UNITED
NATIONS

TD

United Nations
Conference
on Trade and
Development

Distr.
GENERAL

TD/B/COM.2/44
21 November 2002

Original: ENGLISH

TRADE AND DEVELOPMENT BOARD
Commission on Investment, Technology and
Related Financial Issues
Seventh session
Geneva, 20–24 January 2003
Item 3 of the provisional agenda

POLICY ISSUES RELATED TO INVESTMENT AND DEVELOPMENT

Note by the UNCTAD secretariat

CONTENTS

INTRODUCTION

1. Pursuant to the decision taken by the Commission on Investment, Technology and Related Financial Issues on 25 January 2002 at its sixth session, the secretariat has prepared this note on the policy issues related to investment and development, so as to help identify policy questions to be discussed by the Commission on Investment, Technology and Related Financial Issues at its seventh session. This note draws on the analysis in the *World Investment Report 2001: Promoting Linkages* and the *World Investment Report 2002: Transnational Corporations and Export Competitiveness*.

I. GLOBAL FDI ENVIRONMENT

2. After a decade of steady and strong growth, foreign direct investment (FDI) flows declined sharply in 2001 and continued their slide in 2002, declining further by 27 per cent. In 2002, the volume of FDI inflows reached about $534 billion, which contrasts with $735 billion in 2001, and is equivalent to a third of the $1,492 billion peak in 2000. A major factor behind this decline is the slowdown in the world economy, which has reduced world demand and accentuated and accelerated the global restructuring process of major transnational corporations (TNCs) in sectors characterized by excess capacity.

3. The economic slowdown has intensified the competitive pressures that have driven TNCs to search for lower-cost locations. This may result in increased FDI in activities that benefit from relocation to, or expansion in, low-wage economies. Outflows may also increase from countries in which domestic markets were growing slower than foreign markets. There are signs that both factors contributed to the recent increase in Japanese FDI to China and the growth of flows to certain Central and Eastern European (CEE) countries.

4. The decline in FDI in 2001 was mainly concentrated in developed economies as a result of a considerable drop in cross-border mergers and acquisitions: FDI inflows to developed countries shrank by 59 per cent, compared with 14 per cent in developing economies. Inflows into CEE countries as a whole remained stable. In 2002, the same trends continued: a major decline in developed countries (-31 per cent), a smaller decline in developing countries (-23 per cent) and a relatively insignificant fall in FDI inflows into CEE countries (-1 per cent).

5. Flows to the developing world and to CEE countries remain unevenly distributed. In 2001, the five largest recipients attracted 62 per cent of the total flows to developing countries, while the corresponding figure for Central and Eastern Europe was 74 per cent. Among the top 10 country gainers in terms of absolute increases in 2001, eight were developing countries, led by Mexico, China and South Africa. Conversely, among the 10 countries experiencing the steepest declines in FDI inflows, eight were developed countries; Belgium and Luxembourg, the United States and Germany reported the greatest declines.

6. Against this backdrop, concerns have arisen that competition to attract FDI will intensify among countries, especially the type of FDI that can bring major benefits to

recipient economies by enhancing their export competitiveness or by providing linkages with domestic enterprises. Indeed, countries are increasingly recognizing the positive contribution that FDI can make to economic development through an increase in export capacity, employment generation, transfer of technology, industrial upgrading and training of labour. Some countries that have become competitive in dynamic export products, in particular technology-intensive products, have attracted and linked up with export-oriented TNCs.

7. Countries have used various proactive policies and measures to attract and increase benefits from FDI, from targeted promotion policies to incentives and performance requirements, as well as measures to support the enterprise sector. Many of these measures, however, have been subjected to new international rules in the framework of multilateral agreements such as the WTO Agreements on Trade-Related Investment Measures (TRIMs) and on Subsidies and Countervailing Measures (SCM). For example, local content requirements have been phased out by most countries in line with the requirement of the TRIMs Agreement. At the same time, FDI and trade liberalization, as well as more intense competition for FDI, have reduced the reliance on other investment performance requirements.

8. While this new international setting has changed the scope for national policy options, there is still flexibility within the existing international policy framework, for example in the form of extension of transition arrangements and differential treatment of countries at different levels of development. While some agreements are subject to further review, the challenge for policy makers is therefore to make use of the options allowed within the current framework, as well as other policy measures that are not subject to multilateral rules to promote export-oriented FDI and to integrate FDI more deeply into their national economies. In this new policy environment, active policy approaches that work with the market are at a premium. These policies, like other development policies, are often highly context-specific and need to be adapted to the specific circumstances prevailing in each host country. They need to be an integral part of broader development strategies; much also depends on how policies are designed, coordinated and implemented in practice.

9. The following sections review some of the policies used to attract FDI and encourage foreign affiliates to export, upgrade their activities and forge linkages with domestic companies.

II. FDI PROMOTION POLICIES

10. Countries have implemented active FDI promotion policies that have evolved over the years, as the objective has shifted from simply attracting a desired quantity of FDI to attracting quality FDI with a highly beneficial impact on the domestic economy. Thus, three generations of FDI can be distinguished. In the first generation of investment promotion policies, many countries adopt market-friendly policies. They liberalize their FDI regimes by reducing barriers to inward FDI, strengthening standards of treatment for foreign investors and assigning a greater role to market forces in resource allocation. Virtually all countries – to varying degrees – have undertaken steps in this direction. Some countries can go a long

way in attracting FDI with these steps, if the basic economic determinants for obtaining FDI are right.

11. In the second generation of investment promotion policies, Governments go a step further and actively seek to attract FDI by “marketing” their countries. This approach leads to the setting up of national investment promotion agencies (IPAs). The World Association of Investment Promotion Agencies, established in 1995, now has 139 members from 129 countries. Again, of course, the success of proactive efforts depends, in the end, on the quality of the basic economic factors in a host country.

12. The third generation of investment promotion policies takes as a starting point the enabling framework for FDI and a proactive approach to attracting FDI. It then proceeds to target foreign investors at the level of industries and firms to meet their specific developmental priorities, for example in export promotion or linkage creation. A critical element of such investment promotion is to improve – and market – particular locations for potential investors in specific activities. Of course, a country’s general economic, political and regulatory features also matter, because they affect the efficiency of the clusters within it. But the key to the success of these new investment promotion strategies is that they actually address one of the basic economic FDI determinants while understanding the changing location strategies of TNCs. Regardless of the level at which FDI is promoted, the competitiveness of the domestic enterprise sector and a pool of skilled people are the key to the “product” to be marketed. Strong local skills and firms attract FDI; the entry of foreign affiliates, in turn, can feed into the competitiveness and dynamism of the domestic enterprise sector.

13. An important starting point for successful targeting is a good understanding of the relative competitiveness of a host country (or an area within it) for specific activities. While an assessment of a location’s strengths and weaknesses can be undertaken at various levels of sophistication and detail, useful insights can be obtained from a relatively inexpensive rule-of-thumb approach involving an analysis of existing trade and industry patterns, consultations with existing investors (domestic and foreign), an analysis of which competing locations are exporting and what they have attracted in terms of export-oriented FDI, and identification of other factors that might attract export-oriented FDI, including membership of free trade areas, preferential trade schemes, clusters of economic activity and industrial parks. Such an assessment can form the basis for a narrower segmentation of the market, for example based on economic, geographical, demographic and other criteria.

14. Another important element of targeting is a sound analysis of corporate strategies affecting the choice of location. In response to the increased geographical and functional specialization in many industries, countries may find it useful to identify production niches through which they can link up with international production systems. The more focused the approach, the easier it is to streamline IPA activities to meet the needs of investors. Important clues regarding where to look for potential investors relate to foreign affiliates that are already established in the country. They are “living proof” of the existence of investment opportunities, and their presence may be indicative of where to search for additional investment. Their competitors, too, may be prime targets, especially if the existing foreign

affiliates are linked to leading TNCs. Companies that are part of the value chains of domestic as well as foreign affiliates in the host country (e.g. as buyers or suppliers) are also potential targets. Nurturing close contacts with existing firms may generate useful insights into their investment strategies and how these "related" firms make their investment decisions.

15. Targeting should not be a one-off initiative but a continuous learning process in which relationship building plays a key role. Governments need to recognize the importance of dynamism in niche market identification and be aware of the need to revise their strategies over time, as competitive conditions and corporate strategies evolve. Advantages based on preferential market access, for example, are valuable but must fit into a clear plan for creating sustained advantage over time. IPAs can contribute to such plans, but their conceptualization and implementation also involve other agencies of government and public–private partnerships.

16. There are, however, risks involved in developing a more targeted and focused strategy. Resources may be focused on attracting investments that do not materialize, or considerable efforts and resources may be devoted to seeking the wrong types of firms, or firms that would have invested in any event. Improving the overall policy environment for investment – domestic and foreign alike – should not be sacrificed to a selective focus on attracting a few firms. A realistic understanding of the strengths and weaknesses of a location as a base for export-oriented production provides a stronger basis for targeting. There is an obvious risk of wishful thinking in seeking to attract "high-status" TNCs if a country does not have the basic conditions to attract this type of investor (such as an educated and highly skilled workforce and excellent, low-cost infrastructure). Competition for high-profile investment projects can be intense, and for every winner there are often several losers that, in the end, may have expended considerable resources in a failed attempt to attract a project. Thus, for most developing countries, the investors to target will probably not be the largest TNCs in the world, but smaller firms within the appropriate industry or activity.

17. Although adopting an investor-targeting strategy can clearly be effective in attracting FDI, it presents considerable challenges for Governments. Effective targeting requires business-oriented IPAs with well-developed links to the private sector as well as to other branches of government. Investor targeting should be well integrated into the overall development strategy of a country and IPAs need to work closely with other parts of government to identify and, indeed, create comparative advantages that are sustainable rather than ephemeral.

III. POLICIES TO ENCOURAGE LINKAGES

18. Although foreign affiliates have an interest in creating and strengthening local linkages, their willingness to do so can be influenced by government policies addressing different market failures at different levels in the linkage formation process. For example, TNCs may be unaware of the availability of viable suppliers, or they may find it too costly to use them as sources of inputs. In developing countries, policies may be required to compensate for weak financial markets or weak institutions such as vocational schools, training institutes, technology support centres, research and development (R&D) and testing

laboratories, and the like. Well-designed government intervention can increase the benefits and reduce the costs of using domestic suppliers.

19. The role of policy is most significant where there is an "information gap" pertaining to both buyers and suppliers in respect of linkage opportunities, and a "capability gap" between the requirements of buyers and the supply capacity of suppliers, as well as where the costs and risks involved in setting up linkages or deepening them can be reduced. The linkage formation process is obviously affected by a host country's overall policy environment, its economic and institutional framework, the availability of human resources, the quality of infrastructure, and political and macroeconomic stability. But the most important host country factor is the availability, costs and quality of domestic suppliers. Indeed, in addition to being a key determinant for the formation of efficient linkages, the technological and managerial capabilities of domestic firms determine to a large extent the ability of a host economy to absorb and benefit from the knowledge that linkages can transfer. Weak capabilities of domestic firms increase the chances that foreign affiliates will source the most sophisticated and complex parts and components either internally or from a preferred (foreign-owned) supplier within or outside a host economy. For example, domestic firms in Taiwan Province of China and Singapore supply complex inputs to foreign affiliates, but fewer do so in Malaysia, Thailand or Mexico.

20. It is important to note, however, that the policy space available for national linkage policies is narrowing. A number of the direct measures used in the past to increase local purchases (such as local-content requirements or high tariffs on imported inputs) are being phased out as a result of autonomous liberalization by host countries, the decline of interventionist policies and rules agreed in the context of the WTO and other international agreements. This does not mean that the role of policy is less important – on the contrary. But more attention needs to be given to policies that are in line with market forces and that build, in particular, on the mutual interests of both foreign affiliates and domestic firms to create and deepen linkages and foster competitiveness and economic growth.

21. Well-targeted incentives to support the creation and deepening of linkages can have a positive impact on linkages. Thought should be given to rendering this category of development-related subsidies non-actionable (i.e. not open to challenge) under WTO rules. On the other hand, preferential trade arrangements – with rules of origin based on the level of domestic value added or local content – can have important effects on FDI and linkage creation by TNCs in preference-receiving countries. In general, these effects are the more significant, the higher the preferential margin associated with rules of origin and the lower the related administrative costs. Linkage effects of rules of origin, however, also depend on local supply capacity.

22. Beyond requirements and incentives, one general approach involves encouraging linkages through various measures to bring domestic suppliers and foreign affiliates together and to strengthen their linkages in the key areas of information, technology, training and finance. This is a broad approach, and it basically improves the enabling framework for linkages formation. A review of the experience of host countries yields a long menu of specific measures that can be taken in this respect. Such measures can include the provision

of information and matchmaking to help domestic firms link up with foreign affiliates; encouraging foreign affiliates to participate in programmes aimed at the upgrading of domestic suppliers' technological capabilities; promoting the establishment of supplier associations or clubs; the joint provision of services (especially training); and various schemes to enhance domestic suppliers' access to finance.

23. Another approach goes further in that it involves the establishment of a specific linkage promotion programme combining a number of the measures just mentioned. This is a proactive approach, which is typically focused on a selected number of industries and firms, with a view to increasing and deepening linkages between foreign affiliates and domestic firms. As with other policies that span a range of productive factors, activities and enterprises, it is advisable for policy makers that choose this approach to "start small" (perhaps with a pilot scheme) and to build policy monitoring, flexibility and learning into the programme. The need for starting small is all the greater when resources are scarce. Moreover, it is essential for any programme to seek close collaboration with the private sector, both foreign affiliates and domestic suppliers, in design and implementation.

24. Some countries have in fact set up specific linkage programmes involving a combination of different policy measures, and targeting selected industries and firms. Such programmes have been put in place primarily by countries with a large foreign presence and with a (relatively) well-developed base of domestic enterprises. The Czech Republic, Hungary, Ireland, Malaysia, Mexico, Singapore, Thailand and the United Kingdom have all made special efforts of this kind. Some of the programmes are organized at the national level while others have been implemented as regional or local initiatives. Three elements are common to them: the provision of market and business information; matchmaking; and managerial or technical assistance, training and, occasionally, financial support or incentives. Some programmes have also included FDI promotion activities, so as to attract foreign investors in targeted industries. In each case, sustainable linkages will be created only if both foreign affiliates and domestic firms can benefit from them.

25. A special linkages promotion programme should be seen more as a set of building blocks that countries might "mix and match" according to their specific circumstances, rather than as a ready-made prescription that all countries can apply. Clearly, the choice of measures and the way they are combined must reflect the level of development, policy capabilities, resources and objectives of each country. Even countries at similar levels of development may choose different configurations of policy according to their enterprise and institutional capabilities.

26. The starting point for an effective linkage programme is a clear vision of how FDI fits into the overall development strategy and, more specifically, a strategy to build production capacity. The vision has to be based on a clear understanding of the strengths and weaknesses of the economy and of the challenges facing it in a globalizing world. A linkage programme should, in particular, address the competitive needs of domestic enterprises and the implications these have for policies, private and public support institutions, and support measures (including skills- and technology-upgrading).

27. Linkage programmes are at the intersection of two subsets of programmes and policies: those geared towards enterprise development (especially development of small and medium-sized enterprises) and those related to FDI promotion. The former are desirable in and by themselves, as a vibrant enterprise sector is the bedrock of economic growth and development; in the context of the promotion of linkages, the capabilities of local firms are the single most important determinant of success. FDI promotion, in turn, increasingly focuses not only on the quantity of FDI that a country attracts, but also on its quality, including linkage opportunities.

28. Linkage programmes can have two broad objectives: to increase domestic sourcing by foreign affiliates (i.e. create new backward linkages) and to deepen and upgrade existing linkages – both with the ultimate aim of upgrading the capacities of local suppliers to produce higher-value-added goods in a competitive environment. These objectives are interdependent: deepening may spin off new linkages, and spreading linkages may change their quality and depth. A Government's objectives should be shared with all principal stakeholders, as their active participation is needed for the success of any programme.

29. Governments, in cooperation with private sector institutions, need to define the targets of a programme in terms of the industries and, within them, the foreign affiliates and domestic suppliers to be involved. Such an analysis is essential for any linkage strategy – without it, a Government cannot decide how to allocate scarce resources. It also has to take into account trends in the growth and spread of international production networks and their implications for domestic producers, drawing *inter alia* on continuous dialogue with key stakeholders.

30. Governments need to be aware of actions already taken by foreign affiliates and domestic firms. Some of these may need to be encouraged and supported. Governments can act as facilitators and catalysts and ensure that private institutions have the incentives and resources needed. They can be particularly proactive in the following key areas of linkage formation: information and matchmaking; technology upgrading; training; and access to finance. The range of measures that can be taken in each of these areas is wide. Their principal purpose is to encourage and support foreign affiliates and domestic firms in forging and deepen linkages. They constitute a menu from which Governments can mix and match. Specific choices depend on the results of earlier consultations with existing support institutions and relevant programmes in the public and private sectors, as well as with key stakeholders on the specific needs of an industry or a set of firms. The results of linkage forums, linkage workshops and business clinics and the identification of promising domestic firms are also of help here. Governments could also encourage participating foreign affiliates to agree to a coaching and mentoring arrangement with promising local firms.

31. These measures can be underpinned by efforts to strengthen the negotiating position of local firms vis-à-vis foreign affiliates, for instance by providing guidelines or making model contracts available. Special informal mechanisms can also help resolve problems and disputes and contribute to more lasting linkage relationships.

32. The result should be a clear and feasible programme of action. Naturally, at each step of the implementation of a programme, the Government needs to have a clear idea about the costs involved and the resources available.

33. Governments can choose from a number of options in designing the institutional framework for a linkage programme:

- Make the programme a distinct part of an existing body or even set up a special national-level linkage programme under an independent body to act as the focal point for all relevant activities by different departments and institutions;
- Leave the design and implementation of the linkage programme to local authorities, with central advice, encouragement and support from the central Government. This approach might be preferable in large countries or where resources for linkage programmes are limited, or where regions have distinct combinations of locational advantages to offer;
- Involve the private sector as the main executing agency for the linkage programme. Suppliers, affiliates or their associations may set up such a body. The role of the Government would be to act as a catalyst and fulfil regulatory and information functions.

34. The size of a programme depends on its objectives and the resources available. Some programmes benefit from external funding through financial assistance provided by donor countries. In the longer term, however, the financial sustainability of linkage programmes, if directly run by Governments, requires sufficient government funding support. Moreover, cost sharing by participating firms (both buyers and suppliers) is desirable, not only for funding purposes but also for ensuring commitments by the participants. This is feasible, especially when a programme has demonstrated its usefulness and is recognized for its services. Needless to say, to create trust and credibility among enterprises, a programme must be staffed by professionals with the appropriate private-sector-related skills and background.

35. Linkage programmes can work only if they are networking effectively with efficient intermediate institutions providing support in skill building, technology development, logistics and finance. These include standards and metrology institutes, testing laboratories, R&D centres and other technical extension services, productivity and manager training centres, and financial institutions. They can be public or private. It is also important that linkage programmes work closely with relevant private associations – chambers of commerce and industry, manufacturers' associations, investor associations, and so on. Trade unions and various interest groups are other important stakeholders.

36. Finally, it is important to have a monitoring system in place to evaluate the success of a programme. Often, in a learning-by-doing process, a programme needs to be adjusted and

refined as experiences accumulate and situations change. The system could include benchmarks and surveys of users. Criteria could include the following:

- Outreach: the number of companies included in the programme over time;
- Impact: the impact of the programme can be judged by such indicators as the number of suppliers, linked up with foreign affiliates over time; the value of deals and changes in these over time; the share of domestic suppliers in procurement by foreign affiliates; the extent to which R&D activities are being undertaken by domestic suppliers over time (including those resulting in patents); changes in export volumes; the improvements in productivity or the value added at the firm or industry level; and whether a local supplier establishes itself abroad;
- Cost effectiveness: the cost of the programme in the light of the results achieved and the benefits obtained as defined by the objectives laid down at the beginning of the programme.

37. To put into practice the linkage programme developed in the *World Investment Report 2001*, UNCTAD has initiated the implementation of such a programme in Uganda.

IV. POLICIES TO PROMOTE EXPORT-ORIENTED FDI

38. A priority among countries – whether rich or poor – is to upgrade and sustain exports so that they contribute more to development. Just as firms are forced to make their production systems more competitive, so countries have to work out how to move, in any industry, into higher-value-added activities. There are many ways in which TNCs can help to enhance host countries' export competitiveness. The challenge is to tap TNC potential for this purpose. In order to attract export-oriented FDI and to ensure that such investment translates into development gains, countries need to find the most effective ways of making their locations more conducive to the kind of export activities they aim to foster. Even traditionally significant recipients of export-oriented FDI need to upgrade in order to sustain rising wages and maintain their competitiveness as an export base.

39. In line with the dynamic changes in corporate strategies affecting key export industries, the growing competition among countries and sub-national entities for export-oriented FDI, the changing regulatory environment and the changing development objectives of countries themselves, the formulation and the implementation of policies are evolving. While it is recognized that macroeconomic stability as well as structural factors such as technological capacity and human resources are vital in making a location competitive, the focus needs to be on policies related to export-oriented FDI: how to attract, upgrade and benefit from such FDI.

40. Access to key markets is a necessary, but not sufficient, condition for attracting export-oriented activities. Although multilateral trade liberalization has been an important facilitating factor behind the emergence of international production systems and the establishment of export-oriented activities abroad by TNCs, access to developed country

markets, especially for products of export interest to developing countries, needs to be further improved. In particular, tariff peaks, tariff escalation and non-tariff barriers in agriculture, textiles and clothing need to be addressed. Meanwhile, a rise in protectionism could effectively jeopardize the prospects for poor countries to exploit their comparative advantages fully. The growing use of trade measures, such as anti-dumping and safeguards, and of targeted subsidies in developed countries all give cause for concern in this context.

41. Despite the erosion of preferential margins, many regional and preferential arrangements remain important for the location of export production (e.g. in the context of the European Union and its association agreements, the North American Free Trade Agreement, the Caribbean Basin Initiative and the African Growth and Opportunity Act), as do various offshore production schemes. While host-country policy makers need to be aware of opportunities arising from such arrangements, they also need to understand their limits. For example, tariff schedules linked to offshore production schemes generally discourage the use of local components and restrict the upgrading of local operations. Trade preferences in and by themselves provide neither a sufficient nor a sustainable basis for developing competitive export industries (with or without FDI). The same applies to countries that have attracted export-oriented FDI thanks to unused quotas for export to countries that restricted access for textiles and clothing products under the Multifibre Arrangement. As the quotas are to be phased out by 2005, there is a risk of the relocation of existing investment to countries that offer more competitive conditions. Trade preferences need to be seen as a temporary window of opportunity that provides time to allow countries to strengthen their locational advantages.

42. With regard to host-country Governments, there are a number of measures that can be considered to improve the long-term attractiveness of a country as a base for export-oriented production. While the focus here is on policy measures that are directly related to FDI, it should be re-emphasized that these have to be viewed as part of broader efforts to promote development.

43. A key policy area is improvement of access to imported inputs through trade liberalization and facilitation measures. Such efforts are important, as the competitiveness of export-oriented activities (especially in non-resource-based industries) often depends to a large extent on imported inputs. Various countries have tried to generate more exports by foreign affiliates through export-performance requirements. However, in order not to deter inward FDI, these have normally been tied to some kind of advantage received by the investor. In an increasingly competitive environment, and in the light of WTO rules, mandatory export performance requirements are becoming more difficult to use.

44. In order to lower production costs and risks, many countries offer incentives aimed at attracting new or more export-oriented FDI. The use of incentives also has evolved over time. Developed countries frequently employ financial incentives (such as outright grants), whereas fiscal measures are more common in developing countries (which cannot afford a direct drain on the government budget). Incentives have been an important element in the development strategies of many countries, especially those successful in attracting export-

oriented FDI. Some of these countries have adopted an increasingly targeted approach to attracting FDI.

45. The challenge for developing countries wishing to use incentives in their efforts to promote export-oriented FDI is to weigh the benefits and costs involved. When effectively implemented, incentives have typically complemented a range of other measures aimed at enhancing aspects such as the level of skills, technology and infrastructure. To compensate for major deficiencies by offering incentives may not always be a wise strategy, as it increases the risk of public funds being spent on projects that do not offer the externalities needed to warrant the incentives in the first place. Without efforts to improve the business environment, and make it more conducive to attracting investment, upgrading production and embedding FDI into the local economy, there is a greater risk that investors will leave as soon as the incentives expire. Thus, subsidies should not be used as an isolated measure, but rather as part of a broader policy package.

46. When considering using incentives, developing countries need not only to identify the most effective ones, but also to ensure that they conform with the international regulatory framework, notably WTO rules. In this context, attention to the role of export subsidies is especially warranted. Apart from the WTO members listed in Annex VII of the Agreement on Subsidies and Countervailing Measures (namely, LDCs and members listed in Annex VII until their per capita GNP income reaches $1,000), other developing country members will have to eliminate export subsidies as of 1 January 2003, with the exception of those that will be granted an extension of the transition period. And even these need to consider what to do once it expires. The possibility of offering other specific incentives that do not meet the definition of prohibited subsidies remains, but any "specific" subsidy that causes adverse effects on another WTO member's interests is actionable and potentially subject to remedial action. Furthermore, subsidized imports into another WTO member country may be subject to countervailing measures by the latter if they cause, or threaten to cause, material injury to a domestic industry providing the like product in the importing member. The provision of "specific" subsidies therefore becomes risky.

47. The setting up of export processing zones (EPZs), with a view to providing efficient infrastructure and removing red tape within the confines of a limited area, is also a widely used tool in the context of promoting export-oriented FDI. In fact, various countries showing dynamism in world trade, such as China, Costa Rica, the Dominican Republic, the Philippines and Singapore, have established EPZs or other schemes that share some of their characteristics, and these account for a large share of non-resource-based manufactured exports in a number of them. However, the performance of EPZs depends very much on other policies, notably policies that aim at enhancing human resources and creating the infrastructure necessary to attract and upgrade export-oriented FDI. There are many EPZs that have failed to attract substantial investments and have spent more on outlays than they generated in benefits.

48. As in the case of other policy areas, the nature and use of EPZs are also evolving. As already noted, the requirement to export has been relaxed in many countries in recent years, thus allowing for significant domestic sales. More domestic companies are now established in

EPZs, and efforts are being made by Governments to encourage more linkages between foreign affiliates and domestic firms, as well as to encourage the training of local employees and the development of technical and technological infrastructure. The industrial composition of producers within EPZs and other zones is also changing. Whereas low-technology, labour-intensive manufacturing activities used to predominate, new areas such as electronics assembly, electronic design, testing and R&D are opening up, not to mention regional headquarters and global logistics centres. In developing countries, such trends may be accelerated by the WTO disciplines in the area of export subsidies.

49. Particularly in relation to the use of incentives and EPZs, there is also a risk that intense competition for export-oriented FDI will translate into a *race to the bottom* (in social and environmental standards) and a *race to the top* (in incentives). Success in attracting export-oriented FDI should not be judged solely on results in terms of increase in exports and foreign exchange earnings. It should also be judged by the extent to which it can help meet broader economic and social objectives. Countries that pursue more integrated policy approaches to attracting export-oriented FDI – for example, by ensuring tripartite representation on EPZ committees, guaranteeing workers' rights (including freedom of association and collective bargaining), and upgrading skills and working conditions – have tended to attract higher-quality FDI. Singapore and Ireland are two examples of countries that have pursued more integrated policy approaches in this area. In both these countries, efforts were made to promote training, facilitate dialogue between labour and management, and provide first-class infrastructure for investors. Good labour relations and the upgrading of skills enhance productivity and competitiveness.

50. With regard to the risk of an *incentives race to the top*, while the Agreement on Subsidies and Countervailing Measures prohibits the use of export subsidies, other incentives, especially locational ones, are still widely used in both developed and developing countries to promote export-oriented FDI. As competition for export-oriented FDI increases, the risk of ever-increasing incentives offered by competing locations calls for further international cooperation in this area. The differences in resources available for public support to private investment suggest that developing countries are at a disadvantage in such incentive-based competition. A reduction in the use of locational incentives by developed and developing countries should help Governments allocate more resources for the development of skills, infrastructure and other areas relevant to the attraction of export-oriented activities. At the same time, a case could be made for making certain development-oriented subsidies to foreign affiliates non-actionable under WTO rules, for example if they serve to encourage the provision of technology, technical assistance and training to local suppliers and their personnel. However, to avoid "free riding", firms receiving incentives should be required formally to commit sufficient resources on a long-term basis.

51. Another major issue is institution building, which is a complex process. Agglomeration tendencies can be encouraged by the establishment of EPZs, industrial parks and other specialized facilities, often specializing in one or more industries. Institutions engaged in metrology, standards, testing and quality assurance provide the infrastructure of modern industrial activity. Their importance to competitiveness is growing as a result of increasingly stringent quality, precision, tolerance and other standards in international

markets. Other relevant institutions are those responsible for initiating research, providing access to financial resources, and creating business networks and professional associations.

52. Another major element focuses on the training and upgrading of human resources. For knowledge-based activities in particular, training and upgrading of the relevant human resources are essential. Such efforts may involve the establishment of specialized training centres, possibly with the involvement of foreign affiliates. Yet another approach is to attract internationally mobile skills to complement the local skills base. In general, the more knowledge-intensive the activity, the more important it becomes for clusters to attract skills.

53. In conclusion, the continuous need for countries to move up the value-added ladder and improve the attractiveness of their locational advantages is a challenging task for policy makers in developing countries. It calls for more sophisticated and comprehensive policy approaches that take into account changes in corporate strategies and international rule making. Furthermore, at the top of the agenda should be the development of domestic capabilities, as this helps to attract quality FDI, as well as being necessary for facilitating an upgrading of existing activities. Given the potential of improved export competitiveness for promoting development, the need for developing countries to preserve sufficient policy space to pursue their development objectives also has to be recognized. Finally, the extent to which developing countries profit from new opportunities created by the emergence of international production systems depends, to a considerable extent, on their own actions. Developed countries can also help in a number of ways: they can provide assistance for the development of institutional capacity, disseminate information about export-oriented investment opportunities and dismantle barriers to exports from developing countries.

CONCLUSIONS

54. Forging local linkages and expanding exports are means to an end, namely promoting development. Therefore, policies to achieve a synergy between FDI and local linkages and export competitiveness should be an integral part of the overall development strategy of a country. The bottom line is that the degree of success achieved by a host country in attracting and upgrading linkages-intensive and export-oriented FDI, as well as in reaping development benefits from such investment, relies critically on its ability to develop domestic capabilities. Indeed, some of the countries most successful in boosting export competitiveness and leveraging and integrating FDI into the local economy used a two-pronged approach based on developing domestic capacities while targeting foreign resources and assets. Important elements of such an approach can include:

- Ensuring that what is targeted through investment promotion is in line with the country's broader development and industrial strategies;
- Providing a package of incentives in a focused way to encourage TNCs to invest in strategic activities (taking into account WTO rules on export subsidies);
- Involving foreign affiliates in the development and upgrading of human resources;
- Developing high-quality infrastructure, such as EPZs and science parks; and

- Providing targeted support for domestic enterprises and supplier and cluster development.

55. The last policy element addresses a particularly important issue. To benefit fully from FDI, to facilitate an upgrading of foreign affiliates and to make their activities sustainable, host countries need to encourage linkages between foreign affiliates and local suppliers. Export-oriented foreign affiliates – especially if operating in enclaves – often import all or most of their input requirements in terms of components and raw materials, assemble the product in the host country and then export the semi-finished or finished output. It is partly against this background that linkage promotion has become an increasingly important policy area. Linkages with foreign affiliates are a key channel for the diffusion of skills, knowledge and technology to domestic firms.

56. Linkages between domestic suppliers and export-oriented foreign affiliates can also take place more frequently if buyers and suppliers operate in the same spatial and industrial area. Indeed, the increasingly interdependent nature of policies on investment, trade, technology and enterprise development calls for a more integrated approach to fostering export-oriented FDI and economic development. As the development of infrastructure, business services and specialized skills often involves significant levels of investment, many countries have encouraged the formation of localized industrial clusters. Such efforts seek to create conditions that will promote dynamic interaction, learning, technology upgrading and competition among all relevant actors. A number of countries that have seen improvements in their export competitiveness over the past two decades have hosted agglomerations of mainly foreign-owned producers. Prominent examples include Ireland, Malaysia (Penang), Mexico, Singapore and a few countries in Central and Eastern Europe.

57. Against this background, the Commission may want to discuss which national policies are the most important for increasing the benefits from FDI. How have these policies been constrained or enhanced by international agreements? Such an analysis could contribute to the design of international agreements in a manner enhancing their development impact and thus to a more equal distribution of the benefits of globalization.