Asian Development Bank
6 ADB Avenue, Mandaluyong City
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Foreign Direct Investment: The Role of Policy

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ERD POLICY BRIEF NO. 23

Foreign Direct Investment: The Role of Policy

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Douglas Brooks is Principal Economist, and Lea Sumulong is Economics Officer, in the Macroeconomics and Finance Research Division of the Economics and Research Department, Asian Development Bank. The authors acknowledge Ifzal Ali, J. P. Verbiest, and Ernesto Pernia for helpful insights.

This brief analyzes the policy context in which foreign direct investment (FDI) flows occur.[1] It highlights the value for ADB's developing member countries (DMCs) of incorporating their investment policies in a development perspective, and learning from the experiences of countries that have successfully benefited from FDI. A favorable policy framework for FDI is one that generally provides economic and political stability, transparent rules on entry and operations, equitable standards of treatment between foreign and domestic firms, and secures the proper functioning and structure of markets. In general, empirical evidence suggests that policies encouraging domestic investment help to attract foreign investment. However, the importance of policy does not end there.

FDI contributes to the development process by providing capital, foreign exchange, technology (including managerial and marketing skills), competition, and export market access. It can also stimulate domestic investment and innovation. While growing international reserves in many DMCs may have diminished the role of policies meant to attract FDI as a source of financing investment or foreign exchange, a more important role for policy is to ensure that host economies maximize the overall net benefits from the FDI that is received.

The Domestic Policy Context

In general, attracting internationally mobile factors of production requires host economies to improve the quality of their immobile assets, i.e., institutions (including those that enhance human resources) and infrastructure (social, legal, and physical). Governments typically can improve FDI prospects by reducing uncertainty, asymmetric information, and related search and other transaction costs (especially time and number of steps involved in

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[1] For more information, see Brooks et al. (2003).

acquiring approval) faced by foreign investors. Ultimately, however, the ways in which FDI benefits or harms a host economy depends on the context in which the investment and resulting economic activity occurs.

One area of great interest to host countries is technology transfer. Investors put in more proprietary technology and procedures when they feel they have greater control over protection of the proprietary content transferred and greater freedom in its use. Restrictions such as forced sharing of technology through mandatory joint ventures, local content, or performance criteria reduce incentives for the investor to apply modern techniques and technologies, hindering integration into global sourcing networks.[2] Subsidiaries receive greater resources from parent firms than partially owned or independent firms with lower transaction costs involved in technology transfer. Thus, multinational investment is generally superior to direct licensing of technology. Technology transfer and interchange of managers and technicians between parent and subsidiary firms have also been found to be significantly higher for wholly owned subsidiaries than for joint venture partnerships or licensees (Ramachandran 1993).

National-level programs promoting development of linkages between foreign-invested firms and domestic firms commonly include: provision of market and business information; matchmaking by such means as trade fairs or databases; and support to local enterprises through provision of managerial and technical assistance, training, audits and, occasionally, financial assistance or incentives (UNCTAD 2001, 183). The Economic Development Board of Singapore has successfully encouraged foreign investors to voluntarily identify promising local suppliers and contribute to vendor development.

With strengthened interest in human resource development and skill formation in FDI policy, many countries regulate the hiring of foreign workers and impose training requirements on foreign investors. Other countries, like Malaysia, chose to create infrastructure to promote linkages with foreign enterprises. Skills development centers were set up to promote technical and vocational training and the Small and Medium Industries Corporation was established to provide advice, guidance, and assistance to enhance the competitiveness of small and medium-size enterprises (Tham 2003). Such efforts may help to reverse the decline in FDI flows to Southeast Asia.

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[2] *Voluntary* joint ventures spread risk and increase market access offering less disincentives for technology transfer, at least for more established technologies.

Foreign direct investment has seen a dramatic rise in the last 20 years due to increasing recognition of its benefits and growing openness of host economies. Drying-up of commercial bank lending due to debt crises also brought some developing countries to reform investment policies to accept or attract foreign investment, encouraging both portfolio investment and the less volatile FDI. Incentives and subsidies are aggressively offered, particularly to foreign-source investments that support host countries' industrial policies.

Most countries offer incentives—tax concessions, tax holidays, tax credits, accelerated depreciation, export subsidies, import entitlements, and subsidized utility rates—to attract FDI. The People's Republic of China, for instance, offers income tax exemptions to foreign enterprises on the first and second years, and 50 percent income tax reduction from the third to fifth years. In addition, reduced income tax rates are levied on foreign investment enterprises in special economic zones and open coastal regions—15 and 24 percent, respectively, instead of the usual 30 percent (Wang 2003). Meanwhile, Thailand allows duty exemptions on imported raw materials and capital goods for FDI projects locating in export processing zones (Tangkitvanich et al. 2003). Viet Nam also provides duty exemptions on imported capital goods and lower water and electricity rates for firms locating in export processing zones (DPI 2003). Such incentives aim to invite FDI and channel foreign firms to desired locations, sectors, and activities.

Many countries also regulate and limit activities of foreign firms operating within their borders. Such regulations often cover foreign equity ownership, local content requirements, local employment, and minimum export requirements. The Republic of Korea, for instance, used to limit foreign equity participation at 50 percent for every industry without exception (Lee et al. 2003). India, meanwhile, used to impose local content requirements to foreign investors in its automobile industry to promote vertical interfirm linkages (Kumar 2003). This "carrot and stick" approach has long been a feature of the policy framework governing FDI in host economies (McCulloch 1991).

However, tax breaks and subsidies generally influence investment location decisions only at the margin and run the risk of fostering a "race to the bottom" among competing potential locations. Most potential investors give more weight to the size and expected growth of the market to be served, long-term macroeconomic and political stability, skilled or trainable workers, and transportation and communications infrastructure. Financial incentives also often create

distortions and inefficiencies. By distorting relative costs for other sectors and investment projects not targeted for incentives, such schemes typically discriminate against smaller and domestic investors, as well as areas of comparative advantage not recognized as such by policymakers. Perhaps of greatest concern, over time these actions contribute to development of a governance system that lacks transparency and accountability (JBICI 2002).

Too often, policies ostensibly designed to maximize net benefits of FDI for recipient economies ignore their effects on incentives for investors and result in subscale manufacturing plants, frequently through mandated joint ventures, which are not allowed to source inputs freely and contribute little to the country's development. Arrangements between foreign investors and host economy authorities blocking other new entrants to the industry or inhibiting alternative sources of supply are also common but generally not in the best interests of the host economy. However, a host economy can capture scale economy rents through licensing fees or increased factor prices as foreign firms bid up factor costs.

Incentives for a foreign investor and benefits for the host economy will be less when the investment is directed toward serving small and protected domestic markets.[3] The benefits to the host economy are greatest when international companies exploit economies of scale both locally and globally, and update their technologies and managerial practices to remain competitive.

The International Policy Context

In general, FDI is not influenced solely by domestic policies, but also by international agreements. Foreign investors desiring to protect their investments and receive favorable tax treatment on their global profits and host countries wishing to attract greater inflows of FDI have entered into thousands of bilateral and, increasingly, regional agreements related to FDI. Most economies are now party to at least one international investment agreement.

In bilateral and multilateral trade and investment negotiations, most favored nation (MFN) treatment obliges a host economy to offer equally advantageous investment conditions to potential investors

[3] Efforts to protect domestic markets create incentives for foreign investors to reap secondary oligopoly rents from older technology.

from all treaty signatories. National treatment (nondiscrimination) requires similar treatment of both foreign and domestic investors.

Bilateral agreements also shape FDI policy frameworks. Over 2,100 bilateral investment treaties (BITs) and 2,200 double taxation treaties (DTTs) were in effect by end-2002 (UNCTAD 2003). These BITs generally contain binding commitments on expropriation, fund transfers, and compensation due to armed conflict or political instability, on a national treatment or MFN basis. DTTs, on the other hand, usually identify measures to avoid double taxation of the investor by the host and home economies. Disagreements between foreign investors and host governments are usually referred to private arbitration of the International Chamber of Commerce or the International Centre for Settlement of Investment Disputes.[4]

In BITs, commitments vary from one investment partner to another. BITs are popular because they provide host economies flexibility to screen and channel foreign investment to desired sectors or locations while extending protection to foreign investors. Investment provisions in regional agreements are also common when a small group of like-minded governments is more likely to reach agreement than a larger number of governments with diverse opinions.

In the multilateral context, the WTO has established rules associated with trade-related investment measures (TRIMs). TRIMs are a subset of the incentives and regulations designed to influence FDI, but are limited to those that have a direct impact on international trade. Common TRIMs are local content requirements, export performance requirements, and trade balancing measures. Another measure is denying foreign corporations access to host economy markets. In the Doha round of WTO negotiations, investment is one of what have been termed the “Singapore issues.”

Nevertheless, some governments remain cautious about committing to international investment rules. They see international rules as clamping down on their policy sovereignty and limiting their ability to reverse policy decisions; but these same rules encourage FDI. Host governments must thus find the right balance between retaining policy space and reaping the benefits from international cooperation (UNCTAD 2003).

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[4] While private sector arbitration mechanisms generally work satisfactorily, they raise the potential for political disagreements in that a sovereign judicial system can be overruled by an unelected and opaque arbitration panel.

Conclusion

Evidence shows that host economy policies that maximize benefits from FDI must include policies for macroeconomic stability, infrastructure reliability, and labor force training and development. Foreign firms are also more likely to adopt best practices when they cater to competitive host markets. Constraining them to serve protected domestic markets gives them license to be inefficient, while rewarding them with monopoly rents and reducing host economy welfare.

FDI facilitates integration into international supply chains, allowing host economies to increase efficiency of existing activities and to enter new economic activities. Allowing wholly owned affiliates of foreign firms freedom to source from wherever they consider advantageous is *more* likely to lead to domestic suppliers achieving economies of scale and becoming integrated into global supply chains. Externalities in adoption of production, quality control, and managerial processes (including export strategies) frequently spread vertically within an invested sector and eventually to other sectors in the host economy (Moran 2002).

Host economies should therefore not rely only on regulatory and incentive measures to attract FDI. Performance requirements such as joint ventures, technology transfer, local content, and trade balancing requirements may appear beneficial in the short run, but are detrimental to development in the long run. Import-substituting industries benefiting from infant industry protection often do not grow to become globally competitive; domestic content and joint venture requirements for foreign investors often do not yield efficient stimulation of domestic supply chains. Host economies may forego revenues by granting tax incentives such as tax deductions and exemptions, but not receive the corresponding benefits. Host economies are usually best off ensuring that the local environment is conducive both to domestic and foreign investment.

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