CHAPTER XI

INVESTMENT POLICIES

World economic interdependence today is increasingly production-based, not just trade-based as it was in the 1950s and 1960s. The change owes much to advances in transport, information and communications technology, and the liberalization of financial markets. Those advances also propelled the spread of transnational corporations (TNCs) which, in turn, have become prominent agents of integration. Today, TNCs in the largest home countries have internationalized their value-added activities and internalized the exchange of goods and services to such a degree that global sales of affiliates are considerably larger than exports in delivering goods and services to markets world-wide. In addition, the functional breakdown of the value-added chain is creating a new enterprise-level division of labour spanning national boundaries. Equally significantly, research and development is more and more carried out through intra- and interfirm technology networks on a regional or world scale (TCMD, 1992a, ch. VI). Increasingly, therefore, international economic transactions need to be seen from the perspective of foreign direct investment (FDI) (TCMD, 1992a, part III), and Governments have to adapt to this new reality. Some of the challenges for public policy were discussed in chapters VIII to X; here, the focus is on policies influencing FDI flows.

The tendency of TNCs to integrate their activities globally presents opportunities for a new pattern of production among nations. As discussed in chapter VII, the potential is considerable for developing countries, many of which are still marginal to world investment flows: two thirds of the recent expansion in FDI flows to developing countries went to just 10 countries (chapter I). However, the projections in chapter IV suggest that FDI in developing countries will increase substantially over the next decade. In principle, all of them have greater opportunities to attract investment.

New strategies are needed, however, to realize that potential. Many developing countries lack the range of locational advantages required by globally-integrated TNCs. Unless they correct that deficiency, they will be handicapped in the global competition for FDI, high technology and world export markets. Breaking this vicious circle should be a paramount concern for policy makers, at both national and international levels. How this could be done is the subject of this final chapter. It begins with a discussion of the convergence of FDI policies (section A) and then considers the need for more sophisticated policies by developing countries, going beyond the current liberalization trend, to more pro-active measures (section B). It concludes by considering the extent to which integrated international production extends the range of policies that may require international treatment (section C).

A. Competition for investment and the convergence of investment policies

A growing consensus holds that the benefits of FDI outweigh the conceivable costs of hosting TNCs (TCMD, 1992a). This has heightened competition to attract FDI. With the recent changes in Central and Eastern Europe, competition for FDI has become truly global. The regulatory framework for FDI is one tool being used in this competition. As more countries liberalize their FDI policies, they are converging towards common standards (box XI.1) which, in general, cover the following:

- Right of establishment;
- Fair and equitable treatment, including non-discrimination in the application of the law;
- Protection against nationalization (except under clearly defined conditions), and standards of payment of compensation;
- International dispute settlement, including arbitration;
- Assurances for the repatriation of earnings and capital.

These standards are often subject to various derogations and exceptions; but, overall, they characterize a new national approach towards FDI. Bilateral investment treaties further encourage such convergence, especially by stipulating many of these standards, in addition to national treatment. At the same time, the openness to FDI does not, of course, imply that TNCs are no longer constrained by national laws and regulations that provide standards for the conduct of business in general.

With FDI policy regimes converging, the remaining differences in these regimes exercise less and less influence on the locational decision of TNCs. Instead, the appeal of any host country to potential investors is determined by other factors. In an increasingly integrated world economy, the relative attractions of developing countries versus developed countries is of more and more importance. For many developing countries, that is stiff competition. It means that their Governments should play an active role in improving their economies as locations for FDI. Finding appropriate pro-active measures to attract FDI in an emerging international production system is one of the key policy challenges facing many developing countries.

B. Investment policies in developing countries

1. The new openness

The liberalization of FDI regimes has been part of a sea-change in the policies of developing countries, from inward- to outward-looking development strategies. In addition, the growing recognition that TNCs offer

Box XI.1. Namibia's code on foreign direct investment: a legislative example of the trends in convergence

On 28 December 1990, Namibia's parliament passed the Foreign Investments Act,1990. The Act provides for an open regime for FDI and covers the main issues that are often critical for investment decisions: establishment, national treatment, compensation in case of expropriation, international arbitration and the ability to remit profits.

The Act gives effect to three basic principles:

- There is no requirement for screening foreign investments. Apart from a few defined exceptions, a foreign national or foreign-owned company may engage in any business activity in Namibia that may be lawfully undertaken by a Namibian or a Namibian company;
- The Act guarantees national treatment for all foreign investors;
- For major investments, where capital expenditure is above a minimum figure prescribed in the Act and which are designed to be responsive to the economic and social priorities of Namibia, the Act offers special guarantees;

The Act makes clear that:

- A foreign investor would not normally enjoy any special rights or have the benefit of any fiscal or other incentives to which a Namibian citizen or a Namibian company engaged in similar business activity would not also be entitled;
- The foreign investor would be obliged in all respects to abide by the law of Namibia.

A foreign investor whose project may be eligible for special incentives may apply to the Minister of Trade, who will consider the case. However, such an investor has the option to invest without undergoing any approval test and would therefore operate under national treatment.

Those deemed eligible for special treatment are guaranteed foreign exchange availability for loans, and the transfer of profits or proceeds of sale of the investment. Although the Constitution of Namibia guarantees "just compensation" in case of any expropriation, they have the further guarantee that compensation will be made without undue delay and in convertible currency. They are also given the right to refer disputes, including disputes about compensation, to international arbitration.

When an investor has been granted special incentives, they will remain in force only so long as the firm complies with two reciprocal obligations:

- The investor is required to make specific proposals acceptable to the Government for training of Namibians and localization and then to implement them;
- The investor's plan for the investment itself are also set down in detail, and must be honoured, in accordance with an agreed timetable.

Source: Foreign Investments Act, 1990; Act No. 27; published in the official *Gazette of the Republic of Namibia*, No. 129.

a variety of benefits to a host country (TCMD, 1992a) has replaced various concerns with disadvantages potentially associated with TNCs.

In particular, innovation and technological change are now understood as powerful causes of economic growth and dynamic comparative advantage,[1] and TNCs are recognized as the main channels for technological change in many developing countries. Thus, government policy is geared more to capturing the dynamic spillovers of technology transfer, than to reducing its possible costs. Since joint ventures tend to involve less up-to-date technologies than do fully-owned investments, limits on foreign ownership have been greatly relaxed. The same is true of the ceilings on technology licensing fees. Similarly, since the possession of proprietary knowledge matters less than actually using it, Governments in developing countries are now more willing to accept legislation and enforcement of intellectual property protection.

In short, it is more important to host technology than to own it. But this goes along with another maxim: the greater the national ability to innovate, the more a country will be able to use imported technology. The building up of national capabilities should therefore proceed in an open policy framework. This applies particularly to services. Modern financial services, telecommunications, transportation and utilities are essential for developing countries, not only to bolster the efficiency of the wider economy and improve the competitiveness of the export sector, but to insert themselves into the system of integrated international production. Many developing countries have already responded by opening their service sectors to FDI (see chapter III).

Overall, outward orientation is becoming central to development strategy. In pursuing import-substitution, many developing countries used to allow TNCs to invest in protected domestic markets. In the future, developing countries will still want to host market-seeking (import-substituting) investments, but in an open, outward-oriented framework. This is already happening in Latin America and South and South-East Asia.

For most developing countries, however, the new openness and the liberalization of their FDI policies have not yet led to a substantial increase of investment inflows. Partly this is because freer FDI policies are not on their own enough to attract FDI. Partly, there are lags before investors respond to policy change—and, the more dramatic the change, the longer the lag. But the biggest factor is that the differentiating effects of policy regimes count for much less, as the general policy framework and the imperatives of economic factors become the main determinants for choosing where to invest. It is here that the role of Governments is important.

2. Enhancing national capabilities and competitiveness for foreign direct investment

The new openness does not necessarily imply a *laissez-faire* approach to the functioning of markets. Governments still have much to do to ensure that markets are established, and maintained efficiently. This may be particularly difficult when markets operate across borders and are thus affected not only by the decisions of buyers and sellers, but also by external factors, including the policies of other Governments (Dunning, 1992).

By assuming a pro-active role, Governments can help to decrease the costs of market deficiencies. They can remove any entry-barriers and other obstacles that raise transaction costs for TNCs. They can encourage the creation of tangible and intangible assets (e.g., infrastructure assets, technological know-how and organizational capabilities) that determine where TNCs invest. And they can affect the costs of research and development through training grants and tax exemptions, and stimulate domestic entrepreneurship through incentives and the provision of information. To do all this, Governments may need to change their own internal structure, from a hub-and-spoke system to a spider's web of relationships between the central coordinating body and the various ministries/departments (Box XI.2).

(a) *The national enabling framework*

Policies to enhance national capabilities must be framed in the context of sound macroeconomic policy and a credible development strategy. Social policies also matter, for they contribute to political stability. And Governments must invest in physical infrastructure and in education, training and health.

To put it bluntly, an efficient private sector is unlikely without an efficient public sector. In most developing countries, public institutions do not adequately support the functioning of markets or reward entrepreneurial activities. They must be restructured according to modern organizational and management practices. Governments also need to bring in modern accounting practices; allow for the development and deepening of capital markets, including an efficient banking system; and encourage an appropriate range of business services. With the current trend towards liberalization and privatization, the market-enabling role of Government and the need for functional regulatory regimes have become more, not less, relevant.

(b) *Building linkages*

Beyond general development, successful strategies for attracting FDI require the establishment of a virtuous growth circle between FDI, technology diffusion and market expansion. External ties can help developing countries become insiders in a global network. Strategies should aim at participating in global trading networks, at strengthening the links between domestic and foreign firms and at developing policies for attracting foreign firms.

Given the role of technological capabilities in maintaining international competitiveness, links with TNCs are particularly important to strengthen national systems of innovation. Government support for innovation has been particularly successful in Japan, the Republic of Korea, Taiwan Province of China and in Europe, where the "European archipelago of innovation" links research laboratories, universities and knowledge-intensive enterprises. Moreover, the European Community has extended its programmes that support and finance such networks to its less developed regions (OECD/TEP, 1992); a similar approach could be used to embrace developing countries.

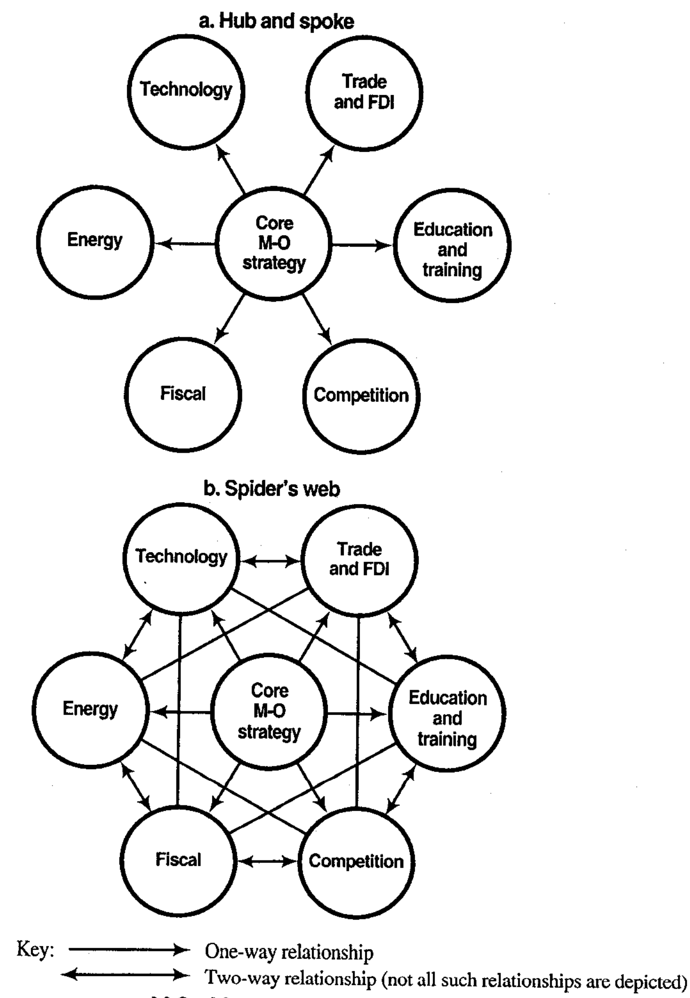
There is also another kind of external linkage for Governments of developing countries to explore: their own TNCs. Outward FDI can have a number of benefits for the home country, including access to markets, acquisition of technology, training and, generally, exposure to the rigours of international competition (TCMD, 1993b). The liberalization of foreign exchange controls promotes FDI, as has happened in the case of the Republic of Korea and Taiwan Province of China. Since 1989, firms from the Republic of Korea need no longer obtain official approval for outward investments of up to $2 million; in the case of Taiwan Province of China, the threshold is $5 million per year. Both countries are now net foreign direct investors. Fiscal policies that stimulate

Box XI. 2. Governing the process of deep integration

Deeper economic integration may force Governments to reexamine their culture and structure of governance. Just as TNCs have adopted new organisational arrangements to promote deeper economic integration at the firm level, a similar response may be required from Governments to ensure the effective implementation and coordination of policy at the national level.

Existing Government structures tend to encourage a series of independent objectives, each pursued by an individual ministry or agency. These agencies compete with each other for available resources, whose allocation is ultimately decided at the executive level. This "hub and spoke" structure is illustrated in figure 1.a. By contrast, a more integrated approach implies a network of vertical and horizontal decision-making relationships between a central coordinating body responsible for the formation and outcome of broad economic strategy and individual departments responsible for advising on and implementing strategy, and ensuring the complementarity and consistency of a chosen strategy across areas. This "spider's web" structure is illustrated in figure 1.b.

Figure 1. Two kinds of intra-government administration[a]



a These diagrams are for illustrative purposes only and do not embrace all areas of government macro-organizational strategy.

Source: Dunning (1992).

FDI from developing-country firms include concessionary loans, tax measures and insurance for FDI. For example, firms based in the Republic of Korea are provided concessionary loans of up to 60 per cent of the FDI amount (80 per cent in the case of FDI by small and medium-size enterprises). They can reserve up to 15 per cent of the amount of FDI for losses, and are offered insurance of up to 90 per cent of FDI against war, expropriation or restrictions on remittance.

(c) Investment promotion

Governments can pursue many approaches to attract FDI (FIAS, 1990; Wells and Wint, 1991; Encarnation and Wells, 1985; Lall and Streeten, 1977). However, all have a common goal: to convince TNCs of their locational advantages. This section identifies a few relatively specific measures that may influence the locational decisions of foreign investors and deserve more attention by policy makers. Since TNC strategies have become more complex, Government policies to attract FDI need to become more sophisticated as well. In particular, they need to take into account the emergence of an integrated international production system.

- Since the implementation of more complex strategies by TNCs means that all parts of the value chain are potential areas for FDI, Governments wishing to attract foreign investment should go beyond general, broad-based efforts and focus on particular functions (e.g., regional headquarters, research and development, accounting) for which they believe they have certain advantages. The measures adopted by the Government of Singapore are an instructive example (box VI.1).

- Countries must learn to market themselves attractively. Some of the best strategies for attracting investment have involved well-funded promotion agencies that use a combination of advertising, direct calling and investment missions. Those activities may best be done by quasi-government organizations, as in the case of Ireland's Industrial Development Authority, or by subcontracting those activities to private agencies, as Thailand's Board of Investment has done with Arthur D. Little, Inc.

- Government agencies should also monitor changes in the structure of FDI, in order to focus their promotion campaigns properly. They should be particularly aware of the growing share of services in the stock of FDI and the role that non-equity ventures play for many TNCs.

- Small and medium-size enterprises are increasingly investing abroad, and their needs are often different from those of large TNCs (UNCTAD, 1993g). They have often been neglected by Governments. As they generally invest smaller amounts than large firms, it helps them not to have to obtain approval if the investment is below a certain size (as in Mexico), or if minimum investment values are abolished (as in Indonesia), or investment requirements lowered (as in Chile and the Republic of Korea). More generally, measures intended to encourage *domestic* small- and medium-size enterprises can also attract their counterparts from abroad, as long as these measures apply to TNCs as well. Fiscal incentives in such countries as Brazil, Cameroon, Chile, Côte d'Ivoire, Malaysia, the Republic of Korea, Sri Lanka, Venezuela and Zaire favour smaller undertakings; so does access to credit in Chile and Singapore (table XI.1.).

- Many countries set up export processing zones as special areas, with favourable regulatory and administrative conditions. Typically, the Government also provides the basic infrastructure, including

Table XI.1. Policy and promotional measures to attract small and medium-size enterprises to host developing countries

Country	*Measure*
Brazil	Corporate income tax of 25 per cent for small and medium-size enterprises, as opposed to 30 per cent for other firms.
Cameroon	Investments with a more than 65 per cent local equity share and a value of less than CFAF 500 million are offered not only a 5 per cent deduction of import tax and duties over 10 years (which are also allowed for other firms), but exemption from capital tax, credit distribution tax, registration duties, company tax and the tax on industrial and commercial profits is granted over an eight year period.
Chile	A 2 to 4 per cent reduced income tax rate for small mining firms is granted; 20 per cent of sales are exempted from corporate tax for certain investments by small and medium-size enterprises in the southern regions. Firms with assets up to $750,000 are eligible for loans through a World Bank/Corporacíon de Fomento (holding company for state enterprises) programme. The minimum FDI level was lowered from $100,000 to $25,000 in 1986.
Côte d'Ivoire	Investments with a value of between CFAF 40 million and 200 million and local employees between five and 50 are offered tax incentives in more industries.
Indonesia	Abolition of the minimum FDI level in 1988.
Malaysia	Manufacturing firms of less than M$ 0.2 million in shareholder's funds and less than M$1 million in fixed assets are allowed a 5 per cent deduction from taxable income for five years and another 5 per cent deduction if they comply with the New Economic Policy. A 50 per cent tax credit on all expenditures on capital equipment is allowed as opposed to 25 per cent for other firms.
Mexico	Foreign direct investment by firms with less than $8 million annual sales, less than 500 employees and whose affiliates are in manufacturing, with net annual sales less than M$4.5 billion (as of November 1988, revised yearly) and export more than 35 per cent of output, needs no approval by the National Foreign Investment Commission as of September 1986.
Republic of Korea	The minimum FDI level was lowered from $0.5 million to $0.1 million in September 1980; in the case of joint ventures with local small and medium-size enterprises it was further reduced to $50,000 in September 1986. Tax incentives for small-scale operations by both foreign small and medium-size enterprises and foreign large firms (but, for the latter, the foreign equity share should be less than 50 per cent) in 74 industries (under six digits of Korean Standard Industrial Classification).
Singapore	Firms with less than S$8 million in fixed assets, that are at least 30 per cent local-owned and have less than 50 employees are eligible for a small-industries finance scheme by the Economic Development Board as of 1976.
Sri Lanka	Firms with less than SL Rs 0.5 million capital in issued shares are eligible for an exemption of corporation tax (it applies to both local and foreign firms).
Venezuela	Small and medium-size enterprises are offered tax and loan incentives without having to comply with the plan for the decentralization of industries (which applies to both local and foreign firms).
Zaire	Firms with a capital of less than Z10 million are offered an extension of duration of exemption from the income tax due on salaries paid to workers to five years in Economic Zone A or two years in Economic Zone B. Additional incentives are: exemption from the tax on revenues of capital assets, the tax on acquisition of land, and import tax and duties (which is also offered to other firms); deduction of expenditures on training of managers and personnel from taxable profits; and exemption from duties on capital increases, duties on registration and duties on acts to form a company or co-operative.

Source: Fujita, 1990.

factory halls etc. (UNCTC, 1990a). Although many of those zones have not lived up to expectations, some have been quite successful. Some may be gradually upgraded into science and technology parks.

- Governments can seek help from their diasporas abroad. A good part of the FDI in China originates from the Chinese overseas community. Expatriate managers and entrepreneurs often have a good knowledge of international markets and their requirements, which can be of great value to host countries.

- Governments can also make their countries more welcoming by cutting the transaction and "hassle" costs that accompany any investment, especially in an unfamiliar place (Dunning, 1992). Measures could include minimizing the risk and uncertainty associated with FDI by encouraging the use of futures markets and of finance investment guarantee schemes; providing good international telecommunication services; supplying information, for example, with respect to FDI regulations and export markets; ready access to government agencies and reducing red tape; and helping in negotiating with clients or suppliers.

- In this context, more could be done about post-approval services, an analogue to after-sales services (Wint, 1993). In some countries, one-stop agencies are meant to provide such services, but they often neglect the post-approval side. Once an investment has been approved, TNCs typically still face various bureaucratic hurdles before they can actually begin production. Work and import permits need to be obtained, relations with financial intermediaries (including the Central Bank), have to be established, permission needs to be obtained to buy or lease land and telecommunications equipment must be installed. All this can take much precious time and thus obstruct the implementation of an investment project (box XI.3).

- Although the protection of intellectual property rights is, overall, not one of the main determinants of FDI, stronger protection is likely to boost the flow of FDI to some industries, such as pharmaceuticals, micro-electronics and the copyright industries (TCMD, 1993f).

- Countries establish embassies to advance their *political* interests in countries of special political importance to them. Perhaps countries should take a similar approach to advance their economic interests regarding those actors that are of special economic importance to them. More specifically, countries may wish to make extra efforts to cultivate relationships with those TNCs that, for instance, control a substantial part of domestic assets

(d) Upgrading

Although FDI is concentrated in only a few developing countries, every developing country is a recipient of some FDI. In short, investment opportunities do exist everywhere—just as every country has some sort of comparative advantage (such as cheap labour or abundant natural resources). Moreover, market-seeking and export-oriented FDI is common in many developing countries.

Much of this FDI, however, offers limited technology and skills, which must be upgraded along the value chain. For example, mining can be upgraded into processing; labour-intensive inputs and offshore assembly can be upgraded into component sourcing; and market-seeking FDI can be upgraded from trading and marketing to assembly of subcomponents, or full assembly and even production of complete product lines for domestic and world markets (Eden, 1991). Although traditional FDI is not insignificant, the big new flows of FDI are along, or (in the case of integrated international production) cut across, these higher links of the value chain (see chapter III).

Few developing countries, however, have achieved a significant upgrading in the composition of their inward FDI (TCMD, 1993e). This is because international production is increasingly determined by factors that go beyond cheap labour and depend on overall national competitiveness. Consequently, a strategy for upgrading needs to combine policies that strengthen national capabilities with specific measures to encourage FDI of a higher value-added nature (box XI.4).

Developing countries have often aimed for particular industries on well-founded economic grounds, e.g., economies of scale, learning economies and externalities. But their targets have sometimes been obscured by demands for a shift of ownership, including direct expropriation. Nowadays, expropriation is far less likely than privatization (box I.1), but this new emphasis is not inconsistent with targeting. Instead, it should be taken as an

Box XI.3. Post-approval problems

Some investors have learned that, even as it is becoming easier to obtain approval to invest, it is not necessarily any easier to implement an approved investment. The following examples illustrate the types of difficulties TNCs often encounter:

- A United States service firm was interested in establishing operations abroad. Like many other countries, its chosen host had simplified its system for approving FDI projects. The company received approval for its investment within four months of filing the application with the Foreign Investment Department of the Ministry of Finance, which collects applications and sends them to the various relevant departments of the Government for their independent approval. Shortly after formal approval was granted, the company's managers went to another government department to obtain an operating licence. Since the company had already obtained approval to invest, and indeed it had already begun the process of shipping equipment to the country, it was expected that the granting of the operating licence would be virtually a formality. Instead, the Department questioned the approval that had been obtained from the Foreign Investment Department. It was only after many months, and the costly engagement of a local law firm, that the company was able to acquire the operating licence and implement its project.
- In another country, a United States manufacturing firm applied to the Board of Investment for permission to invest and qualify for incentives. The firm received permission to invest quickly—within two months of the submission of its application. To its consternation, however, it found that this was only the beginning. It had difficulty getting work permits for expatriate staff, getting permission from the central bank to import machinery and, once the equipment was imported, clearing this equipment through customs. One year after receiving approval from the Board of Investment, the project was still not fully operational. The president of the company said that its "problems began when its investment application was approved by the Board of Investment".
- A Japanese agricultural-processing firm seeking to set up operations in a third country received permission to invest from the Board of Investment. The firm was informed by the Board that the Department of Agriculture had been represented during the investment-approval process and that its project had the Department's approval. Shortly after the company began implementation of the project, however, its operations were halted by the Department of Agriculture. The Department said it had not been able to examine the project adequately during evaluation by the Board of Investment and that it now believed the project would harm local agricultural firms.

Source: Wint, 1993, pp. 76-77.

opportunity to establish more cooperative links between public agencies and TNCs. The approach should be to improve the basic conditions for business even if this is difficult and time-consuming. Countries that seek to rely excessively on a much easier way to attract FDI, namely, by offering various kinds of fiscal and financial incentives, are unlikely to realise unlikely desired long-term results (see section C).

At the same time experience shows that certain incentives work better than prohibitions (Bhagwati, 1988). In the past, many developing countries allowed FDI on a selective basis through licensing and quantitative controls. However, the more successful countries relied chiefly on incentives (particularly production, export or interest-rate subsidies), on moral suasion, and on improving the overall economic climate. In recent years, many developing countries (including the Republic of Korea) have revised their incentives to extend privileges to cover both domestic and foreign enterprises. For example, the Board of Investment in Thailand grants incentives to both domestic and foreign firms in promoted industries and/or areas. Although that approach has met with less success in Africa, the main lesson is that targeting works best in an open FDI framework.

Aside from the issue of how to achieve particular targets, there is the question of what they should be. Developing countries can still make special efforts to attract particular industries—in which they can reasonably expect to acquire comparative advantage; those with large externalities for the rest of the economy; and, perhaps those industries seeking large markets in neighbouring countries. But for many developing countries, the answer is still defined by their technology gaps. Governments often seek out producers of high-technology goods with the expectation of dramatic benefits from technology transfer. However, long-term benefits do not exclusively

Box XI.4. Upgrading foreign direct investment through public-private sector cooperation

Founded in 1976 as a joint venture between the Government of Chile and ITT, the *Fundación Chile* has overcome the learning hurdles of a promotional agency, and the initial distrust of the private sector. It is now a successful model of technological upgrading that complements the natural resource base of the country.

In its formative years, the *Fundación* had close links with ITT, and therefore ready access to the human resources, finance, technology and research departments of a large TNC. These represented a temporary advantage and the initial goal of providing service support quickly expanded into setting up new industries. However, the purpose of the *Fundación* has not been to establish and run an industry for its own sake; rather, it followed an incubator approach aiming eventually to sell facilites to the private sector.

One particularly successful example has been the establishment of a salmon-farming industry. Chile has one of the world's largest fishing industries, but most of the catch has been processed into low-grade, low-value-added fish meal. A small fresh-water salmon farm in southern Chile was acquired, renamed *Salmones Antartica*, and used as a pilot site. The *Fundación* tapped national and international expertise to choose an appropriate technology and solve the formative problems. In particular, it acted as an innovative centre to produce a high-quality fish-feed mixture using local resources. Following the success of the initial pilot, *Salmones Antartica* bought four new farms and expanded production to 400 tons by 1986-1987. The firm was sold to a Japanese processing firm, Nippon Suisan Kaisha, in 1988. The salmon-farming project has met a significant response in Chile. The number of new farms has expanded to create a profitable industry (Huss, 1988, pp. 110-113). In 1990, production had reached 5,600 tons.

More recently, and following the model established by salmon farming, the *Fundación* has initiated a project to upgrade the use of Chile's timber resources. It has already improved the information network to bolster technological and organizational know-how and raise product standards. Training schemes have been organized to ensure the upgrading of skills. A furniture factory was established by the *Fundación* in 1992, and it is hoped that the venture will have a similar catalytic effect on domestic and foreign investor's as did the salmon-farming project (Messner, 1992).

depend on the technology-content of the final product, but on the purchasing needs of the targeted industry in both product and factor markets. Upgrading, including through FDI, cannot proceed independently of existing technological capabilities and supply structures, but must embody a creative tension between inherited conditions and future market prospects.

In any event, Governments must establish and sustain a coherent strategy to promote the long-term competitiveness of firms within their jurisdictions (Tyson, 1992). The nature of international production implies that investment, technology and competition policy are best approached as an integrated package and employed in unison to strengthen markets.

(e) *Policy integration*

For TNCs, investment, trade, technology transfer and the movement of staff are often interrelated ways of expanding abroad. In fact, integrated production strategies typically require that each of these channels is open to a firm, depending on its needs and the nature of a market. Accordingly, a rounded and outward-oriented development strategy is indispensable if a country wants to become part of the emerging system of international production.

But more is required. In the same manner in which TNCs consider FDI, trade, technology transfer and the movement of technical personnel as interrelated, so too must Governments consider their policies in these areas as interrelated. In other words, Governments must reexamine each policy proposal for its impact on the other policy areas and its implications for the wider strategy; table XI.2 indicates a few interrelationships between FDI and trade.

Table XI.2. Policy interdependencies: the effects on foreign direct investment

Policy	*Effects on FDI*
Trade agreements: including free trade agreements and common markets	Encourages FDI for regional markets and promotes inclusion of TNCs in regional integration of production
Stable exchange rates	Encourages all FDI
Investment in physical infrastructure and human capital	Encourages all FDI and can be used to upgrade FDI
Tariffs, quotas, technical standards	Encourages market-seeking FDI, but restricts most other FDI
Tariff drawback schemes	Encourages labour-seeking and component-sourcing FDI
Prohibitions to operate in domestic markets, including restrictions on joint ventures	Restricts all FDI, but may discriminate heavily against FDI in the service sector and against TNCs from developing countries.
Visa requirements, work permits, import licences and domestic content agreements	Restricts all FDI, but particularly damaging to FDI in high technology industries, which use intangible assets
Full access to domestic markets for services producers	Encourages FDI in services and consequently all FDI
Preferential tax treatment for TNCs	Used to target FDI with desired attributes
Preferential tax treatment for TNCs with selected performance requirements	Used to encourage FDI upgrading
Export processing zones	Encourages labour-seeking and component-sourcing FDI
Export subsidies	Encourages labour-seeking, component-sourcing and resource-seeking FDI, but may discourage export-oriented FDI if subsidies are a substitute for needed currency devaluations or where retaliation is feared

C. International production, competitiveness and systemic convergence

The advent of global markets and integrated international production has direct consequences for competitiveness. In a closed economy, competitiveness is very much determined at the firm level. In an open economy (engaging in arm's-length trade), the competitiveness of companies is affected by the comparative strength of national capabilities. In an economy moving towards integrated international production, competitiveness of a firm depends upon the combined locational advantages of each of the nations in which it has affiliates. Consequently, the competitiveness of companies and nations is becoming increasingly interdependent. The previous section suggests that government policies to strengthen locational advantages can play an important role in attracting increasingly footloose economic activities. However, those developments also raise new issues for international economic management.

In such a world, it is very tempting for Governments to rely on fiscal incentives to attract FDI (table XI.3). However, such incentives tend to distort the functioning of the market and the flow of investment and trade. Moreover, they are costly for host countries (and put developing countries at a particular disadvantage), and they are not among the main reasons why TNCs invest. It may therefore be desirable to set some international limits to the use of incentives (box XI.5).

But more generally, as FDI frameworks become broadly similar among countries, economic factors and conditions of production assert themselves as the primary determinants for the location of economic activities. Integrated international production, therefore, shifts the level of competition from the trade and FDI regimes more and more to the level of all national policies and institutions directly affecting the production process. This, in turn, widens the range of issues that are within the realm of international discussions and negotiations (Ostry, 1992a).

Indications of a movement from a trade-based to a production-based regime are already visible in the negotiations over regional integration schemes. The obvious examples are the 1992 single market programme of the European Community, the Canada-United States Free Trade Agreement and NAFTA. All three began by seeking more liberal trading regimes, but have expanded into free production agreements, including various measures directly related to FDI. In fact, these negotiations suggest that a more fundamental "re-think" is required. In a world where FDI is more important than trade in delivering goods and services to foreign markets, where a sizeable part of trade itself is intra-firm and where TNCs are central economic actors, international economic negotiations need to be seen more and more from the perspective of FDI as opposed to trade alone (TCMD, 1992a). Finding the right policy framework to facilitate the growth of integrated international production will be a continuing policy challenge for many years to come.

Table XI.3. Investment incentive measures adopted by selected developing countries during 1992

Country	Type of measure: Fiscal	Type of measure: Other	Geographical scope: Local/ Regional	Geographical scope: National	Coverage: Targeted to FDI	Coverage: Domestic and foreign firms	Targeting to specific industries/activities: Target	Targeting to specific industries/activities: Untargeted
Africa								
Burundi	x		x			x	Exports	
Egypt	x		x			x		x
Ethiopia	x		x			x		x
Malawi	x			x		x	Exports	
Morocco	x		x		x		Banks	
Tunisia	x	x	x			x	Exports	
Asia								
China	x		x		x		Exports	
Democratic People's Republic of Korea	x	x	x		x		High-tech	x
Malaysia	x			x	x			x
Republic of Korea	x			x	x		High-tech services	
Viet Nam	x	x		x			,	
Central and Eastern Europe								
Azerbaijan	Customs			x	x			x
Lithuania	x			x	x			x
Romania	x		x		x			x
Tajikistan	x		x		x			x
Turkmenistan	x	x	x					x
Ukraine	Customs			x	x			x
Uzbekistan	x			x	x		Industrial equipment	
Latin America and the Caribbean								
Argentina	x		x			x	x	
Peru	x			x			Mining	
Sao Tome and Principe	x			x				x

Source: UNCTAD, Programme on Transnational Corporations, drawing from various national sources.

Box XI.5. Incentives and foreign direct investment

There is widespread agreement that incentives are not among the key determinants of the total supply of FDI (Wells, 1986; UNCTC, 1991b). Moreover, evidence collected by OECD suggests that tax incentives are not cost effective, and do not produce an efficient allocation of investment (UNCTC, 1992c). Foreign investors are themselves acutely aware of the difficulties associated with investment incentives and often express reservations about projects whose potential profitability relies on host-country incentives (Reuber, 1973; Group of Thirty, 1984; Kerdpibule and Ramsetter, 1987).

There is also a persistent belief, however, that once a company has narrowed its choice of sites, incentives do count for some industries (UNCTC, 1991b, pp. 42-43). A World Bank study on incentives and performance criteria found that, in two-thirds of the 74 cases studied, the final decision on where to invest was influenced by incentives (Guissinger *et al.*, 1985). A study of the petrochemical industry (Gray and Walter, 1983) found that, although incentives were secondary to corporate strategic planning, in at least one case, in Belgium, the decision to invest was contingent upon an attractive subsidy package. Dunning's (1986) survey of Japanese FDI in the United Kingdom also found incentives to have a modest influence on decisions. In addition, unlike other factors, incentives have the advantage of being under the direct control of Governments.

Although there is some indirect evidence to suggest that subsidies were reduced between 1982 and 1989, many developing countries continue to favour incentive legislation. Moreover, for many industries in developed countries, incentives have continued to grow.[a] In the automobile industry, for example, the evidence from States within the United States suggests that the size of incentives required to induce FDI lies between $120 million and $325 million, well in excess of the financial capacities of many developing countries (UNCTC, 1991b, p. 74).

It is clear, however, that an incentive competition between Governments is very costly, particularly for developing countries, and can generate inefficient investments with disappointing results. If it goes too far, not even the "winning" country obtains a net benefit.

Reducing incentives requires cooperation among Governments. Efforts to date have focused on the regional level. In particular, the OECD has long sought closer harmonization of investment policies among its members, including the reduction of incentives to a minimum level. The European Community has also sought a ceiling on total incentive packages, while allowing for some regional variation. A reduction in trade-related investment measures as a result of the Uruguay Round will reduce those financial subsidies that might be punishable under GATT rules, i.e., those that can be shown to distort trade. However, once the Uruguay Round has been completed, there will still be considerable scope for further improvements.

It might be possible for host developing countries that have already reduced subsidies to domestic producers to extend this approach on a cooperative basis within a region. The need to disclose incentive measures fully and assess their effectiveness, as a first step towards broader harmonization, might also be best achieved at the regional level. As the experience of the existing schemes shows, international harmonization of incentives is a very difficult thing. But, given the limited effectiveness of incentives, their tendency to distort FDI, trade flows and the danger of an incentives war, a concerted effort in this area would be desirable.

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a While figures from the benchmark surveys on United States FDI abroad for 1982 and 1989 show a decline in the total subsidies received by foreign affiliate from $1.3 billion to $1.2 billion, those in manufacturing rose from $947 million to $965 million over the same period. The share of total subsidies provided in developed countries rose from 73 per cent to 80 per cent over this period.

Notes

1 There is an extensive literature on the new growth theory. For a survey, see Grossman and Helpman, 1992.