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CONSIDERATION OF HOST AND HOME COUNTRY POLICIES TO PROMOTE FOREIGN DIRECT INVESTMENT

Host country policies and measures to promote foreign direct investment: a synthesis of eight case studies

Report by the UNCTAD secretariat

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CONTENTS

I. SUMMARY AND CONCLUSIONS

1. This report is a synthesis of policies and measures to promote foreign direct investment (FDI) in the eight host countries which have submitted case studies to the Ad Hoc Working Group on Investment and Financial Flows, namely, Brazil, China, India, Mexico, Morocco, Nigeria, the Philippines and the Republic of Korea.[1] Its purpose is to provide the Working Group with a succinct presentation of the findings of the case studies in order to facilitate the Group's deliberations.[2] No attempt is made to be comprehensive in scope or geographical coverage; or to treat the broad trends, issues and experiences of developing countries in promoting FDI. The latter were the subject of a report by the UNCTAD secretariat entitled "Foreign direct investment in developing countries: recent trends and policy issues" (TD/B/WG.1/7) prepared for the second session of the Ad Hoc Working Group on Investment and Financial Flows, held in June 1993. The present report should therefore be read in conjunction with the secretariat's earlier report.

2. The eight countries examined together accounted for almost 35 per cent of FDI inflows to developing countries in 1980-1991. Three of them - Mexico, China and Brazil - figure among the four leading developing country recipients of FDI during the same period. The eight represent 43 per cent of GDP, 29 per cent of exports and over 61 per cent of the population of developing countries. They offer geographic diversity and some diversity in terms of size, income levels and growth record, although there are neither small countries nor least developed countries among them. They also have different policy approaches towards growth and development due to differences in priorities, political and administrative structures and levels of development. What they have in common, and this with many other developing countries, is that they have liberalized their FDI regulations, although there are variations in degree and timing. Since the 1980s, they have also shown a strong commitment to market-oriented reforms and to a more outward-looking development strategy.

3. The 1980s witnessed a marked change in the attitude of many developing countries towards FDI. The more positive attitude towards FDI is reflected in the general trend towards liberalization of FDI regimes. However, by themselves, FDI policy reforms would not have much influence in investment decision unless accompanied by macro-economic policies conducive to sustained growth and stability. Moreover, even such a broadened economic policy framework constitutes only one element, albeit a vital one, in investment location decisions. Equally important are the existence of economic potential, political stability and other factors which affect the risk and profitability of investment.

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[1] UNCTAD, "Case studies submitted to the Ad Hoc Working Group on Investment and Financial Flows" (Geneva, 1993):

Brazil	TD/B/WG.1/Misc.3/Add.6
China	TD/B/WG.1/Misc.3/Add.5
India	TD/B/WG.1/Misc.3/Add.3
Mexico	TD/B/WG.1/Misc.3/Add.1
Morocco	TD/B/WG.1/Misc.3/Add.8
Nigeria	TD/B/WG.1/Misc.3/Add.9
Philippines	TD/B/WG.1/Misc.3/Add.4
Republic of Korea	TD/B/WG.1/Misc.3/Add.2.

[2] The case studies were submitted in accordance with a format suggested by the Chairman of the Working Group with the assistance of the UNCTAD secretariat.

4. The case studies reveal a high degree of policy convergence in terms of objectives, but show variations in approach and specific measures used. The overriding theme of the trend towards liberalization and market-oriented reforms, which characterized economic policies since the 1980s, is efficiency through competition. While most of the policy measures were undertaken with broader macro-economic objectives in view, clearly these were positive elements which would be attractive to foreign investors. It is, however, hard to measure the extent to which these policies have influenced FDI flows to individual countries. Some of the reforms are too recent or are of a structural nature which will take time to be fully implemented. It is still too early, therefore, to assess the full impact of these policies on FDI. In some countries, (China, the Republic of Korea, Philippines) FDI increased dramatically during the 1980s and early 1990s, despite the sombre world economic situation of recent years, whereas in others (Brazil, Nigeria) FDI flows fell short of expectations.

5. The broad objectives of macro-economic policies pursued by the eight countries have been the achievement of growth and stability. These are essential elements of an enabling investment climate. Fiscal reform has been aimed at keeping a lid on the budget deficit mainly through a more rational use of public funds on one hand and the broadening of the tax base while reducing tax rates on the other hand. The general thrust of monetary policy has been to curb excess liquidity in order to attain price stability, while maintaining flexibility in order to stimulate growth. There have, however, been differing degrees of success with stabilization programmes. They have been quite effective in reducing the budget deficit and inflation in Mexico and Morocco, but in Brazil, difficulties in addressing the fiscal crisis have led to hyperinflation. A gradual process leading to full currency convertibility has characterized foreign exchange policies in most countries. Though experiences vary, there has also been some movement towards a reduction in foreign exchange controls and in some cases a less interventionist approach to wage and price policies.

6. Market-oriented reforms have affected a wide range of economic activities. The principal trade liberalization measures have involved significant reductions in tariff rates; simplification and rationalization of the tariff structure; and a reduction or abolition of import licensing requirements and quantitative restrictions. Although all countries have undertaken such measures, the degree of liberalization has varied considerably among them. Industrial policy reform has been geared to enhancing the developmental contribution by emphasizing efficiency and competitiveness and a more outward orientation. The prominence given to the private sector is reflected in massive privatization programmes (Mexico, the Philippines and, to a lesser extent, Brazil and Nigeria), which have served as a catalyst for FDI growth in many countries, particularly in Latin America. In several countries a gradual opening up of the financial sector to foreigners has also been taking place. Moreover, measures have been adopted to liberalize interest rates and to create confidence in the financial system through a strengthened regulatory framework and higher capitalization ratios.

7. Recognizing the importance of developing technological capabilities not only to promote FDI but, above all, for the efficient functioning and modernization of the domestic economy, some governments, especially in Asia, have stressed investments in infrastructure and human resource development. The growing awareness of the need for sustainable development has also led several countries to establish regulatory frameworks on environmental protection.

8. The host countries examined have made remarkable efforts to liberalize their FDI regimes with a view to greater receptivity towards foreign investors and greater reliance on market-based competition. Where obstacles and disincentives once were the hallmarks of FDI rules and regulations, these have now been replaced by policies to facilitate foreign investment. Though the

process of liberalization that started in the 1980s has now marked each of the countries examined, it is still far from over. Several countries have entered the process rather late, while in some others the pace of liberalization has been slow. Overall, however, the shift has been remarkable. Countries previously known for their stringent attitude towards FDI (including China, India, the Republic of Korea, and Mexico) have, to varying degrees, opened up their economies to foreign investment. An important indicator of this change is the shift from "positive lists" which allowed entry of foreign investment into a few well-defined areas, to "negative lists" which prohibit entry to only a few activities. But significant restrictions remain, especially in so-called sensitive areas such as natural resource exploitation, cement, steel, agriculture, transport, telecommunications, banking and financial services. Many of these areas have traditionally enjoyed State monopoly status.

9. Governments have been careful to make changes where these would not be perceived as disruptive. But they have also shown great willingness to act in those areas where investors' frustrations were more pronounced, such as in the provisions governing the transfer of profits and dividends and the repatriation of capital; as well as the need to strengthen the protection of intellectual property rights; and to remove or reduce performance requirements. Debt-equity swaps, in conjunction with privatization programmes, have not only sharpened foreign investors' perceptions of the evolving investment climate but have also had salutary direct effects on new FDI flows.

10. Fiscal, financial and other incentives remain an important part of host countries' investment promotion packages. While their effects on stimulating new investments are difficult to measure, they nevertheless do have important cost effects on the domestic economy. At the same time, much has been done to improve investment promotion activities, placing higher priority on marketing and the use of joint investment forums. There is also renewed interest in concluding bilateral investment agreements, and in the activities of the Multilateral Investment Guarantee Agency (MIGA).

II. FDI TRENDS AND DEVELOPMENTAL IMPACT

A. Basic characteristics of FDI[3]

11. In the early 1980s, FDI inflows to developing countries registered a very modest growth of less than one per cent (table 1). For the sample countries, FDI declined by over 3 per cent. There was extreme variation in performances, with very high rates of growth for China and the Republic of Korea, but negative growth for the rest. This behaviour highlights the importance of economic growth and macroeconomic stability in FDI flows. Countries, like the Asian newly-industrializing economies (NIEs) and China, which experienced very rapid growth were attractive sites for investment. In contrast, the countries that registered significant decline in FDI inflows were those that were seriously affected by the debt crisis and suffered acute macroeconomic instability.

12. The 1986-1991 period saw a renewed dynamism in FDI inflows to developing countries, with average annual value of $28.1 billion, more than double the 1980-1985 figure. Annual growth rates averaged a solid 17 per cent. The sample countries grew at a rate slightly surpassing the overall average for developing countries. All eight countries registered positive growth. This reflects improved economic performance, relatively stable economic conditions and liberalized trade and FDI regimes. In some countries, like Mexico, privatization

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[3] For consistency in definition, unless otherwise specified, the data used were taken from common international sources and may differ from those shown in the case studies.

and debt-equity swaps acted as catalysts for FDI growth. With the exception of Brazil, each country increased its share in FDI flows to developing countries as compared with the early 1980s, with a remarkable rise registered by the Philippines, Republic of Korea and China. For Brazil, while there was some recovery, continuing inflation, macro-economic imbalances and uncertainties regarding the treatment of foreign capital could explain the significant drop in its share.

13. With regard to the sectoral distribution of FDI flows, in most of the sample countries there has been a tendency for the share of manufacturing to decline and that of services to increase (table 2). This tendency is particularly pronounced in the two Latin American countries and this confirms the general trend in developing countries. The share of FDI flows to the primary sector, however, increased in some countries and declined in others. On the basis of stock figures, FDI is still heavily concentrated in manufacturing. Within this sector, there has been a shift from labour-intensive industries to technology and capital-intensive industries in the Republic of Korea. There are also indications that a shift in the same direction has been taking place in the Philippines as the average employment per project has declined, while equity investment and project cost per direct employee have increased.

14. Proximity to markets and to home countries as well as ethnic and historical ties influence the source of FDI. Thus, the United States is the dominant investor in Mexico and Brazil and in some of the Asian countries. In the 1980s, Japan emerged as the major home country in the Asia-Pacific region, although North America and Western Europe continued to account for a large share of FDI. In Morocco and Nigeria, as with most African countries, the European Community is prominent because of strong historical links. The share of flows from other developing countries, mainly from the Asian NIEs, also increased. The loss of their comparative advantage in labour-intensive activities pushed them to seek new production locations, mainly in neighbouring areas (table 3). An exception to the prominence of developed home countries is China, where investors from Hong Kong, Macau and Taiwan Province account for about one-half of FDI. As to the geographic concentration of FDI, as measured by the share of the three leading home countries in FDI inflows, there seems to be no major change between the early 1980s and the 1986-1992 period, except for India where the degree of concentration has intensified. However, there were noticeable shifts in the order of importance of individual leading home countries which tend to reinforce the growing role of Japanese investment in the Asian region.

B. Developmental impact of FDI

15. There is broad agreement that FDI can make an effective contribution to the development efforts of developing countries. Its actual contribution, however, varies from country to country depending on the importance given to it in the overall economic strategy. FDI has traditionally been sought to supplement domestic savings in order to finance investment and other capital requirements. The significance of FDI in domestic capital formation for the eight countries appears modest. In 1980-1991, FDI accounted for only 2 per cent of gross domestic investment (GDI) (table 4). This average, however, masks a wide variation among countries, with ratios ranging from 0.2 per cent in India to 5 per cent in Mexico and Nigeria. Worth noting also is that for almost all of these countries, there was a marked increase in the FDI/GDI ratio in more recent years, reflecting the growing importance of FDI. This ratio is significantly higher for all developing countries, estimated at over 4 per cent in 1986-1989. As a share of GDP, FDI in the sample countries averaged less than one per cent in 1980-1991, as much as for all developing countries. A substantial increase in this ratio was also registered in recent years.

Table 1: Foreign direct investment inflows to developing countries, 1980-1991

Region/Country	Annual average (in million $)			Percentage share			Average annual growth (%)		
	1980-91	1980-85	1986-91	1980-91	1980-85	1986-91	1980-91	1980-85	1985-91
TOTAL DEVELOPING	20395	12686	28104	100.0	100.0	100.0	11.6	0.4	17.3
Africa of which:	2094	1454	2734	10.3	11.5	9.7	13.8	30.0	2.2
Morocco	95	57	133	0.5	0.4	0.5	10.2	-24.9	69.8
Nigeria	466	210	722	2.3	1.7	2.6	8.3	-10.4	17.3
Asia and Pacific of which:	10117	5152	15082	49.6	40.6	53.7	16.1	5.8	23.1
China	1911	718	3105	9.4	5.7	11.0	33.4	62.6	16.2
India	113	62	164	0.6	0.5	0.6	14.7	-16.5	6.5
Korea, Republic of	424	98	749	2.1	0.8	2.7	38.5	53.0	21.1
Philippines	268	35	501	1.3	0.3	1.8	33.9	-59.0	53.2
Latin America and the Caribbean of which:	8132	6043	10220	39.9	47.6	36.4	6.8	-9.3	14.1
Brazil	1684	1975	1394	8.3	15.6	5.0	-5.4	-10.7	9.9
Mexico	2149	1331	2966	10.5	10.5	10.6	9.9	-41.8	28.0
Memo item: 8 countries	7110	4486	9734	34.9	35.4	34.6	11.1	-3.4	18.2

Source: UNCTAD secretariat based on IMF balance of payments data.

Note: Developing Europe is included in total developing. Growth rates are derived from semi-logarithmic regression equations. Because of negative 1980 values for Nigeria and the Philippines, the growth rates shown are for the periods 1981-91 and 1981-85.

Table 2
Sectoral distribution of FDI inflows (Shares in percentage)

Country	Period	Primary	Secondary	Tertiary
Morocco	1980-85	10.7	30.6	49.9
	1986-92	6.9	24.7	51.3
Nigeria[a]	1980-85	9.2	24.2	62.2
	1986-90	51.1	47.3	2.4
China	1985	8.1	39.5	52.4
	1986-88	3.5	58.7	37.8
India	1980-85	1.7	92.2	6.1
	1988-89(FY)	8.6	88.9	4.3
Korea, Rep. of	1981-85	0.4	66.5	33.1
	1986-92	0.5	64.9	34.6
Philippines	1980-85	37.4	46.2	16.2
	1986-92	15.3	56.3	28.4
Brazil	1980-85	4.5	73.4	19.9
	1986-92	1.2	49.0	45.1
Mexico	1983-85	1.0	78.9	20.0
	1986-92	1.5	36.6	61.9

Source: UNCTAD secretariat based on case studies and international sources.
Note: Shares may not add up to 100 due to unallocated items. Changes in stocks were used when flow data were not available.
[a] The abrupt change in the sectoral distribution could be attributed mainly to net FDI flows in trading and business services which accounted for over 57 per cent of the total in 1980-85 but were negative in 1986-90.

Table 3
Geographic concentration of FDI inflows
(Percentage share of three leading home countries)

Country	3 leading home countries[a]	Stock 1992	FDI Inflows	
			1980-1985	1986-1992
Morocco	France, Saudi Arabia, U.A.E.	44.4	42.8	44.9
Nigeria	United Kingdom, USA	67.4	74.3	73.5
China	Hong Kong, USA, Japan	80.8	83.2	89.1
India	USA, Switzerland, Japan	53.2	35.4	59.0
Korea, Republic of	Japan, USA, Netherlands	79.3	80.8	78.3
Philippines	USA, Japan, Hong Kong	75.1	77.9	73.0
Brazil	USA, Germany, Japan	53.1	58.0	62.2
Mexico	USA, United Kingdom, France	73.1	72.1	73.3

Sources: UNCTAD secretariat based on case studies and international sources.
Note: For the following countries, the figures for each period correspond as closely as possible to the data availability: Nigeria (1980-1990), China (1985-1988), Korea (1981-1992), Mexico (1982-1992).
[a] In the order of importance based on 1992 stock or cumulative investment for Morocco (1980-1992) and Mexico (1982-1992). Stock figures for China are for 1988 and for Nigeria, 1990.

16. These figures, however, do not capture the full role of FDI as an agent for growth and structural transformation. In Brazil, FDI was instrumental in shaping the structure of industry, its technological base and, to a large extent, its trade orientation. Foreign firms were responsible for around one-third of manufacturing sales in 1990. In some sectors such as tobacco, pharmaceutical, transport equipment and rubber products, they were largely dominant. In general, FDI has played a central role in Latin America's industrialization. It has also been instrumental in the industrial transformation to a more diversified or broader-based structure in some of the more dynamic Asian economies. But in the Republic of Korea, prior to the 1980s, it had played a residual role in industrial development, as the strategy was to protect local infant industries: FDI was selectively promoted to supplement investment resources, introduce new technologies and exploit export markets. However, in the 1980s, government policies shifted towards liberalization and FDI was expected to play an important role in the industrial restructuring of the country. Until fairly recently, India had also been highly selective and restrictive towards FDI, which explains the minimal economic weight of FDI in that country. But this is changing, as evidenced by the dramatic shift in policy stance in 1991. Post-reform project approvals from August 1991 to February 1993 amounted to more than five times the value of FDI approvals in the past decade. About 80 per cent of the new approvals were in priority sectors.

Table 4
Ratio of FDI to gross domestic investment (GDI) and GDP
(in per cent)

COUNTRY	Ratio of FDI to GDI			Ratio of FDI to GDP		
	1980-1985	1986-1991	1980-1991	1980-1985	1986-1991	1980-1991
TOTAL 8	1.6	2.4	2.1	0.4	0.7	0.6
Morocco	1.5	2.6	2.1	0.4	0.6	0.5
Nigeria	1.5	14.7	5.0	0.3	2.1	0.8
China	0.8	2.3	1.7	0.2	0.9	0.6
India	0.1	0.3	0.2	0.0	0.1	0.0
Korea, Republic of	0.4	1.1	1.0	0.1	0.4	0.3
Philippines	0.4	6.5	3.3	0.1	1.3	0.7
Brazil	4.2	1.7	2.6	0.8	0.4	0.6
Mexico	3.0	7.2	5.0	0.7	1.5	1.1

Source: UNCTAD secretariat based on international sources.

17. The growing disillusionment with import substitution policies adopted by most developing countries in the 1950s and 1960s led to a shift in orientation aimed at promoting exports of manufactured goods. FDI was viewed as a mechanism to gain access to international markets and to boost exports. For the dynamic Asian economies, FDI was a driving force in their export-led growth as their take-off occurred when foreign investment was already outward-oriented. The experience of Brazil and other large Latin American countries was somewhat different as an important industrialization drive occurred earlier when FDI was predominantly geared towards the domestic market, but FDI became more export-oriented in later years. In Brazil, the increasing trade orientation of technologically sophisticated sectors was determined to a large extent by foreign firms. In the early 1980s, the share of foreign firms in total exports was

around one fourth and in industrial exports about one third. Indicative of their dominance in specific areas was the 63 per cent share in exports of equipment and instruments. Foreign firms in the 1980s assumed a greater role as providers of foreign exchange, with a trade surplus which averaged $3.4 billion annually in 1980-1986. The Export Fiscal Benefit Programme had been effective in improving their contribution to the balance of payments. In Mexico, the shift to an outward-oriented strategy occurred fairly recently, no doubt propelled by the debt crisis and the grave economic difficulties that ensued. In recent years, companies with FDI have become an important source of hard currency. They accounted for some 23 per cent of national exports and 57 per cent of manufactured exports in 1983-1988. In Morocco, FDI inflows have become a major source of foreign exchange in the early 1990s. This is in sharp contrast with the 1980s when the contribution was insignificant. However, in India and Nigeria, where FDI catered mainly to the domestic market, net foreign exchange earnings were little, if not negative.

18. FDI's contribution to overall employment appears small. However, variations exist across countries and sectors. In Mexico, companies with FDI accounted for over 16 per cent of total employment in 1989. In the Philippines, enterprises with foreign equity investment also generated a significant amount of employment. The employment effect of FDI is not limited to direct employment. It also includes employment deriving from backward and forward linkages with the rest of the economy. Indirect employment is likely to be even higher than direct employment (a ratio of 1.6 is cited by the Philippines). In addition, workers generally receive better wages and benefits for comparable skills than in local firms. This is the case in well established transnational corporations (TNCs) in the Philippines.

19. Perhaps the most significant contribution of FDI is qualitative in nature. FDI embodies a package of growth and efficiency-enhancing attributes. TNCs are an important source of technology and managerial, marketing and technical skills. Their presence also promotes greater efficiency and dynamism in the domestic economy. Indeed, most of the sample countries put a lot of weight on the qualitative aspects of FDI. The training gained by workers and local managers and their exposure to modern organizational system and methods are valuable assets. In the Philippines, TNCs have contributed to producing a dynamic managerial class. In the "maquiladoras" of Mexico, the number of technical and administrative personnel has been rising and more sophisticated processes are being used. The upgrading of FDI flows towards more technical and capital-intensive activities in the Republic of Korea and the Philippines has already been mentioned.

20. The full potential of FDI for fostering economic development in host countries can best be reached by strengthening domestic linkages and upgrading flows through encouragement of investment in technology and skill-intensive industries with higher local value-added. The Republic of Korea and India put emphasis on promoting FDI in high-technology industries. However, countries with surplus labour and abundant natural resources have also targeted employment-generating and resource-based FDI. There is a need to fully integrate FDI policies in the industrial and economic development strategy of the country to enhance its developmental impact. Lack of integration could perhaps explain the substantial number of non-productive projects and the small proportion of high-technology projects in China. The Chinese government now hopes to rationalize the structure of FDI in accordance with industrial policy. While initially special policies were introduced in some areas which served as windows for attracting FDI, it is expected that the area-based approach will gradually be transformed into an industry-based approach. An increasing share of FDI production is also being channelled to the domestic market. Mexico's industrial strategy since the mid 1980s has been directed at increasing its participation

in the international economy and FDI has had an important role to play in this strategy.

21. In its case study, the Philippines presented its programme to enhance the developmental contribution of FDI. The main thrust of the industrialization strategy is the development of internationally competitive industries. Initially, emphasis will be given to export products, such as electronics, garments and metals, which have already successfully penetrated international markets. In the longer term, new export products that will make use of the country's natural resources and workers' skills will be promoted. Investments are therefore, encouraged in these areas and also in infrastructure, industrial support facilities, real estate and tourism. To promote the decentralization of industries, incentives are given to projects in less developed areas. The government also supports the growth of small and medium-sized enterprises in all productive sectors, particularly rural agro-based enterprises.

III. DETERMINANTS OF FDI: GENERAL CONSIDERATIONS

A. Main factors and impediments

22. The decision by foreign investors to locate in a specific country depends not only on FDI policies but on a host of other factors. Among the major determinants of FDI are: the availability and cost of natural and human resources; adequacy of infrastructure and support facilities; market size; economic growth and level of development; and political stability.[4] The importance attached to each of these factors depends on the type of investment and the motivations or strategy of investors. The case studies highlighted the role played by these factors in attracting FDI.

23. The availability of natural resources and their costs determine the type of investment and are a major element in its profitability. Most of the sample countries have rich and varied natural resources. Morocco holds three fourths of world phosphate reserves. Petroleum is dominant in the economies of Mexico and Nigeria. The vast areas of China, India and Brazil hold large reserves of different kinds of minerals and sources of energy.

24. Plentiful supply of low-cost labour has been a major attraction for FDI in dynamic Asian economies, which serve as a production base from which to supply world markets. But labour-intensive operations are now finding better opportunities in China, the Philippines and other lower cost Asian countries. The importance of low-cost unskilled labour in location decisions has declined in recent years and greater emphasis is now placed on skills and the "trainability" of workers. With their skilled labour, including technical and management staff as well as a fairly strong industrial base, Asian NIEs like the Republic of Korea will continue to attract substantial amounts of FDI involving capital- and technology-intensive projects. India has an abundant supply of both low-cost skilled and unskilled labour. It has the third largest pool of scientists and technically-qualified manpower in the world. A characteristic of the Philippine labour force is its comparatively high level of education. Morocco has a significant number of qualified workers and specialists in different areas of economic activity.

25. Costs are also affected by the adequacy of infrastructure facilities and the supply of utilities. Unreliable transport and telecommunication services

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[4] See UNCTAD, "Foreign direct investment in developing countries: recent trends and policy issues" (TD/B/WG/1/7).

and insufficient power and water supply create operational bottlenecks which could be very costly. In addition, the existence of efficient financial and other support facilities which can cater to the diversified needs of investors is also necessary. In most of the sample countries, basic infrastructure is fairly well developed although in some, it is unevenly distributed with better facilities in urban or selected areas. This is the case for the coastal areas and special economic zones (SEZs) of China. This also characterizes the road network of India where urban infrastructure is better developed than access to rural areas. Inadequate infrastructure is cited by Nigeria as an impediment to increased FDI flows, although the government has made substantial investment to provide necessary infrastructure and improve services. Since 1990, the Philippines has been experiencing severe power shortages and in an effort to solve the problem, the building of power generating plants was placed on the priority list and was made eligible for financial incentives.

26. The size of the market affects the profitability of investment. This has been a major pull factor for FDI which is mainly host market-oriented and engaged in import-substituting ventures. Despite lower protective trade barriers, the large domestic markets of China, India, Brazil, Nigeria and Mexico would continue to draw attention from investors, given a favourable investment climate. Of course, market size is not determined solely by the size of the population but also by its purchasing power and, in this regard, medium-sized countries with high per capita income like the Republic of Korea are attractive to investors. However, even small countries can have locational attraction if they are strategically located near larger markets or if they establish regional links to form larger markets. The sharp increase in FDI flows to Mexico in the past two years is related to a major extent to the proposed establishment of the North American Free Trade Agreement (NAFTA). The conclusion of a partnership agreement with the European Community could further boost FDI flows to Morocco.

27. One of the most important determinants of FDI flows is economic growth. This is confirmed by the success of the dynamic Asian economies like the Republic of Korea and China in attracting substantial FDI flows. It is further reinforced by the collapse of FDI to highly indebted countries, such as Morocco, Nigeria, the Philippines, Mexico and Brazil, in the early 1980s because of the crippling effect of the debt crisis on their economic growth. Uncertain and poor growth prospects in Africa largely explain foreign investors' hesitancy to undertake new projects in the area, and stagnation of flows at low levels.

28. The type of investment projects is influenced by the level of development. Developing countries with a well-developed and diversified industrial base and technological capabilities, such as the Republic of Korea and India, will be able to attract investments in skill- and technology-intensive projects. The presence of a thriving business community creates a supportive environment for FDI and provides an efficient network of local suppliers and service firms. It could also be a source for potential partners in joint ventures, which could facilitate access to local administration and supporting services. Joint ventures are an efficient mechanism for effecting technology and skill transfers and for developing stronger linkages with the domestic economy. India and the Philippines put considerable stress on promoting domestic entrepreneurs.

29. The importance of political stability in creating a climate of confidence for investors cannot be underestimated. Political instability, whether perceived or real, constitutes a serious deterrent for FDI as it creates uncertainties and increases risks and hence costs. Nigeria cites this factor as among the main impediments undermining efforts to attract FDI, especially new investment. Even brief periods of instability can cause cancellation of projects or interruption of flows. The drop in FDI flows to the Philippines in 1991 could be partly attributed to political disturbances.

B. Economic policy framework

30. Policies that are conducive to sustained growth and macro-economic stability are essential elements of an enabling investment environment. They are as important to foreign investors as they are to domestic ones, as they affect risks and profitability of investment. In the 1980s, many developing countries pursued more liberal policies on trade and investment and other market-oriented reforms in the context of structural adjustment programmes. Although the full effects of some of these measures may take time to materialize, they would eventually lead to increased competitiveness and efficiency. In some countries, like Mexico and, more recently, Morocco and India, they have already had a stimulative impact on FDI flows. In Brazil, once the leading recipient of FDI among developing countries, investors' mild reaction to new trade and industrial liberalization policies may be due to continuing macro-economic instability since the 1980s.

1. Fiscal, monetary and other policies affecting costs

31. A wide range of economic policies is relevant to FDI operations because they have a direct or indirect bearing on costs. Wage and price controls as well as exchange rate and interest rate policies have a direct impact on costs. Corporate tax rates directly affect the rate of return on investment. Other fiscal and monetary policies also affect FDI operations indirectly through their impact on inflation and related variables. While usually not directly involving costs, foreign exchange controls have a discernible negative effect on FDI.

32. The case studies show varying approaches and degrees of success with measures to achieve growth with stability. The cornerstone of price stabilization policies in Mexico was deep fiscal reform. This involved the broadening of the tax base and a reduction in tax rates on the income side and, on the expenditure side, a more rational use of public funds and withdrawal of government from non-strategic activities. A similar approach was adopted by Morocco. In both countries, the government deficit was reduced substantially and inflation was held under control. In contrast, the failure of the stabilization programme in Brazil could be attributed to the difficulties in addressing the fiscal crisis which emerged with growing severity in the second half of the 1980s and which was reflected in hyperinflation. In India and Morocco, efforts are being directed at improving competitiveness of public enterprises.

33. In general, the basic thrust of monetary policy was to curb excess liquidity in order to attain price stability, while maintaining flexibility to promote growth. While in the past the Reserve Bank of India had taken several credit control measures through the statutory liquidity ratios and cash reserve ratios, these were reduced in 1992, hence releasing more funds for lending by commercial banks. With a fall in inflation, some lending rates and term deposit rates were cut, while attempting to keep growth of monetary aggregates within limits. In Morocco, while initially monetary control involved fixing bank credit ceilings, these were abandoned as they were an obstacle to competition and tended to penalize the most dynamic banks. Since January 1991, control measures have involved the use of indirect instruments such as monetary reserves and refinancing terms of the Central Bank.

34. In most of the Asian and African countries in the sample, there has been a gradual move towards full currency convertibility and a reduction in foreign exchange controls. The Republic of Korea moved to a new exchange rate system in 1990, giving market forces a greater role in exchange rate determination. In 1993, India abolished the dual exchange rate system and made the rupee convertible in the trade account. It is now moving towards full convertibility in the current account, which Morocco achieved in 1993. The Philippines has

improved the mechanism for exchange rate determination making it more market-based. Nigeria's exchange rate has been determined by market forces since 1987. However, China's currency is still not convertible and foreign exchange is strictly controlled, although the rule is relaxed for non-residents.

35. As regards wage policies, experiences vary, but there has been some movement toward less rigid wage determination. The Republic of Korea has sought to limit growth in wages through guidelines. In the Philippines, the previous policy of fixing a nationwide minimum wage rate has been replaced by a regionally based system, whereby the minimum rate is determined by representatives of government, labour and employers in accordance with the peculiar needs and economic conditions of each region. In Nigeria, labour unions, on behalf of the workers, negotiate wages with employers. In China, while in the past the government controlled increases in wages and the flow of the labour force, a labour market and social insurance system are being established.

36. Pricing policy has been characterized by a significant reduction or abolition of price control measures. In China, 90 per cent of commodity retail prices are now determined by supply and demand. In India, over the years price controls have been removed for most commodities, except for essential items. Morocco abandoned the rigid, administered price system and only a limited number of products and services still receives subsidies.

2. Trade and industrial policies

37. One of the major developments of the 1980s was the reinforcement of the trend towards trade liberalization, which has become widespread in developing countries. This is a reflection of the shift in industrialization strategy from an inward-looking protectionist orientation to an export-oriented one. This trend already started in the 1970s but was accelerated in the 1980s because of the profound balance-of-payments difficulties experienced by many developing countries.

38. The principal trade liberalization measures involved significant reductions in tariffs and the rationalization and simplification of tariff structure as well as the reduction or abolition of import licensing requirements and quantitative restrictions. Although each of the countries examined undertook such measures, the degree of liberalization varied considerably among them. The Republic of Korea achieved a substantial reduction of quantitative controls and tariffs. In 1992, the import liberalization ratio for manufactured products was virtually 100 per cent and for agricultural products, over 87 per cent. Between 1982 and 1992, the weighted average tariff rates on non-agricultural imports declined from 20 per cent to 8 per cent and for agricultural imports, from 31 per cent to 18 per cent. In Nigeria, import licensing and duty surcharges were abolished and only 16 items remain in the prohibited list. In the Philippines, regulated items were reduced to 135, of which 66 will eventually be liberalized while the rest will continue to be regulated for reasons of health, safety and national security. Average tariff rates which stood at 28 per cent in 1991, are expected to decline gradually to some 20 per cent by 1995. In India, one of the principal aims of tariff reform is to reduce rates progressively to levels comparable with those in developed countries as rates were high by international standards. Maximum tariff levels are to be reduced to 85 per cent by 1993, with some exceptions. Tariff rates have already been reduced for many imported items. They now average about 15 per cent for chemicals, 25 per cent for project machinery, 35 per cent for capital goods, and 40 per cent for tools and electronic equipment. In Morocco, the list of prohibited imports was abolished in 1986 and 90 per cent of imports no longer needs authorization as against 38 per cent in 1983. Maximum tariff rates have also been sharply reduced from 400 per cent in 1983 to 35 per cent currently.

39. A principal component of Morocco's growth strategy is the export sector. In addition to the elimination or reduction of barriers to imports required by this sector, Morocco has simplified its export duty regime and created an export insurance company. Among the export promotion measures undertaken by India is allowing imports of capital goods at a concessional duty of 15 per cent, subject to export commitments. This has already resulted in substantially higher capital goods imports. In addition, schemes for export-oriented units and export promotion zones have been liberalized and extended to the agricultural sector.

40. Regional integration schemes in developing countries are expected to encourage FDI in accordance with the regionally-based strategy of TNCs. Although in Asia regionally integrated production operates in the absence of a formal institutional framework, the agreement for the establishment of the ASEAN Free Trade Area signed in 1993 may lead to enhanced flows of FDI. In Latin America, the move towards the creation of a Southern Common Market (MERCOSUR) could be a factor for greater FDI flows in the area. NAFTA is the main development affecting FDI in the region.

41. In general, the main thrust of industrial policy reforms has been geared at enhancing the developmental contribution of the sector by emphasizing efficiency through increased competition. In India, with some exceptions for strategic reasons, industrial licensing has been abolished. Small-scale industries have been assigned an important role because of their inherent advantages, such as lower capital intensity and higher employment generating potential. They also promote decentralization and regional dispersal of activities and the widening of the entrepreneurial base. To promote small-scale industries which accounted for 34 per cent of the manufacturing production and 40 per cent of exports in 1991, emphasis is placed on providing fiscal concessions and technical support, improving their capital base and infrastructure, and simplifying procedures.

3. *Deregulation and privatization*

42. Another key theme which has gained prominence in recent years is the fundamental role of the private sector in the economy. This is again a reflection of the overriding objective of achieving efficiency through market-based reforms. The government role is then to be limited to that of creating a supportive environment for growth. With this in view, many developing countries have undertaken massive privatization programmes. There are also other factors that have pushed governments to undertake privatization. In some countries, the severe debt burden, large budget deficits, balance-of-payments difficulties and lack of financial resources have prevented the state from undertaking new investments and even necessary maintenance. Privatization has served as a catalyst for FDI growth in many countries, particularly in Latin America. Privatized firms have been particularly attractive to foreign investors because, in general, they had ready-made markets with few competitors, although disguised unemployment in these firms could be a disincentive. So far, FDI has concentrated in the manufacturing and utilities sectors, especially telecommunications, but it could go into mining, primarily through joint ventures or lease of utilities and infrastructure assets.

43. Mexico's privatization programme raised over $ 20 billion. Between 1987 and 1992, 368 entities were privatized in the Philippines generating gross sales of approximately $2.4 billion. These represented 70 per cent of the total planned for privatization. The vast privatization programme of Morocco involves 112 enterprises in various sectors employing 40,000 workers and was open to both local and foreign investors. In Nigeria, almost all facets of the economy have been deregulated. Government holdings in 68 companies were divested and the process of privatizing 12 banks has been set in motion. In Brazil, 19 enterprises were sold but the role of foreign capital was negligible.

4. Development of domestic financial markets

44. The development of a modern financial system is essential for the efficient allocation of resources to productive activities of both domestic and foreign enterprises. In the sample countries, financial reform has involved liberalization of interest rates, gradual opening up of some areas to foreigners, better regulatory framework and higher capitalization ratios to create confidence in the financial system. In Mexico, interest rates have been liberalized, flexible liquidity coefficients substituted for legal reserve regime, and credit controls abandoned. Moreover, the emphasis given to providing a better regulatory framework has created investors' confidence. The Government of the Republic of Korea announced a four-stage interest rate deregulation plan in 1991 aimed at liberalizing about 90 per cent of interest rates by 1996. It has also gradually expanded access to portfolio investment for foreigners and the current 10 per cent ceiling on foreign holdings of local stocks will be raised gradually. In addition, a blueprint for medium and long-term financial deregulation and market opening was announced in 1992. India's financial sector reform involves the phased achievement of the 8 per cent capital-adequacy ratio recommended by the Bank for International Settlements; abolition of branch licensing policy; reduction of statutory liquidity ratio; and deregulation of interest rates. It has also allowed foreign investors to invest in the Indian capital markets with a 24 per cent ceiling of issued share capital in any company. In the Philippines, since 1991, bank branching regulations have been liberalized and capitalization requirements increased for commercial and rural banks. There were also moves to liberalize the entry and scope of operations of foreign banks. Major policy initiatives on capital markets involved a unified stock exchange; issuance of new rules on warrants and on asset-backed securities and amendments to the trading rules of the Manila International Futures Exchange. Morocco has removed the ceiling on foreign participation in the capitalization of banks.

5. Infrastructure investment

45. As mentioned earlier, the adequacy of infrastructure is an important consideration in FDI decisions. The government role in this area has traditionally been large because of the enormous financial requirements and the strategic importance to the country. However, the need to accelerate the development of these facilities in the midst of the economic crisis of the 1980s and the dwindling of government resources led some countries to encourage private sector involvement in this undertaking. The management expertise of private investors - both domestic and foreign - and their access to modern technologies could also result in an improvement in facilities and services. Among the countries that have tried to attract private investors to finance and operate infrastructure facilities are the Philippines and India.

46. In China, the pressure exerted by FDI for increased supply of energy and other infrastructure services in the 1980s necessitated considerable capital investment in this area. The Central Government currently allocates 20 per cent of total expenditures to this item. The Republic of Korea, which has a fairly well-developed physical infrastructure, plans further improvements in this area. It should be noted that the upgrading of industrial structure normally requires a corresponding upgrading of technological infrastructure.

6. Human resource development

47. The development of human resources constitutes an integral part of technological capacity-building, which is essential for the absorption and optimum utilization of new technologies. The availability of skilled labour and the presence of dynamic local entrepreneurs are also major attractions for

foreign investors. In Morocco, 27 per cent of the budget is devoted to education. Since the 1984 reform, particular emphasis has been placed on professional training. The National Manpower Development Plan of the Philippines is aimed at complementing efforts to develop and provide the necessary skills required by industries. Training programmes scheduled for 1993-1998 are expected to result in 5.8 million skilled production workers in line with the objective of raising the growth of industrial employment relative to agricultural employment. In the Republic of Korea, manpower policy emphasizes vocational education and job training and the utilization of untapped labour force.

7. *Environmental protection policies*

48. Sustainable development requires a proper balance between economic growth, a major determinant of FDI flows, and environmental protection. Although in certain areas there could be a conflict between economic growth and environmental quality, in general the two are mutually reinforcing. Awareness of the importance of this issue, although fairly recent in developing countries, is evidenced by the creation of agencies dealing with environmental protection to set policies and monitor compliance. The main thrust of policies involve: pollution prevention or reduction; waste recycling; conservation of natural resources; and raising public awareness to environmental problems. Nigeria had set up national guidelines and standards for environmental pollution controls. In 1991, two laws were passed on national effluent limitation and pollution abatement in industries and facilities generating wastes. The Philippines also encourages cost-effective abatement technologies. The objective of its Environmental Management Project is to strengthen capability in evaluating investment proposals as to compliance with environmental standards, conducting environmental audits and assisting industries to develop environmentally sound projects. To address the problem of deforestation, the Government encourages, through fiscal incentives and preferential lending rates, the establishment of industrial forest plantations to supply raw materials to industries.

8. *Specific policies related to the return of flight capital*

49. Capital flight is a reaction to perceived abnormal risks of holding domestic assets and is a symptom of underlying economic forces. The fundamental requirement for the return of flight capital is, therefore, to restore investors' confidence in the economy. The policies outlined above which are conducive to sustained growth and macroeconomic stability would already go a long way in creating an enabling environment for investors. There are, however, specific measures that can be used to entice or hasten the return of flight capital.

50. In Latin America, the improvement in the economic situation and prospects of a number of countries as well as the sharp decline in interest rates in the United States brought about a massive return of flight capital in recent years. In Mexico, the securities market operated as a mechanism to ease capital repatriation. Between 1990 and 1992, some $7 billion worth of private inflows, which were presumably repatriations, were encouraged by favourable tax treatment. The issuance of the India Development Bonds (IDB) and the launching of the Remittances of Foreign Exchange Scheme were measures taken in 1991, specifically to reverse the outflow of capital. The IDB provided immunity from taxes and recouped a loss of $1.6 billion from foreign currency non-resident deposits. The Remittances of Foreign Exchange Scheme also provided tax immunity, but only for one-time transfer of foreign exchange held abroad. Accruals under this scheme amounted to $863 million.

IV. REGULATORY FRAMEWORK

51. Host countries have made remarkable efforts to liberalize their investment regimes with a view to greater receptivity towards foreign investors and greater

reliance on market-based competition. Where obstacles and disincentives once were the hallmarks of foreign investment rules and regulations, these have now been replaced by a series of specific measures aimed at:

- removing or reducing obstacles to access by foreign investors to certain activities (e.g. banking and financial services, transport, telecommunications);
- removing or reducing limits to foreign equity participation;
- simplifying and streamlining entry and establishment requirements;
- eliminating or reducing performance requirements;
- removing obstacles to the free transfer of profits and dividends; and
- strengthening investment protection.

The objective has been to place foreign-owned firms on the same basis as domestic firms, and to do so in an atmosphere of transparency and predictability.

52. Though the process of liberalization that started in the 1980s has by now marked each of the countries examined, it is still far from over. Several countries have entered the process rather late, while in some others the pace of liberalization has been slow. Overall, however, the shift has been remarkable. Countries previously known for their stringent attitude towards FDI (including China, India, Republic of Korea, and Mexico) have, to varying degrees, opened up their economies to foreign investment. An important indicator of this change is the shift from "positive lists" which allowed entry of foreign investment into a few well-defined areas, to "negative lists" which prohibit entry to only a few activities. But significant restrictions remain, especially in so-called sensitive areas such as natural resource exploitation, cement, steel, agriculture, transport, telecommunications, banking and financial services. Many of these areas have traditionally enjoyed State monopoly status.

53. Governments have been careful to make changes where these would not be perceived as disruptive. But they have also shown great willingness to act in those areas where investors' frustrations were more pronounced such as transfer of profits and dividends and repatriation of capital; protection of intellectual property rights; and performance requirements. Debt-equity swaps, in conjunction with privatization programmes, have not only sharpened foreign investors' perceptions of the evolving investment climate but have also had salutary effects on new FDI flows.

A. Admission of FDI

54. The countries examined generally apply some formal system of approval, registration or licence for FDI. By and large, in recent years the procedures and requirements pertaining to the admission of FDI have been progressively simplified and streamlined. The use of practices aimed at excluding foreign investors from certain sectors of the domestic economy has been substantially reduced. "Negative lists" have replaced "positive lists" in a number of countries. However, important restrictions still exist in some host countries where concerns about the negative effects of any premature exposure of domestic firms to foreign competition and national security concerns have put a significant number of industrial sectors off-limits to foreign investors. Other important restrictions still in use by some host countries include limits on foreign equity holdings in domestic enterprises, and performance criteria such as balancing foreign equity with imports of capital goods, export levels, local content obligations, technology transfer, and employment levels.

55. Since 1984 when the Republic of Korea adopted its negative list, the liberalization ratio for all Korean industries has grown from 61 per cent to 83 per cent in 1993. However, the services sector remains more restricted to foreign investors than the manufacturing sector. In the Philippines, foreign ownership may be allowed to reach 100 per cent in enterprises that export at least 60 per cent of their production, even when such enterprises are placed on

the negative list. In Mexico, a number of activities has been reserved to the State, to Mexican nationals, or has been allowed only minority foreign participation. Forty-seven activities are prohibited from foreign ownership or control. However, export-oriented enterprises (known as "maquiladoras") enjoy up to 100 per cent foreign ownership.

56. In India, with the new industrial policy introduced in 1991, up to 51 per cent foreign equity is allowed in 35 high-priority areas including engineering, chemicals, food processing and tourism. 100 per cent foreign ownership remains restricted to a few high-priority sectors such as power generation, enterprises exporting 100 per cent of their output, and selected high-technology industries such as the hydrocarbon sector. In Brazil, however, sectoral restrictions have recently been strengthened regarding the establishment of foreign firms in a number of sectors. State monopolies or near-monopolies were granted in the 1988 Constitution to such sectors as electricity, telecommunications, ports, lotteries, real estate, shipping, broadcasting, and railways. In order to reduce the role of foreign capital in mining, the 1988 Constitution established that all mineral deposits and hydroelectric power sites were property of the Federal Government and that exploration was restricted to Brazilian firms with domestic capital.

B. Treatment of FDI compared to domestic investment

57. Except where the fulfilment of requirements relating to the negative lists or performance requirements (as in the case of India) are concerned, foreign-owned firms are generally treated on the same basis as domestically owned companies. For example, where import licences may be required (India), this is applied uniformly to domestic and foreign investors alike. In Mexico, foreign investment and domestic investment are to be treated equally in expropriation cases. A notable exception, however, is the treatment of foreign investors with regard to land acquisition. In a number of countries (notably the Republic of Korea, Brazil, China and Mexico), varying degrees of restrictions apply to the acquisition of land by foreign investors.

C. Protection of property rights

58. The protection of property rights, if not yet a universal concept, is certainly a widely applied principle. The constitution and laws of most countries now guarantee protection from expropriation or requisition, except in the interest of national welfare and defense, and upon payment of just compensation. In cases where no formal investment guarantees exist (India), bilateral agreements and membership in multilateral and regional investment protection institutions such as the Multilateral Investment Guarantee Agency (MIGA) and the Arab Investment Guarantee Company, may be regarded by investors as adequate substitutes pending the introduction of national investment protection provisions.

D. Policies towards intellectual property

59. In an effort to attract greater inflows of FDI especially in the high technology sectors, several countries have recently sought to strengthen legislation governing the protection of industrial property rights. Indeed, some countries had long ago enacted legislation governing patents and trademarks in conformity with obligations under the World Intellectual Property Organization (WIPO), thereby committing themselves to extend to nationals of other countries the same privileges they grant to their own citizens. Substantially improved legislation guaranteeing the protection of intellectual property has recently been enacted in China (1985) and Mexico (1991). A similar bill was under discussion in Brazil, while significant improvements have been taking place in the Republic of Korea. The new provisions are intended to facilitate the

transfer of technology to host countries, and to stimulate local research and development efforts.

60. The protection of intellectual property in developing countries should benefit from the outcome of the negotiations on trade-related aspects of intellectual property rights (TRIPS) within the Uruguay Round. Pending national legislation in some developing countries on the protection of patents and trademarks (e.g. Brazil) already reflect certain provisions of the Draft Final Act of the Uruguay Round negotiations on TRIPS. The recent introduction of new legislation and the strengthening of existing legislative provisions in some countries, coupled with improved operational abilities to implement such provisions, gave meaning and credibility to their recognition that adequate and effective protection of intellectual property rights will contribute significantly to the expansion of international trade and the free flow of technology among countries.

E. Transfer of profits and repatriation of capital

61. In recent years, there has been a clear tendency towards the liberalization of regulations limiting the freedom of foreign investors to transfer profits and repatriate their capital. Most countries now have in place provisions enabling the full transfer of dividends, profits and the repatriation of capital after payment of local taxes. Nevertheless, the situation varies from country to country, especially with regard to procedures and methods of application.

62. In India, while the free transfer of profits is allowed for most industries, an exception is made for the consumer goods industry. Here, the transfer of profits is only allowed if it is made out of net foreign exchange earnings. For companies with more than 40 per cent foreign equity, there are procedural requirements for obtaining approval from the Reserve Bank of India (RBI) for the transfer of profits abroad. In addition, capital may be repatriated subject to the sale price being considered reasonable by the RBI, and payment of applicable taxes. In Brazil, the Profit Remittance Law established no limits on transfers but tax authorities often use as a discouraging device the procedure of treating the last five years of reinvested earnings as dividends, on which a 15 per cent tax is levied. Also, accounting practices in Brazil often lead to underestimation of the value of foreign investment. This is due, *inter alia*, to the fact that inter-company loans are registered as debt, and that the book value (in foreign currency) of foreign investors' assets is not allowed to undergo any monetary correction for inflation in their country of origin. As the Profit Remittance Law is based on the principle of disclosure of the value of an investment, underestimation can affect the repatriation of invested capital. In China, net profits and funds from divestment may be remitted abroad through the Bank of China and in accordance with the country's foreign exchange regulations.

63. In contrast, in Morocco the transfer of dividends and profits, and the repatriation of capital are free and automatic. No authorization is required from the Office des Changes. All transfers can be made directly by banks under a general delegation of powers accorded to them.

F. Taxation

64. Policies with regard to taxation of FDI vary widely among the countries examined. These variations apply to such matters as the use of taxes as incentives; the application of taxes to foreign versus domestic investment; the tax instruments used; and the tax rates applied to different industrial sectors.

65. Foreign investment in India does not benefit from tax incentives. Indeed, foreign branch operations in India are taxed at a rate substantially higher than

those applied to locally incorporated companies (65 per cent compared with 51.75 per cent to 57.5 per cent). Income transfers by foreign companies (in the form of dividends, interest, royalties, etc.) are also subject to a withholding tax. Bilateral tax agreements and foreign tax credits help to avoid double taxation and to lower tax rates applied to enterprises from countries which have concluded tax treaties with India. In Brazil, recent modifications to the Profit Remittance Law have resulted in a substantial reduction in the withholding tax on corporate income (from 25 per cent to 15 per cent), and the abolition of the supplementary income tax.

66. In general, apart from the application of special tax incentives, taxes on FDI tend mostly to be levied on corporate income, and are assessed and collected in the same manner as with domestic enterprises. The overall tendency is towards a substantial reduction in corporate income tax rates on FDI.

G. Performance requirements

67. Performance requirements take various forms, including balancing foreign equity ownership with imports of capital goods; export levels; local content obligations; production capacity; production-sharing; employment levels; and technology transfer. The use of performance requirements by host countries is sometimes linked to the provision of incentives to the foreign investor. The obligation to meet such requirements would normally end with the expiration of the specific incentives to which they were linked.

68. With the introduction of India's liberalization policy discussed above, majority foreign equity is now allowed in specified priority sectors provided that the foreign equity covers fully the imports of capital goods; and outflows on account of dividend payments are balanced by export earnings over time. Certain oil and gas fields have been opened up for development by foreign investors on a production-sharing basis. In some other sectors, FDI is allowed where production is intended for export, as in the so-called 100 per cent export-oriented units.

69. In Mexico, certain enterprises with a majority foreign interest may be required to maintain an equilibrium in the accumulated foreign currency balance (exports/imports), and to ensure the utilization of adequate technology. Foreign investors wishing to obtain a "Temporary Investment Trust" in order to invest in certain activities which are totally or partially reserved to Mexican nationals, may be required to show a substantial increase in export levels. In Brazil, the 1990-1992 liberalization programme abolished many of the existing performance requirements. Among those which still exist is the local content requirement, linked to subsidized credits for the acquisition of capital goods in the industrial sector. Performance requirements in the Philippines are linked to incentives provided to foreign investors.

70. The elimination of trade-related performance requirements should result form the entry into force of the Uruguay Round agreement on trade-related investment measures (TRIMs). Some developing countries, (e.g. Republic of Korea), have taken steps to remove performance requirements, thus deciding to treat both foreign and domestic investment on the same footing.

H. Dispute settlement

71. The principles and practices governing the settlement of disputes involving foreign investors have now become more or less standardized and universally acceptable. Once allowance is made for nuances in various national legal norms and practices, all eight countries accept binding international arbitration and mediation in case of disagreement by the parties to a dispute. National arbitration laws must normally be applied prior to any resort to international

arbitration, of which the main instrument is the International Centre for the Settlement of Investment Disputes. In all cases, prior agreement by the parties is necessary.

V. INCENTIVES AND PROMOTIONAL MEASURES TO ATTRACT FDI

72. Fiscal, financial and other incentives remain an important part of host countries' investment promotion packages. While their effects on stimulating new investments are difficult to measure, they nevertheless represent important costs to the domestic economy. At the same time, much has been done to improve investment promotion activities, placing higher priority on marketing and the use of joint investment forums. There is also renewed interest in concluding bilateral investment agreements, and in the activities of the Multilateral Investment Guarantee Agency (MIGA).

A. Fiscal incentives

73. The majority of host countries use a wide variety of fiscal incentives to attract foreign investment. The situation ranges from a few countries with no formal system of special incentives, such as India, to elaborate provisions for tax holidays affecting different industrial sectors; duty exemptions and drawbacks; tax credits on locally produced capital goods; deductions for labour expenses and major infrastructural work. These provisions tend to be mostly concentrated in export industries, export processing zones and special economic zones, but can also be found in traditional sectors.

74. The fiscal incentives systems in the Republic of Korea, Morocco, and the Philippines give a good idea of both the objectives sought and the range of tools which governments have at their disposal. In the Republic of Korea, while the primary objective is to promote free and fair competition between domestic and foreign enterprises based on the principle of national treatment, fiscal incentives are nevertheless used to encourage foreign investment in advanced technologies. One hundred and six kinds of advanced technologies are currently eligible for 5-year exemption from income taxes, corporation taxes, and taxes on royalties. Otherwise, foreign firms in the Republic of Korea are eligible for 3-year exemption on income and corporation taxes, and a further 2 years during which they are eligible for a 50 per cent tax reduction. During the 5-year period, customs duties, special consumption taxes, and value added taxes are also reduced by 50 per cent. Investments in the Masan export free zone benefit from tax exemptions.

75. In Morocco, foreign investment is eligible for tax reductions, or exemptions ranging from 5 to 15 years. Tax exemptions are applied to company taxes, VAT, import duties on equipment (exemption or duty drawback), stamp duty, patents tax and urban tax. Investment in tourism benefits from 7 to 10 year exemption on income tax, and up to 15 years for investment in buildings.

76. In the Philippines, foreign investment which has obtained "pioneer" status may benefit from a minimum of 6-year income tax exemption. The remaining investment, in which up to 40 per cent foreign equity is allowed, may benefit from corporate income tax exemptions (normally 35 per cent of gross income) from between 4 to 8 years. Such investment is also eligible for temporary duty-free imports of capital equipment, machineries and spare parts and a variety of tax credits, deductions and exemptions. Additional incentives are available for investments in areas designated as "less-developed", including those applicable to pioneer industries, as well as 100 per cent tax deductions for major infrastructural works and labour costs. It is estimated that from 1981 to 1992 forgone revenue arising from the grant of fiscal incentives represented annually about 0.64 per cent of Philippines' GDP.

77. Brazil's liberalization programme has resulted in the narrowing down of incentives provided during the 1970s and 1980s. These included subsidized credits by State banks, tax reductions and exemptions granted by the Industrial Development Council to industrial production. The new policy includes fiscal subsidies or risk-sharing in financing R & D projects, as well as a few selective incentives to investment (such as exemption from indirect taxation on capital goods, and accelerated depreciation allowances on all investments), and exports.

78. In China, export-oriented enterprises located in the centre of cities in the special economic zones may have their tax rates reduced by 50 per cent (15 per cent instead of the normal 30 per cent tax levied on income earned in China); while foreign investors in energy, transportation, ports, harbours, or other State-encouraged projects in the economic and technological development zones in the coastal areas may have their normal tax rates reduced by 20 per cent (i.e. a tax rate of 24 per cent is applied).

B. Financial incentives

79. Unlike fiscal incentives, financial incentives to attract foreign investment receive relatively little attention. Indeed, corrective policies adopted by some countries, such as the Philippines, in the wake of the debt crisis have shifted emphasis away from credit subsidies to more efficient resource allocation. Nevertheless, financial incentives are still being used by some host countries. For example, Morocco maintains a system of incentives including such instruments as credit subsidies, interest subsidies, and off-shore financing. The Republic of Korea also allows access by foreign firms to offshore financing for up to 50 percent of their investment requirements, for not more than 3 years.

C. Debt-equity swaps

80. Debt-equity swaps, in conjunction with privatization programmes, have been in use in several debt-distressed countries since the mid-1980s. From 1986 to 1993, debt-equity swaps in the Philippines reduced the nominal value of external debt by US$ 1.4 billion. Incremental investment directly traceable to the debt-equity conversion programme is put at 26 percent of total FDI inflows from 1987 to 1992. Long-term equity investment funded through the programme generated a substantial number of jobs and expanded production.

81. Brazil's debt-equity conversion programme pre-dates the debt crisis of the 1980s. In 1984, conversions represented two thirds of FDI inflows net of repatriations (about US$ 746 million). Following the introduction in 1988 by the Central Bank of a new system of conversions through which all debts were eligible within certain limitations, the debt-equity market ballooned with nearly US$ 7 billion of debt converted in 1988 using a combination of monthly auctions and other established techniques (intercompany loans, direct swaps at par, conversions of hedged deposits). Concerns over the monetary impact of these swaps led to the suspension of the programme in 1989. The Brazilian case study argues that conversions had only a "replacement effect" as FDI inflows remained in the vicinity of US$ 1.5 billion with only the proportion effected through conversions varying. Conversions are deemed to have to provided a subsidy for investments that would otherwise have been made.

D. Investment promotion measures

82. A great deal of effort is being made by host countries in the field of foreign investment promotion. Activities range from institutional reorganization in the processing of investment applications, to the provision of investment information, advisory services and technical assistance to prospective investors; training programmes in the preparation, appraisal and implementation of viable

projects; as well as marketing the advantages and openness of host countries to foreign investors. There is also much interest in the establishment of "one-stop-shop" investment services, and the setting up of joint investment forums where project promoters and foreign investors can get together. Many of these measures are particularly important to investment programmes in India, the Republic of Korea, Mexico, Nigeria and the Philippines; and to a lesser extent in China and Morocco.

E. Export processing zones

83. Several countries have established export processing zones (EPZs) as a means of attracting FDI in export-oriented industries.[5] EPZs are generally equipped with good infrastructure and support facilities and, in addition to customs privileges, operating firms are usually offered more generous incentives than those existing outside the zones. Countries have had varying successes with EPZs. The "maquiladoras" represent the second largest foreign exchange earner of Mexico, generating over 500,000 in direct employment and $19.5 billion of exports in 1992. In China, the Government deemed it necessary to concentrate resources and create a favourable environment in border areas and special economic zones (SEZs), which acted as windows for absorbing FDI. FDI inflows to the SEZs as well as their exports have been substantial. They have also had significant spread effects on surrounding areas. In the Philippines, the four regular EPZs generated over $1 billion exports and some 54,000 jobs in 1992. It also has 10 special EPZs with cumulative private sector investment amounting to 12 billion pesos in 1992. The success of the EPZs has inspired the Government to transform the former United States naval base along Subic Bay into a special economic and free port zone. The six EPZs in India employ 33,000 workers and account for 4 per cent of exports of manufactured products, which are mainly high-technology products. While the significance of the Masan and Iri EPZs in the Republic of Korea has diminished over time, accounting for only 2 per cent of exports in 1991, they have had a substantial impact on regional development resulting mainly from expanded employment opportunities. Employment peaked in 1987 at 41,500. The Republic of Korea is an example of a country where the EPZs have developed backward linkages to a high degree as about 45 per cent of production materials used are supplied by local firms.

F. Bilateral and multilateral agreements

84. There have been significant advances in both bilateral and multilateral investment protection agreements and tax treaties. In recent years, the number of bilateral investment agreements and tax treaties has increased substantially. The Republic of Korea now has in place 30 bilateral investment agreements, and the Philippines is seeking to negotiate such agreements with its top 20 investing partners. In some cases (Nigeria) bilateral agreements have tended to follow long-established North-South political, trade and cultural links.

85. Membership in multilateral and regional investment arrangements such as MIGA, the ASEAN Industrial Joint Venture (AIJV) scheme, and the Arab Investment Guarantee Company are increasingly being seen as providing a stable and attractive framework conducive to greater confidence building, and providing better risk coverage. A majority of host countries are members of MIGA. However, several important host countries have not yet joined MIGA, among them Mexico, as well as India and the Philippines (which have both signed its convention, but not yet completed its membership procedures).

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[5] For more details, see UNCTAD, "Export processing zones: role of foreign direct investment and developmental impact" (TD/B/WG.1/6).