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Foreign Direct Investment Flows into Developing Countries: Impact of Location and Government Policy

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This study addresses vital questions: First, why a select group of developing countries receives the lion's share of Foreign Direct Investment (FDI), while the overwhelming majority of less developed countries are left behind? Second, whether and to what extent FDI inflow is a function of a country's FDI policy regime?

The study identifies market size, the rate of growth in market size, economic competitiveness, infrastructure, and worker productivity as key location factors. Further, several specific FDI and trade policies are germane to attracting a significant volume of FDI. These include lowering the ratio between the volume of FDI that is approved, as against the FDI actually undertaken by streamlining the approval process and removing arbitrary foreign ownership ceilings in sectors open for FDI deter foreign investment. In addition, the ability of foreign direct investors to repatriate capital and remit profits, setting up special economic zones to facilitate FDI, lowering regulatory burdens, and flexible labor policies are desirable vehicles for attracting FDI.

Key Words: Foreign Direct Investment; Developing Countries; Multinational Enterprises; Economic Development.

I. Introduction

The beneficial impact of Foreign Direct Investment (FDI) on a nation's economic growth and development has been widely recognized. National governments in the developing world have increasingly come to view FDI as a valuable source of capital; as a highly advantageous source for accessing Western technology, technical and managerial know-how; and as a way to create and upgrade human capital. FDI provides international market access and vital contacts in world markets, and serves as a platform by which to increase national exports. Firm specific assets – capital; technology; technical, managerial and human resource skills; jobs; and access to markets – often lacking in many

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developing countries are vital to economic development. These special attributes of Foreign Direct Investment are considered as the *sine qua non* of fast-emerging growth economies in Asia (China in particular). Even India, a country that for decades implemented highly restrictive policies against foreign ownership of domestic assets, is vying with other countries in the region to attract FDI.

According to one authoritative study, the economic benefits to developing countries from global capital market access may have been roughly as substantial as benefits achieved from access to trade in goods and services. The limited gain in access to global capital markets may be nearly equal to the approximately \$350 billion a year in additional GDP, or 5% additional increments in GDP, that have accrued through trade in goods and services. Within the mix of global capital (bank loans, portfolio investments and FDI), the latter is reported to have an especially beneficial impact. The study suggests that "...a rise of one percentage point in the ratio of the stock of FDI to GDP will raise GDP by 0.4 %. In the 1990s the ratio of FDI to GDP in the developing countries went up from 7% to 21%. That rise of 14 percentage points implies an improvement in GDP of 5.6%."¹ This increase is exemplified by China's astounding economic growth, partly fueled by the inflow of a huge volume of FDI during the last 15 years.

FDI is the most desirable form of capital inflows for development and growth, compared to other types of foreign capital. Bank debt, for example, is highly risky because the borrower is obligated to pay the loan even if the income of the debtor falls drastically. To be sure, in 2001 developed countries agreed to cancel twenty billion of the developing countries' debt. Still 47 developing countries, including 37 African countries, owe total of \$-422 billion. The risk and volatility of bank debt is compounded by loans denominated in foreign currencies, short maturities, or floating interest rates. Similarly, portfolio equity investments with a very short time horizon are highly prone to capital flights, which occur if investment earnings do not materialize due to other macro-economic events such as currency crises, banking crises,

¹ See Wendy Dobson and Gary Hufbauer, *World Capital Markets: Challenge to the G 10*, (Washington, D.C.: Institute for International Economics) cited in *The Economist*, "A Cruel Sea of Capital: A Survey of Global Finance," May 3, 2003, p. 8.

and other financial calamities. Dobson and Hurbauer estimate the loss of GDP from 24 banking and 36 currency crises in the 1980s and 1990s to be a whopping 2.2% for Latin America. The financial contagion of the 1990s cost Asia 1.4% of GDP per year. In contrast, FDI has a long-term time horizon, and is relatively safe because it is harder to withdraw FDI when economic times are difficult. FDI also offers the benefit of risk-sharing with the host country because the cost of capital investment is dependent upon and moves in step with the host country's economic fortunes.²

In light of the benefits of FDI, the dire need of developing countries for access to foreign capital, and the desire of foreign investors for high rates of return, one would expect increasing FDI inflows -to less developed countries. However, the largest percentage of FDI inflows takes place within the so-called *triad* – North America, Western Europe and Japan. While a dramatic rise is evident in FDI inflows into the developing countries, only ten countries – the so-called big emerging markets – have absorbed the lion's share of the inward FDI. China, Mexico, Brazil, India, South Africa and a select group of Asian countries form the big emerging markets that take the largest share of FDI inflows, with China in 1994 becoming, along with the United States, one of the top two destinations hosts to annual FDI inflows.

All this raises a key question: Why does so little FDI flow from rich countries to the poorer developing countries? To answer this question, one must address two additional questions. The first seeks to identify the determinants of FDI – put differently, what factors motivate overseas expansion by multinational corporations overseas? The second question is why a select group of developing countries receives the lion's share of FDI, while the overwhelming majority of less developed countries are left behind? Specifically, what particular location advantages or attributes of the host country propel a high volume of FDI inflows?

The FDI regime of a host country has been widely acknowledged as a key variable in deterring or attracting FDI. Indeed, a large number of developing countries still shy away from allowing foreign capital to flow in or to leave freely. A case in point is India. Blessed with significant

² Ibid, pp. 8 – 9.

location advantages, such as a huge and growing market and a relatively high rate of economic growth recently, India has been unable to attract a volume of FDI commensurate with its economic size. Surely, the restrictive dirigiste FDI regime, albeit liberalized since 1991, has had a negative impact on inward FDI flows. India's FDI stock of \$4.3 billion in 2002, pales in comparison to China's \$53.7 billion in that same year. Therefore, a related third question is whether and to what extent FDI inflow is a function of a country's FDI policy regime? National government policies regarding foreign investors' ownership of domestic business, corporate taxation, profit repatriation, the setting up of special economic zones to facilitate FDI, the lowering of regulatory burdens, flexible labor policies, the rule of law (upholding of contractual obligations, in particular), other barriers to entry and exit, and many other measures of liberalization critically impact FDI inflows.

In this study we will address these three questions. Accordingly, the essay will present a brief synopsis of theories regarding FDI expansion, including those related to the overseas growth of developing-country FDI. However, since this subject has been covered in a vast amount of literature, our treatment will be brief as we highlight key themes and the works of major authors. Since the second question focuses on the key issue of location advantages, it is useful to treat separately the theoretical underpinning of location 'pull' factors as they are set out in the works of leading scholars, notably the works of John Dunning. Next, we will explore the presence and absence of liberalization and openness in the FDI regime as a spur or a barrier to FDI inflows to the developing countries. Several interpretive examples will be provided. The final section will elaborate on the programmatic implications of this study for national policy.

II. Determinants of the Expansion of Foreign Direct Investment Abroad: A Brief Exposition

More than three quarters of FDI flows from wealthy countries to other advanced rich countries of the so-called *triad*: the United States and Canada, Western Europe and Japan. In 1998, a typical year for investment flows, regional FDI inflows as a percentage of total global flows were as follows: Western Europe accounted for 37% of total FDI,

North America for 33%. In contrast, Asia absorbed 13%, Latin America 11%, Eastern Europe 3% and Africa less than 2%.³ However, a decidedly upward trajectory is evident in a rising trend in FDI investment flows to developing countries, especially considering the fact that China in 2004 received the second largest percentage of FDI after the United States. Such expansion affirms growth in FDI volume. This positive change has been fueled by spectacular economic growth in Asia (China in particular), the push toward liberalization of capital flows in the developing countries, and the desire of many developing nations to compensate for the declining availability and high risk of debt capital.

The motives that govern FDI decision-making are complex and multifaceted, and no single hypothesis applies universally. The evidence suggests that multinational firms invest overseas for a variety of reasons. The motive for a firm to undertake FDI is a function of a multitude of factors, a few of which include the size of the firm, the nature of its business, the type of industry in which it operates, its international orientation, and the level of its international experience and corporate strategy. These firm-specific characteristics determine the motives of a particular firm to undertake international production, and shape the firm's decisions about the size of investment and whether to opt for equity sharing or total ownership.

The theory of FDI expansion is grounded in the proposition that some firms have certain special assets that give them a competitive edge abroad. Competitive or proprietary advantages based on the ownership of certain intangible assets enable a transnational enterprise to undertake international production. Among these assets are proprietary technology, brand name promotion, and skills in marketing, logistics and organization. Global corporations from the advanced countries can leverage a variety of assets. These include highly advanced technology and marketing capabilities, large size, and superior managerial and organizational skills to carry out FDI or to seek out highly concentrated markets. Overall, technological prowess, advanced marketing capabilities, superior brand names and other intangible advantages – sometimes

³ United Nations Conference on Trade and Development, Trade and Development Report 1998, *Global Instability, Growth in Africa* (New York, NY: United Nations Publications, 1998), chapter 1.

referred to as ‘product differentiation’ – give these firms competitive advantages *vis-a-vis* competitors overseas.⁴

The product life-cycle theory, which is grounded in the path-breaking works of Raymond Vernon, is an illuminating framework for explaining the driving force behind FDI generally. Central to this theory is the premise that multinationals enjoy proprietary products and processes, research and development, and marketing and management skills that cannot be fully and profitably exploited in the home market. Further, growth is inhibited by the high income elasticity of demand for the products of these firms and by barriers to trade overseas. The firm can overcome these through FDI. Thus, these firms bring a portfolio of assets such as skills-sets, technologies, know-how and other intangible assets that were first designed to innovate products for sale in the home market. This package of assets is in turn leveraged through FDI and international production abroad- so that the firms may preserve their oligopolistic structure and remain competitive in the ruthlessly competitive environment of their industry at home.⁵

A variety of explanations are offered at the micro-firm level and in the orthodox tradition as to why certain firms are inclined to use FDI. Michael Porter suggests FDI as a competitive strategy of the firm.⁶ Kunichi Ohmae sees global firms as national enterprises carrying out FDI in order to rationalize operations, enhance efficiencies and thereby increase growth and profitability. FDI represents efficiency-seeking enterprises that seek to transcend national identity.⁷ Williamson argues that a firm will expand abroad via FDI “...until the marginal cost of

⁴ See Edward Graham, *Global Corporations and National Governments* (Washington D.C.: Institute for International Economics, 1996), Ch. 2; see also Shah M. Tarzi, “Dynamics of the Rise and Spread of Multinational Enterprises from the Developing Countries,” *Indian Journal of Economics*, No. 315 (Spring 2000).

⁵ For the original formulations of this theory, see Raymond Vernon, “International Investment and International Production in the Product Cycle,” *Quarterly Journal of Economics*, Vol. 80 (1966), pp. 190-207; Vernon, “The Product Cycle Hypothesis in a New International Environment,” Vol. 41, No. 4 (November, 1979), pp. 255-267. This exposition also appears in Shah M. Tarzi, “Dynamics of the Rise and Spread of Multinational Enterprises from the Developing Countries.”

⁶ Michael Porter, *On Competition* (Cambridge, MA: Harvard Business Review Book Series, 1996); see also Porter’s important work, *Competitive Advantage: Creating and Sustaining Superior Performance* (1998).

⁷ Edward M. Graham, *Global Corporations and National Governments*, p. 34.

controlling a larger organization equals the marginal transactional cost of contracting with an outside agent to perform the same function as was internalized within the firm.”⁸ In the radical tradition, the works of Stephen Hymer are noteworthy. He too stresses the role of proprietary advantages such as economies of scale, special managerial and organizational skills, marketing competencies and brand loyalty, among others, as determinants of FDI expansion. He states that “scale economies can be achieved in operations located solely in home markets with part of output exported, while brand loyalty or proprietary technology can be exploited via licensing agreements with firms based in nations outside the home market.”⁹ Hymer, however, is skeptical of the benefit of FDI as transnational enterprises translate these proprietary advantages into unrivaled market power in developing countries and extract unreasonably high economic rent as a condition of entry.

The product-life-cycle theory yields several interesting insights regarding the motives of multinationals from developing countries for undertaking international production. First, the key firm-specific asset is embedded in the down-scaling of technology (to smaller markets) that enable developing-country multinational enterprises to specialize in relatively labor-intensive production abroad to match lower wage rates, using subsidiaries that are modest in size and scale. Second, these firms leverage the cost advantages they enjoy due to lower wages and overhead cost. Third, firms may adopt or improve upon the processes and products associated with the use of highly mature technologies, originally developed by firms from advanced countries and later phased out by such firms. This process amounts to a ‘technological trickle-down’ based on the absorption of mature technologies. These firms’ adoption of such mature technologies to their home-country conditions and their ability to compete on the basis of price enable them to bring these special advantages to bear on investment in other countries.

A growing number of developing-country multinationals also undertake direct investment in advanced countries, notably high technology Indian firms such as Wipro, Infosys, and Satyam, as well as many

⁸ Ibid. p. 39

⁹ Stephen Hymer, *The Multinational Corporation and the Law of Uneven Development: A Radical Approach* (Cambridge and New York: Cambridge University Press, 1979)

Korean enterprises. The product-life-cycle theory does not adequately explain the push by developing-country multinationals to invest in advanced countries where adoption of mature or obsolete technologies does not provide special advantage. A related approach, the 'core competencies building' conception, has been proposed. This frame of reference also accepts the prevailing theory of FDI as envisioned in the product-life-cycle: the developing-country multinationals draw proprietary advantage from the mastery of the relevant technology and subsequently adapt to the host country's market needs. In addition, the core-competencies-building approach takes into account the ability of a developing-country firm to create a set of managerial, marketing, engineering, and technological skills, along with process innovation capabilities, that enable it to compete with firms in advanced countries and undertake FDI in these countries.¹⁰

In addition to the above characteristics, several other key location-attributes pull in FDI:

Multinationals undertake international production to take advantage of lower factor costs of production to lower costs, thereby remaining competitive and profitable.

One major motive of export-seeking firms, especially those in manufacturing, has been to lower the cost of raw materials, land and labor. Offshore investments by advanced-country firms in manufacturing facilities in China and IT services in India are significantly motivated by lower wages in these host countries. On a comparative basis, both skilled and unskilled labor is much cheaper in developing countries, enabling global firms to reduce production costs. However, two qualifications are in order about cheap labor: First, plentiful cheap labor is not by itself a factor for inducing capital inflows. If this were the case, total FDI inflows to less-developing countries would be far greater than the miserly one percent of developing countries' GDP, and would not be concentrated in a select group of ten big emerging markets. The fact that labor, albeit plentiful, is less well educated and less trained in industrial skills than in rich countries is a significant deterrent. Second, in many instances there have been important additional motives, so that differences in wage levels have not been the

¹⁰ The section on developing countries draws on Shah M. Tarzi's work, "Dynamics of the Rise and Spread of Multinational - Enterprises from the Developing Countries."

determining motive. Lower cost factors have become salient as the pressure of competition in export markets has increasingly forced multinational firms to lower their production costs in order to remain globally competitive.

Foreign direct investment is a manifestation of the need of global corporations to capture economies of scale, rationalize operations, and thereby remain profitable, competitive and able to grow.

For a small number of the most sophisticated firms, the prospects of capturing economies of scale and rationalizing operations, and the need to gain access to the technology of developed countries, constitute the primary motives for FDI. The objective of capturing economies of scale is closely associated with firms that have extensive international operations. A concomitant factor is the need to maximize the rate of return through efficiency-seeking measures. Among these are vertical and horizontal integration to maximize profits by minimizing costs, thereby improving the firm's ability fully to utilize its comparative advantage in host countries.¹¹

Multinationals undertake FDI to gain access to and to develop secure and critical raw materials supplies.

FDI induced by the need to gain access to foreign sources of raw materials is common to both developed and developing-country multinationals. For instance, Japanese transnational corporations have increasingly relocated their production operations to be close to the source of raw materials. Such movement has also been to counter the effect of the rapid appreciation of the yen and of rising costs due to rising wages in the aftermath of the 1985 Plaza Accords.¹² For resource-seeking global corporations, access to a secure supply of natural resources is a key determinant for investing in a particular country. It is not surprising that the pioneering Western multinational oil companies sought to gain access to Middle Eastern oil. Their goal was to explore, develop, market and distribute Middle Eastern oil as a vital component of their business strategy.

¹¹ Ibid.

¹² Jaya Prakash Pradhan and Vinoj Abraham, "Attracting Export-Oriented FDI: Can India Win the Race?" *Research Paper*, Jawaharlal Nehru University, New Delhi, India. For a copy of the paper, the contact address is: E-33, Brahmputra, J.N.U., New Delhi-67; E-mail: pradhanjayaprakash@hotmail.com; abrahamvinoj@hotmail.com.

III. Host Country 'Location Advantages': The 'Pull' Factors

Previous authors emphasize microeconomic explanations at the level of the enterprise about the decisions of multinational enterprises to undertake individual FDI projects in a specific country or region. In contrast, some scholars stress the macro-economic determinants of corporate expansion abroad and highlight the economic attributes of host countries that attract FDI. Still others stress the role of the host country's public policies, the FDI regime of the host country in particular, to shed additional light on the extent to which FDI liberalization attracts or deters FDI inflows.¹³ One theoretical framework, John Dunning's OLI model, specifically incorporates these macro-economic issues, FDI policy regime, and other location advantages of the host country as key determinants. Accordingly, a brief exposition of the OLI model is warranted.

According to Dunning, successful and profitable FDI requires that firms possess certain ownership advantages (O), described as competitive or proprietary advantages based on the ownership of some sort of intangible asset that enables them profitably to undertake international production. Advanced-country multinationals, for example, leverage advanced proprietary technology, brand name promotion, marketing, logistical and organizational skills, etc. The host country must offer certain location advantages (L). These location benefits range from cheap labor that reduces the cost of extracting natural resources, skilled labor to increase competitiveness, large market size, a rapidly growing economy, political stability and a stable macro-economic environment, among many others. The firm must have the ability to internalize FDI operations (I). Thus, a company must be able to internalize transaction costs, whether it undertakes FDI operations through a joint venture, by

¹³ A seminal work that stresses the role of the home government's policies is Stephen Krasner's *Defending the National Interests: Raw Material Investments and American Foreign Policy* (Princeton, New Jersey: Princeton University Press, 1978); another major work that highlights the role of public policies is by Robert Gilpin, *Global Political Economy: Understanding the National Economic Order* (Princeton, New Jersey: Princeton University Press, 2001). See also Shah M. Tarzi, "Dynamics of the Rise and Spread of Multinational Enterprises from the Developing Countries."

setting up a wholly-owned subsidiary, or pursuing other options.¹⁴ Since most foreign direct investors can be safely assumed to have ownership (O) and internalization (I) attributes, the key remaining factor is the location advantages offered by the host country.

Drawing on the OLI model, several econometric studies have identified the following key location factors as vital to attracting FDI into developing countries: (1) The size of the domestic market – the larger the size of the domestic market as measured by gross domestic product (GDP) per capita, the more attractive it will be to FDI investors as a potential market for their product; (2) A sustainable moderate-to-high rate of growth – these two factors in combination make a particular country highly attractive. Both India and China have these two vital location attributes; (3) Macroeconomic stability – a relatively stable exchange rate, moderate-to-low rates of inflation, among other factors, contribute to stability; (4) A low level of macro-political risks – since FDI tends to be more long-term when compared to portfolio investment, FDI investors tend to stress political stability as an important factor in their decision to make a long-term commitment through international production; (5) A low level of micro-political risk – this lower risk is expressed in removing restrictions to the free flow of capital, by a stable and transparent FDI policy regime, and an economic policy posture that attracts FDI through such things as low tax rates to a benign regulatory environment. A related dimension here is to provide a distortion-free and open business environment that does not favor domestic industries at the expense of foreign firms as part of a protectionist or import-substituting strategy to promote trade; and (6) A well-developed physical and communication infrastructure – transportation, logistics and communication networks can help attract FDI investors.¹⁵

CEOs and senior corporate executives of multinational enterprises are the ones who make the decision as to which countries are more

¹⁴ John Dunning, "Explaining Outward Direct Investment of Developing Countries: In Support of the Eclectic Theory of International Production," in Krishna Kumar and Maxwell G. McLeod, *Multinationals from Developing Countries* (Lexington, Mass: Lexington Books, 1981).

¹⁵ See V.N. Balasubramanyam and Vidya Mahambare, "Foreign Direct Investment in India," United Nations University, *United Nations Publication*, volume 12, no. 12 (August 2002), pp. 2 – 3. These authors cite an extensive number of econometric studies to bolster the aforesaid conclusions on key location advantages.

attractive and whether to carry out an individual FDI project in a country, and the location factors that determine their decisions regarding FDI flows are by far the most important in explaining why some countries attract FDI and others do not. Their decisions also help to illuminate the policy choices that national governments in the developing countries need to make to 'pull in' FDI. Fortunately, the WEF's 1997 global executive survey provides precisely such data and identifies those key factors that determine FDI location. Jeffrey Sachs, the distinguished development-studies scholar, and his colleague have summarized the six vital factors, revealed in the above survey, that global business executives find to be key determinants in their decisions regarding FDI location in the developing countries.

The most important factor that shapes the decision of multinational enterprise executives about investment location is *market size*. A related vital factor is *the expected rate of growth in the size of the market*. As reported earlier, many of the econometric studies also highlight these factors as two important economic and business elements. Similar to these studies, the WEF's survey also shows executives recognize the importance of *infrastructure*. The latter might include, but is not limited to, construction and maintenance of roads, bridges, ports, harbors, runways, electricity generation and transmission, communication and networking infrastructure, and the like.

Three additional items stand out as critical location factors, which have been adequately emphasized in previous studies. These are: *Competitiveness*, which is defined "...as a country's ability to achieve sustained high rate of growth in per capita real income, as measured by per capita GDP in constant prices. It is judged by the overall competitiveness index (CI). Eight factors make up the CI. These are openness, government, finance, technology, infrastructure, management, labor, and institutions."¹⁶ Further, as Sachs has noted, statistical data validate the perspective of the surveyed CEOs regarding the importance of this key location factor. The second and third related factors cited in

¹⁶The section on the results of the WEF's 1997 global survey draws heavily on the work of Nirupam Bajpai and Jeffrey D. Sachs, "Foreign Direct Investment in India: Issues and Problems," *Development Discussion Paper No. 759*, Harvard Institute for International Development, Harvard University, pp. 4-5. The quote appears in the footnote on page 4.

conjunction with the above are *productivity* and *work habits of workers*.¹⁷

One foundation factor cited by the survey relates to the FDI regime or the public policy posture of the host government regarding FDI. Since this particular factor has profound and immediate relevance to understanding the how and why of foreign economic and investment policies of national governments that could attract or deter FDI, we have chosen to treat this key factor separately.

VI. An Open FDI Regime as a Determinant of Inward FDI: Permitting the Free Flow of Capital

Among all the factors that help attract FDI, the importance of the free flow of capital cannot be overstated. During the period 1950s - 1980s, Roger, this description of the period is ambiguous. Does the author mean 1950-1980, or rather 1950 through the 1980s? Drastic restrictions by developing countries, India among them, on the free flow of capital was significant in severely limiting the inflow of FDI. Even though some of these target countries were endowed with other location advantages, the restrictions on the free flow of capital outweighed these benefits. Data provided by the *Economist* on global capital mobility and flows of capital substantiate the proposition that a large number of developing countries still rank quite low in their openness to international capital mobility and the integration of capital markets, when compared to developed countries.¹⁸

Nevertheless, in the 1990s a significant growth of international production occurred, facilitated by the worldwide liberalization of FDI regimes. Between 1992 -1996 and in 1998, governments of five developed countries and sixty-five developing countries implemented reforms by reducing regulation governing FDI. In the latter group, changes included sectoral reform that opened previously protected industries for foreign investment, incentives to attract foreign investment, streamlining the FDI approval process, the abolition of the approval procedures, and other special schemes designed to facilitate FDI liberalization.¹⁹

The broader global trend in the direction of liberalizing FDI re-

¹⁷ Ibid.

¹⁸ *Economist*, "A Cruel Sea of Capital: A Survey of Global Finance," May 3, 2003, p.

¹⁹ Ibid. p. 5.

gimes and the desire of governments to facilitate FDI is reflected in the dramatic increase during the past decade in the number of bilateral investment treaties (BITs) that have been entered into for the promotion and protection of investment throughout the world. As of January 1997, 162 countries had signed a total of 1,330 such BITs, a threefold increase in only half a decade.²⁰

However, in terms of the impact of the host government's FDI regime, a key location factor is *the ability of foreign direct investors to repatriate capital and remit profits*. The WEF's 1997 global executive survey referenced above reaffirms its importance. Sachs and Bajpia have captured the significance of this location factor, noting that "...there is strong statistical evidence to suggest that investors view inability to repatriate capital and remit profit as one of their main concerns. The more open an economy to the rest of the world, the more likely it is to offer freedom in capital movement across national borders. High degree of openness would imply lesser restrictions on remittances of capital income that may be in the form of interests, dividends, profits, or capital."²¹

V. Interpretive Examples –

India, China, Indonesia and Nigeria

Several interpretive examples provide glimpses of the global trend toward liberalization of policies, and how liberalization and reform, in turn, facilitate capital mobility, including the growth of FDI.²² By any measure, China has become a model of openness to capital mobility, whether evaluated by abolishing restrictions on remittances of capital and the repatriation of profit, Special Export Zones (SEZs) designed to provide a package of financing, high communication network capability, tax incentives, a streamlined approval process, superior physical

²⁰ *World Investment Report 1997: Transnational Corporations, Market Structure and Competition Policy* (New York: United Nations Publication.), p. 180. The results of this study are cited in Shah Tarzi "Host Countries and Foreign Direct Investment from the Emerging Markets," *International Relations*, Vol. 14, No. 4 (April 1999), especially pp. 28 – 36.

²¹ Nirupam Bajpai and Jeffrey D. Sachs, "Foreign Direct Investment in India: Issues and Problems," pp. 4 -5.

²² For an elaborate treatment of the broader issue of capital mobility, see Shah M. Tarzi and So Young Kim, "Defining and Measuring International Capital Mobility and its Consequences: An Overview of the Literature," *The Asian Economic Review*, Vol. 41, No. 3 (December 2000).

infrastructure to facilitate transport of goods and services, ease of entry and exit for foreign direct investors, the sheer number of BITs to tailor investment projects to the need of specific types of foreign direct investors, minimal performance requirements, low ratio of actual FDI to FDI approved by government, flexible labor laws, legal protection for foreign investors, and other characteristics. These and other foreign investment policies have enabled China to leverage its location advantages – such as a huge and growing market and fast economic growth – to attract the lion's share of FDI (\$53.7 billion in 2004). According to an A. T. Kearney survey of a thousand leading global business executives, China has become the top destination for FDI, surpassing the United States.²³

The gradual opening of Indonesia's regulatory framework over three decades and the opening's positive impact in increasing the flow of FDI into that country provides another illustration. Until the Asian financial contagion of the late 1990s, which led to the collapse of the Suharto government, Indonesia was one of the largest recipients of FDI in the developing world. The ability of Indonesia to 'pull in' FDI was to a large extent the result of pro-business, open-door foreign economic policies that welcomed inward FDI. Starting in late 1960, Indonesia adopted a host of measures that facilitated inward FDI, including tax concessions, exemption from import duties on initial capital equipment and raw materials, and accelerated depreciation allowances. The law guaranteed that the government would not nationalize foreign investment. These measures are embodied in the 1967 Foreign Investment Law. These pro-foreign investment policies, in turn, led to a dramatic expansion of new investment projects. By 1970, new investment projects numbered 235 for a total of \$1.2 billion, excluding oil and banking. In 1970 and 1973 the government accelerated the liberalization of the foreign investment regime. The additional measures included the removal of burdensome, time-consuming procedures for the application and approval of foreign investment by the Investment Coordination

²³ A. T. Kearney news releases, "China and India Jockey for the Top Most Attractive Foreign Direct Investment Destination," in www.atkearney.com Link on 'Most Attractive Foreign Direct Investment Destinations,' pp. 1-4

Board, and the provision of tax incentives to foreign investors.²⁴ This open public policy regime regarding FDI prepared the stage for an ever-expanding inflow of FDI in subsequent decades.

An example for Africa is Nigeria, where public policy incentives and the liberalization of the regulatory regime governing FDI helped increase FDI inflows. Nigeria has abundant natural resources that make it attractive to multinational oil enterprises. The Nigerian government managed to improve upon this key location advantage by lowering tax rates, making progress in reducing the level of corruption, and other incentives that cumulatively increased the rate of return on foreign investment in Nigeria, making it a relatively attractive destination in the African continent.²⁵ To be sure, Nigeria does not have the many and diverse location advantages that South Africa has. The latter has a huge and fast-growing market, a politically stable polity, democratic governance and the rule of law, an advanced infra-structure, a strong tradition of private property rights and *eminent domain*, a lower level of corruption, the institutional and administrative capacity to deal with foreign investors, developed communication networks, and many others, attracting a high volume of FDI to make South Africa one of the top ten big emerging markets. Nevertheless, Nigeria provides an example of a typical mid-size African underdeveloped country that made changes favorable to foreign investment policy that resulted in amplifying its location advantages. These advantages included cheap labor and the availability of natural resources, among others.

Regarding the role and impact of host governments' public policies, the degree of restriction on foreign investors in local equity ownership makes a major difference. To retain control over proprietary technology, multinational enterprises tend to favor majority ownership. Therefore, strict limitations on local equity ownership can deter foreign investment. Those developing countries where governments insist on local or state-

²⁴ Donald T. Lecraw 1991. "Third World MNEs Once Again: The Case of Indonesia," Jakarta, Indonesian Institute for Management Development, 1991, *mimeograph*, pp. 1 - 23. The results of Lecraw's study are also cited in Shah Tarzi, "Host Countries and Foreign Direct Investment from the Emerging Markets," *International Relations*, Vol. 16, No. 4 (April 1999).

²⁵ C.N.S. Nambudiri, Lukunle Iyanda, and D. M. Akinnus, "Third World Country Firms in Nigeria," in Krishna Kumar and Maxwell G. McLeod, editors. *Multinationals from Developing Countries* (Lexington, Mass: Lexington Books, 1981).

owned majority ownership and restrict foreign ownership to 50 percent or less run the risk of deterring foreign investment. This is not to say that total equity ownership usually serves national economic interests. Rather, ownership restrictions are another barrier to entry with a deleterious impact on FDI inflows, and therefore would counteract the host governments' efforts to otherwise attract FDI. Yet such restrictions have been experimented with by countries ranging from small Latin American nations such as Paraguay and Bolivia, which restricted foreign equity ownership to 40 percent and 50 percent, respectively, to large developing countries such as India which has many location advantages, a huge market among them, and potential for FDI inflows. The net result has been to discourage foreign direct investors.

In order to illuminate the crucial role of the national FDI regime on FDI inflows, it is especially useful to elaborate on the case of India. India offers several highly attractive location advantages such as a huge domestic market, democratic governance and the rule of law, a tradition of enforceable contracts, and abundant cheap labor. In addition, India has also registered a significant and sustained GDP growth and expansion in the size of its market during the last decade. Yet from 1950 – 1989 the cumulative effect of several key policies and laws of the government of India (Companies Act, 1951; Corporate Tax policies, 1957 - 1991; Monopolies and Restrictive Trade Practices Act, 1969; Industrial Policy Statement, 1973; and Foreign Exchange Regulation Act, 1973) has been a burdensome and highly restrictive *dirigiste* FDI regime. This policy posture permitted foreign financial and technical collaboration in some industries, while seemingly arbitrarily excluding others, a system designed to limit foreign ownership and control. Indira Gandhi's Foreign Exchange Regulation Act (FERA), dictated in part by the desire to attract foreign exchange and partly to please the electorate, forced foreign affiliates to dilute equity holdings to less than 40%; alternately, companies were required to export from India a significant share of their total export.²⁶

The reforms of 1991, and subsequent measures of liberalization,

²⁶ See V. N. Balasubramanyam and Vidya Mahambare, "Foreign Direct Investment in India," pp. 3 - 4.

abolished licensing requirements, reduced tariffs on imports, reduced capital control on FDI, put in place mechanisms to speed the approval of FDI, and raised the ceiling on local ownership to 75 percent in nine key industries. These and other FDI policy measures had a positive impact as FDI accelerated from less than \$1 billion each year in the 1970s and 1980s to \$4.3 billion last year. Nevertheless, as noted earlier, given the huge size of India's market and the relatively high rate of growth of its market in the last decade, the amount of FDI is still miniscule, especially when compared to China. The primary reason, as two leading observers of India's Foreign Direct Investment environment have noted, is that "...A restrictive FDI regime, high import tariffs, exit barriers for firms, stringent labor laws, poor quality infrastructure, centralized decision-making processes, and a very limited scale of export processing zones make India an unattractive investment location."²⁷ However, we acknowledge that India remains the most favorable final destination among all developing countries in information technology and business processes, and it offers the greatest long-term potential in these and in research and development (R&D) investments. However, to realize this immense potential will require streamlining the implementation of the existing policy regime and sustained liberalization in the foreign investment regime.

VI. Conclusion: Policy and Programmatic Implications for National Governments

We have discussed several vital location advantages that serve as key determinants in 'pulling' a high volume of FDI into developing countries. These findings point to a number of specific FDI and trade policies that are germane to attracting a significant volume of FDI.

First, governments need to lower the ratio between the volume of FDI that is approved, as against the FDI actually undertaken. Put differently, between adoption of liberal policies that favor foreign investment and its implementation, effort remains needed for streamlining the approval process, ensuring transparency, lessening market distortion due to burdensome administrative procedures, reducing

²⁷ Nirupam Bajpai and Jeffrey D. Sachs, "Foreign Direct Investment in India: Issues and Problems," the quote appears in the footnote on page 4.

corruption, creating administrative capacity to carry out reform, and many others. The higher the ratio between FDI approved versus FDI actually carried out, the more likely it is that the bureaucratic and regulatory burden inhibits speedy approval, thereby acting as a deterrent to actual FDI. Whereas China has done exceptionally well in narrowing this gap, India has yet to simplify the administrative and bureaucratic procedures to facilitate FDI undertaken.

Second, arbitrary foreign ownership ceilings in sectors open for FDI deter foreign investment. Conversely, FDI inflows are likely to be encouraged if in an expanding number of industries it is deemed desirable by national governments for FDI to allow 100 percent ownership. Transparency and a viable economic and national security rationale as to why some sectors are open to FDI and others are not will also boost foreign investors' confidence.

Third, neo-mercantilist trade policies that protect domestic industries are invariably restrictive because these policies limit the ability to foreign direct investors to use the host country as a platform for the production and export of products. In this context, quota and high tariff rates have especially deleterious effects. In a similar vein, a liberal use of special economic zones (SEZs), bringing a package of well-developed infrastructure, a supply of low cost disciplined labor, flexible labor policies within the SEZ, etc., is a highly desirable vehicle for attracting FDI. China, for example, has set up over 100 SEZs. In a similar vein, the Bilateral Investment Treaty (BIT) geared to the particular needs of specific multinational firms is a viable instrument to increase the rate of FDI inflows.

Finally, a combination of flexible labor policies, upgrading of the quality of human capital, a lower corporate tax rate, further privatization and deregulation of FDI, a stable exchange rate, deregulation and reform of the financial sector (banking, insurance, etc.), and a sustained low rate of inflation are positively correlated with attracting FDI and promoting overall exports.