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Foreign Direct Investment in Southeast Asia: Experience and Future Policy Implications for Developing Countries

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Session No. 4 Paper*

'Advantages' and 'Disadvantages' of FDI Policy Instruments

Frank L. Bartels and S.A. de Crombrugghe*****

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LIST OF ABBREVIATIONS

ASEAN - Association of Southeast Asian Nations

BITs - Bilateral Investment Agreements

DTTs - Double Taxation Treaties

EGM - Expert Group Meeting

EPZs - Export Processing Zones

FDI - Foreign Direct Investment

FPI - Foreign Portfolio Investment

FTZs - Free Trade Zones

GATS - General Agreement on Trade in Services

ICSID - International Centre for Settlement of Investment Disputes

IIAs - International Investment Agreements

IP - Investment Promotion

IPAs - Investment Promotion Agencies

IPPRs - Intellectual Property Protection Rights

Mercosur - Mercado Común del Sur

MHT - Medium and High-Technology

MNCs - Multinational Corporations

MNEs - Multinational Enterprises

MVA - Manufacturing Value-added

NAFTA - North American Free Trade Agreement

PIs - Policy Instruments

RTAs - Regional Trade Agreements

SCMs - Subsidies and Countervailing Measures

TNCs - Transnational Corporations

TRIMs - Trade Related Investment Measures

TRIPs - Trade Related Intellectual Property rights

UNCTAD - United Nations Conference on Trade and Development

UNIDO - United Nations Industrial Development Organisation

WTO - World Trade Organisation

ABSTRACT

This paper delineates and discusses the growing number of factors and variables, which constitute the core of FDI policy instruments. It does so within the new context of the FDI regime and its requisite policy intervention. The range of factors and variables, their FDI elasticities and implications for policy craft as well as the policy dimensions, and array of FDI regulatory, and incentive, measures, trade policies and trade related investment measures are depicted. The relative advantages and disadvantages of policy instruments are viewed through the lens of policy coherence and 'fit' – in spatial sequencing and switching terms – with a country's evolving economic and temporary circumstances and conditions. The need for powerful policy research and analysis is emphasised.

1. Introduction

This paper, intended to provoke a debate, aims at delineating, and attempting to explain, the complexity of crafting Foreign Direct Investment (FDI) policy instruments (PIs)[1], the implications for developing countries and the challenges that they have to face in operationalising PIs. Of particular importance is the calibration of PIs to the new context of FDI [and Foreign Portfolio Investment (FPI)].

It is nowadays accepted that FDI plays a crucial role in industrial development of the developing and industrialised countries alike and can help in boosting economic growth through, for example, total factor productivity growth. FDI increasingly comprises sets of inter-connected operationalised business decisions by Multinational Enterprises (MNEs) in response to changing global and regional competitive, strategic considerations and factor conditions. As such, FDI PIs, which have analytical and regulatory dimensions, are required to manage the landscape of MNEs FDI operations in order to maximise positive externalities accruing to the host location; as well as optimising the allocative efficiencies involved in FDI. According to UNIDO (2003), the policy framework for FDI is a crucial part of the overall national strategy for industrialisation. As the ratio of inward FDI to GDP is, in general, relatively high for developing countries in comparison to industrialised countries, the role of well-designed FDI PIs in economic development cannot be overestimated.

[1] Throughout the paper, policy instruments and policy tools are used interchangeably.

From the outset, we need to appreciate that when we refer to the advantages and disadvantages of FDI PIs, it is in terms of the *relative* merits of the policy tools. It needs to be indicated that, from a policy perspective, the pros and cons of PIs are framed by considerations of who (interest groups) gains or looses. This is not a trivial issue, depending not only on the demographic structure of employment distribution of the labour force in the economy, but also on the changing nature of the relative balance of competitive advantage between countries. These two influences move at two very distinct 'policy speeds' – the first, in generational terms; the second in business cycle terms.

As pointed out by UNCTAD (1996, p.164), "the priorities and objectives of governments and TNCs differ, but their interaction is one of the fundamental dynamics underpinning economic growth and development"[2]. However, governments are primarily concerned with increasing welfare functions within the national economy for the benefit of citizens. MNEs are primarily concerned with maximising the long-term value of the firm for the benefit of shareholders (who may or may not be citizens in the economy of their FDI). These respective duties do not always coincide or converge. They can be highly co-operative and/or conflicutal within firm – Nation-State economic relations [Stopford et. al. (1991)]. The issue of policy craft for FDI (and FPI) is therefore increasingly crucial to the economic well-being of developing countries. Therefore, PIs for shaping the economic environment in order to attract, promote and enhance inward FDI are essential tools that need to be brought into the armoury of the policy-making community. And furthermore, PIs should be aligned with the host countries' industrial policy as well as with their general development goals [UNIDO (2005)].

Fundamentally, PIs are meant, at best, to shape – or even distort – the economic environment of the host country in order to attract and retain higher levels of value adding FDI. The debate questions to what extent this distortion should be oriented in the sense of more liberalisation or more regulation. The debate concerning wither liberalisation and/or regulation of FDI PIs invokes subsidiary issues, which in turn concern the factors and variables of policy. Taxonomically these factors and variables may be grouped in terms of investment or business

[2] In this paper, the terms MNEs, TNCs and MNCs are interchangeable, although MNEs is preferable as it is imbued with connecting the entrepreneurial capacity and capability of international firms more so than the term corporation, which harks back to the organisational rigidities of 'Fordism' [Lipietz (2001)].

climate benchmarking[3], Competitive Industrial Performance criteria [UNIDO (2002)], fiscal items (direct and indirect taxation) and non-fiscal items (grants, etc.). The major challenge to policy makers is that, in a world increasingly influenced by the World Trade Organisation (WTO) and a 'rules-based' approach to policy matters, with diminishing barriers to factor mobility, the range of FDI PIs has expanded to include all the factors and variables of: (i) FDI determinants and motivations[4]; (ii) structural adjustment[5]; (iii) business operational environment[6]; (iv) enterprise performance[7]; (v) ability to do business 'without a hassle'[8]; (vi) macro-economic competitiveness[9]; (vii) economic freedom[10]; and (viii) FDI confidence[11]. Simultaneously, policy discretion arguably has been diminished by the 'rules-based' approach. In terms of competitive industrial performance, the policy factors (and variables) reflect industrial capacity and complexity[12]. In terms of taxation, the pertinent factors and variables of PIs cover direct (income, corporate earning taxes) and indirect (consumption and transaction taxes) fiscal measures.

The rest of the paper is organised as follows. Section two – the new context of the FDI regime – deals with the new context of international investment and the implications for policy makers. Section three – background issues on host policies for FDI – explains the framework for FDI promotion, presents the different policy dimensions and enumerates the various policy

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[3] See A. T. Kearney, 2004, *FDI Confidence Index*, Global Business Policy Council, Volume 7; A.T. Kearney, 2004, *A.T. Kearney's 2004 Offshore Location Attractiveness Index: Making Offshore Decisions*, Chicago; Fraser Institute, *Economic Freedom of the World: 2004 Annual Report*, Vancouver; Heritage Foundation, 2005, *2005 Index of Economic Freedom*; IMD, 2003, *The World Competitiveness Yearbook 2003*, Geneva; Transparency International, *Framework Document: Background Paper to the Corruption Perceptions Index*, Passau; UNDP, 2003, *Human Development Report: Millennium Development Goals: A compact among nations to end human poverty*, New-York; UNIDO, 2002, *Industrial Development Report 2002/2003: Competing through Innovation and Learning*, Vienna: UNIDO; WEF, 2000, *Global Competitiveness Report*, Geneva; World Bank, 2005, *Doing Business in 2005*, Washington D.C.: IBRD/World Bank/OUP.

[4] See Bartels and Pass (2000), p.32 for an indication of the range of motivations.

[5] Resource assets, infrastructure, operating costs, economic performance, governance, taxation, regulatory conditions and framework.

[6] Public services and policy, legal system, corruption, regulatory efficiency, mergers monopolies and competition policy, financial services.

[7] Regulatory capture, influence and lobbying, labour market, rule of law.

[8] Starting a business, hiring and firing workers, access to credit, enforcing contracts, closing a business.

[9] Macro-economic conditions, public institutions, technology.

[10] Trade policy, fiscal burden of government, government intervention in economy, monetary policy, FDI and FPI, banking and finance, wages and prices, property rights.

[11] Propensity of firms to undertake FDI in a particular location.

[12] In a country's Industrial Capability Profile, this comprises manufacturing value-added (MVA) per capita in conjunction with manufactured exports per capita; and share of medium- and high-technology (MHT) in MVA in conjunction with share of MHT in exports. The first pair of indices indicates industrial capacity and competitiveness whereas the second pair connotes industrial depth and complexity. See UNIDO 2002/2003 Industrial Development Report, Competitive Industrial Performance Index.

instruments. Section four – key issues for effective FDI promotion – addresses the issue of "regionalisation" of FDI and the importance of policy coherence within and across national boundaries. Section five – discussion on the pros and cons of FDI PIs – finally debates the relative advantages and disadvantages of FDI PIs. Section six – concluding remarks – concludes.

2. The New Context of the FDI Regime

Taking departure from the EGM working paper – the evolving nature of FDI industrial organisation and challenges for policy and practice[13] – it is clear that FDI, and its transforming (and transacting) relations, are the predominant integrating factors of the global economy. This structural change to the pattern of economic activity presents a fundamentally new context for policy and practice regarding the rules, incentives, laws, promotional mechanisms and strategies necessary to capture and retain FDI. The new context holds implications for policies necessary to change the type of FDI that flows to a particular developing country, or a region.

While the process of economic globalisation and its constituent elements are constantly co-evolving, there are several dimensions concerning the new context of FDI that policy makers in developing countries need to be increasingly aware of. Firstly, MNEs are nowadays adopting a different mode of organisation for their production, functions and operational activities, which can be called 'the global factory' [UNIDO (2005)]. This is stylistically illustrated in Figure 1 below[14].

[13] Working Paper for UNIDO EGM on the evolving nature of FDI industrial organisation and challenges for policy and practice, Bangkok, Thailand, 21-23 March 2005.
[14] It should be noted that while each MNE has its own 'global factory', inter-firm relations mean that several 'global factories' are involved in the production of any one good.

THE GLOBAL FACTORY

MNEs DISTRIBUTED OPERATIONS & SPATIALLY CO-ORDINATED FUNCTIONS

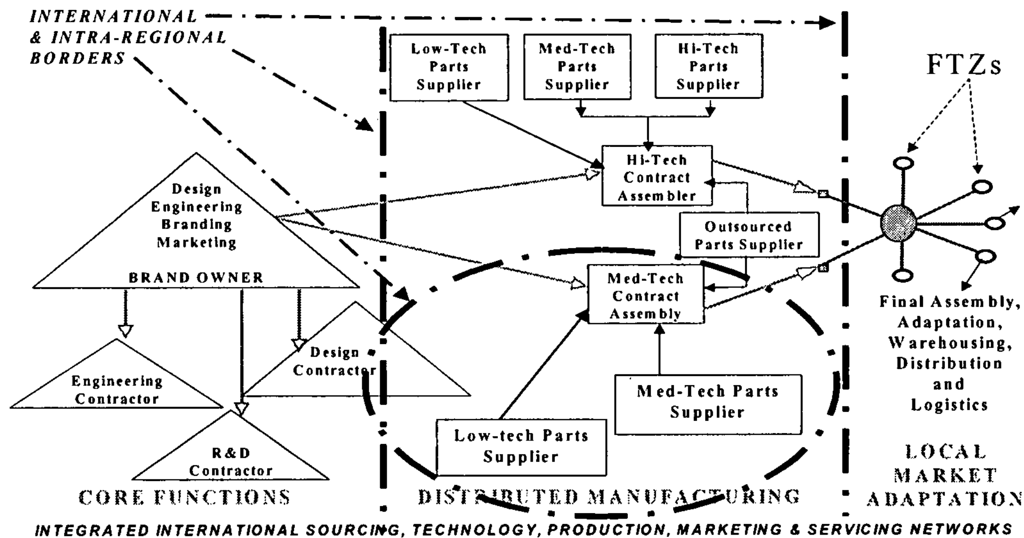

Figure 1: The Global Factory

'The global factory' is co-evolving with the policy environment and the MNE organises its global production through spatially co-ordinated functions. This is characterised by inter-changeability and is in dynamic tension with its internal constituents as well as external forces of competition and co-operation. This context and process is highly complex and its comprehensiveness, with respect to intra- and inter-firm transactions, requires attention by policy makers. The understanding of this phenomenon appears to be extremely necessary for host countries in order to put in place effective FDI policies. There is indeed an increasing need for the host policy environment to reflect 'the global factory' of MNEs.

In addition, policy makers have to bear in mind that, while the global strategies of MNEs are evolving and manifest in the configuration and reconfiguration of the 'global factory', the previous separated patterns of FDI by firms (in sequential time and place and, hitherto, more predictable modes of entry) have been replaced by parallel modes of entry in multifaceted international patterns described as 'alliance capitalism' (which includes Joint Ventures, Strategic Alliances, Co-production and Marketing, co-R&D, Contract Design and Manufacturing with Equity and Non-equity formalities). This is stylistically illustrated in Figure 2 below.

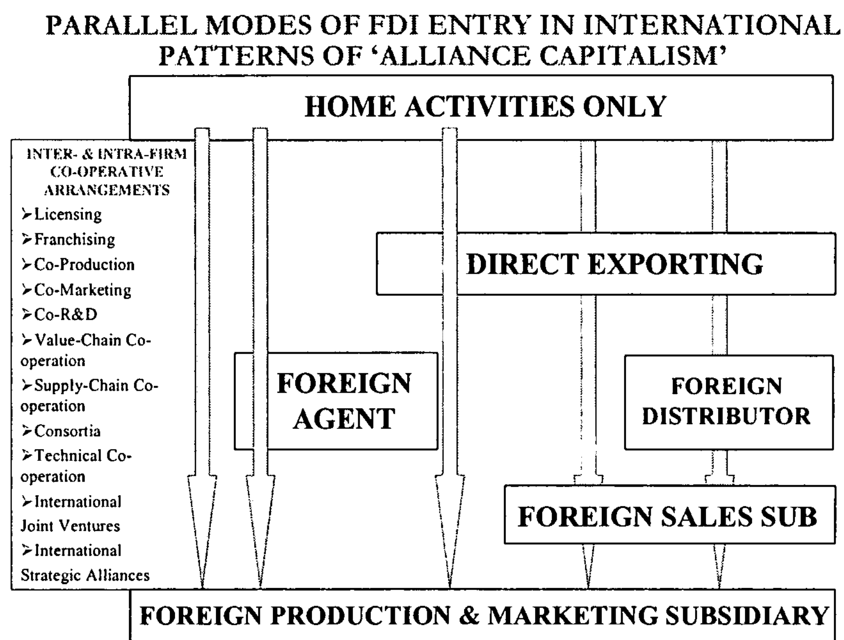

Figure 2: Parallel Modes of FDI Entry in International Patterns of 'Alliance Capitalism'

In this context, policy makers need to move beyond the idea of attracting FDI with the lure of cheap labour and unsophisticated tax incentives[15]. These new operational patterns of FDI are characterised by international networked systems of industrial sourcing, technology, production, marketing and servicing, and place a serious challenge on policy-making in the developing world. Economic and industrial policies of the host countries have to be both appropriate and well sequenced if they want to succeed in capturing the kind of FDI that would boost their industrial development.

These policy issues are related to the increasing trend of the spatiality in FDI [Blonigen et. al. (2004)]. In other words, MNEs not only consider home and host country characteristics when they decide to invest, but also third locations. In fact, there is a spatial correlation between FDI in a particular country and in alternative countries or regions. There is empirical evidence that regions

[15] The productivity adjusted cost of labour skills, and the credibility and predictability of the tax system (both direct and indirect), inter alia, is what is increasingly taken into account in location decisions of MNEs.

surrounded by large markets tend to capture more FDI[16]. It is worth mentioning that third locations acquire significance in MNEs' decision-making especially when their investments deal with vertical integration, as they will be motivated to take advantage of the comparative advantages of different localities. Since FDI decisions are multilateral and multivariate by nature, the interdependence between host destinations is gaining magnitude in MNEs decision-makings and hence should be increasingly factored into the crafting of developing countries' PIs as well as their implementation.

Finally, an additional element that is arguably having a radical impact in the new context of economic globalisation, and FDI in particular, is the set of international laws agreed to by signatories of, and imposed by, the WTO[17]. Although these laws are primarily dealing with international trade, they are also obviously related to issues of international investment (although not as comprehensively). The major framework affecting FDI policy instruments within the WTO rules is the Trade Related Investment Measures (TRIMs), but other agreements such as the General Agreement on Trade in Services (GATS), the Agreement on Subsidies and Countervailing Measures (SCMs) and Trade Related Intellectual Property rights (TRIPs) also address foreign investment issues [WTO (2005)]. In fact, these agreements emphasise that some investment measures are discriminatory, restrict and distort international trade and therefore have to be eliminated. This is an imperative issue for developing countries, as they have to design their FDI regime, and PIs therein, in accordance with the WTO rules, considered internationally as 'hard law'. These considerations constrain the degrees of freedom available to policy makers and require higher order policy research and analysis in relation to competitiveness and trade analysis to generate valid PIs.

However, at the same time as the WTO agreements have reduced the room for manoeuvre of national governments regarding FDI policies, they also have diminished tremendously the barriers to international investment, making the task easier for the investors and, by definition, host countries – given conducive business climates [UNCTAD (2003)]. Thus, one can say that both MNEs and industrialised governments tend to be favoured by the 'hard law', whereas developing countries in general and least developing country host governments in particular tend to have their

[16] This carries major implications for PIs and FDI law operationalised at the regional level and various dimensions of FDI policy, which exploit differentiated factor conditions and costs across the geo-economic space of the region. In addition, robust regional institutions are crucial to workable PIs.
[17] In this regard, it is important to note 'actionable' and 'non-actionable' subsidies in the framework provided by the WTO.

bargaining positions significantly constricted. This makes the task of crafting PIs for FDI extensively more difficult for developing countries, as they are almost only importers of FDI. In contrast, industrialised countries tend to have a more balanced position, as they are the major sources of, and hosts to, FDI.

Thus, policy makers in the developing countries, like their counterparts in industrialised countries, have to adapt their policy tools to the new context of the FDI regime. They need to bear in mind not only the changing strategies and decision-making process of MNEs as well as the international rules of the WTO that are reducing the scope for policy schemes, but also the competing policy and strategies of other FDI host locations.

3. Background Issues on Host Policies for FDI

The growing importance of well-crafted PIs for FDI is illustrated by the increasing numbers of foreign investor – Nation-State disputes being formally registered at the ICSID[18]. This contestation reflects the issue of risk in a rules-based investment and trading environment, and the extent to which good policy and excellent implementation can reduce disputations and thereby reduce the risk associated with doing the business of investing in a particular location. It is crucial to note that all bar one dispute claims have been lodged by investors; and of the claims, 39 (i.e. 78% of total defendants) are against developing country governments. These claims are costly in legal terms as well as adversely affecting the image of the host location at a time when the host country Investment Promotion Agency (IPA) may be attempting to market the country and/or target specific investors for strategic sectors of the economy. Given the increasing rules-based system, shrinking discretion and widening coverage of PIs within BITs, DTTs, RTAs and IIAs[19], it is likely that formal disputes over FDI policy and application of PIs are set to grow in number and legal complexity.

[18] The International Centre for Settlement of Investment Disputes of the World Bank, where registered disputes have increased from three (1994) to 106 (2004) with an additional 54 cases outside the ICSID according to UNCTAD, 2004, Occasional Note, International Investment Disputes on the Rise, UNCTAD/WEB/ITE/IIT/2004/2, 29 November 2004.

[19] Respectively Bilateral Investment Treaties, Double Taxation Treaties, Regional Trade Agreements, and International Investment Agreements.

Furthermore, from a PIs perspective, FDI and FPI have to be increasingly considered in tandem albeit in a sequential manner for policy switching purposes. The stimulation of FDI and FPI inflows depends on the design (and reform) of PIs [Reisen (2001)]. With respect to the widening coverage of PIs, this is due in part to the complexity inherent in the operations of 'the global factory' and partly due to the rising popularity and availability of business and investment climate benchmarking[20]. These benchmarking publications cover a vast array of variables, which in concert depict the comparative characteristics of the economic effectiveness and competitive efficiencies in various countries. Clearly, from a policy craft and PIs perspective, attention to a country's relative position in these benchmark 'league' tables is crucial not only for steering policy but also for assessing the relative validity and success of policy and PIs. This will be further explored below. But before examining the relative 'advantages' and 'disadvantages' of PIs, it is germane to look at the framework for, and policy dimensions of, FDI (and FPI).

A. The Framework for FDI Policy Instruments and Promotion

According to Loewendahl (2001), the framework for cradling the PIs of Investment Promotion (IP) can be divided in four major areas: strategy and organisation; lead generation; facilitation; and investment services. All include several stages to be crafted and instruments to be applied for effective FDI promotion in an integrated manner. In the field of strategy and organisation, the different stages are (i) setting the national policy context, which requires inter-ministerial co-ordination (ii) setting the objectives, (iii) deciding on the structure for operating investment promotion, (iv) implementing a competitive positioning exercise (strategic direction and effective marketing), and (v) executing a sector targeting strategy[21]. In the next area – lead generation – the stages are (vi) marketing, that aims at increasing the awareness of investors, and (vii) company targeting. In the area of facilitation, the stage is (viii) pre-project management and project handling, which aims at converting an investment proposition and investigation into an actual investment. Finally, the last two stages in the area of investment services are (ix) after-care and services improvement as well as (x) monitoring and evaluation. Loewendahl thus draws a clear and precise

[20] Unpublished UNIDO Research on *Policy Determinants of National Innovation Systems* examining policy factors and variables scored by various institutions.
[21] Bearing in mind the need to move rapidly through first, second, third to fourth generation investment promotion strategy and organisation needs to take into account the wider macro-economic setting, which progressively reduces the transaction costs of doing business [World Bank (2005)].

framework of ten different stages to be implemented by host countries, albeit adapted to local circumstances and conditions, for effective investment promotion. However, each country needs to calibrate the ten stages to its overall industrialisation objectives as well as resources available and its evolving stage of development.

By taking a broader perspective on FDI policy instruments and promotion, it is acknowledged that there are three generations of investment promotion [UNCTAD (2002)]. The *first generation* of IP emphasises opening the economy to FDI. The *second generation* is for a government to decide to actively "market" its economy, namely by putting in place a board of investment or an IPA[22]. Most developing countries have moved from the first to the second generation of FDI promotion. Then, several host countries have moved towards a *third generation* of IP by targeting more specific investments. Indeed, IPAs have to change from too narrowly focused promotion strategies in order to increase the efficiency of FDI, by capturing various stages of export-oriented investment, for example. A targeted approach can better help the developing countries to complement and achieve strategic objectives of development and use resources efficiently. However, whereas this third generation of IP is probably more successful for boosting a country's industrial development, it also constitutes a much more complicated task for policy makers since knowledge of FDI issues and implications need to be particularly advanced.

Going a step further, it is suggested that developing countries put in place mechanisms that allow them to move to a *fourth generation* of IP, where IPAs should adapt their strategies to the new complexity of MNEs, as described in the previous section [UNIDO (2005)]. The fourth generation of FDI promotion can be characterised by a reduced distinction between domestic and foreign investment activity in policy terms. In fact, some governments have a special policy framework for foreign investors, which is different to that for domestic investors. However, the trend is to eliminate damaging arbitrage and distortions by having the same, or at least similar, policies for local and foreign investors. Although in the short- to medium-term a separate policy environment for foreign investors may be the only option if these investors are to be attracted, experience suggests it would be best to have a uniform policy environment for both groups [UNIDO (2003)]. Therefore,

[22] In recent years, the establishment of formal IPAs has gathered sufficient momentum such that the number of national IPAs had increased to 158 by 2004 [UNCTAD (2004); UNIDO, 2003, *Africa Foreign Investor Survey 2003: Motivations, Operations, Perceptions and Future Plans – Implications for Investment Promotion*, Vienna: UNIDO].

the thorny issue of 'incentives' should be addressed by focusing on information and communications technology infrastructure, human resource development and social capital formation; and positioning strategic domestic sectors and sub-sectors within the interstices of 'the global factory' and networks of MNEs.

Depending on the level of industrial development, different countries need to improve different aspects of their policy environment, at different times, for attracting FDI. The Figure 3 – The 'Virtuous Cycle' of policy intervention – below, illustrates the inter-connection of the key aspects of the policy framework given by modal neutrality, market contestability and policy coherence[23], and managed by host government, as well as the predominant characteristic structure that drives economic development[24] and the host government specific actions to increase FDI which can be supported and reinforced by UNIDO enabling services [UNIDO (2003)].

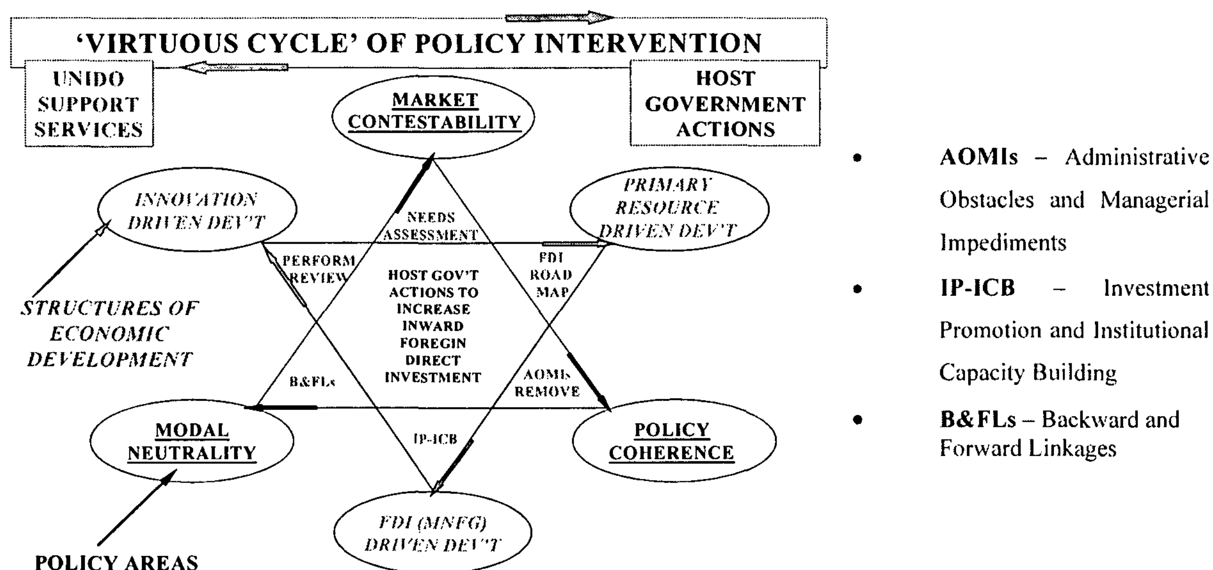

Figure 3: The 'Virtuous Cycle' of Policy Intervention

[23] Modal neutrality describes policies that allow foreign investors to decide for themselves how best to serve the markets they enter. Market contestability embodies the ability of both foreign and domestic investors to compete on a level of playing field for the factors of production. Policy coherence refers to the degree of internal consistency of objectives, FDI policies and interpretation of policies, in their regulatory form, across a range of issues and at different level of government.

[24] See stages of Competitive Development in UNIDO, African Industry 2000, The Challenge of Going Global, p.130.

Hence, from a broad perspective, for example, countries with economies considered predominantly dependent on the primary sector should place greater emphasis on needs assessment and road mapping so that they can look for possibilities to minimise the investors' time and costs, and eliminate or reduce administrative obstacles and managerial impediments. Economies that are predominantly dependent on the commodity resources primary sector would need to place policy emphasis on the regulatory frameworks that moderate ownership rights, land acquisition protocols and the whole system of property rights and transaction laws. The manufacturing driven economies might want to place more emphasis on direct investment promotion and consider institutional capacity building after demonstrating significant progress on the removal of administrative obstacles and managerial impediments to FDI. In a predominantly manufacturing driven development, the host government might wish to bring greater attention to fostering backward and forward linkages. Policy emphasis would focus on Intellectual Property Protection Rights (IPPRs), as the core dimension of manufacturing is production know-how and technology know-why. Innovation driven economies might want to place emphasis on higher levels of performance review while focusing attention on reinforcing integration and linkages. The needs assessment for innovation driven development is of immense strategic importance with respect to technology futures.

The areas of greatest significance for crafting PIs, in terms of fourth generation IP, are therefore: (i) Needs Assessment. It is important for developing country policy makers to have an accurate view of the policy needs of the country – as a host to FDI – in relation to overall industrialisation. For example, PIs may have inadvertent biases or may be inoperable in the practical terms of doing business – thus creating 'gates' for rent-seeking activities. Given the global factory of MNEs, there may be a need to revise legislation, in the light of WTO provisions, regarding joint ventures for example. A policy needs assessment exercise provides policy makers with a measure of the policy areas requiring attention. (ii) FDI road mapping, in other words, ensuring that the developing country IPAs and policy makers are fully aware of the actual 'on-ground' details of making a FDI in terms of requirements and legal process. (iii) Administrative obstacles and managerial impediments and their removal in transparent, and legislatively predictable, phases. This policy area and its instruments reflect the factors and variables enumerated in Doing Business [World Bank (2005)]. (iv) Investment promotion and institutional capacity building which concerns the capability of the relevant authorities, including the IPAs, to engage with foreign investors in a manner that results in better quality FDI inflows. And growing commitment by MNEs to locating

increasing parts of the vertical specialisation of their FDI in the country. This policy area also deals with surveys and the reporting formalities on FDI intentions that permit IPAs to fine-tune policy instruments and measures. It also allows IPAs to develop a forward-looking posture with respect to the likely reconfiguration of the operations of key foreign investors in their economy. (v) Backward and forward linkages to domestic industry investment. This policy area for FDI concentrates on PIs relevant to enabling domestic industrial sectors to integrate into the international production networks of MNEs. PIs therefore need to be oriented towards supporting collaborative forms of MNEs engagement with domestic industry through, for example, joint ventures with promising local firms; local company technological and managerial upgrading schemes; and infrastructure provision via public-private partnerships that improve the efficiencies of intermediation (value-added distribution and logistics). In respect of PIs in this area, two key observations are necessary. First, infrastructure that enables intermediation raises total factor productivity but in a manner that varies across industries. Secondly, infrastructure is correlated with the composition of output in terms of the pattern of international industrial specialisation. Therefore, PIs in this area increase the incomes of factors used intensively in manufacturing [Yeaple and Golub (2002)]. (vi) The performance review of the PIs operationalised by law and implemented by IPAs in investment promotion is crucial to maintaining the relevance of the framework for cradling the PIs for FDI. An essential part is surveying the impact of PIs on investor choices regarding motivations, and entry/exit strategies across industrial sectors, as well as MNEs propensities for collaborating with domestic firms. It goes without saying that the relationship of these choices to incentives, which is measured through surveying, is vital to policy craft.

B. The Policy Dimensions

We now proceed to analyse the different FDI policy dimensions in which PIs are made to be implemented by host countries. It is important to note herein that governments of developing countries choose policy instruments – generalised as incentives[25] – to attract FDI in relation to their overall economic development goals. Thus, different dimensions of incentives can be depicted. Firstly, incentives can be either *general* or *specific* (with a discretionary perspective). A second dimension is the durability of incentives. Indeed, according to the host country's priorities,

[25] Not to be confused with the special category of incentives named fiscal or financial incentives.

incentives could be either *permanent* or *temporal*. However, pragmatically speaking, PIs related to incentives need to change in duration so as to encourage the kinds of FDI and industrial specialisation the country wants. And therefore it is useful to think of these PIs as windows of opportunity which open and close. Another dimension exists at the geographic – or spatial – level since investment promotion policies can target FDI either at a *national* level or at a *regional* or *local* level. Local incentives can be used to promote specific regions of a country that are poorer or in greater need of development. Further, incentives can be used to attract foreign investors to the whole *economy* or only to certain *sectors* or sub-sectors, according again to the specific needs of the country. In the past, this has carried the rubric 'negative' or 'positive' lists which cordoned off strategic sectors of the economy to foreign investors and reserved others for national firms[26]. Finally, at the firm level, incentives can focus either on *all FDI*, or only on *specific investors*. These dimensions are depicted in Figure 4: A Framework for Operationalising FDI Policy Dimensions and Instruments.

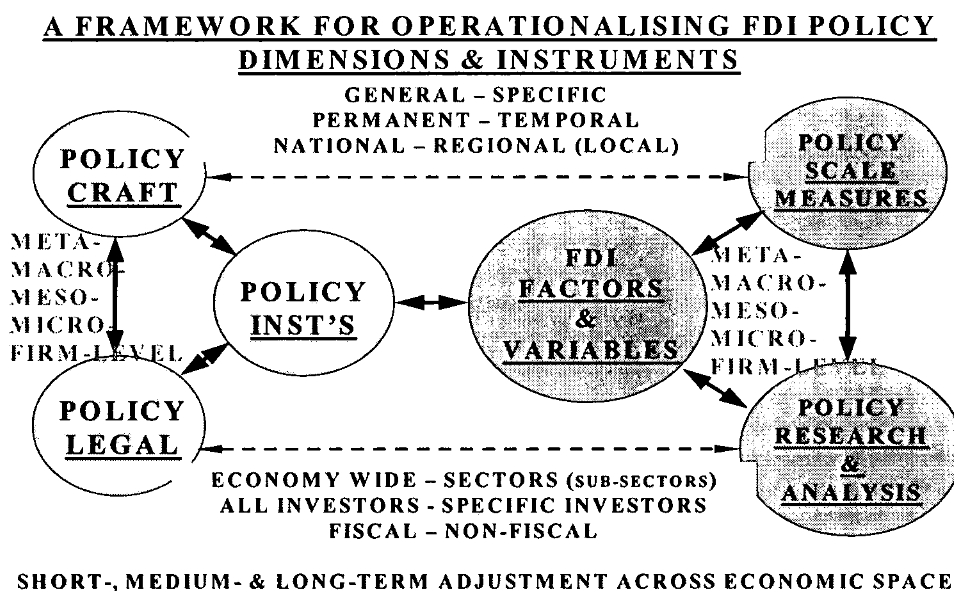

Figure 4: A Framework for Operationalising FDI Policy Dimensions and Instruments

[26] See Arkady Ostrovsky and Kevin Morrison, "Foreign Groups Face Ban from Bidding for Russian Resources", Financial Times, 11 February 2005, p.1 for a contemporary illustration of this phenomenon.

To say that policy craft – creating policy coherence out of the conflicting demands from modal neutrality, market contestability, as well as scaling and measuring the factors and variables which must be considered in policy research and analysis – is a challenge, is an understatement. This paper makes early reference to the growing importance of investment and business climate benchmarking as a guide to policy making. However, econometrically, as every factor or variable (or their combinations) has its own FDI inflow-elasticity and FDI stock-elasticity, IPAs and policy makers with limited resources should concentrate their policy craft on those FDI factors and variables with the highest FDI-elasticities [Christiansen (2004)][27]. In rank order, these are: (i) growth-competitiveness, which combines macro-economic and technology variables, with a FDI inflow-elasticity of 0.63; (ii) economic freedom, combining government intervention, property rights, wages/prices and regulation variables, with a FDI inflow-elasticity of 0.56; (iii) taxation and regulation with a FDI inflow-elasticity of –0.50; (iv) quality of telecommunication services with FDI inflow-elasticity of –0.28[28]; and (v) labour market regulation with FDI inflow-elasticity of –0.26. Furthermore, these elasticities have short- medium- and long-term adjustments rates. This approach begins to lay out the choices available to policy makers in making viable PIs in a systematic manner based on rigorous analysis. Hence, from a fourth generation IP perspective, a focus on the macro-economic environment stability and technology policies to increase the rates of innovation and transfer by PIs that facilitate licensing and franchising for example would be needed. In a similar vein, harmonising taxation regulation across regional space would be a viable policy.

All these elements and issues in Figure 4 reflect the need for sequencing and switching PIs and incentives, both in space and time. In other words, while the FDI policy-making is increasingly more complex and diverse, host governments, according to their development needs, have to adapt to the MNEs dynamic activities by sequencing and switching (in a predictable manner) their FDI policy instruments. Moreover, these different policy dimensions also indicate the importance for host governments to create different levels of policies: the meta- or supra-national level, the macro- or national level, the meso- or regional and cluster level, the micro- or industrial sector and sub-

[27] For example, the FDI stock elasticities of GDP per capita range from 0.89 to 0.96 implying that a 10% increase in a country's GDP per capita would result in a 10% increase in inward FDI stock. Likewise, the FDI inflow-elasticity of a host country's competitiveness (scaled 1 to 5) at 0.63 implies that an increase of 1 point in the scale would result in an increase of 88% inward FDI ceteris paribus. See Christiansen (2004, pp. 32-37) for other FDI-elasticities (economic freedom, taxation, regulation, infrastructure, human resources).
[28] The measurement scale is from 1 to 5 representing increasing poor quality, hence the negative sign on regression coefficient.

sector level and the firm level of organisational strategy and competitiveness [UNIDO (2005)]. The complexity of FDI host policy-making is obvious but the policy dimensions have to be chosen and established in harmony with the general development goals set up by the government.

Ultimately, it could be argued that all these dimensions collapse into one dimension regarding incentives. In fact, incentives can be *fiscal* or *non-fiscal* [Oman (2000); UNIDO (2003)], as selectively illustrated in the Table 1 below. As we can notice, non-fiscal incentives are constituted by *financial* and *non-financial* incentives.

Table 1: Fiscal and Non-Fiscal Incentives

Fiscal incentives	Non-Fiscal incentives
Tax holidays	Depreciation methods
Tax-free imports	Development Banks' loan policies
Tax exemptions	R&D support
	Environmental standards support
	Labour training support
	Government subsidies

Whereas industrialised countries typically utilise financial incentives such as grants, developing countries usually use fiscal incentives, such as reductions in the base rate of corporate income tax, tax holidays and import-duty exemptions and drawbacks [Oman (2000)]. Incentives are widely used to attract MNEs and thus create a climate of policy competition for FDI. Fiscal incentives might be successful for attracting MNEs but incentives-based competition also creates some problems. Indeed, the first problem of incentives is that they represent opportunity cost of resources to host governments. Secondly, there can be a significant lack of transparency regarding incentives, which leaves space for corruption and other kinds of rent-seeking behaviour. Finally, given the dimension choices in Figure 4, incentives also provoke market distortions. Among them, the major ones are the fact that incentives tend to favour large corporate investors at the detriment of small ones as well as foreign over the domestic companies because of their lower risk profile and higher bargaining power. The distortion would tend to disappear (over time) in countries adopting fourth generation of IP, as they would treat foreign and domestic firms equally with regard to incentives.

C. The Policy Instruments

It is noteworthy now to take a closer look at the actual policy instruments that exist for attracting, promoting and accompanying FDI. It is important to bear in mind that the design and the implementation of policies firstly depends on the actual policy instruments, as they are enumerated hereafter. Secondly, they should be converted into law. In fact, it is the country's law that is the highest authority for attracting, or guiding and shaping, inward FDI and it is of crucial importance that all policy tools are translated into national laws. However, the legislative aspect is beyond the scope of this paper. The following Table 2, adapted from various sources [UNCTAD (1996)], shows the different PIs and regulatory measures possible that are related; (i) to admission and establishment, (ii) to ownership and control, (iii) to the actual FDI operations, and (iv) the main incentives offered to foreign investors. However, space does not permit an exhaustive individualised examination of the pros and cons of each policy instrument here. A more general discussion follows below.

The advantages and disadvantages of FDI PIs arise not in absolute terms but relatively from the way they are calibrated and recalibrated and applied in changing circumstances. For example, regarding ownership, a primary resource driven economy would need high modal neutrality to enable wholly owned subsidiaries (as the likelihood of local firms able to joint venture meaningfully would be low) and have PIs that secure property rights. It would be disadvantageous to insist on FDI policy that required MNEs to joint venture with local firms in order to invest in vertically specialised minerals production. Regarding capital depreciation as another example, policies need careful calibration or else intended beneficiaries might not actually alter their capital/labour ratios and capital intensities, in order to upgrade the technological capacity of manufacturing industry.

Table 2: The FDI Regulatory Measures and the Incentive Measures

Admission and Establishment Regulatory Measures	Ownership and Control Regulatory Measures
Sectors ring-fenced from FDI	Equity limits on foreign ownership (E.g. less than 50%)
Quantitative restrictions on numbers of MNEs	Entry modalities limited to IJVs/ISAs, L/F
Minimum Capital Requirements	Mandatory transfer of ownership (Fade-outs)
Subsequent additional capital inputs	Nationality limitation on equity held
Screening, authorisation, registration	Restrictions on use of foreign loans (bonds)
Entry conditions – Meeting criteria (environment)	Restrictions on stocks and share types held by foreign investors (non-voting)
Legal form requirements of FDI	Restrictions on types of share transfers
Restrictions on entry modalities (MAs, IJVs, ISAs)	Restrictions on foreign share holders (dividend, capital)
Special requirements for non-equity (BOT, IJVs, L/F)	'Golden' shares held by host (prevent MAs)
FDI to specific locations (moderate urban drift)	Government appoint reservations to board
Restrictions of imported input factors	Restrictions on nationality of directors
Deposit requirements prior to FDI	Government reserves the right to veto certain decisions
Admission to hosts privatisation deals restricted	Government reserves rights to be consulted prior to decisions
Admission and incorporation fees (taxes)	Restrictions on land rights transfers
Compliances with norms (national security, customs, public morals)	Restrictions on IPPRs

Operations Regulatory Measures	FDI Incentive Measures
Employment restrictions on foreign staff	**Fiscal Incentives**
Performance requirements (*local* sourcing, content, mfg, tt, employment, training, import, export, Vols, BOP, Sales, foreign exchange earnings)	▪ Reductions in corporate tax rates & tax holidays ▪ Losses against future profits
Restrictions on public procurement (MNEs excluded)	▪ Accelerated capital depreciation ▪ Investment/reinvestment permits
Restricted access to local factors inputs, on OPs relocations within host	▪ Lower social security payments ▪ Tax reductions based on staff and marketing expenses
Restrictions on diversification, on access to communications, on free flow of Government data	▪ MVA based incentives: Local content based tax reductions
Operation restriction on public utilities (price control)	▪ Import based incentives: Duty exemptions; tax credits (on materials)
Restrictions on access to local credit, foreign exchange, on capital repatriations	▪ Export based incentives: Duty exemptions; preferential tax on export incomes; tax reduction on foreign exchange; tax reductions on export performance
"Cultural" restrictions	**Financial Incentives**
Information disclosure requirements	▪ Direct subsidies & subsidised loans
Special restrictions on sector operations (banks)	▪ Loan guarantees & public venture capital availabilities
Operational permits & licenses, Technical standards, Royalty ceilings	▪ Guaranteed export credits & Government insurance at low rates
Advertising restrictions on foreign MNEs	**Other Incentives**
	Subsidised dedicated infrastructure, services, Government contracts

The Table 3 below shows on the one hand, the trade policies and on the other hand, the Trade Related Investment Measures (TRIMs) as well as their impact on FDI.

Table 3: Trade policies and Trade Related Investment Measures (TRIMs)

Trade Policies	
Import policies	***Export policies***
Tariffs	Fiscal incentives
NTBs	Export credits and guarantees
Import quotas (voluntary export restrains e.g. Japanese autos)	Export targets
Import licenses	Overseas export promotion agencies
Import deposits	EPZs or FTZs
Import surcharges	Ban on strategic exports
Anti-dumping	Exchange rate manipulation
Special labelling	
Health & safety	
Customs procedure	
Excise documents	
Subsidies to home producers	
Local content requirements	
Government contracts	
Trade Related Investment Measures (TRIMs)	
Trade Measures	***Impact on FDI***
Tariffs, import quantitative restrictions	Induces import substituting FDI
Regional free trade agreements	Promotes FDI in member countries
Rules-of-origin	Induces exports oriented FDI
EPZs	Induces export replacing FDI
Export controls	Shifts sector balance of FDI
Export financing	Induces import substituting FDI
Non-monetary trade agreements	
Safety, health & national standards	

The following Table 4 [UNIDO (2004)] is a good illustration of the effects of PIs used by host countries on FDI and on market imperfection. It shows that sometimes FDI inflows and a perfect market do coincide but at other times, they are in contradiction. Thus, it is interesting to

note that developing countries occasionally have to use policies that distort the market in order to attract foreign investment.

Table 4: Comparative Policy Effects on Market Imperfections and Inward FDI, adapted from Brewer (1993)

Effect on FDI	Effect on market imperfection	
	Increase	**Decrease**
Increase	▪ Protectionist import policies ▪ Weak IPPRs ▪ Subsidies on In-FDI ▪ Undervalued exchange rate ▪ Weak competition policy ▪ Procurement discrimination vs. foreign (non-domestic) firms ▪ Technical standards	▪ Liberalisation of FDI regime ▪ Privatisation ▪ Foreign exchange convertibility ▪ Anti-dumping policies ▪ Import duties on subsidised exports from other countries ▪ National treatment ▪ Strong competition policy ▪ Tariff debates on imports for export oriented FDI ▪ Liberalisation of trade restrictions
Decrease	▪ Overvalued exchange rate ▪ Restrictions on In –FDI ▪ Price controls ▪ Import restrictions on FDI inputs ▪ Export controls on FDI outputs ▪ Restrictions on capital access ▪ Restrictions on capital repatriation	▪ Strong anti-monopoly policy enforcement ▪ Strong arm's length transfer pricing policy enforcement

The analytical challenges of policy formulation and dynamic reconfiguration of policy instruments presented by Tables 2, 3 and 4 are not to be underestimated [UNIDO (2004)]. For example, incentives such as subsidised loans can alter the ratio of foreign to local in the capital structure of the FDI and hence the relative volumes of foreign to domestic investment. The FDI motivations referred to earlier therefore need to be appreciated as being amenable to amplification

regional agreements not only enable more intra-regional investment but also FDI from outside. One can argue that in the case of NAFTA, the third country location thesis is prominent since many MNEs (mostly from Western Europe and Japan) are interested to invest in Mexico in order to penetrate the US and Canadian markets.

Finally, it is worth mentioning that regional-integration agreements also constitute an excellent means to decrease the 'race to the bottom' incentives-based competition and its negative consequences. In fact, one may argue that most of the policy competition among host governments occurs within, rather than between, regions. Therefore, regional agreements have a great potential value to improve the co-operation among host governments to regulate and harmonise their use of PIs and fiscal and financial incentives and thus to limit the harmful effects of excessive policy competition.

Regional-integration agreements and the relevance of regional PIs thus constitute a central means to successfully promote FDI since, on the one hand, they enable more investments to take place, and on the other hand, they enhance co-ordination among host governments.

B. The Legislative Importance of Policy Coherence

As mentioned above, in relation to investment disputes, policy coherence refers to the degree of internal consistency of objectives, FDI policies, the instruments and interpretation of policies, in their regulatory form, across a range of issues, at different level of government in the different localities within the nation. A high level of policy coherence is very important, as it will enhance the probability that the national development priorities will be accomplished [UNIDO (2003)]. This coherence has to emerge at two levels. It should firstly appear in the government's policies but, to make sense, coherence should also materialise when these policies are translated into law.

At the policy level, coherence implies a high degree of consistency between the host government objectives and the actual policies implemented to achieve them, in parallel with a strong connection and co-ordination between the different parts of the government. Policy makers have always to bear in mind that attracting FDI does not constitute an end in itself but a means to boost

by the policy prescriptions of developing country hosts. However, whatever the changes in policy instruments, they need to be set in the tri-lateral policy framework of modal neutrality, market contestability and policy coherence. Signalling changes in policy would need to be well-timed, transparent and consistent with overall industrial development goals.

4. Key Issues for Effective FDI Promotion

Once comprehensively aware of the complexity of the framework for FDI promotion as well as the various policy dimensions and the different PIs themselves, policy makers from developing countries have to pay attention to two critical issues that enable effective investment promotion. On the one hand, there is the increasing influence of regional-integration agreements on international investment and their implications for FDI promotion, and on the other hand, the importance of coherence and consistency, both at the policy and at the legal levels.

A. The "Regionalisation" of FDI

The "regionalisation" process of FDI is a phenomenon with increasing importance. Historically, international rules and agreements have mostly dealt with trade more than with international investment. However, due to the fact that trade issues are gradually more concerned with domestic policy instruments, the divergence between international trade and international investment is becoming less and less prominent [UNCTAD (1996)]. Therefore, international free trade agreements nowadays actually correspond to free trade and investment agreements.

Regional-integration agreements between two or more countries are one of the most powerful means to attract FDI. These agreements have dramatically increased since the mid-1980s, the most significant being NAFTA, Mercosur, ASEAN and the European Union, with a single market since 1985. These regional agreements promote FDI as they facilitate more investment among the member countries but they also promote FDI from outside the region or agreement. Indeed, the first reason why regional agreements attract MNEs is because they create larger markets. Secondly, the establishment of these regional-integration agreements also imply a greater degree of market deregulation within the member countries, which attracts MNEs from outside. Thus,

industrial development [UNIDO (2002)]. In this sense, IPAs should not confine their efforts to capturing foreign investors but expand their work in close co-operation with other levels of the government in order to promote the kind of FDI that would reflect and respond to the overall national objectives. A strong policy coherence would limit the risks related to the strategic interventions carried out by host governments regarding FDI promotion, that is to say, the risk of abusing PIs and misusing the government's resources by capturing the wrong types of FDI or by attracting investments that never actually materialise. Furthermore, it is common that there are conflicts within a country between the aims of an incentives programme and the actual formulation of the programme as well as the capacity of national institutions to administrate it. Policy co-ordination among different parts of government is therefore needed to reduce the negative impacts of incentives.

In addition, it is crucial for effective FDI promotion that the policy coherence, which should exist at the different levels of government, also appears in the legal framework. In fact, a strong and consistent judicial system is exactly what is often lacking in developing countries although it is vital for attracting foreign investors. Laws have thus to be coherent with the PIs implemented by host governments and this is precisely the difficult task because of the new context of the FDI regime, the evolving framework for investment promotion and the increasing complexity of the different policy dimensions, as described in the previous sections.

5. Discussion on the Pros and Cons of FDI PIs

Regarding the advantages and disadvantages of FDI host PIs, as a manifestation of the arguments that have so far been developed in this paper, one could straightforwardly start by stating that these advantages and disadvantages are not absolute but, on the contrary, are both relative and temporal. By the means of liberalising or regulating FDI, host policy tools are meant to distort the economic environment in order to promote FDI that boosts industrial development. Thus, the discussion on pros and cons of FDI PIs actually embodies the debate whether developing country host governments should opt for reform in the direction either more policy liberalisation or more

policy regulation; even though recent trends suggest more pro-FDI laws than anti-FDI regulations have been passed [UNCTAD (2004; 2000)][29].

It is interesting to start by examining the argument regarding infant industry, which is the initial key theory for foreign investment regulation. Shafaeddin (2000), who reviews the theory of Frederick List, argues that no country has developed its industrial base without relying to some extent on infant industry protection. "Both early industrialized and newly industrialized countries applied the same principle, although to varying degrees and in different ways" (p.2). When British classical economists promoted the benefit of free trade, the United Kingdom was in a dominating position in the world economy and was thus able to take advantage of free trade arguably at the expense of the then less advanced economies. However, it is worth mentioning that List defended that protection should only be a means, and thus a temporal stage, to achieve economic freedom and international free trade and investment. And this argument is still valid nowadays. In a world of different levels of industrialisation, market failures do not enable free international competition to promote effective industrialisation in the least advanced countries. Therefore, it appears reasonable that developing countries encourage their infant industry by using the regulation of foreign investment. Nevertheless, regulation should be on a selective rather than on a universal basis and the level of protection should neither be excessive nor too low in order to have a balanced and beneficial relationship with foreign competition[30].

However, taking a more concrete perspective, it is argued by Djankov et. al., (2000) that regulation is impeding FDI and thus disfavours developing countries. In fact, these countries often have very high official costs of entry and MNEs have to follow long procedures before investing [World Bank (2005)]. Whereas the authors recognise that regulation is meant to achieve socially superior outcomes by countering market failures (such as monopolies and negative externalities), they argue that, in real terms, regulation is very often associated with higher corruption and unofficial economies. By using three measures which reflect policy coherence: (i) the number of procedures that MNEs have to go through, (ii) the minimum time required to complete the process

[29] Between 1991 and 1999 cumulatively national regulatory changes pro-FDI amounted to 974, and anti-FDI changes amounted to 61. In 2003 alone, pro-FDI legislative changes amounted to 220.

[30] The term regulation is herein and throughout used in its technical and positive economics sense and is not intended to invoke a normative economic judgment even though, ultimately, all economic action manifests normative consequences.

and (iii) the official costs of entry, the authors conclude that regulation benefits the regulator and not the whole society and obstructs MNEs to invest. Therefore, extensive regulation has the opposite effect from its initial purpose since it is associated with socially inferior outcomes and thus, as a logical corollary, FDI policies should be liberalised.

According to UNCTAD (1998) and UNIDO (2003), the process of FDI liberalisation involves three measures: (i) the removal of those market distortions resulting from restrictions and/or incentives applied distinctively to foreign investors, as they discriminate in the favour of some investors and against some others; (ii) the enhancement of several positive standards of treatment for foreign investors (national treatment, most-favoured-nation treatment, fair and equitable treatment[31]); and (iii) the reinforcement of market supervision in order to guarantee the proper functioning of the market (competition rules, disclosure of information, prudential supervision). However, it is worth mentioning that policies aiming at liberalising FDI are not necessarily the best policies for creating a favourable investment climate and even less for attracting or promoting FDI. Moreover, one can note that the liberalisation process should not be seen as a decline of the role of the state since the third measure mentioned above relates to government regulation[32]. In fact, whereas the two first measures imply FDI liberalisation, their overall beneficial impact depends highly on the presence of competent and well-organised market supervision. Thus, one can argue that liberalisation and regulation of FDI are not contradictory but rather complementary in order to attract and promote FDI that is beneficial for boosting industrial development.

Therefore, the debate goes beyond liberalisation versus regulation of FDI policies and the advantages and disadvantages of PIs are relative to time and space. Investment promotion is a highly complex process and PIs have to be well focused according to the specific conditions of the country. IPAs have to be aware of the growing tendency of benchmarking countries, as mentioned in the previous sections, according to various factors and variables that MNEs use in their FDI decision-making. The task of the IPAs has thus become increasingly more difficult, as they have to take into account these factors and variables for designing and implementing their PIs. Furthermore,

[31] These are specific measures that aim at creating a climate of perfect competition between domestic and foreign firms as they impose that no specific advantage can be given to one specific supplier and that foreign and domestic companies should be treated in the same way.
[32] Note the role of the developmental State in Asia's industrialisation experience.

IPAs of developing countries, after having carefully identified their neighbouring (or non-neighbouring) competitors, also have to consider what sort of FDI policies they will choose. Thus, there are no absolute pros and cons regarding PIs but IPAs of developing countries have to design PIs in accordance with the specific economic conditions of their countries in order to achieve effective FDI promotion.

6. Concluding Remarks

In conclusion, several "take-aways" can be extracted from this paper. Firstly, it appears that the advantages and disadvantages of PIs for FDI are not absolute and do not deal with either good or bad policies. To the contrary, successful PIs are a matter of matching a country's FDI policies to the specific circumstances of its economy, stage of development, location, resources, regional agreements and international competition, in accordance with the priorities set by the government. A real customisation of the PIs has thus to be completed by the IPAs in developing countries, bearing in mind all the factors and variables that guide the MNEs FDI decision-making and following the overall development objectives of the country, as depicted in Figures 3 and 4 above. Secondly, for an effective FDI promotion, a country should be both co-operative and competitive with its neighbouring partners. In fact, as we saw in a previous section, regional-integration agreements constitute a powerful means to attract FDI, especially when the national governments co-operate in order to have coherent and co-ordinated policies. However, IPAs should also be aware of the PIs adopted by competitor countries in order to successfully attract MNEs to invest in their country. Finally, the role of IPAs has become increasingly more complicated, especially now that investment promotion is moving towards a fourth generation. In fact, IPAs have to adopt a much more active and dynamic attitude towards FDI, making constantly upgraded research and analysis as well as advocacy on their country's comparative advantages. Of crucial importance is that IPAs co-operate with other levels of government in order to design and implement coherent FDI polices, which should also be reflected in the legal framework. By complementing some FDI liberalisation with coherent regulation and customised PIs, IPAs in the developing countries should be able to capture and promote those FDI that can assist to speed up their industrial development.

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