PEOPLE'S REPUBLIC OF CHINA

Seminar On Foreign Direct Investment **FY1986**

Beijing, Peoples Republic of China
July 10-16, 1986

1. On July 10-16, 1986, a FIAS team conducted a seminar for senior Chinese officials involved in the planning, approval and monitoring of foreign direct investment in China. The seminar was organized at the request of the State Planning Commission.

2. About 80 Chinese officials from a wide variety of central and provincial government organizations attended the seminar. These officials ranged from senior economists or engineers to department (bureau) heads.

3. The seven-day seminar included five days of morning sessions with presentation of ten papers and afternoon group discussion sessions. There was one day of rest, and a wrap-up session in which the summary of the seminar was presented by IFC and the Chinese participants.

4. The purpose of the seminar was to inform Chinese government officials of the experience that other developing countries have had with private foreign direct investment. Nine of the papers presented discussed the objectives, policies and institutions that developing countries have used to promote and regulate direct investment, and analyzed how direct investment has affected host countries. The tenth paper presented in the seminar described how Chinese policies are viewed by Foreign firms.

5. The seminar began with a paper that discussed the nature of foreign direct investment and its role in developing countries--<u>The Role of Direct Investment in Developing Countries</u>. Direct investment is an attractive form of foreign capital for developing countries because the foreign investor is taking what is called the project risk: he gets no return on his investment unless the project is a financial success. Direct investment, on the other hand, is a specialized form of foreign capital. It tends to be concentrated in a few sectors (e.g., in manufacturing industries such as machinery, transport equipment, and chemicals) and in a few countries (20 countries account for 90% of the flow to developing countries). These limitations have to be considered whenever a country is formulating its investment objectives. The paper described how the benefits of foreign direct investment to the host country depend, in part, on the country's own policies. If these policies unreasonably distort market signals by providing excessive protection, subsidies or disincentives, both foreign and domestic investment may flow into undesirable activities.

6. One of the main objectives most developing countries have in seeking foreign direct investment is to obtain technology from foreign firms. The paper <u>Technology Transfer through Joint Ventures</u> asked whether direct investment is actually important in achieving technology transfer. The conclusion is that it has been important in some cases, but not in others. Direct investment (as opposed to licensing or other means of obtaining technology) can be particularly

useful when the technology transfer requires a sustained effort by the supplier. Moreover, some firms will only supply their technology in conjunction with an investment.

7. Host countries, of course, have different objectives that they hope to achieve through direct investment. Some seek direct investment in a wide variety of sectors and parts of the economy. Others take a more defensive approach. A paper presented to the seminar, Direct Investment Objectives and Policies in Seven Developing Countries, showed that, in part due to different objectives, the share of direct investment in total external liabilities of seven countries ranged from 22% (Brazil) to less that 1% (Yugoslavia). However, the paper also emphasized the need for consistency among a country's objectives, policies and possibilities. In analyzing the experience of the seven countries, the paper showed that not all the countries with broad objectives were able to establish policies consistent with these objectives. In Yugoslavia and Egypt, for example, the amount of investment was constrained because ambitious objectives for foreign investment were not consistent with foreign exchange allocation policies that restricted the amount and character of such investment.

8. Foreign exchange allocation to foreign joint ventures was a central concern of the seminar. A paper dealing with this subject, Systems of Foreign Exchange Allocation, discussed two basic approaches to foreign exchange allocation--administered and market allocation. Administered systems occur when economic policies create a foreign exchange shortage. The particular system of administration used by China (requiring foreign ventures to be self-sufficient in foreign exchange) is used almost nowhere else in the world, and has not worked well where it has been used. Movement from administered to market systems implies a reduction in the control of the authorities, but will lead to more exports, greater efficiency and probably more foreign direct investment, provided there is adequate macroeconomic management. Of course, the "market" can be used to allocate foreign exchange only if it is also used to allocate other resources in the economy.

9. Issues of the foreign exchange impact of direct investment also were raised in a paper on Project Costs and Benefits. There are a number of reasons why the financial costs and benefits of a joint venture may be different from the opportunity costs and benefits of the project to the host country. Economic policies such as tariffs on imports are among the factors that can cause such differences to arise, and affect decisions of investors. The paper showed that a foreign investment could be beneficial to the host country even if it does not have a positive direct foreign exchange balance. Domestic production substituting for imports, for example, is a benefit to the country, even though it does not generate foreign exchange directly. On the other hand, there are many examples, noted in the paper, of projects which have a positive direct foreign exchange balance which are not beneficial to the country. The reason is that the domestic costs of generating that foreign exchange are too high.

10. A paper discussing the financing of joint venture, Financing Joint Ventures in Developing Countries, also dealt with foreign exchange issues. The paper discussed the distribution of risk and return from a project among providers of debt and equity, and foreign exchange and local finance. It discussed the need for both local currency loans, and local financial institutions to provide commercial risk guarantees on foreign currency loans, to facilitate putting together appropriate financial packages for joint ventures. Local currency financing is needed in

most projects to provide a balance of risk and return that is attractive to foreign investors, and to reduce unnecessary foreign exchange obligations of the venture.

11. The interest of foreign firms in investment opportunities in a country can be shaped by the country's promotion efforts and by the investment incentives it gives. The seminar paper on Promotion of Foreign Direct Investment discussed the investment promotion techniques that have been used by developing countries. These techniques consist of supplying information to potential investors about investment opportunities and the investment environment. The critical requirement of such efforts is for the information to be credible. The paper discussed an IFC initiative to establish an institution--the International Investment Corporations for Yugoslavia (IICY)--that was designed both to help foreign investors identify investment opportunities in Yugoslavia, and to better understand the investment environment.

12. The seminar paper on Incentives to Foreign Direct Investment pointed out that the effectiveness of incentives of different types depends on country characteristics. Protection has been an important incentive, for example, in countries with large domestic markets, but is not effective in small countries. Protection, however, also can induce investments that are not beneficial to the country. In large countries, tax incentives have little effect on investment decisions. On the other hand, tax incentives may be useful in small countries promoting export-oriented investments. The paper concluded that in formulating a promotion strategy and incentive policies, it is desirable for the country to limit incentives in magnitude and to focus them on a limited set of activities in which foreign direct investment is expected to make a particular contribution.

13. Screening of foreign investment projects is needed when prices in the economy are distorted by incentives or by disincentives of various kinds (tariffs, taxes, minimum wages, etc.). A seminar paper, The Process of Entry Control for Foreign Direct Investment, described the different organizational approaches host countries have used to screen investment proposals by foreign firms. One conclusion of this view is that the geographical decentralization of investment screening used by China is almost unique in the world. The central government approves foreign investment proposals in most countries, although in some (e.g., Brazil) there is little screening either at the central or regional level. Some countries decentralize screening among central government ministries, but in those countries seeking to promote foreign investment, the screening process is often more centralized in a coordinating body, or even a single organization.

14. When it is viewed in relation to other developing countries, China in many ways presents a unique set of investment opportunities and a unique set of problems for foreign investors. Both the problems and the opportunities are laid out in the seminar paper, Foreign Direct Investment in China: Views of Foreign Firms. The opportunities arise because of the size of the domestic market, the wealth of raw materials, and the potential of the labor force. The problems stem from a lack of information and infrastructure, and the unique economic system which, together with conflicting policies, increases risks for investors. The requirement that joint ventures be self-sufficient in foreign exchange, for example, is in conflict with other policies that raise production costs and make exporting difficult. It is also in conflict with the fact that for most potential foreign investors, China's main attraction is its large internal market. Foreign investors feel that risk is great because joint ventures are not incorporated into the planning system and that

joint ventures are not a true partnership in which both the foreign and local partners assume the same obligations.

15. As a result of these conflicting signals, equity joint ventures in China have focused on: a) the oil industry; b) supplying tourists and other elements of the foreign presence in China; and c) supplying Hong Kong. These types of activities have gone ahead because they avoid the conflict inherent in current policies: They are all foreign exchange generating activities which, however, do not have to worry much about their costs because either demand is insensitive to price or they are exploiting some other special advantage of China (e.g., location and ties to Hong Kong). China, of course, wants more out of foreign direct investment than it is getting from these types of activities. To get more, it must now focus on developing the policy environment that is required in order to match policies with the country's objectives and possibilities.

16. On the basis of the issues identified during the seminar and the high-level meeting, the Chinese authorities have requested FIAS to continue its advisory assistance. The work on the preparation of a contractual joint-venture law, and on foreign exchange balance requirements follow directly from the seminar.

PEOPLE'S REPUBLIC OF CHINA **FY1987**

Diagnostic Review Of Foreign Investment Climate

1. In the summer of 1986 the World Bank was planning its third major economic mission to China. The topic of this mission was to be China's foreign trade and capital flows, and FDI was to be included as a topic. The Bank asked FIAS to lend a staff member to take the responsibility for this topic, and FIAS agreed. The mission took place in October 1986, and the report (No. 6680-CHA) was finished in October 1987. The FIAS input was reproduced as Annex 4 of the report, and summarized in the main text.

2. The report included a brief historical and statistical survey of FDI in China, and also an overview of the forces driving FDI, the benefits it could potentially bring to China, and different strategies that different developing countries had adopted *vis a vis* FDI. It then identified policy problems, or inconsistencies between China's goals and its policies, in several areas:

- China's requirement that most FDI ventures each be self-sufficient in foreign exchange was found to be reducing the total amount of FDI coming to China, and severely reducing technology transfer through FDI by medium- and hi-tech companies. Recommendations were to move toward a free, efficient, legal secondary market as an interim solution, with currency convertibility as the only satisfactory long-run solution.

- Simplification of screening and approval procedures was recommended, along with measures to assure better compliance of local officials with national policy.

- High protection in the domestic market was noted as a dangerous option to use as incentives to FDI. The use of tax incentives was also discussed, in generally discouraging terms except, possibly, in China's "special economic zones."

- Problems with local government or communist party interference in the internal management of joint ventures were noted.

- Problems arising from many local officials' overly exploitative behavior toward FDI ventures were noted, in particular the negative effects this had for the country as a whole in discouraging additional foreign investors. Experience of other countries in creating an environment in which FDI was a positive sum game, whereby both the foreign investors and the local economy gained, were discussed.

- Deficiencies in local sources of loans or loan guaranties were analyzed, with suggestions for strengthening financial intermediation.

- Finally, some packages of changes were recommended, for export-oriented FDI and for increasing technology transfer through FDI. (Increased exports and technology transfer were China's two main objectives for which FDI was sought.)

3. This diagnosis led to a subsequent FIAS project of in-depth analysis of the foreign exchange balance requirement, as the main single problem that was keeping China from getting what it needed from FDI. Recommendations of that work, some of which had been anticipated in the diagnostic contained in the Bank report, were followed by the government, as were other recommendations in the Bank report on access to loan financing, taking a broader view of technology transfer, and reducing the interference in many ways of local officials with China's overall goals relating to FDI.

PEOPLE'S REPUBLIC OF CHINA **FY 1988**

Joint Ventures' Foreign Exchange Balance Requirements

1. In an effort to conserve scarce foreign exchange, China has tried to make every Sino-foreign joint venture earn whatever foreign exchange it needs, for any purpose. This approach has been a major impediment to attracting foreign investment, especially the high-tech investment that China wants. Most high-tech enterprises can export at competitive costs, but usually only after several years of operation. Few high-tech investments come to China if they cannot earn and repatriate profits from domestic sales.

2. Chinese officials had already recognized these facts, and progress had been made in helping enterprises to get the foreign exchange they needed. But the steps taken had not yet been sufficient, and in 1988, at the request of the Foreign Investment Administration of MOFERT, FIAS assisted the Chinese authorities in resolving this problem. A report was delivered to the Government in August of 1988.

3. FIAS and a Chinese counterpart team evaluated the ways already developed to address the foreign exchange problem. Allowing foreign direct investment (FDI) enterprises to export goods produced elsewhere in China, allowing them to invest local currency profits in other enterprises that export, and allowing foreign exchange balancing within a related group of FDI enterprises, were found to have been of use to a few enterprises. But they do not help most enterprises that need it. Import substitution certification, which may guarantee the enterprise foreign exchange from the Government or allow the enterprise to sell its product within China for foreign exchange, was found to have been useful but to carry some risk for the enterprise and some dangers for China. Assisting the enterprise to export was also identified as important, but it was concluded that even further improvements in export incentives would leave many problems unresolved for many enterprises, especially in their early years.

4. Many of these ways to assist FDI enterprises required case-by-case intervention by government officials. There had been many difficult problems, and therefore a lot of such intervention. These attempts had been useful in many instances, but often only after problems that continued for a long time, causing high costs to the enterprise, and much bitterness and bad publicity. Reluctance of government officials to sell scarce foreign exchange to FDI enterprises made the problems more numerous and more difficult. As the number of FDI ventures in China increased, it was expected that such ad-hoc methods would become increasingly ineffective. Thus, FIAS concluded that an automatic system which would resolve most needs in a way that was acceptable (not necessarily perfect), both to China and to the enterprise, would be necessary if China was to attract a larger amount of high-tech FDI.

5. FIAS noted that the only really good way to resolve these problems was to make the local currency convertible. Until such time as that could be done, the recommended next best approach, as a transitional measure, was a legal, well-functioning secondary market in foreign exchange. If an enterprise needed more foreign exchange than it could earn efficiently, it could buy that foreign

exchange at a price reflecting its true value. No country has succeeded in attracting a lot of FDI without permitting it some kind of relatively assured and automatic access to foreign exchange.

6. FIAS found the rudiments of such a system already in China. Local "adjustment centers" permitted FDI enterprises to buy and sell foreign exchange for local currency. But the scope of these centers was too limited, and their markets were subject to drying up of supply and to large price fluctuations. To function acceptably, FIAS recommended that these markets be integrated into one unified national market. Further integration of the FDI enterprise market with that for purely Chinese enterprises was also recommended. Such an achievement would provide the automatic, generally acceptable way to resolve the foreign exchange problems of FDI ventures that China needs.

7. FIAS also constructed a model of the FDI sector in China. Simulations performed with this model, as well as data gathered in China, suggested that the total foreign exchange needs of FDI ventures that do not balance their foreign exchange would not be large relative to the total supply and demand of foreign exchange. Therefore, FIAS concluded that China may be sacrificing a major benefit (the technology transfer that could be achieved from foreign firms that are staying away), in the fear of a cost which is probably minor (the moderate amount of foreign exchange needs that attracting such investment would entail).

GHANA **FY 1986**

Organization, Management, and Implementation Of The 1985 Investment Code

1. In 1986, at the request of the Secretary of Finance and Economic Planning, FIAS provided assistance to the Ghana Investments Center (GIC) in implementing the country's Investment Code (P.N.D.C.L. 116) of 1985.

2. The first phase of FIAS work centered on:

- drafting implementing regulations to clarify and simplify the way in which the code would be interpreted and applied by the GIC, as well as by other branches of government, in the granting of code benefits and incentives;

- streamlining and reorienting the procedures and organization of the GIC, to enable it to more effectively approve, monitor, and promote private investment in Ghana and to become a service and promotion-oriented rather than a control-oriented institution;

- identifying broader policy initiatives, regulatory changes and financial sector improvements that were required outside the GIC framework to strengthen the overall investment climate before the promotional program could be successful. This included the possibility of introducing a swaps program to clear arrears and attract new foreign investment into Ghana.

3. FIAS papers on these subjects were presented at a widely attended week-long workshop in Accra at the end of January 1987 that was opened by the Prime Minister, who was also Chairman of the GIC Board. The workshop generated useful momentum for the GIC to pursue the many recommended procedural and legislative reforms that were needed to create an attractive investment climate. The GIC Board agreed to the FIAS recommendations for internal GIC procedural reforms and structural improvements. Subsequently, however, the GIC proved unable to pursue the agreed agenda because of a continued lack of the necessary physical facilities and budgetary resources. The GIC therefore sought FIAS help in arranging these elements as a first step in a FIAS follow-up work program.

4. After identifying sources of funding for GIC needs, in February 1988 in Ghana, FIAS made a proposal for a follow-up work program to the Prime Minister, the Minister of Finance and a newly-appointed Chief Executive of the GIC. The program was initially accepted but commencement of FIAS work has not yet been requested by the GIC. The program was to involve FIAS and IFC staff working jointly with the GIC and the Prime Minister's office in a series of investment promotion activities, assisted by the Irish Industrial Development Authority (IDA) and by resident advisors to be introduced at the GIC. The promotional work program at the GIC was to comprise the following specific elements: a) improvements in GIC physical facilities and introduction of foreign resident advisors at the GIC to assist in implementing the recommended

reforms (to be funded by the World Bank); b) formulation of a foreign investment promotion strategy, including selection of priority projects for targeted promotion, and assistance in identification of potential foreign partners (to be funded by FIAS, UNDP, IFC and others); c) commencement of an institutional twinning relationship with IDA to assist in preparation of promotion materials, training abroad of GIC staff and establishment at the GIC of capabilities to select and support domestic entrepreneurs and to design and carry out promotion campaigns abroad (to be funded by the Irish and Ghanaian Governments); and d) training in Ghana of GIC staff and other government officials on technology transfer issues.

5. Due to the passage of time and in light of recent discussions with the GIC, the above program may still go ahead, though in substantially modified form.

INDONESIA **FY 1987**

Review Of The Regulatory Framework For Foreign Direct Investment

1. In the second half of 1987, at the request of the National Investment Authority (BKPM), BAPPENAS, and the Minister Coordinator for Economic, Financial and Industrial Affairs, FIAS provided advisory assistance to the Government in the review of the regulatory framework for foreign direct investment.

2. Throughout its history as an independent nation, Indonesia has been an attractive location for foreign direct investment (FDI). Investors have been attracted by an abundance of oil and mineral resources, soil, climatic conditions, and marine life; the size of its domestic market and its potential for development; the availability of low cost labor; and its comparatively easy access through marine transportation. Japanese firms have been the largest foreign investors by far, with assets of US$9 billion in LNG facilities, basic industries, and manufacturing. U.S. investments, valued at US$4 billion follow the Japanese, and are mainly in petroleum production and exploration. European investors, particularly from the Netherlands and the Federal Republic of Germany, also have been active.

3. The basic factors that have attracted FDI in the past will continue to attract it in the future. For example, driven by the strengthening yen, Japanese investors are interested in Indonesia as a potential source of low-cost labor. European firms are interested in the market potential. Asian investors from Hong Kong, Singapore and, more recently, Korea, also are interested in the opportunities offered by the low-cost Indonesian labor market as labor costs rise in their own markets.

4. Despite the attractions of Indonesia, the full potential for foreign investment, particularly to produce for export, were not realized in the 1980s. Investment approvals fell through much of the decade, and actual capital inflows have been stagnant.

5. Since 1985, Indonesia has taken a number of steps to attract more foreign direct investment. The 1987 liberalization of policies governing FDI followed an extended period dating to the mid-1970s during which Indonesia implemented a number of measures to restrict direct investment. These restrictions reflected national aspirations for greater control over foreign investors, and a desire to obtain a larger share of the economic benefits from such investment. They were made possible by the windfall benefits from oil price increases, which reduced the need for foreign capital of all kinds. With the collapse of oil prices in the mid-1980s, however, the need for foreign capital, including FDI, reemerged and along with the need to diversify exports, motivated the liberalization of FDI policies.

6. The questions raised in the FIAS review were whether the economic liberalization measures, particularly the measures announced on December 24, 1987, established a framework for FDI that would enable Indonesia to meet its own objectives for FDI inflows. These objectives were framed

in the context of overall need for foreign capital that would have required a contribution by FDI of about US$1 billion per year by 1990. They also reflected a desire for more foreign investment in export-oriented industries to help Indonesia meet its overall export goals.

7. FIAS sought to answer this question by drawing on the knowledge of the impact of policies on foreign investment decisions, by comparing Indonesia's policies with those of other countries in the region, and by interviewing actual and potential Japanese, European and U.S. foreign investors. The conclusion that emerged from these various sources was that Indonesia maintained a complex regulatory system for FDI that in itself, apart from specific provisions, could have a negative effect on the types of FDI that Indonesia was seeking. Foreign investors voiced concern on particular aspects of this system. A review submitted to the Government in April of 1988 showed that there had been a number of positive changes in the system for screening FDI (DSP lists, BKPM approval procedures) since 1985. Nevertheless, the legal and regulatory framework was still somewhat confusing, and concerns about ownership restrictions remained. Although the December 24, 1987 regulations have gone a long way in dealing with many concerns of foreign investors, there are still some remaining areas that would benefit from further attention by the authorities, notably:

- Ownership restrictions still hinder the expansion of existing firms;
- Ownership restrictions of export-oriented firms in Indonesia are more restrictive than in neighboring countries;
- Land usage and ownership restrictions impede foreign investment in export-oriented agricultural projects;
- Restrictions on expatriate staff impede technology transfer and establishment of high technology and export industries; and
- Restrictions on domestic marketing by PMA firms is a disincentive to investment and an impediment to technological transfer to local consumers.

8. FIAS has continued to work with the Government of Indonesia on strengthening the policy, regulatory, and institutional framework for foreign direct investment.

9. In April of 1989, the Government announced a new package of measures to liberalize the inflow of foreign investments. Some of the FIAS recommendations (such as introduction of a "negative list") have been reflected in the new measures.

INDONESIA **FY1990**

Preparation Of An Investment Promotion Strategy

1. At the request of the National Investment Authority (BKPM) and BAPPENAS, FIAS prepared in 1990 a report on strategies for an investment promotion drive by the Government, and on the related institutional implications.

2. In recent years significant changes have been introduced by the Government of Indonesia which have altered the investment climate and made Indonesia a more attractive location for investment. The program of deregulation is ongoing and further deregulation moves have been signaled in the current five-year plan, Repelita V.

3. Repelita V sets out the economic and social targets being sought over the next five years. These targets include increasing foreign direct investment (FDI) by 12% per annum over the plan period. This represents a challenging target given the highly competitive environment for overseas investment. Repelita V is also committed to a policy of wide-scale dispersal of overseas investments throughout the regions of Indonesia.

4. The level of overseas investment approved annually in Indonesia is now expanding rapidly after a substantial fall in the mid 1980s. FDI approvals in 1988 were US$4.4 billion, over three times higher than approvals in 1987. Preliminary data for 1989 show an even further increase in approvals of FDI. These recent approval figures are encouraging and demonstrate a considerable level of interest by foreign investors in Indonesia.

5. In recent years, the major home countries are the Asian NICs followed by the European Community, the U.S., and Japan. Within the NICs, approvals from Taiwan and Hong Kong have grown rapidly, followed by Korea. Within the European Community, the Federal Republic of Germany, the United Kingdom and the Netherlands have been the main sources of recent approvals. Approvals from Japan, while still substantial, have not shown the recent growth that Japanese investments have shown in some other countries in the region, notably in Thailand.

6. The sectors providing most approvals in Indonesia in the period 1983-1988 were chemicals, paper and pulp, basic metals, and metal goods. In 1988, the leading sectors were chemicals, paper and pulp, textiles, clothing and food. The sectoral composition of FDI approvals shows the continuing importance of resource linked investment in such sectors as chemicals, paper and pulp, metals and food. It also shows the emergence of substantial levels of cost driven investments, which are now apparent in all ASEAN countries, in sectors such as textiles, clothing, and footwear. Investment approvals in the textile and clothing sectors in Indonesia only represented 4.5% of total investment approvals since 1985 but in that same period they have provided 35% of the approved jobs. These sectors are also contributing significantly to exports and accounted for over 7% of exports in 1988.

7. The regional dispersal of FDI approvals within Indonesia has been disappointing to-date

with almost 70% of approvals since 1983 being approved for Java. Lack of infrastructure and suitable business partners are repeatedly mentioned by foreign investors as some of the main reasons why they are reluctant to commit to locations other than Java. Overcoming these constraints in the future will be critical to the success of the investment dispersal policy set out in Repelita V.

8. While investment approvals have increased rapidly in Indonesia since 1986, approvals have increased equally rapidly in neighboring countries. Evidence in the ASEAN region suggests that investors sometimes seek approval in different countries before finally deciding on the selected location. Such double-counting would account for some of the increase in approvals in ASEAN countries but the increase also reflects a substantial underlaying expansion in FDI in the region. In 1988 and 1989, approvals in Indonesia appear to be regaining some lost ground against neighboring countries and in particular against Thailand. Thailand has won a large share of overseas approvals in recent years, especially from Japan but also from the NICs. In conjunction with Malaysia and the Philippines, Thailand now pursues a very active overseas investment promotion strategy.

9. While FDI approvals in Indonesia are expanding, the available evidence suggests that the level of realized FDI investment is not as high as could be expected. There seems to be a substantial and growing gap between potential investment and realized investment. Potential investors who visit Indonesia to examine opportunities seem to drop out in significant numbers both before and after BKPM approval. The indications are that some of these investors proceed to invest in other Asian or ASEAN countries. While some drop-out of approved investment is inevitable, any future strategy must seek to minimize the level of such drop-outs. An expensive and unpredictable element of investment promotion is the identification and the attraction of potential investors on site visits. Once this occurs, it is critical that the maximum possible number of these are quickly converted into realized investors.

10. Many potential investors never visit Indonesia because of a gap between the perception and the reality of investment conditions in Indonesia. Existing investors who are aware of the changes in the investment climate brought about by the deregulation efforts of the Government of Indonesia confirmed that conditions for investment are better than the prevailing perceptions of these conditions. However, surveys conducted by FIAS in major overseas markets highlighted these negative perceptions. These surveys also show that there is not sufficient awareness overseas of the changing policies in Indonesia (perceptions were especially negative among Japanese and U.S. investors).

11. The main concerns underlying these negative perceptions included the lack of suitable partners, a still perceived negative attitude in Indonesia towards FDI, the lack of adequate infrastructure for investments, and bureaucratic problems. The substantial gap which is evident between the perceptions of foreign investors and the reality of investment in Indonesia, is a topic of importance for future investment promotion strategy.

12. The FIAS report divides the process of investment promotion into three separate but interrelated elements, namely, provision of investors services, image-building and investment-generation activities. Different priorities and indicative time frames are given to the

implementation of the proposals set out for each element of the process in a proposed future strategy.

13. The proposals presented give top priority for immediate implementation to a new program of investor services as the first and critical step of future strategy. The primary purpose of this program is to reduce the gap between potential and realized investments.

14. The proposed investor services program focuses on identifying a higher proportion of the potential investors who visit Indonesia, on responding to potential investors queries with an enhanced and relevant information package, on providing an efficient approval system, and on devoting considerable resources to assisting and monitoring the implementation of projects. The program would give special emphasis to existing investors and would seek to establish a portfolio of satisfied existing investors who in turn would help promote Indonesia through their contacts.

15. The proposed image-building program has a second priority but should be implemented immediately, along with a development of a program of investor services. The image-building program would commence with an information and a public relations campaign to be carried out initially within Indonesia. This campaign would aim at boosting the perception of the role of FDI within the community and also at informing overseas representative organizations and individuals in Indonesia of the changes and successes occurring in the country. Selective advertising is suggested to help encourage visiting investors to contact the approval agencies and to support the information and public relations campaign. Organized visits by overseas journalists is proposed as an element of the image-building program.

16. The second part of the image-building program would commence about 1991 and would focus on advertising, information and public relations activities in targeted overseas markets. It is recommended that any advertising program should be undertaken with the assistance of reputable specialists who would advise on such matters as themes, methods and media for delivery, and on evaluation procedures.

17. The second phase of the proposed strategy (1992-1994, approximately) would place increasing focus on new investment-generation activities. The need for, the location, and the degree of such investment-generation activities should depend on the level of FDI arising from the Phase I program as compared with the levels required to achieve development objectives. Final decisions on the focus of the second phase should be made after the Phase I program is well underway, but preparations for Phase II should commence immediately.

18. Based on present information and trends, it is suggested that the Phase II investment-generation activities should progressively lead to the opening of two overseas investment promotion offices: a) the first in Japan to handle investments from Japan as well as those from Taiwan, Hong Kong and Korea; and b) the next in Europe, (possibly located in Brussels for investments from the European Community). If resources allowed and if the results from other offices were favorable, a third priority location would become the West Coast, USA.

19. Overseas offices would initially concentrate on market support activities such as missions and seminars, briefings, direct mail, telephone contacts, ministerial visits, all aimed at building up

a portfolio of potential investors. These marketing support activities would be assisted with advertising, and other image-building activities. With experience and after about one year in the field, a list of priority clients would be prepared and direct marketing techniques would be introduced with these clients. Direct marketing would include arranged meetings and tailored presentations for these clients with detailed follow-up to obtain investment proposals.

20. The report recommends that a comprehensive training and a "hands-on" learning program be initiated immediately which would guide staff into the new strategy and would introduce the operating systems required for its implementation.

21. The implementation of the proposed strategy has implications for organization structure, its staffing and skills and for the operational and control systems used by the organization. This institutional restructuring should be introduced in an integrated and coordinated way with the introduction of the new promotion strategy. One should not be out of line with the other. If BKPM is to be the organization responsible for implementing the new strategy, a significant restructuring of BKPM will be necessary to carry out this strategy. The restructuring proposals cover four main issues:

- reorganization of the operational divisions of BKPM into four Directorates, one for promotion, one for evaluation, one for implementation and the final one for planning and organizational services;

- higher profile and positioning of the promotion activities of BKPM as a major priority for successful strategy implementation;

- establishment at BKPM of a senior level committee with representatives from the key Ministries and from regional governments to help speed up project approval and implementation, at the national level and within the regions; and

- creation of the new role of "project officers" each responsible for direct dealings with a portfolio of projects. Investors would interface directly with their nominated project officers who in turn would interface for the investor with all units within BKPM and within the Government. Such a move should benefit the investor and would clearly define responsibilities and control requirements within BKPM.

22. Greater flexibility in personnel policy is recommended to allow for the recruitment where required, and for appropriate reward mechanisms for key personnel. In addition, it is recommended that a training and a hands-on guidance program should be commenced immediately to help introduce the proposed new strategy together with its new techniques, new information packages, new language and other skills, and new operating procedures.

23. The report proposes the introduction of performance evaluation measures which are "output" focused, which measure realized as well as approved results, and which are relatively easy to collect and require the minimum level of processing. Specifically, the report recommends that the ongoing and up-to-date measure of performance should be based on employment and that this measure should be supported annually with a measure of the value-added impact of

promotions. Periodically, a more complete analysis under the existing seven principles should be undertaken and reported on.

24. The proposals made throughout the report are based on existing policies and deal only with the issue of FDI promotion strategy. Attention is drawn in the report, however, to areas of policy which directly impact on investment promotion, and where further change is likely to be required if Indonesia is to win an increasing share of FDI and gain the most from its promotional efforts. Three policy areas are given special mention for priority action, namely, the close integration of the regional and national efforts towards investment promotion, targeting the delivery of infrastructure facilities to enable maximum investment implementation, and a consistent and transparent line to be followed in the ongoing deregulation drive by the Government of Indonesia.

25. The priority actions that arise from this study can be highlighted as follows:

- a decision by the Government of Indonesia on the proposed promotion strategy together with its emphasis and suggested timing; and

- a decision by the Government of Indonesia on the proposed institutional restructuring regarded as essential for the implementation of this strategy.

26. If these decisions are positive (with or without some modifications), then the following steps should be undertaken immediately within BKPM if it is selected as the institution to carry out the new strategy:

- Establishment of a high level institutional reorganization team charged with preparing and with guiding a detailed scheme of strategy implementation. Its first charge would be to introduce the new proposed structure and assign responsibilities and reporting procedures.

- Initiating of the staff development and training modules.

- Undertaking a broad based study to develop and put in place a new data base on FDI.

27. In addition to these actions, other actions outside BKPM are required as follows:

- Initiate an evaluation of the national and regional links and responsibilities in investment promotion and recommend on future structures as a matter of urgency.

- Prepare a targeted program for the provision of infrastructure facilities over the next few years aimed at maximizing the chances of speeding the implementation of investment.

- Continue the program of deregulation initiated by the Government with a consistent and welcoming emphasis on facilitating private sector investments including FDI.

28. On the basis of the recommendations of the FIAS report, BKPM is preparing a Plan of Action for investment promotion activities. In the meantime, FIAS is finishing a report on the

coordination requirements for investment promotion between the national investment authority (BKPM) and the regional investment authorities (BKPMDs).

KENYA FY**1988**

Diagnostic Review Of Foreign Investment Climate

1. In February 1988 at the request of the Ministry of Finance, FIAS conducted a diagnostic review of the investment climate, focusing on issues of special concern to the Investment Promotion Centre (IPC) and making a proposal for further FIAS work with the IPC. The FIAS diagnostic work reviewed the ongoing work program and training needs of the IPC, the one-stop-shop concept for the IPC, Kenya's new in-bond scheme for manufacture of exports, various investment regulation reforms already underway (the amendments to Kenya's Foreign Investment Protection Act and the proposed Restrictive Trade Practices Bill), the tax regime and incentives that Kenya offers investors, and the pros and cons of creating an investment code in the country.

2. In its mission presentations and reports, FIAS reported the views of foreign investors and made a number of recommendations to the Kenyan authorities on preconditions to a recovery of foreign private investment. FIAS suggested that Kenya would first need to clarify and strengthen its investment policies to eliminate critical gaps and inconsistencies in investment laws, regulations, and official practice. Cases in point were the lack of clear policies on indigenization and the pending legislation on restrictive trade practices that opened the door to arbitrary and discriminatory treatment of firms by officials. The export incentives and other incentives regimes were also found to be inadequate. In particular, there were numerous problems in the proposed rules of manufacturing under bond scheme, and there was a need to reconsider the advantages of the rejected concept of export processing free zones, particularly if privately funded and operated. And finally, FIAS made suggestions as to how the one-stop-shop concept and other IPC programs might be strengthened.

3. FIAS proposed a promotional work program which the Government accepted in January 1989. The resulting work program began in April 1989 focussing on assistance in the preparation of a coherent investment policy statement and institution-building support to the IPC. For the investment policy statement exercise (described in Kenya policy statement summary) a background review of relevant legislation and regulatory practice in Kenya was prepared by consultant lawyers in Kenya following a FIAS study mission in June 1988. The report was reviewed with government officials at a FIAS seminar in Washington in the October 1989 prior to the preparation of the draft investment policy statement. Institution-building work with the IPC has just begun through the development of a training program on investment promotion for IPC staff, other government officials, and selected private sector participants which will begin in October 1990.

KENYA **FY1989**

Preparation of an Investment Policy Statement

Washington, D.C.
October 31 - November 1, 1989

1. In the context of ongoing advisory assistance to Kenya, FIAS conducted a seminar on Kenya's Investment Policy Statement in Washington, D.C. from October 31 - November 1, 1989 at the request of the Ministry of Finance and Investment Promotion Center (IPC). The participants included a delegation from the Government of Kenya, staff and consultants from FIAS, and staff from the World Bank, the International Finance Corporation (IFC), and the Multilateral Investment Guarantee Agency (MIGA).

2. The aim of the seminar was to examine Kenya's investment policy framework in order to provide the Government with suggestions to help draft an Investment Policy Statement. Two working papers were distributed in advance of the seminar as background materials for the seminar. They were:

- a preliminary draft of an investment policy statement prepared by a government working group; and

- a survey prepared by local legal consultants commissioned by FIAS to examine the investment policy environment from the standpoint of laws and regulations as well as practices affecting the investment process.

3. The seminar's participants examined various components of the investment policy framework in Kenya in light of alternative approaches practiced in other countries, and with which FIAS staff are familiar. FIAS submitted to the Government of Kenya a summary paper of the discussion including proposals for change in policy and practice as well as a short list of priority areas for immediate action by the Government.

4. The Government is planning to utilize the FIAS report in preparing an Investment Policy Statement representing government policy and its plan of action in the investment policy field. Since Kenya has a large number of laws of equal constitutional standing, an investment code or a policy statement cannot override other laws effecting the investment process. Thus the proposed Statement will identify necessary changes in existing laws which the Government intends to amend. The Statement will also identify regulations and practices which need changes where the Government can implement immediate actions. In addition, where practices diverge from declared policies or where the policy is not clear, the Statement will attempt to establish clear guidelines for implementation by the various government departments.

<u>CAMEROON</u> **FY1989**

Revision of the Investment Code

1. At the request of the Ministry of Industrial and Commercial Development (MINDIC), FIAS provided assistance to Cameroon in revising its Investment Code. The Government of Cameroon had already begun revision of the 1984 Investment Code as part of its first adjustment program. The draft was an improvement, including more neutral treatment of foreign and domestic investors, for example, but further work was needed to make it both a meaningful improvement in the regulatory environment, and acceptable to the World Bank as a SAL second tranche release condition.

2. A workshop was organized in June of 1989 in Paris gathering high ranking officials from the MINDIC, and World Bank and FIAS staff. The participants discussed the draft of the new Code and proposals put forward by FIAS. It was agreed that the Government would write a new draft based on the workshop discussions.

3. FIAS summarized the proposals that arose from the workshop in a report sent to the Cameroonian Government in August 1989. FIAS's main suggestions were to broadly restructure the code to promote <u>all</u> private investment, grant general rights and guarantees to <u>all</u> investors, and provide special incentives only to companies meeting performance-based criteria linked to the key economic objectives pursued by the Government (e.g., employment exports, entrepreneurial development). Investor guarantees needed to be unambiguous and more extensive (including, for example, transfer of royalty payments, freedom to hire and fire, freedom to set prices, settlement of disputes, etc.). FIAS also suggested creation of a one-stop-shop to speed up the investment approval process.

4. The FIAS report, plus a continuing dialogue with the Government on its successive drafts since the workshop, has contributed to important improvements. Because of the early stage of macroeconomic policy reforms, the final code is likely to fall short in some areas and will need further revision after such reforms have taken place. Many of the FIAS suggestions were reviewed jointly with the Government in January 1990 when a FIAS mission visited Cameroon for a diagnostic review of the investment climate. Implementing regulations for the code were also discussed during that mission with officials from MINDIC. The Code should be passed into law shortly.

LESOTHO **FY1989**

Diagnostic Review of Foreign Investment Climate

1. At the request of the Ministry of Trade and Industry, FIAS prepared during 1989 a diagnostic review of the opportunities and obstacles for foreign direct investment in Lesotho. The mission's report was presented to the Government in July 1989.

2. FIAS found that most foreign investment had been attracted to Lesotho because of economic distortions. These distortions included sanctions against South African exports, interruptions in textile trade due to the Multi Fibre Agreement (MFA), and preferential treatment in public procurement. FIAS expressed concern over Lesotho's reliance on distortions to encourage foreign investment and recommended creating a climate capable of attracting and sustaining export-oriented industries not dependent on these factors.

3. To initiate this change, FIAS proposed that the government institute a variety of measures. First, FIAS reviewed in detail the Pioneer Industry Program, which contains Lesotho's principal investment incentives. Suggestions were made to adopt transparent and automatic criteria, as well as to increase the economic value of incentives without incurring additional revenue loss. The report then explored ways for easing barriers to establishing investments, including streamlining procedures for access to industrial sites and for obtaining work permits.

4. Next, FIAS directed the government's attention to the importance of creating a low-cost production environment. The report addressed measures to reduce the costs of labor and capital. Related to this, FIAS also proposed that the government try to make more effective use of the "financial rand" as an incentive to lower the foreign-exchange cost of investment. Finally, the report analyzed a number of policy proposals under consideration by the government, including requiring a 51% share of state equity in certain projects, offering a protected market to attract investment, and initiating an active program of investment promotion.

5. A FIAS mission visited Lesotho in September 1989 to discuss the report and to begin a second phase of FIAS assistance, which aimed to help the Government to evaluate whether to resume active investment promotion efforts.

LESOTHO **FY1990**

Foreign Investment Promotion Strategy

1. Following completion of the FIAS diagnostic report on the investment climate in Lesotho, at the request of the Ministry of Trade and Industry, FIAS examined the question of whether Lesotho should resume active investment promotion and if so, what the recommended approach should be. FIAS missions, jointly funded by the World Bank, began the work at the end of 1989. A report was delivered to the Government in August 1990 and will be discussed after this year's Annual Meetings. The World Bank has meanwhile incorporated most of the recommendations, as well as funding to support a new investment promotion agency, in a credit which will be negotiated around the same time.

2. The FIAS report first reviewed the history of investment promotion efforts and related industrialization strategy in Lesotho. It found that promotion could have been executed more effectively in the past, and that there is justification for its resumption on a new basis. The report analyzes Lesotho's strategic advantages and options and the industries and foreign investor groups it should target. It also broadly defines the elements that should go into the program including the promotion objectives and techniques that should be used and the organizational arrangements to execute the program.

3. The four post-independence development plans of the Government of Lesotho had progressively established the manufacturing sector as the main engine of growth and employment. Since the small domestic market could not absorb the scale of production necessary for efficient industries, increased manufacturing output was aimed at export markets. The local private sector remains small with limited experience in production for export, so Lesotho must continue to look to foreign investors for its export oriented investment drive. Most of the exceptional annual growth of 18% in manufacturing over the last 20 years has been due to foreign investment in labor intensive export oriented sectors. In 1986, foreign and joint venture firms accounted for 70% of the employment in manufacturing and 90% of manufactured goods exports. This success reflected less the result of promotion efforts than the responses of investors from mainly the Republic of South Africa (RSA) to sanctions, unrest and uncertainties at home.

4. The structural pattern of manufacturing that resulted from past foreign investment raised several concerns on the part of the Government of Lesotho: first, the fear that most foreign investment has been motivated by temporary political or economic considerations, avoiding trade sanctions by South African investors and avoiding quotas by investors from Asian newly industrialized countries (NICs); second, concern over the pace of development of indigenous owned enterprises and the foreign domination of the manufacturing sector; and finally, growing awareness of the need for industrial deepening by promoting backward and forward linkages to existing foreign investment and resource-based activities.

5. Past promotion efforts had suffered from several shortcomings. The first promotion program (1979-82) had a slow start-up due to recruitment problems. Half of the four-year period

was used to recruit and train the necessary staff. When the operation became functional it was only partially effective because of poor investor targeting. The promotion staff had no project appraisal training and therefore the pre-screening of firms prior to making presentations was very weak. The program was aborted too soon for effective measurement of results. Since 1983, a minimal level of promotion had been carried out by Lesotho's National Development Corporation (LNDC) focussed on projects that LNDC wanted to add to its portfolio.

6. FIAS believes that a more effective investment promotion program in Lesotho is both feasible and desirable. The first step in establishing such a program would be to improve the investment environment and the investment policy instruments, along the lines outlined in the July 1989 FIAS diagnostic report.

7. On the basis of these improved policies, a new promotion strategy could be pursued by a new Center. Its targets would include a more diversified list of labor intensive manufacturing sectors for exports to the RSA, Europe, and the U.S. The Center would concentrate first on building an investor services capacity in Lesotho, followed by the launching of investment-generating activities (direct selling to potential investors) in the RSA, and image-building activities (mainly missions and seminars to introduce investors to Lesotho) in the NICs, Europe, and the U.S. (with the help of home governments where feasible). The new Investment Promotion Center would have clear performance objectives against which it would be evaluated. FIAS proposed that the targets for IPC's second year of operation be 550 jobs created through six quality projects implemented as a result of its efforts, rising to 700 jobs (7 projects) in the third year, and 1000 (10 projects) in the fifth year and on.

PAPUA NEW GUINEA **FY1988**

Revision of the Investment Law

1. In recent years, Papua New Guinea (PNG) has made substantial progress in reducing its domestic and external financial imbalances. Government deficits have been lowered, inflation has been moderated, the balance of payments position has been strengthened, and discipline has been restored over external borrowing. Growth, on the other hand, has been weak. GDP growth averaged less than half the population growth rate in the first half of the decade, entailing a significant erosion of per capita income. Growth has picked up since, but mainly due to increased mineral production. In the rest of the economy, growth has remained low and below the population growth rate.

2. The Government's aim (as expressed in the Planning and Budgetary Strategy Paper, 1988-1992) is to accelerate the pace of growth and development by exploiting the opportunities for mineral sector development, while at the same time developing the potential of the non-mineral sectors so as to lay the foundation for sustained and broad-based growth.

3. Private sector development in the PNG is constrained by issues such as high transport costs due to the difficult terrain, the lack of infrastructure, relatively high wages, small and fragmented domestic market, land tenure policies, and some basic weakness of the local private sector. The Government employs very few general control measures over entry and exit of local firms in most of the agriculture, manufacturing, trade, and services sectors. However, it employs strong controls on entry and operations of foreign firms, and the entry and employment of foreign workers.

4. The Government hopes to encourage development of the local private sector by controlling foreign investors. To implement this strategy, the Government established a regulatory and institutional framework that includes the NIDA Act, the employment of foreign workers laws and regulations, and the foreign exchange control regulations. This strategy, pursued since independence, has been partially responsible for an increase of localization of ownership and employment and the reduction of foreign presence in the PNG. However, this policy (together with other aspects of the investment climate) is responsible for the decline in foreign investment (except in the mineral and petroleum sectors), departure of existing investors, and lack of interest in new investment opportunities. The present regulatory system is perceived by foreign investors as responsible for a long investment investigation period (and the high costs associated with it), as well as the perception of uncertainty and high risk in making an investment in the PNG.

5. The Department of Industry requested advice from FIAS on simplifying the approval process for foreign direct investment in the second half of 1987. In discussions with the Government in September of 1988, FIAS proposed major modifications of the foreign investment regulatory regime. Under this proposal, foreign investment would be controlled in certain activities that are reserved for local investors. At the same time, limitations imposed on foreign investors in non-reserved sectors would be reduced. The foreign investment approval system would be adjusted to accommodate the political desire to decentralize certain powers to the provinces, to speed up the decisionmaking process, and to improve coordination within the

Government. The investment authority (NIDA) would be transformed into a promotional agency.

6. Some of the FIAS proposals have been approved by the National Executive Council and their implementation is expected shortly.

THAILAND **FY1987**

Review Of Investment Policy And Incentives Strategy

1. The Office of the Board of Investments, with the support of the National Economic and Social Development Board (NESDB) of Thailand, requested FIAS to assist it in the determination of whether changes in the Investment Promotion Act of 1977 (the Act) or its administration by the Board of Investments (BOI) might be needed to improve the contribution of investment promotion policy to the objectives of the Sixth National Economic and Social Plan (1987-1990).

2. During the 1960s and 1970s, the economy of Thailand had one of the most enviable growth records in the world. Aggregate GDP increased nearly 7% annually between 1970 and 1980, led by industrial growth of 9%. During the most recent five-year plan (1982-86), however, these rates of growth declined, as did the rate of increase in agricultural production. Nevertheless, with the GDP continuing to expand nearly 5% annually, Thailand still outperformed most other developing countries during the early-to-mid 1980s. As for foreign direct investment (FDI), Thailand, during the mid-1980s, followed Singapore and Malaysia to become the third largest recipient of such investments in East Asia (excluding China).

3. Even though the economy of Thailand has performed relatively well, a number of emerging problems have brought into question several of the economic objectives and strategies laid out in the Sixth Plan. The most important of these problems include the following:

- while still comparatively high, rates of economic growth declined and remained substantially below levels projected in the Sixth Plan;

- faltering export growth rates and deteriorating terms of trade, particularly in agricultural goods; and

- continuing rural-urban imbalances in the distribution of income.

4. Reacting to these problems, the Cabinet approved Thailand's Sixth Plan during the fall of 1986. In pursuit of more rapid economic growth, that plan proposes a development strategy which seeks:

- improvements in the investment climate for private enterprise through reductions in government regulations and state competition;

- improvements in economic efficiency through greater reliance on market mechanisms to allocate scarce resources;

- improvements in the country's international competitiveness through reductions in production costs and advances in product quality; and

- improvements in rural-urban income disparities through increased industrial investments outside of the Bangkok metropolitan area.

5. In response to the request for assistance, FIAS staff reviewed the content and application of the Investment Promotion Act in Thailand, consulted with a wide range of government officials as well as the private sector, and drew on IFC's own experience as an investor in a wide range of developing countries. Together these inputs have provided the basis for suggesting changes in Thailand's investment policy and incentive strategy. A report to the BOI was submitted in May of 1987.

6. The recommendations were focused on the foreign investment guarantees and permissions; income tax incentives; duty and tax exemptions or reductions; criteria for the designation of promotion activities and of those not considered for promotion; and criteria for project approval.

7. Some of these recommendations were accepted by the Government and were implemented in September 1987. Notably, the new guidelines for granting tax incentives:

- emphasize location as a prime reason for the grouping of eligible projects and for setting the level of incentives;

- open up sector limitations for projects located outside Bangkok;

- increase the difference in the level of incentives granted to domestic market-oriented projects located in Bangkok and Investment Promotion Zones (IPZ), by decreasing incentives in Bangkok and increasing them in IPZ;

- eliminate the size of investment as criteria for granting certain incentives; and

- limit considerably the use of protection and subsidies in the form of tax exemption on raw materials and parts for domestic market-oriented projects.

TOGO **FY1988**

Revision Of The Investment Code And Preparation Of Implementing Regulations

1. FIAS began work in Togo in mid 1988 at the request of the Ministry of Planning and Mines with a review of the investment climate, focussing on the needed changes to the investment code and prospects for development of export processing zones in the country. To assist the Togolese Government to revise its investment code and to develop a program of action to create free zones, a workshop was held in Washington in December 1988 with government officials. A summary of the workshop was presented to the Government in January 1989 and discussed further with officials in Lom› in February 1989.

2. The workshop produced a draft for a new code, which was adopted in late 1989. Following FIAS recommendations, the code utilizes simplified, performance-based incentives linked to achievement of Togo's employment, export, regional development and local resources development objectives. Investment approvals are also made subject to transparent and automatic criteria under the new code. These changes will reduce the administrative requirements of implementing the code. The new code is also compatible with the Government's new initiatives on tariffs and taxes under its structural adjustment program, for example reorienting incentives away from indirect taxes to direct ones.

3. FIAS also reviewed draft regulations for implementing the new code. This work led to a government request for a second phase of FIAS work focussing on foreign investment promotion linked to efforts to create an export processing zone which the Government actively pursued.

YUGOSLAVIA **FY1988**

Review Of Obstacles To Increased Flows Of FDI And Comments On The Draft Of The New Foreign Investment Law

1. The Government of Yugoslavia opened its economy to foreign direct investment in 1967. Since then, the Government has sought to attract investments in joint ventures by a wide range of foreign firms. While there have been a number of reasons for seeking direct investment, Yugoslavia has been particularly interested in the transfer of technology that could be achieved in this way.

2. Despite its continuing interest expressed through various policy statements and other channels, and despite several changes in the joint venture law that regulates direct investment, Yugoslavia has been noticeably unsuccessful in attracting foreign investors. In 1988, there were no more than 200 joint ventures in operation in Yugoslavia employing US$150-200 million of foreign equity capital, which is less than 1% of Yugoslavia's GDP. By way of comparison, the stock of direct investment in Brazil amounts to 11% of GDP, 27% in Malaysia, and even 11% in Egypt.

3. The Ministry of Foreign Economic Relations asked FIAS to review the environment for foreign direct investment, and to set out the reasons for Yugoslavia's singular lack of success in attracting direct investment. The FIAS analysis, completed in February 1988, reached several conclusions. First, it is important to recognize that there are no particularly strong factors motivating foreign direct investment in Yugoslavia -- in general, foreign firms do not seem to satisfy any of their major strategic needs by investing in Yugoslavia. Moreover, general economic policies in Yugoslavia have not been particularly conducive to direct investment. These factors are compounded in Yugoslavia by its unique economic system, which is an unfamiliar environment for most foreign investors. Of course, it is not just the unfamiliarity of the system, but also some of its specific characteristics, such as the accounting practices, that cause problems for foreign investors. Finally, the system of joint ventures under which foreign investors operate rather than smoothing over difficulties stemming from Yugoslavia's economic system, in fact contributed some additional problems of its own.

4. In a follow-up to this review, a FIAS team visited Belgrade in early December 1988 to discuss with government officials a draft of the new foreign investment law. Discussions were particularly focused on the questions of ownership and property rights, accounting practices, management, repatriation rights, incentives measures, and the needs for coordination of the new investment law with other new relevant legislation, particularly the new company law, which established, for the first time since 1945, the "capitalist" forms of enterprises.

5. The new foreign investment law was adopted on December 30, 1988, and is conceptually a great improvement in comparison to the previous joint venture legislation. However, its full potential impact will be possible to judge only when the various new or revised pieces of the legislation, such as foreign exchange law, tax law, incentives regulations, labor law, etc., are put into effect.

Regional Roundtable On Investment Promotion In Asia And The Pacific

Bangkok, Thailand
October 3-5, 1988

1. Given the phenomenon of a potentially declining supply of foreign direct investment, coupled with an increasing or, at best, stable demand for foreign direct investment, and limited prospects for receiving development finance from the international banking sector, it is little wonder that competition for foreign direct investment has intensified.

2. Competition for foreign direct investment has also increased because of the entry of new players. Developing countries that traditionally, because of their large domestic markets and significant reserves of natural resources, did not think it was necessary to compete for foreign investment have begun to compete seriously for export-oriented investment. This phenomenon appears to be due, among other things, to the changes in the international economic environment that have characterized the period of the late 1970s and 1980s. Over this period, raw material prices seemed more unstable than usual. At the same time, import-substituting policies seemed to be running out of eschewed resource-driven and import-oriented growth strategies in favor of growth strategies that emphasized the export of manufactured goods. Furthermore, over this same period developed countries became even more active as they began to court not only firms from other developed countries, but also firms from developing countries that were beginning to spawn their own multinational enterprises.

3. The objective of the Regional Roundtable (which was hosted by the Office of the Board of Investment of Thailand) was to evaluate the utility of the investment promotion function, identify common promotional structures, compare effectiveness of different promotional techniques in general, review the investment promotion practices of participating countries, and identify needs for possible external assistance on investment promotion matters.

4. The roundtable provided an opportunity for senior government officials, responsible for investment promotion matters, from participating countries (Bangladesh, People's Republic of China, Indonesia, Malaysia, Papua New Guinea, the Philippines, and Thailand) to share their respective experience with investment promotion, and exchange ideas on how to improve these efforts. The roundtable was based, in part, on the findings of a research project on investment promotion sponsored by FIAS.

5. Several conclusions came out of the research and the roundtable. With regard to the effectiveness of investment promotion, a promotion program appears to be most successful in attracting investors to a country if this program focuses on export-oriented investment, whether for export to world or regional markets. There is no evidence to suggest that investment promotion activities were effective in attracting firms to a country to serve the domestic market. For such firms, it would appear, the domestic market itself is the attraction; to reach that market, the

investment elsewhere is unlikely to be a feasible alternative. On the other hand, firms that are seeking sites to serve export markets can choose from a wide range of countries; in this context, it has been suggested that pricing via incentives is likely to have an impact on their investment decisions.

6. For efficient investment promotion programs geared to attracting export-oriented investment, the benefits a country gains from this investment usually exceed the costs of attracting the investment. It has been suggested that the direct employment benefits produced by foreign investment exceed the typical costs of attracting this investment, except where a country has very low wage rates, or where a country is very near full employment. Very low wage countries, if they promote at all, should have extremely targeted promotional programs that cost less per job created than a typical promotional program. Countries that are near full employment should only be promoting investment to obtain benefits other than employment.

7. Since there are other marketing techniques a government can use to attract investment, such as pricing via investment incentives, the question remained of whether there are techniques that can attract investment more cheaply than investment promotion. Based upon a comparison of the costs of an efficient investment promotion program, and the costs to the government of one type of investment incentive, the tax holiday, it was argued that an efficient investment promotion program is less costly than a typical program of tax holidays. This is not to say that tax incentives have no role to play; but for most countries, more resources devoted to promotion have a chance at generating much better returns than would those same resources devoted to longer tax holidays. On the question of investment promotion as a type of industrial marketing, it has been argued that since the investment decision is similar to the industrial buying decision, the research on how corporations make industrial purchases and on how other companies market industrial products is germane to an understanding of the mix of marketing and promotional techniques that is most effective in attracting firms to invest in a country.

8. During the roundtable, all participants agreed that similar to the industrial buying decision, promotion plays a significant role in the investment decision only in cases where governments use appropriate promotional techniques to attract investors in different stages of the investment decision process. Research in industrial marketing suggests that in making the decision to purchase a new product, a buying unit within a corporation or an institution goes through several stages, beginning with initial awareness of the product, and ending with the final purchase. At each stage along this decision process, different promotional media are more effective.

9. During the initial stage of the buying decision, the more effective promotional techniques are impersonal ones, such as advertising. At the final stages of the buying decision, on the other hand, the more effective techniques involve personal contacts from the seller's representatives or from other firms that can provide testimonials. It was argued that the same relationship holds in investment promotion. Impersonal techniques, such as advertising, seem to be more effective in influencing investors who are in the early stages of the investment decision process, while personal techniques, such as tailored presentations to specific companies, are the only techniques that seem to be effective in influencing investors who are in the later stages of the investment decision process.

10. Participants agreed that a number of promotional agencies tend to adapt to the decision processes of their target market by using primarily impersonal promotional techniques to build awareness or an image in the investment community, before attempting to generate investment more directly. Many agencies moved to a focus on investment-generation once an appropriate image was built, and used more personal techniques thereafter to generate investment directly. In many cases, agencies adapted to the decision processes of their target market, and moved through these two stages without an explicit understanding of why the changes were made and the logic behind them. However, if a country already has a favorable image among investors, there should be no need to devote significant resources to image building. Further, if a country has a particularly bad reputation for the intractability of its bureaucracy, for example, and that reputation indeed reflects the facts, then investment promotion efforts might begin with service activities. It may be essential to make existing investors happy, and ease the way for new investors, before any effort at image building can begin. Indeed, if the country has any particularly unattractive features for foreign investors -- in addition to a difficult bureaucracy, political instability or an extremely overvalued exchange rates, for example -- an image building campaign started before the "product" is right is, at best, likely to be a waste of resources. Only when the country can offer itself as an attractive site for at least certain kinds of investment, should it engage in an image-building program. Decision-makers in firms with the capacity to invest abroad are, after all, a very sophisticated group of "consumers". These individuals, prior to committing the capital of their firm, are likely to scan the environment to check the information they obtain from the host government's promotional organization. Promotional agencies should try to work with their governments to design policies to improve the investment climates of their countries. An agency can then attempt to build an image that takes into account these changes in government policy.

11. It has been argued that promotion agencies should have a clear program to ascertain how effectively their image-building activities accomplish the objectives of building or changing images by evaluating particular advertising campaigns, missions, and seminars. In evaluating the activities, they should make two distinct measurements: a measure of the perceptions or attitudes of the population that has been targeted before the start of these activities, coupled with a measure of the perceptions or attitudes of this population after the image-building activities. Without these measurements, it is virtually impossible to evaluate the effectiveness or particular techniques.

12. With regard to the techniques of measurement, it was agreed that such techniques need not be complicated. Investors can be surveyed to determine their attitudes toward investing in a particular country. If an advertising campaign then seems warranted, investors could be surveyed again, after the campaign, to ascertain whether their attitudes have changed. Participants in seminars can even be asked to complete carefully worded questionnaires before and after the seminar to elicit information about the usefulness of the seminar in creating an awareness of, or correcting perceptions about, the country's investment climate.

13. On the question of the appropriate organization for investment promotion, it was noted that, like some other activities financed by governments, investment promotion has certain characteristics that are normally associated with tasks usually located in the private sector. Activities of this type are often financed by a government because they generate social profits that are greater than the private profits they could provide. Where this condition exists, a government

must either finance the activity or risk that it will be underprovided.

14. Governments can adopt two polar positions in their attempts to carry out the non-traditional government activity of investment promotion. A government could carry out investment promotion itself, but this approach has the disadvantage that the government organization may be unable to acquire skills required to manage the activity properly. The required skills may reside in the private sector and be difficult to attract to the public sector, especially with the salary constraints typical of civil services. Accordingly, if the government decides to manage the activity it may also, through various methods, have to take steps to obtain the appropriate skills from the private sector.

15. An alternative approach is for the government to delegate the management of investment promotion activities to the private sector. This approach often has the disadvantage that the private sector will not handle well tasks such as servicing investors by acquiring permits and approvals from other government departments that are usually handled by government. Indeed, neither the wholly public or wholly private approach to the management of investment promotion is ideal.

16. Regardless of the approach that is chosen, there will be management issues with respect to how the inherent disadvantages of either approach are to be overcome. In an attempt to overcome these disadvantages, governments may search for organizational approaches that combine, most effectively, the skills and resources of both the public and the private sectors.

17. Finally, it was observed that regardless of the type of organization involved, whether government, quasi-government, or private, the agencies in the developing countries often engaged in a search for external resources to complement what their governments were willing to spend on investment promotion. More significantly, multilateral agencies, development assistance organizations from some industrial countries, and foreign firms were often willing to assist agencies from these countries with financial and other resources. It was agreed, however, that there is still a lot to be done, both on the side of the sources of such external assistance and the host countries, to fully utilize those resources.

Seminars on Investment Promotion

Paris and Istanbul
March 1989

1. FIAS has organized two roundtables on investment promotion. The first was organized in Paris, France on March 6 and 7, 1989, and the second was held in Istanbul, Turkey, on March 9 and 10, 1989.

2. There is a general consensus among government officials engaged in investment promotion activities, business executives, relevant international agencies, and academics, that recent years have seen a significant increase in the intensity of competition among countries to attract foreign direct investment to their shores. To this end, many governments have either started an investment promotion function and have given those involved the mandate of increasing inward investments, or have placed pressure on the existing promotional bodies to achieve higher levels of foreign direct investment. The objective of the roundtables was to evaluate the utility of the investment promotion function, identify common promotional structures, compare effectiveness of different promotional techniques in general, review the investment promotion practices of participating countries, provide a forum for exchange of ideas among the participating officials, and identify needs for possible external assistance on investment promotion matters. The roundtables were based, in part, on the findings of a research project on investment promotion sponsored by FIAS. The roundtables provided an opportunity for senior government officials from participating countries, responsible for investment promotion matters, to share their respective experience with investment promotion, and exchange ideas on how to improve these efforts.

3. The focus of the Paris seminar was, to a large degree, the issue of "image-building," since the three participants made fundamental policy and regulatory changes in January of 1988 aimed at encouraging the flows of foreign investment to their respective countries. In Turkey, on the other hand, discussions focused on the appropriate mix of "image-building" promotion and "targeted" promotion, as well as on the techniques for investment promotion.

MALAWI **FY1992**

FDI Diagnostic Study

1. In December 1991, the Parliament of Malawi passed two bills which radically improved the country's investment climate. These bills represented a successful culmination of nearly three years of the activities of the Foreign Investment Advisory Service (FIAS).

2. In first approaching FIAS, the Government requested help in writing an investment code. FIAS, however, did not believe that investment codes, per se, had been of much practical help in other African countries. Consequently, with the Government's agreement, the question of whether Malawi needed an investment code was put off, and a diagnostic assessment of the investment environment was completed in FY91. Specifically, FIAS recommended eliminating the industrial license except for a very short "negative list" of activities that would be precluded for reasons of public health and safety. Additionally, it was proposed to abolish complex sets of regulations that delayed such diverse but vital functions as company registration, land leasing and acquisition, duty drawback, obtaining local borrowing, and access to foreign exchange for profit remittances and other international transfers.

3. Beyond these recommendations for deregulation, FIAS also saw the need to build a new institutional framework that would replace the dominant "control mentality" with a new emphasis on service to investors. To spearhead this change, creating a small but influential investment promotion agency was suggested. The intention was for this agency to focus nearly all of its attention on assisting investors, with only minimal effort devoted to image building and pro-active investment generation.

4. After lengthy internal discussions, complimented by further meetings with FIAS, the Malawian government decided at a senior level to implement all of FIAS's recommendations for deregulation and institution building.

5. With agreement on the direction of reform, the next phase of FIAS assistance addressed the task of implementation. There was a need to instill the new changes permanently at both the policy level and within the legal system. Starting first with the policy dimension, FIAS helped the Government prepare a Statement of Investment Policies. This concise document (three pages) laid out the broad intentions of the Government to remove regulatory constraints and to open the Malawian economy to both local and foreign investment. With its pledge of freedoms, including the freedom to invest, to own and lease land, to obtain foreign exchange, to manage companies without government interference and to have access to international arbitration, the Statement set a liberal tone rarely heard in Africa.

6. To follow-up the Policy Statement with concrete details, FIAS assisted the Government to prepare a short handbook, spelling out the simplified investment procedures and containing other information of importance to potential investors. The Investors Guide pulled all of the relevant requirements and benefits prevailing in Malawi into one easily readable document. Among these benefits was a special incentive for exports, which FIAS helped to design in order to offset the high cost of transportation, affecting goods sent abroad from land-locked Malawi.

7. With the policy dimension of the implementation process accomplished, FIAS developed a new project in FY92 to focus on the legal side of the problem. The first goal was to ensure that the former system of regulatory controls was dead. In this context, FIAS argued for repealing outright the entire Industrial Development Act so that the old system of licenses would not be subsequently resurrected.

8. The Government accepted FIAS's argument and requested the Parliament to repeal the Industrial Development Act. The legislature agreed to the repeal, passing at the same time, a new law for introducing the negative list. The Industrial Licensing Act, 1991, is a simple vehicle for allowing the government to screen investment applications for activities that may pose serious threats to public health and safety. It contains a schedule of manufacturing pursuits that require a license, which are presently limited to: firearms, ammunition, chemical and biological weapons, explosives, manufacture involving hazardous wastes and products whose manufacture includes radioactive material. To prevent unwarranted additions to this negative list, changes can be made only upon the advice of a newly created investment promotion agency.

9. Parliament also passed a second vital bill. The Investment Promotion Bill, 1991, was drafted with the support of FIAS and contained two main provisions. The first accorded "paramount status" to the Investment Policy Statement and the Investors Guide, which were included in the text of the Bill. This granted these documents the full legal status of Parliamentary sanction.

10. The second aspect of the Bill was equally important. It created a statutory autonomous agency to promote investment in Malawi. The agency was accorded the usual responsibilities of such an institution, including to provide services to investors, to publish information about the investment climate, to carry out image building and investment generation activities and to recommend policy changes to the Government. Its Board of Directors will be high-powered, headed by the Secretary to the President and Cabinet, who is second only to the President of Malawi in authority. Other members would include the Secretaries of the economically-related ministries and two businessmen representing the private sector, one of whom will serve as Vice Chairman.

11. In sum, FIAS has assisted Malawi to redefine thoroughly its approach to private investment, helping the government to jettison a suffocating system of regulatory controls. The new initiatives will open the economy to the potential benefits of investment, while still protecting public health and safety. By maintaining a close involvement in the implementation process, FIAS has been able to help the government breathe life into the reform program by giving it concrete expression in policy, law and the birth of a new institution.

GHANA **FY1993**

Investment Incentives and the Structure and Functions of the Ghana Investment Center

12. For some time the Government of Ghana has been liberalizing policies toward foreign direct investment as part of a large structural adjustment program. In fact, Ghana was one of the first clients of the Foreign Investment Advisory Service (FIAS) when, in FY87, assistance was given to write implementary regulations for a then new Investment Code. Despite the changes and improvements made over the years, Ghana has not obtained the amount and breadth of foreign investment that was desired. Many problems in the environment for foreign and domestic investors remained, among which were a complicated set of investment incentives and approval processes that necessitated the Ghana Investment Center to focus more on approvals than on investment facilitation.

13. The Government asked for assistance from FIAS to address these issues. In a week-long seminar, and subsequent comments on a new draft Investment Act, FIAS helped the Government formulate a new set of incentives that would be administered automatically through the tax systems. The main features of the new incentive structure include:

- i) lower income tax rates for certain sectors;
- ii) capital allowances on investments in buildings, machinery and equipment;
- iii) loss carry-forward provisions; and
- iv) equalization of withholding taxes between foreign and domestic investors.

14. In addition, the legislation would provide for rationalization of the management of the new tax system, rationalization of the system for issuing resident visas to expatriates, strengthened investment guarantees, and registration of technology transfer agreements.

15. With these changes the Ghana Investment Center would divest itself of the investment and incentive approval functions. The intention would be for the Center to refocus its efforts on investment promotion and facilitation. FIAS has been asked to assist the Center to redefine its internal structure and functions following passage of the Investment Act.

Diagnostic Study and Investment Act

16. The Foreign Investment Advisory Service (FIAS) was asked by the Zambian Government to conduct a diagnostic study of the investment environment in the country, and to propose amendments to the existing Investment Act. To carry out the task, FIAS looked into a range of policy, regulation and institutional issues that were of concern to investors. Based on a field investigation, FIAS suggested that the Government focus on changes in the following four specific areas:

- i) provide investors with strengthened investment guarantees;
- ii) introduce simplicity and efficiency into the investment incentive system;
- iii) to simplify and streamline investment approval procedures; and
- iv) re-orient the Investment Center from a regulatory agency to one that would be more focused on investor's servicing and investment promotion.

In amending the Investment Act, the reform of the incentive regime constituted the most controversial issue. FIAS found that opinions on this issue were divided between the Ministry of Commerce and Industry, whose major concern was to encourage investment, and the Ministry of Finance, whose major concern was to reduce revenue losses and budget deficits. FIAS emphasized the importance of balancing these two needs and, by working closely with both ministries, helped develop a consensus on a set of policy changes that were announced in the new Budget Speech of 1993.

To carry out the announced policy changes, the Government further requested FIAS to provide technical assistance to the re-drafting of the Investment Act. Consequently, a second FIAS mission went to the country, followed by the visit of a Government drafting team to Washington. A new Investment Bill was prepared by the team in early 1993, featuring the following changes based on FIAS recommendations:

- i) guarantee 100% repatriation of after-tax dividends, capital, interest, royalties and management fees;
- ii) liberalize and simplify the entry approval procedures by introducing a <u>short</u> negative list of sectors, where foreign investment is more restricted, and abolishing investment licensing for all other sectors that are not on the list;
- iii) abolish manufacturing licensing;

iv) make the process of Investment Certification, which replaces investment licensing and manufacturing licensing, automatic and non-compulsory;

v) free the process of Investment Certification from the minimum investment requirement and, as a compromise, put such a requirement under the immigration control;

vi) abolish discretionary tax holidays and duty exemptions granted by the Investment Center; and

vii) change composition of the Investment Board by reducing members from the public sector and increasing members from the private sector -- the resultant Board reflects an equal weight of public and private sectors.

17. This Bill was debated in the Parliament in the months that followed, and it was passed in September as the Investment Act of 1993, with a few variations. Basically, the passed Act retained all the above mentioned features, <u>except</u> the abolition of duty exemptions. Duty exceptions were perceived by FIAS to be undesirable because of its implications on Government revenue and the continuing need for screening by the Investment Center.

18. FIAS, in the meantime, prepared a main report which was delivered to the Government in June, 1993. In this report, FIAS elaborated on a number of issues, some of which went beyond the Investment Act, i.e., the land-use issue, access to local financing, and the judicial system. The report emphasized the need for continued efforts by the Government to address these issues in order to further improve the overall investment environment in Zambia.

Promoting Backward Linkages Between Foreign and Local Firms

19. The Philippine Government has been trying, since the 1970s, to promote linkages between large, assembly enterprises established by foreign investors, and small and medium sized indigenous parts and components manufacturers. After two decades of efforts, through various regulations and programs, the objective is yet to be reached. The failure to have more successful backward linkages prompted the Government to ask the Foreign Investment Advisory Service (FIAS) to study how backward linkages might be more efficiently encouraged. The specific purposes of this study are: a) to investigate the existing industry and policy conditions to identify the opportunities for and impediments to developing backward linkages in the country; and b) to recommend any policy adjustment or government actions necessary to enhance the conditions for future development of such relationships.

20. On the basis of these investigations, it is clear that the accumulated foreign investment stocks on the one hand, and the level of certain local supporting industries on the other, have provided a base for developing backward linkages. Prospects are most promising in the industries that are more labor-intensive and less technologically complex, such as electrical appliances and certain auto parts and components. It is evident that there is a willingness among many assembly firms to subcontract locally for purely industrial and commercial reasons. The interest is likely to grow if local suppliers can improve their quality and supply capacity.

21. The prime impediment to formation of backward linkages in the Philippines lies in the relative inadequacy of the local parts producers in providing products that are competitive in terms of price and quality. Evidence from the investigation shows that the majority of parts producers have remained at relatively small scale of production. Many of them are under-capitalized, using aging technology and equipment, and suffering from serious managerial defects. Recovery from the economic recession in the 1980s has been particularly slow in this group of industries. Today, many firms are operating at only 50-60% of their production capacity.

22. While complex economic and social factors might help explain the present level and status of the Filipino parts industries, the past industrial strategy also has been a very important factor impeding the development of these industries. Two basic elements of that strategy have been important. First, government polices for many years emphasized the role of large, final-stage assembly industries of consumer goods while neglecting the development of a wide range of supporting industries. Secondly, government policies and programs applied in the past emphasized import substitution by using protectionist measures, such as import restrictions and local content requirement.

23. The emphasis placed on the assembly firms seems to have been misplaced. The investigation by FIAS has shown that most assembly firms are rather unwilling, or unable, to help supplier firms through financial and technical assistance. Indeed, they would not deal with any particular local supplier unless the supplier proved himself capable of meeting their demands.

This was sometimes due to the fact that assembly firms do not have the technical capacity to help the supplying firms. Other assembly firms are simply unwilling to bear the high costs required by substantial technical improvement of the suppliers.

24. The emphasis on protectionist methods has been supported by the argument that policies such as import control and local content requirements work in favor of domestic industries. The findings of the FIAS study, however, suggest that protection seems to have given the domestic producers an advantage in the domestic market only, which in effect paralyzed the domestic producers in competition in the rest of the world. As the evidence shows, protracted protection has led to deterioration of quality, escalation of costs and, of greatest concern, an apathetic attitude towards technological and managerial improvement among all domestic producers in the production process, assemblers and suppliers alike. In the cases where local content is enforced by official requirements, the effect is to encourage in-plant production or subcontracting at lower quality and higher costs. Protection also has encouraged industries to be solely responsive to domestic demand and, thus, has severely constrained the volume of production. While this has been harmful to the growth of many assembly activities, it has particularly hurt the development of parts and components industries, since the latter could not be economically feasible at the available operational scale.

25. Based on these observations, it is probable that the local content requirements, intended to assist local parts industries, has actually been inhibiting the development of backward linkages in the country. Given the required scale of many parts industries and the small size of the Philippine domestic market, policies that induce primarily domestic market oriented production in a protected environment are bound to backfire. To further liberalize trade and obtain more export markets, therefore, seems to provide a more realistic alternative to achieve a competitive level and quality of production.

26. It is noticeable that the Philippine Government has in recent years become increasingly aware of the limits of the protectionist strategy and has started to move towards a more outward looking and liberal approach to development. FIAS evidence seems to suggest that where there are more liberal policies, there is a more viable and sustainable growth of backward linkages. The import liberalization of electrical appliances, for instance, seems to have had a dramatic impact on the growth of both assembly and supplier industries producing those products. Linkages established in this sector today are more a function of the market itself, that is, to be responsive to such factors as prices, quality and other industrial and commercial needs. Moreover, as firms are now more exposed to international competition, they become more sensitive to technical changes, product standardization, managerial improvements, and so on, and many eventually reach, through exports, and efficient scale of operations. This kind of linkage points to a new direction that future backward linkage development in the country should follow.

27. All these observations suggest that two fundamental shifts are required in the strategic approach of the Government if the goal of promoting more viable domestic supplier industries and more effective backward linkages is to be achieved. First, there is a need to shift more emphasis to policies and programs designed to directly assist the supplier industries. Secondly, there is a need to move further away from the protectionist approach towards a more liberal one, emphasizing competition and export promotion. Both changes are essential and neither can be

dispensed with if the goal of advancing more effective and efficient backward linkages is to be achieved.

Small- and Medium-Sized Enterprise (SME) Development

28. Supporting policies for SME Development is important because the majority of suppliers in the Philippines today are SMEs. The future backward linkage policy will need to include a strong SME policy component aimed at upgrading domestic manufacturers in a wide range of supplier industries.

29. The past industrialization strategy, as mentioned earlier, always assigned a leadership role to large enterprises engaged in consumer goods assembly activities, whereas the current SME supporting policies emphasize the resource-based, micro or cottage enterprises outside metropolitan areas. The stress on the two extremes have left out a large group of SME manufacturers, which produce a whole range of intermediate goods, such as the metal, plastics and rubber parts and components. It is, however, this "missing middle" that could have been the major force in industrialization, and their labor-intensive nature certainly suggests that they provide a basis for exploiting the country's comparative advantages. It is also this group that should play a pivotal role in building up competitive industrial networks through backward linkages.

30. Given this situation, we suggest that the Government develop an Industrial Integration Program that will broaden the industrial base, strengthen the supply side of backward linkages, and actively promote linkages between assembly operation and SME suppliers. Such a scheme will need to be coordinated with the efforts to modify the existing industrial policies and SME policies.

31. In practical terms, this means that the Department of Trade and Industry (DTI) should re-evaluate its current industrial integration program and the needs of the participating private sector, especially the SMEs. The change in the policy will take into account the fact that parts and components suppliers would need to be clustered around the major assemblers, so that the future strategy would pay more attention to SMEs around major industrial sites and in urban areas, especially the national capital region (NCR). This may mean some trade-off between the need for regional development and the need for industrial integration based on SME development in major urban centers or the EPZs. Given the different nature of this proposed scheme and the existing SME programs, there is perhaps a need to separate the management of the Industrial Integration Program from that of the current SME programs.

32. Special attention should be given to the current financial assistance programs because financial constraints are among the top concerns of most SME suppliers. The banks usually have limited interest in lending to SMEs, which are considered to be high risk and high cost customers. Most SMEs are left to finance their needs from their own personal or family savings, or to turn to the informal market at much higher costs. Moreover, as seen in the interviews, most assemblers are much less willing to provide financing to their suppliers than expected; on the contrary, the suppliers are often requested to provide 30-60 days credit to the assemblers, which presents an additional burden on the financially strapped SMEs.

33. In an effort to alleviate the financial constraints on the small businesses, the Philippine Government has established a number of credit and guarantee programs for SMEs. However, these lending programs, like most SME policies, focus on the minor and cottage businesses, engaged in resource-based activities and those located away from the major urban centers. As a result, they leave out most of the SMEs that are potential suppliers in forming backward linkages.

34. In this situation, we suggest that the Government redefine its SME financing programs to include the objective of developing industrial linkages, with a particular view to helping SME parts suppliers access available financial assistance. This would mean consolidating programs, reducing bureaucratic rules of accessing available funds, and changing policy to make funds available to the majority of SMEs that could be involved in linkage programs.

35. There is a need to re-examine the investment incentives of the Board of Investment (BOI) that are aimed at offsetting the negative elements in today's investment environment to encourage private investment, including the parts manufacturers. The problem of the existing system does not lie in its level of incentive or its sector coverage, but in the ability of its targeted population to access the system. Certain criteria used by the regulators are creating special difficulties for SMEs in the sectors under study. According to this criteria, BOI will only grant investment incentives if it determines that there is not already "adequate capacity" in the industry.

36. Such procedures have made the access to investment incentives particularly difficult for the SMEs engaged in the metal, plastic and rubber parts manufacturing. In these sectors, there are endless types of products made and materials used, not to mention the different sizes and purposes of each part. It is, therefore, almost impossible for the regulator to establish a reasonably "measured capacity" or to determine whether the particularly proposed production is "adequately exploited" or not.

37. Based on these observations, we suggest that the Government re-examine the existing incentive system, its criteria and procedures, to make the system more useful to backward linkage development. Specifically, the system can be modified in the following manner:

i) To exempt the parts and components sectors from the minimum export requirement and the "adequately exploited" criteria;

ii) To exempt the eligible SMEs from the publication and public hearing procedures;

iii) To exempt SME suppliers of parts and components from the 10% minimum public offering requirement; and

iv) To exempt SME parts and components supplier in the targeted sectors from the Metro Manila restriction.

Trade Policies

38. Trade policies and the current duty drawback system are crucial in affecting the access to raw materials for parts producers. Although the trade regime today is much more open than a decade ago, the overall situation is still far from adequate. There are still high duties imposed on some raw materials (such as plastics) and capital goods. The Philippine Government has established a system called "Duty Drawback/Exemption Scheme (DDS)" to deal with this problem. However, the duty drawback takes a complicated form which involves an overly bureaucratic and time-consuming process.

39. Based on these observations, FIAS recommends that DTI-BOI amend, or actively lobby for amending, the following specific policies that directly affect the supplier industries and indirect exporters:

(i) The new Import Liberalization Program should include all raw material and parts and components that are needed by the suppliers (metals, plastics and rubber products) of assembly operation in the Philippines (for export or domestic market); and

(ii) The DTI-BOI should continue to press for an immediate resolution of the DDS management problem.

Localization Programs

40. To implement the proposed strategic shifts to support backward linkage promotion, the Government will need to consider certain modifications of the existing programs. The existing programs that are still of significance today are the Motor Vehicle Development Programs (MVDPs), which are based on an approach that belongs to the past. The two major elements of these programs, i.e., the "local content" and foreign exchange requirements, are open to questions. The "local content" component, as seen earlier, appears especially counter-productive in relation to its objectives. This requirement emphasizes an across-the-board approach which fails to take adequate consideration of the country's comparative advantages, of local supply capacity and of cost.

41. Experiences in many competitive countries suggest that the extent of localization percentage can vary greatly among sectors and countries, depending on each country's economic size and its comparative advantages. The key to successful backward linkages is, therefore, not the absolute percentage of local content across the board, but market-based selection of certain parts and components whose production is competitive in the Philippines -- whether because the parts are more labor-intensive or less technically complex. Once such parts and components are identified by the market, the Government could support these industries in production not only for domestic consumption, but also for exports. Suppose the realized local content is only 10% of the total input of each car assembled in the Philippines; as long as this 10% provides the country an opportunity to develop a strong line of the parts industry supplying both domestic and export market, the ratio should not be considered a failure but a success of industrial policy.

A Comparative Assessment of Foreign Investment Policies

42. After liberalizing its foreign investment policies starting in the summer of 1991, the Government of India asked FIAS to see how the resulting policies compared with those of other relevant developing countries. Consequently, FIAS compared Indian policies and institutions with those of China, Indonesia, Mexico, Turkey, and Poland. These countries, like India, have large local markets that are of interest to foreign investors. All have domestic cost advantages that provide a basis for exporting manufactured goods. Finally, with the possible exception of Poland (which has been actively seeking foreign direct investment for only three years), these countries have been quite successful in attracting foreign direct investment.

43. Policies in seven areas were compared: a) entry and ownership restrictions on foreign investment; b) trade and exchange policies; c) taxes and incentives; d) capital markets and project finance; e) labor and management policies; f) infrastructure and land; and h) legal protection and dispute settlement mechanisms.

44. From the perspective of foreign investors, these are the most important aspects of the policy and institutional framework for foreign direct investment. The work of FIAS in dozens of developing countries, and interviews with hundreds of firms have shown that these are the policy areas where problems typically arise. Of course, other major factors, including the size and growth of the market and political orientation and stability, also affect the flow of investment to a country, but analysis and comparisons of these factors are beyond the scope of the study.

45. The comparisons showed that there are issues in all of the areas reviewed that the Government of India may wish to address as it considers further improvements of the investment environment. The most pressing issues are in the first two areas listed above: i.e., entry and ownership policies; and trade and foreign exchange policies. India has made significant progress in these areas in recent years, but the review of policies in the other countries shows that there are still substantial improvements that could be made. Following these issues in importance are corporate taxes and a broad range of issues relating to production inputs.

46. The changes in **entry and ownership policies** made in July 1991 opening 34 industries to automatic majority ownership, and the subsequent establishment of the Foreign Investment Promotion Board as a high level approval process for exceptional proposals in these and other industries, have made India a player in the foreign investment game. However, most of the other countries have either more automatic approval processes than India, or a wider range of industries open to majority or even 100% ownership by foreigners, or both. Poland and Turkey have very few sectors that are not open to majority or even 100% foreign-owned investment, and obtaining approval requires little more than registration of investment plans. Indonesia and Mexico have more restrictions on what is open, and more lengthy approval procedures than Poland and Turkey, but still are more open to foreign investment than India. China has a decentralized investment approval process that has built up a record of liberal and rapid approvals, particularly in special

economic zones and coastal cities.

47. **Trade and foreign exchange policies** affecting direct investment are also less favorable in India than in the other countries. Export-oriented investment is burdened by both the dual exchange rate and heavy protection of capital goods and intermediate product imports. Protection of capital goods and intermediate products does not affect 100% export (actually 75%) oriented firms in India, but it does have an impact on firms that would like to emphasize sales in the domestic market, along with substantial exports. Most of the comparator countries, in contrast, have markedly reduced trade protection, with the result that the anti-export bias has been substantially reduced for both foreign and domestic investors, and foreign investment with both domestic and export targets has expanded as a result. Even China has been systematically reducing domestic protection and has assured that export-oriented firms in the Special Economic Zones and coastal cities have had access to production inputs at international prices.

48. Compared with most developing countries, India has had a good record in making **foreign exchange** available to foreign investors for repatriation of dividends, royalties, and capital. These allocations, however, are still subject to administrative control, which causes concern on the part of potential investors. These concerns are less prevalent among most of the comparator countries. Indonesia, Mexico, Poland and Turkey have nearly convertible currencies, with few controls on buying and selling of foreign exchange. In China, there is a dual exchange rate system, but it is significant that a foreign investor can sell all foreign exchange earned at the market rate in the exchange centers, whereas in India, only 60% can be sold at the market rate.

49. While less pressing than entry, ownership, trade and exchange issues, taxes are a negative factor that requires the attention of the Government. The comparative analysis suggests that India is a relatively high tax country for foreign investors, with corporate tax rates of 57.5% for closely held companies, including surcharge, and relatively high divided remittance taxes. Corporate tax rates in all of the comparator countries are lower than in India. India's high tax rates are largely offset by investment incentives granted to exporting firms. Instead of relying on incentives to lower effective tax rate however, most of the comparator countries, have opted for moderate and broadly based tax rates. This is the approach followed by China, Indonesia, Mexico and Poland, and it is an approach that FIAS recommends to India.

50. The comparative analysis identified a few other selected issues that warrant the attention of the Government of India as it seeks to improve the environment for foreign direct investment.

- Reducing restrictions on the use of local debt financing by foreign investors, and increasing the supply of <u>local currency term loans</u> would complement the local equity market and give India an advantage for foreign investors in relation to comparator countries.

- Legislation to reduce structural rigidities in the <u>labor market</u> would enable India to exploit its considerable labor resources, and would open up strategies for attracting foreign investment in labor intensive industries. Such legislation also should facilitate exit by firms that are not viable.

- Finding a workable means of increasing the availability of electric power to investors is very important in India. Some of the comparator countries, notably China, have dealt with infrastructure deficiencies by concentrating resources in specific geographic areas that are otherwise attractive to investors.

- Attention needs to be given to two specific legal matters: i) providing patent protection to pharmaceuticals, chemicals, food products and seeds; and ii) providing a stronger legal basis for majority ownership by foreign investors, many of whom fear that there could be future reversion to the 40% legal limit that is still in the FERA. As a general matter, increased resources are needed to clear court backlogs so that commercial disputes can be resolved quickly.

Coordinating Foreign Investment Promotion

51. The Government of India is seeking to attract more foreign direct investment to help modernize Indian industry and to more closely integrate India into the global economy. Other developed and developing countries have found that coherent programs of investment promotion can help to increase the inflow of direct investment by effectively marketing the country and its investment opportunities to potential investors. This paper suggests ways that India also can benefit from improved investment promotion.

52. India does not now have a coherent investment promotion program. With the liberalization of investment policies in July 1991, a large number of organizations in India and outside began to organize various activities to promote foreign investment in India. FIAS reviewed many of these activities and concluded that there has been a lot of wasted effort. It appears that a large number of institutions are trying simultaneously to move up the promotion learning curve. In this situation, there is a role for the Government to better coordinate and support investment promotion activities in order to build a promotion program in India. Investment promotion programs typically seek to build or rebuild the country's image as an attractive destination for investment, generate export-oriented investment through direct contact with targeted investors, and provide services to both prospective investors (pre-approval services) and approved investors (post-approval services). Such programs are also capable of advocating that the government reform its investment policy to allow **and welcome** more foreign investment.

53. In a coherent investment promotion program the promotional foci, techniques, and structures are chosen to meet the specific promotional needs of the country. India's immediate promotional needs lie principally in two areas: correcting real obstacles to the successful operations of foreign investors; and closing the gap between the reality of its investment opportunities and the perceptions of the world's investment communities. The perceptual obstacles to investment relate to India's negative image as a site for foreign investment. Rather than being perceived as a desirable destination for foreign investment, India is likely to be viewed by foreign investors as a poor country that overly restricts business activities and is very hostile toward foreign investment. These images have historically had a base in fact, but the facts have changed in the direction of making India a more attractive site for foreign investment. The images of investors have not changed, however, in large part because no systematic attempt has been made to change them.

54. Thus, this paper suggests that India needs a promotional program that will reduce the real and the perceived obstacles to investment. The real obstacles can be reduced with the help of a promotional program that advocates continued investment policy reforms, and that provides services to investors. The perceived obstacles can be reduced through an appropriately developed and executed image-building campaign that seeks to alert investors to the recent changes within India and to the advantages the country provides as a site for foreign investment.

55. This does not mean that the government should take over the promotion effort. In fact, one of India's strengths in the field of investment promotion is the large number of public and private sector institutions that are willing to take promotion initiatives. These initiatives should be encouraged. However, there is a need to assure that a consistent message is being conveyed, and to provide some central source of expertise so that the different initiatives can be carried out in a cost effective way.

56. In order to do so, FIAS proposed the creation of a new quasi-governmental organization that would have the mandate to stimulate, support and guide promotional activities throughout India. This approach would allow for the development of a coherent, national promotion strategy, while it also allows for other private and public sector participation in promotion activities. A quasi-governmental approach increases the participation of the private sector which is critical in changing internal attitudes towards private investment and external images of India as an "over-governed" country.

57. This quasi-governmental organization would coordinate a carefully crafted national image-building campaign, provide pre-approval services at the national level, support and monitor the provision of services at the state level, advocate new investment policies, and, in time, coordinate an investment generating program aimed principally at attracting export-oriented investment. The proposed unit would be a small professional organization staffed by specialists in the areas of public relations, investment services, and the development of promotional strategies. It would have the prestige, and the financial and technical resources to coordinate, encourage, assist, and monitor the promotional activities of public and private organizations throughout India. While precise estimates of the budget that would be required by such an organization are premature, they probably would be in the neighborhood of several million per year in the early years.

58. Some part of the resources available to the central promotion organization would be used to support promotion activities at the state level, which need to be strengthened. This can be achieved by having the industry departments of each state, with the collaboration of private investors in the state, focus principally on the provision of enhanced services to investors. These services would include the streamlining of the state-level approval process investors must navigate in order to implement their investments, and assisting investors acquire the infrastructure they need to implement investments. All states must recognize that timely and hassle-free implementation of investments is important to foreign investors, and will thus lead to increased investment flows.

An Assessment of the Foreign Investment Environment

59. The purpose of this study is to assess the overall investment environment in Nepal, with a view to enhancing the capacity of the country to attract foreign investment. The study concludes that both trade policies, and industrial and investment policies need to be addressed by the Government in order to improve the prospects for private investment. While changes in these two policy areas are equally important, the approaches suggested to deal with the problems in each area are somewhat different. In the case of trade policies, reform pursued by Nepal would have to take into account its geographic and long-standing economic ties with India and specific steps taken must be carefully coordinated with India. Industrial and investment policy, reforms, on the other hand, can be carried out much more independently and changes can be made ahead of India.

60. Nepal's trade policy reform has been complicated by the existing open border shared with India. This open border system, while facilitating the Indian-Nepalese bilateral trade essential to Nepal's economy, limits Nepal's independence in its trade policies towards third countries. To prevent the open border from becoming a loophole of India's trade barriers against the rest of the world, Nepal has had to align itself with India on trade and foreign exchange policies.

61. Given the constraints imposed by India, options for Nepal in trade liberalization should consider two alternative scenarios. In the first scenario, India would quickly liberalize its own economy, and Nepal should not hesitate but pursue the same direction and liberalize itself together with India. There is a second scenario, in which India would move more slowly towards liberalization or remain autarkic, although this seems to be less likely given the recent development in India. In this scenario, Nepal would have to develop a clearly divided two-tier trade policy, one to target India and the other to target third countries.

62. What Nepal should never under-estimate, in either scenario, is the great trade and investment opportunities implied by its bilateral relationship with India. India would always, offer Nepal the largest and most convenient source of inputs and market of outputs.

63. Two major policy obstacles must be removed before the strategy of targeting India can become successful: (1) the local content requirement imposed by the Trade Treaty on Nepal's manufactured exports to India; and (2) the restrictions Nepal has imposed on the size and location of FDI which limit potential Indian investment in Nepal. Both rules are ineffective in current practice. Because of the existing open border, the local content requirement has been unable to stop the flow of manufactured goods from Nepal to India through illegal trade activities. For the same reason, Nepal's restrictions on investment size and location have not been particularly effective either in preventing Indians from crossing the border or in doing business in Nepal.

64. A worthwhile trade-off, therefore, might be that the Government of India relax its local content requirement on Nepal's manufactured exports to India while Nepal relaxes its restrictions on Indian investment in Nepal. Assuming Nepal adopts a more effective customs system to prevent trade deflection, the local content requirement would not only become unnecessary, but

also become counterproductive to encouraging bilateral trade. Likewise, the Nepalese concern over Indian acquisition is inconsistent with Nepal's economic interests. Indian firms should, in fact, be considered as the most likely source of investment in Nepal because of historical, geographical and cultural linkages. Relaxing restrictions on Indian participation in Nepalese industry would probably benefit Nepal by improving access of Nepal's manufactured goods to be exported to the Indian market.

65. If trade policy reform in Nepal is constrained by the Indian factor, reforms in industrial and investment policies could, and should, be carried out by Nepal much more independently. Six policy areas requiring fast changes are identified by this report, namely, industrial licensing, taxes and incentives, availability of foreign exchange, legal environment, immigration and work permits, and land-use system. Successful reforms along these policy lines would allow Nepal to provide private investors a more enabling environment.

66. The key issue of industrial licensing is to further reduce the level of government intervention and to make it as easy as possible for competing entrepreneurs to enter the market. The new Industrial Policy took a step forward in abolishing industrial licensing except for those industries on a "negative" list. The list introduces a small number of clearly designated activities of which new entry may require licensing for a specified short period of time, say, two years. Activities that are not on the list thereby allow free entrance to all domestic investors.

67. For foreign investors, however, licensing is still required and this includes joint ventures, management and technology agreements, marketing collaboration, etc. This requirement is very counterproductive to the goal of encouraging foreign investment and modernizing domestic industries. As an alternative, the Government may consider introducing a similar short negative list for foreign investment as for domestic investment. Moreover, the additional approval of all agreements with foreign firms by the Technical Committee in the MOI is worse than useless and should be dropped. Finally, restriction on FDI in cottage and small scale industries should be reconsidered. The underlying reason for this restriction is, understandably, the fear of India, since Indians are more likely to be interested in investing in cottage and small industries. As mentioned earlier, however, Indian firms may actually be the most feasible and desirable potential investors in Nepal.

68. Taxes and incentives present another area, in which major government efforts are required if the investment environment is to be substantially improved. The main defects of the present system are high marginal rates on corporate and non-resident tax payers, poor administration and arbitrary assessment procedures, and a pervasive use of incentives including: tax holidays, tax exemptions, special deductions, allowances, etc. As a result, corporate tax revenue contributes only 5% to the total tax revenue, while discretionary handling of tax holidays and tax assessments has increased the uncertainty that prevents companies from long-term business planning. FIAS recommends that the Government make strenuous efforts to broaden the tax base and reduce the tax rates.

69. The availability of foreign exchange is one of the most important factors investors study when they consider an investment opportunity. The new Foreign Investment Policy grants foreign investors the right to repatriate their dividends, royalties, and capital proceeds -- all at the

prevailing rate of exchange and with no limit on the amounts that can be transferred. This change in policy, however, awaits effective implementation. The Rastra Bank will need to issue circulars to commercial banks to authorize foreign exchange availability for remittances.

70. An appropriate and effective legal environment is crucial to private firms, local and foreign. Nepal's legal system at present is opaque, incomplete, and unsuitable to support industrialization and private sector growth. One of the urgent tasks for Government therefore, is to improve the existing system of judicial administration to ensure that an effective, prompt and inexpensive legal service is available to private investors. To do so, the Government will need to improve those laws and regulations that affect local and foreign private investments and the system of legal enforcement. It will also need to build effective procedural and institutional mechanisms for implementing the existing laws and regulations, with particular attention to needs to protect property rights, enforce contracts, and settle investment and commercial disputes.

71. Improvements in procedures for immigration and work permits is an important aspect of a successful implementation of the new Foreign Investment Policy. Currently, foreigners investing or working in Nepal are required to go through a long, cumbersome process of applying for non-tourist visas and work permits. To facilitate foreign investors and technical and managerial teams, the Government should make an effort to simplify the procedures and introduce workable institutional mechanisms.

72. The current land-use system in Nepal is inadequate. To accommodate growing industrial activities, Nepal is in need of a new land-use system that would allow larger tracts of land and improved infrastructure. Regulation of industrial land should be completely separated from that of land for other uses. The planning horizon should be extended. Large industrial zones should be demarcated in all of the large and small towns in the country, and the land should be available on long-term leases of at least 50 years. Moreover, the transfer of a lease to another industry should be automatically approved and the land allowed to be mortgaged (with the use limitation provision).

73. To improve its FDI management, HMG in the late 1980s, the Government established a Foreign Investment Promotion Division (FIPD) under the Ministry of Industry, as a one-stop-shop to facilitate foreign investors. The recently announced Foreign Investment Policy moved FDI responsibility from FIPD to DOI, in order to provide a unified authority serving both local and foreign investments. FIAS believes that the one-window system in Nepal will make sense only if the policy reform continues. Administrative process in Nepal will truly improve if requirements of permits and approvals of various kinds by different government agencies are minimized and approval procedures simplified. The one-window institution, only in such instances, can then become a helpful agency whose major responsibility is to assist incoming investors in securing whatever permits are still required and in meeting other needs, such as those for information and access to developed infrastructure.

Investment Promotion Strategy

74. With a view to increasing FDI inflows, the Government of Sri Lanka has, since 1989, taken several steps aimed at strengthening the policy environment for FDI. The momentum of economic reform since 1989 has given new impetus to the efforts to promote FDI. It has been recognized that past policies emphasizing FDI promotion, mainly in EPZs, no longer meet the needs of the economy. The country's comparative advantage consists of a large surplus of a relatively educated and potentially productive labor force. This valuable resource has remained largely under-exploited, partly due to the relative scarcity of capital and technological resources at home. FDI in this context appears more appealing than ever as it can bring packaged capital and technology, create employment, and provide new accesses to overseas markets.

75. The main objective of this study is to provide a framework for a more focussed promotion strategy based on the country's sources of comparative advantage, policy environment for FDI and the institutional framework needed to carry out and facilitate promotion activities.

Strengths and Weaknesses as a Location for FDI

76. An analysis of historical flows of FDI to Sri Lanka shows that foreign investment levels to date have been low and erratic, although a sizeable level of employment has been generated in FDI projects. Textile projects have, until recently dominated both the number of projects and employment in the newly established firms. The bulk of employment in this sector is for female workers. In recent years, the service sector has taken over from textiles as the leading source of new investments. Many of the service activities promoted are in property developments and in consultancy.

77. Foreign investments in Sri Lanka are from a wide range of source countries. Cumulative U.K. investments surpass those from other countries, but these investments appear to be primarily in refurbishing traditional plants. In more recent years, the dominant source of new investments is the Asian NIE's -- Korea, Hong Kong and Singapore, with little investment to date from Taiwan, China.

78. Interviews of foreign investors currently operating in Sri Lanka suggest that Sri Lanka's comparative advantage is found in four areas:

- Labor: availability of skilled or trainable labor force with competitive wages;
- Quotas: access to markets through quotas and other forms of preferential agreements, particularly as they relate to garments;
- Geographic location: location of Sri Lanka in relation to potential markets in Europe and the Middle east as a low cost primary manufacturing site; and

- Micro-climates: wide range of climatic zones in Sri Lanka, and its potential as a production site for specialized plantation and non-plantation agricultural products.

79. The gathering momentum of economic reform after 1989 gave a new impetus to FDI promotion. The 1990 Investment Policy Statement (IPS) introduced several important changes to the investment policy framework: first, the early reliance on the case-by-case approval procedure was abandoned, and a new system based on the concept of automatic approval was introduced; second, various restrictions on the activities and ownership structures of joint ventures were lifted; and third, the previous emphasis on limiting FDI activities within isolated environments and favoring one group of investors over another was withdrawn. Instead, the focus was placed on a unified policy framework for all investors and the development of close linkages between the FDI activities and local economy.

80. The IPS only set the goals, and the achievement of such goals requires effective implementation. Since the announcement of the IPS, the Government has made a number of efforts to put the intended changes into place, but the pace of the overall movement has been slower than originally expected. Of the policy areas in which major problems were identified at the announcement of the IPS, improvements have been quite uneven. Quite remarkable efforts have been made to improve FDI approval procedures and availability of foreign exchange, whereas little has been done with regard to taxes and incentives, access to local credit, and institutional restructuring.

81. Of these, incentive streamlining and BOI restructuring stand out as two areas that should receive first priority from the Government in the months to come. Clearly, restructuring of BOI is a matter of implementation and it will be mostly up to the Institution itself to take the necessary steps to this end. On streamlining tax incentives, however, a stronger consensus is still needed at a policy-making level and efforts by both BOI and the rest of the Government will be required. It seems that the Government will have to first make a clear decision on the extent and timing of the intended changes in the incentive system.

Investment Promotion Strategy

82. Viewed against both the improving policy environment and international experience of what is required for FDI promotion and realization, Sri Lanka's investment promotion strategy needs to be modified in a number of ways. The priority and resources given to the task need to be increased, an overall focus and direction needs to be decided upon, and the detailed operations of the strategy itself need to be altered substantially. Future strategy calls for an increased emphasis on, and integration of, investor servicing as a key element of its promotion activities. It also calls for a wider range of investment-generation techniques including a fundamental switch from a general shot-gun approach to promotions, to one which targets priority countries, sectors and companies.

83. The two fundamental priorities underpinning this strategy are a more targeted approach to future investment generation activities, and the introduction of much greater attention to the crucial role of investor servicing, including a one-stop service for investors. When fully expanded

and implemented, these fundamental elements of strategy are designed to increase the flow of FDI to the country, to broaden the sectoral mix of investments, to improve the conversion of approved projects into realized projects, and to help spread investments throughout all regions of the country. Coupled with active domestic investment promotion including activities to develop backward linkages into the economy, this strategy should result in a better linkage between new FDI and the local economy.

84. In the context of more targeted investment generation, an initial focus on Asia is suggested for two main reasons:

i) the dramatic expansion that has occurred in recent years in the FDI flows originating in Asia; and
ii) the substantial rise that has occurred in Sri Lanka's FDI projects from Asia since 1990.

85. The expansion in FDI investment from Asia has arisen as locations like Korea, Hong Kong, Singapore and Taiwan, China have joined Japan as major sources of FDI. At the same time, developments in Eastern Europe have substantially reduced potential flows from EC countries, and the USA has never been a major investor in Sri Lanka. Sri Lanka's increased investment from locations such as Korea, Hong Kong, Singapore and Japan means that it is now becoming a credible location for investments from these countries and promotion activities in the immediate future should build on and seek to reinforce this now found credibility.

86. The strategy for investment generation also needs to focus on priority sectors, and niches within these sectors. The FIAS project team developed a list of priority sectors and niche opportunities on the basis of discussions with private firms, (both domestic and foreign), and with Government officials in Sri Lanka. These opportunities are expected to be in textiles and garments; engineering and electronic component manufacturing; natural resources; tourism; infrastructure; and port services.

87. The strategy also contains suggestions for phasing of the targeted investment generation, and the descriptions of the elements of investment servicing. These investor-seeking activities can cover pre and post approval information and assistance, and efficient and transparent approval process, arranging investors "site visits," providing one-stop-servicing , and monitoring investors progress to the implementation of their projects. Initially, these services can be provided in a passive way with promotion executives concentrating on responding quickly and accurately to investors queries. Later, they can be developed into an active campaign where BOI executives actively offer information and support from the initial contact with investors, through the approval and project realization process, and into after-care follow-up.

Institutional Implications

88. To implement their investment promotion strategies, most countries have set up direct government bodies when parastatal agencies are not used. Such bodies have been established in Thailand, in Indonesia and in the Philippines. When properly organized with clear and independent reporting procedures, such government bodies have been effective. Those that have been most successful have had their own Board of Directors and have operated separately from the day-to-day activities of their parent departments. The presence of a clear and independent legal framework for the agency, a separate board for management and control, an exclusive focus and responsibility on investment promotion and realization, and a separation from day-to-day activities of parent ministries are all factors which help improve their performance.

89. The FIAS report makes detailed suggestions as to how Sri Lanka could come closer to the ideal structure by building on the strengths, and remedying some of the weaknesses of the existing Board of Investments.

90. To implement the new strategy, domestically and overseas, a major restructuring within the BOI is recommended as well as a strengthening of its institutional links within the public and private sectors. Restructuring within BOI is required to deliver on the new strategy and, the creation of a new post of Executive Director, Promotions is recommended together with two divisions within that directorate to undertake specific promotional functions.

91. Outside BOI, mechanisms are suggested to link into public sector bodies and into the private sector for two main purposes. Firstly, to provide an institutional framework to identify and develop Sri Lanka's priority investment targets for the future and, secondly, to coordinate the delivery of services and facilities to new investors. The degree to which these institutional links can be forged will greatly influence the performance of BOI in attracting the implementing FDI projects.