

Investment Advisory Series
Series B, number 3

***Best Practices in Investment
for Development***

How Post-Conflict Countries can Attract and Benefit from FDI:
Lessons from Croatia and Mozambique



United Nations

UNITED NATIONS CONFERENCE ON TRADE AND DEVELOPMENT

Best Practices in Investment for Development

Case Studies in FDI

**How Post-Conflict Countries
can Attract and Benefit from FDI:**

**Lessons from Croatia and
Mozambique**



UNITED NATIONS

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Use of a dash (–) between dates representing years – for example 2004–2005 signifies the full period involved, including the beginning and end years.

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UNCTAD/DIAE/PCB/2009/15

UNITED NATIONS PUBLICATION
<i>Sales No. E. 10.II.D.18</i>
ISBN 978-92-1-112812-3
ISSN 1995-6088

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Printed in Switzerland

PREFACE

The *Investment Advisory Series* provides practical advice and case studies of best policy practice for attracting and benefiting from foreign direct investment (FDI), in line with national development strategies. The series draws on the experiences gained in, and lessons learned through, UNCTAD's capacity-building and institution-building work in developing countries and countries with economies in transition.

Series A deals with issues related to investment promotion and facilitation and to the work of investment promotion agencies (IPAs) and other institutions that promote FDI and provide information and services to investors. The publications are intended to be pragmatic, with a how-to focus, and they include toolkits and handbooks. The prime target audience for series A is practitioners in the field of investment promotion and facilitation, mainly in IPAs.

Series B focuses on case studies of best practices in policy and strategic matters related to FDI and development arising from existing and emerging challenges. The primary target audience for series B is policymakers in the field of investment. Other target audiences include civil society, the private sector and international organizations. Series B was launched in response to a call at the 2007 Heiligendamm G-8 Summit for UNCTAD and other international organizations to undertake case studies in making FDI work for development. It analyses practices adopted in selected countries in which investment has contributed to development, with the aim of disseminating best practice experiences to developing countries and countries with economies in transition. The analysis forms the basis of a new technical assistance work programme aimed at helping countries to adopt and adapt best practices in the area of investment policies.

For Series B, UNCTAD's approach is to undertake case studies of a pair of developed and developing or transitional economies that exhibit elements of best practices in a selected issue. Country selection follows a standard methodology, based primarily on the significant presence of FDI and resulting positive outcomes.

The Investment Advisory Series is prepared by a team of UNCTAD staff and consultants in the Investment Policies Branch, under the guidance of James Zhan. This study of the Series B was prepared by Rory Allan, Ioanna Liouka, Cam Vidler and Zbigniew Zimny, with contributions from Samuel Forquilha, Zrinski Pelajić and Danijela Tepšić. Fact-finding missions were undertaken in Croatia and Mozambique in April 2009 and April 2008 respectively. Contributions and comments were received from Chantal Dupasquier, Kalman Kalotay and Joerg Weber as well as from Peer Review Panel members Khalil Hamdani, John Kline and Stephen Young. The report has also benefited from views of current and former government officials, the domestic and foreign private sector and academics. The programme has received financial support from the Government of Germany.

Geneva, October 2009

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ABBREVIATIONS

ADB	African Development Bank
ASSC	areas of special State concern
BIT	bilateral investment treaty
BOT	build-operate-transfer
BROT	build-rehabilitate-operate-transfer
CEE	Central and Eastern Europe
CEFTA	Central European Free Trade Agreement
EBRD	European Bank for Reconstruction and Development
EFTA	European Free Trade Association
EIB	European Investment Bank
EU	European Union
FDI	foreign direct investment
GDP	gross domestic product
HAMAG	Croatian Agency for Small Businesses
HBOR	Croatian Bank for Reconstruction and Development
HDI	Human Development Index
ICT	information, communications and technology
IFC	International Finance Corporation
IFZ	industrial free zone
IPA	investment promotion agency
LDC	least developed country
MIGA	Multilateral Investment Guarantee Agency
MPDC	Maputo Port Development Corporation
ODA	official development assistance
PPI	public-private initiative
R&D	research and development
RDZ	rapid development zone
RIA	Regulatory Impact Assessment
SAA	Stabilization and Association Agreement
SADC	Southern African Development Community
SEZ	Special Economic Zone

SME	small and medium-sized enterprise
SOE	State-owned enterprise
TIPA	Croatian Trade and Investment Promotion Agency
TNC	transnational corporation
TRIMS	Trade-Related Investment Measures
UNDP	United Nations Development Programme
USAID	United States Agency for International Development
VAT	value added tax
WTO	World Trade Organization

Croatia



Mozambique



KEY FACTS TABLE

	Croatia					Mozambique				
	1990	1995	2000	2005	2008	1990	1995	2000	2005	2008
Population (million)	..	4.67	4.51	4.44	4.42	13.54	15.95	18.25	20.83	22.38
Annual GDP growth ¹ (%)	..	-5.4	3.2	4.7	2.4	-1.0	3.8	8.6	8.5	6.0
GDP per capita (\$)	..	4028	4090	8665	13730	224	161	236	316	418
GDP by sector (%)										
Services	..	56.3	61.9	62.4	63.0	48.4	51.9	52.3	48.86	47.66
Industry	..	33.4	29.3	30.3	30.1	17.1	14.2	24.1	24.8	25.5
Manufacturing	..	23.6	21.0	19.91	19.4	11.2	7.4	12.0	15.1	15.8
Agriculture	..	10.4	8.8	7.3	6.8	34.5	33.9	23.6	26.4	26.8
FDI inflows ² (\$ million)	..	95	907	1520	4383	5	32	179	258	587

FDI outflows² (\$ million)	..	12	77	287	170	0.19	0.05	-0.43	-0.02	0.04
FDI inflows (% of GDP)	..	0.57	6.02	4.64	7.22	0.30	1.76	3.23	1.64	6.27
FDI inflows (% gross fixed capital formation)	..	3.7	27.6	16.4	22.9	2.0	6.5	10.4	8.8	26.5
Total exports (\$ million)	..	6972	8503	18694	28538	229	411	689	2087	3120
Exports of goods and services (% GDP)	..	38.6	47.1	47.1	47.7	6.1	12.6	12.7	30.5	27.0
Imports of goods and services (% GDP)	..	49.5	52.3	55.8	56.3	38.3	52.4	37.8	44.4	42.1
Share of population in poverty³ (%)	..	..	2	2	..	..	69	54	..	..

Source: UNCTAD, FDI/TNC database, UNCTAD GlobStat Database, World Bank, WDI.

¹ Annual GDP growth rates for 1990, 1995, 2000 and 2005 are calculated as annual average growth rates for the previous five-year periods.

² FDI Inflows and Outflows for 1990, 1995, 2000 and 2005 are calculated as annual averages for the previous five year-periods.

³ Poverty ratio at \$1.25 a day. Data for Croatia refer to year 2001 and 2005. Data for Mozambique refer to years 1997 and 2003. Source: World Bank, World Development Indicators.

I. INTRODUCTION

Croatia and Mozambique have made huge strides in entrenching peace since emerging from conflict in the early 1990s. Alongside this achievement, they have registered considerable success in attracting foreign direct investment (FDI), both in terms of the aggregate value of investment inflows, as well as long-term commitments by large transnational corporations (TNCs). Normally, FDI requires peace and stability. The purpose of this study is to examine the reverse relationship: whether, when and how FDI can be attracted and utilized in post-conflict conditions to promote economic stability and development, thereby making a contribution to peace-building.

The experiences of Croatia and Mozambique can offer practical lessons for countries in post-conflict circumstances in how to utilize FDI to help build and maintain peace. The paired cases offer interesting opportunities for comparison and contrast. (The *Key Facts Table* above sets out the two countries' basic economic indicators.) Croatia is a relatively industrialized country in South-Eastern Europe that declared independence in 1991, followed by armed conflict that lasted until 1995, and resulted in a problematic peace that was not solidified until a few years later. Mozambique is a developing country in Africa that emerged from nearly three decades of colonial conflict and civil war, resulting in an internal cease-fire and sustained stability subsequent to the peace accord of 1992. Although the two countries differ significantly in terms of their socio-economic development, politics, demography, geography, and the nature of their respective conflicts, they both managed to effectively confront common challenges that are typical of post-conflict conditions. Their diversity brings a wider perspective regarding how successful policies can be adapted to different national contexts.

FDI can contribute to peace but, first and foremost, conflict is not suitable to attracting FDI. Therefore, in conflict and post-conflict situations, official development assistance (ODA) is expected to be, at least initially, a more visible form of external

financial and technical support than private investment. Its contributions are expected to help achieve specific recovery objectives such as basic humanitarian relief, restoration of government services and rehabilitation of infrastructure. But if post-conflict countries succeed early in convincing foreign investors that peace or cease-fire is sustainable, FDI may start coming soon after the conflict (or even during, if hostilities are affecting only part of the territory) and have positive effects for post-conflict development. FDI has, of course, a commercial objective: its primary goal does not include contributing to economic and social recovery. Moreover, FDI is rarely the major source of capital formation, output and employment in any economy. It will never by itself deliver economic prosperity, let alone be the driving force in peace-building. FDI is one of many factors and its contribution should be assessed in this context. When, how and in what forms and areas FDI might contribute to peace-building and what policies might enhance this contribution is not well understood. This study explores these issues.

The legacy of conflict

The legacy of conflict is cruelly inhibiting. The population has typically suffered death and wounding (mental, as well as physical), resulting in displacement, both internally and externally. The physical infrastructure that constitutes the arteries of communication and transportation – roads and rail lines, air and seaports, power and telecommunications grids – has been damaged, deactivated and destroyed. Often, land mines remain undetonated and un-mapped, paralyzing ground transport and agriculture. Local business communities and companies have diminished capacities and severed international connections. Unemployment is ubiquitous, exacerbated by demobilized combatants. Skilled labour has been killed, chased away, or has lapsed into obsolescence. Financial resources are depleted, and financial services constrained. Government revenue streams have dried up and been diverted to

military priorities. External trade and investment partners have withdrawn to other opportunities.

The post-conflict government has a daunting array of pressing responsibilities: humanitarian relief for displaced persons and refugees, rehabilitation and reconstruction of salvageable structures and networks, employment for demobilized soldiers, and reconciliation of opposing factions if the struggle was internal. Inevitable triage is necessitated by scarce capital and human resources, forcing wrenching policy choices between short- and longer-term priorities: securing the peace by delivering immediate, visible peace dividends to the population vs. investing in infrastructure restoration, human resource development and institution-building to lay a credible foundation for future economic recovery.

Governments emerging from conflict confront unique burdens beyond the normal challenges of socioeconomic development. As former United Nations Secretary-General Kofi Annan has observed, nearly half of those States sink back into armed hostilities within five years of a peace agreement.¹ This is, however, not the case with Croatia and Mozambique.

The FDI appeal and challenge

The risk of civil war and its recurrence is statistically greatest in low income, commodity-dependent economies (Collier *et al.*, 2003). The underlying assumption of this study is that, other things being equal, improved economic conditions will contribute to sustaining peace. Strong and diversified FDI inflows have a role to play in this process, and therefore may reduce the risks of renewed conflict.

For a post-conflict government, the prospect of attracting private foreign investment holds obvious appeal. FDI can offer

capital, foreign exchange, technical and managerial know-how, employment, stimulus and financing for infrastructure construction or rehabilitation, procurement and production of domestic goods and services, and access to external markets. Moreover, early arrival of TNCs as “flagship” investors can send a powerful signal to the international business community that the host country is “back in business”.

A government determined to capture these potential FDI benefits must formulate and implement effective policies and regulations with two aims:

- *Attracting* foreign investment; and
- *Utilizing* that investment for development and peace-building.

Even preliminary consideration reveals that the threshold barriers are formidable. Attraction requires convincing risk-averse foreign firms, with alternative destinations at their disposal, that (a) the conflict is resolved; (b) underpinning infrastructure has survived or is in the process of being restored; (c) skilled labour has not all emigrated; and (d) sufficient raw materials, intermediate inputs and fiscal incentives are available to make the post-conflict investment climate competitive.

Confronting a war-torn landscape, a prospective investor that seriously considers plunging in is likely to want to carve out a physical and operational enclave that minimizes its investment’s contact with, and dependence upon, the battered national economic environment. Earmarks of this desired risk-mitigating isolation might be anticipated to include:

- Plant-siting in a dedicated industrial zone with secure perimeter and services;

-
- Reliance on imported management personnel;
 - Export orientation;
 - Resource-seeking investment based on low cost assets and perhaps combined with inattentive regulation of extraction rates, transfer pricing and environmental impact;
 - Market-seeking investment based on the purchase of undervalued domestic companies, including State-owned enterprises (SOEs);
 - A guaranteed right to resolve legal disputes offshore, by international commercial arbitration; and
 - Extraordinary fiscal dispensations as a hedge against renewed hostilities during an extended period of investment construction and initial operations.

In sum, this entails a light footprint, privileged entry and operating conditions, and minimum contact with the host economy.

The low-contact preference of foreign investors directly confronts the post-conflict government's economic peace-building agenda. To address the recovery and reconstruction priorities outlined above, that agenda requires from the foreign investor:

- High, early revenues, in some combination of shared profits, taxes and royalties;
- Numerous jobs and training for local labour, including skilled positions;
- Decentralized siting of plants and other investor facilities to provinces hardest-hit by the conflict;
- Contribution to provincial infrastructure rehabilitation;

- Deliberate development and utilization of locally sourced investment inputs; and
- In-kind and financial contributions to local health and welfare.

In sum, this entails heavy footprint involving maximum contact with the host economy.

Not only do these competing agendas predict root tensions between a foreign investor and the host government, they also provoke internal contradictions within the government's own policy framework. The same incentives the government may feel compelled to offer in order to attract foreign investors to its post-conflict environment – e.g. enclave privileges, tax and duty holidays, reductions and exemptions – can dilute and defer achievement of the government's economic peace-building objectives.

Focusing on Croatia and Mozambique, this study examines the particular issues of FDI attraction and benefit arising in post-conflict countries, as set out in a likely government agenda:

- What kinds and volumes of FDI inflows can be expected when conflict ends and over what timeframes? What policy measures impact these outcomes?
- What are the key contributions of FDI, and how can these be improved by government policies and programmes?

Note

- ¹ United Nations Secretary-General Kofi Annan's Tip O'Neill Lecture, "Learning the lessons of peace building", Magee Campus, University of Ulster, United Kingdom, October 2004.
http://www.un.org/Depts/dpko/dpko/articles/sg_article181004.htm

II. CONFLICT AND FDI INCROATIA AND MOZAMBIQUE

Croatia is located in South-Eastern Europe, across the Adriatic Sea from Italy. With its 1,777-kilometre long mainland coastline and 1,185 islands, it represents an attractive tourist destination. The eastern part of Croatia is mostly a flat fertile land suitable for agriculture. Croatia has plenty of forests, rivers and lakes but no significant mineral resources, apart from some oil and gas deposits along the Hungarian boarder and in the Adriatic Sea. A network of highways and railways connects major cities and coastal areas. Croatia also has seven international airports, three major freight seaports, three passenger seaports and four river ports. The Croatian transportation network connects to four Pan-European corridors that link Croatia to European and world markets. Its labour force is well-educated and skilled, not only in traditional industries, but also in the science and technology sectors.

Tucked against Africa's south-eastern edge, Mozambique's 2,700-kilometre coastline has high, largely untapped, economic value including hydrocarbon and titanium deposits, fisheries resources and tourism sites. Interior lands add rich agricultural, agro-industrial, forestry and mining potential. Six seaports and three major overland corridors connect Mozambique with the United Republic of Tanzania to the North, Malawi, Zambia and Zimbabwe to the West, and South Africa and Swaziland to the South. Thirteen major rivers contribute hydro-generation potential as well as irrigation for Mozambique's agricultural sector that employs the vast majority of the population. Overall, the Mozambican workforce is very poorly educated and has limited skills.

1. History of the conflict

Both Croatia and Mozambique have experienced disastrous conflicts. In Croatia, the conflict was shorter and did not significantly affect the Western and Northern regions of the country. In Mozambique, the conflict continued for a protracted period of

time and, although it was mainly focused in the Southern and Central regions, it destructively affected the entire country.

Croatia emerged as an independent State from the break-up of the former Socialist Republic of Yugoslavia, together with several other countries of the Balkan Peninsula. The conflict in the Western Balkans erupted as these States sought their independence in the early 1990s, motivated by dissatisfaction with the Yugoslav Government, ethnic considerations, as well as inspired by independence movements and democratic changes in Central and Eastern Europe. Croatia itself held democratic elections in 1990, adopted the Constitution and issued the Independence Declaration on 25 June 1991. This was contrary to the official policy of the Yugoslav Government and to the wishes of ethnic Serbs inhabiting Eastern, Central and Southern parts of the country. In response, ethnic Serbs in some Central and far Eastern regions of the country formed a new entity, the Autonomous Region of Serb Krajina (later renamed into the Republic of Serbian Krajina), which was supported by the Government in Belgrade and the Serb-dominated Yugoslav army.

The fighting erupted and was especially heavy in the border city of Vukovar, which fell to Yugoslav forces in November 1991, together with the Eastern part of Croatia. In total, one third of the country's territory was occupied during 1991–1995. The United Nations-sponsored cease-fire followed. Until 1995, however, the armed conflict remained mostly intermittent, with occasional breaks of the cease-fire. In August 1995, the Croatian Army re-conquered most of the Serb-controlled territory, apart from Eastern Slavonia, Baranja and Western Sirmium. The war ended in November 1995 with the negotiation of the Erdut Agreement providing for the transitional administration of Eastern Slavonia, Baranja and Western Sirmium by the United Nations. In 1998, under United Nations supervision, Croatia peacefully regained control over the remaining occupied territory. During the conflict, hundreds of thousands of

people were displaced within and from Croatia. There was also an influx of ethnic Croat refugees fleeing the war in neighbouring Bosnia and Herzegovina.

Mozambique has endured two disastrous conflicts. A war of national liberation against the Portuguese colonial power raged from the early 1960s through 1974. Independence was declared in July 1975, but a civil war soon erupted, pitting the governing Frelimo party, led by Independence hero Samora Machel, against the Renamo rebel group, sponsored successively by the Rhodesian and South African military forces. With Frelimo increasingly centralizing power and economic decision-making in the more urbanized and industrial South, the conflict also took on a regional dimension, with Renamo rallying the poorer, agriculturally dependent Northern and Central provinces under the banner of “the rest versus the South” (Weinstein and Laudemiro, 2005).

The civil war in Mozambique affected the entire country. In the early part of the war, until the mid-1980s, violent incidents against civilians were distributed between the South and Centre of the country, especially in the border provinces of Manica and Tete. During the second and more brutal phase of the war, fighting expanded from the border regions towards the sea and became more concentrated in the South, while also spreading to the Northern areas. At the peak of the violence, in 1991 and 1992, there were, on average, around 160 incidents per year in the South, 80 in the Centre, and 50 in the North. The Renamo forces often targeted civilian populations, including the looting and destruction of property, which led to the widespread displacement of local populations.

Following the signing of the civil war peace accord between Frelimo and Renamo in Rome in October of 1992, the United Nations coordinated a successful programme of disarmament and demobilisation. A first round of democratic elections was conducted

in 1994, stimulating the return of 1 million refugees and a tentative process of national reconciliation and peace-building.

2. Economic consequences of the conflict and resumption of economic growth

In both countries, the conflict and the transition process to a market economy brought about dire consequences, leading to unprecedented economic downturn. An enormous decline in the gross domestic product (GDP), erosion of infrastructure, dramatic rises in unemployment, and the loss of foreign export markets, were immediate results of the conflict. Nonetheless, economic growth in both countries started to pick up soon after the conflict ended. By the beginning of the twenty-first century, both economies were experiencing stable growth.

In Croatia, GDP fell sharply during the early 1990s (-21 per cent in 1991, -9.7 per cent in 1992 and -3.7 per cent in 1993). Hyperinflation set in, with retail prices increasing by 123 per cent in 1991, 665 per cent in 1992 and 1,517 per cent in 1993. The exchange rate of the Croatian dinar (CRD) jumped from 18.7 CRD per \$1 in 1991 to 3,577 in 1993.¹ Manufacturing was badly disrupted by the conflict and the loss of foreign markets in other former Yugoslav republics. Exports fell and unemployment rose rapidly, from 9 per cent in 1990 to 20 per cent in 1995 (EIU, 1996). Employment in the sector nearly halved as a result of the conflict and transition shock (Sonje and Vujcic, 1999). By the mid-1990s, out of 35 manufacturing branches, 21 were still in decline, including major ones such as textiles, leather, woodworking and ferrous and non-ferrous metal industries. This was due not only to the conflict, but also to the post-privatization bankruptcy of former State-owned enterprises (SOEs).

The war destroyed many farms and rural communities. Nearly a third of agricultural land remained inaccessible due to the

mine fields. A quarter of agricultural machinery was destroyed, reducing production levels. The war further produced some 500,000 refugees, many of whom had to be accommodated in the hotels on the coast (some of them well into the twenty-first century). Tourist infrastructure in many destinations was severely damaged. For example, the coastal city of Dubrovnik was subject to sustained shelling, and nearly half of the hotels were damaged. Tourist visits fell to 20 per cent of the pre-war level (UNDP, 2008: 54).

Upon ending of the conflict, economic growth started to pick up. Hyperinflation was defeated in 1993, owing to the stabilization programme and the successful exchange rate policy of the Croatian National Bank. Between December 1993 and December 1994, retail prices fell by 3 per cent (EIU, 1996). GDP growth resumed in 1994 and, since then, with almost unchanged population, translated into a rapid growth of GDP per capita (growing at 4 per cent annually from 1995 to 2000, and 5.6 per cent in 2007). Croatia has entered the ranks of middle-income countries with a GDP per capita of over \$11,000 in 2007, far higher than in neighbouring Serbia and Montenegro,² and Bosnia and Herzegovina (where GDP per capita is \$6,500 and \$3,500 respectively). Still, the country trails Slovenia (\$22,000), another neighbour, by a significant margin. Unemployment has fallen, though at a rate of 16.3 per cent in 2007, it still remains a problem. Politically, Croatia has become an increasingly stable and democratic country. Relations with the neighbouring countries are improving, although some disagreements concerning the borders remain. With European Union membership likely in the coming years, Croatia will further consolidate positive changes.

In Mozambique, the war against the Portuguese and the announcement of independence in 1975 was promptly followed by the wholesale exodus of 200,000 Portuguese settlers, including almost all technical and managerial professionals. Property and productive infrastructure were abandoned and the new Government

inherited a largely paralysed economy and unskilled human resource base.

The civil war that subsequently erupted brought about additional destruction, resulting in the loss of most social facilities and services, emigration of 1.5 million refugees, internal displacement of 3 million other Mozambican nationals, and a near-collapse of the State. The civil war eroded an already poor infrastructure, including such prime economic assets as the 1,200MW Cahora Bassa hydroelectric generation facility, and important ports serving both Mozambique and other countries. At the bottom of this plunge, Mozambique ranked as the world's poorest country. Annual real GDP growth rates during the 1980–1989 period plummeted to -1.5 per cent, from 3.6 per cent during previous years (1970–1980).

Following the signing of the civil war peace accord of 1992, GDP has grown steadily, reaching an average of 7.9 per cent between 1992 and 2007. As a result, per capita GDP has doubled since the mid-1990s. The number of those living in poverty has declined from 69 per cent in 1997 to 54 per cent in 2003, although the majority of the population remains subsistence rural dwellers. There is also some discussion that poverty rates may have been underestimated and have increased since then, especially among rural dwellers.³ Mozambique is no longer the world's poorest economy, although as of 2008, it was still 10th poorest based on GDP per capita. The United Nations Human Development Index (HDI) for 2008–2009 ranks Mozambique 11 from the bottom of 182 countries.⁴ Due to the dependence of most of the population on the agricultural sector, Mozambique remains vulnerable to external price shocks as well as natural disasters. Thus, despite having attained a remarkable economic recovery, Mozambique's starting point was so dire that it remains one of the poorest countries in the African region and will continue to face significant challenges. On the other hand, the stable political situation and sound economic

policies make Mozambique a favourable destination for international aid donors and lending institutions, which will likely continue their support in the coming years.

3. A snapshot at FDI attraction

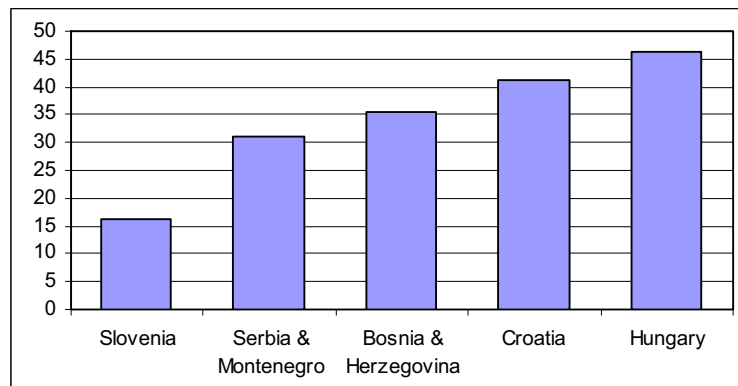
The respective conflicts had adverse effects on FDI inflows in Croatia and Mozambique. Nonetheless, soon after peace was restored, both countries attracted significant levels of FDI. Although rising FDI to developing countries has been a major feature of the global economy since the late 1980s, Croatia and Mozambique stand out; an even more impressive feat given the countries' difficult starting points.

During the conflict period (1991–1995), Croatia received average annual FDI inflows of only \$76 million. After the conflict ended, FDI in Croatia took off, increasing significantly on an annual basis. Inflows amounted to \$907 million per year during 1996–2000, \$1.5 billion during 2001–2005 and \$4.2 billion during 2006–2007. Croatia compares favourably to its neighbours in terms of FDI attraction relative to the size of the economy (figure II.1). In Croatia, the FDI stock accumulated (i.e. cumulative inflows) between 1990 and 2007 exceeded 40 per cent of 2007 GDP, compared to 46 per cent in Hungary, 35 per cent in Bosnia and Herzegovina, 31 per cent in Serbia and Montenegro, and 16 per cent in Slovenia. In 2008, Croatia maintained its high level of FDI inflows, receiving a total of \$4.4 billion.

Mozambique also experienced a remarkable post-conflict turnaround in FDI attraction. In the five years preceding the peace treaty in 1992, Mozambique attracted only \$9 million of FDI on average per year. A decade later, average annual FDI inflows of the previous five years averaged \$215 million. FDI grew steadily until 1997, and it took off to a much higher level thereafter. This strong uplift after 1997 is associated with FDI in two “megaprojects”⁵: the

Mozal aluminium smelter and the Tamane gas project. By 2007, these two projects accounted for 60 per cent of Mozambique's stock of FDI. They tend to dominate the discussion of Mozambique's FDI attraction performance and it is widely assumed that they wholly account for Mozambique's outperformance in FDI attraction.

Figure II.1. Croatia and neighbouring countries: the ratio of total cumulated FDI inflows for 1990–2007 to GDP (%)



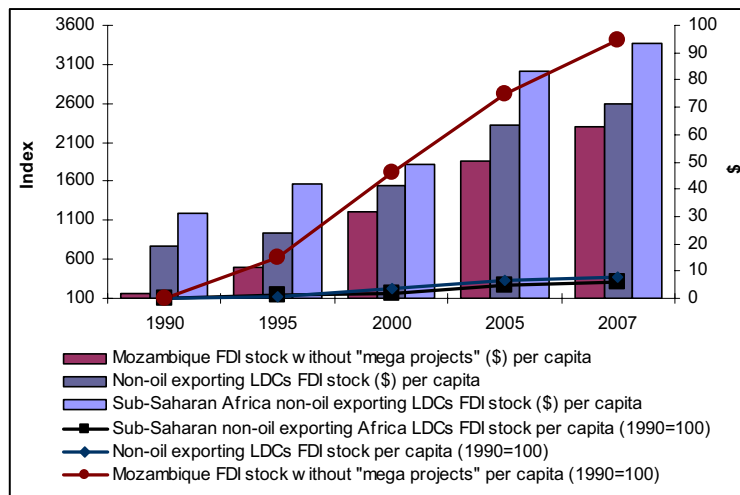
Source: UNCTAD FDI/TNC database.

Note: Although Serbia and Montenegro separated in 2006, data are provided for both countries aggregately in 2007 in order to facilitate comparison through time.

Nonetheless, on an international comparative basis, Mozambique has also outperformed its peer group in FDI attraction, even *without including megaprojects*. Figure II.2 shows FDI stock per capita in Mozambique, excluding megaprojects, for selected years. This is compared with FDI stock per capita in all least developed countries (LDCs) excluding oil exporters and also for this same LDC group in sub-Saharan Africa. When peace came, Mozambique had accumulated a small fraction of FDI stock compared with the situation in its peers. Thereafter, FDI grew much

faster in the country, such that by 2007 Mozambique's FDI per capita had almost reached that of its peers.

Figure II.2 FDI stock per capita in Mozambique (\$)



Source: UNCTAD WIR/TNC database

Notes

- ¹ The dinar was replaced on 31 May 1994 by the kuna at a rate of 1 kuna = 1,000 CRD.
- ² Although Serbia and Montenegro separated in 2006, data are provided for both countries aggregately in 2007 in order facilitate comparison through time.
- ³ For a discussion of poverty trends in Mozambique, see Hanlon (2007); Arndt (2008); and World Bank (2007).
- ⁴ The HDI is a composite measure encompassing life expectancy, adult literacy, educational attainment and GDP per capita.
- ⁵ So called “megaprojects” are large projects defined by the Mozambique Code of Fiscal Benefits as investments with capital value of at least \$500 million.

III. POLICIES AND FDI INFLOWS

A. Objectives and policies

1. Economic philosophy

The conflicts in Croatia and Mozambique coincided with a change in economic philosophy, from socialist planning and the reliance on SOEs in the economy, to a market-based system, relying primarily on private enterprises. This new approach was reflected in their respective Constitutions, which set the foundations for future policy towards foreign investors. It is also notable that this change in approach occurred prior to the end of the respective conflicts.

Following independence from formerly socialist Yugoslavia, Croatia joined a group of economies, mostly in Central and Eastern Europe, that were moving towards a market-based, capitalist economic system.¹ Croatia's 1990 Constitution contains objectives and general principles that have underpinned Croatian economic policy in the years since. Economic objectives outlined in the Constitution include stimulating "economic progress and social welfare" and caring "for the economic development of all its regions" (article 49). The new Constitution also replaced former Yugoslav economic laws and supported actions required to build a new system, notably the privatization of SOEs. It redefines Croatia's economic model, stating that "entrepreneurial and market freedom shall be the basis of the economic system of the Republic of Croatia".

The Constitution gives foreign investors the same legal rights as domestic investors (national treatment, article 48) and provides other guarantees ("foreign investors shall be guaranteed free transfer and repatriation of profits and the capital invested" – article 49). Any investment, including FDI, can be expropriated, but the provision conforms to customary international law, that is, expropriation must be for a (defined) public purpose, such as national security, environment, and public health, and only possible

upon full compensation based on the market value of investment (article 50).

Much like Croatia, Mozambique started the post-conflict period with a legacy of socialist policies, adopted after independence, which had failed to support improved living standards. Frelimo, the former ruling party, had believed in central direction, development of heavy industry and State ownership of large commercial farms. The Constitution forbade private ownership of land, although existing private owners were not usually forced out. However, this philosophy began to change from the mid-80s. For instance, the policy of supporting large State farms changed to more support for small farmers.

Two signal changes were the Economic Recovery Programme of 1987–1991, which included an International Monetary Fund (IMF) and World Bank-supported set of structural adjustments, and the introduction in 1990 of a new Constitution that was more liberal in a political and economic sense than its predecessor. In addition to stating the objectives of economic development and scientific and technological progress (article 6), Mozambique's Constitution broke from the country's socialist past by recognizing the role of a market economy in achieving them.² Among other pillars of the new "economic order", article 41 mentions "market forces" and the "initiatives of economic agents", although these are to be backed by a prominent role for the State, including regulation for economic and social purposes, as well as the possibility of full and joint state ownership of companies. Foreign investment is directly addressed in article 45, which permits "foreign ventures... in all economic sectors, except those that are exclusively reserved for State ownership or development by the State".

2. General investment laws, treaties and institutions

The Constitutions of Croatia and Mozambique were followed up by a series of investment-related laws and international treaties in the 1990s and early 2000s that aimed to boost the investment attractiveness of the country. Generally, these measures focused on creating an enabling legal environment for investors by granting them national treatment, guarantees against expropriation, as well as simplified dispute settlement and tax rules. Both countries also founded investment promotion agencies (IPAs) relatively early in the post-conflict period. However, Croatia's current IPA was re-established in 2002 and only became fully operational in 2005, while Mozambique's IPA has maintained continuity since its establishment in 1993.

Since the rights of domestic and foreign investors are guaranteed in the Constitution, Croatia did not pass a specific foreign investment law. However, the rights included in the Constitution have been confirmed and/or elaborated upon in specific legislative acts. Notable laws include the 1995 Company Law, the 1996 Law on Free Zones, the 1996 Law on Privatization, the 1997 Law on Takeovers of Stock Companies, and the 2000 Investment Promotion Law. Although the Law on Ownership and Property Rights of 1996 requires that foreigners who wish to acquire property in Croatia gain Government approval, this process excludes foreign investors if incorporated as Croatian legal entities. The Competition Act of 2003 (replacing the Law on Protection of Market Competition of 1995) ensures competitive equality of all enterprises, including those owned by foreigners.³ The Croatian Foreign Exchange Law of 2003 (replacing earlier acts with similar basic provisions and in particular the Foreign Exchange System, Foreign Exchange Operations and Gold Transactions Act, first adopted in 1993) permits foreigners to maintain foreign currency accounts and to make payments abroad. The 2003 Law on Foreigners (amended in 2009) consolidated several separate pieces of legislation from the

early and mid-1990s, outlines a relatively liberal, if somewhat cumbersome, framework for the residence and employment of foreign workers.

High standards of treatment and protection of FDI by Croatia have also been confirmed in nearly 60 bilateral investment treaties (BITs).⁴ Notably, Croatia has ratified BITs with the United States and Canada in 1996 and 1997, which, apart from including high standards (such as protection against indirect regulatory takings, international arbitration of investment disputes and the prohibition of performance requirements), also include a national treatment clause applying to the FDI entry phase (most other BITs apply the national treatment only to the post-entry phase). This clause thus clarifies the “equal treatment” from the Constitution as also applying to entry. The Croatia–United States BIT does indicate that several sectors are closed to FDI, including fisheries, air and maritime transport, and related activities (including maritime services). All other industries, however, are thus open to FDI. In addition, the lack of performance requirements in national legislation allowed Croatia to prohibit such requirements in the agreement. In line with international standards, Croatia prohibits expropriations and nationalizations, except for a public purpose, implemented in a non-discriminatory way in line with due process of law and subject to prompt, adequate and effective compensation. Through its BITs and membership of relevant international agreements,⁵ Croatia adheres to international standards of dispute resolution, permitting State-investor disputes and referring them to international arbitration.

Multilateral and regional instruments have also been used to confirm an FDI-friendly legal environment. For example, Croatia, after joining the World Trade Organization (WTO) in 2000, fully applied the WTO TRIMS agreement without exceptions or a transition period. The establishment of a free trade area with the European Free Trade Agreement (EFTA) and the Central European

Free Trade Agreement (CEFTA) in 2001 and 2002 further entrenched principles of national treatment. Entry negotiations with the European Union, started in October 2005, will formidably improve Croatia's regulatory and institutional framework for FDI through the rule of *acquis communautaire*, according to which all new entrants have to adjust their basic laws and institutions to those already existing in the European Union. Under the Stabilization and Association Agreement (SAA) signed in 2001, Croatia has been harmonizing its laws and regulations with those of the European Union in five key areas: market competition and state aid, intellectual, industrial and commercial ownership, public procurement, technical regulations, and consumer protection.

Croatia's approach to investment promotion has lacked continuity, but is now operating at full capacity. The Trade and Investment Promotion Agency (TIPA), the country's current IPA, was re-established in 2002, and has only been fully staffed and operational since October 2005. The agency replaced a small unit within the Ministry of Economy that had been dealing with investment promotion since 2000. Croatia's previous IPA, operational during the 1990s, was abolished with the election of a new Government in 2000. As of 2009, the new agency employs 32 professionals, 10 of them in the investment support division. Its mandate includes promoting the country, generating investment through the provision of information and direct targeting, and facilitating investment procedures (licenses, permits, applications for incentives, etc.). In recent years, TIPA's functions have become more pro-active, with the creation of platforms that encourage feedback from foreign investors and help coordinate policy at various levels of Government.

Like Croatia, within several years from the end of the conflict, Mozambique had put in place the basics of reforms on matters that would otherwise inhibit FDI. These reforms were not necessarily of "international standard", and significant obstructions

to normal business operations remained (and do so to this day). However, they signalled a welcoming approach to FDI and were important measures to facilitate its entry.

The first pieces of major investment legislation in the post-conflict period were the 1993 Investment Law, which was passed in tandem with the 1993 Code of Fiscal Benefits (expanded on in the next section), as well as the 1996 Foreign Exchange Control Regulation Law. In contrast with legislation in Croatia, the Investment Law touched directly upon the rights and obligations of foreign investors, explicitly opening the economy to FDI in any area not reserved for the State, and providing national treatment to all foreign investors.⁶ For approved eligible investments (i.e. those of \$50,000 and above, counted as the sum of equity and shareholder loans⁷), the law contained “guarantees” of due process regarding expropriation and compensation thereto and the opportunity of recourse to international arbitration to settle disputes. Repatriation of profits and proceeds of disinvestment were guaranteed, although the latter had to take place over five years. The Foreign Exchange Control Regulation Law permits exporters to retain foreign exchange earnings and use them for current and capital account transactions, although the latter (and dividend repatriation) still required prior approval. Importantly, import payments were freed up.

Like Croatia, Mozambique has signed and ratified a number of BITs, the first being with Portugal in 1996 (entering into force in 1998).⁸ Other notable agreements have been made with South Africa (1997), the United States (1998), the Netherlands (2001), China (2001), France (2002), Germany (2002), and the United Kingdom (2004). The Mozambique–United States BIT, based on the United States model BIT, provides the usual guarantees of national and most favoured nation treatment, as well as limits on expropriation, transferability of investment-related funds, restrictions on

performance requirements, access to international managers, and the use of international arbitration.

The 1993 Investment Law also saw the creation of CPI, Mozambique's IPA. The agency acts as a one-stop shop, offering a comprehensive service in support of foreign investors. The IPA currently serves various functions: attracting foreign investment, providing assistance to investors in the approval and implementation of investments, registration of investment projects, guaranteeing the concession of fiscal and customs incentives, promoting business linkages between national and foreign companies, identifying potential financial or technological partners for joint ventures, identifying and disseminating investment opportunities, and providing assistance programmes for business.

3. Privatization

In conjunction with their general economic reforms, both Croatia and Mozambique engaged in significant privatization of State assets and enterprises. Even before the conflict ended, Croatia began privatizing SOEs, often selling them to foreign investors who could bid, at least formally, on an equal footing with domestic investors. In Mozambique, privatization also began early on. In both cases, aside from several large SOEs purchased by foreign investors, the majority of privatizations were limited to small firms purchased by local investors.

As part of the transition towards a market economy, Croatia launched the privatization programme, which continues today. Foreign investors, due to national treatment guaranteed in the Constitution, were allowed to participate in privatizations from early on. According to the World Bank privatization database, the first privatization to a foreign investor was that of a cement plant in 1992, followed by the sale of two chemical plants the next year.⁹ During the initial period of Croatia's existence, the share of the

private sector in GDP grew rapidly, increasing from a quarter in 1991 to 55 per cent in 1997. In the late 1990s, major privatizations occurred in the banking and telecommunications sector, yet other public infrastructure was largely off the table. Foreign investors were involved either through direct purchases from the Government, or the post-privatization purchase of failing firms. Privatization of services was particularly attractive to foreign investors, because it offered domestic market access and also some monopoly power, as opposed to export-oriented manufacturing which had limited access to the European market at the time.

By 2000, the privatization process slowed down in response to concerns of corruption, especially regarding preferential sales of the Croatian Privatization Fund to politically-connected domestic interests (Grubisa, 2005). In 2001, the Law on the Revision of the Transformation and Privatization was passed, and an official inquiry was called. Based on the study of 1,006 cases of privatization, the report found that 931 had involved abuses or unlawful behaviour, resulting in significant damage to the Croatian economy. Aside from diminishing the value of capital and reducing employment, 23 per cent of the privatization cases had resulted in bankruptcy, while another 64 per cent of the privatized businesses had not expanded. Privatization since then has been more limited. As of June 2008, the Croatian Privatization Fund portfolio still included 894 companies (mostly in processing, followed by trade, tourism, agriculture and transportation), although only 98 were majority shareholdings (Croatian Privatization Fund). Nonetheless, despite the flaws in the overall process, the irregularities were mostly related to the allocation of SOEs to domestic investors. The involvement of foreign investors in privatizations, especially in the banking and telecommunications sectors, has more often been associated with improved economic outcomes.

Mozambique's privatization programme began in the late 1980s, and sped up after the signing of the peace accord in 1992

(Pitcher, 1996). In 1987, the Government sought loans from the World Bank, which mandated a structural adjustment programme that included the sale of SOEs to the private sector. This recommendation was supported by Mozambique Government research as well, which documented the poor state of these firms, especially in the agricultural sector. The privatization programme had several objectives, including reducing the Government's fiscal burden, developing the private sector, increasing economic efficiency, reducing administrative burdens, developing capital markets, and getting access to markets, capital and technology. The programme is largely seen as a success case when compared to privatization attempts in other African countries.¹⁰

SOEs up for privatization were split into two groups according to size. Small and medium-sized firms were sold through the relevant parent ministry, primarily to domestic investors.¹¹ Large firms, on the other hand, were available equally to foreign and domestic investors through a competitive bidding process relying on an international advertising campaign to promote the opportunities. Due to the larger size of the assets sold to foreign investors, from 1989 to 1999, 50 per cent of the total equity invested in privatization was foreign, despite the small share of total transactions.¹² By 1996, Mozambique had privatized 548 firms, the greatest number among African countries. As a result of the privatizations, the number of SOEs dropped by 43 per cent from 1990 to 1995. However, the Government maintains at least a minority ownership in some 200 of the most important companies including some in telecommunications, ports, electricity distribution and railroad.

4. Fiscal regime and business climate

Along with passing new investment laws and concluding treaties, both countries adjusted their tax regimes to better accommodate domestic and foreign investors, although Mozambique made more efforts in this area early on. In Croatia,

specific investment incentives were introduced several years after the conflict and they typically have not discriminated between domestic and foreign investors, or between sectors, although investments in certain regions or of certain size were given advantages fairly early on. In Mozambique, tax incentives were introduced earlier and have tended to be differentiated based on sector and project size. In both countries, non-tax costs of doing business remain high, but efforts have been made to reduce them.

Croatia has not aggressively used its general tax system to lure foreign investors. The corporate income tax rate, at 20 per cent, is significantly higher than its Eastern European neighbours, such as the former Yugoslav Republic of Macedonia (15 per cent), Hungary (10-16 per cent), Serbia and Montenegro (10 per cent). The withholding tax on dividends was abolished only in 2005 (TIPA, 2008: 62). On the other hand, Croatia has signed 48 double-taxation treaties in order to reduce the potential tax liabilities of foreign investors (UNCTAD, 2008).

Although Croatia does not distinguish between domestic and foreign investors, investment incentives have existed since the early transition years. According to the Free Zone Law (implemented in 1996), incentives include a five-year, 50 per cent corporate tax reduction for initial investments up to 140,000 euros, a full corporate tax break for investments higher than 140,000 euros, in addition to tariff-free imports. By 2008, there were 13 such zones in operation, four seaport-based and nine strategically located throughout the country near the borders. Incentives in Free Zones are indiscriminate in that they do not target any specific economic activities or performance (e.g. exports or technological upgrading). Perhaps due to the lack of sectoral discrimination, with the exception of some local tax cuts for production-oriented activities, Free Zones have attracted mainly wholesale trading and storage activities. The latest amendment to the Free Zone Law, in 2008, adjusted incentives to European Union requirements on State

subsidies, most notably phasing out the corporate tax reductions by 2016–2017.

Investors, both foreign and domestic, have also been encouraged to establish their operations in the many business zones spread around Croatia. These zones, administered at a municipal or city level, offer investors superior transportation access, serviced land at competitive prices, as well as reduced local taxes, communal infrastructure fees and other mandatory local contributions. The Ministry of Economy, Labour and Entrepreneurship, through its 2004–2007 small and medium-sized enterprise (SME) development programme, has provided 46 million euros to assist with the development of 285 Business Zones (135 zones had received support as of 2008). These funds support the construction of local infrastructure and, in some cases, are complemented with transfers of State land to local communities.

An early exception to the general incentives available to investors were three separate laws aiming at encouraging investments in underdeveloped or remote areas, many of which suffered damage during the war: (a) the Law on Areas of Special State Concern (ASSC) of 1996; (b) the Law on Revival and Development of the City of Vukovar of 2001; and (c) the 2002 Law on Hilly and Mountain Areas. Incentives consist of corporate tax exemptions or reductions and are subject to a minimum employment requirement. Investments in regions gravely affected by the war are granted full corporate tax exemptions. Investments in other regions receive corporate tax reductions ranging from 25 to 75 per cent of the normal rate. This regional development framework, however, was adjusted in 2009 in order to comply with European Union requirements on regional development and subsidies. Moreover, as with the incentives under the Free Zone Law, all corporate tax reductions are being phased out, and will all be abolished by 2017.

The Investment Promotion Law of 2000 (also amended in 2006 to adjust incentives to European Union requirements) marked a shift towards incentives encouraging specific contributions from investment, including the creation of new jobs, the encouragement of large capital investments, education and professional development, as well as investments in technological development, innovation centres, and strategic business support services. Incentives include lower corporate tax rates and exemptions from customs on certain imported equipment. As a general rule, investments with larger contributions in terms of capital value and employment, receive larger incentives. Incentives include corporate tax rate reductions or exemptions, as well as subsidies for employee training programs, infrastructure construction and new machinery. In cases where an investment is considered to have particularly high contributions, the Government can provide discretionary corporate tax reductions.

Analyses of Croatia's investment climate by sources such as the World Bank, the European Bank for Reconstruction and Development (EBRD), the European Union, and commercial services of large home countries such as the United States, point to the continuing need for improvement in Croatia's business climate. These criticisms do not necessarily relate to the content of business laws of Croatia, but are more related to problems with their enforcement, bureaucratic procedures, corruption and, overall, a generally higher cost of doing business compared to competitive locations in Central and Eastern Europe. According to the 2010 World Bank Doing Business rankings, Croatia is 103rd among 183 economies ranked by the World Bank in terms of the "ease of doing business". The country stands particularly low in "employing workers" (163rd), "construction permits" (144th), "protecting investors" (132nd), "starting a business" (101st) and "registering property" (109th).¹³ In the past few years, however, there have been

several reform efforts to improve the business climate (see box III.1).

On the surface, Mozambique's tax regime is not very competitive, although this is offset by a series of exceptions and incentives. The official corporate income tax rate is higher than that of Mozambique's peers,¹⁴ although it has dropped from 35 per cent (over the 1999–2002 period) to 32 per cent (from 2003 to 2007). Mozambique has not been nearly as active in the area of double-taxation agreements as Croatia, creating potential additional tax liabilities for foreign investors. Nonetheless, agreements have been signed with important FDI source countries including Portugal (1991), Mauritius (1997) and South Africa (2007).

Box III.1. Efforts to improve the business climate in Croatia

The Government of Croatia has recently undertaken efforts to improve the country's business climate. One major area of reform has been that of the courts. Efforts have aimed at reducing the backlog and length of cases and bankruptcy procedures. Other reforms related to the cadastre and the land registry which, apart from harmonizing the data, introduced a user-friendly system to search the databases online. The number of backlog land registry cases at the courts was reduced by 70 per cent from 2004–2008. To streamline unnecessary bureaucracy, the Government launched the "e-initiatives" in 2005. The initiative has shortened property registration, which could sometimes have taken several years. Moreover, company registration, tax submissions, and registration of pension and health services can be done online.

In 2006, a project (the so-called "Hitrorez" project, assisted by the United States Agency for International Development (USAID)) was initiated, aiming to eliminate thousands of laws that unnecessarily complicate business. During the first phase of the project in 2006–2007, the project identified some 799 regulations to be simplified or eliminated.

/...

Box III.1 (concluded)

Out of 501 recommendations accepted by the Government, 70 per cent had been implemented as of mid-2009. The second phase of the project was the establishment of the Office for Regulatory Impact Assessment (RIA), an initiative that has been supported through European Union programme assistance.

Foreign investors in particular have also seen an improved business climate in recent years. Since 2005, IPA has helped foreign investors navigate regulations, as well as identify and apply for fiscal incentives. Frequent consultations with foreign investors have also allowed the Croatian Government to improve the quality of legislation. For example, the American Chamber of Commerce (AmCham) in Croatia, along with other foreign trade chambers, persuaded the Government to make some adjustments to the Law on Foreigners (amended in 2009) in order to reduce some of the requirements for temporary residency that were imposing a burden on companies when bringing staff and their families into the country.

Mozambique made use of general and specific tax incentives early on. These incentives have created a significant wedge between the standard and effective tax rates faced by investors. Mozambique's tax incentives were first laid out in the 1993 Code of Fiscal Benefits, which applies to eligible investments under the 1993 Investment Law. The Code of Fiscal Benefits has enabled foreign investors to bypass much of the uncompetitive and convoluted general tax regime on business, and provided tax exemptions, reductions, and deductions (box III.2). These incentives have often been linked to specific Government objectives, such as technological development, skill dissemination, regional development, and infrastructure reconstruction. For example, the fixed investment tax credit offered by the Code is currently doubled and even tripled for investments in the less developed Central and Northern provinces.

Box III.2: 1993 Code of Fiscal Benefits – Standard Measures

- Exemption of import duties (art. 13);
- Investment tax credit (5 per cent of investment in fixed assets for 5 years, deductible from corporate income tax (art. 15). This credit was higher in the early post-conflict years;
- Accelerated depreciation (twice normal rate under corporate income tax). Rehabilitation expenditure included (art. 16);
- Corporate income tax deduction for advanced-technology equipment (15 per cent of taxable income for first five years) (art. 17);
- Corporate income tax deduction for professional training of Mozambican workers (5-10 per cent of taxable income) (art. 18);
- Corporate income tax deduction for construction and rehabilitation of physical infrastructure/public utilities (120 per cent in Maputo and 150 per cent in the provinces) of value of expenditure for first 10 years (art. 19);
- Exemption from stamp duty (first five years) on corporate capital and 50 per cent reduction in property transfer tax in agro-industry, industry and hotels (first three years) (arts. 20 and 21).

Export processing zones, and the associated incentives, were foreshadowed in the Investment Law and further elaborated on in the Code of Benefits. These were termed Industrial Free Zones (IFZs), for single or integrated activities, and Special Economic Zones (SEZs), for larger areas. These provide exemption from import duties, including value added tax (VAT), a 60 per cent reduction in corporate tax for 10 years, as well as an exemption from real property transfer tax. The Mozal aluminium smelter was eventually developed as a designated IFZ and other large industrial investments similarly have IFZ status. Rapid development zones (RDZs) were also designated, which provide an investment tax credit of 20 per cent for five years and the same exemption from real property tax offered to investments in IFZs.

In addition to the standard fiscal package and special economic zones, the Code of Fiscal Benefits offers incentives to a limited number of high-priority investment categories provided that these investments satisfy more stringent eligibility criteria and promise to deliver specified contributions. These included an 80 per cent reduction in corporate taxes until 2012 for agricultural investments, as well as exceptional incentives negotiated with the Minister of Finance for investments over \$500 million that are expected to contribute to national and regional employment and economic development. With the help of the World Tourism Organization, a special set of incentives for the tourism sector has been provided, including an extra three per cent reduction in investment tax credit, and accelerated depreciation at three times the normal rate.

Investments in resource extraction have also been granted particular advantages. In the mining sector, a specific fiscal regime was introduced in 1994 in order to provide a competitive proposition to investors in a sector expected to have strong FDI attraction potential. This regime was elaborated on in the 2002 Mining Law. In addition to outlining royalty rates, the law exempts investors, contractors and subcontracts from import and export duties, and investments over \$500,000 are given a 25 per cent investment tax credit for five years (expires in 2010). In 2001, the Petroleum law was passed, providing similar import and export exemptions, as well as a 25 per cent investment tax credit for the first eight years (also expires in 2010).

As in Croatia, Mozambique's business climate is a weak point. According to the World Bank, Mozambique ranks 135th out of 183 countries due to particularly poor performance in the areas of "dealing with construction permits" (159th), "employing workers" (156st), "registering property" (151st), "closing a business" (136th), and "trading across borders" (136th), among others (World Bank, 2007). Thus, it negatively contrasts with top regional performers,

namely Seychelles, Kenya, and especially Botswana, Namibia and Mauritius. On the other hand, the country ranks an impressive 41st in terms of “protecting investors”. Despite the country’s overall weak business climate, the CPI, which has registered major foreign investments and administered the associated special fiscal regime since the early 1990s, can help foreign investors bypass some of these problems.

5. International and bilateral assistance

Both Croatia and Mozambique have benefited from international, regional, and/or bilateral financial aid and technical assistance. Early in the post-conflict years, loans and grants from international financial institutions and donors were crucial sources of financing to the governments for the rebuilding of physical infrastructure, which was an important precondition for attracting FDI. Financial and technical assistance also played a key role in institutional reform and the development of government programmes, especially in Mozambique. Multilateral investment guarantees and financing to major private sector projects were also important for FDI facilitation.

The World Bank has been perhaps the largest source of official financing for Croatia, particularly in the area of infrastructure. Of the \$2.5 billion lent to 41 projects in the country from 1989 to 2009, 33 per cent went to the transportation sector and 24 per cent to the water sector. Early funding went towards emergency reconstruction (\$128 million), highway construction (\$80 million), emergency transport and mine clearance (\$102 million), investment recovery (\$30 million), reconstruction in Eastern Slavonia (\$41 million), as well as railway modernization and restructuring (\$101 million). Although social projects (e.g., greater efficiency of public administration and the legal system) are becoming more prominent, physical infrastructure remains a key recipient of Bank funding. Some of these projects, such as the

proposed Rijeka Gateway II port upgrading, provide a direct opportunity for the participation of FDI (box III.3).

European regional financial institutions have also been very important to Croatia's economic recovery and policy reforms, particularly as the country has moved towards EU accession. Like the World Bank, the EBRD has provided significant financing for physical infrastructure, especially early on. From 1994 to 2007, the EBRD extended loans worth \$2.2 billion to finance a variety of projects with a total capital value of \$6.3 billion. Infrastructure projects accounted for 42 per cent of the total value, primarily in the area of transportation and electricity (EBRD, 2007). Of the 102 projects carried out by the bank over this period, 34 were implemented in the immediate post-conflict period, from 1994 to 1999. Since 2001, the European Investment Bank (EIB) – the European Union's financing institution – has lent \$1.8 billion. The rehabilitation and expansion of infrastructure (transportation infrastructure, in particular) has absorbed 64 per cent of this total. However, the Bank is currently expanding its financing activities to include more focus on the environment, health, and education sectors.

Moreover, the European Commission (EC) itself has provided substantial assistance, totalling 887 million euros from 1991 to 2006. Up until 2000, this assistance was focused almost solely on humanitarian aid, refugee return, democratic reforms, and human rights. From 2001 to 2004, however, the scope of this aid expanded to include some business climate reforms and SME programmes, as well as initiatives to improve public services and build administrative capacity. The United Nations Development Programme (UNDP) often played a role in implementing these initiatives. Since 2005, pre-accession funds, channelled through Croatian ministries and often matched by the Croatian Government, have focused on preparing the country's institutions for eventual integration into the Union. This aid has included several regional

infrastructure projects and sectoral programmes, particularly in agriculture.

In terms of bilateral assistance, from 1993 to 2008, the United States, a major actor in the peace process and one of the most active bilateral donors to Croatia, channelled a total of \$350 million through USAID, primarily in order to strengthen civil society and Government institutions and regulations.¹⁵ For example, USAID was a major supporter of the Hitrorez Project, which aimed at improving the business climate by reducing unnecessary regulations.

Box III.3. The Rijeka Gateway II project

A recent example of an ODA project aimed at upgrading physical infrastructure is the so-called Rijeka Gateway II project. Rijeka is one of five Croatian ports. The Project, first initiated in 2003, was granted an 84 million-euro loan by the World Bank in 2009.

The project will not only upgrade the port itself but also related infrastructure, integrating the port with the surrounding region. The project is expected to involve significant job creation (potentially 2000 direct and 1000 indirect positions) and to stimulate regional economic activities of up to 200 million euros by 2025. The idea is to develop the Rijeka Port into a financially self-sustained major regional container port with an upgraded and extended passenger terminal. This requires building adequate road connections, a reduction of congestion in the Rijeka Bypass (these are part of the planned project) and, in addition, railway infrastructure modernization along Trans-European Network corridors. The project will open opportunities to foreign investors through the participation in PPPs in the port component.

FDI facilitation efforts by the Multilateral Investment Guarantee Agency (MIGA) and the International Finance Corporation (IFC), both of which are part of the World Bank Group, have also been significant. Although only active in Croatia since 2000, MIGA has guaranteed a total of eight foreign investments

worth over \$350 million, the majority of which were inter-company loans to Croatian subsidiaries of foreign banks.¹⁶ The IFC, the private sector lending arm of the World Bank Group, arguably played a more important role in FDI facilitation in Croatia, especially in the immediate post-conflict period. Beginning with its first project in 1995, the IFC has completed 13 investments through a mix of loans and equity stakes, mostly in the financial, manufacturing and agribusiness sectors, for a total \$519 million. Early investments included a joint venture with an Italian bank in 1995, as well as a capacity expansion of a cement plant in 1997 that had been sold to a Swiss cement company in 1992. Afterwards, the IFC continued to work with foreign investors to provide finance to the banking sector, participating in several privatization-related projects and subsequent lending expansion.

Like Croatia, Mozambique has received financial assistance from various multilateral and bilateral sources to rebuild and expand physical infrastructure, both during and after the conflict.¹⁷ Since joining the World Bank in 1984, Mozambique has received \$3.5 billion in loans from the organization, of which the largest portion has gone into a combination of roads, ports, railways, water and sanitation. The European Commission has also provided significant assistance in this area, with a total of \$851 million between 1994 and 2008, with transportation infrastructure being the main focus. From 1993 to 2007, the regional African Development Bank (ADB) has lent Mozambique \$108.5 and \$72 million for road transport and electricity projects.

Financial and technical assistance from international partners figured prominently in Mozambique's early reform process as well. One of the earliest examples of this involvement was the World Bank's structural adjustment programme in the late 1980s, required by the organization in exchange for providing loans to the Mozambique Government, which was facing a collapsing economy at the time. A key policy to come out of the programme was the

privatization of SOEs, to which the World Bank approved \$501.7 million worth of credits from 1990 to 1995 (White and Bhatia, 1998), although they were criticized for some of the conditionalities imposed (box III.4). In 1990, Mozambique also received technical advice from the United Nations Programme on Transnational Corporations (subsequently a division of UNCTAD) on the country's investment law, on fiscal reforms for mining investment, on investor protection in free zones, on existing fisheries investment agreements and on prospects for investment in the Moatize coal project. During this period, the World Tourism Organization helped the Mozambique Government draft a five-year plan (1995–1999) for the development of tourism in the country.

The technical assistance offered by these international agencies has been followed up since then. For example, the World Bank has been involved in technical assistance programmes focused on creating linkages between FDI projects and local SMEs, as well as some of the redrafting of sectoral investment legislation in the late 1990s and early 2000s. UNCTAD prepared an investment guide on behalf of Mozambique in 2001, and more recently, through its EMPRETEC Mozambique programme, UNCTAD has been developing a training course for the tourism sector, adapting it to meet the requirements of promoting linkages between foreign investors and local firms. Funds to support health and education, business development, as well as public finances in general, have also come from UNDP, ADB, and USAID.

As in the case of Croatia, FDI facilitation efforts by MIGA and the IFCE, have been important, especially with respect to securing industrial megaprojects. Since 1998, MIGA has provided over \$300 million in guarantees to foreign investors in Mozambique, including to major stakeholders in the Mozal aluminium and Sasol natural gas projects, as well as several other oil and gas, transportation and agribusiness projects. The IFC also helped

facilitate some of these investments, for example, by providing loans and quasi-equity to both the Mozal and Sasol projects. It was an especially prominent player in the Mozal project, initially providing financing of \$120 million in 1998. In support of a \$992 million expansion (Mozal II) several years later, the IFC invested a further \$25 million and coordinated lenders for additional \$600 million.¹⁸ The organization has also created a lending programme for SMEs in an effort to stimulate local supplier linkages with the project.

Box III.4. Mozambique's cashew industry and the World Bank

The World Bank received criticism for its insistence on the liberalization of the Mozambique cashew processing industry so quickly after privatization. Their requirement to eliminate export taxes on raw cashews in 1995 was motivated by a desire to expand the sales market and increase prices for rural cashew growers, while limiting the size of the seemingly inefficient cashew processing industry. However, a later study done by Deloitte and Touche on behalf of the Government, also funded by the World Bank, found that this policy had led to unnecessary job losses and had had an overall negative effect on the country's economy. In response, the World Bank tacitly agreed to the re-imposition of export taxes in 1999.

Source: "The cashew industry's sad saga of liberalization", Africa Recovery, United Nations, 2000.

B. Attracting FDI in post-conflict conditions

1. Timing

FDI flows in Croatia and Mozambique began near the ends of their respective conflicts, and picked up very quickly afterwards. This is typically not the case in many areas of the world affected by conflicts. Investors wait much longer before they become convinced

that a conflict country has returned to political and economic stability. But the cases of Croatia and Mozambique suggest that under the right conditions, namely credible peace and strong governmental commitment to economic reform, FDI can respond very quickly to the end of a conflict. This initial FDI can then serve as a signal to foreign investors, triggering an exponential rise in flows over subsequent years.

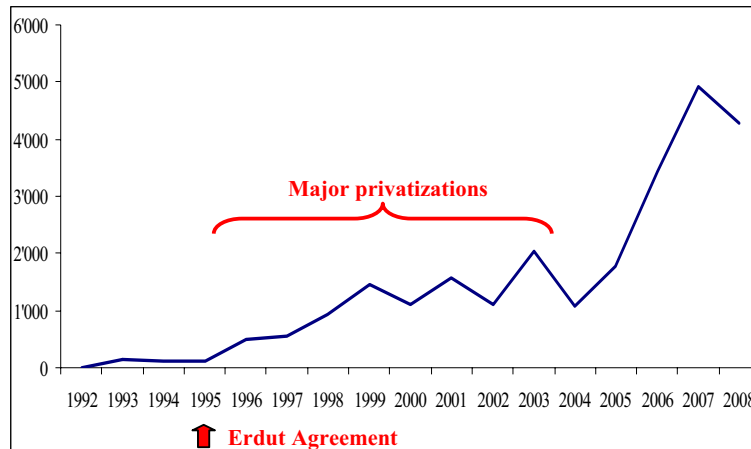
As a part of socialist Yugoslavia during the 1980s, Croatia received virtually no FDI. The economy predominantly relied on SOEs and foreign firms were not active, with the exception of a handful of small projects in the form of joint ventures. Thus, even during the conflict years from 1992 to 1995, Croatia managed to attract more FDI (\$380 million of total FDI inflows) than the whole of Yugoslavia during the much longer period of 1980–1989 (\$72 million). Nonetheless, the conflict still severely limited FDI opportunities (figure III.1). When the conflict ended in 1995, Croatia FDI inflows rose rapidly. Beginning in 1996, FDI inflows increased every year until 1999.

This trend occurred despite the fact that potential sources for further conflict remained in place for at least a couple of years (the territorial dispute concerning the existence of the Serb-controlled territory lasted until 1998). In the case of the Balkans, the strong interest of the European Union in ending the conflict and the involvement of the United States and the United Nations served as guarantees that cease-fire and subsequent commitments concerning peace agreements would be honoured. In an atypical development, it was the United States who became the first large home country for FDI in Croatia, just after the conflict ended in the second half of the 1990s. This likely added to confidence that the United States involvement in maintaining peace in the region was serious and lasting. Another important pre-condition to attract FDI was the successful stabilization programme of 1993, which restored macroeconomic stability. As a result, since the end of the conflict,

FDI inflows have been determined by factors other than the political risk associated with the conflict.

The Government's privatization programme was also an important factor in determining the timing of FDI inflows to Croatia. Major sales of former SOEs to foreign investors in the banking, telecommunications and energy sectors in the late 1990s and early 2000s accounted for the substantial inflows over this period. Further FDI by the initial investors, often financed by reinvested earnings¹⁹ and intercompany loans, in particular, has been responsible for much of the subsequent rise from 2004 on. For example, many foreign banks (mainly from Italy and Austria, later also from France and Hungary) have injected additional capital into their Croatian subsidiaries. These continued inflows of FDI are indicative of the fact that existing investors considered Croatia as a good and safe investment opportunity.

Like Croatia, Mozambique has increasingly attracted FDI throughout the 1990s and 2000s. Figure III.2 compares annual FDI inflows to Mozambique on a per capita basis with those of its peer group – the African non-oil exporting LDCs. At the height of the conflict, Mozambique missed out on the general upsurge in FDI around the world. However, it is interesting that FDI inflows to Mozambique began recovering, from a very low level (Mozambique attracted only \$3 million of FDI on average per year between 1980 and 1989), two years before the conflict formally ended in 1992. Conditions had already improved and some FDI occurred in anticipation of a formal peace settlement. During this period, Mozambique was already revising its investment policies and the Government's privatization programme was in motion. The early recovery in FDI inflows allowed Mozambique to outperform its peers on a per capita basis from 1991, a year before peace was signed. This outperformance predates the arrival of the much discussed megaprojects, which began with Mozal in 1998.

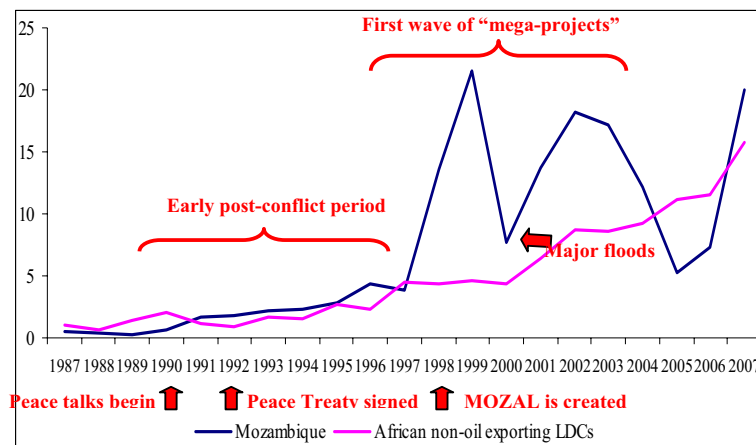
Figure III.1. FDI inflows in Croatia, 1992–2008 (\$ million)

Source: Croatian National Bank – <http://www.hnb.hr/eindex.htm>.

Unlike in Croatia, where a major determinant of FDI trends has been the privatization of large SOEs in the service sector, the spikes in FDI inflows to Mozambique after the late 1990s can be mostly attributed to the sheer magnitude of megaprojects in industry and raw materials. The most notable megaproject, Mozal, an aluminium smelter, started in 1998 and went into production in 2000, followed by an additional capital investment several years later. Other major projects that have impacted the general FDI trends of Mozambique since the late 1990s include the Sasol natural gas project (initiated in 2001 and completed in 2004), as well as projects relating to steel production, titanium and coal mining, and a possible oil refinery to be constructed in the coming years. Geography has also featured strongly with severe weather events (such as the major floods in 2000 and drought in 2002–2005),

inflicting major damage on the Mozambican economy, thereby creating sharp declines in FDI inflows.

Figure III.2. FDI inflows in Mozambique – per capita, 1987-2007 (\$)



Source: UNCTAD WIR/TNC database.

2. FDI by sectors

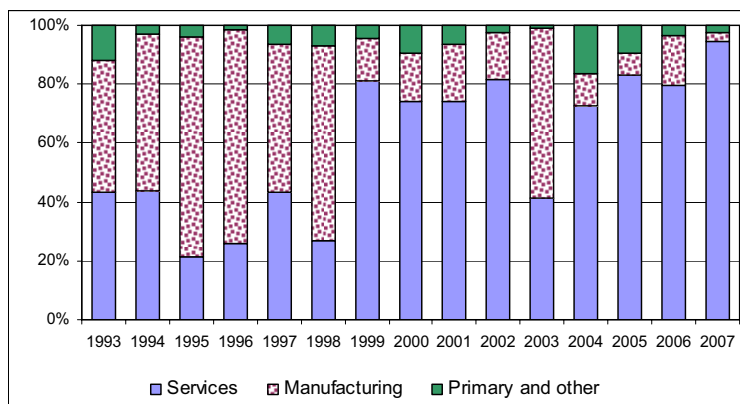
Being quite different countries in terms of resource endowments, human capital, geographic location and pre-existing State assets, it is not surprising that the sectoral distribution of FDI in Croatia and Mozambique has been very different.

Croatia's FDI has primarily gone into the service sector (71 per cent of total inflows from 1993 to 2008), and has largely focused on serving the domestic market. The scale of service FDI is due primarily to banking and telecommunications privatization in the late 1990s and early 2000s (figures III.3 and IV.1), although wholesale and retail trade have been important sectors as well. In

fact, mergers and acquisitions (M&As) are the prevailing form of FDI in Croatia, accounting for 61 per cent of total FDI inflows from 1992 to 2007. Although it has been attracting a declining share of total FDI inflows, the manufacturing sector, and the chemical industry in particular, was an important recipient of foreign investment in the immediate post-conflict period, from 1994 to 1998.

The banking sector has been the largest recipient of FDI, a process jumpstarted by privatizations in the late 1990s. From 1993 to 2000, the number of State-owned banks dropped from 26 to 3, while the number of privately-owned banks rose from 18 to 40. Foreign investors were important buyers of both State banks and banks that had recently been privatized to domestic investors. By 2000, foreign banks made up 90 per cent of total banking sector assets, up from 7 per cent just two years earlier (Kraft, 2002: 13). FDI in the sector continued to be strong in the years after, as foreign banks extended shareholder loans to Croatian subsidiaries. From 1993 to 2008, the banking industry received a total of 7.7 billion euros in FDI, by far the largest inflows of any industry. The share of national FDI inflows going into the banking sector has gone from under 5 per cent at the end of the conflict to nearly 60 per cent at its peak in 2007 (Croatian National Bank).

Wholesale trade and commission trade has received the second most FDI, with inflows of 1.8 billion euros from 1993 to 2008. Many of these activities take place in Free Zones, several of which are located within the country's seaports. If FDI in retail trade is added, total inflows to the trade sector rises to 2.8 billion euros. Trading activities make up a substantial share of total employment and are a reflection of rising domestic consumption and the entry of large-scale foreign retailers and investors in shopping centres and outlets.

Figure III.3. FDI inflows into Croatia by sector, 1993–2007 (%)

Source: Croatian National Bank – <http://www.hnb.hr/eindex.htm>.

The third-largest sector for FDI inflows has been the chemical and pharmaceutical industry (1.6 billion euros). Along with food products and non-metallic minerals (such as cement), this industry was a major driver of FDI inflows during the end stages of the conflict and the immediate period afterwards. Chemical plants were among the first SOEs sold off to foreign investors in 1993. By 1996, the industry received more than half of all FDI inflows. A more recent example of foreign investment in this sector was the purchase of Pliva, Croatia's largest pharmaceutical company, by United States-owned Barr for \$2 billion in 2006.

The petroleum refining sector only began receiving FDI in 2003, but has since amassed total inflows of 1.5 billion euros, making it the fourth largest industry in this regard. These investments have been due primarily to the partial privatization of INA, a former SOE with several oil refinery assets, to Hungarian-owned MOL Group. Following an initial purchase of 25 per cent of

the company's shares in 2003, MOL became the largest shareholder in 2008, with an ownership stake of just under 50 per cent.

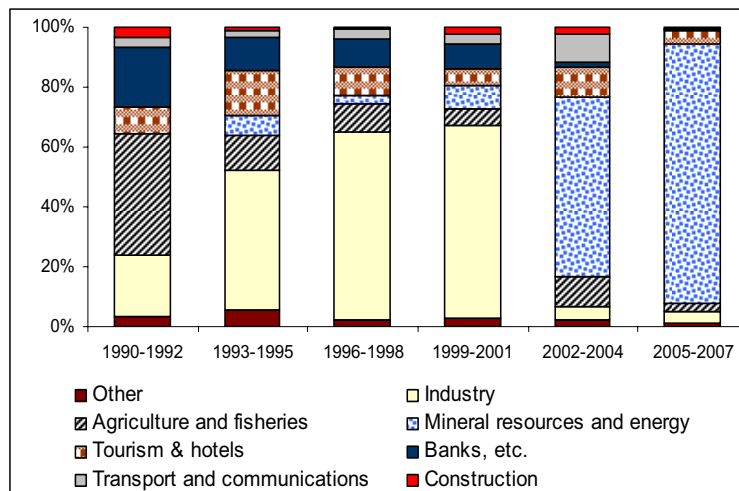
The information, communications and technology (ICT) sector comes in fifth among industries with FDI inflows of just under 1.3 billion euros from 1993 to 2008. As in the banking sector, these inflows were driven by privatization sales. In 1999, 31 per cent of the shares of SOE Hrvatski Telekom were purchased by Deutsche Telekom for \$850 million. The initial privatization has been followed by additional investments, including the expansion of the telecommunications network, costing almost \$1 billion. Although not as significant in terms of capital value, ICT acquisitions made in 1995 by Siemens and Ericsson expanded quickly and have developed into major research and development (R&D) centres for software and telecommunications technologies.

In addition to the sectors mentioned above, FDI has also gone into real estate activities (1.2 billion euros), oil and gas extraction (1 billion euros), and hotels and restaurants (0.6 billion euros) (Croatia National Bank). Presumably, a large share of investments in real estate and hotel and restaurants has been for tourism purposes.

With less foreign involvement in privatization, as well as a relative lack of existing State and private assets, Mozambique's FDI inflows have predominantly gone into greenfield projects. FDI has been most dominant in industry, mineral resources and energy production, but it also initially played a major role in agriculture and, more recently, in tourism (figure III.4). The sectoral distribution of FDI inflows in particular years is highly sensitive to the scale of individual investments. The dominance of large foreign investments in the Mozambican economy can hardly be overstated. By one account, the top 20 investments account for 85 per cent of national industrial growth. There are currently 11 large projects above the Government's \$500 million capital-value threshold that

are in the construction stages. The presence of natural resources, as well as Mozambique's improving electricity and transportation infrastructure, are partly responsible for this trend.

Figure III.4. Sector and industry share of foreign direct investment in Mozambique by year of approval (1990–2007)



Source: CPI.

Note: Due to a lack of data on sectoral FDI in Mozambique, figures are based on the *expected* FDI value of projects with over 25 per cent foreign equity and are, therefore, are not directly comparable with yearly FDI data. FDI inflows according to this data can often lead “real” inflows by one or two years.

FDI in agriculture and agribusiness has been a priority since the late stages of the conflict and immediately after. The Government wanted FDI to provide employment in rural areas, to create markets for small-holder farmers and to serve as a basis for regional development. As mentioned earlier, this sector was a major

target for privatization sales. Although small and medium-sized farms (including agricultural land) and businesses were sold primarily to local investors, larger state-owned farming assets were also sold to foreign investors. Throughout the 1990s, major projects were initiated in several provinces, mostly in the growing and processing of cash crops, such as coffee, cotton, sugar, timber and tobacco. These investments were often in the form of joint-ventures with the Mozambique Government. More recently, there has been a surge in biofuels projects, exemplified by ProCana, which is producing ethanol from sugar and has anticipated capital investments of \$500 million over 15 years. Other notable agricultural projects include a 40,000 hectares teak plantation in Niassa, initiated by a consortium of Norwegian and Swedish investors. In Cabo Delgado and Niassa, foreign investors are developing “game farms“, which will double as hunting preserves and meat-production facilities.

FDI in manufacturing also began relatively early in Mozambique, and increased dramatically in the post-conflict period, especially with the arrival of megaprojects in the late 1990s. Two of the first major FDI projects came out of the country’s privatization programme: the 1992 sale of Cimentos de Mozambique to Portugal’s Cimpor, SA for \$20 million, as well as the 1995 sale of Cervejas de Mozambique for \$14 million to Indol, a Dutch subsidiary of South African Brewery. These were followed in 1996 by several foreign investments in food and beverage manufacturing, Coca-Cola and Parmalat being among the investors involved (CPI data). But these early inflows were later dwarfed by FDI in megaprojects, the most notable being the Mozal aluminium smelter, which was commissioned in 1999 and received additional FDI in 2001 for an expansion completed in 2003 (box III.5).

Since the early 2000s, FDI has increasingly flowed to the mineral sectors. As with the manufacturing sector, these inflows have been dominated by megaprojects. One of the first such

projects, approved in 2000 at a capital value of \$103 million, was the Kenmare Resources Moma titanium sands project in Nampula Province, which has since been followed up with further investments. In 2002, another titanium mining project, Limpopo Corridor Sands, with Australian investor WMC Resources, was approved for construction in Gaza Province, with a total expected capital investment of \$1.2 billion. However, the project still remains in the planning stages.

Mozambique's first hydrocarbon project, the Temane Gas Project, was initiated in 2001 with an initial capital commitment of \$1.2 billion, and started production in 2006 (box III.5). The project, which involved a joint venture between South Africa's Sasol, the Mozambique Government, and the IFC, began a trend of foreign investment in the energy sector. For example, Suez of France has taken a lead in designing and developing a 500-MW gas-fired plant at Sangusia on the South African border, out-taking the Government share from the Sasol pipeline. Major coal extraction projects have been planned for the near future, which has, as a result, spurred significant foreign investor interest in coal-fired power plants. In 2007, a petroleum refinery with a total capital value of \$5 billion was approved for construction in Nampula Province, to be headed by Ayr Logistics of Texas, United States.²⁰

In 2003, Mozambique received a significant foreign investment in the telecommunications sector, with the arrival of Vodacom Mozambique, a joint venture mobile telephony firm majority-owned by South Africa's Vodacom. Although the FDI involved in this greenfield project was only \$59 million, the total capital value of the project was expected to be nearly \$570 million (CPI data).

Box III.5: Mozambique's "mega" FDI projects

The *Mozambique Aluminium Smelter* ("Mozal") was the first major foreign investment project in Mozambique and remains the anchor of the Maputo Development Corridor linking Mozambique to South Africa. Commissioned in 1999 with a current capital value of \$2.2 billion (including an expansion finished in 2003), Mozal is the largest industrial development project thus far in Mozambique, accounting for over 50 per cent of Mozambique's national foreign-exchange earnings, export revenue and manufacturing output. The third-largest aluminium smelter in the world, it currently produces 570,000 tons of aluminium ingots annually. The plant imports alumina from Australia, coke from America, and electricity generated at Cahora Bassa in Mozambique's Tete Province and routed for roundabout transmission (in the absence of direct North-South transmission capacity in Mozambique) through the South African grid and Swaziland back to the smelter. Mozal exports its entire aluminium production through Maputo Port to Rotterdam for processing, distribution and sale across Europe. The Mozambique investment is owned 47 per cent by BHP/Billiton of Australia, 25 per cent by Mitsubishi of Japan, 24 per cent by IDC of South Africa, and 4 per cent by the Government of Mozambique. Mozal's management identifies four main reasons for the attraction of investing in Mozambique: (a) the proximity of a seaport for imports and exports; (b) "relatively cheap power"; (c) multilingual host nationals available for employment and training; and (d) a competitive package of fiscal incentives (both Mozal and Sasol are housed in IFZs).

Sasol's Temane Gas Project is the only hydrocarbon investment in Mozambique currently in production. A \$1.2 billion capital commitment, it comprises gas field installations, a Central Processing Facility and an 865 km pipeline carrying natural gas to South Africa. Following commissioning in 2004, the project began commercial gas sales in 2006. Under Sasol management, the project is owned by a joint venture composed of Sasol of South Africa (70 per cent), the Mozambican Government's National Hydrocarbons Company (25 per cent) and the World Bank Group's International Finance Corporation (IFC) (5 per cent). Sasol's stated reasons for their presence in Mozambique are (a) a search for additional feedstock

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Box III.5 (concluded)

to keep pace with growing South African demand; (b) determination to get ahead of the pack in initiating Mozambican hydrocarbon exploration and development; and (c) an overarching corporate strategy to expand Sasol's regional market presence and penetration across Southern Africa.

Source: Synthesized from interviews, corporate websites and secondary documentation.

FDI in tourism has made up a relatively small share of total inflows, yet it represented a significant portion of inflows in the immediate post-conflict period, and has grown considerably in absolute terms since. Annual inflows rose from an average of \$12 million per year from 1993 to 1995, and to an average of \$86 million from 2005 to 2007. This trend is exemplified by the experience of Pestana Hotels and Resorts of Portugal, which now operates three Maputo hotels and is preparing to open a nearby resort. This large Algarve-based chain invested in Mozambique as one component of a corporate strategy of internationalization, especially to Lusophone countries. Their current investment of \$50 million will more than double with next year's resort opening. Other major coastal resorts stretch from southern Gaza Province to northernmost Cabo Delgado.

3. Geographic sources of FDI

In both countries, FDI at the end of the conflict and in the immediate post-conflict period came primarily from countries well-placed to assess the local conditions and level of investment risk associated with the aftermath of the conflict. While regional sources of FDI were arguably the most important for both Croatia and Mozambique, significant inflows also came from investors in distant countries who nonetheless had a privileged account of the situation. In Croatia, FDI from the United States, which was closely involved in the peace process and a major source of bilateral aid afterwards,

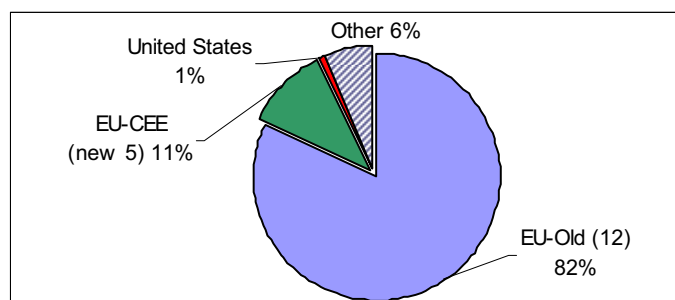
figures prominently in the years after the conflict, although most of these investments were divested soon after. In Mozambique, Portuguese investors, were important, especially in the early post-conflict years, likely due to former colonial ties and a common language. Although it might be expected that the Diaspora (i.e. those externally displaced during and after the conflict) could be a source of FDI through return investment or migration, this does not seem to be the case for Croatia or Mozambique.

Overall, the countries of the European Union have been dominant in terms of FDI to Croatia (figure III.5). From 1993 to 2008, they accounted for 93 per cent of cumulated FDI inflows into the country. Out of this total, “old” EU members accounted for 82 per cent while “new” EU members from Central and Eastern Europe accounted for a small, but significant 11 per cent. The United States has been a small overall net investor in Croatia, with cumulated flows of \$228 million during 1993–2008 (a share of only 1 per cent). In terms of individual countries, Austria has been the largest home country for Croatia’s FDI (with cumulated flows of 5.8 billion euros), followed by the Netherlands (3.3 billion), Germany (2.7 billion), Hungary (2.1 billion) and France (\$1.3 billion). These five countries have accounted for 75 per cent of Croatia’s FDI. Noteworthy is the role of neighbouring countries in Croatia’s FDI: Austria, Hungary and Slovenia, despite them not being significant outwards investing countries on a global level.

The composition of the largest home countries changed significantly during the conflict and post-conflict years. The first significant FDI inflows during the post-conflict period (1995–2000) came overwhelmingly from Germany, the United States and Austria. Over the 2000s, Austria became top source country for FDI, while the Netherlands and Hungary increased their importance. Aside from Deutsche Telekom’s investments in the telecommunications network in 2001, FDI from Germany has not been very significant during this period. Although investors from the United States (key

party in the Erdut peace negotiations), were among the first to enter Croatia in significant numbers, major divestments during 2002–2008 decreased the country's total stock of FDI in the country to an insignificant value.

Figure III.5. Geographical composition of FDI in Croatia, based on cumulated inflows during 1993–2008 (%)



Source: Croatian National Bank – <http://www.hnb.hr/eindex.htm>.

Croatians who fled the country in the late 1960s and early 1970s have represented a pool of potential investors in the country. However, FDI from this source has been rather limited. According to a survey conducted in 2003 by the Club 100 – a grouping of Croatian businesspeople living abroad – the Diaspora in the United States, Canada, Argentina, Bolivia, Chile, Germany, South Africa, Australia and New Zealand possessed \$30 billion in capital and employed 378,000 people. In 2004, the Club 100 held their first international conference in Cleveland, attracting more than 250 Croatian businesspeople living abroad to explore potential cooperation with local Croatian companies. Although the participants publicly declared their willingness to invest in Croatia, one major concern was the fact that Croatia did not offer any special treatment for investment from former nationals. No organized large-

scale investments followed from the meeting, although there were a few individual cases, often connected with unsuccessful privatizations. However, there have also been some positive examples of investments in the tourism sector, particularly hotel chains and supporting services. Croatian nationals who were displaced during the conflict itself have not played a major role in FDI inflows, considering that many were displaced internally or had limited capital.

Although data for Mozambique is more limited, prominent source countries for FDI, in terms of the number of approved projects and their total capital value, have included South Africa, Portugal, the United Kingdom, Mauritius, the United States, China, Australia, Switzerland, Ireland and Japan (CPI). According to UNCTAD, South Africa has been the most significant home country for investment, despite its earlier partisan role in the conflict.²¹ Remarkably, Mozambique quickly set aside any bitterness and instead has welcomed investment from South Africa on equal terms with foreign investment from other countries, although this was largely due to the change to majority Government in the country. As with Austrian, Hungarian and Slovenian FDI to Croatia, South African investors were well placed to assess the political and institutional situation in Mozambique.

Investments from Portugal arrived early after the conflict and have typically been in agriculture, manufacturing or tourism. Available data from UNCTAD shows that the country maintained its position as one of the top investors through the late 1990s and early 2000s. Early privatizations in the cement industry, for example, went to Portuguese investors. At the same time, these investments do not appear to have been driven by a desire of the Portuguese settler community to return to Mozambique.²² Part of this result could be reluctance on the part of the Mozambique Government to approve of investment by former Portuguese-citizen residents who had resettled in South Africa. In the aftermath of

independence, many Portuguese fled and some even destroyed property before leaving. However, Mozambique was not hostile to Portuguese investors from Portugal, and the common language may have helped facilitate their involvement.

Similar to the case of former Portuguese colonials, the Mozambique Diaspora does not seem to have been a significant source of FDI in the post-conflict period. Host nationals who fled the conflict have not committed significant direct-investment resources (only remittances from South African mines). Those displaced by the conflict were mostly poorer rural people who had no business experience and little opportunity in apartheid South Africa to acquire skills or capital.

Notes

- ¹ According to some views transition started earlier, when Croatia was still part of former Yugoslavia, and when central planning was abandoned, enterprises were given greater independence and prices and labour market were liberalized (Sonje and Vujcic (1999): 1).
- ² Constitution of Mozambique. Approved and enacted on 2 November 1990.
- ³ Although, in practice, private enterprises are sometimes still disfavoured in competition with State-owned ones, which receive State subsidies and bailouts.
- ⁴ As of 2009, Croatia has signed 57 BITs and ratified 42 of them. Eight BITs were signed during 1991–1995 (with Albania, Argentina, Chile, China, Malaysia, Poland, Portugal and Romania) and 20 during 1996–2000 (*Source*: UNCTAD BITs database). As will be seen later, there is no correlation between early BIT partners and home countries that started investing in Croatia during the conflict.
- ⁵ Croatia is a signatory to the 1923 Geneva Protocol on Arbitration Clauses, the 1958 New York Convention on the Execution of Foreign Arbitration Decisions, the European Convention on International Business Arbitration and the Washington Convention on the International Centre for the Settlement of Investment Disputes (ICSID).
- ⁶ Croatia's Constitution, which explicitly addresses the rights of foreign investors, precluded the need for this type of legislation.
- ⁷ For national investors the qualifying threshold was set at \$5,000.
- ⁸ As of 2009, Mozambique had signed 21 BITs and ratified 15 (UNCTAD, 2008).
- ⁹ 1988–1999 Privatization Transaction Data: Croatia – <http://www.fdi.net/documents/WorldBank/databases/plink/soceco/1croatia.htm>.
- ¹⁰ White OC and Bhatia A (1998): 113. Positive aspects of the programme included the extent of privatization, the financial impact on government, the performance of privatized enterprises, as well as government commitment to the policy.
- ¹¹ From 1990 to 1995, 92 per cent of privatization transactions were to local investors, primarily in the retail sector.

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- ¹² Foreign investors participated in the sale of larger State enterprises, especially large State-owned farms.
- ¹³ The World Bank Group (2009). *Doing Business in 2010*. The rankings are based on the business environment facing a typical locally-owned firm, and therefore has limitations when applied to FDI, especially if international firms are operating in special institutional environments made available only to foreign investors, such as an investment promotion agency.
- ¹⁴ The average corporate tax rate for a sample of sub-Saharan Africa low-income countries for which data is available from the World Bank, WDI, was 34 per cent in 1999 and 30 per cent in 2002. The sample includes Kenya, Malawi, Nigeria, Senegal, Uganda, the United Republic of Tanzania, Zambia and Zimbabwe.
- ¹⁵ United States Mission to the OSCE, Statement on the Closure of USAID Mission in Zagreb, 29 May 2009.
- ¹⁶ List of MIGA guarantees in Croatia – http://www.miga.org/projects/index_sv.cfm. Presumably, guarantees against currency transfer restrictions were important to these investors.
- ¹⁷ Official Development Assistance to Mozambique Database – <http://www.odamoz.org.mz>
- ¹⁸ Summary of Project Information: Mozal II. IFC website – <http://www.ifc.org/ifcext/spiwebsite1.nsf/projects/2E623B9C3F7533A6852576BA000E2483>.
- ¹⁹ Reinvested earnings have been rising as a proportion of total FDI, from 7.5 per cent in 1997 to 17.4 per cent in 2008 (UNCTAD – online data sheet on Croatia).
- ²⁰ This anticipated investment can largely account for the inflated share of mineral resource and energy FDI between 2005 and 2007 in figure III.4.
- ²¹ UNCTAD, FDI/TNC database. Data are based on information reported by selected economies.
- ²² In 27 interviews, only three instances were collected as exceptions to the pattern described. These include a Lonrho Corporation which actively mediated between the warring parties in Manica Province, a decision by Pestana Group to renovate a Maputo hotel that had sentimental value to the CEO's father, and an ecotourism project connecting Limpopo National Park to South Africa's Kruger National Park.

IV. FDI IMPACT

1. FDI and infrastructure restoration

The immediate aftermath of the conflict in both countries was a significant erosion of physical infrastructure, due to sabotage, insufficient funds, or a lack of security to provide for maintenance. Adding to that, as a least developed country, Mozambique already had a legacy of poor infrastructure even before the outbreak of the civil war. Despite its potential contribution to infrastructure rebuilding, neither country introduced FDI in this sector until several years after their conflicts had ended. There are three reasons that can help account for this: (a) foreign investors generally considered infrastructure projects to be too risky during or immediately after the conflicts; (b) there was limited economic activity with which to anchor infrastructure projects and provide an adequate return to investors; and (c) perhaps most importantly, in the early 1990s the global movement towards the private participation in infrastructure was at its infancy and it would thus be unreasonable to expect it to spread quickly to post-conflict countries. Nonetheless, considering these factors, and compared to peers, FDI in infrastructure was introduced fairly early in the two countries.

As mentioned, prior to the arrival of FDI, financial support from international institutions and aid donors was vital for restoring key physical infrastructure in Croatia and Mozambique. Participation of foreign investment in infrastructure rebuilding came many years after peace settled in. Though attracted with a delay, FDI seems to have had an increasingly important contribution to infrastructure expansion, restoration and/or upgrading in both countries. Yet, international partners have remained a significant source of infrastructure financing.

In Croatia, foreign investment did not contribute to infrastructure restoration during the early post-conflict years. In some infrastructure categories (bridges, ordinary roads, railway tracks, electricity distribution lines), FDI simply has not taken place

at all, or has been an exception to the rule. In rebuilding its physical infrastructure, Croatia relied largely on its own resources and efforts, supported by loans from international institutions such as the EBRD and World Bank (see section III.A.5).

With time, and the necessary legislation in place,¹ FDI started contributing to upgrading and improving some parts of the country's infrastructure, most notably in electricity, telecommunications, water, and road transportation. The first FDI-sponsored project in infrastructure – a \$194 million greenfield project in electricity generation by a German investor – took place in 1997. Five additional investments were made in electricity, transportation and telecommunications (box IV.1) in the two years afterwards. According to the World Bank (World Bank PPI database), the total capital value of public-private initiatives (PPIs) from 1997 to 2000, many of which involved foreign investors, was \$2 billion. Since 2000, seven more projects have been initiated, including an investment in a water treatment plant, for a total capital value of \$5.6 billion. Almost all infrastructure projects in Croatia involving the participation of foreign investors have been greenfield projects, with the exception of Deutsche Telekom's purchase of Hrvatski Telekom and its fixed-line telecommunications network in 1999 and 2001. Most infrastructure projects with FDI participation have been joint ventures with local investors, including private and public companies, and many projects have also benefited from the assistance of international and regional financial institutions. Several projects in electricity generation (one), toll roads (three) and water treatment plant (one) have been based on build-operate-transfer (BOT) or build-rehabilitate-operate-transfer (BROT) contracts. Croatia has used this model to increase the supply of electricity (within a system run by a State monopoly – Croatia did not deregulate electricity transmission or delivery) and to expand and improve its road and water treatment infrastructure. Although not typically considered in this light, one of the biggest FDI successes in

terms of infrastructure rehabilitation and expansion has arguably been the banking sector (box IV.2).

Box IV.1. Foreign investment in Croatia's telecommunications infrastructure

Projects in telecommunications infrastructure in Croatia involved two greenfield FDI projects in mobile telephony and a partial divestiture of the State-owned fixed-line monopoly (which included cell phone provider Cronet) to Deutsche Telekom. By 2008, there were three foreign mobile operators and 12 fixed-line operators, both foreign and domestic.

Altogether these projects have been the result of deregulating reforms of the telecommunications sector, aimed at inducing competition in the sector. The mobile market has been liberalized in 1998, and the formal liberalization of the fixed-line market took place in 2005, after adopting a regulatory framework in 2003 and establishing an independent regulatory authority (the Croatian Regulatory Agency – CTA). Allowing entry of several mobile and fixed operators, both foreign and local, resulted in vigorous competition leading to the expansion and improvement of services, and price, and call rates reductions (Skudar, 2004: 20). As a result, Croatia is one of the most advanced countries of the region with regard to the density of mobile telephony, with 130 mobile phones per 100 people (Croatia 2009 Progress Report, 2009: 37).

FDI in fixed-line telecommunications has also resulted in expanded network, improved services (the network is now 100 per cent digitalized), reduced prices (NCC, 2003: 33) and has had a positive impact on employment (Jovancevic, 2007: 832). However, the incumbent, Hrvatski Telekom, has managed to maintain a strong position in the market, and competition has been slow to develop. Thus, challenges remain before full benefits of a competitive market can be reaped by the economy and consumers.

Despite a limited attempt to use FDI for infrastructure purposes during the early and mid-1990s, Croatia still managed to be more active in this area than other countries from the former

Yugoslavia.² In Bosnia and Herzegovina, for example, out of a total of seven projects from 1990 to 2007, only one was undertaken during the 1990s (in mobile telephony). Similarly, in Serbia and Montenegro, only two out of six projects occurred during this time (both in 1997 in telecommunications). As preparations for such projects take time, Croatia used the conflict and post-conflict years to prepare ground for FDI in infrastructure.

Box IV.2. Contribution of FDI to Croatia's financial system

Banking is an important part of institutional infrastructure of any country and an important component in business environment. Croatia started privatizing banking in the early 1990s, mainly to domestic investors (foreign investors were only allowed to engage in greenfield investment). A massive banking crisis also emerged at this time, leading to fiscal costs estimated at 22 per cent of GDP (Sonje and Vujcic, 1999: 2). Things had not improved by 1998, when domestic banks, still inexperienced and lacking the necessary skills and technology, had run into problems again (World Bank, 2004). Bad debts accumulated and many banks became insolvent. Instead of using taxpayers' money to rescue the banks on the verge of bankruptcy, Croatia, following the example of some other countries in Central and Eastern Europe (CEE), decided to permit foreign investors to buy them. Quickly, FDI came to dominate the sector. The banking system was saved and soon upgraded, owing to the injection of new capital, technology, expertise, transparency and prudent management.

As a result, Croatia's banking system is now considered well developed and highly competitive (EBRD, 2007: 10). In terms of stability and solvency, Croatia matches the level of new EU members from CEE and is close to the level of EU-15, traditional members of the EU.³ FDI in banking helped improve services, resulted in lower interest rates and allowed enterprises more favourable terms of borrowing (NCC, 2003: 33 and Jovancevic, 2007: 832–833). Moreover, the banking sector in Croatia has been largely unaffected by the global financial crisis of 2007–2009.

Looking at the future, a major LNG (liquefied natural gas) terminal (Adria LNG project) is being developed by a consortium of foreign companies, led by E-On (Ruhrgas, Germany) with Total,

OMV and RWE Gas also participating. Involvement of Croatian partners is predicted to be 25 per cent of the project's equity. The terminal, to be located on Krk Island, will be connected to the mainland through pipelines, distributing gas not only to Croatia but also to neighbouring countries, as the re-gasification capacity of the terminal will be four times the Croatian annual gas consumption. The capital required by the project is estimated at \$800 million–1 billion.

Prior to the end of the conflict in Mozambique, all major physical infrastructure had been under State ownership and management. This included electricity, telecommunications, water and sanitation, as well as roads, ports, railways and airports. Moreover, keeping these facilities under State ownership was the intention in the early post-conflict years. Thus, by 1992, there had been no work on the regulatory reforms needed to introduce private investment.

Initial rehabilitation of prime economic assets, such as the Cahora Bassa electricity plant and the ports, were undertaken by the Government with substantial support from international financial institutions and bilateral aid. Among these projects, port and rail improvement were crucial for the delivery of humanitarian relief both to Mozambique and other drought-affected countries. The railways were not safe from pilferage and attack for some years after peace was formally established and this also militated against private investment.

If involved at all, foreign companies in the early post-conflict years participated in infrastructure projects through management contracts without investment commitments. The Government acted by the mid-1990s to initiate port and rail concessions to private investors. But these private investors in turn had difficulty in obtaining debt finance. For example, the Nacala Corridor port and rail concession, which was awarded to a

consortium including smaller foreign investors in the 1990s, did not obtain debt financing until 2005.

The earliest and most significant foreign investments in Mozambican infrastructure have not been for the restoration of basic public services, but for facilities “anchored” by megaprojects – a so-called “development corridors” approach. A study of public–private initiatives (PPIs) since 1990 in 10 post-conflict countries argues that, by leveraging megaprojects to increase the economic and financial viability of PPIs, Mozambique has been an outlier among post-conflict countries in terms of attracting private investment in infrastructure (Schwartz *et al.*, 2004). The key example of this approach has been the Maputo Corridor, where the Mozal smelter is located. The construction of Mozal in 1998 justified major FDI infrastructure projects, including a \$120 million investment in two power transmission lines from South Africa (constructed in 1999–2000), a \$180 million cross-border toll road linking Maputo with the South Africa’s industrial heartland (constructed from 1998 to 2001), as well as a master concession to upgrade Maputo’s main port (box IV.3). The Maputo Corridor initiative helped give momentum to other infrastructure-related FDI in the early 2000s, including projects in rail, water supply, power generation, telecommunications (Vodacom), and can also be seen as a precursor to the 2002 Sasol gas project. In terms of overall impact, some of these projects helped to improve public services (for example, electricity supply in Maputo improved), but the principle focus has been to service large FDI projects.

In comparative terms, Mozambique attracted FDI in infrastructure quite early, due in particular to its development corridor approach. However, the major thrust of FDI in infrastructure is expected in a “second generation” of projects that will not have come into operation until at least 10–20 years after conflict has ceased. The legal scope for FDI has remained largely unchanged, but the practical scope has widened. For example, the

presence of increased industrial activity combined with coal and natural gas deposits is likely to provide the opportunity for new projects in power generation (section III.B.2). Again, rather than directly improving public services, most of these investments will focus on servicing major private sector projects, increasingly in natural resource development. However, new FDI in railways, for example, promises to bring wider public benefits. Electricity distribution, sanitation services and fixed line telephony have remained State operated activities.

Box IV.3. The Maputo port concession

Maputo Port Development Company (MPDC) is a 51/49 joint venture between foreign investors (DP World of Dubai and Grindrod Group of South Africa) and the Mozambican Government. Established in 2002, the project is structured as a BOT port management and operating concession for 15 years, renewable for another 10. MPDC interviewees indicated the investors were attracted to Maputo Port as a neglected and languishing asset with potential to expand into a regional Southern African shipping hub: “a service industry, a world-class port”. They envision increasing their initial \$78 million investment to \$500 million, renewing their concession for an additional 25 years.

2. FDI and revenue generation

Restoration of social services and essential infrastructure after a conflict is an immediate and urgent call on public expenditure. A prospective contribution of FDI is to enhance revenue collection and thus have a positive, though indirect, impact on improving the conditions for peace. Croatia and Mozambique have both relied on privatization, often to foreign investors, as a direct source of government revenues, and as a means to relieve the State budget from the need to subsidize underperforming SOEs. The operations of foreign investors can also be a significant source of tax revenues, as appears to have been the case in Croatia. On the other

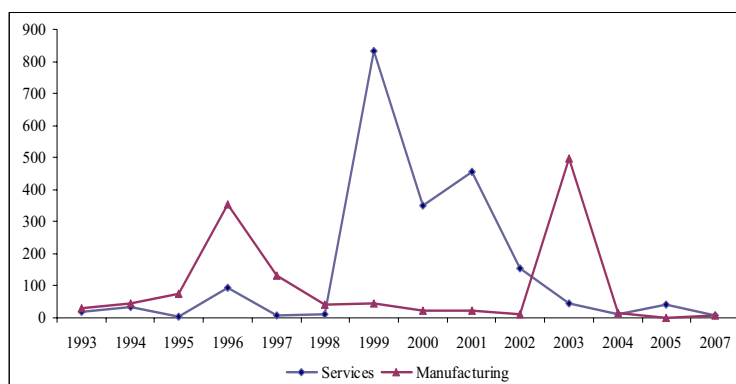
hand, despite attracting similarly large amounts of FDI, tax revenues in Mozambique have remained limited as a share of GDP. The reason for this, and the extent to which fiscal incentives have played a role, is hotly debated.

In Croatia, privatization to foreign investors was a significant source of Government revenues in the immediate post-conflict period. From 1993 to 1998, privatization generated \$845 million of FDI inflows and, presumably, a similar amount in government revenues – 80 per cent of these revenues came from the sale of manufacturing companies (figure IV.1). After privatization extended to the banking, telecommunications sectors, revenues increased significantly (to \$2.5 billion from 1990 to 2003), and the proportions reversed: services accounted for 81 per cent of revenues. The only significant non-service privatization to foreign investors over this period was the sale of oil refiner INA to Hungarian MOL Group in 2008. The largest source of privatization revenue has been the sale of the State-owned telecommunication monopoly, Hrvatski Telekom, to Deutsche Telekom, which resulted in two payments to the Government: \$850 million in 1999 and further \$465 million in 2001 (raising the stake of Deutsche Telekom in the company from 31 per cent to 51 per cent).⁴ By the mid-2000s, privatization had slowed down and privatization-related FDI fell to \$80 million during 2004-2007.

Gains to Government budget from FDI have not been limited to proceeds from the sale of SOEs to foreign investors. As in other transition economies, many SOEs in Croatia had to be subsidized to survive. A case in point are Croatia's five shipyards which have remained State-owned (they are about to be privatized). In the second half of the 1990s, ships were one of Croatia's biggest export items. But losses of shipyards and direct and indirect subsidies exceeded the value of exported ships (NCC, 2003: 32). The sale of underperforming SOEs has thus likely reduced the burden on public finances. Even in the domestic private sector,

foreign investment has often resulted in restructuring and efficiency gains, which decreased the need for government bailouts. This is evident with respect to Croatian banks. Often initially privatized to domestic investors, they soon ended up in problems, potentially requiring huge public resources to save them. After foreign investors were allowed to buy domestic banks, the banking sector was able to stand on its own feet.

Figure IV.1. Privatization-related FDI inflows in Croatia, 1993–2007 (\$ million) (Equity FDI and reinvested earnings)



Source: Croatian National Bank.

Reductions in corporate taxes and/or tariffs on imports, as offered in Croatia for manufacturing investments made in special zones and disadvantaged regions, and for large, employment-intensive investments, have the potential to reduce fiscal revenues. The number of firms receiving incentives, as well as the estimated value of these incentives, has risen steadily in recent years (the equivalent of 100 million euros in 2007).⁵ Moreover, many foreign investors have qualified for incentives under the Free Zones and Investment Promotion Act and thus may be expected to pay less tax

than local firms. However, this does not appear to have been the case in Croatia. From 1996 to 2004, the share of non-financial foreign affiliates in total corporate profits before taxes roughly corresponded to their share of total corporate taxes paid (table IV.1). On the other hand, however, the modest power and use of fiscal incentives to attract FDI may be one of the reasons why Croatia has received less greenfield manufacturing FDI than other countries from CEE. One study argues that “FDI incentives in Hungary have helped with the rapid restructuring of manufacturing industry, increasing Hungary’s international competitiveness, while such changes have taken place quite slowly in Croatia” (Hunya and Skudar, 2007: 29).

Table IV.1 The share of non-financial foreign affiliates in total corporate tax revenues and profits in Croatia, 1996-2004 (%)

	1996	1997	1998	1999	2000	2001	2002	2003	2004
Corporate tax revenue, %	2.4	3.2	3.9	4.1	5.6	6.8	7.5	9.4	10.1
Profits before tax, %	2.5	2.8	3.6	4.1	6.1	7.4	6.9	8.8	10.7

Source: Hunya and Skudar (2007): 28.

It should also be noted that incentives offered by the Croatian Government have primarily concerned corporate taxes. Foreign and domestic investors have been typically required to pay indirect taxes, including VAT, local taxes and employment taxes, although there are often exceptions offered locally. These fiscal contributions are not negligible. In one example, the arrival of foreign and domestic investors into the Varazdin Free Zone resulted in a significant increase in the local budget, opening unprecedented possibilities to the local Government. Between 2003 and 2008, companies in the zone (the majority of which have been foreign) generated 3.43 per cent of total county revenues. These revenues

have been used to upgrade local health establishments, education and infrastructure.⁶

In Mozambique, privatization has also been an important source of Government revenue, particularly during and immediately after the conflict. As mentioned in section III.A.3, foreign investors are believed to have made up 50 per cent of the equity invested in the sale of SOEs from 1989 to 1999. A World Bank report on privatization in Africa estimates overall privatization sales to foreigners from 1989 to 1995 at \$152 million (White and Bhatia, 1998). As in Croatia, privatization added to Government finances not only through sales revenues, but also by reducing the burden of subsidizing SOEs. By the late 1980s, a full 34 per cent of Government spending was going to financing indebted SOEs (Pitcher, 1996). For example, one 1987 study by the Government of Mozambique showed that nine State-owned farms in Nampula Province owed \$25 million, with little prospect of repayment.⁷

Due to rapid economic growth, overall tax revenues in Mozambique have grown quite strongly, but the Government taxes as a share of GDP remains very low (table IV.2). Indeed, relative taxation levels peaked prior to the end of the conflict. This is puzzling, since FDI inflows have been dominated by very large industrial and resource-based projects, which typically generate significant resource-rent revenues. Corporate income tax compared with GDP has fallen somewhat, while the sharpest reduction in contribution has been due to lower taxes and duties on exports and imports. Mozambique revenue collection has been below the sub-Saharan Africa average since 1993, but has had a similar experience as other least developed East African countries (table IV.2). Thus, the country's success in attracting FDI has not led to a commensurate boost in relative Government revenues, making this a controversial subject in Mozambique. Many point to the fiscal incentives given to major projects as the primary reason for this problem, although this argument is questionable (box IV.4).

**Table IV.2. Mozambique Government revenue collection
(% of GDP)**

	1993	1996	1999	2000–2002	2005 (projected)
Mozambique					
Total revenue	13.6	10.8	12.0	12.9	13.2
Of which:					
Corporate income tax	1.0	0.8	0.9	1.3	1.9
VAT			2.7	4.8	5.0
Taxes on international trade	3.5	2.1	2.0	2.0	1.7
Total revenue - others					
United Republic of Tanzania	..	11.9	10.7	10.9	12.9
Uganda	..	10.5	11.6	11.8	12.8
Sub-Saharan Africa	..	20.3	21.4	22.3	24.1

Source: IMF (2005).

Box IV.4. Have incentives reduced FDI-related tax revenues in Mozambique?

There are several reasons to believe that incentives have not been the major cause of low Government revenues in Mozambique.

First, much of the missing revenue has been due to general non-compliance with taxes. One estimate suggests that, in 2002 and 2003, the gap between potential and actual revenue collection was 12 per cent of GDP in the three main taxes – income taxes, import duties and VAT (IMF, 2005). However, three quarters of this gap was made up of non-compliance (particularly in VAT) and the remainder “exemptions” (again primarily VAT exemptions, presumably on basic consumer items and on small businesses). Corporate tax exemptions accounted for only 0.5 per cent of GDP, while the Mozal corporate income tax exemption accounted for 0.1 per cent of GDP. Import duty exemptions accounted for a very modest 0.2 per cent of GDP.

Second, even investment under OECD tax regimes would yield little corporate tax revenue in early years due to depreciation allowances and interest on debt. This would likely depress estimates of “lost” revenue

/...

Box IV.4 (concluded)

from major foreign investments, certainly including Mozal which commenced operations only in 1999.

Third, Mozambique's standard tax rates are high and certain incentives may in part simply reduce the tax burden to competitive levels. By 2003, even after major reforms including those of 2002 the combined corporate rate (32 per cent) and dividend withholding rate (20 per cent) in Mozambique was the highest in the SADC region. This raises the question as to whether an investment would have taken place without the incentives. Much of the focus on the contribution of FDI to Government revenues focuses on the liberal treatment accorded to the Mozal and Sasol megaprojects. However, officials involved in these negotiations believe that the concessions were important to attract such large projects so as to put Mozambique on the world investment map.

Fourth, although fiscal incentives have been given to several important FDI projects, the extent to which these are widely distributed is likely overestimated. In interviews with foreign investors, several emphasized they had received no tailored fiscal privileges. Although some are only now beginning to pay substantial corporate income taxes, this is primarily due to start-up losses. As an illustration, Vodacom spokesmen insisted that, contrary to public perceptions, their Mozambican mobile telephony affiliate is paying substantial national and municipal taxes, duties and fees – e.g., \$313,000 in withholding taxes alone for the month of March, 2008. Moreover, Ministry of Agriculture representatives believe that FDI in cashew, cotton and sugar plantations pay substantial amounts of taxes.

3. FDI and employment

High unemployment, affecting a large majority of the population, is a common problem in all countries recovering from conflict, due to economic collapse and the demobilization of soldiers. Soaring unemployment rates pose a clear threat to sustaining credible peace. FDI, through its direct and indirect job-creating potential, has a critical role to play, as has been clearly

demonstrated in the cases of Croatia and Mozambique. FDI in Croatia has contributed to job creation, yet its reach has been limited, and has varied by sector. In Mozambique, although also unevenly distributed by sector, employment benefits have been more impressive, driven by a focused Government approach. Apart from job creation effects, FDI attracted in post-conflict situations often pays higher wages and can help build human capital. Although data on the latter effects for the two countries have not been plentiful, there are affirmative indications.

During and after the conflict, Croatia suffered from very high unemployment, reaching 20 per cent in 1995. Along with growing FDI in the country, the unemployment ratio has been reduced over time. Following the creation of thousands of new jobs, the share of foreign affiliates in total employment increased from 3 per cent in 1998 to 11.2 per cent in 2004. Yet the impact of FDI on employment in Croatia differs by mode of entry.

The employment benefits from greenfield investment are obvious. Greenfield FDI created 36,302 new jobs during 1996–2004, out of which nearly three quarters were created in the service sector, with the highest number in trading services (14,000), followed by financial services (4,975) and other business activities (1,471). On the other hand, FDI entry through acquisitions of ailing SOEs, with inflated and inefficient employment, led to reduced employment following the acquisition. However, employment has tended to rise after the companies have been restructured and modernized by foreign owners. A case study of 50 Croatian companies (most of them manufacturing companies) acquired by foreign investors through privatization between 1993 and 1998 shows that, in the year of acquisition, these companies employed 18,000 people. By the fourth year after acquisition, employment had fallen to 15,000, yet started increasing by the sixth year (Hunya and Skudar, 2007: 25–26).

Overall, foreign affiliates in non-banking activities accounted for 11 per cent of total employment in 2004 (up from 3 per cent in 1998), but in selected industries the share was much higher: 32 per cent in insurance, 17 per cent in banking, over 13 per cent in textile and leather industries and around 12 per cent in basic metal industry, sewage and retail trade (Hunya and Skudar, 2007: 52). FDI-related employment has been highest in the service sector. For example, employment growth in the retail trade is largely related to the rapid expansion of foreign-owned retail chains, shopping centres and outlet locations. On the other hand, the share of foreign affiliates in manufacturing employment is the lowest among regional peers (Hunya and Skudar, 2007: 20).

Despite some positive signs, FDI-related employment in Croatia seems to have had limited reach. Unemployment in Croatia still remained at a relatively high level of 16.3 per cent in 2007, higher than in all EU countries except Poland and Slovakia. The job creation rate (that is, the share of new jobs in total employment) was very low, 3.5 per cent, while in countries such as Lithuania or Bulgaria it was, respectively, 10 per cent and 7 per cent (EBRD, 2007: 6). This poor performance might be associated with the relatively “hands off” approach to measures aimed at promoting contributions from foreign investment.

Apart from job creation, FDI in Croatia can be associated with higher productivity and wages, when compared to the rest of the economy. Foreign affiliates in the country exhibit higher labour productivity than domestic companies – nearly twice as high as 1998–2004 – thus contributing to the average productivity increase in the entire economy. They also pay higher wages than domestic firms; 33 per cent higher in 2004. High wage and productivity levels among foreign affiliates may also be indicative of on-the-job training.

In Mozambique, new job creation through private investment, including foreign investment, was a high Government priority, because of the need to offer livelihoods to over a million displaced persons and demobilized combatants, and to reduce the fiscal burden of Government support. When peace came, Mozambique had a workforce in formal employment of 500,000, of whom 300,000 were public sector employees. This was a tiny private sector formal employment base in a population at the time of around 14 million. Around 80 per cent of the labour force was in subsistence or smallholder agriculture, rather than in formal employment.

Statistics on employment by foreign-owned enterprises were not systematically collected until 1998.⁸ Investments registered with the CPI (i.e. those over \$50,000 seeking guarantees and incentives) from 1998 to 2007 show that planned FDI projects were expected to employ a total of approximately 137,000 citizens. Compared with the low level of formal employment when conflict ended, this is an impressive contribution. FDI in agriculture and agro-industry was the major employer (43 per cent), followed by manufacturing (21 per cent), and tourism and hotels (13 per cent). Agriculture and agribusiness was also the most prolific employer per dollar of FDI. In this sector, the creation of one job required, on average, \$5,400 of FDI. In manufacturing, it was \$6,200 of FDI per job. In other sectors, the employment gains have been modest, especially in large capital-intensive foreign investment projects in the extractive sector. There has been almost no net new employment in financial services, as the limited FDI has engaged mostly in restructuring and modernizing the banking industry, characterized by inflated employment. Over the period 1998–2007, it took nearly \$25,000 of FDI in banking to create a new job. Aside from the varying labour intensity of different industries, the role of incentives may have had an influence on the sectoral distribution of FDI-related employment (box IV.5).

Box IV.5. Incentives to boost employment in Mozambique

Employment benefits in Mozambique have been associated with the granting of incentives in particular sectors. Agriculture and agro-industry were given the strongest fiscal incentives (apart from the megaprojects) and the employment outcomes are some vindication of this approach. FDI in hotels and tourism, also associated with special incentives, has also been a noteworthy source of employment, as these are industries which can be difficult to revive in post-conflict conditions. On the other hand, Mozambique has never utilized Free Zone incentives to boost employment in labour-intensive manufacturing. Its Industrial Free Zones essentially house the capital-intensive megaprojects.

To these figures on direct employment should be added indirect employment of suppliers. Examples cited by interviewees included 30,000 employees and suppliers at the American tobacco investment in Tete, and 20,000 producer families benefiting from the American cotton plantation and mill in Zambezia. Phase II of the Mozal project (2002) was projected to entail a relatively minor increase of the citizen workforce of 1000 employees. However, direct and indirect job creation of 3,500 including employment during construction was envisaged.

FDI in Mozambique has also contributed to domestic skills building. Several foreign investors interviewed emphasized their vigorous contributions to capacity-building of local staff. Pestana Hotels sends 50 Mozambican employees each year to its headquarters properties in Portugal for intensive exposure to on-the-job and classroom training. Maputo Port Development Corporation (MPDC) has proactively reached out to local technical schools and to Maputo University to recruit student interns for stipend-paying internships (especially in ICT and accounting), leading to permanent staff positions for the best and the brightest. Beyond technical training in in-service skills, investors also emphasized a less tangible capacity-building contribution. Several respondents laid claim to

exposing local staff to “corporate culture”, which they variously defined as international standards of professional dedication, discipline, accountability and transparency, quality control and competitiveness. One of many tragic legacies of protracted conflict in Mozambique, according to these informants, has been the loss of collective memory of formal employment.

4. FDI and small business support

FDI brings with it a package of new technologies and working practices that, when transferred to the local economy, can stimulate economic growth. A key factor determining the benefits that host countries can derive from FDI are the linkages that foreign affiliates create with domestically-owned firms, particularly SMEs. These benefits are especially relevant in post-conflict situations, when local SMEs are often barely surviving. Croatia has initiated several programmes for SME development, but these have typically not addressed FDI. In contrast, Mozambique appears to have made more conscious and proactive efforts to stimulate SME linkages, especially with FDI megaprojects, although the capacity of SMEs to engage in these relationships remains limited. Yet both countries have primarily benefited from spontaneous linkages created through the initiative of foreign affiliates themselves, although these successes have tended to be a more recent phenomenon. Many TNCs are interested in helping and upgrading their clients or local suppliers through upstream and downstream linkages because it makes economic sense: it stimulates sales and/or provides cheaper sources of supply than those from imports.

Croatia has not used measures to directly stimulate FDI support to the local SME sector. It has treated domestic and foreign firms equally and has not used performance requirements vis-à-vis foreign investors. Yet Croatia has had a number of general and sector-specific programmes, especially in more recent years, aimed at building local SMEs capacities, and thus increasing the propensity

of SMEs to form linkages with foreign investors. These initiatives have traditionally been supported by USAID, the EBRD, and more recently, the European Union. The Government has supported SMEs through subsidized loans from HBOR (the State bank for reconstruction and development), and through guarantees offered by HAMAG (the state guarantee agency). The adoption of innovations and technological developments by SMEs has also been encouraged through BICRO (Business Innovation Centre), which provides financial assistance in this respect. In addition, the Government has supported cluster formation and development through its annual SME Development Programme. From 2004 to 2007, the ministry supported 13 cluster initiatives and in 2008, this support was extended to 47 clusters.⁹ Many general measures taken by the Croatian Government to improve the business climate, such as the Hitrorez project and e-initiatives, though directed to all firms, have been of particular importance to SMEs, for which excessive bureaucracy and administrative inefficiency is particularly burdensome.

The only measure specifically aimed at encouraging cooperation between foreign investors and local companies is included in the mandate of TIPA, whose task has been, among others, “matchmaking [foreign investors] with [local] joint venture partners and linking with local suppliers”.¹⁰ There are some signs of progress in this area, as the TIPA has recently expressed support for SMEs within cluster programmes. For example, the Croatian Semiconductor Cluster (SEMICRO) was founded in 2008 by 39 SMEs, in cooperation with TIPA, with the goal of promoting the sustainability of the Croatian semiconductor industry and attracting foreign investment. Also in 2008, TIPA co-founded the CRANE business angels network to link innovative SMEs with foreign and domestic investors (venture capital and private equity funds).

Many FDI contributions to SME development have relied on the initiative of foreign affiliates. In one example, Microsoft,

present in Croatia since 1996, has operated a business development unit with the intention of expanding the market for the company's products through capacity and skills development among potential buyers and value added partners. Microsoft has helped develop, among others, 30 local ICT companies and has at present 370 partners. The company locally outsources a call centre, technical services and accounting, employing some 1,700 people.¹¹ Another example of linkages comes from international supermarket chains in Croatia (Metro, Billa, Spar, Lidl, Mercator, Kaufland, etc.), many of which give product quality support and credit to their local suppliers. In addition, the planned LNG terminal, being developed by a consortium of foreign firms led by EON (Germany), if implemented, will create local linkages during the construction and operational phase. During the construction phase, the project will employ 1,000–1,500 people, creating extensive local linkages. While operational, the terminal will create 50–100 jobs, and an additional 100 through contracted services providers.¹²

In Mozambique, a more proactive initiative for stimulating FDI contributions has been the Government's prescient and persistent campaign to utilize Mozal as a dynamo to drive and develop SME linkages. Those involved believe the keys to this success were threefold: (a) early, determined and sustained commitment by Government regulators; (b) an independently motivated foreign investor; and (c) generous, timely injections of technical assistance from international partners (box IV.6).

Linkage contributions to SME development in Mozambique have also taken place on the initiative of foreign affiliates. Noteworthy examples were highlighted during interviews. Smallholder farmers supplying and supported by agribusiness processing plants (for sugar, maize, cotton and tobacco factories) are the most numerically significant manifestation of this outsourcing. A second example is that of mobile telephony firm Vodacom, which is building a downstream nationwide distribution chain of 1,200

SME exclusive distributorships (with 4,000 indirect employees), with plans to expand to 10,000 subscriber outlets within five years. Finally, MPDC pays \$25 million/year to local contractors and suppliers for goods and services operating Maputo Port.

Box IV.6. Mobilizing foreign investment for SME development

As early as the mid-1990s, the Mozambican Government was aware that national SMEs in industrial services and manufacturing were barely surviving, with low competence, few customers and no access to affordable credit. The Ministry of Industry, with World Bank technical-assistance funding, commissioned a 1997–1998 study of SME development potential. The study concluded that sustained progress was unrealistic without the engine of a major FDI hub. Mozal’s arrival at this precise moment seemed hugely opportune.

In entry negotiations, the Government pressed for inclusion of an upstream SME linkages programme. BHP/Billiton was highly receptive. However, the initial 1999 pilot (with 10 SME suppliers plus service-road-construction subcontractors) was an unmitigated failure. Essentially, all local participants failed to meet Mozal’s procurement requirements for quality and quantity control, and punctual delivery and performance. Additional practical constraints were bundled contracts of a scale and complexity beyond local SMEs’ capacity, and English-language contract documentation.

At this point, with the programme on the brink of collapse, the Government’s Investment Promotion Agency (CPI) stepped in to rescue the flagging effort. In partnership with BHP/Billiton and IFC, CPI ratcheted up the linkages programme when Mozal II was commissioned in 2001:

- Twin SME training and empowerment initiatives were collaboratively designed, for Mozal-II construction and operations respectively, with focus on building local firms’ confidence as well as their technical and commercial competence;

/...

Box IV.6 (concluded)

- CPI acted as matchmaker, pre-screening SMEs to meet Mozal's identified procurement needs;
- BHP Billiton's training and mentoring costs soon rose to \$1 million annually, covering tailored courses on contractor/supplier strategic planning, management, marketing and finance;
- Complementary technical assistance facilitated local financial institutions' capacity to extend affordable commercial credit to SMEs;
- Goods and services contracts were sliced and packaged into locally digestible units (for example, separating smelter landscaping services from garden maintenance);
- 27 initial contracts were distributed among 17 SMEs. This roster steadily expanded to 25 SMEs receiving capacity-building assistance. Today, 250 regular Mozal domestic suppliers and contractors include 90 SMEs. The smelter's local sourcing budget averages \$10 million/month;
- CPI further facilitated Mozal supply linkages by developing the adjacent Beluluane Industrial Park, targeting companies servicing Mozal as well as compatible manufacturing plants; and
- CPI has established a permanent division for SME-linkage promotion, liaison, monitoring and trouble-shooting.

5. FDI in reviving and diversifying exports

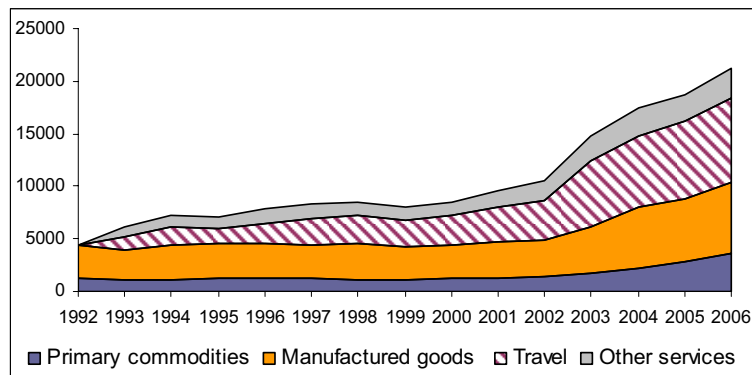
Another major problem facing post-conflict countries relates to the interruption of foreign trade during the conflict and post-conflict years, which hurts traditional exports and limits opportunities in foreign export markets. FDI can assist post-conflict countries overcome the challenge of reviving and diversifying their exports, thus contributing to economic growth and macroeconomic stability. In Croatia, the export contribution of FDI was relatively

small in the early post-conflict years through to the early 2000s, but the situation has changed considerably in recent years. In Mozambique, FDI has been a major factor behind export growth and diversification away from a reliance on agricultural trade, due mainly to the sizeable contributions of megaprojects.

During the conflict and early post-conflict years, Croatia's exports of goods stagnated, falling as a share of GDP, from 30 per cent in 1994 to 20 per cent in 1997. As one study notes: "Even when the war ended and GDP started to recover, no growth of exports materialized that would be comparable to the achievements of other advanced Central and Eastern European (CEE) countries" (Sonje and Vujcic, 1999: 25). However, by 2000, the share had risen back to a 25 per cent of GDP (NCC, 2003). Exports of services in the post-conflict period rose at a faster rate than manufactures, almost exclusively on the account of tourism receipts (figure IV.2). Croatian exports in general have grown more rapidly and, although they continue to be primarily driven by trade in services, exports of manufactures have increased quickly as well. With services increasingly making up a larger share of exports, Croatia's export structure has diversified significantly since the end of the conflict. However, Croatia has not managed to become a significant exporter of more complex, technologically advanced goods.

In contrast to many other CEE countries (such as Poland, Hungary or the Czech Republic), FDI was not an important factor in Croatia's exports during the 1990s. Even by 2000, foreign affiliate exports as a share of total Croatian exports was only 15 per cent (Hunya and Skudar, 2007), whereas in 1999, it was 80 per cent in Hungary, 56 per cent in Poland and 47 per cent in the Czech Republic. Although its role has been limited, this does not mean that FDI had no impact on exports. A study of 21 manufacturing industries during the period between 1996 and 2002 argues that "FDI has positively and significantly affected exports, but the extent of this impact was relatively low" (Vuksic, 2005: 131).

**Figure IV.2. Croatia's exports of goods and services, 1992–2006
(\$ million)**



Sources: UNCTAD GlobStat Statistics, Goods exports 1992-1994, Galinec *et al.* (2002).

There are several reasons that can explain the inability of FDI to stimulate exports in Croatia until recently. First, Croatia's post-conflict tension with the European Union, related to ethnic issues and cooperation with the international tribunal in The Hague, resulted in the lack of trade association agreements with the European Union and CEFTA; agreements which most CEE countries had been party to since the early or mid-1990s (Sonje and Vujcic, 1999). As a result, trade barriers to Croatia's exports were higher than for its peers, and the difference was growing over time. Given the lack of a clear schedule for the elimination of trade barriers to the dominant regional market, foreign investors were reluctant to undertake export-oriented projects in Croatia. Second, Croatia experienced rapidly increasing labour costs in the mid-1990s, making Croatian labour relatively expensive compared to its competitors. Third, Croatia did not specifically target foreign investors in export-oriented activities. As a result of these factors,

most FDI in Croatia has been to serve the local market, exemplified by the major investments in telecommunications and banking.

The situation, however, has been changing. In the early 2000s, Croatia became a member of WTO, concluded an association agreement with regional trading partners (EFTA and CEFTA), and entered accession negotiations with the European Union in 2005. These efforts greatly increased Croatia's access to foreign markets, and are partly responsible for the more rapid increase in exports in 2002, especially in the manufacturing sector. Moreover, some foreign investors have also argued that labour costs, when adjusted for the high productivity of Croatian workers, are internationally competitive. Many foreign investors have since quickly taken advantage of the opportunity to use Croatia as an export base. From 2002 to 2004, the share of foreign affiliates in total exports rose from 24 per cent to 36 per cent (Hunya and Skudar, 2007). Moreover, foreign-owned firms were found to be 71 per cent more likely to export than the national average. The experience of the Free Zone in Varaždin illustrates the rise in export-oriented production by foreign investors in recent years (box IV.7). Nonetheless, despite the expansion and diversification of trade, booming imports to Croatia have resulted in a growing external debt.

Like Croatia, Mozambique's exports during the 1990s remained at fairly low levels (figure IV.3). The agricultural sector, traditionally dominating the country's undersized exports, had a dominant share and was one of the sole sectors to experience growth over this period. Mozambique's tourism sector, despite the country's remarkable natural assets, was underdeveloped and further decimated due to the armed conflict. However, beginning in the early post-conflict period, the country started experiencing a steady, albeit slow, growth of exports.

Box IV.7: Exports from the Varaždin Free Zone

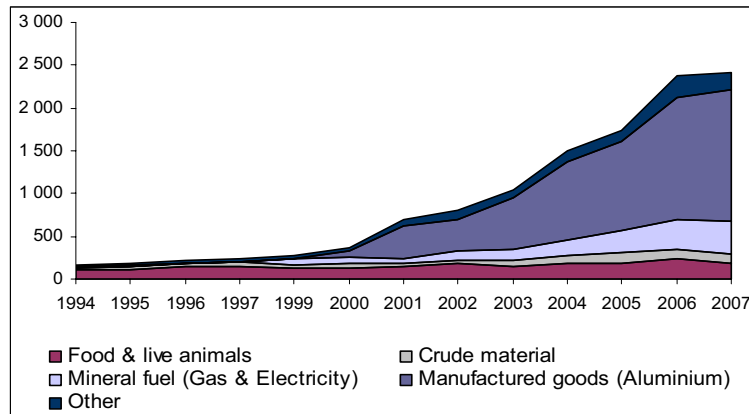
Established in 2001 and located in the North close to Hungary, Slovenia and Austria, the Varaždin Free Zone it is the biggest export-oriented greenfield zone in the country, and the only one that focuses almost exclusively on the production of goods. As of 2008, the zone contained 11 companies (six of which were German or Austrian), employed 2,588 workers, and was responsible for 18 per cent of Varaždin County's exports (350 million euros in 2007) (Mikac, 2009: 11). Products produced in the zone include medical devices, CNC machinery, electro-materials, products from aluminium, and inputs for the automotive industry. For example, locating in the zone in 2005, Austrian-owned Boxmark, a producer of leather seats and components for Audi, Porsche, Bentley, Lamborghini, among others, by 2008 had become the seventh largest exporter in Croatia.

Although FDI contributions to export growth began in the early post-conflict period, the pace of growth accelerated considerably in the early 2000s, after the first wave of megaprojects materialized. This expansion of trade has been driven almost exclusively by FDI projects, especially the Mozal aluminium smelter. In 2006, megaprojects accounted for 70 per cent of goods exports. Although exports of services have lagged those of goods, the tourism sector, which has attracted substantial levels of FDI, grew rapidly from 2001 to 2005, with total receipts rising from \$64 million \$130 million, which corresponds to an average annual increase of 15 per cent (OECD, 2008).

Since 2000, FDI in Mozambique has drastically shifted the structure towards mineral fuels, and electricity, and especially manufactures (predominantly aluminium) As mentioned, agricultural and fish products traditionally dominated Mozambique's exports. For the period 1994–1997, these accounted for almost three quarters of the economy's goods exports. With the start-up of the Mozal aluminium smelter in the early 2000s, the

share of manufactured goods rose enormously, eventually accounting for almost three quarters of the country's exports of goods throughout 1999–2007 (figure IV.3). Taking advantage of the IFZ trade regime,¹³ Mozal produces aluminium from imported raw materials originating in Australia and exports it to the European Union, where Mozambique has benefited from preferential market access. Additional investments in Mozal's production capacity, completion of the Sasol gas pipeline to South Africa, and a rise in electricity export prices charged to South Africa for Cahora Bassa power have also been the main drivers of exports of manufactures and mineral fuel since the early 2000s.

Figure IV.3 Mozambique's goods exports by sector (\$ million)



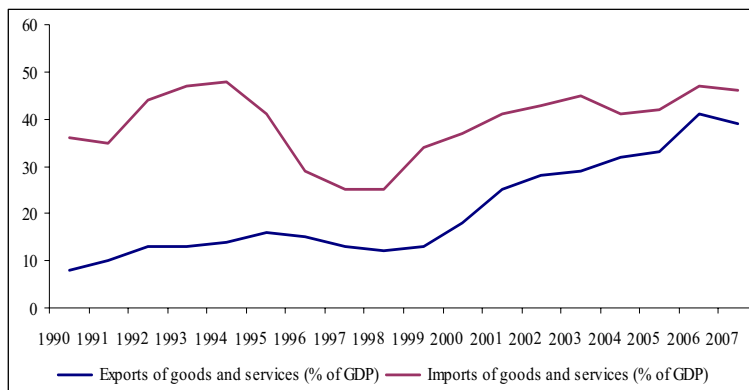
Source: UNCTAD, Comtrade (data available from 1994 onwards).

With the emergence of new export items, the share of traditional agricultural products (e.g. cashews, cotton, refined sugar, tobacco and fishery products) in total exports has diminished, although trade in these products has continued to grow in absolute

terms. These exports have remained significant in terms of their contribution to rural incomes and employment, and continue to benefit from FDI in the sector. Future investments in export-oriented agribusiness are expected to play a major role in this area.

The rise in exports from Mozambique has coincided with rising trade liberalization and access to the markets of its major trading partners, including the European Union and South Africa. Mozambique acceded to WTO in 1995 and in 1999 developed the Trade Policy and Strategy (TPS) of 1999. Already enjoying preferential access to European Union markets, in 2002, Mozambique was declared eligible for access to the United States market under the African Growth and Opportunity Act (AGOA). In terms of regional economic cooperation, Mozambique has been involved in the South African Development Community (SADC), and the Cross-Border Initiative (CBI). South Africa and the European Union have proven to be Mozambique's most important trading partners.

In Mozambique, the sharp increase in exports has led to an increase in imports, as the major exporting megaprojects require foreign machinery and primary inputs, especially during the start-up period. Apart from alumina inputs for Mozal, other major imports are oil, followed by food and chemicals. Nonetheless, the gap between exports and imports seems to be gradually shrinking (figure IV.4). Some import substitution has taken place in recent years, with the increased production of raw and processed agricultural and consumer goods. Although responsible for a significant share of imports, the effect of megaprojects on the balance of payments has been positive. For the first quarter of 2007, for example, megaprojects accounted for 81 per cent of goods exports, but only 24 per cent of imports. At the same time, there is some concern over risks related to the dependence of the country on aluminium exports.

Figure IV.4 Mozambique's exports and imports (% of GDP)

Source: World Bank.

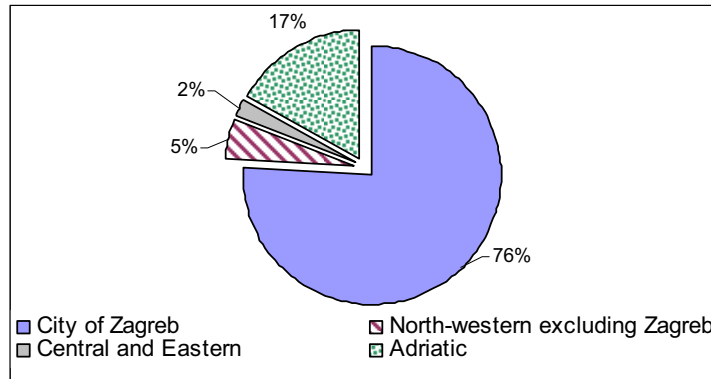
6. FDI in disadvantaged regions

Post-conflict countries often have deep horizontal inequalities, with some regions suffering much higher unemployment rates, as well as lower economic growth. This imbalance can threaten peace, especially if these regional inequalities correspond to divisions during the conflict, as appears to have been the case in Mozambique and Croatia. Although FDI inflows to disadvantaged regions have the potential to help alleviate these inequalities, foreign investment is much more likely to locate in urban and industrial centres, where it can access local skills and markets, and where there is more developed infrastructure. In Croatia and Mozambique, strong regional inequalities existed during and after the conflict, and continue to be evident. Although FDI has certainly been important to the reconstruction and development of regions highly affected by the conflict, it has not been a catalysing force in converging development levels.

In Croatia, significant regional disparities going back to the conflict years remain pronounced (UNDP, 2008). As of 2007, the median household income of the richest two counties (City of Zagreb and Istria County) was 2.9 times that of the three poorest counties in the Central–Eastern region of the country. Similarly, the unemployment rate in Croatia ranged from a low of 6 per cent in the City of Zagreb to just under 30 per cent in Vukovar–Syrmia (a county located in the far East and the site of a major siege during the conflict). The Adriatic region, although also exposed to the conflict, has income and employment levels closer to the national average.

The distribution of FDI inflows has mirrored that of economic activity and employment. According to regional FDI statistics,¹⁴ Croatia's capital, the City of Zagreb, has accounted for three quarters of cumulated FDI inflows from 1993 to 2008 (figure IV.5). The Adriatic region is second with 17 per cent, followed by the North-western region surrounding Zagreb, with 5 per cent. The Central–Eastern region has received the least FDI, with only 2 per cent of the national total.

Time-wise, the City of Zagreb began to receive some limited FDI projects during the conflict, although the volume picked up significantly after 1995, and increased exponentially until 2007. Other counties did not see significant FDI inflows until the late 1990s and early 2000s, and these were mostly in the North-western and Adriatic regions. The rise of tourism-related FDI in the Southern Adriatic region is notable considering that these areas were exposed to significant damage and refugee inflows during the conflict. The areas most heavily affected by the war in the Central–Eastern region only began receiving significant foreign investment in the mid-2000s, and even then, the majority of these projects have been limited to the counties of Osijek–Baranja and Brodsko–Posavska. That said, the County of Vukovar–Srijem which, as mentioned, suffers from the highest unemployment in Croatia, has had some recent success in attracting FDI projects (box IV.8).

Figure IV.5. Cumulated inflows of FDI in Croatia by region, 1993–2008 (%)

Source: CNB.

Mozambique has had similarly high levels of regional inequality. The Northern and Central provinces in Mozambique have traditionally relied heavily on agriculture, and have had lower incomes, and higher rates of poverty than the more industrialized Southern provinces. In 2004, for example, real GDP per capita in local currency was 2,120 (10^3 Meticaïs) in the North, 2,500 in the Center, and 6,354 in the South.¹⁵ At the province level, the richest part of the country has been the Maputo province, which in 2007 had a real GDP per capita of 11,661. These disparities correspond to the regional divisions during the conflict period that pitted the South against the Northern and Central regions of Mozambique (Weinstein and Laudemiro, 2005). Thus, addressing these inequalities has been a high priority of the Government.

Box IV.8. Incentives for FDI in disadvantaged regions in Croatia

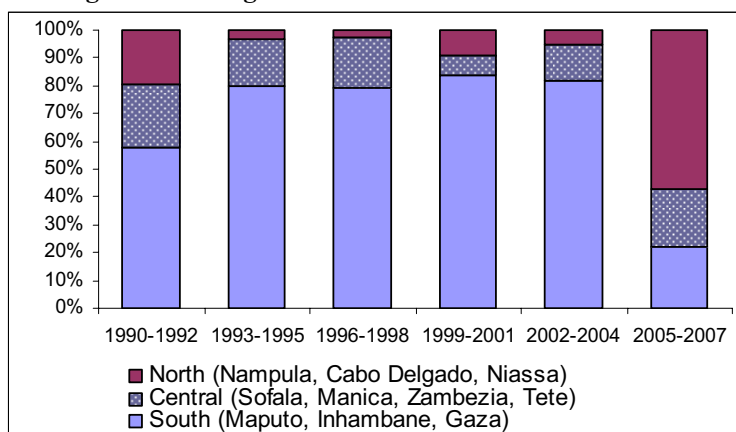
Croatia has provided incentives to promote foreign and domestic investment, in its disadvantaged regions, including areas that suffered damages during the conflict, and the City of Vukovar in particular. A number of these areas also have their own local or regional development agencies that promote investment and development. For example, the local development agency of Vukovar–Srijem County, where the City of Vukovar is located, has been involved with the World Bank and MIGA in efforts to attract foreign investment. The agency maintains a database of projects in the county and actively seeks out potential foreign partners and investors.

Partly due to these efforts, the City of Vukovar has managed to attract two Italian manufacturing projects to its Free Zone, which was established in 2003. The companies, Pezzutto Tekstil (60 employees) and Tiskara Nardi (100 employees), both supply Benetton, a major Italian retail chain. Other investors in Vukovar include Lidl (German retail chain) and Lukoil (15 employees). Two major greenfield investments in manufacturing are also expected: a 22 million-euro factory by Adriatica, an Italian producer of fertilizers, as well as a water cooler factory by a United States–Republic of Korea firm. At full capacity, the two projects will employ up to 125 people.

The Southern provinces, and Maputo in particular, which includes the Maputo development corridor, have clearly dominated FDI attraction, accounting for around 80 per cent of total project value from 1993 to 2004 (figure IV.6).¹⁶ Maputo has managed to capture the majority of national banking, construction, industry (including Mozal), and infrastructure investments.¹⁷ This can be accounted for by the strategic objectives of foreign investors, including proximity to South African markets and Mozambican ports, as well as access to reliable electricity supplies and local consumer markets. Natural resource deposits have also attracted FDI in neighbouring provinces, one example being the Temane gas fields

in Inhambane that were developed by Sasol. Considering that the South was disproportionately exposed to violence during the conflict, the rapid increase in FDI flows to the region has been impressive and an important catalyst in restoring economic activity. Primarily as a result of the megaprojects, the Southern provinces had an average real GDP growth rate of 9.3 per cent from 2001 to 2006, slightly higher than the Northern and Central provinces (UNDP, 2007).

Figure IV.6. Regional share of FDI-related investment



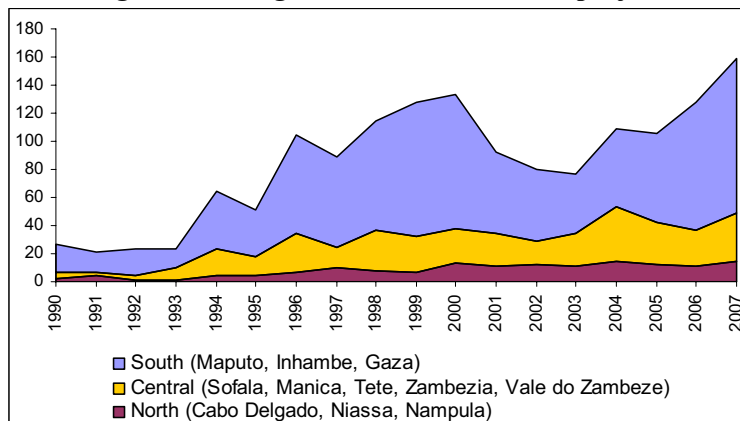
Source: CPI.

Note: Regional distribution of the total capital value of investments involving FDI (foreign ownership must be over 25 per cent).

The Northern and Central provinces have received much less FDI. Two significant recent exceptions have been the Kenmare Resources Moma titanium sands project and a planned \$5 billion oil refinery project, both in the Northern Province of Nampula. The refinery project, approved in 2006, accounts for the inflated share of FDI investment in the North for 2005–2007 in figure IV.6.

Infrastructure constraints in both cases, however, demonstrate the difficulties of locating in this part of Mozambique. During the construction phase of its project, Kenmare Resources had to land equipment on the beach due to a lack of port facilities.¹⁸ In order for the refinery investment to become viable, the project includes plans for the parallel construction of extra power generation capacity and a highway. These constraints limit the potential of megaprojects in the region.

Although the value of FDI inflows to these regions since the conflict has been low compared to the Southern provinces, the number of FDI-related projects in the Northern and Central provinces continues to rise, albeit slowly (figure IV.7). These projects have mostly been in agriculture, minerals and tourism, activities which are predictably more widely distributed at the subnational level, and attract resource-seeking FDI (box IV.9). As a major employer, FDI in the agriculture sector has contributed to improving rural incomes, particularly in the Central provinces. From 1997 to 2003, according to a national poverty survey, the percentage of the population in poverty dropped from 88 per cent to 34 per cent in Sofala, from 68 per cent to 45 per cent in Zambezia, and from 62 per cent to 44 per cent in Manica, while there were substantial drops in other Central and Northern provinces (Fox *et al.*, 2005). Since 2003, however, there is some concern that poverty rates in rural areas have risen (World Bank, 2007).

Figure IV.7. Regional breakdown of FDI projects

Source: CPI.

Box IV.9. Tourism in disadvantaged provinces

The tourism industry is one area where FDI has been increasingly well distributed throughout Mozambique, particularly along its 2,500-km coastline of tropical beaches as well as into largely unspoiled National Parks. For example, Rani Corporation of Dubai “took the plunge” by developing a five-star resort in remote, disadvantaged Cabo Delgado Province. This prestige property, occupying restored and renovated Portuguese colonial buildings, now anchors a successful Pemba tourism zone, encompassing no fewer than 10 additional, less pricey neighbouring properties.

On the other hand, some commentators, such as the Pestana Group, consider tourism-investment expansion to remote provinces premature, in view of weak transportation infrastructure, on-site construction and operating services. Reconciling these positions, the National Director of Tourism called the survey’s attention to the coastal tourism boom gathering momentum in Inhambane Province, outside the Maputo Corridor, but within easy ground access of the capital.

Notes

- ¹ For example, the legislation on concessions (1992), the regulation of monopolies in mobile telephony (1998) and in telecommunications (2003), and on public–private partnerships guidelines (2006) and law (2008).
- ² *Source:* World Bank and PPIAF, PPI Project Database (<http://ppi.worldbank.org>).
- ³ *The Global Competitiveness Report 2006-2007*. World Economic Forum, Geneva.
- ⁴ World Bank (2004): 185.
- ⁵ Ministry of Finance. February 2009. Profit Tax Reliefs, Exemptions and Incentives 2002–2007.
- ⁶ Ikić R. Interview Radimir Cacic Varazdin County Prefect – <http://sutra.undp.ba/index.aspx?PID=26&RID=38>; and Mikac (2009): 12.
- ⁷ Mozambique, Ministerio de Agricultura, January (1988): 20.
- ⁸ CPI. Even after 1998 the job figures are incomplete, thereby potentially underestimating the already significant job-creating contribution of foreign investment. On the other hand, these figures are based on *planned* projects, and the real outcomes may have been lower.
- ⁹ SME Development Program 2008 – results, Ministry of Economy, Labour and Entrepreneurship.
- ¹⁰ TIPA, Invest in Croatia <http://www.apiu.hr/docs/apiuEN/documents/502/Original.pdf>.
- ¹¹ UNCTAD interview with Microsoft Croatia, Zagreb, April 2009.
- ¹² Dr. Michael Mertl “Adria LNG project presentation”, ADRIA LNG, Zagreb, 2 October 2008: 33.
- ¹³ The Industrial Free Zone (IFZ) regime, in place since 1999, has been Mozambique’s main export promotion strategy, with the largest IFZ enterprise being the Mozal aluminium smelter.
- ¹⁴ For data collection purposes, the value of foreign assets spread across Croatia (such as banks, insurance, retail trading and telecommunication companies) are allocated to the location of the company’s headquarters. Since many foreign companies have their headquarters in the City of Zagreb, its prominence in FDI inflows may be exaggerated.

- ¹⁵ Channing A (2007). "Comments on Mozambique: 'The war ended 15 years ago but we are still poor', authored by Joseph Hanlon." National Directorate of Studies and Policy Analysis, Ministry of Planning and Development.
- ¹⁶ CPI (2008). Based on the total value of planned projects involving FDI, and thus include other forms of finance, including loans and funds from local investors.
- ¹⁷ As in the case of Croatia, it is possible that some of the FDI formally attributed to Maputo was distributed more evenly throughout the country due to investments made by companies headquartered in the capital.
- ¹⁸ "Moma project undertakes Normandy-style beach landing." *Mining Review*. Issue 2. 2006.

V. BEST PRACTICE LESSONS

Countries in conflict are not ideal locations for foreign investors to undertake projects. Conflict formidably increases the risks of investing, as it is typically associated with unstable government, destroyed or damaged infrastructure and serious disruptions in economic activities, resulting in falling production, GDP and high inflation – all factors discouraging or preventing FDI. When the conflict ends, uncertainty about the chances for lasting peace remains among foreign investors, since they often are in a worse position than domestic investors to assess developments in a post-conflict country. Therefore, typically, domestic investment and official aid or loans make up the bulk of investment. Nevertheless, post-conflict countries can take steps to actively pursue FDI, and to benefit from its potential contributions to investment, employment, public finances, macroeconomic stability, infrastructure, business development and economic growth in general, all of which can help sustain peace in the long run. Achieving these outcomes requires a balance between, on the one hand, providing a competitive policy environment to compensate for the increased risks facing investors in post-conflict countries and, on the other, maximizing FDI's positive impact on the national economy.

Croatia and Mozambique have balanced these competing agendas effectively, thus managing to both attract and benefit from FDI in their economies. Soon after peace was restored, both countries attracted significant levels of FDI, often matching or exceeding FDI received by their peaceful neighbours and peers. This FDI has had a variety of positive impacts on their economies, which has presumably helped the peace-building process. The experiences of Croatia and Mozambique – even though garnered by two very different countries in different conflict situations – provide some useful insights into measures that can lead to early resumption of FDI, as well as opportunities for FDI to play a meaningful, and positive role in post-conflict situations. On the other hand, differences among them (in terms of geography, levels of development, resource endowment, etc.) mean that some lessons

from Mozambique are not applicable in Croatia (and vice versa). Needless to say, any lessons must be adapted to the specific situations and conditions facing other post-conflict countries.

1. There is no need to wait until the conflict is resolved to start preparing an FDI-friendly environment. It is useful to develop a blueprint for reforms in advance of the peace settlement

In both countries, institutional capacity was weak during the conflict years, creating formidable barriers to intended changes. This weakness extends the time that is required to design and implement reforms and engage stakeholders. Nevertheless, early attention to basic reform measures, along with targeted technical assistance from international partners, can ensure that the necessary legal framework to attract FDI is present in the immediate post-conflict period.

Croatia and Mozambique began to consider key reforms well before the peace agreement was signed and these were introduced, at least partly, late in the conflict years as well as immediately after the peace settlements. An early start can provide the necessary legal and economic stability to offset some of the uncertainty associated with post-conflict investment climates.

Croatia began its transition to a market economy and opened up to FDI at the beginning of the conflict, most notably with its 1990 Constitution, which outlined its post-socialist economic model and equal treatment of foreign investors. These basic principles were confirmed and expanded on during and immediately after the conflict, in various pieces of legislation, such as on the freedom to hold foreign exchange accounts in 1993, as well as the 1995 Company Law. These laws coincided with the beginnings of an extensive privatization programme extended on equal terms to foreign investors. Finally, a successful macroeconomic stabilization plan was initiated and completed in 1993.

Mozambique began reforming the country's economic policies towards market principles and foreign involvement well before the peace accord was signed in 1992. Efforts began in the late 1980s, with a set of structural adjustments under the Economic Recovery Plan, which included, among other aspects, a privatization programme. In 1990, the new Constitution was passed, which was more economically liberal than its predecessor, and made room for foreign involvement in the economy. The drafting of legislation on investment and business taxation was also clearly underway during the peace talks, and some, including the 1993 Investment Law (which also created the country's IPA) as well as the accompanying Code of Fiscal Benefits, were implemented immediately after the conflict.

Initial reforms aimed at reviving investment can be basic. Pragmatism should be a guiding principle. This facilitates their early launch. Specific details, elaborations and improvements, as well as further reform efforts, can be subsequently introduced as the institutional capacity of the government improves.

Croatia's early investment-related rules, most notably those formulated in the 1990 Constitution, were very general. Tax incentives were introduced later and did not typically discriminate between domestic and foreign investors or between sectors. Despite an initial more or less "hands-off" approach to FDI, in recent years Croatia has stepped up efforts to address FDI-related issues, including the passing of an Investment Promotion Law in 2000 with more specific size- and activity-related tax incentives, the creation of a workable IPA in 2002, as well as a series of regulatory and judicial reforms to lower the costs of doing business.

Mozambique concentrated its early investment reforms on a basic investment law and fiscal regime. Mozambique did not overhaul the previous foreign exchange control system (specific legislation on the matter was only passed in 1996), preferring

instead to provide practicable arrangements to qualifying investments. Although the fiscal regime was introduced earlier than in Croatia, and was more targeted by sector and project size, tax incentives were further revised and calibrated throughout the 1990s and early 2000s through other pieces of legislation, such as the 2002 Mining Law.

Early reforms in both countries provided key basic conditions for foreign investment – international standards of treatment and protection, and workable tax and foreign exchange arrangements. More detailed and complex legislation relating to other conditions and requirements tended to come later, especially in the case of Croatia.

International, regional and bilateral technical agencies are valuable partners in the early stages to provide advice on reforms, financial assistance to bolster internal capacity, and to bring an international perspective and facilitate post-war reconstruction.

Mozambique, in particular, made much use of advice and financial aid from bilateral and international agencies while developing its reforms in the years leading to the peace settlement. Technical assistance from a variety of agencies, including the World Bank and UNCTAD, helped compensate for the Government's weak capacity for policy research and administration. By seeking reviews or second opinions on important policy issues, the government also ensured that it was not beholden to any particular source of advice.

There is some evidence that the reform process also gives an early "heads up" to potential investors and can help in advancing the decision to invest once the reforms are promulgated.

During the conflict years, FDI in both countries, though small, was present, showing that an FDI-friendly reform process can

even help mitigate some of the risks posed by conflict. Even small commitments by foreign investors may help encourage further inflows in the future by more risk-averse investors or in sectors requiring additional conditions (e.g. access to international markets or other necessary legislation). Despite the fact that potential sources for further conflict in both countries remained in place for at least a couple of years, FDI started increasing immediately after the conflict, and grew steadily in subsequent years.

2. Anchor the country's FDI-related laws to international standards

The use of BITs, international dispute resolution, WTO legal disciplines and regional agreements, among others, can reinforce investor perceptions of legal stability, which is important for FDI attraction in post-conflict countries.

In both countries, commitments to international standards and proved adherence to international laws, regulations and procedures helped foster confidence by the international business community.

Croatia has signed and ratified numerous BITs (including with the United States), confirming high standards of treatment and protection of foreign investors. Through its BITs and membership in relevant international agreements, Croatia adheres to international standards of dispute resolution, permitting State–investor disputes and referring them to international arbitration. Other multilateral and regional instruments have been used. Croatia has applied the WTO TRIMS, is a member of EFTA and CEFTA, and is currently in accession negotiations with the European Union, which will allow it to piggy-back on its strong rules and regulatory institutions.

Mozambique has also signed several BITs, including one with the United States. These treaties provide the standard

guarantees of protection to foreign investors. Another example of Mozambique's use of international standards was its early membership in the WTO (1995), which demonstrated a commitment to adhere to international standards and enhanced the transparency and predictability of its trade regime.

3. FDI attraction efforts should primarily focus on source countries with an advantage in understanding local host country conditions

Early FDI is most likely to come from regional sources. Investors from these countries can better assess the level of investment risk in the post-conflict country. Other countries with special relationships with the post-conflict country, such as those with language commonalities, or countries with a role in the peace process, may also be potential sources. FDI from these countries can amount to a confidence-building measure, sending a signal that informed investors consider the country a good place for investment.

In Croatia, regional sources, as well as the United States, were particularly important during the early post-conflict years. Investors from neighbouring countries, including Austria and Slovenia, which are not among the major FDI source countries globally, were present. Tense relations caused by unresolved post-conflict issues did not prevent investors from these countries and others in the region from undertaking FDI in Croatia. Although not a major source overall, during crucial post-conflict years (1996–1998), the United States was the top foreign investor in Croatia. Due to the role the country played as a major peace-broker and provider of technical assistance and development aid, United States companies may have had access to credible information regarding local conditions.

In Mozambique, early investments came principally from neighbouring South Africa and Portugal. Although South Africa's

apartheid Government supported Renamo during the civil war, Mozambique was open to investment from the country after the fall of the regime. Investors from Portugal, the former colonial power, also had significant presence throughout the late 1990s and early 2000s. Investors from these countries, due to regional proximity, historical ties, and linguistic similarities, were better placed than more distant countries to assess developments and to respond earlier to emerging investment opportunities.

A large Diaspora with significant assets provides a pool of potential early investors. However, these investors need to be proactively sought out through transnational business networks and targeting efforts.

Though the Diaspora (i.e. citizens who sought refuge abroad) may be expected to be a significant early source of FDI, their access to information on local conditions through their social networks, it did not play a noticeable role in FDI inflows to Croatia or Mozambique. In Croatia, most of the post-conflict migration movements (or displacements) were internal or within former Yugoslav countries. Given the nature of the Yugoslav economic system prior to the conflict, many refugees lacked capital and entrepreneurial skills. Despite the significant emigration of Croatian workers during the late 1960s and 1970s, some of which have since gained control of a significant pool of assets, efforts to engage these potential investors have been limited, and there have been few success stories. Similarly, in Mozambique, host-nationals who fled the conflict have not committed significant direct-investment resources (only remittances from South African mines), as they lacked the wealth and skills to be significant future investors.

4. Generous, targeted incentives may be necessary to secure and extract additional benefits from FDI projects

Post-conflict countries may need to offer above-average incentives (including tax exemptions, deductions, subsidized infrastructure, etc.) to compensate for political risk and ensure competitiveness with their peers. Incentives are often necessary to enlarge the local footprint of FDI projects, which can be expected to be small if the investors face an uncertain environment.

In Croatia, the lack of incentives early on may be associated with the difficulties in attracting greenfield FDI projects in the manufacturing sector, as well as the limited employment generation. The majority of FDI, especially in the late 1990s and early 2000s, has been related to the privatization of financial and telecommunications SOEs, which offer ready-made assets for investors and have relatively little employment benefits. Incentives introduced since the early 2000s, including those related to size of investment and employment levels, have signalled a more proactive approach.

Mozambique offered generous incentives to a limited number of high-priority investment categories, provided that these investments satisfied more stringent eligibility criteria and promised to deliver specified contributions. These fiscal measures show evidence of thoughtful design to promote investment in high priority activities such as the revival of agriculture, to support specific outcomes of job creation, small business and regional development, and to attract megaprojects with which to anchor development corridors. Other specific measures existed to support asset restoration and infrastructure rehabilitation.

These incentives can be seen as “first generation” attempts to galvanize investment, and in due course can be revised as the investment climate normalizes.

As countries recover from the destruction inflicted by conflict on the physical and institutional environment, the use of special arrangements to attract investment can be scaled down. In Croatia, for example, certain fiscal incentives are being phased out, partly in response to EU accession negotiations. The phasing out of incentives will likely prove popular in Croatia, since there has been, as in Mozambique, concerns regarding the unfair treatment of businesses in these locations.

5. Special economic zones are simple ways of creating ideal regulatory environments for FDI in the presence of weak overall business climates

At a time when general national services are in a perilous state, these zones can rapidly offer workable infrastructure and competent streamlined administration of customs and other regulatory services. Moreover, they can facilitate private investment in key physical infrastructure and can be useful vehicles for regional dispersion of investment.

The establishment of special economic zones can offer an easy and rapid solution for magnetizing foreign investment. In both countries, these zones can be linked to the attraction of foreign investment, either under a non-targeted approach (Croatia did not target any specific economic activities or performance) or a more focused approach (Free Zones in Mozambique targeted particular sectors and projects).

For example, the Varazdin Free Zone in Croatia, conveniently located on the border of Slovenia, has succeeded in creating good business conditions through providing cheap land, reduced bureaucracy and tax incentives. The zone stands out in terms of attracting FDI into export-oriented manufacturing activities and has made an important contribution to employment and exports, thereby becoming a model for the rest of the country. Locally

administered business zones have also been important in terms of providing infrastructure and public services. In Mozambique, IFZs essentially house capital intensive megaprojects. The Mozal aluminium smelter was eventually developed as a designated IFZ and other large industrial investments, such as Sasol, similarly enjoy IFZ status. Job creation for Mozambican nationals and the exportation of a significant percentage of production are essential requirements. The IFZ regime has in fact been Mozambique's main export promotion strategy.

Yet, free zones exhibit varying degrees of success, depending also on the quality of government and authorities. Successful examples suggest that local management has a major role to play in turning a legal framework available to all into a best practice. The Varazdin Free Zone in Croatia exemplifies how the quality of local management, local initiative, and perhaps, a business-oriented mentality, are key conditions for a workable and successful free zone regime.

6. Privatization can benefit public finances and attract FDI early on

Countries coming out of a conflict often have weak government finances, making privatization an effective way to generate quick revenue, assuming that there are State assets appropriate for sale and an institutional setup to ensure fair prices for them. The participation of foreign investors in the privatization can speed up the process, as local investors often lack capital, especially in the case of large projects. In addition, foreign companies can bring technology, managerial skills and other expertise, with which to modernize former state-owned enterprises and limit their burden on public finances.

Croatia and Mozambique both raised revenues from privatization sales to foreign investors early in the post-conflict

period (or even during the conflict, in the case of Mozambique). From 1993 to 1998, revenues from foreign participation in Croatian privatizations were \$845 million, while they amounted to \$152 million in Mozambique from 1989 to 1995. Privatization in both countries added to the Government finances not only through sales revenues, but also by creating additional “revenue savings” from reducing the burden of subsidizing ill-performing SOEs. In the case of Mozambique, these costs were debilitating, rising to 34 per cent of Government spending by the late 1980s. Among other benefits, for Croatia, the renewal of the banking sector through privatization to foreign investors reduced the need for expensive bailouts.

Privatization-related FDI carries with it fewer risks for the investor than greenfield investments (one of the reasons being that an SOE is purchased together with its market). Hence, it can be a significant force in increasing FDI in post-conflict situations. Additional capital inflows from the initial investor may ensue in cases of successful privatization, and may subsequently attract and persuade other more risk-averse investors to engage in projects of their own.

In Croatia, the first privatizations took place in the manufacturing sector in the early 1990s (before the end of the conflict). By the late 1990s, privatization was in full swing, exemplified by the sale of the State-owned telecommunications network to Deutsche Telekom. The privatization of banking and telecommunications was followed by further FDI from the same investors in the 2000s, through reinvested earnings and inter-company loans. For example, Deutsche Telekom made a substantial greenfield investment within a few years of the initial privatization.

Although Mozambique’s privatizations were much less significant as a share of overall FDI since the early 1990s, likely due to the small size of state assets, the attractiveness of the SOEs in agro-industry helped drive early FDI inflows. These inflows

reinforced the credibility of government commitments regarding the treatment of foreign investors.

Privatization should be pursued cautiously, with careful consideration of employment and transparency issues.

It is important to recognize the negative short-term effects that the restructuring of SOEs may have on employment, especially considering that employment is a top policy priority for peace-building in post-conflict countries. In Croatia, privatizations initially resulted in job losses, although these were more than made up for by future hiring after a return to profitability. In Mozambique, the privatization and liberalization of the cashew sector resulted in massive job losses, fomenting considerable social unrest. Thus, in a post-conflict country, the revenue effects of privatization need to be weighed against potential job losses, especially if they will take place in regions with already high levels of unemployment.

The process of privatization should also be as transparent and competitive as possible, in order to maximize revenues and encourage a stable legal environment for foreign investors. The main danger in these circumstances is that privatization may lead to the abuse of public funds and resources. Initial privatizations in Croatia, for example, were far from transparent and characterized by many irregularities. Ill-implemented and corrupt privatization was responsible for the bankruptcy of many former SOEs, leading to increased unemployment and shrinking exports. That said, the participation of foreign investors with superior access to capital provides added bidding competition. Also, with few drawbacks to the local political economy, foreign investors can improve the transparency of the privatization process, and reduce the likelihood of political favouritism.

- 7. The employment impact of FDI differs by sector and mode of entry. It may be desirable to offer incentives to encourage investment in labour-intensive sectors, or to limit privatizations and sales of domestic firms to foreign investors, especially in the immediate post-conflict period. However, long-run considerations of efficient labour allocation should not be ignored.**

The capital value of FDI projects often does not relate to its employment impact. Investments in labour-intensive industries will create a larger number of jobs per unit of value invested. Fiscal incentives to encourage FDI in these sectors may be justified, especially in the aftermath of conflict.

In Croatia, greenfield FDI has created the most employment in the wholesale and retail trade sector, some of which has located in Free Zones since the early 2000s. Despite the banking sector receiving nearly three times more FDI in terms of dollar value, it created significantly fewer jobs over the same period. Similarly, in Mozambique, foreign investment has created a very large number of jobs in agriculture and agribusiness, despite this sector receiving very small sums of FDI in relative terms. Agriculture was a major focus of the Government in the post-conflict period and various incentives were provided to encourage its development.

However, attention should be paid to the trade-off between providing short-term employment through targeted incentive regimes on the one hand, and allowing a more market-based allocation of labour on the other. While employment may be an imperative for the immediate peace-building process, it must be properly balanced with considerations of future upgrading into more skill- and capital-intensive activities.

Although immediate job creation is more associated with greenfield FDI, entry through privatizations and M&As may

improve employment in the long run after restructuring. Policymakers should be aware of the relative advantages of both.

Just as incentives for labour-intensive industries may be a key element of peace-building policies, there may be a reluctance to privatize or sell domestic firms to foreign investors for fear of job losses due to restructuring. Croatia's privatization programme resulted in several such experiences, yet employment also tended to rise after the firms were restructured. Moreover, Croatia's loss-making State-owned shipyards are a reminder of the long-term costs that might be associated with an approach that overemphasizes the preservation of employment.

8. FDI cannot be expected to alleviate regional inequalities, but it still has a role to play in improving conditions in disadvantaged regions

The natural tendency in all countries is for FDI to cluster in or near major cities due to proximity of markets, good infrastructure and congenial living conditions for expatriate staff. This tendency is reinforced in post-conflict countries due to infrastructure and poorer security in remote areas. Incentives alone do not seem to overcome this obstacle. At times, these unbalanced FDI inflows may even heighten regional inequalities.

Depressed regions in post-conflict countries are potential sources of instability. The use of strong and well-designed incentives for FDI to locate in these regions may not be sufficient to help alleviate this imbalance. For example, in Croatia, FDI has overwhelmingly gone to Zagreb and the North-western region, despite the presence of location-specific incentives for depressed areas in the Central–Eastern part of the country. Although these incentives have helped attract nominal sums of FDI to these regions, the inflows have been negligible from a national perspective. Similarly in Mozambique, although raw materials megaprojects in

the North and Central parts of the country are being planned, most FDI to this point has been concentrated in the more industrialized South, the Maputo development corridor in particular. From a peace-building perspective, it is concerning that the regions attracting the highest levels of FDI were already the richest parts of the country after the conflict.

Facilitating resource-seeking FDI, which is location-specific, may be the best approach to attracting FDI to regional development. The primary focus of the Government in this case should be on providing the necessary supporting infrastructure.

Resource-seeking FDI, which is less concerned with proximity to consumer markets and human capital, is a more likely realistic way to assist disadvantaged areas. For example, in Croatia, FDI in the tourism sector along the Adriatic Sea has helped increase economic activity in a region that is far removed from the industrial centre around Zagreb. Similarly, new raw material projects in Northern and Central Mozambique, aside from providing modest employment benefits, will help anchor FDI in infrastructure, which can improve the region's investment attractiveness for future investors. The tourism industry in Mozambique, which takes advantage of the coastline and rural scenery, is increasingly locating in the Central and Northern provinces. Also, FDI in agriculture, which was a significant employer, has played a major role in these regions. Obviously, attracting resource-seeking FDI presupposes the existence of resources, in this case raw materials, tourism assets and agriculture, and therefore limits the widespread applicability of this lesson.

In Croatia and Mozambique, tourism and resource extraction investments in disadvantaged regions have been, by definition, in more isolated parts of the country with poorer infrastructure. In the case of Mozambique, this constraint appears to be one of the top factors holding back further tourism investments in

the Northern and Central provinces. Lack of adequate electrical supply and road system has hampered efforts to develop natural resource projects in these regions as well. One solution used by Mozambique has been to link new megaprojects with foreign investments in infrastructure.

9. Backbone infrastructure may not benefit from substantial FDI for several years after the conflict is resolved. During these years, ODA is a more important external source of funding for these projects. Over time, FDI can come to play a more direct role.

Commercial and security risks deter FDI in the early years after war. Also, private foreign involvement in infrastructure requires rather sophisticated institutional preconditions, which may not be present so shortly after a conflict. There is an opportunity for multilateral, regional and bilateral assistance to fill the financing gap and help rebuild infrastructure.

Croatia and Mozambique experienced a slow start in introducing FDI in their infrastructure projects, as the prospect of using FDI in these sectors was limited due to perceived political risk.¹ In addition, major legislation for infrastructure was absent in the immediate post-conflict period. Given the lack of foreign involvement through FDI, official flows of capital were a more influential external funding source for infrastructure restoration and construction, until several years after the conflict was resolved. Both countries made use of extensive loans and grants from the World Bank, regional development banks (EBRD, ADB), as well as bilateral aid agencies. In fact, the majority of funding from these sources went into infrastructure projects. This allowed major transportation, energy, water and sanitation infrastructure to be improved or extended, which also helped improve the investment climate for future FDI.

Development corridors can be useful in mobilizing a cluster of FDI in infrastructure. Successful development needs an anchor project, which FDI is best placed to supply. Development corridors could also be a useful device for coordinating international financial institutions and FDI in their respective roles.

Even after the appropriate legislation is passed and political risk declines, FDI in infrastructure may still not materialize unless there are reasonable expectations of recovering the costs of the investment. Mozambique's experience shows that, in the right conditions, development corridors, which house large megaprojects, can mobilize significant FDI in infrastructure that can improve economic services to the general public, especially via transport improvements in road, port and rail. The Maputo development corridor, which has leveraged the Mozal smelter and Sasol natural gas project in order to raise private capital for related infrastructure investments, is a prime example. This approach allowed Mozambique to attract FDI in infrastructure faster than its regional peers, even those without a history of conflict.

There are opportunities for international financial institutions to support this strategy by teaming up with foreign investors both in major industrial or raw material projects, and in the infrastructure investments themselves. Several projects in the Maputo development corridor, for example, have made use of financing from the IFC as well as guarantees from MIGA.

10. FDI can be successful in raising and diversifying exports

FDI can stimulate export performance of economies emerging from conflict by supporting traditional exports and creating new export opportunities. It can also support export diversification, which helps reduce the volatility of economic growth and incomes.

In the case of Croatia, lack of access to European Union markets, among other things, limited export potential in the immediate post-conflict period. In the early 2000s, as relations with the European Union normalized, exports rose quickly. Over this period, foreign affiliates began to make up a larger share of the goods trade, which helps explain the expansion in manufacturing exports. Exports of services and tourism in particular have also risen significantly. Although the role of FDI in these non-manufacturing exports is less clear, the tourism industry has benefited from FDI inflows.

In Mozambique, FDI has been a more obvious driver of exports. Aside from electricity exports, rapid export growth since the late 1990s has been primarily due to FDI megaprojects in aluminium (Mozal) and natural gas (Sasol). Traditional exports did not rise significantly, but stayed at consistent levels, contributing mainly to rural incomes. In addition, Mozambique's tourism sector, largely untapped, has recently become a main focus of foreign investors in the country and is developing rapidly through substantial FDI inflows. FDI has thus contributed greatly to shifting the trade structure of the economy from agriculture to manufacturing and services, although there is concern over an increasing reliance on commodity-based exports.

Export-oriented megaprojects can generate foreign exchange and improve the balance of payments, and thus help maintain macroeconomic stability.

In the case of Mozambique, the first major FDI project, Mozal, accounts for over 50 per cent of the country's national foreign-exchange earnings and export revenue. Additional investment in Mozal's capacity has reinforced steady export growth in more recent years. The Sasol project, with its natural gas exports to South Africa also has a large impact on trade. Despite of these projects needing to import goods and services from abroad, their

overall effect on Mozambique's trade balance has been positive. However, future macroeconomic stability in Mozambique also requires attention to possible overexposure to price movements of a limited set of commodity-based products.

11. Weak business climates for local firms may hinder their ability to spontaneously link with FDI and create valuable spillover effects. This necessitates either strong reform efforts at the local level or government action to improve the capacity of SMEs to coordinate with FDI.

The presence of FDI inflows does not necessarily indicate an attractive business environment for small and medium sized local enterprises.

A large portion of Croatia's FDI has gone towards the privatization of large banks and services companies, while most FDI in Mozambique has gone into megaprojects. These FDI projects have been administered at a relatively high institutional level, involving considerable contact between investors and Government officials or the investment promotion agency, and thus have tended to bypass many of the regulatory and institutional barriers expected to be prevalent in post-conflict countries. Clearly, it is possible for FDI inflows to be high while the business climate facing local SMEs remains poor. A poor business climate limits the potential of SMEs to expand and innovate to the level required to spontaneously engage in meaningful linkages with FDI, which have the potential to expand beneficial locally-intensive economic activities.

Based on the ratings given by the World Bank Doing Business Report, Croatia and Mozambique appear to suffer from these problems. However, Croatia's reform efforts, including the Hitrorez project, and other reforms focusing on streamlining bureaucracy and increasing transparency, appear to have somewhat improved the situation over the past few years.

While waiting for reform efforts to materialize, it is helpful to have active SME and linkage programmes that either match local SMEs with foreign investors or boost the former's absorptive capacity. These programmes can also benefit from financial and technical assistance from international partners.

Although efforts to connect local firms with foreign partners have not been systematic, both countries have taken some measures to facilitate linkages between SMEs and foreign affiliates. Croatia has not used explicit measures for stimulating FDI support to the local SME sector, although recent initiatives by the Croatian Trade and Investment Promotion Agency as well as efforts to provide capacity to SMEs may result in some linkages. In Mozambique, a much more proactive initiative for stimulating FDI contributions has been the Government's campaign to use Mozal as a dynamo to drive and develop SME linkages.

FDI-SME linkage programmes need considerable public funding and expertise. Thus, post-conflict countries with restricted public finances and limited administrative capacity may find it difficult to co-sponsor these programmes. There is a case for giving these programmes a higher priority for aid notwithstanding all the other urgent calls on donor support in the early post conflict years. In the case of Croatia, numerous international partners, including the EBRD and USAID, for example, have sponsored programmes supporting local SMEs, although these were not specifically focused on linkages. In Mozambique, the Mozal linkages programme has received support from the IFC, along with strong commitments from foreign investors and the Government.

Policy efforts, however, should remember that many linkages are formed at the initiative of the foreign investor. Thus, these investors should have a key role in the creation of government or donor-sponsored linkage programmes.

Despite some successful policies, the overall experience in both countries is that SME linkages most often come about at the initiative of the investor. In Croatia, foreign investors such as Microsoft have been critical for extensive development of skills in local SMEs. In Mozambique, in addition to Mozal, large agricultural and agro-processing investments have been the most prominent developers of linkages, although they have largely done so in the absence of proactive government programmes. Despite the existence of some positive examples, there is still disappointment that FDI and associated programs have not fostered more local business development.

12. FDI helps improve tax revenues in absolute terms, but it cannot be expected to necessarily improve the Government's tax revenue as a share of GDP. Tax compliance and collection, as well as a VAT system, are central to generating sustained revenues for reconstruction and should receive early Government attention and donor support.

FDI contributions to economic activity help raise government revenues, even in the presence of fiscal incentives.

In Croatia, FDI has been an important source of tax revenues, not only through the corporate income tax and VAT, but also through contributions to local Government. For example, the arrival of foreign investors on the basis of incentives into the Varazdin Free Zone resulted in significant increase of the local budget, which was translated into upgrading of local infrastructure and education. Tax incentives provided since the late 1990s and early 2000s also do not appear to have had significant negative effects on taxes paid for foreign companies.

Mozambique, despite attracting substantial FDI, has seen Government revenue rise only in line with GDP, which has kept overall tax revenues low as a portion of economic activity. While

some point to the fiscal incentives given to megaprojects as the primary source for this problem, the key issue seems to have been the relatively late introduction of a VAT (1999, see below), as well as general non-compliance with taxes.

Post-conflict governments can achieve a major boost in scarce revenues by giving serious and early attention to improved tax compliance. Presumably donor programmes can offer important support.

FDI increases the tax base and thus contributes to increased government revenues. Yet, overall poor tax compliance in Mozambique has likely been a serious source of revenue loss, far more severe than fiscal incentives. A 2002–2003 estimate suggests that corporate income tax and import duty incentives reduced budget revenues by no more than 1 per cent of GDP (the net loss is less if the incentives encouraged investment by streamlining a complex tax system). On the other hand, revenue losses due to poor compliance were nine times greater (there is no separate evidence on whether foreign investors were more or less compliant than national investors).

Early attention to developing a VAT system is vital to ensure that revenues are buoyant to improved economic activity, including that generated by FDI.

Value added taxation is a powerful broad-based system of generating tax revenues as it does not require a large bureaucratic apparatus, although care has to be taken to ensure that it does not unduly burden the poorest sections of the population. Croatia introduced a VAT in 1995, which became effective in 1997. In contrast, Mozambique only introduced a VAT in 1999, seven years after the peace settlement. However, it had an immediate and significant impact on revenue collection easily surpassing revenue collections from corporate tax and duties on international trade.

Note

- ¹ Besides, as explained earlier, the global trend towards private participation in infrastructure was at its infancy in the early 1990s and it would thus be unreasonable to expect it to spread quickly to post-conflict countries.

VI. CONCLUSIONS

Burdened by the remnants of conflict, continuing threats of security lapses, significant market failures and weak institutions, post-conflict countries can hardly be described as normal economies. The task of transforming them into vibrant, productive and self-sustaining systems is no simple assignment. Development aid alone cannot transform damaged economies, and it is here that FDI can be a valuable tool for economic recovery and restoration. By examining the successful examples of Croatia and Mozambique, this study has shown that post-conflict economies can attract and utilize FDI in order to help achieve long-term economic growth and stability, which can assist in the peace-building process.

Attracting FDI in the immediate aftermath of the conflict is not wishful thinking. Under the right conditions, namely credible peace and strong governmental commitment to economic reform, FDI can respond quickly. Post-conflict countries should initially aim at establishing the necessary preconditions, such as restoration of macroeconomic stability and basic foreign investment laws. FDI attraction measures in the form of investment incentives and privatization are a useful way to offset the risks facing foreign investors in post-conflict environments. Financial and technical assistance from international agencies has a major role to play both in the reform process, but also in the rehabilitation and construction of infrastructure, which is crucial to FDI attraction. The initial presence of FDI can send positive signals to other foreign investors, triggering an exponential rise in flows over subsequent years. After the immediate post-conflict period, more complex forms of FDI, including in infrastructure, and the corresponding legal framework, can be considered.

Utilizing FDI for economic development requires strategic policy. FDI can have a strong, positive impact on conflict-affected countries, bringing much-needed private capital, technology, skills, government revenue, and by stimulating local industries and exports. Yet, these benefits from foreign investment are not automatic. Left to its own devices, FDI is unlikely to form the

desired level of development links with the local economy. Well-tailored policies, including the use of megaprojects to anchor FDI in infrastructure, linkage and capacity-building programmes for SMEs, competitive and transparent privatization to restructure SOEs, the promotion of resource-based FDI in depressed regions, effective tax collection, as well as other policies explored in this report, can help maximize the potential contributions of FDI. Again, international partners can play a role in the financing and formulation of these strategies.

A solid policy agenda encompasses coordinated measures for attracting foreign investment, as well as for securing and magnifying potential benefits. Yet, taking into consideration the above, there is clearly no “one-size-fits-all” policy solution for attracting and benefiting from post-conflict investment. The adoption of a post-conflict private investment regime needs to be specifically tailored to each county’s level of development and distinctive characteristics.

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