! So with these myths circulating, it is not surprising that many people feel that there is a "race to the bottom". Another illustration of restrictions on union activities is the kind of publicity material that many foreign investment agencies use to try to attract investment to export processing zones in developing countries. There are numerous examples of either formal derogation from domestic labour law or *de facto* non-enforcement of such law. That is the situation in many of the *Maquilas* in Central America.

This situation will become more acute with the entry of China into the WTO, and clearly this raises important questions here in Mexico about the type of investment that Mexico seeks to attract. A much-publicised *Business Week* article early in 2001 argued that Mexican wages were now no longer competitive with those of China and that there would be an outflow of foreign investment from the *Maquiladores* to the Chinese Special Economic Zones. An OECD study on Trade and Labour Standards, published in 2000, pointed out that China was a special case and an exception with regard to its findings that suppression of core labour standards did not affect trade performance. In the case of China it clearly does. Mexico therefore faces strategic choices about what form of foreign direct investment it wishes to attract, and how this can be more closely integrated in its own domestic development strategy.

The broad conclusion that we have drawn from recent experiences is that countries now have to face choices about the type of investment they seek to attract, and how these are integrated with a

development strategy. These are sometimes called the “high road” and the “low road” approaches. The “low road”, where competition is focused on attracting low cost production, means that countries just become a production platform with highly mobile investment and continuing pressure on wages. There is, however, a “high road” option, where countries focus on achieving quality and stable investment based on skilled workforces and steadily rising productivity. OECD work has shown that in the long run the “high road” model does work. It is more consistent with a balanced development strategy.

TUAC sees the OECD Guidelines for Multinational Enterprises as an important practical step in the process of setting government expectations of corporate behaviour. They are a first step towards establishing rules to protect corporations that observe standards, treat their workers well, and protect the environment, from those corporations that do not. TUAC is now treating the awareness and enforcement of the Guidelines as a priority, and has published a *TUAC User’s Guide to the Guidelines*, which is also available on the TUAC website at http://www.tuac.org.

Looking ahead to the 2002 UN Conference in Monterrey on Financing for Development, a key message is that the best policy for attracting investment is for governments to adopt policies that favour development. They need to ensure good governance, a respected legal structure, good educational systems, a social safety net, a healthy and skilled workforce, and good infrastructure. Such approaches also require increased resources, and OECD countries must also now be serious about expanding their ODA budgets to 0.7 per cent of GNP.

With this goal and approach to development, governments can then see unions as partners in the important endeavour of building up trust and empowerment among those who are currently excluded from the advantages of development.

FDI In Emerging Markets Banking Systems,

Jorge Roldos,
International Monetary Fund (IMF)

Introduction

During the 1990s, one of the most striking structural changes in many emerging markets' financial systems has been the growing presence of foreign-owned financial institutions, especially in the banking system. As noted by Eichengreen and Mussa (1998), many emerging markets have been reducing barriers to trade in financial services since the early 1990s, but it was not until the second half of the decade that foreign financial institutions acquired a substantial presence across many emerging markets.

Measures of foreign participation and control in some key emerging-market banking systems demonstrate the extent to which large inflows of FDI and portfolio investment have transformed the sector during the 1990s. The share of investment in the financial industry in the total inward FDI stock to Central and Eastern Europe reached 13.6 per cent in 1999, the highest sectoral share in that region, while the comparable figure in Latin America was 12.3 per cent (second only to business activities in the tertiary sector)[1]. High shares of FDI in the financial sector have resulted in significant changes in the ownership structure of the industry, and the proportion of total bank assets controlled by foreign-owned banks in Central Europe currently stands at around 70 per cent, while in some major Latin American countries, more than half of total bank assets are controlled by foreign institutions.

The sharp increase in FDI in emerging market banking systems is a result of the globalisation of the financial services industry, together with the removal of barriers to entry in several emerging markets. In response to deregulation and disintermediation processes, the financial services industry has diversified across geographic and product lines. Although there are strong incentives for foreign banks to expand abroad, they have until recently faced substantial barriers to entry in most emerging markets. However, the need to strengthen financial systems and reduce the costs associated with recapitalising and restructuring banks in a post crisis period, led the authorities in a growing number of emerging markets to open their banking systems to foreign entry in an effort to improve banking system efficiency, and to have banks that are part of organisations that hold globally diversified portfolios.

The increase in foreign participation has led to a series of studies focused on the effects of foreign bank entry in domestic financial systems. While the sharp rise in the level of foreign bank participation in many emerging markets is clear evidence that the authorities in these countries have concluded that foreign bank entry will have an overall positive effect on the banking system, the effects of foreign bank entry on the efficiency and stability of the local banking systems has been much debated in many countries. A general finding of the empirical studies that have included either mixed samples of mature and emerging markets (for instance, Claessens, Demirgüc-Kunt, and Huizinga, 1999) or have focused on emerging markets, is that foreign banks in emerging markets have been more efficient in terms of both costs and profits than domestic banks – whereas the opposite is true for mature markets. Moreover, significant foreign bank entry was associated with a reduction in both the profitability and overall expenses of domestic banks.

The evidence on the stability effects of foreign bank presence is more mixed, but an increasing body of evidence points to the fact that banks with a long-term commitment to emerging markets tend to provide a

stable influence. Evidence from the Japanese and Asian banking crises indicates that banks sometimes choose to shrink host-country operations more than those at home when they have home-country problems (Peek and Rosengren, 2000). However, recent case studies suggest that foreign banks in Argentina and Mexico have expanded operations even when facing host-country problems (see Goldberg, Dages and Kinney, 2000). Also, Palmer (2000) notes that U.S. money centre banks generally sustained the operations of their offshore branches and subsidiaries during the recent emerging market crises.

This paper summarises and updates results presented in Chapter V of IMF (2000) and Mathieson and Roldos (2001). The following issues related to the increased role of foreign banks are highlighted. First, measures of foreign participation and foreign control derived from banks' balance sheets mirror the important increase in financial sector FDI during the second half of the 1990s. Second, an empirical analysis of the determinants of foreign bank entry shows that an index of banking crises (based on the work of Kaminsky and Reinhart, 1999 and Caprio and Klingebiel, 1999) contributes to explaining to a large extent the increased foreign bank presence in emerging markets. A third section of the paper reviews both the theoretical arguments and the available empirical evidence about the effects of foreign bank entry on both the efficiency and stability of the domestic banking system.

Particular attention is given to examining how the lending and deposit-taking activities of domestic and foreign banks respond to large domestic and external shocks, and the degree to which foreign banks have been supported by parent companies during a crisis or when they get into difficulty. The final section addresses some of the policy issues raised by an increased presence of foreign banks in the domestic banking system, including the need to develop effective cross-border prudential supervisory and regulatory policies for large complex banking organisations and the new instruments and derivative products they introduce, the degree of parental support that is likely to be offered to local establishments during periods of difficulty, the banking concentration issues that can arise, and the effects of foreign bank entry on the level of systemic risk in the banking system.

Increase in Foreign Bank Entry to Emerging Markets

The extent of foreign ownership in emerging markets' banking systems has increased dramatically during the second half of the 1990s and further increases are already occurring in a number of countries. There have, however, been widely divergent trends across different regions, with Central Europe showing much larger increases than Asia (Table 1).

The increased activities of foreign banks in emerging markets can be measured either in terms of foreign bank participation in domestic banking markets or in terms of how effectively foreign banks control banking activities. For example, while foreign banks might participate in a number of joint ventures as minority shareholders, the local majority shareholders might control the overall operations of the banks. Using publicly available balance sheet and ownership data,[2] Table 1 presents measures of both participation and control by foreign banks in different regions. Foreign participation is measured as the ratio of the sum across all banks of the assets of each bank multiplied by the percentage of equity held by foreigners to total bank assets.

In contrast, the table presents two measures of the extent of bank assets under effective foreign control since corporate control may not be directly and exclusively related to the proportion of a bank's equity held by a particular owner. While holding more than 50 per cent of total equity typically ensures effective control of a bank, a number of analysts have argued that hostile takeovers are unlikely to occur when the existing owners hold more than 40 per cent of bank equity.[3] The extent of foreign control is thus measured by the ratio of the sum of the total assets of those banks where foreigners own more than either 40 or 50 per cent of total equity to total bank assets.[4]

Table 1. Foreign Bank Ownership in Selected Emerging Markets[1]

	Total Assets	Foreign Control[2]	Total Assets[3]	Foreign Participation	Foreign Control[2]
	December 1994	December 1994	December 1999	December 1999	December 1999
	(In billions of U.S. dollars)	*(In percent)*	*(In billions of U.S. dollars)*	*(In percent)*	*(In percent)*
Central Europe					
Czech Republic 5/	46,6	5,8	63,4	65,7	86,7
Hungary	26,8	19,8	32,6	59,5	56,6
Poland	39,4	2,1	91,1	36,3	52,8
Total	112,8	7,8	187,1	50,2	65,0
Turkey	52,0	2,7	156,2	1,6	1,7
Latin America					
Argentina	73,2	17,9	157,0	41,7	48,6
Brazil 5/	487,0	8,4	732,3	17,8	17,1
Chile	41,4	16,3	112,3	48,4	53,6
Colombia	28,3	6,2	45,3	16,2	17,8
Mexico 5/	210,2	1,0	204,5	54,1	47,6
Peru	12,3	6,7	26,3	33,2	33,4
Venezuela	16,3	0,3	24,7	34,7	41,9
Total	868,6	7,5	1302,4	29,8	29,5
Total excluding Brazil and Mexico	171,4	13,1	365,6	39,5	44,8
Asia					
Korea	638,0	0,8	642,4	11,2	4,3
Malaysia	149,7	6,8	220,6	14,4	11,5
Thailand	192,8	0,5	198,8	6,0	5,6
Total	980,5	1,6	1061,8	10,9	6,0

Source: IMF staff estimates based on data from Fitch IBCA's BankScope Database.

[1] Ownership data reflects changes up to December 1999 while balance sheet data is the most recent available in Fitch IBCA's BankScope.

[2] Ratio of assets of banks where foreigners own more than 50 percent of total equity to total bank assets.

[3] For Central Europe and Asia available balance sheet data is in most cases for December 1998.

[4] Same as footnote 2 but at 40 percent level.

[5] Includes major transactions in 2000-01.

Central Europe

Foreign participation in Central Europe increased considerably in the second half of the 1990s, and by mid-2001 the share of banking assets under foreign control had reached almost 70 per cent (Table 1). Following the banking crises of the first half of the decade, the privatisation of state-owned banks increased foreign participation substantially. Initially, most of the sales were of medium-sized banks, but more recently the large state-owned saving and foreign trade banks have been sold. Hungary took the lead in the privatisation process, and by end-1999 foreign participation in the banking system was about 60 per cent of total assets. Poland's privatisation process, accelerated in 1999–2000 and, with the sale of Bank Pekao in mid-1999, the share of bank assets under foreign control rose to 53 per cent. The Czech Republic began to privatise its state-owned banks in 1998, and by early 2000 three of the four large state-owned banks had been sold. As a result, foreign institutions controlled 46 per cent of total banking assets by end-1999, and that share increased to more than 60 per cent with the sale of the second largest bank in March 2000 and to almost 90 per cent of bank assets with the sale of Komercni Banka to Société Générale in mid-2001.

Latin America

Although foreign banks have been present in Latin America for many decades, there has been a quantitative jump in the degree of foreign participation in the second half of the 1990s with the

acquisition programme initiated by the leading Spanish financial institutions. Indeed, the presence of foreign banks is important not just because of the size of their market share, but also because leading institutions in almost every country are controlled by foreign institutions.

Foreign banks had a relatively large presence in Argentina and Chile by end-1994 (see Table 1), but the share of assets under foreign control increased to the 50 per cent level following a series of mergers and acquisitions in 1996–97. In the larger markets of Brazil and Mexico, foreign participation has traditionally been lower, but assets under foreign control had reached 18 per cent by end-1999. However, the sale of the third-largest Mexican bank in May 2000, and of the second-largest in June 2000, brought the share of assets under foreign control to about 40 per cent; the sale (yet to be completed) of the largest Mexican bank to Citigroup would bring that figure to more than 60 per cent. Brazil is the only banking market in Latin America where foreigners are unlikely to have a dominant position, owing to a large share of bank assets under government control and the existence of three large, well-capitalised, and well-managed private banks. The entry of two large European banks in 1997–98 nevertheless changed the banking landscape and increased competition, and the privatisation of some state banks has increased the share of foreign bank participation to around 20 per cent of bank assets.

Asia

Foreign banks have played a smaller role in most Asian financial systems than in Central Europe or Latin America, reflecting in part official policies that have limited entry, especially into local retail banking markets. The restrictions on foreign bank entry have typically involved limitations on both the number of foreign banks that could enter the market and the number of branches they could establish within the market. After the crisis, several countries liberalised entry norms for foreign banks, with the exception of Malaysia. However, foreign bank participation in Malaysia is 23 per cent of total commercial bank assets, one of the highest in the region.[5]

The speed and scope of the foreign influx in Korea and Thailand has been lower than originally expected by most analysts.[6] The sale of Korea First Bank to Newbridge Capital accounts for the increase in foreign control in Korea (see Table 1), while the increase in foreign participation also captures the increasing (minority) stakes in several banks.[7] Foreign bank participation in Thailand has been traditionally low, though the involvement of foreign banks has been larger than the figures in Table 1 suggest, owing to the banks operating through the Bangkok International Bank Facility (BIBF).[8] After the crisis, four banks were sold to foreign institutions, increasing the share under foreign control from 0.5 per cent at end-1994 to 4.5 per cent at end-1999 (Table 1). However, the share of assets under foreign control could rise with the privatisation of the other intervened banks.

Factors Increasing FDI in Emerging Markets Banking Systems

The dramatic increase in FDI in emerging markets banking systems is a result of the globalisation of the financial services industry, together with the removal of barriers to entry in several emerging markets.

The globalisation of the financial services industry has resulted in banks facing competition from a variety of non-bank sources of credit and financial services (particularly securities markets) and this has fueled an ongoing consolidation of banking systems in both mature and emerging markets.[9] Foreign bank interest in emerging markets has being driven by technology-induced economies of scale and scope that are being exploited by geographic and product diversification worldwide. While only a handful of banks are able to conduct global commercial banking, a number of banks, leveraging language and cultural affinities, have emerged as “regional evolvers”—that is, banks that focus their

activities on a particular region, such as the Spanish banks in Latin America, the Austrian, Belgian, Dutch, and German banks in Central Europe, and, to a lesser extent, the Australian and Japanese banks in Asia.[10] The large Spanish banks redefined their international expansion strategy after the Asian crisis, pulling out of that region and focusing on becoming large regional banks in Latin America and Western Europe.

Although there are strong incentives for foreign banks to expand abroad, they have until recently faced substantial barriers to entry in most emerging markets. A greater openness to foreign trade and investment, combined with the need to build up more efficient and stable financial systems in the aftermath of crises, have been major catalysts for the removal of barriers to entry of foreign institutions. As noted by Eichengreen and Mussa (1998), many emerging markets have been reducing barriers to trade in financial services since the early 1990s, and allowing for the entry of foreign financial institutions has been just one facet of this more general liberalisation. Nonetheless, by the mid-1990s, only a modest amount of foreign bank entry had occurred (Table 1). In part, this limited foreign entry reflected concerns about the potential effects of foreign bank entry and the political resistance to such entry by the domestic banking industry.

While significant changes in the restrictions on foreign bank entry have at times been motivated by a desire to improve the levels of competition and efficiency in the banking system, they have often been triggered by the need to help reduce the costs of restructuring and recapitalising banks following a major crisis, as well as a desire to build an institutional structure in the banking system that is more robust to future domestic and external shocks. The experience with banking system instability in many emerging markets since the 1970s (Lindgren, García, and Sall, 1996) has demonstrated the need to make domestic banking systems more robust to large external and domestic shocks. While the authorities in most emerging markets have moved to strengthen prudential supervision, there has been a recognition that relatively small banks holding internationally undiversified portfolios remain a source of vulnerability in the face of large shocks. To improve on this situation and often to help reduce the costs associated with recapitalising and restructuring banks in a post-crisis period, the authorities in a growing number of emerging markets have begun to open their banking systems to foreign entry in an effort to improve banking system efficiency and to have banks that are part of organisations that hold globally diversified portfolios.

While there are a number of factors that could potentially influence a bank's decision to enter a particular market or the authorities willingness to allow such entry, it is an empirical issue as to which of the factors have been most important during the 1990s. To examine the relative importance of the different factors influencing foreign bank entry, Mathieson and Roldos (2001) studied the determinants of foreign participation using data on 1,135 banks from 15 countries[11] for the period from 1991 to 1999. The estimation results for the pooled annual data suggest that, not surprisingly, foreign banks increase their participation in and control of banks that earn relatively high rates of return on equity. In addition, the results also suggest that a previous banking crisis and improved macroeconomic conditions are likely to lead to greater foreign participation and control. A banking crisis during the previous three-year period raised both foreign participation and control by about 10 percentage points. This suggests that countries experiencing a banking crisis regularly turn to foreign banks to help rebuild and restructure the domestic banking system. Finally, the regional dummies are highly significant, confirming the differential attitude toward foreign bank entry in Asia and Central Europe.

Effects of Foreign Bank Entry

The sharp rise in the level of foreign bank participation in many emerging markets is clear evidence that the authorities in these countries have concluded that foreign bank entry will have an overall

positive effect on the efficiency and stability of the banking system. Nonetheless, the effects of foreign bank entry on the efficiency and stability of the local banking systems has been much debated in many countries. This section examines the nature of the arguments concerning the likely effects of foreign bank entry, as well as the available empirical evidence.

Arguments Concerning Banking Efficiency and Stability

Allowing foreign bank entry is generally seen as improving both the efficiency and stability of the banking system. It is argued that foreign banks will help improve the quality, pricing, and availability of financial services, both directly as providers of such enhanced services, and indirectly through competition with domestic banks. These new financial products can provide better opportunities for portfolio diversification and intertemporal trade, and foreign banks are often seen as improving the allocation of credit as they have more sophisticated systems for evaluating and pricing credit risks.

Similarly, it has also been argued that the entry of foreign banks can improve the overall stability of the domestic banking system. In particular, foreign banks can provide a more stable source of credit and can make the banking system more robust to shocks. This greater stability is said to reflect the fact that the branches and subsidiaries of large international banks can draw on their parent for additional funding and capital when needed. Finally, the entry of sound foreign banks is seen as implicitly allowing a country to import strong prudential supervision for at least a portion of the financial system.

Others see foreign banks as making much less of a contribution to an efficient and stable banking system. One concern is that foreign banks "cherry pick" the most profitable domestic markets and customers, leaving domestic banks to serve the other (more risky) customers and thereby increase the overall riskiness of domestic banks' portfolios. In addition, it has been argued that it may be difficult for foreign banks to transfer some of the credit risk evaluation methods used in mature markets, as their credit scoring methods may face informational constraints in emerging markets and end up reducing the availability of credit to small firms.[12]

Apart from the impact of foreign bank entry upon the stability of domestic banks, there have also been concerns about the behaviour of foreign banks during crisis periods. Indeed, in Asia one of the most frequently cited reasons for limited foreign bank entry is the perception that foreign banks have "cut and run" during recent crises, especially in the period following the 1997 crises. While it is evident that cross-border lending to emerging markets has often fallen sharply in the 1990s in post-crisis periods, there is the question of whether foreign banks with a local presence are more likely to maintain their exposure to domestic borrowers than are foreign banks that only engage in cross-border lending. A final concern that is often voiced is linked to the issue of whether they will be adequately supervised: some observers have argued that the complex cross-border financial transactions undertaken by international banks may be difficult to supervise by either the host or the home-country supervisors.

Empirical Evidence on Efficiency Effects

This debate over the potential effects of foreign bank entry has led to a number of recent empirical studies of the efficiency and, to a lesser extent, the stability effects of foreign bank entry. One of the striking findings of recent studies of the effects of foreign bank entry on banking system efficiency is the differing result for mature and emerging markets. In examining the experience of France, Germany, Spain, the United Kingdom and the United States, for example, Berger and others (2000) analysed cost and profit efficiency for both foreign and domestic banks using annual data for 1993–98. In these mature markets, they found that foreign banks were less efficient in terms of either costs or

profits, on average, than domestic banks. However, some banking organisations – particularly from the United States – were found to consistently operate at or above the efficiency levels of domestic banks. They argued that this latter result reflected the fact that the home field advantages of domestic banks were offset by the global advantages (which reflect such factors as superior risk management practices, superior product mix, or more diversified portfolios) enjoyed by some foreign banks.

In contrast, virtually all empirical studies that have included either mixed samples of mature and emerging markets or have focused on emerging markets have concluded that foreign banks have been more efficient in terms of both costs and profits. For example, Claessens, Demirgüc-Kunt, and Huizinga (1999) examined the behaviour of banks in 80 mature and emerging markets in the period from 1988 to 1995 to investigate how net interest rate margins (between lending and deposit rates), overhead expenses, taxes paid, and profitability differed between foreign and domestic banks. Foreign banks were found to have higher interest rate margins, profitability, and tax payments than domestic banks in emerging markets, while the opposite was true in mature markets. Moreover, significant foreign bank entry was associated with a reduction in both the profitability and overall expenses of domestic banks.

In addition, the efficiency effects of foreign banks on emerging markets' banking systems appeared to occur as soon as there was entry, and did not depend on gaining a substantial market share.[13] Performance indicators for a sample of emerging markets in the more recent period 1996–98 (see IMF, 2000) seem to confirm that foreign banks operating in these markets are relatively more efficient than domestic banks. Finally, further evidence on the beneficial effects of foreign competition is provided by qualitative studies that assess the response of the successful local incumbents (see, for example, Abut, 1999).

There are no broad-based studies on whether foreign banks ration credit to small firms to a larger extent than domestic banks, but a recent study on the Argentine banking industry does find evidence supporting that hypothesis. Berger, Klapper, and Udell (2001) show that small businesses tend to receive less credit from large banks and foreign banks, and that this effect is magnified for small firms with loan repayment delinquencies. The authors argue that foreign-owned institutions may have difficulty extending relationship loans to opaque small firms.

Why is there such a sharp contrast between the effects of foreign bank entry for mature and emerging markets? To a significant degree, the contrasting results reflect differences in initial conditions. All of the recent studies of mature markets cover periods where the banking system regulations have long since been liberalised, and banks faced competition not only from other banks but also from a variety of non-bank sources of credit (especially capital markets). Such competition had already put intense pressures on net interest rate margins and forced banks to merge and/or adopt new technologies to help reduce overhead costs. While foreign bank entry could intensify these competitive pressures, the scale of such an increase would typically be marginal. In contrast, the studies of the effect of such entry on emerging markets have typically focused on periods where the banking systems have only recently been liberalised and/or were coming out of crisis periods. In either situation, the banks were just emerging from periods where there had often been extensive restriction on new entry into the banking system, non-market determination of key interest rates (because of either official interest-rate ceilings or oligopolistic determination of the interest-rate structure by bankers' associations), and limited degrees of competition from non-bank sources of credit. While such an environment increased the franchise value of banks and allowed relatively inefficient banks to survive, these created strong profit opportunities for new banks that could operate with more efficient cost structures and offer more market-related interest rates. In this situation, the entry of foreign banks could have a major impact on banking system efficiency both directly, because of their own operations, and indirectly, because they forced other banks to become more efficient if they wished to survive.

Empirical Evidence on the Stability Effects of Foreign Bank Entry

Whatever the effects of foreign bank entry on banking system efficiency, an equally important issue for many emerging markets is whether such banks are likely to contribute to banking system stability and to be a stable source of credit, especially in crisis periods. There are two related issues here: whether the presence of foreign banks makes systemic banking crises more or less likely to occur, and whether there is a tendency for foreign banks to "cut and run" during a crisis.

There are surprisingly few studies of the relationship between foreign bank entry and systemic banking crises. However, Levine (1999) has recently attempted to analyse the impact of foreign bank presence on the probability that a banking crisis will occur. Levine's empirical study builds on the earlier work of Demirgüc-Kunt and Detragiache (1998), which used a multivariate logit model to relate the probability that a banking crisis would occur during a particular period to a series of macroeconomic and banking system indicators by adding a measure of the number of foreign banks relative to the total number of banks. The foreign bank share variable was found to have a negative and significant coefficient, which led Levine to conclude, after controlling for the effects of other factors that are likely to produce banking crises, that greater foreign bank participation was a stabilising factor.

The stability of foreign bank lending has also been examined by contrasting the behaviour of cross-border and local lending[14] by foreign banks during crisis periods. For example, Palmer (2000) noted that U.S. money centre banks generally sustained the operations of their offshore branches and subsidiaries during the recent emerging market crises. While cross-border claims in Asia decreased 36 per cent between June 1997 and June 1999, local claims declined just 6 per cent (in Korea, local claims actually rose 19 per cent). In addition, U.S. banks claims' on Latin American countries actually increased during that period. Palmer (2000) argued that the disparity between movements in cross-border and local claims reflected the fact that U.S. banks that had developed local franchises in the region saw good prospects beyond the crises, while the extent of franchise development (and the associated commitment) was much less for institutions primarily involved in cross-border lending.[15]

Peek and Rosengren (2000) find substitutability between cross-border lending and increased FDI in some Latin American banking systems, but they conclude that measures of foreign bank penetration that include both lending by subsidiaries and cross-border lending do increase after crisis episodes. Finally, Goldberg, Dages, and Kinney (2000) examined the lending behaviour of foreign and domestic banks in Argentina and Mexico in the period surrounding the 1994–95 Mexican crisis and concluded that foreign banks exhibited stronger loan growth compared to all domestic-owned banks, with lower associated volatility, and thereby contributed to greater stability in overall financial system credit. Furthermore, they found strong similarities in the portfolio composition of lending and the volatility of lending by private foreign and domestic banks in Argentina, while the same was true in Mexico for banks with low levels of problem loans. Overall, they argued that bank health, and not ownership, *per se*, was the critical element in the growth and volatility of bank credit.

In a more recent study of the Asian experience, Laeven (1999) considered the behaviour of foreign and domestic banks in East Asia (Indonesia, Korea, Malaysia, the Philippines, and Thailand) in 1992–96 to identify the role of ownership structure in determining vulnerability to domestic and external shocks. In examining both the profitability and risk-taking activities of banks, he found that foreign-owned banks took relatively limited risks and showed an increase in efficiency relative to other banks. In addition, family-owned and company-owned banks were found to hold the most risky portfolios. Moreover, banks that required restructuring after the crisis of 1997 were mostly family-owned or company-owned and almost never foreign-owned.

It is often argued that local operations of foreign banks are likely to have recourse to additional capital from their head-offices in times of financial stress. This is a largely untested proposition, however, with only a

few clear examples to support it. In Hungary, for example, when the brokerage subsidiaries of foreign banks suffered large losses in the aftermath of the Russian crisis, head-offices quickly injected capital.[16] But these recapitalisations required were small, relative to the size of local operations. In another example of foreign support, Portugal's Banco Espírito Santo injected more capital into its Brazilian subsidiary Banco Boavista Interatlantico, after the latter had to make good on the losses sustained by its mutual funds after the devaluation of the real in January 1999. Similarly, Credit Commercial de France injected capital into its Brazilian subsidiary (CCF do Brasil) in 1998 to absorb losses derived from the financial markets turbulence of October 1997.[17] However, there are also examples of foreign banks that withdrew from emerging markets after having failed to establish a profitable presence. Market participants suggest foreign banks are likely to examine whether or not to inject capital on a case-by-case basis, trading off future value (including international reputational effects) against cost. Minority shareholders are viewed as less likely to make capital injections during periods of financial stress.

Apart from the stability of foreign bank lending and capital support, there is also the issue of whether foreign banks can contribute to the stability of the domestic deposit base. Foreign banks contribute to the stability of the domestic financial system, for example, if depositors shift their funds to foreign institutions that are perceived as sounder than the local banks rather than engaging in capital flight. Flight-to-quality was widespread during the Asian crises, as depositors shifted funds from finance companies and small banks toward large banks, especially foreign banks. The market share of deposits in foreign banks tripled in Korea and Indonesia between January 1997 and July 1998, while in Thailand it increased from 2 per cent of total deposits to 5 per cent in the period December 1996 to December 1997.[18] The crisis that began with the failure of a large bank in Argentina in March 1980 led to runs on three other banks, with foreign banks among the beneficiaries of the flight-to-quality.[19] Similarly, concerns about the ability of Argentine banks to meet depositor demands following the Mexican crisis of 1995 led depositors to shift their funds to foreign banks.[20] More recently, rumours of financial difficulties at Postabank—the second largest bank in Hungary—led to a run by depositors that benefited in part foreign institutions.[21]

In sum, the evidence on the effects of foreign bank entry supports the conclusion that the competitive pressures created by such entry have led to improvements in banking system efficiency in terms of lower operating costs and smaller margins between lending and deposit interest rates. There is as yet only limited evidence as to whether a greater foreign bank presence contributes to a more stable banking system and less volatility in the availability of credit.

Policy Issues

The growing presence of foreign banks has raised a number of complex policy issues, especially in relation to cross-border supervision and regulation, banking system concentration, and systemic risks and official safety nets.

Cross-Border Supervision and Regulation

The growing presence of foreign banks in many emerging markets, as well as the expansion of emerging market banks to offshore markets, have increased the complexity of the tasks facing supervisory authorities, especially in emerging markets. Banking supervisors have long been aware of the potential problems associated with cross-border banking activities, and a series of principles and best practices has evolved to establish effective prudential supervision of these activities. The key objective of the supervisors of internationally active banks has remained that of ensuring that no activity of these banks escapes effective supervision and that co-ordinated remedial action can be

undertaken when necessary. Nonetheless, the collapse of institutions such as BCCI in 1991 and Peregrine Investments in 1998[22] has illustrated how a constantly evolving set of institutional structures and legal arrangements could potentially be used to escape effective prudential supervision.

Moreover, the recent experience of the Bank of New York has demonstrated how readily cross-border banking linkages can be used for purposes of fraud and money-laundering. Indeed, one of the on-going concerns of bank analysts and supervisory authorities is that the increasing complexity of cross-border banking activities and institutional arrangements—including the development of virtual banks that operate in several jurisdictions,[23] will allow some activities to "fall between the cracks."

From the perspective of emerging markets' banking supervisors, there are a number of issues that have become increasingly important as the presence of foreign banks has expanded. First, there is the issue of how to monitor the local establishments of large international and regional banks. As foreign banks become an important source of financial services, emerging markets' supervisors need to be aware of the financial positions of not only the local branches and subsidiaries of major international and regional banks but also the parent bank. Indeed, difficulties at the parent bank could raise questions about the survivability of the local affiliate, even if its position is fundamentally sound. Second, one of the key strategies employed by major international banks to gain market share when they enter an emerging market is to offer a variety of new financial products, including OTC derivative products. While these new derivative products can allow for better hedging of a variety of risks, experience has shown that they can be readily used to evade prudential regulations. As a result, emerging markets' supervisors will need to upgrade their ability to analyse the growing use of these instruments. A third issue is understanding when and to what extent parent banking organisations will support their local operations in times of difficulty or crisis.

Large Complex Banking Organisations

The ongoing consolidation of the global bank industry has created a set of large international and regional banks that engage in a broad range of complex on- and off-balance-sheet transactions and their total assets are multiples of most emerging markets' GDPs. These institutions are typically the parents of the foreign branches and subsidiaries established in most emerging markets. Understanding and supervising the exposure of these large international organisations has led to special measures by mature markets' supervisors and requires a level of financial expertise that may be lacking in many emerging markets. For instance, supervisors in the United States have selected a small subset of large, complex, banking organisations (LCBOs), and have established teams of examiners who are delegated to monitor each one of these LCBOs.[24] Since difficulties at one of these parent organisations could quickly create doubts about the viability of its local branches and subsidiaries, the stability of emerging markets' financial systems has become increasingly dependent on the quality of prudential supervision in the mature markets. Nonetheless, emerging markets' supervisors will still need to develop the expertise to monitor a new range of activities and instruments that are likely to be used by the local establishments of LCBOs. The need to acquire such expertise has been demonstrated by the role that derivative products have played in recent balance-of-payments crises.

Derivative Products and Prudential Supervision

As noted earlier, one of the strategies employed by major international banks when they enter an emerging market is to offer a variety of new products, including OTC derivative products. These new derivative products can be a source of considerable benefit since they increase the ability to separate and market risks and thereby allow for better hedging of a variety of risks that were previously undiversifiable. However, as noted by Garber (2000), these instruments can also be used to take on excessive risks, especially in weak

financial systems with obsolete accounting systems, slow reporting systems, and unprepared supervisors. Moreover, derivatives can be used to evade prudential regulation and capital or exchange controls.[25]

Parental Support

A key consideration influencing the decisions of both the authorities to allow foreign banks to enter and local residents to place deposit in these banks is the extent of support that these banks are likely to receive from their parents. There are both legal and reputational issues involved in determining the support that is likely to be forthcoming during difficult periods. From a narrow legal perspective, a bank subsidiary is a stand-alone entity with its own dedicated capital, and the parent's formal obligation to support its subsidiary is generally limited to the amount of invested capital. However, the relationship between a bank and its subsidiary can be broader as a result of statutes (U.S. law, for example, requires banks to guarantee their subsidiaries' capital) or from contractual provisions between a bank and its subsidiary (that may be imposed by the regulatory authorities as a condition for issuing a license to a subsidiary). In contrast, a branch has no independent legal personality distinct from that of its parent, and claims on the branch actually constitute claims on the parent.[26] Even apart from the legal requirements, a parent bank would typically have an incentive to support its local branches and subsidiaries because of the reputational effects associated with allowing their failure and collapse. Indeed, the failure of a large branch or subsidiary in one country could call into question the parent's support for its establishments in other countries or even the strength of the parent's own financial position.

A number of factors are likely to influence both the likelihood and extent of a parent bank's support for its foreign establishments. One key factor is the financial position of the parent bank. A parent bank under profit pressure and with a weak capital position may have little capacity to raise the funds needed to recapitalise a large troubled foreign entity. Another important factor is the degree to which the parent bank is committed to developing a sustained presence in the local market. As noted earlier, some foreign banks enter a market primarily to service customers from their home market who have set up operations in the local market. Should those customers fail or leave the market, these banks would be less inclined to maintain a local presence. Another issue is the degree to which the difficulties encountered by the local establishment have arisen as a result of its own actions (such as having inadequate controls against fraud) or are due to events beyond its control (such as the imposition of capital controls or the expropriation if its assets). While the parent bank will typically have a strong incentive to remedy problems created by weak internal controls, it may have a much smaller incentive to support its local establishment if *force majeure* events prevent the local entity from making payments.[27]

Banking System Concentration

The expansion of large foreign banks (often with global balance sheets several times local GDP) into emerging markets has prompted concerns about concentration in the local banking markets. The entry of such institutions can affect banking system concentration both directly and indirectly. In some cases, large foreign banks have acquired a significant share of local bank assets by purchasing a local state bank that was being privatised or by acquisition of a large private bank that was in need of recapitalisation. The entry of such banks would in turn create pressures on local banks to merge in order to remain competitive, both by capturing economies of scale in back office operations and by being viewed by depositors as offering the same degree of safety and soundness as large foreign banks. Moreover, in some countries, such as Chile, the concentration issue arose when the parents of two local foreign banks merged.[28]

There are concerns that such concentration could create monopoly power that would reduce banking system efficiency and the availability of credit, open up new avenues for the transmission of disturbances from mature to emerging markets, and increase the risk that these institutions will become too big to fail locally. It has been argued that a high degree of banking system concentration will adversely affect output and growth by yielding both higher interest-rate spreads (with higher loan rates and lower deposit rates) and a lower stock of credit than in a less concentrated, more competitive system. However, there are conflicting theoretical views on the effects of such concentration on growth and output, and the limited empirical evidence yields conflicting results.[29] In any event, the recent experiences of Chile and Mexico suggest that emerging markets should equip themselves with antitrust laws appropriate to deal with the complex issues involved in the definition and resolution of anticompetitive cases in the financial sector. The share of total assets held by some of the international banks in Central Europe and Latin America is around the 15–25 per cent level, suggesting fairly large exposures to relatively volatile regions and also highlighting the potential for "reverse contagion."[30]

Systemic Risk, Official Safety Nets, and Cross-Border Banking

Systemic risk associated with cross-border banking can arise if either liquidity or solvency problems of banks in one country create similar problems for financial institutions elsewhere in the international financial system. As noted by Berger and others (2000), the contagion effects associated with such problems can be transferred across different financial systems through failures to settle in payments systems, panic runs that follow the revelation of institutional problems, or falling prices, liquidity problems, or markets failing to clear when large volumes are traded under crisis conditions. In addition to creating problems for the implementation of monetary policy, such contagion will also impose the costs arising from the bankruptcy and financial distress of institutions affected by the contagion.

Systemic risk can conceptually either decrease or increase as a result of a growing foreign presence in the banking system. Consolidation may help reduce systemic risks if it creates a smaller set of larger institutions that are more efficient, better diversified, and that can be monitored more readily by prudential supervisors and market participants. On the other hand, systemic risks could rise because the failure of larger institutions can be more severe. In addition, a weakened parent bank could quickly drain funds from a local bank to support its own position.

Cross-border banking activities can affect the cost of maintaining an official safety net under the financial system in a number of ways. If governments are more likely to protect large banks because they are regarded as "too big to fail," then the mergers stimulated by foreign bank entry could increase the implicit costs associated with maintaining the official safety net. To contain these costs, there will be a need to strengthen prudential supervision of such institutions or eventually to limit mergers that sharply increase systemic risks. Moreover, the entry of foreign banks and associated local mergers could bring into the official safety net institutions that normally receive only limited access to the safety net.

In many emerging markets, banks are not stand-alone institutions but are rather a part of holding company groups. Even when banks are of a relatively modest size, the existence of these groups raises issues about what level of consolidation should occur when evaluating bank capital adequacy. The key issues are that the holding company can potentially transfer capital and asset and liability positions among its various entities if they are not treated on a consolidated basis, and that there will not be arms-length transactions between the various members of the group. As the banks owned by the groups become too large to fail, there is the concern that support provided to the bank during a crisis period will either directly or indirectly assist the rest of the group. In many respects, these potential problems can only be minimised by consolidation at the group level.

NOTES

1 In contrast, the share of financial sector FDI in Asia stood at 1.8 per cent of total FDI, while the average for developing countries was 4.2 per cent (see UNCTAD, *World Investment Report 2001).*

2 The data are from Fitch IBCA's Bank Scope database. There are three major advantages of using this database. First, coverage is comprehensive, with banks included accounting for about 90 per cent of the assets of banks in each country; second, the agency makes an effort to adjust individual bank accounts for differences in reporting and accounting standards, and puts the accounts into a standardised global format (see Claessens, Demirgüc-Kunt, and Huizinga, 1999); and, third, it allows for the use of individual bank data (usually unavailable from official sources) to analyse several definitions of ownership and performance ratios for domestic and foreign banks. The main drawback is that the activities of some foreign branches are not captured, which leads to an underestimation of the level of foreign participation, especially in countries where entry through branches is the main modality – such as the Asian countries. Whenever such underestimation is important, this is indicated in the text.

3 See García Cantera (1999).

4 The measures of foreign participation and foreign control would be identical if all banks were fully (i.e., 100 per cent) owned by either domestic or foreign investors. In some instances, our measures of foreign control can exceed the measure of foreign participation. This can occur because all the assets of a "controlled" bank are regarded as foreign-owned, whereas our participation measure counts only the product of banks' assets and the proportion of equity held by foreigners as foreign-owned assets.

5 This figure refers to commercial banks only; the figures in Table 1 are lower because they include finance companies and merchant banks that are majority-owned by Malaysian interests.

6 The increase in foreign participation since the beginning of the financial crisis has been around 9 per cent of total assets in both Korea and Thailand (including the recent sale of Bangkok Metropolitan Bank).

7 Foreign banks have been allowed to open branches in Korea since 1967. There were 52 foreign bank branches in September 1997, and their market share was just 2 per cent of total financial system assets (see Baliño and Ubide, 1999).

8 The BIBF scheme was established in 1993 to develop Bangkok as a regional financial centre. In addition to offshore lending, the BIBF also allowed to lend locally in foreign currencies, and the rapid growth of this lending in 1994–97 contributed to the financial crisis (see IMF, 1998a). Despite the fact that this type of lending has been substantially curtailed since 1998, the numbers in Table 1 appear to underestimate foreign bank participation in Thailand.

9 See G-10 (2001) for a thorough description and analysis of the process of consolidation in the mature markets and IMF (2001) for a similar process in emerging markets.

10 A couple of Singaporean banks also have regional ambitions, especially Development Bank of Singapore, which has made acquisitions in Thailand, Hong Kong SAR, and the Philippines.

11 The countries are Argentina, Brazil, Chile, Colombia, the Czech Republic, Hungary, Korea, Malaysia, Mexico, Peru, the Philippines, Poland, Thailand, Turkey, and Venezuela.

12 See Garber and Weisbrod (1994).

13 Studies of the experiences of Argentina (Clarke and others, 1999), Colombia (Barajas, Steiner, and Salazar, 1999), Turkey (Denizer, 1999), and eight Asian economies (Claessens and Glaessner, 1999), also report results that support these conclusions.

14 Cross-border claims are those booked outside the foreign counterparty's home country, usually at the lender's head office. Local claims on the foreign counterparty are those booked in the local office of the reporting bank, that is, offices located in the country of the counterparty.

15 See IMF (2000).

16 See IMF (1999).

17 See Fitch IBCA (1999b).

18 See Domac and Ferri (1999).

19 See Baliño (1991).

20 See IMF (1995).

21 See OECD (1999).

22 Peregrine had grown to become Asia's largest investment bank outside Japan before its collapse in January 1998. It was not registered or regulated as an investment bank, but was in fact structured as a group with some 200 subsidiaries, many of which were special purpose vehicles registered offshore (see IMF, 1998a).

23 See IMF 2001 for a discussion of issues related to the growth of e-finance.

24 See Meyer (1999).

25 See Mathieson and Roldos (2001).

26 See IMF (1998b), p. 51.

27 It is evident from recent episodes of "ring-fencing" of the obligations of the local branches of some major international banks in Asia that there are clear limits on the extent of parental support for these local operations (see IMF 2000).

28 The merger of Banco Santander with Banco Central Hispano resulted in the merger of their respective subsidiaries, Banco Santander Chile and Banco Santiago, the two largest banks in the country with a combined market share of about 28 per cent of total deposits (see IMF 2001).

29 For example, Levine (2000) found no statistical relationship between banking system concentration and any negative outcomes for financial sector development, banking system fragility, or growth. In contrast, Cetorelli and Gambera (1999) found that, while banking system concentration helps those industries heavily dependent on external financing, the overall effect on output was negative.

30 See IMF (2000 and 2001).

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Institutions, Integration and the Location of Foreign Direct Investment,

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Introduction

One of the most striking features of the trend toward globalisation in recent times has been the increased importance of foreign direct investment around the world. Over the last couple of decades, these flows have increased by a factor of almost 10. To put this evolution into perspective, trade flows around the world, by comparison, only doubled during a similar period. This substantial increase in FDI flows has not been gradual over this timespan. FDI flows have been characterised by periods of stagnation (such as the first half of the 1980s and 90s), followed by periods of explosive growth. During the second half of the 80s and 90s, the annual rate of growth of FDI was close to 25 per cent!

The evolution of FDI flows to Latin America has followed a similar trend. However, Latin America did not take advantage of the first FDI boom of the late 80s. Inflows of FDI into the region remained fairly stable from 1980 through 1993, increasing at an annual rate of less than 2 per cent. The boom of FDI into Latin America began in 1993, and since that year, flows into the region have been growing at almost 30 per cent per year. As a result of the latest boom, Latin America has regained the share in FDI flows it had lost during the late 1980s, and is currently receiving around 10 per cent of all flows of FDI.

Furthermore, while FDI flows to the developing world have increased so spectacularly, other forms of capital flows have remained fairly stagnant. In fact, FDI represents by far the most important source of private external finance to Latin America in recent years. When it comes to private external financing for Latin American countries, FDI has virtually become the "only game in town".

In this context in which FDI is increasing rapidly but other alternative forms of external financing are declining, two questions become very relevant. First, does FDI have a positive effect on host countries? And if so, what can countries do to make themselves more attractive to foreign investors?

The question of whether FDI generates positive welfare effects for the host countries has been the subject of heated debate in recent years. In principle, there are several mechanisms through which FDI could generate positive spillovers for the rest of the economy.[1] If the foreign firm is technologically more advanced than most domestic companies, it is possible that the interaction of its technicians and engineers with domestic firms may result in positive knowledge spillovers. Positive spillovers may also arise if the foreign firm trains the labour force, which then may be hired by other domestic firms. A related source of positive spillovers, studied by Rodriguez-Clare (1996) is the potential for the development of new inputs, or the increase in the quality of existing ones, which may be possible due to the demand created by the foreign investment, but may become available for domestic firms as well.

Yet another source of externality identified by Aitken, Hanson and Harrison (1997) is that multinationals that export their goods to foreign markets may induce domestic firms to follow suit, thus acting as "catalysts" for domestic exporters. Borensztein, De Gregorio and Lee (1998) find

[1] The authors gratefully acknowledge helpful comments and suggestions made by Eduardo Lora, Alejandro Micco and Shang-Jin Wei. The views and interpretations in this document are those of the authors, and should not be attributed to the Inter-American Development Bank.

evidence that FDI has a positive effect on growth, provided the level of human capital in the host country is sufficiently high. Thus, in order to benefit from the advanced technology introduced by foreign firms, the host country has to have the capacity to absorb it. However, FDI may also lead to negative spillovers, as domestic firms may be displaced by the foreign firm, or find that the cost of factors of production increases as a result of the foreign direct investment.[2]

The answer to the question of the benefits of FDI for the host countries may depend on the manner in which FDI is attracted to a country. In a context in which countries compete aggressively by offering subsidies to potential investors, it is possible that any potential net benefits generated by FDI projects will be competed away, and will accrue to the foreign investors. Competing by offering subsidies, however, is not the only way for countries to court potential investors. Oman (2000b) discusses other forms of competition, both benign and potentially harmful. Countries could compete by improving their institutions, the quality of their labour force, or the quality of their infrastructure. This competition, which Oman refers to as a "beauty contest" would obviously have positive externalities. On the other hand, countries could compete by relaxing labour or environmental standards, which could have obvious adverse effects on the welfare of the population. The important issue of the effects on host countries of competition with subsidies has recently been addressed by Fernández-Arias, Hausmann and Stein (2000).[3] The focus of this paper, however, is on Oman's "beauty contest". While the effects of a wide variety of variables on FDI location are examined, special emphasis is placed on the role played by the quality of host country institutions as a determinant of the location of FDI.

The role of institutions in FDI location has received some attention in recent years. Wheeler and Mody (1992) find that a composite measure of risk factors, which includes institutional variables such as the extent of bureaucratic red-tape, political instability, corruption, and the quality of the legal system, does not affect location of U.S. foreign affiliates.[4] However, in their index these variables are lumped together with others such as attitudes toward the private sector, living environment, inequality, risk of terrorism, etc., making it impossible to assess the role of individual variables. Using data on bilateral FDI stocks from OECD countries, Wei (1997, 2000) finds that corruption, as well as uncertainty regarding corruption, has important negative effects on FDI location.

This result is robust to the use of different measures of corruption. Hausmann and Fernandez Arias (2000) study the effects of institutional variables on the composition of capital inflows, using six different institutional variables compiled by Kaufmann *et al* (1999), as well as indices of creditor and shareholder rights from La Porta *et al* (1997, 1998a, 1998b).[5] They find that better institutions lead to a *reduction* of the share of inflows represented by FDI. They conclude that, in comparison to FDI, other forms of capital are more sensitive to the quality of institutions. When they look at the effects of their institutional variables on FDI as a share of GDP, only a small subset of the institutional variables – regulatory burden, government effectiveness and shareholder rights – remain significant after including some controls. Their summary measure of institutions, the first principal component of Kaufmann's six institutional variables, does not have significant effects on FDI.

The role of institutions in attracting FDI is also studied. As in Wei (1997, 2000), use is made of bilateral data on FDI from the OECD *International Direct Investment Statistics Yearbook*, but a much wider set of institutional variables is taken into account. Unlike Hausmann and Fernandez-Arias (2000), the focus here is on FDI *per se*, rather than as a share of capital inflows. In addition, the use of bilateral data allows the use of a much richer set of control variables than the one used by these authors.

A second important feature of globalisation has been the increase in the number of trading blocs that have been formed during the last decade, or are currently under consideration. Examples of trading blocs implemented or strengthened in the Latin American region during the last decade include NAFTA, MERCOSUR, the Andean Community, the Central American Common Market, and the G-3,

among others. Perhaps more importantly, negotiations are under way for the creation of the Free Trade Area of the Americas, an initiative which would create a hemispheric free trade area by the year 2005, and which would no doubt have a tremendous impact on the economies of the region. The deepening of regional integration leads to the following questions: do source countries tend to locate FDI in host countries to which they are linked through free trade agreements? Beyond the size of the country itself, does the size of the market to which a country's goods have free access affect the location of FDI?

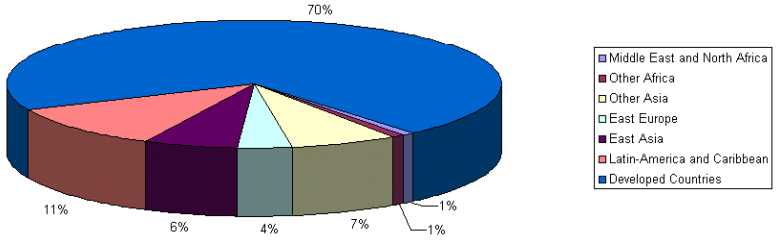
The rest of the paper is organised as follows: Section 2 looks briefly at the location of FDI flows in Latin America. In Section 3 institutional variables are introduced, as well as some simple exercises to take a first look at the association between these variables and location of FDI. In Section 4, the rest of the data is presented, with a discussion of the empirical strategy based on the gravity model. Section 5 presents the main results on the determinants of the location of FDI. Section 6 presents some sensitivity analysis, and conclusions are drawn in Section 7.

Foreign direct investment in Latin America

The introduction presented the general trends of foreign direct investment around the world, as well as the evolution of these flows for Latin America as a whole. In this section, a closer look is taken at FDI flows into Latin America. It should be pointed out that a very detailed analysis of these flows is beyond the scope of the present paper. Instead, focus is put on three questions: First, how does Latin America compare with other regions in terms of its success in attracting FDI? Second, which countries have been more successful in this regard? Third, where do FDI flows to Latin American countries originate? In other words, which source countries are responsible for most of the flows to the region?[6]

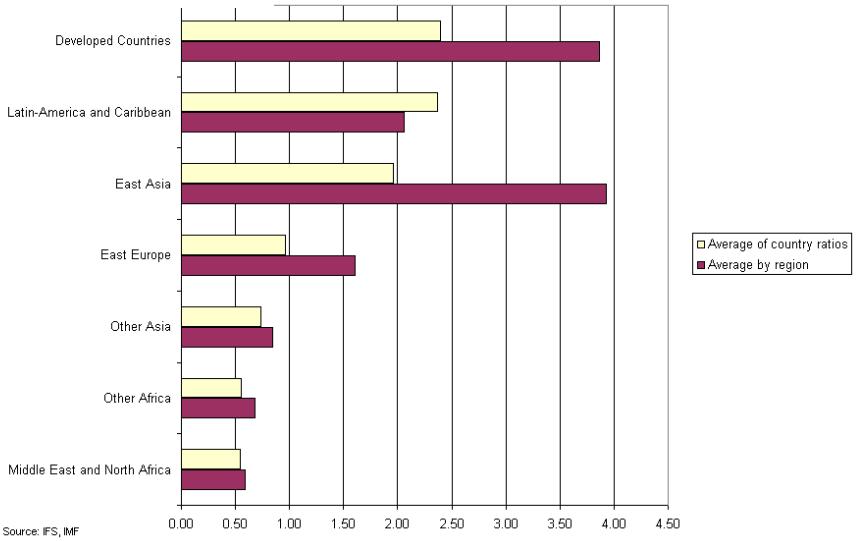
To answer the first two questions, we have used data on FDI flows from IFS, averaged for the period 1997-1999. A first look at the distribution of FDI flows around the world is presented in Figure 1, which shows the share of total FDI that goes to each of the regions. Developed countries received 70 per cent of FDI flows in this period. Latin America comes second among these regions, with 11 per cent of the total, quite a bit more than countries in East Asia, for example, which received 6 per cent of total FDI flows.

Figure 1 : Distribution of FDI Inflow 1997-99



Source: IFS, IFM.

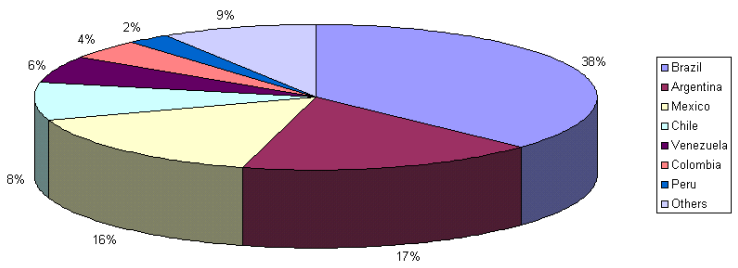
Figure 2 **Total Inflows as percentage of GDP by Region**



A more interesting comparison, however, comes from looking at FDI inflows normalised by GDP. This is presented in Figure 2. The dark bars represent yearly inflows over GDP for each of the regions, averaged over the period 1997-99. Once normalised in this way, East Asia appears to be the region that receives the most inflows, nearly 4 per cent of GDP, closely followed by the developed countries. The corresponding value for Latin America is just above 2 per cent. The light bars represent the simple average of the ratios of FDI flows over GDP across the countries in each region, in contrast to the darker bars, where all countries in the region are given the same weight. According to this measure, Latin America comes a close second to the developed countries, with annual flows of 2.4 per cent of GDP. The fact that the light bar is longer in Latin America is a reflection of the fact that smaller countries in the region tend to have larger shares of FDI flows over GDP, while the contrary is true in the developed countries, as well as in East Asia.

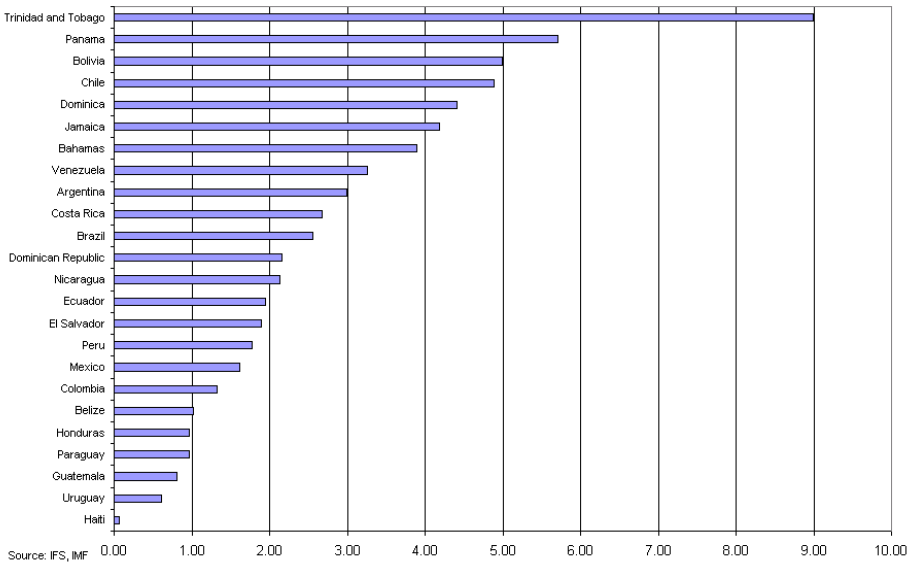
Figure 3 provides a first, rather crude, answer to the second question. The countries that have received the largest flows are Brazil, with 38 per cent of the total, followed by Argentina, Mexico and Chile.

Figure 3 : **Distribution of FDI inflows in Latin-America and Caribbean countries**



Source; IFS, IMF

Figure 4 : Inflows as percentage of GDP

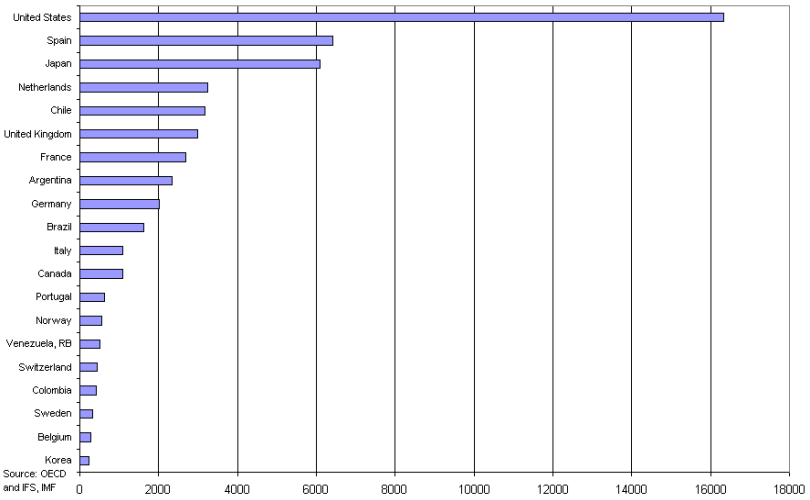


These four countries received nearly 80 per cent of total inflows. Figure 4 provides a more meaningful answer, normalising FDI flows by GDP. Trinidad and Tobago, which received FDI inflows averaging 9 per cent of GDP in the period 1997-99, is by far the country with the most inflows, followed by Panama, Bolivia, and Chile. In Trinidad and Tobago, foreign direct investment has been mainly associated to large energy projects (in particular, related to natural gas, following the deregulation of the sector). In Panama, privatisation of services and investment in pension funds administration have played a major role. In Bolivia, the energy sector has been at the centre of the country's efforts to attract FDI.[7] Countries such as Chile and Argentina have increased their ranking thanks to huge individual acquisitions by two Spanish companies, Endesa in the case of Chile, and Repsol in the case of Argentina.[8] In contrast, countries like Brazil, Costa Rica and Mexico, which according to popular perception receive a disproportionate amount of FDI flows, are, in fact, only slightly above the regional average in the case of the first two countries, and below the regional average in the case of Mexico.

Latin American countries participate in FDI flows mostly as recipients. However, some of the countries in the region have recently become more active as sources of FDI. In particular, Chile, Argentina and Brazil, Colombia and Venezuela have been increasing their share as sources of FDI. The case of Chile is the most notable. For the period 1997-99, its FDI outflows represented 38 per cent of total outflows from the region, and almost 2.5 per cent of GDP. Argentina is second as a source country. In this case, outflows represent 28 per cent of the regional total, but this only corresponds to 0.5 per cent of GDP.[9]

Where do FDI flows to Latin American economies originate? In order to answer this question, it is not enough to have data on aggregate inflows of foreign direct investment to individual countries. It is necessary to use data on bilateral flows of FDI, that is, data that identifies the source country for each flow, as well as the host country. For this purpose, we used bilateral data for 1997 on FDI flows from the OECD *International Direct Investment Statistics Yearbook* (2000).[10] The ranking of countries, according to their importance as a source of FDI to Latin America, is presented in Figure 5.[11] Not surprisingly, the United States is the most important source of FDI for the region. More remarkable is the fact that Spain is already in second place. As we will see later in the paper, common language and past colonial links may be playing an important role here. Chile and Argentina, and to a lesser extent Brazil, have also become major players as a source of FDI for Latin America.[12]

Figure 5 : Inflows towards Latin-American and Caribbean countries 1997



Institutional variables and FDI flows – a preliminary exploration

In order to explore the role of institutional variables as determinants of the location of FDI, a large number of institutional variables have been drawn from several different sources. The first set of institutional variables is the governance indicators developed by Kaufmann *et al* (1999a, b). These indicators are constructed on the basis of information gathered through a wide variety of cross-country surveys as well as polls of experts. These authors use a model of unobserved components, based primarily on data for 1997 and 1998, which enables them to achieve levels of coverage, for each of their indicators, of approximately 160 countries. They construct six different indicators, each representing a different dimension of governance: voice and accountability, political instability, government effectiveness, regulatory burden, rule of law, and graft. This clustering of institutional indicators into different dimensions allows us to study whether some dimensions of governance matter for FDI location, while others do not. Kaufmann *et al* standardised their indicators so that they all have mean zero and a standard deviation of one, and in all cases larger values indicate better institutions.[13]

Voice and accountability, as well as political instability and violence, aggregate those aspects related to the way authorities are selected and replaced. The first variable focuses on different indicators related to the political process, civil rights, and institutions that facilitate citizen control of government actions, such as media independence, for example. The second variable combines indicators that measure the risk of destabilisation or removal from power of the government in a violent or unconstitutional way.

The indicators clustered in Government Effectiveness and in Regulatory Burden are related to the ability of the government to formulate and implement policies. The first variable aggregates indicators on the quality of bureaucracy, the competence of civil servants, the quality of public service provision and the credibility of the government's commitment to its policies. The second brings together indicators related to the content of the policies, such as the existence of market-unfriendly regulations such as price controls and other forms of excessive regulation.

The last two variables, Rule of Law and Graft, consider aspects related to the respect, on the part of both citizens and the government, for the institutions that resolve their conflicts and govern their interactions. The first of these includes variables that measure the perceptions on the effectiveness and

predictability of the judiciary, as well as enforceability of contracts, while the second aggregates different indicators of corruption.

While in general it can be expected that improvements in the governance indicators will make countries more attractive to foreign investors, not all of these dimensions are expected to have similar effects. A foreign investor may be more worried about excessive regulation, corruption, or disregard for the rule of law, and less worried about the independence of the media, or the ability of citizens to hold their leaders accountable.

A second source for institutional variables is the International Country Risk Guide (ICRG) compiled by the PRS Group. Unlike those of Kaufmann *et al*, these indicators rely exclusively on polls of experts. The variables considered are a subset of those available from the ICRG database – specifically, the Risk of Repudiation of Contracts by the Government, Risk of Expropriation, Corruption in Government, Rule of Law and Bureaucratic Quality.[14] While the first two variables are coded on a 0 to 10 scale, the last three are coded between 0 and 6. In all cases, higher rankings imply better institutions.

A third source for institutional variables is La Porta *et al* (1998). In particular, we use an index of shareholder rights developed by these authors. In contrast to the previous two sets of indicators, this variable is based on objective data: the analysis of the laws and commercial codes in each country. The index varies between 0 and 5, with higher values indicating stronger protection of shareholders.

Our last source for institutional data is the World Business Environment Survey (WBES), a joint initiative of the World Bank and the IDB that surveys about 100 enterprises in 100 countries. While the survey is very extensive, here the focus is on a specific question in the survey, in which respondents are asked to assess whether a number of factors constitute major obstacles for the operation and growth of their business in the country. These factors are taxes and regulations, policy instability, functioning of the judiciary, corruption, street crime, organised crime, and anti-competitive practices by government or private enterprises.[15] Due to the way these variables are constructed, as the percentage of affirmative responses per factor for each country, in this case lower values indicate better institutions.

It is important to emphasise that we are using three different types of institutional indicators: some based on experts opinions (which may suffer from problems of subjectivity), others based on cross-country survey data (which may suffer from problems of comparability), and others based on the objective analysis of laws and legal codes. Yet another set of institutional variables combines the different types into governance indicators. The use of these different types of variables to study the effects of institutional variables on the location of FDI should provide a good sense of the robustness of the results.

A first look at the evidence

In this section, the focus is on the evidence on institutions and the location of FDI. Unlike the main exercise in the paper, where the focus is on bilateral FDI stocks, here we use FDI inflows from IFS, which are available for a wider range of countries. In addition, in this first look at the data, only the institutional variables from Kaufmann *et al* (1999) are used. In the six scatter plots presented in Panel 1, we plot each of the six governance indicators against the average (for 1997-99) FDI inflows normalised by the GDP of 1998. Although the relationship between institutions and the FDI/GDP ratio does not seem to be linear, all show a positive and highly significant correlation.[16] So, it would seem that better institutions are associated with more FDI inflows. However, there may be some problems with this conclusion.

All the correlations between the six institutional variables are high, ranging from 0.62 to 0.94 (the average is 0.76). In addition, all these variables are highly correlated to GDP per capita (correlations

range between 0.65 and 0.8). This raises the concern of whether these six variables are in fact capturing essentially the level of development of the economy, or other omitted factors such as the quality of the infrastructure or the education of the labour force. In order to address this problem, we look instead at the partial correlation between FDI/GDP and the institutional variables, holding constant for GDP per capita.[17] The partial correlation is obtained using the following steps: 1) obtaining the residuals from a regression of FDI/GDP on a constant and GDP per capita. 2) obtaining the residuals from a regression of an institutional variable on a constant and GDP per capita. 3) The partial correlation is the simple correlation between these two residuals. Intuitively, we correlate the component of FDI ratios left unexplained by GDP per capita, against the component of institutions left unexplained by GDP per capita. In Panel 2, we plot these correlations for each one of Kaufmann's institutional variables.

As expected, all the correlations on Panel 2 are lower than the corresponding ones from Panel 1, in which GDP per capita is not kept constant. However, they all remain significant, with the exception of voice and accountability. The correlation is strongest in the cases of regulatory burden, government effectiveness and graft, which provides a first indication of the relative importance of the institutional variables as determinants of the location of FDI. While these partial correlations provide a preliminary idea of the findings, a more complete analysis of the determinants of FDI location is necessary to determine in a more precise way the role played by institutions in this regard. This is done in the rest of the paper, using data on bilateral stocks of FDI, in the context of a gravity model.

The determinants of the location of FDI: Data and empirical strategy

The scatter diagrams presented at the end of this paper are obviously a very rough indication of the effect of the institutional variables on the location of FDI. In particular, there are a number of variables that may affect location which need to be taken into account. In this section, the question of the determinants of FDI is studied more carefully, and more generally, estimations are made for a gravity model of bilateral FDI.

Four different groups of explanatory variables are studied. The first group consists of the variables that are typically used in gravity models of trade, such as GDP, per capita GDP, distance between the source and the host countries, as well as dummies reflecting whether the countries share a common border, a common language and common colonial links. The second group consists of variables, other than the institutional ones that can affect the attractiveness of a country as a location for FDI, such as the level of taxes on foreign direct investment activities, human capital, infrastructure quality, etc. The last two groups of variables are the focus of the paper: the institutional variables described in the previous section, and variables associated with trade integration, such as common membership in a free trade area, or the size of a host country's "extended market".

FDI data

Bilateral outward FDI stock for 1996 from the OECD *International Direct Investment Statistics Yearbook* (2000) database is used as the main dependent variable. This information is available with a breakdown of 63 host countries from 28 OECD source countries, but as several source countries do not report any information, or do not have significant outward FDI, the sample size is reduced to 1,025 observations.[18] Data limitations in some of the control variables will further reduce the sample used in most of the regressions to 846. Using *outward* stocks ensures that differences across countries in the definition and measurement of FDI do not alter the relative allocation of FDI for each of the source countries.

The reason for using stocks rather than flows as the main dependent variable is that the characteristics of host countries should have an effect on the total amount of exposure that a firm in a source country

may want to have in them. Firms can and do adjust this exposure, upwards or downwards, according to their business strategies, and to changes in the relative attractiveness of different locations.[19] Thus, flows of FDI may partly reflect not just the relative "beauty" of different locations, but also changes in this relative beauty.[20] In spite of this argument, in a number of regressions the gross bilateral flows of FDI have been used to check the robustness of the results. In these cases, outward flows for the period 1995-97 have been averaged, in order to deal with the lumpiness of investment.

The gravity model

Our empirical strategy is based on the gravity model, that is, a standard specification in the empirical literature on the determinants of bilateral trade that has also been used recently in the analysis of FDI location.[21] In its simplest formulation, it states that bilateral trade flows (in this case bilateral FDI stocks) depend on the product of the GDPs of both economies and the distance between them, in analogy to Newton's gravitational attraction between two bodies. The gravity model has been very successful in predicting bilateral trade flows, and has good theoretical foundations.[22] Typical variables added to the simplest gravity specification in the trade literature include GNP per capita or population, as well as dummies indicating whether the two countries share a common border, a common language, past colonial links, etc. These variables can also be relevant for FDI. For example, the fact that two countries share the same language may encourage FDI flows between them, since it reduces transaction costs (foreign executives learning the language of the host country, need to hire bilingual workers, translation of contracts, etc).

Our basic regression specification is:

$$log(FDI_{ij} + 0.1) = \alpha d_i + \beta x_{ij} + \gamma z_j + \delta inst_j + \varepsilon_{ij}, \qquad (1)$$

where FDI_{ij} is the stock of outward FDI of source country i in host country j in 1996, d_i is a vector of source country dummies, x_{ij} is a vector of bilateral control variables (such as log distance between source and host country, and dummies for adjacency, common language and past colonial links), z_j is a vector of host country characteristics (including traditional gravity variables such as log GDP and log GDP per capita, as well as other characteristics which may affect the attractiveness of the host for FDI, such as tax rates on foreign corporations, quality of infrastructure, etc), $inst_j$ represents the institutional variable considered in the regression, and $\bullet_{ij}$ is the error term.[23] Given the high degree of correlation between the institutional variables, we include them in the regressions one at a time, in order to avoid problems of multicollinearity.

The double-log specification has been chosen because it has typically shown the best adjustment to the data in the empirical trade literature using the gravity model. In our sample, most source countries show some zero values for the bilateral FDI stock. These observations, which would be dropped by taking logs, provide very relevant information for the location of FDI, so their omission would lead to an important bias in the estimation of the coefficients of interest. For this reason, the log (FDI_{ij} +0.1) is used as our dependent variable in order to keep these zero observations.[24] The standard gravity model usually includes the source country's size (GDP) and also its population or GDP per capita. In our specification source country dummies are included instead, to capture all the relevant characteristics of the countries. As Wei (2000a) points out, this specification is preferred because it also solves the problem posed by possible differences in the definition and measurement of FDI across source countries.

Gravity variables

The bilateral distance is the "great circle distance" used in Frankel, Stein and Wei (1995). The information on adjacency, official language and colonial links, taken from Rose (2000), is available on his website, and was complemented with information from the 1999 *World Factbook* available on the CIA's website.[25] GDP and GDP per capita are adjusted for purchasing power parity, and were taken from the World Bank's WDI (2000).

Attractiveness variables

Beyond our institutional variables, there are many other factors that can affect the attractiveness of a host country as a location for FDI. Here we consider tax rates on foreign corporations, restrictions on FDI activities, different measures of the education of the labour force, average wages, the quality of the infrastructure, the rate of homicides, and the rate of inflation, to control for macroeconomic instability.

The tax rate data consists of withholding tax rates of foreign corporations on dividends, as reported by Price Waterhouse (1997). In cases where tax treaties exist between the host country and some source countries, tax rates on foreign corporations will differ according to the nationality of the foreign owners. In order to account for these differences, we use bilateral data on tax rates, taking into account the content of the tax treaties in existence. Tax rates may also differ, within a host country, according to the sector of activity, or the structure of ownership of the firm (i.e., on the share of the firm that is foreign-owned). In these cases, since we do not have information on the structure of foreign ownership, or the sectors of activity, the simple average of the different rates reported has been used. We expect a negative impact of tax rates on FDI.[26]

Consideration is also given to the existence of restrictions on FDI activities, which are reported in the IMF *Exchange Arrangements and Exchange Restrictions* (1997). This publication reports on two types of capital controls that should affect FDI: The first of these is the existence of restrictions on the purchase of assets that qualify as FDI, such as foreigners not being able to invest in certain sectors, or acquire more than a given share of a domestic company. Unfortunately, the data does not distinguish between controls on inflows or outflows, which means that the controls could refer to restrictions on nationals investing abroad. The second type of control involves restrictions on liquidation of direct investment, including repatriation of proceeds from the sale of investments, repatriation of profits, etc. A problem with both variables is that they reflect the existence of a restriction, but not the severity of the restriction. Countries that ban FDI outright are lumped together with countries that have mild restrictions on very few strategic sectors.[27]

In order to measure human capital, updated data for 1995 from Barro and Lee (2000) has been used. While the Barro-Lee database contains several indicators of the stock of human capital, we prefer the percentage of the population older than 25 years that has at least attended any post-secondary educational institution. This choice is justified by the assumption that foreign firms may base their location decisions on the availability of skilled workers. One problem with the Barro-Lee data is that it is greatly affected by the educational achievement of individuals who are no longer part of the labour force. This is particularly problematic in countries in which access to education has increased substantially over the years. As an alternative, on the basis of Barro and Lee's data as well as data on age composition of the population from the United Nations, we constructed a variable that approximates the average years of education of the population between the age of 25 and 45.[28] As a proxy for labour costs, we use the ratio of wages and salaries paid in manufacturing (in current dollars) to the total number of employees in the sector, from the UNIDO database. A problem with the data on wages is that it is only available for half of the countries in our sample.

Another variable considered is the quality of infrastructure in the host country. The location decision in many industries may critically depend on the quality of communication and transportation facilities, the reliability of the provision of electricity, etc. It could be assumed that countries with a higher quality of infrastructure should be able to attract more FDI. From the results of a survey of experts from the Global Competitiveness Report of the World Economic Forum, 1999, the measure used is the average host-country score on the survey, in response the following question: Is the infrastructure of the country among the best of the world? Responses ranged from 1 ("strongly disagree") to 7 ("agree totally").[29]

Social instability, violence and crime may affect the economic outcomes, and in particular, the location decision of FDI. While these aspects could be captured in the Kaufmann variable of Political Instability and Violence, or in the crime variables from the World Business Environment Survey, it is interesting to test this hypothesis with more objective data. Here, the average homicide rates in 1991-95, are taken from the World Health Organisation (WHO).[30]

FDI location decisions may be affected by risk considerations about the host country. While several risk dimensions are considered in the institutional variables, it is possible that macroeconomic instability is an additional relevant factor. In order to control for macroeconomic volatility we incorporate average inflation rates over the period 1991-95.[31]

Trade integration variables

Two of the variables used are associated with trading blocs. The first one is a dummy variable that takes a value of 1 if the source and host countries belong to the same free trade area (or customs union). This variable is used to explore whether firms in source countries favour their FTA partners when deciding about investment location. We construct it using information about the status of several FTAs from the appendix in Frankel *et al* (1997).[32]

Another interesting question is whether the size of the market to which a host country has free access is a relevant factor in attracting FDI. In order to analyse this, a market size variable, defined as the log of the joint GDP of all the countries that are FTA partners of the host country has been constructed. The GDP of the host country has been excluded from this measure of market access, since we are already controlling for domestic market size. As with the previous variable, here again we use the information on the status of FTAs from Frankel *et al* (1997).

The next section presents the results of our estimations. The descriptive statistics of most of the variables used in the regressions are presented in Table 1.[33]

Empirical results

Table 2 presents the results of the estimation including gravity and attractiveness variables only. Column (1) includes only the variables corresponding to the extended gravity model. All the coefficients have the expected sign, and most and are statistically significant, the exceptions being the colonial links dummy, which is in fact significant in all the remaining regressions, and adjacency. The size of the host economy – i.e. GDP – shows an elasticity that is slightly greater than one when holding constant the GDP per capita. This would mean that, all other things being equal, an increase in the host countries' GDP leads to a more than proportional increase of FDI. However, in all regressions except for Column (1) the hypothesis of a unitary elasticity cannot be rejected. GDP per capita, common language, and adjacency have a positive impact on FDI, while distance has a negative impact. The coefficient for distance suggests that a 1 per cent increase in this variable results in a

0.75 per cent reduction in the stock of FDI. Even more so than in the case of trade, we can think of this variable not just as transportation costs, but as a proxy for transaction and informational costs, which tend to increase with distance. The effect of the dummies is also quite important economically.

In column (2) of Table 2, three additional variables are introduced: a measure of human capital, inflation, and the tax rate on dividends of foreign corporations. In the rest of the Table we add, one at a time, the quality of infrastructure, average wages, restrictions on FDI and homicides.[34] None of the variables introduced in column (2) is statistically significant The stock of human capital – using the Barro-Lee variable of percentage of the population older than 25 years that has attended at least some post-secondary institution – shows the expected sign in all regressions. A higher stock of human capital seems to attract more FDI, but the effects are never significant. Similar results are obtained when we replace this variable by our measure of average years of education for population between the ages of 25 and 45 (not reported in the table).[35] Macroeconomic instability, measured by the average inflation rate, appears to have a negative impact on FDI, but in most regressions the impact is not significant. Neither is the tax rate, although the coefficients do show the expected negative sign in all regressions.

In column (3) we introduce an additional explanatory variable – the quality of the infrastructure in the host country. The variable is significant and shows that better infrastructure attracts FDI. It also renders the effect of GDP per capita insignificant, suggesting that this variable is in part capturing differences in infrastructure development between rich and poor countries. In column (4) we add average wages. It is a common hypothesis that low wages are an important factor in attracting FDI. Our results, however, are not consistent with this hypothesis. On the contrary, wages appear to have a significant and positive effect on FDI, a result that is even stronger if GDP per capita is excluded from the regression.[36] In column (5) we test the influence of restrictions on FDI activities of the host country. Even though the point estimate shows the expected negative sign, the coefficient is not significant. This result can be attributed to the problems identified above in the definition of this variable. A more detailed analysis that addresses the severity of FDI might produce more conclusive results.[37] Finally, in column (6) we include the homicide rate as an explanatory variable. The coefficient is negative and significant at a level of 10 per cent. As expected, a higher environment of crime and violence tends to reduce the attractiveness of the country to foreign investors.

The impact of institutional variables

In Table 3 we report the results of the estimates adding to the specification of the second column of Table 2 our first set of institutional variables: the governance indicators of Kaufmann *et al* (1999). The first six columns consider each of these indicators separately, while the last column includes the average of the six.[38] All these variables, with exception of voice and accountability, are highly significant and show the correct sign. More importantly, their impact is economically significant.

The variable with the largest impact is regulatory burden, which captures the quality and market friendliness of government policy. A one standard deviation improvement in regulatory burden increases the stock of FDI by a factor of 6.5![39] Although this may seem like a surprisingly large impact, it is important to understand that a one standard deviation improvement in this variable is quite substantial. Such an improvement would, as an example, take the quality of government policies in Mexico to the level of Australia.

Similarly, an improvement of one standard deviation in government effectiveness, a variable that captures factors such as the quality of public services, the quality of the bureaucracy, the competence and independence of civil servants, the independence of government policies from political pressures, and the credibility of government's commitments, increases FDI by a factor of nearly 4.[40] Such an

improvement, for example, would increase the index of Russia to that of Argentina, or the index for Morocco to that of Chile. Similar improvements in one standard deviation for graft, rule of law, and political instability would increase FDI by 227 per cent, 126 per cent and 77 per cent, respectively.

The corresponding impact of an improvement in the summary variable of governance is an increase in FDI of nearly 205 per cent. Notice that GDP per capita loses significance, and becomes negative in several of the regressions, when institutional variables are considered. This suggests that richer countries may be getting more FDI not because they are rich, but because they have better institutions. All other variables appear to be quite robust to the inclusion of the institutional variables. In several regressions the tax rate now shows highly significant estimates. A one percentage point increase in the tax rate decreases the stock of FDI by about 4 to 5 per cent.

Table 4 looks at the impact of a different set of institutional variables: those reported in the International Country Risk Guide (ICRG) for 1995. Unlike those of Kaufmann *et al*, which combine indicators based on polls of experts with cross-country surveys, these rely exclusively on polls of experts. Compared to the surveys, these polls have the advantage that substantial efforts are made to ensure comparability across countries. However, they may be subject to subjectivity bias. For example, the fact that Costa Rica has landed Intel may change the perceptions of experts about this country. For this reason, in the last column of Table 4 we consider an index of shareholders rights, a more objective variable developed by La Porta *et al* (1998), based on the analysis of the relevant laws and commercial codes of each country.

Out of the five ICRG variables, four have the expected positive sign, but only two of them, representing the risk of repudiation of contracts by government, and the risk of expropriation, are statistically significant. The impact of these variables, which can be directly associated with the enforcement of property rights, is also quite large, although smaller than that of Kaufmann's governance indicators. An improvement of one standard deviation (=0.51) in the expropriation risk variable results in an increase in FDI of 74 per cent.[41] Similarly, an improvement of one standard deviation (=1.12) in the variable measuring the repudiation of contracts increases FDI by 77 per cent.[42]

Bureaucratic quality, rule of law, and corruption are not significant. It is surprising that corruption has the wrong sign, particularly given the findings in Wei (1997, 2000), who reports that corruption has a strong negative impact on the location of FDI, using this same measure of corruption, among others. These results may be partly due to multicollinearity between the institutional variables and GDP per capita, a variable that was left out in Wei's studies. In fact, corruption becomes positive, although not significant, if GDP per capita is excluded from the regression, while rule of law and quality of the bureaucracy become highly significant.

The principal component of the five variables reported in column (6) is positive and significant. Similar results apply to the shareholder's rights variable from La Porta *et al*, a variable which should have a particularly large impact on minority-owned investments. The conclusion from this table is similar to the one using the Kaufmann *et al* variables: better institutions attract FDI.

Table 5 presents the results of our last set of institutional variables, drawn from the World Business Environment Survey (WBES).[43] In contrast to the polls and the variables based on actual laws and codes, these surveys can potentially have more serious problems of comparability. Their advantage, on the other hand, is that they contain responses from a larger number of people (in this case, 100), who have a deep knowledge of the countries in which their business operates.[44] As discussed in Section 3, here we will focus on a specific aspect of this survey: that of major institutional obstacles to the operation and growth of the business in the country.

For each of the institutional dimensions reported in the table – taxes and regulations, policy instability, functioning of the judiciary, corruption, street crime, organised crime and anti-competitive practices – the variable represents the proportion of respondents who considered that dimension to be a major obstacle for the development of their business. In contrast to the institutional variables used above, we expect their coefficients to have a negative sign. As Table 5 shows, all the institutional variables have the expected sign. While the functioning of the judiciary, taxes and regulations are highly significant, organised crime, corruption and policy instability are significant at a 10 per cent level. Only anti-competitive practices and street crime are not significant.

Taken individually, the results of Tables 3 through 5 suggest that institutional development is a good way to attract FDI. Taken together, the conclusions are much stronger still: Whether they are measured through polls of experts, cross country surveys, or on the basis of laws and legal codes, institutions matter for the location of FDI, and they matter a lot! Section 6 contains some further robustness checks. In particular, a different estimation procedure is used, and a check is made on whether the results are similar when bilateral flows of FDI are used in place of the stocks. Before that, however, we will turn to a different dimension: the role of trade integration on the location of FDI.

The impact of trade integration on FDI

In this section two different aspects of trade integration, and its impact on the location of FDI are analysed. We begin by exploring whether bilateral FDI is larger among pairs of countries that belong to the same free trade area. There are several channels through which this variable could have an impact on FDI. First, countries belonging to an FTA often make efforts to further reduce transaction costs, by homogenising legal norms, setting up institutions to handle cross-border disputes, etc. Second, FDI is often established in order to take advantage of some characteristic of the host country (low wages, for example), but with the objective of re-exporting production to the source country. In these cases, the elimination of trade barriers between the host and the source countries will increase the attractiveness of the FTA partners *vis à vis* other potential hosts (or even domestic production in the source). Through these two channels, membership in the same FTA should increase bilateral foreign investment. A third argument goes in the opposite direction. If production is intended for the host-country market, the bilateral elimination of trade barriers may reduce FDI, since it becomes cheaper to serve this market through trade. The effect on FDI of common membership in an FTA, then, is an empirical question, which we explore in Table 6.

As column (1) of Table 6 shows, the dummy for common membership in an FTA is positive, and although it is not statistically significant at conventional levels, it is significant at a level of 15 per cent. Although its impact is smaller than those of common language, colonial links or common border, it is still quite important economically. A host country that is an FTA partner with a source country will receive 70 per cent more FDI than a non-partner, other things being equal.[45] However, this variable loses its significance when the second trade integration variable is introduced, to which we turn next.

Does the size of the "extended market" matter? Columns (2) and (3) present the results of the estimation when our market size variable, which captures the size of the host country FTA partners, is included. The extended market size has a positive effect on the location of FDI, but the coefficient is not significant. The point estimate suggests that doubling the size of a market to which the host country products have free access leads to a 1.5 per cent increase in location of FDI. These effects do not seem at first sight to be very important economically. However, they are important for the case of small countries that join large economic areas. It is worth mentioning that the inclusion of the trade integration variables does not affect the importance of institutions in any significant way.[46]

It seems reasonable to think that the effect of changes in the extended market size on FDI location should depend on the size of the host country in question, and perhaps on the initial size of the extended market as well. It is also possible that while countries benefit from joining a source country in an FTA, they may be hurt by the formation of other FTAs since these result in FDI stocks being diverted away from them. These are all issues that are left for future research.

Robustness

The left-hand truncated nature of our dependent variable can be a source of bias and inconsistency in the OLS estimates. In order to investigate the sensitiveness of our results to the estimation method, in this section we estimate several specifications of the gravity model using the TOBIT method instead. As our main goal is to find out the effects of institutions on FDI, we will focus our robustness analysis on these variables.[47] In Table 7 we present the TOBIT estimation of equation (1) using the different institutional variables defined earlier. With the exception of voice and accountability from the Kaufmann *et al* database, all the institutional variables are positive and highly significant. These results are perfectly consistent with those of the OLS estimation.

Previously we made the point that the key variable for multinational firms is the position of FDI they hold in the host country. In this sense, in a cross-section analysis the stock data should be the variable to study in order to understand the location decisions, rather than the FDI flows. In spite of this argument, here we will show that the qualitative results still hold if we analyse the flow data instead. In Table 8 we repeat the estimations of equation (1) including the same institutional variables, but this time using the average bilateral flows of FDI between 1995 and 1997 as the dependent variable. Here again, the main results of the previous section hold. All the institutional variables are positive and highly significant, with the only exception of voice and accountability.

Conclusions

Foreign direct investment flows around the world have increased at very fast rates in recent times. At the same time, other forms of foreign financing for emerging countries have declined. What can emerging countries do to become more attractive to foreign investors, and benefit from their activities? This paper has studied the determinants of bilateral stocks of FDI, with particular focus on the role played by institutional variables, as well as by trading blocs, on FDI location.

Results show that the quality of institutions has positive effects on FDI. The impact of institutional variables is statistically significant, and economically very important. Using our summary variable from Kaufmann et al (1999), an improvement of one standard deviation in institutional quality results in increases in FDI stocks of nearly 130 per cent. These results are robust to the use of a wide variety of institutional variables, collected from different sources, using different methodologies. Furthermore, they are also robust to different specifications, and different estimation techniques.

This strong result suggests that countries wishing to attract foreign investors will be well served by striving to improve the quality of their institutions, a strategy that, in addition, should generate other positive externalities. The paper provides a preliminary view as to which institutional dimensions may matter more than others. In particular, market-unfriendly policies, excessive regulatory burden, and lack of commitment on the part of the government seem to play a major role in deterring FDI flows. While we find that integration may have some effects on the location of FDI, these effects are much weaker, and less robust, than the effects of institutions.

NOTES

1 For a discussion of potential spillovers in the context of the case study of Intel in Costa Rica, see Larraín, López-Calva and Rodríguez-Clare (2000)

2 For a relatively recent survey of the effects of FDI on host countries, see Blomström and Kokko (1997). For a more skeptical view regarding the benefits of FDI for host countries, see Hanson (2000).

3 See also Bond and Samuelson (1986) and Black and Hoyt (1989)

4 Their risk factor variables were taken from the Country Assessment Service of Business International.

5 The institutional variables from Kaufmann *et al* (1999) are regulatory burden, voice and accountability, government effectiveness, political instability, graft and rule of law. We will describe these in more detail below, as we will use them here as well.

6 For a much more complete and detailed analysis of FDI flows into Latin America, see Cepal (2000). For a similar analysis for FDI trends around the world, see UNCTAD (2000).

7 See Cepal (2000), pp. 55-57 for a discussion of FDI flows into Panama and Trinidad and Tobago, and pp. 89-97 for a detailed account of the strategy to attract FDI in Bolivia.

8 See Cepal (2000) pp. 139-177, for a very complete account of the aggressive expansion of Spanish firms into Latin America.

9 We did not have data on FDI outflows from Mexico, which should be important as well.

10 This database also provides information on bilateral FDI stocks, which will be used later on in the paper when the determinants of the location of FDI are studied.

11 Notice that the figure includes a number of Latin American countries. The OECD dataset only includes investment flows that originate or are located in OECD countries. However, it is possible to infer the value of FDI outflows from individual Latin American countries to Latin America, by substracting from total outflows in each country (as reported in IFS) the outflows of FDI to each of the OECD countries (as reported by the OECD).

12 The way the data for Latin American countries was constructed, discussed in the previous footnote, may be overstating their relative ranking, for two different reasons. First, Latin American countries could be a source of FDI for other non-Latin-American, non-OECD countries. These flows would be counted here as flows into Latin America. Second, the bilateral data used for OECD countries does not include all Latin American host countries. Those countries which are included, however, represent more than 90 per cent of the total inflows between 1997 and 1999. Neither of these factors should be of significance.

13 In our empirical work, these variables were re-standardised to have mean zero and standard deviation of one in our own sample, in order to simplify the interpretation of the coefficients, as well as the comparison of their relative importance.

14 This is the same set of ICRG variables previously used in Knack and Keefer (1995).

15 The question actually asks about a wider set of potential obstacles. For a detailed description of the survey, see Lora, Cortes and Herrera (2001)

16 In each one of the scatter plots, we report the correlation coefficient, as well as the p-value.

17 See Greene (1997), p. 248.

18 18 source countries and 58 host countries, 18*(58-1) = 1025.

19 An example of a downward adjustment would be the closure or sale of a foreign owned manufacturing facility in a host country.

20 We thank Shang-jin Wei for this argument in favour of the use of stocks.

21 See Eaton and Tamura (1994), Wei (1997, 2000), Lipsey (1999), Portes and Rey (1999) and Blonigen and Davis (2000).

22 For a discussion of the origins and theoretical foundations of the gravity model, see Frankel *et al*, (1997).

23 Notice that we work with some variables that are bilateral in nature (the xij), while in others the observations are independent across host countries, but not within host countries. For this reason, in our empirical work we will use clustered standard errors for those variables that represent characteristics of the host countries, including our institutional variables. This recognises the fact that, in estimating these coefficients, we do not really have close to one thousand independent observations, but rather 58 of them. As a result, the standard errors are adjusted upwards, while the coefficients are unaffected by this procedure.

24 This specification to deal with the problem of the observations with a value of zero for the dependent variable has been used in gravity models of trade by Eichengreen and Irwin (1995, 1997), and more recently by Redding and Venables (2000). One million dollars is the minimum non-zero value in the sample, so that 100.000 (i.e. adding 0.1 because the stock is reported in millions) is a considerably lower value, and at the same time it seems not to assign too much importance to cases where no investment is undertaken. In section 6 we will use a TOBIT estimation that deals with the problem in a different way, in order to check the robustness of our results.

25 We would have liked to include a dummy for common currency unions, which have been found by Rose (2000) to have very important effects on trade. However, Panama and the U.S. were the only pair of countries in our sample that shared the same currency.

26 An important consideration which we left out of the analysis is the existence of tax credits in some source countries, which may reduce the effect of this variable. For evidence on the impact of tax credits on the effects of tax rates on FDI location, see Hines (1996).

27 In addition to reporting the existence of restrictions, this publication includes detailed descriptions of the nature of these restrictions. This means that it is possible to create an index of the severity of restrictions, a task that may be worthwhile, but which exceeds the scope of this paper.

28 We are grateful to Suzanne Duryea, Miguel Szekely and Andrés Montes for their input in constructing this variable.

29 Alternatively, we also used an index of infrastructure based on telephone lines per person and paved roads per square kilometer, which was provided by Alejandro Micco. Results were fairly similar, and for this reason we did not report these in the empirical section.

30 We are grateful to Daniel Lederman for sharing his data on homicides used in Fajnzylber, Lederman and Loayza (2000).

31 More precisely, our measure is log (1 + inf/100), which is the standard specification in order to reduce the importance of outliers.

32 Specifically we account the following FTAs and custom unions: NAFTA, EEA, MERCOSUR, ASEAN, Group of Three, EFTA, Australia – New Zealand, CEFTA, GCC, Andean Community, SACU, and CACM.

33 Since in most of our regressions our sample size is 846 observations, the descriptive statistics presented here correspond to these observations. In order to simplify the interpretation, all the variables which enter in logs in the regressions are described according to their levels instead.

34 With the exception of FDI restrictions, these variables are not available for all the host countries, and thus reduce the sample size significantly.

35. More generally, we found that results are very sensitive to the human capital variable utilised.

36 The effect of wages on FDI for the case of non-OECD host countries is also positive and significant, although smaller than that for OECD countries. These results are consistent with similar findings by Wei (2000).

37 Restrictions on liquidation of FDI proceeds did not yield significant results either.

38 Like Hausmann and Fernandez-Arias (2000), we have also considered the first principal component of the six governance variables. The results are similar to the case of the simple averages reported here. In fact, the correlation between the principal component and the simple averages is 0.995.

39 Remember that these variables have been standardised, so that one standard deviation is equal to 1. The impact on the stock of FDI is given by exp (1.869) – 1 = 5.482. This implies an increase in FDI stocks of 548 per cent, i.e., the stock of FDI increases by a factor of 6.48.

40 More precisely, the effect would be exp (1.354) - 1 = 2.873. This implies an increase of 287 per cent.

41 exp (1091*0.51) – 1 = 0.74

42 exp (0.512*1.12) – 1 = 0.77

43 Since the surveys cover a narrower set of countries, the number of observations in this table is reduced compared to that in Tables 3 and 4.

44 For a more thorough discussion of the advantages and disadvantages of polls and surveys, see Kaufmann *et al* (1999)

45 exp (0.552) – 1 = 0.737

46 This can be seen by comparing the coefficients from this table with those of the last column of Table (2).

47 We also carried out a robustness analysis for the other variables considered in the previous section. In general, the results are robust and are available upon request.

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Table 1: Descriptive Statistics

Variable	Obs.	Mean	Std. Dev.	Min.	Max.
FDI Stock 1996 (mill. US$)	846	2,668	9,819	0.000	134,559
Average FDI Flows 95-97 (mill. US$)	752	414	1,634	0.000	28,411
Tax Rate on dividends	846	0.099	0.084	0.000	0.350
Quality of Infrastructure	756	4.463	1.436	2.040	6.730
FDI Restrictions	846	0.710	0.454	0.000	1.000
Homicides (per 100,000 people)	792	5.859	13.336	0.222	85.506
Higher Education (per cent of population > 25 years)	846	15.256	9.319	2.200	48.700
Average Inflation rate 91-95	846	0.227	0.450	0.012	2.477
Average Wages 1995 (current US$)	529	16,915	13,322	1,215	42,019
Voice and Accountability (Kaufman)	846	0.000	1.000	-2.624	1.160
Political Instability (Kaufman)	846	0.000	1.000	-2.394	1.462
Government Effectiveness (Kaufman)	846	0.000	1.000	-1.814	1.657
Regulatory Burden(Kaufman)	846	0.000	1.000	-2.364	1.514
Rule of Law (Kaufman)	846	0.000	1.000	-1.938	1.532
Graft (Kaufman)	846	0.000	1.000	-1.585	1.518
Repudiation of Contract Risk (ICRG)	846	8.775	1.122	5.000	10.000
Risk of Expropriation (ICRG)	846	9.681	0.510	8.000	10.000
Corruption (ICRG)	846	4.357	1.130	2.000	6.000
Rule of Law (ICRG)	846	5.110	1.098	2.000	6.000
Bureaucratic Quality (ICRG)	846	4.478	1.340	2.000	6.000
Taxes and Regulations (WBES)	566	0.306	0.183	0.025	0.660
Policy Instability (WBES)	566	0.306	0.203	0.030	0.721
Judiciary (WBES)	530	0.123	0.074	0.015	0.328
Corruption (WBES)	566	0.205	0.155	0.012	0.589
Street Crime (WBES)	566	0.223	0.172	0.012	0.612
Organised Crime (WBES)	566	0.209	0.167	0.026	0.705
Anti-competitive policies (WBES)	530	0.199	0.130	0.038	0.712

Note: The Variables used in logs in the regression are presented in their original levels.

Table 2: Attractiveness Variables, OLS Estimation

	(1)	(2)	(3)	(4)	(5)	(6)
GDP	1.279	1.157	1.156	1.129	1.168	1.152
	[9.79]**	[9.40]**	[8.28]**	[7.63]**	[8.96]**	[9.83]**
GDP per capita	1.14	0.972	0.163	-0.492	0.9	0.876
	[4.35]**	[3.16]**	[0.40]	[0.70]	[2.70]**	[2.55]*
Distance	-0.749	-0.834	-0.958	-1.168	-0.835	-0.788
	[4.23]**	[4.51]**	[5.24]**	[6.75]**	[4.53]**	[4.03]**
Common Language	2.405	1.844	1.478	1.243	1.849	2.045
	[4.39]**	[3.62]**	[2.74]**	[2.01]	[3.60]**	[3.70]**
Coloniser	0.693	1.792	1.841	2.052	1.773	1.815
	[0.72]	[2.92]**	[2.47]*	[3.10]**	[2.83]**	[2.69]**
Adjacency	0.974	0.588	0.348	0.043	0.558	0.614
	[1.51]	[0.91]	[0.50]	[0.04]	[0.85]	[0.93]
Higher Education		0.013	0.018	0.032	0.016	0.016
		[0.62]	[0.94]	[1.32]	[0.74]	[0.69]
Inflation		0.000	0.001	0.000	0.000	0.000
		[0.11]	[2.92]**	[0.53]	[0.09]	[0.32]
Tax rate		-3.708	-2.888	-4.249	-3.817	-4.122
		[1.27]	[0.95]	[1.12]	[1.25]	[1.24]
Quality of Infrastructure			0.444			
			[1.99]#			
Average Wages				0.835		
				[1.95] #		
FDI Restrictions Dummy					-0.188	
					[0.41]	
Homicides						-0.235
						[1.73] #
Observations	989	846	756	529	846	792
R-squared	0.62	0.66	0.69	0.69	0.67	0.67

Robust t – statistic in brackets

significant at 10 per cent level ; * significant at 5 per cent level; ** significant at 1 per cent level,

Table 3: Kaufmann et al (1999a) Institutional Variables, OLS Estimation

	(1)	(2)	(3)	(4)	(5)	(6)	(7)
GDP	1.151	1.22	1.198	1.455	1.211	1.25	1.265
	[8.55]**	[10.39]**	[11.41]**	[14.41]**	[10.02]**	[10.75]**	[10.60]**
GDP per capita	1.163	0.631	-0.264	-0.015	0.268	-0.177	-0.005
	[3.06]**	[2.74]**	[0.82]	[0.06]	[0.73]	[0.46]	[0.01]
Distance	-0.827	-0.723	-0.74	-0.848	-0.735	-0.726	-0.684
	[5.34]**	[4.72]**	[6.24]**	[6.39]**	[5.08]**	[5.48]**	[4.66]**
Common Language	1.92	1.719	1.32	1.35	1.559	1.334	1.479
	[4.01]**	[3.61]**	[2.71]**	[2.96]**	[3.33]**	[2.66]*	[2.88]**
Coloniser	1.821	1.804	1.45	1.569	1.599	1.631	1.76
	[3.25]**	[3.40]**	[3.21]**	[3.44]**	[3.27]**	[3.51]**	[3.64]**
Adjacency	0.55	0.691	0.888	0.857	0.84	0.93	0.865
	[0.84]	[1.06]	[1.42]	[1.28]	[1.27]	[1.45]	[1.32]
Tax rate	-3.109	-4.31	-5.457	-4.286	-5.102	-5.351	-5.623
	[1.03]	[1.53]	[2.73]**	[1.98]	[2.04]*	[2.28]*	[2.10]*
Voice	-0.095						
	[0.25]						
Political Instability		0.571					
		[2.37]*					
Government Effectiveness			1.354				
			[5.63]**				
Regulatory Burden				1.869			
				[5.82]**			
Rule of law					0.814		
					[2.80]**		
Graft						1.184	
						[3.81]**	
Average Kaufmann variables							1.116
							[3.10]**
Observations	864	864	864	864	864	864	864
R-squared	0.67	0.67	0.7	0.69	0.68	0.69	0.68

Robust t – statistics in brackets

significant at 10 per cent level ; * significant at 5 per cent level; ** significant at 1 per cent level

Table 4: ICRG and La Porta et al (1998) Variables, OLS Estimation

	(1)	(2)	(3)	(4)	(5)	(6)	(7)
GDP	1.141	1.075	1.124	1.147	1.169	1.134	1.147
	[9.42]**	[9.31]**	[8.31]**	[8.68]**	[9.35]**	[9.11]**	[6.90]**
GDP per capita	0.668	0.798	0.808	1.235	0.884	0.592	0.817
	[2.75]**	[3.14]**	[2.26]*	[3.85]**	[3.36]**	[1.94]	[2.88]**
Distance	-0.789	-0.774	-0.793	-0.848	-0.734	-0.728	-1.188
	[5.54]**	[5.59]**	[5.21]**	[5.85]**	[4.41]**	[4.65]**	[7.39]**
Common Language	1.636	1.754	1.774	1.965	1.851	1.677	1.4
	[3.52]**	[3.81]**	[3.75]**	[4.08]**	[4.02]**	[3.54]**	[2.83]**
Coloniser	1.718	1.713	1.846	1.826	1.722	1.744	1.525
	[3.17]**	[3.29]**	[3.53]**	[3.44]**	[3.38]**	[3.40]**	[2.60]*
Adjacency	0.709	0.719	0.649	0.469	0.715	0.81	-0.185
	[1.06]	[1.09]	[1.00]	[0.73]	[1.08]	[1.21]	[0.27]
Tax rate	-4.378	-4.565	-3.413	-3.178	-3.816	-4.199	-2.983
	[1.66]	[1.82]	[1.19]	[1.17]	[1.36]	[1.46]	[1.15]
Risk of Repudiation of contract by Government	0.512						
	[3.36]**						
Risk of expropriation		1.091					
		[3.62]**					
Bureaucratic Quality			0.199				
			[0.90]				
Corruption				-0.157			
				[0.71]			
Rule of law					0.226		
					[1.07]		
First Principal Component of ICRG variables						0.284	
						[2.03]*	
Shareholder Rights							0.505
							[4.97]**
Observations	864	864	864	864	864	864	649
R-squared	0.68	0.68	0.67	0.67	0.67	0.67	0.69

Robust t – statistics in brackets

significant at 10 per cent level ; * significant at 5 per cent level; ** significant at 1 per cent level

Table 5: WBES Institutional Variables, OLS Estimation

	(1)	(2)	(3)	(4)	(5)	(6)	(7)
GDP	1.237	1.189	1.121	1.134	1.136	1.143	1.169
	[12.05]**	[9.11]**	[7.61]**	[7.42]**	[7.00]**	[7.48]**	[7.95]**
GDP per capita	1.192	1.039	0.798	0.974	1.124	0.983	0.907
	[4.33]**	[3.41]**	[3.60]**	[3.08]**	[3.66]**	[3.32]**	[2.87]**
Distance	-0.735	-0.494	-0.525	-0.501	-0.536	-0.535	-0.575
	[3.70]**	[2.44]*	[2.55]*	[2.37]*	[2.50]*	[2.55]*	[2.57]*
Common Language	1.048	1.454	1.551	1.57	1.532	1.518	1.787
	[2.54]*	[3.39]**	[3.50]**	[3.56]**	[3.26]**	[3.13]**	[3.33]**
Colonizer	2.561	2.280	2.000	2.357	2.399	2.341	2.210
	[3.17]**	[3.02]**	[2.88]**	[3.19]**	[3.00]**	[3.02]**	[3.07]**
Adjacency	0.852	0.82	0.939	0.872	0.804	0.852	0.753
	[1.37]	[1.27]	[1.50]	[1.34]	[1.23]	[1.29]	[1.12]
Tax rate	-3.243	-2.94	-4.613	-2.637	-2.359	-2.582	-3.051
	[1.15]	[0.96]	[1.34]	[0.98]	[0.78]	[0.93]	[1.02]
Taxes and Regulations	-3.856						
	[2.89]**						
Policy Instability		-2.256					
		[1.92]#					
Judiciary			-8.166				
			[4.03]**				
Corruption				-2.663			
				[1.87]#			
Street Crime					-1.285		
					[1.33]		
Organised Crime						-2.260	
						[1.69]#	
Anti-competitive practices by Government or private enterprises							-2.283
							[1.07]
Observations	566	566	530	566	566	566	530
R-squared	0.71	0.69	0.7	0.69	0.69	0.69	0.69

Robust t – statistics in brackets

significant at 10 per cent level ; * significant at 5 per cent level; ** significant at 1 per cent level

Table 6: Trade Integration Variables, OLS Estimation

	(1)	(2)	(3)
GDP	1.253	1.257	1.248
	[10.51]**	[10.61]**	[10.50]**
GDP per capita	-0.009	-0.009	-0.011
	[0.02]	[0.02]	[0.03]
Distance	-0.584	-0.695	-0.616
	[4.20]**	[4.74]**	[4.33]**
Common Language	1.53	1.517	1.553
	[3.03]**	[2.91]**	[3.01]**
Coloniser	1.768	1.768	1.773
	[3.71]**	[3.70]**	[3.73]**
Adjacency	0.841	0.782	0.773
	[1.28]	[1.18]	[1.16]
Tax rate	-5.501	-4.95	-4.937
	[2.06]*	[1.87]	[1.87]
Average Kaufmann variables	1.05	0.99	0.954
	[2.95]**	[2.77]**	[2.68]**
Same FTA	0.552		0.429
	[1.47]		[1.20]
Market size		0.018	0.015
		[1.21]	[1.08]
Observations	864	864	864
R-squared	0.68	0.68	0.68

Robust t – statistics in brackets
significant at 10 per cent level ; * significant at 5 per cent level; ** significant at 1 per cent level

Table 7: Institutional Variables, TOBIT Estimation.

	(1)	(2)	(3)	(4)	(5)	(6)	(7)	(8)	(9)
GDP	1.574	1.656	1.641	1.896	1.668	1.717	1.701	1.569	1.4
	[8.71]**	[9.86]**	[11.75]**	[11.14]**	[10.52]**	[11.62]**	[10.17]**	[9.25]**	[6.49]**
GDP per capita	1.759	0.872	-0.383	0.119	0.295	-0.267	0.119	0.686	1.003
	[3.47]**	[2.80]**	[0.91]	[0.33]	[0.62]	[0.53]	[0.22]	[1.85]	[2.79]**
Distance	-1.277	-1.095	-1.075	-1.209	-1.096	-1.071	-1.036	-1.081	-1.569
	[6.02]**	[5.13]**	[6.07]**	[6.32]**	[5.46]**	[5.57]**	[4.75]**	[5.17]**	[7.70]**
Common Language	2.544	2.243	1.693	1.818	1.988	1.691	1.961	2.115	1.712
	[4.11]**	[3.57]**	[2.62]**	[3.00]**	[3.18]**	[2.54]*	[2.89]**	[3.37]**	[2.72]**
Coloniser	2.33	2.344	1.833	2.025	2.061	2.102	2.274	2.264	2
	[2.80]**	[3.00]**	[2.68]**	[2.92]**	[2.79]**	[3.05]**	[3.19]**	[3.04]**	[2.57]*
Adjacency	-0.216	0.048	0.371	0.304	0.275	0.405	0.278	0.25	-0.93
	[0.25]	[0.06]	[0.43]	[0.34]	[0.31]	[0.47]	[0.31]	[0.28]	[1.17]
Tax rate	-3.454	-5.568	-7.033	-5.336	-6.814	-6.992	-7.055	-5.698	-3.484
	[0.80]	[1.33]	[2.34]*	[1.62]	[1.82]	[2.01]*	[1.78]	[1.32]	[0.99]
Voice	-0.384								
	[0.73]								
Political Instability		0.694							
		[2.02]*							
Government Effectiveness			1.809						
			[5.63]**						
Regulatory Burden				2.173					
				[4.53]**					
Rule of law					1.127				
					[2.95]**				
Graft						1.593			
						[4.02]**			
Average Kaufmann variables							1.33		
							[2.70]**		
First Principal Component of ICRG variables								0.434	
								[2.70]**	
Shareholder Rights									0.619
									[4.44]**
Observations	864	864	864	864	864	864	864	864	649

Robust z – statistics in brackets

significant at 10 per cent level ; * significant at 5 per cent level; ** significant at 1 per cent level

Table 8: Institutional Variables, OLS Estimation, Dependent Variable FDI Average Flows 1995-1997

	(1)	(2)	(3)	(4)	(5)	(6)	(7)	(8)	(9)
GDP	0.857	0.913	0.896	1.083	0.905	0.925	0.934	0.856	0.788
	[9.20]**	[10.50]**	[11.61]**	[14.71]**	[10.45]**	[11.22]**	[10.61]**	[9.81]**	[7.42]**
GDP per capita	0.816	0.344	-0.189	-0.143	0.129	-0.095	0.009	0.304	0.365
	[3.20]**	[2.13]*	[0.73]	[0.80]	[0.48]	[0.34]	[0.03]	[1.44]	[1.69]
Distance	-0.659	-0.572	-0.588	-0.656	-0.581	-0.581	-0.558	-0.571	-0.813
	[6.29]**	[5.36]**	[6.80]**	[6.82]**	[5.65]**	[6.00]**	[5.31]**	[5.57]**	[7.00]**
Common Language	1.612	1.448	1.207	1.171	1.351	1.236	1.325	1.415	1.228
	[4.59]**	[3.96]**	[3.28]**	[3.53]**	[3.77]**	[3.25]**	[3.42]**	[3.90]**	[3.52]**
Coloniser	1.012	1.034	0.821	0.868	0.907	0.937	1.011	0.989	0.7
	[2.08]*	[2.17]*	[1.88]	[2.16]*	[1.95]	[2.10]*	[2.23]*	[2.19]*	[1.33]
Adjacency	0.138	0.259	0.395	0.44	0.357	0.399	0.359	0.344	0.035
	[0.37]	[0.71]	[1.09]	[1.15]	[0.95]	[1.08]	[0.96]	[0.93]	[0.08]
Tax rate	-2.502	-3.6	-4.271	-3.714	-4.101	-4.142	-4.29	-3.555	-2.969
	[1.17]	[1.77]	[2.81]**	[2.38]*	[2.21]*	[2.33]*	[2.19]*	[1.70]	[1.67]
Voice	-0.197								
	[0.78]								
Political Instability		0.38							
		[2.45]*							
Government Effectiveness			0.835						
			[4.38]**						
Regulatory Burden				1.335					
				[5.86]**					
Rule of law					0.514				
					[2.57]*				
Graft						0.693			
						[3.29]**			
Average Kaufmann variables							0.649		
							[2.73]**		
First Principal Component of ICRG variables								0.197	
								[2.66]*	
Shareholder Rights									0.417
									[5.00]**
Observations	768	768	768	768	768	768	768	768	577
R-squared	0.74	0.74	0.76	0.76	0.74	0.75	0.74	0.74	0.78

Robust t – statistics in brackets

significant at 10 per cent level ; * significant at 5 per cent level; ** significant at 1 per cent level

CHAPTER II

BENEFITS OF FDI FOR DEVELOPMENT: COUNTRY EXPERIENCES

The Importance of Foreign Direct Investment in the Economic Development of Mexico,

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Benefits of Foreign Direct Investment (FDI)

Mexico enjoys preferential access to 850 million consumers in 32 countries through the network of Free Trade Agreements (FTAs) it has in place in North America, Latin America, Europe and the Middle East[1]. Mexico has obtained market access for its exports, fostered new investment opportunities, and provided more and better paid jobs through its network of FTAs.

In addition to FTAs, Mexico has negotiated 19 bilateral investment treaties (BITs)[2]. BITs are based on National Treatment and Most Favoured Nation principles, and they contain dispute settlement mechanisms that provide legal certainty to investors.

Trade and investment liberalisation have greatly benefited Mexico. Exports are the driving force behind economic growth and job creation. Foreign sales more than doubled their share in Mexico's GDP from 15 per cent in 1993 to 31 per cent in 2000. Mexico's dynamic export performance has contributed almost half of the growth in the GDP, and currently Mexico has become the 8th largest exporter in the world.

Mexico has also become the third largest recipient of FDI among developing countries. The network of free trade agreements and economic reform policies has made Mexico an attractive place for national and foreign investment. Since 1994[3], Mexico has received around 107 billion dollars in investment in plant and equipment. This capital inflow averages 12 billion dollars a year, three times the annual amount received in the five years prior to NAFTA.

Investments are not only bigger, but also better. They translate into jobs, technology transfer, export opportunities, and training for workers and executives. Better investments contribute to increased productivity that leads to higher wages. In the past few years, the rate of employment in firms with FDI has grown twice as fast as the national average. Firms with FDI have created one out of every four new jobs since 1994, and currently retain about 20 per cent of formal employment. Firms with FDI also pay better than other companies. On average, firms with FDI pay salaries that are 50 per cent higher than the national average wage.

Exports and FDI have contributed to the creation of a more integrated and competitive market. Joint ventures have stimulated a regional boom in sectors such as automotive, electronics, and textiles. In fact, nearly 87 per cent of total FDI is currently located in two of the most active sectors of the economy: financial services and manufacturing.

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[1] Mexico has signed 11 FTAs with: Chile; Canada and the United States (NAFTA); Colombia and Venezuela (TLC G3); Bolivia; Costa Rica; the fifteen members of the European Community; Iceland, Liechtenstein, Norway and Switzerland; Guatemala, Honduras and El Salvador; Nicaragua; Israel; Uruguay.

[2] Mexico has signed BITs with: Germany; Argentina; Austria; South Korea; Spain; Cuba; Denmark; Finland; France; Greece; the Netherlands; Italy; Iceland; Portugal; the Czech Republic; Sweden; Switzerland; Uruguay; Belgian-Luxembourg Union.

[3] Cumulative FDI from January 1994 to September 2001.

Challenges for the future

Mexico has achieved important relative preferences with respect to its competitors in foreign markets. Thanks to the NAFTA, Mexico is now fully integrated in the North American market, along with the United States and Canada. Today, Mexico is the second largest export market for U.S. goods, and has displaced Japan as the U.S.'s second largest trading partner. Mexican exports to the U.S. have grown twice as fast as those from the rest of the world. As a result, Mexico has increased its share in total U.S. imports from 6.8 per cent in 1993 to 11.4 per cent in September 2001.

Almost 94 per cent of Mexico's exports will have duty access by 2003. However, there are decreasing returns of market access, and each percentage point increase in participation is harder to reach.

Tariff advantages are temporary, and Mexico needs to implement new programmes and strategies in order to stay a step ahead of its main competitors in the global markets.

Mexico faces international competition both to sell its products abroad and to attract FDI. In the domestic market of goods it competes with imported commodities; it also competes in the markets of its main trading partners, the European Union and the U.S., with products that originate in these regions as well as with the suppliers from other countries. Mexico's main competitors in the goods market are Asian economies: South Korea and Chinese Taipei due to their high technological level, and China and India due to their low labour costs.

Asian economies are also among Mexico's main competitors for foreign direct investment. The two largest recipient countries are China and Brazil, which received 278 and 131 billion dollars respectively in the period from 1994 to 2000. Mexico ranks third among developing countries (86 billion dollars), closely followed by Argentina and Singapore.

In order to face the competition, Mexico has to exploit its most fundamental comparative advantages:

Its young, increasingly skilled and abundant population. Mexico needs to invest in human capital: education, health and worker training. This is the highest yielding form of investment that the government can engage in, since it provides the population with the lifetime tools to succeed.

Its privileged geography. Mexico needs to exploit its location as a natural hub for trade and investment. It shares a 2,000 mile border with the largest market in the world, the U.S.. Mexico is also a gateway to the rest of Latin America and Asia. In order to take advantage of its geography, Mexico needs to invest in the creation of a world class infrastructure. This involves building roads, investing in ports and their surrounding infrastructure, as well as developing first-rate airports and industrial parks.

Its network of free trade agreements. Mexico has guaranteed market access for most of its products. Nevertheless, more than 80 per cent of Mexico's trade continues to be with the United States. While the relationship with Mexico's northern neighbour will continue to be of supreme importance for the future of the country, Mexico must work hard to diversify trade and take advantage of this complex web of trade agreements that is already in place.

The decision to invest in any given country is ultimately based on the combination of risk and return that the country has to offer. That is, investment flows will travel to those countries that offer an attractive combination of risk and return. An attractive risk-return combination can be reached either by increasing returns and/or by lowering risks to investment. In the case of Mexico there are several elements that contribute to the increase of the returns to investment, such as the preferential access to 32 countries, access to competitively priced and international quality inputs, Mexico's fundamental comparative advantages, among others. On the other hand, risks to investment can be diminished

through guaranteeing market access, providing certainty and clear rules of operation, and by offering macroeconomic and political stability.

Attractiveness to investment is a dynamic concept. Mexico needs to constantly improve its combination of risk and return so that the country can continue to be an attractive place for foreign and national investment.

Removing Administrative Barriers to FDI: Particular Case of Turkey,

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With the recent trends of globalisation, liberalisation in foreign currency, and trade regimes, the volume of FDI has increased throughout the world. Since the early 1980s, world Foreign Direct Investment flows have grown rapidly - faster than both world trade and world output. According to UNCTAD figures, foreign direct investment inflows, which amounted to $160 billion in 1991, reached $1,271 billion at the end of 2000, experiencing an eight-fold increase. In particular, cross-border mergers and acquisitions among developed countries have shaped FDI figures over the past few years.

When Turkey is compared to neighbouring countries, Central Europe can be seen as an emerging location for FDI. As a recipient country, Turkey has been lagging behind compared to its potential. Despite its strong potential, Turkey has not benefited very much from increased FDI flows brought on by globalisation. From 1995 to 2000, FDI inflows to Turkey averaged about US$750 million net per year equivalent to about 0.4 per cent of GDP. This percentage places Turkey 81st out of 91 developing and transition countries, where on average the annual inward FDI ratio to GDP is about 2 per cent. Turkey's annual net FDI flows have stagnated at the levels of the late 1980s, while worldwide FDI increased by a factor of 12 during the 1990s, thanks in large part to globalisation.

A recent UNCTAD study, "Inward FDI Index", captures the ability of countries to attract FDI after taking their size and competitiveness into account. The index is the ratio of three ratios, showing each country's share in world FDI relative to its shares in GDP, employment, and exports. According to this index, Turkey receives less FDI than countries of comparative economic size and "under-performs" in terms of attracting FDI.

A number of studies were carried out on foreign investors in Turkey to find out why Turkey under-performs in terms of attracting FDI, and the major causes were identified as administrative barriers to investments in the form of cumbersome, unclear, time-consuming procedures.

Turkey's major strengths

In its efforts to attract foreign investment, Turkey has both advantages and disadvantages. Its main strengths can be summarised as:

- Unique geographical location creating diverse market opportunities
- Population of 63 million whose consumption patterns are improving
- Qualified, efficient, young, educated and cost-competitive work force
- A dynamic and globally integrated economy with an improved business environment
- A well-developed telecommunications and transportation infrastructure
- The existence of prominent transnational companies in the world.

But the low levels of FDI in Turkey can be attributed to several disadvantages such as:

- Political and economic instability

- High inflation and real interest rates
- Delays in the privatisation programme
- Existence of an unrecorded economy
- Frequently changing legislation
- Lack of competition and efficiency in the economy.

Reforms are underway

Turkey is now adopting an ambitious economic programme for the transition to a stronger economy. The main features of this economic programme include stern measures to:

- continue fighting inflation under the floating exchange-rate system in a determined manner
- carry out the extensive restructuring of the banking sector
- launch an ambitious structural reform agenda
- strengthen the balance of public finances to prevent deterioration in the future
- implement an incomes policy based on social consensus
- introduce reforms to raise competition and effectiveness in the economy.

To strengthen the real economy, a special emphasis is given to the reforms to enhance competition and effectiveness, including several structural reform laws for the better functioning of markets such as:

- sugar law
- tobacco law
- natural gas law
- civil aviation law
- electricity market law
- privatisation of Turk Telecom.

Removing Administrative Barriers to FDI

An “Administrative Barriers to Investment” project also aims at general improvement in the investment climate of Turkey. This project is only the first, but an important step in creating a better "investment climate" in Turkey. Making improvements in the business environment is not a matter of pleasing foreign investors; it is a matter of raising the level of competitiveness in Turkey and raising the incomes of Turkish workers over the long term. Attracting FDI is only a means to an end. Turkey as a whole suffers from these barriers and disincentives to invest, which hurts the competitiveness of Turkish producers. In order to raise incomes in Turkey, the economy will have to operate in an increasingly competitive world economy.

It is known that the old order of economic protection in which countries could get away with bad administrative environments no longer exists. We also realise that, if certain changes are not made,

both Turkish and foreign-owned companies will have trouble producing even for the domestic market - through increased competition from imports - and will not be able to compete in export markets.

The ultimate goal of this project was, therefore, to increase the competitiveness of the Turkish investment environment for all private businesses, thus creating a better "investment climate". The Administrative Barriers project was carried out last year with a strong political will from the Government, as well as support from public institutions and the private sector. Administrative Barriers are areas where investors come into contact with public sector authorities to enter the country, work in the country, establish businesses, operate businesses, and they can counteract general liberalisation reforms, delay or prevent new investments, impede re-investments by existing investors, scare off new investors who tend to rely on information obtained from already existing investors. Turkey has been criticised for its difficult investment climate by international investors and institutions:

- Global Competitiveness Report (World Economic Forum) ranked bureaucratic 'red tape' as a leading competitive disadvantage for Turkey.
- Price Waterhouse Coopers (PWC) estimated the effect of Turkey's opaque business climate to be equivalent to a 36 per cent increase in the corporate tax.
- PWC also estimated that the cost of lost, or foregone, FDI in Turkey per year due to opacity is over US$1.8 billion.
- The FDI Diagnostic Report conducted by FIAS in 2000 also pointed to Administrative Barriers as an impediment to new investments.

The Government of Turkey requested FIAS to jointly realise this project. It is an important step in the programme to strengthen the real economy. The aim is to improve the investment climate of the country, to the benefit of both foreign and local investors. The project has a strong political will from the Government, as well as support from public institutions and the private sector. The project is also expected to have positive results in the struggle with the unrecorded economy, and in redefining the role of the state to its core functions.

The project has evolved as follows:

- Preparation of the report for Administrative Barriers study
- Conference to share the results of the report and other various findings
- Workshops and establishment of study groups such as:
  - Company Registration
  - Employment
  - Sectoral Licensing
  - Land Access and Site Development
  - Taxation and Incentives
  - Customs and Technical Standards
  - Intellectual Property Rights
  - Investment legislation
  - Investment promotion.
- An action plan has been prepared, based on the results of the workshop and transformed into a Decree.
- The study groups are designated as technical committees to carry on the studies, and report regularly.
- Some immediate measures have already been scheduled by the Decree.

In the decree, the framework for problems and possible actions to be taken have been identified for each of these nine areas, and technical committees will continue their studies on these issues. The committees will be supervised by an “Investment Climate Improvement Co-ordination Council”, which will report quarterly to Council of Ministers and to the private sector at large. The Decree also includes a “short-term scheduled actions list” for immediate measures to be taken within the first three months.

The streamlining of various administrative procedures is not a cure-all to stimulate investment. It can, however, send valuable signals to foreign and domestic investors that the government is serious about reform and promoting investment. The actions needed to remove administrative barriers are often not costly in financial terms, but involve the much harder task of overturning embedded thinking amongst government officials, as in some cases, problems are due to an absence of dialogue between government departments and with the investor community. The "action plan" to be applied will do just this, and open discussions within the government and the private sector.

Having the political will, and showing this will through a decree, participants will be forced to find a mutual solution to the problem.

NGOs, the private sector, and academicians are also members of the study, and leading private-sector NGOs will take part in the high council where decisions will be taken.

Next Steps

This project is the first step in creating a better investment climate in Turkey. As complementary efforts over the next months, it is planned to:

- Set up a well-funded Investment Promotion Office for which technical assistance is sought from the OECD, WB, UNCTAD and countries with success cases.
- Hold regular high-level Investor Council Meetings
- Put in place a revised database system
- Set up a backward linkage programme to ensure that smaller local enterprises also are as internationally competitive as possible, and add value to the activities of the larger companies.

These efforts form a cornerstone of the government's new private-sector development strategy to create a more transparent and stable investment climate.

The main features of the foreign investment policy of Turkey are:

- The same rights and obligations for foreign and domestic investors.
- No limitation in equity participation ratios (only 50,000 US Dollars capital share for each investor).
- Free access to specific sector markets which are also free for Turkish investors.
- Free transfer of profits, fees, royalties and the repatriation of capital.
- Only a registration procedure required for license, know-how, technical assistance and management agreements.

- No compulsory conversion of foreign currency brought by foreign investors into national currency.
- In addition to these legislative features, the following factors provide a more secure investment environment:
- Turkey is a member of multilateral organisations like the OECD, WTO, IMF/World Bank/MIGA.
- International arbitration is possible for the settlement of disputes where foreign investors are involved.
- Avoidance of Double Taxation Agreements with 46 countries have been signed and come into force.

Protection and Promotion of Investment Agreements have been signed with 65 countries and 43 of them have entered into force. Turkey is also a candidate country for membership of the European Union:

1996 - Turkey entered a customs union with the EU and is playing a pivotal role in developing economic co-operation with economies of Eastern Europe and Central Asia. These policies have helped to create an entrepreneurial and resilient private sector.

1999 - Announcement of Turkey as a EU candidate country.

2001 - "National Programme" for the adoption of the "Acquis" of the European Union has been published and the necessary legislative modifications are in progress.

However, these measures only form the first steps for attracting FDI. As an effort to keep in line with world experiences and trends in FDI, establishing a promotion agency and developing a "sectors policy" to attract FDI in its own premises is now being evaluated.

The Benefits of FDI in a Transitional Economy: The Case of China,

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China is one of the most popular investment destinations in the world. Throughout much of the 1990s, China accounted for 50 per cent of foreign direct investment (FDI) going into developing countries, and in recent years, China has been the second largest recipient of FDI in the world, after the United States. The agreements between China on the one hand and the United States and the European Union on the other, over China's accession into the World Trade Organisation (WTO) may increase China's already impressive FDI inflows significantly. According to a forecast by Goldman Sachs, within three to four years, China's WTO membership could boost FDI to 100 billion dollars a year, from the current 40.4 billion dollars.

Despite the huge FDI inflows into China every year, both the dynamics driving up FDI inflows and the economic effects of FDI are not well understood. Many of the conventional explanations, such as those that emphasise FDI as a form of capital import or as a mechanism to transfer know-how, do not fit well when applied to the case of China. This paper first presents some of the salient characteristics of FDI inflows into China, and then discusses the benefits associated with such a large volume of FDI inflows.

The main point of this paper is that the contribution of FDI inflows mainly arises from the fact that FDI inflows overcome or attenuate some of the fundamental inefficiencies in the Chinese economy. Furthermore, FDI has played a substantial efficiency-improving function in large part because the Chinese government itself is unwilling to adopt those internal reforms, such as privatisation and regulatory reforms that will tackle the sources of these inefficiencies directly. Much of this paper is based on my forthcoming book, *Selling China: Foreign Direct Investment during the Reform Era* (New York: Cambridge University Press).

Some salient characteristics of FDI inflows

Three FDI patterns stand out among many of the details that will be presented in the next few sections. First, there is a pervasive presence of foreign-invested enterprises (FIEs) in many industries and in many regions. Second, equity alliances dominate the forms of business alliances between foreign and domestic firms. China's FDI absorption is high, not necessarily because the Chinese economy is more integrated to the rest of the world compared to other economies, but because of the dominance of equity alliances over other possible business alliances between foreign and Chinese firms. Third, many of those firms investing in China are very small and are quite different from those firms making investments in other countries. Taking those three characteristics together suggests that FDI has played a more important role in the Chinese economy than one would expect from the usual economic and business factors. Furthermore, FDI, as an equity capital flow, seems to command certain advantages over other forms of business alliances between foreign and domestic firms.

External vis-à-vis *internal economic integrations*

In November 1999 the Chinese government agreed to a set of far-reaching accession terms demanded by the United States as a condition for Chinese membership in the WTO, and in November 2001 China formally became a member of the WTO. China's accession terms include a drastic reduction of

tariffs, removal of non-tariff barriers, a substantial opening of China's financial and telecommunications service sectors to foreign investments, and a substantial relaxation of many of the current ownership restrictions, etc.

By a number of conventional measures, China's economy is in fact quite open without the benefit of WTO membership. For structural reasons, it is unlikely that China would ever be as export-oriented as other East Asian economies, as Dwight Perkins pointed out in the mid-1980s (Perkins 1986). But for a large continental economy, foreign trade already accounts for a substantial portion of China's GDP. Using the official exchange-rate conversion yields a trade/GDP ratio of 40 per cent.[1] In the U.S., the foreign trade/GDP ratio was about 23 per cent in 1994, and in Japan, it was about 20 per cent in 1998. The extent of China's dependency on FDI is also high. Since the early 1990s China has been one of the largest FDI recipients in the world. In 1994, for example, China alone accounted for 49 per cent of total FDI flows to developing countries and 15 per cent of worldwide FDI flows.

Not only is the absolute size of FDI large, its relative size—measured by the FDI/capital formation ratio—surpasses that of many countries in the world (discussed below). Furthermore, foreign-invested enterprises (FIEs), i.e., joint ventures between Chinese and foreign firms or wholly owned foreign subsidiaries, have established a sizable presence in the Chinese economy. In a number of industries, they have come to command a dominant position. On the basis of these facts, one would have expected that the next major reform thrusts by the Chinese government would have focused on internal aspects of the Chinese economy, for example, a programme to privatise inefficient SOEs, to strengthen China's legal regime, to effect more regulatory and bureaucratic transparency, and to combat official corruption, etc.

The outsized roles of foreign trade and FDI in the Chinese economy are even more interesting when one compares China's external trade and FDI dependency with its patterns of internal, cross-provincial trade and investments. In a 1994 report, the World Bank notes that interprovincial trade normalised by provincial GDP was smaller than intra-European trade (World Bank 1994). Transportation costs may explain some of this, but during the reform era interprovincial trade has in fact declined, even though there have been massive investments in roads, railways, and airport facilities. Furthermore, trade economists have long noted a home bias in trade patterns, i.e., domestic residents tend to buy from one another much more than they do from foreigners. In 1988, interprovincial trade in Canada, for example, was about 20 times trade with the 30 states in the United States with which the Canadian provinces traded most intensively.[2] Here are two deeply similar countries in terms of economic, political, and linguistic dimensions that should facilitate trade, and yet internal trade still exceeds external trade by a wide margin.

Chinese provinces depend on FDI to a far greater extent than they do on one another as a source of investment funds. Take, for example, Guangdong province. In 1992, Guangdong invested about 2.5 per cent of its total investments in other provinces, while other provinces' investments in Guangdong amounted to 1.7 per cent of Guangdong total investments. In the same year, FDI accounted for 31.7 per cent of Guangdong investments, far surpassing both Guangdong export of capital to other regions and its import of capital from other regions.[3] In RMB terms, the 1.7 per cent of investments in Guangdong from other provinces amounted to 260 million dollars. To put this number in perspective, in 1992, firms based in tiny Macao, known more for its casinos than its computers, and more for its gangs than for its garment making, invested 202 million dollars in China and 169.6 million dollars in Guangdong. This is a startling fact: Macao's investments in Guangdong amounted to 84 per cent of what the rest of China invested in Guangdong.[4]

This outsized investment position held by foreign firms is by no means limited to Guangdong, a province that has wooed foreign investments particularly aggressively. Sichuan, an interior province traditionally isolated from the outside world, also depended more heavily on FDI than on investments

from other provinces. In 1993, investments from other provinces represented 0.22 per cent of Sichuan's total investments; foreign investments, however, represented 5.4 per cent. The data compiled by the World Bank show that between 1985 and 1993, on average six provinces out of four relied more heavily on FDI than on investments from other provinces.

Some researchers bemoan the fact that FDI is highly concentrated in the coastal provinces and that China's hinterland provinces have not attracted much FDI. In a paper on this topic, Francois Gipouloux shows that eastern China accounted for 84.5 per cent of the cumulative FDI between 1985 and 1991 and 87.3 per cent between 1992 and 1998. "FDI distribution," Gipouloux proclaims, "has been extremely uneven" (Gipouloux 2000). This is a common view among economic officials in China and, as a result, in recent years, the Chinese government has made FDI promotion a component of its development strategy for the central and western provinces of China.

In many ways, this view of FDI is quite misleading. The true puzzle is not why the poor, land-locked provinces do not get much FDI; the puzzle is why they get any at all. The view that FDI distribution is uneven relies on statistics on the percentage shares of FDI distributed among Chinese provinces. Remember, though, that China during this period attracted an enormous amount of FDI and thus a small portion of FDI is still a large number. According to statistics provided in Gipouloux's study, the interior regions of China accounted for about 13 per cent of cumulative FDI inflows between 1992 and 1998. During this period cumulative FDI flows into China as a whole amounted to 242.26 billion dollars. This means that the interior regions of China received 31.49 billion dollars in FDI. To put this number in perspective, India's entire FDI inward stock, as of 1997, was only 11.21 billion dollars.[5]

Relative size of FDI

There is no question that the absolute size of FDI inflows into China has been huge. For some years in the 1990s, China accounted for about half of the total FDI going to developing countries. In 1996, FDI inflow, on a paid-in basis, amounted to 41.7 billion dollars. This compares to about 80 billion dollars that went to the United States in the same year. The third largest destination of FDI capital was the United Kingdom, which received 30 billion dollars. This type of comparison led to the claim that China was the second largest recipient of FDI capital in the world.

The absolute size of FDI, however, does not tell the whole story. Countries vary in their economic and market size and the size of FDI flows should be gauged relative to the size of the host economy. The absolute size of FDI flows to the United States in 1996 was twice as large as Chinese FDI but the U.S. economy was roughly seven times as large (on the basis of official foreign exchange conversion). In that sense, the United States is less "dependent" on FDI than China even though the absolute size of FDI flows into the United States is much greater.

A more useful measure is FDI normalised by the economic size of the FDI host. This is a measure of the relative size of FDI. One measure of the relative size of FDI is the "FDI/capital formation ratio." It is FDI divided by the total fixed asset investments made by foreign and domestic entities in a given year. The ratio tells us something about the relative importance of FDI to a country's economy. Conceptually, the FDI/capital formation ratio is driven by the willingness on the part of foreign investors to invest in a country relative to the willingness on the part of domestic investors to do the same.[6] In 1990, China's FDI/capital formation ratio was 3.7 per cent and it rose to 17 per cent in 1994. If the FDI/capital formation ratio rises rapidly within a short period of time (as it did in China in the 1990s), an interesting research question emerges: Why do foreign and domestic investors view the same market growth opportunities differently?

Table 1 presents data on FDI/capital formation ratios in China and a number of other countries to provide a comparative perspective. Between 1993 and 1997, on average, FDI flows into China accounted for about 15 per cent of total capital formation. This ratio is one of the highest among the countries in the table, even compared with countries that are considered as traditionally very dependent on FDI, such as some Southeast Asian countries. As pointed out before, even though the United States attracted a greater amount of FDI, the relative importance of FDI in the case of the United States is far smaller than it is in the case of China. FDI only accounts for some 6 per cent of total investments; China's FDI dependency is almost three times as large. Compared to other Asian economies, China was less dependent on FDI in the 1980s, but in the 1990s its FDI dependency was among the highest in the region. Its FDI/capital formation ratio during the 1993-1997 period was lower than Singapore, about the same as Malaysia, and much higher than Indonesia, Thailand, and the Philippines. The standard wisdom in the commentary on FDI in Asia is that China is a lot more similar to Southeast Asian countries than to Korea, Taiwan, and Japan in terms of their FDI dependency. This standard wisdom is right, to a fault. In fact, in the 1990s, China was among the most highly FDI-dependent economies in Asia, more than some of the Southeast Asian economies

The FDI/capital formation ratio is also influenced by the size of domestic investments as well as the size of FDI. To control for differences in domestic investments, we can use the FDI/GDP ratio as a measure of the relative size of FDI. By this measure, China also stands out among Asian countries in terms of its high reliance on FDI. In a recent paper, Urata presents FDI inflow/GDP ratios for nine Asian economies (China, Hong Kong, Korea, Taiwan, Indonesia, Malaysia, Philippines, Singapore, and Thailand) between 1986 and 1997.[7] Between 1986 and 1991, China was ranked between number four or number seven among these nine economies. Between 1992 and 1997, China was ranked consistently either as number two or number three as most dependent on FDI, behind Singapore, and sometimes behind Malaysia as well. Take the year 1995 as an example. In that year, China's FDI/GDP ratio was 5.1 per cent, compared to 2.2 per cent for Indonesia and 1.2 per cent for Thailand. (It was 4.8 per cent for Malaysia and 8.5 per cent for Singapore.)[8] The claim that China is highly dependent on FDI does not at all depend on comparing China with traditionally low FDI-dependent economies, such as Japan and Korea.

Conventional explanations of what are usually thought to be important drivers of FDI do not quite work either. Economists often invoke the so-called "savings-investment" gap theory to explain FDI flows.[9] The reasoning is straightforward. An internal imbalance in a developing economy—a resource gap between its savings and its investment requirements—leads to an external imbalance on the country's balance of payments: shortage of foreign exchange. This shortage must be financed by a combination of drawing down the foreign exchange reserves and an inflow of foreign exchange in a variety of forms. FDI is one such inflow.

A "saving-investment" gap, however, is incongruous with China's large FDI absorption. In the 1990s, China had one of the highest savings rate in the world, at 41.76 per cent between 1994 and 1997. The puzzle is that China's reliance on FDI deepened at the very time when the capital shortage was apparently being alleviated. By all indications, China should have been awash in capital. China's savings rate rose from an initially high level throughout the reform era. Between 1986 and 1992 the savings rate hovered around 36 per cent, and between 1994 and 1997 it rose to 42 per cent, second only to Singapore (51 per cent).[10] The acceleration of the savings rate coincided closely with an explosive growth of FDI. Between 1979 and 1997 the gross cumulative FDI flows were US$220 billion on a paid-in basis. Much of this FDI was invested after 1992. Between 1992 and 1997 the total FDI inflow was US$196.8 billion.

Table 1. Relative FDI Size, Macroeconomic Developments, and FDI Controls 1993-1997

Countries	FDI flows/gross fixed capital formation (per cent)		Gross domestic savings rate, 1994-1997 (per cent)	Current account balance/ GDP, 1994-1997 (per cent)	Business environment for foreign investors		
	1987-1992	1993-1997			Ease of foreign acquisitions on 1-10 scale (country ranks out of 46 countries), 1996	Business environment ranks, 1996-2000 (out of 60 countries)	Corruption perception rank, 1997 (out of 52 countries)
China	4.0	14.6	41.76	2.74	5.69 (41)	44	41
Philippines	6.0	8.6	15.5	-8.5	5.89 (40)	35	40
Indonesia	2.7	6.14	33.5	0.0	6.29 (37)	46	46
Thailand	5.6	3.76	37.97	-6.28	5.05 (42)	30	39
Malaysia	18.8	14.1	39.98	-0.75	4.73 (43)	24	32
Taiwan	3.3	2.78	25.6*	-2.7*	5.94 (39)	21	31
Korea	1.1	1.06	35.71	-1.78	3.64 (46)	29	34
Singapore	32.2	27.0	50.92	16.4	7.69 (30)	6	9
Hong Kong	9.9	10.2	31.92	-1.35	8.80 (12)	3	18
Brazil	1.8	5.32	20.13	-0.765	7.71 (29)	38	36
Mexico	9.4	15.3	21.35	0.53	7.76 (28)	34	47
India	N/A	2.40	21.15	-2.64	6.61 (35)	45	45
United States	6.0	6.38	15.57	-1.61	8.56 (19)	1	16
Canada	5.3	8.28	20.37	1.71	7.44 (32)	5	5
United Kingdom	13.5	12.4	14.71	-0.943	8.84 (10)	4	14

Note: *: 1994 only.

Source: FDI data are from (United Nations Centre on Transnational Corporations 1999), Annex Table B.5. Savings and resource balance data are from the *World Development Report*, various years; for Taiwan, the source is (Asian Development Bank 1995). The ease of foreign acquisitions measure is based on a survey conducted by International Institute for Management Development in Switzerland. Respondents are asked in the survey to rate countries according to a 10-point scale. The perfect score, 10, is given to countries that do not impose any restrictions on foreign acquisitions and zero is for those countries in which foreigners may not acquire control. The data are reported in (International Institute for Management Development 1996). Business environment rank is a broader measure and it is devised by the Economist Intelligence Unit. The country ranks for the 1996-2000 period are reported in (Business Environment Scores and Ranks 2001). The corruption perception rank is devised by Transparency International and the 1997 data are reported on http://www.gwdg.de/~uwvw/ accessed on October 23, 2001.

Thus China imported more capital when it saved more and imported less capital when it saved less! China's balance-of-payment statistics bear this out. In the 1990s, China ran a current account deficit only in 1993 and the balance-of-payment accounting convention says that in the current account surplus years China was a net capital exporter, not an importer. As Table 1 shows, on average between 1994 and 1997, China exported capital to the rest of the world to the tune of almost 3 per cent of its GDP. The large FDI inflows, on top of the large current account surpluses throughout much of the 1990s, led to a huge accumulation of foreign exchange reserves. As of June 2001, China's foreign exchange reserves stood at 183.9 billion dollars, easily the largest accumulation of foreign exchange assets among the emerging markets.

China's heavy dependency on FDI is also surprising given its substantial FDI controls and its difficult business environment. As shown in Table 1, China's FDI regime was not particularly liberal in the 1990s. In terms of ease of foreign acquisitions, China was ranked fourth from the bottom among the countries included in the table. In terms of business environment rank, it was 44th among the sixty countries surveyed by the Economist Intelligent Unit during the 1996-2000 period. China was more dependent on FDI than some of the countries with more liberal FDI policies and with a better business environment.

Corruption is generally thought to deter FDI. Based on a statistical analysis of bilateral investment from fourteen source countries to forty-five countries during the 1990-1991 period, Wei reports that corruption deters inward FDI in the same way as taxes on income of MNCs, and that the corruption effect is large. Raising the corruption level from that of Singapore to that of Mexico is equivalent to the effect of a rise in the income tax rate by 20 per cent. Findings of this sort have provided powerful justifications for efforts to improve public governance. James D. Wolfensohn, the President of the World Bank, stated, "We need to deal with the cancer of corruption. … We can give advice, encouragement, and support to governments that wish to fight corruption – and it is these governments that, over time, will attract the larger volume of investment" (Wolfensohn 1996).

But corruption is rampant in China while its FDI dependency is high. Table 1 reports corruption perception index devised by Transparency International in 1997. China is ranked 41st among 52 countries covered by Transparency International. According to a survey of the Political and Economic Risk Consultancy conducted in the mid-1990s, China was rated by foreign managers as the most corrupt on a list of eleven Asian countries that included some of the most notoriously corrupt countries in the world, such as India and Indonesia. According to some estimates, between one-third to one-half of all business deals in China involved some form of corruption and bribes amounted to 1-10 per cent of sales. One business researcher quipped, "there are probably as many types of corruption as there are types of tea."[11]. China's huge inward FDI flows would seem at odds with the presumed depressive effect of corruption.

Lack of technology transfers

Technology is an intrinsically difficult concept to measure and quantify. The evidence is fairly clear that the level of hardware technology – technical sophistication embodied in machinery and equipment – associated with China's FDI flows is low. Evidence about the technological content of FDI, in the hardware sense, is available in two ways. First, an indirect measure of the hardware technology is the country origin of the FDI. A high proportion of China's FDI inflows originates from low-tech Hong Kong, but this measure is imprecise. Cross-country FDI distributions can be explained by many factors, such as cultural as well as geographic distance. That much of FDI originates from China's neighbours is not surprising in and of itself. A more pertinent issue is whether factors such as GDP size and composition of the economy under-explain China's FDI patterns. To that end, Shang-jin Wei has undertaken research that shows that China has attracted far less FDI from high-tech OECD

countries than one would have predicted on the basis of its GDP size and human capital quality. This is a more direct indication of the low technological content of China's FDI inflows.

The other measure is to contrast China's FDI patterns with the patterns of its technology imports. Technology imports refer to importation of technology licensing, patents, and turnkey projects. In contrast to FDI, technology imports transfer technology to a host country *via* arms-length market transactions rather than *via* an ownership arrangement. Research by the United Nations Centre on Transnational Corporations in 1992 shows that typically the level of technology transfer associated with FDI is of more recent vintage and is more sophisticated as compared with the kind of technology transferred *via* arms-length market transactions. China, however, exhibits precisely the opposite pattern. This is shown by the country origins of technology trade *vis-à-vis* the country origins of FDI. The majority of China's technology trade is with the OECD countries, whereas the majority of China's FDI originates from the non-OECD economies.

The second type of evidence is more direct. It comes from survey and interview research conducted by two researchers, Stephen Young and Ping Lan, who have conducted the most systematic study on this topic so far. Their data come from a postal survey of 361 FIEs in Dalian city and detailed interviews with managers of thirty-six sampled FIEs. Their findings suggest that on average the level of technology as embodied in the FDI was two years ahead of China's existing level even though the "technology gap" between the investing countries and China was commonly perceived to be twenty years. The "technology package" was in most cases incomplete, meaning that the package included only one or two of the three components of what constitutes a complete technology transfer – product, process, and organisational technology. Less than 25 per cent of the technology transfer projects incorporated all three components. One interesting finding of their research is that foreign firms apparently invested in China to source Chinese technology, as evidenced by the fact that a significant number of Chinese firms were more technologically advanced than their foreign investors (Young and Lan 1997).

But technology is not only embodied in machinery and equipment; technology is an encompassing concept that incorporates not just technical knowledge but such tacit knowledge as organisational, managerial, and marketing know-how. Arguably for China, software technology is a far more important component in any technology transfer that accompanies FDI inflows. Much of the FDI, as mentioned before, originates from low-tech economies such as Hong Kong and is heavily concentrated in labour-intensive industries. In this regard, measuring the technological content of FDI by the technical sophistication of the machinery and equipment is misleading and can potentially result in an under-estimation of FDI's contributions to the Chinese economy.

But the idea that foreign firms bring software technology to China is somewhat incongruous with the fact that many foreign firms are active investors in those product areas in which Chinese entrepreneurs should possess unrivalled operating and product know-how. Take herbal medicine for example. The Chinese have practiced herbal medicine for thousands of years; indeed herbal medicine is known as Chinese medicine in many quarters of the world. In 1995, there were some 325 FIEs in the herbal medicine business, generating sales of 3.8 billion yuan. In comparison, in the same year, there were more than twice as many TVEs and private firms (784) in this business, and together they generated sales of 4.5 billion yuan.[12] Thus in a business where one would assume native entrepreneurs to be quite competent and knowledgeable, foreign-owned firms in fact were larger in size than the non-state indigenous firms. To be sure, many of these foreign investors themselves are most likely to be overseas Chinese entrepreneurs from Hong Kong and Taiwan and they thus possess some skills in this product segment as well. However, it is implausible to argue that overseas Chinese producers are systematically and pervasively more knowledgeable about herbal medicine than the mainland Chinese producers.

Hong Kong and Taiwanese firms are efficient, entrepreneurial, and dynamic. Compared to an average firm in China, they command superior knowledge about the organisation of production, management, and overseas marketing. Not only do they possess marketing know-how through years of exporting, they also control overseas marketing channels and have earned the trust of large wholesalers and retailers in the developed economies.

It is important to note that overseas marketing control itself does not necessarily lead to dominance of production by foreign firms. In the 1960s and 1970s, giant Japanese general trading corporations, such as Mitsubishi, controlled much of the overseas marketing of footwear. Although these trading corporations often actively sponsored Taiwanese entrepreneurial start-ups in footwear production, they did not invest in them. They simply sourced from these numerous and independent facilities (Levy 1991). Similarly, firms such as Levi Strauss, with an unrivalled advantage in brand name recognition and superior marketing power, sources from independent producers on a massive scale. The widespread impression that FDI is a function of superior marketing controls and skills of the foreign firms is erroneous. No doubt this statement is true in some situations but it is not true in other situations in which foreign marketing controls and skills can be accessed and utilised by indigenous manufacturing firms through a contractual arrangement.

Some have pointed out that investors in China in labour-intensive production are not Western retailers themselves but their purchasing agents located in Hong Kong, Taiwan or Korea. This is a factually valid observation but the relevance of this statement to an FDI analysis is not clear. The example of Mitsubishi shows that there is no intrinsic reason why an agency firm—i.e., one which purchases products for Western retail outlets—has to invest to source its products. A firm like Mitsubishi played identical functions as many of the agency firms today in Hong Kong and Taiwan, and yet it sourced its products rather than directly operated production facilities. An agency function itself does not give rise to FDI; the feasibility, or lack thereof, of contract production does that. A more relevant analytical matter, thus, is to examine those conditions that affect feasibility of contract production, not who is doing the direct investments.

It is not at all clear why there is not an indigenous supply of managerial capabilities and entrepreneurship such that they have to be imported *via* FDI on a massive scale. This is an especially pertinent issue in export-oriented industries where the firm size is small; production is often unintegrated; the operation is of an overwhelmingly assembly nature; and performance often entails a dedicated and specific task (such as sewing buttons on shirts or manufacturing the uppers for shoes). Is the lack of indigenous supply of these basic skills due to low human capital on the part of Chinese entrepreneurs and workers? Or is it possible that indigenous entrepreneurship is in fact extant but the problem is that its utilisation is impeded somehow? Is the managerial know-how being transferred of such a nature that it requires an ownership arrangement such as FDI? Is it actually so bundled to the capital that other mechanisms of transfer, such as hiring and contracting foreign managers, cannot be utilised? Even more basically, has the much-touted transfer of know-how in fact taken place on a scale commensurate with the scale of China's FDI?

Preferences for ownership arrangements

As Table 2 illustrates, FIEs account for an extremely large share of Chinese exports, far more than FIEs did in Taiwan and Indonesia. FIEs also dominate export marketing channels across the board, both in labour-intensive and capital-intensive industries, unlike in Taiwan and Indonesia. The important and growing financing functions of FDI in China's export production are widely heralded by economists and government officials alike. Little noticed, however, is the fact that the history of export-oriented FDI is one of replacing market transaction mechanisms, such as export processing, with non-market transactions through the affiliates of the investing MNCs. Contractual alliances such

as export processing and compensation trade have been completely eclipsed by ownership arrangements through FDI as China has become more accessible to MNCs. In 1983, the contractual capital inflow—i.e., leasing, compensation trade, and export processing—was about 44 per cent of all FDI inflows; by 1992, the contractual capital inflow virtually disappeared (about 2.59 per cent of FDI in that year). More tellingly, not only did contractual capital inflows shrink relatively but also absolutely as FDI expanded. In 1988, the contractual capital inflow amounted to 546 million dollars; in 1994, it fell to 179 million dollars (State Statistical Bureau 2001).

Table 2. FIEs' Export Shares of Total Exports in Three Economies: China, Taiwan, and Indonesia (Per cent)

	China (1995)	Taiwan (1980)	Indonesia (1995)
Labour-intensive industries	Garment and footwear: 60.5 Leather and fur products: 73.2 Furniture: 75.1	Garment and footwear: 5.66 Leather and fur products: 9.64 Lumber and bamboo products: 2.72	Garment and footwear: 33 Leather and related products: 19.7 Furniture: 14.0
Capital or technology-intensive industries	Electronic and electrical appliances: 83.4 Paper and paper products: 53.4 Chemical materials and products: 31.6	Electronic and electrical appliances: 50.5 Pulp paper and paper products: 4.54 Chemicals: 34.9	Electric, measuring and photographic apparatus: 78.8 Computer and parts: 91.8 Machinery and vehicle parts: 86.1 Paper and paper products: 29.8 Chemical materials: 42.3
Manufacturing industries	47.1	20.57	29.0

Sources: Chinese data are from the Office of Third Industrial Census 1997, and Taiwanese data are from Ranis and Schive 1985, Table 2.12, p. 109. Indonesian data are unpublished and were provided to the author by the Indonesian government through the kind assistance of Timothy S. Buehrer and Lou Wells. Professor Lou Wells generously provided the English translation of the Indonesian text.

This prevalence of ownership arrangements, in lieu of contractual alternatives, is in fact profoundly puzzling. To explicate this puzzle requires a word or two about the main similarities and differences between an equity and a contractual arrangement. Exporting through an affiliate of a foreign firm means that the goods move from a Chinese production facility to a foreign location but *within the same corporation*. (The foreign firm may use the goods as inputs in the next stage of production or may sell them to other independent buyers.) An alternative arrangement might be as follows: the same Chinese production facility, but owned by a Chinese entrepreneur, ships the goods to the same foreign company and receives a payment. He, the Chinese entrepreneur, can receive payment that covers the full costs of production plus a profit mark-up, or he can receive payment only for the service of combining together the inputs supplied by the foreigner to create an output. The foreign company, upon receipt of this product, disposes of it in whatever fashion that suits its purposes.

Export market access is not a sufficient explanation as both equity and contract arrangements provide such an access. Two other benefits are often mentioned in the literature. One is that an equity arrangement facilitates know-how transfer and the other is that an equity arrangement enables foreign managers to impose quality controls more effectively. While both are plausible explanations, they fail

to account for the full scale of China's export-oriented FDI. Evidence about know-how transfer within export-oriented MNC production networks is surprisingly thin. As for quality controls, it is a common business practice that foreign vendors often monitor quality at fabrication sites under contract production. Contract production in garment making for export is widely adopted in India and Turkey and indeed was adopted in Hong Kong, Taiwan, and Korea in the 1970s. Unless one is prepared to argue that Chinese quality control capabilities are vastly inferior to those of Indians, Turks, and other East Asians, quality control alone cannot account for the large scale of export-oriented FDI. Furthermore, quality control motivation is at odds with the prevalence of equity arrangements in the production of ivory and jade sculptures where Chinese managers and workers should be quite skilled. As pointed out before, in this industry, foreign ownership of FIEs averaged 88 per cent in 1995.

Some economists have argued that FDI, as an equity arrangement, provides a safeguard against contractual hazards—i.e., those hazards that arise when a foreign firm is subject to unexpected adverse changes operating in a host nation. For example, a local contractual partner can renegotiate the terms of the contract after the fact, or inappropriately capture the profits of past research and development undertaken by the foreign firm. This type of problem is likely to be more prevalent in countries that offer poor property rights protection and that are underdeveloped in rule of law (such as China). Foreign firms thus favour equity arrangements and majority controls because they give foreign firms more operating controls.[13]

While this is a plausible explanation for the prevalence of ownership arrangements in capital- and technologically-intensive industries, it is less plausible when it comes to labour-intensive industries. It is important to note that FDI is a contract too, just as a production contract between a foreign and domestic firm. If anything, a foreign firm may prefer a production contract because a production contract is a short-term contract while FDI is a long-term contract. Under a bad legal regime, economic agents may operate under a short-term horizon and may not be confident to commit themselves to a long-term arrangement. Contractual sanctity is most important in situations in which switching costs are very high but in a perfectly competitive industry, by definition, switching costs are low and it is less necessary to rely on an ownership arrangement to safeguard against a contractual breach. FDI is a safeguard against a specific form of contractual hazards, mainly those that arise when substantial intangible assets are involved in production. For example, a local firm may free ride on the brand name, reputation and R&D of the foreign firm in situations in which the foreign firm maintains an arms-length relationship with a local firm. This is the reason why FDI, instead of technological licensing, is found to prevail in countries that have a poor intellectual property rights regime (Oxley 1997). FDI is not a safeguard against all the contractual hazards that result from a general underdevelopment of rule of law. Bad laws and ineffective legal enforcement are detrimental to FDI contracts as well as to production contracts.

Benefits of FDI for China

Many of the rather unusual FDI patterns in China suggest that FDI inflows into China are driven by different dynamics from other countries and thus they may require a different analytical perspective. In the following sections, I discuss this alternative perspective and the efficiency effects associated with China's FDI inflows.

An alternative FDI perspective

Under identical macroeconomic conditions, whether a country gets more or less FDI relative to domestic investments depends on the competitiveness of its firms *vis-à-vis* foreign firms. Conceptually, for FDI to occur, foreign investing firms need not be among the most technologically

advanced and organisationally sophisticated MNCs in the world. All that is required is that they are more efficient than the indigenous firms in the host economies. For this reason, the competitiveness of indigenous firms affects FDI incidence as much as the competitiveness of foreign investing firms. If Chinese firms had been more efficient, they could have responded more effectively to an expansion of domestic or foreign markets and foreign firms might have found it less profitable to invest in China. FDI might not have risen as rapidly as it did in the 1990s.

Here the quality of China's financial and economic institutions matters for FDI. At any given level of market size or labour cost, well-designed financial and economic institutions will make indigenous firms more competitive. It is unlikely that China would receive a massive amount of labour-intensive FDI when efficient local entrepreneurs were able to access capital easily. Small foreign firms may find it more profitable to engage in contract production instead. Poorly designed financial and economic institutions, on the other hand, hamper local entrepreneurs from reaping the benefits of domestic and external market growth and may lead to greater investment opportunities for foreign firms. Efficient economic and financial institutions lead to efficient firms, and inefficient economic and financial institutions would lead to greater FDI inflows in the presence of attractive macroeconomic fundamentals. The reason is that inefficient indigenous firms are unable to respond effectively to the new market opportunities.

The main manifestation of inefficiencies in the Chinese economy is that China's vast financial resources and attractive business opportunities have been allocated to the most inefficient firms—China's state-owned enterprises, while China's most efficient, dynamic and entrepreneurial firms, its private firms, are denied the same resources. It is also important to note that to this day the Chinese government has refused to undertake a large-scale privatisation programme to deal with many of the problems in the state sector, while it has actively sought FDI.

The result is an across-the-board uncompetitiveness of domestic firms. Let me use a computer example as an illustration. Imagine a personal computer of early-1990s vintage equipped with a Windows 2000 operating system. Now imagine another computer, which was the most high-powered on market in 2001 but was equipped with a DOS operating system from the 1980s. This is an inefficient combination of hardware and software resources and capabilities and the likely result is poor performance from both computers.

If we use software capabilities to refer to entrepreneurship, risk taking, business acumen, profit motives and hardware resources to refer to financial resources, market opportunities, advanced technology and equipment, this computer analogy gives us an idea of how the Chinese economic system has functioned. To put it simply, the Chinese system has allocated the best of its hardware resources to firms with the worst software capabilities and skills, i.e., SOEs. At the same time, the system denies its firms with the best software capabilities, i.e., private firms, access to its abundant hardware resources. The cumulative effect of this economic allocation decision is that private firms did not have sufficient resources to grow and develop into competitive firms while SOEs have squandered the resources they did have. Indigenous firms are thus uncompetitive across-the-board, and FDI surged in the 1990s as indigenous firms failed to effectively respond to the new market and production opportunities.

A comparison with India is helpful here. Although India's economy is about half the size of the Chinese economy and its growth rate is lower, India is now home to a number of very large and globally competitive firms. We use a crude metric, the size of firms, as the measure. The size of firms is a rough, although imperfect, indicator of a firm's growth potentials. Today, the largest private firm in China is the Hope Group, located in Sichuan province. This agribusiness conglomerate generated annual sales of 600 million dollars in 1999.[14] The largest private firm in India, Tata Group, generated sales of 7.2 billion dollars in 1995, and its tea business division alone generated sales of 163 million

dollars in the same year.[15] Take another example, this one from the pharmaceutical industry. In 1997, the largest pharmaceutical firm in China was Sanjiu, with sales of 670 million dollars (Nolan 2001, p 161). Contrast Sanjiu with Ranbaxy Laboratories Limited of India, one of the largest Indian pharmaceutical firms. In 1995, Ranbaxy generated sales of 2.27 billion dollars, despite the fact that the Chinese pharmaceutical market was three times as large as the Indian market. Ranbaxy has invested aggressively in China through its two affiliates there (Ghemawat 1998).

Efficiency of FDI

Even though the fundamental underlying causes of China's high FDI demand have been inefficient financial and economic institutions, one should not make the inference that the effects of the large FDI inflows into China are inefficient. In fact, the opposite is true. As many of the FDI inflows were driven by the relatively superior entrepreneurship of foreign firms, the effect of FDI is an increase in the overall efficiency of the Chinese economy. Potentially profitable but unfunded business ventures are now being funded by foreign entrepreneurs and they have grown and created value in a way that would not have been possible without this type of FDI. As a matter of fact, the most efficient form of FDI is precisely the type of FDI Chinese economic officials most often deride—the labour-intensive and export-oriented FDI originating from Taiwan, Hong Kong, and Macao. The efficiency associated with this type of FDI has less to do with the transfer of marketing and management know-how, as often alleged in writings on this topic. The more important effect is that this type of FDI counteracts the distortions and inefficiencies of two prominent features of China's economic policy, namely, an inappropriate industrial policy regime that allocates China's financial resources toward wasteful heavy-industry projects and an ownership bias in favour of China's least efficient firms.

The effect of FDI must be judged against the extant inefficiencies in the Chinese economic system. This is a productive way to think about both the efficiency effect of FDI and the limitations of such an efficiency effect. At its core, what labour-intensive FDI has done is to offset some of the inefficiencies in the Chinese system. The same logic applies when assessing the efficiency contributions of FDI in heavy industries and of foreign acquisitions of assets previously under the control of SOEs *via* JVs or more direct methods. In heavy and capital-intensive industries, SOEs compete mostly with other SOEs. Although competition is better than no competition, it is important to note that all the SOEs are subject to similarly soft budget constraints and such a kind of competition may not lead to the most efficient results. FIEs are the only firms allowed by the government to compete with SOEs. Again, by a deliberate policy of imposing market entry restrictions on indigenous private firms, FIEs represent a genuine source of competition in the Chinese economy by default.

In some parts of the country and in certain industries, the FDI phenomenon is associated with transferring assets and managerial controls from SOEs to foreign firms. The parent SOEs are specialising increasingly in the provision of social services, funded in part from the dividend payouts from their stakes in their FIE affiliates. Many SOEs with equity interests in FIEs have shed their operating and managerial functions. On the asset side of their balance sheets, a growing portion of their assets consists of equity claims on FIEs and more and more of their income consists of non-operating sources, such as dividend payments from their affiliated firms.

All things considered, SOEs are better at providing social services than at providing commercial services and products. Asset acquisition by foreign firms, in all likelihood, has the effect of improving allocative efficiency. There are, however, several caveats. First, because private firms have been systematically suppressed, they cannot bid for the assets of SOEs as effectively as they otherwise would be able to. As a result, foreign firms are more successful bidders. Secondly, and probably more importantly, because the government does not allow a large-scale privatisation programme, only foreign firms can launch bids for SOE assets. Thus the acquisition by foreign firms of SOE assets

takes place in an asset market that is not as competitive as it could be. This is a cost for the country because it means that foreign firms are able to acquire Chinese assets at possibly more advantageous terms than otherwise would be the case. This cost attenuates the larger benefits of privatisation and competition associated with FDI. Third, the suppression of domestic entrepreneurship raises the demand for the privatisation functions played by the MNCs. Remember that foreign firms are wooed to invest in China by tax breaks and the conferral of other benefits. To some extent, China desperately needs foreign capitalists to take over its insolvent SOEs precisely because it does not allow its own capitalists to do so.

Conclusion

The concluding section of this paper discusses the main benefits of China's accession to the WTO. The main benefits have less to do with enhanced roles of foreign trade and FDI in the Chinese economy, as foreign trade and FDI are already playing very important roles in China's economic development. The most important benefit of WTO membership is that it will attenuate the inefficiencies of domestic financial and economic institutions.

WTO accession is likely to promote internal reforms in three ways. First, the Chinese leaders today are faced with a stark choice between socialism and nationalism. Socialism as an economic idea has failed all over the world but in China it has failed in a particular fashion: it has created many profitable business opportunities for foreign firms. So far the strategy has worked brilliantly. In the early 1990s, when the economy was growing rapidly, there was less concern from the public about how the economic pie was divided between foreign and domestic firms. But as the economy begins to slow down, policy-makers and the Chinese public will be more concerned about the distributive implications of such a strategy. It is likely that economic nationalism will be on the rise. Many in China increasingly fear foreign firms as formidable competitors in the market place and as threatening to drive indigenous firms out of business. The failures of Chinese firms are driven by a policy choice of the government to support the least efficient SOEs to the detriment of the efficient private firms, not by competition with foreign firms. It is likely that the Chinese state may decide to support private firms out of a nationalistic imperative. It may conclude, as I do here, that the most efficient and the most competitive firms are private firms and that they constitute the only viable competitive force with foreign firms. It is plausible that the increasingly encouraging stance of the government toward the private sector, including a statement issued by President Jiang Zemin on July 1 2001 to welcome private entrepreneurs into the ranks of the Chinese communist party, came from this realisation.

The second likely effect of WTO membership comes from the efficiency improvement of China's service sector. Reforms in China's service sector, in banking, insurance, wholesaling, retailing and telecommunications, have lagged behind reforms in the real sector. SOEs still dominate these service industries to a far greater extent than they do in the manufacturing sector. The service sector is particularly important in an economy because service firms are in business for business, and inefficiencies of service firms have a significant dragging effect on the entire economy. WTO accession is going to force China to open its doors to the most efficient foreign service providers. This would be beneficial to China's indigenous private firms. Inefficient service SOEs—the banks being just one example—are a bottleneck for the growth, development and maturing of China's indigenous private firms. Had the Chinese state opened up its service sector earlier and had the financial resources and corporate opportunities been allocated to firms with good business acumen and the right mix of performance incentives, world-class Chinese private firms would have appeared on the scene by now, probably in household appliances and electronics, such as those in Korea and Japan that emerged during their economic takeoff eras.

The third likely effect of WTO membership is that China will become more institutionally integrated into the global economy. So far, the open-door policy has increased China's *economic* integration, i.e., an increasingly large share of the GDP is traded on the world market and a large portion of the capital formation comes from foreign sources. But China's economic, regulatory and legal institutions remain quite insulated. WTO membership will change that. After its formal accession, the Chinese government will have to re-write many laws and regulations on its book in order to conform to the requirements of WTO membership. Removing and streamlining cumbersome business regulations will lower transaction costs for *all* firms, whether foreign or domestic, and will benefit those efficient domestic firms operating in a local market niche or endowed with substantial local know-how. Many in China fear that WTO accession will wipe out indigenous firms. This is patently unfounded. The greatest threat to private firms in China is not competition from foreign firms but China's own inefficient business environment and its commitment to SOEs. The best evidence is that Guangdong, the most open province in China, is the home of some of the best indigenous firms in China.

NOTES

1 The purchasing power parity conversion yields a lower ratio, but purchasing power parity measures are plagued by uncertainties about what constitutes the exact purchasing power parity rate. Even if the "true" trade/GDP ratio is half of the ratio calculated on the basis of the official exchange rate, 20 per cent of GDP in foreign trade is still quite large.

2 The finding is reported in (McCallum 1995), as quoted in (Ghemawat 2000).

3 Guangdong's investment figure is calculated from Table 2.6 (World Bank 1994, p. 52).

4 To clarify, China bans FDI in casinos and thus Macao's large investment position cannot be attributed to this source of its competitive advantage.

5 The data on India are provided in [United Nations Centre on Transnational Corporations, 1998 #2120], Annex Table B.3. The poor, hinterland provinces of China absorbed either more than or about the same level of FDI as some of the star economies in Latin America. As of 1997, the FDI inward stock for Argentina was 36 billion dollars and for Chile, 25.1 billion dollars.

6 This measure, while commonly used in academic studies, is not without some problems. Not all FDI finances new equipment and plant investments. Some FDI flows finance the acquisition of existing assets. Thus a portion of the numerator and the denominator may measure different economic activities. (I thank Professor Huw Pill for pointing out this problem.) An additional problem is that this measure may systematically under-estimate FDI dependency in some economies while over-estimating FDI dependency in others. For example, the capital market is less active in Asia than in the United States. This may exaggerate FDI dependency of the United States when much of the FDI finances acquisition of existing assets. For example, in the late 1990s, the FDI/capital formation ratio rose sharply in the United States. This must have been a result of a sharp rise in merger and acquisition activities, which would warrant using total market capitalisation as the denominator.

7 The FDI/GDP ratios are from (Urata 2001).

8 The choice of the year 1995 is not arbitrary. Because FDI flows can fluctuate more than GDP, I chose a medium ratio for China rather than either the highest or the lowest ratio. In 1993 and 1994, China's FDI/GDP ratio was as high as 6.4 per cent and 6.2 per cent, respectively, compared to 4.9 per cent in 1997. The year 1997 probably should not be used because the Asian financial crisis might have adversely affected FDI flows into Southeast Asian countries.

9 The discussion in this section is based on (Meier 1995, especially pp. 247-263).

10 The savings rate is defined as the difference between GDP and final consumption divided by GDP. The data are reported in (State Statistical Bureau 1998).

11 The survey results are reported in (Li and Lian 1999). Street-wise and politically savvy Beijingers have a more vivid description of the corruption problem in China. According to folk wisdom, if all the officials are lined up against a wall and executed, too many are killed. If only every other official so lined up is executed, too few are killed.

12 Data are from (Office of Third Industrial Census 1997).

13 I thank Professors Pankaj Ghemawat, Tarun Khanna, Dwight Perkins, and Lou Wells for raising this issue.

14 See (International Finance Corporation 2000), p. 4.

15 Information on Tata Group is from (Khanna, Palepu and Wu 1998).

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FDI and Its Impact on Employment and Social Policies: The Malaysian Experience,

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Introduction

Over the past three decades, unions and workers were asked to believe that industrial peace would attract investment and create employment that would automatically lead to better wages, better labour standards and greater respect for workers rights. The absence of strikes and protests at the workplace did bring in FDI and help to create jobs, but the promised improvements in the standard of living and trade union rights has yet to materialise.

It is now clear that under increasing globalisation corporations will be on the move, chasing after cheap labour to maximise profits, and there will be no gains without serious and concerted efforts for workers and trade unions.

Following the Asian economic crisis, the Asian and Pacific Regional Organisation of the International Confederation of Trade Unions (ICFTU-APRO) highlighted the plight of millions of workers thrown out of jobs in the region where most countries had no social protection. Workers without jobs or wages were left to fend for themselves. It was reported that the economic and social impacts on their families were so devastating that in an increasing number of cases, children were taken out of school. The long-term effect of such economic and social deprivation will be reflected in the future development of the countries concerned.

Since 1998, the Malaysian Trade Union Congress (MTUC) has repeatedly emphasised the social partner role of trade unions together with employers and governments, and seeks to develop better and meaningful standards for social development.

There are very few legal provisions on social safety nets in Malaysia and what does exist is inadequate. Unlike employees in the Government service – who do not face retrenchment or termination – security of tenure in the private sector always remain a matter of serious concern. The 1997 East Asian economic crisis suddenly placed even greater pressure on trade unions to address this issue with greater urgency and persistence.

A decade of growth

Following a downward spiral of tin and rubber prices and stagnating global demand, Malaysia experienced negative economic growth in the mid-1980s. Between 50,000 and 100,000 workers lost their jobs, spread out across nearly all sectors.

The government responded by trying to boost investment and spending. To attract foreign investment, the government introduced new incentives under the Promotion of Investments Act 1986, cut down on red-tape, opened up new industrial zones, and modernised the infrastructure. These government initiatives coincided with the revaluation of the yen in 1985, encouraging a large number of Japanese manufacturing firms to lower production costs by off-shoring production units to Southeast Asia. In subsequent years, investment from Taiwan, South Korea and later Singapore followed suit. Foreign direct investment increased from just RM 1.7 billion in 1985 to peak at RM 17.2 billion in 1992.

On the back of foreign investment, the manufacturing sector grew by 329 per cent between 1987 and 1997, and contributed 46.9 per cent to the country's growth during that period. Foreign ownership of manufacturing increased from 33 per cent in 1985 to 44 per cent in 1995. Foreign investors also became dominant in crucial sectors, for example, owning up to 86 per cent of the electrical and electronics sector. As of 1996, foreign-owned firms controlled nearly 70 per cent of Malaysia's manufactured exports.

Limits to Growth

The large inflow of foreign investment, while very effective in reviving the economy, is not, by itself, a long-term solution to economic development. At the primary level, it has to be accompanied by several domestic developments such as a transfer of technology to local firms, the development of local production capacity and sourcing of inputs, and the development of local human resources. Generally, if indigenous enterprises fail to take advantage and benefit from foreign firms, then the economy may well get stuck as a labour-intensive export-manufacturing platform for multinational companies.

Such a scenario, at least, partially exists in Malaysia. For example, electronics industries, which contribute close to 65 per cent of manufactured exports, still import close to all their inputs. In 1996, the sector actually ran a RM 400 million deficit in its trade balance, exporting RM 104.3 billion but importing 104.7 billion.

Suppressing Wages

For a country with a small population like Malaysia, inviting labour-intensive foreign investment creates a tight labour market that threatens to increase labour costs. In 1979, Singapore dealt with the same issue by allowing wages to rise, thereby pushing out labour-intensive industries in favour of more technology-intensive investment. This allowed for a general increase in wages and improvement in the living standards of workers and has, a generation later, produced a highly-skilled workforce able to support high-tech, rather than labour-intensive industries.

The Malaysian government, on the other hand, responded to the labour problem with the large-scale recruitment of foreign workers. Bowing to pressure from major corporations about rising workers wages, the government began to import labour, thereby slowing wage increases among blue-collar workers. By the end of 1996, the migrant labour population had reached an estimated 2.5 million.

According to the Ministry of International Trade and Industry (MITI), for the period from 1987 to 1995 total factor productivity (TFP) only increased by 1.8 per cent. For the manufacturing sector, the increase was 4.7 per cent. Growth has been mainly spurred by an increase in capital and labour inputs. MITI reports that the contribution of various factors to average value-added growth was 53 per cent capital, 31 per cent labour, and only 16 per cent productivity.

Effects on labour

Retrenchment and Reduction in Wages

Following the 1997/98 economic slowdown, to reduce production costs in response to decreasing demand, employers drastically reduced overtime work, lowered or withdrew bonuses, froze salaries, cut allowances and wages, and in extreme cases retrenched workers. There are also cases of employers

who were not genuinely affected by the economic slowdown but used the opportunity to impose cost-cutting measures on staff. Retrenched workers were not re-employed, and those who found alternate employment found their earnings drastically slashed.

In early 1998 several companies, especially those engaged in manufacturing construction-related products, closed down and shut their gates without due notice as required under the law. Employers responded to trade unions' criticism by reasoning that the provisions of the Employment Act (Termination and Lay-off Regulations) permit them to retrench without notice so long as they pay wages in lieu of notice.

New Regulation To Monitor Retrenchments

Following MTUC's repeated complaints and public criticism, the government introduced a regulation requiring employers to notify the nearest Labour Department at least 30 days before retrenching workers. The government also accepted MTUC's proposal to set up a tripartite workers retrenchment monitoring committee. MTUC proposed that the committee should go further than merely monitoring retrenchment, and instead propose concrete measures to maintain employment.

Raise the Quantum of Termination Benefits

MTUC asked the government to consider tax incentives to encourage employment, amending the Employment Act to increase coverage of the Act and the quantum of retrenchment benefits, thereby discouraging retrenchment. At the same time, the government should continue to expand job creation programmes to absorb unemployed workers. The plantation and agriculture sectors should be forced to improve working conditions and quality of employment to enable local workers to take up the work. Re-training of retrenched workers should be a priority.

Strengthening the safety net

Following a series of discussions and extensive debate at the tripartite labour forum, *The National Labour Advisory Council* held in 1980, the government introduced termination and lay-off benefits regulations to impose a certain minimum safeguard and payment of retrenchment compensation ranging from ten to twenty days wages for each year of service depending on the length of service.

Quantum of retrenchment benefit is grossly inadequate, and has remained without any change since it was introduced twenty years ago.

By organising workers in the private sector, however, unions have significantly enhanced the quantum of retrenchment benefits through collective bargaining. In the banking sector, unions negotiated special packages for employees who volunteered to accept retrenchment, as high as two and a half months salary for each year of service. Union efforts helped to reduce anxiety and tension amongst affected workers.

Thousands Deprived Of Retrenchment Benefits

Nevertheless, more than 10,000 workers who lost their jobs are still waiting for their retrenchment benefits, many pending for more than three years.

In its disclosure of a list of ten companies, including MNCs, involved in the manufacture of metal, plastics, wood, electrical and electronics products, MTUC highlighted the government's failure to act firmly to enforce the Labour Laws, which had led to more employers openly defying the Labour Department's directive.

The Employment Act 1955 has specific provisions requiring employers to give 4 to 8 weeks notice prior to retrenchment and pay severance benefits ranging from 10 to 20 days wages for each year of service, based on the length of service.

Receivers appointed to manage debt-ridden companies take refuge under the provisions of the Company's Act, and refuse to comply with Labour Court Orders. Many of them frustrate workers by challenging the Labour Court's Awards at the Session Court, High Court, and Court of Appeal.

Retrenchment & Unemployment Fund

Four years ago MTUC submitted a proposal to set up a National Retrenchment and Unemployment Fund. Employers and workers should each be required to make a statutory contribution of RM1.00 per worker per month towards the scheme. Contributions will grow at the rate of RM2.00 per worker per month, and contributions from the existing 5 million SOCSO members will be able to yield RM10 million a month, i.e. RM120 million a year.

The funds, as well as the proceeds from investments, could be utilised to pay the retrenchment benefits of workers who have been deprived of such benefits. The quantum should be pursuant to the Employment (Termination and Lay-Off Benefits) Regulations, 1980, or according to the terms and conditions of their respective collective agreements.

The Fund should also consider paying retrenched workers a monthly allowance to support their families until they get a new job.

Retrenched workers should be required to register themselves with the Employment Exchange, as a condition to apply for a fixed monthly allowance. MTUC proposed a waiting period of 3 months before they can receive unemployment relief.

Workers who refuse to accept suitable alternative employment offers, or offers made available to them by the Employment Exchange, will be disqualified from receiving any assistance from the scheme.

MTUC's proposal to entrust the Social Security Board with the administration of the scheme would eliminate additional administrative costs. The government is supportive of the scheme, but in the face of vehement opposition by employers, the government seems to have back-tracked.

Minimum Wage Campaign

Following an extensive study of more than 165 collective agreements throughout the country, MTUC concluded that government support and intervention is urgently required to ensure a fair living wage for working people.

Currently the Employment Act, which sets minimum conditions on annual leave, sick leave, public holidays, working hours and a few other terms and conditions, is silent on the basic and most essential issue of wages. This absence of a specific provision on wages has led to widespread exploitation.

Minimum Living Wage

Minimum wages constitute an integral and a very important element of the trade union movement's holistic approach towards creating, sustaining, and improving the quality of life of workers.

MTUC's proposal of RM900 per month as minimum wage is based on the essential and basic needs of a single person.

Survey on Minimum Wage

A study of wage scales in 165 companies showed that even in major towns such as Penang, Ipoh, Shah Alam and Johore Bahru, unskilled general workers are paid as low as RM300 to RM350 per month.

Overall, the study shows that 46.2 per cent of the companies involved are paying a minimum wage below RM400 per month, and only 15.4 per cent of the companies pay more than RM500.

Responding to employers' call to link wage increase with productivity, MTUC agrees that a major portion of wage increase must be based on productivity. In order for such a scheme to be fair and effective, a minimum wage must be put in place before implementing a productivity-related annual wage increase. A minimum wage must take care of workers' basic needs.

MTUC stressed that by setting and implementing a minimum living wage of RM900, the government will be able to:

- address industries' need for manpower
- reduce dependency on foreign labour
- eradicate poverty
- improve purchasing power
- strengthen and increase manufacturing
- facilitate positive economic growth
- foster fair competition among companies.

With 2 million foreign workers in the country, the government is in a good position to discard and bring to an end the low wage regime.

Social Security

The Social Security Scheme, launched in Malaysia in 1971, was essentially to set up an employment injury insurance scheme. Over the years, trade unions have secured substantial changes to the social security act:

- to increase its scope and coverage;
- enhance compensation for permanent and temporary disablement due to employment injury;
- compensation for permanent disablement due to illness;

- compensation for dependents of workmen in the event of death, due to illness or employment injury.

Health Care

Health care at government hospitals and clinics is provided free of charge to government employees, but is available to all members of the public at reasonable cost. The quality of healthcare in government hospitals and clinic, however, remains unsatisfactory.

In the private sector, unions have negotiated for better quality healthcare at employers' cost, predominantly for employees only, and this coverage is discontinued on retirement, retrenchment, or termination. The need to improve healthcare and find ways to finance this crucial service is imperative.

Impact of Freedom of Association And Collective Bargaining on Social Development

ILO convention No. 87 on Freedom of Association and Protection of the Right to Organise was adopted at the 31st Session of the ILC in 1948, and it is reported that as of September 2001, 136 countries have ratified the convention, and 149 countries have ratified Convention No 98 on the right to organise and collective bargaining, adopted at the 32nd Session of the ILC in 1949.

It is a shame that more than 50 years since these conventions were adopted, many governments still refuse to accord the most basic and fundamental rights to workers. And even countries that have ratified these conventions have not promulgated appropriate legislations in line with the principles set out in them.

Workers' Rights and Development

In spite of the effectiveness of collective bargaining as an important tool to narrow the ever-increasing income gap, governments are either convinced or intimidated by MNCs' arguments that trade unions and collective bargaining rights will drive away investors. In the name of globalisation and competition, powerful corporations, both foreign and national, have restricted the growth and influence of trade unions, removed well-established minimum standards, blocked minimum wage legislations, and weakened collective bargaining.

Improving Conditions of Work And Life

Trade unions are the largest independent, democratic, non-governmental organisations in most countries of the world, including Malaysia. They are structured to represent their members and working women and men generally at the workplace, by industry, sector and occupation, on a national scale. A common feature of trade union work is the goal of improving the working and living conditions of working people. The means of achieving this goal include collective bargaining with employers at various levels, influencing government policies that impact on conditions of work and life, and providing direct services to members through the representation of grievances, legal assistance, and social welfare programmes. Perhaps the simplest way to describe the role of trade unions is that they aim to get the fears and aspirations of people whose voice in society would otherwise not be heard, understood and addressed.

Organised around the process of work, trade unions aim to exert bargaining power on the contract of employment and the factors that affect it, to ensure that working people are treated with dignity and justice. Their goal is to counter-balance the inherently unequal relationship between individual workers and employers, thus enlarging citizens' freedom to influence a key determinant of their lives. In doing so, they are expressing interests that can conflict with those of powerful groups in society, but which can be resolved to mutual advantage and in the public interest where effective processes of industrial relations are built up. To quote from the 1995 World Development Report, "***… the probability of governments passing inefficient labour legislation may be higher when workers' right to representation is not protected***."

Social Stability and Progress

From its foundation in 1919, the ILO has sought to develop standards in the social and employment field that reflect the interest of all nations in social progress and the development of institutions that enable social problems and conflicts to be resolved. Its standards take the form of principles to be applied in national law and practice. They thus provide a framework that is clear in terms of objectives, but provides sufficient flexibility to be adapted to national circumstances.

In recent years, as the interdependence of the world economy accelerated and respect for democratic forms of governance spread, the ILO was able to develop a large degree of consensus over the universal applicability of seven of its most basic Conventions. The ILO Declaration on Fundamental Principles and Rights at Work and its Follow-up, adopted by the International Labour Conference in June 1998, sets out the commitment of the international community to establish a social minimum at the global level which responds to the realities of globalisation. The seven Conventions specified in the Declaration are core labour standards which, when properly observed, create the foundations for a sound system of industrial relations in which trade unions, together with employers and governments, can play a constructive role in working to ensure that social progress goes hand in hand with the progressive opening of markets to international trade and investment.

Core ILO Conventions Ratified by ASEAN Member Countries

C29	Forced Labour Convention, 1930
C87	Freedom of Association and Protection of the right to organise Convention, 1948
C98	Right to Organise and Collective Bargaining Convention, 1949
C111	Discrimination (Employment and Occupation) Convention, 1958
C182	Worst Forms of Child Labour Convention, 1999

Convention	Malaysia	Indonesia	Singapore	Thailand	Philippines	Viet-nam	Cambodia	Laos	Myanmar
C29	√	√	√	√			√	√	√
C87		√			√		√		√
C98	√	√	√		√		√		
C111		√			√	√	√		
C182	√	√	√	√	√	√			

The economic and financial turmoil of 1997-1998, which started in Southeast and East Asia and spread to affect nearly all countries, has served to highlight the need for a new architecture to govern world financial markets. Its severe social impact on the most affected countries has also drawn

attention to the difficulty of achieving financial stability without also ensuring social stability and progress.

Conclusion

Powers and Influence of MNCs

In Malaysia, the birth and growth of trade unions are severely restricted. Unions were barred from the electronics industry during the early 1970s to encourage foreign electronics producers to locate plants in Malaysia. A no-union policy, along with tax holidays and other incentives, attracted dozens of the world's largest electronics companies. MNCs, mainly from OECD countries, exert a great deal of pressure on the government to successfully ensure that independent industrial unions are not permitted.

Respect for freedom of association is central to the attainment of economic development and sustainable growth. The evidence from many industrialised countries – France, Germany, Japan, Norway, etc. – indicates the positive link between increasing wages and obtaining better productivity by improving the motivation of workers. Higher wages also act as a spur to productivity improvements by obliging employers to try harder to make economies on other elements of their costs, so increasing the efficiency of the production process. Furthermore, setting higher social standards often forces employers to upgrade, and so results in more efficiency and higher growth in the long run.

Trade unions play an essential role in the development process by achieving a sustainable distribution of income and wealth. Unions have played a crucial role in improving wages and working conditions, so ensuring that the benefits of productivity growth are not confined to a small elite but are distributed more widely over the whole population. Productivity, growth, and development all depend upon a generalised perception that the labour market is equitable. Where this does not exist, the consequence has either been stagnation – shown by the below-average long-term performance of many Latin American economies with extreme income and wealth inequality – or social and political instability that has undermined development efforts.

Key Drivers for Investing in Costa Rica: the Intel Experience,

Anabel González,
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Introduction

In November 1996, Intel Corporation announced its decision to locate a semiconductor assembly and testing plant in Costa Rica. At the time, people wondered why Intel, the world's leading semiconductor manufacturer, had chosen Costa Rica, a small country located in the middle of the Americas. Today, after more than four years in Costa Rica, Intel has expanded and diversified operations, and Costa Rica has benefited extensively from its presence in the country.

This paper attempts to explain Intel's key reasons for investing in Costa Rica, using the case to highlight why Costa Rica has been successful in attracting companies not only in the information technology sector, but in other areas as well. A brief description of the country is followed by a summary of Intel's site selection process. The paper goes on to explain Intel's decision to establish its plant in Costa Rica, and ends with a description of Intel in Costa Rica at present.

Costa Rica

Costa Rica is located in Central America, between Nicaragua and Panama, bordering the Caribbean Sea and the Pacific Ocean. It is a small country (51,100 square kilometres), roughly the size of West Virginia in the U.S., with a population of 3.6 million. Though a developing country with a GDP per capita of a little more than US$4,000, Costa Rica's long-term commitment to investing in health and education has resulted in a high level of human development; it is ranked 41st in the world by the United Nations Human Development Index. Costa Rica also has a long-standing tradition of peace, and it is the oldest democracy in Latin America.

Costa Rica's GDP in 2000 was US$15,040 million, about half of Intel's sales for the same year, (US$33,700 million[1]). With a small and open economy, Costa Rica has been actively integrating into the world economy over the past two decades. Trade as a percentage of GDP is 83.9 per cent, and this figure is still rising, as exports and imports continue to increase more rapidly than domestic production. Although the country exports more than 3,000 products to over 100 markets, more than 30 per cent of its exports are now microprocessors, and 50 per cent of its trade is conducted with the U.S.

Foreign direct investment has been at the heart of the country's development strategy for a considerable number of years. Alongside trade, FDI has been a main engine of growth, increasing from levels of around $60 million per year in the mid-1980s to an average of about $500 million in the past 5 years. On a per capita basis, this is slightly higher than the average for Latin America, though in the case of Costa Rica FDI has been mainly concentrated in greenfield investments.

[1] Intel, *Silicon is in*, 2000 Annual Report, 2000.

Intel's site selection process

Based on Spar, and the author's personal knowledge of the case, Intel's site selection process may be summarised as follows. For additional details, the process is well documented in several studies[1].

As shown in Chart 1, Intel's process began with basic desk research of a list of 13 countries located in Latin America and Asia. The choice of these countries was based on several criteria, including stable economic and political conditions, human resources, a "pro-business" environment, logistics and manufacturing lead-time, and a fast-track permit process. At the initial stage, Intel officials reviewed the original list in order to eliminate those countries that, for some reason or another, did not meet the basic requirements. After several months of research, the list was narrowed down to Argentina, Brazil, Chile, Costa Rica, Indonesia, Mexico and Thailand. In order to increase regional diversification[2], the Asian countries were dropped from the list, leaving the four Latin American countries as candidates for Intel's new plant.

Chart 1: INTEL'S SITE SELECTION PROCESS

Long-list: Argentina, Brazil, Chile, China, Costa Rica, India, Indonesia, Korea, Mexico, Puerto Rico, Singapore, Taiwan, Thailand
Criteria: stable economic and political conditions, human resources, "pro-business" environment, logistics and manufacturing lead time, fast-track permit process

Short-list: Brazil, Chile, Costa Rica, Mexico
Criterion: increased regional diversification

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During the second stage of the process, Intel visited all the short-listed countries to carry out on-site analysis of each of the candidates. In the case of Costa Rica, the first visit was in April 1996. From then on, an Intel team visited the country almost every week to gather all the relevant facts necessary to make the company's decision as well informed as possible. A few months later, Chile and Brazil were dropped from the list. Chile was eliminated for its "lack of emphasis on the electronics sector and air transportation logistics", and Brazil because "Intel felt the business environment, at that time, would not be suited to the type of operations they were considering"[3]. Hence, Mexico and Costa Rica remained the only two contenders, and in November 1996, Intel publicly announced its decision to build its new semiconductor assembly and testing plant in Costa Rica.

Why Costa Rica?

The following three sets of reasons explain why Intel chose Costa Rica, according to Spar and the author's knowledge of the case:

[1] For a detailed description of Intel's site selection process, see Spar (1998), Gonzalez (1997) and Rodriguez-Clare (2001).

[2] Intel already had plants in Asia, specifically in Malaysia, the Philippines, and China. Additionally, it also has plants in Israel and Ireland.

[3] Spar, p. 10.

- Country factors: Intel liked Costa Rica for several reasons: its long history of political and social stability, including rule of law and low levels of corruption; its commitment to an open economy and to trade and investment liberalisation policies; its development of human resources, including an incipient development in the electronics sector; and a receptive investment environment, where other multinationals testified as to their positive experiences in the country.
- "Negotiating tactics": when Intel announced its decision to invest in the country, it did so – as it usually does – on the condition that it received all the necessary permits and authorisations within a given time. The Government of Costa Rica and CINDE, the country's investment promotion board[1], worked jointly in order to make sure that Intel could finish its plant and start operations within a given timeframe. Gonzalez explains this process in detail, which was characterised by a co-ordinated approach directly led by the President of Costa Rica and the Minister of Foreign Trade, whom he appointed as the lead government official in charge of the project. Speed and flexibility characterised the process. In addition, the country's export processing zone regime, which had a fixed set of incentives not subject to negotiation, was a definite asset.
- Specific "concessions": all concessions granted to Intel were not really specific to the company, but were generally applicable to other companies that met the required conditions. As Rodriguez-Clare states, "in this sense, it could be argued that these were not concessions, but rather Intel-inspired reforms to improve the country's competitiveness". The reforms were concentrated in three areas: education, infrastructure, and taxes. In the first area, they included the addition of several technical and university programmes designed to increase the level of certain specific competencies in electronics. In the area of infrastructure, it included the establishment of a new lower rate for energy-intensive industrial facilities, as well as the adoption of an open-air aviation policy to promote the increase in the number of flights to and from Costa Rica, and the construction of a few roads. Finally, in the areas of taxes, the government requested a formal interpretation from the Attorney General of a new law that was ambiguous as to whether it applied to companies in the export processing zones. The result was favourable to Intel.

Intel in Costa Rica today

Intel began operations on schedule in November 1997, a year after its decision to establish in Costa Rica was announced. Having invested almost US$500 million, Intel employs more than 2,200 people (of whom about 35 are currently expatriates) and performs several processes and assembles several products in Costa Rica, including the Pentium 4 processor. Its impact on the economy has been significant, accounting in 1999 for almost 60 per cent of total growth experienced that year and almost 40 per cent of total exports. Most importantly, however, Intel is contributing to Costa Rica's development in three specific ways:

- Investment attraction: Intel has helped Costa Rica to attract FDI, not only in the electronics sector, but in other areas as well, and not only through the "stamp of approval" that its presence signifies in the country, but also through active participation in investment promotion and persuasion efforts both in Costa Rica with potential

[1] CINDE is a private, non-profit, apolitical association, declared of public interest by the Government, which acts as Costa Rica's official agency for attracting FDI into the country.

investors, and abroad. Moreover, Intel itself has expanded and diversified its investment in Costa Rica, recently establishing a separate facility to develop software in the country.

- Backward linkages: Intel's presence in the country has been determinant in promoting backward linkages through domestic companies and through the operation of foreign companies in the country. In the case of the former, Intel now has more than 300 local suppliers of goods and services, and is working hand-in-hand with the Government to develop a "second-stage" group of suppliers, more directly involved in the production process of the company. Very significantly, Intel Capital invested in a Costa Rican software company it considered strategic to its operations, contributing to the development of a very promising indigenous software industry. Backward linkages have also been effective in enhancing competitiveness, particularly as regards promoting improvements in export/import logistics in the country.
- Development of human resources: as Rodriguez-Clare explains, Intel has generated significant externalities through the training of its own workforce, usually abroad, and the support of educational programmes in public universities to improve the curriculum and teacher training in technical fields.

Final comments

The future of Costa Rica depends, among other factors, on its ability to attract FDI, not only for its beneficial effects on the economy, but also for the positive impact it has in the development of the country. The Intel site-selection process demonstrates that attracting investment is not an easy task. The country, however, seems to have what it takes: political and social stability, economic openness and liberalisation, a receptive investment environment, skilled human resources, improving infrastructure, strategic location and a proactive, positive attitude on the part of the Government, CINDE, and the business and academic communities. Continued improvement is, of course, a must. Other success stories have followed Intel in the electronics sector (Remec, Sawtek, Reliability, Protek, among others) as well as in business services and medical devices sectors: Procter and Gamble has located its largest Global Business Services Centre in Costa Rica to service all of its subsidiaries in the Americas, Abbott Laboratories is expanding its recently opened plant to 50,000 m2, Baxter is making additional investments in its long-standing plant in Costa Rica, etc. The challenge ahead is to continue making success stories happen, and to enhance their positive impact in Costa Rica.

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Foreign Direct Investment in Africa: Policies Also Matter,

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Introduction

For many observers, the capacity of African countries to attract foreign direct investment (FDI) is principally determined by their natural resources and the size of their local markets. Over the years, despite their unstable political and economic environments, Nigeria and Angola have been two of the most successful countries because of their comparative location advantage in oil.

The apparent lack of interest of transnational corporations (TNCs) in African countries that have attempted to implement policy reforms has also contributed to support this argument. The balkanisation of African countries is frequently used as an argument that this continent has been much less favoured than Asia and Latin America over the past decade. It has been argued that the reforms in many African countries have been incomplete and thus have not fully convinced foreign investors to develop activities that are not dependent on natural resources and aimed at regional and global markets. True, it takes time for a country to modify its image, especially when the State has a long tradition of policy intervention, and when the reforms have been mostly symbolic with the adoption of new texts that have not yet been translated into action.

This paper will identify which African countries have been able to attract FDI by improving their business climate. These countries show that pro-active policies and reform-oriented governments can generate FDI interest. This conclusion does not differ from the one reached for countries such as Singapore or Ireland. It simply makes the point that African countries can also be successful in attracting FDI that is not based on natural resources or aimed at the local market, but rather at regional and global markets, by implementing policy reforms. An econometric analysis of 29 African countries and a detailed review of two successful ones – Mali and Mozambique – will illustrate which policy factors have played a significant role in the improvement of their business climate – at least in the views of foreign investors.

Determinants of FDI in Africa

Although there have been a considerable number of analytical and empirical studies on FDI inflows,[1] there has been a limited consensus on which factors play an unambiguous role in explaining the location decision of TNCs. It is generally accepted that market size and access to natural resources are crucial determinants in their decision processes.

Not surprisingly, the African countries that have been able to attract most FDI have been those with the largest tangible assets such as natural and mineral resources as well as large domestic markets.

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About 65 per cent of total FDI inflows to Africa were concentrated in South Africa, Nigeria, and Cote d'Ivoire in 1996/1997, which also accounted for about two-thirds of the sub-continent's GDP during the same period (Table 1). The role of market size can be further evidenced by the almost perfect positive correlation between FDI inflows and GDP for a group of 29 African countries during 1996 and 1997 (the correlation coefficient equals 0.99)[2].

The role of natural resources in the location decision of TNCs is apparent through the sectoral allocation of FDI inflows within the region. Traditionally, about 60 per cent of FDI in Africa is allocated to oil and natural resources (UNCTAD, 1999). This is corroborated by the coefficient correlation between FDI inflows and the total value of natural resources in each country,[3] which appears close to unity (i.e. 0.94) for the group of 29 African countries during 1996-1997. The African region possesses not only large reserves of oil, gold, diamonds and copper, but also more than half of the world's cobalt and manganese, one third of bauxite, and more than 80 per cent of chromium and platinum. The sub-continent is also among the main exporters of agricultural products such as cocoa, coffee, and sugar.

The strong reliance of African countries on their natural resources and market size has been well evidenced by many studies.[4] It might be more pertinent to look at which countries – that could not rely on the natural resources and the size of their domestic market – have been most successful in attracting FDI over the past few years. To do so, we propose to normalise the value of total FDI inflows by GDP and the total value of natural resources in each country. For simplicity, we label this indicator as the business climate for FDI (FDIBC):

$$FDIBC_i = FDI_i / (GDP_i * NR_i)^a \qquad (1)$$

where FDI is defined as the FDI inflows in country i, GDP as the gross domestic product, and NR the value of natural resources (all of them expressed in dollars). Equation (1) assumes that the elasticities of FDI inflows to changes in GDP and natural resources are both equal to unity (a = 1), which seems consistent with the estimated elasticities that will be reported later in the paper for the group of African countries surveyed in this paper.[5]

Our indicator captures the attraction of African countries for FDI when they can rely on everything except their natural resources and market size. Therefore, it reflects not only policy and political variables but also a series of structural factors such as infrastructure, transport costs, and human capital. By indicating the attraction of the FDI business climate for each country, it complements the data collected in investors' surveys and cross-country ranking such as *The Africa Competitiveness Report* published by the World Economic Forum. One has to keep in mind, however, that our indicator reflects existing rather than potential data/information and, thus, might be a poor predicator of future FDI flows.

The ranking of 29 African countries according to the indicator proposed above is presented in Table 2 (first column). In 1995-1997, the most attractive country was Namibia, followed by Mali, Mozambique, Zambia, Chad and Senegal.[6] The least attractive were Congo, Sierra Leone and Ethiopia. Preliminary findings for 1998 indicate that there have not been many changes in the ranking, with Mozambique and Namibia still at the top of the list.[7] A rapid comparison across regions reveals that Singapore had a FDI business indicator index twice as high as the best African country in 1995/1997. However, Ireland and Hungary were ranked about the same level as Senegal and Mauritius. This result may appear surprising at first sight, but one can observe that the flows of FDI were about the same in Senegal and Ireland, when compared to their respective GDP in 1997 (about 3.8 per cent) and Ireland has, in dollars, more natural resources than Senegal. It may also reveal some of the limits of our indicator when the differences in GDP are too big across countries – the

assumption that FDI is perfectly elastic to changes in GDP might not be robust across regions or countries with large differences in GDP levels.

Table 1. FDI inflows and GDP: ranking of 29 African countries average 1996-1997
(Millions of $US)

	Net FDI Inflows	GDP
South Africa	2313.5	129094
Nigeria	1566.0	36540
Cote d'Ivoire	305.1	10251
Angola	265.5	7396
Tanzania	154.0	6707
Uganda	148.0	6555
Namibia	109.9	3453
Ghana	101.3	6762
Senegal	92.2	4542
Mozambique	68.3	1944
Zimbabwe	66.5	8512
Zambia	64.0	4051
Mali	61.6	2532
Mauritius	46.7	4151
Cameroon	40.0	9115
Benin	31.5	2137
Guinea	20.6	3998
Chad	16.5	1603
Kenya	16.2	9899
Madagascar	12.1	3552
Congo, Republic	8.5	2298
Central African Republic	5.5	954
Ethiopia	5.0	6330
Rwanda	2.4	1771
Congo, Democratic Rep. Of.	1.5	6904
Malawi	1.5	2424
Burundi	1.0	1137
Niger	1.0	1858
Sierra Leone	1.0	940

Source: World Development Report, World Bank (1999).

Table 2. Business Climate for FDI: Ranking of 29 African countries average 1995-1997

Country	FDI/business climate [a]	ICRG political risk [b]	Institutional Investor [c]
Namibia	1	1	NA
Mali	2	12	13
Mozambique	3	11	18
Zambia	4	4	14
Chad	5	NA	NA
Senegal	6	13	6
Angola	7	18	20
Benin	8	NA	12
Mauritius	9	NA	1
Cote d'Ivoire	10	8	8
Tanzania	11	5	10
Uganda	12	15	11
Central African Republic	13	NA	NA
Ghana	14	7	4
Madagascar	15	9	NA
Burundi	16	NA	NA
Rwanda	17	NA	NA
Zimbabwe	18	4	3
Congo, Rep.	19	14	19
Nigeria	20	17	15
Niger	21	20	NA
Guinea	22	19	17
Malawi	23	6	7
Cameroon	24	16	9
Kenya	25	5	5
South Africa	26	2	2
Ethiopia	27	10	15
Sierra Leone	28	21	22
Congo, Dem. Rep.	29	22	21

Sources: Author's own calculations; Pigato (1999).

a. The business climate index is defined as net FDI inflows normalised by GDP and the total value of natural resources in each host country.

b. Political-risk rating based on the opinion of banks, TNCs, and other institutional investors indicating corruption, political and judicial institutions.

c. Institutional-Investor rating measures a country's creditworthiness, which is mostly determined by economic and financial variables.

Our ranking can be compared with those obtained in some well known surveys such as the International Country Risk Guide (ICRG) and the Institutional Investors (II) ratings that are reported in the second and third columns of Table 2.[8] If the ranking appears quite similar for a few countries,[9] there exist significant differences both at the top and bottom of the table. While South Africa, Zimbabwe, Kenya and Malawi appear in the bottom half of our ranking they are on the top of the list for the two other indicators. On the other hand, Mali and Mozambique have not been ranked very high by the ICRG and II indexes but are among the most attractive countries according to our indicator.[10]

In our opinion, these differences can be explained by the more global concept captured by our indicator, which aims at reflecting the FDI that cannot be explained by the size of the local market and the availability of natural resources. As mentioned earlier, it reflects not only the policy and political environment in a host country but also a series of factors such as the geographical location, infrastructure, and the stock of human capital. The ICRG and II indexes capture only two of these multiple elements: the political and financial risks in each country. Another major difference is that these indexes are built with investors' surveys, mainly international banks, and thus are more subjective and forward-looking than our indicator that is constructed by using actual FDI flows and economic data. These differences can be illustrated by the cases of Zimbabwe and South Africa. Although Zimbabwe appears to be a country with low political (fourth out of 24 countries) and financial (third) risks, the fact of the matter is that most foreign investors have been reluctant to invest there. Their prudence may be explained by the weak growth performance over the past few years and numerous barriers against FDI, especially when Zimbabwe is compared to market-oriented neighbours such as Zambia, Uganda and Mozambique. Those obstacles are not captured by the ICRG or II index. The South African economy has benefited from large inflows of FDI in recent years, but they have been mainly due to the privatisation process, the return of companies based in neighbouring countries during the apartheid period, and the interest of investors in the large domestic market (about three times greater than the second largest African country, i.e. Nigeria). Those factors are not related directly to the business climate, which remains quite problematic. The trade liberalisation process remains timid, with the exclusion of some important industries and relatively long transition periods. The economic growth performance in recent years has proved to be too modest to convince foreign investors, which is reflected in our indicator but not clearly in the ICRG or II index.

It might be useful to examine the variations in the business climate, as a source of attraction for FDI, for the group of 29 African countries over the past decade (Table 3). At the end of the 1980s, the most attractive countries were Zambia, Mauritius, Chad and Benin. Then in the early 1990s, Benin, Namibia, Chad, Zambia and Mozambique were ranked as the most performing countries. In the last few years, Namibia, Mali and Mozambique appeared at the top of the list. Overall, we found that the ranking has been relatively stable over time with about the same strong and weak performers, suggesting that it takes time to establish a good or bad reputation.

A few countries have shown significant changes in their business climate over the past decade. Foreign investors have recognised the progress achieved by countries such as Mali (from 26 in 1986-1990 to 5 in 1995-1997), Uganda (from 24 to 13) and Mozambique (from 13 to 3), where FDI inflows jumped about 600 per cent, 100 per cent and 90 per cent, respectively, between 1993-1994 and 1995-1997. On the other hand, several countries have seen a severe deterioration of their investment environment: Rwanda (from 6 to 18), Niger (from 7 to 22), and Congo Republic (from 8 to 20). Those countries went through unstable political events during these years, with a strong and negative impact on foreign investment.

What makes a business climate attractive in Africa?

At first sight, there are no apparent patterns that emerge from the ranking presented in the previous section. It could have been *a priori* argued that the small, non-oil exporting, and landlocked countries would have made the strongest effort to improve their business climate to attract foreign investors. There are two – complementary – approaches that can be followed to attempt to define what the successful countries have been doing right. First, an econometric analysis can help to identify the main factors. Second a description of the policy reforms implemented in a few successful countries may be practical. These two approaches are presented below.

Table 3. Comparison over time of the business climate for FDI in Africa

Rank	Average 1986-1990	Average 1991-1994	Average 1995-1997
1	Zambia	Benin	Namibia
2	Mauritius	Namibia	Mali
3	Chad	Chad	Mozambique
4	Benin	Zambia	Zambia
5	Rwanda	Mozambique	Chad
6	Niger	Angola	Senegal
7	Congo, Rep.	Mauritius	Angola
8	Central African Republic	Senegal	Benin
9	Guinea	Ghana	Mauritius
10	Namibia	Uganda	Cote d'Ivoire
11	Madagascar	Madagascar	Tanzania
12	Angola	Nigeria	Uganda
13	Mozambique	Guinea	Central African Republic
14	Senegal	Rwanda	Ghana
15	Nigeria	Tanzania	Madagascar
16	Cote d'Ivoire	Congo, Rep.	Burundi
17	Kenya	Mali	Rwanda
18	Burundi	Zimbabwe	Zimbabwe
19	Ghana	Malawi	Congo, Rep.
20	Ethiopia	Burundi	Nigeria
21	Malawi	Kenya	Niger
22	Uganda	Cote d'Ivoire	Guinea
23	South Africa	Ethiopia	Malawi
24	Mali	South Africa	Cameroon
25	Congo, Dem. Rep.	Congo, Dem. Rep.	Kenya
26	Cameroon	Cameroon	South Africa
27	Zimbabwe	Niger	Ethiopia
28	Sierra Leone	Central African Republic	Sierra Leone
29	Tanzania (N/A)	Sierra Leone	Congo, Dem. Rep.

The absence of reliable statistical data on most African countries precludes a rigorous econometric analysis. However, as a starting point, we proceeded with panel data and cross-country analyses of the 29 countries presented earlier in which we tested a number of explanatory variables. The selection of these variables was done on the basis of the existing literature and the following equation was chosen:

$$FDIBC_{it} = a_0 + a_1 g_{it} + a_2 IR_{it} + a_3 T_{it} + a_4 TM_{it} + a_5 UP_{it} \quad (2)$$

with:

$FDIBC_{it}$ = business climate for FDI in country i at time t

g = GDP growth

IR = illiteracy rate (per cent of people aged 15 and above)

T = trade/GDP

TM = telephone mainlines (per 1,000 people)

UP = ratio of urban to total population

Contrary to most econometric studies, we do not try to explain FDI inflows but rather the FDI that does not arise from market size and the natural resources available in the host country. Therefore, the dependent variable used in the regression is our business climate indicator as defined by equation (1). As discussed earlier, we assume that FDI inflows respond to a change in GDP or natural resources with perfect elasticity. To check the robustness of this assumption, we have also estimated the same equation but with FDI inflows as a dependent variable and GDP and natural resources as explanatory variables. We found the respective elasticities of 0.91 and 0.92 and 1.4 and 1.2 in our panel and cross-country regressions (see Table 4, third column).[11]

A brief explanation might be necessary for our selection of explanatory variables, which has been partly driven by the availability of data in the World Bank's database. [12] The economic growth rate should influence positively the business climate for FDI as it reflects an improvement in economic performance. Most recent studies have also evidenced that the degree of openness, as measured by the trade share in GDP, should influence positively foreign investors through trade liberalisation and higher competitiveness. The illiteracy rate should be inversely related to the availability of relatively skilled labour – a major factor in the location decision of TNCs. The number of telephone lines per 1,000 people is viewed as an indicator of infrastructure and communication development. Finally, the recent literature has argued that investors can be lured by concentration of other companies or customers, since it reduces their transport costs and there are evident economies of scale in the development of backward and forward linkages. This argument might be partially captured by the share of urban population (as a percentage of total population). Note that we will also test the relationship between our indicator of business climate and the political and financial risks indicators reported in the preceding section.

Table 4. Econometric results: sensitivity of business climate to policy variables
(T-statistics in parenthesis)

	Panel data [a]		Cross Country	
Dependant variable	FDI business climate	FDI inflows	FDI business climate	FDI inflows
Economic growth	0.123		0.101	0.587
	(1.90)		*(1.71)*	*(1.96)*
Trade openness	0.163	2.812	0.172	1.812
	(2.43)	(3.23)	*(1.94)*	*(1.50)*
Illiteracy rate	-0.209	1.097	0.139	0.489
	(-0.39)	(1.09)	*(1.33)*	*(0.80)*
Telephone lines	-0.0404	-0.407	0.0129	-0.144
	(-0.51)	(-0.42)	*(0.15)*	*(-0.46)*
Urban population	-0.978	-0.228	-0.0937	-0.525
	(-1.21)	(-1.26)	*(-0.49)*	*(-0.63)*
GDP		0.91		1.415
		(3.97)		(*4.28)*
Natural resources		0.92		1.214
		(7.04)		(*3.89)*
Adj R^2	0.08	0.433	0.04	0.56

[a] Fixed-term effects were used for our panel data regressions.

We estimated equation (2) for the panel data of 29 countries over the period 1990-1997. Alternatively, we proceeded with cross-country regressions using the average values of the selected variable during the same period. The panel data regression includes fixed-term effects because the results from testing the homogeneity of such effects indicate that the changes in the FDI business climate include critical time-correlated elements common to all countries.

The estimated results of our panel regression indicate that GDP growth rate and trade openness have been positively and significantly correlated with the investment climate in Africa (Table 4).[13] The positive impact of trade openness seems to confirm the arguments that trade liberalisation leads to a more general reduction in administrative barriers and improves the business environment in the host economy – countries with low trade barriers also tend to have low barriers to FDI – as well as conveys the right signal to the international business community (Lall, 2000). In a more specific context, free trade zones have been highly successful in attracting FDI with stable, growing economic environment and trade liberalisation (Madani, 1999). In contrast, the illiteracy rate, the number of telephone lines and the share of urban population do not appear to have been major determinants in the business climate for FDI in the region. Those results corroborate those obtained in the cross-country regression. Note that we also tested the impact of political and financial risks (as measured by ICRG and II), but these did not appear significant in the business climate in our (cross-country) regressions. These findings are not surprising in view of the significant differences in the rankings presented in Table 2, but contradict somewhat the results obtained in other studies. For example, Zdenek Drabek and Warren Payne (1999) found a highly positive correlation between the ICRG index and FDI for a sample of countries, including both industrial and developing countries. The inclusion of only four African countries in their sample may explain the difference between their and our estimated results.[14]

The above results are indicative but should be interpreted with caution because of several statistical and econometric problems. There are numerous data shortcomings in most African countries.[15] For example, it would be interesting to separate how much of the FDI inflows were the result of privatisation receipts; but the data were not consistent and available for the surveyed countries over a sufficient period of time. Also, the variables used in the regressions may capture imperfectly the relationship with the business climate; for example the number of telephone lines does not always reflect the quality and costs of the telecommunication infrastructure in each country. The same problems can be associated with the illiteracy rate and the urban population. The estimated effects of GDP growth and trade openness might be biased because of causality problems since changes in the business climate may determine and be determined by the GDP growth rate. Foreign companies may simultaneously follow or push the trade liberalisation effort in a country.

To circumvent these statistical and analytical shortcomings, one could use more sophisticated econometric techniques or alternative indicators. Instead, we propose to examine more closely the experience of two individual economies – Mali and Mozambique – that have shown major improvements in their business climate during the 1990s, as shown in Table 3.[16] If, in terms of FDI growth, the performance of Mali appears less impressive, it has to be taken into account that its geographical position (landlocked and not close to the South African market) is not as favourable as that of Mozambique.

What have Mali and Mozambique been doing right? This can be hard to summarise because establishing an attractive business climate for FDI is a multi-dimensional effort. Yet, a few major actions can be identified (see Table 5 for details and chronology). First, it appears that these two countries have established a stable macroeconomic environment, at least by regional standards, for a prolonged period of time. The political climate also became secure after a period of high instability. Both countries used aggressive trade liberalisation and privatisation programmes (especially Mozambique) to attract foreign investors. The governments approved important pieces of legislation, including new Mining (1991) and Investment (1995) Codes in Mali[17] and a new Industrial Free Zone regime in Mozambique (1994). Moreover, the adoption of international treaties related to FDI helped to increase the governments' visibility in the international business community as well as provided additional insurance to potential foreign investors. Last but not least, the Presidents have played an important role in promoting their countries abroad, in the case of both Mali and Mozambique.

Table 5. Major actions in Mali and Mozambique

Area	Mali	Mozambique
• Macroeconomic stability	The macroeconomic indicators improved dramatically, as real GDP growth reached approximately 7 per cent in 1997, up from 0.6 per cent in 1990. Average annual inflation, as measured by the consumer price index for Bamako, was reduced from 12.4 per cent in 1995, to 4 per cent in 1998. Both the external account deficit and fiscal deficit were reduced, and a prudent credit policy was pursued.	The economic growth rate jumped from 4.0 per cent in 1990 to 13.3 per cent in 1997. Inflation was reduced from 70 per cent in 1994 to single digits by 1997.
• Trade liberalisation	The trade openness ratio increased from 49 per cent in 1990 to 60 per cent in 1997, with a reduction in tariffs and the elimination of several non-tariff barriers.	The trade openness ratio increased from 53 per cent in 1990 to 63 per cent in 1997. In 1996, the Government rationalised and lowered the tariff structure, averaging around 14 per cent.
• Privatisation	After a slow start, privatisation receipts reached $22 million in 1997, including the sale of several enterprises in the financial and manufacturing sectors.	Mozambique's privatisation programme is one of the most active in Africa as well: more than 900 state enterprises have been privatised, including the entire banking sector and a number of state manufacturing firms. The privatisation receipts reached $37 million in 1997.
• Focus on one/few major projects	Investment projects in the mining sector (gold) were realised by Rand Gold and Ashanti, facilitated by the reform of the Mining Code in 1991.	The development of the new $1.3 billion MOZAL aluminium smelter facility.
• Political stability	In March 1991, a series of clashes between the people and the army culminated in the arrest of the President. In January 1992, the Alliance pour la democratie au Mali (ADEMA), leading a coalition of opposition parties, established electoral dominance, while its candidate was elected President. He was recently re-elected in May 1997 for another five-year term.	The General Peace Agreement in 1992 between FRELIMO and RENAMO and the general elections that followed in 1994 were important steps towards national reconciliation and stability. FRELIMO won the first national election. The opposition, RENAMO, retains almost 45 per cent of the seats in parliament.
• Implementation of new laws and accession to international agreements related to FDI	• Mining Code (1991) • Investment Code (1995) • Multilateral Investment Guarantee Agency (1992) • Convention on the Recognition and Enforcement of Foreign Arbitral Awards (1994)	• Industrial Free Zone (1994) • Multilateral Investment Guarantee Agency (1994) • World Intellectual Property Organisation (1996) • Convention on the Settlement of Investment Disputes between States and Nationals and States (1995)

Another interesting element is that FDI inflows were triggered by the implementation of a few large projects such as the MOZAL project in Mozambique. True, those projects were initially triggered by the presence of natural resources, but they have contributed to put these two countries on the radar screen of international investors. The same argument obviously applies to privatisation.[18] As an

illustration of this multiplier effect, it suffices to look at the investment projects financed by the International Finance Corporation (IFC) – the private arm of the World Bank Group – in Mozambique and Mali over the past few years. Those investments range from projects in banking to printing and tourism, for a total commitment of $65 million and $134 million in Mali and Mozambique respectively, as of June 1998. Interestingly, the IFC's portfolio in Mozambique was the largest in Africa, while that in Mali ranked in sixth position, greater than that in Nigeria, Cameroon or Ghana. We believe that the IFC's portfolio allocation illustrates well the interest of the international private community in these two countries and the progress that they have achieved in their business climate.[19]

It is also revealing to compare Mali and Mozambique with countries such as Kenya and Cameroon, which have been much less successful in attracting FDI in spite of larger local markets and abundant natural resources (Table 1). The business indicator for the latter two countries shows that they have not been attractive, twenty-fifth and twenty-fourth respectively in 1996/1997. Indeed, these countries have not been able to focus on any of the actions that have been identified as key elements of the recent success of Mali and Mozambique. Their macroeconomic performance has been below the regional average, their privatisation and trade liberalisation efforts rather timid, there have been no major foreign investment projects, and only a few legislative changes have been implemented in recent years. Last but not least, these two countries have established a reputation of high corruption and lack of transparency.

A final word of caution might be necessary. Both countries, Mali and Mozambique, have been through a spectacular recovery during the 1990s, after several years of internal disruption and (dis)investments by foreign companies. The large FDI inflows observed in the past few years might therefore benefit from a catch-up effect in which it was relatively easy to attract investment projects during the initial recovery but that maintaining such a pace would be increasingly more difficult over time. Only a sustained effort in improving the business climate will continue to attract (foreign) investors. And, in both countries, there is still much room for improvement in areas such as infrastructure, transport costs, and human capital.

Conclusions

Countries that can offer a large domestic market and/or natural resources have inevitably attracted foreign investors in Africa. South Africa, Nigeria, Ivory Cost, and Angola have been traditionally the main recipients of FDI within the region.

Over the past decade, several African countries have attempted to improve their business climate in an effort to attract foreign companies. Establishing a competitive business climate is a difficult task because it takes time – not only to implement policies but also to convince potential investors. In the case of Africa, it is even more difficult because most countries are not even on the radar screen of most companies. In 1997, we found that Mozambique, Namibia, Senegal and Mali were perceived as the countries with the most attractive investment environments. Those countries were also able to attract substantial FDI inflows, more than countries that have bigger local markets (Kenya, Cameroon, Congo) and/or natural resources (Congo, Zimbabwe).

To improve the climate for FDI, an econometric analysis indicates that strong economic growth and aggressive trade liberalisation can be used to fuel the interest of foreign investors. Similarly, a closer look at the experience of Mali and Mozambique – two countries that have shown a spectacular improvement in their business climate during the 1990s – reveals that the implementation of a few visible actions is essential in the strategy of attracting FDI. Beyond macroeconomic and political stability, those countries focused on a few strategic actions such as:

- opening the economy through a trade liberalisation reform;
- launching an attractive privatisation programme;
- modernising mining and investment codes;
- adopting international agreements related to FDI;
- developing a few priority projects that have a multiplier effects on other investment projects; and
- mounting an image-building effort with the participation of high political figures, including the President.

Interestingly, these actions do not differ significantly from those that have been identified as being behind the success of other small countries with limited natural resources such as Ireland and Singapore about twenty years ago.

NOTES

1 See for example, Wheeler and Mody (1992); Singh and Jun (1995); UNCTAD (1998).

2 The link between FDI inflows and size could be further explored, as, for example, one might argue that there may exist a non-linear relationship between these two variables. This goes, however, beyond the scope of this paper.

3 The total value of natural resources in each country is estimated as the sum of the primary and the secondary sectors, minus manufacturing. Source: World Bank's *World Development Report* (1999).

4 See for example, Pigato (2000) for a review.

5 The assumption that both elasticities equal unity is valid for the group of African countries covered in this paper. However, if the sample is widened to include industrial countries for example, this assumption does not hold because of the large differences in GDP levels between countries (for example, United States and Burundi).

6 The good ranking of Chad and Zambia reflects that the first country offers great oil reserves (not reflected in our indicator of natural resources) that have attracted companies interested to explore those possibilities; Zambia has followed a relatively aggressive privatisation programme and liberalisation policy.

7 The 1998 ranking is incomplete because the data on FDI inflows are still missing for a few countries.

8 Unfortunately, the Competitiveness Indicator developed by the World Economic Forum is not available for most of the countries covered in this paper. However, Namibia and Mauritius were also well ranked in their 1998 ranking, but South Africa was perceived as much more competitive, while Mozambique much less than reported in this paper.

9 For example, Namibia has been traditionally perceived as a secure country, with satisfactory macroeconomic indicators, a good and reliable judiciary system and access to the large South African market. Similarly, the weak performance of Sierra Leone and Congo has been well publicised with their unstable political climate and multiple economic problems.

10 In fact, the coefficient correlation between our indicator and the ICRG and II indexes is negative for the period 1996-1997 (see more details in the next section).

11 Wheeler and Mody (1992) found that market size had a positive influence on capital expenditures by manufacturing affiliates of United States TNCs between 1982 and 1988, with an elasticity of 1.57. Elasticity for the highest-income countries was 1.86, while that for the lowest-income countries was 0.74.

12 For a good review of determinants of FDI in the African context, see Srinivasan (1999). Note that we tested additional explanatory variables to those reported in the text such as income per capita and a dummy variable for landlocked countries. However, those do not appear to influence significantly the business climate index.

13 Our findings are consistent with the results obtained by Elbadawi and Mwega (1997) in a recent regression analysis of FDI in Africa.

14 A closer look at the data indicates that the variations in the ICRG index are not large across African countries, which are all at the bottom of the ranking. The influence of the political climate on investors' decisions may only occur when there are significant differences across countries, which is the case in the Drabek-Payne sample as it includes countries such as Denmark and Sierra Leone.

15 As indicated in the previous footnote, we tested additional variables.

16 It has to be noted that preliminary indications shows that if Mozambique remained the economy with the most attractive business climate in 1998, Mali declined to seventh place in 1998 from fourth in 1996/1997.

17 See also UNCTAD and ICC (forthcoming).

18 One of the positive externalities of the MOZAL project in Mozambique has been its impact on the Government's commitment to reduce administrative barriers. For fuller details, see Wells (2000).

19 It would be worth exploring further if the IFC investments have been perceived as signals by other private investors that the business climate has been improving in the host country.

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CHAPTER III

GOVERNMENT RESPONSIBILITY: BEYOND TRADITIONAL FDI POLICIES

The Need for a Broader Policy Approach to Foreign Direct Investment,

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Introduction

Foreign Direct Investment (FDI) has long been considered an instrument of exploitation and a threat to national sovereignty in a number of countries. This attitude has considerably changed of late, however. Today it is widely recognised that FDI can act as an engine of economic growth. It is, therefore, not astonishing that most countries – whether developed, developing, or in transition – seek to attract FDI to advance their economic development. In particular, developing and transition economies are often in great need of the resources that FDI typically provides: these are, besides capital, intangible resources such as technological know-how and managerial skills.

Home and host countries all have a common interest in maximising the gains from foreign investment and, more generally, from transnational economic activities. They should, therefore, strive for a better understanding of the conditions for increasing the benefits from FDI. The objective of the international community should be to make sure that all countries can benefit from the international division of labour and the ensuing growth of the world economy. In particular, less developed and transition countries should be supported in their efforts to reap the full benefits of FDI. To achieve this aim, numerous measures have been introduced around the world.

Traditional Policies

This paper first looks at some of the well-known promotional measures, such as incentives for inward investment by host countries and supporting policies for outward investment by home countries. It goes on to discuss what a broader policy approach to FDI, one that would suit the long-term needs of host and home countries in an ever more integrating world economy, could look like.

Host-country measures

The demand for FDI has sharply increased over the last ten to fifteen years. Governments on all continents now actively compete for FDI. In order to attract their share of the limited FDI supply, host countries apply a variety of measures. These include, on the one hand, fiscal and financial incentives such as a reduction in the base income tax rate, tax holidays or government subsidisation. On the other hand, host countries also adapt their regulatory environment to suit the needs of foreign investors. They may, for example, enhance the protection of intellectual property rights; they may, however, also be tempted to relax the enforcement of labour and environmental standards.

Most of these investment incentives have undesirable effects.[1] Fiscal and financial incentives, for example, entail direct costs: expenses of US$100,000 per expected job are not unusual at all. The indirect costs of such incentives in terms of inefficient resource allocation and market distortions can

[1] cf. Charles Oman: "Policy Competition for Foreign Direct Investment", Development Centre Studies, Development Centre of the Organisation for Economic Co-operation and Development, OECD Publications, Paris 2000.

be even more important. Rent-seeking behaviour by investors, not to mention corruption and bribery, waste scarce resources while investment incentives for foreign investors may lead to discrimination and discouragement of local investors. Such distortions at the expense of domestic enterprises are particularly detrimental in view of the need for many countries to develop a diversified and expanding domestic business sector. For host countries, however, the deployment of local business is key to reaping the full growth potential of FDI.

Home-country measures

Home countries have an interest of their own to promote investment in developing and transition economies, especially in order to foster the internationalisation of their small and medium-sized enterprises (SMEs). They support private companies in their endeavours to invest in developing countries by improving awareness of business opportunities in host countries and *via* financial intermediary instruments such as venture capital, leasing or guarantee funds. In Switzerland, to give a specific example, measures have been designed to meet the needs of investors at the different stages of implementation of a project, from the first draft to its completion. Instruments include a Government-sponsored institution that provides information to interested companies, helps them in finding foreign partners and, more generally, offers them assistance during the pre-investment phase. A Study Fund also facilitates and financially supports systematic preparation of private investment projects through feasibility studies, pilot projects and risk-sharing with promoters. The guiding principle behind this policy is to widen profitable and sustainable investment opportunities in developing and transition countries that are particularly in need of FDI. At the same time, the institutions referred to assume a share of the perceived increased investment risk.

Bilateral and multilateral instruments

Unlike in the area of trade in goods and services, there exists no global institutional framework governing international investment. International investment is mainly regulated within the scope of regional agreements (integration agreements of different types) and bilateral investment treaties (BITs). Within the OECD, the Codes of Liberalisation of Capital Movements and of Current Invisible Operations together with the Declaration on International Investment and Multinational Enterprises provide a relatively comprehensive and balanced framework for international investment. In terms of investment policy, the guiding principle of these OECD instruments is the concept of National Treatment. This concept reflects the perception that in an economically interdependent world, where countries actively compete for foreign investment, it generally speaking makes no economic sense to treat foreign investors less favourably than domestic ones. All 30 OECD Member countries, as well as five non-Member countries (Argentina, Brazil, Chile, Estonia and Lithuania), already adhere to the Declaration on International Investment, while several other countries are currently undertaking steps to do so.

New Approaches

The concept of 'functioning markets'

During the 1990s, when FDI flows soared and many of the recipient countries registered amazing growth rates, the various measures taken by host and home countries did in fact seem to be crowned with success. But then, in 1997, the Asian crisis abruptly called traditional policies into question. It suddenly became clear that liberalisation and promotional measures do not by themselves guarantee sustainable economic growth and development. Many economists will argue that this insight was not new. Be that as it may, at least since the Asian crisis, it has been widely accepted that the globalisation

of markets and the removal of obstacles to trade and investment can only bear their fruits if the freed market forces are integrated into appropriate national (and international) legal and institutional frameworks. These frameworks should guarantee the rule of law, the transparency and accountability of government policies, as well as responsible corporate governance – all of which are crucial elements to ensure the long-term 'functioning of markets'.

The various elements of this concept of 'functioning markets' do not, as such, i.e. individually, represent new measures. They have to be seen as an *ensemble, a coherent set of regulatory and institutional measures that in their interplay are conducive to an enabling environment*, both for foreign investment and domestic entrepreneurship. The equal treatment of foreign and domestic investors is, as we have seen, important to no small degree for developing countries. An essential feature of the concept of 'functioning markets' is also its long-term orientation, i.e., the inclusion of *sustainability concerns.* Indeed, ignoring aspects of social and environmental viability in economic policy may, over time, also lead to market failure and disruptions in economic development. Let's now look at some of the key elements of this whole concept:

Key elements of 'functioning markets'

The rule of law and good (public) governance

What is most important in order to create and maintain the functioning of markets is the rule of law. This includes, besides basic principles of justice, an efficient judicial system to resolve disputes, and enforcement mechanisms to implement the subsequent decisions. Furthermore, it includes the setting-up of a sound legal framework for business activities in general. Basic economic freedoms, such as property rights, the right to free commercial and industrial activity, and the freedom to enter into private contracts are all essential pillars of such an economic environment based on the rule of law. On an international level, the notion of the rule of law finds its expression, *inter alia*, in the concept of good (public) governance. Apart from the rule of law, this concept also encompasses responsible government practices and the absence of corruption. There are good reasons for which, nowadays, the fight against corruption forms an important part of international economic co-operation.

Corporate governance

Modern economies with numerous transactions involving foreign countries also need sophisticated sets of norms in such fields as company law, capital market law, or contract law and bankruptcy law. The economic rationale of these rules is that they provide transparency and accountability. The Asian crisis has demonstrated how important the observance of such standards is for the stability of economic activities, and that neglecting them can destroy the fruit of otherwise promising prosperity in newly emerging economies practically overnight. Some of the principles recommended in this field are generally referred to as corporate governance. They are promoted in various forums, most prominently in the OECD. All stakeholders in companies, be it the shareholders, workers, creditors, suppliers, or the State, are interested in sound business practices in such fields as accounting, managing company finances, and dealing with human resources in order to create an environment of confidence and transparency for investment and related economic activities.

Competition law

Competition laws undeniably represent an important prerequisite for the 'functioning of markets'. They ensure the contestability of domestic markets, thereby favouring efficiency and dynamism and

working against the accumulation of rigidities and harmful oligopolistic rent-seeking behaviour. A state-of-the-art competition law constitutes one of the main pillars to guarantee equal competitive opportunities and to prevent the benefits from liberalised trade and investment from being reduced through collusive practices and abuses of dominant market positions. At an international level, we are far from asking for a harmonised universal competition law, but we recognise the need for convergence of rules and effective international co-operation. The application of multiple and often diverging national antitrust laws on the behaviour of enterprises with transnational activities, i.e., that act in a variety of markets, leads to unwholesome situations that should be avoided in the interest of economic operators as well as of the States involved.

Core labour standards

Another ingredient that, in my view, should be part of a sustainable economic order is the observance of basic labour standards. By now, this seems to be largely accepted by the participants of the world economy. In 1998, the International Labour Organisation adopted a Declaration on Fundamental Principles and Rights at Work. This instrument calls for freedom of association, effective recognition of the right to collective bargaining, the elimination of all forms of forced and compulsory labour, effective abolition of child labour, and the elimination of discrimination with respect to employment and occupation. I would like to particularly stress the importance of the freedom of association and of the right to collective bargaining. Freedom of association not only creates the basis for a good relationship between employers and employees – which in turn constitutes an important pillar of social stability, but also fosters transparency and accountability, thereby constituting an important prerequisite for public and corporate governance. In addition, freedom of association and the right to collective bargaining guarantee that employees partake in the fruits of economic liberalisation and new technologies, thereby indirectly fostering higher labour productivity.

Protection of the environment and sustainability

An essential element of long-term 'functioning markets' at national and international levels is the protection of our environment and, in particular, our shared global heritage. The fact that we all share the same environment leads to the inevitable need for co-operation among nations to promote sustainable growth and prevent the degradation of the global environment. In this context, let me point to a particular issue in the discussion on international investment. There already exist international instruments that prohibit – or at least discourage – the lowering of environmental standards with a view to attracting FDI. Provisions to that effect would also have been, by the way, an important ingredient of the Multilateral Agreement on Investment (MAI) that was negotiated during the late 1990s. Debates on how such standards can be integrated into existing OECD instruments are continuing.

The role of international co-operation

Most of the policies described above have to be designed and implemented on a national level, particularly because existing international structures would be far too weak to secure their effective enforcement. National policy and lawmakers need, however, the support of the international community. With a view to the integrating world economy, it is crucial that measures be co-ordinated on an international level. This does not imply that national laws have to be identical – nevertheless, a certain functional equivalency of national rules is essential; to achieve this aim, a minimal international consensus on common values is indispensable.

The various issues related to the concept of 'functioning markets' are tackled in many international forums, *inter alia*, the OECD, the Bretton Woods Institutions, the United Nations and the WTO. I would like to take this opportunity to emphasise the pace-setting role of the OECD in the investment field. From its earliest days, Member governments have used the Organisation as a mechanism for systematically reducing the extent of their restrictions on international capital flows of all kinds. But, more importantly, the Organisation has never limited its activities to mere liberalisation. The OECD has always adopted a much broader approach. Over the years, it has made a unique contribution to the study and understanding of the economic effects of FDI on the world economy. It has also worked extensively to manage the effects of globalisation through the development of rules and the encouragement of best practices, thereby dealing with important issues such as good public or corporate governance, the behaviour of multinational enterprises, or corruption and bribery. All in all, the OECD has developed a fairly comprehensive and balanced framework to improve the international investment climate and to encourage the positive contributions multinational enterprises can make to economic, social and environmental goals. The various OECD instruments are widely accepted and oftentimes even taken up in other forums, such as the United Nations and the World Bank.

International co-operation should not only involve governments, but also multinational enterprises (MNEs). While governments need to provide an appropriate regulatory framework for investment, it is also important that MNEs conduct themselves as good corporate citizens. Especially in recipient countries, where rules and institutions do not yet allow for long-term sustainable development and stability of liberalised markets, MNEs should make their contribution to 'functioning markets'. They should, for instance, avoid individual corporations gaining undesirable competitive advantages by sidestepping or ignoring international labour or environmental standards. One important instrument towards this goal is the OECD Guidelines for Multinational Enterprises. This subject deserves further discussion, and is the subject of another presentation during this Conference.

Final remarks

Traditional policies and measures for attracting or promoting inward investment can, at the utmost, play a complementary role. They do not by themselves attract (sustainable) FDI. We should always bear in mind that investors make their investment decisions on the basis of economic considerations! In other words, FDI tends to flow to countries where investors can expect a reasonable return on capital. And such returns depend primarily on market opportunities, along with sound economic policies and a legal framework that is transparent and predictable. In other words, they depend on 'functioning markets'.

To conclude, let me reiterate that instead of concentrating on measures that are at the most second-best options, countries should focus their endeavours on shaping a pro-business environment in recipient economies and on improving the long-term functioning of markets – a concept that, as we have seen, also takes into account sustainability concerns. How can this concept be turned into effective action? What is needed above all are *new partnerships* between host and home countries – which should possibly also involve multinational enterprises and civil society groups – with a view to contributing to the capacity building efforts in recipient economies.

This first Conference under the auspices of the OECD Global Forum on International Investment could be a significant step towards this goal.

Foreign Direct Investment In Developing Countries: Determinants And Impact,

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Introduction

Perhaps much more has been written on Foreign Direct Investment (FDI) in the development process than any other aspect of development.[1] This should be of little surprise; the characteristics of FDI, its rapid growth, and pivotal role in the process of globalisation in recent years, its intimate relationship with trade, and its historical antecedents have all attracted the attention of economists, political scientists, economic historians, and in recent years, management specialists and anthropologists. The principal characteristic of FDI, which sets it apart from other sorts of international capital flows, is the control over operations exercised by the investing entity over the investor entity. Ownership of equity and, more importantly, command over technology and know-how enable firms to exercise control over operations. It is control over operations that enables foreign firms to transfer technology and know-how to the recipients of FDI. And FDI is a potent instrument of development because of its ability to transfer technology and skills to developing countries.

Several developments in the global economy since the decade of the 1980s have softened the opposition to FDI and rekindled faith in its ability to promote development. Indeed, suspicion and distrust of foreign firms seems to have yielded place to a new-found faith in their ability to promote growth and development objectives. A number of factors have influenced this change in attitudes including increased familiarity with the operations of MNEs, reduced flows of alternative sources of finance such as bank credit and foreign aid, and the demonstrable success of several developing countries with FDI. Further, the information technology revolution has wrought dramatic changes both with respect to the channels through which technology and know-how is transmitted and its impact on the technology absorptive capacity of host entities.

Thus, although voices of dissent and opposition to FDI continue to be heard, principally from the critics of Globalisation (Noorena Hertz, 2001), the challenges facing policy-makers in developing countries are now of a different order than those during the decades of the 1960s and 70s. Briefly put, the challenge is how best to attract substantial volumes of FDI and utilise it effectively in the promotion of development objectives. Effective utilisation of FDI involves not only maximisation of the benefits of FDI but also minimisation of its costs, for FDI is not without its social costs. One of the enduring worries of host countries with FDI is the exercise of control over decision-making by foreign firms. The recent growth in mergers and acquisitions (M&As) – as opposed to greenfield investments – of locally owned firms has heightened these worries. By definition, acquisitions involve the take-over of existing locally owned firms by foreign firms, and the surrender of control over operations by the former to the latter.

This paper addresses two interrelated issues of concern to developing countries: factors that determine FDI flows and the preconditions for the efficient utilisation of FDI in the development process. Section 2 of the paper discusses the principal determinants of FDI. Section 3 analyses the necessary pre-conditions for the efficient utilisation of FDI in the development process. Section 4 identifies issues for further discussion.

Determinants

The extant theoretical and empirical literature on determinants of FDI yields the following broad propositions.[2]

- Host countries with sizeable domestic markets, measured by GDP per capita and sustained growth of these markets, measured by growth rates of GDP, attract relatively large volumes of FDI.

- Resource endowments including natural resources and human resources are a factor of importance in the investment decision process of foreign firms.

- Infrastructure facilities, including transportation and communication networks, are an important determinant of FDI.

- Macroeconomic stability, signified by stable exchange rates and low rates of inflation, is a significant factor in attracting foreign investors.

- Political stability is conducive to inflows of FDI.

- A stable and transparent policy framework towards FDI is attractive to potential investors.

- Foreign firms place a premium on a distortion-free economic and business environment.

- Fiscal and monetary incentives in the form of tax concessions do play a role in attracting FDI, but these are of little significance in the absence of a stable economic environment.

- Regional groupings and preferential trading arrangements between prospective recipients of FDI may induce increased inflows.

- Foreign direct investment that enables investor entities to exercise control over operations is the preferred method of foreign enterprise participation for most investors. Licensing agreements and joint ventures are usually exceptions dictated by exceptional circumstances.

These propositions, some of which may overlap others, are anchored in theoretical insights and a variety of statistical studies. Here we comment on some of the significant propositions, without engaging in an exhaustive review of the literature.

Size of Markets

Size of markets and sustained growth of markets are an obvious attraction to profit-maximising firms. Most statistical studies on the determinants of FDI in developing countries attest to the importance of market size.[3] (Balasubramanyam and Salisu 1991, Dunning, 1973, Agarwal. 1980) The theory underlying this proposition is that firms that possess advantages such as a new technique of production or even a well-known brand name (known in the literature as ownership advantages) require sizeable markets both at home and abroad in order to maximise returns to their investments in generating the unique advantages they possess. Although markets abroad can be serviced through exports, tariffs and trade restrictions may be a barrier to exporting. In addition, the physical presence of the firm in the

market facilitates the acquisition of market intelligence. Investments that are attracted to host countries because of the size of markets are known as market-seeking investments (Dunning, 1993).

It should be added that not all FDI is domestic-market oriented. There are also export-market oriented investments both in relatively large countries such as China, and small economies such as Mauritius. The attraction of these countries for foreign firms is their resource endowments – including cheap but efficient labour. Investments that seek such endowments are referred to as resource-seeking FDI (Dunning, 1993). Yet another variety of FDI, referred to by Dunning as efficiency-seeking FDI, may also respond to relatively low wage costs in developing countries. Efficiency-seeking investments consolidate and rationalise market-seeking and resource-seeking investments that companies may have undertaken in the past. Such investments may result in an international division of labour, with capital-intensive segments of the production processes and products located in the developed countries and the labour-intensive processes and components located in the developing countries. In some cases FDI may be undertaken in locations with cheap labour for the assembly of components and parts. It should be noted that in these types of labour-seeking investment it is not just low wage costs, but it is the efficiency wage or low wages coupled with relatively high productivity that counts in the investment decision process of foreign firms.

Infrastructure

The significance of infrastructure facilities as a determinant of FDI needs no elaboration. Infrastructure facilities are to be defined broadly in this context to include not only transportation and communications but also a favourable environment for work and leisure. These are vital for any type of investment be it foreign or domestic. Illustrative in this context is the experience of India's software industry. While the industry requires little by way of transport facilities, the firms in the industry are dependent on satellite facilities for exporting their wares. In addition, one of the often-cited reasons for the clustering of software firms, including foreign-owned firms, in the south Indian city of Bangalore is the ambience of the city, with excellent facilities for school level education, and sports and recreation facilities (Balasubramanyam and Balasubramanyam, 2000).

Macroeconomic Stability

Low inflation rates and stable exchange rates are important determinants of FDI for more reasons than one. First they attest to the stability and the underlying strength of the economy. Second, they provide a degree of certainty relating to the future course of the economy and impart confidence in the ability of firms to repatriate profits and dividends. Weak economies with high levels of domestic borrowing and debt, measured by the ratio of budget deficits to GDP and total volume of borrowing to GDP, are often compelled to institute exchange controls and controls on the capital account of the balance of payments. Third, more often than not a stable macroeconomic environment also implies a stable political environment. Political and economic stability are usually intertwined (Balasubramanyam and Salisu, 1991).

Product and Labour Market Distortions

One of the most significant determinants of FDI is a distortion-free economic environment. Admittedly, a stable macroeconomic environment presupposes a distortion-free environment. A distortion-free environment, however, has specific implications for trade and investment policies. Distortions in product and factor markets are said to occur when product and factor prices deviate from their true social opportunity costs. For example, wage rates for labour in the manufacturing

sector may exceed earnings in an alternative occupation such as agriculture. Again, domestic-market prices for goods and services may exceed those for comparable imports, and prices for exportables may be lower than that for comparable goods sold on the domestic markets. These distortions are mostly policy induced, in the sense that minimum wage policies and restrictions on imports in the form of quotas and tariffs and subsidies for exports serve to distort market prices away from their true social opportunity costs.

A predictable consequence of such distortions is the misallocation of resources and investments away from sectors and activities in which the country possesses a competitive advantage. Such distortions also have an impact on the volume of FDI host countries are able to attract. For a long time it was the received wisdom that restrictions on imports in the form of tariffs and quotas would induce increased flows of FDI. This belief is based on the proposition that trade and capital flows are substitutes for one another and a restriction on trade would induce firms to invest in the protected markets (Mundell 1957). Recent research, however, suggests that trade and FDI complement one another and need not necessarily be substitutes (Greenaway and Milner, 1988). Furthermore, countries with a distortion-free market environment, free of policy-induced incentives and restrictions, tend to attract relatively larger volumes of FDI than distortion-ridden economies. Jagdish Bhagwati of Columbia University gave a precise enunciation of this proposition when he argued that:

> "With due adjustments for differences among countries for their economic size, political attitudes towards DFI and political stability, both *the magnitude of DFI inflows and their efficacy* in promoting economic growth will be greater over the long haul in countries pursuing the export promotion (EP) strategy than in countries pursuing the import substitution (IS) strategy" (Bhagwati 1978).

Several features of Bhagwati's hypothesis are noteworthy. The first of these is the reference to the trade policy framework of countries that are host to FDI. The inward-looking IS strategy, pursued with vigour until recently by countries such as India, is exemplified by tariffs and quotas on imports, and in many cases restrictions on spheres of activity and volumes of investment by both domestic and foreign investors. Quite often, IS regimes are also characterised by subsidies on exports, a sort of second-best policy to promote exports, but the protection from import competition afforded to import substituting industries exceeds the incentives for exports provided by subsidies. The policy orientation of EP regimes, as defined by Bhagwati, is its neutrality. In other words, the policy regime favours neither the production of import-substitutes nor exportables; on average, tariffs on imports match the subsidies on exports. Resource allocation in an EP regime would be dictated by market forces and the dictats of comparative advantage as opposed to the policy-induced investments in the IS regime. In general, EP regimes tend to be relatively free of policy-induced distortions.

Tariffs on imports do attract FDI into protected industries, but ultimately it will not be as large as that attracted by EP regimes. This is because incentives offered by the IS regime tend to be artificial, in the sense that they are often designed to compensate for the lack of location-specific advantages, and their continuation is subject to the whims of the policy-makers. Foreign firms wary of unexpected policy changes are unlikely to commit large volumes of FDI in IS countries. And FDI that is attracted by restrictions on imports, the tariff-jumping variety of FDI, is likely to be transient, lasting as long as the artificial policy-induced incentives. Statistical evidence in favour of these propositions is robust (Balasubramanyam and Salisu 1981, Balasubramanyam, Sapsford and Salisu, 1996).

Incentive Schemes

Apart from trade policies, most developing countries offer a variety of subsidies to foreign firms. These include tax holidays, tax concessions, and exemptions from duties on imports of parts and

components and export duties. The ubiquitous export-processing zones found in most developing countries are also designed to attract FDI. It is doubtful if these incentives weigh heavily in the investment decision process of foreign firms. The evidence on the issue is not conclusive. (Guisinger, 1986). Developing countries may be compelled to offer such incentives only because their competitors for FDI offer them. If none of the countries offer such incentives, the location decision of FDI would be based on the resource endowments of host countries and the climate for efficient operations they provide. Most such incentives are tied to performance requirements of one sort or the other. Given the nature of these incentives and the fact that each of the host countries offer such incentives only because others do so, it is likely that they are yet another source of distortions in the market for FDI.

Integration Schemes

Much is written on the impact of regional integration schemes and preferential trading arrangements on FDI, mostly in the context of the EU and the NAFTA. While the impact of such arrangements between developing countries on FDI is yet to be investigated in detail, there is little reason to argue that integration schemes *per se* induce increased flows of FDI. In general, integration schemes allow for free trade between member countries, but restrict imports from third countries. The free trade element serves to enhance the size of markets, while the tariff element impedes imports from third countries into the region. Both these effects are likely to induce increased inflows into the region. The received wisdom, though, is that the market-enlargement effect is much more significant than the tariff effect in inducing increased flows of FDI. Furthermore, it is policies designed to eliminate distortions and liberalise trade and investment, which often either precede or accompany integration arrangements, that are likely to induce increased flows of FDI. Integration *per se* may have little effect on the volume of FDI members of integration schemes are likely to attract (Blomstrom and Kokko, 1997). Here again, the factors of significance in attracting FDI are liberalised trade and investment regimes, and the removal of product and factor market distortions.

Methods of Foreign Enterprise Participation

In the past, several developing countries, such as India and Brazil, attempted to have their cake and eat it too. Technology-licensing agreements with foreign-owned firms and joint-ventures were seen as methods of importing technology and know-how without at the same time yielding control over operations to foreign entities. The characteristic feature of licensing agreements is the absence of ownership of capital on the part of foreign firms and hence control over operations. Foreign firms entering into such agreements with locally-owned firms provide management services, technical information or both, in return for an agreed upon fee and royalties. Although seemingly attractive to both parties, licensing agreements pose a number of organisational problems, most of which arise from the imperfections in the market for knowledge.

First is the ever-present threat of imitation and loss of monopoly over rent-yielding advantages firms possess. Knowledge is a public good in the sense that once produced the volume of it does not diminish with use. It can be replicated at very little cost, in other words the marginal cost of replicating knowledge is far below the average cost of producing it. Second, there are problems associated with the pricing of technologies; purchasers of technology would be reluctant to name a price in the absence of information on its nature and characteristics, and sellers would be loath to impart such information lest they lose their monopoly over their assets. Third, most complex technologies cannot be effectively transferred in the absence of involvement in operations through asset participation and managerial control on the part of the owners of technology.

In the face of these and other market imperfections, FDI is the preferred option for the exploitation of the rent-yielding advantages firms possess. Most theoretical explanations for the birth and growth of MNEs are cast in terms of market imperfections (Buckley and Casson, 1991). MNEs overcome such imperfections by internalising operations from production to sales, i.e. by forging backward and forward linkages. They effectively by-pass the market as it were, and confine operations to the internal bureaucracy of the firm.[4] It is sufficient to note here that in general, FDI is the preferred method of foreign enterprise participation for most firms.

FDI is undertaken either through greenfield investments or through M&As. Although M&As are a phenomenon of significance in the developed countries, around one third of FDI flows to developing countries in recent years is an account of acquisitions (UNCTAD, 2000). Much of these acquisitions are in Latin America, followed by East Asia. While privatisation programmes account for the growth of acquisitions in Latin America, the East Asian ones are a result of the financial crisis in these countries. As stated earlier, M&As have heightened developing country worries concerning surrender of control over operations to foreign firms. They also pose interesting issues concerning their efficacy in promoting development objectives relative to greenfield investments.

While we discuss their implications for efficacy in section 3, M&As also have an impact on the volume of FDI countries are able to attract. It is often argued that M&As, as opposed to greenfield investments, result in very little new investments, only a transfer of ownership of existing assets from locally-owned firms to foreign-owned firms. This may be fallacious for two reasons. First, moneys paid by the foreign firms to the locally-owned firms may be invested elsewhere in the economy by the latter. Second, the essence of FDI is the technology and know-how it transfers to the host economy. And most, though not all, locally-owned firms that are acquired are ailing firms, on the verge of bankruptcy, which require the infusion of technology and managerial know-how if they are to survive.

The concern relating to control over decision-making arises in the case of both greenfield investments and acquisitions. But in the case of acquisitions control is surrendered by the locally owned entities to the foreign firms, and it is this sense of having to surrender something that one owned that arouses antipathy to acquisitions. It is, however, worth noting that relatively liberal policies governing acquisitions do not necessarily attract large volumes of FDI. Foreign firms acquire local firms mainly because of the relatively easy access to assets of one sort or the other, including marketing channels and R&D facilities. In the absence of assets, which can be restructured and refined, acquisitions are unlikely to materialise.

Attitudes and Business Environment

The list of determinants of FDI discussed here may seem exacting, but they are not insuperable. Most of the determinants of FDI are policy-driven. Admittedly, resource endowments, including natural resources and labour, are beyond the control of policy-makers. But not all FDI is of the resource-seeking variety, and labour can be trained and organised through appropriate education and training policies. The most significant determinants of FDI, which are amenable to policy, include the institution of distortion-free product and factor markets. These can be achieved, as several developing countries in East Asia and elsewhere have demonstrated, through openness to trade and investment, and abolition of domestic policies that impede competition in the market place. Another important determinant of FDI is transparency and stability of policies towards FDI. Frequent changes in policies relating to the spheres of activity of foreign firms, fiscal and exchange-rate policies are unlikely to inspire confidence in the stability of the host economies on the part of foreign firms.

Facts and figures on the volume and pattern of FDI in developing countries reflect the significance of the determinants discussed here. The volume of FDI flows to developing countries has increased

substantially over the years (Table 1). Several factors referred to earlier have contributed to the observed growth of FDI. Those which rank high among these factors are a dramatic change in attitudes towards private enterprise participation in general and FDI in particular, growing familiarity with the operations of MNEs and most importantly, the embrace of liberal trade and investment policies by most developing countries. Even so, FDI continues to be the preserve of a select few developing countries. Much more than 65 per cent of the total stock of FDI at the end of the year 2000 was in no more than eight developing countries (Table 4). The picture does not alter much even after the economic size and other attributes of host countries are taken into account.

Most of the high achievers in the FDI stakes are also high up in the growth and income league tables. Arguably, FDI itself may be one of the factors that have contributed to their growth. Even so, FDI has to be accumulated over the years to reap its rewards in the form of technology, know-how, and contribution to trade. There could be little dispute that, apart from the infrastructure facilities they provide, it is the business environment in these countries that has enabled them to attract relatively high volumes of FDI. Business environment is many faceted; it includes not only attitudes towards foreign enterprise participation but also the quality of the bureaucracy and its ability to implement policies, the structure of incentives, efficient financial and legal institutions, and a stable macroeconomic environment. Admittedly, these are characteristics of relatively rich developing countries and the developed countries.

Even so, many of these factors are policy driven. Instituting the sort of policies conducive to an attractive business environment, however, is fraught with problems. Institution and development of a stable and attractive business environment is contingent upon what is referred to as the three Cs-Commitment, Competence and Consensus (*The Economist*, 1992). Top-level policy-makers must be committed to instituting liberal trade and investment policies, the bureaucracy must be capable of implementing the policies, and there should be a consensus between various interest groups. Of the three, commitment and consent may be the most difficult, as most developing countries have the competence to institute the relevant policies.

Local business interests, politicians and bureaucrats, and the elite or the opinion makers in the host countries may not always consent to the sort of policies required to attract high volumes of FDI. In this context the contrasting experience of China and India is instructive. China has successfully attracted substantial volumes of FDI compared with its equally populous neighbour India. Average annual inflows of around $2 to $3 billion of FDI that India has attracted in recent years pales into insignificance compared with the $40 billion China has attracted (Table 5). Perhaps China is able to attract high volumes of FDI because policy-makers are not constrained by lack of consensus, they are able to impose consensus rather than seek and promote it. It is also likely that distrust and suspicion of FDI is much less of a problem when more than three-quarters of FDI flows are from the Chinese Diaspora resident in neighbouring Asian countries. The battery of incentives afforded to foreign firms in the eastern coastal regions of China, including the export-processing zones, and a faith in the ability of FDI to promote trade and incomes suggests a high degree of commitment to liberal FDI policies. (Wei and Liu, 2001)

India, too, liberalised its trade and FDI regime in 1991. Although India's average tariff rates continue to be as high as 35 per cent, there has been a considerable loosening up of tariffs on a variety of intermediates and components and the domestic industrial licensing system has been abolished. India has also watered down its objections to majority equity participation by foreign firms, and has attempted to streamline the foreign investment approval process. All this suggests commitment. Even so, the volume of FDI in India is relatively low. India has yet to erase its traditional image of hostility to private enterprise and FDI. Policy pronouncements may be ineffective in the face of opposition from the elite and opinion makers, powerful lobbies, and reluctance to implement agreed-upon policies by the bureaucracy. The much-publicised problems associated with the Enron power project

in the State of Maharashtra are illustrative in this context. Attitudes towards FDI apart, India's stringent labour laws, cumbersome procedures for approval of foreign investment projects notwithstanding protestations to the contrary, and political exigencies which compel the party in power to cater to entrenched interest groups, are all factors contributing to the low volumes of FDI India has attracted.

It is also to be noted that piecemeal liberalisation efforts may not be successful in attracting FDI. For instance, a reform package that liberalises the foreign trade regime but leaves factor-market distortions untouched, as in the case of India, may be of little attraction to investors. A liberalised trade regime may encourage competition in the market place, but faced with labour legislation which restricts hiring and firing of labour, foreign firms may opt to service the market through exports from their home base rather than through FDI. In sum, promotion of a business environment conducive to foreign enterprise participation requires not only competence but also commitment and consensus; a configuration of the three is not easily achievable.

Efficacy of FDI

High volumes of FDI alone do not contribute to the social product. Needless to say, the contribution of FDI to growth and development objectives, including dissemination of technology and know-how, promotion of trade, and employment creation, is conditional upon its efficient utilisation. In many cases, the private rates of return to investments made by foreign firms may exceed their contribution to the social objectives of the host countries. Here again, it is the policies of the host countries and the business environment they provide that influence the outcome. In general, the preconditions necessary for attracting FDI are also the ones that determine its efficacy in promoting growth and development objectives. The principal propositions concerning the efficacy of FDI can be grouped into two: those that are anchored in trade theory and those embedded in growth theory, principally the endogenous growth theory (Romer 1990, Lucas 1988). Here we identify the principal propositions.

1. FDI is not a panacea for the development problem; it is a catalyst of growth and development.

2. The type of trade policy regime in place influences the allocative efficiency of FDI.

3. Competition in the market place is an essential precondition for the effective utilisation of FDI.

4. Incentive packages and various sorts of regulations imposed on foreign firms may not always be conducive to the efficient operations of foreign firms.

FDI is not a panacea for the development problem, it is a catalyst of growth

As discussed earlier, FDI is attracted to locations with a developed infrastructure and endowments of cheap but efficient labour. Foreign firms seek resources that can be combined with the ownership advantages they possess. In the process, they augment and develop host-country resources. They build upon the endowments in host countries in their bid to maximise the rent-yielding advantages they possess. FDI is thus most effective in the presence of co-operant factors.

This insight, though not a revelation, we owe to statistical studies of the impact of FDI on growth rates of host countries (Blomstrom, Lipsey and Zejan 1995, Balasubramanyam, Sapsford and Salisu 1999). The statistical studies suggest that a threshold level of human capital needs to be in place in host

countries before the growth-enhancing effects of FDI can be unleashed. Such a threshold level of human capital is to be found mostly in the more developed amongst the developing countries And it is for this reason, statistical studies suggest, that FDI is most effective in promoting growth in countries which have achieved a threshold level of development.

The explanation for these observations is that countries host to FDI must be capable of absorbing the technology imparted by foreign firms, a process that may also entail restructuring imported technologies to suit local factor and product market conditions. Profit-maximising firms would neither be willing nor able to undertake the substantial investments in establishing infrastructure facilities and initiating education and training programmes. They would, however, build upon that which already exists.

Threshold levels of human capital may, however, exist in specific segments and sectors of economic activity even in relatively poor countries. FDI can be socially efficient in these sectors provided it is afforded a distortion-free business environment, unencumbered by restrictions and regulations. An excellent example of such FDI is foreign investment in India's software sector, which consists of both wholly foreign-owned subsidiaries and joint ventures. Here, the resource sought by foreign firms is not unskilled labour, but skilled labour proficient in the production of software. And for the most part such investments are export oriented. They are designed to exploit the genuine comparative advantage India possesses in the production of software. The managerial and marketing skills foreign firms provide assist the country in exploiting its human capital endowments, a result of past investments in education. Apart from the technology embodied in the computer hardware they import, foreign firms also transmit what is termed as tacit knowledge or human skills. The mix of the two depends on their size and market orientation (Siddharthan and Nollen, 2000). Diffusion of such skills in the economy takes place with the frequent movement of software engineers from one company to the other, and also when they opt to set up their own companies.

Trade Policy Regimes and Efficacy of FDI

The main contribution of standard theories of international trade is that free trade is a positive sum game; it confers gains on all the trading partners. The gains are twofold: specialisation gains and exchange gains. The former arise from the allocation of resources and specialisation in production based on comparative advantage of the trading countries, and the latter from an opportunity to trade at a set of prices different from that in autarchy. Standard trade theories also demonstrate that in general, policy-induced interference in free trade in the form of tariffs and quotas on imports would result in a misallocation of resources and loss of efficiency gains from trade. Resources will move from the production of exportables into the protected and the relatively profitable importables.

Restrictions on imports may, however, induce inflows of foreign capital, including FDI, into the production of importables. The issue, then, is whether or not such tariff-jumping variety of FDI is socially efficient from the point of view of the host countries. The consensus on the issue is that whilst such tariff-jumping FDI may be profitable from the point of view of the foreign firms it may not be socially profitable for the host country. Foreign firms would enjoy markets sheltered from import competition and reap substantial rewards for their investments. The host country, however, would lose because of a) the presence of FDI in areas of activity in which it does not possess comparative advantage b) protection-induced misallocation of domestic resources away from lines of activity in which it enjoys a comparative advantage, and loss of specialisation gains from trade c) payment of profits to foreign-owned factors of production. In general, tariff-induced inflows of FDI would restrict growth (Bhagwati, 1973).

Admittedly, FDI in the import-competing industries may contribute to skill formation and technological change. But these sorts of dynamic gains from FDI are uncertain. Foreign firms would have little incentive to invest in the development of skills and technology in the presence of highly profitable markets, sheltered from international competition. FDI can generate dynamic advantages only in the presence of an appropriate climate for investment, which is free of factor and product market distortions. In the presence of sheltered markets and tariff-induced distortions, foreign firms may rest content with tried and tested technologies and evince little interest in promoting managerial efficiency. The technology they transfer to the import competing industries may not suit the factor endowments of the host country, for it would be in industries in which the country does not posses a comparative advantage. Several statistical studies endorse the proposition that the tariff jumping variety of FDI not only results in the importation of technologies that are not appropriate to the factor endowments of host countries, but also results in social rates of returns which are well below the private rates of returns to foreign investors (Lal 1975, Balasubramanyam 1973). In other words, the country would have been better off importing the products than making them at home with the tariff-jumping variety of FDI.

A number of statistical studies have investigated the comparative export performance of locally-owned and foreign-owned firms and spillovers of technology and skills from foreign-owned firms to locally-owned firms, in countries such as Morocco, India and Mexico (Kumar, 1990, Haddad and Harrison, 1993, Blomstrom and Persson, 1983, Blomstrom and Kokko, 1998). While these studies yield a mixed bag of conclusions, it is fair to say that in the presence of protected domestic markets and the absence of effective competition, both the export performance of foreign-owned firms and spillover effects tend to be low.

In general, FDI that exploits the innate comparative advantage that host countries possess contributes to efficient resource allocation and specialisation and trade. This is not to say that the only socially efficient variety of FDI is of the trade promoting variety. It is just that comparative advantage and market forces free of policy-induced distortions should guide the allocation of FDI between import-competing activities and export-promoting activities. This is the message of Bhagwati's hypothesis, referred to earlier, which argues that FDI is much more efficacious in EP countries than in IS countries. Note that the hypothesis does not rule out production by foreign firms for the domestic market, provided that distortion-free market forces guide such investments. Statistical evidence in support of this proposition is robust (Balasubramanyam, Sapsford and Salisu, 1966).

Competition in the Market Place and Efficacy of FDI

The foregoing discussion has centred mainly on the static or allocative efficiency in the presence of FDI. Much more significant are the dynamic benefits FDI can confer on host countries. Such dynamic benefits, which can shift the growth path of host countries on to a new trajectory, include spillovers of production technology and know-how from foreign-owned firms to the rest of the economy, production of new knowledge and product innovations with investments in research and development. Growth theory, in its recent incarnation, referred to as the endogenous growth theory, provides rich insights into the sort of dynamic benefits FDI can provide and the preconditions necessary for the generation and dissemination of such benefits. There are two issues of concern here: what are the factors that contribute to the generation of new knowledge, broadly defined to include technology, managerial know-how, and labour skills, and what are the factors which promote the diffusion of such knowledge from the producers to the rest of the economy.

In the traditional literature technological change is usually assumed to be exogenous. In other words, there are no specific explanations for its generation and diffusion. Furthermore, there is an assumption that increased investments in capital formation meet with diminishing returns to capital. The so-called

endogenous growth theory contests these propositions. Technical change can be endogenous in the sense that firms compete with each other on the basis of new cost-reducing methods of production and innovations designed to produce new and differentiated products. Those in the lead capture markets and retain their market shares until imitators of their products and processes appear. The emergence of competition spurs renewed research and development efforts. Technical change is associated not only with physical capital but also human capital.

Learning by doing, learning by doing what others are doing, and investments in education all contribute to the growth of productivity of labour. Now if labour productivity increases *pari passu* with investments of capital per unit of labour, diminishing returns to capital will be arrested. Noteworthy here is the role of competition in the market place that spurs investments in knowledge creation. It is competition and its threat to the monopoly over advantages that firms possess that compels them to create new knowledge. It is the necessity to keep one step ahead of competitors that promotes investments in R&D and innovations. These observations hold true of foreign firms in developing countries too. Competition from imports and from locally-owned firms provides the incentives for foreign firms to generate new knowledge.

It is again competition that serves to disseminate or diffuse technology and know-how. Knowledge once produced is non-rivalrous, in the sense that the use of it by one entity does not preclude others from using it. Rivals can imitate technology, human capital or skilled labour may move between firms, and knowledge can be diffused through various sorts of linkages between firms. Foreign firms may establish locally-owned suppliers of components and parts and impart the technology and know-how required to produce such components. This they may do either because such sub-contracting of the production of components is cost effective or because of host-country initiatives in establishing such sub-contractors (UNCTAD 2001).

An illuminating early case study of a multinational enterprise in India provides evidence of diffusion of technology and know-how through linkages between the MNE and local suppliers. As the study states "these inter industry linkages also entail a variety of other relationships whereby skills, technological information and capital are transferred, production co-ordination is achieved in uncertain and narrow markets, and prices are negotiated when free competition is not feasible " (Lall, 1983). These sorts of technology diffusion, the study reports, were found to occur even in the protectionist environment in India in which the MNE was operating. Effective competition in the market place would no doubt have sharpened and extended such linkages.

It is also worth noting that while individual firms may meet with diminishing returns to investments in knowledge creation, diffusion and spillovers of knowledge may serve to promote productivity and efficiency at the level of the aggregate industry and the economy. Insights derived from the new growth theory endorse the dynamic benefits FDI is capable of generating, but the precondition for the generation and diffusion of knowledge on the part of foreign firms is effective competition in the market place. It should be added that spillovers of knowledge or externalities from FDI do not materialise automatically. Apart from effective competition in the market place, appropriate policies for the dissemination of knowledge and its absorption by the recipients have to be instituted. These include provision of information on the sources of know-how, investments in education and training of labour, efficient financial institutions that can provide resources for potential suppliers of components and parts to foreign firms, and government support as opposed to needless intervention.

The Policy Framework and Efficiency of FDI

In most developing countries FDI is subject to an array of rules and regulations. There are also a number of incentive schemes including tax exemptions, tax concessions and various sorts of subsidies

designed to attract FDI. These are collectively referred to as Trade Related Investment Measures (TRIMS). Export Processing Zones (EPZS) also known as Free Trade Zones (FTZS) to be found in most developing countries can also be included under this heading. Firms located in these zones are allowed to import equipment and parts free of import duties, and exports from the zone are also exempt from export duties. They are trade-related as they impact on international trade at one remove or the other. For instance, Local Content Requirements (LCRS) that stipulate that foreign-owned firms should source a specific proportion of their components and parts from local resources would restrict imports. Again, the requirement that foreign-owned firms should export a certain percentage of their exports if they are to enjoy majority ownership of equity also has an impact on trade.

These measures are supposed to serve several objectives – garner the maximum possible benefits from the operations of foreign firms to the host countries, satisfy the desire of bureaucrats to retain power and control, provide local businessmen a complementary role in the operations of foreign firms and in some cases protect them from foreign competition. In other words, these measures ostensibly allow host countries to exercise economic sovereignty over the operations of foreign firms. In some cases TRIMS are also designed to offset policy-induced distortions elsewhere in the economy. Export subsidies and equity regulations tied to exports are an attempt to offset the attractions of a protected domestic market, so too are the EPZS pervasive in developing countries.

An extensive body of literature has analysed the impact of these measure on the productive efficiency of foreign firms and their welfare consequences for the host countries (Greenaway 1991, Balasubramanyam 1991, UNCTAD, 2001). Although there is a case for the regulation of FDI, the impact of these measures on the economic welfare of host countries is at best uncertain and at the worst negative. For instance, in the absence of cost-effective suppliers of components, LCRS may increase the costs of production of foreign-owned firms and reduce efficiency. Foreign firms may react to such regulations by withdrawing their investments and servicing the host-country markets through exports. If they do continue with their operations they may pass on the increased costs to consumers through higher prices for the products they sell. LCRS imposed on export-oriented foreign firms may impair their efficiency and price competitiveness in international markets. For instance, exports of foreign firms in the automobile sector of India are reported to have increased substantially following the liberalisation of imports of automobile components in the year 1991 compared with their performance when they were compelled to rely on domestic sources (Narayanan, 1998).

TRIMS such as those which tie equity participation to exports, are equally problematic. These are imposed for narrow balance-of-payments reasons and not for broader development objectives. In the presence of distortion-free markets, comparative advantage and market forces would guide the investment allocations of foreign firms. Equity-oriented export requirements are put in place to offset distortions elsewhere in the economy, which provide artificial incentives for production oriented towards domestic markets. These restrictions hardly fulfill development objectives. A foreign firm, which does not wish to comply with equity restrictions, may dilute its equity in favour of indigenous suppliers and opt to produce for the protected domestic market. And indigenous capital, whose social opportunity costs could be considerable, will also be oriented towards the protected domestic market. The net result is the creation of rents in protected markets for both the foreign-owned and domestically-owned firms. And it would also result in a reduction in trade. There are other instances where foreign-owned firms are allowed 100 per cent ownership of equity if their entire output is exported. Suppose that export prices are lower than those prevailing in domestic markets, and that foreign firms service both markets. In this case foreign firms operating in the protected domestic market would have an incentive to bridge the price difference between the two markets by raising prices on the domestic market. In essence, domestic consumers would provide an export subsidy to the foreign firms.

All this is not to say that TRIMS are weak instruments for promoting development objectives and should be prohibited. Well-designed TRIMS, which take into account domestic supplier capabilities and nurture locally-owned firms with investments in education and training, do result in the development of local suppliers and create jobs. But TRIMs that are ostensibly designed to promote development objectives, but are in practice no more than devices to delimit control over operations by foreign firms, may be counter-productive. Indeed, TRIMS that serve to promote competition in the market place are to be encouraged, for as said earlier, it is effective competition that spurs efficiency.

As discussed earlier, M&As also raise specific issues relating to competition and the efficacy of FDI. The concern here is that acquisitions concentrate economic power in the hands of foreign firms and limit competition. The inevitable restructuring of operations of the acquired firms may result in loss of jobs and in some cases a transfer of specific managerial functions and R&D from the host countries to the locale of the foreign firms. The available evidence on these issues, exhaustively analysed by the UNCTAD, is inconclusive. Admittedly, an acquisition results in increased control over decision-making in the hands of foreign firms. But to the extent that the firm continues to service the market, competition in the market place would not be eliminated, which indeed would be the case if the firm were to go bankrupt. According to the UNCTAD survey, other concerns such as loss of jobs are real, but in the long run the net impact of M&As on jobs and exports does not differ much from that observed in the case of greenfield investments. But a legitimate question here is just how long the long run is. For this reason, appropriate competition policies that safeguard local interests without at the same time restricting efficient operations of the acquired firms are crucial.

In sum, it would be a folly to expect profit-maximising firms, be they foreign or locally owned, to specifically address the development objectives of host countries. They do contribute to development objectives if – and only if – the business environment is conducive to efficiency of operations. As Paul Streeten puts it "it is not sensible to transfer income by attempting to transform the MNE from what it is – a profit-seeking animal – into something it is not – a public service" (Streeten, 1971). In the final analysis, as I.M.D. Little noted early on in the debates on FDI – FDI is as good or as bad as the host-country policies.

Issues for Debate

The foregoing has merely skimmed the copious literature on FDI and noted the main issues. Most of this is what may be termed received wisdom. In recent years, however, the debate on globalisation, with FDI being the prime force of globalisation, has caused several new issues to emerge. Three issues figure on most agendas on globalisation. The first of these relates to labour standards and MNEs. Second is the argument that MNEs and FDI contribute to the degradation of the environment. Third is the long-standing thesis, which has surfaced again in the debates on globalisation, that FDI deprives developing countries sovereignty over economic policy, concentrates economic power in the hands of foreign-owned firms, and poses a threat to local interests. Here we merely identify the issues of debate for further discussion.

The issue of labour standards has several strands to it. First, there is the widespread concern that wage rates in poor countries are abysmally low compared with what labour earns in developed countries, and that this amounts to exploitation of labour. Second is the concern that profit-maximising MNEs adopt dual standards in their labour policies. The standards they set for wage payments and labour welfare in developing countries fall far short of the standards they adopt in their home countries. Third is the concern that practices such as the employment of child labour are morally reprehensible. There is no dispute that exploitation of labour, including child labour, is socially undesirable and must be eliminated. The issue though is what is a just wage? Is the theoretical precept that wage rates reflect the opportunity cost of labour, what it can earn in alternative occupation, and that the opportunity cost

for labour is close to zero in poor countries, much too glib an explanation for the low wages in poor countries? Is it right to say that if MNEs do adopt dual standards on labour welfare, they are not to be blamed, the blame should rest with host-country governments and the absence of labour legislation in these countries? Is it legitimate to argue that labour standards are culture specific and it would be injudicious to transplant developed countries standards into developing countries? Is child labour an economic phenomenon born out of poverty, inefficient credit markets, and lack of education, and MNEs passively reacting to prevailing labour market conditions? (See Jafarey and Lahiri (2001) for an excellent discussion of Child Labour).

The issue of the environment and the MNEs too has several strands. Do MNEs move production facilities to countries with lower standards? Do lower standards in some countries force other countries to follow suit in order to protect their competitive advantage in trade and investments? Is it legitimate to impose developed country standards on poor countries? The environment issue appears to be much more tractable than the labour standards issue. Evidence in favour of the first proposition appears to be weak. In the face of widespread concern for the environment, which is a global problem, MNEs wish to be seen as good citizens keen on protecting the environment (Bhagwati, 1995).

Most MNEs invest in technologies that preserve and promote the environment. Whether or not the concern for the environment on the part of MNEs is born out of self-interest rather than altruism is arguable, but they can't be accused of deliberately seeking locales with low standards. There is no reason to suspect that poor countries blithely ignore the need to preserve the environment and let loose MNEs to despoil it. Their concerns, however, may be different from those of the developed countries. They may accord priority to objectives such as access to safe drinking water rather than the preservation of non-renewable resources. And imposing uniform standards on poor countries may be injudicious. Even so, there are issues relating to the environmental obligations of MNEs, the institution of incentive structures that promote the environment, and whether or not trade and investment policies should be geared to the preservation of the environment.

The thesis that FDI and MNEs pose a threat to the economic sovereignty of host countries, undermine interests of locally-owned entities and concentrate economic power in the hands of foreign firms is an old refrain. Indeed, the variety of issues relating to FDI all centre on the objective of host countries to garner the maximum possible benefits from FDI without at the same time yielding control over decision making to foreign firms. But control over operations, which in turn facilitates transfer of technology and know-how and efficient operations, is the key characteristic of FDI. This dilemma has resurfaced in recent years with the growth in FDI and one of its modalities – mergers and acquisitions (M&As) of locally-owned firms. As said earlier, M&As mostly relate to FDI in developed countries, where they account for the bulk of FDI flows. In developing countries, M&As account for around a third of total flows, although there are wide regional variations.

Among the factors that motivate M&As, the most significant is the desire to acquire assets of one sort or the other without having to invest in building them up from scratch. This is the asset-seeking sort of FDI discussed earlier. The costs and benefits of such FDI to host countries is an area yet to be investigated in detail. Available evidence, however, suggests that the impact of M&As on competition in the host countries may not be much different from that in the case of greenfield investments. These two types of FDI may eliminate competition, and in many cases they can also promote competition. The relevant issue for discussion here, however, is the design of appropriate policies that serve to mitigate the costs of M&As and maximise their benefits to host countries. It is worth pondering whether or not a set of universal rules and regulations, with derogations where necessary, may be superior to country-specific policies and bilateral agreements.

Indeed, there may be a case for instituting FDI on the agenda of the WTO. In fact, bits and pieces relating to FDI have been incorporated in the WTO. These relate to the agreement on trade in services,

TRIMS and trade-related intellectual property rights (TRIPS). Most trade in services requires the presence and establishment of the suppliers of services in the locale of the consumers, in other words FDI. Moreover, MNEs account for a substantial proportion of world trade, the central concern of the WTO. It may not therefore require a giant step to include FDI on the agenda of the WTO in a much more cohesive fashion than at present. Even so, the proposal is likely to arouse controversy both because of the ever-present worries and concerns regarding FDI, and the recent suspicion and distrust of the WTO on the part of the opponents of globalisation. There may be legitimate grounds for urging a reform of the WTO centering on the concerns of developing countries and the promotion of their development objectives. But to say that the institution is fundamentally flawed and that it is designed to promote the interests of developed countries is an exaggeration.

In sum, FDI in developing countries poses a variety of issues – most of which arouse intense debate. This paper has identified some of these issues and reviewed the major insights from the vast literature on the subject. Its modest objective is to identify issues for discussion and not present settled conclusions.

NOTES

1. Surveys include Aggarwal 1980, de Mello 1996, Balasubramanyam and Sapsford 2000.
2. Langhammer, R. (1991), Levis, M. (1979), Schneider, F. and Frey, B. (1985).
3. Per capita GDP should be measured in terms of purchasing power parity exchange rates to provide an accurate measure of the size of markets.
4. See Buckley and Casson (1991), Dunning (1993) and Caves (1982).

ANNEX OF TABLES

Table 1. Stock of Inward Foreign Direct Investment by Host Region and Economy

(US$ billion)

Host Region / Economy	1980	1985	1990	1995	1999	2000
World Total	**616**	**894**	**1889**	**2938**	**5196**	**6314**
Developed Countries	**375**	**546**	**1380**	**2052**	**3354**	**4210**
E.U.	186	236	740	1131	1835	2376
U.S.A.	83	185	395	536	966	1239
U.K.	63	64	204	200	368	483
Japan	3	5	10	34	46	54
Developing Countries	**241**	**347**	**488**	**849**	**1740**	**1979**
Africa	16	25	39	61	89	95
Latin America & the Caribbean	50	80	117	202	520	607
Argentina	5	7	9	28	62	73
Brazil	18	26	37	43	164	198
Mexico	8	19	22	41	78	91
South, East & S.E. Asia	175	213	297	535	1047	1184
China	6	11	25	137	306	347
Hong Kong	139	144	163	188	405	470
India	1	1	2	6	17	19
Korea, Republic of	1	2	5	9	32	42
Malaysia	5	7	10	29	49	54
Singapore	6	13	29	60	83	89
Taiwan Province of China	2	3	10	16	23	28
Thailand	1	2	8.2	17.5	21.7	24
Least Developed Countries	3	5	8	17	31	35

Source: World Investment Report, 2001

Table 2. Stock of Inward Foreign Direct Investment: share of principal countries, 1980-2000 *(percentage)*

Host Region / Economy	1980	1985	1990	1995	1999	2000
World Total	**100**	**100**	**100**	**100**	**100**	**100**
Developed Countries	**60.9**	**61.1**	**73.1**	**69.8**	**64.5**	**66.7**
E.U.	30.1	26.4	39.2	38.5	35.3	37.6
U.S.A.	13.5	20.6	20.9	18.2	18.6	19.6
U.K.	10.2	7.2	10.8	6.8	7.1	7.6
Japan	0.5	0.5	0.5	1.1	0.9	0.9
Developing Countries	**39.1**	**38.8**	**25.8**	**28.9**	**33.5**	**31.3**
Africa	2.6	2.8	2.1	2.1	1.7	1.5
Latin America & the Caribbean	8.1	8.9	6.2	6.9	10.0	9.6
Argentina	0.8	0.8	0.5	1.0	1.2	1.2
Brazil	2.8	2.9	2.0	1.4	3.2	3.1
Mexico	1.3	2.1	1.2	1.4	1.5	1.4
South, East & S.E. Asia	28.4	23.8	15.7	18.2	20.2	18.8
China	1.0	1.2	1.3	4.7	5.9	5.5
Hong Kong	22.6	16.1	8.6	6.4	7.8	7.4
India	0.2	0.1	0.1	0.2	0.3	0.3
Korea, Republic of	0.2	0.2	0.3	0.3	0.6	0.7
Malaysia	0.8	0.8	0.5	1.0	0.9	0.9
Singapore	1.0	1.5	1.5	2.0	1.6	1.4
Taiwan Province of China	0.4	0.3	0.5	0.5	0.4	0.4
Thailand	0.2	0.2	0.4	0.6	0.4	0.4
Least Developed Countries	0.5	0.6	0.4	0.6	0.6	0.6

Source: World Investment Report, 2001

Table 3. Inward Stock of FDI as Percentage of Gross Fixed Capital Formation, 1989-1999 *(percentage)*

Host Region / Economy	1989-1994	1995	1996	1997	1998	1999
World Total	**4.1**	**5.3**	**5.9**	**7.5**	**10.9**	**16.3**
Developed Countries	**3.7**	**4.4**	**4.8**	**6.1**	**10.6**	**17**
E.U.	5.4	6.7	6.5	8.1	15.7	27.7
U.S.A	4.8	5.3	7.0	7.9	11.3	17.9
Developing Countries	**5.2**	**7.7**	**9.1**	**10.9**	**11.7**	**13.8**
Africa	5.8	6.7	7.6	9.1	8.8	10.4
Latin America & the Caribbean	6.2	9.6	12.3	15.9	17.6	27.3
Argentina	8.6	12.1	14.1	16.1	12.2	47.7
Brazil	1.7	3.8	7.0	11.7	18.4	31.3
Mexico	10.1	20.6	16.7	17.7	13.2	11.7
South, East & S.E. Asia	5.9	8.2	9.1	10.1	10.4	11.2
China	7.9	14.7	14.3	14.6	12.9	11.3
Hong Kong	14.8	14.6	21.7	19.8	29.9	60.2
India	0.6	2.4	2.9	3.8	2.9	2.4
Korea, Republic of	0.8	1.0	1.2	1.7	5.7	9.3
Malaysia	19.4	15.0	17.0	15.1	13.9	20.1
Singapore	30.3	31.2	29.7	35.3	20.6	26.1
Taiwan Province of China	2.9	2.4	3.0	3.4	-	4.4
Thailand	5.0	2.9	3.0	7.2	20.7	13.7
Least Developed Countries	5.7	5.2	5.4	**5.9**	6.2	7.9

Source: World Investment Report, 2001

Table 4. Stock of Inward FDI: share of principal developing countries
(percentage)

Host Region / Economy	1980	1985	1990	1995	1999	2000
Argentina	2.07	2.02	1.84	3.30	3.56	3.69
Brazil	7.26	7.41	7.60	5.01	9.43	9.99
Mexico	3.36	5.42	4.59	4.84	4.48	4.60
China	2.49	3.03	5.08	16.18	17.59	17.53
Hong Kong	57.68	41.50	33.40	22.14	23.28	23.75
Korea, Republic of	0.46	0.63	1.07	1.11	1.84	2.12
Malaysia	2.16	2.13	2.11	3.38	2.80	2.74
Singapore	2.57	3.75	5.86	7.02	4.77	4.50
Total	78.00	66.00	62.00	63.00	68.00	69.00

Source: World Investment Report, 2001

Table 5. **Inflows of FDI by Host Region/Economy**
(US$ billion)

Host Region / Economy	1989-1994	1995	1996	1997	1998	1999	2000
World Total	**200**	**331**	**385**	**478**	**693**	**1075**	**1271**
Developed Countries	**137**	**203**	**220**	**271**	**483**	**830**	**1005**
E.U.	77	113	110	128	261	467	617
U.S.A.	43	59	84	103	174	295	281
U.K.	19	20	24	33	71	82	130
Japan	1	0	0	3	3	13	8
Developing Countries	**60**	**113**	**152**	**187**	**188**	**222**	**240**
Africa	4	5	6	7	8	9	8
Latin America & the Caribbean	18	32	51	71	83	110	86
Argentina	3	6	7	9	7	24	11
Brazil	1	5	10	19	29	31	34
Mexico	7	10	10	14	12	12	13
South, East & S.E. Asia	35	74	89	99	86	96	137
China	14	36	40	44	44	40	41
Hong Kong	4	6	10	11	15	25	64
India	0	2	3	4	3	2	2
Korea, Republic of	1	2	2	3	5	11	10
Malaysia	4	6	7	7	3	4	6
Singapore	5	9	10	13	6	7	6
Taiwan	1	2	2	2	0	3	5
Thailand	2	2	2	4	5	4	2
Least Developed Countries	1	2	2	3	4	5	4

Source: World Investment Report, 2001

Table 6. Inflows of FDI by Region as a percentage of total world flows *(percentage)*

Host Region / Economy	1989-1994	1995	1996	1997	1998	1999	2000
Developed Countries	**68.5**	**61.5**	**57.1**	**56.8**	**69.8**	**77.2**	**79.1**
E.U.	38.3	34.3	28.5	26.7	37.7	43.5	48.6
U.S.A.	21.3	17.8	21.9	21.6	25.2	27.4	22.1
U.K.	9.6	6.0	6.3	7.0	10.2	7.7	10.3
Japan	0.5	0.0	0.1	0.7	0.5	1.2	0.6
Developing Countries	**29.8**	**34.2**	**39.6**	**39.2**	**27.2**	**20.7**	**18.9**
Africa	2.0	1.4	1.5	1.5	1.1	0.8	0.6
Latin America & the Caribbean	8.7	9.8	13.3	14.9	12.0	10.3	6.8
Argentina	1.3	1.7	1.8	1.9	1.1	2.2	0.9
Brazil	0.7	1.7	2.7	3.9	4.2	2.9	2.6
Mexico	3.3	2.9	2.6	2.9	1.7	1.1	1.0
South, East & S.E. Asia	17.5	22.2	23.2	20.6	12.4	9.0	10.8
China	7.0	10.8	10.4	9.3	6.3	3.8	3.2
Hong Kong	2.1	1.9	2.7	2.4	2.1	2.3	5.1
India	0.2	0.6	0.7	0.8	0.4	0.2	0.2
Korea, Republic of	0.4	0.5	0.6	0.6	0.8	1.0	0.8
Malaysia	2.0	1.8	1.9	1.4	0.4	0.3	0.4
Singapore	2.4	2.7	2.7	2.7	0.9	0.7	0.5
Taiwan	0.6	0.5	0.5	0.5	0.0	0.3	0.4
Thailand	1.0	0.6	0.6	0.8	0.7	0.3	0.2
Least Developed Countries	0.7	0.6	0.6	0.6	0.5	0.5	0.3

Source: World Investment Report, 2001

Table 7. Inflows to largest developing country recipients as a proportion of total flows to developing countries (percentage*)*

Host Region/Economy	1989-1994	1995	1996	1997	1998	1999	2000
Argentina	4.52	4.95	4.56	4.89	3.87	10.88	4.64
Brazil	2.51	4.83	6.88	10.00	15.31	14.13	13.97
Mexico	11.03	8.40	6.49	7.39	6.16	5.37	5.48
China	23.42	31.63	26.35	23.61	23.23	18.16	16.98
Hong Kong	6.99	5.48	6.86	6.07	7.84	11.08	26.83
Korea, Republic of	1.46	1.57	1.52	1.52	2.87	4.77	4.24
Malaysia	6.65	5.13	4.78	3.48	1.43	1.59	2.31
Singapore	8.05	7.75	6.80	6.92	3.35	3.24	2.66
Total	65.00	70.00	64.00	64.00	64.00	69.00	77.00

Source: World Investment Report, 2001

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Making FDI and Financial-Sector Policies Mutually Supportive,

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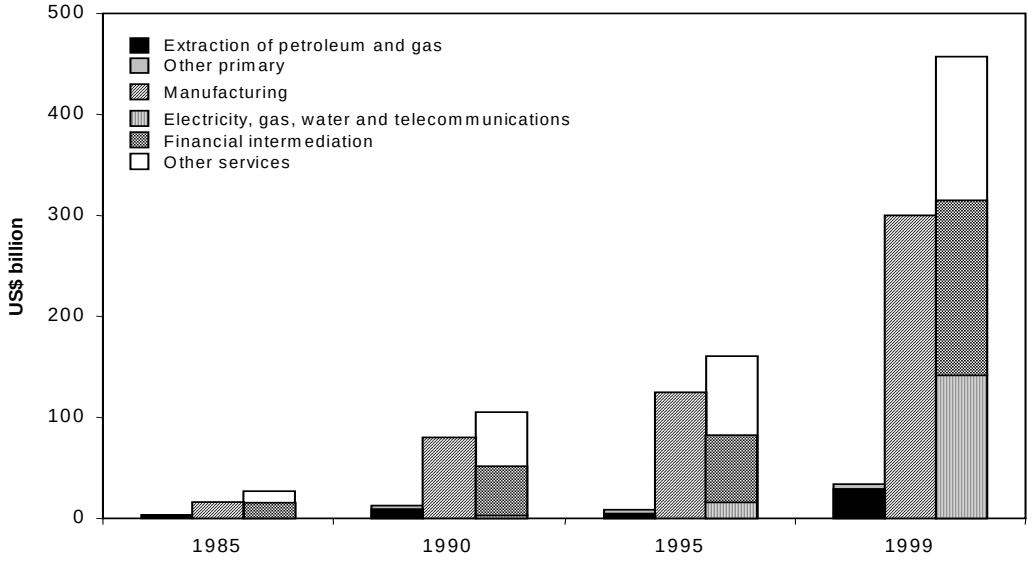
The development of a sound and efficient banking and financial sector is widely recognised as an important ingredient of an effective system of resource allocation and robust growth within national economies. It has also proven to be a key condition for ensuring orderly capital account liberalisation. Finally, a solid domestic infrastructure for banking services and capital markets is among the parameters considered by investors as they decide on the location of their investments.

This paper addresses the following question: to what extent can foreign direct investment (FDI) in the banking and financial industry sector support capacity building and more generally enterprise development in this sector?

What are the trends?

An important trend in world FDI flows in recent years has been the strong orientation of FDI towards the services sector. More than half of OECD countries' FDI involves the services sector. Banks and other financial institutions accounted for a very high share of these investments. But only a small part of OECD countries' FDI outflows is directed to developing countries – largely concentrated in a few countries in Latin America and Asia. This suggests that a significant under-exploited potential exists for many other countries around the world to catch up.

Total OECD FDI outflows to selected sectors



Source: Compiled from OECD (2000), International Direct Investment Statistics Yearbook.

The orientation of FDI towards services has been accompanied in a number of countries by a significant relaxation of the remaining discriminatory barriers to foreign direct investors' participation in the banking and financial sector. Harmonisation and mutual recognition of regulation has also been an important factor in facilitating FDI in this sector.

The experience of some of the former transition and emerging market countries that recently joined the OECD illustrates these policy developments:

- At the time of their accession to the OECD in 1995-96, OECD Members from Eastern and Central Europe applied comparatively few restrictions to FDI in banking and finance. However, the Czech Republic required special approval for foreign ownership of domestic banks, and Poland and Hungary did not allow the establishment of branches by non-resident financial institutions. After the introduction of appropriate non-discriminatory prudential arrangements, these restrictions have now been removed. Slovakia acceded to the OECD in 2000 with no restrictions.
- When Korea acceded to the OECD in 1996, foreign ownership of domestic financial institutions, as well as other parts of the corporate sector, was subject to discriminatory limitations. While the establishment of foreign bank subsidiaries was not legally forbidden, in practice no licences were given. Formal restrictions existed with respect to certain other categories of foreign institutions. As a requirement for OECD accession, commitments toward future liberalisation of FDI, and as a response to the 1997 financial crisis, these restrictions were removed in 1998. The government also announced a policy of ending direct interference in bank management. Promotion and transparent implementation of these measures will be key to their success.
- Upon accession to the OECD in 1994, Mexico undertook to extend most NAFTA provisions to OECD Member countries, including those fully liberalising the direct establishment of, and direct investment in, several categories of non-bank financial institutions. Mexico also agreed to consider extending the remaining market access benefits accruing to NAFTA-based financial institutions, which concerned banks, insurance companies and securities dealers. This extension was decided in 1998 and became fully effective in 2001.

What are the potential benefits of FDI in the banking and financial sector?

Broadening of the capital base of the banking and financial sector

Recent crises in Asia and other countries have revealed the fragility of many national banking sectors. Governments have often had to recapitalise the sector and resolve non-performing loan problems, since they generally had difficulty in finding a sufficient number of large and healthy domestic banks – or other investors – to back the failed institutions. Encouraging take-overs by foreign investors have therefore been used in banking crisis resolution programmes, for example, in the Nordic countries, Hungary, Korea, Mexico and Slovakia. During periods of retrenchment of domestic banks' balance sheets, the entry of foreign institutions may also be needed if the process of credit intermediation is to be maintained, thus paving the way for a faster recovery.

Participation by foreign strategic investors in bank privatisation programmes on the basis of transparent and non-discriminatory rules has also proven instrumental in ensuring a timely and effective implementation of these programmes.

Transfer of financial know-how and increased efficiency

Foreign participation contributes to increased competition between financial service providers. This competition benefits the economy by providing incentives for adopting improved corporate management standards, reducing overall intermediation costs, improving the quality of risk management and boosting advisory and other services offered to enterprise and household clients. Foreign institutions also allow instant access to key competitive assets such as advanced financial management systems, marketing expertise in retail banking and presence in global markets.

In Korea, for instance, increased foreign participation and the resulting enhanced competition are now seen as key to raising managerial skills in local institutions. Another interesting reported example of this is the case of UK commercial banking. When acquiring the Midland Bank, HSBC brought with it from Asia a cash-flow method of assessing lending to SMEs, moving away from a traditional collateral approach. This increased the possibilities for smaller companies to gain access to bank lending, aligning practice in the UK with that already in place in Thailand and Korea.

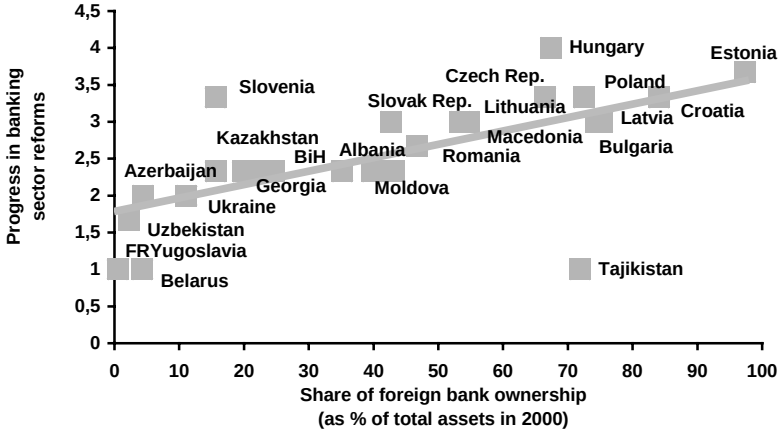
Prudential standard upgrading and compliance

Local supervisory authorities can enhance prudential standards by opening market access to foreign banks and other financial institutions already subject in their home countries to Basel and to other internationally accepted requirements to capital adequacy, risk management and information disclosure. They are likely to benefit directly from the high standard of prudential surveillance of the entrants, and indirectly to the extent that the entrants promote good standards in the host economy.

The presence of foreign financial services competitors, coming from outside established local circles, can also assist the local supervisory authorities as they take steps to limit politically motivated and other connected lending, corruption, and other illegal financial activities.

In sum, there is broad empirical evidence that foreign involvement helps banking sector development. Using a sample of 21 transition countries, recent findings by EBRD show a clear correlation between the share of foreign bank ownership and a synthetic index of privatisation, interest-rate deregulation and other banking sector reform indicators.

Foreign Involvement Helps Banking Sector Reforms



Source: EBRD

Risks of adverse impact

The possibility that more efficient foreign financial institutions can crowd out local institutions is real. While the impact in the longer term is beneficial to the industry and the economy as a whole, labour market policies apply to minimise the social costs of adjustment in the short term.

Abuse of market position is best combated through appropriate, non-discriminatory competition policy, which, again, is underpinned by a dismantling of entry barriers to the financial service markets. In Hungary, for example, the majority of banking and financial sector assets are located in institutions originating from other OECD countries. It has been argued that maintaining barriers to cross-border competition in financial services would have amounted to protecting these institutions from overseas competition and depriving the country of the full benefits accruing from the presence of sophisticated foreign-controlled financial institutions.

It has also been argued that foreign financial institutions are not subject to the same civic spirit and sense of social responsibility as local institutions. In fact, major international banks and other financial institutions are those most often represented in the financial sectors' efforts to develop a reporting framework in support of sustainable development or in the banking sector's initiative for defining good management practice in the fight against money laundering. In addition, while social objectives can be attained by many other means than through the financial sector, nothing should prevent governments from imposing certain non-discriminatory requirements on financial institutions. In the United States, for example, banks are required through the Community Reinvestment Act to recycle a proportion of the deposits they take from poorer regions as loans in those areas.

Policy challenges facing governments

Maximising the benefits of FDI for financial sector development creates important challenges for governments.

The first policy challenge is to establish a broad enabling environment conducive to attracting high quality investors. Such an environment includes *inter alia* transparent regulatory and supervisory practices. Moreover, financial institutions cannot perform efficiently if public governance and other parts of the system work poorly.

Once FDI has been attracted to the domestic financial sector, more institutions are therefore in operation. A second challenge is hence to upgrade the regulatory framework and the supervisory authorities' monitoring capacity. In particular, this entails the involvement of host-country authorities in bilateral information sharing and other co-operative arrangements with their home country counterparts, as well as active interest in the work undertaken in standard-setting international forums, including the OECD.

Thirdly, it must be recognised that the opening up of a domestic financial system to foreign participation has wider structural ramifications. As financial practices become increasingly market based, weak debtors can no longer count on forbearance and evergreening of loans, sectors previously considered as "strategic" lose their special status, and financial institutions demand influence on the capital structure of their corporate borrowers. Additional policy measures may be needed in order to deal with the changing environment – *inter alia* in areas such as improved insolvency rules and foreclosure procedures for the corporate sector. Governments should therefore consider taking steps toward greater financial sector openness in unison with, and as a supplement to, their broader policies toward structural reform in the private sector.

Impact of Competition Policy on FDI Flows: The Russian Case,

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Globalisation, foreign direct investments and multinational enterprises

The current stage of international economic relations is characterised by increasing globalisation which is an objective process expressed in growing international trade, foreign investments, integration of financial markets, and rapid development of new technologies.

Foreign direct investments (FDI) are playing a substantial role in these processes, promoting world integration. In recent years, the growth rates of FDI were higher than those of foreign trade. FDI is a mutually beneficial process, enabling recipients to attract the newest foreign technologies, capital, and managing experience, and opening new foreign markets for the investing countries.

The FDI criterion is now used to determine a national economy's integration into the world economic system. The ratio of world FDI inflows to GDP increased dramatically in recent years, while the ratio of foreign trade to GNP remained the same. It can thus be concluded that in recent years global integration has taken place through FDI rather than through foreign trade.

FDI provides the basis for the dynamic development of international production, which becomes a significant element of international economy. Around 63,000 parent firms and 700,000 foreign affiliates of transnational corporations now carry out international production in nearly all the countries of the world. Despite the fact that a significant share of FDI is still realised on a regional level, international production is generally moving from regional to international level.

FDI, competition, and restrictive business practices

The bulk of FDI and international production is realised *via* mergers and acquisitions (M&As), with a growing share of transnational and large-scale operations. FDI therefore promotes transnational concentration on the markets, which may raise some concerns from the point of view of effective competition.

M&As can be classified functionally as horizontal (between firms in the same industry), vertical (client-supplier or buyer-seller operations), or conglomerate (between companies in unrelated industries). In terms of value, about 70 per cent of cross-border M&As are horizontal. But vertical M&As have also been increasing in recent years.

Cross-border M&As increased by 35 per cent in 1999, reaching, according to UNCTAD estimates, $720 billion in over 6,000 deals. The growing economic concentration is influencing the character of competition, which also becomes international. Current international competition can be characterised as a battle of giants. Competition becomes more and more keen, and a chosen competitive strategy may predict not only the perspectives, but also the very existence of the company.

The main part of cross-border M&As is undertaken by TNCs based in developed countries. But the number of such operations is also growing in developing and transitional countries. TNCs are usually oriented on highly concentrated markets, thus promoting economic concentration on an international scale. The consequences of TNC activity for competition on the recipient-country market may be different, and depend on many factors, including market access conditions, size of TNC, sufficient number of domestic competitors, etc.

M&As undertaken by TNCs usually bring positive effects for recipient countries thanks to effects of scale, first of all in new technology industries, enabling them to overcome the high cost barriers needed for the introduction of innovations.

But sometimes such M&As may have negative consequences for competition, for example when a foreign company – a former exporter – acquires its competitor on the domestic market, thus creating a dominant position on the market, or when two former foreign exporters merge, or when such a transaction strengthens the market position of the new company.

Such consequences are usually analysed by competition authorities in corresponding countries, which subsequently issue their prescriptions to merging companies. A preliminary notification of economic concentration in anti-monopoly authorities usually has an obligatory character.

Russia: the impact of competition policy on FDI flows

Competition policy may influence FDI flows in two ways. First, through application of the anti-monopoly law that eliminates anticompetitive actions of companies on the market. And second, through active participation of the anti-monopoly authorities in economic reforms, thus safeguarding their pro-competitive character.

Application of the Russian anti-monopoly legislation to foreign companies

The Russian anti-monopoly law may be applied both to Russian and foreign economic entities and natural persons if their activity could have a negative effect on competition in the Russian goods markets.

According to Art.2 of the Russian Anti-monopoly Law (the Law "On Competition and Limitation of Monopolistic Activity on Goods Markets"), this law extends to relations affecting competition on goods markets in the Russian Federation involving Russian and *foreign legal persons*, federal executive bodies, bodies of the subjects of the Russian Federation, bodies of local governments, as well as natural persons.

The Law also applies in those instances in which the activities undertaken by said persons *beyond the boundaries of the Russian Federation* lead or may lead to a restraint of competition or have other negative effects on markets in the Russian Federation.

The Russian Anti-monopoly Law does not contain any special provisions concerning foreign companies. The principles *of national treatment* and *most favoured nation (MFN)* are applied by conducting competition policy in Russia.

Anti-monopoly control over M&As involving foreign companies

State anti-monopoly control over economic concentration constitutes one of the main conditions of the functioning of a normal market economy. In accordance with international practice, the Russian anti-monopoly regulation provides for a preliminary notification of large concentrative operations. Art.18 of the Anti-monopoly Law contains provisions on the preliminary control of certain kinds of operations. The Law contains criteria in accordance with which transactions shall be obligatorily notified in advance to the Ministry for the Anti-monopoly Policy and Support of Entrepreneurship (MAP), with the purpose of obtaining its consent to the transaction. There are, *inter alia,* transactions such as acquisition by a person (group of persons) of voting stock (shares) in the authorised capital of an economic entity giving such a person (group of persons) the right to dispose of more than 20 per cent of such stock (shares).

MAP has the right to reject the application for an economic concentration if it considers that this transaction will result in the creation or strengthening of a dominant position or in a restriction of competition. Transactions concluded in violation of the procedure established by the Law leading to the creation or strengthening of a dominant position and/or restricting competition may be nullified in a general court, based on a suit of the federal anti-monopoly body.

Keeping in mind that the bulk of transactions involving the participation of foreign investors constitute large-scale transactions, most of them fall under provisions of the preliminary anti-monopoly control. There are no special provisions in the Russian Anti-monopoly Law concerning the treatment of transactions on economic concentration with the participation of foreign companies. The regulators are not concerned with the nationality of companies – the same rules are applied to all companies.

The number of negative replies of the Anti-monopoly Ministry to applications on economic concentration is rather low, and constitutes about 2 per cent of the total. The main reason for rejecting the notified deals is usually the likelihood of creating or strengthening a dominant position on the market as a result of such a deal.

In Russian anti-monopoly practice there are only few cases where MAP has rejected a transaction involving the participation of foreign companies. The principle of national treatment and most favoured nation are fully applied in the Russian anti-monopoly control over economic concentration. But MAP grants the greatest part of consents to transactions (both national and international) under certain (usually behavioural) conditions.

Among such conditions the following could be mentioned:

- keeping MAP regularly informed about volumes of production, with justification of changes in these volumes;
- informing MAP on prices of the produced goods with justification of any changes;
- informing MAP in advance of intentions to change the policy on supply and realisation, etc.

In previous years it was believed that a system of informing MAP on forthcoming changes would enable it to prevent the cutting of production by monopolistic entities, as well as avoiding price increases and discriminations of purchasers and customers. But taking into account the limited resources of the Anti-monopoly Ministry, this approach seems to be too ambitious and difficult to accomplish. That is why MAP is now changing its approach and is going to set mainly structural rather than behavioural conditions when approving mergers.

As mentioned above, there are no discriminatory provisions *vis-à-vis* foreign companies in the Russian Anti-monopoly Law. But in practice, foreign companies sometimes face rather strong opposition on the part of regional authorities that try to prevent the dominance of a foreign company on the regional market. Voices contra "total monopolisation of the Russian economy by foreign companies" are especially strong in the regions where the communist influence is high.

For the purpose of making the situation with international transactions more transparent, a new statistical reporting form was introduced in MAP some years ago. The results of the consideration of transactions involving foreign companies in the anti-monopoly authorities (including information from the territorial bodies) are now available. This will help to provide a more transparent picture of the impact of competition regulation on foreign investment flows.

From the point of view of anti-monopoly legislation, the most dangerous are mergers joining economic entities-rivals, producing and supplying to the market similar or mutually substituted goods – i.e. horizontal integration. Bearing this in mind, anti-monopoly control in cases of merging economic entities producing similar goods is stricter.

When investigating mergers, especially horizontal, anti-monopoly bodies use the following criteria to help define the rate of risk for competition:

- whether the merger would result in a significant concentration of the market;
- whether there are reasons to consider that the merger would have a negative effect upon competition (i.e. whether the merger may create or strengthen market power, or facilitate its application);
- whether the new economic entities on the market may create entry barriers for competitors;
- whether the merger would be a factor of increasing effectiveness which the merging enterprises could not reach by any other means;
- whether there is a probability that the merger would result in the bankruptcy of one of the parties to the deal and its assets would be lost for the market in case the merge fails.

In spite of the financial crisis of 1998, foreign investors have increased their activities in acquiring shares of Russian enterprises. In the fuel and energy sectors, where the concentration processes are developing very fast, transactions involving foreign capital are growing rapidly. In 2000, the number of petitions and notifications related to transactions with foreign investors in this sector increased by 45 per cent, and including share purchase transactions – by almost 57 per cent.

Foreign participants in the market are most interested in investment in the consumer-market branches, followed by the fuel and energy sector in second place, with the timber industry and the market of synthetic detergents in third place. Large vertically integrated structures are the most active in capital re-distribution, especially in the ferrous and non-ferrous metallurgy, chemical and oil-chemical sectors, the machine-building branch, the pulp and paper industry, and in the agricultural sector – in particular, in the markets for grain, meat and products of its processing, sugar, etc. The process of concentration in the aluminium and copper-ore industries through the consolidation of shares in the hands of one group of owners is an example of this. The aim of the transactions in buying shares of the largest ferrous plants is the formation of several vertically integrated companies.

In a situation of growing economic concentration on Russian and world markets, anti-monopoly control of economic concentration becomes one of the primary instruments to maintain competition and economic stability in the markets.

Anti-monopoly control over anti-competitive practices

The abuse of dominant position would seem to be a rather widespread infringement, witnessed by the annual growth of claims made by economic entities. In 2000, the number of claims on abuse of dominant position by economic entities increased by 19 per cent, amounting to almost half of all the claims received by anti-monopoly bodies. Anti-monopoly bodies enhanced their activity on ascertainment and prevention of abuse of dominant position, and the number of proceedings instituted on this kind of infringement increased by more than 35 per cent in 2000. Also in 2000, MAP and its regional offices investigated about 2,500 cases (claims together with the initiative of an anti-monopoly body) on signs of violation of Article 5 of the Law "On Competition…" (abuse of dominant position in a goods market by an economic entity). Violations were proven in 1,073 cases. Of these, 43 per cent were eliminated voluntarily without bringing action, and 728 cases (57 per cent) were brought to action. One sixth of the decisions of the anti-monopoly bodies were appealed in court, and about a quarter of all appealed decisions were declared invalid. It should be mentioned that the proving of violations related to the abuse of the dominant position is one of the most difficult in anti-monopoly practices. As a rule, in such processes powerful structures with strong legal staff stand against the anti-monopoly bodies.

Most of applications on the abuse of dominant position are related to the electro- and heat energy markets, gas, railway services, and telecommunications services. The number of applications in this sphere is growing from year to year. Their share in the general amount of applications on Article 5 amounted to 61 per cent in 2000. This provides evidence of the non-decreasing level of monopolistic activity of economic entities in the Russian goods markets, especially in those of natural monopolies. The most widespread violations remain the same – imposing of disadvantageous terms of contract, unjustified refusal to conclude contract, as well as violation of the price-setting order prescribed by law, and monopolistic pricing.

In 2000, MAP investigated the actions of a group of affiliated persons, *viz* "Gasprom" firm, "Astrachangasprom" firm, "Orengburggasprom" firm (hereafter referred to as the Group) towards the Inter-regional Association of phosphorus fertilizer producers "Phosagro". The Group unjustifiably refused to conclude a contract with "Phosagro" on the delivery of liquid sulphur, though the delivery was possible, thereby hindering its access to the market. MAP Russia Commission ascertained the domination of the Group in the sphere of transportation services of liquid sulphur in special tanks (the share of the Group is more than 65 per cent of the general quantity of tanks in Russia).

The Group transferred almost the whole fleet of tanks to the rent of the "Ortofert" firm, so that the possibility of subleasing tanks and concluding contracts on sulphur transportation was eliminated. This way the Group forced the consumers of liquid sulphur to conclude contracts on the sale of liquid sulphur with the "Ortofert" firm, and this outraged the rights of liquid sulphur consumers. Following the results of the investigation, MAP Russia Commission issued the prescription to the Group to stop the violation of point 1 Article 5 of the Law "On Competition…" and ordered the Group to stop its practice of concluding exclusive contracts on liquid sulphur delivery and agreements on the lease of the specialised tanks for liquid sulphur transportation with certain economic entities, including those of the Group. The Group was also ordered to create no obstacles in making direct agreements of liquid sulphur delivery to the economic entities that use this raw material for their production process. Further investigation showed that the Group had fulfilled all the prescriptions.

The practice of ascertainment and suppression of agreements (concerted practices) of economic entities that restrict competition is undertaken on the basis of Article 6 of the Law "On Competition…". In 2000, 45 cases of violation of this article were examined. In 18 of these, violations were proven and 12 administrative proceedings were instituted. The increase in applications in cases of violation of this article is noticeable, though, according to the results of examination,

almost two-thirds of application cases were rejected. It should be mentioned that, as in 1999, most of the applications contained complaints about anti-competitive agreements of economic entities related to fixing and maintaining prices, tariffs, discounts, additional payments, and extra-charges in the sphere of natural monopolies.

In May 1999, the Southern Siberian Regional Office of MAP Russia administrated proceedings against 76 owners of petrol stations (PS) in Krasnoyarsk for violation of Article 6 of the Law "On Competition…" on the basis of simultaneous levelling-up of oil-products prices. The single prices increase in the PS allowed the actions of their owners to be classified as monopolistic collusion aimed at establishing and maintaining single prices bringing excess profit…The Commission of the Regional Office stated that the action of 25 economic entities competing in the market of the oil-products retail trade in Krasnoyarsk, who had a joint share of more than 35 per cent in the retail market for trading in petrol marks AI-76, 80, AI-92, 93, was aimed at establishing and maintaining higher prices for the pointed petrol marks. The co-ordination of their action on fixing and maintaining prices is proved by the simultaneity of the price rises and the maintenance of their levels in the period under review. The Commission issued a prescription to the participants in the agreement to transfer the profit received in violation of the Anti-monopoly legislation into the federal budget. Three economic entities appealed this decision in the Arbitration Court, and in two cases the decision of the Regional Office was declared legally valid. The prescription of the Regional Office was fulfilled, and the profits made from the infringement of anti-monopoly legislation were transferred to the federal budget.

In 2000, litigation was instituted in the Court of Appeal on the basis of the lawsuit brought by a number of oil product sellers against the Regional Office (Saint Petersburg and Leningradskaya Oblast). The Regional Office had issued the prescription on both the cessation of violation of Article 6 of the Law "On Competition…" and the transfer of the profit made to the federal budget, which had been issued in accordance with the case on anti-competitive price agreement instituted against the above-mentioned economic entities in 1999. The Court deemed the actions of the Regional Office lawful. Thus, the illegal profits were requisitioned and used for the needs of the State budget.

Overcoming administrative barriers

A significant area in the enforcement practice of the Russian Anti-monopoly Ministry concerns cases connected with the elimination of anti-competitive acts and actions of governing bodies (Art.7 of the Law). Most of the claims submitted to the Ministry in this regard contain allegations about acts of governing structures that hinder the economic activities of enterprises, prohibit free trans-regional movement of goods, provide ungrounded benefits, or establish prohibitions for certain companies, or constitute the unlawful unification of governing and commercial functions.

In 2000, the Ministry considered more than two thousand acts of governing bodies, and the Ministry found that almost half of them were in violation of the anti-monopoly law. MAP issues prescriptions both to regional authorities and federal regulatory bodies. In 2000, MAP issued a prescription to the Ministry of Railways to stop violations of the anti-monopoly law, which was further confirmed by the decision of Moscow Court of Arbitrage.

This issue is of great interest to foreign investors, and MAP is concentrating much of its attention on the elimination of such violations.

Keeping in mind that the acts and actions of governing bodies, especially of regional bodies, exert a significant influence on the situation in the markets, MAP initiated the practice of *preliminary agreeing* such acts with the regional anti-monopoly authorities with the purposes of preventing acts that restrict competition. In 2000, the anti-monopoly bodies examined 3,000 draft legal acts and

enactments of the legislature under the procedure of preliminary control (33 per cent more than in 1999), which helped prevent many violations in the phase of the acts' elaboration.

Anti-monopoly bodies interact with the Ministry of Justice and the Prosecutor's offices in the process of stopping anti-competitive actions of governing bodies. The activity of MAP in this sphere is especially important in safeguarding the single economic area in Russia, and in providing free movement of goods and capital.

Intellectual property rights

The prevention and suppression of unfair competition contributes to the establishment of civilised goods markets. These activities are exercised under Article 10 of the Anti-monopoly Law.

Art.10 of the Russian Anti-monopoly Law prohibits *unfair competition*,[1] including:

- the dissemination of false, inaccurate, or distorted information capable of causing losses to another economic entity or causing damage to its business reputation;
- misleading consumers as to the character, method (means) and place of production, consumer properties and quality of a good;
- making an incorrect comparison of goods produced or sold by an economic entity with the goods of other economic entities;
- the sale of a good involving illegal use of the results of intellectual property and means of differentiation of a legal person, individualisation of output, or performance of work and provision of services, equated with them;
- the receipt, use, or disclosure of research and technical production or trade information, including a commercial secret, without the consent of its owner.

Art.10 has been actively used in the law enforcement practice of the Anti-monopoly Ministry. The results of prevention and suppression of unfair competition show that the sale of goods through the illegal use of intellectual activity outcome is the most frequent one. Compared with 1999 the amount of cases on unfair competition has increased. Most petitions deal with the sale of goods with illegal use of trademarks (42 per cent), on misleading consumers (24 per cent), and giving false information in advertising (15 per cent).

In order to suppress unfair competition practices, MAP Russia, together with other federal bodies of the executive branch, carries out many relevant activities. In this connection, the Ministry organised a vast effort on the ascertainment and elimination of facts in the falsified mineral water "Borgiomi" sale. As the result of investigation only, MAP regional offices issued 184 prescriptions on the elimination of the violation of the anti-monopoly legislation and consumers' rights property legislation to unfair producers and sellers.

[1] "Unfair competition" is defined in the Anti-monopoly Law (art. 4) as "any actions by economic entities designed to gain advantages in the course of entrepreneurial activity which contravene the relevant provisions of current legislation, usage and practices of business dealings, dictates of respectability and straight dealing, and reason and fairness, which may cause, or have already caused, damage and losses to other economic entities - competitors, or may damage their business reputation".

Competition and trade policy

MAP has rather broad responsibilities for influencing trade policy.

In accordance with *Art.11* of the Competition Law, the Anti-monopoly Ministry *may issue recommendations to the executive bodies* and local governments relating to the implementation of measures directed towards the promotion and development of markets and competition. In accordance with *Art.12* of the Law, MAP may *submit proposals* to executive bodies concerning the introduction of licensing and its cancellation, changes in customs tariffs, and the introduction and abolition of quotas.

Art.16 of the Law stipulates that:

With the aim of further development of goods markets and competition, support of entrepreneurship, and demonopolisation, a federal anti-monopoly authority may forward to the relevant federal executive authorities recommendations relating in particular to:

- the licensing of export-import operations and modifications of customs tariffs,
- the making of modifications in the list of activities subject to licensing and the licensing procedure.

As can be seen from these provisions, the Anti-monopoly Ministry has the right to influence a foreign trade and investment policy, but the recommendative character of possible actions limits the scope of this influence. Nonetheless, MAP is actively using its scope of responsibility to influence foreign economic policy, submitting recommendations to the Ministry of Economic Development and Trade and to the Government concerning rates of import tariffs and quotas, licensing systems, and access for foreign investments.

It could be concluded that the legally fixed rights and practical activities of the Anti-monopoly Ministry in this area have positive effects for trade, safeguarding its non-protectionist and non-discriminatory character.

It is widely recognised that national trade policy can affect competition on internal markets. Of particular concern are high tariffs, quantitative restrictions, and discrimination in the public procurement system, etc.

Despite the fact that WTO rules include the consideration of competition aspects when introducing trade measures, in many cases the measures introduced mainly reflect the interests of the lobbying industries (competing domestic producers) rather than the interests of consumers or the goals of the national economy's efficiency. This situation may be to a great extent explained by the current system of decision-making in this area: in most countries the introduction of trade measures is the responsibility of trade authorities, and the competition bodies usually have very limited possibilities to influence trade policy. However, trade restrictions represent a serious hindrance to competition, and should therefore be regarded not only as a trade policy area, but also as a common area of trade and competition policy. Only such an attitude could guarantee the real economic efficiency of trade measures.

For non-member countries of the WTO (such as Russia), the observation of this principle is especially important because such countries are not bound by strong international obligations concerning the liberalisation of their trade regime. In these circumstances, when the national trade authorities are free to introduce protectionist measures, the anti-monopoly bodies should pay additional attention to

possible competition infringements in trade areas, and try to prevent and to stop any restriction of competition.

Participation in forming a national trade regime has for a long time constituted one of the most important directions of MAP's activities. With the goal of safeguarding a comprehensive, analytical approach to trade measures, the Methodological Recommendations were elaborated and are used by MAP to assess the impact of trade measures on competition in the national market. MAP participates in the preliminary consideration of each case of the proposed trade restrictive measures, and submits its decisions to the authorised executive structures.

MAP's approach to dealing with proposed trade measures is based on the analysis of a number of factors, such as:

- import penetration ratio,
- existing barriers to import,
- structure of the national product market,
- competitiveness of the "protected" domestic product,
- type of product to be protected,
- the applicant share in the total volume of the production (shall be not less than stipulated in the Law),
- deterioration of the situation in the corresponding sector,
- strong relationship between deterioration of this situation and growing imports.

Russia: FDI - general view, trends and problems

Until recently, the volume of FDI in Russia was very moderate. FDI into fixed capital declined dramatically during the last decade. But beginning in 2000 positive tendencies became evident. In 2000, FDI inflows increased to US$4.26 billion. In the first half of 2001, FDI inflows in Russia increased by 40 per cent as compared with the first half of the previous year – up US$2.5 billion.

The accumulative volume of foreign investments in Russia was US$27.2 billion in 1999, US$29.25 billion in 2000, and US$33.84 billion in 2001. The bulk of these were direct investments (US$12.76 billion in 2000 and US$17.6 billion in 2001).

The leading foreign investors in the Russian economy (share in foreign investments volume) are as follows:

- Germany – 18 per cent
- USA – 15.9 per cent
- Cyprus – 15.2 per cent
- France – 10.5 per cent
- United Kingdom – 9.6 per cent
- Netherlands – 6.6 per cent
- Italy – 4.9 per cent

- Sweden – 2.1 per cent
- Switzerland – 1.8 per cent
- Japan – 1.6 per cent

As regards *different economic sectors*, the fuel and food sectors have maintained their leading positions in the volume of FDI inflows, with 23 per cent and 28 per cent respectively. These sectors are followed by trade, transport, and telecommunication. The share of machinery, timber, and other sectors remains insignificant.

The *main investment initiatives* in Russia with FDI are the following:

- The biggest investment projects are concentrated in the *oil and gas sectors*. About 50 joint ventures in the oil-processing sector have been created with American, British, French, German, Canadian, Japanese and other foreign companies.
- In the *food industry* there are now numerous projects in the form of joint ventures, as well as wholly foreign companies. The biggest foreign companies are attracted by, and bring investments to, first of all the pastries and meat industries, followed by the production of non-alcoholic beverages, beer, and tobacco.
- In the *aero-cosmos industry* the joint project "Sea Launch" has been initiated, with the participation of Russian, Ukrainian, Norwegian and American companies. The first demonstration and launch of a commercial satellite took place in 1999. A group of Russian companies, together with Egyptian participation, realised a joint project in the production of "Tupolev" aircrafts.
- In the *machinery sector* the joint production of turbines was started together with the company ABB. This company has already established about 20 joint ventures in Russia in electro-technics.
- A number of projects with the participation of German and Japanese, American and Norwegian companies were started recently in the *telecommunications sector*, mostly in the modernisation of telecommunications systems.

(*Source:* "Survey of the Russian Economy", Working Centre for Economic Reforms by the Government of the Russian Federation, 1/2000)

FDI is now mostly concentrated in the big industrial towns and *regions* such as Moscow, St.Petersburg, and Nigni Novgorod. A large share of FDI is accumulated in the central and north regions of Russia, in particular in Leningradskaya, Novgorodskaya, and Kostromskaya oblast. In Tatarstan, regional authorities managed to create attractive conditions for foreign investment.

In general, it can be concluded that the *investment climate* in Russia has improved over the past few years.

Macroeconomic indexes show positive tendencies. In 2000, GDP rose by 8 per cent, and in the first half 2001 by 5.4 per cent. In the first half of 2001, industrial growth increased by 5.5 per cent, and the real incomes of the population by 5.4 per cent. Inflation was 21 per cent in 2000, and 18 per cent in 2001.

Extensive structural reforms have been initiated over the past few years. The new Land Code was adopted, as well as the first and second parts of the Tax Code. A number of new laws in the framework of de-burocratisation of the economy were adopted in 2001. The reform of the railway system has already begun, and the reform of banking sector is currently under discussion.

In numerous ratings of FDI-attractiveness, however, Russia is unfortunately still lagging. The most important remaining problems faced by foreign investors in Russia are the following:

- complicated tax system
- infringement of investor rights, *inter alia* in the procedures of bankruptcy
- infringement of intellectual property rights
- contradictory and insufficiently transparent legislation, problems in its implementation
- weak court system
- corruption
- weak banking system
- high administrative barriers
- inadequate accounting system.

Governmental policy towards FDI: the role of the Russian Anti-monopoly Ministry

The attraction of FDI and the creation of a good investment climate in Russia is now considered by the Russian Government as one of its most important economic tasks.

The intergovernmental agreements on promotion and mutual protection of investments, signed between Russia and 54 foreign countries, is contributing to the improvement of the investment climate. In addition, 80 intergovernmental agreements on avoiding double taxation have also been signed.

The bulk of the work on improving the investment climate is undertaken in the framework of the Consultative Council on Foreign Investments (CCFI), which incorporates the main foreign investors into the Russian economy. The President of the Russian Federation, Mr. Putin, and the Prime Minister of the Russian Federation, Mr. Kasjanov, personally take part in the sessions of this Council. Through the CCFI, a regular direct dialogue between the Russian authorities and foreign investors is taking place.

The Russian authorities announced that they do not distinguish between domestic and foreign investors, no discriminatory approaches are applied, and existing problems are considered as common problems that need to be eliminated.

With the purpose of improving the investment climate, the Russian Government has elaborated four blocks of draft laws: on taxes, on structural changes, on labour relations and on court reform. The adoption of these laws will lead to stabilising the rules of the game on the Russian market.

The Russian Ministry for Anti-monopoly Policy and Support of Entrepreneurship (MAP) participates actively in this work. The role of MAP is not limited to anti-monopoly policy; it also includes promoting pro-competitive reforms and economic development. The main current directions of this work include:

First, the *modernisation of the Anti-monopoly Law* is now in progress, and a number of amendments to the Law will be considered soon in Parliament. With these amendments, the anti-monopoly legislation and practices will become more effective.

Second, MAP plays a significant role in the current process of *deregulation*, restructuring of natural monopolies, and promoting competition principles in their functioning mechanisms. MAP is working closely with other ministries in reforming railroads and energy sectors, proposing the division of real natural monopolies and competitive sectors.

Third, MAP continues its activities in support of entrepreneurship, initiating the processes of *de-burocratisation* of the economy. The Government is now undertaking serious actions to eliminate high administrative barriers, organising this work on the basis of recently adopted laws, such as "On Protection of Rights of Legal Persons by State Control Measures", "On Licensing of Certain Types of Activities", "On State Registration of Legal Persons", and others. These laws establish a single principle of licensing throughout the entire territory of Russia, and radically simplify the whole system of licensing. Whereas in the past about 2,000 types of activities needed licenses, there are now only 104. The new law on state registration (which will come into force in July 2002) establishes the "one window" principle for the registration of legal persons. This will make the registration of legal entities much easier, faster, cheaper and transparent, eliminating many of the different intermediate instances.

Fourth, MAP undertakes concrete steps for safeguarding *intellectual property rights protection* and fair competition on the territory of the Russian Federation.

Fifth, working together with the Russian Ministry for Economic Development and Trade, MAP contributes to *eliminating or reducing trade barriers*, creating a competitive environment in Russia and preventing unjustified protectionism. Foreign economic legislation is now also modernised in accordance with WTO rules. The accession of Russia to the WTO will also contribute to a stable business environment in Russia. One of the very important documents - the Customs Code - was adopted recently by the Russian Parliament in the first hearings. The Customs Code will establish much more simple and transparent customs procedures in accordance with WTO principles. A special group, with the participation of foreign investors, is preparing radical changes to the existing complicated system of certification, marking, etc. The draft Law "On Certification" will introduce a new system of technical requirements in accordance with international practice. In the near future the legal basis for agreements on product sharing will be completed, a pressing requirement in attracting more foreign investors into the fuel sector.

In this way, the Russian anti-monopoly authorities are now playing an import role in supporting general governmental policy directed at the creation of an attractive investment climate in the country.

Foreign Direct Investment and Taxation: The Case of South Africa,

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Introduction

South Africa's economy is the largest in Sub-Saharan Africa, more than four times larger than that of the rest of Southern Africa.

Since South Africa's transition to democracy in 1994, the economy has undergone a major transformation. This has included:

- Signing up to the WTO and the consequent extensive phasing down of import tariffs.
- Commitment to a sound macroeconomic policy in the form of the Growth, Employment and Redistribution (GEAR) framework, which has resulted in the stabilisation of key macroeconomic variables, such as inflation, the budget deficit to GDP ratio, and real interest rates.
- The completion of Free Trade Agreements (FTAs) with the European Union and the Southern African Development Community (SADC), qualification for preferential tariff access in terms of the unilateral U.S. Africa Growth and Opportunity Act (AGOA) as well as ongoing negotiations with respect to an FTA with MERCOSUR.

These policy measures have led to steady economic growth, strong export growth, and the attraction of foreign direct investment from a wide range of countries.

FDI stock, annual flows, and sectoral breakdown

Tabulated below are South Africa's inflows of FDI over the past few years, as well as the latest available stock position, broken down by sector.

Annual FDI inflows, 1993 – 2nd quarter (Q2) 2001 (Rand millions)

1993	1994	1995	1996	1997	1998	1999	2000	Q1 2001	Q2 2001
33	1,348	4,502	3,515	17,587	3,104	9,184	6,083	1,726	52,872

Source: South African Reserve Bank Quarterly Bulletin.

According to official statistics, FDI into SA has been on a general upward trend since 1994. Large inflows were recorded in 1997 and 1999, which were largely related to the partial privatisation of state assets, namely Telkom (telephone operator) and South African Airlines. 2000 recorded inflows of R6 billion.

R1.7 billion in FDI flowed in during the first quarter of 2001. The second quarter of 2001 recorded a massive inflow of R52 billion. This figure is unusually high, and the largest share is attributed to the buy-out of the De Beers minority shareholders by (London Stock Exchange-listed) Anglo American.

* This report has been compiled by South Africa's official export and foreign direct investment promotion agency: Trade and Investment South Africa.

Notwithstanding this, evidence from the official foreign direct investment and export promotion agency, Trade and Investment South Africa (TISA), activities indicate the likelihood of a strong inflow of 'normal' FDI for 2001.

TISA Committed investments: 1 April to 25 October 2001

Sector	**Source**	**Value (Rm)**	**Type**	**Region in SA**
Automotive	Italy	71	Brownfield	Port Elizabeth
Automotive	Germany	1,500	Expansion	Pretoria
Automotive	USA	70	Greenfield	Port Elizabeth
Automotive	Germany	12	Expansion	Port Elizabeth.
Automotive	USA	12	JV	Cape Town
Metals	Italy	100	JV	Johannesburg
Chemicals	Switzerland	15	To be confirmed	
Chemicals	Netherlands	270	New	Sasolburg, Free State
Chemicals	Algeria	40	New	Bethlehem, Free State
Chemicals	UK	50	New	Cape Town
Chemicals	SA/Japan	1,120	New	Sasolburg, Free State
Chemicals	Zimbabwe	8	New	Johannesburg
Chemicals	UK	50	New	Sasolburg, Free State
Chemicals	South Korea	18	New	Port Elizabeth
Clothing & Textiles	USA	50	Expansion (JV)	Western Cape
Clothing & Textiles	UK	150	Expansion (JV)	Western Cape
Clothing & Textiles	UK	169	New	Atlantis, Western Cape
Agro-processing	UK	25	New	Gauteng
Agro-processing	Germany	180	New	KwaZulu Natal
Agro-processing	Germany	165	New	Eastern Cape
		4,075		

Although these investments are committed, rather than realised, and are consequently subject to change, they are indicative of the scale and nature of the FDI South Africa has attracted in 2001.

A further dimension of these investments is that, in contrast to the nature of FDI in many emerging markets over the last few years (including South Africa), none of the investments indicated in the table are privatisation related. This implies that they generally add to the capital stock.

Investments have largely fallen into three major sectors: automotives, chemicals, and clothing and textiles. This is attributable to major recent investment interest in the automotive sector, chemicals projects ranging from pharmaceuticals and cosmetics to industrial chemicals, as well as investments in apparel and agro-processing related to AGOA and the EU free-trade agreement.

In regional terms, a range of companies in East Asia and Europe have shown a keen interest in South Africa, driven by competitive input prices and opportunities that have been created by trade agreements. The revitalisation of the automotive sector has attracted major European investors. Clothing and Textiles investments from European companies have been made largely to take advantage of preferential access to the U.S. market *via* AGOA.

Returning to official FDI statistics, the table below demonstrates the official FDI stock position, broken down by sector, as at the end of December 1999. These are the latest official stock figures available.

Sectoral breakdown of FDI stock, 31 December 1999 (Rand millions)

Agri-culture	Min-ing	Manu-facturing	Elec-tricity	Con-struction	Whole-sale	Trans-port	Fin-ancial	Comm-unity services	Total
406	114095	79486	-	506	10596	8411	104992	138	318630

Source: South African Reserve Bank Quarterly Bulletin

The stock figures above are of limited use. This is because they aggregate all historical FDI in particular sectors and are not a good guide to recent developments. For instance, South Africa has long been an economy with a strong mining base, and hence the largest stock of FDI falls within mining, which has been accumulated for more than a century. However, over the past few years, only a small proportion of South Africa's FDI has occurred within the mining sector.

Official flow statistics provided by the Reserve Bank do not provide a breakdown of FDI flows by sector, source country, region, or type of investment. This is an important issue, and TISA is currently engaged with the Reserve Bank in order to facilitate the collection of more detailed official FDI flow and stock figures.

Government policies affecting the FDI environment

In principle, and in accordance with its WTO obligations, South Africa does not discriminate between domestic and foreign investors. The major policy framework that impacts on FDI is therefore the macroeconomic framework: GEAR.

Macroeconomic Policy

The core elements of GEAR are:

- fiscal deficit reduction to contain debt service obligations, counter inflation, and free resources for investment;
- an exchange-rate policy to keep the real effective rate stable at a competitive level;
- consistent monetary policy to prevent a resurgence of inflation;
- restructuring of state assets to optimise investment resources;
- an expansionary infrastructure programme to address service deficiencies and backlogs;
- a commitment to the implementation of stable and co-ordinated policies.

The GEAR strategy has been successful in stabilising major macro variables. This includes the inflation rate, the budget deficit relative to GDP, as well as the balance of payments. Growth has been lower than projected, but the economy has continued to grow despite difficult conditions after the 1998 financial crisis and the recent global slowdown. Growth is predicted to outstrip most other emerging economies in 2002 and hence to weather the post September 11 storm.

Key macroeconomic variables, 1997 – 2nd Quarter (Q2) 2001

	1997	1998	1999	2000	Q1 2001	Q2 2001
Real GDP (Rand billion)	533	537	548	566	575	579
GDP per capita (R thousand)	16.6	17.5	18.5	19.9	N/A	N/A
Real GDP growth (per cent)	2.5	0.7	1.9	3.1	2.0	2.3
Balance of Payments (Rand bn)	10.8	-4.0	25.8	5.1	-0.6	8.0
Budget deficit as per cent of GDP	4.5	2.9	2.0	2.0	N/A	N/A
Inflation rate (per cent)	8.5	6.9	5.2	5.3	7.5	6.3
Net Open Forward Position (US $ billion)	-16.2	-22.5	-13.0	-9.5	-9.4	-5.3
Foreign debt to GDP	26.4	28.2	29.9	29.3	N/A	N/A

Source: South African Reserve Bank Quarterly Bulletin

Industrial Strategy

South Africa's Industrial Strategy, as articulated by the Department of Trade and Industry, is focused on increasing value addition within the South African economy, lowering costs, and shifting the economy into more knowledge-intensive activities.

South Africa is endowed with raw materials, cheap energy, and a solid infrastructure, which provides a competitive advantage in a range of processing activities. However, there have been significant shifts towards more high value-added activities, supported by supply-side measures. A good example of this is the impact the Motor Industry Development Programme (MIDP) has had on attracting major international players and upgrading the automotive industry.

More recently, the focus of industrial strategy has shifted toward the creation of a knowledge economy. This strategy seeks to address competitiveness directly through encouraging under-provided activities such as skills, research and development, and the deeper penetration of information technologies into the economy.

South Africa's industrial strategy generates opportunities for FDI in a range of activities. These include mineral processing, energy-intensive investments, as well as increasingly in high-tech and services sectors.

The Industrial Strategy is actively supported by selected investment incentives. These include:

- **The Strategic Investment Programme (SIP)** – a tax allowance for large investments with strong employment and linkage effects.
- **The Small and Medium-sized Enterprise Development Programme (SMEDP)** – a cash grant for small and medium-sized manufacturing, tourism, high-value agriculture and aquaculture enterprises.
- **Skills Support Programme (SSP)** – a cash grant to support training of employees.
- **Critical Infrastructure Fund (CIF)** – a fund that can underwrite part of the cost of infrastructure undertaken by a local authority, which is necessary to ensure a particular investment.
- **Foreign Investment Grant (FIG)** – assistance with relocation costs.

Trade Strategy

South Africa's trade strategy has concentrated on gaining preferential access to important markets alongside a tariff phase down. Access to the European Union (EU) and the Southern African Development Community (SADC) markets have been facilitated *via* the conclusion of Free Trade Agreements (FTAs). The next phase of this strategy encompasses building strong trade relations with major emerging markets, such as Brazil, India, and Nigeria. The access afforded to the United States market by the African Growth and Opportunity Act (AGOA) has served to bolster this strategy. South Africa is already beginning to reap the benefits of AGOA with large increases in exports to the United States in the first few months of meeting the qualification criteria (in March 2001).

The trade access negotiated or afforded to South Africa creates significant opportunities for FDI, in order to take advantage of preferential access to major markets.

Microeconomic reforms

While the macro-level reforms identified above have resulted in a sound macroeconomy, the focus of policy has shifted towards addressing issues that cannot be adequately dealt with at the macro level. These included the following:

- Restructuring and privatisation of state assets to ensure greater economic efficiencies. This applies particularly to the transport parastatals.
- Addressing unemployment more directly through some form of wage or employment support, as well as revisiting South Africa's labour legislation.
- Improving skills levels to increase employment, as well as address the skills needs of industry through reform of the immigration framework.

These reforms are aimed at lowering the costs of doing business, lowering unemployment, and increasing industry access to the skills it needs.

Legal framework and financial infrastructure

South Africa has a constitution that protects property rights and an independent judiciary. It has a sophisticated commercial law. Its financial infrastructure is world-class with the presence of most major international banks.

> *The breadth of financial products and services is unparalleled in other emerging market economies, and there is depth as well: the stock market is the 13th largest in the world, and the bond market offers first-world size and liquidity.* (World Bank 2001: Discussion Paper 16).

Consequently, foreign investors by and large face the same legal and regulatory environment as domestic investors. There are certain regulations, however, which are unique to foreign investors, and tend to be for reporting or balance-of-payments reasons. These include:

- Foreign companies are required to register as external companies before immovable property may be registered in their names.
- There is a restriction on the local borrowing of business entities that are 75 per cent or more owned or controlled by non-residents.

Exchange controls have effectively been abolished in relation to non-residents, and the Government is pursuing a policy of gradually relaxing the remaining exchange controls applicable to residents.

Problem areas highlighted by investors

South Africa is like any other developing country in the sense that foreign investors do experience difficulties during the investment process. The following are the major areas of concern that have been reported by foreign investors.

- A general burden of bureaucracy at different levels of government with respect to setting up business. This includes issues such as:
  -Lack of information with respect to the requirements to set up a plant
  -Long lead times for utilities such as electricity and telephones
  -Inadequate bandwidth.
- Difficulties in securing work permits for managers and professionals, as well as long waiting periods for such documentation.
- Costs and 'hassle factor' of compliance with labour legislation.
- Inadequate investment incentives.

Trade and Investment South Africa works actively to resolve these problems. This occurs through direct intervention with the relevant government department, local authority, or parastatal. It also includes ongoing interventions at the policy level, in order to improve the business environment in South Africa.

Policy messages

From the perspective of TISA there is some measure of frustration with respect to the manner in which South Africa is classified as an investment destination. Despite the much praised establishment of sound macroeconomic fundamentals and ongoing improvements in South Africa's rating for portfolio investment by agencies such as Standard and Poor and Moody's, TISA feels that South Africa has not attracted as much FDI as its economic fundamentals justify.

While there are undeniable socio-economic problems such as high unemployment and HIV/AIDS levels, it is felt that these factors do not adequately account for the levels of investment seen so far. Financial crises in certain economies have had a spillover effect on others as portfolio investors withdraw from the basket of 'emerging markets', despite the lack of any linkage between certain emerging economies. This has a negative impact on foreign direct investment.

The policy message that TISA wishes to see from the OECD conference is that there should be a more informed evaluation of emerging market economies in general, and promising African economies in particular. Undue Afro-pessimism should not lead to irrational investment decisions.

ADDENDUM

South-African Income-Tax System

The South African Tax system, in line with the international community, changed from a source-based to a residence-based system with effect from the 1 January 2001. This means that South African residents will be taxed on their worldwide income. Non-SA residents will still be taxed on income from SA source subject to the Double taxation agreements with different Countries.

Principal taxes

SA imposes the following direct and indirect taxes:

Direct Taxes

Income Tax, Secondary Tax on Companies (STC), Capital Gains Tax and Donations Tax

Indirect Taxes

Value Added Tax, Estate Duty, Stamp Duties, Transfer duties, Customs and Excise Duties, Marketable Security Taxes, Regional Services Council Levies, Skills Development levies

Income Tax

Income tax is imposed on individuals, small business corporations, and employment companies, companies and other business corporations.

Companies pay income tax at the rate of 30 per cent and, in addition, companies pay Secondary Tax on Companies (STC) on dividends declared at the rate of 12.5 per cent. Small business corporations are taxed at the rate of 15 per cent for the first R100 000 of taxable income and 30 per cent for amounts in excess of R100 000. Employment companies or labour brokers are taxed at a 35 per cent rate. In the case of natural persons tax is levied at progressive rates from 18 per cent to 42 per cent.

Other entities like Partnerships are not regarded as separate legal entities and therefore income earned by the partnerships will be taxed in the hands of the individual partners separately in the proportion of their interests. Trusts are generally regarded as conduit of income to the beneficiaries, so income earned by trusts is normally taxed in the hands of the beneficiaries. Trusts that do not distribute income to the beneficiaries are taxed separately at the rate of 32 per cent for amounts up to R100,000 and at the rate of 42 per cent for income in excess of R100,000. Employers are required to deduct employee’s tax from remuneration earned by their employees and directors.

Donations tax

Donation tax is payable on property disposed of by means of a donation by SA residents and companies incorporated or managed and controlled in SA (excluding public companies) at the rate of 25 per cent, reduced to 20 per cent from 1st October 2001. Donations by individuals up to R25,000 per annum are exempt from tax.

Capital Gains Tax (CGT)

SA has introduced CGT with effect from 1st October 2001. CGT will apply to SA residents on worldwide assets, or Non-SA residents on immovable property in SA or assets of a branch or agency in SA. Disposal of an asset will trigger CGT. A portion of the gain realised on the sale of an asset will be included on the taxable income of a taxpayer at the rate of 50 per cent if it is a company, close corporation, business or family trust. Gains realised by natural persons will be included at the rate of 25 per cent. A primary residence occupied by the owner is exempt from CGT. Assets owned by exempt institutions, private motor vehicles, personal belongings, and lump-sum benefits of most superannuation and life assurance policies are also exempt from CGT.

Branches of Foreign Companies

An external company, or the South African branch of a foreign company, which has its place of effective management outside South Africa will be subject to a tax of 35 per cent on taxable income derived from a source within SA, in respect of years of assessment ending on or after 1 April 1996.

Estate Duty

Estate duty is levied in respect of the property of every person at the date of his/her death at the rate of 20 per cent. The first R1million of the estate is exempt.

Customs and Excise duties

Excise duty is a tax imposed on certain commodities produced locally e.g. automobiles, jewellery, beer and wine. Imported goods are subject to similar levies in the form of customs duties. A rebate of customs duty can be obtained if the imported goods are to be used in manufacturing for export.

Regional Services Council levies

The Metropolitan councils impose a regional services levy on businesses and joint services boards for the supply of basic services within their regions. It is based on the gross consideration received by the business and on salaries paid to employees.

Marketable Securities

This tax is imposed on the purchase of listed marketable securities e.g. shares listed on the stock exchange. The tax is 0.25 per cent of the consideration paid in the transaction.

Stamp Duties

Are imposed on contractual documentary agreements. Some stamps are at a fixed amount and others at *ad valorem* rates.

Transfer Duties

This is a duty on transfers of immovable property based on the value of the property that is transferred.

Value Added Tax (VAT)

VAT is levied at the rate of 0 per cent and 14 per cent on most transactions involving the supply and consumption of goods and services including immovable property.

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FOR FURTHER INFORMATION

Submission by the South African Chamber of Business (SACOB) to the Portfolio Committee on Finance concerning the Draft Taxation Laws Amendment Bill 2001: Proposed Introduction of Capital Gains Tax: http://www.cgtsa.co.za/discuss/010801_01.htm.

Focus on the new Africa: UNCTAD Fact sheet on Foreign Direct Investment:
http://www.unctad.org/en/pub/fdiafrica_fact.htm

South Africa as an International Economic Player:
http://www.southafricahouse.com/documents/CBI.htm

Africa Matters:
http://www.voa.gov/thisweek/library/archive/aug01/africa per cent20matters.html

Is Export-Oriented FDI Better?

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Introduction

The potential benefits of FDI, especially for developing countries, have been well documented in the literature.[2] Multinational enterprises (MNEs) are a source of capital, employment, technology, management skills and international distribution networks, among many other things. However, it has also been argued that these benefits vary according to the characteristics of different types of FDI and that some types of FDI are better than others. This has led, perhaps naturally enough, to arguments advocating the promotion of FDI that is, in one way or another, 'better'. This development is important to the extent that it implies that some types of FDI are more deserving of incentives than others.[3] Furthermore, there is growing recognition of the potentially negative implications associated with the growing use of financial and fiscal incentives in policy competition for FDI (OECD, 2001), such that any argument in favour of concentrating incentives on certain types of FDI deserves careful consideration.

With respect to trade, export-oriented FDI is, *ceteris paribus*, generally considered better than non-export-oriented FDI. Indeed, the positive role of export-oriented FDI, especially in the context of development, has been well documented (Lall, 2000). UNCTAD (2001) has therefore suggested that developing countries should actively seek to attract "the right FDI" in order to "tap into the new international production systems of TNCs, the perhaps most dynamic elements of international trade".

The objective of this paper is to take a step back and address the question, is export-oriented FDI really better? More specifically, we consider the possible implications of policies aimed at attracting export-oriented FDI in the context of current thinking on the dynamics of MNE behaviour. The rationale for this approach is that policies geared towards MNEs need to take into account the nature of these in order to be effective.

Section 2 selectively reviews some of the theoretical literature on MNEs in terms of the role played by information gained from foreign operations in shaping their subsequent FDI and trade patterns. This review suggests that many initial FDI projects will not be export-oriented at first but that such an orientation can emerge over time as MNEs learn more about the performance of their initial investments and possibilities for expanding production in particular markets. In effect, MNE theory raises questions concerning the feasibility of accurately identifying export-oriented FDI. Section 3 presents firm-level time series data on the international operations of a sub-sample of Fortune Global 500 companies. These data highlight one of the major motivations behind FDI, namely the performance of existing FDI. Data are also presented on the foreign intra-firm sales of a sample of Fortune Global 500 companies. These show that the share of foreign intra-firm sales in total foreign

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1 The views expressed are personal and should not be attributed to the OECD or its Member countries. Comments should be addressed to michael.gestrin@oecd.org.

2 See, for example, UNCTAD (1999), Part 2.

3 We are not here concerned with the issue of the merits of providing incentives to attract FDI. Rather, we recognise that the use of incentives to attract FDI has become pervasive and that, to the extent that policy-makers accept the argument that export-oriented FDI is better than non-export-oriented FDI, they are likely to act accordingly in terms of the conferral of incentives to investors.

sales by foreign affiliates is quite low and that the share shows no apparent upward trend, in contrast with the share of third-party sales by foreign affiliates. This would seem to suggest that the growth of FDI during the 1990s has been motivated more by market access considerations than by opportunities for more deeply integrated international production, one of the arguments that has been put forward for the promotion of export-oriented FDI. Section 4 concludes with some policy implications.

The role of information in the FDI decisions of MNEs

Policies that aim to shape or influence the behaviour of MNEs need to take into account the behavioural characteristics of these. With respect to the export-orientation of the foreign subsidiaries of MNEs, the theoretical literature is rather sparse. However, the theoretical international business literature nonetheless highlights certain features of MNE behaviour that are relevant to a consideration of whether or not there is merit in identifying and subsequently promoting FDI that is export-oriented. One of the key themes that recur in the literature is the role of information (or the lack thereof) in shaping the investment patterns of MNEs.

Information plays a central role in the FDI decision-making process. Before making FDI decisions, either with respect to new FDI projects or existing foreign facilities, managers will collect and evaluate information on a wide range of issues, such as the economic characteristics of foreign markets, the resources available to the firm (including those related to information itself) and possible responses of competitors.

Vernon (1966) is one of the first contributions to the international business literature to include information gained from initial FDI in a model of MNE behaviour. He points out that once MNEs have made their initial investment, "more ambitious possibilities for their use may be suggested… Accordingly, it may prove wise for the international firm to begin servicing third-country markets from the new location" (Vernon, 1966, p.18). This constitutes in effect the first instance of a dynamic model of international production by MNEs, in which the act of investing in foreign markets provides new information that feeds back into the international strategy process and the patterns of trade associated with FDI. What this suggests is that it is difficult to make a clear distinction between FDI that is export-oriented and FDI that isn't, since this orientation can change over time.

The 'Scandinavian school' deals even more explicitly in learning from prior involvement in foreign markets as a force in shaping subsequent patterns of international business activity. Originating in the study of four Swedish firms by Johanson and Wiedersheim-Paul (1975), the central premise of this literature is that the internationalisation process is characterised by a series of incremental steps. Johanson and Wiedersheim-Paul identify four stages of the "establishment chain", each representing an increase in the degree of involvement in foreign markets. These are: 1) no regular export activities, 2) export *via* independent representatives, 3) sales subsidiary and 4) production/manufacturing.

Information plays a central role in this explanation of the international activities of MNEs, with each stage increasing the amount of information that the firm has available to it regarding foreign markets; "the first [stage] means that the firm has made no commitment of resources to the market and that it lacks any regular information channel to and from the market. The second means that the firm has a channel to the market through which it gets fairly regular information about sales influencing factors. It also means a certain commitment to the market. The third means a controlled information channel to the market, giving the firm ability to direct the type and amount of information flowing from the market to the firm. During this stage the firm also gets direct experience of resource influencing factors. The fourth stage means a still larger resource commitment" (Johanson and Wiedersheim-Paul, 1975, p.28). Recalling Vernon's (1966) point that subsequent opportunities to serve third markets from a subsidiary might become apparent, we might add a fifth stage to the incremental stages model,

in which the firm increases its commitment to the foreign market even further by increasing capacity with a view to serving export markets.

In the context of the current discussion of the merits of export-oriented FDI over non-export-oriented FDI, the Scandinavian School implies, along the lines of Vernon (1966), that the dynamics of MNE behaviour and their tendency to take an incremental approach to internationalisation, make the identification of FDI that is export oriented from the outset a difficult exercise. If MNEs themselves do not know what their eventual commitment to a particular market will be at the time that an initial investment is made, depending upon the subsequent performance of the initial investment, it seems unlikely that policy-makers will know the answer either.

The first explicit recognition of the potential role of information on the performance of existing FDI in shaping the subsequent FDI decisions of MNEs is provided by Boddewyn (1979a, 1979b, 1983a, 1983b), who considers whether the core explanations for FDI (Dunning's eclectic paradigm in particular; see, e.g. Dunning 1993) also serve to explain instances of foreign direct disinvestment (FDD) (see also Chopra et al, 1978). The motivation for asking this question was that FDD "has received hardly any attention from economists even though [the] phenomenon is already significant" (Boddewyn, 1983b, p.346).

One of Boddewyn's key insights is that "information levels are more apparent in FD [foreign direct divestment] than in FI [foreign direct investment] decisions. Before investment, there may be little familiarity with the possible foreign production site while divestment decisions apply to *known* locations" (Boddewyn, 1983b, p.349). This information plays an important role in the FDD decision but not in the initial FDI decision because the information is simply lacking before the investment is made. However, the significance of this point extends well beyond issues relating to FDD. Where an MNE already has a presence in the form of FDI, the logic outlined by Boddewyn would suggest that any subsequent decisions relating to resources committed to the foreign markets in question should be based to a significant extent on information gained on these markets because this information reflects, in real terms, the actual strength of the firm's ownership advantages, the benefits of internalisation, and the strength of the location advantages. Likewise, the degree to which FDI is export-oriented will be conditioned by information gained through the initial investment, especially concerning regional markets.

Buckley (1989) provides another example from international business theory in which the role of information from existing FDI shapes subsequent FDI decisions of firms. He does so in the context of the specific challenges faced by small and medium-sized enterprises (SMEs) engaging in early internationalisation. Among the theoretical constructs he posits as useful in the interpretation of the FDI decisions of SMEs is the 'gambler's earnings' hypothesis, which suggests that, like seasoned gamblers, firms will begin the game with a small stake but then continually plough "back their 'winnings' (profits) into the game until a real 'killing' [is] made" (p. 103). The smallness of the initial stake owes, along the lines of Aharoni (1966) and Vernon (1966), to uncertainty about the likelihood of success in foreign markets.

However, once the initial foreign investment proves profitable, "uncertainty is lower and the costs of search for further profit approximate to zero" (p. 103). The result is that firms will "reinvest in [the] safe bet – the existing subsidiary… In other words, foreign investors are hypothesized to exhibit a bias in the allocation of investment funds towards existing, profitable subsidiaries" (p. 103-4).

That the performance of an MNE's international operations should influence subsequent FDI decisions is highly intuitive. After the initial FDI decision, managers obtain data on the costs of production in foreign markets, the profitability of FDI projects, the quality of the output from these facilities, and opportunities for increasing exports to the home and third markets. This information in effect

constitutes the acid test for the *ex ante* expectations of managers concerning the strength of the ownership, location and internalisation advantages for initial FDI projects. Furthermore, as globalisation progresses, this dynamic should come to play an increasingly important role in the FDI decisions of MNEs to the extent that very few markets or regions constitute 'virgin' territory for MNEs. As Rugman (2000) has argued, most of the world's leading MNEs have established operations across the Triad (Japan, North America and the European Union) and, as such, these enjoy the benefits of *ex-post* information on the performance of their foreign operations in these regions. They do not have to 'reinvent the wheel' with respect to sequential FDI, as implied by most empirical studies on the determinants of FDI.

Information on the performance of FDI represents the cumulative representation of all variables that actually influence performance and hence shape subsequent FDI decisions of MNEs. Traditional models of MNE behaviour, on the other hand, with their static equilibrium orientation, effectively ignore the role of information on the performance of FDI in subsequent FDI decisions and imply that, each time an MNE considers FDI it does so as if such were an initial investment in an unknown market. This static equilibrium approach can also be found in much of the policy literature to the extent that MNEs and FDI continue to be viewed in terms of a 'package' of various benefits for the host economy, as opposed to a fluid evolutionary process linked to corporate behaviour and strategy in which the 'package' is constantly changing.

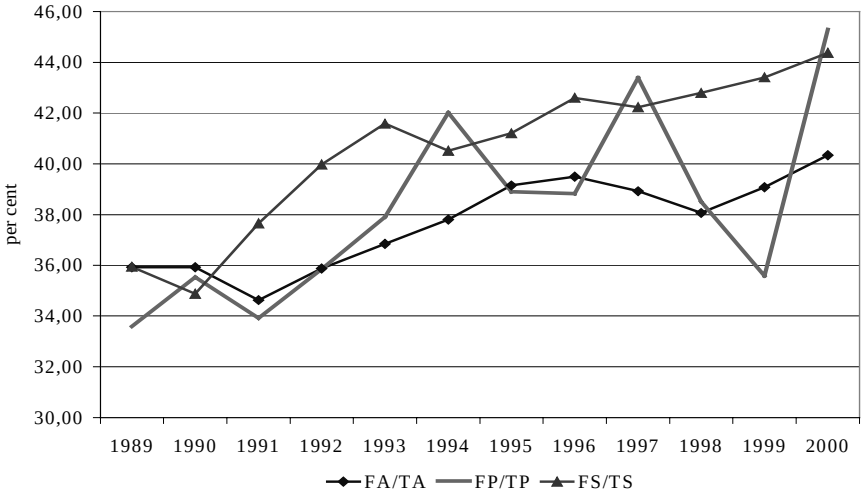
With respect to the view that export-oriented FDI is generally better than FDI that is not export-oriented, this review of the literature suggests that making such a distinction is fraught with difficulties given the dynamic nature of MNE behaviour in foreign markets. Indeed, while FDI has clearly contributed to the export performance of some countries (see, e.g. Lall, 2000), what has not been documented is whether this contribution was preceded by a period of more inward-oriented FDI along the lines suggested by the various theories outlined above. What this implies for policy is that the targeting of certain types of FDI with a view to promoting long-run export competitiveness might need to involve efforts to attract FDI that, at least initially, is not export oriented at all. This is more so the case to the extent that a significant amount of FDI is conducted by SMEs, whose initial forays into international markets are unlikely to be export oriented (UNCTAD, 2001).

Data on the performance of FDI

The previous section considered the role of information on the performance of FDI in shaping the subsequent FDI decisions of MNEs. This literature highlights the dynamic nature of the commitments that MNEs make to foreign markets and the role of information on the performance of existing foreign operations in shaping future commitments. One of the implications of this literature is that export orientation will, to a significant extent, be a function of the information received over time concerning opportunities in the market(s) in question.

In this section we will present descriptive data indicating that positive performance in foreign markets has been one of the driving forces behind the internationalisation of production during the 1990s. Figure 1 shows the shares of foreign in total assets (FA/TA), revenues (FR/TR) and profits (FP/TP) of 100 MNEs from the Fortune Global 500 between 1989 and 2000. The first clear trend in the chart is the steady process of internationalisation by these firms. In 1989, the average share of foreign in total assets for the sample was 36 per cent. By 2000, this share had increased to just over 40 per cent.

Figure 1. The foreign investment profitability gap



Source: Gestrin et al (2001)

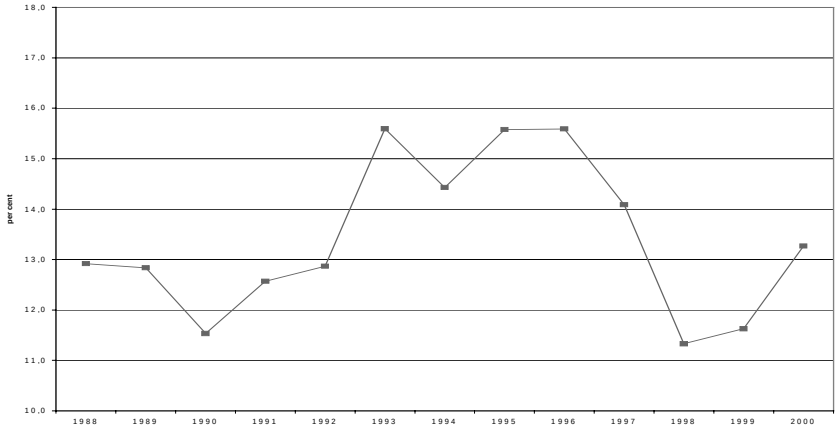
The second point to note is the tendency for the share of foreign revenues and profits to exceed the share of foreign assets. What this indicates is that throughout the 1990s, with only a few exceptions, the foreign assets of this sample of MNEs were generating a disproportionate share of total revenues and profits. This is an intuitive finding, and one that is consistent with the view that the 1990s witnessed the progressive globalisation of MNE activity. As long as MNEs generally managed to earn higher profits in foreign markets than at home, they logically continued to increase their investments in these. In the context of the previous discussion of the dynamic nature of MNE behaviour and the tendency of these to take an incremental approach to their foreign operations, this suggests itself to a fairly basic policy conclusion. Policies that allow MNEs to generate profits and revenues through their foreign operations are likely to encourage further foreign investment in existing projects and in new capacity.

But to what extent is the sales intensity of foreign assets observed in Figure 1 export oriented? This is difficult to know with certainty but we can make certain inferences based upon intra-firm sales data. A distinction is usually made between horizontal and vertical FDI. Horizontal FDI tends to be market seeking, and involves the establishment of foreign facilities engaged in functions similar to those in other markets. Vertical FDI involves the distribution of various parts of an MNE's value chain in countries where the various activities are best served by location advantages. A commonly held view is that an increasing share of global FDI is of this type, and that MNEs are increasingly engaging in integrated international production.

Vertical FDI is export oriented (and import oriented) almost by definition. Integrated international production aims to concentrate certain value-chain activities in particular countries and to then export the intermediate products to the next stage of processing in other countries. Horizontal FDI might or might not be export oriented, but is certainly more likely to be characterised by the incremental approach described in section 2 above.

To the extent that MNEs are increasingly engaging in FDI for integrated international production, we would expect that a rising share of foreign affiliate sales be intra-firm. However, recent research has suggested that this is not the case. Rangan (2000), for example, observes that "over the thirty years spanning 1966-1997…the share of U.S. multinationals' intra-firm exports in total U.S. manufacturing exports has remained remarkably stable" (p. 3). This observation is supported by data on the foreign intra-firm revenues of a sample of 30 MNEs from the Fortune Global 500 for which these data were available from 1989 through 2000 (Figure 2).

Figure 2. The share of foreign intra-firm revenue in foreign arm's length revenue



Source: author's calculations

Figure 2 seems to indicate that there is no obvious upward trend in the propensity of MNEs to make FDI with a view to integrated international production networks. Furthermore, to the extent that these companies are representative (indeed, given that these are among the largest companies in the world we would expect them to be most likely to engage in IIP), the share of total revenue generated through intra-firm sales is modest at around 13 per cent.

Within the context of the present discussion concerning the desirability of promoting export-oriented FDI, we might draw several tentative conclusions from these descriptive data. First, it would seem that most FDI remains horizontal in nature and that, at least in this sample of companies, there is no clear trend towards integrated international production. One policy implication of this is that policy-makers should probably not over-estimate the potential benefits of integrated international production for export competitiveness in their FDI promotion schemes. Second, most FDI continues to be horizontal in nature and, as such, is likely to have the incremental characteristics outlined in section 2. To the extent that MNEs engage in incremental horizontal FDI, policy-makers need to take into account the fact that domestic markets might well be the main initial focus of MNE strategy but that this does not preclude increased export orientation over time.

Policy conclusions

The main message of this paper is that, although the potential benefits of export-oriented FDI are widely acknowledged, this does not necessarily lend support for policies aimed at targeting and promoting export-oriented FDI. One reason for this, outlined in our short review of international business literature, is that MNEs tend to take an incremental approach to foreign markets, especially new ones, and that their commitment to these over time will be conditioned to a significant extent by observed performance. Policies that aim to attract export-oriented FDI risk either neglecting or even discouraging FDI that might initially be oriented towards the domestic market but become more export-oriented over time. Indeed, policies that focus on attracting export-oriented FDI, to the extent that these either neglect or even discourage non-export-oriented FDI, might actually detract from export competitiveness in the medium and long term.

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Trade and Investment Linkage: A WWF Perspective,

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Foreign direct investments play a critical role in shaping the future of our planet. Without significant flows of private capital into developing countries, poverty will continue to be one of the principal underlying causes of environmental degradation worldwide. But at a time when the earth's natural resources are already dangerously overexploited (WWF's Living Planet Index reports that a third of our natural wealth has been destroyed in the past three decades), international investment also poses a major threat to sustainable development.

This is on top of the fact that FDI often fails to return the basic economic benefits expected. Poverty alleviation is not happening fast enough. Income disparities are growing, and technology transfer and economic development are often distant hopes. Today, policy-makers are rekindling the debate over proposed new agreements to help open borders to private investors. We need to refocus this debate by giving serious attention to promoting conservation and sustainable livelihoods for people and not just to protecting corporate profits.

Research by the WWF shows that the interactions between FDI and sustainable development are complex. FDI can boost the economic growth of a country by increasing its total productive capacity, creating positive spillover effects (transfer of cleaner and more efficient technology, knowledge, skills) as well as spurring competition and innovation. However, these positive impacts depend on a variety of factors, including the presence of strong domestic regulation. A number of cases exist where investment has taken place at such a scale and pace that it has overwhelmed host country regulatory capacity, resulting in inefficient production and irreversible environmental destruction.

The negative impacts are most prevalent in the natural resource sectors such as forestry and mining, and in export-zone manufacturing that form the largest proportion of investment flows to developing and least developed countries. These investments are often located in remote areas, and thus their impacts have not received wide attention in the host countries or internationally. Moreover, these activities frequently have few linkages to host-country economies – they extract and export raw materials contributing little to long-term development. There is not much real priming of the development pump (problems of leakage of profits, lack of technology transfer, anti-competitive practices, etc).

While governments have devoted extensive efforts in a global competition to attract foreign investors, their support for environmental governance has lagged behind. Environmental governance is defined as mechanisms, processes and institutions through which citizens and public interest groups articulate their interests, exercise their legal rights, meet their obligations and mediate their differences. The attributes of a good governance process are that it is participatory, transparent and accountable. Formal elements of governance include, but are not limited to, the development of national environmental laws and institutions, as well as mechanisms for public participation and the use of environmental impact assessments.

[1] This presentation is drawn largely from the papers written by Richard McNally on FDI and environment and the draft investment and environmental governance paper written by Tony Zamparutti which was commissioned by David Schorr, WWF, U.S..

Many countries have established essential laws and institutions for environmental governance, but implementation remains difficult. For example, in many countries, environmental institutions lack the necessary funding, staff and equipment to carry out essential environmental protection work. Progress has been 'chilled' by the fierce competition among countries for investment flows. Indeed in many countries, economics and other ministries are reluctant to co-operate with environment authorities and to encourage the development of environmental requirements. In some countries, domestic economic interests may also be encouraging this 'chill'. This lag is an obstacle to sustainable development and ongoing environmental degradation has brought high economic and social costs.

In Costa Rica, deforestation, much of it due to land clearing for cattle ranching, cost the country at least $4 billion in the 1980s, and where included in national accounts would have reduced economic growth by 20 per cent a year. The cost of environmental degradation in Nigeria is estimated over US$5 billion a year, which is more than 15 per cent of its GDP. These estimates merely focus on national and local costs. If we look at the implications of resource degradation at a global level, then we have examples of deforestation contributing to the worldwide loss of biodiversity, and forest fires and the loss of potential carbon storage aggravating climate change.

Curiously, the main prescription offered to developing countries to solve this problem is more investment. Developed country political and business leaders have repeatedly claimed that FDI is actually the solution: investment will bring economic growth, they assert. As countries grow wealthier, they will start to address their environmental problems. Behind this rhetoric lies an economic theory, the environmental Kuznets curve, which contends that 'grow now, clean up later' is a standard path for development. This theory rests on weak evidence at best, and provides dangerously wrong lessons for development.

*Both the methodology and the message of Kuznets curve are flaw*ed. The hypothesis has been tested only for local airborne pollutants. Studies claim that pollution increases up to a turning point and declines thereafter – between US$5,000-8,000 per capita as the turning point.

The Kuznets curve suggests that a clean environment is only for the wealthy. Even if we accept this simplistic correlation, it will take many years of accelerated environmental degradation with potentially large catastrophic and irreversible effects before they could reach the turning point. The fact that one third of our natural wealth has been destroyed in the past 25 years makes one wonder where these resources will come from. The turning point of US$5,000-8,000 is way above the income of most of the world's inhabitants.

Kuznets curve also ignores the cost of environmental problems and their global dimension. The assumption that the environment is merely a luxury good and one with national dimensions is a central problem for the Kuznets curve argument. The global biodiversity loss, global warming, and the spread of toxic pollutants show no evidence of following the EKC.

1. There is no 'market solution' – and the challenge of environmental governance must be addressed directly. However, governments, particularly in developing countries, have been concerned that improving environmental governance will prove expensive and will divert resources from other necessary development needs, and moreover, stronger environmental requirements will deter investors.

2. The costs of many elements of better governance are relatively low, in particular related to the costs of environmental degradation. Production and economic growth are not locked in a zero-sum trade-off with environmental impacts. For factories, there are many opportunities for low-cost pollution prevention, some of these indeed reduce pollution costs and improve quality; and modern production methods can often cut pollution levels. For natural resources, there are a host

of methods provided that can protect natural values and provide long-term revenues: the Forestry Stewardship Council has guidelines for sustainable forestry, and international initiatives are underway to identify best practices in mining. Moreover, effective environmental governance is more than a set of rules imposed by governments, and instead involves interaction of citizens and local communities, business and markets, and government agencies.

3. Furthermore, better governance should not deter foreign investors as many corporations have committed themselves to high environmental performance. Studies indicate that society has accepted market capitalism in exchange for deepening and broadening the standards of accountability to encompass the environmental, social and economic dimensions of corporate activity. In addition, in many cases, companies have found that better environmental performance has indeed improved profits, through pollution prevention approaches that improved production efficiencies. In countries with strong environmental liability, lawsuits from pollution victims have forced companies to pay high fines. There are also a number of consumers from developed countries who are prepared to pay for a premium for 'green products' and increasingly shun products from companies associated with major environmental problems.

4. Environmental governance is not an obstacle for FDI flows. The low cost of environmental governance – compared to costs of environmental degradation – suggests that it will not drive away investment but could even attract it. Within Europe for example, national and regional investment-promotion efforts often highlight positive environmental conditions related to the quality of life, innovative government programmes, and strong corporate environmental performance.

5. Today, proposals for new investment rules are driven mainly by international business and by governments who increasingly believe – for one reason or another – that freer flows of international capital will help their nations prosper. But today's vision of prosperity too often ignores the need for sound environmental stewardship. With FDI growing at unprecedented rates, and despite the slight dip last year, governments have not fully made the case for pouring diplomatic resources into new rules to promote investment.

6. In the mid-1990s, OECD countries were unable to complete negotiations for a proposed MAI – in part because of fears raised by some governments about the impact the MAI would have on their ability to pursue legitimate public policies. Meanwhile, the investment chapter of NAFTA has generated a rash of cases brought by private parties seeking to use NAFTA in ways not intended by its drafters, as a tool to resist domestic environmental and other regulations.

7. Unfortunately, the lessons of these experiences have not been fully learned. In a significant setback for the environment, WTO ministers in Doha agreed to expand WTO rules on investment. WWF considers that negotiations towards an investment regime within the WTO should not be pursued. Until the international debate seriously addresses the relationship between the basic needs of conservation and sustainable development, all international investment negotiations will be premature. This WTO decision promises to increase the already heated controversy over international investment rules.

8. The WWF believes that better international investment can bring substantial benefits, especially to developing countries. However, this positive outcome will only occur inside a regulatory framework that actively promotes sustainable development and ensures that environmental limits are preserved.

9. Creating the right regulatory framework to harness investment to support sustainable development will be challenging and will require a variety of actions at all level. This framework should provide host countries with the flexibility and ability to control investment flows that undermine their pursuit of sustainable development. Basic elements of the framework would include the following:

   - Developing integrated policy packages – liberalisation in the context of policies for conservation and sustainable development.
   - Close governance gaps by providing development assistance that supports recipient-country efforts to develop good environmental governance, including capacity building and knowledge, skills and technology transfer; allocate financing to monitor and enforce environmental standards; impose disclosure requirements.
   - Encouraging corporate accountability and best practices, including through adherence to OECD MNE guidelines and minimum binding environmental regulations in key natural resource sectors.
   - Developing balanced investment rules by ending hostility to legitimate domestic regulation, forbidding competitive deregulation, avoiding potential conflicts with MEAs, promoting returns to LDC economies through technology transfer, integration.
   - Promoting transparent and accountable institutions and mechanisms – provide mechanisms for ensuring and strengthening stakeholder/civil society consultations, participation and activities related to investment decisions that affect them.
   - Providing incentives for sustainable investment (ending perverse subsidies, promoting private 'green investment' mechanisms.
   - Conducting impact assessment (look before you leap).
   - Implementing debt service commitments by developed countries and effective special and differential treatment for developing countries to address the current imbalance in international trade and investment policies and practices.

The above is a long list, and entails changing the way governments work. However, there are political decisions that are practically and realistically within reach now. WWF urges governments to:

   - Insist that the Doha Ministerial Declaration: a) does not mandate an automatic start to negotiations on the Singapore issues after the Fifth Ministerial Conference; b) mandate the continuation of a study process on these issues; and c) require that any decision to launch negotiations on these new issues must be made AFTER the Fifth Ministerial Conference and must be on the basis of, but not be determined by, a decision made at the Fifth Ministerial Conference by the Members by explicit consensus regarding the modalities for such proposed negotiations on new issues.
   - Fix NAFTA and other existing agreements.
   - Reorient regional and bilateral negotiations with governments explicitly declaring their intention to adopt a new and more balanced approach to investment agreement negotiations. More specifically, governments involved in such negotiations should detail how new agreements will address each of the basic elements of the new approach discussed above. Of particular importance is to clarify the need for an integrated policy package approach, including developing flanking measures and for establishing investment rules that balance private rights with public needs.
   - Undertake stakeholder-oriented sustainability assessments (look before you leap).

CHAPTER IV

CAPACITY BUILDING IN HOST COUNTRIES

Foreign Direct Investment: Policies and Institutions for Growth,

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Introduction

At the epicenter of globalization has been the multinational corporation.[1] Globalization – the process of integrating national economies into one global economy -- occurs through four main channels: trade, capital flows, information and people. Multinational corporations embody all four. The distinguishing feature of multinational investment[2] is that headquarters in home countries controls business decisions of affiliates in foreign lands– in their marketing strategies, production choices, and investment decisions – and it is this fact that has raised sporadic nationalistic backlashes and questions.

Questions concerning the implications of foreign investment for economic growth are particularly important: Does foreign investment accelerate economic growth? What are the main channels? What policies can elicit growth-enhancing FDI as opposed to FDI with low or even negative value added? This paper reviews the literature, and concludes that indeed foreign direct investment usually does contribute to growth, but more often through its impact on technological progress than through its effects on investment levels. Moreover, the growth effects are not automatic or universal. The policy and institutional environment is decisive in determining the ultimate contribution of foreign investment. A last section therefore reviews five interrelated sets of policies.

First, The Facts: Recent Patterns and Trends about MNCs in Developing Countries

Beginning with the theoretical insights of Hymer (1960) and Kindleberger (1967), economists have increasingly recognized that the growth of multinational enterprise is more than simply a cross border capital flow in search of higher returns. Rather, MNCs individually possess a unique package of assets— capital *plus* a differentiated product, technology, management skills, and/or marketing know-how. This package of assets allows them to compete with local firms, whose superior knowledge of local conditions would otherwise give them a competitive advantage.[3] While debt creating capital flows are aimed at achieving a contracted return to capital, foreign direct investments are aimed at achieving a return to that package of assets, hence the need to maintain control of all parts of the package – technology, brand-name, or marketing expertise -- through ownership.

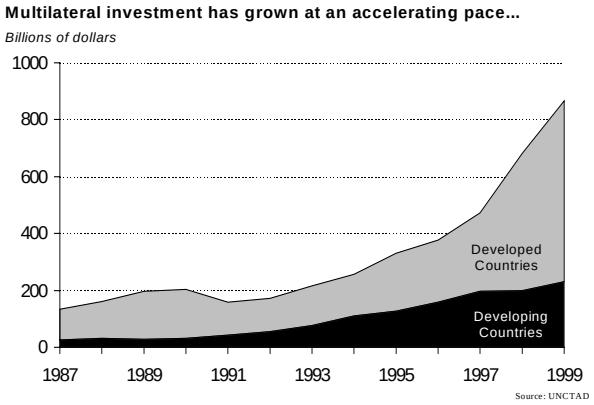
While foreign investment is not new, the dimensions today are staggering and pace of growth rapid. Foreign direct investment (FDI) has grown worldwide from about $60 b. in 1982 to $865 b. in 1999 (Figure 1)– a flow nearly as big as the whole economy of China that year. In the 1990s, seven patterns of multinational investment in developing countries, in some cases dimly evident earlier, began to take shape:

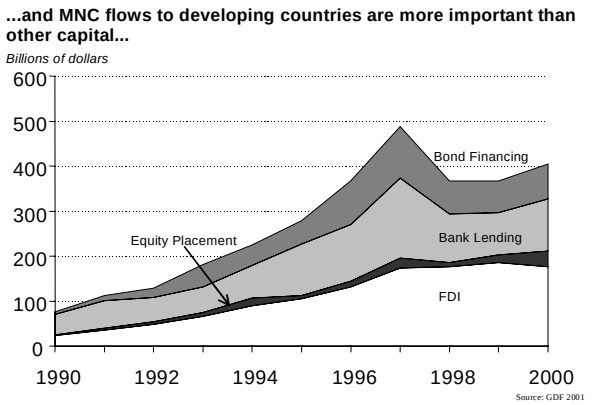
* The author wishes to express his appreciation to Yeling Tan, Yong Zhang, Fernando Martel Garcia and Shweta Bagai for their research assistance and invaluable discussions, and to Milan Brahmbhatt, Mary Hallward-Driemeier, Bernard Hoekman, Michael Klein, Jacques Morisset and Edith Wilson for their thoughtful comments on earlier versions of this paper.

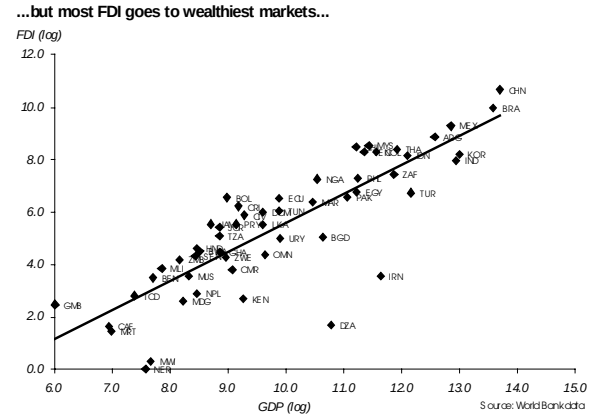
- The lion's share of multinational investment has gone into rich countries, and, in the last five years, this share has increased (Figure 1). This is because many MNCs, especially in manufacturing and services, are seeking markets and the biggest consumer markets are in the large economies of US, EU, and Japan.[4]
- In the 1990s, cross-border mergers and acquisitions were changing the structure of global industry, as firms owing allegiance to stockholders in several countries have become common; in just 5 years between 1995 and 1999, the value of cross-border mergers rose from a worldwide total of $200 billion to more than $500 billion by the end of 1999 (Evenett, et al, 2000: 3; UNCTAD, 2000)[5]. M&A as a form of entry is directly correlated with level of development; the more developed an economy, the more likely is it that incoming FDI will enter the market via acquisition.
- Of all multinational investment going to developing countries, the great bulk goes to countries with the largest internal markets – that is, countries with relatively high per capita income and/or large populations. Exceptions are those countries with heavy restrictions on inward FDI, such as Korea until 1998. These same countries have also received an even greater share of other forms of private capital inflows, in part because they have the sophisticated financial and legal infrastructure necessary to support arms-length contractual financial flows.
- Investments in the service sectors –insurance, finance transportation, and telecommunications – have become an increasingly large share of total outward investment, rivaling manufacturing investments and swamping more traditional investments in primary production, such as petroleum and mineral exploitation.
- For developing countries, foreign direct investment is --on average -- the largest single source of foreign private capital, comprising anywhere from half to three quarters of global long-term resource flows to developing countries. FDI, to say nothing of other private capital flows, has become far more important to developing countries than official development finance. The shifts in recent years have been dramatic: in 1991 foreign direct investment flows were somewhat less than official flows through multilateral and bilateral foreign aid programs exceeded FDI; by 2000, FDI had grown to become more than 5 times more important than official flows.
- Advanced developing countries continued to spawn an ever larger number of their own MNCs. For example, Taiwan (China) and Hong Kong are leading investors in China and other areas of Southeast Asia, while in Latin America Chilean companies invest in Argentina and Brazil, and Argentina and Brazilian companies have reciprocated. Korean firms' investments abroad were roughly one-third of huge inward investments in 1999.
- Low income countries have not fared as well. Low-income developing countries receive relatively little foreign direct investment as a share of the total. And they are losing ground. The share of FDI going to low-income developing countries has dropped precipitously since the mid-1990s (Figure 1). What private capital low-income developing countries do receive is primarily from foreign direct investment.

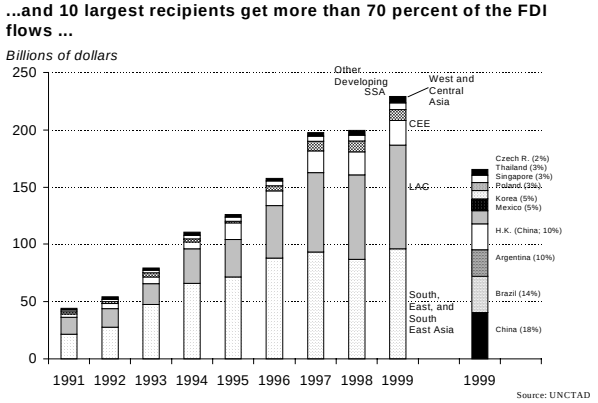
With weaker legal and regulatory systems, it is virtually impossible for the poorest countries to obtain appreciable flows of private capital any other way—because laws governing bank lending and portfolio flows do not offer private foreign investors sufficient protection (see Haussman, 2000). On the other hand, FDI as a share of investment in low-income countries is roughly equal to the middle income countries (see World Bank, *Global Development Finance 2002*).

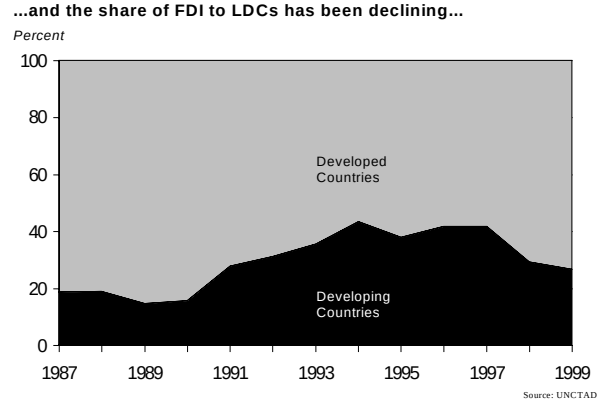
Figure 1: Foreign direct investment surges in the 1990s

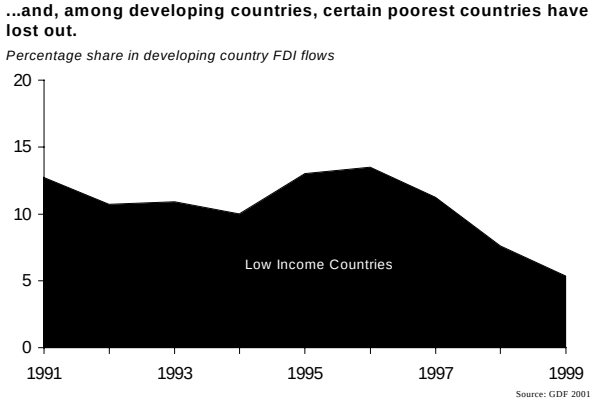












Effects of MNCs on Growth in Developing Countres

Does openness to multinational investment accelerate growth? The weight of theory would suggest that MNCs could contribute positively to growth: as is often cited, they bring capital, technology, skilled management and technical staffs, and ways of doing business that are usually more modern. Indeed, several econometric studies have shown that, controlling for other factors, foreign direct

investment flows are positively associated with economic growth (for example, see UNCTAD,1998 and World Bank, 2001a for all developing countries; Van Ryckeghem (1994) for Latin Amerca, and Chulai, (1997) for China). However, the direction of causation is not clear: do MNCs cause more rapid growth because they bring new investment, or are they merely attracted to more rapidly expanding markets to exploit growth opportunities?

The answer is probably both. Theory does not provide a single guide simply because the institutional settings and endowments are quite varied and complex (see Cooper, 2001). One problem, for example, is that those elements in the investment climate that are conducive to MNCs are also conducive to more domestic investment and to greater growth in productivity. Many of the methodological critiques that Rodriguez and Rodrik (1997) and Cooper (2001) apply to cross sectional studies of trade openness and growth also apply to the somewhat less abundant literature on the relation of FDI and growth. With these caveats in mind, let us review recent studies on the two main channels through which MNCs affect the pace of economic growth: by adding to the amount of investment and by increasing productivity.

Investment

With globalization, multinational investment has been rising over the decades as a share of total capital formation throughout the world. UNCTAD calculates that FDI inflows amounted to just 3.4% of all private capital formation in developing countries in 1980; this number rose to 5.2% in 19990, and hit 12.9% in 1998 (UNCTAD, 2000: 5). But has this investment added to new capital stock or merely preempted private domestic investment that would occurred in the absence of FDI? The *Global Development Finance 2001*, suggests that most was additive; based on cross-country regressions of the determinants of domestic investment ratios to GDP over 1972-1998, found that a one percent increase in foreign direct investment produces a 0.8% increase in domestic investment (World Bank, 2001a: 5-8).

The effects were not the same for all countries. The marginal impact of FDI on domestic investment was highest for those countries with higher average educational attainment. Figure 2 displays this relationship graphically. Herrera and Garcia (2000) found that FDI in Latin America and Asia tend to crowd out domestic investment in countries with low levels of education, but increase it in countries with higher levels of education; this is because more skilled workers increase the absorptive capacity of economies.

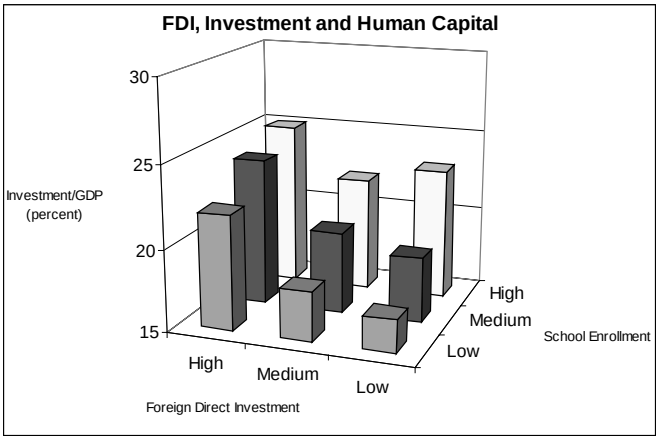
Technological Progress

Recent growth theory has minimized the role of capital accumulation in the growth process and instead focused on technological progress. Easterly and Levine (2001), for example, rank countries by their pace of growth over the 1980-99 period and conclude for that technological improvements reflected in total factor productivity (the unexplained residual in Figure 3) account for the great bulk of the observed growth rates of the high performing countries.

If technology does hold the key to growth, then assessing FDI's contribution to technological progress is likely to greater importance than its addition to capital stock. Both Klein (2000) and Graham (1995) in their respective comprehensive literature reviews give greater to weight to the efficiency-inducing effects of multinational corporations. Indeed, Borenzstein et al (1994), in one of the more sophisticated studies, shows that FDI contributes more directly to growth through their technological transfer than through domestic investment, a contribution that increases significantly and proportionately to levels of educational attainment in host countries.

Figure 2.

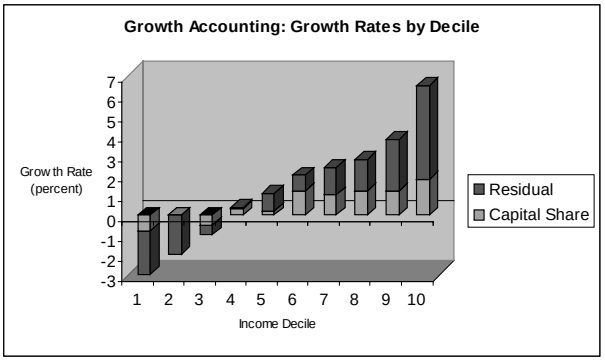
FDI adds more to investment when countries provide more education



Source: World Bank, *Global Development Finance, 2001*

Figure 3

Technology is most important for fast growing countries



The residual in the regression is interpreted to be the contribution of technology.
Source: Easterly and Levine, 2001

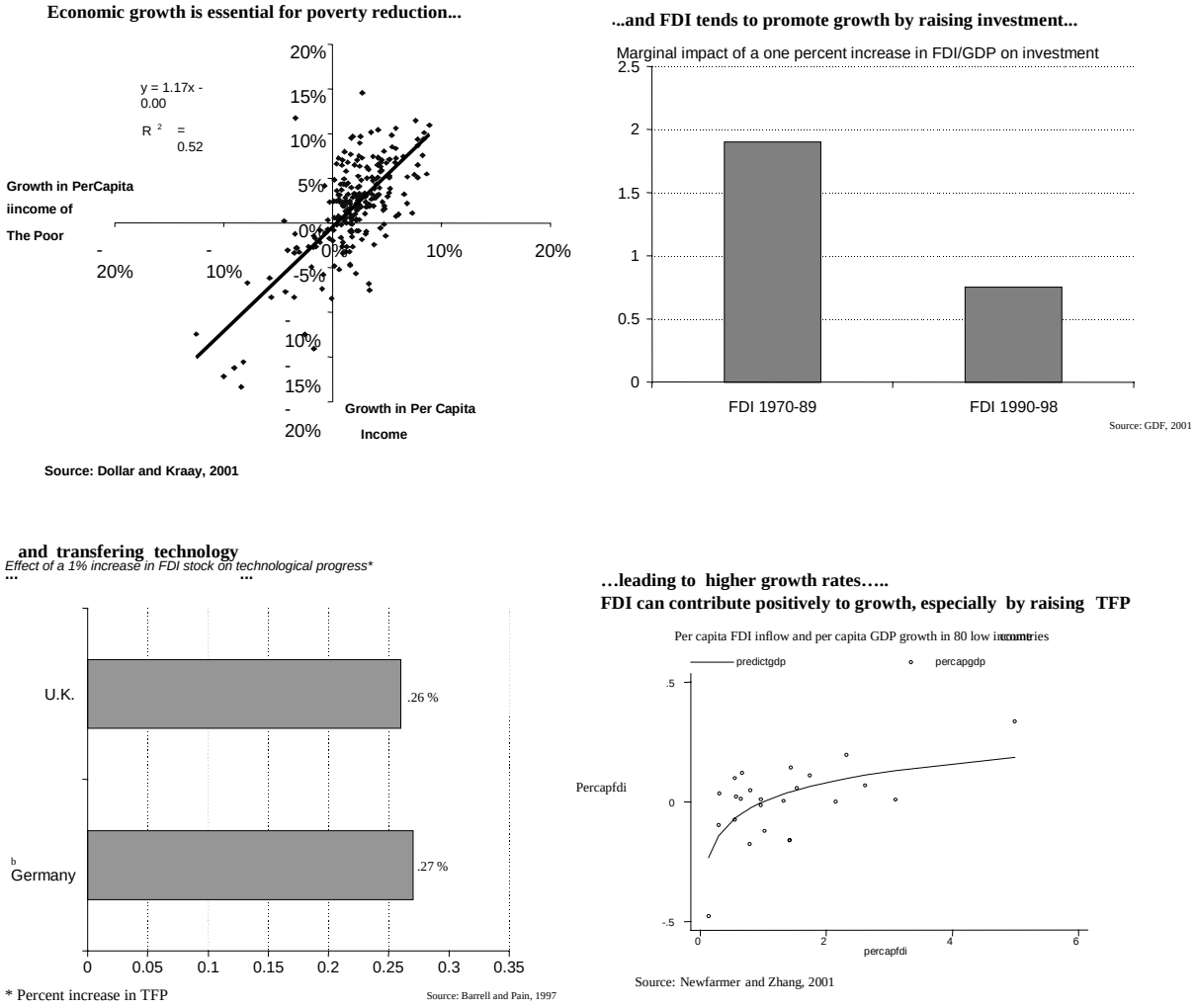
Several studies show that FDI tends to raise output and/or productivity – through introduction of *new technologies* (e.g, Sun, 1998 study for China; Barrel and Pain, 1997 for UK and Germany; Djankov and Hoekman for Czech Republic), and by *increasing export intensities* that, among other things, allow firms to achieve scale economies (see Aitken et al 1997 study of Mexico). Keller (2001), examining technology diffusion within the OECD, finds that globalization has accelerated the pace of

technological diffusion relative to the 1970s, and that FDI accounts for about 15 percent of the bilateral diffusion of technology (though the primary channel is international trade). Finally, de Mello (1999) in his study of 15 OECD and 17 developing countries concluded that in general FDI was positively associated with growth, primarily through TFP effects for developed countries, and through capital accumulation in his (somewhat narrow) sample of developing countries.

MNCs may also make their suppliers or competition better – through so called *spillover effects*. The idea is that MNCs demand higher quality and cheaper inputs; and competitors are forced to raise their efficiency game; and managers and workers that are trained by MNCs often move on to other firms.

But this literature has as many studies that find no spillovers as ones that find positive spillovers (e.g., Haddad and Harrison, 1994). Blomstrom and Kokko (1996 and 1997) conclude their thorough review by arguing that competition and competence in local markets are the principal determinants of spillovers. Saggi's (2001) review seconds their agnosticism but argues that the bulk of studies are in effect looking for horizontal (intra-industry) spillovers rather than the more promising vertical and linkage (inter-industry) effects.

Figure 4 - Growth, Foreign Investment and Poverty Reduction Can Go Hand in Hand…



Bottom line? The overwhelming weight of evidence is that there is a rather direct contribution to growth, whether through additions to the capital stock and/or technological base of countries, and it is a contribution that is magnified in proportion to the level of education, the intensity of competition, and the soundness of the policy environment.

Getting the Most (TFP) Out of Foreign Investment: Policy Matters

While as a general rule it can be asserted with confidence that FDI contributes to growth in developing countries, some countries obtain more growth for a given amount of investment than others. While many circumstantial reasons explain this, policies make an important difference in performance. But which ones? In fact, several policy areas are important, and they tend to be mutually reinforcing through complementarities and synergies. Let's consider five.

Adopting Macroeconomic Policies for Stability

Macroeconomic instability deters investment and, with it, foreign direct investment. When demand becomes problematic, inflation is high and unpredictable, and competitiveness subject to wide fluctuations through swings in the real exchange rate, investors have no assurance that the earnings potential of their investments will be realized years later when new plants come on stream. Macroeconomic instability escalates risks. Gastanaga, et al (1998), for example, emphasize the importance of competitive exchange rates and expected rates of growth in attracting FDI, both of which are adversely affected by macroeconomic instability.

Removing Policy-Induced Barriers to Entry

Policies that affect the condition of entry in industry and services have important consequences for productivity growth (see Frischtak and Newfarmer, 1994). Sound policies will amplify the positive contributions of MNCs, much as poor policies or corrupt enforcement can erode them (see Djankov and Hoekman, 1999).[6] In this respect MNCs are not unique; bad policies also undermine the contributions of domestic firms. A cornerstone of any policy framework is competition.[7]

Trade barriers to competition are an important starting point. If trade policies provide high protection, they will limit competition, allow for shared monopoly pricing, and incur the inefficiencies of price distortions. Lall and Streeten (1977:172-174) studied some 90 foreign investments, using a cost-benefit methodology, found that more than 33% *reduced* national income; this was mainly of excessive tariff protection that allowed high cost firms to produce for the local market at very high prices, even though they could have imported much more cheaply. (It turns out domestic firms performed even more poorly.) Encarnation and Wells (1986) found that between 25-45% of 50 projects studied (depending on analytical assumptions) reduced national income; again the main culprit was high protection.

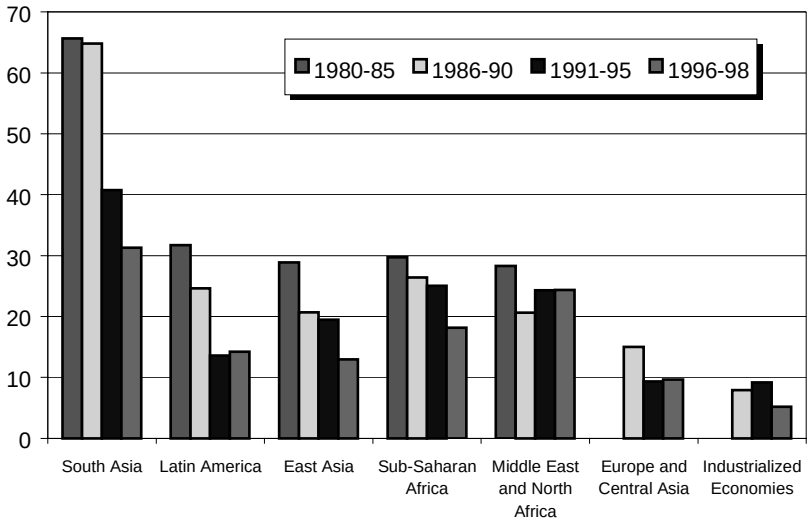
Trade and tax policy often interact in ways that magnify their competition-retricting effects. The case of Argentina in the 1980s illustrates the importance of policy in determining the net contribution of MNCs (and domestic firms). In an effort to encourage settlement of Tierra del Fuego, the southern most tip of the country (partly in response to territorial disputes with Chile), the government set up special production zone to assemble electronic products with generous tariff protection and tax subsidies. Firms were encouraged to assemble many types of electronic goods there for re-sale to the highly protected Argentine market at enormous mark-ups, so televisions in Argentina routinely

exceeded international prices by 150-400 percent. The regime of protection and subsidies was so lucrative that foreign (and some domestic) firms bought products in Japan, shipped them to Panama where they were broken down and then shipped to Tierra del Fuego for subsequent re-assembly and resale in the mainland of Argentina. By 1990, estimates of the cost to the (then bankrupt) Argentine treasury ranged from 0.5 to 1.0 percent of GDP. The winners in this scheme were the producing companies and few thousand (perennially cold) workers in Tierra del Fuego; the losers were Argentine consumers and businesses who had to pay high prices, thousands of workers that would have otherwise gotten jobs in more internationally competitive new activities in the mainland, and the Argentine poor who, among others, had to pay the tax of high inflation to close the fiscal accounts.

The good news is that average tariff levels throughout the developing world have come down by roughly half since these studies were done (see Figure 5), and so many of the inefficiencies and high multinational (and domestic) profits associated with trade protection have undoubtedly been reduced. This has improved the contribution of foreign and domestic investment alike to growth. Looking to the future, it might be speculated that the advent of price information over the internet may give consumers new options to source products and thereby increase potential contestability.

Figure 5 Average tariff barriers have been coming down…

(Average unweighted tariffs, by region)

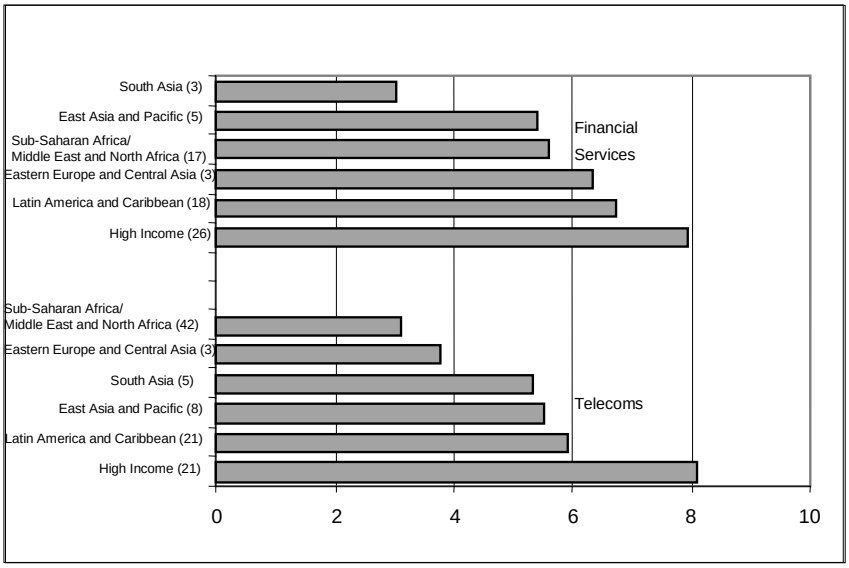


Source: World Bank, *Global Economic Prospects, 2001*

Less progress has been made in the provision of services. Mattoo, et al (2000) calculated an index of service sector liberalization for a sample of countries. Their conclusion is that services liberalization – reducing entry requirements to domestic and foreign investment -- has lagged in behind that of most rich countries, to the detriment of productivity (see Figure 6) . Services vital to productivity such as finance, telecommunications and others (e.g., retail and wholesaling, accounting, and legal services) are highly restricted in developing countries. Reducing these barriers to entry in a well regulated context could provide new impetus to investment, technological progress and growth.

Figure 6

Services liberalization indices: Telecoms and financial services



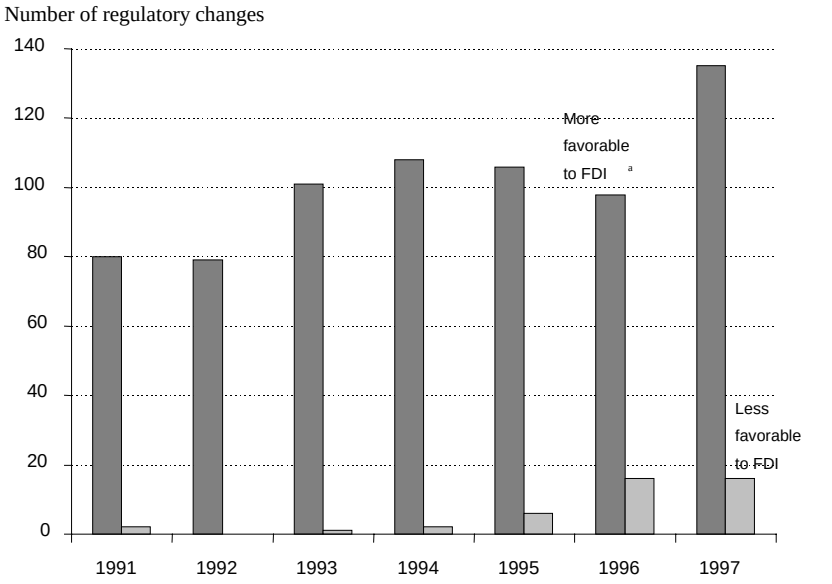
Note: The openness index for telecommunications captures the degree of competition, restrictions on ownership and the existence of an independent regulator (needed to enable competitive entry), and draws on an ITU-World Bank database for 1998. The index for financial services captures the restrictions on new entry, foreign ownership and capital mobility, and draws primarily upon commitments made by countries under the GATS, which are known to reflect closely actual policy, and data in the IMF's Annual Report on Exchange Arrangements and Exchange Restrictions.

Source: Mattoo, Rathindran, and Subramanian 2001.

Several policies that have proven less effective in producing efficient results include domestic content requirements, ownership restrictions, and preferential treatment for national investment as well as tax and credit incentives. Moran's (1998) careful review of studies in domestic content requirements, ownership restrictions, and preferential treatment concludes that the costs they impose on the local economy – in the form of higher costs of inputs, lost tax revenues, and "a proclivity toward stasis" that stunts development – shackles growth and is counterproductive. He acknowledges possible benefits to local economies from export requirements imposed on selected large scale, high barrier to entry, differentiated industries with high linkage effects (a point we will come back to below).

This tendency has changed in the last decade as governments everywhere are working hard to remove restrictions on incoming multinational investments as part of strategies to improve their investment climates[8]. UNCTAD (2000) found that governments were systematically easing restrictions on incoming foreign direct investment (figure 7). East Asian governments in the years after the crisis opened formerly restricted sectors in finance, retail sales, and manufacturing to foreign direct investment. In Thailand, for example, the government has recently permitted new entry in the financial sector. Korea has gone from among the most closed economies to foreign investment, to one of the most open in the four short years since the Asia crisis. Malaysia, with its already relatively open FDI regime, has been the single exception in maintaining its few pre-crisis restrictions (see World Bank, 2000: 56-60)

Figure 7 - Governments have generally reduced restrictions on FDI.



a/ Including liberalizing changes or changes aimed at strengthening market
b/ Including changes aimed at increasing control as

Source: UNCTAD,

Policies that promote competition are also important. Because MNCs possess a package of assets that other firms have difficulty replicating, the result is oligopolies, markets where the three or four leading firms dominate the market. Indeed, the average concentration of MNC-dominated product markets is higher than for product markets with domestic competitors. Since MNCs tend to produce in oligopolistic markets, several studies have show that MNCs, like their domestic counterparts which also possess market power, can raise prices to receive above-normal profits; this raises the return to foreign capital at the expense of consumers in the local economy.[9] For example, Newfarmer and Marsh (1994) found that firms in Brazil – MNCs and domestic firms --operating in concentrated markets with high market shares had reported profits rates of nearly double those of firms in workably competitive markets. This raised the costs of multinational investment to the local economy, and can bias the distribution of gains from multinational investment toward the home country unless economic policy promotes competition.

Beyond removing policy barriers, competition policies can reduce the costs of foreign investment through several instruments. For example, advertising raises product differentiation barriers that are reflected in supra-normal profits. Treating advertising as an investment and taxing it accordingly can reduce the effects of product differentiation barriers to entry. Similarly, competition policy can curtail restrictive business practices. These all have the effect of ensuring that potential market power of MNCs (or domestic firms) does not undercut the positive benefits that they would otherwise bring. Policies affecting the governance of corporations (e.g., including bankruptcy laws, disclosure, protection of minority interests) and policies to enhance the competitive discipline in markets (e.g., rules governing trade associations, interlocking directorates, restrictive business practices, and competition policy generally) are still weak, and in virtually all countries could be improved to enhance the productivity of their domestic business sectors, foreign and domestic alike (see Fristak and Newfarmer, 1994). In Asia, for example, weak corporate governance proved to be an achilles heel that brought on the crisis.[10]

In sum, removing barriers to competition – whether produced by governments in the form of trade protection, entry restrictions or other regulations, domestic content requirements, or by MNCs themselves in the form of restrictive business practices from their global market base is a high priority in the list of policies needed to get the most out of foreign investment (see Frischtak, 1994).

Creating a Positive Investment Climate

Providing a positive environment that encourages and facilitates investment is key to creating the conditions for harnessing FDI to the take of growth. Stern (2001) defines "investment climate" as "the policy, institutional and behavioral environment, both present and expected, that affects the returns and risks associated with investment. It encompasses macro stability and openness, good governance (transparent tax administration, effective laws and enforcement, restraints on corruption and bureaucratic harassment, sound regulation and efficient public services), and quality of infrastructure. These factors are necessary to support both domestic as well as foreign investment.

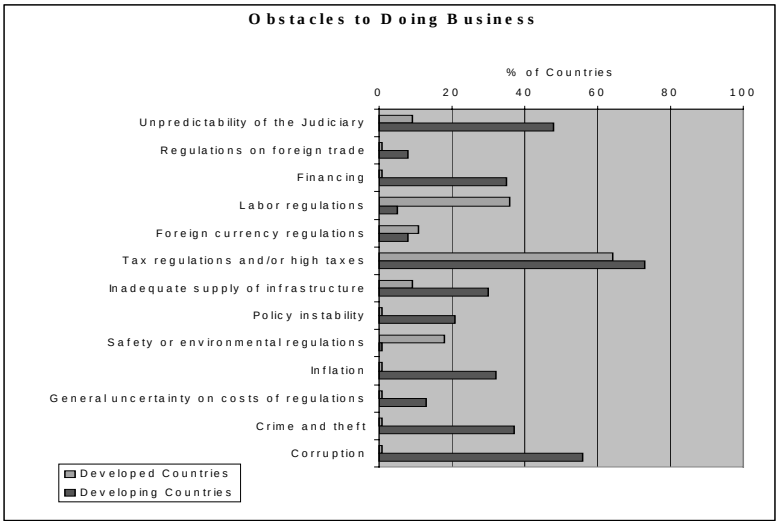
Not only are these factors important to elicit investment, they are essential to ensure that investment produces a return. Consider the Middle East. Stern notes that investment rates were often high in the 1980s and 1990s, but per capita GDP declined 0.8 annually in the 1980s and increased only 1.1% in the 1990s. "One of the primary reasons that such high rates of investment generated so little additional output is tha the institutional structure of the labor market has systematically misallocated labor (Stern, 2001:5)

Important elements of "good governance" are enforcement of property rights and control of corruption. Keefer and Knack (1995), using cross country regressions, concludes that the institutions protecting property rights are among the most important in the growth process. A subset of property rights is intellectual property. Establishing the right balance between granting monopolistic rents to technology owners to stimulate innovation and making technology widely available to benefit society at competitive costs requires establishing a delicate balance. Maskus (2000) concludes based on cross country data that FDI representing easily imitable goods and services is likely to increase as intellectual property rights are strengthened. Mansfield (1994) concludes that weak intellectual property regimes may diminish the incentives for MNCs to set up local R&D facilities or otherwise transfer technology, for fear of losing control. However, both Maskus (2000) and the World Bank (*Global Economic Prospects, 2002* chapter 5) emphasize that enforcement is costly and has to take into account national circumstances (e.g., protecting patent rights for medicines when confronting national epidemics), so regimes have be tailored to level of development and country needs.

Corruption, one indicator of poor governance, is also a disincentive to investment. Wei (2000) established a baseline level of corruption for a large sample of countries, and, according to his measure, concluded that an increase in the corruption level from that of Singapore to that of Mexico would have the same negative effect on inward FDI as raising the tax rate by 50 percentage points. Mauro (1997) finds that a decrease in his corruption index by one standard deviation is associated with an increase in the investment rate by more than 4 percentage points. Gastanaga, et al (1998) reaches similar conclusions. Indeed, Pfefferman et al (1999) find that corruption ranks second only to high tax rates in their survey of nearly 4,000 firms of obstacles to doing business, followed by unpredictability of the legal system (which itself can be associated with corruption) (Figure 8).

Figure 8 Corruption is a major deterrent to investment

Improving institutional environment can help…



The graph shows that business executives see the unpredictability of the judiciary to be a serious obstacle to doing business in 48% of all developing countries.

Survey covered 3,951 firms in 74 countries.

Source: Pfefferman, Kisunko, Sumlinski. *"Trends in Private Investment in Developing Countries and Perceived Obstacles to Doing Business"*

Investing in Education and Infrastructure

Attracting foreign investment and realizing its maximum contribution to both investment and technological progress is closely related to public investments in education. The World Bank's *Global Development Finance Report 2001* presented the statistical relationship between FDI's contribution to total investment, as shown in Figure

Getting the most productivity out of foreign direct investment also depends on knowledge related variables. As mentioned above, Borenzstein et al (1994) underscored the role of education in eliciting a technological contribution from FDI: foreign investment contributes more directly to growth through their technological transfer once the stock of human capital – measured by levels of educational attainment—reaches a threshold minimum in host countries. This finding is consistent with those of Herrera and Garcia (2000) for Latin America and Asia.

Educational narrowly defined is not the only important knowledge-related variable affecting MNCs' investment decision. Dunning (1998), for example, stresses the rapid growth of asset-seeking FDI. He concludes they increasingly value locations that have the best institutional and economic facilities relative to more conventional criteria of access to raw materials and low labor costs.

Adopting More Proactive Policies

The four preceding policy areas share three important commonalities: (a) they tend to focus on government policies that affect the whole economy (e.g., macro stability, education, and infrastructure); (b) they to move incentives facing all investors towards neutrality with respect to ownership or business activity (e. g., reducing trade protection); and (c) they tend to make the market

more competitive by removing barriers to competition. What has been the experience with tax incentives and other policies designed specifically to attract FDI or encourage technological progress?

One set of policies that has proven to be costly and yet produce only dubious benefits has been tax incentives to attract foreign investors. At the most basic level, incentives cannot offset negative factors in the investment climate that otherwise deter investment (see Morisset and Pirnia, 2001). Recent research on incentives in Indonesia by Wells and Allen (2001) suggests that tax incentives to foreign investors are not cost effective and may prove to be counterproductive, by delaying the implementation of reforms that are more likely to affect investment decisions. The major factors influencing investment decisions – investment climate, education, infrastructure, etc. – almost always account for greater differences in relative costs among countries. Once taxes are within the range international norms, differentials given by incentives among countries rarely figure so prominently in total costs that they are important enough to alter location decisions. More important is their cost. Because it is impossible to distinguish between investment that would occur only with incentives from investment that would occur without them, the government must pay numerous investors who would have invested anyway to attract few that will invest only in response to the incentive. In effect, the lower the responsiveness of investors to marginal changes in tax rates, the more ineffectual and costly are incentives. The same principles apply to rich countries seeking to promote FDI in particular regions.[11]

Other policies may include an array of government interventions (see Dunning and Narula, 1998 for an illuminating inventory). One set of such policies are attempts to attract and guide FDI into activities that the government sees as most beneficial. investments in "targeted" infrastructure designed to create technology-based clusters. Rosenberg (2001) reviews evidence on the attempt to recreate the US experience with Silicon Valley developing technology clusters in other parts of the world. He reviews six separate experiences (Taipei, Bangalore, Cambridge-England, Tel Aviv, Finland and Singapore). He concludes that only one, the Hsinchu-Taipei (Taiwan, China), had reasonable success in generating the positive externalities associated with clusters, and this because it developed as low-cost supplier to Silicon valley itself. Finland was also successful by building niche product lines (mult-standard cellular telephone technology) not covered by incumbents into substantial advantage. They conclude that governments should avoid this strategy because of the difficulty in picking winners and using government subsidies to overcome barriers to entry in global industries. For these reasons, the World Bank's study of trade strategy in Latin American (*From Natural Resources to the Knowledge Economy)* recommends building forward on natural competitive advantages and is cautious about investments in cluster to promote high technology production (see de Ferranti, et al, 2002).

A strategy with less risk is to encourage backward linkages, a recommendation of Sauvant (2002) and UNCTAD (2001). To the extent that vertical linkages from buyers to suppliers can be encouraged, they may well speed technological diffusion. However, policies to encourage such developments are better advised to focus systematically on removing impediments to domestic entry into supplier industries than raising barriers to competition in an effort to support local industries, such as local content requirement that raise barriers to foreign competition or procurement rules that discriminate against foreign suppliers.

In sum, there may well be opportunities for pro-active policies in support of more rapid technological diffusion and growth. But those that are likely to be most successful with the least likelihood of being captured by special interests (sometimes domestic business and sometimes MNCs themselves) are those that expand competition, use neutral incentives, and focus government energies on augmenting the supply of badly needed public goods.

NOTES

1 The UN Center on Transnational Corporation distinguishes between "multinational corporations", large corporations with ownership in several countries and affiliates in many countries, and "transnational corporations" whose owners reside predominately in a single country. An example of the former is Royal Dutch Shell Petroleum or, now, Chrysler-Damlier. General Electric is a more conventional transnational corporation. More conventional usage follows the Harvard Multinational Enterprise Project definition – a large corporation with subsidiaries in two or more countries. We use the terms here interchangeably.

2 We use the term "multinational investment" interchangeably with foreign direct investment. In strict terms, foreign direct investments are those cross border flows of equity and long term debt from a parent to an affiliate in which the parent owns at least 10% of outstanding equity. The reader should be aware that the statistics underpinning our knowledge on foreign direct investment have significant shortcomings because global statistics are complied from sources using different definitions and based on different survey techniques; many of these are described well in Cantwell (1994).

3 Dunning 1994 has summarized this literature.

4 Controlling for market size, however, developing countries actually get somewhat more FDI – some $29 per $1000 of GDP compared to $22 in developed countries (UNCTAD, 2000: 26).

5 See UNCTAD, 2000 for an ambitious quantitative review of mergers and acquisitions.

6 See also Blomstom and Kokko 1997.

7 See Frischtak, 1994

8 See Conklin and Lecraw, 1997 for a recent review of changing restrictions in 10 countries and policy alternatives that may produce better economic outcomes..

9 Several studies have shown this relationship in both the developed and developing countries, including Connor, 1978.

10 See World Bank, *East Asia: Road to Recovery* (1998) Chapter 1, and *East Asia: Recovery and Beyond* (2000) Chapters 2 and 3.

11 Feinberg and Newfarmer (1984), for example, calculated that the original provision in the Caribbean Basin Initiative to grant tax incentives in the US legislation would have had very high costs to the US Treasury relative to the additional investment – because the incentives would have been paid on investment that would occurred anyway.

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International Investment Agreements and Instruments,

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Introduction

Over the past few decades, there have been significant changes in national and international policies on foreign direct investment (FDI). These changes have acted as both cause and effect in the ongoing integration of the world economy and the changing role of FDI in it. They have found expression in national laws and practices, and in a variety of international instruments, bilateral, regional, and multilateral.[1]

FDI acquired increasing importance as the twentieth century advanced, and it began gradually to assume the forms prevalent today. In international legal terms, however, FDI long remained a matter mainly of national concern, moving onto the international plane, where rules and principles of customary international law applied, only in exceptional cases, when arbitrary government measures affected it in a negative manner.

In the 1980s, a series of national and international developments radically reversed the policy trends prevailing until then, with an immediate impact both on national policies regarding inward FDI and on regional and worldwide efforts at establishing international rules on the subject. At the end of the 1990s, host countries sought to attract FDI by dismantling restrictions on its entry and operation, and by offering strict guarantees, both national and international, against measures that seriously hampered investors' interests.

Today, an international legal framework for FDI has emerged. It consists of many kinds of national and international rules and principles, of diverse form and origin, differing in strength and degree of specificity.

Trends in Foreign Direct Investment.

Foreign Direct Investment (FDI) plays a key role in the globalisation process, generating both challenges and opportunities for more and more nations. In 2000, FDI grew by 18 per cent faster than other economic aggregates like world production, capital formation and trade, reaching a record of $1.3 trillion.[2] The scope of activities by transnational corporations (TNCs) has never been greater. Estimates show that more than 60,000 TNCs today control some 800,000 foreign affiliates worldwide. Developed countries remain the prime destination of FDI, accounting for more than three-quarters of global inflows. Cross-border mergers and acquisitions (M&As) constitute the main stimulus behind FDI, and these are still concentrated in the developed countries. As a result, inflows to developed countries increased by 21 per cent and amounted to a little over $1 trillion.[3]

FDI inflows to developing countries also rose, reaching $240 billion. Nevertheless, their share in world FDI flows declined for the second year in a row, to 19 per cent, compared to the peak of 41 per cent in 1994. The 49 least developed countries (LDCs) as a group remained marginal in attracting FDI, even though FDI flows in that group are on the rise, as is the role of FDI in their economies. Central and Eastern Europe maintained their share of around 2 per cent in terms of world inflows, and in

Africa and Latin America inflows in 2000 declined even in absolute terms, for the first time since the mid-1990s.

The most important factors that determined not only the dynamism of FDI flows in 2000, but also the location of transnational investment were:[4]

- *Liberalisation of investment regimes*. Between 1991 and 2000, a total of 1,185 regulatory changes were introduced in national FDI regimes, of which 1,121 were in the direction of creating a more favourable environment for FDI. During 2000 alone, 69 countries made a total of 150 regulatory changes. Of these, 98 per cent were more favourable to foreign investors.

The liberalisation of FDI regimes and the strengthening of international standards for the treatment of foreign investors allow firms greater freedom in making international location decisions and in choosing the mode for serving each market and meeting functional needs.

- *Technological progress.* The dynamics of international production largely reflect the nature, speed, and pervasiveness of technical change. Rapid innovation provides the advantages that propel firms into international production; thus, innovation-intensive industries especially tend to be increasingly transnational, and TNCs have to be more innovative to maintain their competitiveness.
- *Corporate strategies*. Managerial and organisational factors strengthen the new locational determinants of FDI. A greater focus on core competencies, with more horizontal hierarchies and stronger emphasis on networking, steers investments towards locations with advanced factors and institutions, and distinct clusters. New organisational techniques stimulate a more efficient management of global operations, encouraging a greater relocation of functions.

FDI flows are, however, expected to decline in 2001 for the first time in a decade, as a result of the slowdown in the world economy and the decline in cross-border mergers and acquisitions. FDI flows are expected to decrease significantly in developed countries, from $1,005 trillion in 2000 to an estimated $510 billion in 2001 (i.e. by 49 per cent). In the case of developing countries, the decline is estimated to be 6 per cent, from $240 billion to $225 billion. Such an expected drop in FDI flows oblige policy-makers to rethink their domestic strategies not only to attract FDI but also to maximise its benefits. [5]

Relevance of the Relationship between Trade and Investment

International trade is an important engine of economic growth carried out mainly among related enterprises. According to the World Trade Organisation (WTO), there are empirical studies showing that FDI contributes to enhance the export outcome of the developing countries. Such a contribution could be *direct* when carried out through the export activities of the multinational enterprises, or *indirect*, when costs and barriers faced by domestic companies by the time they want to start exporting or broadening their exports are reduced. Those studies conclude that there is a global positive correlation between the FDI and the exports of the developing countries.[6] In this regard, successful commercial liberalisation is possible only if it is accompanied by a liberalisation of productive capital flows generating fresh resources, more transfer of technology, better managing practices and jobs. That explains why countries have tended to create international instruments to promote and protect investment flows in line with an international legal framework to promote the export and import of goods and services.[7]

Even when there are an important number of international instruments that regulate investment flows (e.g. OECD Codes of Liberalisation, GATS, TRIMS), compared to the broad norms governing commercial flows, there is no multilateral agreement that comprehensively regulates world investment flows. This situation has led nations to negotiate bilateral or regional agreements to promote and protect FDI.

Worldwide Investment Rules

Bilateral Investment Treaties (BITs).

BITs are a principal element of the current framework for FDI. More than 1,941 bilateral treaties have been concluded since the early 1960s, most of them in the decade of the 1990s.

As elements of the international legal framework for FDI, BITs have been useful since they have developed a large number of variations on the main provisions of international investment agreements (IIAs) – especially those referring to the ways in which national investment procedures may be taken into account. Although the treaties remain quite standardised, they are able to reflect in their provisions the differing positions and approaches of the many countries that have concluded such agreements. The corpus of BITs may thus be perceived as a valuable pool for IIAs.[8]

BITs were initially addressed exclusively to relations between home and host, developed and developing, countries. Yet over the years they have shown a remarkable capability for diversification in participation, moving to other patterns, such as agreements between developing countries, with countries with economies in transition, or even with the few remaining communist countries. Thus, while lacking the institutional structures and emphasis on review and development of multilateral and regional instruments, BITs appear capable of adapting to special circumstances. The increase in the number of BITs between developing countries suggests that they may also be useful in dealing with some of the problems in such relationships.[9]

Even when the principal focus of BITs has been from the very start on investment protection, they also cover a number of other areas to promote investment:

- Broad definition of investment.
- National treatment.
- Most favoured nation treatment.
- Disciplines concerning expropriation and compensation.
- Guarantee the right to transfers.
- Subrogation provisions.
- Mechanisms for the settlement of disputes State to State and Investor – State.

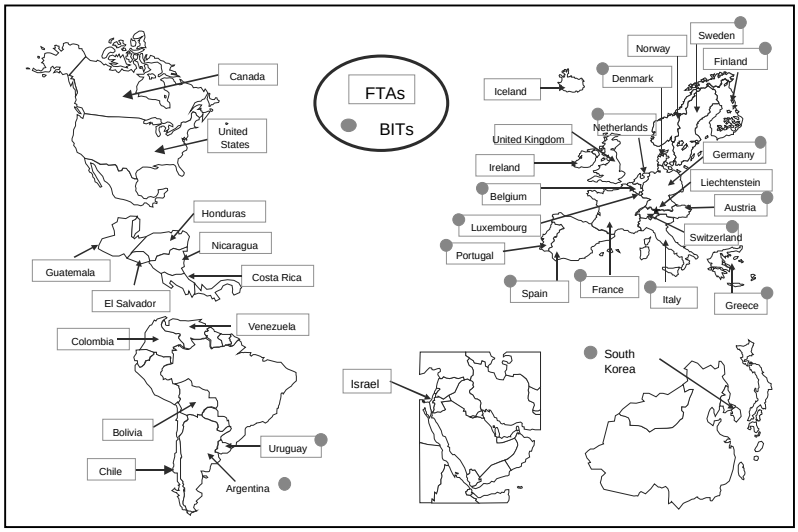
Regional and Plurilateral Agreements

Regional and plurilateral agreements are those in which only a limited number of countries participate. Such instruments are increasingly important in FDI matters.

Regional economic integration agreements, for instance, involve a higher than usual degree of unity and co-operation among their members, sometimes marked by the presence of supranational institutions. NAFTA, APEC and the OECD are significant examples of regional agreements.

Free Trade Agreements

To illustrate the value of free trade agreements (FTAs), the case of Mexico is a good example. Mexico has become a very attractive country to foreign investment thanks to its broad net of FTAs. Today, Mexico has preferential access to 850 million consumers in 32 countries.



All the FTAs signed by Mexico include investment chapters. These chapters contain the following principles and provisions:

- Broad definition of investment, based on the concept of enterprise.
- National treatment.
- Most-favoured nation treatment.
- Minimum standard of treatment.
- Senior management and board of directors.
- Reservations and exceptions.
- Performance requirements.
- Expropriation and compensation.
- Transfers.
- Investor – State Dispute Settlement Mechanism.

FTAs in this context refer to new investments and more exports and, consequently, more and better paid jobs and a stronger domestic market. It is certainly clear that FTAs will not immediately solve the long-standing problems of inequity, unemployment and marginalisation, but they will – and they have to – contribute to solve them efficiently.

Organisation for the Economic Co-operation and Development (OECD)

The OECD has long been at the forefront in efforts to develop international rules relating to capital movements, international investment, and trade in services. Member governments have set "rules of the game" for themselves and for multinational enterprises established in their economies by means of legal instruments to which all Members must adhere.

These instruments have been regularly reviewed and strengthened over the years to keep them up to date and effective. They contain the main legal commitments of OECD Members and provide an essential yardstick in assessing the extent to which candidates for OECD membership adhere to standards set by these instruments.[10]

- Codes of Liberalisation: The Code of Liberalisation of Capital Movements and the Code of Liberalisation of Current Invisible Operations constitute legally binding rules, stipulating progressive, non-discriminatory liberalisation of capital movements, the right of establishment and current invisible transactions (mostly services). All non-conforming measures must be listed in country reservations against the Codes.
- Declaration and Decisions on International Investment and Multinational Enterprises: The 1976 Declaration by the Governments of OECD Member countries on International Investment and Multinational Enterprises constitutes a policy commitment to improve the investment climate, encourage the positive contribution that multinational enterprises can make to economic and social progress, and minimise and resolve difficulties which may arise from their operations. The latest review by the OECD of the above mentioned Declaration and Decisions was held in 1991. All 30 OECD Member countries, and three non-Member countries (Argentina, Brazil and Chile) have subscribed to the Declaration.

The Declaration consists of four elements, each of which has been underpinned by a Decision by the OECD Council on follow-up procedures:

- The Guidelines for Multinational Enterprises.
- National Treatment.
- Conflicting requirements.
- International investment incentives and disincentives.

All parts of the Declaration are subject to periodical reviews. A major review of the Guidelines was completed in June 2000.

Asia – Pacific Economic Co-operation (APEC)

APEC was established in 1989 in response to the growing inter-dependence among Asia-Pacific economies. With its 21 member economies, APEC has established itself as one of the primary regional vehicles for promoting open trade and practical economic and technical co-operation.

APEC Economic Leaders met for the first time in November 1993. They envisioned a community of Asia-Pacific economies, based on the spirit of openness and partnership that would make co-operative efforts to promote, among others, the free exchange of investment. In subsequent annual meetings, APEC Ministers and Leaders further refined this vision and launched mechanisms to translate it into action. APECs work on investment has centred on:

- the Non-Binding Investment Principles.
- the Facilitation and Liberalisation Principles (Osaka Action Agenda).
- the Individual Action Plans.
- the Collective Action Plans.

Andean Community (CAN)[11]

The Andean Community is a sub-regional organisation endowed with an international legal status, which is made up of Bolivia, Colombia, Ecuador, Peru and Venezuela, and the bodies and institutions comprising the Andean Integration System (AIS).

The Community provisions in effect with regard to investment are *Decisions 291* and *292*. The former contains the general regime governing foreign investment and the latter regulates the case of the Andean multinational enterprises. These provisions are complemented by national laws and regulations, together with bilateral arrangements or agreements to promote and protect investments signed by Member Countries with third countries and even among themselves.

Decision 291, the *Regime for the Common Treatment of Foreign Capital and Trademarks, Patents, Licensing Agreements and Royalties,* enacted in March 1991, contains the definitions of foreign direct investment, and classifies investors and enterprises into national, mixed and foreign. It sets out the rights and obligations of foreign investors (national treatment and the right to transfer profits abroad in a freely convertible currency), but its provisions in general yield to the stipulations of national legislation on the subject. The Community body of law can therefore be said to give the Andean countries full freedom to regulate this field through their own national legislation.

It should be recognised, even so, that national legislation on the subject has been oriented since the mid-1980s to move toward facilitating the entry of foreign investment and giving it national treatment in almost all aspects, with the result that there is a large degree of coincidence among the laws of the different countries.

This is the result of the application of a standard economic conception for the entire region and the application and evolution of multilateral rules and regulations, particularly those of the GATT and TRIMS.

On the other hand, Decision 292, approved in March 1991, regulates the case of Andean multinational enterprises – AMEs – that are defined as those in which at least 60 per cent of the capital belongs to national investors from two or more Member Countries. These enterprises enjoy national treatment with regard to the public procurement of goods and services, the right to transfer abroad in a freely convertible currency the pertinent dividends, tax matters and the right to open up branches in other Member Countries. They also enjoy tax equality in regard to domestic taxes, provisions to avoid double taxation of income (in addition to those of Annex 1 to Decision 40, which contains the Agreement among the Andean Countries to Avoid Double Taxation) and on the transfer abroad of capital, and facilities for the hiring of Sub-regional personnel (qualified personnel of Sub-regional origin are considered to be national personnel for purposes of the application of quotas of foreign workers).[12]

Caribbean Community (CARICOM)[13]

The Caribbean Community and Common Market (CARICOM) was established by the Treaty of Chaguaramas, which was signed by Barbados, Jamaica, Guyana and Trinidad & Tobago, coming into effect on August 1, 1973. Subsequently, the other Caribbean territories joined CARICOM: Antigua and Barbuda, Bahamas, Belize, Dominica, Grenada, Haiti, Montserrat, St. Kitts and Nevis, Saint Lucia, St. Vincent and the Grenadines and Suriname.

From its inception, the Community has concentrated on the promotion of the integration of the economies of Member States, co-ordinating the foreign policies of the independent Member States and in functional co-operation, especially in relation to various areas of social and human endeavour.

The work in CARICOM includes the negotiation of Protocols. Protocol II, on the *rights of establishment, Provision of Services and Movement of Capital,* contains the relevant provisions on investment:

- Definition of investment.
- National Treatment.
- Compensation for losses.
- Transfers.

Common Market of the South (MERCOSUR)[14]

On March 26 1991, Argentina, Brazil, Paraguay and Uruguay signed the Treaty of Asuncion, creating the Common Market of the South. MERCOSUR constitutes the most relevant international project committed by those countries.

Investment is a special matter for MERCOSUR, and there are thus two international relevant instruments:

- The 1994 Protocol on the Promotion and Protection of Investments coming from Non-Members (Protocol of Buenos Aires).
- The 1994 Protocol of Colonia for the Reciprocal Promotion of Investments inside MERCOSUR.

Both Protocols encompass, among others, provisions related to definitions, treatment and protection of investment, and dispute settlement.

Free Trade Area of the Americas (FTAA).

The effort to unite the economies of the Western Hemisphere into a single free trade agreement began at the Summit of the Americas, held in December 1994 in Miami, Florida, USA. The Heads of State and Government of the 34 democracies in the region agreed to construct an FTAA, in which barriers to trade and investment will be progressively eliminated.

In 1998, through the San Jose Declaration, the Ministers of Trade agreed to “create a stable and predictable environment that protects investors and their investments and related flows, without creating barriers to the investments coming from outside the Hemisphere.” Such a task was given to

the Negotiating Group on Investment (NGIN), which months later was mandated to develop a comprehensive framework that incorporates the rights and obligations on investment, taking into account the substantial areas previously identified by the FTAA Working Group on Investment (WGI).

During the first phase of negotiations, 12 topics were considered as the elements to be included in an Investment Chapter:

- Basic definitions.
- Scope.
- National treatment.
- Most favoured nation treatment.
- Fair and equitable treatment.
- Expropriation and compensation.
- Compensation for losses.
- Key personnel.
- Transfers.
- Performance requirements.
- General exceptions and reservations.
- Investor – State dispute settlement mechanism.

During the second phase, the NGIN started a draft investment chapter as a result of a mandate given by the Ministers of Trade in the Fifth Ministerial Meeting, held in Toronto on November 1999.

Later, at the Sixth Ministerial Meeting (Buenos Aires, April 2001), a general mandate was given to all Negotiating Groups to intensify efforts in order to solve existing divergences and reach a consensus, with a view to eliminating "square brackets" of the draft texts. Negotiating Groups were also asked to receive proposals from the delegations.

Up to the present, the NGIN has received six new topics that have been included in the draft chapter along with the initial twelve substantive topics.

Investment in the Multilateral Context

Multilateral Agreement on Investment (MAI).

In 1995, the 29 OECD Member countries plus the European Commission[15] began negotiations on a Multilateral Agreement on Investment in order to meet the need for international co-operation to treat FDI matters comprehensively.

The MAI sought to facilitate capital flows among countries, eliminate investment barriers, improve the level of treatment and, consequently, properly protect investors and their investments.

The basic provisions contained in the MAI were:

- Scope.
- Treatment and protection of investment.
- Exceptions and safeguards.
- Financial services.
- Taxation.
- Transfers.
- Performance requirements.
- Expropriation and Compensation.
- Reservations.
- Relationship to other international agreements.
- Dispute settlement.

Because of the number and complexity of the topics covered, after long negotiations and internal consultations, the MAI was suspended. Notwithstanding the goodwill of the governments involved, the difficulty of linking the differing interests in a single text, plus the complex negotiation system, stopped negotiations in April 1998. The objective was that each country make internal consultations and re-think its position carefully. Nevertheless, in December 1998, the MAI was suspended definitively.

World Trade Organisation (WTO).

After the Uruguay Round, international investment became a relevant issue at the core of the multilateral trade system. Even when it would appear that the only agreement to exist is the Trade Related Investment Measures Agreement (TRIMs), which has reduced scope limited to certain performance requirements, other agreements, especially the General Agreement on Trade in Services (GATS), and less relevant, the Trade Related Intellectual Property Rights (TRIPs) and the Agreement on Subsidies and Countervailing Measures (ASCM), incorporate disciplines related to investment. Furthermore, any conflict arising on an investment is settled by the rules established in the Understanding on Dispute Settlement.

Trade Related Investment Measures (TRIMs).

This Agreement recognises that certain measures on investment can cause trade distortions. It limits its scope to investment measures related to trade in goods (not in services) and forbids Member States to apply a TRIM not compatible with the obligations established in the 1994 GATT Articles III (National Treatment) and XI (General Elimination of Quantitative Restrictions).

There is an illustrative list of TRIMs attached to the Agreement that describes those measures that are inconsistent with the obligations mentioned above since they are mandatory or enforceable under domestic law or under administrative rulings, or because their compliance is necessary to obtain an advantage. It includes measures that:

- Require the purchase or use by an enterprise of products of domestic origin or from any domestic source.

- Require that an enterprise's purchases or use of imported products be limited to an amount related to the volume or value of local products that it exports.
- Restrict the importation by an enterprise of products used in or related to its local production or the exportation or sale for export by an enterprise of products.

It is important to say that the Parties made a commitment to review the Agreement within the five years following its entry into force. The review would include possible enlargement of the illustrative list, and the addition of complementary provisions related to policy competition for investment.

The TRIMs Agreement has certain limitations:

- It only focuses on goods but ignores the services sector.
- The illustrative list only considers a limited number of TRIMs, if compared to the comprehensive list contained in NAFTA Article 1106 (Performance Requirements).
- It basically codifies current GATT jurisprudence, allowing the Parties a temporal escape from their obligations.

General Agreement on Trade in Services (GATS).

The GATS is considered the agreement of the multilateral trade system comprising the largest number of provisions – protection and liberalisation – related to investment. It rests on three pillars:

- A framework of general provisions applicable to all measures affecting trade in services (e.g. MFNT, transparency, disclosure of confidential information, increasing participation of developing countries, economic integration, mutual recognition, general exceptions).
- Specific commitments of national treatment and market access applicable only to those sectors and sub-sectors included in the lists of commitments of each country.
- Some Annexes that explain the manner in which GATS rules are applied to specific sectors (e.g. air and maritime transport, financial services, telecommunications).

Even when the GATS does not mention the term "investment", this is included in the third mode of supply (commercial presence). In this sense, commercial presence is defined as any type of business or professional establishment, including through: i) the constitution, acquisition, or maintenance of a juridical person; or, ii) the creation or maintenance of a branch or representative office within the territory of a Member for the purpose of supplying a service.

Dynamics of Liberalisation.

- The GATS Agreement does not grant the right of establishment. On the contrary, it is subject to the terms set out in the lists of commitments.
- The main provisions refering to liberalisation are: Most Favoured Nation Treatment (art. II), Market Access (art. XVI) and National Treatment (art. XVII). Of those disciplines, the MFNT is the only principle applicable to all Members and services sectors, although qualified by the exceptions to that obligation.
- Market Access is defined according to six types of limitations that the Members should prevent imposing.

- The National Treatment provision obliges each Member to accord to services and suppliers of services of any other Member, treatment no less favourable than that it accords to its own like services and service suppliers. Article XVII points out that national treatment does not always need to be identical, provided it does not modify the conditions of competition of foreign suppliers.
- The GATS allows Members to maintain non-conforming measures provided they list them in the list of commitments under a negative approach. Likewise, Members may adopt new discriminatory measures in those sectors not established in the list of commitments (on a MFN basis) or in sectors subject to MFNT exceptions.

Other applicable provisions

- Article V establishes a general exception with respect to Economic Integration Agreements.
- There are general exceptions similar to those contained in the GATT.
- Provisions of future negotiations on safeguards and subsidies are established.
- GATS applies a test of "substantial business operations" to determine who qualifies to obtain the benefits of the Agreement. There are property and control elements included.
- There are no provisions on performance requirements or monitoring.

Investment Protection.

The GATS has only a few provisions related to the protection of investment:

- Payments and transfers: It is not a general obligation; Members should not limit the current payments and transfers in committed sectors.
- Balance of payments clause.
- No provisions on expropriation and compensation.
- The Understanding on Disputes Settlement is applied.

The Future of Investment in the Multilateral Context

Since the suspension of the MAI negotiations, there have been several concerns about the necessity of having an international framework of rules on investment which facilitate capital flows among countries, eliminate barriers to investments, improve the level of treatment to them and, in general, secure an appropriate protection to investors and their investments. Such demand has been heightened due to the structural imbalance existing in the multilateral system. It should be remembered that while WTO Agreements establish rules applicable to trade and services – and investment in services – there is no applicable provision for investment in the goods sector (e.g. manufactures).

However, a negotiation of multilateral rules on investment would not be an easy task. Little political interest in multilateral negotiations has been shown. In fact, countries have given priority to regional or bilateral agreements, in part due to the difficulty to find consensus and in part also because of the fear that those kind of mechanisms be used as a platform for a renewal of unjustified NGO activism.

Some have wondered whether the political costs of an eventual agreement are justified by the economic benefits. Some countries believe not. But the reality will be seen in few months when discussion for a possible multilateral set of rules on investment is carried out, according to the mandate given in the last Ministerial Conference.

At the Fourth Session of the Ministerial Conference (Doha 9-14, November, 2001), Ministers recognised the case for a multilateral framework to secure transparent, stable and predictable conditions for long-term cross-border investment - particularly foreign direct investment - that will contribute to the expansion of trade. Ministers agreed that negotiations would take place after the Fifth Session of the Ministerial Conference (in mid-June) on the basis of a decision on modalities of negotiations to be taken, by explicit consensus, at that session.

In the period until the Fifth Session, further work in the Working Group on the Relationship between Trade and Investment will focus on the clarification of the following issues:

- Scope of definition.
- Transparency.
- Non-discrimination.
- Modalities for pre-establishment of commitments based on a GATS-type, positive list approach.
- Developing provisions.
- Exceptions and balance-of-payments safeguards.
- Consultation and settlement of disputes between members.

Any framework should reflect, in a balanced manner, the interests of home and host countries alike, and take due account of the development policies and objectives of host governments as well as their right to regulate in the public interest.[16]

Perspectives

Today, international investment faces a patchwork of regional and bilateral instruments that regulates FDI flows. On the one hand, the existence of such a quantity of instruments definitely provides evidence of the levels of convergence that have been reached on investment, as well as the interest of countries to guarantee more stability in investment rules. On the other hand, it also introduces elements of confusion, inefficiency, and uncertainty, since it enhances the fragmentation and overlapping of different regimes applicable to FDI in a world in which investments are global or regional.

From this, it can be inferred that a multilateral negotiation on investment would be convenient. A multilateral framework could be useful to reduce conflict among the rules of different countries and, at the same time, would reduce the inefficiencies and the unequal distribution of resources that provoke the number and diversity of rules on investment.

Nevertheless, a certain reluctance to realise a multilateral project can be perceived. Even if in the Doha Ministerial Declaration there is a commitment for negotiations in three years, strong technical, juridical, and political conflicts may obstruct progress in the matter. It is to be hoped that the best outcome be reached from a technical perspective (i.e. trade – investment) and, most of all, from a human dimension.

NOTES

1 *Trends in International Investment Agreements: An Overview*. UNCTAD.

2 *World Investment Report 2001: Promoting Linkages.* UNCTAD.

3 *World Investment Report 2001: Promoting Linkages.* Op. cit.

4 Idem.

5 Idem.

6 "The Relationship between Trade and Foreign Direct Investment: Note by the Secretariat". World Trade Organisation. Geneva, September 18, 1997, pages 23-24.

7 Flores Bernés, Miguel *¿Cómo se regularán los flujos de inversión a la entrada en vigor del Tratado de Libre Comercio México – UE? (análisis de los instrumentos jurídicos: APPRIs y TLCUEM). Revista Mexicana de Derecho Internacional Privado (1ª Edición). Academia Mexicana de Derecho Internacional Privado y Comparado,* April 2000, p. 91-108.

8 *Trends in International Investment Agreements: An Overview*. UNCTAD.

9 *Trends in International Investment Agreements: An Overview*. Op.cit.

10 www.oecd.org

11 www.comunidadandina.org

12 Idem.

13 www.caricom.org

14 www.mercosur.org

15 Five observer countries also participated: Argentina, Brazil, Chile, Hong Kong and the Slovak Republic.

16 http://www.wto.org

Technical Assistance and Capacity Building Related To Foreign Direct Investment,

European Commission*

Introduction

International Investment rules at bilateral, regional and multilateral level can play a key role for the purpose of improving the legal environment for FDI worldwide, as a complement to domestic reforms. It is widely acknowledged, however, that investment rules alone are not enough to ensure that all countries attract a greater proportion of the increasing flows of FDI. The main determinants of international investment flows in a given country are market size and structure, macroeconomic and political stability, level of infrastructure, labour skills, etc.

At the same time, it is also clear that the enabling environment for FDI is crucial to attract foreign investors or at least to avoid discouraging them. In our view, an improved legal framework should be developed, together with accompanying measures aimed at creating a supportive business framework, which would maximise the potential that countries have for attracting FDI. This enabling environment for FDI should include, beyond the legal framework, good governance, effective justice systems, respect for the rule of law, etc. The benefits of a sound, enabling environment are widespread. Not only does it make a country more attractive to FDI inflows, but also helps it to absorb the flows in a more productive way, for example through the efficiencies of better governance. It can also help reduce capital flight and encourage greater domestic investment. In this context it will be crucial to identify what appropriate assistance could be envisaged to ensure that developing countries exploit their full potential by attracting more capital flows and consequently increase their economic growth.

As a first step, developing countries could receive assistance on two fronts: on the one hand, assistance should aim at identifying the key requirements for increasing their attractiveness as investment locations and the key bottlenecks that frustrate domestic policies to this end. On this basis, assistance could then be directed at building capacity to: 1) regulate the domestic markets in order to attract investment; 2) identify and deal with obstacles to ordinary market functioning, e.g., competition policy. On the other hand, developing countries should receive assistance to negotiate effectively international investment rules and to transpose the results of negotiations into domestic laws and regulations.

This paper attempts to identify possible fields for technical assistance in the context of the possible future negotiations of international investment rules. It also refers to some of the existing technical assistance instruments provided by the European Community as well as by international organisations.

This submission does not propose to reach conclusions on these issues. Rather, its objective is to open a debate among Members on:

- whether the existing instruments are adequate;
- whether they should be revised to take into account specific needs and objectives that are not yet fully taken into account;
- whether notable gaps exist in the field of technical assistance and capacity building related to investment, and how they could be filled.

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* Communication of 23 May 2001 from the European Community and its Member States to the Working Group on the Relationship between Trade and Investment of the World Trade Organisation. The views contained in this document were presented at the Global Forum by Mr. Carlo Pettinato, Trade and Investment, Directorate General for Trade, European Commission.

The paper is organised into two main sections. The first section looks at the wider issue of capacity building in the general context of sustainable development of developing countries, and gives some suggestions on how the WTO and its Members could contribute to improve the coherence of the existing Technical assistance/Capacity building initiatives related to trade and investment. The second part deals with the immediate needs of a developing country wishing to negotiate international investment rules, in terms of both identifying and defending its interests in such a negotiation and then transposing the results of the negotiations into domestic laws and regulations.

This paper does *not* deal with the bigger issue of actually increasing and improving the capacity building element of development assistance. This is an issue that goes well beyond the mandate and the ability of the Working Group.

Building capacity to attract, absorb and benefit from FDI – Defining needs and identifying gaps in current assistance programmes

As mentioned above, the main challenge relates to improving the overall capacity of many developing countries to attract a higher share of FDI flows and to absorb inflows in a manner conducive to smooth and sustainable economic development. This is a medium- to long-term issue, which also needs the co-ordinated and coherent support of international institutions and individual developed-country donors in order to maximise the benefits for those developing countries undertaking efforts on their own in this regard. Clearly, all efforts in this area should be fully consistent, and developed within the context of the World Bank/UN global strategy on sustainable development and poverty eradication.

The WTO and its Members, however, could kick-start a process of coherence in the area of investment by providing developing WTO members with resources to a) identify the priorities for action; b) catalogue the technical assistance and capacity building initiatives already under way; c) identify gaps in the overall assistance being provided; d) ensure greater coherence of the action of international institutions and individual donors; e) identify the "capacity bottlenecks" that limit the ability of developing countries to attract, absorb and benefit from FDI; f) better target international assistance to this end. WTO members should consider to what extent existing instruments, such as for instance the Integrated Framework for LDCs or JITAP, could be used for this purpose.

This would help developing countries to better target their request for assistance and greatly improve the effectiveness of the assistance itself. It remains clear that there is *no single model of technical assistance* that all countries should follow. Technical assistance programmes have to be targeted at the specific priorities and needs identified by individual or groups of developing countries that would allow them to effectively implement as well as benefit from multilateral investment rules.

Multilateral investment rules are designed to underpin domestic investment regimes and to reassure foreign investors that, whatever the rules of a potential host country look like, they will always comply with certain basic principles. The resulting greater legal certainty would produce greater propensity to invest abroad and greater FDI flows overall, and would also minimise the risk of capital flights. Moreover, a large number of potential host countries, especially among developing countries, suffer from a "perception gap", where they are perceived by foreign investors as posing a much greater risk than the reality would justify. This multilateral underpinning of domestic investment rules would go a long way towards bridging that gap.

Nevertheless, even once issues of (real or perceived) legal (un)certainty have been totally or partially laid to rest, the fact remains that many developing countries have a limited capacity, because of their physical or geographical situation, or precisely because of their undeveloped economy, to attract a

growing share of FDI, absorb it into their economic fabric, and in the end fully benefit from it. The fact that neither multilateral rules nor the WTO as an organisation can solve this problem does not mean that they cannot play a positive role towards finding solutions.

The areas for improvement are many: for instance, better market opportunities (including through regional integration); a functioning legal system; establishment and enforcement of fair competition rules to curb abuses by foreign and domestic firms; development of better banking and financial structures, including better lending facilities for local entrepreneurs; domestic laws and regulations clarifying investors' responsibilities; improved governance, etc. Efforts by developing countries to achieve improvements in these areas could be supported through coherent and co-ordinated programmes by international institutions (World Bank, IMF, UNDP, etc.), regional institutions and individual donors. The need for co-ordination and participation of many donors in this area is particularly acute.

By now the EU and its Member States have gained considerable experience with financial and technical assistance in developing and transition countries. EU programmes are currently being provided to numerous partner countries, including those of Central and Eastern Europe, Russia and the CIS, several countries in the Mediterranean, Latin America, ACP countries, etc. Some of these programmes cover technical assistance designed to strengthen public administration, harmonise standards or reform legal systems.

In the context of foreign investment, such assistance – as will be provided for example by PROINVEST[1] – is intended to focus on private sector development, on support of investment promotion agencies, as well as on legal and financial sector weaknesses in order to reduce non-commercial risk and to increase investors' confidence to engage in these markets. To foster development it is thereby crucial to create a virtuous cycle of finance, investment, and growth. *Adherence to the rule of law, nationally and internationally*, and *local capacity building* in this respect deserve special attention in (future) EU assistance programmes.

The negotiation of international investment rules and their transposition into domestic laws and regulations

Besides the longer-term issue relating to the capacity of a developing country to attract a significant share of FDI flows and to absorb inflows in a manner conducive to its smooth and sustainable economic development, the WTO and its Members could start considering what could be done in the short to medium term.

In particular, if investment negotiations were to be launched, WTO members would be faced with the need to identify and analyse their domestic laws and regulations that would be relevant to the operations of foreign investors and that could be affected by multilateral rules. This issue would be relevant to both the negotiation and the implementation phase of investment rules.

This analysis assumes that, in an investment agreement, WTO members would negotiate obligations in three main areas:

- Transparency;
- Non-discrimination (both MFN and National Treatment);
- Market Access.

Technical assistance needs in these areas will be briefly examined in turn. In general, however, an important element to improve developing WTO members' "negotiating capacity" would be their

ability to identify domestic laws and regulations that may need to be preserved, in order to pursue developmental objectives, through, for instance, MFN exemptions, National Treatment exceptions, absence of, or limited commitments on access, etc.

Thus, enabling developing WTO members to recruit and train staff for this work and/or (perhaps on a transitional basis) to use external specialised human resources (e.g. teams of lawyers and economists) could go a long way towards improving their ability to negotiate investment rules compatible with their level of development, as well as to enable them to transpose these rules in their domestic legal order.

Transparency (and dissemination of information)

The transparency of the domestic investment regime is crucial to attract foreign investors in any given country. The question of identifying the domestic laws and regulations that are of most immediate interest to prospective investors, and especially the dissemination of this information, should be an important element of investment promotion.

It is objectively difficult for any country to identify and list all the domestic laws and regulations that may be relevant to the operation of foreign investors (or of domestic investors too, for that matter). These laws and regulations are usually scattered in different legislative and regulatory texts (even where some of them are collected in an "investment code") and are the responsibility of different branches of government or, in many countries, of independent agencies or sub-national governments. A developing country will need help in financing and training the human resources to comb through such domestic laws and regulations, and to devise suitable, effective and non-cumbersome procedures to comply with any multilateral transparency and notification requirements.

The World Bank (MIGA,[2] FIAS[3]), for instance, has instruments aimed at improving dissemination of information and investment promotion. In the Asia-Europe Meeting (ASEM) context, partners have also created a website (the Virtual Information Exchange) which provides information on the investment regime in each of the ASEM partners and on the implementation of the ASEM Investment Promotion Action Plan (IPAP), including a list of most effective measures to attract FDI.[4] WTO members should try to make the most of these instruments and share information in order to identify best practices for investment promotion and dissemination of information.

Technical assistance for the specific goal of improving transparency could build on existing projects and offer officials and investment promotion agencies from developing countries support in terms of know-how as regards (i) identification of national legislation concerning investment, (ii) dissemination of information, and (iii) strengthening the capacity to upgrade regulatory frameworks and to maintain this upgrading. In this context, the existing activities of the World Association of Investment Promotion Agencies (WAIPA) could also be very useful.[5]

Non-discrimination

Non-discrimination provisions are likely to take the form of both MFN and National Treatment obligations. Whatever negotiating format is chosen, neither of these obligations is likely to be an absolute one, realistically speaking. There will be exceptions or exemptions from these obligations in one form or another. A WTO member, therefore, will have to identify the areas and analyse the reasons for which it needs to preserve flexibility when deciding whether or not to grant MFN or NT treatment to foreign investors. For instance, GATS today contains a list of MFN exemptions. If a similar mechanism were to be used in an investment agreement, a WTO member would need to decide which exemptions it wishes to maintain.

Again, the problem developing WTO members face here is one of having sufficient resources to carry out this identification exercise. This identification would also be the obvious basis for the implementation of MFN and National Treatment provisions in the domestic legal system after conclusion of the negotiations.

Technical assistance for policy-makers and their officials could concentrate on (i) the identification and analysis of host countries' relevant legislation, and (ii) the analysis of the cost and benefits of excluding certain areas from MFN/NT provisions.

Market Access

This assumes that the preferred option to deal with access of foreign investors is that of voluntary commitment, sector by sector, by each WTO member. In this case too, a WTO member needs to make a cost-benefit analysis as part of the negotiation process. Some WTO members may need to identify the sectors where opening to foreign investors would be problematic for their developmental objectives and where they wish, therefore, to maintain restrictions to access. The same analysis would then be the basis for dismantling, in the implementation phase, those restrictions that the Member has chosen not to maintain.

Technical assistance for policy-makers in this area could focus on: (i) the economic analysis of removing or maintaining restrictions to entry in a given sector; (ii) programmes aimed at facilitating the transposition of international rules into domestic legislation.

Good examples in the area of technical assistance for the negotiation of investment rules already exist. UNCTAD is running a multi-donor project aimed at assisting developing-country governments in the negotiation of international investment agreements.

NOTES

1. The overall objective of the programme is to increase investment (domestic, cross-border, and foreign) in the ACP regions leading to economic growth, job creation and the strengthening of the private sector, thus contributing to economic integration within these regions and their incorporation in the world economy.
2. The MIGA Agency, part of the World Bank group, aims at encouraging foreign investment by providing viable alternatives in investment insurance against non-commercial risks in developing countries thereby creating investment opportunities in those countries. MIGA is also involved in programmes, dissemination of information on investment opportunities, and technical assistance that enhances national investment promotion capabilities.
3. The Foreign Investment Advisory Service (FIAS) helps developing and transition country governments design initiatives to attract foreign direct investment. FIAS advises on laws, policies, incentives, institutions, and strategies. It helps countries increase the amount of investment they receive – and the benefits this investment produces.
4. See more information on http://europa.eu.int/comm/external_relations/asem_ipap_vie/intro/prog_report_en.htm.
5. http://www.waipa.org

FDI's Linkages with Enterprise Development,

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Jamaica's Export and Investment Promotion Agency

Introduction

Foreign direct investment in developing countries has increased dramatically over the past ten years. As a result, many developing countries have begun to search for ways to increase the benefits from such investment. One of the ways is through increased backward linkages between foreign controlled companies and local firms. In the process of promoting linkages, many countries have recognised that the protectionist policies and local content programmes previously used to force foreign companies to buy local inputs do not work well in the changed international environment. Studies have shown that:

- Economic liberalisation helps rather than hurts domestic suppliers, including SMEs;
- Institutional support focusing on upgrading the capabilities of domestic suppliers is critical;
- Promotional programmes combining public and private resources can accelerate linkage development.

Much in tandem with the recent wave of cross-border investment flows, the Jamaican economy has been attracting increased Foreign Direct Investment Inflows (FDI) in recent years. These inflows have not been associated with economic growth, however, as shown by the much-documented recent economic freeze of the Jamaican economy. This has been the focus of major research in the developing and developed world and has been given high priority in the Research programme of the Jamaica Promotions Corporation (JAMPRO) since 1999, when the organisation's Investment Review summarised as follows:

"Jamaica's major challenge will be the ability to attract investments which will have a higher multiplier effect than those attracted in the past…. Two important reasons for the low multiplier are:

- Low structural linkages between foreign investors and the local supply chain; and
- An incentive regime that encourages the import of raw materials for production.

Imports are a leakage from the circular flow and this leakage reduces the additional impact of investments in the secondary rounds of the multiplier process."

The report further purported that:

"These leakages can be minimised by the institution of a national linkage programme similar to that operated by Enterprise Ireland. Local investors are encouraged to facilitate foreign ownership in a partnership to bring many previously cash-strapped locally-owned firms out of receivership."

The 2000 Global Investment Overview capitalised on the research done in 1999 to conclude the following:

"Changes in investment cannot, in isolation of other injections, generate economic growth. Despite the impressive investment performance, investment generation will only generate growth where it jointly

works with labour and capital improvements, and becomes more export oriented. The two major characteristics of FDI inflows in Jamaica which prove anti-developmental are the fact that inflows are less export oriented than in previous years, and they also use less local inputs than imports…"

This research proved to support recent empirical research by showing that where FDI is of an enclave nature, the spillover effects often associated with such investments, including most importantly, technology transfer and the inherent improvements in productivity, does not diffuse throughout the other sectors of the economy, and reinforces the plantation economy dynamic.

Interestingly, the 2001 UNCTAD *World Investment Report* (*WIR*) has focused on the topic "Promoting Linkages" in its current issue[1]. In the preface of the report, the following comment by the UN Secretary General echoes the cry of the developing world on getting the most for the economy out of every project:

"There is a need to promote links between foreign affiliates and domestic firms in developing countries, so as to strengthen the domestic enterprise sector. This is the bedrock of economic development, and would go a long way towards giving domestic firms a foothold in international production networks while embedding foreign affiliates more fully in host economies"

Research from the World Bank[2] indicates that linkages are a precursor to beneficial FDI inflows. Indeed, there are various studies examining the relationship between FDI inflows and growth, with the majority showing that liberalisation on its own is a necessary but not a sufficient condition for growth from foreign direct investment. A synopsis of various studies reveals that FDI promotion must be seen as part of an economic development strategy geared at improving the capacity of local companies, and as such involves a pivotal role for linkage development strategies.

Studies on the Jamaican economy shows that whereas FDI can greatly assist in technology sharing amongst other things, the real adaptation of these technologies is done in large part by local firms who then localise these technologies to improve their efficiency – a *process* known as "innovation"[3]. Therefore, it is when partnerships are formed between the suppliers of capital (TNCs) and those best able to localise its use (Jamaican firms) that capital's marginal productivity increases and stimulates company development that places the economy on the optimum growth path. These partnerships also reduce the net cost of capital to both TNCs and Jamaican firms.

Because of the link between capital (sourced mostly through imports and FDI) and technology, in Small Island Developing States (SIDS), innovation becomes dependent on the ability to procure capital, which is in turn a function of the import regime and the investment policy of the host economy.

From Jamaica's standpoint an economic development strategy promoting linkages both amongst local firms, and between local firms and foreign partners, is essential for its development and economic growth by providing the avenue for the outlet of Jamaica's creativity or innovation. Jamaica is eager to become a part of the global economy, and it is against this background that backward linkage development strategies are superior to a strategy of seeking special and differential treatment geared at maintaining trade preferences[4].

Forms of economic linkages

There are three basic forms of economic linkages. These linkages, which will be described in a cross-border sense, are equally applicable between firms in one country. They are:

- *Backward linkages* ("sourcing") - Linkages created where the local firm supplies raw material/intermediate products/services to the foreign affiliate**.** Or as the WIR puts it, when foreign affiliates acquire goods or services from domestic firms;
- *Forward Linkages* ("distribution") - When foreign affiliates sell goods or services to domestic firms or where domestic firms use the final products of the foreign affiliates as raw materials in the local production process;
- *Horizontal linkages* ("co-operation in production") – Where foreign firms interact with domestic firms engaged in producing goods and services at the same stages of production**.** A joint venture between two companies producing electronic components would be an example of such a linkage.

Benefits of backward linkages

Clearly, the focus of linkage development for SIDS has to be on backward linkages. These linkages offer benefits to foreign affiliates and domestic firms, as well as to the economy in which they are forged. For developing countries, the formation of backward linkages with foreign affiliates assumes particular importance. From the standpoint of foreign affiliates, local procurement can:

- Lower production costs in host economies; and
- Allow greater specialisation and flexibility, with better adaptation of technologies and products to local conditions.

The presence of technologically-advanced suppliers can provide affiliates with access to external technological and skill resources, feeding into their own innovative efforts.

From the domestic suppliers' side, the direct effect of linkages is generally a rise in their output and employment. Linkages can also transmit knowledge and skills between the linked firms. A dense network of linkages can promote:

- Production efficiency;
- Productivity growth;
- Technological and managerial capabilities; and,
- Market diversification for the firms involved.

For the host economy as a whole, linkages can:

- Stimulate economic activity and,
- Where local inputs substitute for imported ones, benefit the balance of payments.

The strengthening of suppliers can in turn lead to spillovers to the rest of the host economy, contributing to a vibrant enterprise sector and making foreign affiliates less "footloose". According to the 2001 WIR, the benefits provided through linkages with foreign affiliates tend to be of greater significance than those among domestic firms because of the stronger knowledge and skills base of many foreign affiliates.

Linkages can improve the competitiveness of domestic firms and through outsourcing, allow the foreign affiliate to reduce production costs and specialise in core operations.

The current trends among Transnational Corporations (TNCs) of focusing more on their core business and relying more on outsourcing represent new opportunities for firms to link up to the global production systems of TNCs. An average manufacturing firm may spend more than 50 per cent of its revenues on purchased inputs. But becoming a supplier to a leading TNC is no easy task.

Increased competitive pressure is forcing firms on all points of the supply chain to select suppliers that can meet stringent demands in terms of cost, quality, and timely delivery. This often leads foreign affiliates in globally-oriented industries (such as electronics and automobiles) to use other TNCs as suppliers rather than to rely on domestic sources.

Factors influencing linkage promotion

The 2001 *WIR* stresses that the extent to which foreign affiliates forge linkages with domestic suppliers depends on the costs and benefits involved, as well as on differences in perceptions and strategies at company level. Probably the most important factor affecting the degree of local sourcing in developing countries is related to the availability of supply capacity. The lack of efficient domestic suppliers is a common obstacle to the creation of linkages, particularly in developing countries. Therefore, the decision to source locally depends mainly on the:

- Cost/Price,
- Quality,
- Reliability, and
- Flexibility of local suppliers,

relative to overseas suppliers. Outside of these main factors, there are other secondary motives for linkages that can include:

- *Investment motives and strategies of the TNC* – Domestic-market-oriented affiliates generally purchase more locally than do export-oriented firms;
- *Technology and market position of the TNC* – Foreign affiliates producing standardised products tend to outsource more to local companies whilst companies making extremely specialised products tend to outsource less to local companies;
- *Sourcing flexibility of the local affiliates of the TNC* – Affiliates considered to be "centres of excellence", with regional or global mandates for complete products, services or technology, tend to be more integrated with local suppliers;
- *Age of foreign affiliates* - The more experience a TNC gathers in a foreign country, the more managers are recruited locally and the more knowledge it gains about sourcing locally, thus lowering the cost to sourcing locally;
- *Mode of establishment* – Affiliates established through M&As are likely to have stronger links to local suppliers as they have already established sourcing networks embodied in the acquired firm;
- *Size of affiliate* – large affiliates tend not to source from local suppliers because amongst other reasons, the local suppliers cannot easily supply large volumes on a consistent basis to quality specs; and
- *Sector in which affiliate operates* – It is easier to outsource when the technology is divisible into discrete stages and services than when it is a continuous process. The most

viable sectors for outsourcing, therefore, are those in which products are standardised – such as low value added textiles, some electronic components, some automobile components[5], mining, and back-office service operations.

Effective government intervention

Linkages naturally occur in the corporate world. These initiatives are, however, motivated by individual company interest, and in many cases are dominated by the sub-contractors with the loudest voices. Recognising the mutual benefits that linkages can provide, both TNC affiliates and host governments have set up supplier development and linkage programmes, as discussed in the 2001 *WIR*.

Among the success stories are Saint Gobain's supplier development efforts in India, the Irish linkage development programme, and the Local Industry Upgrading Programme in Singapore.

While TNCs have a self-interest in forging links with domestic suppliers, governments can play an important role in promoting linkages, notes the WIR. The willingness of firms to use local suppliers can be influenced by government policies addressing various obstacles to the linkage formation process in order to raise the benefits and/or reduce the costs of using domestic suppliers. For example, TNCs may be unaware of the availability of viable suppliers, or they may find it too costly to use them as sources of inputs.

Drawing on the experience of a wide range of countries, the 2001 *WIR* presents a menu of specific measures that have been used to promote linkages. These include:

- The provision of information and matchmaking;
- Encouraging foreign affiliates to participate in programmes aimed at upgrading domestic suppliers' technological capabilities;
- Establishing training programmes in partnership with foreign affiliates for the benefit of domestic suppliers; and
- Various schemes to enhance domestic suppliers' access to financing.

A few countries – such as Costa Rica, the Czech Republic, Ireland, Malaysia, Singapore and the United Kingdom – have set up comprehensive linkage development programmes involving a combination of different policy measures and targeting selected industries and firms. Such programmes have often met with considerable success.

Well-targeted government intervention can tilt the balance in favour of more linkages and thereby contribute to knowledge transfers from TNCs that can feed into the development of a vibrant domestic enterprise sector.

Of course, like other development policies, linkage promotion efforts need to be adapted to the circumstances prevailing in each host country, and should be undertaken in close collaboration with the private sector and other stakeholders. *The more linkage promotion policies go hand-in-hand with small and medium-sized enterprise (SME) development and targeted FDI promotion policies, the more they are likely to be successful.*

Policies to foster greater & deeper backward linkages

To deliberately facilitate and promote linkage development both among local firms and between domestic and foreign firms, governments globally have used:

- High tariffs on imports;
- Strict rules of origin with high local content requirements for preferential market access;
- Local Content Requirements (LCRs) for entry and establishment;
- Joint venture requirements for incentives or entry and establishment;
- Export performance requirement; and
- Technology transfer requirements.

These have worked in varying degrees to stimulate initial partnerships. However, due to the fact that these all tend to increase production costs for the TNCs, particularly in SIDS, these partnerships have tended to be short-lived. Of the above policies/measures, LCRs are now contraband (TRIMS Article 2), whilst WTO member countries have agreed not to increase tariffs above bound rates. However, all WTO members are allowed to use the following measures in investment promotion[6:]

- *Local equity requirements* – Specify that a certain percentage of a firm's equity should be held by local investors;
- *Technology transfer requirements* – Require specified technologies to be transferred on non-commercial terms and/or specific levels and types of research and development to be conducted locally; and
- *Licensing requirements* – Oblige the investor to license technologies similar or unrelated to those it uses in the home country to host-country firms.

However, whilst recognising that the above policies can generate some initial linkage development between TNCs and the local supply chain, the host country's best policy in developing and deepening these links for long-term partnerships is one in which the local supply chain is upgraded to be able to seamlessly fit into the TNCs production processes.

As stated above (see section 5), there have been four main measures to achieve a well-developed local supply chain (see Table 1).

From global experiences documented in the 2001 *WIR*, where TNCs see profit-making opportunities, they have been prepared to offer assistance for local companies, and have engaged in the following activities:

- Finding new suppliers through public announcements and supplier visits/quality audits;
- Transferring technology *via* the provision of proprietary product know-how, produce designs/technical specs, consultants, joint R&D, provision of machinery, tech support, quality audits, co-operation clubs, self-employment assistance, inventory management assistance, quality assurance assistance;
- Providing training *via* training courses, in-house/plant training;
- Sharing information *via* informal exchange, consultations, annual purchase orders, provision of market information, encouraging suppliers to join supplier associations; and

– Extending financial support *via* guaranteed pricing, advances and prompt payments, medium- and long-term financing.

Table 1: Specific Government measures to create and deepen linkages

Information /matchmaking	Technology Upgrading	Training	Finance
Provision of information: ✔ Handouts and brochures; ✘ Constantly updated electronic database; ✔ Seminars and missions. Matchmaking: ✔ Broker; ✘ Supporting supplier audits; ✘ Advisor in subcontracting deals; ✔ Fairs & exhibitions; ✔ Missions planning.	✘ Technology transfer as a performance requirement; ✘ Partnership with foreign affiliate; ✔ R&D incentives; ✔ Technology modernisation programmes/ incentives.	✔ Promoting supplier associations; ✔ One-stop training service; ✔ Support for private training; ✔ Collaboration with int'l agencies.	✔ Protection against unfair business practices; ✔ Encouraging on-time payments; ✔ Indirect financing to suppliers through buyers; ✔ Co-financing development programmes; ✔ Finance windows to local firms; ✘ Mandatory transfer of funds from foreign affiliates to local suppliers.

Notes: ✔ in place in Jamaica; ✘ Not in place in Jamaica
Source: *World Investment Report 2001*, amended with information for Jamaica.

Linkages as a component of Jamaica's investment strategy

TNC-local firm backward linkages in Jamaica's economic development

In Jamaica's immediate Post-1940s economy, sugar was the main industrial commodity, and because of its capital-intensive nature and the fact that there was a very underdeveloped "private sector" at that time, very few linkages existed.

As the economy developed, linkages were forged between ex-slaves who did not work on the plantation, and ex-slaves who still worked on the plantation. Farmers[7] provided agricultural products to plantation workers, thereby forming some of the initial linkages in the Jamaican economy.

It would not be until the rise of banana production that greater linkages would be formed between the domestic co-operatives of banana growers and the major banana TNC, Standard and United Fruit Ltd. During the “Golden years” of the 1950s and 60s, when bauxite and tourism were booming, linkages between the local and foreign private sector operating in Jamaica still remained underdeveloped.

Again, the main linkage between local firms and TNCs was through trade, as there were few joint ventures. At that time, subcontracting or more appropriately, Business Process Outsourcing (BPO), was not the global reality it is today.

In the 1970s and 80s, economic policies were hostile towards FDI inflows, and even though high tariffs, various LCRs, Trade-Balancing requirements, and other TRIMS were imposed, linkages were not developed as TNCs simply went to other, less hostile, locations.

In recent times, linkage development in Jamaica has been intensified with the increased inflows of in-franchise operations mainly in the restaurant/fast food, car rental, and courier services sub-sectors. In addition, Jamaica's strategy to attract telemarketing agencies and companies wishing to outsource back-office operations has also yielded positive results, with linkages being developed in the Information and Communications Technology (ICT) industry.

In the sub sectors in which these backward/sourcing linkages have been developed, there has been some dynamism. The fast-food sub-sector has been increasingly sourcing local dairy products, beef, poultry, seafood, fresh produce, sauces/condiments, fibreglass furniture, and janitorial services from Jamaican companies. With the boom in fast-food services, there has been an increase in the number of local companies in the supply chain. *This open competition to supply franchises has resulted in greater efficiency in these Jamaican companies, certainly an economic dynamic encouraging company development.*

The hotel sector has also been an important source of demand for local suppliers of entertainment services, food, construction services, janitorial services, specialty apparel for spas, as well as furniture.

JAMPRO, working with Cable and Wireless Jamaica and IMEX Technologies, has developed a website to allow local farmers to form linkages with hotels (local or foreign owned), agro processors, and agricultural fresh produce exporters, thus deepening linkages by providing more complete information on trading opportunities.

The constraints on farming, however, are more binding than those on other local companies – particularly as irrigation and other water provision services increase cost expenses. As a result, small farmers have not been able to grow and benefit from the linkages that have been formed.

SIDS such as Jamaica cannot exert any influence on TNCs to form partnerships with local companies. The only lever that Jamaica can use is the competitiveness and creativity of Jamaican firms as a starting point for linkage development.

There are significant costs for both parties involved in partnerships, as local companies that have been involved in former failed partnerships complain of TNCs' refusal to provide prompt payment; TNCs in turn complain about the inability of local firms to meet their volumes consistently, and to meet the required technical specifications.

Government initiatives with indirect linkage benefits

Against the background mentioned in section 6.1, Jamaica has embarked on various strategies including:

- A significant *Modernisation of Industry programme* which relieves companies through a tax waiver of general consumption tax on machinery purchased as part of a modernisation programme. Jamaica Promotions Corporation (JAMPRO), the export and investment facilitation arm of the Jamaican government, supplies engineers, quality assurance officers, and other experts to supervise this process.
- Technical assistance programmes, chief of which is the *Trade Development Programme funded by the European Union (EU),* which assists companies in Research and Development Initiatives.
- *R&D incentive* through the National Commission on Science and Technology (NCST), which provides for duty-free entry of equipment imported for use in Research initiatives.
- Also recently, the British Government through the British High Commission recently launched the *Linkage Development Fund*, which allows for financing of select projects under strict guidelines involving joint ventures between Jamaican companies and an overseas affiliate.

These Government initiatives are not a component of any deliberate linkage strategy, but are part of a microenterprise development strategy geared at improving their competitiveness and productivity. The clear link between both a linkage strategy and a general competitiveness strategy provides some hope for future backward linkages that will facilitate the development of Jamaican firms in the new global environment.

TNC Initiatives to help Jamaican Companies

There are also instances where TNCs operating in Jamaica have:

- Provided Training for local firms (e.g. in the ICT industry);
- Infrastructure investment (e.g. in the Bauxite Industry);
- Employed guaranteed pricing schemes (e.g. Fresh produce industry); and
- Shared information with local suppliers (e.g. Restaurant Franchise sub-sector)

Certainly this contribution to the development of Jamaican firms is recognised and greatly appreciated. However in reaction to the fact that in most cases of commodity production, the Jamaican supply chain is underdeveloped and uncompetitive, these initiatives have mainly been unstructured, and as such, unable to provide the long-term consistent push to domestic firms to enable their development.

What these initiatives from TNCs have been able to do, in some instances, is provide local firms with windfall profits, which in some cases have been inappropriately used.

It is believed, and demonstrated in other countries, that TNCs are willing to invest in the supply chain where it is seen to be competitive to do so in the short run. This not the general case for the Jamaican supply chain.

Jamaica's recent FDI attraction strategy

The main economic strategy geared at investment maintenance and stimulation has been that of keeping inflation in a single digit, reducing fiscal "crowding out", and ensuring exchange-rate stability. The strategy has also included improvements in human resource capabilities, intellectual property rights protection, and infrastructure. Jamaica's investment strategy as articulated in the NIP involves three components:

- A system of incentives based on performance-based criteria;
- A broad-based strategy geared at dealing with the productive disincentives in the Jamaican economy; and
- An activist strategy of Investment packaging based on target sectors

Included in the criterion for selection of target opportunities/sectors are *inter alia*:

- Export performance/potential;
- Enhancing the level of skill and technical experience of the Jamaican workforce; and
- Strengthening linkages.

This strategy has not been implemented to the fullest, as the incentive system is still under review, and the programme to address the various productive disincentives still has some way to go in addressing these constraints.

However, against this background, Jamaica has been able to attract a significantly increased level of inflows into the economy. This improved FDI inflow performance[8] can be ascribed to a number of factors:

- The government's policy towards foreign investors has relaxed considerably[9];
- The government privatisation programme accounting for nearly one-third of all FDI inflows in 1999[10];
- The government's policy encouraging investments through export-processing zones (EPZs)[11]; and
- Independent acquisitions by intra regional investors from Trinidad and Barbados.

Strategic policy direction for Jamaica

Globally, in every instance where linkage programmes have been used, there have been positive spin-offs. Jamaica does not have a structured programme to assist in linkage development, but as stated earlier, the National Industrial Policy (NIP), recognises the importance of developing strategic alliances in the general investment promotion and development strategy.

There are technical co-operation programmes in place that can assist in developing linkages; however, the main deterrents continue to be:

- The *uncompetitive cost structure* which Jamaican supplier companies face;
- The *small size and inflexibility* of the average Jamaican company, constraining exploitation of economies of scale; and

- The inherent problems caused by the *non-use of joint production* between local firms.

Certainly, as the world now refocuses on the topic of building partnerships with TNCs, rather than attempting to compete with them, Jamaica now has to do the same, and even investigate the feasibility of implementing a structured programme for linkage development in a manner which leads to the development of small local companies.

However, as the developed world applies diplomatic and economic pressures for creative and eager countries like Jamaica to become more fully integrated in the world economy, *the high innovative quotient of countries can only be utilised where TNCs partners make commitments in the long term.*

Jamaican companies have much to offer to the world in a unique way. Mutually beneficial long-term partnerships that foster SME development will enable their effective participation in the global economy. Negotiations in Qatar, and beyond, will be the strategic focus, and the intention will be to use a menu of the appropriate allowed TRIMS, and other provisions, to fashion an investment regime that will encourage TNCs to form partnerships with Jamaican companies.

The policy direction for Jamaica to maximise the contribution of investment flows will therefore involve:

- Improving the local supply chain; and
- Fashioning a policy environment which stimulates/motivates TNCs to partner with Jamaican companies.

[1] Indeed this seems to put the previous issue of the WIR in context, as the 2000 WIR focused on cross-border M&As and Development, and showed that under certain conditions M&As are a form of linkage which can contribute towards economic growth and development. The 2001 WIR builds on this research to show the conditions under which linkages can benefit economies.

[2] Klein, Aaron, Hadjimichael, 2000. "Foreign Direct Investment and Poverty Reduction", FIAS Occasional Paper.

[3] Dillon Alleyne, James, Vanus. 2001 Unpublished paper, Department of Economics, UWI

[4] It is however recognised, that trade preferences are a form of linkage promotion.

[5] In Mpumalanga Province, RSA, automobile factories have been established which simply attach the bumpers to automobiles.

[6] Certainly, SIDS such as Jamaica are not as highly leveraged as other larger developing countries to be able to effectively negotiate with TNCs for the use of these measures.

[7] In some cases, plantation workers were more than subsistence farmers and sold at the markets as well.

[8] According to the 2001 *WIR*, FDI inflows into Jamaica increased from US$147 million in 1995, to US$456 million in 2000.

[9] Since the 1980s, a number of restrictive measures have been phased out, including the Foreign Exchange Control Act, which made it difficult for investors to take capital out of the country, and the long list of "prohibited sectors", which kept foreign firms out of certain industries, has been abolished. Foreign investors can now invest in almost any area of the economy, with policies towards FDI transparent

and non-discriminatory. There is now no regulation of foreign exchange transactions, imports of technology and other inputs, or loans raised in the domestic markets by foreign investors. Moreover, property rights are protected under the Jamaican Constitution and *via* a number of bilateral treaties. Foreign investors are now accorded national treatment. Dispute resolution mechanisms also exist. In addition, depending on the nature of the proposed investment and export potential, there are tax holidays, duty exemptions, and other benefits to investing companies.

[10] There have been significant privatisations in telecommunications, tourism, insurance, banking, manufacturing, and minerals. Plans for enhanced privatisation in the utilities and the infrastructure sectors (telecommunications, energy, transport) are under consideration, with some activities, such as spectrum auctions for mobile phone services, already undertaken. Air Jamaica is already 75 per cent privately owned, and there have been efforts in the direction of divesting investment in two major international airports.

[11] Under the 1982 Jamaican Free Zones Act, investors are allowed to operate in foreign exchange across a range of activities including warehousing and storing, manufacturing, redistribution, processing, refining, assembling, packaging and service operations like insurance, banking, and professional services. Incentives include a 100 per cent tax holiday in perpetuity. Since 1996, firms outside the free zone can also benefit from free zone status, providing they export at least 85 per cent of their production. Exports from free zones increased by roughly 40 per cent in the period 1992-1999, though interestingly, foreign exchange earnings have only increased by 9 per cent over the same period and employment has fallen from 14,220 to only 9,991 jobs. The middle of the decade seems to have been the most successful for free zones, with foreign exchange earnings and employment peaking in 1995 and gross exports in 1996.

CHAPTER V

INITIATIVES FOR CORPORATE RESPONSIBILITY AND ECONOMIC DEVELOPMENT

Corporate Social Responsibility and Economic Development,

Mr. Jim Baker ,
International Confederation of Free Trade Unions (ICFTU)

There are plenty of examples of idiot-savant development, where the economic is advanced and the social is primitive. Economic and social development can only be separated in the mind. In the lives of individuals and communities, the economic and the social cannot be separated.

The well-being of the great mass of people ought to be an indicator of economic development. That may be an abstract concept, but no more so than the confidence of financial markets, a subject that has long fascinated economists and government officials. Development should mean the creation of good and decent jobs that offer futures for workers and their children and not the expansion of dead-end, survival economic activity.

Corporate social responsibility (CSR) needs to be looked at in terms of its relevance to economic development in a broad and sustainable sense. How can foreign direct investment or sourcing combine with CSR in order to contribute to an environment in which there is growing prosperity for the majority? And how can it contribute to greater democracy and justice in societies without, at the same time, despoiling the earth? There are different approaches to CSR, some much better than others. The best form, sustainable corporate social responsibility, contributes to sustainable societies.

However, before looking seriously at the possible contribution of CSR, it is important to overcome the hype and exaggeration that often accompany that term and to be realistic about what it can contribute, even in the best of circumstances. That is not to say CSR is not important, but rather to temper evangelistic excesses with a dose of reality.

CSR must be considered in the context of the competitive pressure to violate workers' rights mentioned earlier. Outside of garments and sporting goods and toys, in other words, industries where there are extensive supply chains and where consumer pressure exists, CSR is almost unknown. The only major exception is extractive industries where consumer awareness of human rights and the environmental issues has created a degree of sensitivity.

The market environment and the downward pressures that are part of the global economy, particularly in certain industries, are one explanation of why there are so many more "win-win" situations in speeches than there are in real life. As long as comparative advantage can come from the most vicious exploitation of workers including the violation of fundamental rights, there will be limits on the power of CSR to have a positive influence on development.

CSR cannot be expected to replace governments. If it is seen as a privatisation of labour standards, it is bound to fail. It cannot adequately fill the void created by governments that are unwilling or incapable of protecting the rights of their citizens or are actively opposed to the exercise of those rights.

The history of development at national level demonstrates that binding rules are necessary to provide for the respect for workers rights even if those rights, within that framework, are further and effectively protected by voluntary measures like collective bargaining.

There is no reason to believe that globalisation will require anything less. And there is no question that, sooner or later, such binding rules will come into being. The growing body of regulations and

procedures that protect property rights at global level will require a social counterpart. It is time for governments and the social partners to begin serious discussions of binding social regulation that is workable and provides the necessary space for global social dialogue and agreement. This must be part of the global governance agenda.

The potential impact of CSR is variable. Its possible impact is not determined by whether countries are developed or developing. It relates, rather, to whether or not governments effectively protect labour standards. In countries where labour laws are good and enforced, enterprises will be responsible because they have no choice. Similarly, it will be difficult to evaluate the effects of CSR in countries where forming a free trade union is considered to be subversion.

But in a large number of countries, while governments do not force companies to behave, they do not prevent them from doing so. That is the case in some partially democratic countries, but it is also true in the United States, for example, where the laws do not force companies to fully respect the rights of workers to organise and collectively bargain, but they allow them to do so.

The OECD Guidelines for Multinational Enterprises specifically address this situation. They call for good industrial relations policies and, in the case of opposition to union organising, mean that companies should take a positive attitude towards trade unions and, in particular, an open attitude towards the organisational activities of trade unions. The practices encouraged by the Guidelines go beyond simply obeying the law.

But there is another important difference between the Guidelines and other CSR approaches. Good corporate behaviour is an expectation of governments and there is a role for governments in the implementation of the Guidelines. Governments are required to establish National Contact Points that are required to handle and report on cases.

The Guidelines are not legally binding, but the principles are not voluntary in the sense that companies are not free to pick and choose among them. And although the Guidelines can serve as a model or benchmark for codes, their application does not depend on their adoption by companies. All companies are expected to honour them.

The test of the revised Guidelines will be the extent to which governments take them seriously. Companies will take them seriously if that message comes loud and clear from governments and if they become integrated into the full range of government policies related to inward and outward investment as well as to relationships in the supply chain.

There have been objections from employers to measures that encourage respect for the Guidelines by, for example, linking them to the receipt of public money made available to companies in the form of export credits. They claim that such measures violate the voluntary spirit of the Guidelines. This is in spite of the fact that no company is forced to apply for or accept such credits. For comparison purposes, one could look at other voluntary measures relevant to the world economy. For example, any agreement between the IMF and a government on a structural adjustment programme is voluntary. Such an agreement might require slashing the public payroll, cutting wages, selling off state assets and many other measures. The government is free to reject the loan. By comparison, one could easily argue that export credits, although they may be important to a company, are, indeed, very voluntary.

The revised Guidelines offer an enormous opportunity for governments to be relevant to the social needs of the global economy. It is an opportunity that should not be missed through expedience, indifference, or timidity.

In recent years, International Trade Secretariats (ITS) – trade union organisations that group unions by industry and occupation – have developed social dialogue with a large number of their global counterparts, multinational enterprises, and, on rare occasions, employer associations. In one case, this has resulted in a fully-fledged global collective bargaining agreement covering wages, hours, and working conditions between a group of ship owners and the International Transport Workers Federation, the ITF. In addition, there are ten framework agreements between ITS and multinationals. These agreements most often consist of a limited number of principles, but they reflect a relationship that allows the resolution of conflicts and misunderstandings before serious problems develop. They have also provided the space for workers to organise without fear.

The OECD Guidelines address rights, but are clearly imbued with the notion of good industrial relations, in other words, employers recognising, respecting, and dealing with the representatives of workers, their trade unions. Framework agreements and other forms of global social dialogue are intended to produce such relationships at the workplace, so that the workers can resolve their own problems.

By encouraging global social dialogue, the UN Global Compact can help create an environment in which constructive and pragmatic global industrial relations can further develop. It also serves as a platform for global dialogue on important issues. Such a dialogue took place on complex questions related to zones of conflict. A new round of discussions is beginning on sustainable development in the run up to the Johannesburg meeting next year.

Another area of CSR, one that has received most of the attention even if it has not achieved very much in terms of results, is unilateral codes of conduct. These are policy proclamations by companies. They have provided considerable employment for public relations and social auditing firms, but it is not clear that they have produced much real change on the ground. There is no involvement of governments or trade unions, although international labour standards are often included in unilateral codes. In many cases, however, certain critical standards are missing, usually freedom of association and collective bargaining. And interlocutors are not sought; they are created.

The nature of the different approaches to CSR determines their value in terms of development. Sustainable CSR is not taking care of or pretending to take care of workers by remote control through processes that do not implicate workers in determining the direction of their own lives. They may flirt with “empowerment”, but rarely produce real power for working people.

Unilateral codes do not necessarily change the balance of power at the workplace nor can they guarantee that social promises made by companies are being kept. Particularly in the area of freedom of association – the key enabling right that allows other workers’ rights to be protected – outside inspectors will be measuring the freedom of workers to speak, rather than their real rights to organise. In addition, when the inspectors leave, in the absence of unions there is no guarantee that even visible abuses will not return.

The interest of trade unions in CSR is related to the extent that that it provides an enabling environment for organising. It can, in the best of cases, open up the space for organising. However, in other cases, it can substitute top-down processes for legitimate worker representation or produce a disembodied worker voice. At the political level, a parallel would be the replacement of free elections by polls and focus groups. In other words, marketing instead of democracy.

Sustainable CSR is based on creating a free workplace where workers can organise. Trade union organisation sustains the protection of workers’ rights and benefits for workers.

Sustainable CSR is also of value to the company in terms of its own production as well as its reputation. Free trade unions at the workplace in the company's own facilities or in supplier work sites provide an opportunity for real worker participation in producing better quality goods. They provide workers with the independent power and capacity needed to have real co-operation with their employers. They can help build an environment where employers perform better and more honestly and credibly. Unions also guarantee that workers' rights are being respected, something that unilateral human resource management methods or third-party approaches, no matter how sophisticated, cannot provide.

Sustainable CSR also can help power development. The establishment of diverse centres of power aids development. In addition, workers learn democracy at the workplace, even if political democracy is not yet fully established or is weak. This helps change the nature of societies by building democratic forces and deepening popular participation in society beyond the usual elites.

Sustainable CSR can produce workplaces that are islands of freedom in societies that do not yet protect workers' rights. Trade unions, free to operate at the workplace, help change the balance of power in society. Their numbers and economic power can create the space for other elements of civil society to emerge. A dramatic example of effective and sustainable CSR was the massive civil disobedience of employers, including many foreign-based multinationals, in South Africa, where many companies recognised black trade unions before it was legal to do so. Trade unions were strengthened and better placed to play a central role in bringing down apartheid and ensuring that post-apartheid South Africa would be a democracy.

Sustainable CSR, by allowing workers to organise, also begins to change the nature of globalisation. International trade union solidarity is a major force for justice that can help balance the global economy. Trade unions, through their international solidarity structures, work together to create broader observance of workers' human rights. In doing so, at the same time they strengthen the competitive positions of decent companies and decent governments. They begin to produce the type of global regulation and governance that encourages good social and economic development strategies at national and international levels and discourages a race to the bottom.

Sustainable development, participatory development, and rights-based development can be nice phrases or they can become much more. All require changes of a fundamental nature. Freedom of association enables workers to build free and independent institutions and is, therefore, a powerful force for real social and economic development. Sustainable CSR can help liberate the power of workers to protect themselves, change their workplaces and their communities, and live their lives in hope and dignity.

Corporate Social Responsibility and Competitiveness,

Dr. Enrico Massimo Carle,
Chairman,
BIAC Committee on International Investment and Multinational Enterprises

Facts about the Corporate Role

Businesses have been investing and trading internationally for as long as history. With them, they have brought the market-based economy and have bound together the peoples of the globe in commerce.

Globalisation is a word to describe, for better or worse, the acceleration of this economic integration, and corporate social responsibility has become a hot topic for businesses, governments and the community at large.

Today, there are calls for businesses to take on more responsibility for human rights, the environment, social conditions, poverty reduction, and even for education, as if the page were blank.

But in fact, corporate responsibility has always been fundamental to a company's competitiveness and long-term success. Through their investment choices, research programmes, personnel policies, manufacturing processes, and customer service orientation, international firms have led the way on many fronts.

Companies have been, and continue to be, key players in promoting innovation and sustainable growth and are significant agents of positive change at all levels of the polity.

Corporate Social Responsibility – The Instruments

First, there are the laws. Second, there are regulations. These are requirements. The notion of corporate social responsibility is quite separate.

From the start, is important to remember that corporate social responsibility is about the voluntary measures that a company takes to develop good management systems, which in turn enhance a company's ability to sustain its franchise, build a record of sustained growth, and do so by engaging positively with the societies in which it operates.

Corporate responsibility objectives, or goals of "better practices," may or may not be derived from "codes" but are reflected through the implementation of management systems.

The decision by a company to adopt a corporate code of conduct or one of the many corporate responsibility pacts, systems, initiatives or other instruments that are being promoted today, will depend on the objectives of the individual company and the relative value added each code or initiative can offer. The primary audience for many codes often remains the company itself, namely its business units, managers, employees and shareholders.

Most importantly, it is the behaviour of the company that counts – not the existence of a formal set of business principles to which management "signs up." So whether or not a company decides to adopt and publish a business code, vision, principles or similar communication vehicle should not be seen as an indicator of its commitment to good business practices.

Many companies with a deep commitment to modern management and corporate social responsibility are too busy producing sustainable growth and shareholder value to engage in what some consider showmanship or self-serving puffery.

But today, an increasing number of companies are investing significant resources to communicate to the public what has always made them competitive in the first place – their good management systems – which aim at implementing good company practices and policies related to environmental health and safety, quality of the working environment, employee benefits and community relations, all essential to the private sector's role in contributing to economic development.

For example, a recent survey of U.S. manufacturers conducted by the National Association of Manufacturers and the Manufactures Alliance, illustrates a number of practices followed by manufacturing companies with respect to ethical, labour, and environmental standards in developing countries.

The survey shows how manufacturing companies are creating benefits in these areas through implementation of their management systems in developing countries, and how the direct positive impact of these companies on labour and environmental standards in the broader policy context can be more effective than punitive actions, for example trade sanctions, against developing country governments.[1] You can find this study on their website, www.nam.org.

Generally, multinational enterprises apply uniform environmental and personnel practices in the different locations in which they operate. According to a recent study by the Global Environmental Management Initiative, GEMI, in many cases they apply higher standards than those required by the host government or followed by local companies. This study can be found at www.gemi.org.

OECD Guidelines for Multinational Enterprises

With respect to the various corporate social responsibility global instruments that are available to business, the OECD Guidelines for Multinational Enterprises merit particular attention.

As the only comprehensive set of voluntary principles for international business collectively endorsed by governments, the OECD MNE Guidelines serve as an important benchmarking tool for companies as they develop their internal management systems. They have played that role for more than 25 years.

The clear aim of the MNE Guidelines is to improve the climate for foreign direct investment, sustainable growth, and to promote the positive contribution that multinational enterprises can bring to society.

At the outset, the Guidelines were intended to provide government recommendations for good business conduct and, as part of the wider OECD Declaration on International Investment and Multinational Enterprises, to encourage a balance of responsibility between international business and governments.

BIAC and its member organisations continue to communicate and promote the Guidelines at international, national, and local levels. In working towards this goal, the MNE Guidelines continue to be valued and taken seriously by business in the implementation of improvements in company policies and practices.

[1] U. S. Manufacturing Industry's Impact on Ethical, Labour, and Environmental Standards in Developing Countries: A survey of Current Practices. Manufacturers Alliance/MAPI and the National Association of Manufacturers. April 2001. The survey can be found on the Internet at www.NAM.org.

The OECD MNE Guidelines are voluntary, and act as a tool. They are neither a law nor a regulation. They are not enforced but utilised.

Limits

While a company is dedicated to protecting its corporate image, brand integrity and employment reputation in all the markets in which it operates, at the same time, it is clear that there are limits on what should be expected from company performance.

Companies cannot substitute for governments in building the policy mosaic, in other words the co-ordinated legal framework and basic infrastructure needed to establish fully functioning market economies that attract business and are necessary for a company to flourish.

In order to trade and invest in open markets, companies seek out market environments with economic and societal stability, established rule of law, regulatory frameworks that promote competition, enabling infrastructure, quality education and training opportunities, protection for intellectual property rights, real competition, and the absence of corruption.

Those framework conditions attract opportunities for economic growth. Their absence signals at least caution if not avoidance. Good public governance is essential to attract FDI and trade, which in turn increase consumer choice, create jobs, and most importantly, generate revenue for public spending on education and training that is essential for economies to adjust to and sustain the benefits of growth.

While economic integration, investment, trade and diffusion of technologies support growth, they also induce adjustment by the persons and economies that reap their benefits. A fundamental requirement for addressing these adjustments lies with an adequate education system and the availability of training in basic skills. Education – including lifelong learning – is essential to enable a society to cope with the inevitable shifts and opportunities in the labour market.

In short, open markets encourage development of good public governance. The integration of markets and increased removal of trade and investment barriers make the instruments of governance all the more important to ensure contestable markets, and good public and private governance is essential to maximising the benefits of investment by responsible business.

Conclusion

Business is faced with a plethora of instruments, codes and principles that are being developed at national, sectoral, and international levels. It is important that policy-makers keep in mind that the benefit of such initiatives is the implementation of effective management systems within companies.

With this in mind, both governments and business alike need to be sure that policy decisions in these areas enhance and do not inhibit the benefits of trade and investment that can be gained by developing and developed countries alike.

BIAC represents the business community, the companies, of the 30 OECD Member countries. The global presence of many of these companies involves them, potentially, in every corner of the world market contributing jobs, technology, training, and – not least – capital.

Business will continue to be the key player for sustainable economic growth as it continues to focus on its core activity: creating prosperity, in a responsible and engaged manner.

Foreign Direct Investment and Corporate Codes of Conduct in National Development Strategies: Costs, Benefits and Policy Options,

Brett Parris,
Economic Policy Officer, World Vision

Introduction

In March 2002, the UN will host a major international conference on Financing for Development in Monterrey, Mexico. The conference has been called for a variety of reasons, not the least of which is the recognition of a crisis today in development funding for developing countries.

At its 34th High Level Meeting in May 1996, the OECD's Development Assistance Committee (DAC) adopted a number of International Development Goals, which included:[1]

1. Reducing the proportion of people living in extreme poverty in developing countries by at least 50 per cent by 2015.

2. Substantial progress in primary education, gender equality, basic health care and family planning, including:
   - Universal primary education in all countries by 2015.
   - Eliminating gender disparity in primary and secondary education by 2005.
   - Reducing the death rate for infants and children under the age of five years in each developing country by two-thirds of the 1990 level by 2015, and reducing the rate of maternal mortality by three-fourths during this same period.
   - Making access available through the primary health-care system to reproductive health services for all individuals of appropriate ages, including safe and reliable family planning methods, as soon as possible, and no later than the year 2015.

3. Current national strategies for sustainable development, in the process of implementation, in every country by 2005, so as to ensure that current trends in the loss of environmental resources - forests, fisheries, fresh water, climate, soils, biodiversity, stratospheric ozone, the accumulation of hazardous substances and other major indicators - are effectively reversed at both global and national levels by 2015.

At that time, the average level of official development assistance (ODA) given by OECD countries was 0.3 per cent of their combined GNP. In 1999, when the targets already seemed unreachable, the level of ODA had fallen to 0.24 per cent. This figure is actually slightly higher than that for 1997, when it reached an all-time low of 0.22 per cent. In fact, from 1992 to 1997 total DAC Members' ODA fell by 21 per cent in real terms. Only *four* OECD countries consistently give above or equal to the UN target of 0.7 per cent of GNP: Denmark, Norway, the Netherlands and Sweden.[2]

In this context of relatively stagnant support for ODA, and concerns over the volatility of portfolio investment in the wake of the Asian financial crisis, many look to an increased role for foreign direct investment (FDI) as a way of boosting finance for development. Along with trade liberalisation, the imperative for developing countries to entice more FDI has become a mantra emanating from major

international institutions such as the World Bank, IMF, WTO and OECD, as well as most governments.

The Report of the High-Level Panel on Financing for Development, popularly known as the Zedillo Report, after its chair, former Mexican President, Ernesto Zedillo, explicitly recommends that developing countries "should create an attractive environment for foreign investment, especially FDI".[3] In itself, this is a fairly general, innocuous recommendation. Of concern though is the extent to which the growing emphasis on FDI is both displacing adequate debate on the scandalously low levels of ODA, and fostering an uncritical stance towards FDI itself.

FDI flows are certainly extremely important. They rose 18 per cent in 2000, to a record $1.3 trillion[4] (UNCTAD, 2001a). But latest UNCTAD estimates point to a *decline* of 40 per cent of FDI for 2001 – down to $760 billion – due mainly to a pause in the frenetic pace of mergers and acquisitions (M&As) seen over the past two years.

Given that these M&As took place mainly between developed countries, which account for the bulk of FDI flows, of more relevance is the proportion of FDI flowing to developing countries. Unfortunately, based on UNCTAD's preliminary estimates, this is also predicted to decline this year, from $240 billion in 2000 to $225 in 2001. One encouraging sign is that Africa is projected to receive an increase in FDI, from $9.1 billion in 2000 to $11 billion this year, though this follows a slump from $10.5 billion in 1999.[5]

Even so, it is obvious that FDI flows into developing countries are dwarfed by flows to the wealthier OECD countries. To what extent then can FDI fill the gap in providing "financing for development"? Given the urgency of the need for external resources, should FDI be sought out and accepted uncritically? Moreover, what is the appropriate role for transnational corporations (TNCs), and corporate codes of conduct in the development of poor countries?

To many people, and to some NGOs, the latter question hardly warrants consideration. In an era of 'corporate globalisation' the TNCs are the enemy – and no good can come from consorting with the enemy.[6]

However, things are not so simple. There are both benefits and costs to FDI by TNCs in developing countries. This paper explores some aspects of the costs and benefits of FDI, and in particular the question of appropriate FDI policies. The pros and cons of codes of conduct are then discussed in this context.

The Developmental Context of FDI

FDI and Economic Growth

Investment has long been recognised as one of the keys to economic development, though its precise relation to economic growth remains controversial. While some studies, such as that of de Long and Summers (1991 & 1992), concluded that the rate of capital formation, *determines* the rate of growth, others, such as Blomström *et al* (1996) refute this claim. They argue that while fixed (capital equipment) investment may be important, other factors such as institutions, the economic and political climate, inflows of FDI, lower population growth, and the efficient use of investment are also critical for strong growth.

Poon and Thompson (1998) analyse FDI and growth data between 1987 and 1994 and conclude that Japanese manufacturing FDI to Asia and U.S. service FDI to Latin America both contributed to the growth of those regions.

On the basis of a time series and panel data analysis of FDI and growth, de Mello (1999) showed that while FDI is meant to increase growth in recipient countries *via* technological upgrading and knowledge spillovers, in fact, its effects are sensitive to the degree of complementarity and substitution between FDI and domestic investment. Moreover, in his earlier survey of the effects of FDI on developing countries, he concluded that the final impact of FDI on output growth depends on the scope for efficiency spillovers to domestic firms (de Mello, 1997). It is by this means that FDI leads to increasing returns in domestic production, and increases in the value-added content of FDI-related production.

In other words, FDI certainly can contribute to economic growth, but whether it does so, and the extent to which is does so, are significantly influenced by other factors specific to the local economic environment. The appropriate role of FDI, and therefore of TNCs, must therefore be viewed in the much larger context of an appropriate domestic development strategy. It is here that one of the principal dangers of an unbalanced approach to FDI lies.

The Importance of a Domestic Development and Investment Strategy

Dani Rodrik, professor of international political economy at the John F. Kennedy School of Government at Harvard University, has been particularly scathing of an uncritical approach to global economic integration. In his view, such an approach allows an obsession with integrating into the global economy to obscure the necessity for the careful formulation of a sound domestic development strategy:

> "Countries that have done well in the post-war period are those that have been able to formulate a *domestic* investment strategy to kick-start growth and those that have had the appropriate institutions to handle adverse external shocks, not those that have relied on reduced barriers to trade and capital flows. … Policy-makers therefore have to focus on the fundamentals of economic growth – investment, macroeconomic stability, human resources, and good governance – and not let international economic integration dominate their thinking on development." (Rodrik, 1999, p. 1).

He is particularly critical of an overemphasis on trade and capital market liberalisation:

> "Global integration has become, for all practical purposes, a substitute for a development strategy. This trend is bad news for the world's poor. The new agenda of global integration rests on shaky empirical ground and seriously distorts policy-maker's priorities. By focusing on international integration, governments in poor nations divert human resources, administrative capabilities, and political capital away from more urgent development priorities such as education, public health, industrial capacity, and social cohesion. Globalization is not a short-cut to development. … Policy-makers need to forge a domestic growth strategy by relying on domestic investors and domestic institutions. The costliest downside of the integrationist faith is that it crowds out serious thinking and efforts along such lines." (Rodrik, 2001, p. 55).

Illustrative of Rodrik's emphasis on the importance of a domestic development strategy is Korea's well-known aversion to FDI in the early stages of its development. The Korean government had an

explicit strategy of developing domestic technical capability through technology licensing, financed through foreign loans and import taxes rather than through FDI, except in the light manufacturing export sector. In almost all years from 1965 to 1989, FDI as a percentage of total foreign capital inflow fell below 5 per cent (Amsden, 1989, p. 76).

Even today, FDI for most countries (66 per cent in 1991-97) is not more than 10 per cent of total investment, although those countries with ratios equal to or above 15 per cent increased from 7 per cent to almost 25 per cent between the 1970s and late 1990s (UNCTAD, 1999b, p. 168).

Rodrik's comments are also all the more pertinent when account is taken of the geographical bias of FDI flows. UNCTAD (2001a) notes that the world's top 30 host countries (including OECD countries) account for 95 per cent of total world FDI inflows and 90 per cent of stocks.

Kozul-Wright and Rowthorn (1998) develop this theme, emphasising the regional nature of much FDI. They argue that unlike Malaysia, located at the hub of a fast-growing, integrating region, most developing countries will be unable to rely on substantial FDI, and will instead have to rely overwhelmingly on their own resources and domestic producers.

Two major conclusions follow from this section:

- First, while FDI can contribute to economic growth, whether it does so is highly dependent on the domestic economic environment.
- Second, while FDI will be important for some countries, there is simply not enough FDI to assist most developing countries, especially the poorest. Most such countries still require substantial amounts of ODA to lift their populations out of poverty, and all require a well-crafted domestic development and investment strategy.[7]

At a deeper level still, lies the issue of the costs and benefits of the FDI that *is* available. In discussions of FDI, TNCs, and codes of conduct, it is often just assumed that FDI is beneficial and that the real question then is the conduct of the companies concerned. It will be argued here that while company conduct, and therefore codes of conduct are obviously important, we must not neglect the prior question of whether a given investment is in fact likely to benefit the host country. Should developing countries simply solicit and accept any FDI?

Costs and Benefits of FDI

Cost-Benefit Analysis and FDI

It is widely acknowledged in principle that there are economic and social costs as well as benefits from FDI (and the international competition for FDI). But in practice this increasingly seems to be forgotten.

Like other major projects, FDI should not be accepted (or solicited) uncritically, but instead evaluated in a comprehensive economic and social cost-benefit framework. This should include appropriate shadow prices (especially for government revenue, foreign exchange and labour), appropriate discount rates and appropriate distributional weights[8]. Shadow prices are prices calculated to take into account the true opportunity costs of resources and inputs and any externalities resulting from the project. These can be negative, such as pollution, congestion or crowding out of domestic capital, or positive, such as technological spillovers or higher productivity.

Appropriate social discount rates are essential because it is well known that private rates of return and discount rates can diverge markedly from optimal social rates of return and discount rates. Private interests tend to discount the future more heavily (i.e. use higher discount rates) than is optimal from a broader social perspective – especially in an environment where property rights or regulations are ill defined and a 'tragedy of the commons' effect can ensue.

Appropriate distributional weights should be used to account for equity considerations. An investment project which yields 100 already rich people $50,000 each is by no means as developmentally effective as one which yields 50,000 very poor people $100. To ignore distributional weights is to assume an effective distributional weight of '1' for the 'average' income level. This assumes 'a dollar is a dollar', and that an extra dollar's benefit to a rich person is identical to an extra dollar's benefit to a very poor person. This may make the calculations easier, but it ignores the vast empirical evidence to the contrary and the entire economic theory of diminishing marginal utility of income.

The over-arching context for the cost-benefit evaluations should be the country's own development strategy, incorporating fundamental goals such as social development, poverty reduction, and industrial diversification. A simplistic financial accounting framework that accepts any project that will bring in $X million and 'create' X-thousand jobs is therefore manifestly inadequate.

Little and Mirrlees (1991), two of the founders of cost-benefit analysis, were very critical of its woeful neglect by the World Bank in its own projects at the Bank's 1990 Annual Bank Conference on Development Economics. This neglect, as Little and Mirrlees emphasised, was a "shattering indictment" of the Bank's operations, because shadow prices are nothing less than the marginal effects on social welfare of any quantity change. They are the true opportunity costs of a resource use: "Shadow prices and cost-benefit analysis are inseparable. Sometimes actual prices coincide with their shadow values, as if on the equator in the midday sun. Only then is financial analysis also cost-benefit analysis."[9] Unfortunately, its practice by most developing country governments is unlikely to be significantly better than the Bank's.

But if these factors are not taken into account in assessing the desirability of a given FDI, there is no way of knowing beforehand whether the investment will benefit the country or harm it. To assume that FDI *must* be beneficial is ideology – not economics.

For example, Young and Miyagiwa (1986) showed that a country can in fact be immizerised through foreign investment *via* the growth of its labour force, which increases the payments that have to be made to foreign investors. This occurs when both the elasticity of substitution between labour and capital and the elasticity of supply of foreign capital are both low, and there is no tax on returns paid to foreign capital.

Such adverse outcomes have also been noted empirically, as Helleiner (1989, p. 1457) and Cardoso and Dornbusch (1989, p. 1415) point out. In particular, both Reuber's (1973) and Lall and Streeten's (1977) studies found that around *one-third* of the foreign investment projects analysed *reduced* the host country's national product. Similarly, Encarnation and Wells (1986) discovered that 25-40 per cent of projects earned *less* in terms of the opportunity costs of resources, than the country paid for them.

Meier (1995, p. 260) illustrates a useful basic cost-benefit equation whereby FDI could be evaluated:

$NSB = SP_{outputs} - SP_{inputs}$ + Net Externalities + K inflow + Return to domestic investors + Taxes & Royalties – D & K repatriated in foreign exchange.

Where: **NSB** = Net Social Benefit; **SP** = shadow price; **D** = Dividends, interest and profits; **K** = capital

As Meier notes: "Considering the stream of social benefits and social costs and discounting to the present, it would be in the interest of the host government to allow entry if the present value of the NSB is greater than 0 at a social discount rate".

A small number of cost-benefit analyses have been carried out in an effort to assess the impact of FDI overall on particular countries. Shiong (1997) analysed the costs and benefits of FDI in Malaysia using a Little-Mirrlees (1974) framework, with and without investment scenarios. Shiong weighed the benefits against costs for Malaysia, and concluded that "the positive benefits of foreign direct investment are far higher than the negative ones, and similar investment should be strongly encouraged".

Table 1 summarises some of the potential costs and benefits of FDI offsetting them where appropriate. It is illustrative, not exhaustive.

Table 1. Summary of some of the potential costs and benefits of FDI

Potential Costs of FDI	Potential Benefits of FDI
• Potential crowding-out of locally-funded investment	• Increased local investment *via* availability of new (foreign) capital
• Losses suffered by local entrepreneurs because of greater competition for labour	• Increased employment
• Increased market concentration through loss of domestic competitors	• Increased competition improving overall efficiency
• Investment in enclaves contributing to dualistic economic structures	• Backward (and forward) linkages to domestic industries
• Loss of domestic control over key strategic industries	• Demonstration effects on local industries on issues such as export behaviour, technology choice, managerial practices
• Local staff may be given only junior positions	• Training of local labour and staff turnover from TNCs to domestic firms
• Reduced incentives for local R&D if technological spillovers are extensive	• Technology transfer & spillovers – including technical assistance to suppliers and customers
• Greater risk of withdrawal of investment than with domestic investors	• Cheaper, high-quality locally-manufactured import substitutes
• Negative net resource flows and adverse balance-of-payments outcomes once profits are repatriated.	• Tax revenues on the project after the tax holiday period and income-tax payments by foreign specialists
• Abuse of transfer pricing leading to loss of government tax revenue.	
• Capital inflow causes exchange rate to appreciate.	
• Increased inequality	
• Restrictions on subsidiary's exports by parent company	

It is obviously beyond the scope of this paper to consider all of these issues in detail, so the following discussion will merely highlight some of the most pertinent considerations in evaluating potential FDI, highlighting the diversity of outcomes in different contexts.

FDI and Technological Spillovers

One of the most commonly emphasised potential benefits of FDI is the "technological spillover" effect, and while FDI can undoubtedly facilitate technology transfer, the evidence on this is more mixed than one might be led to believe.

Aitken and Harrison (1999), for example, examined the evidence on the impact of FDI on 4,000 firms in Venezuela from 1976-1989 and found that while productivity improved in small plants (with less than 50 employees) with foreign equity participation, it *reduced* the productivity of wholly domestically owned plants in the same industries. The overall effect of the foreign investment with these two offsetting forces was "quite small", and the gains appeared to be captured entirely by joint ventures. They also "found no evidence of technology 'spillovers' from foreign firms to domestically-owned firms".

Conversely, Chuang and Lin's (1999) study of 8,846 Taiwanese firms using 1991 census data found beneficial spillovers to domestic firms from FDI: A 1 per cent increase in an industry's FDI ratio produced a 1.40-1.88 per cent increase in domestic firm's productivity. However, they also noted that this diffusion of technological learning can have the effect of *reducing* local firms' incentives to conduct their own R&D. They therefore recommended, once a country's technical capacity has reached a desired level, that policies be introduced to encourage local firms to conduct their own R&D.

Positive externalities from FDI such as technology spillovers are also highly sensitive to market structure and to any strategic interaction between firms. Analysing detailed micro-level data from Indonesian firms, Sjöholm (1999) found that competition increases the degree of spillovers from FDI since it spurs TNCs to transfer more modern technology to their affiliates. This reinforces the similar results of Blomström *et al* (1994) and Kokko (1996). But Blomström and Kokko (1996) also point out that while FDI may initially increase competition in developing countries, it may also eventually reduce it if local firms are driven out of business. This is especially true if the foreign firm engages in unfair, anti-competitive practices, such as predatory pricing, because it is able to sustain heavy initial losses by cross-subsidisation from its parent or affiliate companies. Appropriate FDI policy for a given sector therefore depends on a careful analysis of local market structure to maximise the scope for technological spillovers and other positive externalities. It should not be assumed that they will automatically materialise.

FDI, Wages and Income Inequality

TNCs are often accused of 'exploiting cheap labour', but it is important to bear in mind local wage rates, assuming that these are not kept artificially low by repression and persecution of labour leaders. Given this caveat, evidence suggests that TNCs can have a *positive* effect on local wage rates. Lipsley and Sjöholm's (2001) study of 19,911 firms in Indonesia, and the Aitken *et al* (1996) analysis of firms in Mexico, Venezuela and the United States, both support the conclusion that TNCs tend to pay higher wages than their local counterparts. In some cases they also induce local competitors to pay higher wages than they would have otherwise.

The question of the relationship between FDI and income inequality has also been controversial. Recently Tsai (1995) undertook a major cross-country regression study of the issue, paying particular attention to data comparability and model specification. Tsai also introduced geographical dummy variables, which have largely been absent from previous studies that found that FDI increased inequality.

Tsai concluded that the geographical factors in fact capture a large degree of the inequality, and that only in East and Southeast Asia did FDI appear to have contributed to inequality in the 1970s.[10]

The Trade Regime and Sectoral Considerations

The trade regime and sectoral considerations exert an enormous influence on whether FDI is likely to be beneficial to a country or not, and they greatly complicate any facile assumption that FDI is beneficial no matter where it goes. Helleiner (1989, p. 1457) noted, for example, that bad projects with negative social rates of return tend to be systematically associated with higher levels of domestic protection against imports.

Buffie (2001) used a series of optimising dynamic general equilibrium models to investigate the welfare effects of FDI under various trade regimes. He emphasised that the fear that FDI will crowd out domestic investment "is a legitimate economic concern, not just raw xenophobia. When the return on capital exceeds the social time preference rate, crowding out of domestic investment is associated with a welfare loss" (p. 293-294). This potential welfare loss has to be weighed against the purported benefits of FDI. He is particularly critical of FDI in the domestic manufacturing sector, especially if it is protected, since while unemployment may decline in the short run, it generally rises in the long run. Moreover, FDI can crowd out domestic capital so strongly that the aggregate capital stock and employment in the high wage manufacturing sector *decline*.

Rodríguez-Clare (1996) has shown that the linkage effects and benefits of FDI to the local economy are generally stronger when companies intensively use locally produced intermediate inputs. When FDI creates enclave economies with few local linkages it can, under some circumstances, harm the developing economy.

In short, it matters what sector of the economy FDI flows into and whether that sector has potential for ongoing strong linkages to the local economy. Poon and Thompson (1998, p. 155) suggest for example that Japanese service sector FDI had virtually no impact on economic growth in either Latin America or Asia between 1987 and 1994 because investments in the late 1980s were largely in relatively unproductive real estate.

In addition, investment in some sectors is arguably directly harmful. There are grave concerns in some developing countries over the increased investment by OECD country 'Big Tobacco' companies, with all the associated negative public health externalities. Weissman (1998) notes that due to stagnant or declining sales in the developed countries, tobacco companies are increasingly looking to developing countries for their profits. In a similar vein, the South Centre (1997, p. 38) emphasises the social costs of FDI in 'junk food' production and distribution among the poor, especially in urban areas. Such junk food may displace more nutritious (and cheaper) local foods, leading to losses of income for farmers and poorer diets and increased diabetes and heart disease for consumers. It is entirely possible that the net social returns of such investments are negative.

The nature of the trade regime also directly affects optimal FDI policy. Very different policy recommendations on domestic equity requirements are required for example, depending on whether imports are restricted by tariffs or by quotas, and depending on the degree of capital mobility. Using a general equilibrium model, Chao and Yu (2000) demonstrated that with quotas, increasing the equity requirements improved welfare in the short run but reduced it in the long run. Conversely, with tariffs, domestic equity requirements lower welfare initially but raise it over the long term.

The possibility or threat of FDI can also act endogenously to affect the trade regime itself. Ellingsen and Wärneryd (1999) make the point that since a high level of protection is an inducement for foreign firms to set up domestic operations, this acts as a brake on domestic firms' desire for increased protection. The threat of FDI, and hence increased local competition, is likely to be of greater marginal concern than more imports.

FDI, Transfer Pricing, and Tax Avoidance

Abuse of intra-firm transfer pricing remains a serious problem for developing country governments dealing with TNCs (UNCTAD, 1999a,b). Intra-firm trade prices may be under or over-invoiced in order to shift profits for tax purposes or to evade trade taxes or foreign exchange controls. The lack of transparency of such trades and the difficulties of monitoring make this one of the prime sources for the power disparities between local firms and TNCs. Transfer prices can be used to cross-subsidise affiliates to undercut and drive out local competition.

This is related to the problem of the use of tax havens and capital flight through over-invoicing imports and under-invoicing exports – the means by which foreign assets can be accumulated and sold in the black market (Cardoso & Dornbusch, 1989, p. 1427). On the import side, incentives to under-invoice imports in order to avoid import taxes work in the opposite direction from incentives to over-invoice in order to effect capital flight. However, on the export side, under-invoicing achieves both goals. Hence export under-invoicing is rife. Cuddington (1986) for example found that between 1977-1983, exports were under-invoiced by an average of: 19.6 per cent in Argentina, 12.7 per cent in Brazil, 12.8 per cent in Chile, 33.6 per cent in Mexico and 27.8 per cent in Uruguay.

More recently in the *Wall Street Journal*, Phillips (1999) reported that the U.S. Internal Revenue Service estimates that transfer-pricing abuses costs the U.S. government $2.8 billion each year. Finance professors John Zdanowicz and Simon Pak from Florida International University in Miami put the figure closer to $35.6 billion in 1998:

> "Combing through anonymous Customs records, the researchers found $18,000 dot-matrix printers being imported from Japan and $2,600 radial tyres coming from Indonesia. And somebody in the U.S. is exporting $12,000 helicopters to Italy and $135 howitzers to South Africa."

These kinds of results make it difficult to assess the true trade consequences of FDI and undoubtedly result in large losses of fiscal revenues for governments.

FDI and Balance-of-Payments Considerations

This is a complex area which is beyond the scope of a short paper, but it is important to note that FDI can have unforeseen and unhelpful macroeconomic consequences under the wrong circumstances. In essence, the problem is that while the initial investment is a capital inflow, assuming the investment is profitable, this will eventually become a net outflow of foreign exchange as profits are repatriated. While this is not necessarily bad in and of itself, since the FDI project can still be a net gain for society, it does mean that the country has to finance this outflow somehow. If the investment has been productive and in an export sector earning foreign exchange, this is unlikely to be a problem. But, again returning to sectoral considerations, if the investment was in, say domestic non-traded services, or in domestic marketing and retailing, especially of imports (such as a supermarket), the foreign-exchange demands could be a very significant problem (South Centre, 1997, p. 47).

FDI is also assumed to be far more stable than portfolio 'hot money' investments, but this assumption has also been questioned by World Bank research. Claessens *et al* (1995) used time-series analysis of balance-of-payments data for five industrial and five developing countries and found that long-term flows were often as volatile and at least as unpredictable as short-term flows.

The balance-of-payments considerations and potential volatility of FDI should therefore not be ignored or underestimated.

Policy Instruments

This section will concentrate on just four of the main policy issues influencing the benefits of FDI, and will be followed by a more in-depth discussion of another instrument, corporate codes of conduct, in Section 5.

Export Requirements

A number of commentators have highlighted export requirements as an important means by which developing countries can capture more of the benefits of FDI.

Rodrik (1987) showed that in the presence of a 'second-best' environment that includes tariffs and oligopolistic behaviour in host-country markets, export-performance requirements can improve national welfare by reducing payments to foreign capital, reducing the output of overproduced commodities, and shifting profits towards domestically owned firms. Chao and Yu (1996) also showed that for a small 'full employment' economy with tariffs, an investment tax linked with export requirements is the most desirable policy.

Buffie (2001, p. 367) concluded that export requirements are the *only* way in some circumstances, (such as with FDI in the protected domestic manufacturing sector), to ensure that FDI does not *reduce* social welfare. He even showed that when there is strong crowding out of domestic capital, the export requirement might need to be as high as 55-70 per cent of output.

Technology Transfer and Joint Venture Requirements

Some governments have made technology transfer or joint ventures an explicit condition of FDI. However the results of such policies are mixed.

Kokko and Blomström (1995) for example, studied the manufacturing operations of majority-owned foreign affiliates of U.S. TNCs in 33 host countries in 1982. They found technology upgrading and imports were best encouraged by increasing levels of competition to erode the TNCs' technological advantages, and also improving the skills of the local workforce to enhance their capacity to absorb technological improvements. Conversely, they found a negative relationship between performance requirements and technology transfers reflected in data on payments of royalties and license fees. However, such performance requirements had little effect on technology transfer embodied in machinery and equipment.

Joint ventures are one popular means of trying to ensure technology-transfers, but Moran (1999, pp. 9 & 199-125) found scant evidence that this was effective. In general, technology transferred to

compulsory joint venture partners tended to be older, and when forced, such alliances are often fraught with difficulties.

Education and Training

Borensztein *et al* (1998) analysed the effects of FDI on a cross-section of 69 developing countries during the 1970s and 80s, and concluded that FDI was indeed an important vehicle for technology transfer. However, they also found that the higher productivity produced by FDI held only when the host country had a minimum threshold stock of human capital (proxied by educational attainment)[11]. Moreover, they contend that "FDI contributes to economic growth only when a sufficient absorptive capability of the advanced technologies is available in the host economy" (p. 115). More disturbingly, they also point out that for countries with very low levels of human capital, the direct effects of FDI are negligible or negative (p. 123).

Xu (2000) evaluated the performance of U.S. TNCs as a channel for technology diffusion in 40 countries from 1966 to 1994. He also found that while the technology transfers boosted productivity in developed countries, they did not do so for less developed countries below a minimum level of human capital availability. Similarly, Blomström and Kokko (1998) found that the positive effects of FDI tended to increase with the level of local labour capability and the degree of competition.

These results once again highlight the importance of the domestic development strategy, focused on enhancing national capabilities.

Taxes and Incentives

The escalation in incentives is another serious problem, and a zero-sum game overall for competing governments. Usher (1977) outlined the complexities of designing an appropriate incentive programme, given extensive technical change and the problem of redundancy in incentives – a problem exacerbated in a context of competition between governments which is resulting in firms capturing more and more of the overall benefits of FDI.

Developing countries increasingly try to tempt scarce FDI with elaborate overtures. In 1997, *The Economist* ran a four-page 'Promotional Feature' by the Government of Nigeria, then under the dictator General Sani Abacha. The extensive list of incentives offered included the following, showing that even labour rights violations are not beyond the purview of some governments:

> "Under the laws of the export processing zones in Nigeria, investors are exempted from all forms of taxes and levies. They have unrestricted exportation and repatriation of capital and profits rights, duty free importation of goods, exemption of such goods from pre-shipment inspection and 100 per cent business ownership, foreign or local. …. Apart from the tax holiday, *there is a 10-year ban on labour strikes and lockouts in the zone*. Protection of investments is also guaranteed. Getting business done at the Calabar Export Processing Zone is very easy. It is a 'one stop' approval system."[12]

Such lavish inducements are by no means confined to the developing world, however. In 1996, the U.S. State of Alabama for example, won the contract for Daimler-Benz's new plant employing around 1,500 people – after Alabama had yielded a $300 million package of tax breaks and subsidies – that is, $200,000 per job. The same year Germany gave Dow Chemical a $6.8 billion subsidy for a plant employing 2,000 people, which translates to $3.4 million per job (Moran, 1998, p. 97).[13]

But Haaparanta (1996) has shown that paying higher subsidies than other countries is by no means a guarantee of securing increased FDI. Furthermore, with such incentive competition comes the temptation to reduce taxes, but this must also be carefully considered. Chitrakar and Weiss (1995) undertook a cost-benefit evaluation of FDI in Nepal in the 1980s. They concluded that FDI had indeed benefited Nepal, but that most of this benefit came through tax revenues – and specifically from sales and excise taxes rather than profit taxes. They therefore urged caution with regard to long tax holidays and that "foreign investment should be approached from a bargaining perspective, rather than one of uncritical welcome" (p. 464).

Buffie (2001, p. 318, 368) also showed that while FDI in an export enclave is normally welfare improving (if profits *aren't* taxed), in a diversified economy that exports both primary products and manufactures, this result is weakened. In fact, FDI "crowds in domestic capital and reduces unemployment only if foreign profits are taxed at a sufficiently high rate. *Ceteris paribus*, the required tax rate is lower the more resource/capital intensive is the export product."

Hanson (2001) is also critical of incentives such as subsidies to attract FDI, especially given the weak evidence for technological spillovers. He argues that Brazil's subsidies to motor vehicle manufacturers may have lowered national welfare, whereas Costa Rica was wise not to offer Intel subsidies to invest.

Competition to offer more and more lavish inducements to potential investors can be inimical to appropriate FDI policies, and can in fact turn otherwise beneficial projects into ones which *reduce* overall welfare. Great care must be taken to ensure that any incentives offered to firms do not tip the balance from a net benefit to a net cost. Again, this 'balance point' will only be located if a proper cost-benefit analysis is undertaken.

Corporate Codes of Conduct

What is the role of corporate codes of conduct in all of this? Without question they have proliferated in the past two decades. The ILO first issued its *Tripartite Declaration of Principles concerning Multinational Enterprises and Social Policy* in 1977, revising them in 1991 (ILO, 1991). The OECD (2000b) recently revised its 1976 *Guidelines for Multinational Enterprises* after consultation with a wide variety of stakeholders. Beyond these two well-known examples lie thousands of individual company, association, and international codes.

Opinions differ markedly on their role and utility. At one extreme, some view voluntary codes of conduct as window dressing at best, and misleading public relations exercises at worst. Others see an important role for codes of conduct in 'raising the bar'. Much of course depends on three factors, which will be discussed in turn: First, the issues that are included in the codes; second, how these codes are promoted, monitored and enforced; and third, what gets left out of the codes.

The Content of the Codes

Corporate codes of conduct vary enormously in their scope and purpose. The new OECD *Guidelines for Multinational Enterprises* is certainly an important document with the potential to provide a useful benchmark for improving the social and environmental performance of TNCs. Last year the OECD (2000a) reviewed 246 other voluntary codes of conduct from companies (48 per cent), associations (37 per cent), partnerships of stakeholders (13 per cent) and international organisations (2 per cent). The codes were dominated by labour and environmental concerns, with consumer protection, bribery and corruption also featuring strongly.

In an earlier study, Kolk *et al* (1999) examined 132 codes, including 11 'macro' codes from organisations such as the ILO, OECD, UNCTAD and the WHO, 84 'micro' codes from individual TNCs, and 37 'meso' codes – 13 from social interest groups and 24 from business groups. They analysed the codes in terms of three categories:

- *Social* – including employment, training, working conditions, industrial relations and force;
- *Environmental* – including management policies, input/output, stakeholders, finance and sustainable development;
- *Generic* – including consumer interests, communities, global development, ethics and legal requirements;

Obviously different codes focus on different aspects of these three categories depending on their purpose. This section of the paper concerns primarily the ability of codes of conduct to modify TNC behaviour in a 'pro-development' way. At this stage then, we are interested not just in what the codes tend to cover, but in what difference they make. For these purposes, more important than the coverage of particular issues, is a code's *compliance likelihood*:

> "Compliance likelihood is determined by the compliance mechanisms included in the codes and the extent to which claims put forward are measurable. The more specific the codes are, the better they can be measured and, subsequently, monitored." (Kolk *et al*, 1999, pp. 153-4).

A major component of the content of the codes is therefore how *specific* they are. Are they simply general platitudes, or are they built around specific goals and targets?

On a scale ranging through 'General', 'Frail', 'Moderate', 'Mod/Strong' to 'Strong', Kolk *et al* (1999, p. 162) found that in fact 45.8 per cent of business groups' codes and 40.5 per cent of firms' codes were 'General', leaving much room for interpretation. Those classed as 'Frail' (predominantly general) accounted for a further 33.3 per cent of business group codes and 20.2 per cent of firm codes. In other words, nearly 80 per cent of business groups' codes and over 50 per cent of firm codes were either completely or predominantly *General*. At the other end of the scale, just 12.5 per cent of business group codes and 25 per cent of firm codes were 'Mod/Strong' or 'Strong', containing predominantly specific prescriptions and restrictions.

In order to be able to monitor performance, one has to have something to measure. Yet, in van Tulder and Kolk's (2001) analysis of codes of conduct in the sporting goods industry, the authors found that 61 per cent of the 84 general corporate codes of conduct in their reference group contained not a single quantitative standard. None of the sporting goods codes described monitoring systems and processes in any detail. Kolk *et al* (1999, p. 163) found similar results with only around 10 per cent of codes having more than *one-quarter* of their statements attached to quantifiable measures.

Related to measurability is the time horizon envisaged. Again, Kolk *et al* (1999, p. 163) found that 73 per cent of codes had no time horizon defined at all, and a further 13 per cent were vague. In just 14 per cent of cases was the time horizon clear.

Assuming, not unreasonably, that a more specific, measurable code is more likely to influence specific behaviours than a general one, these results suggest that there is a great deal of room for improvement in the content of codes – if their goal is in fact to influence firms' behaviour.

Promotion, Monitoring and Enforcement

At least as important as the development of the content of a particular text is the institutional framework that determines the extent to which it is promoted, implemented, monitored and enforced. Here the record is even more patchy.

According to the OECD (2000a, pp. 30 & 35), 66 per cent of the 246 codes they analysed and 71 per cent of all company codes mention some type of monitoring procedure, but these are overwhelmingly *internal* procedures. This leaves around 30 per cent of codes which do not mention any type of monitoring *at all* - a result confirmed by van Tulder & Kolk (2001, p. 274). Of the 118 company codes analysed by the OECD, only 45 had provisions for reporting on performance, and of these, only 24 provided for external reporting. More disturbing was the finding that only four mentioned independent, external monitoring and only two mentioned a formal complaint body. Kolk *et al* (1999) reinforce this general picture, discovering not only that 32 per cent of firms codes do not mention any type of monitoring at all, but also that the majority of firms' codes (58 per cent) only envisage self-monitoring.

Of particular concern is the finding of the Council on Economic Priorities (1998), that of those firms with sourcing guidelines based on labour rights, only 44 per cent actually bothered to monitor the implementation of the codes. Even then, this was again undertaken internally in the vast majority of cases (as cited in Kolk *et al*, 1999, p. 169).

It is important to emphasise that the necessity of independent monitoring is directly related to the vagueness of the code:

> "Although an independent monitoring party increases compliance likelihood, the strictness of the code also plays a role. If criteria are very strict, even a relatively dependent actor might suffice, whereas independence will be crucial when vagueness prevails." (Kolk *et al*, 1999, p. 168).

It is hardly surprising that independent monitoring is probably the most neglected dimension of the 'codes of conduct' issue. Fine words and noble intentions are easy to write (and a delight to market), but monitoring, transparency, and compliance are more painful and entail more far-reaching changes to corporate cultures and practices than many companies are prepared to countenance.

Yet this is precisely where the credibility of the codes is forged – or lost. World Vision works with a few TNCs around the world – often on a purely advocacy basis, and in other cases more co-operatively. World Vision recently experienced a situation where a company wanted to work with us. They had an impressive code of conduct, which was meant to be monitored by external auditors. We tried to explain that we couldn't just take their word for it that they were improving conditions in their factories – we needed some external verification. We struggled for months to get them to show us copies of the audits – or at least a representative sample. Finally we were allowed to view a small number of summaries, with many important details deleted. This was both disappointing and inadequate.

Some codes are quite promising. These include Social Accountability International's SA8000 accreditation system modelled on the ISO9000 'Quality' series[14]; the Code of Labour Practice adopted in 1996 by the Fédération Internationale de Football Association (FIFA) – which includes detailed compliance mechanisms and severe sanctions for non-compliance; and the 1997 Workplace Code of Conduct produced by the Apparel Industry Partnership (AIP) – which is more specific than most firm

codes, is monitored both by the firms and external monitors, and includes sanctions for non-compliance (Kolk *et al.*, 1999, p. 157).

Issues Omitted

Just as important as the issues included in codes of conduct are the issues that are omitted, since it is often these other factors that have a major influence on whether FDI is socially beneficial or harmful in developing countries.

The OECD (2000a, pp. 15,16) found that:

- 61 per cent of company codes do not mention disclosure of relevant information.
- Only around 20 per cent have any mention of competition, and most of these are very general.
- Only 32 per cent of codes committed firms against making political contributions.
- Only 1 code out of 246 mentioned the issue of taxation.

But as has been discussed previously, these issues – degrees of competition and appropriate taxation particularly – are precisely some of the key factors that should be considered in a cost-benefit analysis of FDI.

Likewise, disclosure of relevant information and refraining from interfering in the political process by making inappropriate campaign contributions are also critical for a well-functioning polity and sound policy, yet these are barely mentioned. The studies of the corporate use and abuse of public-relations strategies by Stauber and Rampton (1995) and Beder (1997) suggest that this is a tremendously important omission.[15]

One gem came from the website of a large PR firm in 1998:

> "[Firm Name]: Managing perceptions that drive performance
>
> Perceptions are real. They color what we see ... what we believe ... how we behave. They can be managed ... to motivate behaviour ... to create positive business results. … At [Firm Name] we believe that … [t]he role of communications is to manage perceptions in order to motivate behaviours that create positive business results. …In this age of accelerating change and borderless, instantaneous communication, the proactive management of perceptions has never been more important. [Firm Name] is in the Perception Management business. We are focused on adding value to our clients through the use of Perception Management."

Knowing that some companies spend tens of millions of dollars on PR firms such as Burson-Marsteller, Ketchum, Hill and Knowlton, and Fleischman-Hillard to 'manage' our perceptions, we can be certain that things are not always as they appear.

A chilling recent example of the corporate abuse of PR was exposed last year in the respected medical journal *The Lancet* (Ong & Glanz, 2000). The tobacco industry, led by Philip Morris, had attempted to subvert and delay a study on the effects of second-hand smoke undertaken by the WHO's International Agency for Cancer Research, in order to try to prevent more restrictive anti-smoking laws in Europe. The authors maintain that "The documents and interviews suggest that the tobacco industry continues

to conduct a sophisticated campaign against conclusions that second-hand smoke causes lung cancer and other diseases, subverting normal scientific processes" (p. 1253).

Related to the concern about the omissions from codes of conduct, is the role that the codes themselves may be playing in relation to national laws. As Gereffi *et al* (2001) point out, corporations and business groups have used pre-emptive developments of less-stringent voluntary codes to head off binding legislation.

The Place of Codes of Conduct

Voluntary codes of conduct can only go so far towards ensuring positive social benefits from FDI. As discussed previously, far more fundamental is a sound institutional environment with a competent, honest, bureaucracy and judiciary, and laws which protect the environment from excessive pollution and which protect basic workers rights – such as minimum age, health and safety, the right to organise and collectively bargain, and so on. When this basic legal and political framework is functioning well, codes of conduct can be an added spur to even better performance. They can also be useful in encouraging responsible corporate behaviour in a less than ideal political and legal environment. But codes cannot replace this framework. Most importantly, they should not be used to hinder the development of a proper legal framework, or mask the need for one.

Kolk *et al* (1999, p. 171) conclude with an incisive assessment of an important role that codes of conduct do play at the present time:

> "Codes – now more than ever before – have the function of deciphering the limits of regulation and the roles of governments, firms and representatives of civil society. Codes are an 'entry to talk'. The agenda-setting potential of codes, therefore should not be underestimated."

Beyond being an 'entry to talk' and helping to set the agenda for future discussions, codes of conduct are probably most useful in proportion to their specificity, measurability, degree of external monitoring, and enforceability. Since the vast majority of current codes fail these tests, the more robust codes mentioned previously such as SA8000, FIFA's Code of Labour Practice, and AIP's Workplace Code of Conduct, show most promise of enhancing the benefits of FDI in developing countries.

Conclusions

There is no doubt that FDI can contribute to development. However a number of caveats and conclusions may be drawn from the preceding discussion.

First, the scale and geographical scope of FDI falls far short of the extra resource requirements of most developing countries. There remains an urgent need for increased ODA, especially for the poorest countries.

Second, while FDI can contribute to economic growth, and more importantly to improved social welfare, it does not always do so. Furthermore, whether it does or not is *not* related wholly to the properties of the specific project, or the conduct of the individual company. Just as important are the economic and social circumstances of the host country – including factors such as levels of human capital, the trade regime, the degree of competition in local markets, the local shadow prices of foreign exchange, labour and capital, and the local social discount rate.

From this it follows, thirdly, that developing countries must be helped to strengthen their institutional capacities to analyse proposed FDI using a social cost-benefit framework combined with economic models appropriate to the country's economy. More broadly, the importance of a sound and competent local institutional framework can hardly be overemphasised. Well-crafted, appropriate, and dutifully enforced competition, tax, labour, health and safety, and environmental laws are essential to ensuring that FDI improves overall welfare.

Fourth, on the international policy front, developing countries must retain the freedom to devise FDI policies appropriate to their own circumstances, including measures such as export performance requirements and restrictions on entry to particular sectors. Any moves to curtail these freedoms under future WTO investment negotiations should be strenuously resisted by developing countries.[16]

Fifth, FDI must be seen as just one part of an overall, domestic development strategy, focused on building local capacities and domestic investment. Where FDI can contribute to this strategy and improve overall social welfare, it should be welcomed. But it should not be pursued to the detriment of these primary goals.

Sixth, escalating incentives to attract FDI is ultimately a zero-sum game for governments, diverting government revenues and energies into subsidising TNCs. Developing countries cannot hope to match the resources of the wealthy OECD countries and since the marginal value of government resources are arguably more valuable for them, they should resist trying to do so. Multilateral approaches must be found to curb this harmful competition.

Finally, voluntary corporate codes of conduct vary enormously in what they include, what they leave out, and whether any independent monitoring or enforcement takes place. They therefore vary accordingly in how useful they are. Well-crafted and well-monitored codes of conduct can be a useful adjunct in a sound political and legal environment to help 'raise the bar' of corporate behaviour. They can also be useful in encouraging responsible TNC behaviour in a less than ideal political and legal environment. But they should in no way be used to forestall the development and enforcement of sound environmental, social and labour laws. Neither should they be used to mask the need for a sound economic and social cost-benefit analysis of proposed investments.

Just because a company has a wonderful, well-monitored and well-enforced code of conduct, doesn't automatically mean its investment is going to make a given developing country or region better off. The cost-benefit analysis needs to be undertaken. It might well reinforce the case for a particular investment or even the opening up of an entire sector. But then again, it might not. It might show that a country is better off restricting some types of investments and imposing performance requirements on others.

NOTES

1 DAC, (1996) "Shaping the 21st Century: the Contribution of Development Co-operation", May, Development Assistance Committee of the OECD, Paris, 20 pp.

2 OECD, (2001) Development Co-operation 2000 Report, The DAC Journal 2000, Vol. 2, No. 1; OECD, Paris, pp. 96-97.

3 UN (2001) “Report of the High-Level Panel on Financing for Development”, Executive Summary, Recommendation 4, UN, New York & Geneva. [http://www.un.org/reports/financing/summary.htm]

4 All dollar amounts are in US dollars.

5 UNCTAD (2001b). These estimates were made on 3 September 2001, before the events of September 11 which are likely to exacerbate the economic downturn and increase uncertainty, leading to delays or cancellations of investment projects.

6 One recent, imaginatively-titled book, was even called *Corporations Are Gonna Get Your Mama,* (Danaher, 1997).

7 See also Lensink & White (1998) on this.

8 See for example: Brent (1998), Dinwiddy & Teal (1996) and Squire (1989).

9 Little & Mirrlees (1991) as reprinted in Layard & Glaister (1994), p. 210.

10 Tsai emphasises that this result refers only to the marginal effect not the total effect.

11 A point that is reinforced by Balasubramanyam, *et al* (1999).

12 Nigeria (1997), "Calabar Export Processing Zone", The Economist, Vol. 342, No. 8004, February 15, pp. 79-82. Emphasis added.

13 These examples are a small example of the broader problem of state-subsidised corporate welfare in both domestic and foreign investment. See the series in Time by Barlett and Steele (1998).

14 See: http://www.cepaa.org/introduction.htm

15 For more, see the Centre for Media and Democracy, http://www.prwatch.org/

16 For a good discussion of proposals on investment under the WTO from a developing country perspective, see Singh (2001).

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Emerging Market Investment:
Is Corporate Governance and CSR the problem or the solution?

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Most people would agree that it would be a "good thing" to have more significant investment in emerging markets and for this investment to act as an incentive to "sustainable development", assuming that this rationale also meets their fiduciary targets. Who could argue against the "win-win" outcome? Sustainable companies, sustainable economies, sustainable environments, sustainable societies – and in the case of USS, sustainable investment returns! So the question is this: Are investors who are interested in corporate governance (i.e. whether a company is run for the benefit of its ultimate shareholders) and corporate social responsibility (i.e. whether a company deals responsibly with its social and environmental impact) part of the problem or part of the solution when it comes to investing in emerging markets?

This paper covers four points:

- How different investors have very different agendas. Governments who want to mobilise resources need to understand that different investors respond to different drivers, and then choose who they want to work with most.

- How to encourage some major investors – who are wary of emerging markets – by responding to the developing interest in corporate governance and corporate social responsibility by investors.

- Who needs to do what, and in this context the focus is on what OECD and non-OECD governments can do.

- And finally, why institutional investors are not the cure.

There is a range of investors – something that is often forgotten when referring to "the City" – each with differing interests:

- Arbitrageurs who own the stock for a very short period.

- Mutual funds who have annual tax considerations.

- Active managers with a two- or three-year holding pattern.

- Insurance companies who generally hold for a bit longer than active managers and a bit shorter than pension funds.

[1] USS is the third largest pension fund in the UK, with over 170,00 members from the UK University system and assets of about £20 billion. The company has made a commitment to adopting a Socially Responsible and Sustainable Investment policy within its overall investment process.

- Pension funds that typically might hold a stock for several years.

- And Index funds that are permanently held by definition (whilst the stock remains in the relevant index).

Given all these very different interests, who should governments and inter-governmental bodies like the OECD listen to most carefully? I would suggest – impartially, of course – that pension funds and other institutional investors should get this recognition. Why?

- Pension funds are the most patient sources of capital. They typically hold shares for several years. To the extent that it is possible in a world of quarterly and yearly benchmarks, they also have a 20 to 30-year timeframe in considering their liabilities and investment strategy.

- With the growth of pension funds in the OECD world, institutional investors are significant players. The ten largest pension funds in the world – USS unfortunately doesn't make the list –together account for a lot of money. The global pension fund market is $15.5 trillion. Just focusing on the UK, institutional investors own over half of the UK stock exchange.

- And finally, the beneficiaries of *funded* pension funds make up a significant percentage of society, especially in some OECD countries.

So in some ways, what is good for pension funds is a good proxy for what is good for society as a whole.

Many people have been concerned about corporate governance issues for some time and increasing numbers are now becoming concerned about CSR issues as well. In October 2001, the UK Association of British Insurers launched a set of guidelines on social, ethical and environmental issues, dealing with this difficult debate from a risk-management perspective. At the launch event, a senior ABI spokesperson said: "Two years ago, it would have been unthinkable [for the ABI] to be having this gathering. Our members weren't very concerned with corporate social responsibility. [It] was seen as extraneous and a distraction." Currently these guidelines refer to UK companies but inevitably the process will go international. And the U.S. Council of Institutional Investors – which represents 110 U.S. pension funds and nearly 100 money managers – declared for the first time in its 16-year existence that investors can promote "responsible business practices and good corporate citizenship" as part of their "fiduciary responsibility of protecting long-term investment interests."

Why are mainstream investors taking these issues seriously? At one level, important stakeholders – like our members, pressure groups and our governments – are asking us to. Some funds and some countries have more active, better-organised and better-informed sources of pressure than others, but this is a global trend. But fundamentally investors are organisations who respond best to fiduciary duty. And we are now getting evidence that this *is* the right thing to do from a *bottom-line* perspective as well, provided we take a pragmatic approach. By pragmatic I mean a "best of class" (i.e. companies who are leaders in their sectors) or "constructive engagement" approach (i.e. where we don't screen but do engage with companies to encourage them to adopt good practice standards). I am contrasting these options with a wholesale negative screening (i.e. ethical investment) model. The following four studies document this correlation.

- In a very interesting study, McKinsey's interviewed 200 institutional investors who together control $3 trillion in assets. Three-quarters of them said board practices are at

least as important to them as financial performance. Over 80 per cent said they would pay more for the shares of a well-governed company than for the same company if it were poorly governed. The actual premium they were willing to pay varied country by country – an extra 18 per cent for a UK company, and 27 per cent for a company in Indonesia or Venezuela.

- The stockbrokers, CLSA, have done an extensive study of corporate governance in emerging market corporations. They looked at over fifty indicators divided into seven key criteria of good corporate governance: 1) management discipline, 2) transparency, 3) independence, 4) accountability, 5) responsibility, 6) fairness and 7) social responsibility. They found that there is a striking degree of correlation between share-price outperformance and corporate governance. Their key finding was this. Of the largest companies across the emerging markets, the average US$ return for the past three years has been 127 per cent. The average return for companies in the top corporate governance quartile was more than double this at 267 per cent.

- The U.S. Environmental Protection Agency undertook a major study into the relationship between environmental and financial performance of a company and the investment returns to be had. It concluded: "A significant body of research shows a moderate positive correlation between a form's environmental performance and its financial performance. However, capital markets have been slow to incorporate environmental information into mainstream investment decision-making."

- A major study of 1,500 listed U.S. companies by academics from Harvard and Wharton has discovered a "striking" correlation between governance and stock prices. An investment strategy that bought the firms in the lowest decile of the index (strongest shareholder rights) and sold the firms in the highest decile of the index (weakest shareholder rights) would have earned abnormal returns of 8.5 per cent per year during the sample period. This paper, *Corporate Governance and Equity Prices*, is likely to emerge as the single most persuasive academic case to date that good governance can boost investor returns and lower the cost of capital for companies.

This is not to say that corporate governance and CSR analysis is a sure-fire way to pick stocks. There are, of course, many other issues which can be more important. What *can* be said, however, is that there is no evidence that better CSR or corporate governance standards result in reduced financial performance of the company, while there is a lot of evidence of a positive correlation. What is the basis for this linkage to the bottom line? Is it because better corporate governance and better CSR reduce risks? Is it because it helps to identify outperformance potential? Or is it simply a proxy indicator for good management? The answer is probably a mix of all three, but in actual fact it doesn't matter why the link works – the key thing is that that it does. *So if governments help ensure that companies meet benchmark standards on corporate governance and CSR, this will encourage a more positive approach from potential investing institutions.* And this is important given that currently, according to UK government estimates, only 2-4 per cent of money invested by pension funds has gone to developing countries.

How is this interest translating itself on the ground? The following are just two examples of what is happening:

In Thailand, CalPERS – the largest pension fund in the world, and a pioneer in corporate governance issues – has set up its *Thailand Equity Fund*. The fund has a target of $250 million and will only make investments in companies that agree to comply with Government of Thailand and IFC environmental

and social policies, including high standards of corporate governance and transparency. According to William Crist, CalPERS President, the other side of the coin to the economic crisis is that it has "created an unprecedented investment opportunity" resulting in CalPERS wanting "to participate in the renewed growth of Thailand's leading enterprises while securing a good long-term investment for our members."

And Brazil is going to be an important test case of whether corporate governance reform can spur economic growth. Bovespa, São Paulo's stock exchange, is about to see its first IPO for the Novo Mercado, the new market shaped only for those corporations meeting high governance standards. Many other companies are busy restructuring to meet fresh governance guidelines for Bovespa's main board. Foreign investors, led by the large U.S. fund, TIAA-CREF, are pressing top companies to meet best practices. At the same time, the International Finance Corporation, an arm of the World Bank, has become the anchor shareholder for an activist corporate governance fund managed by Bradesco Templeton. Another fund manager, Rio de Janeiro-based Dynamo, is showing index-beating results from activism. In November 2001, ABN Amro Asset Management launched a fund aimed only at companies with superior records in social, environmental and corporate governance practices. The consultancy LCV is marketing a new corporate governance rating service to Brazilian companies, as is Unibanco on the CSR agenda. And, in October 2001, ex-Bradesco-Templeton fund manager Paulo Conte Vasconcellos founded ProxyCon to advise investors and companies around Latin America on governance. All this comes on top of a new law expanding shareholder rights.

Interest is so significant that it is likely that emerging market activist funds of the kind that are doing very well in the U.S. and EU will soon be set up. In these situations, investors buy into a company that has the potential to be a success but is held back by remediable corporate governance factors, shake it up in a positive way and liberate shareholder value. This development will be much more effective if governments can develop a shared understanding about corporate governance, a point covered later in this paper.

The main point here is that there are things that can be done to improve the access of emerging market companies and countries to this, a specific but very significant, slice of global capital. Clearly, investors may be more concerned about other issues (e.g. political and economic instability and, of course, business fundamentals) but provided these things are not ignored, action on corporate governance and CSR issues can only help.

And so to the third point, what can governments do? In a nutshell, OECD governments need to send clearer signals to the public (i.e. the ordinary members of pension funds) and the trustees of these funds that they want investors to be responsible and active long-term owners. The UK Government is getting many things right in this regard. Amongst other things, it has:

- Commissioned Paul Myners, a well-respected City professional who could not be dismissed as a campaigner or outsider, to look at how fund management works. He said he was "particularly concerned by the value lost to institutional investors through the reluctance of fund managers to actively engage with companies in which they have holdings even when they have strong reservations about strategy, personnel, or other potential causes of corporate underperformance".

- Asked pension funds to disclose their approach to social, environmental and ethical issues. Similar disclosure acts have now been passed in Australia and Germany, and action is under consideration by the European Commission.

What else can governments do? They can be supportive of their companies' adoption of good practice standards in corporate governance and CSR. This is as important for OECD governments – since companies based in their countries are often the clients for companies in non-OECD countries and able to use influence to transmit standards down the supply chain – as it is for non-OECD governments.

Here again, taking the example of the UK, the government has:

- Commissioned the Company Law Review that seeks to bring company law into the 21st century through a focus on board leadership, proactive management of strategic risk (including social and environmental issues) and disclosure to owners and other stakeholders.

- Made clear, some would argue in an overly cautious way, that it wants major companies to monitor and report on environmental performance, and that it supports emerging international standards such as the OECD treaty on bribery and corruption.

- Appointed a Minister for Corporate Social Responsibility to co-ordinate the overall approach.

The important point is not the particular methods a government uses to send these signals. Some non-OECD countries are very actively engaging with the UN Global Compact, for example. The key issue is: are the words and policies being translated into actions?

And are there things that government shouldn't do? The most important thing is not to make it any harder for institutional investors to be responsible shareholders. There are some who would say that many investors need no encouragement in this regard. A litmus test is the issue of voting at AGMs. In order to vote equities with regard to a company based in Belgium, it is necessary to make a decision in less than 16 days, shares will be blocked for three days before the meeting, and it is obligatory to attend in person. The situation is pretty much the same in Finland, the Netherlands, Thailand, Turkey, to mention but a few.

What else can be done? Instigate a dialogue. The best companies now spend a lot of effort, through their investor relations departments, building relationships with USS. Could countries not do the same? The Institute of International Finance issued a paper earlier this year, *The Principles for Private Sector Involvement in Crisis Prevention and Resolution*, highlighting the need for active and regular two-way contact to help market participants manage risks and to help authorities identify early signs of market concerns.

Coming back to the question of whether investors who are interested in corporate governance and CSR are the problem or the opportunity, they could be said to be both. Which they turn out to be will depend heavily on what governments do. What is clear is that companies and countries that are able to compete on this front will have better access to more capital. And competing on this basis is surely a good thing. After all, a "win-win world" is in everyone's interest: sustainable companies, sustainable economies, sociable environments, sustainable societies and sustainable investments.

I would like to conclude with the words of someone who is well known in OECD circles, Ira Millstein, a leading corporate governance specialist and the chairman of the Global Corporate Governance Forum, which is sponsored by the OECD and the World Bank. Writing in the *FT* a week after September 11th, he said: "Eliminating poverty and misery is crucial to the 'just war'; ideologues and fanatics breed on poverty and oppression. Diminishing the great economic divide between 'haves'

and 'have nots' will require as much energy, effort and dedication as rooting out those who perpetrated the events of September 11."

What Mr. Millstein was saying was that an expanded definition of corporate governance that includes the corporate social responsibility agenda is part of the solution in a world of growing inequality and tension. It's not the *only* solution and it may not even be the *most* important thing in some situations. It is a well-known fact that FDI is very concentrated, with five economies, led by China, Mexico and Brazil, receiving 56 per cent of it. This is in marked a contrast to the 1994-1997 period, when concentration was diluted as economic prospects improved in many developing countries, and a wider range of countries obtained access to the capital markets.

It is also widely recognised that the massive creation of wealth in the past decade – with global savings and investment estimated at $7.5 trillion last year – has "bypassed" dozens of least developed countries (LDCs), as a forthcoming UN report will conclude. It is clear that there needs to be an increase in overseas development aid – a challenge which most OECD governments are not meeting. In October 2001 Mr. Wolfensohn made frequent references to the disparity between international aid and domestic subsidies. Liberalisation of those sectors where OECD countries have protected markets, and where non-OECD countries can compete, is a priority, as is the need to do this in a way that is socially responsible.

What needs to be stressed, and this is the fourth point, is that institutional investors are not the "cure". Governments cannot expect them to do their work for them. But if governments can set the right context, then investors can play an important supportive role. Investors may now, like governments, be ready to hear that what happens in far-off places is no longer something that has no strategic relevance to their work. What they do not need are appeals to be more moral or more long-term. These are undoubtedly good things. But given the way institutional investors are held accountable by their clients, they do not have a lot of scope for acting very differently. What they *do* need is for governments to put in place strategic frameworks that genuinely change the risk/reward calculation of investing in emerging markets.

To recap, OECD governments need to encourage investors to be responsible and active shareholders. And what is needed, from both OECD and non-OECD governments, is to encourage companies to adopt benchmark standards of good practice on corporate governance and CSR issues. As part of this, it will be essential to develop a meaningful consensus between OECD and non-OECD governments on the relationship between, on the one hand, the rights of the shareholders, and on the other, the responsibilities that corporations have to other stakeholders – something which will be particularly important as corporate governance activism develops. As these things happen, "pension power" could really become a major part of the solution.

Codes of Conduct in Support of Development?

Herbert Oberhänsli,
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and on behalf of the International Chamber of Commerce, Paris

Nestlé has been a foreign direct investor since the 19th century, both in Europe and overseas. The first investment in a factory in the developing world – in Brazil – dates from 1921, and this factory is, incidentally, still part of the Group. It is one of the 450 factories run by Nestlé in more than 80 countries today. A considerable number of these factories are located in remote regions within these countries, especially milk factories manufacturing local raw materials.

Among theses products produced all over the world are milk products, cooking aids, and prepared dishes, drinks, chocolate, and confectionery, among others.

Nestlé has a 135-year history, with a proven track record of socially responsible behaviour long before professors invented CSR, and long before this rapidly increasing number of guidelines of good behaviour flooded the market.

The same holds for environment: Nestlé built the first water treatment plant in 1926; at that time, the term 'environment policy' did not yet exist. This is not to say that everything was, and is, perfect; in 135 years of history, mistakes were also made. These mistakes were normally corrected by Nestlé staff, who, besides their professional skills, have a conscience – a word that has not been mentioned in the course of this meeting.

As stated earlier by Mr. Carle, the BIAC chairman, companies that have been investing for many years do not enter this debate on the environment, social conditions, poverty reduction or education, with a blank page. They can draw on real experience and actual achievements when addressing the question put up by the organisers of the forum, i.e., how can one strengthen a firm's contribution to development?

There is no "one-answer-fits-all" to this question, but a few important general principles can be identified, including the following:

- to *focus* on what you know best; that is, normally, the business itself. If everybody feels responsible to everybody for everything, nothing will happen, as in Dostoevski's novel, *The Brothers Karamazov*.
- to *think and act long-term*, in the interest of the company and its owners, without neglecting the interest of business partners upstream and downstream, workers and their families. Despite some negative remarks from participants here at this conference related to win-win outcomes, we strongly believe in the idea of win-win business initiatives.
- to use *dialogue, not guidelines*, a dialogue with the people who are actually concerned.

The main dialogue must take place in the countries where we invest, with linkage partners, with customers, with the people actually affected.

This said, it is clear that some of the dialogue also has to be on the global level. In 1999, the UN Secretary General Kofi Annan established a double platform for this global dialogue.

The platform includes:

- the UN Global Compact
- the Investment Guides initiative.

The UN Global Compact

The compact consists of only nine key sentences that are intended to be a platform for dialogue and cover: environment, social and labour rights, human rights.

The nine key sentences are general enough to fit all situations. They are inoffensive to non-western cultures. They are precise and focused enough that they actually matter.

Three additional remarks pertain specifically to this last point:

- The platform of the UN Secretary General provides focus, rather than the frequently changing selection of topics that are fashionable in progressive circles of the West that can sometimes be seen elsewhere.
- The platform allows for the allocation of responsibility to all the partners in the dialogue, according to their key competencies.
- The Global Compact is also an urgent response to concerns about proliferation in the number of codes and guidelines, their scope, and their size. Some of these guidelines have been extended to such a size that they have moved from the CEO's desk to the lawyers and other specialists.

Investment guides

The second part of the platform established by UN Secretary General Kofi Annan is not so well known, but equally important. The Investment Guides allow a structured dialogue between Least Developed Countries and industry. The partners in this dialogue, besides UNCTAD as moderator, are host-country governments, local invested firms and foreign investors.

The main discussion is on how to make least developed countries more attractive to investors. Results are very practical. To take just one example, namely Ethiopia: while government stressed low labour costs (they had probably heard western diplomats talking about the foreign investors race to the bottom, a concept in contradiction with the track record of the huge majority of international firms), industry participants succeeded in convincing them that the main obstacle to running a business there was high transportation time and cost.

The two parts of the platform are a true framework of dialogue and progress.

Main dialogue must be led locally

Nestlé buys direct from more than 300,000 milk farmers worldwide. Among the countries are: Brazil, China, India, Pakistan, Senegal, Sri Lanka, Vietnam and many more, also Mexico, with several thousand farmers in Chiapas.

Initially, when starting to deliver milk to Nestlé, most of these farmers own no more than one to three cows or buffaloes (e.g., in Asia).

Dialogue starts with establishing a relationship of trust. One way of doing this is to pay farmers reliably, exactly on time, and in poorer areas, make payments on a weekly rather than a monthly basis.

It is necessary to have advisors who already have a basic understanding of the other side of the dialogue. We have 1,000 agricultural advisors worldwide, who go and visit farmers, help them improve productivity and quality, and learn from them what kind of cow is best for a given climate. At a very early phase of Nestlé investment, Swiss cows were imported to developing countries; clearly, this did not work. Listening is also an important part of the dialogue.

As the dialogue progresses, advice can be given. In Brazil, Nestlé's advisors had observed that farmers had built sunroofs, so that cows could find shelter from the strong mid-day sun, which had a positive effect on milk production per cow. It took some time to convince the milk farmers in Chiapas to adopt this practice for their cows; their initial reaction had been: our cows are not princesses.

The relevance of these stories about cows is that, for one thing, they are the reality out in the field. The same stories could be told under the heading of "social responsibility" and "animal protection". Nestlé prefers to do it under the headings of common commercial interest and as a result of dialogue for better mutual understanding.

Summing-up

In order to achieve something focus is needed. This holds true for firms in particular: focus on the main competencies in order to contribute best to the development of countries and societies where they are active.

Of equal importance is to open a dialogue for mutual understanding, without lecturing. The outcome sought by such a dialogue should:

- signal the companies' own priorities and show understanding of the priorities of others;
- understand different cultures and aspirations;
- indicate where companies have to adapt and make corrections.

The large number of potential partners for dialogue also requires focusing on those who actually have something at stake. Among them can be included (the list is not exhaustive):

- farmers supplying goods, other local suppliers, workers, employees, and trade unions, customers, consumers and their organisations, governments for the local dialogue;
- host countries' authorities, local and foreign invested firms for the Investment Guides;
- governments, UN and other firms for the Global Compact.

Last but not least, discussion must also take place within companies. Nestlé's main platforms for this are the Corporate Business Principles and the Nestlé Management and Leadership Principles.

The Role of Foreign Direct Investment and Multinational Enterprises in the Economic and Social Development of Energy-Rich Transition Countries: The Case of Azerbaijan,

Fikret M. Pashayev,
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Ministry of Foreign Affairs, Azerbaijan

The role of FDI in economic development has special significance when applied to the newly independent energy-rich transition countries in the Caspian Sea region. During the last decade this region became very attractive due to a number of factors, in particular the existence of considerable oil and gas deposits and the significant transportation opportunities between Europe and Asia. Multinational Enterprises (MNEs) largely invested in the countries of the Caspian region despite the difficulties of the transition period, the consequences of military conflicts, and the competition and rivalry that derive from the geopolitical interests involved.

Reforms in Azerbaijan and FDI

Azerbaijan, which is situated in the heart of the region of Caucasus and Central Asia, experienced extremely difficult conditions in the early years of its post-communist political and economic transformation. Following the collapse of the Soviet Union, Azerbaijan inherited an ineffective command economy and fractured productive, financial, and trade links. As a result, the economy suffered from serious macroeconomic imbalances. Improper foreign economic policy resulted in inefficient foreign economic relations. The privatisation process was behind schedule and the level of foreign investments was very low. Military aggression by neighbouring Armenia and occupation of 20 per cent of the territory of Azerbaijan brought massive destruction and resulted in one million refugees and internally displaced persons in the country.

These circumstances, coupled with some other negative factors, resulted in a deep economic and social downturn. According to 1995 data, the country's GDP decreased by 53 per cent, the volume of agricultural production by 44 per cent, industrial production by 62 per cent, the volume of investments by 45 per cent, and the social welfare of the population diminished by a multiple of 3.7 compared to the 1990 figures.

With new leadership taking office in 1993, new legislation concerning various aspects of social and economic development has been introduced, and new institutions have been established. The general economic policy of Azerbaijan was based on liberalisation, private sector development, and transforming the country to a market economy as quickly as possible. As a result of this policy substantial progress was achieved not only in stabilising the macroeconomic situation, but also in attracting considerable foreign investments in the country's economy.

In the process of reform, about 300 laws and more than 700 legislative acts have been adopted. Three economic programmes have been implemented for the purposes of macroeconomic stability, structural reforms, and the restoration of economic growth. As a result of these measures, GDP in 1995-2000 increased by 24.4 per cent. The growth of GDP in 2000 reached a record figure – 11.4 per cent. Industrial output for the same period grew by 8.5 per cent, and the services sector by 11.3 per cent. As compared to 1999, the volume of Azerbaijani foreign trade in 2000 increased by 75.4 per cent, exports increased almost threefold, while imports grew by 13 per cent.

Over the past few years, an environment conducive to the participation of foreign investors in the privatisation process has been created. Within the framework of active foreign participation, Azerbaijan, on the one hand, is party to a number of international conventions, treaties, and bilateral agreements covering respective investment areas, and, on the other hand, is on the way to improving its national legislation system. The country's legislation on foreign investment protection is considered to be one of the most advanced and comprehensive in the former socialist bloc area.

This is confirmed by the opinion of many analysts. According to Ian Lewis and Jon Marks "… Azerbaijan may well find itself with a lot more in common with Norway than with Nigeria in a decade or two. Meanwhile, Azerbaijan undoubtedly represents the best environment for international traders and investors within the whole of the CIS". (*Trading with Azerbaijan*. Wales, UK, 2001, p.19).

One of the most important aspects of the business environment is business regulation, including investment procedures. The government of Azerbaijan has begun documenting investment procedures and business regulations, soliciting feedback from the private sector, and seeking advice on removing administrative barriers to investment.

During the period 1993-2000 a total sum of US$9 billion was invested in the economy of Azerbaijan, including US$6 billion in foreign investments (FDI amounted US$5.3 billion). In 2001, expectations for FDI are US$1.2 billion. At present, there are more than 2,700 businesses with foreign capital, which constitute 16.6% of the total number of enterprises operating in the country.

Attracting foreign investments in the energy sector, the cornerstone of the country's economy, is of special importance. Since 1994, Azerbaijan has concluded 21 PSAs on the development of the country's hydrocarbon resources, with the participation of 33 companies from 15 states; over the next 30 years, foreign investments in the oil and gas sector will total approximately US$60 billion. The volume of extracted oil will reach 40-45 million tons in 2010-2015. Over the next five years, investments into this sector of economy are expected to reach US$10 billion.

The largest investors in the hydrocarbon sector are BP Amoco, Exxon Azerbaijan Ltd, Statoil Absheron A.S., TotalFina Elf, Itochu Oil Exploration, Agip, Unocal Khazar, TPAO (Turkey), Lukoil Overseas (BVI) Ltd., and others. The major investors in oil equipment and support services are Halliburton (US), Schlumberger (France), Kvaerner (Norway), and Aker Maritime (Norway).

Each individual oil contract (contracts worth billions of US dollars) was ratified in conformity with the legislation of the Republic, designed to be stable and invariable (subject to its term) throughout the entire duration of the contract. Concurrently it was decided that the form of contract between the parties would be of the "production sharing" type of agreement widely used in modern practice.

MNEs and Economic Development

Industrialisation and the diversification of the economy constitute two of the main elements in the development of any country. Today, several developing and transition economies have made substantial progress in developing their national industries.

The adoption of such a strategy is necessary for Azerbaijan. Currently the Government is working on a 10-year programme for economic development. The interests of MNEs and local enterprises in this programme are crucial. If the right development strategy is chosen, companies can benefit from it as well.

The import substitution policy could be considered as a way to develop national industry. Taking into account that Azerbaijan receives higher profits from the exploitation of its oil and gas deposits, it is clear that there is a basis for such a policy.

The import substitution policy in Azerbaijan should be accompanied by further development of the private sector. Currently, the country's second stage of privatisation is being conducted full pace.

MNEs could be one of the major actors in the realisation of an import substitution policy. Already there are several companies whose subsidiaries in Azerbaijan allow the production of certain industrial goods locally, thus achieving import substitution to some extent. So far, the best results have been demonstrated by Garadagh Cement (Switzerland), Castell (France), Baku Steel Company (UK), and Coca-Cola.

Furthermore, an import substitution policy could further be transformed into an export-oriented policy. This would be of interest to large MNEs, which could choose Azerbaijan for the production and export of their products to the other markets in the region.

As an energy-rich state located at the cross-roads between Europe and Asia, Azerbaijan is keenly interested in securing access to the Trans-European and Trans-Asian transportation networks that would facilitate the development of industrial and trade links between the countries of the region, improving access to markets and increasing integration links. Using its geographical location, resources, and potential, the country is actively engaged in the restoration of the Great Silk Road, the creation of the Europe-Caucasus-Asia transport corridor (TRACECA).

With a view to developing East-West links, Azerbaijan proposes fostering trans-regional co-operation. Among the priorities for such co-operation are areas of transport, energy, trade, and investment. In this context, the country has great expectations of MNEs' support in the modernisation of the transport and communications infrastructure, along with the implementation of new and large-scale projects like TRACECA, North-South Transport Corridor projects, as well as the Trans-Caspian, Baku-Tbilisi-Ceyhan and INOGATE oil and gas transportation projects.

Corporate Social Responsibility

While there is no single, commonly accepted definition of corporate social responsibility, or CSR, it generally refers to business decision-making linked to ethical values, compliance with legal requirements, and respect for people, communities, and the environment.

CSR is defined as operating a business in a manner that meets or exceeds the ethical, legal, commercial, and public expectations that society has of business. It is viewed as a comprehensive set of policies, practices, and programmes that are integrated throughout business operations, and decision-making processes that are supported and rewarded by top management.

Today, a lot is expected of MNEs. The Azerbaijani people have come to expect more of business, and are increasingly looking to the private sector to help with a myriad of complex and pressing social and economic issues.

With increasing trade globalisation trends and shrinking resources in mind, the Government is attaching more importance to regulatory issues. In this situation local and multinational companies in particular should rely less on the government for guidance, and adopt their own policies to govern such matters as environmental performance, working conditions, etc.

MNEs' efforts will result in improved working conditions, less environmental impact, and greater employee involvement in decision-making that can lead to increased productivity.

The special role of MNEs is seen in supporting human rights and encouraging equal opportunity at all levels of employment, including racial and gender diversity in decision-making committees and boards. MNEs are closely engaged in the training and advancement of disadvantaged workers to provide them with career development opportunities and increase their social awareness, promote greater tolerance and understanding among people, thereby helping to improve the quality of life for employee communities to live in dignity and equality.

Benefits for Azerbaijan

MNEs in Azerbaijan continue to make their contribution to the implementation of social and humanitarian projects by developing and implementing a number of projects in education, science, culture and health care, and social security.

For example, Chevron-Texaco provides assistance to relieve the refugee problem in the country. Chevron has sponsored the refurbishment of the State Children's Hospital in Baku, the establishment of the Modern Economics Library in the Baku Oil Academy, and the Library in the International Ecological University in Baku. The company also supports the Institute of Manuscripts of Azerbaijan, the Azerbaijani State Opera House, and the Baku Musical Academy through various projects.

BP Amoco supports a range of community, educational, scientific, and cultural initiatives with local partners in Azerbaijan. These include educational support in terms of helping local schools with refurbishment, educational materials, and equipment, support for victims and refugees of the war with Armenia, road safety, and assisting Azerbaijani scientists to develop closer links with their counterparts worldwide.

Exxon and Chevron also sponsored the participation of many Azerbaijani representatives from both the public and private sectors in various training courses at prestigious U.S. universities.

At the same time, MNEs in Azerbaijan can be more engaged in interaction with government structures in addressing such issues as the elaboration of a development strategy and the planning and implementation of concrete projects aimed at eradicating poverty, developing the non-oil sector, and supporting entrepreneurship.

MNEs could also be more involved in collaboration with the private sector. The recently established Azerbaijan Entrepreneurs Confederation (ASK, in its Azerbaijani initials) needs such co-operation. MNEs, together with local private companies, can promote progress in the development of many new industries and the elaboration of social programmes. According to the President of ASK, Mr. Alekper Mamedov, through membership in ASK, MNEs, especially companies like BP Amoco and ExxonMobil can make their input to the social and economic development of Azerbaijan more valuable and results-oriented, as has happened in other energy-rich countries of the region, for example in Kazakhstan. The social dimension of this co-operation is of particular value, with the human factor being increasingly one of the major driving forces of economic development.

In conclusion, it can be said that the track record of MNE operations in Azerbaijan could lay a solid foundation for further development of their co-operation with both the public and private sectors, with active involvement of all stakeholders interested in the country's prosperity.

Do Corporate Responsibility Initiatives Work for Development?
An OECD Perspective,

Pierre Poret,
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Responsible business conduct by multinational enterprises (MNE) can help countries reap the full benefits of international direct investment for development. The thirty five – OECD Member and non-Member – countries adhering to the Guidelines for Multinational Enterprises wish to work with developing countries in order to strengthen the capacity of foreign direct investment and corporate responsibility to promote economic development and enhance the welfare of citizens around the world.

Private initiatives for corporate responsibility are efforts by companies to develop and maintain internal control systems that allow them to comply with market, regulatory, and other legitimate expectations. As such they are not new initiatives. Over the past 10 years, however, a major movement of voluntary and often public initiatives among international enterprises has taken place at an unprecedented pace.

A recent OECD Study, *Corporate Responsibility—Private Initiatives and Public Goals*, using databases covering over two thousand organisations in thirty countries, shows that most large OECD-based multinational enterprises have participated in this movement in one way or another. These initiatives initially involve the issuance of codes of corporate conduct setting forth commitments in such areas as labour relations, environmental management, human rights, consumer protection, competition, disclosure and fighting corruption. These codes are often backed up by management systems that help firms respect their commitments in their day-to-day operations. More recent developments include work on management, reporting and auditing standards and the emergence of supporting institutions (for example, professional societies, consulting and auditing services). The OECD Study also identifies a number of areas where further consideration and action might be particularly useful and relevant to development (e.g. corporate responsibility *vis-à-vis* the supply chain and issues for extractive industries).

The countries adhering to the OECD Guidelines[1] want to use them as a framework to reinforce private initiatives for corporate responsibility. The Guidelines, which were first adopted some 25 years ago, provide a multilaterally endorsed set of comprehensive (and often quite detailed) recommendations for responsible business conduct.

It is possible to read these Guidelines as a first step in tackling the development agenda that now confronts the international community. The approach of the Guidelines is not one of regulation, but rather one that favours co-operation and accumulation of expertise in order to enhance further the benefits of international investment. A few illustrations:

- In chapters II, IV and VIII, the Guidelines recommend a series of steps that MNEs should take to facilitate technology diffusion and human capital accumulation in host countries – two areas which have long been recognised as central to growth and productivity increases in less developed countries;

[1] The text of the Guidelines is available at http://www.oecd.org/daf/investment.

- In chapter II and others, MNEs are asked to co-operate with local communities, keeping in mind the distinctive needs of different communities as well as their cultural diversity;

- The Guidelines also state that MNEs should refrain from seeking or accepting exemptions from host country regulatory requirements in areas such as environment, labour or financial incentives. This echoes efforts by developing countries to avoid being trapped into some kind of a "race to the bottom" or in a zero sum game of incentive-based competition to attract FDI, which in the long run benefits no country.

- The Guidelines cover all core labour standards and underline the importance of capacity building in host countries through local employment and training. The recommendations draw on an agreed body of international thought on labour rights, most of it developed in the International Labour Organisation. Far from imposing inappropriate labour standards on developing countries, the Guidelines enhance the positive role that multinational enterprises can play in helping to address the root causes of poverty, through their labour management practices, their creation of high-quality jobs, and their contribution to economic growth.

- Chapter VI enlists MNEs in the fight against bribery and corruption in host countries – an area which, we know, an increasing number of developing country governments now consider central to their reform efforts;

- Chapter III on disclosure promotes business transparency on the basis of the standards set forth in the OECD Principles of Corporate Governance. Further global dissemination of these standards will promote development by strengthening the effectiveness and robustness of financial systems everywhere.

- The Guidelines also contain provisions asking MNEs to respect the human rights of all people affected by their operations. While the countries adhering to the Guidelines recognise that governments play the primary role in protecting human rights, companies can help in a number of important ways. Respect of human rights is increasingly viewed as the most fundamental feature of successful market systems. Thus, the business community's assistance in promoting human rights will not only help reduce the suffering caused by human rights abuses, but will promote economic development.

The Guidelines have an important complementary role to play in the process of discussion and consensus building. The Guidelines can enhance the visibility and public understanding of private initiatives, thereby making them more effective from companies' point of view and more credible from the point of view of civil society in host and home countries. The Guidelines' implementation procedures, which adhering governments are committed to support, can also be used to promote and disseminate management practices that help companies respect appropriate norms for business conduct.

At the same time, private initiatives for corporate responsibility raise significant challenges from a developing country perspective.

These initiatives can occasionally have "unintended consequences". The background associated with one of the business association codes in the database of the OECD Study shows how problems can inadvertently arise from well-meaning initiatives. The code emerged as a result of what is now an infamous case of unintended consequences of NGO activity – in this case, in response to the revelation that children were involved in the production of soccer balls in Pakistan. As a result of NGO activity,

soccer balls suppliers in Pakistan were instructed to stop employing children immediately, which they did. However, since many of the children had been brought in from surrounding areas to work in factory-type situations, they ended up on the streets without caretakers or family supervision.

In a further development of this same episode, soccer ball retailers worked extensively with the ILO and with NGOs to restructure conditions of production in the Pakistani soccer ball industry. Their aim has been the progressive elimination of child labour. This restructuring increased the market share of formal, factory-like production sites ("stitching centres"), while decreasing the market share of "cottage" or home-based production (where it is more difficult to control participation of children). But this shift also undermined the economic autonomy of adult women in the region, who are less involved in factory work than in home-based production. This was another largely unintended consequence.

These examples underscore the need to proceed carefully with corporate responsibility initiatives and to have adequate knowledge of local conditions. A "one-size-fits-all" approach cannot work.

Corporate responsibility raises challenges to host country governments too. More and more, governments' business can no longer be as usual. Private initiatives cannot work if public governance and other parts of the system work poorly. When companies are serious about reputation risk management and their public commitments towards corporate responsibility, they may find situations where they will decide to reduce their investments or even opt for alternative business locations depending on the quality of the governance environment in which they operate. Governments may have to respond to this by adapting and accelerating regulatory reform efforts. However, while regulatory reforms have costs, in the long run they will be beneficial to the country. Experience shows that they are the surest way of attracting and retaining first-class and long-term investors, whether foreign or domestic.

Indeed, the notion of corporate social responsibility is not meant to be a substitute for the responsibility of other stakeholders, particularly states themselves. Mutual dependence exists between enterprises and the societies in which they operate: a business sector cannot prosper in a failing society, and a failing business sector inevitably distracts from general well-being. States have the responsibility of ensuring a favourable environment for business, through provision of such services as law enforcement, appropriate regulation, and investment in the many public goods and services used by business. And businesses, beyond their core objective of yielding adequate returns to owners of capital, are expected not only to obey the various laws applicable to them, but also to respond to the societal expectations that are not written down as formal law.

Meeting these challenges calls for private-public sector partnership, together with active co-operation among developed and less developed countries – bilaterally or through multilateral institutions, including the OECD. By and large, the Guidelines, with their multi-stakeholder consultation and consensus-building procedures, are the precursor of an emerging global system of governance combining legal requirements, voluntary compliance, and co-operative arrangements with a view to ensuring that globalisation works for all.

ANNEX 1:

OECD INVESTMENT INSTRUMENTS

Since its inception some forty years ago, the OECD has long been at the forefront in efforts to develop international "rules of the game" relating to capital movements, international investment and trade in services. Member governments have established disciplines for themselves and for multinational enterprises by means of legal instruments to which Member countries commit themselves. These instruments have been regularly reviewed and strengthened over the years to keep them up to date and effective.

The Declaration on International Investment and Multinational Enterprises

The OECD Declaration on International Investment and Multinational Enterprises is a political agreement providing a balanced framework for co-operation on a wide range of investment issues. The Declaration contains four related elements: (1) the *National Treatment* instrument; (2) the *Guidelines for Multinational Enterprises*; (3) an instrument on *International Investment Incentives and Disincentives*; and (4) an instrument on *Conflicting Requirements*. It is supplemented by legally binding Council Decisions on implementation procedures, and by Recommendations to adhering countries to encourage pursuit of its objectives.

The Committee on International Investment and Multinational Enterprises (CIME), comprising all Member countries and a number of non-Member observers, is the OECD body responsible for promoting and overseeing the functioning of the Declaration. All OECD Members are party to it. As of February 2002, six non-Member countries (Argentina, Brazil, Chile, Estonia, Lithuania and Slovenia) have adhered to the Declaration and participate in related OECD work as a counterpart to the obligations undertaken under the instrument. Israel, Latvia, Singapore and Venezuela are engaged in adherence procedure as of this date. Other non-Members willing and able to adhere to the Declaration would be welcome.

Adhering to the OECD Declaration on International Investment and Multinational Enterprises

The OECD Council is the body in charge of inviting interested non-Member economies to adhere to the OECD Declaration on International Investment and Multinational Enterprises and related OECD acts, and to become full participants in that part of the CIME work, which directly concerns them.

As a condition, applicants have to apply liberal policies towards foreign direct investment and be willing and able to meet the requirements and the related OECD acts. To ensure this, a full review of the applicant's foreign direct investment policies is carried out, after which the invitation may then officially be issued by the Council.

Non-Members adhering to the Declaration are entitled to participate in the work of the CIME related to the Declaration and related acts, as a counterpart to the obligations undertaken under these instruments.

The National Treatment Instrument

The National Treatment Instrument stipulates that adhering countries shall accord to enterprises operating on their territories and owned or controlled by nationals of another adhering country, treatment no less favourable than that accorded in like situations to domestic enterprises. The instrument does not prevent adhering countries

from taking measures necessary to maintain public order, to protect their essential security interests and to fulfil commitments relating to international peace and security.

Under the Third Revised Decision of the Council on National Treatment, countries adhering to the Declaration shall notify the Organisation of all measures constituting exceptions to the National Treatment principle within 60 days of their adoption and of any other measures which have a bearing on this principle (the so-called "transparency measures"). These measures are periodically reviewed by the CIME, the goal being the gradual removal of measures that do not conform to this principle. Exceptions to National Treatment fall into five categories: *(i)* investments by established foreign-controlled companies, *(ii)* official aids and subsidies, *(iii)* tax obligations, *(iv)* access to local bank credit and the capital market, and *(v)* government procurement. Transparency measures include *(i)* measures based on public order and national security interests, *(ii)* restrictions on activities in areas covered by monopolies, *(iii)* public aids and subsidies granted to government-owned enterprises by the state as a shareholder.

The National Treatment Instrument is solely concerned with discriminatory measures that apply to foreign-controlled enterprises *after* they are established, *i.e.* not with their right of establishment. If restrictions prohibit or impede in any way the activities of foreign-controlled enterprises, compared to domestic ones, these restrictions are to be reported as exceptions to National Treatment. If and when an official monopoly is abolished, the stipulations of the National Treatment Instruments will begin to apply to the sector formerly covered by the monopoly.

Adhering countries are expected to comply with the *standstill* principle, that is to refrain from introducing new measures and practices that would constitute additional exceptions to National Treatment. The CIME conducts examinations to monitor and ensure compliance with the National Treatment Instrument, and to issue recommendations to this effect. Most of these recommendations have been made to individual countries, but a number of them were of a general character. Concerning investment by established foreign-controlled enterprises, adhering countries should give priority in removing exceptions where most adhering countries do not find it necessary to maintain restrictions.

In introducing new regulations in the services sectors, adhering countries should ensure that these measures do not result in the introduction of new exceptions to National Treatment. Adhering countries should also give particular attention to ensuring that moves towards privatisation result in increasing the investment opportunities of both domestic and foreign-controlled enterprises so as to extend the application of the National Treatment instrument.

In the area of official aids and subsidies, adhering countries should give priority attention to limiting the scope and application of measures which may have important distorting effects or which may significantly jeopardise the ability of foreign-controlled enterprises to compete on an equal footing with their domestic counterparts.

Finally, with regard to measures motivated by based on public order and essential security interests, adhering countries are encouraged to practice restraint and to limit such measures to the areas where public order and essential considerations are predominant. Where motivations are mixed (*e.g.* partly commercial, partly national security), the measures concerned should be covered by exceptions rather than merely recorded for transparency purposes.

The exceptions to National Treatment notified by all adherent parties to the Declaration can be found on the Internet, at http://www.oecd.org/daf/investment.

The OECD Guidelines for Multinational Enterprises

The Guidelines for Multinational Enterprises are recommendations jointly addressed by governments to multinational enterprises operating in or from adhering countries. They provide voluntary principles and standards for responsible business conduct, in a variety of areas including employment and industrial relations, human rights, environment, information disclosure, combating bribery, consumer interests, science and technology, competition, and taxation.

The Guidelines express the shared values of governments of countries that are the source of most of the world's direct investment flows and home to most multinational enterprises. They aim to promote the positive contributions multinationals can make to economic, environmental and social progress.

Observance of the Guidelines is voluntary. Their non-binding nature, however, does not imply less commitment by adhering governments to encourage their observance. The active system under which the Guidelines are promoted and implemented attests to the importance adhering countries give the Guidelines. Adhering countries shall set up National Contact Points (NCPs) to deal with the implementation of the Guidelines at the national level. The purpose of NCPs is to undertake promotional activities, handle inquiries and to act as a forum for discussion with the parties concerned on all matters covered by the Guidelines so that they contribute to the solution of problems, which may arise in this connection. NCPs also meet annually to share experiences and report to the CIME. Adherent countries are encouraged to translate the text of the Guidelines in their own official language(s).

The CIME's responsibilities under the Guidelines include responding to requests from adhering countries on specific or general aspects of the Guidelines, organising exchanges of views on matters relating to the Guidelines with social partners and non-Members, reviewing the Guidelines and/or the procedural Decisions so as to ensure their relevance and effectiveness, and reporting to the OECD Council on the Guidelines. The Committee is also responsible for issuing, as necessary, clarifications of the Guidelines. The purpose of these clarifications is to provide additional information on whether and how the Guidelines apply to a particular situation.

The Review concluded in 2000 enabled the OECD to respond to the need for a thorough consideration of the Guidelines and to ensure their continued relevance and effectiveness. Many features of the Guidelines have been maintained: observance by firms is still voluntary; the institutional structure of the follow-up procedures is broadly unchanged and the Guidelines remain an integral part of the OECD Declaration.

In comparison with earlier reviews, however, the changes to the text are far-reaching and reinforce the core elements – economic, social and environmental – of the sustainable development agenda. With respect to implementation, the Review has provided guidance for the functioning of National Contact Points, and has clarified the CIME's role. The Review benefited from consultations with the business community, labour representatives, non-governmental organisations and non-Member governments.

Incentives and Disincentives

The instrument on International Investment Incentives and Disincentives recognises that adhering countries may be affected by this type of measure and stresses the need to strengthen international co-operation in this area. It first encourages them to make such measures as transparent as possible so that their scale and purpose can be easily determined. The instrument also provides for consultations and review procedures to make co-operation between adhering countries more effective. Adhering countries may be called upon to participate in studies on trends in and effects of incentives and disincentives on FDI, and to provide information on their policies.

Conflicting Requirements

The instrument on Conflicting Requirements encourages adhering countries to co-operate with a view to avoiding or minimising the imposition of conflicting requirements on multinational enterprises. In doing so, they shall take into account the general considerations and practical approaches recently annexed to the Declaration. This co-operative approach includes consultations on potential problems and giving due consideration to other country's interests in regulating their own economic affairs.

The Codes of Liberalisation

Since its creation, the OECD has supported the liberalisation of trade in goods and services, and movements of capital between Member countries. This support finds concrete expression in two legally binding agreements

among Member countries: the OECD Codes of Liberalisation of Capital Movements and of Current Invisible Operations, to which all Member countries adhere.

The Codes' principal idea is simple: Capital and services should circulate freely across national frontiers. OECD considers that opening markets fully to cross-border flows of capital and services is beneficial both to host and home countries and their citizens. The OECD Codes complement and reinforce other multilateral instruments promoting a liberal international economic environment.

The ***Capital Movements Code*** is the only multilateral instrument promoting liberalisation of the full range of international capital movements, other than the rules of the European Union and of the European Economic Area. When it was created in 1961, its coverage was limited to foreign direct investment and some other long-term operations. However, since then, national economies have become more integrated, financial market regulation has become more harmonised and financing techniques have become more sophisticated. As a consequence, Member countries have gradually extended the list of transactions until it could be considered complete. Today, the Capital Movements Code applies to all long- and short-term capital movements between residents of OECD countries, except government operations. Examples of such movements are the issuing, sale and purchase of shares, bonds and mutual funds, money market operations, and cross-border credits, loans and inheritances.

Coverage of cross-border trade in services by the ***Current Invisibles Code*** is large, but not quite as comprehensive. Cross-border trade in services means the supply of services to residents by non-resident service providers, and vice versa. The service providers can be companies or individuals. Major sectors covered are banking and financial services, insurance, professional services, maritime and road transport, travel and tourism, and films.

Although the two Codes differ from each other in certain respects, the general principles that govern these two instruments are broadly the same. In adhering to the Codes, the Member countries undertake to remove restrictions on specified lists of current invisible operations and capital movements. The ultimate objective is that residents of different Member countries should be as free to transact business with each other as are residents of a single country.

At the same time, OECD Members believe that each country should be able to advance progressively towards this goal according to its own rhythm. The Codes provides for the flexibility of lodging reservations to specific operations and a number of safeguards, to take account of the state of development of its economy and financial markets, as well as of public interest concerns. Rather than pressing for liberalisation through *quid pro quo* negotiations, the Codes depend on a consultative process in which each country's individual needs, concerns and possibilities are taken into consideration.

Despite the progressive broadening of the Code obligations, the scope of Member countries' reservations has dramatically declined. Apart from the remaining restrictions on inward direct investment in a few economic sectors and the non-resident acquisition of real estate, virtually all Member countries have dismantled their controls on capital movements.

While the Codes themselves cannot take credit for all of the liberalisation that has taken place over the past 40 years, they have provided an important multilateral framework for sustaining the individual liberalisation paths pursued by Member countries, building domestic capacity and encouraging non-discriminatory extension of liberalisation to all Member countries. The Codes have also served as a useful yardstick by which the liberalisation efforts of Member countries can be judged and compared over time.

Moreover, if the legal commitments under the Codes only apply to the OECD area, Member governments shall endeavour to extend the benefits of liberalisation to all members of the International Monetary Fund. Thus, residents of developing countries and countries in transition will be able to reap the advantages of free market access in OECD countries to the same extent as OECD residents.

ANNEX 2:

LIST OF PARTICIPANTS

OECD Member Countries

BELGIUM

Mr. Keld Larsen
Commercial Aggregate
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