Chapter IV

POLICY IMPLICATIONS

A. The growing role of foreign direct investment in the world economy

The decade of the 1990s promises to be one in which foreign direct investment will play a major role in shaping world economic development and the structure of the international economy. Since recovering from slow growth in the early 1980s, global flows of foreign direct investment have increased far more rapidly than world trade and output, reaching nearly $200 billion in 1989, for a total world stock of $1.5 trillion. Developing countries remain relatively marginalized in the rapid rise of global foreign-direct-investment flows: of total outflows in 1990, $163 billion were invested in developed countries and $30 billion in developing countries. Although flows of foreign direct investment to developing countries increased by 78 per cent in absolute terms between the periods 1980-1984 and 1985-1989, their share in total inflows fell from 25 per cent to 18 per cent. Furthermore, flows to developing countries are highly concentrated, with 10 developing countries accounting for three fourths of total inflows to developing countries. Although current trends indicate a strengthening of the position of certain developing countries and regions, especially in light of the emerging regional core network strategies of transnational corporations, it is unlikely that the declining share of world-wide foreign-direct-investment flows to developing countries as a group will be reversed in the near future, despite efforts by nearly all of those countries to open up their economies to foreign direct investment and liberalize their policy regimes.

The present volume has presented an analysis of the changing structure of world foreign-direct-investment flows. The bipolar foreign-direct-investment pattern of the early 1980s had been transformed by the end of the 1980s into one dominated by the Triad, comprising the United States, the EC and Japan, which account for some 80 per cent of world-wide outward stocks and flows. Part of the reason for the emergence of a tripolar structure is that integration within the EC has reached a level such that the EC can now be properly considered as a single home region. If current trends continue, the EC could eventually surpass the United States as the most important host region for foreign direct investment; Japan, which invests more abroad than does the United States in terms of flows, could soon surpass the United States as a home country in terms of stock.

The rate of growth of foreign direct investment within the Triad has outpaced that in the rest of the world. The increasing share of intra-Triad stock reflects, in part, the growing strategic orientation of transnational corporations from the Triad towards other Triad members. Japanese transnational corporations, in particular, appear to be pursuing a strategy to build self-contained, regionally-sustainable networks of affiliates in each of the Triad members. The low level of foreign direct investment in Japan stands out against an otherwise growing convergence of the Triad members in outward and inward foreign direct investment.

The Triad members individually also dominate foreign direct investment in most other countries. The pattern for over 30 host countries shows a clustering of those countries around a single Triad member, typically located in the same region. Trade data reveal a similar pattern of clustering around a Triad member. In the case of Japan, the regional clustering of Asian countries around Japan as a home country coincides with the building up of regional core networks by Japanese transnational corporations, geared towards gaining market share in the region itself as well as to exporting to the other two legs of the Triad. In North America, some United States transnational corporations appear to be pursuing similar, though less developed, strategies involving their Mexican affiliates.

B. The issue of governance

1. National issues

One of the trends highlighted in the present volume is the growing regionalization of the world economy. National economies are becoming increasingly linked in regional groupings, whether through initiatives at the political level, as in the case of the integration of the European Community, or through activities at the private-sector level, as in the case of regional networks of Japanese corporations in Asia. In North America, regional integration is also a significant development, and free trade among countries is likely to be extended across the entire northern part of the continent, from Canada to Mexico, and could one day even come to include parts or all of Central and South America. As described in this report, regionalization is one of the important factors behind the recent growth of foreign direct investment and its growing role in the world economy.

Despite this trend towards integration, the individual country remains the most important arena for policy-making. International institutions have not developed to the extent that they can replace the role of national Governments in setting economic development agendas, and in structuring their policy-making frameworks accordingly. In the EC, several institutional measures, such as the development of an EC-wide competition policy and common monetary unit, represent far-reaching attempts to shift the policy arena in certain areas from the national to the regional level; however, decision-making authority over the key variables which will affect their economies in general and flows of foreign direct investment in particular still remains with national Governments.

The trend towards regionalization counterposed against the authority of individual countries to set economic policy could lead to a new set of challenges for national Governments. Regional integration implies increased competition among firms in the region, which often respond to the opening of borders by shifting their activities according to where they make the most economic sense, irrespective of national borders. It is possible that, as a result of this, economic activity in the region will eventually come to reflect the comparative advantages of member States, leading the region as a whole to be "better off" in terms of economic efficiency. The opening of regional borders to economic competition, however, may also put competitive pressures on the national policy systems that regulate economic activity in the individual countries concerned. In other words, economic competition in a region could engender competition among regulatory regimes. For example, a country with policies of high taxation and extensive social benefits may find its fiscal base eroded, if businesses shift to neighbouring countries with lower taxes following regional integration. National policies regarding state ownership of industry are also likely to come under pressure in a regional grouping which aims to encourage free and fair competition. A whole range of policies, including industrial, environmental and social policies, may face increasing pressures to change as a result of integration with countries with different policy frameworks. Integration may thus lead not only to competition among firms, but to competition among policy systems, and national Governments are likely to find it necessary to adjust their policies to reflect the new environment.

Even where formal economic integration agreements among States are not in place, transnational corporations in many parts of the world are increasingly viewing regions, rather than individual countries, as the relevant production and market spaces; regional core networks are one expression of that emerging orientation. Whether or not they belong to a regional grouping, many Governments will increasingly need to frame their foreign-direct-investment policies in the context of not only the national, but also the regional economy. Such policies, as highlighted earlier in the present report, go beyond investment measures to include others which are likely to have a significant impact on foreign direct investment: technology and trade policies are two of the most important. Over the long term, measures taken in those areas, which can significantly affect the competitiveness of a country, are likely to have as much, if not more, impact on the behaviour of transnational corporations than investment measures (barring, of course, measures that prohibit or severely limit inward investment altogether). Furthermore, policy frameworks will need to be more closely coordinated to reflect the interlinkages between investment, technology, trade and financial flows. In other words, a number of key policy issues and their implementation may need to be re-evaluated in light of the regional activities of transnational corporations.

2. *Multilateral issues*

The issues outlined above raise anew the question of governance, particularly in a multilateral context. No single country can effectively regulate the activities of transnational corporations, and the boundaries between national and international issues of governance are becoming increasingly blurred with the increasing globalization of business activities. As discussed above, the capacity of Governments to manage their economies and achieve national objectives in areas ranging from fiscal policy to environmental control is being strained by the growing importance of transnational corporations in the international economy; in fact, a number of issues can no longer be addressed through national action alone. A prime example is the depletion of the ozone layer, in which transnational corporations play a role; this is a problem which requires international action and a multilateral framework as recently adopted in the form of the Montreal Protocol. Another example arises in the area of fiscal policy, where information necessary for tax purposes often has to be obtained from abroad and may require multilateral efforts. In a period where markets are expanding to cover regions rather than single countries, anti-trust issues and competition policies also take on an international dimension. Among developed countries, the need for policy coordination is being felt, for example, in the area of transfer pricing. Competition among countries for more foreign direct investment, if free from any rules, may lead to a "beggar-thy-neighbour" policy and detract from the bargaining power of Governments *vis-à-vis* transnational corporations. Therefore, the effective and stable governance of international economic relations requires effective international instruments to deal with the broad range of issues related to the globalization of business activity — problems that are beyond the capacity of national regimes of governance.

Regrettably, such a multilateral framework is lacking, although elements are emerging in the form of various agreements in specialized subject areas. However, attempts at coordination have been episodic and often limited to the context of regional economic blocs. This, coupled with the fact that foreign direct investment is concentrated in the Triad and a small number of developing countries, raises the possibility that foreign-direct-investment policy regimes will be increasingly determined by either bilateral negotiations among Triad members and/or by regional negotiations with one of the Triad members. Overall there is the potential danger of an emerging world characterized by powerful regional economies in which all but a handful of developing countries must remain as outsiders. Some developing countries are emerging as important strategic locations for the regional and global strategies of transnational corporations; many which are not could face the possibility of being further marginalized in terms of foreign-direct-investment inflows. Furthermore, the trend away from a multilateral framework of governance to one in which cooperation is realized only between small groups of selected countries represents a threat to the ability of developing countries to bargain effectively for policies to improve their position *vis-à-vis* developed countries. In the absence of a multilateral framework formulated with the participation of all members of the international community, a large number of countries run the risk of not having an effective voice in the determination of the foreign-direct-investment regime governing international economic relations.

C. Policy implications for improving investment flows to developing countries

Within a broader multilateral context, special attention needs to be given to developing countries. Despite an increase in the absolute volume of investment inflows to developing countries, the decline of their share in world-wide flows continued in the late 1980s. Considering the pivotal role that foreign direct investment plays in economic development — not only in its own right, but also because of its interlinkages with trade, technology and financial flows — there is a need to reverse the marginalization of developing countries and the resultant inequity in the international division of labour. This, in turn, points to the need for coordinated public policies by host countries, home countries and international institutions in order to remedy the existing situation.

1. Policy implications of the Triad and of interlinkages

Although an increasing share of world-wide inward foreign direct investment is being concentrated in the Triad, the sources of such investment are diversifying somewhat. As a result, developing countries are competing for a relatively smaller share of inward investment from a growing array of sources. Within the Triad, the EC has increased its role as a home country, and Japan has emerged as a significant source of outward investment, while the United States, compared to the other Triad members, has declined markedly in its importance as a home country. If, as indicated earlier, linkage to a Triad member is a significant determinant of the location of foreign direct investment, then those developing countries which are not linked to a Triad member and do not participate in a regional integration effort risk becoming marginalized in the world economy. Furthermore, if the corporate strategy to become "regional insiders" in each leg of the Triad becomes widespread, then many developing countries — as "outsiders" — may become even more peripheral. Such a situation could have important negative impacts on the structure of host economies, given the fact that transnational corporations are the integrating agents for world-wide flows of investment, trade, technology and finance, as described in chapter III.

The task of policy-making regarding foreign direct investment in a world characterized by a Triad and interlinkages will become increasingly complex for developing countries. In particular, the margin for effective policy-making utilizing traditional liberalization and incentive instruments is narrowing, though the scope for further improvement in the foreign-direct-investment framework of all developing countries has not yet been exhausted. 75/ That is because the scope for further liberalization and additional incentives diminishes as more and more of such measures are being implemented by more and more countries; in addition, the effectiveness of such measures in attracting investment becomes more limited when virtually all countries have adopted them. In light of this, it may be appropriate for developing countries to review their investment incentives and to structure them on the basis of a coordinated and realistic appraisal of their effectiveness.

At the same time, developing countries must recognize the new opportunities that are presenting themselves. They stem from the emergence of a Triad in outward investment, as opposed to the domination of the United States as a home country 10 years ago; the growing number of home countries outside of the Triad, particularly among the newly industrializing countries; and the globalization strategies of transnational corporations from the Triad, implying a continued search for new markets and production locations. But the creation of an attractive foreign-direct-investment regime alone, although necessary, is not sufficient to enable a country to take advantage of those opportunities. Additionally, measures are needed to improve domestic economic performance in general, and, in particular, to increase demand growth and to improve infrastructure and human resources. Thus, measures to attract foreign investment will increasingly have to encompass policies beyond traditional regulatory and promotional instruments. Incentives provided on a multi-country level are also likely to prove more effective particularly if the pattern of regional investment clusters described above, and the strategies of transnational corporations to form regional core networks of affiliates, prove to be important developments in the 1990s.

In framing their foreign-direct-investment policies, developing countries need to pay special attention to the interlinkages described in chapter III. Specifically, regulatory regimes covering foreign direct investment need to be integrated, or at least coordinated, with policies that govern technology transfer, trade, and international finance, in light of the role of transnational corporations as the integrating agents for those functions (developed countries, unlike developing ones, tend not to have explicit foreign-direct-investment regimes, although the need to coordinate interrelated policies remains important). Such a change in the policy framework of developing countries implies a change not only in the regulatory environment, but also in the institutional mechanisms and organizations which develop and implement policy in the above-mentioned areas.

Given that an increasing share of global foreign direct investment is being directed to the Triad and that additional competition has emerged for investment from host countries in Central and Eastern Europe, policy makers in developing countries should make efforts to diversify sources of inward investment. Such sources might include non-Triad developed countries, emerging home countries among the newly industrializing countries, as well as small and medium-size companies from both developed and developing countries.

While increasing investment flows is important, policy-making should not be solely focused on the quantitative aspect. Developing host countries would be well advised to undertake systematic assessments of the foreign direct investment they receive and where it can make a significant qualitative contribution and explore ways and means to enhance that contribution.

The emergence of regional networks of affiliates with a Triad member at the core of the networks appears to be accompanied by a significant amount of trade between developing-country affiliates in the networks. Intra-firm trade within those networks has been instrumental in promoting exports from host countries, particularly those which are incorporated into the networks of Japanese transnational corporations. Those networks can also strengthen regional integration among developing and developed countries, and often serve to lay the groundwork for successful initiatives in the policy sphere. In so far as foreign direct investment is driven by regional core network strategies of transnational corporations, regional integration schemes which do not include a Triad member do not seem to have succeeded in accelerating foreign-direct-investment inflows. 76/ Hence Triad members as well as other developed countries, should assist developing countries in structuring regional integration arrangements in a manner that can boost investment inflows, including inflows from non-Triad home countries.

Home countries could also assist by strengthening incentives to their transnational corporations for investment in developing countries. Those incentives can take the forms of providing guarantees, risk insurance, preferential tax treatment of profits and dividends earned in developing countries, financial support for market investigations and feasibility studies and preferential market access to exports from developing countries. Many developed countries already have some schemes in those areas. 77/ What is required is a fresh examination of the existing measures and the determined will to improve and supplement them to increase their effectiveness.

There is also a role for multilateral institutions. They can contribute towards increasing the locational advantages of developing countries by providing financial and technical assistance in such areas as improvement of infrastructure, the development of human resources and the design of promotional services. Perhaps more importantly, they can help developing countries to improve the quality of foreign direct investment obtained and to increase the gains therefrom through technical assistance in a variety of areas. A number of multilateral organizations already have programmes in those areas which need to be further supported and augmented.

2. *Measures to strengthen the contribution of transnational corporations to least developed countries*

In discussing policy measures to improve flows of foreign direct investment to developing countries, special attention needs to be paid to least developed countries, which receive extremely low volumes of foreign direct investment. A number of them will continue to receive marginal amounts of such investments until basic problems of human and infrastructural development are resolved. Still, there are opportunities for transnational corporations to act as catalytic agents in the development of those countries. But the realization of the full potential of those opportunities requires coordinated action by the international community at large. Some of the major elements of such a coordinated action plan are indicated below. 78/

(a) *Host countries*

As host countries, it is the primary responsibility of least developed countries to make their investment climate congenial to transnational corporations. Their recent efforts in that direction should be further strengthened along the following lines:

- Least developed countries should keep their foreign-direct-investment policy regimes under continuous review. Despite some major changes, there are instances of exclusion of certain sectors from foreign direct investment, restrictions on local borrowing, on purchase of shares in local companies and on remittances by transnational corporations. Each least developed country should, therefore, keep reviewing these and other restrictions in the light of its own economic circumstances and remove or relax them to the extent practicable and desirable. Once a suitably structured regime is put in place, frequent changes should be avoided, since the stability of the policy environment is an important consideration for transnational corporations.
- Often, although official government policies towards transnational corporations have changed, their administrative structure and practices have not. For example, 100 per cent foreign ownership may be allowed under foreign-direct-investment laws and yet minority joint ventures are preferred in practice. Such disparity between official policies and actual practices fosters confusion among prospective investors and should be avoided.
- Transnational corporations attach a great deal of importance to an honest and efficient public administration in matters dealing with approval of investment proposals, import and export licences, provision of complementary inputs or services, such as electricity, water supply and transportation and assessment of taxes. There is scope for improvement in those areas to which least developed countries should pay greater attention.
- Least developed countries need to adopt a more targeted and promotional approach to foreign direct investment. The existing administrative structures dealing with foreign direct investment in most least developed countries have evolved essentially out of a regulatory approach. In the present climate, least developed countries need to search out actively transnational

corporations that would have potential interest in particular countries because of their unique endowments and target promotional efforts to translate such potential interest into actual investment. For example, despite low per capita income, some least developed countries have fairly sizeable domestic markets because of large populations. Some have significant endowments of such natural resources as minerals, timber or fisheries, whereas others may be an attractive base for export of labour-intensive products and yet others may have a comparative advantage in the development of tourism. Similarly, targeted efforts should also be directed towards small and medium-size transnational corporations, as well as transnational corporations from other developing countries. An exclusive focus on large transnational corporations from developed countries may not be very fruitful.

- In an increasingly competitive environment for foreign investment capital, least developed countries should pay greater attention to the development of infrastructure, human resources and entrepreneurship which have a significant bearing on the locational choice of transnational corporations.

(b) Home countries

In view of the many constraints faced by least developed countries, the measures taken by them to attract foreign direct investment will have to be reinforced by complementary actions on the part of home countries.

- There are some disincentives for outward investment in some countries in the form of requiring prior authorization, limits on the export of investment capital to countries outside certain regions, or the requirement of deposit of a portion of the investment in non-interest bearing accounts. Where any form of restriction on outward investment exists, special relaxations should be granted for least developed countries. For instance, it can be provided that no prior authorization would be needed for investment of any size in a least developed country.
- Fiscal incentives for outward investment should also be focused on least developed countries. In particular, home countries could unilaterally offer tax credit for taxes paid by their transnational corporations in least developed countries and grant higher tax concessions for dividends and profits remitted from least developed countries.
- Financial assistance for investment is generally provided through public development finance corporations. A proportion of the resources of those organizations should be earmarked to support investment activities in least developed countries, including feasibility studies and co-financing of joint ventures.
- Home countries should strengthen measures to increase the flow of information on viable projects in least developed countries that could be of potential interest to their transnational corporations. Embassies of home countries can play a useful role in this regard.
- With regard to preferential access for exports from least developed countries,

home countries should widen product coverage, relax rules of origin and simplify documentation procedures under existing arrangements such as the generalized system of preferences, the Lomé Convention and the Caribbean Basin Initiative of the United States. Such measures could ignite transnational corporations' interest in least developed countries as an export base.

(c) *Multilateral agencies*

The climate for foreign direct investment depends on many factors beyond the control of national policies of least developed countries. In order to overcome the many structural bottlenecks, measures adopted by host least developed countries and home countries have to be complemented by multilateral actions.

- Least developed countries have initiated a number of reforms to attract transnational corporations. However, there is a need for a simultaneous change of perceptions on the part of transnational corporations, which have not traditionally viewed least developed countries as attractive investment sites. Multilateral institutions should play a vigorous role in changing these perceptions by organizing round tables between government officials of least developed countries, their private enterprises and executives of transnational corporations.
- A number of least developed countries are actively pursuing efforts to privatize their state-owned enterprises. International organizations should assist least developed countries in securing participation of transnational corporations within the framework of such privatization programmes and could provide co-financing for that purpose.
- International financial institutions can facilitate the participation of transnational corporations in least developed countries by designing innovative investment packages, as has been done in some African countries by such institutions as the International Finance Corporation, the Commonwealth Development Corporation and the European Investment Bank.
- The search for transnational corporations interested in investment in least developed countries is a time-consuming process and may turn out to be quite expensive. International organizations could effectively reduce the cost of the search by acting as intermediaries between least developed countries and transnational corporations.
- International organizations could assist least developed countries to set up data banks which could serve multiple purposes such as the provision of macroeconomic and sectoral information of interest to transnational corporations and the collection of data on variables required by national authorities for screening and approval of investment proposals.
- Regional cooperation can help promote foreign direct investment in least developed countries by enlarging market size. International organizations could assist in strengthening existing regional arrangements or in the formation of new ones which are considered appropriate.
- Some serious thought should be given to the establishment of regional investment

centres — perhaps one in Asia and the Pacific and one in Africa. These regional centres could act as vehicles for the dissemination of information on investment opportunities in least developed countries, the establishment of contacts with interested transnational corporations, assistance to least developed countries in conducting negotiations with transnational corporations, as well as for the provision of training to least developed countries' government officials and private sector executives in basic business skills, such as accounting, management and financial administration.

- Recognizing that the benefits of foreign direct investment to host countries are significantly determined by the terms of specific agreements and that many of the least developed countries do not possess strong negotiating skills to secure the best possible terms, multilateral organizations could assist least developed countries in structuring foreign direct investment agreements, joint ventures and non-equity arrangements in various sectors.

A number of international organizations already have programmes in those areas. But the programmes should be more focused on least developed countries.

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The growing importance of foreign direct investment in the world economy, not only in its own right, but also because of its close linkages with trade, technology transfers and financial flows, is by now well established. With that perspective in mind, the international community may wish to give consideration to achieving a consensus on ways and means to attract a greater flow of foreign direct investment to developing countries and to improve its qualitative content. Since, as indicated earlier, the scope for action by individual host countries has become rather limited, the need for coordinated multilateral action by all concerned — host countries, home countries, international institutions and transnational corporations — is all the more important.

Such action needs to take into account the interlinkages between improving foreign-direct-investment flows to developing countries and improving flows of technology, trade and finance. In fact, given the nature of those interlinkages, foreign-direct-investment policies today can no longer be formulated and implemented separately from those concerning trade and technology transfer. Initiatives being taken in those areas should therefore be increasingly coordinated with a view to maximizing the effectiveness of actions which seek to encourage the development and growth of developing countries.