

THE WORLD BANK

ECONOMIC POLICY NOTES

No. CPD-4

*The Bank's Approach to
Direct Foreign Investment in
Developing Countries:
An Evaluation*

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December 1986

Policy Group

Country Policy Department

This series of Economic Policy Notes is intended to bring to the attention of Bank managers and economists interesting issues of country economic policy and Bank operational policy emerging from the work undertaken in the Country Policy Department.

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I. INTRODUCTION

1. The purpose of this paper is to evaluate the Bank's involvement in assisting member countries to attract and benefit from direct private foreign investment, and to suggest a set of general principles within which future Bank assistance and policy advice can be framed. Foreign investment is an area which has generated an extensive body of literature, especially on the evaluation of economic effects in host countries. This paper does not review the literature on foreign investment or attempt to evaluate its relative merits. Rather, it assumes that it is up to the host government to decide whether, and to what extent, foreign investment forms part of its development strategy. The question then is what has been, or should be, the Bank's role given a government's stance toward foreign investment.

2. Through economic and sector work, policy-based lending and the activities of IFC, the Bank has generally encouraged member countries to adopt a more open and less restrictive stance toward foreign investment. Although the Bank has supported countries' efforts to attract and benefit from foreign investment, its approach has been flexible and has varied according to each country's development objectives, its potential for attracting foreign investment, and the need to correct structural and policy distortions which can reduce the net benefits to the host economy. Where countries adopt a highly defensive and restrictive attitude toward foreign investment, the Bank's role is limited to evaluating the economic effects of government policies and pointing out instances where the same objectives could be achieved more efficiently through alternative policies.

3. Section II briefly reviews the role of foreign investment in developing countries, and major areas in which host government policies and practices influence foreign investment. Section III describes the Bank's involvement in assisting countries to improve foreign investment policies and draws from the study by K. Hallberg, " Foreign Investment Incentives and Restrictions in Developing Countries: An Analysis of World Bank Policy Recommendations " (CPD, November 1986). Section IV evaluates the Bank's approach and Section V suggests a set of guidelines for future Bank involvement. Annex I provides a brief annotated bibliography intended as an introduction to the extensive literature on foreign investment; Annex II presents data on recent trends in foreign investment flows; and Annex III reviews foreign investment objectives and policies in four developing countries.

II. FOREIGN INVESTMENT IN DEVELOPING COUNTRIES

Recent Trends

4. Net inflows of foreign direct investment into developing countries increased through the 1970s (Annex II). Its share in total capital inflows, however, declined substantially with the rapid rise in external borrowing, especially from commercial banks. In 1973, direct investment flows financed about 20% of the combined current account deficit and net reserves accumulation of non-oil developing countries, compared with an average of about 12% in later years. As a result, these countries' share of foreign investment in total gross external liabilities fell from an estimated 27% in 1973 to 17% in 1983. Much of this investment, however, is concentrated in a few countries that have large domestic markets, are rich

in natural resources, or have export-oriented economies. Six countries (Brazil, South Africa, Mexico, Singapore, Indonesia, and Malaysia) accounted for 38% of the stock of direct foreign investment in developing countries at the end of 1983.

Economic Impact

5. There is considerable controversy surrounding the economic effects of foreign investment in developing countries. Advocates of foreign investment tend to emphasize its potential for:

- o becoming an important source of external risk capital;
- o transferring technological, managerial, and marketing expertise, which otherwise would not be available to the host country;
- o generating externalities, especially in terms of employment creation and labor training;
- o providing access to foreign markets; and
- o creating backward and forward linkages with local firms and entrepreneurs.

Critics of foreign investment point to costs which may result from:

- o a net foreign exchange loss when profit repatriation and other payments are taken into account;
- o the use of transfer pricing in intrafirm transactions to evade profit and foreign trade taxes;
- o negative external trade effects due to relatively high import and low export propensities
- o the transfer of technology which is capital-intensive, and hence inappropriate for a labor-abundant economy, insufficient or too costly;

- o the higher industrial concentration and reduced competition in domestic markets generally associated with foreign investment; and
- o financial crowding out of local firms when foreign subsidiaries are allowed to borrow domestically.

6. Although the impact of foreign investment will vary in each country, the economic costs and benefits attributed to foreign investment are determined, to a considerable extent, by the policies of the host government. Negative effects generally result from, or are compounded by policy distortions in domestic markets. For example: overvalued exchange rates discourage foreign investors from exporting while making imported inputs more attractive; minimum wages reduce the employment potential of foreign investment; excessive protection insulates highly concentrated industries from foreign competition. Moreover, many negative effects are created by the lobbying of investors or by the misguided efforts of governments to attract investment. These efforts are often successful in attracting investment but misguided since over the long run they often create distortions which negate many of the potential benefits of foreign investment.

Foreign Investment and Adjustment

7. Unlike debt, foreign investment does not require servicing unless it earns a positive return. To the extent that returns are affected by economic disturbances, it can be argued that adjustment to external shocks should be comparatively easier in countries with a larger share of foreign investment in total external liabilities. A recent study by the IMF ¹ suggests that total returns on equity investments are more strongly corre-

¹/ IMF (1985), pp. 22-25 and Appendix III.

lated with a country's ability to service its external liabilities than are interest payments on external debt. For a group of non-oil-exporting countries, the estimated annual rate of return on direct investment was positively associated with the annual growth rate of GDP. By contrast, there was little association between these countries' GDP or export growth, and the average interest rate paid on outstanding external debt. For 28 countries involved in debt rescheduling during 1983, the stock of direct foreign investment accounted for 14% of total external liabilities, compared with 24% for 49 countries that did not reschedule. With the sharp decline in commercial bank flows since 1981, there is increasing agreement on the need to mobilize additional non-debt creating resources, especially for the highly indebted countries. Although at this stage of the adjustment cycle, foreign investment is generally preferable to additional borrowing, as with foreign debt, the long term impact on growth will depend on whether resources are invested in activities with high economic rates of return.

Foreign Investment Policies

8. Due to insights gained from industrial organization theory, foreign investment in developing countries is commonly viewed in terms of a bilateral monopoly situation (e.g., Kindleberger, 1969; Newfarmer, 1985). Foreign investors' market advantage is based upon a unique combination of factors not readily available to domestic firms, whose familiarity with local conditions would otherwise give them a considerable advantage. Foreign investment is then, almost necessarily, associated with imperfect markets and the returns to their unique combination of factors are usually higher than in workably competitive markets. The host government, in turn, controls the terms of access to the domestic market or natural resource. From this view of foreign investment generally follow policy prescriptions

favoring: (i) negotiating the terms of entry and operation to ensure that the greatest share of gains remain in the country; (ii) unbundling the foreign investment package to obtain these factors at a lower cost; and (iii) introducing more competition.

9. A country's underlying attractiveness to foreign investors is determined by a combination of factors, not all under the control of host governments. Structural features such as market size, geographical location, resource endowments and physical as well as human infrastructure are important determinants of foreign investment but are clearly not within the purview of government policies. Taking such factors as given, there are four major areas where government action influences the climate for foreign investment and where the Bank has tended to focus its analysis and recommendations. They are: (i) government controls on foreign investment; (ii) the incentive framework applicable to foreign investment; (iii) administrative procedures for the approval and regulation of foreign investment; and (iv) the investment promotion efforts of host governments.

10. Controls and Regulations. In an attempt to maximize net benefits, many countries combine an expressed desire to attract foreign investment with restrictions and regulations on entry and performance. Restrictions on foreign investment may also respond to broader social and political concerns which transcend economic considerations. Restrictions frequently cover: ownership; repatriation of profits and dividends; employment of expatriates; domestic borrowing; technology transfers; or specific industries where foreign investment is excluded. Performance regulations can be tied to incentive eligibility or defined as minimum requirements, and can affect: exports; employment and training; investment location; or domestic content.

11. Although these controls aim to increase the net benefits to the host country, they often entail conflicting objectives and can effectively operate as strong barriers to entry. Restrictions on the repatriation of profits and dividends, are a major disincentive to foreign investment. Performance requirements and ownership restrictions are also important deterrents when set unrealistically high relative to the conditions and potential of the host economy. For example, the program to encourage a rapid takeover of many foreign-owned firms in Zaire during the early 1970s, led to a substantial decline in productivity as well as a loss of foreign investment inflows. The extent to which foreign investment will be discouraged, however, depends on how attractive the host country appears to foreign investors. Mexico, for example, has been relatively successful in attracting foreign investment despite fairly strict rules on foreign ownership.

12. Incentive Systems. Most developing countries combine some degree of regulation and control with a range of incentives to attract foreign investment. Incentives are generally designed to: (i) compensate investors for structural deficiencies (e.g., poor infrastructure, small markets, lack of skilled labor) and higher risks in the host country; (ii) narrow the difference between social and private returns, on the assumption that there are significant positive externalities (e.g., transfer of technology, development of backward areas); (iii) promote particular sectors (e.g., manufacturing), or subsectors (e.g., electronics), which the government believes will accelerate economic development; or (iv) compensate for policy-induced distortions in domestic markets (e.g., minimum wages, import duties on capital goods). In many cases, incentives are available to both

foreign and domestic investors, but in practice unequal treatment tends to prevail because foreign investors generally face different entry and regulatory requirements.

13. Although not aimed exclusively at foreign investors, protection against competing imports is the most common and powerful incentive offered by developing countries. In addition, many countries adopt a variety of special incentives directed at foreign investment. Incentives are generally embodied in an investment code which specifies concessions and/or exemptions available to firms that meet certain conditions (e.g., size, location, employment). The most widely used special incentives are tax concessions and tariff exemptions. Tax incentives may include tax holidays, accelerated depreciation, and reinvestment allowances. Tax holidays offer full or partial exemption from income and other taxes for a period generally ranging from 5 to 10 years. In some cases the length of the exemption period varies with the size of the investment, the number of jobs created (e.g., Malaysia, Philippines) or the use of local raw materials (e.g., Ecuador, Morocco). Accelerated depreciation allows firms to write off the cost of capital equipment against gross revenues over a short period. Reinvestment allowances exempt reinvested income from corporate income tax. Tariff concessions generally exempt capital and intermediate goods, and occasionally raw materials, from import duties for periods of 5 to 10 years, or in the case of some large projects, for as long as 15 to 25 years (e.g., Togo, Guinea). The exemptions often apply only to goods not produced domestically. Other incentives may include subsidized interest rates, and the provision of infrastructure and services, often in industrial estates or export processing zones. As an added incentive, sites are sometimes provided at subsidized prices (e.g., Cameroon).

14. Most of the economic literature tends to view the benefits to be derived from foreign investment incentives with considerable skepticism--a skepticism which tends to increase in the face of most countries' weak administrative capabilities, and the frequently complex and ambitious nature of incentive systems. The case against protection, the most common incentive, is well established. It can be shown that under certain conditions, foreign investment which comes in over quotas and import duties (tariff jumping) can be immiserizing for the host country.² Although import protection often succeeds in attracting foreign investment, it generally leads to investment decisions which are highly distorted in economic terms. For example, the protection-induced distortions that gave rise to Chile's automobile industry during the 1960s and, more recently, Togo's steel mill, have been extensively discussed in the literature. Moreover, incentives once granted are difficult to remove. Investment decisions made on the basis of distorted incentives, such as excessive protection, give rise to vested interests which become powerful opponents of subsequent government efforts to reform its policies.

15. In addition to the risks of encouraging economically distorted investment, it is not clear that through a finely tuned incentive system most developing countries can successfully capture positive externalities, select sectors which will be economically viable over the long run, and efficiently compensate for policy distortions. Although extracting positive externalities can be an important objective, externalities are difficult to identify and quantify, complicating the task of setting appropriate

2/ See for example: Balasubramanian (1970); Brecher and Diaz-Alejandro (1977).

incentive levels and evaluating their economic impact. In practice, it is difficult to show that externalities are significant and that governments can effectively design and implement incentives that encourage positive externalities, without introducing additional distortions.

16. Incentive systems targetted at particular industries or subsectors presume that the government is adept at identifying the economy's comparative advantage over the long term. Although countries such as Japan, Korea, and Brazil appear to have done so successfully, even their success in picking winners has been disputed, and experience shows that for most developing countries this is not an easy task, especially where market signals are so distorted by government interventions that they cannot effectively guide resource allocation decisions. More importantly, the promotion of specific sectors or industries implies the relative discouragement of others, particularly agriculture.

17. The most effective way of dealing with distortions is to remove them but since this is not always possible, under some circumstances a case can be made for the adoption of compensatory incentives (e.g., export subsidies, tariff exemptions). In practice, however, the incentives commonly adopted and the criteria used to determine eligibility are costly to administer, often introduce new distortions without fully offsetting existing ones, and can have unintended economic consequences. For example, many governments subsidize exports to offset the anti-export bias of their protection systems. Export subsidies, however, seldom compensate fully for trade and exchange rate policies which effectively discourage exports, are financially costly, are frequently abused, and can lead to exports for which the country does not recover its costs of production. Despite attempts to encourage increased employment in the Philippines, the incen-

tive system subsidized capital to a greater extent than labor. For new projects, accelerated depreciation, import tax exemptions, and tax credits were estimated to have reduced the user cost of capital by at least 40%. Deduction of training expenses, in contrast, reduced labor costs by only 4% (Galenson, 1984).

18. Most surveys of foreign firms suggest that foreign investment incentives, as they are generally implemented, exert a relatively minor influence on the investment decision-making process.³ Special tax incentives appear to be particularly inefficient; the benefits to investors are generally smaller than they appear and the costs to the host country may be greater than is immediately obvious. To the extent that special tax incentives are redundant, they confer benefits to selected investors, which would have invested anyway, at the implicit cost of taxing other investors or taxpayers more heavily. Investors may prefer moderate taxes coupled with fair enforcement to highly concessional short-term rates followed by high taxes imposed in a discriminatory or arbitrary manner. Tax instruments operating on a broad base allow the market to determine which sectors and projects offer the most economic investments. Indonesia recognized this fact when it eliminated special tax incentives in favor of lower tax rates.

19. Administrative Systems. The host country's administrative procedures for the implementation and regulation of its foreign investment strategy are also important. Bureaucratic barriers and the uncertainty created

3/ An exception is Guisinger (1985) who concludes that incentives do influence the location of foreign investment. Guisinger, however, includes import protection as an incentive whereas most other surveys do not treat it as a specific foreign investment concession.

by the arbitrary application of screening procedures and incentives are major deterrents to foreign investment. Potential foreign investors are usually attracted by having from the start, clear rules of the game which are applied efficiently and uniformly. Although the case-by-case approach is meant to deal with the redundancy issue by granting incentives only to firms which would have not invested otherwise, there is no satisfactory method of establishing such causality. Outcomes will depend on the relative skills and bargaining strengths of administrators and investors. A case-by-case or discretionary system, however, places a heavy burden on scarce administrative capacity in the host country, is time-consuming and costly for investors, is more susceptible to corruption than an automatic approach, and is fraught with rent-seeking activities. Moreover, the benefits that detailed, ad hoc regulations are designed to capture may not materialize if those that administer them, even if honest, have not sufficient time or expertise to administer them effectively. While most developing countries rarely approximate a fully automatic procedural system, the extent to which discretionary elements are removed can be a major influence on foreign investment and the countries' benefits from it.

20. Promotion. A number of developing countries have established investment promotion centers abroad and in their countries to provide information on the opportunities for foreign investment. These centers can supply recent economic information as well as details of relevant foreign investment regulations and procedures. In some cases, they can also provide a range of pre-investment services, carry out preliminary screening of potential investments, assist investors in developing local contacts and obtaining the necessary administrative approvals. Although promotional activities can be useful, especially when a country's economic conditions

and prospects are improving, such activities can be costly and often duplicate information already available. No amount of skillful promotion can substitute for sound economic policies and efficient administrative procedures, and in fact may be detrimental when the promotional message does not match economic realities.

III. BANK GROUP INVOLVEMENT IN FOREIGN INVESTMENT PROMOTION

21. A major part of Bank Group involvement in support of foreign investment policy reforms is carried out through adjustment lending, economic and sector work, informal policy advice, and the activities of IFC. In addition, the recently-established Multilateral Investment Guarantee Agency is expected to play an important role in improving the foreign investment climate by insuring investors against certain types of political risk.

Adjustment Lending

22. To the extent that adjustment lending supports improvements in macroeconomic and sectoral policies, and thus the overall investment climate, it increases the ability of the host country to attract and to benefit from foreign investment. Foreign investment policy reform, however, has not been an important component of adjustment lending. Conditions directly related to foreign investment are infrequent and, when included, tend to be less specific than those in other policy areas. In most cases, host countries are encouraged to be more open to foreign investment and to attract investors through institutional reforms, streamlining of administrative procedures and, less frequently, changes in incentives. In all cases, policy reforms do not appear to represent a major shift in countries' stance toward foreign investment.

23. Structural Adjustment Loans (SALs). Objectives and conditions dealing specifically with foreign investment were included in only 10 of the 34 SALs approved by the end of CY1985. The most frequent condition is the creation or reform of a government agency charged with promoting foreign investment or facilitating the investment approval process. The Jamaica SAL I proposed the creation of a National Investment Promotion Company and the setting up of bilateral business groups to identify and develop investment opportunities in the country. The Cote d'Ivoire SAL II supported the creation of an Industrial Promotion Bureau while the Mauritius SAL I called for the appointment of investment promotion consultants in order to impart greater dynamism to the promotion of investment overseas. The Mauritius SAL II required the establishment of an Export Development and Investment Authority. Panama's SAL I and Turkey's SAL III stated their support for previous government efforts to create institutions responsible for promoting foreign investment.

24. A related and also frequent objective is to simplify approval procedures and reduce red tape for foreign investment. Often, the intention is to create a "one-stop" or "one-window" institution for investment approvals. The Jamaica National Investment Promotion Company, supported by SAL I, is to be a "one-stop" promotion agency that will centralize all dealings with foreign investors, coordinate bureaucratic approvals and ensure speedy processing. The Korea SAL II required a simplification of approval procedures, including replacing the positive list of industries open to foreign investment with a negative list where foreign investment is prohibited or restricted, and a reduction in the approval period for new and additional foreign investments.

25. Specific policy reforms were included in only a few SALs. For example, Panama SAL I proposed linking simplified export incentives for foreign investment to employment creation. The most comprehensive set of foreign investment policy reforms is contained in Korea's SAL II, which endorsed previous government measures to: increase the number of industries in which foreign investment is permitted; relax ownership restrictions by raising the maximum foreign share-holding for selected industries from 49% to 100%; and reduce minimum capital requirements.

26. Conditionality involving industrial sector and trade policies are a common element of most SALs. Although not specifically directed at foreign investment, many of the sector reforms are relevant to foreign investors, especially those dealing with investment code and incentives reform. The actual impact on foreign investment will depend on the extent to which each country's investment regulations approach equal treatment for foreign and domestic investors. Investment code reform was included in 11 of the 34 SALs approved. Generally, policy reforms are not clearly spelled out but tend to appear more as statements of intent to clarify, simplify, or rationalize existing guidelines on the regulation of investment and the application of incentives. In a few cases, the intention is to make incentives automatic rather than discretionary (Mauritius SAL I, Panama SAL I). The most detailed investment code and incentive reforms were those for Philippines II and Thailand I. The Philippines SAL II proposed replacing the large number of fiscal incentives with a smaller number of new incentives. The Thailand SAL I proposed to review the existing system in order to: encourage export expansion relative to import substitution; reduce the capital bias in many projects; and increase the automaticity in the application of procedures.

27. Sector Adjustment Loans. Conditions relating to foreign investment are infrequent in sector adjustment loans and most often involve reforms not specifically directed at foreign investment. As with SALs, sector adjustment loans support reform of existing regulations in order to improve the climate for foreign investment, particularly in export-related industries, or they encourage simplified investment review procedures and increased automaticity. The Costa Rica Export Development Loan included a technical assistance component to assist a government agency to develop and execute a program for the promotion of foreign investment in export industries. The Ghana Second Reconstruction Imports Credit assisted in the preparation of a new investment code which would provide legal protection against expropriation and guarantee the repatriation of capital, profits and approved fees. The Madagascar Industrial Assistance Project supported a revision of the investment code to make the granting of benefits for priority investments more automatic. In the Pakistan Energy Sector Loan, the Bank supported the adoption of a new gas producer pricing formula designed to attract foreign investment in exploration. It also encouraged the Government to participate, as minority partner, in joint-ventures in the oil and gas sector.

Economic and Sector Work, and Policy Dialogue

28. The Bank's advice and analysis of foreign investment policies is most frequently channeled through country economic memoranda and industrial sector reports, as well as informal discussions within the context of the country policy dialogue. The Bank's analysis of foreign investment tends to be brief and generally focuses on the need to reform investment codes and improve administrative procedures. The 1982 economic report on Jamaica, although noting recent progress in attracting foreign investment,

identified the complexity of Jamaica's public sector as a major constraint on foreign investment. The report called for: rationalization of public administration, including the simplification and reduction of statutes and regulatory requirements; consolidation and elimination of a substantial number of public agencies; and a sharper demarcation of responsibilities among those that remain. In Somalia, while recognizing that the country cannot expect a large inflow of foreign investment, the 1985 economic report suggested clarifying and increasing the automaticity of incentive eligibility as well as removing restrictions on profit repatriation.

29. Although economic and sector work (ESW) on industrial policies is extensive, only rarely has the Bank carried out a systematic review of a country's foreign investment policies, either as a self-contained study or as a major component of an industrial sector report. Two exceptions are Pakistan and Indonesia. The 1985 report, *Private Foreign Investments in Pakistan*, provided a detailed review of policies and regulations, recent trends and patterns in investment flows, and a set of policy recommendations. The report's major recommendations included: adoption of equal treatment for investment approval in selected industries; establishment of a "one-stop" approval process; review of industrial location policies; reform of foreign investment incentives to levels comparable to those of other Asian countries; and a more liberal policy toward royalty and technical fee agreements. Indonesia's 1981 *Industrial Sector Report* contains an extensive analysis of foreign investment. Citing the past and potential importance of foreign investment in Indonesia, the report reviews foreign investment policies, the impact of the changing policy environment, and makes detailed policy recommendations which emphasize the high economic costs of government regulations and intervention. Specific proposals are

made for the role of the Investment Coordinating Board, investment and labor policies, equity sharing, incentives reform, and financial policy reforms in areas relevant to foreign investment.

30. In 1980 the Bank and UNDP sponsored a study on the investment incentive system of Thailand. This report differs from most Bank approaches in that it supported a somewhat more restrictive stance toward foreign investment. For example, the report is concerned with: excessive reliance on foreign technology and its inhibiting effect on the development of indigenous technology; accelerating the substitution of local for foreign inputs; and unbundling of foreign technology, management and capital flows. In order to encourage local ownership and control, it called for greater attention to the areas where foreign investment is required and ensuring local ownership and control exists unless it can be clearly demonstrated that foreign control is essential to ensure necessary technology transfers, capital inflows, or market access. The government was also urged to diversify its promotional efforts toward countries other than the U.S. and Japan, which already accounted for a large share of foreign investment.

31. In East Africa, industrial sector reports have proposed incentive reforms, improvements in approval procedures and increased automaticity. For example, the 1985 report on Rwanda's manufacturing sector emphasized the inconsistent and highly discretionary system of granting special benefits to foreign investment. It proposed a simplification of approval procedures, clarification of, and increased automaticity in, the granting of incentives. It also suggested that pending the implementation of proposed tariff reforms no exemption of import duties should be granted. The 1985 industrial finance report for Kenya noted that while the government's

efforts to encourage Kenyanization were understandable, it was not clear that limitations on foreign investment were achieving the intended objectives and generated negative externalities with respect to local borrowing limits. However, it concluded that under existing conditions it would be appropriate for the government to maintain borrowing and repatriation restrictions in order to prevent financial crowding out of local firms and capital flight. The report also suggested that the promotion of joint ventures would be consistent with the government's objectives of both increasing foreign investment flows and encouraging local participation.

32. In West Africa, the IDJ division has been actively involved in advising member countries on investment code reforms to reduce distortions, both through formal ESW and informal policy discussions. The most extensive involvement has been in Cote d'Ivoire where the division's work has provided background for investment code reforms included in the SAL program. Investment code reforms have also been suggested for Ghana, Guinea, Senegal and Togo. In Latin American countries, the Bank has received fewer requests for advice on foreign investment policies or investment code reviews. There appear to be two major reasons. In Latin America, foreign investment tends to be politically sensitive and the larger countries already possess local expertise to evaluate and implement foreign investment policies.

33. The issue of foreign investment also arises in the Bank's efforts to encourage privatization of state-owned enterprises. An important obstacle to privatization is the narrow field of potential buyers that are generally acceptable to divesting governments. In many countries foreigners are ruled out as purchasers (e.g., Bangladesh, Brazil, Pakistan). In others, the share of ownership that foreign nationals can acquire is

limited by law or in practice. In dealing with this issue, the Public Sector Management Unit has not explicitly recommended sales to foreigners. Foreign participation, however, has been an implicit issue in some cases where a foreign party was the most likely or sole investor (e.g., Panama). ESW generally does not address this issue or treats it only in general terms. For example, the 1985 industrial finance report for Kenya cautiously suggested that encouraging increased participation by foreign firms and improved incentives for foreign equity inflows could become pertinent if the government eventually decided to divest any significant part of its equity holdings in industrial concerns to foreign firms

The Baker Initiative

34. The need to increase foreign investment is part of most medium-term adjustment strategies under the Baker initiative. Specific policy reforms vary by country but generally include: reform of investment codes and incentives; streamlining of investment approvals, and incentives; equal treatment for foreign and domestic investors; promotion of joint ventures in the energy sector; and reduction of risk associated with currency convertibility and expropriation. For example, the strategy paper for one of the Baker countries identifies unclear rules of the game for foreign investors, delays in investment approvals, and the limitation of 49 percent foreign ownership as important constraints to foreign investment. The paper recommends placing three or four investment proposals on a fast-track approval path every year, in order to improve the country's image among foreign investors. Over the medium term, there would be a need to review investment, labor, and other laws to broaden, clarify and simplify the terms and conditions under which foreign investment is permitted. Other

policy changes would include the acceptance of international arbitration for investment disputes and the establishment of internationally acceptable rules for patents and copyrights.

The International Finance Corporation (IFC)

35. IFC has played an important role in attracting foreign investment to developing countries, especially to countries and sectors that generally have not been the largest recipients of direct investments. By providing complementary financing, IFC acts as a catalyst for foreign investment in specific projects. Since 1974, IFC has been involved in the financing of over 150 joint ventures between foreign and domestic private investors. This accounted for about 25 percent of the total number of projects in which IFC made investments during the period.

36. IFC's efforts to attract foreign investment often extend beyond a purely financial role. In addition to assistance in structuring project concepts and finding foreign partners, IFC has worked with governments to develop appropriate policy frameworks. In order to expand its advisory function, IFC recently created the Foreign Investment Advisory Services (FIAS) to provide assistance in four main areas: (i) formulating a general framework of policies and institutions to promote and regulate foreign investment; (ii) establishing the policies that will facilitate direct investments in specific priority industries; (iii) devising foreign investment promotion strategies; and (iv) developing policies to govern technology transfers. FIAS can also help countries to implement its recommendations. A fee is agreed for each assignment but a significant portion may be covered by third party financing.

37. Another recent IFC innovation is the Guaranteed Recovery of Investment Principal (GRIP), primarily designed to reduce investment risks for equity investors in developing countries. Under GRIP the investor

provides the funding while IFG makes the investment in its name and assumes the full risk of loss of principal. Dividend income and capital gains on the investment are shared and, at the end of an agreed period, the investor can decide to become full legal and beneficial owner of the shares, or disengage from the investment with principal intact.

The Multilateral Investment Guarantee Agency

38. The need to reduce non-commercial risks faced by foreign investors and the seeming under-provision of risk insurance by private markets and official government agencies, have prompted the Bank to create the Multilateral Investment Guarantee Agency (MIGA). The objectives of MIGA will be to improve and stabilize conditions for productive foreign investment in developing member countries and to enhance the benefits of such investments to host economies. These objectives are to be met by: (i) offering investment guarantees to investors from both industrialized and developing countries against non-commercial risks; (ii) providing a consultative forum for the exchange of experience among members on investment policies and program issues; (iii) negotiating agreements related to guaranteed investments; and (iv) technical assistance and research services. MIGA will also disseminate information on investment opportunities in developing member countries to potential foreign investors.

IV. EVALUATION OF THE BANK'S APPROACH

General Approach

39. Although the promotion of foreign investment has not figured prominently in Bank policy advice and structural reform programs, the Bank's approach has been generally appropriate by: (i) focusing on improving the

general investment climate through the adoption of an appropriate macro-economic and sectoral policy framework; (ii) encouraging governments to reduce controls on foreign investment; (iii) emphasizing the benefits of clearer, simpler, and less discretionary administrative procedures; and (iv) generally placing the issue of foreign investment incentives within the wider context of overall investment and trade incentive reforms. In addition, the more important role assigned to foreign investment under the Baker initiative, increasing support by IFC, and the establishment of MIGA are expected to improve the prospects for increased foreign investment flows to developing countries.

40. The adoption of a domestic policy environment that sets macro-economic and sectoral conditions favorable to savings and investment, and allows input and output prices to reflect real scarcities more closely, is the most effective way of maximizing net benefits to the host economy. Bank assistance to improve economic management, reduce economic distortions, and carry out institutional reforms is its most important contribution to the promotion of efficient foreign investment. To this extent, the Bank's emphasis on structural adjustment programs and policy reforms to improve the supply response of productive sectors is appropriate, even when direct measures to attract foreign investment are not explicitly encouraged.

Institutional Reforms

41. Direct Bank involvement in the promotion of foreign investment has focused on the need for institutional reforms in two major areas: administrative procedures and promotional activities. Most of the institutional reforms recommended or supported by the Bank aim to improve or streamline administrative procedures for the implementation of existing foreign

investment policies. Although the desirability of increasing automaticity in both investment approval and incentive eligibility is frequently mentioned, it is usually limited to stating general principles or endorsing government efforts to reduce the discretionary element in investment codes. Only in a few cases does Bank analysis and conditionality target specific regulations or incentives which can be made less discretionary in their application.

42. Given the considerable influence of bureaucratic barriers on the overall investment climate, the Bank's emphasis on reducing barriers to entry and simplifying administrative procedures is clearly appropriate. However, three suggestions can be made for strengthening future Bank analysis and advice. First, greater emphasis should be placed on the severe burden imposed on many countries' administrative capacity by a highly detailed and discretionary system of investment regulations. In many cases the complexity and monitoring requirements of regulations designed to implement foreign investment policies bear little relationship to the country's administrative capabilities. Although the opportunity cost of scarce administrative expertise devoted to regulatory functions is frequently mentioned in Bank analysis, it needs to be stressed and documented in greater detail, especially in smaller countries with skilled manpower constraints and where regulations are clearly redundant or distortionary.

43. Second, Bank support for less discretionary systems could benefit from greater specificity. Although many governments attempt to introduce more automatic procedures, their efforts are often derailed by the bureaucracy itself, which generally has a vested interest in maintaining a highly regulated system. Bank analysis which clearly identifies redundant and inefficient regulations can considerably strengthen the prospects for

administrative reforms. In addition, two approaches offer considerable scope for gradually introducing the principle of automaticity in countries' regulatory systems. The first approach involves adopting a negative list, which specifies only those industries where foreign investment is excluded or subject to special regulations. As was done in Korea, the initial list can be quite extensive but once the principle is accepted, efforts can concentrate on gradually reducing the number of industries subject to discretionary rules. A second approach involves replacing approval requirements by a reporting or registration system. For example, in Korea firms wanting to import technology report their intention to the relevant ministry, which has 20 days to respond or the import is considered approved. In Pakistan, firms need only register royalty and technical fee agreements and no prior approval is required if they conform to published, albeit restrictive, guidelines. Firms seeking exceptions to the guidelines must go through a cumbersome approval process at the Central Bank as well as the relevant ministries.

44. Third, administrative procedures do not always follow the rules and guidelines set by legislation and official government policies. In some countries, the gap between official rules and their practical application can be considerable. For example, some corporations granted tax incentives under Zaire's Investment Code complained that they were effectively called on to pay the taxes (Fitzgerald, 1985). For this reason, Bank analysis of bureaucratic constraints on foreign investment can often be strengthened by reference to the manner in which administrative practices are actually applied. Clearly, this is not an easy task and cannot be addressed comprehensively in all countries. However, case studies and selected examples may provide valuable insights on the actual

problems faced by investors. Where governments are attempting to streamline regulations on foreign investment, imparting a more practical tone to the analysis of administrative barriers would enhance the effectiveness of the Bank's policy dialogue.

45. The Bank's approach to promotional activities has been supportive of government intentions to establish or strengthen promotion agencies, often with private sector participation. While some amount of promotion may be appropriate, perhaps for countries where the investment climate is clearly improving, the Bank has not attempted to evaluate the effectiveness of various promotional activities. The Bank should encourage governments to monitor closely the cost-effectiveness of their promotional activities and to the extent that efforts are being made to streamline administrative procedures, emphasize the investment facilitation rather than the marketing aspect of promotion agencies. Care should also be taken to avoid raising unrealistic expectations about the effectiveness of promotion measures when not complemented by steps to improve the host country's investment climate.

Incentives

46. The Bank's emphasis on improving economic management and reducing bureaucratic barriers rather than increasing or fine-tuning incentives to attract foreign investment is justified. Where incentive changes are proposed or endorsed, Bank recommendations and analysis are generally part of a wider package of investment and trade incentive reforms. In most cases, governments are encouraged to move closer to equal treatment for foreign and domestic investors and in a few instances to bring incentives more in line with those of other developing countries which compete for the same type of foreign investment. Only in the case of export processing zones

are foreign investment incentives treated separately from the domestic policy environment, but in some cases the government is advised to extend similar concessions to domestic producers.

47. Two suggestions can be made to strengthen the Bank's analysis of investment incentives. First, although it is appropriate to evaluate investment incentives relative to trade policies, it is also important to view them as part of tax policies and, if relevant, public expenditures. Too often, incentives in investment codes are evaluated against alternative codes, with little or no analysis of the implications for countries' overall fiscal policies. Second, advising countries to make their incentives comparable with those of competing countries may be detrimental to developing countries as a whole. To the extent that competition among countries in investment incentives influences the location of economic activity, it provides leverage for investors to minimize their tax payments. Although each country would appear to maximize its level of investment, the competition may lead to a net transfer from developing to developed countries, without increasing total investment. If marginal changes in incentives do not influence the location of investment, revenues foregone or expenditures incurred are a net loss to the host country.

V. FOREIGN INVESTMENT POLICIES: SOME GENERAL PRINCIPLES

48. The objective of the Bank's advice on foreign investment policies should not be to increase the flow of foreign investment at any cost, but rather to ensure that whatever investments take place have high economic rates of return. Since any investment can be made financially profitable given sufficient concessions or subsidies, foreign investment policies

should not be judged in terms of the investments they may help to attract, but on their contribution to a more efficient utilization of resources. Thus, in some instances Bank advice may well discourage foreign investment over the short-to-medium term. For example, Bank support for trade liberalization, elimination of special concessions, or easier entry into domestic markets, may act as a disincentive to future investors. Concerns over the efficient allocation of resources, however, should override the desirability of raising foreign investment levels.

49. This paper has argued that for most countries, the unbundling of foreign investment, and negotiating terms of entry and performance turn out to be very difficult to do effectively and run the risk of creating greater distortions than they offset. This does not imply that countries cannot, or have not, succeeded in these efforts--Japan, Taiwan, Korea, and Brazil appear to have done so--only that very few countries have sufficient leverage and administrative skills to do so effectively. Important exceptions may be investments in natural resource industries or very large single projects where the host country holds a particular advantage. In such cases vigorous bargaining over entry and performance, if necessary with the assistance of outside expertise, may be advisable.

50. The fact that foreign investment is almost invariably associated with imperfect markets suggests that a major focus of foreign investment policies should be to increase competition in domestic markets. Trade liberalization, freer factor markets, and lower entry requirements can reduce substantially the oligopolistic advantages enjoyed by most foreign investments as well as increasing the economic efficiency of such investments. Other measures to increase competition, such as: antitrust legislation, limits on restrictive practices in patents and licensing (as Brazil

and Mexico have done effectively), and public efforts to support local research and development, may be feasible for the larger and more advanced developing countries.

51. As a general rule, a strategy to promote foreign investment should place less emphasis on special incentives to attract foreign investment than the creation of a sound investment climate. The two most important influences on the investment climate which are under the control of the government are the general economic policy framework, both at the macro-economic and sectoral levels, and the administration of rules and regulations governing foreign investment. Improved economic policies and streamlined administrative procedures should precede and, in fact, be the major selling points of foreign investment promotion policies.

52. In most countries, however, reforming economic policies and administrative procedures can be difficult and protracted. Moreover, most countries will choose to maintain a combination of incentives and regulations on foreign investment to serve economic, political or social objectives. In the absence of wide-ranging policy and administrative reforms, a number of general principles can be suggested as a guide: First, incentives should be simple. Direct, clear, and temporary incentives are generally preferable to indirect and structural incentives. Second, incentives should be neutral. Incentives which are neutral among sectors, especially agriculture relative to manufacturing, and among industries, should be preferred. Third, the application of incentives should be automatic. Where discretion is retained, it should be bound by clear and published criteria to reduce investors' uncertainty and arbitrariness on the part of administrators.

53. Clearly, these are general principles only and valid exceptions may exist. In all cases, however, the analysis of foreign investment incentives should be framed within a wider evaluation of the country's overall tax, trade, and investment incentives structure. Since most countries do not apply equal treatment to foreign and domestic investors, the decision to relax foreign investment regulations should consider the impact on existing distortions and domestic markets. Major changes in a country's foreign investment policy may raise questions of sequencing when combined with other economic liberalization reforms. Analysis of foreign investment policies needs to consider the timing of reforms aimed at increasing incentives and/or establishing equal treatment for foreign and domestic investors when there is also a need to liberalize trade, the capital account, and domestic capital markets. The recent literature on the sequencing of liberalization suggests some general principles applicable to foreign investment. In order to avoid compounding existing distortions, macro-economic and sectoral reforms should be implemented before substantially liberalizing foreign investment policies. Trade liberalization in particular should precede the offering of additional incentives or removal of entry barriers to foreign investment. Extending this principle to the domestic capital market it can also be argued that liberalization of the domestic financial system should precede the lifting of restrictions on local borrowing by foreign investors, especially when there are major interest rate distortions.

54. The principle of automaticity should apply also to the host country's administrative procedures for the regulation and implementation of foreign investment policies, especially in relation to entry requirements and incentive eligibility. Emphasis should be placed on the opportunity

costs and efficiency losses generally associated with highly regulated and discretionary administrative procedures. Excessive bureaucratic barriers should be eliminated or minimized, particularly where they are redundant and involve overlapping responsibilities. Regulations should lend themselves to being phased out once clearly defined market objectives have been achieved. Where government agencies are charged with both regulatory and promotional functions, as is sometimes the case with investment or export promotion agencies, the possibility of separating the two activities, preferably to be undertaken by different agencies, should be evaluated. Although not fully eliminating political risk, the adoption of government guarantees against expropriation or the willingness to submit disputes to arbitration can have a favorable impact on the perceptions of foreign investors.

55. Investment promotional activities should be as specific as possible, cost effective and should be designed to facilitate foreign investors' dealings with the host bureaucracy and establishing contacts with the local business community. Promotional activities should be evaluated and adjusted regularly to take account of changes in markets and host countries' economic and business environment. Expectations concerning the effectiveness of promotional activities should not be exaggerated. The impact of promotion is relatively small compared to other factors which are involved in the investment decision process.

An Introduction to the Literature on Foreign Investment

1. The following list is intended as a brief introduction to the extensive literature on foreign investment. References are grouped according to major topics: (i) general; (ii) costs and benefits, (iii) technology; (iv) industrial structure; (v) balance of payments; (vi) incentives; (vii) promotion; (viii) home country policies; and (ix) data and definitions.

General

2. A good general introduction and review of the literature on foreign investment can be found in:

- Caves, R. E. Multinational Enterprise and Economic Analysis. Cambridge: Cambridge University Press, 1982.

Other general references include:

- Dunning, J. H. (ed.) Economic Analysis and the Multinational Enterprise. London: Allen & Unwin, 1974.
- Kindleberger, C.P. American Business Abroad: Six Lectures on Direct Investment. New Haven: Yale University Press, 1969.
- Vernon, R. Sovereignty at Bay: The Multinational Spread of U.S. Enterprises. New York: Basic Books, 1971.

Costs and Benefits

3. A full discussion of the costs and benefits of foreign investment for host developing countries can be found in:

- Biersteker, T. J. Distortion or Development? Contending Perspectives on the Multinational Corporation. Cambridge: MIT Press, 1978.
- Lall, S. and P. Streeten. Foreign Investment, Transnationals, and Developing Countries. London: MacMillan, 1977.
- Newfarmer, R. Transnational Conglomerates and the Economics of Dependent Development. Greenwich: JAI Press, 1980.
- Ranis, G. The Multinational Corporation as an Instrument of Development. New Haven: Yale University Press, 1976.
- United Nations Centre on Transnational Corporations. Transnational Corporations in World Development: Third Survey. New York: UN, 1983.

Technology

4. Issues relating to the diffusion of technology through foreign investment are covered in:

- Lall, S. and P. Streeten (1977).
- Morley, S. A. and G. W. Smith. "The Choice of Technology: Multinational Firms in Brazil." Economic Development and Cultural Change (25), January 1977, pp. 239-64.
- Moxon, R. W. "The Cost, Conditions, and Adaptation of MNC Technology in Developing Countries," in The Economic Effects of the Multinational Corporation, edited by R. G. Hawkins. Greenwich: JAI Press, 1979.
- Newfarmer, R. (1980).
- Waitsois, C. "The Revision of the International Patent System: Legal Considerations for a Third World Position." World Development. February 1976, pp. 85-89.
- Westphal, L., Y. Ehee and G. Pursell. "Korean Industrial Competence: Where It Came From." World Bank Staff Working Paper No. 469. Washington, D.C.: World Bank, 1981.

Industrial Structure

5. A comprehensive analysis of the contribution of industrial organization theory to the evaluation of the costs and benefits of foreign investment, as well as case studies of international industries in Latin America can be found in:

- Newfarmer, R. (ed.) Profits, Progress and Poverty. Notre Dame: University of Notre Dame Press, 1985.

Other works dealing with industrial structure and multinational enterprises include:

- Caves, R. E. (1982).
- Lall, S. "Transnationals, Domestic Enterprises, and Industrial Structure in Host LDCs: A Survey." Oxford Economic Papers (30), July 1978, pp. 217-48.

Balance of Payments

6. A number of studies examine the effects of foreign investment on the host country's balance of payments, including: profit repatriation, foreign borrowing, import and export propensities, and intrafirm trade. An

interesting approach is adopted in the IMF paper, which focuses on the relationship of foreign investment to other financial flows and its influence on the adjustment process in developing countries.

- International Monetary Fund. "Foreign Private Investment in Developing Countries: A Study by the Research Department of the International Monetary Fund." Occasional Paper No. 33. Washington, D.C.: IMF, 1985. (A summary of the paper can be found in: D. Goldsbrough. "Foreign Direct Investment in Developing Countries." Finance and Development 22:1, March 1985, pp. 31-4.)
- Jenkins, G. P. "Taxes and Tariffs and the Evaluation of the Benefit from Foreign Investment." Canadian Journal of Economics (12:3), August 1979, pp. 410-25.
- Lietaer, B. A. Europe + Latin America + The Multinationals: A Positive Sum Game for the Exchange of Raw Materials and Technology in the 1980s. Farnborough, England: European Centre for Study and Information on Multinational Corporations, 1979.
- Waitsoos, C. Intercountry Income Distribution and International Enterprises. Oxford: Clarendon Press, 1974.

Incentives

7. Incentive policies of host countries and their impact are covered in a large number of references. In most cases they provide comprehensive overviews of the types of incentives used and general suggestions for reform.

- Billerbeck, K. and Y. Yasugi. "Private Direct Foreign Investment in Developing Countries." World Bank Staff Working Paper No. 348. Washington, D.C.: World Bank, 1979. (Prepared as a background study for the 1979 World Development Report.)
- Brecher, R. and C. Diaz Alejandro. "Tariffs, Foreign Capital and Immersizing Growth." Journal of International Economics, 7, November 1977, pp. 317-22.
- Galenson, A. "Investment Incentives for Industry: Some Guidelines for Developing Countries." World Bank Staff Working Paper No. 669. Washington, D.C.: World Bank, 1984.
- Guisinger, S. and associates. Investment Incentives and Performance Requirements: Patterns of International Trade, Production and Investment. New York: Praeger, 1985.

8. Survey results on the effectiveness of incentive policies are quite numerous. For example:

- Balasubramanian, V. N. "Incentives and Disincentives for Foreign Direct Investment in Less Developed Countries." Weltwirtschaftliches Archiv, 120:4, 1984, pp. 720-35.
- Fitzgerald, B. "Investment Incentives in Zaire." GPD Discussion Paper No. 1985-34, August 1985.
- Frank, I. Foreign Enterprise in Developing Countries. Baltimore: Johns Hopkins University Press, 1980.
- Hughes, H. and Y. P. Seng (eds.). Foreign Investment and Industrialization in Singapore. Canberra, 1969.
- Lent, G. "Tax Incentives for Investment in Developing Countries." IMF Staff Papers, Vol. 14, July 1967, pp. 249-321.
- Reuber, G. et al. Private Foreign Investment in Development. Oxford: Clarendon Press, 1973.
- Robinson, H. The Motivation and Flow of Private Foreign Investment. Menlo Park, California: International Development Center, Investment Series No. 4, 1961.

Promotion

9. Analysis of the need for promotional activities and the elements that contribute to successful promotion strategies are less frequently covered but some discussion can be found in:

- Guisinger, S. and associates (1985).
- Muller, R. E., A. L. Domike, and J. Holtzman. Trends in Foreign Investment in Developing Countries: Mexico's Relative Performance. Washington, D.C.: Economic Development Group, 1985.

Home Country Policies

10. Major issues relating to the policies of home countries toward foreign investment in developing countries are reviewed in:

- Billerbeck, K. and Y. Yasugi (1979).
- International Monetary Fund (1985).
- Kroeller, E. "The Experience of OECD in Promoting Investment Among OECD Countries and Between them and Developing Countries," OECD, May 1978.

Data and Definitions

11. The IMF Balance of Payments Manual defines foreign direct investment as investment made to acquire a lasting interest in a foreign enterprise with the purpose of having an effective voice in its management. Since in practice investors' motives are difficult to establish, many countries set a minimum proportion of foreign ownership of the voting stock (generally between 10% and 25%) as evidence of direct investment. Equity investments in enterprises below the minimum are classified as portfolio investment. This definition, however, is not sufficiently flexible to accommodate recent qualitative changes in foreign investment. In particular, a number of different management participation approaches (e.g. technical assistance agreements, long-term supply contracts, and production sharing) have emerged as alternatives to direct management control by the parent company. Thus, it is likely that traditional definitions based on equity participation underestimate actual foreign investment activity in developing countries.

Data on direct foreign investment can be obtained from: OECD, Development Cooperation; and IMF, Balance of Payments Statistics. Data problems and definitional issues are discussed in: Billerbeck, K. and Y. Yasugi (1979), Annex I; and IMF (1985), Appendix I.

Table 1: Composition of Financing Flows in Developing Countries, 1973-83
(billion US Dollars)

	1973	1974	1975	1976	1977	1978	1979	1980	1981	1982	1983
Net Direct Investment	4.2	5.1	5.3	5.3	5.3	7.2	9.4	8.9	13.1	12.6	9.3
Official Transfers	5.5	8.8	7.1	7.4	8.2	8.2	11.5	12.5	13.1	12.5	12.0
Official Net Long-Term Borrowing	5.7	7.8	11.8	12.8	12.7	13.7	16.9	19.4	24.3	23.5	24.5
Private Net External Borrowing	5.7	16.5	22.2	18.6	18.6	32.4	36.9	58.1	66.4	37.1	18.4
Other Sources	-0.5	0.6	-1.8	2.0	-2.8	-2.3	0.3	-5.8	-4.7	-4.5	-1.6
TOTAL	20.6	38.8	44.6	46.1	42.0	59.2	75.0	93.1	112.2	81.2	62.6
<u>Memo Items:</u>											
Direct Investment as a Share of Total Flows (%)	20.4	13.1	11.9	11.5	12.6	12.2	12.5	9.6	11.7	15.5	14.9

Source: IMF (1985), p. 4.

Table 2: Stock of Foreign Direct Investment and External Liabilities
in Developing Countries, 1973 and 1983

	<u>Stock of Foreign Direct Investment</u>		Average Annual Growth 1973-83	Total Outstanding External Debt 1983	Share of Foreign Investment in Total Gross External Liabilities 1983
	1973	1983			
	(billion US dollars)		(%)	(billion US dollars)	(%)
Brazil	7.5	24.6	12.6	88.0	21.8
South Africa	0.4	17.1	7.4	17.4	43.8
Mexico	3.1	13.6	15.9	89.4	13.2
Singapore	0.6	7.9	29.4	0.7	91.9
Indonesia	1.7	6.8	14.9	30.4	18.3
Malaysia	1.2	6.2	17.8	15.9	28.1
Argentina	2.5	5.8	8.8	44.4	11.6
Venezuela	3.6	4.3	1.8	35.1	10.9
Hong Kong	0.9	4.2	16.7	5.5	43.2
Chile	0.5	3.0	19.6	14.1	17.5
Philippines	0.9	2.7	11.6	23.9	10.9
Peru	1.0	2.5	9.6	12.4	16.8
Others	<u>35.1</u>	<u>101.0</u>	<u>11.2</u>	<u>458.4</u>	<u>13.4</u>
TOTAL	67.0	200.5	11.6	1,035.6	16.2

Source: IIF (1985), Appendix IV.

Foreign Investment Objectives and Policies in Selected Countries

Brazil

1. Of the countries that have adopted an open approach to direct foreign investment, Brazil has been the most successful in attracting and benefiting from foreign investment. The country's constitution guarantees equal treatment to foreign and domestic investors and, unlike most other countries, it does not screen foreign investment proposals. Brazil has no restrictions on profit remittances, has welcomed foreign investment into most of its manufacturing sectors, and imposes no equity restrictions. At the same time Brazil does not rely on a wide range of specific incentives to attract investment. The main incentive has been access to its large domestic market which has enjoyed moderate to high protection. In a number of cases, Brazil has also attempted to promote foreign investment in specific sectors (e.g., automobiles, shipbuilding, chemicals) by negotiating comprehensive programs with multinationals, which satisfied government objectives, such as types of foreign investment and technology transfers and the requirements of foreign investors, such as level of protection and availability of imported inputs. These efforts were mainly aimed at import substitution.

2. Brazil's approach to foreign investment began changing in the late 1960s. The government adopted a more export-oriented set of policies which changed the incentive system facing Brazil's manufacturing sectors. As a result, exports from foreign as well as domestic firms increased rapidly during the 1970s and 1980s. More recently, Brazil has become more restrictive toward foreign investment. There is now greater pressure to form joint ventures and the importation of technology has become more difficult when there are local substitutes available. The government now also imposes limits on royalties, fees, and license payments. This change in policy reflects Brazil's objective of reducing dependence on foreign technology and the country's increased confidence in its ability to develop and utilize its own technology.

Korea

3. During the 1970s the scale and pattern of direct foreign investment in Korea was controlled by the government through a comprehensive set of guidelines and regulations. Elaborate criteria were set up to screen applications so as to keep out projects which might offer significant competition in domestic or overseas markets to local firms, as well as projects which essentially provided only capital and not much technology. The level of foreign ownership was effectively limited to 50% by a plethora of guidelines which made it difficult to obtain approval for a majority foreign-owned venture. Furthermore, the minimum scale of investment was set at \$50,000 per project, and gradually raised to \$500,000 in 1979, to prevent small-scale, footloose investments seeking only to take advantage of Korea's low-cost labor in assembly and packaging operations. All con-

sidered, during this period Korea possessed one of the more forbidding environments for foreign investment in developing countries. Consequently, foreign investment played a relatively minor role in Korea's development.

4. Government policy toward foreign investment experienced a reversal in 1980 when, in an attempt to cope with an economic crisis featuring high inflation, negative growth, growing debt-service difficulties and a large balance of payments deficit, a broad-based program of trade and financial liberalization was adopted. Among the elements of this program were several measures to liberalize the regulations governing foreign investment. Since then the scope has been expanded and the procedures simplified. In particular, under a set of guidelines adopted in July 1984, an automatic approval system and a negative list system have come into operation which now make Korea one of the developing countries more open to foreign investment. Only 82 of Korea's 999 industrial sectors are prohibited to foreign investment and a further 215 are subject to strict restrictions. The remaining 660 sectors are now open. In the open sectors, a project is given automatic approval if the amount of foreign investment is not more than the equivalent of \$1 million and the ratio of foreign investment is less than 50%. In addition to more liberal guidelines for investment and the standard guarantees for repatriation, Korea now encourages foreign investment also through its trade and financial liberalization policies which permit greater flexibility in decisions regarding sourcing of inputs and disposition of outputs, in the use of financial facilities, in the management of liabilities and in foreign exchange dealings.

5. The improved environment for foreign investment since 1980 has shown encouraging results. During the two decades ending in 1981, the cumulative volume of direct foreign investment was around \$1.2 billion. Since then, the cumulative stock has more than doubled to \$2.6 billion. Korea's liberalization program should enhance its competitiveness and thereby make the country even more attractive to foreign investment.

Yugoslavia and Egypt

6. Yugoslavia and Egypt changed their approach to direct foreign investment during the past 20 years. Yugoslavia, in the late 1960s, and Egypt, in the early 1970s, decided to open their economies to foreign investment. A major motivation for Yugoslavia's 1967 legislation allowing foreign investors to invest directly through joint ventures was a dissatisfaction with licensing arrangements, which appeared to have been unsuccessful in transferring Western technology to the country. The government also expected that a more open approach would improve the competitiveness of Yugoslav enterprises and enable them to increase exports to the West. Direct investment was excluded from only a few sectors and the government also adopted a number of specific tax incentives to encourage foreign investment in less-developed areas of the country.

7. Egypt, like Yugoslavia, sought to encourage the transfer of technology, increase exports, and save foreign exchange through import substitution. A wide range of sectors were opened to direct foreign investment, with priority given to land reclamation, housing, tourism, manufacturing,

and animal husbandry. Foreign investment must be through joint ventures with the public or private sector, but, with the exception of certain sectors such as construction and banking, there are no strict percentage requirements for local participation. In order to encourage the transfer of labor skills and management expertise, the government imposes local employment requirements. Both countries excluded foreign ventures from their normal system of foreign exchange allocation, requiring firms to use a fixed percentage of whatever foreign exchange they earned for their import and profit repatriation requirements. After some time, both Egypt and Yugoslavia eased somewhat the foreign exchange requirements in response to complaints that it was discouraging foreign investment.

8. Despite having relatively large domestic markets, foreign investment in Egypt and, to a greater extent, Yugoslavia has fallen well below expectations. Although a number of specific country reasons have discouraged foreign investment, a major obstacle in both countries has been the lack of consistency between their foreign investment objectives and their macroeconomic policies. For example, both countries imposed a foreign exchange balancing requirement on foreign firms but their economic policies discriminated against exports. Technology transfers were also discouraged by the foreign exchange balancing requirement. In Yugoslavia it is likely that agricultural price controls destroyed the incentive for agro-industry investments which would have benefitted less-developed regions.