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Enhancing the enabling environment at all levels to strengthen productive capacity, trade and investment: mobilizing resources and harnessing knowledge for development

Creating an institutional environment conducive to increased foreign investment and sustainable development

Note by the UNCTAD secretariat

Executive summary

The interactive thematic round table is a ministerial-level UNCTAD XII event. It will bring together key ministers, global business leaders and heads of international organizations, who will address the main issues in enhancing the development dimension of national and international investment policies, and building the institutional capacities needed to enhance the development benefits derived from investment and enterprise development. The debate will focus on the emerging challenges and key elements in building an environment conducive to investment and development. What are the best practices in investment policymaking? What are the efforts needed by host and home country Governments and the international community, including UNCTAD, to improve the existing global and national policies for investment and development? How can foreign investors be encouraged to contribute to the development of the host countries? The present note provides some background information to the discussion.

I. Introduction

1. Foreign direct investment (FDI) is recognized as a major potential contributor to growth and development. As demonstrated by UNCTAD's extensive research over many years, FDI brings not only capital to the host country, but also technology, management know-how and access to new markets. It also generates employment and tax revenues, and contributes to building the productive capacity that enables countries to maximize their opportunities to benefit from globalization. FDI supplements other forms of capital flows, and usually entails a long-term commitment to the host economy and its supply capacity. However, these positive impacts are not automatic. Policy measures are needed to facilitate FDI, to safeguard the public interest in the conduct of business, and to maximize the wider benefits that FDI can bring to the host economy.

2. The growth in inward FDI flows to developing and transition economies reflects the fact that these countries have continued to open up to FDI and to provide increasingly attractive institutional environments for such investments. At the same time, countries are becoming more aware of the need to develop their policy frameworks to ensure greater development gains from FDI.

3. With the emergence of a new phase of globalization characterized by a new geography of international trade and investment relations, new technologies and new interdependencies, countries need to integrate their FDI policies within broader development strategies. FDI better serves development aims if it broadens and deepens domestic productive capacity. This can take several forms, including transfers of skills and technology, and upgrading capacity of national firms through linkages with foreign affiliates to gain more substantive roles in global value chains. These outcomes do not occur automatically. They require an integrated approach to investment policy.

4. The creation of an institutional environment that enables a country to address the challenges outlined above remains a key policy task for all countries, in particular developing and transition economies. In addressing this issue, policymakers can draw on the lessons from successful experiences and past failures, and engage in an exercise of collective learning aimed at sharing best practices. These should be widely communicated, including through international dialogue, as called for by the Group of Eight Major Industrialized Countries' (G8's) 2007 Summit and the Finance for Development Monterrey Consensus. The interactive thematic round table described in the present note is part of that process.

II. What are the current challenges in building an environment conducive to investment and development?

5. Countries seek foreign investment because of the positive impacts it can generate in the host economy. Investors are interested, of course, in securing an adequate rate of return, but in the process of making an investment, broader effects are also generated. The challenge for policymakers thus lies in designing appropriate strategies and policies that maximize the positive effects and minimize any possible negative effects of foreign investment, in line with their particular national circumstances and development goals.

6. National characteristics – including a country's geography, political and institutional organization, level of development, intrinsic business potential and core infrastructure – differ, and so do the challenges that countries face in attracting and benefiting from FDI.

7. Countries with large markets have found it relatively easy to attract market-seeking FDI. They have found it more difficult to change orientation towards attracting efficiency-seeking FDI – including inducing foreign affiliates to become more internationally competitive, export-oriented and innovative – and earn a place in the regional and global production mandates of their groups. Foreign affiliates of this latter type are likely to have a sustainable and developmental presence in their host countries. The challenge for host countries is to devise a strategy that combines consistent competitive pressures (reduced import protection and greater competition in domestic markets) with appropriate support to strengthen business efficiency through regulatory, infrastructure and skills improvement. Such a strategy encompasses both local and foreign investors.

8. Export-oriented FDI, often located in export processing zones, has contributed to the growth of many countries. Such FDI is efficiency-seeking but has usually relied on low-cost labour and is often supported by trade preferences. However, some countries have attained lower middle-income developing status and can no longer rely on low-cost labour to attract efficiency-seeking FDI. Here, the challenge consists of offering additional sources of competitiveness to FDI, such as skills, infrastructure, research and development support, and a high-standard regulatory framework so that export-processing zones can evolve to continue performing as relevant platforms for FDI attraction. Moreover, the shift to higher labour value added investment may have to spread beyond these zones, which often coexist with protected non-dynamic manufacturing for local consumption.

9. Another challenge is how to attract FDI to economies that face special problems in overcoming size constraints. Their local markets may be too small to attract significant amounts of foreign investment and the entry of dominant foreign companies could undermine meaningful internal competition. Attracting market-seeking FDI through tariff protection will not encourage sustainable competitive outcomes, yet skills and infrastructure may also be poor and thus unhelpful in attracting efficiency-seeking FDI. Nevertheless, there are cases of small countries that have succeeded in attracting and benefiting from foreign investment, with Ireland and Singapore as the best-known advanced country cases.

10. Obtaining beneficial FDI can be a particular challenge in transitional economies, due to regulatory frameworks that are unfamiliar to foreign investors and the dominance of State enterprises in the local business fabric. However, the opportunity to attract FDI can also be an incentive to establish a general regulatory and institutional framework conducive to growth and development, to diversify the ownership structure, and to reform State enterprises. It can thus play an important role in the transition process towards a market economy. The positive contributions of FDI in this respect to China, Lithuania and Viet Nam are cases in point.

11. Many countries have recently emerged from conflict or have a longer post-conflict experience. Once a degree of security and stability have been attained, the questions that arise are: (a) how can FDI be attracted? and (b) what are the areas where FDI can most contribute to building peace by improving economic conditions? The first generation of FDI is likely to be undertaken by those that fled the conflict, and whose early return could help to restore banking services, basic logistics, merchandising operations and mobile telecommunications. Later, FDI could help rebuild key public services such as electricity generation, ports and airports. Diaspora investment may also be an important source of FDI in property and services. Ultimately, the challenge is to attract FDI that consolidates the peace through employment generation, local business stimulation, and regional development and stabilization.

12. Infrastructure development remains one of the greatest challenges for developing country businesses to compete effectively in world markets. This includes electricity supply, roads, ports and telecommunications. Large-scale and long-term financing is required, some of which can be supplied, in the right circumstances, by FDI. A key issue here is the ability to obtain foreign investment in capital-intensive infrastructure projects, while at the same time providing sensitive public services and protecting infrastructure perceived as being of strategic importance for national safety and security. Public–private partnerships are often considered a solution. Still, this may only apply to a limited number of sectors and, again, further country-specific circumstances. Accordingly, different sectors of economic activity need to be treated differently through policy measures, in order to maximize value for development in developing countries.

13. Using FDI to address the challenges of climate change and to promote environmentally sustainable development is in the interest of all nations and stakeholders. "Green" FDI refers to two types of investment: (a) that which goes beyond national environmental standards – i.e. which is "compliant plus"; and (b) that which is the direct production of environmental goods and services in host countries. Such "green FDI" can be encouraged through effective policy measures and incentives at both the national and international levels. An example of the existing international dimension of encouraging "green FDI" is through the investment opportunities arising from the Clean Development Mechanism (CDM).

14. Strengthening the productive capacity of developing host countries, including the development of a vibrant small- and medium-sized enterprises (SMEs) sector, is another challenge vital for developing countries to achieve the development goals contained in the Millennium Declaration. The establishment of business linkages between SMEs and transnational corporations (TNCs) is one of the ways to enhance the productive capacity and international competitiveness. Local firms can obtain critical assets such as finance, technology, management skills and specialized knowledge by forming relationships with TNCs. These relationships also assist them to benchmark their operations against best suppliers globally. One important host country factor influencing linkage formation is the availability of local suppliers with competitive costs and quality. Key for the development of such local capacity is a favourable enabling environment comprising broader micro- and macroeconomics, as well as social policy aspects such as training and education that go beyond core FDI policy framework.

15. To find the appropriate policy response to these challenges within a particular national setting and in the context of the international trade and investment systems is a daunting task. For this, developing countries could benefit from experiences of successful practices adopted by other countries.

III. What are the elements of an environment that is conducive to investment for sustainable development?

16. Some of the fundamental determinants for attracting FDI are largely outside the direct control of national policy – factors such as location, resource endowment and size of the domestic market. However, there is much that Governments can do to put in place the right conditions for attracting and benefiting from foreign investment. Government policy can work towards improving the economic determinants of FDI, through measures such as skills and infrastructure development and market-enhancing trade agreements. Active investment promotion and facilitation programmes can complement these measures. The national investment framework and the general regulatory environment can be designed and administered both to facilitate investment and to appropriately regulate business to protect the public interest from potential

negative effects. Finally, wider development benefits can be sought from FDI by various strategies to broadening and deepening its contribution to national productive capacity.

17. The investment framework for FDI consists both of the specific rules and regulations governing the entry, treatment and protection of foreign investors and the general policy measures of taxation and regulation that apply to all businesses. A key issue in this context is that conditions for the entry and operations of foreign investment should be clearly defined and transparent. Accordingly, there should be clear criteria for the designation of sectors and activities in which FDI restrictions exist. This includes considerations of whether restricting FDI will weaken competition or worsen the overall investment climate. Policies on FDI entry should thus work in tandem with competition policy. Predictability is also crucial when it comes to screening foreign investment for national security reasons or in order to protect strategic industries.

18. Other things being equal, investors tend to favour countries with strong investment protection. Good practice in this area exhibited by a sound track record is paramount, together with a protection and treatment regime in national laws and/or treaties. Key protection standards include national treatment, most-favoured nation treatment, fair and equitable treatment, the freedom of transfer of funds, compensation in case of expropriation and access to international dispute settlement. International investment agreements (IIAs) play an important role in this context by helping to make the regulatory framework for FDI more transparent, stable, predictable and secure – and thus more attractive to foreign investors. However, the myriad of existing international investment rules also implies a growing need to ensure and maintain policy coherence at the national and international levels, and there are concerns on how to properly balance private and public interests in these agreements, and how to ensure that they adequately address the development dimension.

19. General policy measures consist of operating measures affecting all business activities, including FDI, but not designed explicitly for foreign investors. They include measures related to the fiscal regime, foreign exchange regulations, trade, industrial relations, labour relations, land, intellectual property rights, health, safety, environmental protection, consumer protection, competition policy and enforcement of the rule of law. Effective and efficient regulatory policy in these areas is essential to protect the public interest and to increase the benefits that an economy derives from FDI. For example, effective competition policy underpins the competitiveness of the entire economy. This extends to developing appropriate competitive rules to guide private participation in infrastructure. A high-standard environmental protection regime is equally required, particularly in countries with fragile ecosystems or sizeable resource extraction activities. Labour laws and health and safety standards can help to ensure decent work conditions. These measures must apply to all businesses, but can have particular importance for TNCs, which are often large and dominant in their host countries. At the international level, the Kyoto Protocol and future multilateral efforts on climate change will also have direct and indirect implications for foreign investment and host countries. All this merits policy reviews and further policy measures in line with the existing and emerging international consensus on climate change issues.

20. More dynamic issues are now influencing regulatory policy. For example, the attraction of skills becomes important alongside the protective issues of work and residence permitting. Measures in the regulatory framework to encourage FDI in less-advantaged areas within countries become more central in enhancing the developmental impact of FDI. Encouraging foreign affiliates to upgrade and deepen their operations needs ever more attention to increase confidence in the sustainability of FDI. Responding to new challenges in the regulatory regime of export processing

zones in low-to-middle income countries arising from increased labour costs and World Trade Organization (WTO) agreements, taking advantage of policy flexibilities provided therein, also becomes more significant.

21. Proactive measures can, over time, change certain economic determinants of FDI attraction in the host country. Ways to improving these “dynamic” economic determinants include increasing market potential through international trade agreements, improving skills, building infrastructure and offering advanced science and technology capacity for corporate research and development. These efforts must be complemented by maintaining a first-rate standard of administration of the investment framework, including an impeccable standard of governance and adherence to the rule of law. Otherwise, proactive measures to improve the economic determinants of FDI will be undermined.

22. Government policy can also be aimed directly at maximizing the development benefits of FDI. One channel is through encouraging and deepening linkages between foreign enterprises and local companies. These are often lacking because local firms meet neither international production standards nor corporate requirements in terms of consistency/continuity and volumes of production. Support could be provided for technological upgrading and for increasing domestic value added to achieve, maintain and upgrade international competitiveness in increasingly sophisticated products and services. It is important to review existing SME promotion and export promotion activities, and to adapt them to the new reality and requirements of global markets. Policymakers also need to identify opportunities both in mature and emerging sectors of their economies that offer SMEs the potential to integrate into global value chains. Another channel is through encouraging foreign affiliates to upgrade their own operations by taking stronger parts in the regional or global product mandates of their parent groups. This entails measures in the general policy regime of tariff protection, taken in step with measures to improve the costs and quality of the labour force and infrastructure. It can also include specific support measures working directly with foreign affiliates and their parent organizations. A complementary dimension is public–private dialogue that can encourage socially responsible actions by companies.

IV. How can the international community, including UNCTAD, assist in improving the existing national and international frameworks for investment and development?

23. The policy approach to foreign investment a country chooses is conditioned by national circumstances and global trends. At the national level, there has been increasing reliance on market forces for the allocation of resources, and on the private sector as the primary engine of economic growth. Indeed, national policies in the last years have become more and more welcoming to FDI, with some 95 per cent of related policy changes (recorded by UNCTAD since the mid-1980s) having that effect – although the incidence of measures aimed at greater control of FDI access has grown since 2004. These more restrictive measures are limited to a few countries and sectors, however. With the liberalization of FDI regimes across developing countries, the national FDI framework has increasingly become a less important impediment to FDI inflows.

24. At the international level, the accelerating process of globalization – with its rapid expansion of international production and intra-firm trade and technology transfers – has led to strong competition amongst countries for foreign investment. One aspect is that all countries are now parties to at least one IIA, with the current universe of IIAs now exceeding 2,600 bilateral investment treaties, 2,700 double

taxation treaties and almost 300 other international treaties with investment components such as free trade and regional integration agreements.

25. There is also increasing recognition by investors of their corporate social responsibilities and by their Governments of the need for home country measures to encourage FDI and technology transfer to developing countries, particularly the least developed among them.

26. In addressing policy issues, developing countries and transitional economies can draw on international experiences of successes and failures.

27. Against this background, participants of the round table may wish to address the following issues:

(a) What are the most effective policies that host countries can employ to attract foreign investment, in line with meeting their development objectives and the challenges outlined above?

(b) What are the most effective policies to widen the development benefits from the foreign investment that a country receives, including in terms of the promotion of business linkages and enterprise development policies, and to make FDI contribute to meeting its development objectives and the challenges outlined above?

(c) What actions can the home countries of foreign investors take to support such policies?

(d) How can the engagement of the private sector in meeting the development challenges outlined above be encouraged and made more effective?

(e) What actions can the international community take to support such policies?