FOREIGN INVESTMENT INCENTIVES AND RESTRICTIONS IN DEVELOPING COUNTRIES: AN ANALYSIS OF WORLD BANK POLICY RECOMMENDATIONS

Kristin Hallberg (Consultant)

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Abstract

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In recent years the World Bank has advised member countries on how they could improve their policies toward private foreign direct investment, by means of policy conditionality in adjustment lending as well as economic and sector work. While recognizing the importance of a country’s overall macroeconomic and sectoral policies in determining the volume and benefits of foreign investment, this study reviews a more limited set of Bank recommendations aimed directly at influencing foreign investment flows, allocation, and the conduct of multinational firms, and evaluates selected policy instruments in light of the relevant literature. The analysis focuses on the conditions under which government intervention to influence the allocation of foreign investment has an economic (as opposed to political or social) justification, and on the expected cost and effectiveness of alternative policies. Some general guidelines are presented for the design of foreign investment policies in developing countries.
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I. INTRODUCTION

In recent years the World Bank has advised member developing countries on how they could improve their policies toward private foreign direct investment (hereafter referred to as "foreign investment"). Policy reforms have been included as conditions for structural adjustment and sector adjustment loans; recommendations have been made via economic and sector work; informal comments have been provided on investment code reforms proposed by the countries themselves. The proposed revisions in investment incentives and disincentives were intended to attract a greater volume of foreign investment as a source of needed external capital, to increase the benefits that the host country would derive from foreign investment, and to eliminate the distortionary effects of existing policies.

The purpose of this paper is to evaluate Bank recommendations with respect to foreign investment policy reform, attempting to answer the following questions: What has been the general philosophy that has guided policy recommendations? By what means was the Bank involved in making policy suggestions, and what recommendations were made? Were these recommendations sensible, given the policy objectives of the Bank and of the host country?

Issues that arise in any analysis of foreign investment in developing countries, and the literature relevant to an understanding of these issues, are extensive. This paper has therefore a limited scope. First, though we provide a brief review of the literature on the objectives and instruments of foreign investment policy, we do not attempt to identify optimal strategies for various groups of countries with different characteristics and objectives. Rather, the paper concentrates on selected policy instruments proposed by the Bank, evaluating them in light of the relevant literature. Second, while recognizing the importance of a country's overall macroeconomic and sectoral policies in determining the amount of foreign investment it receives and the benefits it derives from such investment, this study evaluates the more limited set of policies that are aimed directly at influencing foreign investment flows, allocation, and conduct. Finally, though the paper discusses the objectives that host countries try to achieve with foreign investment policy, it does not attempt to answer whether, on net, foreign investment is "good" or "bad" for host developing countries.

The paper begins with some background material intended to serve as a framework for an analysis of policy recommendations. The first section of the paper examines the conditions under which government intervention designed to influence the allocation of foreign investment and the conduct of multinational enterprises has an economic justification. The range of policy instruments used by governments, and factors which constrain an individual country's ability to employ these instruments, are examined. Evidence from the literature on the expected costs and effectiveness of foreign investment policies is presented. For countries whose objective is to attract a greater volume of foreign investment, some general guidelines for the design of foreign investment policy are
presented. To conclude this section, we consider the question of the appropriate sequencing of foreign investment policy reform in the context of economic liberalization.

Section III of the paper presents an overview of the ways in which the Bank has advised member countries on foreign investment policy reform—including conditions in structural and sector adjustment loans, formal and informal recommendations on changes in investment codes as part of economic and sector work, the Baker Initiative, etc. The general approach the Bank has taken, and the kinds of policies that have been recommended, are outlined.

Finally, the last section of the report takes a more detailed look at two policy directions representative of Bank suggestions: the reform of host-country institutions responsible for promoting and regulating foreign investment, and the principle of equal treatment for domestic and foreign investors. Evaluating these recommendations in light of the relevant literature, we discuss the economic justification for the recommended policy, and the expected costs and effectiveness of the policy change.
II. OBJECTIVES, POLICIES, AND POLICY EFFECTIVENESS

Host governments in developing countries use a wide variety of policies to induce, restrict, and control foreign direct investment and the behavior of multinational enterprises. The great array of observed foreign investment policies arises from differences in economic and political objectives, in the economic and political environment in which firms and governments operate, and in factors constraining the use of some policies. Hence it is impossible to identify a single "appropriate" set of policies that developing countries should direct toward foreign investors. Yet when the government's objectives can be identified, it should be possible to choose preferred policy instruments on the basis of efficiency, effectiveness, and cost.

FOREIGN INVESTMENT OBJECTIVES

From a broad perspective, it may be said that the objective of the host government is to maximize what it perceives to be the net benefit (i.e., gross benefits less costs) that accrues to the host country as a result of foreign investment.¹ The general categories of "perceived benefits" and "perceived costs" may include political, economic, social, and cultural effects; may accrue to the country in the future, with less than perfect certainty; may be directly, indirectly, or only circumstantially attributable to the operations of foreign firms; may be influenced by values thought to be irrational by outsiders (xenophobia, isolationism); and may be incorrectly perceived by uninformed policymakers. We do not attempt to validate some types of perceived benefits and costs (e.g., economic) and ignore or invalidate others (e.g., cultural); the kinds of issues that concern host governments are simply taken as given.

It will be useful, however, to distinguish between objectives that have an economic rationale, and those whose justification is noneconomic (political, social, cultural). The former are cases in which a net economic benefit is sought—increases in income to individuals or to the host government, possibly accruing over time and/or with some degree of uncertainty. Objectives justified on a noneconomic basis are those that, while not seeking net economic gains, nevertheless bring something of value to domestic citizens.

Economic Objectives

What kinds of foreign investment policy objectives are purely economic? A simple neoclassical model of international trade and investment would conclude that no kind of government intervention to influence the amount or composition of foreign investment could bring a net economic gain to the host country. Assuming a world of complete and competitive markets, flexible prices, and no barriers to international capital move-

¹ A full discussion of the costs and benefits of foreign investment for host developing countries is beyond the scope of this paper. On this subject, see Biersteker (1978), Lall (1976), Lall and Streeten (1977), Newfarmer (1980), Ranis (1976); Streeten (1971), and the United Nations (1983).
ments, international investment capital will flow from countries where it is abundant to countries where it is scarce. The result is an efficient international allocation of investment according to comparative cost conditions. Government intervention to alter this market-determined allocation, either by offering incentives or by imposing restrictions, will reduce world economic welfare as well as the economic welfare of the host country (though certain groups within the country might be made better off). The conclusion of this argument is that, under the assumption that prices fully reflect opportunity costs, government intervention to alter the allocation of foreign investment is never justified on the grounds of economic efficiency.

Given this argument, what explains the observed multitude of policies in developing countries directed toward foreign investment? One possible explanation is that the objectives of foreign investment policy are noneconomic: political, social, cultural, or irrational. Put more harshly, that such policies "are noneconomic responses reflecting the peasant, mercantilist, Populist, nationalist, xenophobic instincts that most people start life with or the irrationality that indulges in the fallacy of misplaced concreteness (or wants to have its cake and eat it too)." Another is that host governments are uninformed as to the true costs and benefits of the policies they adopt—for example, engaging in competitive incentive-bidding with other potential host countries, when the empirical evidence suggests that incentives are a relatively ineffective way of attracting foreign investors.

A third possible explanation for government intervention is that the assumptions of the comparative costs model are frequently violated, particularly in developing countries. Prices fail to accurately reflect opportunity costs; put another way, there exist economic distortions, or gaps between private and social costs or benefits. Under these conditions, some government intervention to influence foreign investment may be economically justified—meaning that net economic welfare is increased by the intervention. In addition, both the theoretical and empirical evidence strongly suggest that the markets in which multinational enterprises operate are not perfectly competitive, with the result that foreign firms are able to earn excess profits. Because of these violations of the assumptions of simple comparative costs models, there are three kinds of host government objectives that may be economically justified: (1) the desire to influence the production of externalities by foreign firms; (2) the desire to achieve second-best solutions: to compensate for the existence of other types of distortions in the economy that are difficult or impossible to remove in the short run; and (3) the desire to appropriate some or all of the excess profits accruing to imperfectly competitive foreign firms.

Externalities: An externality is a benefit or cost created by the foreign firm as a "byproduct" or "spillover effect" of its operations, for which it does not receive or pay compensation. For example, if a firm adds to the level of skill of local workers, and does not receive payment for this training by being able to pay below-market wages, it creates a "free" benefit as a byproduct of its operations. To the extent that the benefit


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can be appropriated by the workers themselves (in the form of higher future wages), they should be willing to pay for it by temporarily accepting below-market wages. If, however, the training is not paid for in the form of lower wages, and/or is diffused to other workers or firms in the economy and is not fully paid for in market transactions, a positive externality accrues to the country. The creation of externalities by foreign firms doesn't necessarily justify government intervention; in theory, however, the host government should be willing to provide investment incentives equal in value to the (expected present discounted) value of the positive externalities generated, less other costs introduced by the government policies.

Also justified on economic grounds is the objective of limiting the production of, or forcing compensation to be paid for, negative externalities that result from the presence or operations of foreign firms. If, for example, a country's failure to develop an indigenous innovative capacity is due to technological dependence on multinational enterprises, there may be a case for restricting the entry of foreign firms, or controlling the way in which technology is transferred. Multinational firms are sometimes accused of promoting dual labor markets, encouraging an elite, highly paid group of workers who have an incentive to remain in the foreign investment sector. The resulting uneven distribution of income, immobility of labor between sectors, and social divisiveness, may present a case for using government policy to influence the firm's employment practices.

Finally, it is often argued that multinational enterprises have a negative impact on host country economic efficiency, by reducing competition in the industries in which they operate. Government policy to reduce the monopolistic advantages of foreign firms may then have an economic justification.

Using this externality argument, the following foreign investment objectives may be justified on an economic basis:

- the training of labor, including management (a positive externality);
- the creation of backward and forward linkages with local firms (a positive externality);
- the transfer of technology (a positive externality);
- the preservation of environmental quality (limiting a negative externality);
- the achievement of scale economies (usually a positive externality);
- the generation of an optimum level of competition (usually limiting a negative externality).

In proposing policies to influence the production of externalities thought to be due to the activities of foreign investors, host governments must avoid errors of mistaken attribution. It may not be possible, for example, to infer that multinational enterprises cause higher levels of
concentration in the industries in which they operate. Multinationals may operate in sectors that contain few sellers, but the causes of high levels of concentration may lie elsewhere—in economies of scale, marketing, finance, or organizational efficiency. Many of the aforementioned externalities, while perhaps largely created by foreign firms, could equally well be created by local firms with similar characteristics.

What is the economic justification, then, for directing government policies toward multinationals per se, rather than at any and all firms that produce those externalities? In many cases it may be costly or impossible to attribute the production of externalities to particular firms. In those cases where the production of externalities seems to be highly correlated with the presence of multinationals, the least costly (not to mention politically feasible) course of action for the host government may well be to direct policies toward foreign investors as a group.

Second-Best Solutions: Government intervention to influence the actions of foreign investors may also be economically justified in order to compensate for the negative effects (on foreign investors or on the host country) of existing distortions, in situations where the distortions cannot easily be removed in the short run. Examples of this pattern are frequently found in developing countries where markets are distorted by protectionist policies, administered prices, or minimum wages. The resulting price signals in the market economy fail to lead to the desired amount or composition of investment, or the desired conduct and performance of firms. Though the "first-best" strategy might be to remove the distortion directly, the government may be unwilling or, at least in the short run, unable to do this. The following foreign investment objectives may be justified on the basis of second-best reasoning:

- the use of appropriate technology. Foreign firms are often accused of using capital-intensive techniques inappropriate to the relative labor abundance of developing countries. If the use of these techniques is caused by minimum wage policies that raise the price of labor above its shadow price, a first-best solution would be to remove the wage distortion; however, this may be politically impossible or conflict with other development objectives. A more feasible second-best strategy might be to impose employment requirements on firms.

- limits on the production of nonessential goods. If the private market value of some goods exceeds their social value, leading to "overproduction" in a social sense by the private market, the government may choose a second-best solution of limiting production by restricting foreign business entry into these industries.

4/ For a review of the evidence on the technology choices of multinational enterprises in developing countries, see Moxon (1979) and Lall (1978).
improvement in the balance of payments. Many host developing countries express the concern that, on balance, the operations of foreign firms will have a negative impact on the balance of payments, and there is a desire to limit this negative impact. Or, the existence of balance of payments problems may be caused by factors outside the operations of foreign firms, but it is believed that foreign firms can be manipulated to contribute to balance of payments improvement. The first-best strategy to achieve balance of payments objectives would be to use the appropriate macroeconomic policies (monetary, fiscal, and/or exchange rate policies) to eliminate external imbalances. However, this may be difficult because of short-run balance of payments rigidities and constraints facing developing nations. Often, the magnitude of the price changes and income reductions necessary to remove external deficits would be so extreme as to threaten economic stability and development efforts. For these reasons, the government may choose to use a second-best microeconomic solution to the problem by influencing the operations of foreign firms.

higher aggregate employment levels. Minimum wages or structural rigidities may prevent the attainment of full employment; employment requirements for foreign firms is a second-best solution to the problem of distorted labor markets.

protection of local infant industries. In this case, the distortion is really the absence of complete capital markets that would allow infant industries to borrow against their presumably profitable future. A better government strategy would probably be to temporarily subsidize infant industries (if justified on the basis of their economic contribution when mature). A second-best strategy is to restrict competition through tariffs or restrictions on foreign firms.

Capturing Excess Profits: Contrary to the spirit of simple models of perfect competition, the existence of foreign investment is best explained by the presence of firm-specific advantages: access to technology, markets, management, etc. The ownership of these advantages explains why multinational enterprises are associated with one or another kind of special market power. According to the Hymer (1976) view, the multinational enterprise is a monopolist or, more often, an oligopolist in product markets, investing in foreign subsidiaries in order to stifle competition and protect its market power. The oligopolistic foreign firm is able to earn excess profits, due to the lack of competition in product markets. A somewhat different view is provided by the "appropriability theory" of foreign investment, which sees firm-specific advantages as giving multinational enterprises monopoly power in markets for key productive inputs. The ownership of these assets gives the firm the power to reap economic rents.

5/ On this subject, see Kindleberger (1984), chapter 4.

A host government may be able to capture some or all of the excess profits gained by imperfectly competitive foreign firms. If the government is able to do so without removing all incentives for the firm to invest, the host country receives an increase in economic welfare by such intervention. Otherwise, the foreign firm may decide to close its subsidiary, and no excess profits remain to be captured.

Noneconomic Objectives

Our discussion of economic objectives does not imply that only economically justified intervention is "justified" in a larger social sense. The host country has political, social, and cultural objectives which it may try to achieve using policies that are costly in economic terms. For example, governments may seek to:

- internalize (nationalize) control over resource allocation;
- localize (that is, reduce dependency on external sources for) inputs—skills, technology, goods, research and development;
- diversify the sources of foreign inputs;
- protect national security;
- redistribute income (by economic or social class, by ethnic or religious group, by sector or region);
- induce or prevent changes in population distribution;
- prompt a greater sense of participation (for example, to force public or employee ownership and/or participation in decision-making);
- socialize the means of production;
- gain international prestige; and
- effect greater international integration, within or outside of the region. 7

While recognizing the validity of noneconomic objectives in the formation of foreign investment policy, the social benefits derived must be weighed against the economic costs of policies designed to achieve these objectives.

Obviously, not all objectives are consistent. For example, the desire to access relatively cheap foreign inputs may be inconsistent with the desire to reduce dependence on foreign sources of supply; the desire to modernize by importing capital-intensive technologies may conflict with the objective of increasing employment. In particular, governments need to be

aware of the trade-offs between economic and political costs and benefits. Not only must governments evaluate the consistency of one foreign investment objective with another, they must be concerned with the consistency between foreign investment objectives and the broader objectives of their development plans.

FOREIGN INVESTMENT STRATEGIES

For each political or economic objective, there is often a wide range of policies that, at some cost, would achieve that goal. The choice of a particular policy is then the result of the predicted cost and effectiveness of policy alternatives, as well as of factors constraining the government's ability to use them.

Table II-1, taken from a recent study for the IFC by Stephen Guisinger and associates, gives an idea of the wide range of instruments used by host governments to attain foreign investment objectives. The table organizes incentives and disincentives according to their effect on the foreign firm's income statement. Instruments are categorized by whether they affect the revenues of the firm (Category I), its input costs (Category II), or the components of its value-added (Category III). The effect of each instrument on the firm's after-tax return on owners' equity is indicated by a plus or minus.

To illustrate the range of instruments that may be available to reach a particular objective, consider the case of a host country that wishes to encourage the use of locally-produced capital equipment by foreign firms. The host government could use one or all of the following instruments: (1) tariffs on imported equipment; (2) prior import deposits on imported goods; (3) exemptions from sales taxes on domestic capital goods; (4) subsidies for the use of local capital goods; (5) local content requirements for capital equipment; and (6) incentives linked to performance requirements for the use of domestic equipment. Each instrument will have a different effect on the profitability of the foreign firm, and may achieve the local content objective with varying degrees of effectiveness and cost. The optimal instrument is chosen on the basis of an assessment of expected effectiveness and cost, including the costs of receiving less foreign investment should the instrument reduce the profitability of projects.

Effectiveness and Cost

The question of the expected effectiveness of the instrument has two parts. First, is the investor behavior to be induced by the policy (e.g., the use of locally-produced capital equipment) effective in achieving the ultimate objective of the policy (e.g., the development of infant capital goods industries, the forging of linkages between industrial sectors, etc.)? Second, is the policy instrument (e.g., tax concessions for firms that use local equipment) effective in altering the behavior of investors (using more local equipment)?

8/ Guisinger (9185), pp. 2-3.
<table>
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<tr>
<th>Incentives/Disincentives</th>
<th>Effect on After-Tax Return On Owner’s Equity</th>
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<td>Affecting Revenues</td>
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<tr>
<td>Tariffs</td>
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<tr>
<td>Differential sales/excise taxes</td>
<td>+ or -</td>
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<tr>
<td>Export taxes/subsidies (including income tax credits)</td>
<td>+ or -</td>
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<tr>
<td>Quotas</td>
<td>+ or -</td>
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<tr>
<td>Export minimums</td>
<td>+</td>
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<tr>
<td>Price controls (or relief from)</td>
<td>+ or -</td>
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<tr>
<td>Multiple exchange rates</td>
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<tr>
<td>General overvaluation of currency</td>
<td>-</td>
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<tr>
<td>Government procurement preference</td>
<td>+</td>
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<tr>
<td>Production/capacity controls</td>
<td>+</td>
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<tr>
<td>Guarantees against government competition</td>
<td>+</td>
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<tr>
<td>Prior import deposits</td>
<td>+</td>
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<tr>
<td>Transfer price administration</td>
<td>-</td>
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<td>Affecting Inputs</td>
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<td>Tariffs</td>
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<td>Differential sales taxes (and exemptions therefrom)</td>
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<tr>
<td>Export taxes/subsidies (including utilities)</td>
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<td>Quotas</td>
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<td>Price controls</td>
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<tr>
<td>Multiple exchange rates</td>
<td>+ or -</td>
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<td>Subsidy or tax for public-sector suppliers</td>
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<tr>
<td>Domestic-content requirements (including R &amp; D)</td>
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<td>Prior import deposits</td>
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<td>Transfer price administration</td>
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<td>Limits on royalties, fees</td>
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<tr>
<td>Multiple deductions for tax purposes</td>
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<tr>
<td>Cash or in-kind grants for R &amp; D</td>
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<td>Incentives/Disincentives</td>
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<td>After-Tax Return</td>
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<td>Capital</td>
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<td>Direct subsidy</td>
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<td>Cash grant</td>
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<tr>
<td>Tax credits/investment guarantees</td>
<td>+</td>
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<tr>
<td>Specify if reduces book value:</td>
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<tr>
<td>Subsidized leasing</td>
<td>+</td>
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<tr>
<td>Cost of capital goods</td>
<td></td>
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<tr>
<td>Tariff/sales tax exemption on imported/domestic equipment</td>
<td>+</td>
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<td>Prior import deposits</td>
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<tr>
<td>Local-content requirement for capital equipment</td>
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<td>Subsidized buildings</td>
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<td>Subsidized cost of transportation</td>
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<td>Cost of debt</td>
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<td>Subsidized loans</td>
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<td>Loan guarantees</td>
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<tr>
<td>Covering of foreign exchange risks on foreign loans</td>
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<tr>
<td>Priority of access (including limitations on foreign firms)</td>
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<tr>
<td>Cost of equity</td>
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<td>Subsidized equity through public investment agencies</td>
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<td>Exemption from capital gains taxes/registration taxes</td>
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<td>Guarantee against expropriation or differential treatment</td>
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<td>Minimum financial/in-kind ratio</td>
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<th>Incentives/Disincentives</th>
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<td>Tax holiday/reductions</td>
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<td>Accelerated depreciation</td>
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<tr>
<td>Special deductions and valuation practices (inflation adjustment; multiple plant consolidation)</td>
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<td>Tax sparing and double-taxation agreements</td>
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<tr>
<td>Loss-carry-forward provision</td>
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<td>Contractual stabilization rates</td>
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<tr>
<td><strong>Labor</strong></td>
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<tr>
<td>Wage subsidies (including indirect, i.e., multiple deductions of wages for tax computations/reduction of taxes on labor)</td>
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<td>Minimum wage</td>
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<td>Relaxation of industrial relations laws</td>
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<td>General preinvestment assistance</td>
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<td>Countertrade requirements</td>
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</tbody>
</table>

On the latter question, much of the empirical evidence on the effectiveness of host country policies in altering investor behavior concludes that marginal changes in investment incentives or disincentives have little effect on the decisions of foreign investors. The majority of surveys of foreign firms show that the most important factors influencing their choice of location are not directly related to foreign investment policies: market size and potential, political stability, the availability and reliability of infrastructure, wage rates, etc. Interestingly, the differences found between governments and investors as to which factors are believed to be important is striking: governments seem to believe that investment incentives are quite effective in attracting foreign investors, while the investors themselves do not. A recent statistical study of factors influencing foreign investment in developing countries also suggested that resource endowments, the level of economic development (measured by the level of per capita income), and to a lesser extent recent growth performance, are much more influential in attracting foreign investment than are tax concessions.

In contrast to most survey studies, a recent study for the IFC by Stephen Guisinger and Associates (1985) concludes, on the basis of interviews with corporate executives and government officials, that investment incentives do influence the location decisions of foreign investors. His study found that in two-thirds of the cases studied, the policies of host country governments influenced the location decision. The study concluded that even though managers often claim that they ignore incentives, their selection of a particular country usually seemed to take incentives into account. In addition, the Guisinger study found performance requirements to have a fairly strong negative impact on locational decisions. Important disincentives included the sharing of ownership and technologies, local content requirements, employment or export targets, limitations on the transfer of funds, price controls, profit ceilings, and bureaucratic red tape.

The explanation for Guisinger's results may lie in the definition of "incentives" (which includes protection from imports that compete with the foreign firms' products) and the design of his questionnaire. He asks investors if they would locate in a particular country if that country eliminated all investment incentives and disincentives, while other countries maintained incentive policies at existing levels. Guisinger recognizes that the latter assumption yields a measure of the maximum

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9/ Reviews of empirical studies on policy effectiveness are found in Galenson (1984) and Balasubramanyam (1984); see also Frank (1980) and Hughes and Seng (1969).

10/ Galenson (1984), p. 37; see also Frank (1980).


effectiveness of incentives, since actual changes in incentives are likely
to be small and perhaps followed by similar policy changes in competitor
countries.

It is not uncommon for host countries to employ a wide array of
detailed incentives and disincentives, perhaps hoping to increase all pos-
sible benefits and reduce all possible costs of foreign investment. In
many cases, however, an investment incentive will only serve to offset a
disincentive in its effect on the profitability of foreign firms. From the
point of view of foreign investors, no net incentive or disincentive has
been provided; no induced change in investor behavior should be expected.
Yet the policies may be costly for the host government to implement, or
create domestic distortions, resulting in a net loss to the host country.
The implication is that governments should be aware of the net incentives
(or disincentives) offered to foreign investors, and avoid costly offset-
ting policies.

In a similar vein, government authorities need to be aware of
situations where policies fail to provide their intended incentive or
disincentive to foreign investors, due to factors outside the host govern-
ment's control. A classic example is that of corporate income tax reduc-
tions offered as investment incentives. Clearly such incentives are costly
to the host government, since tax revenues are lost. But the incentives
will be meaningless to a foreign firm, and thus ineffective in accomplishing
their goals, if the firm's home country offers tax credits for corporate
taxes paid by the firm in the host country. The only effect of this
incentive is to shift tax revenue from the host country to the source
country. Thus the host government needs to be aware of how the incentive
effect of the tax policy is related to the ways in which foreign earned
income is taxed in the source country.

A recurring theme in much of the literature on the effectiveness
of host government policies toward foreign investment is that, while
policies directed specifically toward foreign investors are of limited
significance in attracting investment, a country's overall macroeconomic
and sectoral policies are of paramount importance. According to a recent
study by the International Monetary Fund, "the provision of a stable
economic environment and the adoption of appropriate financial and exchange
rate policies may be even more important for encouraging foreign investment
and for increasing net benefits to the host country than policies related
specifically to promoting such investment." 13 Broad fiscal, monetary, and
exchange rate policies, along with political and economic stability,
adequate markets, and the availability of inputs, establish the basic
investment climate that attracts or fails to attract foreign investors.

As an example, the IMF study cites the fact that a number of
countries (particularly in Africa and the Caribbean) with small domestic
markets and limited natural resources were unable to attract significant

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13/ IMF (1985), p. 14. For similar conclusions, see Weigerl and Miller
inflows of foreign investment during the 1970s, despite offering generous incentives. However, a few countries with relatively small domestic markets that pursued open economic policies and maintained few restrictions on foreign investment (including Hong Kong, Singapore, and, to some extent, Malaysia) were able to attract substantial export-oriented foreign investment, while generally offering only moderate incentives. 14

The first part of the policy effectiveness question, the effectiveness of induced changes in investment allocation and investor behavior on the ultimate objectives of the host government, is more difficult to determine. While foreign investment seems to have contributed to development objectives in some countries, a number of empirical studies of the impact of incentives and induced investment on individual economies reach discouraging conclusions. 15 Some examples:

- A study of Mexico's tax exemption policies in the 1950s estimated the contribution of investment by exempt sectors to the country's per capita income and to employment, and found that the direct contribution was small. 16

- A study of the impact of investment incentives in Ghana found that, in general, firms receiving incentives operated inefficiently and lost foreign exchange. There was little evidence of linkages between them and other Ghanaian firms; they were mostly capital intensive; and most were not located in rural areas. Thus the incentives failed to achieve their objectives of promoting efficient use of the country's resources, earning foreign exchange, promoting interindustry linkages, training local workers, and increasing investment in rural areas. 17

- A World Bank report on industrial development strategy in Thailand examined policies designed to promote manufactured exports during the 1970s. Exemptions from import duties and various taxes apparently had little impact; the share of exports in total production of firms awarded incentives was no higher than the average for all industrial firms. However, the disappointing results may have been due in part to the burdensome procedures required to obtain the incentives. 18

- A study of the Philippines found that the investment incentive system, despite its attempts to encourage employment, subsidized capital to a greater extent than labor, presumably inducing a more capital-intensive type of investment than would

15/ See Galenson (1984) for a review of these studies.
18/ World Bank (1980).
otherwise have been the case. 19 Fiscal incentives in the form of generous depreciation allowances and subsidies on capital have been identified as one of the principal factors contributing to the artificially low price of capital in developing countries, leading both domestic and foreign firms to adopt capital-intensive technologies. 20

Again, the presence and creation of market distortions appear to be conditions that limit the benefits gained from the host country's foreign investment policies. According to a study for the World Bank by Weigel and Miller (1985),

"Experience has shown that attempts to manipulate the conditions under which outside investors operate can markedly lower the net benefits derived from local subsidiaries of foreign firms and may, in fact, result in costs exceeding benefits. But, if market distortions can be reduced, local resources can be brought to bear in a more rational fashion and the investment climate will be more conducive to investment flows that prove to be rewarding to both foreign investors and to the country where the direct investment is made." 21

Examples of cases where existing distortions can limit the benefits of foreign investment include:

- **Trade barriers**: if foreign direct investment occurs in response to higher prices caused by overt market protection, there is a good chance that the resulting products will be relatively high-priced, profits will also be high, and foreign firms will be dominant. These consequences are likely to be reinforced by direct and indirect subsidies. Excess profits may then be moved out of the country by transfer pricing strategies.

- **Duty-free allowances for capital goods imported under overvalued exchange rates**: given these distortions, foreign firms are likely to use proportionately more capital than would have been the case with more neutral policies.

- **Artificially low domestic interest rates**: this distortion not only encourages the choice of capital-intensive techniques by foreign firms, it may also result in crowding out of local borrowing, since foreign firms with superior risk characteristics are likely to have preferential access to loans. 22

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Not only increased by the absence of existing distortions, their costs are minimized when the policies themselves introduce as few new distortions as possible. In essence, this is the "specificity rule" of second-best solutions: when a divergence between private and social benefits or costs suggests the need for government intervention in an activity, it is more efficient to use those policy tools that are closer to the source of the distortion. 23 Again we illustrate using the example of the host country wishing to promote the development of an infant capital goods industry. Suppose that foreign firms prefer to import their capital equipment because it is of better quality and lower price than local substitutes. Yet the host government believes that, when mature, the local industry will be competitive with imports in both respects. The government's chosen policy could be a tariff on imported capital goods. The tariff will raise the cost of these goods to all domestic purchasers, including local users as well as foreign firms, introducing a new distortion. Perhaps more importantly, this type of infant industry protection may not induce the local capital goods industry to improve quality and become competitive with imports at world prices. A better choice of instrument would be one directed more specifically at the source of the problem—the lack of low-cost production techniques and technical know-how in local capital goods industries. The government could, for example, provide subsidies to capital goods firms for labor training, or provide incentives (or requirements) for foreign firms to transfer the necessary labor skills and technical knowledge. This policy will get at the problem more efficiently than a tariff.

Induced distortions are only one type of cost that governments need to consider when choosing between alternative policies. Other costs may include increased government expenditure or reduced tax revenue, and the administrative costs associated with policy implementation.

Constraints

Policies that increase the gains accruing to the host country at the expense of the foreign firms' profits are known as outcomes in a zero-sum game. At some point, these policies may cause investment projects to become unprofitable for foreign investors, and the investments will not be made. In a zero-sum game, there are fundamental conflicts between the objectives of the host government and the objectives of foreign firms. However, there are usually opportunities for mutual advantage through policies that can both increase the attractiveness of the country to potential investors and increase the likely benefits that the country receives from such investment. These are known as outcomes in a positive-sum game. The host country faces greater constraints when it attempts to capture increased benefits in a zero-sum game than in a positive-sum game.

In cases where zero-sum strategies are pursued, the host country is constrained by its bargaining power vis-a-vis the foreign firm or firms. A country in a strong bargaining position may be able to capture a larger share of the gains from the foreign investment project (up to the point where the net gains to the foreign investor turn negative and the investment is not undertaken). This bargaining position is in turn a function of (1) the country's relative attractiveness to investors (its natural resource base, domestic market size, available infrastructure, etc.) compared to that of countries with which it competes for foreign investment; and (2) the country's policy stance toward foreign investment relative to that of its competitors, and the expected policy reactions in those countries. In some industries (e.g., minerals extraction), the bargaining strength of the host country compared with the foreign investor may change over the life of the investment project.

For countries in earlier stages of development, a policy bias toward generating government revenue may be justified. This is the "infant government" argument for choosing taxes and tariffs rather than subsidies or grants to induce changes in investor behavior. For low-income nations, the most serious domestic "distortions" may relate to the government's inability to provide an adequate supply of public goods. In these cases, choosing revenue-creating policies may bring the greatest social benefits to the country. Similarly, a government's choice of policies may be limited by a shortage of technical, managerial, and professional staff to negotiate and implement effective foreign investment policies.

Finally, a country's policy choices may be limited by regional agreements. For example, the Andean Foreign Investment Code limits the degree to which Andean Pact countries can choose policies toward local ownership and profit repatriation (though some Andean Pact countries have adhered less strictly to Decision 24 in recent years). Or, a country's ability to offer incentives in the form of product protection may be limited by restrictive cooperative agreements such as the General Agreement on Tariffs and Trade (GATT).

Policies to Attract Foreign Investment

Many host developing countries are currently in a process of opening their economies to foreign investors, reversing a trend toward greater restrictions that characterized the 1970s. Given that the objective of many host countries is to increase the flow of foreign investment, what advice should the Bank give? On both theoretical and practical grounds, what types of policies should the Bank promote in these countries? This section reviews some of the general guidelines discussed in the literature, and suggests how the preferred strategy should vary with the characteristics of the host country in question, as well as of the type of foreign investment it wants to attract. Following this section, we also consider the question of the appropriate sequencing of policy reforms in countries that wish to attract a greater volume of foreign investment.
To set up a framework for the discussion, focus on the decision process of a multinational firm considering an investment project abroad. If the risk-adjusted rate of return on the project, as perceived by the foreign firm, exceeds some threshold "hurdle rate", the project will be undertaken; if it falls short of that reservation rate, the investment will not be made. What are the components of this risk-adjusted rate of return? The real return on an investment project is uncertain, and may be thought of as a random variable with a probability distribution—each possible return is associated with a particular probability of occurrence (see Figure II-1). These probabilities are themselves functions of the probability distributions of random variables that affect the project's return: supply and demand conditions throughout the life of the project; government regulations in the home and host countries; foreign exchange rates; etc. The project's expected return, \( E(R) \), is the mean of the distribution of returns; its "riskiness" is represented by the variance of that distribution (or by its standard deviation, \( \sigma_R \)). The project's risk-adjusted rate of return will rise with an increase in the mean return, a reduction in the variance of returns, or a combination of the two.

From the foreign investor's point of view, there is a tradeoff between expected return and risk. This tradeoff is illustrated in Figure II-2, which shows two investors' preference functions (indifference curves) for the return and risk associated with foreign investment projects. Each curve represents combinations of expected return and risk that yield the same level of "utility" (in other words, the same risk-adjusted rate of return, \( RAR \)). For example, points B and C represent different combinations of \( E(R) \) and \( \sigma_R \) that yield the same risk-adjusted rate of return, \( RAR_2 \). Curves further to the left represent higher risk-adjusted rates of return (in the diagram, \( RAR_2 > RAR_1 \)). An investor's subjective tradeoff between risk and return is revealed by the slope of the indifference curves, with a steeper slope indicating a greater degree of risk aversion. In the figure, Investor B is more risk averse than Investor A.

Suppose that foreign investment projects in a country currently exhibit the return and risk values at point A, corresponding to the risk-adjusted rate of return \( RAR_1 \). Suppose also that the government of the host country wishes to increase that return to \( RAR_2 \) in order to attract a greater volume of foreign investment. It could do so by using policies that increase the expected return on investment projects (a move to point C), by raising expected revenues and/or reducing expected costs to foreign investors. Alternatively, it could attempt to reduce the riskiness of investment projects (a move to point B). Combinations of the two could also be used. In addition, remembering that what matters are the subjective opinions of foreign investors, the government could attempt to alter investors' perceptions in these directions. While the evidence on successful strategies contains examples of all three ways of increasing a country's attractiveness, a surprising number of successful strategies concentrate on the components of "risk" and "perception".
FIGURE II-1
Distribution of Returns to an Investment Project

FIGURE II-2
Investor's Risk-Return Preference Function
The attraction of foreign firms to a particular economy depends on a combination of economic, strategic, and political factors, some of which are under the control of the host governments and others are not. Those not under the control of host governments include the internal motivations and determinants of investments by foreign firms, and the economic conditions and policies of home countries. Nevertheless, a number of other factors which influence foreign investment are under the control of host governments. The literature on host country policies toward foreign investment suggests the following guidelines for successful strategies:

General and Sectoral Policies: It must again be emphasized that the host country's macroeconomic and sectoral economic policies are of paramount importance, not only in determining the amount of foreign investment attracted to the country but also in determining the costs and benefits of whatever investment does take place. A recurrent theme in the literature is that the policies that establish the economic environment for foreign investment are more effective than incentives or regulatory policies related specifically to private investment or to the particular practices followed by foreign investors.

For example, excessively high tariffs or overvalued exchange rates can result in windfall profits for foreign firms and losses to host countries. Financial policies that are based on artificially low interest rates may induce foreign firms to use the subsidized local credit markets for financing. If capital goods can be imported duty-free at an overvalued exchange rate, making machinery and equipment cheaper than they would have been under more neutral policies, foreign as well as domestic firms would tend to substitute capital for labor. At the sectoral level, a comprehensive and detailed sectoral development program can enable the host government to decide in advance about the need for private investment and the number and size of projects that would be desirable. It would also provide advanced information to potential foreign investors, reducing uncertainty and risk. 24

Incentive Policies: Because of competition among developing countries for foreign investors, many host governments offer a wide range of incentives: tax concessions (generous investment write-off provisions, tax concessions on sales, exports, license fees, etc.); tariff concessions (exempting or reducing tariffs on imported inputs and the provision of protective tariffs); financial incentives (investment grants, local loans at interest rates below the market level, subsidies for exports, wages, training of local labor, research and development activities, energy, etc.); and other incentives (exchange control concessions, efforts to curb labor union activities, lowering environmental or employment safety standards, etc.). Such incentives are frequently designed to offset such disincentives as poor general economic policies and a lack of structural factors favorable to private investment.

24/ Billerbeck and Yasugi (1979), pp. 15-16.
Yet, a poor general economic climate often means that incentive policies are ineffectual; when the economic climate is perceived to be favorable, investment incentives are frequently redundant. The benefits to foreign firms provided by tax incentives are generally smaller than they appear at first glance, the costs to the host country may be greater than is immediately obvious, and there is a possibility that part of the foregone tax revenue may eventually be taxed by the investor country--thus implying a transfer of tax revenue from developing to developed countries. As a general rule, less emphasis should be placed on incentive policies than on the creation of a sound general investment climate.

Market protection is often cited as an important incentive that attracts foreign firms to produce import substitutes, and there is empirical support for this claim. Yet, while protective policies may increase the volume of foreign investment, it may not increase the benefits derived from foreign investment. Protected from foreign competition, foreign (as well as domestic) firms may operate inefficiently, and the result in terms of inefficiency and higher prices is frequently costly to the host country.

It would be a mistake to conclude that investment incentives are never effective in attracting foreign investors. The effectiveness of incentives in attracting and benefitting from foreign investment depends on the types of investment the country is trying to attract, whether the incentives reduce the price of factors of production ("factor protection") or alter the prices of goods and services purchased or sold by the firm ("commodity protection"), and on the existence of competition from countries vying for similar types of foreign investment. A recent study by Guisinger (1985) defined three "markets" for foreign investment: investments oriented toward the domestic market of a single host country, investments oriented toward countries within a common market, and investments to produce for the worldwide export market. The results of a survey of multinational firms showed that factor protection plays an insignificant role in attracting foreign investment oriented toward the domestic market, but commodity protection is important. In the markets for outward-oriented foreign investment (both common market and export), commodity protection is insignificant, but factor protection is moderately important. The study also concludes that countries facing stiff competition for similar types of foreign investment may lose some "market share" if they reduce incentives while the incentives offered by their competitors remain unchanged. 25

Reducing Investor Uncertainty: In cases where the objective is to attract foreign investors (selectively or not), the government should recognize the extent to which foreign investors desire to minimize uncertainty: multinational firms are, by the nature of their planning and operational requirements, "lovers of the predictable". 26 Policies to increase investor confidence are particularly important in countries that have had frequent and significant changes in attitude and legislation toward foreign investment, as well as in countries where changes in

economic philosophy or the degree of market orientation have left gaps in
the legal or commercial structure typically expected by foreign firms. A
host government can attract foreign firms, even if it lays down stringent
conditions, if it is accepted that it will stick by those conditions in the
future.

An obvious way of reducing investor uncertainty is to aim for
policy stability over time. Yet it should be recalled that the "rules of
the game" on paper usually differ from actual practice. For political or
other reasons, many countries in the process of changing their stance in
the direction of welcoming more foreign investment prefer to maintain the
old laws on the books, while granting more exceptions to the rules. In
these cases, the key to reducing investor uncertainty is to grant excep-
tions in a manner consistent across firms in an industry, so that potential
new entrants, suitably informed, may know what to expect.

Clear and consistent objectives at all levels of government:
Frequently, the foreign investment policy objectives as seen by top govern-
ment officials are not the same as the objectives perceived by government
authorities at lower levels, including those who are charged with implemen-
ting rather than formulating the policies. In the case of Egypt, for example,
cabinet-level policy seeks to welcome selected foreign investment. Yet at
lower levels of the bureaucracy, the desire for more government control
over private business decisions, a result of Egypt's recent Socialist past,
is apparent. The implementation of policies designed to encourage foreign
investment is thus frustrated by fundamental conflicts and questions relating
to objectives: what kind of economy is Egypt to have, with what
degree of government control over private market decisions?

A recent survey of foreign firms (Frank, 1980) gave Asian coun-
tries, particularly Malaysia and India, high marks for the clarity with
which they express their general development objectives. African nations,
with the exception of Nigeria, were also seen as having well-defined goals.
The firms evaluated Latin American and Caribbean countries less favorably
in this respect. Brazil was the South American country most frequently
cited as having clear, well-articulated aims, and Colombia was also men-
tioned. Opinions differed about how articulate Peru and Mexico were in
stating their goals, and Jamaica was not perceived as having clear
objectives. 27

Bureaucracy: However well-planned the policies of the government
and however beneficial their effects in theory, an inefficient, compli-
cated, or corrupt bureaucratic structure of enforcement can frustrate much
of the purpose of the effort and deter prospective investors from entering
the country. The importance of removing bureaucratic barriers will be
explored in more detail in the last section of this report; in the present
context it is sufficient to note that a streamlining of procedures, a mini-
mization of red tape, and a clarification of regulations can by itself
increase the attractiveness of a country to foreign firms.

Promotion: A number of developing countries have established investment promotion centers abroad and in their own countries to provide information on the opportunities for foreign investment in their economies. These centers can supply up-to-date economic data as well as details on the relevant laws and procedures on investment by foreigners; in some cases they can also carry out a preliminary screening of potential investors, discouraging those which are clearly inappropriate and encouraging those which are desirable.

The recent experience of some Southeast Asian countries demonstrates the benefits of aggressive "marketing" of investment opportunities in countries that seek to attract foreign investors. An aggressive promotional effort may include such elements as identifying profitable investment opportunities and advertising them to potential investors, opening investment information offices in major source countries, making public media advertisements, and assigning government personnel to facilitate investment approval. A successful promotional strategy is usually one that is subject to periodic review to determine whether or not the strategy is achieving its objectives. These efforts may more than pay for themselves in terms of the amount of foreign investment attracted. 28

The Sequencing of Policy Changes

In the context of economic liberalization programs in developing countries, the problem of recommending a specific sequencing of policy reforms has been considered by Edwards (1985) and McKinnon (1982). Many times, due to political or other constraints, it is not possible to pursue the liberalization of both the trade and capital accounts of the balance of payments simultaneously; it may not even be desirable to do so. In those cases, the question of sequencing becomes very important. Though alternative sequencing paths can be followed depending on the country under consideration and on the nature of the initial distortions, Edwards and McKinnon derive some general principles of sequencing:

- In countries with rudimentary domestic capital markets and controlled interest rates, impediments to external capital movements (both inflows and outflows) should not be relaxed before liberalizing the domestic financial sector. This is because if the capital account is liberalized at a time when domestic interest rates are fixed at arbitrarily low or negative levels, an outflow of capital will result.

- In an inflationary environment, the liberalization of the domestic financial market can only be fully undertaken if the fiscal deficit is tightly under control. The existence of a

28/ The subject of promotional activities is considered in greater detail in the final section of this report.
large fiscal deficit which is financed by an inflation tax necessitates that reserve requirements on banks be kept high, and interest payments on deposits be kept low. In this way it is assured that the base on which the inflation tax is collected—the stock of base money—is not eroded. If the fiscal deficit is not controlled before domestic interest rates are liberalized, the inflation tax base will be reduced, and the rate of this tax—the rate of inflation—will have to be increased for the government to collect the same amount of resources.

From a macroeconomic perspective and considering real exchange rate responses, it is more prudent to liberalize the current account before relaxing capital controls. The experience with destabilizing capital flows immediately following a capital account liberalization—especially in Korea in 1966 and in Chile, Uruguay and Argentina in the late 1970s—has generally been negative and has jeopardized other aspects of the reform package. Moreover, it has been argued that "incorrect" portfolio investment decisions made on the basis of distorted prices are easier and cheaper to reverse than incorrect real investment decisions.

Questions of appropriate sequencing may also arise when changes in foreign investment policy are combined with other economic liberalization reforms. If a host country wishes to promote a greater volume of foreign investment through the use of new incentives, should the incentives be offered before, during, or after the transition to a more open economy? What is the proper sequence of "liberalizing" reforms directed at foreign investors (meaning, presumably, a move toward equal treatment between domestic and foreign investors), when this is to be combined with reforms liberalizing the trade account, the capital account, the domestic financial market, and the fiscal situation? While this question has not received much attention in the literature, we propose the following ideas:

(1) In general, macroeconomic and sectoral policy reforms intended to reduce distortions should be implemented before incentives or more equal treatment of foreign investors is introduced. This proposition is based on the following arguments:

A nondistorted economy with a rational price structure is a much more effective incentive than specific incentives directed toward foreign investors. The granting of specific incentives may simply waste resources if the general economic climate is not favorable to foreign investment.

The benefits of foreign investment will be greater, and the costs lower, if the investment occurs in a relatively non-distorted economy. For example, foreign investment attracted to a country with a distorted trade regime may lead to a loss of foreign exchange.

Clear and consistent policies are an important factor in attracting foreign investors; changing the rules of the game after foreign firms have entered into investment projects will create an atmosphere of greater uncertainty for future investors. For example, a foreign firm attracted to a host country market because of a high degree of protection may operate inefficiently; moreover, it may suddenly find its project unprofitable if import restrictions are reduced. The disincentive effect of this policy change on other potential foreign investors may be significant. In addition, any other incentives that were offered to the initially-protected firm will have been wasted if the firm closes operations in the country.

(2) An application of this general principle suggests that trade liberalization should precede the offering of additional incentives to attract foreign investment. For example, any "anti-export bias" should be reduced before export incentives are granted. The incentives are not likely to outweigh the disincentive effect of distorted price signals, and will simply cost government revenues.

(3) There may be an argument for liberalizing the domestic financial sector before lifting restrictions on local borrowing by foreign firms, since borrowing by foreign firms at artificially low interest rates may crowd out funds needed by the government and by local firms. In other words, there is a danger involved in granting equal treatment to foreign investors if financial markets are distorted.

(4) Using the argument above that real investment decisions are more costly to reverse than portfolio investment decisions, there is a case for liberalizing the trade account and foreign investment before liberalizing other external capital flows. 31

(5) As with any liberalization program, a major policy issue related to foreign investment reforms is that of credibility. Only when potential foreign investors are convinced that the liberalization of trade and the financial system are complete and sustainable, will they make the investments required for economic growth. How the government can increase the credibility of its program is an area in which there is less agreement. Some authors have argued that it may be important to have an abrupt change in policy in order to establish credibility. In contrast, gradualism may invite speculation about future policy reversals. 32

32/ Stockman (1982), p. 188.
In sum, it is important to emphasize the general principle that foreign investment brings greater net benefits to the host country when it occurs in an economy where relative prices reflect true opportunity costs. Application of this principle will frequently suggest that measures to attract foreign investment should be preceded by economic liberalization to reduce domestic distortions. It may also argue for differential treatment of foreign investors as a second-best solution until liberalization reforms are achieved.
III. AN OVERVIEW OF WORLD BANK INVOLVEMENT IN FOREIGN INVESTMENT POLICY REFORM

This section of the report provides an overview of the ways in which the World Bank has been involved in suggesting or requiring changes in foreign investment policies in host developing countries. The overview covers approximately the period since 1980, the year in which adjustment lending programs began. World Bank involvement in foreign investment policy reform has taken two general forms: conditions required as part of structural and sector adjustment loans, and dialogue with member countries as part of economic and sector work. IFC involvement has been in the form of advisory services, informally or, occasionally, more formally at the request of member governments. In the future, Bank involvement in foreign investment policy reform will increase through the Multilateral Investment Guarantee Agency (MIGA), the Baker initiative for medium-term growth in heavily indebted countries, and the IFC's new foreign investment policy advisory activities.

ADJUSTMENT LENDING

Since 1980, the Bank has introduced a new style of lending characterized by a policy focus and conditionality. These loans and credits include export rehabilitation credits, which provide foreign exchange for critical industries; single import loans; "sectoral" lending of various types; and Structural Adjustment Loans (SALs). These lending vehicles accounted for 20 to 30 percent of total Bank lending, depending on definition. They carry varying degrees of conditionality, and the extent to which they are "projectized" also varies. But all are tied to policy change, the SAL most of all.

Structural Adjustment Loans

The original justification for SALs was the need to help many developing countries carry out a difficult process of policy and institutional reform in an unfavorable international economic environment. Increasingly, "inappropriate domestic policies" have been cited as growth obstacles calling for basic structural adjustments. The rationale for SALs has thus come to focus on the developmental usefulness of reforming domestic policies.

The stated objectives of structural adjustment lending are:

- to support a program of specific policy changes and institutional reforms to achieve an efficient use of resources and thereby to contribute to a sustainable balance of payments in the medium and long term, while maintaining growth;

- to assist a country in meeting the transitional costs of needed structural changes in industry, energy and agriculture by augmenting the supply of freely usable foreign exchange; and
to act as a catalyst for the inflow of other external capital to help ease the balance of payments situation. 33

In a SAL, the Bank reaches an understanding with the Government on a monitorable action program set out in a Letter of Development Policies which is part of the formal loan documentation. In some cases, the Bank itself plays only a minor role in persuading countries to undertake policy reforms--some countries would be likely to pursue those policies anyway. Programs supported by SALs vary, but they have in common the following principal concerns:

(i) changes in trade regimes so as to improve the competitiveness of, and incentive for, exports;
(ii) mobilization of domestic and foreign resources;
(iii) improvement in the efficiency of domestic resource use; and
(iv) institutional reform. 34

The conditions in SALs may be divided into the following topic areas: domestic resource mobilization (fiscal budget and tax policy, financial markets, etc.); public sector planning and management (including management of public enterprises); and trade and exchange rate policy (with foreign investment policy included in this last category). Figure III-1 indicates the frequency of conditions in each of these categories for SALs approved in fiscal years 1980 through 1985. While some kind of trade policy reform appears as a major component of nearly all SALs, conditions relating to foreign investment policy in particular have appeared in only ten of the 32 SALs approved by the end of fiscal year 1985 (with an additional two by the end of calendar 1985).

Of course, policy conditions that will affect foreign investment go beyond those specifically mentioning foreign investors. In particular, conditions relating to the industrial sector appear with great frequency. These include, for example, reforms of investment codes or investment incentives that are, at least in principle, available to all investors, whether domestic or foreign. And in light of the empirical evidence in the literature on foreign investment that emphasizes the overwhelming importance of a country's macroeconomic and sectoral policies in determining the amount and net benefits of foreign investment it receives, almost all of the structural adjustment policy reforms in SALs are of potential influence to foreign investment. While recognizing the importance of macroeconomic


FIGURE III-1

Structural Adjustment Loans (FY 1980-1985): Policy Topics and Sectors

<table>
<thead>
<tr>
<th>TOPICS</th>
<th>No. of SALs</th>
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<tbody>
<tr>
<td>Domestic Resource Mobilization</td>
<td>1</td>
</tr>
<tr>
<td>Budget Admin. &amp; Control</td>
<td>5</td>
</tr>
<tr>
<td>Financial Markets</td>
<td>10</td>
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<tr>
<td>Price Regime</td>
<td>15</td>
</tr>
<tr>
<td>Taxes and Revenue</td>
<td>20</td>
</tr>
<tr>
<td>Public Sector: Planning &amp; Mgmt.</td>
<td>25</td>
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<tr>
<td>Development: Planning &amp; Mgmt.</td>
<td>30</td>
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<tr>
<td>Public Enterprises: Mgmt.</td>
<td>35</td>
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<tr>
<td>Public Sector: Empl. &amp; Wages</td>
<td></td>
</tr>
<tr>
<td>Public Sector Investment Program</td>
<td></td>
</tr>
<tr>
<td>Trade and Exchange Rate Policy</td>
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<td>External Debt Management</td>
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<td>Export Incentives &amp; Promotion</td>
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</tr>
<tr>
<td>Exchange Rate Management</td>
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<td>FOREIGN DIRECT INVESTMENT</td>
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<tr>
<td>Import Regime Reform</td>
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<td>SECTORS</td>
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<tr>
<td>Agriculture &amp; Rural Development</td>
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<tr>
<td>Education</td>
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<td>Energy</td>
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<td>Industry</td>
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<td>Population, Health &amp; Nutrition</td>
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<tr>
<td>Transportation</td>
<td></td>
</tr>
<tr>
<td>Urban Development &amp; Water Supply</td>
<td></td>
</tr>
</tbody>
</table>

No. of SALs 1 5 10 15 20 25 30 35

and sectoral policy reform, this paper focuses more narrowly on policy reform specifically directed toward foreign investment or toward private investment codes.

Based on the stated objectives of the SAL program—increased efficiency of resource use, and a sustainable balance of payments and economic growth in the medium and long term—it would be expected that the foreign investment policy reforms included as SAL conditions would be focused on

1. Promoting a positive contribution of foreign investment to the balance of payments—by attracting the types of foreign investment that will increase exports and/or reduce imports, or by manipulating the effects of firms' operations on the balance of payments;

2. Promoting positive effects of foreign investment on domestic efficiency;

3. Promoting the contribution of foreign investment to long-term growth—probably through the production of externalities derived from such investment, such as labor training and technology transfer;

4. Increasing the complementary influence of foreign investment on other types of external capital flows to the host country; and

5. To the extent that foreign investment has a net positive influence on the balance of payments, other external capital inflows, efficiency, and growth, simply attracting a greater amount of it.

In addition, if by necessity of simplicity the policy reform conditions included in SALs must be limited to a few key areas, foreign investment conditions would be expected in SALs only for those countries in which foreign investment is currently or potentially important as a source of balance of payments improvement or long-term growth. For reasons of efficiency, foreign investment policy conditions should themselves introduce as few distortions as possible. Finally, it would be expected that the foreign investment policy reforms would be consistent with SAL conditions in other areas. For example, if the SAL requires a decrease in government expenditure, then one would expect foreign investment incentives that require large government outlays to be discouraged.

Foreign Investment Policy Reforms in SALs

Objectives and conditions dealing specifically with foreign investment were included in only ten of the thirty-two SALs approved by the end of fiscal year 1985. In those ten cases, the foreign investment policy
reforms were not particularly detailed and did not represent major shifts in the country's stance toward foreign investors. The objectives and policy conditions can be summarized as follows:

**Objectives:** In general, policies are designed to attract more foreign investment, in some cases to liberalize technology imports, and in at least one case to remove obstacles to private initiative. The objective of attracting export-oriented foreign investment in particular is sometimes mentioned.

**Creation or reform of institutions to promote foreign investment:** Perhaps the most frequent SAL condition relating to foreign investment in particular is the creation or reform of a government agency charged with promoting foreign investment in the country or facilitating the application process for foreign investors. The Jamaica SAL I calls for the creation of the Jamaica National Investment Promotion Company and bilateral business groups to identify and develop investment opportunities in Jamaica; the Ivory Coast SAL II calls for the creation of an industrial promotion bureau which would serve as the focal point for potential investors in the country; the Mauritius SAL I calls for the appointment of investment promotion consultants in order to secure more dynamic forms in investment promotion overseas, and the SAL II calls for the establishment and operation of the Mauritius Export Development and Investment Authority to promote foreign investment and export sales; Panama's SAL I and Turkey's SAL III state their support of previous government efforts to create institutions responsible for promoting foreign investment.

**Streamlining of approval procedures:** A sometimes related, and also frequent, condition is that of simplifying approval procedures and reducing red tape for new foreign investments and reinvestments. In many cases the condition specifies the creation of a "one-stop" institution for investment approval. The Jamaica National Investment Promotion Company to be created as a condition of Jamaica SAL I was intended to be a "one-stop" promotion agency that would centralize all relations with potential investors, "fathering" each proposal, coordinating bureaucratic action, and ensuring speedy processing. The Korea SAL II calls for simplification of approval procedures, including replacement of the positive list system of industries open to foreign investment with a negative list system to specify only those industries in which foreign investment is prohibited or restricted, and immediate approval for projects satisfying certain criteria concerning factors such as share and size of foreign equity in a project. Previously, all applications required deliberation with concerned ministries and, if above a certain size, approval by the Foreign Capital Project Review Committee. The Panama SAL I supports the government's previous creation of a National Investment Council to assist investors in dealing with local bureaucracy. Another type of simplification is to make the granting of investment incentives automatic rather than discretionary (Mauritius SAL I, Panama SAL I).

**Other specific policy reforms:** In one or two cases, specific policy reforms were included as SAL conditions. For example, the Ivory Coast SAL II calls for a series of new incentives to be introduced on the basis of criteria related to employment creation, training, and installa-
tion outside Abidjan. The Korea SAL II gives support to previous government reforms, including expansion of the number of industries in which foreign investment is allowed; relaxation of ownership ratios, allowing an increase in the maximum foreign shareholding from 49 percent to 100 percent in certain industries; and a reduction in minimum capital requirements. The action program specifies further increases in the number of industries open to foreign investment from 50 percent to 64 percent of all sectors, and increases in the number of sectors open to 100 percent foreign investment to 15 percent of manufacturing subsectors. The Panama SAL I proposes linking simplified export incentives to employment.

Investment Code Reform in SALs

Conditions involving industrial sector policies are a common component of most SALs (see Figure III-1). Clearly, many of the industrial sector conditions will be relevant to foreign investors: tax policies, tariffs and restrictions on imported industrial inputs; subsidies to manufacturing firms; etc. Of the industrial sector reforms in SALs, perhaps those most directly of concern to foreign investors are revisions in investment codes. Investment codes describe the incentives offered to investors (domestic and foreign) satisfying certain eligibility criteria, and the obligations of the government and the investors. They generally provide tariff and fiscal concessions to firms that meet certain conditions, often related to size, choice of sector, employment creation, location, and use of domestic raw materials. Investment code reforms were included as conditions in at least eleven of the thirty-two SALs approved by the end of fiscal year 1985.

Some SALs call for the government to propose revisions in investment codes, but the nature of the reforms is not specified. In some cases the intent of the proposed reforms is to clarify the codes; in others, to "rationalize" the system of incentives. The kinds of conditions included in SALs relating to investment code reform generally fall into the following areas:

Review of the investment code/industrial incentive system: In a number of cases, the first in an intended series of SALs merely proposes a review of the existing incentive and requirement system (Ivory Coast I, Korea I, Thailand I, Pakistan I). Subsequent SALs frequently require implementation of proposed changes.

General revision of the investment code/industrial incentive system: In many SALs, specific investment code reforms are not included. Instead the condition is more generally to "revise the existing code" or make "adjustments in the incentive framework" (Ivory Coast II, Togo I, Thailand II, Turkey I Supplement, Guyana I).

Replacement of discretionary with automatic incentives: In line with the intent to simplify approval procedures (discussed above), a frequent feature of SALs in which specific investment code reforms are proposed is that of making incentives automatic rather than discretionary or negotiated on an individual basis (Mauritius I, Thailand I, Panama I).
Revisions to encourage export-oriented investment: Mauritius I proposes a tax holiday for firms in export processing zones; Philippines II includes export incentives; Thailand I proposes the creation of additional export processing zones and bonded warehouses.

Reduction of distortions/compensation to investors for distortions: Conditions relating to investment code reform were most detailed in the cases of the Philippines SAL II and Thailand's SAL I. In both, the importance of removing or compensating firms for existing distortions is emphasized. In the case of the Philippines, the SAL suggested replacing the large existing number of fiscal incentives with a smaller number of new incentives specifically aimed at compensating investors more directly and fully for market imperfections. This included removing some incentives available to domestic producers under the existing system which provided considerable inducement to capital-intensive investments, and providing compensation for discrimination against exports arising from the tariff and trade regime. In the case of Thailand I, the condition was to review the existing system of investment incentives, with the objective of substantially reducing distortions arising from the nature of incentives so as to encourage exporting relative to import substituting industries; to reduce the capital bias in many projects; and to increase automatic treatment in the procedures.

Sector Adjustment Loans

In addition to SAL-supported programs of economy-wide economic reforms, the Bank has supported reform and restructuring through sector adjustment loans. Sector adjustment loans support sectoral programs of policy and institutional change, including restructuring of capacity, to increase resource mobilization and the efficiency of resource allocation. The objective of these loans is to promote the introduction and effective implementation of sector policies necessary for sustained rapid growth, within an acceptable macroeconomic framework. They cover a continuum ranging from major changes in macroeconomic policies to the establishment of an appropriate framework for sectoral investments; the range of issues covered depends on the objectives of the operation and country circumstances. Sector adjustment operations are normally tranched, with release of the second tranche being linked to the progress of the sectoral adjustment program. 35

Conditions relating to foreign investment are found infrequently in sector adjustment loans (see Table III-2). In those cases where such conditions are found, they most often involve reforms of investment codes affecting all investors, rather than policy reforms directed specifically at foreigners. Though less detailed and extensive than investment policy reforms included in SALs, the Sector Adjustment Loan conditions attempt to achieve some of the same goals:

**Table III-1: STRUCTURAL ADJUSTMENT LOANS WITH CONDITIONS RELATING TO FOREIGN INVESTMENT**
(Fiscal Years 1980-85)

<table>
<thead>
<tr>
<th>Country</th>
<th>Date of Board Approval</th>
<th>Amount (US$ mil.)</th>
<th>Foreign Investment Policy Conditions</th>
<th>Relevant to Foreign Investment</th>
</tr>
</thead>
<tbody>
<tr>
<td>Kenya I</td>
<td>03/25/80</td>
<td>55.0</td>
<td>X</td>
<td></td>
</tr>
<tr>
<td>Kenya II</td>
<td>07/01/82</td>
<td>130.7</td>
<td>X</td>
<td></td>
</tr>
<tr>
<td>Turkey I</td>
<td>03/25/80</td>
<td>200.0</td>
<td>X</td>
<td></td>
</tr>
<tr>
<td></td>
<td>and Supplement</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Turkey II</td>
<td>05/12/81</td>
<td>75.0</td>
<td>X</td>
<td></td>
</tr>
<tr>
<td>Turkey III</td>
<td>05/27/82</td>
<td>504.5</td>
<td>X</td>
<td></td>
</tr>
<tr>
<td>Turkey IV</td>
<td>06/23/83</td>
<td>500.8</td>
<td>X</td>
<td></td>
</tr>
<tr>
<td>Turkey V</td>
<td>06/14/84</td>
<td>373.0</td>
<td>X</td>
<td></td>
</tr>
<tr>
<td>Bolivia I</td>
<td>06/05/80</td>
<td>50.0</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Philippines I</td>
<td>09/16/80</td>
<td>200.0</td>
<td>X</td>
<td></td>
</tr>
<tr>
<td>Philippines II</td>
<td>04/26/83</td>
<td>302.3</td>
<td>X</td>
<td></td>
</tr>
<tr>
<td>Senegal I</td>
<td>12/18/80</td>
<td>60.0</td>
<td>X</td>
<td></td>
</tr>
<tr>
<td>Guyana I</td>
<td>02/05/81</td>
<td>22.0</td>
<td>X</td>
<td></td>
</tr>
<tr>
<td>Mauritius I</td>
<td>06/02/81</td>
<td>15.0</td>
<td>X</td>
<td></td>
</tr>
<tr>
<td>Mauritius II</td>
<td>12/08/83</td>
<td>40.0</td>
<td>X</td>
<td></td>
</tr>
<tr>
<td>Malawi I</td>
<td>06/25/81</td>
<td>45.0</td>
<td>X</td>
<td></td>
</tr>
<tr>
<td>Malawi II</td>
<td>12/20/83</td>
<td>55.0</td>
<td>X</td>
<td></td>
</tr>
<tr>
<td>Ivory Coast I</td>
<td>11/24/81</td>
<td>150.0</td>
<td>X</td>
<td></td>
</tr>
<tr>
<td>Ivory Coast II</td>
<td>07/05/83</td>
<td>250.7</td>
<td>X</td>
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</tr>
<tr>
<td>Korea I</td>
<td>12/17/81</td>
<td>250.0</td>
<td>X</td>
<td></td>
</tr>
<tr>
<td>Korea II</td>
<td>11/08/83</td>
<td>300.0</td>
<td>X</td>
<td></td>
</tr>
<tr>
<td>Thailand I</td>
<td>03/02/82</td>
<td>150.0</td>
<td>X</td>
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</tr>
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<td>Thailand II</td>
<td>03/31/83</td>
<td>175.5</td>
<td>X</td>
<td></td>
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<tr>
<td>Jamaica I</td>
<td>03/23/82</td>
<td>76.2</td>
<td>X</td>
<td></td>
</tr>
<tr>
<td>Jamaica II</td>
<td>06/14/83</td>
<td>60.2</td>
<td>X</td>
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<tr>
<td>Jamaica III</td>
<td>11/20/84</td>
<td>55.0</td>
<td>X</td>
<td></td>
</tr>
<tr>
<td>Pakistan I</td>
<td>06/01/82</td>
<td>140.0</td>
<td>X</td>
<td></td>
</tr>
<tr>
<td>Togo I</td>
<td>05/17/83</td>
<td>40.0</td>
<td>X</td>
<td></td>
</tr>
<tr>
<td>Togo II</td>
<td>05/30/85</td>
<td>27.8</td>
<td>X</td>
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<tr>
<td>Yugoslavia</td>
<td>06/28/83</td>
<td>275.0</td>
<td>X</td>
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</tr>
<tr>
<td>Panama</td>
<td>11/15/83</td>
<td>60.2</td>
<td>X</td>
<td></td>
</tr>
<tr>
<td>Costa Rica</td>
<td>04/16/85</td>
<td>80.0</td>
<td>X</td>
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</tr>
</tbody>
</table>

**Notes:**
1. Includes Structural Adjustment Loans and Structural Adjustment Credits.
2. Program Discontinued.

**Sources:** Directory of Structural Adjustment Loan Policy Conditions, FY 1980-1985. (Country Policy Department, the World Bank, January 1986) and relevant Presidents' Reports.
### Table III-2: SECTOR ADJUSTMENT LOANS I/ WITH CONDITIONS RELATING TO FOREIGN INVESTMENT (Fiscal Years 1980-85)

<table>
<thead>
<tr>
<th>Country</th>
<th>Operation</th>
<th>Date of Board Approval</th>
<th>Amount (US$ mil.)</th>
<th>Foreign Investment Policy Conditions</th>
</tr>
</thead>
<tbody>
<tr>
<td>Brazil</td>
<td>Ag. Credit/Export Dev.</td>
<td>10/04/83</td>
<td>303.0</td>
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<td></td>
<td>Export Dev. I</td>
<td>10/04/83</td>
<td>352.0</td>
<td></td>
</tr>
<tr>
<td>Burkina</td>
<td>Fertilizer</td>
<td>02/26/85</td>
<td>13.7</td>
<td></td>
</tr>
<tr>
<td>Colombia</td>
<td>Trade Policy</td>
<td>05/23/85</td>
<td>300.0</td>
<td></td>
</tr>
<tr>
<td>Costa Rica</td>
<td>Export Development</td>
<td>05/03/83</td>
<td>25.2</td>
<td>X</td>
</tr>
<tr>
<td>Ghana</td>
<td>Reconstr. Import I</td>
<td>06/28/83</td>
<td>40.0</td>
<td></td>
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<tr>
<td></td>
<td>Export Rehab.</td>
<td>01/03/84</td>
<td>76.0</td>
<td>X</td>
</tr>
<tr>
<td></td>
<td>Reconstr. Import II</td>
<td>03/28/85</td>
<td>60.0</td>
<td>X</td>
</tr>
<tr>
<td>Guinea-Bissau</td>
<td>Reconstr. Import</td>
<td>12/13/84</td>
<td>10.0</td>
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</tr>
<tr>
<td>Jamaica</td>
<td>Export Dev. Fund I</td>
<td>05/31/79</td>
<td>31.5</td>
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<td>Export Dev. Fund II</td>
<td>04/30/81</td>
<td>37.0</td>
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<td>Export Dev. Fund III</td>
<td>06/16/83</td>
<td>30.1</td>
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<td>Korea</td>
<td>Industrial Finance II</td>
<td>06/06/85</td>
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<td>Madagascar</td>
<td>Industrial Assistance</td>
<td>01/15/85</td>
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<td>Malawi</td>
<td>Smallholder Fertilizer</td>
<td>04/26/83</td>
<td>5.0</td>
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<td>Mauritania</td>
<td>Public Enterprises</td>
<td>03/26/85</td>
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<tr>
<td>Mexico</td>
<td>Export Development</td>
<td>06/23/83</td>
<td>350.0</td>
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<td>Morocco</td>
<td>Ind. &amp; Trade Policy I</td>
<td>01/31/84</td>
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<td></td>
<td>Ag. Sector Adjustment</td>
<td>06/20/85</td>
<td>100.0</td>
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<tr>
<td>Nigeria</td>
<td>Fertilizer</td>
<td>09/13/83</td>
<td>250.0</td>
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<tr>
<td>Pakistan</td>
<td>Fertilizer</td>
<td>09/16/80</td>
<td>50.0</td>
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</tr>
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<td></td>
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<td>05/23/85</td>
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<td>Philippines</td>
<td>Ag. Sector/Inputs</td>
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<td>Sierra Leone</td>
<td>Ag. Sector</td>
<td>06/14/84</td>
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<td>Sudan</td>
<td>Ag. Rehab. Program I</td>
<td>03/25/80</td>
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<td>50.0</td>
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<td>Export Rehab. Program</td>
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<td>Turkey</td>
<td>Ag. Sector Adjustment</td>
<td>06/18/82</td>
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<td></td>
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<tr>
<td>Uganda</td>
<td>Ag. Rehabilitation</td>
<td>02/24/83</td>
<td>70.0</td>
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<tr>
<td>Uruguay</td>
<td>Agricultural Sector</td>
<td>08/29/84</td>
<td>60.0</td>
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<td>Yugoslavia</td>
<td>Fertilizer Sector</td>
<td>05/06/84</td>
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<tr>
<td>Zambia</td>
<td>Exp. Rehab. &amp; Diversif.</td>
<td>03/20/84</td>
<td>75.0</td>
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</tr>
<tr>
<td></td>
<td>Agric. Rehab.</td>
<td>01/29/85</td>
<td>25.0</td>
<td></td>
</tr>
<tr>
<td>Zimbabwe</td>
<td>Manufacturing Exp. Prom.</td>
<td>02/15/83</td>
<td>70.0</td>
<td></td>
</tr>
</tbody>
</table>

**Notes:**
1. Includes IDA Sector Adjustment Credits.
2. Loan Cancelled.

**Source:** Presidents' Reports.
the review of existing legislation and regulations with an eye toward improving the climate for foreign investment, particularly in export-oriented industries (for example, the Costa Rica Export Development Loan, the Ghana Second Reconstruction Imports Credit);

- simplifying investment application procedures and increasing automaticity (for example, the Madagascar Industrial Assistance Project, the Zambia Industrial Reorientation Project);

- removing incentives and regulations that are redundant or distortionary (the Madagascar Industrial Assistance Project).

Non-adjustment types of sector loans ("sector investment loans") rarely include conditions relating to foreign investment. 36

To summarize, some brief comments may be made regarding the foreign investment conditionality contained in the Bank's adjustment loans:

- To the extent that adjustment loans improve macroeconomic policies and the overall business environment (by reducing economic distortions, rationalizing the price structure, etc.), they are likely to both increase the ability of the host country to attract as well as to benefit from foreign investment.

- Conditions relating specifically to foreign investment are infrequent; when present, they are less specific than are conditions in some other topic areas (such as trade and exchange rate policy). In general, foreign investment policy reform is not an important part of adjustment loan conditionality.

- When foreign investment is mentioned, host countries are usually encouraged to be more open to foreign investors and to take actions to attract them.

- The most common theme in SALs where foreign investment is mentioned is that of institutional reform. Frequent conditions are the creation of promotional agencies, streamlining approval procedures, and removing red tape. The advantage of this approach is that the burdensome bureaucracy in many developing countries is often cited by foreign investors as a major obstacle to successful investment projects. The problem with concentrating on institutional reform is that it is usually long-term in nature, and not readily quantifiable. 37

36/ Exceptions include the Guinea Mineral Sector Management Project (1985).

37/ Berg and Batchelder (1985), in a critical analysis of experience with SALs, question whether institutional issues should be part of SALs at all.
ECONOMIC AND SECTOR WORK

The Bank's involvement in foreign investment policy reform has come principally through related conditions in SALs, which of course are partly the result of dialogue between the host country governments concerned and the Bank's regional economists, primarily those in Industrial Development and Finance divisions. However, the Bank has been involved, usually more informally, in policy discussions with member governments as part of its economic and sector work. In most cases the Bank has not conducted a systematic review of a country's foreign investment policies, or proposed major revisions. But Bank economists have reviewed investment codes, proposed some revisions, and included brief analyses of foreign investment policies in periodic country economic memoranda and industrial sector reports. In addition, occasional internal working papers and outside consultants' reports have dealt with such issues as private sector development and industrial incentives.

At the outset, the difficulty of identifying all cases of Bank involvement in this area should be emphasized. In many cases, full reports on the Bank's rationale and proposals were not prepared, and the written materials available may tell only part of the story. Therefore, this overview may underestimate the extent of Bank involvement. The information in this section was gathered from three main sources: (1) country economic memoranda and industrial sector reports since 1979: a keyword search of report abstracts revealed those reports that dealt with foreign investment, investment incentives, private sector development, etc.; (2) conversations with Bank regional economists, particularly those in Industrial Development and Finance divisions; and (3) special studies written by Bank economists that deal at least tangentially with foreign investment policy. From these sources an attempt was made to judge the extent of Bank involvement in foreign investment policy reform, the kinds of reforms that were (and were not) suggested, and (if identifiable) the guiding philosophy of Bank proposals.

Foreign Investment Policy Reform

Probably the most extensive review of foreign investment policies included as part of an industrial sector report is contained in the 1981 study, "Indonesia: Selected Issues of Industrial Development and Trade Strategy" prepared by the East Asia and Pacific regional office. Citing the past and potential importance of foreign investment to the Indonesian economy, the report provides a detailed review of foreign investment policies, the impact of the changing policy environment on foreign investment flows, and policy recommendations. The recommendations put forward are generally consistent with recent policy advice to the Indonesian government suggesting high costs relative to the benefits of the increase in regulation and intervention in many economic processes. The reforms are aimed at restoring conditions under which private profitability is a close approximation of the net benefits to the economy, and which then allow for greater scope for market mechanisms and incentives to guide the economy. Specific recommendations are proposed for the appropriate role for the Investment
Coordinating Board, investment policy, labor policies, equity sharing policies, policy support for weaker economic groups, incentive systems, and financial policies in the areas in which such policies, programs, or institutions affect the foreign investment process.

**Investment Code Reform**

In the West Africa projects department, the IDF division has advised member countries on revisions in their investment codes, with the objective of reducing distortions created by them. More informally, the division has commented on changes in investment codes under consideration by member governments. The case with the most extensive involvement was the Ivory Coast, where the division's work provided background for investment code reforms included in SALs. Investment code revisions have been suggested for Guinea, possibly to be included in a SAL now being considered. The division was also involved in discussions regarding a new investment code in Ghana, and prepared comments on code revisions proposed in Togo and Senegal. A recent paper by Galenson (1984) describes the investment codes of some West African countries, reviews the evidence on the costs and effectiveness of investment incentives, and presents some general principles that could be used in designing incentive systems.

The Bank, jointly with the UNDP, sponsored studies of the investment incentive systems of Malaysia and Thailand during 1980-84. The reports were prepared by two Australian consulting firms. The Malaysia study attempts to identify ways in which existing tax and credit incentives adversely affected the manufacturing sector. Some incentives were found to contain firm, factor, industry, and/or trade biases which were not necessary to or consistent with their purpose; some appeared to cost more in terms of tax revenue foregone than would be required to achieve such purpose; and others were found to have little effect because their delivery method was excessively dependent on profit. The study recommended detailed reforms in order to remove the bias against export activities, facilitate backward linkages, and reduce discretionary elements in the system.

The study of Thailand found that existing fiscal incentives were not structured to compensate directly for specific price distortions which served to favor the use of capital relative to labor, production for the home market relative to production for the export market, and location in and around Bangkok relative to decentralized locations. Indeed, a number served to reinforce the distortions and to have considerable detrimental side effects. The study recommended a long-term strategy to minimize price distortions (by rationalizing the tariff structure and business tax rates, phasing out of quantitative import restrictions and import surcharges, eliminating most price controls, etc.); a medium-term strategy which accepted existing distortions as given but devised incentives to directly compensate for them; and a short-term plan revising approval criteria to better achieve development objectives. This report differs from most Bank studies in the sense that it promotes a somewhat more restrictive stance

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toward foreign investors. For example, it is concerned with excessive reliance on foreign technology and its inhibiting effect on the evolution of indigenous technology; acceleration of the substitutions of local for foreign inputs and "unbundling" of the technology, management, and capital package are recommended. Out of concern for encouraging local ownership and control, it calls for more attention to be paid to determining the areas in which foreign investment is required and in ensuring that where it is involved, local ownership and control is apparent unless it can be clearly demonstrated that foreign ownership and control is essential to ensure the necessary technology or capital inflows and market access. The government is also urged to direct its promotional activities toward countries other than the U.S. and Japan, which already accounted for a large share of foreign investment.

The Latin America divisions of the Bank have received fewer requests from member countries, particularly the larger ones, for advice on foreign investment policies or investment codes. The reasons cited include (1) in Latin America, foreign investment is a particularly sensitive political issue; (2) there is the fear that the Bank might be perceived as representing the interests of multinationals; and (3) the larger Latin American countries already possess local expertise to evaluate policies and suggest reforms. In these countries, future involvement by the Bank in suggesting policy reforms as part of economic and sector work is not anticipated, though such requests are possible from some of the smaller Latin American countries (e.g., Ecuador and some of the Caribbean countries).

A review of industrial sector reports reveals other cases where changes in investment codes were proposed. Some illustrative examples:

Uganda: The report suggests a modification of the tax holiday offered to foreign investors, increasing the incentive offered and putting Uganda's law more in line with the schemes adopted by other countries; elimination of minimum-size requirements on initial investments; and the extension of incentives and guarantees against expropriation to local investors.

Kenya: The report identifies areas where government policy provides disincentives to foreign investors: limits on profit repatriation, restrictions on local borrowing, and higher income tax rates for foreign firms than for local firms. The Bank recommends relaxation of the local borrowing limit for foreign firms, a change in the exchange rate used to value capital gains before repatriation to the current rate rather than the historical rate, and easing of restrictions on employment of expatriate personnel.

Rwanda: While recognizing that the investment climate for foreign investors in Rwanda is good, the report criticizes the vagueness of criteria used to determine eligibility for investment incentives and cumbersome application procedures. Changes
are proposed in order to increase the automaticity of project approval. Increased efforts to encourage investments in the agricultural sector are encouraged.

Somalia: The Bank suggests offering more attractive incentives and guarantees in order for Somalia to compete with some other countries (e.g., Mauritius) which have been more successful in attracting foreign investors. Specific suggestions include reducing the discretionary element in investment approval, dropping the distinction between "productive" and "unproductive" investments, and considering the removal of restrictions on profit repatriation.

Jordan: Recommendations focus on promotion activities and reducing investor uncertainty, perhaps by making available risk insurance to potential investors in order to counter the political volatility of the Middle East.

Private Sector Development

Increasingly, the Bank has paid attention to the role of the private sector in medium- and long-term development strategies. For example, a recent study by the Industry Department examined the constraints to private sector development in Sub-Saharan Africa, ways to create a better environment for entrepreneurship and efficient, competitive markets, and the role of the Bank in this process. In general, the report concludes that African governments could accelerate progress towards their economic goals by widening the scope for private enterprise by removing barriers and constraints to private initiative and fostering open, competitive markets. Though not offering detailed policy proposals for foreign investment, the report cites the need to improve the image of African countries in the eyes of foreign investors through the use of serious promotion efforts. The role of the Bank in this process should be to provide funds to local promotional agencies, foster its own promotional efforts, and give technical assistance for the revision of investment codes to ensure non-discrimination between domestic and foreign investors.

Privatization of State-Owned Enterprises

The issue of foreign investment also arises in the Bank's efforts to encourage privatization of some state-owned enterprises (SOEs). A recent study of the divestiture experience in developing countries (Berg, 1986) notes that, at least in newly industrialized and middle-income countries, foreigners are generally ruled out as purchasers of SOEs, adding to the problem of a narrow field of potential buyers acceptable to divesting governments. The Public Sector Management Unit of the Projects Policy Department, in dealing with this issue, has not explicitly recommended sales to foreigners. However, sale to foreigners has been an implicit issue in some cases (e.g., Panama) where a foreigner was the most
likely (or only) purchaser. The issue is more likely to arise when privatization of management through leases and management contracts, rather than privatization of ownership, is pursued.

To summarize, elements of the Bank's approach to foreign investment policy reform through economic and sector work include: (1) generally removing restrictions on foreign investors, such as limitations on profit repatriation; (2) the removal of, or compensation for, distortions that affect foreign investors; (3) the principle of "automaticity"—that is, granting investment incentives automatically to firms satisfying clearly-stated criteria, rather than discretionary or negotiated approvals; (4) meeting the competition—keeping the level of incentives offered competitive with that of other countries competing for similar types of foreign investment; and (5) approaching equal treatment for domestic and foreign investors.

After reading the foreign investment-related conditions in adjustment loans and sector work, one is left with the impression that much more could have been said, and should have been said in cases where foreign investment is now or potentially important to balance of payments improvement and long term growth. It appears that more of an effort could be made to (a) identify the kinds of distortions that inhibit foreign investment and limit its benefits, and target policies toward removing them; (b) identify areas in which positive externalities from foreign investment are possible, and encourage them; and (c) be aware of which kinds of incentives are likely to be ineffective, whether because of redundancy or because of competition from other prospective host countries. In a similar vein, the Bank needs to keep in mind this competition aspect when it proposes foreign investment conditions to several different countries that compete in the same "market" for foreign investment.

THE BAKER INITIATIVE

The so-called "Baker Initiative" represents the beginnings of a plan, initiated by the U.S. government, to achieve a manageable level of debt and sustainable economic growth in the countries with substantial external debt. The Baker proposal encompasses three core elements:

(1) Foremost, debtor countries are expected to adopt, under the workout programs contemplated by the proposal, comprehensive macroeconomic and structural policies, supported by the Fund and multilateral development banks, to promote growth and balance of payments adjustment;

(2) Second, a continued central role for the Fund and a larger role for the Bank, in conjunction with increased and more effective structural adjustment lending by the MDBs, both in support of the adoption by debtors of market-oriented policies for growth; and

(3) increased lending by commercial banks.
The Baker plan emphasizes the need for a strong increase in investment and savings, suggesting a shift away from large government expenditure programs, particularly in tradeable goods sectors, and toward the establishment of policies and institutions that will stimulate private investment. The plan emphasizes not only an increase in investment, but also an improvement in its productivity. In most of the heavily indebted countries, total investment has been declining, as increased debt service payments and reduced external inflows were accommodated by cuts in both public and private investment. Measures to reverse this trend include: establishment of the proper incentive structure in terms of pricing policies (including interest rates) and institutional reform in order to encourage private sector investment; improvement in the efficiency of existing public sector investment; improved allocation of new public sector investment to activities yielding high rates of return; and limiting public investment to fields where private sector involvement cannot be expected.

The Baker initiative identifies several obstacles that have prevented a larger flow of foreign investment to the heavily-indebted countries: (1) the generally unfavorable investment climate arising from the debt situation and current macroeconomic policies; (2) tax structures not conducive to foreign investment; (3) restrictions on foreign investment such as limits on profit repatriation and majority foreign ownership; and (4) risks perceived by investors, such as the risk of currency inconvertibility and expropriation.

The promotion of foreign investment is said to be a significant part of the financing of adjustment programs. Most of the policy measures included in Baker strategy papers--trade reform, deregulation, and proper pricing policies--would contribute to creating a healthy economic environment which would encourage such investment. But it has also been proposed that the World Bank group could also support the acceleration of foreign investment by cofinancing "B" loans to help joint venture projects, through an expanded role of the IFC, and by alleviating noncommercial risk burdens through MIGA.

Foreign investment is specifically mentioned in a majority of the medium-term strategy papers that the Bank has prepared for each of the Baker initiative countries. The package of policy reforms proposed, and the specificity of those reforms, varies by country. The kinds of reforms proposed include the following:


40/ Ibid., p. 29.
A general "review of policies" with the objective of attracting more foreign investment;
the reform of investment codes, tax and other fiscal incentives, etc., many of which will benefit both domestic and foreign investors;
the removal of restrictions to foreign investment;
the streamlining of investment approvals and investment incentives;
clear rules of the game for, and no discrimination between, foreign and domestic investors;
the promotion of joint ventures in the energy sector;
the reduction of risk associated with currency inconvertibility and expropriation.

Perhaps the most detailed proposals for foreign investment policy reform are found in the medium-term strategy paper for Mexico. The goals of the plan include achieving stabilization of the economy, increased non-oil exports, and lower incremental capital-output ratios (ICORs). Non-oil exports are to be promoted partly by a "better definition of and further relaxation in the rules for private foreign investment". Lower ICORs are also hoped to result from changes in policies toward foreign investment. The strategy paper cites the recent drop in foreign investment in Mexico, though noting that new investment in the "in-bond" (assembly-for-export) sector has increased. Recommended as an initial step is an extension of the in-bond program, allowing those factories to gradually increase their share of authorized sales to the domestic market in areas such as computers, agro-industries, and food services. The report identifies other problems that have inhibited more foreign investment: unclear rules of the game for foreign investors, delays in investment approval procedures, and the limitation on foreign ownership to 49 percent. As an "up-front action", the paper suggests putting three or four applications for foreign investment yearly on a "fast-track" approval process to improve Mexico's image among foreign investors. In the medium term, the report recommends a review of existing investment, labor, and other laws to broaden, clarify, and simplify the terms and conditions under which foreign investments are permitted. Other policy changes should attempt to "ensure fundamental property rights", accept international arbitration of investment disputes, and establish internationally acceptable rules for patents and copyrights.

IFC ACTIVITIES

The International Finance Corporation (IFC) is, of course, the World Bank's affiliate especially concerned with private sector development in developing countries. The IFC's role has been called that of a
"catalyst", attracting private sources of capital to projects in which the IFC, through loans and equity investments, assumes a minority position. Typically the IFC will join with a domestic partner and a foreign investor to launch a project which will strengthen the domestic private sector and bring capital, know-how, and development to a country's economy.

The IFC has also been involved, usually in an informal way, in advising member countries on foreign investment policy. For example, the IFC was extensively involved in discussions with Egypt in the early 1980s on foreign investment policy reform. More recently, the People's Republic of China has requested IFC assistance in designing new policies toward multinational corporations. The IFC has prepared a series of papers on various aspects of foreign investment policy in developing countries, to be presented at a seminar in China in July 1986. Other countries, including Colombia and Ecuador, have requested IFC assistance in reviewing their own policies. In response to these requests, the Development Department of the IFC has created a new foreign investment advisory group, to expand and coordinate efforts in this area.

THE MULTILATERAL INVESTMENT GUARANTEE AGENCY

In Section II of this paper, we noted that host countries seeking to attract a greater volume of foreign investment do so by means of policies that increase the perceived risk-adjusted rate of return received by foreign investors. In turn, this perceived risk-adjusted rate of return may be increased by raising expected returns, by reducing risk, or by altering investors' perceptions in these directions.

The literature on the effectiveness of foreign investment policies strongly suggests that reducing risk and providing information to foreign investors are potentially very effective measures, particularly given the current economic problems of many developing countries. Studies indicate that perceptions of political risk can discourage the flow of foreign investments. 41 For example, a recent study of the energy industry concluded on the basis of interviews with 40 multinational energy companies that concerns about political risks, past experiences with expropriation, instability of contracts, and politicization of energy development have greatly contributed to energy companies' caution about investing in developing countries. 42 The study reveals, however, that energy firms recognize that the developing countries remain an important element in worldwide strategy, both as a critical resource base and as an essential market in the long run. While the private sector is apparently willing to invest on a significantly increased scale, the report concludes that it would not do so unless there were a real change in both the perception and

41/ For a summary of survey and cross-section studies on political instability as a variable influencing the flow of foreign investment, see Agarwal (1980) and Aharoni (1966).

reality of non-commercial risks faced in these countries. Most firms covered in the study agreed that a globally operating investment guarantee scheme, if combined with World Bank guarantees in certain cases, and perhaps national and commercial political risk insurance, would greatly assist the private sector in developed economies to invest in developing countries' energy projects.

Perceptions of instability and risk not only reduce the flow of foreign investment, they may also affect the types of investments made. A high level of risk may, for example, mean that foreign investment is dominated by larger firms. Unlike small- and medium-sized firms, larger concerns have methods of self-insurance and are able to diversify their risks and protect their investments by other means. By attracting only large investors, host countries are not able to take advantage of the fact that smaller companies are often content with more balanced contractual arrangements and are better able to offer appropriate technology suited to the needs of these countries. Uncertainty about the medium- and long-term future may also encourage investors to go into ventures that yield high rates of return over a short period, whereas many beneficial investment projects have longer gestation periods.

To the extent that available guarantees provided by national agencies and the private market have inherent limitations because of their mandates and respective objectives, there is a need for a global investment guarantee agency to provide co-insurance with, and reinsurance of such existing facilities and to complement their work by activities of its own. The desire to reduce non-commercial risks faced by foreign investors, and the seeming under-provision of risk insurance by the private market, has led the World Bank to create the Multilateral Investment Guarantee Agency (MIGA). The hope is that this agency, by providing guarantees against non-commercial risks in a more comprehensive and effective manner than what is available at present, will remove a major impediment to international investment.

The MIGA's role would go beyond the provision of non-commercial risk insurance; it would combine insurance with broader service and advisory functions. In addition, it has been proposed that coverage be extended to funds brought from abroad by nationals of a developing member country, in order to reverse the capital flight phenomenon which has badly damaged the economies of many developing countries in recent years. A host country's membership in MIGA may also increase confidence of foreign investors and contribute to a positive impression about the host country's receptiveness to foreign investment. Finally, the MIGA may offer information services to potential foreign investors, identify potentially suitable projects, and give technical assistance to host countries interested in particular investment opportunities. Generally, the agency could play a positive role in the establishment of respected standards for the treatment of foreign investment and in the development of international law in this area.
IV. AN EVALUATION OF SELECTED POLICY REFORMS

Previous sections of this paper provided background material relevant to an evaluation of the economic costs and benefits of foreign investment policies, and gave an overview of the kinds of policies the Bank has recommended or required in its lending operations. In this section, we choose for more detailed evaluation two policies that, broadly speaking, typify the posture of Bank recommendations. The first is that of institutional reform: policy changes that streamline foreign investment approval procedures, cut red tape and bureaucratic delays, create one-stop approval institutions, or create foreign investment promotional agencies. The second is the principle of equal treatment (or its opposite, discriminatory treatment) for domestic and foreign investors. The focus is on the economic arguments for policy reforms, justified by the presence of externalities and distortions; and on the expected effectiveness of the reforms.

INSTITUTIONAL REFORM

Across all means of Bank policy recommendations (adjustment lending, economic and sector work, the Baker Initiative, etc.), the policy change most frequently encountered is that of institutional reform of agencies responsible for approving, regulating, or promoting foreign (and sometimes also domestic) investment. In most cases, the stated objectives of institutional reforms are to increase the volume of foreign investment inflow generally; in some cases, to increase foreign investment in export-oriented industries; and to increase the efficiency of resource allocation. Though other objectives may remain unstated, it is reasonable to assume that the objectives of these policy proposals are mostly economic (i.e., increasing the net economic benefits of foreign investment) rather than political, social, or cultural.

The institutional reforms suggested fall into two main areas: (1) "reducing bureaucratic barriers": streamlining investment approval procedures; creating one-stop approval agencies to replace existing systems of multiple agency approval requirements; reducing the time needed to process investment applications; "automaticity"--making approval procedures automatic (for firms satisfying certain criteria) rather than discretionary across firms; clarifying the "rules of the game" for foreign investors; and (2) "promotional activities": creating or reforming foreign investment promotional agencies to disseminate information about investment opportunities and sometimes offering other assistance to foreign investors.

To evaluate the wisdom of suggested institutional reforms, we refer to the analytical framework developed in Section II of this paper, and attempt to answer the following questions: Do there exist economic distortions (divergences between private and social costs or benefits) that the institutional changes are intended to remove or compensate for? Are the reforms expected to increase the positive externalities or reduce the negative externalities associated with foreign investment? Are the economic benefits of the reforms expected to exceed their economic costs? And are the reforms expected to be effective in altering investor behavior and in achieving the ultimate objectives of increasing the amount and net benefits of foreign investment to the host country?
Reducing Bureaucratic Barriers

Examples of the Bank's recommendations in this area include:

- **Guyana SAL/SAC I**: the loan contains a provision stating that "to provide the private sector with clear 'rules of the game', the private sector investment code will be clarified and expanded."

- The Action Program of the Jamaica SAL I cites the government's creation of the Jamaica National Promotion Company, a "one-stop" promotion agency that centralizes all relations with potential investors. The agency "'fathers' each proposal, coordinates bureaucratic action, and ensures speedy processing."

- The Korea SAL II cites previous government reforms of foreign investment guidelines, including simplifications of administrative requirements and procedures: a reduction in the approval period of new foreign investment from 80 days to 30-60 days and for additional investments from 60 days to 10-30 days. Further reforms to be submitted to the legislature include the replacement of the existing list of industries open to foreign investment with a negative list specifying only those industries in which foreign investment is prohibited or restricted.

- The Baker Initiative country study for Argentina proposes a reduction in bureaucratic delays relating to investment approvals, particularly for foreign investors. Similarly, the Nigeria country study suggests that the government streamline regulatory measures relating to industrial approvals.

- The Korea SAL II proposes replacing the existing system of investment approval (in which all applications by prospective foreign investors require deliberation with concerned ministries and, if above a certain size, require approval by the Foreign Capital Project Review Committee) with a new system in which all applications satisfying specific criteria (including the foreign investors's share of equity in the project and the total amount of foreign equity) will be approved by the Ministry of Finance immediately, without deliberation with other ministries or approval by the FCPRC.

- The Panama SAL I cites the government's proposal to replace the existing contract system (in which the investor contracts with the government to carry out an investment project in return for exemptions from income tax and import duties,
reduced rates of taxation, protection against foreign competition, etc.) with a general system of incentives to a wider potential group of beneficiaries, thereby eliminating the concept of individually negotiated contracts.

- The Mauritius SAL I states that the government is trying to ensure that administrative controls which are not necessary are abolished and that regulations are made definite, with incentives to investors automatic rather than discretionary.

- The Zambia Industrial Reorientation Project requires the enactment of proposed legislation that provides moderate and automatic incentives in the form of income tax deductions and grants for training and research and development for enterprises that either export, produce with high local content, are located in a rural area or are classified as small-scale enterprises.

- The 1985 Manufacturing Sector Memorandum on Rwanda cites problems with the discretionary nature of the granting of advantages under the existing investment code. The report supports the government's plan to change the code in order to establish clear qualification criteria and make its application more automatic.

- A 1985 economic report on Somalia states that "multiple classification and complex eligibility criteria should be avoided...simplicity, automaticity, clarity and uniformity are the characteristics of most effective investment codes...The level, number and duration of the concessions seem to be unduly dependent on the bargaining power and influence of the investor. Any arbitrary discrimination between one enterprise or one product and another may result in inequity and distortion of investment flows."

In the category "bureaucratic barriers" we include a variety of obstacles and procedures, purposeful or not: government screening procedures that allow or disallow foreign investment projects to proceed and approval procedures for investment incentives, often involving more than one government agency or ministry; unclear criteria for project approvals and the granting of incentives; unclear rules regarding restrictions or performance requirements for foreign investors; and discretionary elements in the approval process. Most of the bureaucratic barriers for which reforms have been proposed may be considered mechanisms for implementing policies rather than as policies themselves. The latter are intended to achieve certain objectives, such as increased exports, employment, or access to technology; the objective of the former is merely to implement the policy. For example, informing investors of industries open to foreign investment by means of a negative list system as opposed to a positive list system is merely a mechanism for implementing the policy of certain
sectoral restrictions. In other cases, the bureaucratic barriers have characteristics of policies themselves---for example, granting incentives according to a discretionary mechanism really means using different criteria (e.g., the bargaining power of individual firms) than are used in an automatic mechanism applied consistently across firms. Thus, the evaluation of these reforms must take into account further changes in costs and benefits.

Clearly, some bureaucratic procedures are necessary to implement most policies of incentives and restrictions. For those bureaucratic procedures that are basically implementation mechanisms rather than components of the policies themselves, the objective of institutional reform should be to move to the least costly implementation strategy---by reducing implementation costs to the host country (increasing the net benefits of the policy), or by reducing the distortionary effects of the implementation itself on the behavior of foreign investors. Institutional reforms that reduce implementation costs to the host government as well as reducing investment costs to the foreign investor are "positive-sum" reforms. The key, then, is to identify implementation strategies that exhibit "excess" bureaucratic barriers: those whose removal would reduce costs for the government or foreign investors or both, and would not change the basic policy stance if the latter is deemed to be appropriate.

Some of the institutional reforms that have been suggested by the Bank are likely to reduce excess bureaucratic barriers without causing further policy change. Examples include:

Clarifying the "rules of the game" for foreign investors. It is likely that few benefits are derived by the host country by deliberately making its policies vague or opaque. Exceptions could occur if obscuring policies increased the government's bargaining power vis-a-vis foreign firms. Providing policy information is not likely to be very costly in terms of government revenue and added bureaucracy. Yet this information reduces uncertainty for actual and potential foreign investors, thereby increasing the incentive to invest. Surveys of firms support the idea that clarity and consistency of policies are very important to foreign investors, even if those policies themselves are restrictive.

"Streamlining procedures". It is difficult to argue with this general Bank recommendation, since it implies that fewer or simpler procedures will merely remove excess bureaucratic barriers and not alter the basic policy stance. Again, surveys of multinational firms indicate that complicated approval and incentive procedures are an important disincentive to invest.

Other Bank-recommended reforms, while clearly reducing costs to foreign investors and thus providing a greater incentive to invest, are more likely to alter the composition of firms receiving approvals---a change whose costs and benefits must be evaluated. For example:
Reducing the time needed for investment and incentive approvals. While this reform does not necessarily change fundamental policies toward foreign investment, it may increase implementation costs to the government if speeding approval processes requires more government personnel. If approval is granted by default once a maximum time limit is reached, some projects that would have been otherwise rejected may receive approval. The question is then whether the benefits of receiving investments that would not have been proposed under the more delayed system outweigh the costs of allowing these projects to slip through.

"One-stop" approval agencies. The "multi-stop" procedure common in many host countries allows ministries of different sectors and jurisdictions to influence the project's approval or the granting of incentives. A more centralized screening institution may diminish the influence of some concerned agencies, or it may provide a fairer representation of the country's interests. Whether or not the centralized bureaucracy alters the number or composition of firms receiving approvals really depends on how these different interests are represented in the centralized agency. Unfortunately, the available literature is scarce on successful methods of organizing "one-stop" agencies.

Automaticity. An "automatic" mechanism for granting project or incentive approvals is one in which the criteria for acceptance are known and applied equally to all firms: for example, a general system of incentives to be given to all firms that meet requirements of size, foreign equity share, export orientation, or location. This type of mechanism has been proposed by the Bank to replace "discretionary" procedures, in which entry contracts are negotiated with firms on an individual basis.

Theoretically, there are certain advantages to the discretionary system. The first of these is the ability of the government to avoid redundant incentives that cost revenue but do not change the firm's decision to invest. By refusing to grant incentives to firms that would invest anyway, the government in effect captures some "producer surplus" from foreign firms. Incentives could be reserved for projects that would be unprofitable without them, but have net economic benefits to the host country, even when the costs of the incentives are included. Second, a discretionary system allows the government to respond to differences in bargaining power across firms. And finally, discretion allows the government to consider the total net benefits of each project, rather than applying a rigid rule according to the achievement of thresholds (though exceptions and "flexible interpretations" could be granted in an automatic system).

However, there are strong practical and political economy arguments against using a discretionary mechanism, especially for a small low-income country. Automaticity conserves on a scarce resource--skilled administrative employees--and reduces the incentive for corruption. For the foreign firm, automaticity reduces uncertainty and saves time that would be spent negotiating with the government. And, in fact, it is not
clear that governments using a discretionary system have been very successful in "picking the winners" on an individual basis—in other words, successfully anticipating which foreign investment projects are those that will contribute most to development efforts. In the final analysis, the government must weigh the net benefits of the (potentially costly) system of individual project evaluation and negotiation, with the easier and more certain system of automatic approval. In most developing countries, the arguments for automaticity probably dominate.

Are efforts to streamline screening and incentive systems effective in attracting more, and more beneficial, foreign investment? Based on several surveys of multinational firms, the answer would appear to be "yes". Managers of foreign firms often cite cumbersome bureaucratic requirements and delays as a major disincentive affecting the location of their investments. Typical of these studies is a survey of ninety multinational firms with operations in developing countries was carried out by Frank (1980). He found that the manner in which rules and regulations are administered in many developing countries is a major deterrent: "Excessive red tape, bureaucratic incompetence, indecision, and corruption are common. One firm withdrew from a country because of widespread corruption. Another stated that 'things like unkept appointments, unbusinesslike officials, corruption, and inefficiency all put great personal strain on our people. The rewards have to be great to make us persevere rather than do business in places with fewer day-to-day trials.'"

The reasons behind foreign investors' concern over bureaucratic barriers is explored further in Goodman (1985). In a survey of home-office executives and subsidiary managers of multinational firms with operations in Andean Group countries and Brazil, Goodman finds that managers making investment decisions are frequently more concerned about saving executive time than they are about maximizing profits. One manager states:

"Making huge profits is not my bottom line. If I have a terrific year I worry whether I can manage a repeat performance... This is a small subsidiary. Even doubling or tripling last year's profits would have little impact at headquarters. My bottom line is to make a satisfactory showing and, most important, not to waste my boss's time worrying about my territory... or too much of my own time on projects that should be well on their way." 

Other quotes from managers of multinational firms support the idea that restrictive policies themselves may not be the major deterrent to foreign investment, whereas policy instability and inefficient policy implementation may be:

43/ Frank (1980), p. 112.
"Behind our initial skepticism regarding the Andean Group, we were hoping that it would develop new opportunities for our business. We found we could cope with the letter of Decision 24, but we were constantly frustrated by the changes in its interpretation and, more importantly, the endless inefficiency of host country officials implementing both the general provisions and their own national regulations. We are very disappointed in what we have seen so far." 45

Goodman found that managers of small subsidiaries which were of only marginal interest to global strategies were very concerned about time efficiency. However, managers involved with Brazilian operations, usually of central concern to the headquarters' global strategy, were more concerned about overall profit rates. He concludes that the efficient use of management time--of both the subsidiary manager and the headquarters staff--is a primary consideration for small nation investment decisions and is of secondary concern in large nations. Large multinational firms are only likely to expand operations in small developing nations if their managers view the investment process as streamlined, fair, easy to understand, and generating benefits which advance their firms' global strategies. Goodman's finding—that executive time is the central concern for marginal decisions and that revenue implications are primary for central decisions—may explain why incentives which stimulate investment in some larger, more industrialized countries may not necessarily work in the same way in more marginal areas such as small developing countries. 46

While it is common to find survey results citing the concern of multinational firms over bureaucratic barriers, it is more difficult to find evidence that removing such barriers will actually result in an increased flow and quality of foreign investment. Those who believe that a supply response will occur frequently cite the experience of some Southeast Asian countries (Singapore, Malaysia, Korea, Taiwan) that were able to attract a growing amount of foreign investment during recent years, even while foreign investment in the developing world generally was in decline. According to Goodman, the opposite pattern of foreign investment growth in Southeast Asia compared to Latin America was due to two crucial differences: (1) while capable of flexible interpretations of regulations, neither the Andean Group nor its six member countries possessed the administrative capacity to streamline investment permissions and regulation such that multinational firms' management time could be used effectively; and (2) in addition to regulating multinational firms, the Southeast Asian countries aggressively devised means to attract particular foreign firms to invest in their nations' economies (on the second point, see below). 47

45/ Ibid., p. IV-14.
46/ Ibid., pp. 6, 10, 13.
47/ Ibid., p. VI-14.
should be careful in attributing Southeast Asia's successful attraction of foreign investment to these factors alone. As the author himself points out, Southeast Asian countries and Latin America exhibit wide differences in politics, cultures, histories, resource endowments, and levels of development.

The results of surveys of foreign firms and our analysis above suggest the following conclusions relevant to Bank policy recommendations:

- Bureaucratic barriers and the uncertainty created by them are an important deterrent to foreign investment.
- By reducing foreign firms' costs of investment, the reduction of bureaucratic barriers increases the incentive to invest; further, the effect on investment decisions by firms may be greater than a simple profit recalculation would suggest.
- Reducing bureaucratic barriers may be an effective strategy especially in the case of smaller developing countries that are "marginal" to the global strategies of multinational firms. Particularly in these countries, the Bank's emphasis on institutional reform rather than increasing costly incentives to attract foreign firms is probably justified.
- The Bank's strategy is unambiguously positive in the case of streamlining clearly "excessive" implementation processes. In cases where streamlining alters the composition of firms receiving entry approvals or incentives, a further evaluation of the costs and benefits of the reform may be needed.

Promotional Activities

Institutions and activities designed to promote foreign investment in the host country include organizations of local and foreign businessmen who identify and develop investment opportunities; government agencies that provide information to potential and current foreign investors, put foreign investors in contact with local partners and suppliers, assist foreign investors in dealing with local bureaucracy, and in some cases offer financing; advertising campaigns in public media; and foreign investment information and promotion activities carried out by the host government in source country offices. Examples of Bank recommendations include:

- The Jamaica SAL I calls for the formation, on a bilateral basis, of joint business groups with industrialized countries to identify and develop investment opportunities in Jamaica.
- The economic program of the Ivory Coast SAL II proposes that the government set up, in conjunction with the private sector, an industrial promotion bureau to serve as a focal point for potential investors in the country.
The Mauritius SAL I calls for the appointment of investment promotion consultants in order to secure more dynamic forms of investment promotion overseas. The SAL II contains as a condition the establishment and operation of the Mauritius Export Development and Investment Authority (MEDIA), an autonomous institution that will enable prospective investors to deal with only one agency for obtaining all necessary information and clearances to start and operate an industry in Mauritius. MEDIA is to act as a contact point for potential foreign investors and foreign importers, provide them with necessary information, and put them in contact with local businessmen. MEDIA is especially intended to promote Mauritius as an attractive base for the establishment of export-led industries.

The Panama SAL I supports the government's establishment of a National Investment Council, headed by leading Panamanian businessmen, to promote export industries and assist investors in dealing with local bureaucracy.

Measures taken under the Turkey SAL III include the hiring of an investment banking consortium to promote foreign investment in petroleum, tourism, mining, and agroindustries, as well as to review the relevant laws and regulations.

It is well known that the extra uncertainty, lack of information, and cultural differences associated with transactions across countries are a barrier to both international trade and international investment. The foreign investor is said to be at an inherent disadvantage relative to his local competitor precisely because of his lack of knowledge of local economic conditions, sources of inputs, and marketing. Reducing uncertainty (providing knowledge) lowers barriers to international flows of investment capital, and puts foreign investment on a more equal footing with opportunities in the investor's own country.

Should host government provision of information to potential foreign investors be seen as the removal of or compensation for an economic distortion? Information regarding the general investment climate, incentives and regulations affecting foreign investors, and specific investment opportunities may be viewed as a "public good", since consumption of the good by one firm does not reduce the amount of the good available for others. One would expect that this public good would be underprovided by the private sector in a market economy. Therefore, there is a role for the government to play in providing the socially optimal amount of this public good.

To the extent that foreign investment-related information is specific to a particular firm, the conditions for an optimum are the same as for a private good. In this case, government provision of information
is merely a subsidy to the foreign firm, reducing the firm's costs of production. Viewed another way, promotional activities may be seen simply as a form of advertising: efforts by the "seller" (the host country) to change the image in the minds of "buyers" (potential foreign investors) of the characteristics of the "product" (the host country business environment).

It is not obvious that it is the host country as seller that should pay the costs of information transfer. If the transfer of information causes mutually beneficial trades to occur, both buyer and seller gain, and therefore theoretically should be willing to share the costs of the information transfer. Yet, "who bears the burden" depends also on how the gains from trade are distributed between the buyer and seller, and the bargaining power of the parties involved. If foreign investors as a group are defined to be "the buyer" and each individual host country is a "seller", then the bargaining power of the host country vis-a-vis foreign investors is a function of the availability of other foreign investment opportunities in competitor countries. For example, a country with unique and attractive resources or location has more bargaining power, due to inelastic demand, than does a country whose competitors have similar endowments and characteristics (a case of elastic demand). Thus to the extent that countries compete for the same kinds of foreign investment, they will be forced to bear the cost of information transfer themselves.

The question of the extent to which host countries compete for similar types of foreign investment was explored in some detail by Guisinger (1985). According to his survey of governments and multinational firms in ten developed and developing countries, all countries compete for foreign investment to some degree. Foreign investments were found to be generally oriented toward one of three markets: the domestic market of a single host country, a common market, or one for investments to produce for the worldwide export market. For the countries surveyed, the intensity of competition differs among these markets, and results in different strategies being taken toward foreign investment. The degree of promotion, as one element of strategy, was found to be "low" for foreign investments oriented toward the domestic market, but "moderate" for investments oriented toward common markets or worldwide exports:

"Agencies responsible for foreign investment policy in countries engaged principally in the market for inward-directed foreign investments did not perceive their country to be in competition with agencies from other host countries. They also seldom had representatives abroad who actively solicited foreign investments, and they tended to regard negotiations with foreign investors as essentially a bilateral process. In contrast, officials from common market countries, especially the EC, frankly recognized that they were participating in a competitive process. These officials acknowledged that whereas investment incentives were designed primarily to channel domestic savings into priority areas,
investment policies, at least at the margin, were influenced by competitor country policies. All EC countries have official representatives in major capital-exporting countries to identify prospective investors and provide information about their countries. Officials from countries participating in worldwide export also tended to perceive their countries to be in competition for foreign investment, but not to the same degree as officials from EC countries." 48

In sum, Guisinger finds that countries do compete for outward-oriented foreign investments, and their strategies depend to a large degree on the actions of their competitors. This leads to the conclusion that for many countries seeking outward-oriented foreign investment, promotional activities are a defensive strategy--in order to maintain their market share of foreign investment, they must advertise to keep up with the competition.

This evidence supports the hypothesis that, given the promotional activities in competitor countries, a single country's market share of foreign investment depends on its own attention to promotion. There is less evidence, however, that the "size of the pie" (the total volume of foreign investment going, say, to developing countries) would be increased if all host countries increased their promotional efforts simultaneously. In other words, there is little evidence on the aggregate elasticity of supply of foreign investment with respect to promotional activities by all buyers--or, for that matter, with respect to host country policy reforms in general.

A recent study by Muller, Domike, and Holtzman (1985) attempts to identify elements of successful promotion strategies. The six host countries analyzed in detail (Brazil, Korea, Malaysia, Singapore, Spain, and Taiwan) successfully increased their shares of foreign investment in recent years, in spite of the decline in total flows of foreign investment to developing countries in general. This success was attributed by the study to a close coordination between (1) foreign investment policies; (2) foreign investment promotion activities; (3) an industrial development strategy, including targeting of priority industries for development; and (4) analysis of changes in the structure of world industry, its probable future evolution, and corresponding adjustment of policies. 49 Singapore and Malaysia, which have had particular success at attracting preferred types of foreign investment, have "one-stop" promotion agencies that aggressively seek out new foreign investment, and are also responsible for policy formulation and regulation. Officers in these agencies are responsible for and specialize in particular industries. The officers follow a project through from its initial promotion to final implementation and also provide post-investment consultancy services.

49/ Muller et al. (1985), p. ii.
The study recommends that host countries use industry-specific policies to help identify individual investment opportunities, which may then be fulfilled through an active search of prospective investors. This search should include active efforts to publicize the host country's favorable investment conditions and identify and seek out prospective investors. 50

In sum, the Bank's focus on promotional activities is probably justified in most cases. The evidence on successful promotion strategies suggests the following:

- Promotion activities are especially important for countries with a large number of rival countries, similar in resources, objectives, and policy instruments.
- The importance of promotion activities depends on the type of investment the country wants to attract (it is more important in the competitive market for outward-oriented foreign investment than for investment intended to serve the local market) and on characteristics of the firms it wants to attract (e.g., a country wishing to attract small- or medium-sized multinational firms, whose information costs may be high, will need to devote more effort to promotion).
- The most successful kind of promotion strategy—measured both in terms of volume and of development benefits—is probably one that is targeted toward particular industries and potential investors. In this area, the Bank's recommendations could be more detailed.
- Periodic monitoring of the results of promotional activities is important, particularly in the case of costly activities such as investment offices located in source countries. Strategies should be modified in accordance with monitoring results.

It is, however, important to re-emphasize a point raised earlier that efforts to attract foreign investment are most effective in countries where the overall investment climate is favorable, and that the net benefits of the foreign investment are higher in countries with an appropriate incentive structure. When these conditions do not hold, promotion efforts may be meaningless or even harmful to the host country.

EQUAL TREATMENT FOR FOREIGN AND DOMESTIC INVESTORS

National treatment for foreign investors, while not always an explicitly stated policy reform suggested by the Bank, is at least a trend and underlying theme in the Bank's proposals, particularly in the Baker plan. Examples of these reforms include:

50/ Ibid., p. 8.
The Korea SAL II supports an expansion of the number of industries in which foreign investment is allowed, and the relaxation of ownership ratios, allowing an increase in the maximum foreign shareholding from 49 percent to 100 percent in certain industries. Relaxation of foreign ownership restrictions is a move in the direction of equal treatment for foreign and domestic investors.

A Uganda industrial sector report recommends extending incentives and guarantees against expropriation to local investors.

An industrial sector report for Kenya recommends relaxation of local borrowing limits on foreign firms, putting them on a more equal footing with domestic firms in local capital markets.

The Baker country papers generally recommend clear rules of the game for, and no discrimination between, foreign and domestic investors.

To evaluate policy reforms that suggest or move in the direction of equal treatment for foreign and local investors, we view "equal treatment" to be the removal of policies of "differential treatment"—policies that discriminate between foreign investors and local investors. Are there economic objectives that justify differential treatment? Or do countries discriminate between foreign and domestic investors solely to achieve noneconomic (political, social, cultural) objectives?

Focusing on economic objectives alone, it is clear that equal treatment of foreign and local investors is optimal in a "first-best" world. With complete, freely functioning, and competitive markets, any government policy that alters the amount and allocation of investment, including those that discriminate between foreign and local investors, reduces economic welfare for the host nation as a whole (though certain groups may be made better off). As long as private and social costs or benefits are equal, there is no economic justification for differential treatment, even if there are differences in behavior, size, or industrial composition between local and foreign investors. Thus, for example, the fact that foreign firms transfer profits abroad and local firms do not, is not in itself a justification for differential government intervention; only if distorted markets (e.g., foreign exchange scarcity caused by a disequilibrium exchange rate) create a need for government intervention is differential treatment (e.g., restrictions on profit repatriation by foreign firms) justified.

A necessary condition for differential treatment to have an economic justification, then, is that the world is characterized by externalities or other distortions that create a divergence between private and social costs or benefits. In addition, however, one of the following conditions must hold:
The divergence between private and social costs or benefits is due to the firm's multinationality per se. Where the effects of multinational enterprises have nothing to do with their multinationality per se, then general policies--though they may need to be modified because of the presence of multinationals--are sufficient to take care of the divergence of private and social interests. Where the divergence occurs because of the multinationality, then policies specific to foreign firms may be justified. For example, the global strategies of multinational firms (which are different than the national strategies of local firms) may cause an undesirable domestic industrial structure.

The divergence between private and social costs or benefits, while not caused by multinationality per se, is correlated with multinationality, and furthermore it is difficult or costly to reduce the divergence by attacking the "true" cause. For example, the presence of foreign firms in an industry may be associated with imperfect competition in that industry; if a first-best solution (increasing competition through a more liberal trade policy, or antitrust policy) is difficult to administer, a second-best solution to the problem of imperfect competition may be to restrict the entry of foreign firms.

According to some authors, the presence of multinational enterprises clearly alters the path of development in host countries, through their influence on the type of investment and other dimensions of firm behavior, including the generation and use of technology, trade behavior, the exercise of market power, and investment in a particular product mix. The extent and pattern of these differences are likely to vary between industries, the strategy of firms, and their degree of multinationality, but mainly perhaps according to the type of foreign investment and the environment, system, and policy variables of the country in which they operate. Below, we briefly examine the evidence in some areas in which foreign firms are said to behave differently from local firms, or where the effects of foreign firm operations are said to differ from the effects of local firm operations. These three areas are (i) industrial structure, (ii) the balance of payments, and (iii) technology. In each, we are concerned with whether differences in behavior are due to "foreignness" or "multinationality" per se or other factors; the presence or absence of external effects or other distortions; and whether as a consequence there is an argument for differential treatment.

Industrial Structure

Do multinational enterprises, due to their foreignness, impinge on economic structure and changes in industrial structure in host developing countries? Foreign firms may have different objectives or respond to economic stimuli differently than local (or "uni-national") firms, such that foreignness exerts an independent influence on industrial structure in

the host country. On the other hand, the presence of foreign firms may be correlated with certain kinds of industrial structure in the host country, but not be a causal factor. In most areas of concern, there are conflicting opinions in the literature on the causality question.

The empirical evidence clearly shows a close correlation between foreign investment and seller concentration, in host developed as well as developing countries. For example:

- A study by Fajnzylber and Martínez-Tarrago (1976) showed that foreign firms in Mexico made 61 percent of their total sales in markets with four-firm concentration ratios of 50 or greater and less than 10 percent in markets with four-firm concentration ratios of less than 25; by comparison, Mexican firms sold only 29 percent in the highly concentrated markets and 33 percent in low concentration industries.

- Newfarmer and Marsh (1981), in a cross-sectional econometric study of Brazil’s manufacturing sector, found a positive correlation between foreign ownership of an industry and industrial concentration. The measures for minimum efficient scale, industry advertising, and concentration in the U.S. were also positively correlated, controlling for other factors.

- Connor and Mueller (1977) found in Brazil and Mexico that there was a strong positive relationship, after controlling for other factors, between market concentration and two other measures of market imperfection (product differentiation and relative market share) and the level of foreign ownership in an industry. In addition, they found a strong direct correlation between the level of market concentration in Mexico, Brazil, and the U.S.

Yet the observed association of foreign investment with industrial concentration does not identify whether the association is due to a causal relationship between the two variables, or whether foreign ownership and seller concentration in an industry are due to common causes. Does foreign investment cause industrial concentration or is it attracted to concentrated markets? If foreign firms cause concentration, they may decrease competition; if they are merely attracted to concentrated markets, they may increase competition. The question is, then, whether causal links can be established both theoretically and empirically.

Some authors find no strong evidence either to support or refute the hypothesis of a causal link between foreign investment and concentration. According to Caves' (1982) review of the empirical literature on this issue,

53/ Other empirical studies of foreign investment and industrial concentration include Dunning (1958), Steuer et al. (1973), and Lall (1979).
"The substantial overlap between the sources of entry barriers and the sources of foreign investment implies that the two should be highly correlated across industrial markets, as indeed they are. These relationships do not themselves prove that any direct causal relationships exist between foreign investment and concentration... Multinational enterprises are large firms that often operate in concentrated industries. However, there is no decisive evidence that multinational status feeds back to make industries still more concentrated or less competitive. Nor is there evidence that rules out the possibility of these adverse effects."\textsuperscript{54}

Others find stronger evidence to support causality. A survey of the literature by Newfarmer (1985) uses industrial organization theory to explore the effects of foreign firms on host country economic structure. On the question of the effects of foreign investment on host country industrial structure, he concludes:

1. The process of internationalization affects not only the global organization of an industry, but also the structure and performance of domestic industry in developing countries. To the extent that multinational enterprises "grow differently" from national economic entities, transnational control of investment changes the path of growth in developing countries.

2. Theory and evidence strongly support the idea that foreign investment arises out of market imperfections in home markets and in international trade. Foreign firms investing abroad in manufacturing tend to grow out of differentiated oligopoly while those investing in primary resources tend to grow out of undifferentiated oligopoly.

3. There is a clear link between foreign investment and noncompetitive industrial structure in developing countries, with multinational firms bridging differentiated oligopolies in several national markets. The question of whether multinational firms actually cause increases in concentration, barriers to entry, and product differentiation, or whether they simply are attracted to highly concentrated markets, is still unresolved. Yet, a strong case can be made that the activities of foreign investors have promoted imperfect markets in host developing countries.

4. There is considerable support for the hypothesis that "foreignness" is a market structural variable with an independent influence on firm behavior and performance. To

\textsuperscript{54} Caves (1982), pp. 102 and 112.
some extent, multinational firms behave differently from domestic firms in their acquisition, advertising, technological, trade, and trade pricing activities, with corresponding implications for industrial performance.

Local market structure does appear to be related to profitability, but evidence is not always consistent on the role of multinational firms. Evidence concerning the reported profitability of firms suggests that foreign firms per se are not necessarily more profitable than domestic firms, once market structure is taken into account. This finding might not hold if profits repatriated through transfer prices were visible.

To conclude, there is some theoretical and (to a lesser extent) empirical support that multinational firms affect industrial structure in host countries differently than do uni-national firms. In some cases, differential treatment may be justified. Ideally, host government policies designed to control these effects should not be ad hoc, partial, piecemeal, or discriminatory against foreign firms. The Bank and the host government need to have at least some broad idea of the kind of industrial structure they are aiming for, be aware of the role that foreign firms play in restructuring industry, and take this into account when designing the framework in which foreign firms operate and the policies to be directed specifically toward them.

**Balance of Payments**

The impact of foreign investment on the host country's balance of payments has long been a sensitive and controversial issue. In many developing countries, the prevailing view is that multinational enterprise operations result in a net foreign exchange loss to the host country. Support for this belief usually comes from an examination of the capital accounts in the host's balance of payments on an annual basis or over a period of several years. If net capital inflows from new foreign investment are exceeded by the net outflow of repatriated earnings on existing foreign investments, it is concluded that the operations of foreign firms cause a net drain on foreign exchange reserves.

Empirical evidence on the net capital-account effects of foreign firms in developing countries is, of course, quite sensitive to the time period studied. At the very least, the evaluation should be made over a period of time long enough to cover fluctuations in capital flows caused by changes in macroeconomic conditions. Even so, in a simple model of the foreign investment process, the capital repatriated over the life of the project would equal the invested capital plus the return on the project (all discounted appropriately). The net outflow of capital from the host country is just the return on the foreign investor's investment, which one would expect to be paid to the owner of those factors.

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Even accepting the idea that the foreign firm expects eventually to repatriate at least a normal return on its invested capital, there are other reasons why a host country may be concerned about the effects of foreign firms on the balance of payments:

- The timing of profit repatriation may add to balance of payments pressures in the host country. For example, a firm anticipating local currency devaluation may attempt to repatriate profits before the devaluation takes place, putting further downward pressure on the local currency. The fact that foreign firms ultimately care about profits expressed in a foreign currency may add to speculative pressures against the local currency in other areas as well.

- Foreign firms may borrow from different sources than local firms. If, for example, foreign firms borrow more funds from abroad than do domestic firms, their debt service will require more foreign exchange.

- Foreign firms may have different propensities to import inputs and export outputs than do local firms, leading to different effects on the host country's current account. The current account impact of foreign firms also depends on the extent to which their production substitutes for imports. Empirical studies of the balance of payments effects of foreign firms generally show that the capital flow effects of foreign investment are overshadowed by the effects on the current account. 56

- The large volume of intrafirm trade by foreign firms may have unfavorable effects on the host country's balance of payments because of transfer pricing strategies: the overpricing of imports and the underpricing of exports to minimize host country taxes or avoid controls on profit repatriation.

The incentive to use transfer pricing strategies to minimize taxes or avoid controls on profit repatriation arises from intercountry differences in business taxes, restrictions on profit repatriation in the host country, and/or an overvalued exchange rate in the host country. A first-best strategy to solve the problem of evasive transfer pricing strategies would be to change the incentive structure: align business taxes with those in other countries or negotiate double-taxation agreements; maintain a realistic exchange rate; allow free repatriation of profits and dividends. In a second-best situation where these actions are not feasible, differential treatment of foreign firms in order to restrict transfer pricing strategies may be required.

56/ Lietaer (1979).
There are reasons to believe that, due to their different interests, foreign firms may have a higher propensity to import than do their local counterparts. Multinational firms that produce import substitutes may initiate local production through the assembly of imported components, gradually shifting to local inputs as supplier industries develop and relative costs shift in favor of local purchase. However, foreign firms may lag domestic firms in the process of domestic integration for several reasons: local inputs may be risky in quality and supply; the parent firms may profit from exports to captive subsidiaries; costs may be different due to economies of scale; and exports to subsidiaries from the parent can increase profits through transfer pricing strategies. 57 Although some studies have shown no significant difference in import propensities between the subsidiaries of foreign-owned firms and domestic firms, the majority point to higher import propensities for foreign firms. 58

An argument could be made that foreign firms might export either more or less than domestic firms. The multinational enterprise following a global strategy will supply its export demand from areas of lowest costs, or where excess capacity exists, or where national pressures or incentives for exporting are most effective. Foreign firms may have better information than domestic firms about export opportunities and may have marketing operations already in place. However, it could be that with production facilities already in place in several markets, parents would discourage subsidiary exports on the grounds that such exports would be competitive with existing operations. 59 Some evidence on the export propensities of foreign firms allows weak support for the conclusion that foreign firms have lower export propensities than do national firms, except in cases where the host government has created incentives for foreign firms to export. 60

Even after accounting for all direct and indirect effects of the operations of foreign firms on both the trade and capital accounts of the host country's balance of payments, there remains another major aspect of the question. Foreign firms are highly skilled in forecasting foreign exchange risk and in protecting their assets against losses when balance of payments difficulties cause a country to devalue. They reduce foreign


58/ Using a variety of methodologies, such findings are reported for Peru (Vaitsos, 1978), Mexico (Jenkins, 1979), and Brazil (Fajnzylber, 1970), (Newfarmer and Marsh 1981a,b).


60/ Studies that show a lower export propensity for foreign firms include Vaitsos (1974) for Brazil, Argentina, Mexico, Colombia, Peru, and Venezuela; and Fajnzylber and Tarrago (1976) for Mexico. A study of Central America (Willmore, 1976) found that foreign firms exported slightly more than domestic firms. Newfarmer and Marsh (1981b), for Brazil, found no significant difference, even when controlling for industry.
exchange risks by using local borrowing instead of bringing in outside funds, by accelerating payments for goods and services outside the country, and by advance repatriation of profits. In countries where multinational operations are large, financial strategies of such enterprises can easily place a critical amount of pressure on a currency when it appears to be weakening. The anticipatory actions of foreign firms may add instability to the process of rationalizing exchange rates.

Thus there is some theoretical basis and, to a lesser extent, empirical support, for the hypothesis that multinational firms affect the host country's balance of payments differently than do domestic firms. Yet this difference alone does not provide an economic justification for government policy to influence those effects, even when a balance of payments problem exists. Theoretically, the first-best strategy to improve the balance of payments (a "macroeconomic" problem) would be to use the appropriate macroeconomic policies (monetary, fiscal, and/or exchange rate policies) to eliminate the external imbalance. Attempting to solve the balance of payments problem using "microeconomic" instruments such as restrictions and incentives for foreign firms is a second-best solution to the problem.

The second-best solution may be justified, however, if adjustment to changes in macroeconomic policy variables is delayed, or if the magnitude of the price changes and income reductions necessary to remove the deficits would be so extreme as to threaten economic stability and development efforts. These conditions describe the present situation for many developing countries. To summarize:

- Differential treatment for foreign and domestic firms with respect to foreign exchange transactions may be justified. This is because there is some evidence that foreignness (and the objective of pursuing global strategies rather than unnational ones) leads to different balance of payments effects, and because for a variety of reasons host developing countries may need to use second-best solutions to balance of payments problems.

- Probably the least distortionary restrictions and incentives will be those directed at practices clearly resulting from the firms' multinationality: e.g., transfer pricing, profit repatriation, and speculative currency movements. Yet host governments must bear in mind that the freedom to repatriate profits is cited by foreign firms as an important condition for investment.

- The issue of the sequencing of economic liberalization policies (see Chapter 2) is relevant in the present context. For example, when it is desirable to liberalize the current account before the capital account, temporary restrictions on profit repatriation by foreign firms may be justified.

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Technology

Many host developing countries attempt to influence the amount and kinds of technology transferred by foreign firms. In the context of differential treatment, the issue is whether the kinds of technology transferred by foreign firms is different than technology developed locally or imported through other means by local firms; and whether technology transferred through foreign investment has different effects on local innovative capacity. Again, the existence of differential effects, along with the presence of externalities or other distortions, may justify host government intervention to attract or restrict technology transfer.

Those who argue that foreign firms ought to be offered incentives to transfer technology argue that, especially in developing countries, it would be costly or impossible for certain types of technology to be developed locally; therefore, this knowledge must somehow be imported from abroad. In many cases, imported technology may only be available through direct investment, particularly where the technology is the sole property of the foreign firm and is not willingly sold on a licensing basis. In addition, externalities such as the inducement of more modern techniques in competing firms, stimulation of complementary research and development activities in the recipient firm or its suppliers, or improvement in the quality of local factors of production (particularly the training of labor) can be a boost to the development process in the host country. Therefore, the existence of positive externalities plus the fact that certain technologies are only available through direct investment by foreign firms, argue that technology incentives should be given to foreign firms.

Critics of technology transfer through foreign firms use the following arguments:

(1) The technology transferred by foreign firms reflects economic conditions in home countries: it is designed to conserve on costly labor in the production process, and is directed toward the production of high-income, sophisticated consumer goods. Hence, it is felt that the technology transferred is inappropriate to the needs of the host developing country, both because it is biased against the use of abundant labor, and because the mix of output produced by that technology is not suited to the host's consumption in its present stage of development. There are, therefore, inherent differences between the technology transferred by foreign firms, and technology developed or imported by local firms; but these differences may argue for restrictions rather than incentives.

(2) The externalities associated with technology transfer may not be automatic. Foreign firms operate in concentrated industries in which rents are gained from proprietary ownership of technological know how. This implies that the interests of the multinational firm in maintaining ownership of its "knowledge assets" are in direct conflict with the host country's desire to acquire that technology.
Foreign firms are said to create technological dependence in host developing countries. Because foreign firms bring technologies that have been developed abroad, the host country does not learn the research and engineering skills necessary to continue technology growth, and does not create the critical mass of innovation necessary to spur development. In this respect, technology transfer through foreign investment is said to have negative external effects on the development of local innovative capacity.

Much of the technology transferred is said to be "fictitious", in the sense that the transfer is mainly through patents and trademarks designed to preserve the multinational’s monopoly power. Similarly, many host countries argue that they are forced to pay too high a price for technology transferred by multinational firms.

Do foreign firms make technology choices different from those of local firms in similar industries? Unfortunately, there are few cases where such close comparisons have been made. Most studies have resorted to comparing large and diverse groups of foreign and local firms. At least for Latin American countries, these studies do not indicate overwhelming evidence that multinationals adapt less to local resource availability than do local firms. An exception is a study by Newfarmer and Marsh (1981b), which through a comparison of a matched sample of Brazilian firms in disaggregated industries, found multinationals to be consistently more capital intensive than local firms. In general, however, "the mass of conflicting evidence, the occasional use of imprecise methodology, the inherent problems of definition and measurement, all do not support any strong statement about the relative performance of transnational corporations and local firms." 63

Some authors attribute the choice of inappropriate technologies by foreign firms to the fact that the competitive pressures faced by multinationals may be so weak that they are able to meet their profit targets and other goals without searching for and employing the less familiar, more labor-intensive techniques. Thus the failure of foreign firms to adapt their production techniques more fully to labor-abundance arises from a "permissive environment", which allows foreign firms to produce profitably without searching extensively for technological alternatives. The firms may be engaging in "satisficing" behavior rather than maximizing profits. Hence, the problem may be better described as one of imperfectly competitive market structures rather than of the nationality of firms.

62/ These studies include Strassman (1968) for Mexico and Puerto Rico; Lall and Streeten (1977) for Colombia; Vaitos (1976) for Peru; and Fajnzylber (1975) for Mexico.


64/ For example, Morley and Smith (1977a,b).
With respect to training externalities created by foreign firms, there is some evidence to suggest that foreign firms do engage in extensive training of the workers in their affiliates, sometimes because of government requirements, but usually to further the company's productivity or sales. Frequently cited are the formal courses or on-the-job training given to employees, or training given to suppliers to ensure that they will meet quality or delivery goals. Training in management techniques is common in cases where the foreign firm is attempting to replace expatriate managers with local employees (again, frequently because of government requirements). Since multinationals have tended to concentrate in technology-intensive industries, they also have been an important source of training in the use of technology. It has been estimated, for example, that IBM alone has trained about half of the computer users in Latin America. There are also indications that multinationals lose many of the workers they have trained to local enterprises, generating the transfer of skills to the host country.

Finally, some studies have considered the issue of the creation of technological dependence by multinational firms. In this area, it does appear that domestic firms are more likely to invest in knowledge-creating activities than are the subsidiaries of foreign firms. The basis of the technology owned by foreign firms is research and development carried out almost exclusively in home countries. What research and development that has been undertaken in host countries has been funded by local enterprises.

The conclusions to be drawn from this evidence are basically that (a) technology transfer through multinational firms may be the only means of obtaining some types of technology; (b) technology transfer is an area in which significant positive externalities may be gained by the host country; and (c) there are some differences between foreign and local firms in the kinds of technologies used, their cost, the ways that the technology is adapted to local conditions, and how innovative capacity is advanced by foreign firms compared to local firms. There may thus be an argument for some types of government intervention to influence the transfer of technology by multinational firms, and to treat foreign firms differently than domestic firms.

CONCLUSIONS

This paper has attempted to evaluate the sensibility of Bank advice and conditionality in the area of foreign investment policy reform. To do this, we referred to the theoretical and empirical literature on foreign investment in order to derive policy guidelines for host developing countries. With respect to Bank involvement in this area, we are inter-

65/ For example, see Moxon (1979), p. 203.
66/ Ibid., p. 203.
67/ See, for example, Newfarmer (1980) for Brazil; Gereffi (1982) for Mexico; and West (1982) for Argentina.
ested in the question of whether conditionality in adjustment loans, economic and sector work, and other policy initiatives contains "sensible" policy advice; and in the question of whether there were policy reforms that the Bank should have proposed, but did not. Here, we briefly summarize the answers to these questions as found by this research.

Initially, it is important to recognize that there is no single "optimal" set of foreign investment policies that the Bank should promote in all host countries. Not only does a successful strategy vary with the characteristics of the host country, it also depends on the host country's objectives-economic objectives as well as social, political, and cultural goals. While this paper focuses on policies designed to achieve economic objectives (influencing the production of externalities, compensating for distortions, capturing excess profits of foreign firms), the legitimacy of noneconomic objectives should not be denied by the Bank in advising policy reform. In such cases the Bank's role should be to advise the most efficient set of policies to achieve those noneconomic objectives, while pointing out the economic costs that the country must pay to achieve them.

What general guidelines can be given to countries wishing to increase the net economic benefits of foreign investment? In this paper we have emphasized the importance of a country's overall investment climate as the crucial condition necessary to attract foreign investment, and the importance of the right incentive structure to derive benefits from it. While some determinants of the investment climate are beyond the control of policymakers (for example, the country's natural resource base and global location), others-most importantly, the degree to which prices reflect scarcity values—are influenced by the country's macroeconomic and sectoral policies. In most developing countries, efforts to increase the net economic benefits derived from foreign investment should start with attempts to rationalize the price structure and provide a stable macroeconomic policy environment for all investors, both domestic and foreign. Investment incentives directed at foreign investors are usually overrated by host governments, and can be particularly costly in countries where the general investment climate is unfavorable to begin with.

Efforts to attract a greater volume of foreign investment must somehow increase the perceived risk-adjusted rate of return to foreign investors. This may be done by increasing expected returns (increasing revenues and/or decreasing costs), reducing the riskiness of investment projects, or altering investors' perceptions. The effectiveness of raising expected returns as opposed to reducing risk depends on foreign investors' subjective tradeoffs between these two factors. Since surveys of foreign firms frequently indicate that investors place a high priority on risk reduction, policies to reduce uncertainty—the provision of insurance, aiming for policy stability over time, reducing uncertainty in the implementation of policies—are likely to be an effective means of encouraging more foreign investment. This is particularly true in countries considered "marginal" to the global investment strategies of foreign firms, and in countries that have had a history of unstable macroeconomic or foreign investment policy.
Again particularly in the case of smaller, lower-income developing countries considered marginal to foreign investment strategies, bureaucratic delays and red tape are a major disincentive to foreign investment. Efforts to streamline approval procedures and make investment incentives more automatic will reduce the time and uncertainty of foreign investment projects, and are likely to be effective in increasing the volume and benefits of foreign investment.

In some countries, aggressive promotion efforts make sense, both to attract a greater volume of foreign investment, and to attract the kinds of investment projects that meet current development objectives. Host country promotion agencies can provide information to potential foreign investors on general economic conditions, foreign investment policies, and specific investment projects, as well as fathering project applications through the approval process and perhaps helping to make financing arrangements. Successful promotion efforts are typically those that target certain sectors or industries for foreign investment, and aggressively seek out firms whose operations would advance development objectives. Costly promotion efforts are probably not a wise strategy in countries whose investment climate is extremely poor; in these countries, improving the macroeconomic policy environment should come first.

Economic objectives--increasing the net gains to the host country from foreign investment--may be achieved by selective restrictions or incentives influencing foreign investment allocation and operations. Just as a domestic economy free from government intervention may not maximize economic welfare, complete openness to foreign investors may not be in the economic interest of the host country either. Moreover, there are areas in which government intervention which discriminates between domestic and foreign investors is justified. These are cases where (a) economic externalities, distortions, or excess profits argue for government intervention; and (b) there exist differences in structure, conduct, and performance of foreign as compared to domestic firms. Theoretically, these differences should be caused by multinationality per se, but differential treatment may sometimes be justified in the presence of differences that are merely correlated with multinationality. Such considerations may, for example, justify restrictions on foreign firms to maintain competitive markets, achieve balance of payments objectives, or develop local innovative capacity. On a practical level, however, the desirability of government intervention is limited by the government's ability to intervene effectively and minimize the introduction of new distortions.

Have Bank policy suggestions and conditionality made sense according to these guidelines? The limited scope of this report prevented a detailed country-by-country analysis of host country investment climates and policy environments that existed prior to Bank advice, or of the actual effectiveness of policy reforms taken. Yet, based on the literature and on the guidelines above, the Bank's approach is frequently supported. In SALs, the Bank concentrates on policy reforms that are intended to remove
economic distortions; the implementation of substantial foreign investment incentives is typically not encouraged; the focus of foreign-investment-specific policy reforms is often on institutional reform, promotional activities, and the reduction of bureaucratic barriers. These directions in policy reform are also evident in economic and sector work and in the Baker Initiative. The creation of the Multilateral Investment Guarantee Agency is a step in the right direction of reducing noncommercial risks faced by foreign investors. The policy of equal treatment for foreign and domestic investors, a stance recommended particularly in the Baker studies, needs to be approached more carefully.

Were there other policy reforms that would have been sensible for the countries concerned, which the Bank did not promote? In many cases, probably yes. First, while the Bank does not usually advise that additional foreign investment incentives be instituted, a significant reduction in existing incentives is usually not recommended either. An excess supply of ineffective or redundant incentives characterizes foreign investment policy in many developing countries. When this is the case, the Bank should advise that they be eliminated or phased out. Second, the Bank could look more carefully at foreign investment incentives within the context of the country's overall incentive and trade policies. Third, while the Bank is correct to suggest promotional activities in some countries, the recommended activities are rarely aggressive enough or targeted to particular needs and objectives. In this area, foreign investment policy needs to be detailed and consistent with other development objectives. Fourth, when foreign investment-specific policies are recommended, the sequencing of these reforms with the other policy reforms proposed in SALs and recommended in economic and sector work is frequently not considered an important issue. Finally, to provide directions for future policy work, the Bank needs to follow up on the actual implementation and effectiveness of its foreign investment policy recommendations.
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APPENDIX: FOREIGN INVESTMENT CONDITIONALITY IN SALs

For each of the following ten structural adjustment loans approved during fiscal years 1980-85, the following information was gathered from the relevant President's Report:

(1) Date of loan approval; amount of loan; terms of disbursement; amount disbursed by December 31, 1985; whether or not program was discontinued.

(2) Existing conditions in the recipient country which suggest that policy reform is needed; if available, existing stance toward foreign direct investment.

(3) The major objectives of the SAL (an objective was considered major if it was mentioned in the loan summary); if available, objectives of foreign-investment-specific policies.

(4) Conditions relating to foreign investment (includes policies not explicitly mentioned as conditions for release of the second or third tranche, but cited as evidence of the government's commitment to carrying out structural adjustment reforms); in many cases this includes conditions relating to all types of private investment, that would be expected to affect foreign investors.

Guyana SAL/SAC I

(1) Approved 2/3/81; US$22.0 mil; US$22.0 disbursed as of December 31, 1985; program discontinued.

(2) Summary of economic conditions in Guyana notes that the economy is "based on the export of sugar, rice, bauxite, and alumina.... When Guyana gained its independence in 1966, much of the economy was owned and controlled by foreign enterprises operating principally in bauxite mining and alumina processing, sugar production and retail trade. The indigenous private sector was limited to local trading and agricultural activities. Shortly after independence, the government sought to gain control over national assets through acquisition of foreign-owned enterprises, created new state-owned financial institutions and nationalized the bauxite/alumina and sugar industries.

"...In recent years, the country's economy has been adversely affected by a number of factors, including poor weather conditions, difficult industrial relations, the exodus of technical and managerial personnel and deteriorating terms of trade.

"...The government made concerted efforts in 1978 to alleviate the country's severe economic problems. It entered into a one-year standby agreement with the IMF that year..." Among the measures included in the agreement was the "removal of restrictions on foreign companies transferring depreciation funds."
Guyana's economic problems have "emphasized the need to take steps toward resolving long standing constraints to increasing and sustaining investment, savings and output levels. The scarcity of managerial, technical and administrative talents, especially in public enterprises, lack of encouragement for private sector activities, insufficient attention to maintenance and rehabilitation of the country's physical infrastructure, inadequate remuneration levels for technical, supervisory and managerial cadres and the consequent exodus of such personnel are some of the key constraints which are now receiving attention in the country's structural adjustment effort."

Notes that "Guyana's efforts over the last five years to adapt its policies and programs to changes in the international economic environment have proven inadequate... while an investment code was announced and encouragement was provided to some private investors, there was lack of a comprehensive and clearly articulated program for promoting the role of private investors."

(3) The objectives of the SAL are to support a comprehensive economic program designed by Guyana to stem the deterioration in the economy, stimulate economic growth and restore balance of payments equilibrium. Economic program aims at:

- improving productive capacity, especially of exportable commodities and manufactured items produced by the private sector;
- completing the execution of the 1980-82 public sector investment program.
- Bank Group financing of the program would provide foreign exchange to meet critically needed inputs for export-oriented industrial and agricultural operations in both the public and private sectors.
- Bank loan would finance a revolving Export Development Fund in the manufacturing sector.
- A related technical assistance loan which is being submitted separately would support institutional arrangements and policies to promote development of Guyana's exports, and improve the systems for monitoring execution of the public sector investment program and for expenditure control.

(4) Both the IMF's EFF arrangement and the structural adjustment loan and credit are based on the government's economic program.

(a) Under the provisions of the EFF, the government is expected to work towards "improvements in the relationship between the government and private sector, particularly through the removal of obstacles to private initiative."
(b) The "Investment" section of the government program states that "the government is also promoting expanded levels of private investment, both domestic and foreign. In this regard, the government has already been successful in attracting U.S., Canadian, French and German companies to conduct oil, mineral and metal explorations. The Guyana Cooperative Agricultural and Industrial Development Bank is making increased credit resources available to the private sector with the financial and technical assistance of the CDB, the IDB, and bilateral donors. To provide the private sector with clear "rules of the game", the private sector investment code will be clarified and expanded. Moreover, the employment of an Industrial Adviser and the establishment of the Export Development Fund are expected to help promote increased participation of the private sector in the economy."

(c) The specific actions to be taken in 1981 as conditions for the structural adjustment loan and credit include an investment program (public and private investment) that states: "...the Guyana investment code would be elaborated to provide clear guidelines for both domestic and foreign investors. The government has sought technical assistance from India for this purpose. A progress report on this matter would be given by the government to the Bank by September 30, 1981."

(d) The second tranche of the loan is subject to the Bank being satisfied with the progress made in the execution of the government’s economic program, including "detailed provisions for giving effect to the Guyana Investment Code".

**Ivory Coast SAL II**

(1) Amount US$250.7 mil; approved 7/5/83; to be disbursed in two tranches.

(2) Background on the economy notes that "agriculture was the basis for rapid development...coffee, cocoa, and timber became the main source of exports, income generation, and public savings to finance a spreading infrastructure network...Current economic and financial stringencies stem largely from the difficulties the country faced in adapting to the rapid changes in the world economy after 1975." Notes rise in public spending (and public expenditures as a percentage of GDP), leading to a deterioration in public savings and a severe financial crisis in 1980. An IMF EFF was implemented for the period 1981-83.

To restore a reasonably high and sustainable growth path, cites need for improvement in the following weaknesses:
-- deficiencies in the management of public sector resources;
-- the loss of dynamism in agriculture;
-- excessive and misdirected protection arising from the widespread introduction of quantitative restrictions and distortions in the tariff system, which eroded industrial productivity and exports.

The main medium-term objectives for SAL II were:

-- "further improvements in public finance management and investment policy, as well as a progressive restructuring of current expenditures"

-- "further rehabilitation of parastatal enterprises though the implementation of reorganization programs developed under SAL I..."

-- "continuing the rationalization of agricultural policy..."

-- "implementation of the first phases of the structural adjustment reform of the industrial sector which was identified under SAL I, and preparing a series of additional reforms."

-- "Definition and implementation of reforms in urban housing policy...".

(3) The loan was the second to support the implementation of the government's comprehensive program of structural adjustment. "The principal aim of this program of basic policy changes is to promote sustainable growth and increase public savings in the medium term". Detailed action programs are intended to:

-- further improve public finance management and investment policy;
-- rehabilitate parastatal enterprises and improve their management;
-- make additional improvements to the agricultural incentive system;
-- reduce the excessive levels of protection and remove distortions in industrial incentives;
-- reform housing policy (including a structural shift in housing investment from the public sector to the private sector).

(4) The economic program proposes (1) a revision of the Investment Code and of domestic taxation, and (2) reform of the institutions in charge of industrial promotion. On (1): "The Investment Code will be revised to encourage the creation of new industrial enterprises without discrimination
against local suppliers of intermediate inputs to these new activities. In particular, the provision allowing priority firms to import intermediate inputs duty-free will be abolished. At the same time, a series of new incentives will be introduced on the basis of criteria related to employment creation, training, and installation outside Abidjan." On (2): "The objective of the Government is to abandon the reliance on purely public initiatives for industrial promotion, and to develop joint ventures with the private sector in this field. The government has decided to dismantle the ineffective public entity in charge of the promotion of small- and medium-scale enterprises, and to replace it with two small parapublic agencies with limited and qualified staff. The first agency will be in charge of providing technical assistance to small- and medium-scale enterprises. The second will provide essential financial support exclusively to these enterprises. Moreover, the government will set up, in conjunction with the private sector, an industrial promotion bureau which will serve as a focal point for potential investors in the country."

In the Interim Program, the specific conditions include the adoption of a draft Revised Investment Code as well as the decrees for the creation of the new parapublic agencies for the promotion of small- and medium-scale enterprises.

The SAL II Action Program includes the conditions (1) creation of an investment promotion agency, and (2) rationalization of incentives for reinvestment.

In the government's section on its economic program, it describes the proposed revisions in the Investment Code. These include:

- "reformulation of the measures provided for in the 1959 Code in order to adapt them to the country's economic situation. In particular, the automatic exemption from import duties on intermediate products for priority enterprises will be eliminated, so as not to penalize potential local manufacturers of such intermediate products.

- Introduction of new measures designed to consolidate certain fundamental aspects of Ivory Coast's industrial policy: encouragement of establishment of enterprises in the provinces; job creation; training within enterprises; and export promotion.

- measures in favor of small and medium scale enterprises."

Jamaica SAL I

(1) Approved 3/23/82; US$76.2; to be disbursed in two tranches; all disbursed as of December 31, 1985.

(2) "The government elected in 1980 faced grave economic problems. The cumulative effects of past policy decisions and the evolution of the international economy since 1973, had led to a severe balance of payments
crisis that reflected serious structural deficiencies. This situation impeded the utilization of productive capacity and clouded prospects for its expansion as well as for employment creation. By late 1980, the crisis had pervaded all areas of the economy."

"The main problems... included a productive structure which needed to be repaired and reoriented; a potentially dynamic tourism sector damaged by social and political unrest, a decline in service quality, and the international economic situation; an acute scarcity of skilled managerial and technical personnel, particularly in the public sector; an unfavorable investment climate for domestic and foreign capital provoked by a high level of political rhetoric coupled with trade union activism and a deterioration of law and order; and persistent and large deficits in both public finances and the balance of payments."

(3) According to loan summary, the government's principal objectives are "to bring the economy out of its long depression and to correct serious structural weaknesses by putting unutilized capacity to work particularly in those sectors that will produce quick and substantial incremental foreign exchange earnings and initiating adjustments in industrial and agricultural policies that provide a basis for expansion of productive capacity. The government relies on the private sector as the main engine of growth, and has attributed a greater role to market mechanisms, creating an environment in which private initiative can prosper."

Among the objectives stated in the government's program was the objective to "promote private investment, both domestic and foreign, through the simplification of existing regulations and procedures governing such investment, and the formation, on a bilateral basis, of joint business groups with industrialized countries". Specifically, the policy objective in the SAL is said to be "to attract private external capital through the creation of appropriate incentives for direct foreign investment, repatriation of Jamaican capital, and attracting migrants' savings":

As described in the government's Development Policy Statement, one objective of the economic program is "to expand the industrial sector through incremental domestic and foreign capital formation."

(4) The plan calls for (1) creation of Jamaica National Investment Promotion Co.; (2) creation of bilateral business groups with U.S., Canada, UK, Germany, and Venezuela; (3) establishment of a system of retained accounts for importers; (4) decriminalization of informal foreign exchange market. Noted in this section that Jamaica's IMF EFF attributes an important role to direct foreign investment.

In the Action Program, this is described as follows: "In order to attract private capital, the Government has set out to restore an atmosphere of confidence in the country and in the quality of its own economic management, as well as to provide appropriate stimuli. The Government has entered into an extended agreement with the IMF and has adopted a stern attitude in the wage negotiations in which it participated, contributing to a mood of wage restraint that is gradually spreading throughout the
economy. In order to attract direct foreign investment the government has launched a vigorous promotional campaign through the creation of bilateral groups of businessmen that will identify and develop investment opportunities in Jamaica. On the domestic front, the government has created the Jamaica National Investment Promotion Co., a "one-stop" promotion agency that centralizes all relations with potential investors." The agency "'fathers' each proposal, coordinates bureaucratic action, and ensures speedy processing."

Jamaica SAL III

(1) Approved 11/20/84; US$55.1 mil.; to be disbursed in two tranches; all disbursed by Dec. 31, 1985.

(2) Recent economic developments: "With the disappointing export performance and the rapid rise in imports, there has been a sharp deterioration in the current account of the balance of payments....It was partly as a result of this performance on the balance of payments that Jamaica failed to meet the targets of its arrangement with the IMF in 1983/84. The three-year arrangement agreed in March 1981 was successfully complied with until March 1983, when the net foreign assets test was missed by some US$140 million. However, it was judged that this was primarily due to a shortfall in capital inflows which would be received at a later time. Therefore, a waiver was granted and the targets for FY 1983/84 were adjusted accordingly. However, the pace of adjustment was insufficient to meet these revised targets, and the performance criteria were not met in September 1983. The Extended Arrangement was then abandoned, to be replaced by a new one-year Stand-by to cover the fiscal year 1984/85, and this came into effect in June 1984."

(3) Objectives of SAL III: "The first two SALs approved by the Bank in March 1982 and June 1983 were designed to address four main areas of economic problems: (i) a difficult balance of payments situation; (ii) serious fiscal imbalance; (iii) sluggish performance of both the industrial and agricultural sectors; and (iv) an overregulated economy. The programs required the government to take actions and perform studies to identify constraints and design appropriate remedies. The proposed third SAL includes action programs in the five areas covered in the first two SALs, plus the energy sector. The program aims to achieve export development and economic deregulation."

SAL II continues to have a medium-term focus; and attempts to assist in the achievement of the goals of the stabilization program in four ways: (1) to help the government reduce expenditure in a rational, equitable, and efficient way; (2) to reduce petroleum imports; (3) to expand exports, above the level that would be generated solely on account of the change in the exchange rate; and (4) provide financing to achieve these goals.
(4) Contained in the Action Program:

(a) "The Jamaican private sector is launching a development finance institution, with external support, which will be empowered to lend directly for developmentally sound projects."

(b) The sugar industry continues to require subsidies, despite efforts in previous SALs. Three factories have been closed, and a management contract has been signed for the remaining three government-owned factories and estates with a foreign private sector company.

(c) Under SAL III, while continued attention will be paid to the public enterprises and public investment, both from a budgetary and a resource allocation point of view, renewed emphasis will be placed on private sector aspects.

(d) "The agricultural sector offers major potential for export development in Jamaica. The SAL programs are designed to stimulate this improvement through changes in relative prices between crops produced for the domestic and export markets, and through programs to rehabilitate and revive the traditional industries of bananas and sugar. To support these programs, the government of Jamaica has launched a major initiative to attract foreign investment in agriculture (AGRO 21). This program aims to bring 200,000 acres of idle or underutilized land into production of export crops over a five-year period."

Korea SAL II

(1) Approved 11/8/83; US$300.0 mil.; all to be disbursed within approximately one year; disbursed by Dec. 31, 1985.

(2) Summary of the economy notes that "within two decades, Korea advanced from one of the world's poorest countries to the ranks of the middle-income countries. Economic policies encouraged investment in sectors where Korea had a comparative advantage. However, the very success in stimulating the economy generated a number of structural problems." These included domestic supply bottlenecks that led to increased import requirements, excess credit demand, domestic inflation, and increases in real wages greatly exceeding productivity growth. "The accelerating inflation, sharply rising unit labor costs, and a rigid exchange rate policy resulted in progressively eroding export competitiveness. The domestic economy was severely overheated and faced major structural problems with supply bottlenecks, excess capacities in heavy industries, and a relatively energy-intensive output mix." Deterioration of the economy in 1979-80 was partially reversed by successful (though
costly) stabilization policy during 1980-82. The attention to correcting internal and external imbalances during this period was followed by a Five-Year Plan (1982-86) designed to address structural problems. The government requested the World Bank to provide assistance for the program.

(3) Objectives contained in loan summary: "The proposed loan would be the second to support the implementation of the government's comprehensive structural adjustment program which aims at keeping the balance of payments manageable while sustaining the growth momentum of the economy. To achieve these objectives, a comprehensive program of structural reforms is being carried out by the government in the areas of (i) industry; (ii) energy; and (iii) public sector efficiency. In industry, the program includes import liberalization, tariff and tax incentive reforms, further liberalization of foreign investment, and restructuring of the fertilizer industry...".

The government's Economic Plan (supported by both SAL I and SAL II) indicates the following industrial policy objectives: "(a) to change the incentives system from selective direct incentives to general indirect incentives with primary concern for improving productivity, manpower development, and technology; (b) to encourage competition by expanding import liberalization; (c) to reduce and simplify the tariff structure; (d) to increase foreign investment and accelerate liberalization of technology imports; (e) to carefully examine large projects to avoid imbalances among subsectors and excessive investment; and (f) to give financial and management assistance to small and medium enterprises."

(4) "The government is seeking to induce increased foreign investment into Korea in order to promote competitiveness and efficiency among Korean industries and to accelerate technological development. A major reform of foreign investment guidelines was initiated in 1980. The main features of the 1980 reforms included expansion of the number of industries in which foreign investment was allowed; relaxation of ownership ratios, allowing an increase in the maximum foreign shareholding from 49% to 100% in certain industries; a reduction in the minimum capital investment requirements from US$500,000 to US$100,000; and major simplifications of administrative requirements and procedures, resulting in a significant reduction in approval periods. The process of liberalization was continued in 1982. The number of industries open to foreign investors was further increased from 427 to 521 out of a total of 855 industries (and from 320 to 381 out of 400 manufacturing industries). The number of industries in which up to 100% foreign ownership is allowed was increased from 56 to 65 (of which 61 were in the manufacturing sector). Also, further simplifications of administrative requirements and procedures were introduced, including reduction in the approval period of new foreign investment from 80 days to 30-60 days and for additional investments from 60 days to 10-30 days. This reform process is ongoing. A further major reform will be submitted to the National Assembly during October 1983. The main element of the reform will
be the replacement of the present list of industries open to foreign direct investment with a negative list specifying only those industries in which foreign investment is prohibited or restricted. Implementing regulations will be issued by the first quarter of 1984 and the number of industries in which foreign investment is permitted will be substantially increased under the new system. Approval procedures will also be further simplified. Under the present system all applications by prospective foreign investors require deliberation with concerned ministries and, if above a certain size, require approval by the Foreign Capital Project Review Committee (FCPRC). Under the new system all applications satisfying specific criteria (including the foreign investor's share of equity in the project and the total amount of foreign equity) will be approved by the Ministry of Finance immediately, without deliberation with other ministries or approval by the FCPRC."

"The Action Program of SAL II includes:

(1) Submission of the revised Foreign Capital Inducement Act to the National Assembly in October 1983.

(2) After approval by the National Assembly, implementation of the revised law during the first half of 1984."

In a later section, the policy changes are described as "further increases in the number of industries open to foreign direct investments from 50% to 64% of all sectors (95% of all manufacturing subsectors). Increase in the number of sectors open to 100% foreign investment to 15% of manufacturing sub-sectors."

Mauritius SAL I

(1) Approved May 4, 1981; amount US$15.0 million; to be disbursed by the end of FY82.

(2) Description of the economy: "Externally, the current account of the balance of payments remains in heavy deficit (14 percent of GDP in 1980/81 is forecast). Sugar, the main export earner, has shown only a small growth in output, while the earlier rapid growth in export earnings in the manufacturing and tourism sectors has not been sustained. Despite successful attempts to constrain the volume of import growth, the import bill continues to grow due to rising import prices. Thus, Mauritius has been forced to incur substantial non-project debt to finance the deficit. Together with the debt required to finance the much-increased public sector investment program, this would lead to a rapidly increasing debt service ratio, which if not controlled could reach untenable levels by the mid-1980s. Internally, despite a high tax burden (23 to 25 percent of GDP), the fiscal deficit remains high, due to high public current and capital expenditures. Unemployment is high (over 9 percent of the labor force) and is growing."
(3) As stated in the loan summary, "The proposed loan would make $15 million equivalent available to the Bank of Mauritius to finance imports of essential goods, mainly for use in the industrial and agricultural sectors, so as to allow economic growth and investment to be maintained. It would thus support Mauritius in carrying out a medium-term program of structural adjustment of its economy, aimed at developing export earnings in industry, sugar and tourism, at increasing the economic return to be derived from the public sector investment program, and at improving efficiency in certain key areas of public expenditure."

(4) The Government's adjustment program supported by the loan includes an action program for the industrial sector, consisting of a wide variety of measures including:

(i) Double-taxation agreements to extend, for taxpayers from countries that invest in Mauritius, the benefit of the Mauritian tax-holiday provisions to the taxes they pay in their home countries.

(ii) Intensified efforts to promote Mauritius to potential investors, and also to promote Mauritian exports. A consultant firm is to be appointed, with EEC finance, to represent Mauritius in the UK in seeking investors.

(iii) An amendment to the EPZ legislation in July 1980, inter alia to make automatic (instead of as previously discretionary) the extension of the tax holiday from the first ten years of a firm's operation, so that from the eleventh to the fifteenth year 50 percent of the income is tax-exempt, and from the sixteenth to the twentieth year, 25 percent.

Mauritius SAL II

(1) Approved 12/8/83; amount US$40.0 million; to be disbursed in two tranches; all disbursed by Dec. 31, 1985.

(2) Description of the economy notes that "Mauritius is an island situated in the Indian Ocean, densely populated and with an economy dominated by sugar production. Despite significant expansion of other sectors since the early 1970s, sugar still occupies around 90 percent of the cultivable area and accounts for about 60 percent of export earnings. The level of economic activity, therefore, is highly sensitive to fluctuations in sugar production and exports.... After the decline of sugar prices in 1976, severe economic difficulties emerged... a sharp deterioration in the balance of payments, aggravated by expansionary fiscal and monetary policies." Increasingly, the deficits were financed by drawing down reserves and reliance on external borrowing on non-concessionary terms.

"Mauritius' economic imbalances result primarily from the government's expansionary policy response to rising unemployment, and the country's heavy dependence on a single commodity. Favorable conditions in the
mid-1970s led the government to expand public expenditures; when resource availabilities increased during the sugar boom, the government embarked on a policy of income redistribution through general salary increases, expansion of public sector employment and a large infrastructure investment program. Failure to take prompt action to revert to more austere economic policies when sugar prices declined resulted in excessive budgetary deficits, strong domestic demand, rising domestic inflation, and ultimately in large balance of payments deficits."

(3) As stated in the loan summary, "The proposed loan would finance essential imports and support the second phase of the government's structural adjustment program which aims at improving the balance of payments position in the medium term while accelerating the growth of output and employment. The second phase of the program includes (i) a program for export-led industrialization; (ii) a program for tourism development; (iii) a program for agricultural diversification; (iv) measures to promote employment and (v) policies to improve public resource management....The main benefits of the program would be to enhance sustained growth and employment opportunities. The program would also improve the structure of the balance of payments and maintain creditworthiness by limiting the country's reliance on foreign borrowing."

(4) The program for export-led industrialization has four areas: "(i) maintaining the country's export competitiveness vis-a-vis other countries competing in the same markets; (ii) reforming the system of export incentives to extend it to all firms involved, directly or indirectly, in export activity; (iii) attracting foreign investment and technology which is considered as the most effective means of expanding exports of manufactured products; and (iv) encouraging private investment by strengthening the equity base of Mauritian enterprises and providing them with adequate capital."

To attract foreign investment for exports: SAL II contains as a condition for disbursement of the second tranche the "establishment and operation of the Mauritius Export Development and Investment Authority (MEDIA). The government has recently passed legislation (September 1983) establishing a new entity, MEDIA, to promote foreign-investment and export sales. MEDIA, an autonomous institution, will enable prospective investors to deal with only one agency for obtaining all necessary information and clearances to start and operate an industry in Mauritius. The principal functions of MEDIA are: (i) to promote, assist and develop exports from Mauritius; (ii) to engage in investment promotional activities designed to promote Mauritius as an attractive base for the establishment of export-led industries; (iii) to plan, implement and review programs of action for the development of exports and investment in industries manufacturing for export; (iv) to develop and manage industrial sites and buildings within the framework of the National Physical Development Plan; (v) to advise the government on all matters relating to the development of exports and investment promotion. MEDIA will reorganize current export and investment promotion functions of the Ministry of Industry and
Cooperatives. It will act as a contact point for potential foreign investors and foreign importers, provide them with necessary information and put them in contact with local businessmen. MEDIA will also assist in matters such as designs, product development, packaging, advertising and after-sales services. The Bank is proposing to include US$0.5 million in Technical Assistance Loans, being processed with SAL II, to cover 66% of MEDIA's operating expenses for the years FY84-86. After this date the government and private sector will meet all expenses."

Fiscal incentives for industry include: "Based on IMF recommendations, the government has decided to lower the existing tax rates on companies and introduce a tax payable at the source before distribution of profits. This is a first step and the rates will progressively be unified over a period of time. Reducing nominal tax rates from the existing levels should improve investor perceptions. In addition, the companies' balance sheets should be improved and the firms' ability to borrow should be increased."

Panama SAL I

(1) Approved 11/15/83; US$60.2 million; all disbursed by Dec. 31, 1985.

(2) Panama has capitalized on its geographic location and international transport facilities to build an important export-oriented service sector. The main areas of recent expansion have been in banking, tourism, and international commerce. The development strategy initiated by the government in 1968 aimed at major social reforms while attempting to sustain growth through increasing and diversifying exports. Although this strategy was initially successful in combining rapid growth with social reform, the economy was adversely affected by both external and domestic developments in the mid-1970s. In the face of these difficulties, the present government has formulated a new medium-term development strategy. The scope of the public sector is to be reduced and the remainder made more efficient. Opportunities for the private sector are to be sought in Panama's external markets through the accelerated production of goods for export.

The prevailing structure of investment incentives (not just directed toward foreign investment) is summarized as follows: "The usual incentive mechanism for manufacturing investment is a contract with the government under which the investor undertakes to carry out an investment project in return for exemptions from income tax and import duties, reduced rates of taxation and/or tax credit certificates. On expiring, these contracts have been renewed automatically. In addition, benefits usually include protection against foreign competition through import quotas or other quantitative restrictions. Incentives such as reinvestment and accelerated depreciation allowances favor the intensive use of capital relative to labor. Effective protection of final goods produced for the local market is frequently excessive, and has diverted entrepreneurial and financial resources away from exports. Individual contracts
relate benefits to negotiating strength rather than desirability of the project, increase dispersion of effective protection, and discriminate against small firms. Quota protection is usually accompanied by price controls which limit profitability, favor consumption over savings and discourage investment."

(3) According to the loan summary, the government’s economic program is "intended to direct economic activity towards areas of Panama’s comparative advantage. The strategy aims at creating new growth opportunities by re-orienting the economy towards accelerated production, by the private sector, of goods for export. The main areas covered include (i) greater efficiency in both the allocation of resources within the public sector and reduction of its scope; and (ii) measures to stimulate greater export orientation and increased employment in the manufacturing sector; (iii) a new agricultural policy geared towards greater efficiency and a higher volume of goods for export..."

(4) Industrial Incentives Legislation: "Government proposes to replace existing contract system with a general system of incentives to a wider potential group of beneficiaries, thereby eliminating the concept of individually negotiated contracts." (This measure is expected to be taken in 1984 or 1985, after completion of the necessary legislation.)

National Investment Council: "The government established a National Investment Council in October 1982 to promote export industries and assist investors in dealing with local bureaucracy. Headed by leading Panamanian businessmen, it has already been successful in attracting a number of investors to Panama despite the international economic climate. Technical Assistance is to be provided by USAID to enable it to expand its promotion activities abroad."

Also proposed for 1984-85: "Linking simplified export incentives to employment".

Turkey SAL III

(1) Approved 5/27/82; US$304.5 million; all disbursed by end of 1985.

(2) "The economic policies pursued during the 1970s led to rapid economic growth, especially in industry, until the mid-1970s. By then the incipient problems were greatly aggravated by the rise in the cost of oil and other imports which led to a sharp deterioration in Turkey's terms of trade. The response was inappropriate--continued expansionary policies and capital-intensive import-substituting investment, based mainly on external borrowing, much of it short-term....It was not until January 1980 that the government launched a policy of structural adjustment towards a greater reliance on market forces and an outward orientation....The objectives of the 1980 program included a reduction in the rate of inflation, an increase in foreign exchange inflows, improved domestic resource mobilization through greater public sector efficiency and increased private savings, a more rational public investment program, and better external debt management."
According to the loan summary, SAL III is intended to further support Turkey's stabilization and structural adjustment program initiated in January 1980, and designed to restore sustainable growth. "The measures which provide the basis of this new loan are in the areas of (i) macroeconomic policies--domestic resource mobilization, export promotion, import liberalization, medium-term framework; (ii) rationalization of public investment; (iii) reform of the State Economic Enterprises; and (iv) policies in the agriculture and energy sectors."

Structural issues include the desire "to restore credit-worthiness, promote private foreign investment, and obtain substantial funds from commercial banks/investors on reasonable terms". Current situation described as follows: "Considerable net transfers to commercial banks. Some improvement in inflow of private foreign direct investment, but mostly through liquidation non-guaranteed trade arrears. Government re-entered commercial markets in 1981 with EXIM bank loan."

"Since Turkey's exports depend heavily on products produced by the private sector, export growth will ultimately require additional investment by the private sector in agriculture, industry, and transport."

Measures taken under SAL III include "measures to promote private investment, including the hiring of foreign consultants to promote investments in petroleum, tourism, mining, and agro-industries as well as relevant laws and regulations. Future actions include "revision of mining, tourism and petroleum laws in 1982 to reflect recommendations of consultants and facilitate foreign investment."

"If the export drive is to be sustained, Turkey will need technology, access to markets and substantial investments which are beyond the capacity of the domestic private sector and the State. There is thus a need to attract substantial foreign investment. Foreign investors have been slow to respond to the variety of new incentives which the government offers. In 1981, 109 foreign companies received licenses to invest $334 million, up from $92 million in 1980, but $290 of this was financed by purchases of Turkish lira abroad from holders of non-guaranteed trade arrear obligations. Foreign investors have been discouraged by earlier experiences in Turkey, and by the investment approval process, which still remains cumbersome, despite well intentioned efforts to streamline it."

"To further stimulate foreign investment, the Central Bank has hired an investment banking consortium (Lazard Freres, Kuhn Loeb Lehman Brothers, and S.G. Warburg & Co.) to promote foreign investment in petroleum, tourism, mining, and agroindustries, as well as to review the relevant laws and regulations. To date, the most promising area seems to be petroleum exploration. In addition, to facilitate foreign investment, the government is planning to revise the laws pertaining to investments in mining and petroleum and has recently revised the law regarding tourism. However, results are likely to be long-term given the current depressed world economy and the competition for investable funds."
Yugoslavia SAL I

(1) Approved 6/28/83; US$275.0 million; to be disbursed in two tranches; all disbursed by end-1985.

(2) "Despite an impressive record of economic and social development since World War II, Yugoslavia today faces perhaps its most difficult economic situation since the upheavals with accompanied economic liberalization in 1965. The domestic and international repercussions of the events which followed the 1979 oil price shock are still being felt by the Yugoslav economy...higher oil prices and interest rates, sluggish world trade and more difficult access to international commercial bank credit. However, the severity of Yugoslavia's economic problems also reflects structural deficiencies in the pattern of Yugoslav development which became increasingly apparent in the seventies...These conditions prompted the government to introduce a series of stabilization measures in 1980. The main elements of the stabilization program introduced thus far have been restrictive monetary and fiscal policies to curb investment and reduce inflationary pressure, and the more active use of exchange rate policies to encourage exports. At the same time, imports have been scaled back in line with the revenues accruing from export earnings and more limited foreign borrowing."

(3) The loan is intended to support the country's structural adjustment program, the principal aim of which is to "place the country's balance of payments with the convertible currency area on a sounder footing, and to improve the efficiency of investment selection and resource allocation in the economy. To achieve these objectives, specific actions are to be taken in the areas of investment planning and resource allocation, interest rate policy, foreign exchange allocation, export promotion, export incentives, the regulatory framework for price control, price adjustments in the energy and transportation sectors, and the financial accountability of enterprises."

"The main areas that have been selected for action in the structural adjustment program are: (i) investment planning and resource allocation; (ii) foreign exchange allocation and external trade policies; and (iii) price policies and enterprise decision-making."

(4) "Additional legislation will be introduced in six months (by December 1983) to stimulate foreign investment."