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A Contribution to WDR 2005 on Investment Climate, Growth and Poverty

Creating FDI Friendly Environments in South Asia

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Key Messages

1. Structural liberalisation and tariff reduction are not enough to make a country attractive to investors. South Asia attracts the lowest rate of foreign direct investment (FDI) in the world at just 0.5 per cent of GDP and has fallen behind in the competition for FDI.
2. The countries of South Asia are ranked among the least competitive in the world. The region's economic performance is poor. The public service is exposed to political interference and characterised by bribery and corruption. Potential investors see the political risks as "extremely high".
3. Investment is flowing to countries with better domestic investment climates: good governance, sound institutions and a system of property rights."
4. To bring investors to South Asia, governments must promote good governance, expand market reforms, reduce the burden of regulation, and work harder and more visibly to establish a liberal policy environment that sustains market incentives and investor trust.

David Irwin is former head of the Small Business Service and is now a consultant in economic development. This case study draws freely on papers presented at the FIAS South Asia FDI Roundtables, in Dhaka 2002: Michael Lester, "Establishing an attractive policy environment for FDI". Sanjaya Lall, "Enhancing competitiveness to attract FDI" & "Focusing on generating a competitive export environment". And in Maldives 2003: Scott Jacobs, "The importance of institutions in determining the investment environment". Jo Beth Bertens, "Tax administration". Richard Filmer, "Customs administration: impediments to trade". Jacqueline Coolidge, "International benchmarks for administrative barriers & lessons concerning reforms". Wali Bhuiyan, "A foreign investor's experience with administrative barriers in South Asia"

Introduction

1. Productive investment plays a critical role in growth and development, so improving the climate for attracting foreign investment in developing countries is regarded as increasingly important. However, the level and productivity of that investment is greatly influenced by a raft of government policies, regulations and institutions that shape the opportunities, costs and incentives faced by firms and entrepreneurs.

2. DFID has jointly sponsored two South Asia[1] Regional Investment Roundtables with Foreign Investment Advisory Service (FIAS) in Dhaka (2002) and the Maldives (2003), attended by high-level representatives from governments and the private sector.

3. The Dhaka Roundtable looked at the features of a successful environment in which to attract Foreign Direct Investment (FDI), such as infrastructure, IT development and the opportunity to link into global supply chains. It also identified administrative barriers faced by foreign investors. The Maldives Roundtable addressed these administrative barriers in greater detail, focusing on possible reform processes.

4. This case study draws on the papers presented at those Roundtables in order to address three broad questions posed by WDR2005:

(i) What role can improvements in the investment climate play in accelerating growth and poverty reduction?
(ii) What constitutes good practice in relation to the key elements of a sound investment climate, and what have we learned about the possible role of more selective or pro-active measures?
(iii) What strategies for reforming the investment climate promise to be successful, and what role might international cooperation play in supporting reform efforts?

Advantages from FDI

5. Creating a good investment climate, one that encourages the private sector to invest, create jobs and increase productivity, is a key factor in achieving economic growth and poverty reduction.

6. Jacobs argues that opening markets leads to higher rates of private investment which in turn leads to higher economic growth. He notes that firms and sectors with high FDI have higher average labour productivity and pay higher wages.

7. Poverty reduction depends heavily on sustained economic growth. Ever-accelerating productivity improvements in the private sector have been the engine of economic growth and unprecedented improvements in personal incomes on a global scale. There has not been a single economy in the world that has not had high growth without substantial FDI[2] (though Korea and Taiwan relied far more on building capacity and importing technology.[3]

8. A study in five South Asian countries found that, from 1980 to 2000, “FDI inflows contributed more to GDP growth in South Asia than did an equal amount of foreign borrowing”[4]. Other work has shown that FDI is relatively resilient to financial crises. In East Asian countries, such investment was remarkably stable during the global financial crises of 1997-98, in contrast to other forms of private capital flows.

9. So there is an imperative to attract FDI, but countries seeking it have to balance the potential benefits against the costs – perceived in economic, social and political terms. The challenge to governments is to put in place FDI policies that realise the potential benefits, balancing potential ‘market failure’ risks against the risks of ‘government failure’, always associated with interventionist policies.

Attracting FDI

The enabling environment

10. There are now over 63,000 firms with foreign operations in over 800,000 affiliates.[5] NCs are dominant traders and account for around two thirds of world trade. So they want a business friendly environment, one that is conducive to doing business easily and profitably.

11. Multi-national companies, with their ability to bring large amounts of investment, have considerable choice about where to invest. Policies that are good for indigenous businesses are also good for MNCs, though the reverse is not always true. Whilst this case study is about creating an environment that will attract FDI, ideally governments should pursue strategies intended to improve the environment for all businesses.

12. When businesses are considering whether and where to invest, they look at a wide range of factors – some factors will be barriers or deterrents and some will be motivators, including particularly whether there is a local or regional market and whether they can make a return. Some barriers, unless properly addressed, will deter completely and, no matter how attractive the incentives, investors will not invest. Incentives cannot compensate for a lack of the fundamentals, particularly the market and the business environment. Incentives might influence the decision on where to invest, but not the initial decision on whether to invest.

13. Market size is important, but less so than in the past. With globalisation and falling information and transport costs, national market characteristics matter less than the characteristics of the regional market. Efficient supporting institutions (eg R&D, finance) are required. Cheap labour and primary resources are declining in significance. Governments must be demonstrably “open for business”.

14. Factors which investors take into account[6] include:

(i) Political and social stability (with a well-managed macro-economy).

(ii) Consistent application of policies.

(iii) Fair regulatory framework – with clear, transparent & predictable economic, legal and tax policies – which is not over prescriptive or prone to unjustified delays. Administration and procedures should be clear and efficient. The rule of law – regulations needed to be adhered to and corruption avoided.

(iv) Supportive framework for private enterprise with open markets.

(v) Opportunity to make a fair return on investment (with easy inflows & remittances).

(vi) Equal treatment for foreign & local firms.

(vii) Strong institutions.

(viii) Enforceable intellectual property rights.

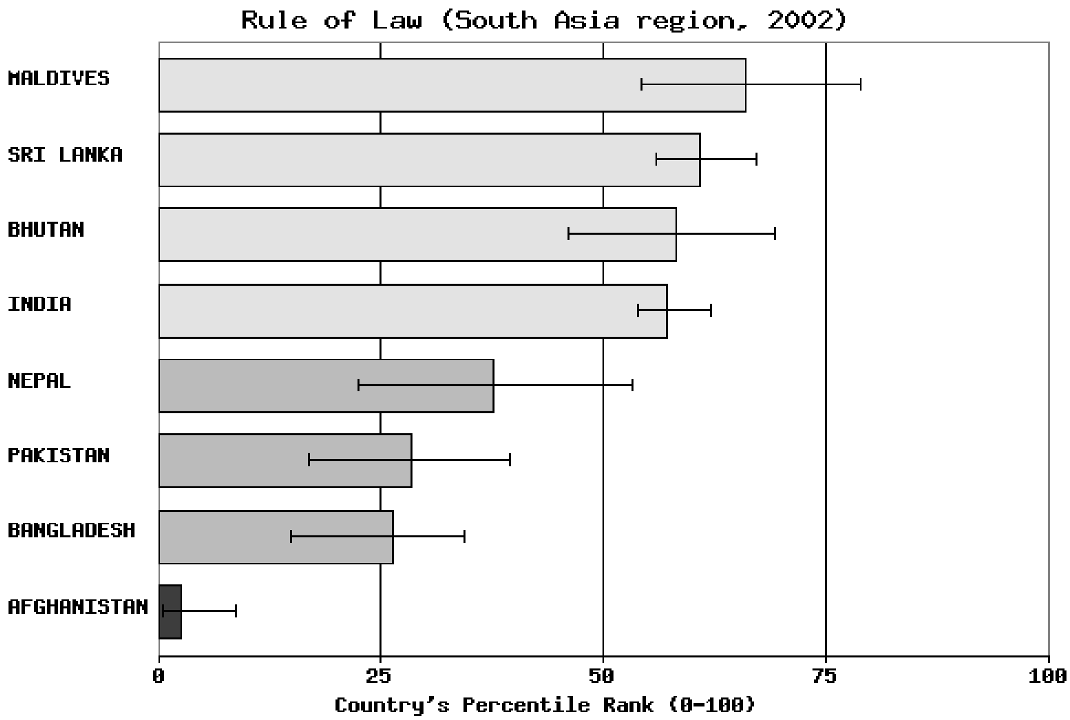
(ix) Enforceable property rights.

(x) Good supply chains and ability to source materials and sub-contractors locally.

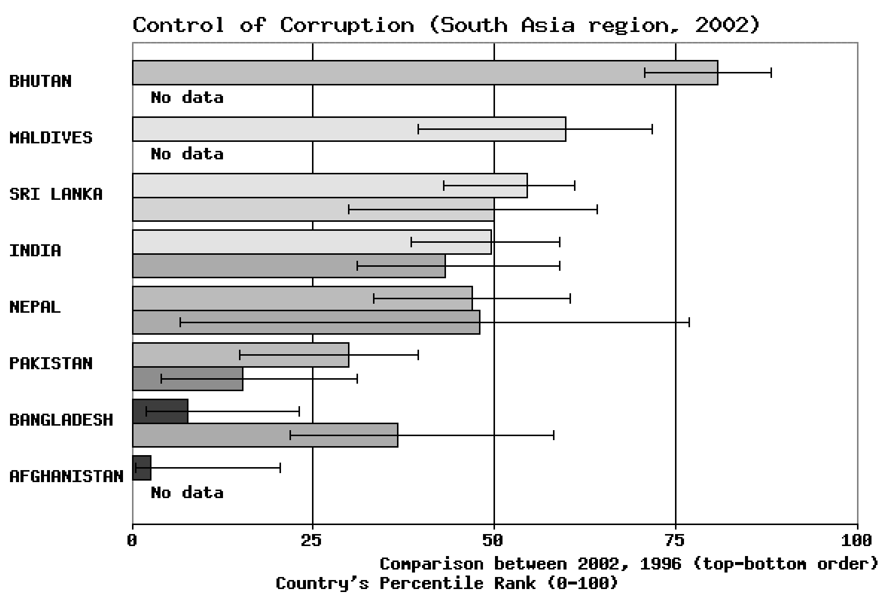
The disabling environment

15. Instead of seeking to remove barriers, streamline regulations and create an enabling environment, it seems that many governments still seek to impose controls and regulations on inward investors. Poor legislation and regulation, or poorly enforced legislation, and high levels of corruption are all likely to deter potential inward investors.

16. Surveys by the World Bank[7] suggest that the countries of South Asia all have some way to go with the rule of law. Bhutan comes out best in relation to corruption. Bangladesh has fallen over the last few years and is now bottom of the list of 133 countries (which excludes Afghanistan) surveyed in Transparency International's Perceived Corruption Index.



Source: D. Kaufmann, A. Kraay and M. Mastruzzi, 2003: Governance Matters III: Governance Indicators for 1996-2002 (http://www.worldbank.org/wbi/governance/pubs/govmatters3.html)



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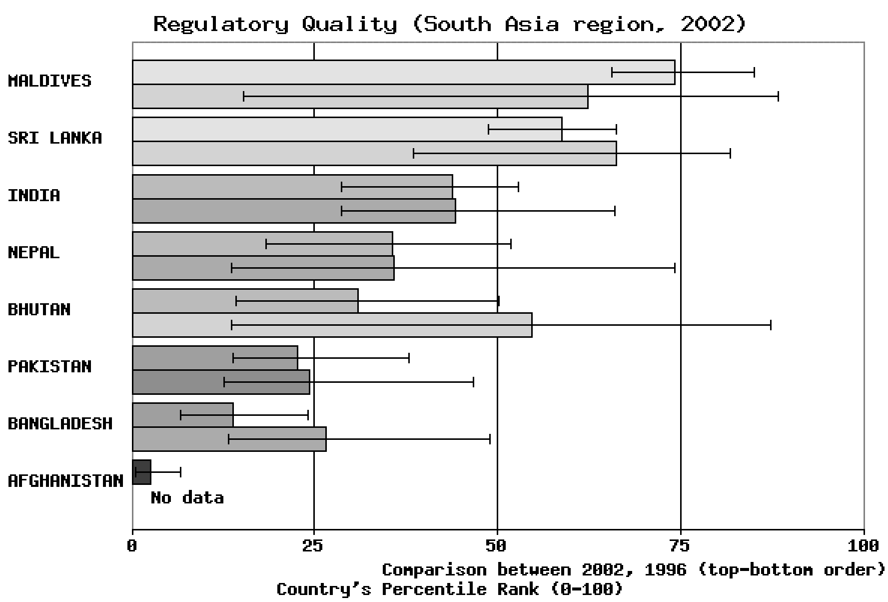
17. Jacobs notes that most studies show that the quality of the business environment is more important in influencing FDI flows than traditional investment incentives such as low wages, tariff cutting and special investment inducements. One study[8] of entry barriers in 85 countries found that countries with heavier regulation of entry have higher corruption and larger unofficial economies, but not better quality of public or private goods. Countries with more democratic and limited governments have lighter regulation of entry. The study found that the worldwide average number of screening procedures facing a new entrant is 6.04, and that meeting the official entry requirements in the average sample country requires roughly 47 days and fees of 47 per cent of GDP per capita. The sample included three South Asian countries, of which India is substantially worse than the global average. Pakistan is at about the global average. Sri Lanka performs better than the global average on most measures. It is worth noting that per capita FDI from 1999-2001 followed the same order: India worst, Pakistan next, and Sri Lanka far ahead. Reducing regulatory risk (the risk that governments will change



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the rules of the market or will apply rules to benefit national incumbents) is critical in increasing investment inflows, particularly in vital infrastructure sectors characterised by long-term commitments, high sunk costs and intricate property rights.

18. Other issues include:

(i) Concern about foreign control: perceived as threatening to domestic political sovereignty and the national interest.

(ii) Opportunities for local enterprise: Small, indigenous businesses are seen to be threatened by FDI if investors are allowed a free rein in domestic markets. This often motivates sector restrictions, local content rules and equity ownership limits.

(iii) Local content rules: restrict foreign investors' flexibility to make commercially efficient sourcing and procurement decisions. They potentially inhibit the transfer and diffusion of best practice to local industry.

(iv) Capturing rents: The desire to bargain over the division of profits is another barrier. Where government-created market distortions result in high profits, limiting the entry of foreign firms does at least keep those rent returns within the country, albeit to the detriment of domestic consumers. The policy challenge is to minimise the overall opportunities for rent-seeking by putting in place effective competition and regulatory policies for all firms.

(v) Outright bans: effected by 'negative lists' of forbidden sectors, or 'positive lists' of permitted sectors. Positive lists, or no lists but a requirement for approval, introduce undesirable scope for discretion compounded by lack of transparency or appeal mechanisms, and hence more scope for corrupt practices.

(vi) Equity limits placed on foreign ownership compromise both the flow and quality of FDI. The joint ventures which result are often weak and short-lived, in contrast to those undertaken purely on the basis of mutual commercial judgements.

(vii) Official approvals: often require submission and assessment of large amounts of information, but have little real effect except to introduce delays, uncertainty and lack of transparency and accountability.

(viii) Vague criteria, such as 'contribution to economic development' and 'market disruption', are often used as a basis for regulatory decisions. They introduce administrative discretion and investor uncertainty and are best avoided.

(ix) Taxes: Taxes and tariffs are so high in some countries that incentives are then needed to make an investment project viable. A more effective approach is to put in place a modern and moderate general tax regime applied uniformly across all tax-payers, conducive to investment of all types, and which gives businesses the predictability that they want.

(x) Transparency of law: If laws are not publicly available, it creates an air of uncertainly, and a suspicion that the laws may be changed often or that tax laws are applied on an ad hoc basis. Providing easy access (e.g. via the government's web site) sends a message that the country is investor-friendly.

(xi) Incentives: Many countries create all kinds of special exemptions and incentives, ostensibly to encourage investment. However, if the procedures necessary to qualify for those investment incentives, special exemptions and tax refunds are not transparent and clear, they are ineffective. It is usually more effective to reduce the overall tax rates than to offer exemptions and incentives.

(xii) Repayments: Slow repayment, especially of VAT, can create serious cash flow problems for a firm, and can create a prohibitive expense especially for new firms.

(xiii) Customs administration is an important consideration as it can impact directly on costs of production and indirectly through reduced flexibility of operations. Customs impediments can involve additional costs of unnecessary paperwork to meet customs requirements, but also demands for unofficial payments made to avoid other higher costs. Discretion in the system can lead to unexpected delays and in some cases differential treatment between traders. As a general rule, the more officials required to inspect and approve a transaction, the greater the delays and the greater the scope for corruption. Reforms can result in major savings for exporters, such as those in Bangladesh where the maximum number of signatures required to clear goods has dropped from 25 to 5 in four years and export clearance times have dropped from an average of 72 hours to three hours in the same period.

(xiv) Export-oriented FDI: Where a developing country market is small, trade liberalisation can support efficient, globally competitive scale FDI operations. It appears that countries which export more are also more attractive to foreign investors.

(xv) Liberal trade policies are important both to allow firms to develop markets and to produce goods and services efficiently once an investment is made.

(xvi) Land: Foreign enterprises often face difficulties in owning or leasing land. Securing tenure can be difficult where land is communally owned or state owned and where clear conveyancing and titling is lacking.

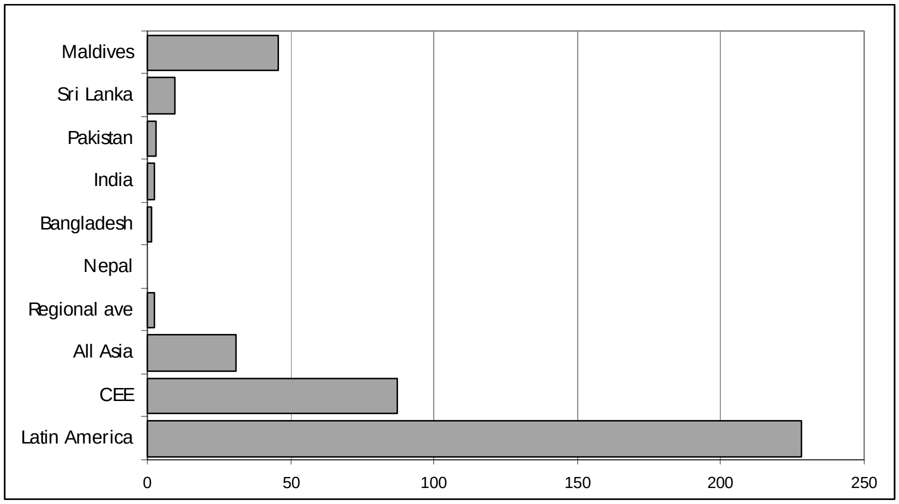
(xvii) Expatriate labour restrictions: By restricting the ability to bring in their own personnel, many host countries hope to force investors to train and employ local labour. The restrictions can be counter-productive, and may not even be needed; expatriate labour is very expensive and investors have a strong economic incentive to substitute local staff as soon as possible.

FDI in South Asia

19. Structural liberalisation and tariff reduction are not enough to make a country attractive to investors today. South Asia still attracts the lowest rate of foreign direct investment (FDI) in the world at just 0.5 per cent of GDP.

20. South Asia has fallen behind in the competition for FDI. FDI per capita varies widely in South Asia, from just US$ 0.23 per person per year (in 1999-2001) in Bhutan, to US$ 45.41 per year in the Maldives. The annual inflow of FDI into the region was an average of just US$ 2.57 per person. It is interesting that Sri Lanka, which began its structural reforms first and has gone the furthest in market liberalisation, is among the front-runners in the region in FDI, despite years of internal strife.

21. he average FDI inflow for all developing countries in Asia is over ten times higher than in South Asia. Only the Maldives exceeded the Asian average. Latin America received almost 100 times more.



22. The countries of South Asia are ranked among the least competitive in the world, on factors such as economic performance, especially in regard to the macro economy, international investment competitiveness, domestic economy and international trade. They fall a long way behind on business efficiency, which covers the labour market, globalisation, financial markets, management practices and productivity. Government efficiency is poor. Weakest of all, is infrastructure, covering health and environment and basic infrastructure.

23. The region's economic performance is poor. Government efficiency is very poorly ranked for cross border ventures, which cannot be negotiated without government intervention, foreign investors may not acquire control in domestic companies, and the public service is exposed to political interference and characterised by bribery and corruption.

24. Potential investors see the political risks as "extremely high". Business operations and remittances risks are seen as between "very high" and "extremely high". Operating conditions are regarded as at least "poor" due to bureaucracy, infrastructure and work ethic, while in some cases infrastructure and general economic weakness make them "dreadful".

25. Other problems include:

(i) the FDI regime does not match best practice;
(ii) FDI promotion and targeting are weak;
(iii) Trade regime is still biased against exports;
(iv) Transaction costs are relatively high;
(v) Social & political uncertainty is growing;
(vi) Liberalisation is hesitant.
(vii) Government does not give the impression of being ‘open for business’.

Principles for policy makers

26. Based on studies in Bangladesh and Nepal, as well as a group of countries in the south Pacific, Filmer has suggested five principles for the design of effective and efficient customs administration but which could apply to all regulation:

(i) transparency;
(ii) predictability;
(iii) comprehensiveness;
(iv) simplicity and
(v) accountability.[9]

27. There are a number of areas[10] where Governments can do more to improve their business environment.

Good governance[11]

28. Good governance denotes a desirable state of affairs and so is the key to success of all the reforms. Political and bureaucratic accountability are the two principal components of good governance and, without them, good governance is not possible. Securing progress on this front is the highest priority as continued difficulties pose a serious threat to the sustainability of even the development achieved already. Establishing the rule of law is in fact a pre-requisite to ensuring good governance.

29. The size of the state institutions is frequently large and thus mostly inefficient, unproductive and hazardous. So, rightsizing the government is important. By reducing the number of officials in the decision making process in various state organs, transparency and accountability of bureaucracy can be established. Offering a reasonable compensation package to the officials retained is a key factor in ensuring transparency and accountability.

Commit to ethics and the rule of law

30. A reputation for honesty is the bedrock of credibility. Governments should build strong ethics infrastructures to reduce problems such as corruption and conflicts of interest. Institutions with direct contacts with the private sector should take strong and visible action by adopting a tough ethics code on conflicts of interest.

31. A legal culture where there is a general acceptance within society that issues are resolved within a legal framework is essential. Agents within the system must confidently expect others within the system to abide by the set of rules contained within the legal system. There must be a sound judicial system, separated from the executive branch of government. Archaic laws, especially those related with trade and investment should be updated in line with the needs of the day.

Build credibility through consistent adherence to market solutions

32. The litmus test is whether the institutional regime, through sustained commitment to a clear set of rules, is credible to investors, producers and consumers. Credibility can be built in many ways. Weaker independence of independent regulators can, for example, be offset by transparent procedures and stronger judicial review and consumer oversight.

Maximise transparency throughout the entire policy process

33. Transparency is key to regulatory quality. In addition to democratic values of openness, transparency in regulatory decisions and applications helps to cure many of the reasons for regulatory failures - capture and bias toward concentrated benefits, inadequate information in the public sector, rigidity, market uncertainty and inability to understand policy risk, and lack of accountability. Transparency helps create a virtuous circle - consumers trust competition more because special interests have less power to manipulate government and markets.

Adopt clear and simple rules and enforce them

34. Policies and standards must be unmistakably clear and fairly implemented. Simplicity is more important than a regulatory regime that addresses every situation. In countries with weak legal traditions, simple rules place fewer demands on courts, are cheaper and more likely to be accurate, and reduce the risk of corruption.

Strengthen external checks on administrative action

35. A range of oversight mechanisms is good protection against capture and administrative abuse. The Sri Lankan telecommunications regulator concluded that “one of our biggest achievements was that instead of…appeals going through back channels, we created a situation where an appeal was submitted to the court of appeals”.

Improve skills in the public sector

36. The World Bank emphasises that investing in people is a key to growth, and this is particularly the case when civil servants unfamiliar with market principles are responsible for regulating market behaviour. Training of administrators is needed to

deal positively with the needs of business, to maintain and develop regulatory quality, and to reflect the growing complexity of economic activity.

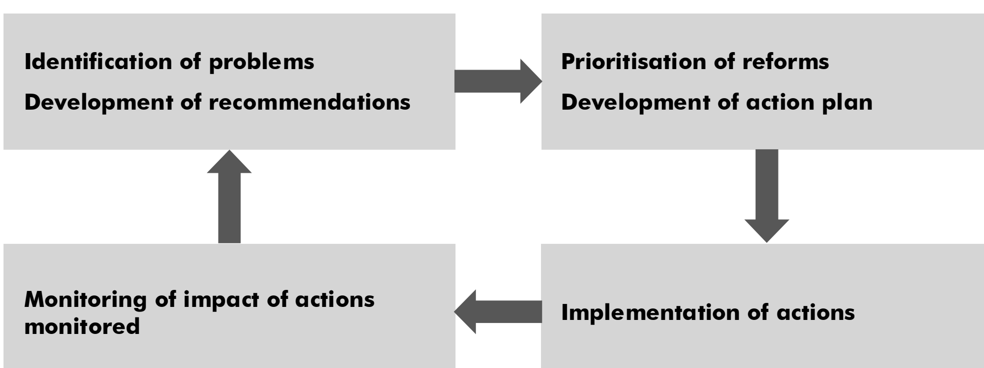
Policy makers need to benchmark key indicators of the business environment and the investment framework.

Regulatory reform[12]

37. Governments are recognising that their best route to economic growth and prosperity is to harness the private sector effectively. Increasingly governments are setting up mechanisms to listen to a business voice, on the basis that they are most likely to be able to think through the implications of proposed changes to regulations.

38. This can be most effective when there is a champion within government, preferably a first rank Minister, someone who can take tough decisions, and keep everyone on side.

39. Creating a mechanism within government, which includes Ministers and representatives of the business community, to review proposals for regulation and to quiz Ministers about their intentions can a have positive effect. To do so, however, it needs real teeth and needs to be able to set its own agenda, following the stages shown in the cycle.



Conclusions and recommendations

40. The World Bank has noted that "investors are becoming more selective in choosing their investment destinations. As a result, investment is flowing to countries with better domestic investment climates: good governance, sound institutions and a system of property rights."[13]

41. Businesses recognise the need for regulation and taxation. But they want this to be balanced against their need to be competitive and profitable. Jacobs notes that the reform agenda is not about unleashing the market by abandoning the role of the state, but recognising that strong states and strong markets are complementary, so institutional reform strategies must be aimed at strengthening markets and states simultaneously. Societies tend to mistrust market institutions, though they may not trust public institutions either. It is this lack of trust that is a major cause of over-regulation.

42. Effective, efficient government action improves trust in markets and states and contributes to the performance of both. A strategic and inherently political approach is necessary, since building public confidence may require trade-offs in short-term and long-term benefits and costs. Concrete steps are needed to demonstrate that important public interests such as safety and equity will be safeguarded within dynamic and global markets.

43. To bring investors to South Asia, governments must expand market reforms, reduce the burden of regulation and work harder and more visibly to establish a liberal policy environment that sustains market incentives and investor trust.

44. For South Asia, the major institutional challenges over the next few years are to promote good governance, unwind extensive state involvement in the economy, discourage entrenched habits of rent-seeking and seek to eliminate corrupt practices, build new capacities in the public administration, and create the market-based regulatory regimes and institutions that will support investment, innovation, and vigorous

competition. This kind of reform will accelerate structural adjustment and create economies that are more flexible and competitive in regional and global markets, and that grow faster with lower inflation.

45. An improved investment environment can be 'signalled', and often fostered, by well-targeted aid, such as multi-lateral loans, designed to support improved policies and building governance, institutions and infrastructure necessary for private sector productivity improvement.

Notes

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[1] The countries of South Asia comprise Afghanistan, Bangladesh, Bhutan, India, Maldives, Nepal, Pakistan, and Sri Lanka

[2] According to Joe Battat of FIAS in his opening remarks at the Dhaka Roundtable.

[3] Lall

[4] Agarwal P, “Economic Impact of FDI in South Asia”, 2000, quoted in Jacobs.

[5] Lall

[6] See Lall and Jacobs

[7] See info.worldbank.ord/governance/wbes/front.htm

[8] Djankov. S, et al, “The regulation of entry”, World Bank, 2002, quoted in Jacobs.

[9] It is interesting to note how closely these parallel the UK’s Better Regulation Task Force’s five principles of good regulation: proportional, accountable, consistent, transparent and targated.

[10] Cited from Jacobs, except where indicated

[11] Bhuiyan

[12] Coolidge

[13] Quoted in Jacobs