International Investment Perspectives

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Foreword

Investment has proven to be a powerful catalyst for innovation, sustainable growth and poverty reduction. The 2002 UN Monterrey Consensus identified private capital, including foreign direct investment, as "vital complements to national and international development efforts" and emphasised the need "to create the necessary domestic and international conditions to facilitate direct investment flows". These necessary conditions include "a transparent, stable and predictable investment climate, with proper contract enforcement and respect for property rights, embedded in sound macroeconomic policies and institutions". Regrettably investment levels in many countries continue to fall short of development needs, and a concerted effort by governments, enterprises, civil society and international organisations may be needed to create the right conditions for private investment.

This edition of International Investment Perspectives is devoted to a vital part of OECD's follow-up to the Monterrey Consensus: the Investment for Development Initiative launched in Johannesburg in November 2003. The central element of this Initiative is the Policy Framework for Investment. The Framework is intended as a checklist of policy questions aimed at assisting governments in creating an environment that is attractive to domestic and foreign investors and that enhances the benefits of investment to society. It recognises that the needs of countries at different levels of development call for a flexible and non-prescriptive approach that provides constructive policy guidance across a range of areas in order to maximise the contribution of investment to development.

The Framework is presently being developed by a Task Force through a partnership process involving OECD members and any interested non-member governments, in co-operation with civil society and other international organisations. The Framework will ultimately cover ten policy areas that contribute to a healthy investment environment: investment policy; investment promotion and facilitation; trade policy; competition policy; tax policy; corporate governance; corporate responsibility and market integrity; human resource development; infrastructure development; and public governance. This edition deals with the trade, competition and tax aspects of the Framework.

Another important element of the Investment for Development Initiative is the quest to realise the synergies between official development assistance and private

investment foreseen by the Monterrey Consensus. Joint work by the OECD Development Assistance and Investment Committees has been undertaken in this area and the process continues. The present edition of International Investment Perspectives includes two articles summarising parts of this work.

Manfred Schekulin
Chair, OECD Investment Committee

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Note by the Editor

International Investment Perspectives is an annual publication. Each issue includes an update of recent trends and prospects in international direct investment and provides analysis of investment policy questions of topical interest. Articles are based principally on contributions by the OECD Secretariat, which have been developed within the framework of the activity programmes of the OECD Investment Committee.

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Chapter 1

Trends and Recent Developments in Foreign Direct Investment*

Foreign direct investment (FDI) outflows from the OECD area to the rest of the world picked up from USD 593 billion in 2003 to USD 668 billion in 2004. However, direct investment inflows continued on a downward trend, reaching a comparatively low USD 407 billion in 2004. Outward FDI from the United States reached USD 252 billion in 2004 to hit an all-time record. While this to some extent reflects the weakness of the dollar it also points to a very strong interest among US companies in acquiring corporate assets abroad. Conversely, direct investment into Germany and France, the two largest economies of the European continent, fell sharply in 2004. The downturn largely reflects a repayment, out of Europe, of inter-company loans and other positions between related enterprises.

OECD countries' traditional role as net providers of FDI to the rest of the world grew even more pronounced in 2004. Net outflows, estimated at USD 261 billion, were the highest in recorded history. Most of this money went to developing countries. As in earlier years, China and a couple of Asian financial centres remain the largest recipients, but FDI into a range of countries, including Russia, India and much of South America, has also picked up lately. On top of this, several of the more advanced developing countries are emerging as outward investors, their national companies establishing subsidiaries in neighbouring countries and increasingly also on a more global basis.

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Highlights

Foreign direct investment (FDI) outflows from the OECD area to the rest of the world picked up from USD 593 billion in 2003 to USD 668 billion in 2004. However, it may be premature to talk of a turnaround in the investment cycle: direct investment inflows continued on a downward trend; they were estimated at USD 407 billion in 2004, following USD 459 billion in 2003.

FDI outflows from the United States reached USD 252 billion in 2004 – up from USD 141 billion in 2003 to hit an all-time record. While this to some extent reflects the weakness of the dollar it also points to a very strong interest among US companies in acquiring corporate assets abroad. Of the largest 25 cross-border mergers and acquisitions (M&A) in 2004, five had a US-based company as the acquirer.

Inward FDI into Germany and France, the two largest economies of the European continent, fell sharply in 2004. In France the inflows almost halved, falling from USD 43 billion to USD 24 billion. In the case of Germany, foreign investors even withdrew about USD 39 billion from the country as opposed to an inflow of USD 27 billion in 2003. (Readers are reminded that inward FDI figures include the transactions, including withdrawals, between foreign-invested enterprises and their foreign mother companies.) The downturn largely reflects a repayment, out of Europe, of inter-company loans and other positions between related enterprises.

Amid declining inflows and increasing outflows, the OECD countries' net direct investment outflows to the rest of the world reached record high levels in 2004. The OECD area was a net contributor of USD 261 billion worth of direct investment – most of which went to developing countries.

Among developing countries, China and a couple of financial centres in Asia continue to receive the "lion's share" of direct investment. Inward FDI into mainland China reached an all-time high of USD 55 billion in 2004 following USD 47 billion in 2003. However, other economies have made progress as well:

- South America seems to be climbing out of the trough that followed the Argentine crisis. Inflows in 2004 to Argentina (USD 4 billion in 2004), Brazil (USD 18 billion) and Chile (USD 8 billion) were in all cases around twice the levels they recorded in 2003.

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- India is making steady progress in establishing itself as an attractive destination for FDI. Inward direct investment has trended upwards since the late 1990s to reach USD 4.3 billion in 2003 and USD 5.3 billion in 2004. As Indian FDI statistics are less inclusive than most this figure is moreover a low-end estimate.
- Inflows to Russia, having already picked up in 2003, gained further speed in 2004. As in earlier years, much investment went to the hydrocarbons retailing sectors, but there is also a growing tendency for foreign producers of consumer goods to establish production sites in Russia.

While developing countries continue to be important recipients of FDI, several of them are gaining importance as outward investors as well. One case in point is Latin America (*e.g.* Mexico and Brazil) where large companies appear to be in a process of, first, engaging in regional integration through investment, next developing truly international corporate networks. Chinese enterprises have increasingly undertaken "strategic" investment abroad, *inter alia* to gain access to raw materials. However, while these trends are observationally interesting the sums involved are still small by international comparison.

As regards the future outlook, figures for mergers and acquisitions in the first half of 2005 indicate that FDI in the OECD area as a whole may finally be rebounding. M&As already recovered through 2004 and the improvement has carried on into 2005. On present trends both inward and outward FDI in OECD countries could increase by 10-15 per cent in 2005.

In recent years the environment for international investment has differed quite strongly across countries. The macroeconomic performance of the high-growth economies in Asia and certain other developing regions has contrasted sharply with the sluggish economic growth in much of continental Europe. Between the two extremes, the continued economic recovery in some countries – *e.g.* the United States – has allowed for a gradual restoration of investor confidence.

Another important economic factor has been the weakening US dollar (USD). In addition to influencing the relative competitiveness of alternative production locations, and hence affecting the allocation patterns of international business, it has also had a more direct impact on foreign direct investment (FDI). Apart from "equity investment" (*e.g.* greenfield investment projects and mergers and acquisitions, M&As) FDI includes large amounts of cross-border transactions between the related entities within the ownership structures of multinational enterprises (MNE). Many MNEs have reportedly taken advantage of the weak dollar to repay inter-company loans, which has had the effect of depressing inward FDI figures in some the European economies in 2004.

Thirdly, structural factors may also have favoured direct investment outside the OECD area. Investors are increasingly attracted to large economies that offer not only competitive production costs but also access to a buoyant customer base. Given their present high rates of economic growth, many of the more populous developing economies hold prospects of becoming far larger within the next one or two decades and international businesses are increasingly betting on this outcome. In addition, regulatory and administrative reforms have encouraged international investors to take a closer look at developing countries. The recent changes in the international trade architecture, including China's WTO accession and the termination of the Multi-Fibre Arrangement, have further encouraged direct investment.

1. Foreign direct investment in OECD countries

The net export of direct investment capital from OECD countries to the rest of the world keeps hitting new records. Net outward FDI went from USD 134 billion in 2003 (already sizeable by historical standards) to an all time high USD 261 billion in 2004[1] (Figure 1.1). The OECD area has traditionally acted as a net exporter of FDI and one may choose to see the recent figures as a

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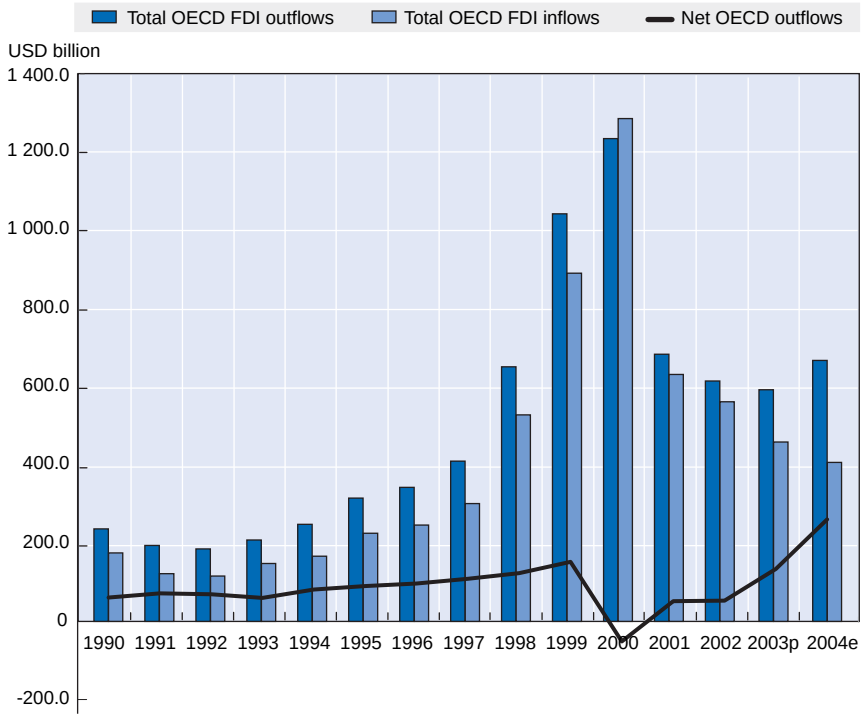
Figure 1.1. **FDI flows to and from OECD**



Notes: p: preliminary; e: estimate.
Source: OECD International Direct Investment Database.

confirmation of a long-term upward trend. However, following the low figures immediately after the investment boom in 2000 the recovery in net outward flows has been remarkably swift, and it remains to be seen if a more lasting upward shift in OECD countries' role as capital providers to the rest of the world has taken place.

The growing net outflows from the OECD reflect larger outflows as well as smaller inflows. Total outward FDI from OECD countries have increased from USD 593 billion in 2003 to USD 668 billion in 2004, largely reflecting a recovery in the outflows from the United States. At the same time the total inward FDI of the 30 OECD countries reached a seven-year low USD 407 billion. The inflows do, however, still compare favourably with the levels recorded during most of the 1990s. The decline in inflows over the last several years was initially influenced by a contraction in FDI to the United States but has more recently reflected declines in most of the continental European economies.

1.1. *Recent trends in FDI*

In terms of inward FDI 2004 brought a "return to normal" in the sense that the United States regained the role as the world's principal destination for direct investment it has played for most of the last two decades. Total inflows to the United States were USD 107 billion, up from a historically low level of USD 67 billion in 2003 (Table 1.1). According to recent supplementary information the upturn was led by a surge in cross-border mergers and acquisitions into the US financial sector.[2] In second place, the United Kingdom received USD 78 billion worth of FDI in 2004, likewise following weak inflows in the years immediately before.

The position of the United States as a provider of outward FDI was even stronger. With outflows of USD 252 billion in 2004 this country provided more than a third of total OECD direct investment outflows. In a number of other countries outward FDI held up well compared with previous years. The United Kingdom, Canada and a group of continental European economies all had outflows in the range of USD 40 to 65 billion in 2004.

In the rest of the OECD area, Japan stayed almost unchanged from the year before with outward direct investment at USD 30 billion and inflows just under USD 8 billion. Japan's habitual position as a net exporter of FDI is consistent with its current account surplus and with the, still, reported difficulties for toward foreign investors to penetrate a range of sectors. The trend in inward as well as outward FDI in continental Europe was downward. This was influenced by financial rearrangements within the group of multinational enterprises – notably the repayment of a large number of inter-company loans – but it also reflected lower equity investment, apparently due to weak macroeconomic performance and concerns about the competitiveness of some production locations.

1.1.1. *Trends in selected countries*

Germany has attracted particular interest, not least as the figures in Table 1.1 would seem, at first glance, to indicate that foreign companies have stopped investing in the German economy and are engaged in a process of massive withdrawal. However, as already predicted in the previous issue of *International Investment Perspectives*, the German 2004 figures (and to some extent 2003 as well) have been influenced by massive shifts in inter-company loans within the MNEs operating in and from Germany. In 2004, total equity investment into Germany was USD 22 billion, which, while somewhat lower than previous years, was comparable with other large developed economies. In the overall figures this was drowned out by no less than USD 46 billion in credit flows (following another USD 9 billion in 2003) out of foreign-owned German companies toward related enterprises. According to corporate

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Table 1.1. **Direct investment flows to and from OECD countries: 2001-2004**

USD billion

	Outflows				Inflows			
	2001	2002	2003p	2004e	2001	2002	2003p	2004e
Australia	12.1	7.9	14.3	16.7	4.6	15.6	6.8	42.2
Austria	3.1	5.8	6.8	7.2	5.9	0.4	7.4	4.9
Belgium/Luxembourg	100.6	. .	. .	. .	84.7	. .	. .	. .
Belgium	. .	12.7	36.9	26.1	. .	15.6	32.1	34.4
Canada	36.0	26.7	21.5	47.4	27.7	21.5	6.4	6.3
Czech Republic	0.2	0.2	0.2	0.5	5.6	8.5	2.1	4.5
Denmark	11.6	5.2	1.3	–11.1	11.6	6.9	2.7	–11.4
Finland	8.4	7.6	–2.6	–1.0	3.7	7.9	3.3	4.7
France	86.8	50.5	53.2	47.8	50.5	49.1	42.5	24.3
Germany	39.7	15.2	–3.6	–7.3	26.4	50.6	27.3	–38.6
Greece	0.6	0.7	0.0	0.6	1.6	0.1	0.7	1.4
Hungary	0.4	0.3	1.6	0.5	3.9	3.0	2.2	4.2
Iceland	0.3	0.3	0.4	2.4	0.2	0.1	0.3	0.4
Ireland	4.1	10.3	3.5	11.4	9.7	29.0	26.9	14.1
Italy	21.5	17.1	9.1	19.3	14.9	14.6	16.4	16.8
Japan	38.4	32.3	28.8	31.0	6.2	9.2	6.3	7.8
Korea	2.4	2.6	3.4	4.8	3.5	2.4	3.5	8.2
Luxembourg	. .	126.2	101.1	59.0	. .	117.1	92.4	57.0
Mexico	4.4	0.9	1.8	3.5	27.7	15.3	11.7	16.6
Netherlands	48.0	33.9	37.8	1.5	51.9	25.1	19.3	–4.6
New Zealand	0.9	–1.2	–0.1	0.9	4.2	–0.5	0.7	2.6
Norway	–1.3	4.2	2.1	1.9	2.0	0.7	3.8	2.2
Poland	–0.1	0.2	0.2	0.8	5.7	4.1	4.1	6.2
Portugal	6.2	0.2	7.3	6.2	6.3	1.8	6.6	1.1
Slovak Republic	0.1	0.0	0.0	0.2	1.6	4.1	0.6	1.1
Spain	33.1	31.5	23.4	42.0	28.0	35.9	25.6	9.9
Sweden	6.4	10.6	21.3	11.9	11.9	11.7	1.3	–1.9
Switzerland	18.2	7.9	15.1	25.2	8.9	6.3	16.6	4.5
Turkey	0.5	0.2	0.5	0.9	3.3	1.0	1.7	2.6
United Kingdom	58.9	50.3	66.7	65.4	52.7	24.1	20.4	78.5
United States	142.3	154.5	140.6	252.0	167.0	80.8	67.1	106.8
Total OECD	**683.8**	**614.9**	**592.8**	**667.8**	**632.0**	**561.9**	**458.8**	**406.6**

Notes: Data are converted to US dollars using average exchange rates; p: preliminary; e: estimate.
Source: OECD International Direct Investment Database.

observers this partly reflects changes in the corporate tax code making it less attractive for MNEs to retain liquid reserves with their German affiliates. Most likely, it was also influenced by the historically high valuation of the eruro.

The drop in outward investment from Germany in recent years, on the other hand, seems more closely related with actual changes in corporate

allocation. In 2004, outward equity investment became negative as, for the first time in many years, German companies new investment abroad was dwarfed by their liquidation of prior investments. This finding is believed to have been influenced by the unravelling of corporate holding structures but it also confirms a longer term trend for corporate Germany to become a less active outward investor.

France habitually records large inward and outward FDI flows relative to the size of its economy. 2004 was no exception, although it should be noted that outward flows held up much better than inward investment. The drop in inward FDI from USD 42 billion in 2003 to USD 24 billion in 2004 was influenced, as in the case of Germany, by declining inter-company loans, but it also reflected a drop in equity investment from USD 17 billion to less than USD 5 billion. The decline could reflect a dwindling number of large-scale transactions (*e.g.* cross-border mergers and acquisitions), because independent data indicate that the number of individual direct investment projects into France actually increased by 7% in 2004.[3]

The *United Kingdom* bucked the trend in 2004 as one of the few European countries to see a sharp pick-up in inward FDI to USD 78 billion (more than double the levels of 2003). One reason for this was that, unlike for most of continental Europe, an apparent pick-up in large scale mergers and acquisitions – including cross-border M&As – affected inward as well as outward flows (see also the following section). The two largest individual M&A transactions, inward and outward, were both in the financial sector. They had publicly announced values of around USD 15 billion (inward) and USD 9 billion (outward) respectively. In addition to a few large transactions, outward investment from the United Kingdom was held up by internationally very high amounts of reinvested earnings. This reflects the large outward investment positions that UK companies have built up, *inter aliavis-à-vis* North America and the Commonwealth. In 2004, UK-owned companies accumulated reinvested earnings in their foreign subsidiaries of around USD 26 billion.

Canada experienced one of the world's largest increases in outward FDI in 2004, reflecting, among other things, the largest takeover in history by a Canadian enterprise of a foreign company. As an outward direct investor, Canada shared third place with France in the 2004 league table.[4] Inward FDI held up in 2004, albeit at a comparatively low level. It should be added that the broadly unchanged figures from 2003 to 2004 mask a drop in net acquisitions by foreign enterprises that was compensated for by higher inter-company loans.

Direct investment into *Spain* has fallen markedly in the last couple of years, reaching USD 10 billion in 2004, amid comparatively high levels of liquidation of previous investments by foreign companies. Moreover, Spanish FDI statistics remain influenced by a growing number of special purpose

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entities (SPEs – financial companies set up to act as a conduit for investment) boosting the recorded inflows and outflows without having much, if any, effect on the Spanish corporate sector. According to recent estimates, if the investment through SPEs is disregarded, Spanish inward investment in 2004 was less than one billion USD, following inflows in the range of USD 7 to 9 billion in the years immediately before.[5]

Conversely, Spanish outward direct investment picked up in 2004. Most of the increase was due to a one-off cross-border acquisition from Spain into the United Kingdom, but the figures also reflect the continued activity of Spanish businesses in neighbouring countries and in Latin America. In the last two years, Mexico, Chile and Brazil all figured on the top-10 destinations for Spanish outward direct investment.

Switzerland traditionally acts as an exporter of direct investment capital. Even so, the 2004 inflows of FDI were unusually low (USD 4.5 billion) – and would have been even lower had FDI figures not been held up by large reinvested earnings. 2004 was the first year for more than a decade in which foreign direct investors taken as a whole withdrew equity capital from Switzerland. (The same reservation applies as in the case of Spain: Switzerland is also host to a large number of SPEs.) At the same time, direct investment out of Switzerland picked up to reach USD 25 billion, bolstered by both renewed outward equity investment and large reinvested earnings in the foreign subsidiaries of Swiss enterprises.

Data for many of the smaller European countries must be interpreted with caution, as their year-to-year fluctuations tend to be dominated by capital transactions between related enterprises and the activities of SPEs. One case in point is the apparent collapse of direct investment to and from the *Netherlands* in 2004, which largely reflects massive changes in inter-company loans between corporate entities in the United States and Netherlands. Another example is the concurrent drop in outward and inward FDI in *Denmark*. More detailed information reveals that this due to the elimination of positions held via SPEs, in the absence of which flows in and out of the country would be close to zero.[6] The decline in inward and outward FDI in *Luxembourg* in 2004 should be considered as a return to (or toward) more normal levels. It follows several years of inflated figures due to restructurings of international holding companies located in Luxembourg.

1.2. Individual "deals": a closer look at mergers and acquisitions

While M&As are only one element in total FDI flows, in most OECD countries they account for more than half of total investment. In addition, they tend to be the component of FDI that responds most strongly, or most immediately, to changes in the business climate, financial conditions and

macroeconomic performance. Overall data for cross-border M&As in 2004 and early 2005 may hence provide additional guidance on where FDI is heading. Some caution is, however, called for: privately collected M&A data tend to be more inclusive than official FDI statistics. FDI data include only the value of corporate assets actually transferred, whereas published M&A data tend to take as their starting point the total market value of the enterprises acquired. The data used in the remainder of this section was kindly provided by Dealogic.

According to recent data, M&As have recovered much more swiftly than FDI since 2003. This confirms a story hinted at in the previous section: the gradual recovery in FDI (so far limited to outward flows) took place amid a stronger corporate interest in new projects, counterweighted by large withdrawals of inter-company loans within existing corporate networks. The total assets of cross-border M&As in OECD countries grew by more than a third in 2004 (Table 1.2).

Table 1.2. **Cross-border M&As to and from OECD countries, total**

USD billion

	Outward	Inward
1995	138.0	151.0
2000	1160.8	1134.2
2001	606.4	586.6
2002	378.3	409.4
2003	309.7	328.0
2004	413.0	452.8
January-May 2005	216.6	221.6
Estimate 2005	519.8	531.9

Source: Dealogic.

In the first five months of 2005 total outward M&As worth USD 216.6 billion were recorded and the inflows amounted to USD 221.6 billion. If these numbers are taken to be indicative for 2005 as a whole then, by an admittedly rough estimate, total 2005 outward flows could amount to around USD 520 billion and inflows to some USD 530 billion. If borne out by the facts, these will be the largest cross-border M&As since 2001.

Based on historical patterns of co-variation between cross-border M&As and FDI this can be translated into a projection of FDI flows. On current trends, both inward and outward FDI in the OECD area could increase by between 15 and 20% in 2005.

1.2.1. Recent sectoral trends and individual transactions

Individual cross-border M&A transactions in 2004 and the first half of 2005 confirm the picture of a "return to normal". Gone is the dominance

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of telecom companies and the exorbitantly priced transactions that characterised the end of the 1990s and 2000. The growing amount of international M&As in the last couple of years has been more broadly based across sectors and has involved, mainly, a large number of deals in the range from USD 2 to 5 billion. It should, however, be noted that the traditional manufacturing sectors, especially the ones directly targeting consumers, have not yet seen any particular increase in cross-border takeover activity. Some of the main sectoral trends are listed below.

As was the case prior to the "telecom boom" of the late 1990s, many of the largest international M&As in 2004 and 2005 have taken place in the *financial sector*. The two largest individual deals was the takeover of Abbey National of the United Kingdom by the Spanish Banco Santander Central Hispano (estimated by Dealogic at USD 16.8 billion) and the Canadian insurer Manulife Financial Corp's acquisition of John Hancock Financial Services of the United States (USD 14.0 billion). A third very large takeover in the financial sector was Royal Bank of Scotland's 2004 purchase, through its Citizens Financial Group subsidiary, of Charter One Financial Inc. of the United States for USD 10.2 billion.

The financial sectors of Asian countries also witnessed foreign acquisitions of companies and strategic positions. In 2004, Capital Research and Management of the United States paid around USD 3.0 billion for a 10% stake in UFJ Holdings of Japan, and Citigroup of the United States acquired the Korean KorAm Bank for USD 2.7 billion. In early 2005, Korea First Bank was bought by Standard Chartered of the United Kingdom for USD 3.2 billion.

Another area that has seen a lot of recent activity is *real estate investment and administration*. This sector is not traditionally a hotbed of foreign takeovers, but in 2004 and early 2005 it attracted, especially within continental Europe, large amounts of international investment. The Italian Fondo Immobili Pubblici was privatised into the hands of a group of foreign investors for USD 4.5 billion, Fortress Investment Group LLC of the United States paid USD 4.3 billion for almost all the shares in GAGFAH of Germany and Sophia SA of France was acquired by General Electric of the United States for USD 4.2 billion. Moreover, the largest individual transaction in the first half of 2005 also falls within this category. Metrovacesa SA of Spain paid USD 6.8 billion for 38.5% of the shares in French Gecina SA.

In the utilities sector, *energy production and distribution* was the target of several large cross-border takeovers in 2004 and 2005. In 2004, International Power plc of the United Kingdom and Japanese Mitsui and Co jointly acquired the international power generation portfolio of Edison Mission Energy in a deal valued by Dealogic at USD 5.5 billion. TXU Australia was acquired by Singapore Power Ltd for USD 3.7 billion, the industrial gas operations of the German company Messer Griesheim GmbH were taken over by Air Liquide SA

of France for USD 3.3 billion and E.ON AG of Germany paid USD 2.9 billion for 44.6% of the shares in Sydkraft AB of Sweden. Two of the largest transactions in early 2005 were the acquisition of the UK National Grid Transco for USD 5.7 billion by an international group of investors and a USD 5.8 billion debt-equity swap with the international creditors of British Energy plc.

While the activity in the *telecom sector* may be "a shadow of its own self", several important transactions nevertheless took place in the last 1½ years. Notably, the troubled WorldCom Inc of the United States was acquired by an international group of creditors in a transaction valued at USD 10.7 billion. Within Asia, a number of Chinese mobile phone companies were acquired in one USD 4.1 billion deal by China Mobile Ltd of Hong Kong (China) and a group of phone operators based in Germany (locally incorporated affiliates of Turkcell, LM Ericsson and TeliaSonera) paid USD 3.0 billion for Iran's second mobile phone license. In early 2005, Intelsat Ltd of Bermuda was acquired by UK-based Zeus Holdings Ltd for USD 5.1 billion and Vodaphone Group of the United Kingdom paid USD 4.5 billion for ClearWave NV of the Netherlands.

Finally, a few high-profile international acquisitions in the *pharmaceuticals and biotechnology sectors* bear mentioning. The largest transaction in this area was the USD 5.7 takeover of Hexal AG of Germany by the Swiss group Novartis. Other pharmaceuticals acquisitions included the Israeli company Teva Pharmaceutical Industries' purchase of Sicor Inc of the United States for USD 3.4 billion and Roche Holding's USD 3 billion sale of its non-prescription drug unit to Bayer AG of Germany. Within the biotechnology sector, UCB of Belgium acquired, in a much-publicised transaction, the high-tech UK company Celltech Group for USD 2.7 billion.

1.3. Taking the longer perspective

Over the last decade the role of OECD countries as the world's foremost provider of direct investment funds has been firmly established (see also the following section). Net outflows from the OECD area reached USD 1 020 billion over the last decade (1995 to 2004 – see Table 1.3). The United Kingdom, France, Japan and Switzerland have been the OECD's main net exporters of FDI. By contrast, the United States, which has consistently acted as the OECD area's most active inward and outward investor, recorded net outflows over the last ten years that were comparable with those of a medium-sized European economy.

As a recipient of total direct inward inflows the United States is, unsurprisingly, in a class of its own. Between 1995 and 2004 the country received USD 1 435 billion worth of inward FDI. It is tempting to conclude that, if one disregards the flows through SPEs in the Benelux countries, the total inflows to the United States exceeded the combined amounts received by the world's number two, three and four by a wide margin. However, there are no

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Table 1.3. **Cumulative FDI flows in OECD countries 1995-2004**

USD billion

Inflows		Outflows		Net outflows	
United States	1461.4	United States	1511.6	United Kingdom	404.1
Belgium/Luxembourg	868.4	United Kingdom	938.4	France	317.0
United Kingdom	534.3	Belgium/Luxembourg	870.0	Japan	223.5
Germany	375.5	France	673.0	Switzerland	121.2
France	356.0	Germany	429.8	Netherlands	93.9
Netherlands	273.8	Netherlands	367.7	Spain	84.0
Canada	206.6	Japan	280.9	Canada	69.0
Spain	184.0	Canada	275.6	Germany	54.3
Sweden	157.9	Spain	268.0	United States	50.2
Mexico	147.9	Switzerland	209.3	Italy	26.0
Ireland	139.3	Sweden	166.1	Finland	22.6
Australia	118.2	Italy	126.5	Sweden	8.1
Italy	100.6	Australia	73.8	Portugal	7.8
Switzerland	88.1	Finland	72.1	Iceland	2.5
Denmark	71.2	Denmark	60.8	Belgium/Luxembourg	1.6
Japan	57.4	Ireland	46.6	Norway	0.5
Poland	56.2	Korea	39.9	Austria	–4.1
Finland	49.5	Austria	39.7	Greece	–4.5
Korea	48.6	Portugal	38.8	Korea	–8.7
Austria	43.8	Norway	37.0	Turkey	–9.3
Czech Republic	41.0	Mexico	10.6	Denmark	–10.4
Norway	36.5	Hungary	4.5	Slovak Republic	–11.6
Hungary	35.2	Turkey	4.4	New Zealand	–18.2
Portugal	30.9	Greece	4.3	Hungary	–30.8
New Zealand	19.7	Iceland	4.2	Czech Republic	–39.4
Turkey	13.7	Poland	1.6	Australia	–44.4
Slovak Republic	11.8	Czech Republic	1.6	Poland	–54.5
Greece	8.9	New Zealand	1.5	Ireland	–92.7
Iceland	1.7	Slovak Republic	0.2	Mexico	–137.3
Total OECD	**5 538.2**	**Total OECD**	**6 558.6**	**Total OECD**	**1 020.3**

Source: OECD International Direct Investment Database.

reliable estimates of the extent to which FDI to the United States may itself be inflated by throughflows, for instance via Caribbean offshore centres.

This testifies to the continued attraction of the US economy to investors worldwide, but another couple of factors have also been at play. First, the United States has been running sizeable current account deficits over the past decade, whereas many other OECD countries, as well as China, have recorded corresponding surpluses. The need to finance these imbalances has necessarily led to financial flows into the United States, parts of which, given

the generally benign US investment climate, have taken the form of FDI. Secondly, the large gross inflows have periodically acted as the counterpart to similarly large outflows. During the mini-boom in mergers and acquisitions in the late 1990s and 2000, veritable cross-border "takeover chains", by which the proceeds from one sale were used to finance the next purchase, were reported, boosting total outflows and inflows without necessarily affecting net direct investment positions by much.

2. The growing role of non-member economies

2.1. Direct investment into non-OECD economies

2.1.1. Adherents to the OECD Declaration on International Investment and Multinational Enterprises

Nine countries, while not members of OECD, adhere to the OECD Declaration on International Investment and Multinational Enterprises, namely Argentina, Brazil, Chile, Estonia, Israel, Latvia, Lithuania, Romania and Slovenia. Among these countries the main recipients (and to some extent originators) of FDI are habitually the ones located in South America. 2004 was no exception (Table 1.4). However, inflows into Romania picked up sharply in 2004, including large amounts of greenfield investment attributed by analysts to this country's successful macroeconomic stabilisation policy and investors' efforts to position themselves in a changing European landscape. According to authorities a large number of further greenfield and brownfield projects are under consideration, which, if borne out by the facts, could lead to a further firming of FDI to Romania in the coming years.

In South America as a whole 2004 brought a rebound in inward direct investment from levels that, while high compared with many other developing countries, were well below past standards. Argentina, in particular, appears to be bouncing back. Following the deep crisis after the country's currency turmoil in 2002 many foreign direct investors, not least in the utilities sector, eliminated their investments. However, an export-led recovery now seems firmly established, which has contributed to a resumption of investor interest. More investment could be forthcoming. During a visit to Argentina by Chinese President Hu Jintao in November 2004, public and private Chinese companies signed letters-of-intent to invest almost USD 20 billion over the coming decade in Argentina's transport, hydrocarbons, mining, construction, telecommunications and tourism sectors.

Brazil received USD 18.2 billion worth of FDI in 2004, the largest inflows in three years and almost twice the level recorded the year before. This figure was reportedly influenced by major ownership changes in the brewery sector, which also boosted the outward FDI flows. However, it also reflects a more

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Table 1.4. **Foreign direct investment in selected non-member countries**

USD billion

	Inward FDI				Outward FDI			
	2001	2002	2003	2004	2001	2002	2003	2004
Adherent countries:[1]								
Argentina	2.2	2.2	1.9	4.3	0.2	–0.6	0.8	0.3
Brazil	22.5	16.6	10.1	18.2	–2.3	2.5	0.2	9.5
Chile	4.2	2.5	4.4	7.6	1.6	0.3	1.9	0.9
Estonia	0.5	0.3	0.9	0.9	0.2	0.1	0.1	0.3
Latvia	0.1	0.3	0.3	0.6	0.0	0.0	0.0	0.1
Lithuania	0.4	0.7	0.2	0.8	0.0	0.0	0.0	0.3
Israel	3.6	1.8	3.9	1.7	0.7	1.0	2.1	3.2
Romania	1.2	1.1	2.2	5.2	0.0	0.0	0.0	0.1
Slovenia	0.5	1.7	0.3	0.5	0.1	0.2	0.5	0.5
Others:								
China, Mainland	44.2	49.3	47.1	54.9	6.9	2.5	–0.2	1.8
Hong Kong, China	23.8	9.7	13.6	34.0	11.3	17.5	5.5	39.7
India	3.8	3.7	4.3	5.3	0.8	0.5	0.9	2.3
Russia	2.7	3.5	8.0	11.7	2.5	3.5	9.7	9.6
Singapore	15.0	5.7	9.3	16.1	17.1	3.7	3.7	10.7
South Africa	6.8	0.8	0.7	0.6	–3.2	–0.4	0.6	1.6

1. Countries adhering to the OECD Declaration on International Investment and Multinational Enterprises.

Source: IMF Balance of Payments Statistics and national sources.

general resumption of investor interest as the recovery of South America's largest economy continues.

Chile also saw its inward direct investment almost double, from USD 4.4 billion in 2003 to USD 7.6 in 2004. The largest single operation in 2004 related to financial restructurings of multinational enterprise already present in Chile (Endesa España), but the improvement also involved large amounts of equity investment. Most of the largest individual transactions were found in the telecom sector.

2.1.2. China

Inward FDI into the Chinese economy keeps hitting new records. In 2004 the figure was USD 54.9 billion – the highest level on record. This should be seen in concert with a surge in outward FDI from Hong Kong (China) from an unusually own USD 5.5 billion in 2003 to USD 39.7 billion in 2004. There is little doubt that Hong Kong-based investors account for much of the direct investment into the mainland, but it would be too simplistic to ascribe the boom in Chinese FDI simply to "round-tripping" of investment and similar financial and statistical artefacts. There is a real concern among observers in

China about a possible overheating of the investment cycle, with large amounts of "hot money" pouring into the country from neighbouring economies. These inflows mostly do not target listed equity, and a fair amount of them takes the form of property investment. Another reason for the high and increasing FDI inflows is reinvested earnings. Many of the past investment projects have proven highly profitable and investors have been in no hurry to repatriate their profits.

Among OECD-based multinational enterprises, direct investment into China largely has traditionally taken the form of greenfield projects with the purpose of producing locally to the Chinese market. Much of the public and press's recent interest may have focused on the emergence of China as a low-cost production base in industries such as textiles, but the evidence suggests that these enterprises are largely either locally owned or controlled by members of the Chinese diaspora. Enterprises domiciled in OECD countries tend to trade with them rather than own them. A new development in inward FDI is the growing importance of cross-border M&As, which until a few years ago were virtually unheard of in China. In 2004, one well-publicised example of this was the acquisition by Anheuser-Bush of a controlling stake in Harbin Breweries.

2.1.3. Russia

Russian inward direct investment, having already picked up in 2003, improved further to reach USD 11.7 billion in 2004. As in earlier years, the energy sector attracted large amounts of investment. One of the landmark deals in 2004 was the acquisition by ConocoPhillips of a strategic position in Russia's largest oil company Lukoil. Conversely, an upsurge in investment into the manufacturing of consumer goods marks a departure from earlier trends. As mentioned in earlier issues of the *International Investment Perspectives,* most foreign-controlled enterprises have until recently contended themselves with accessing Russian consumers through sales and distribution networks. More recently, many of these companies have been establishing production sites in Russia to produce near the markets. This appears to have been influenced, on the one hand, by a retail boom in Russia, fed both by increasing household incomes and soaring consumer credits. Moreover, relatively high import duties have also affected MNEs' choice between servicing consumers locally or from production sites abroad.

Based on anecdotal evidence one industrial sector in Russia stands out as a recipient of FDI in recent years, namely automobile manufacturing.[7] Ford Motor Company, which undertook a greenfield investment near St. Petersburg in 2002, has reported a sharp pickup in its sale of locally produced cars. General Motors tied up with AvtoVAZ a few years back and has recently committed itself to investing in its plant in Vsevolozhsk to increase its

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capacity fourfold. Volkswagen and Renault have also launched projects, and Toyota is in the final stages of preparing a car plant near St. Petersburg that, when it enters into operation in 2006, is expected to be one of the largest in Russia.

2.1.4. India

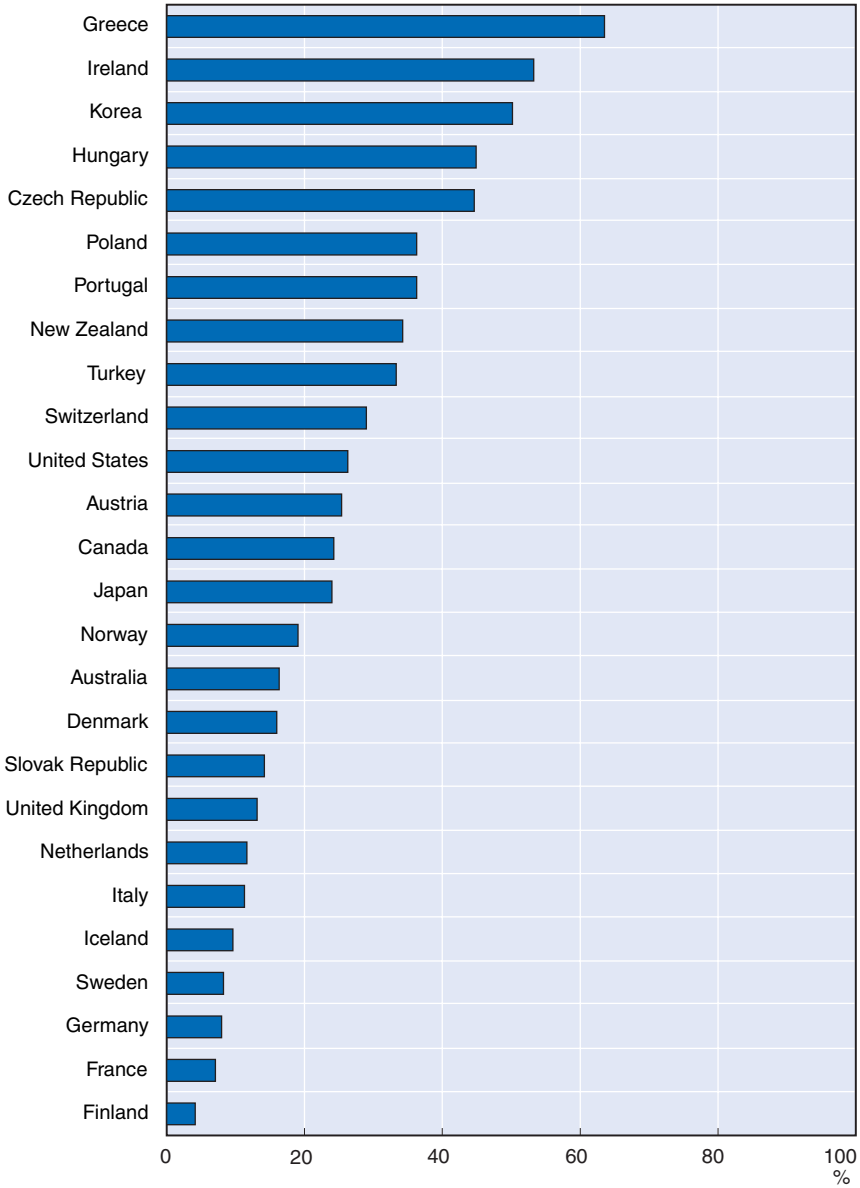
Another interesting observation is the gradual, steady growth in inward direct investment to India. At USD 5.3 billion in 2004 the numbers are dwarfed by the inflows to China and below FDI in Singapore, Hong Kong (China) and, more recently, Russia, but there may nevertheless be cause for celebration. First and foremost, Indian FDI data are systematically too low because the statistical definitions hitherto in force fail to include several transactions commonly considered as direct investment (*e.g.* non-cash acquisitions, reinvested earnings of indirectly held investment enterprises and short-term trade credits between related enterprises).[8] India is now altering its measurement of FDI in accordance with internationally standard methodology and is expected soon to produce re-estimates for recent years that will be significantly higher than previously published figures. Secondly, the process of opening India to foreign direct investment started later than in China and certain other developing economies. Less than a decade ago FDI flows into India were paltry, so the levels attracted in 2003 and 2004 represent a major improvement over previous levels. If the national commitment to further economic and regulatory reform remains on track there is no reason why this growth in direct investment should not continue in the coming years.

2.1.5. Investment from OECD countries toward the rest of the world

As indicated earlier, the main outward direct investing countries tend to be the ones with the largest domestic economies, the ones with the biggest current-account surpluses and the ones that are particularly closely integrated with neighbouring countries. However, this does not imply that these countries are particularly open toward the (non-OECD) rest of the world. When examining the share of total outward FDI positions that is invested in non-OECD countries, a different pattern emerges (Figure 1.2).

The figure illustrates the well-known adage that direct investment has a strong affinity to neighbouring countries. The Western European economies, most of them active outward direct investors, have tended to invest their funds in other EU countries rather than in non-OECD economies. Conversely, countries on the geographic edge of the European Union (*e.g.* Greece, Hungary and the Czech Republic) hold around half their outward FDI positions with non-OECD countries, and the same applies to South Korea. Among the larger OECD economies, the United States and Switzerland stand out as having

Figure 1.2. **Share of total outward FDI positions that are invested outside the OECD area**



Source: OECD Economic Globalisation Indicators (2005).

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outward direct investments that are comparatively strongly directed out of the OECD area.

The bilateral outward direct investment positions of OECD members *vis-à-vis* individual developing and emerging economies yield additional insights. For instance, notwithstanding the massive FDI flows to Mainland and Hong Kong China in recent years, Latin America remains the region of the developing world that has received the largest inward direct investment from OECD countries (Table 1.5). This mainly reflects an investment position of no less than USD 229 billion from the United States to Latin America. Perhaps surprisingly, the second-most important direct investor in Latin America so far has been Switzerland with a total position of USD 45 billion.

Secondly, whereas China had by 2002 amassed a sizeable inward FDI position of USD 44 billion *vis-à-vis* the OECD area, this amount is less than what was attracted by Hong Kong (China) and, particularly, Singapore. Again, the bulk of China's inward direct investment has originated in neighbouring countries. On the other hand, financial centres such as Singapore and Hong Kong have received massive amounts of inward investment from countries such as the United States, United Kingdom, Japan and Switzerland.

Africa is the one developing region where the large European economies appear to play a more important role as direct investors than the United States and Japan. Measured by bilateral investment positions, the largest investor

Table 1.5. **Inward investment positions by OECD countries in selected non-member countries, 2002**

USD billion

Destination	Direct investment originating from:									
	United States	Japan	Germany	United Kingdom	France	Italy	Canada	Switzer-land	Others	OECD total[1]
Latin America[2]	**228.8**	**. .**	**14.5**	**35.7**	**15.3**	**9.4**	**. .**	**45.3**	**42.0**	**391.0**
Argentina	11.2	. .	1.2	1.5	2.3	1.7	3.2	0.5	3.9	25.5
Brazil	27.6	4.0	5.0	3.4	6.4	2.5	4.8	2.7	15.9	72.3
Chile	10.0	. .	0.5	2.4	0.6	0.1	3.8	0.3	0.7	18.4
Asia[2]	**150.6**	**52.9**	**23.4**	**38.8**	**11.2**	**2.2**	**. .**	**19.0**	**29.9**	**328.0**
China	10.5	12.4	6.6	5.4	2.5	0.5	0.5	1.4	4.6	44.4
Hong Kong, China	41.6	5.4	3.8	9.2	1.7	0.5	1.7	2.1	4.0	70.0
India	3.3	1.3	1.6	2.1	0.6	0.4	0.1	0.4	1.3	11.1
Singapore	52.4	10.4	6.1	10.9	3.4	0.3	2.7	10.4	6.6	103.2
Africa	**16.3**	**1.2**	**4.2**	**17.8**	**17.2**	**3.3**	**1.8**	**2.5**	**9.0**	**73.3**
South Africa	3.4	0.3	2.5	11.2	0.5	0.3	0.1	0.9	1.3	20.5

1. Sum of outward positions from those OECD countries for which data are available.
2. Excluding OECD member countries.

Source: OECD International Direct Investment Database.

into Africa is the United Kingdom (USD 18 billion – most of which in South Africa) followed by France (USD 17 billion – much of which in francophone Africa). Inward investment to Africa from the OECD economies remains puny compared with other parts of the world – though less so when compared with the size of the populations and economies of the recipient countries.

2.2. Emerging economies, emerging outward investors

While almost all developing countries remain net importers of FDI, several of them have nevertheless emerged over the last decade as important outward investors. Unsurprisingly, it is the relatively more advanced economies (*e.g.* certain ASEAN countries, South Africa within Africa and Brazil and Chile within South America) that have taken the lead. The principal recipients of this new outward direct investment have, at least initially, been other developing countries – mostly located within the same region and often benefiting from proximity and cultural ties with the investor countries.

Data are scarce but the 2004 World Investment Report estimated, based on an analytic study, that "south-south investment" between developing countries could account for as much as one-third of global FDI flows.[9] This does not mean, however, that investment between developing countries is inexorably on the rise. For instance, the 1997 Asian financial crisis took a heavy toll on south-south direct investment within the ASEAN country and severely affected some of the region's poorest countries.[10]

An even more recent development is the emergence of companies from developing countries as inward direct investors into the OECD area. Developing countries with large current-account surpluses have in the past reinvested their proceeds in the industrialised world, including in the form of direct investment (the example of OPEC in the 1980s comes to mind). However, it is much more recent that international corporate players have emerged in developing countries who seek to integrate corporate entities in OECD countries in their global value chains. The evidence of this development is to this point largely anecdotal. Some of it, covering three selected regions (China, Russia and Latin America), is surveyed in this section.

2.2.1. China

During the past quarter of a century, as well as becoming a major FDI destination, China has started to become an increasing source of FDI to the rest of the world. Chinese enterprises have been investing abroad during most of the post-1978 reform period. In the early 1980s branches of mainland companies were set up in Hong Kong to invest overseas (and, incidentally, to engage in "round-tripping" to take account of investment incentives in China itself). The main aim of overseas FDI by Chinese corporations was to organise

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China's rapidly-expanding international trade and secure natural resource inputs, although there was also some – mainly market-seeking – investment in manufacturing operations outside China.

Consequently, the bulk of China's outward FDI has in trade and resources, with manufacturing a relatively small component and services negligible. The geographical distribution of this FDI is skewed towards the Asia Pacific region, with little so far in Europe. This pattern is likely to change as Chinese enterprises seek market share and technology in developed countries, especially through M&A, and as services-sector enterprises widen their geographic reach. (Hard data for Chinese outward direct investment are not yet available; some of the statistical caveats are highlighted in Box 1.1.)

Greater outward FDI became a declared policy goal for the government in 2000. In March 2000 a new policy of encouraging Chinese companies to invest outside China[11] was announced in the government work report delivered at the annual meeting of the National People's Congress (China's parliament). This new policy was put on a par with the established regional policy of developing China's hinterland and was to be first implemented by those Eastern coastal regions where conditions were ripe.[12]

The policy reorientation took place partly as a means of recycling the country's burgeoning foreign exchange earnings to prevent overheating of the domestic economy. This is related to the fact that, by the early years of the 21st century, China had acquired ample foreign exchange reserves.[13] While the government boasted repeatedly of surpluses on both current and capital account, Chinese economists warned of potential risks including upward pressure on the renminbi and over-rapid expansion of monetary supply. The abandonment of central planning of the economy in the 1990s had deprived the authorities of direct physical controls to slow investment in order to maintain stable economic growth.

This "going global" policy has several complementary aims. Firstly, it is intended to secure natural resources. Again, this was already an aim of outward investment in the 1980s and 1990s, but it has grown enormously in importance as Chinese industrial growth has accelerated at a rate that is rapidly exhausting domestic resources, especially energy. Secondly, China has established a comprehensive industrial base but still lags the rest of the world in high technology and management methods. Acquiring overseas companies which already possess these can enable Chinese enterprises to modernise more rapidly, and Chinese enterprises actively engage in M&A activities worldwide to gain market share and acquire technology. The acquisition of the IBM personal computer business by Lenovo for USD 1.25 billion is an example of the scale of such transactions.

Box 1.1. **Spotlight on China's outward FDI statistics**

China's total accumulated outward FDI is far smaller than the comparable figure for inward FDI, but is almost certainly much higher than indicated by official statistics. The official balance-of-payments figure of USD 1.8 billion in 2004 understates actual outward FDI[1] and it is difficult to identify a clear trend. Sizable – and highly visible – M&A deals will probably account for an increasing proportion of total outward FDI in future years, perhaps increasing the accuracy of estimates of China's outward FDI.

Official statistics for China's outward FDI flows differ between government agencies and from estimates by organisations outside China. According to Ministry of Commerce (MOFCOM) figures, a cumulative total of 6 610 Chinese firms had invested USD 8.4 billion abroad by end-2001 in terms of contracted investment.[2] By end-2003, this had risen to 7 410 firms investing USD 11.4 billion. The State Administration of Foreign Exchange (SAFE), which measures actual outflows and therefore also includes non-approved outward FDI, estimates cumulative outward FDI in 1982-2001 at USD 34.6 billion, rising to USD 38 billion cumulated to end-June 2003. UNCTAD lists cumulative FDI to end-2000 as USD 27.2 billion.

MOFCOM's figures have so far underestimated total outward FDI because they only include investments that have been submitted for official approval. This situation is, however, changing. From May 2005, Chinese entitities are required to notify MOFCOM of all planned outward investments, both to improve statistical coverage and to enable companies to share experience of problems encountered in business environments outside China. In addition, whereas contracted FDI always greatly exceeds actual FDI inflows to China, in the case of outflows actual FDI exceeds contracted FDI. Another reason why underestimation may be significant is that unapproved outward FDI is much larger than approved outward FDI, as indicated by local survey data. Such underestimation probably accounts in part for the regularly high entries for "net errors and omissions" in China's balance of payments from 1991 to 2001.

Balance-of-payments figures for outward FDI published by China's State Administration for Foreign Exchange also appear low and may not accurately reflect the current trend. These statistics show a decline in recent years from a peak of USD 6.9 billion in 2001 to a net outflow of USD 152.3 million in 2003, then a small recovery to USD 1.8 billion in 2004.

Despite certain inconsistencies, official data provide useful sectoral and geographical breakdowns of China's outward FDI. Approximately 59% of outward FDI is trade-related, 20% in natural resources and 12% in manufacturing. At end-2000, 2 859 non-trading Chinese enterprises were recorded as operating in 160 countries and territories. Over two thirds were in

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Box 1.1. **Spotlight on China's outward FDI statistics** *(cont.)*

the Asia-Pacific area and over 70% were in developed industrial or newly-industrialised economies. The top ten destinations accounted for 53.2% of the total: United States (310 Chinese-invested enterprises), Russian Federation (285), Hong Kong, China (236), Thailand (145), Australia (112), Canada (91), Japan (89), South Africa (81) and Malaysia (80). There are four main types of investing enterprise: specialised trading companies, producing enterprises, transport and construction engineering enterprises, and SMEs.

1. This figure appears consistent with the latest national total for outward investment approvals on the MOFCOM web site [*www.fdi.gov.cn*], which shows contracted outward FDI of USD 770 million in the first five months of 2004.
2. All figures in this and the next two paragraphs are cited in Zhao Wei *op. cit.*

Since the announcement of China's "going global" policy, other countries have actively sought Chinese investment. For example, in September 2003 and 2004, IPAs from several OECD member countries made presentations promoting Chinese FDI in their countries at the annual China International Fair for Investment and Trade in Xiamen. Competing investment destinations in the developing world that have been concerned since before China's 2001 WTO accession that FDI from third countries would be diverted from them to China have also been seeking more FDI from China.

2.2.2. Russia and other Central and Eastern European countries

The general picture of FDI in Central and Eastern Europe (CEE) in recent years is one of increasing "investment maturity" – a growing tendency for countries to invest outward and to play an important role in the international capital reallocations of MNEs, rather than simply act as recipient of one-off inward investment projects. This follows earlier phases of first foreign trade liberalisation and regulatory reform in the early 1990s followed by a surge in inward FDI especially from countries in the European Union. A recent study concluded that outward FDI of CEE countries in recent years has been boosted by two factors.[14] First, the most competitive economies in Central Europe are now host to well-capitalised subsidiaries of MNEs that are increasingly used as bridgeheads for direct investment in other countries of the CEE region. Second, companies in countries that have been separated from the economic entities to which they belonged prior to the upheavals of the 1990s (one frequently quoted case is Slovenia *vis-à-vis* the rest of ex-Yugoslavia) have been busy re-creating economic tries by means of cross-border investment.

In this process, the Russian Federation may be characterised as a "late starter". However, the emergence of Russia as foreign investor now attracts

increasing attention within the government (which until recently was more concerned with fighting illegal capital outflows than monitoring the lawful ones) and the domestic business community. Recent data indicate that role of FDI in overall Russian international investment flows, inward as well as outward, is usually strong by international comparison. Moreover, direct investment is proportionally more important in Russia's total outward investment (60%) than in its inward investment stock (44%).

As mentioned earlier, Russia's outward direct investment may remain modest by the standards of most OECD countries, but the country has in recent years placed itself as one of the main capital exporters among transition and developing countries. (Alternative measures of outward FDI do, however, come up with a more modest USD 4.2 billion of investment in 2004 than the figures reported in Table 1.4.[15]) Unlike the case in many OECD countries, the destinations and origins of Russian inward and outward FDI differ significantly. The most important source of inward foreign direct investment is Cyprus (28% of total foreign direct investment in 2004) and thought to be largely influenced by Russian investors domiciled in this country. The most important recent recipients of Russia's outward direct investment have been the United Kingdom (31% of the total), followed by Netherlands (13%) and Iran (10%).

Whilst the role of Russia as an outward investor is growing, some political and business commentators regret the country's still limited investment presence abroad, especially in the territory of the former Soviet Union.[16] Ukraine (with only USD 58 millions of direct investment) is the only CIS country which last year appeared among the major foreign direct investment destinations, but after the locations such as Gibraltar and Cyprus.

Russian observers have also argued that the motivations of most Russian investors abroad are based on short-term considerations rather than on longer-term investment and diversification strategies. Several recent or continuing operations of Russian major firms, such as initial public offerings in western stock markets and participation in foreign bidding, could be a case in point. They seem to be mainly motivated by concerns of these firms over what they see as the tax administration and more generally government interference threatening their activities in Russia.

As Russia continues to reform her economy, the "opportunistic" (as opposed to strategic) approach of domestic businesses could arguably be problematic. If the experiences of OECD countries are anything to go by, Russia's economic development and modernisation depends on its participation in international production and distribution networks. There is arguably a need for a larger exposure of the domestic business sector to international investment, including through a more active involvement of Russian firms abroad.

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2.2.3. Latin America

In Latin American countries, not unlike the CEE experiences mentioned above, the process of integrating with international commercial networks has undergone several phases. Following a decade of macroeconomic and political stabilisation, and responding to the privatisation programmes of many countries, MNEs invested strongly in Latin America from the early 1990s. At that time, most of the main "indigenous" MNEs domiciled in Latin American countries were found in the energy sector and owned or controlled by governments.

In the course of the 1990s a number of locally-owned companies gained market shares and gradually established a cross-border network within the region. Some apparently benefited from a demonstration effect from the foreign corporate presence, as well as the fact that several MNEs reduced their presence in the region in response to macroeconomic turmoil and regulatory uncertainty. A recent study by the United Nations dubbed such enterprises "Trans-Latins" and found that the 10 largest ones outside the mining and mineral extraction sectors (by consolidated sales) are the Mexican-controlled, telecommunications companies Telmex and America Movil, the cement producer CEMEX and the drinks manufacturer FEMSA, likewise of Mexico.[17] Outside the OECD area, the main Latin American MNEs are the construction company Odebrecht (Brazil), the steel manufacturers Gerdau (Brazil) and Tenaris (Argentina) and the drinks manufacturer Ambev (Brazil).

More recently, a growing number of the "Trans-Latins" are establishing themselves outside the Latin American region, and a few appear in the process of establishing truly global networks. Such companies include Gerdau, Teraris and the Mexican petrochemicals company Grupo Alfa, which in addition to establishing themselves in United States and/or Canada have also set up subsidiaries in Europe and Asia. A case in point is CEMEX, with is now present on four continents. Its most recent transaction, to gain better access to the European market, was the acquisition of the dominant international concrete manufacturer RMC of the United Kingdom.

3. Investment is increasingly covered by international agreements

As most countries' direct investments abroad have continued to expand, investment authorities have taken steps to enter into investment treaties, or other agreements with investment content, with a growing number of foreign governments. This development is by no means limited to OECD countries, but a closer look at the recent trends in investment agreements affecting the major OECD countries is nevertheless instructive.

As shown in Table 1.6, the twelve largest outward investors among OECD countries have to date contracted some 670 bilateral investment treaties (BIT) and some other 25 BIT-like provisions in free trade agreements (FTAs). This

represents almost a third of all investment agreements in the world.[18] Germany, Switzerland, the United Kingdom, France and the Netherlands are party to close to 70% of the BITs concluded by OECD countries. Mexico, the United States, Australia and Canada account for 90% of the OECD area's FTAs including BIT-like disciplines.

Of even greater interest than the number of BITs and FTAs are the amounts of direct investment actually covered by these agreements. These too are estimated in Table 1.6. It appears that in European countries the amounts of outward direct investment covered by BITs rarely exceed 10% of the totals, except for the cases of Spain (25%) and Germany (12%). However, the apparently low European coverage needs to be seen against the fact that the bulk of this investment is directed at other European countries and mostly covered by the high standards of EU or EFTA treaties. When these treaties are accounted for European outward investment appears to enjoy high levels of treaty protection – well above 60%. Japan, which embarked relatively recently on the BIT/FTA process, has a comparatively small share of its outward investment positions – less than 12% – covered.

In many countries that have embarked on FTAs with investment contents, these agreements now cover a larger share of the outward investment than BITs. Particularly striking is the case of Australia whose BITs cover less than 3% of the outward FDI stock. Conversely, 60% of the outward investment is covered by Australia's four FTAs – three of which were contracted in the last two years.[19] The proportion of Canadian and US outward direct investment covered by FTAs is also rather high – about 43% and 20% respectively – whereas their BITs barely cover one per cent. The main explanation for this apparent importance of FTAs is that Australia, Canada and the United States have major investment destinations as their FTA partners. As indicated by Figure 1.3, the number of new BITs coming into force has been receding since the mid-1990s. The countries under review have so far only concluded 4 new BITs in 2005, as compared with record high of 53 in 1996. Historically, European countries have been the most active BITs negotiators. Decades ago they started signing treaties with newly-independent African nations and countries on the Mediterranean Rim. Following this their focus moved to Central and Eastern Europe, Latin America and, most recently, the Asian continent. The United States also became quite active from the 1990s. To date this country has entered into 39 BITs, first with Latin American and transition economies, and more recently with Asian and MENA countries.

Several FTAs with investment content have come into force in the last two years. The NAFTA agreement in 1994, while not the first FTA of its kind, is frequently credited with having triggered an increasing interest in such arrangements. Similar or comparable approaches have been applied 25 times (Table 1.6). The United States has been active in this respect – with 8 FTAs

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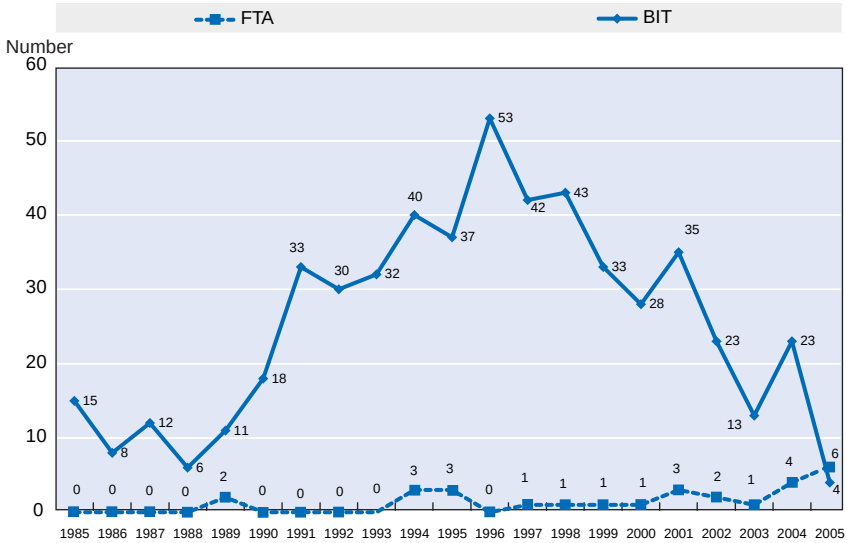
Figure 1.3. **Newly contracted BITs and FTAs in main OECD countries***
(as of June 2005)



* Australia, Canada, France, Germany, Japan. Mexico, Netherlands, Spain, Sweden, Switzerland, United Kingdom and United States. No attempt has been made to eliminate double-counting, of which there are 11 apparent examples: 6 BITs and 5 FTAs.

Source: OECD Investment Division.

concluded and another 20 reportedly under consideration. Japan has concluded an FTA with Singapore and is reportedly making progress in its negotiations for economic partnership agreements with Thailand, Malaysia and the Philippines.

In another recent development, FTAs with investment contents are no longer confined to regional economic partners. Some of the more recent agreements even span countries located on different continents. Mexico is an example of this. In addition to 8 regional agreements, it has concluded FTAs with the European Union, EFTA and Japan.

Investment agreements are not a "one way street" protection outward investment from OECD economies. They provide protection to inward investors as well, and while outward direct investment from the OECD area tends to outweigh inward investment, Table 1.6 nevertheless gives rise to some interesting observations in this respect. Canada, for instance, is committed to uphold treaty standards for 64% of the direct investment received. In Australia it is 34% and in the United Sates it is a comparatively low 10%. In Europe around half of all inward direct investment benefit from the high standard EU/EFTA treaty protection. BITs and FTAs protect a very limited share of the inward FDI in European countries.

Table 1.6. **BITs and FTAs in main OECD countries**[1, 2]
(percentage of outward and inward direct investment stock)[3]

	Investment agreements			Outward FDI positions protected by BITs and FTAs (as share of total outward FDI positions)			Inward FDI positions protected by BITs and FTAs (as share of total inward FDI positions)		
	Number of BITs	Number of FTAs	Total number of agreements	Protected by BITs	Protected by FTAs	Total	Protected by BITs	Protected by FTAs	Total
Australia	14	4	18	3	60	63	1	32	34
Canada	21	4	25	2	44	45	0	64	64
France	84	0	84	6	0	6	1	0	1
Germany	113	0	113	12	0	12	1	0	1
Japan	11	2	13	8	4	12	2	1	4
Mexico	17	11	28	n.a.	n.a.	n.a.	19	65[4]	84
Netherlands	79	0	79	9	0	9	1	0	1
Spain	47	0	47	25	0	25	2	0	2
Sweden	54	0	54	6	0	6	0	0	0
Switzerland	98	1	99	10	1	10	0	1	1
United Kingdom	93	0	93	7	0	7	2	0	2
United States	39	8[5]	47	1	20	22	0	10	10
Gross Total	670	30	700	(Includes double-counting)					
Net Total	664	25	689	(Excludes double-counting)					

Notes: EU portion among total world in each country (outward stock, inward stock): France 54.8% and 73.2%; Germany 53.4% and 74.2%; Netherlands 50.1% and 62.1%; Spain 43.3% and 69.0%; Sweden 59.3% and 62.4%; Switzerland 42.9% and 56.0%; United Kingdom 56.9% and 46.8%.
Spain's and Mexico's FDI figures are based on accumulated FDI flow data.
Double-counting: BIT(6); Mexico-France, Mexico-Germany, Mexico-Netherlands, Mexico-Spain, Mexico-Sweden, Mexico-Switzerland.
FTA(5): US-Canada, US-Australia, NAFTA (US-Canada-Mexico), Japan-Mexico.

1. The listed countries account respectively for 91.9% and 83.1% of OECD total outward and inward investment stock.
2. The number of BITs and FTAs are based on information available as of June 2005.
3. Stock figures are based on the OECD data available for 2002 or 2003.
4. Not including the Mexico-EU Agreement.
5. Including the Central American Free Trade Agreement.

4. Spotlight: a globalisation of the "knowledge economy"?

In view of the growing importance of investment in non-OECD countries, analysts have looked into the evolving nature of these countries' attraction to OECD-based investors. It was traditionally assumed that investment into developing countries in particular is motivated either by the availability of resources or by companies' search for low-cost production sites. However, for some time now it has been clear that this explanation is often too simplistic. Investors into low-cost locations (*e.g.* the textile industries of certain Asian countries) have the option of trading at arms-length with local enterprises, or even integrating them fully into their own global value chains, without taking

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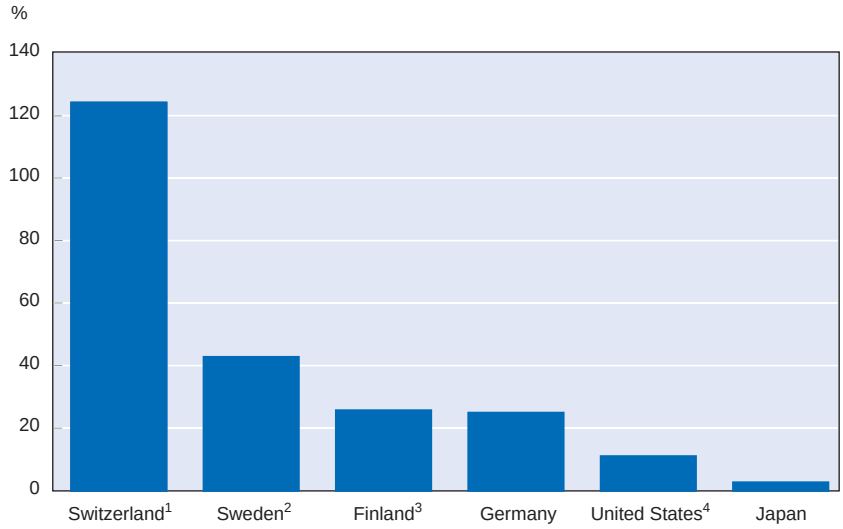
an ownership share. As it turns out, MNEs increasingly take the step from trading with a country to establishing a presence as part of more elaborate corporate strategies, which include producing locally for international consumption as well as servicing local markets. This is nowhere clearer than in a trend observed over the last decade for international investors to choose host countries in the developing world not solely on the basis of their costs (and quality of enabling environment) but also as a function of the size of these countries' domestic economy.

In a more recent development what has been termed "strategic asset seeking" investment, previously thought to be the preserve of the most highly developed economies, now also appears to be coming to developing countries. One of the most frequently quoted examples is the off-shoring of software development services to the Indian subcontinent to benefit from the human resources present there. Less visibly to the outside, the allocation of traditional industrial production to large developing countries (*e.g.* automobile manufacturing in South America and the Former Soviet Union) is also accompanied by an increasing reliance to competences such as engineering services that are locally available.

A recent publication by the OECD (Economic Globalisation Indicators – see Box 1.2) sheds some light on the cross-country nature of MNEs' knowledge-

Figure 1.4. **R&D expenditure by affiliates abroad as a percentage of domestic R&D expenditure, 2001**



1. 2000.
2. Manufacturing sector only.
3. 1998.
4. 2002.

Source: OECD Economic Globalisation Indicators (2005).

Figure 1.5. **Domestic ownership of inventions made abroad,[1] 1999-2001[2]**

The European Union is treated as one country; intra EU co-operation is excluded.

1. Share of patent applications to the EPO invented abroad in total patents owned by country residents.
2. Priority years.

Source: OECD Economic Globalisation Indicators (2005).

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Box 1.2. **Economic Globalisation Indicators**

Multinational enterprises (MNEs) are key to internationalisation of markets, referred more generally as "globalisation", which has gone through significant developments in the past two decades. Economic integration is central to this development but it is not the only element while social, cultural, political and institutional dimensions cannot be neglected.

Recognising the importance of globalisation for policy making, strategic decisions, and other types of economic and social research and analysis, OECD took the initiative to develop a set of meaningful indicators to measure the phenomenon based on comprehensive factual information.

The first important step was to develop a methodology for new indicators while traditional statistics alone are no longer sufficient to analyse fully the magnitude and consequences of globalisation and need to be supplemented. In addition, new concepts had to be identified and integrated into a common framework which would serve as the basis for comparable analytical tools.

The results of this work are included in the recently published *OECD Handbook on Economic Globalisation Indicators* (*Handbook*) which benefited largely from the expertise of a wide network of OECD experts including officials from member countries and from other international agencies.

The objectives of the *Handbook* are twofold:

i) Identify a set of relevant globalisation indicators to gauge the magnitude and intensity of the globalisation process, and to enable policymakers and other analysts to monitor the developments over time.

ii) Provide national data compilers with the methodological and statistical guidelines they may need to construct the indicators and to make them compatible with international standards.

Interpreting the recommendations of the *Handbook*, OECD is in the process of preparing a new publication which includes a variety of indicators of which only a few are included in the present article. The forthcoming publication (in October 2005) will cover indicators relating to:

a) International trade and investment.

b) Foreign direct investment.

c) Activities of multinational enterprises in the manufacturing sector.

d) Activities of multinational enterprises in the services sector.

e) Comparison between manufacturing and services sectors of multinational enterprises.

f) Contribution of foreign-controlled affiliates to value added and labour productivity in manufacturing and services sectors of host countries.

g) Internationalisation of industrial research and development.

Box 1.2. **Economic Globalisation Indicators** *(cont.)*

h) Cross-border ownership of inventions.

i) Technology balance of payments.

j) Internationalisation of technology intensive products in compiling countries.

k) Share of foreign-controlled affiliates of the information and communication technology sector.

l) Aspects of trade globalisation.

intensive activities.[20] One example of this is the share of total corporate research and development (R&D) that is performed outside the home country of MNEs. Data are only available for a few countries but it appears that MNEs domiciled in small countries – however technologically advanced – are more prone to take research activities overseas. The best example of this is Switzerland whose enterprises spend more than half of their total R&D budgets abroad (Figure 1.4). This has been attributed to the fact that a country with only 7 million inhabitants needs to tap into the human capital of other nations to sustain some of the world's most technologically advanced (for instance, pharmaceutical) enterprises.

The indication is that the foreign component in corporate R&D is growing quite strongly. The study quoted above also indicates that the R&D expenditure in affiliates of parent companies abroad has increased at annual rates ranging from 10 to 20 per cent between 1995 and 2001. However, this comparison includes only four OECD countries, namely Germany, Japan, Sweden and the United States. Among these countries, the growth in foreign R&D spending was strongest among Swedish multinational enterprises and weakest in the United States.

An alternative way of measuring foreign corporate control over innovation is the nationality of patents. Based on the OECD Patent Database it appears that companies in some of the smallest European countries are strongly dependent on foreign R&D activities for innovations. In Switzerland and Ireland close to half of all patent applications relate to inventions made abroad, and in Luxembourg the share is no less than 80 per cent (Figure 1.5). The most "closed" countries in this respect do not include the OECD's largest economy, the United States whose enterprises benefit to a significant degree from innovation abroad. Companies domiciled in Asia and Southern Europe, on the other hand, seem to depend largely on domestic research and development for their technological progress.

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Notes

1. It should, however, be noted that as businesses in most of the host countries do note use dollars as their reference currency the figures will be biased upward by the low level of the USD.
2. T. W. Anderson (2005), "Foreign Direct Investment in the United States: New Investment in 2004", *Survey of Current Business,* June 2005, Bureau of Economic Analysis.
3. Invest in France Agency (2005), "Foreign Direct Investment in France: Summary of 2004 Results", mimeo. This paper also estimates that more than 20 000 new jobs were created through FDI in 2004 and another 9 000 jobs were preserved.
4. This assumes the exclusion of Luxembourg from the comparison. FDI flows through this country are dominated by the presence of a large number of special-purpose entities established solely with the purpose of acting as conduits for investment.
5. State Ministry for Tourism and Commerce (2005), "Spanish Foreign Direct Investment Inflows and Outflows", 2004, Mimeo.
6. Denmark's National Bank (2004-2005), *Direkte Investeringer*, various issues.
7. FDi Magazine (2005), "Consumer spending keeps FDI in Russia on Course, April/May.
8. This point has been brought up several times in academic literature. For a recent overview, see N. Chandra Mohan (2005), "Redefining FDI: can the elephant trump the dragon?", *India Now,* Vol. 2, Issue 1.
9. Aykut, D. and D. Ratha (2004), "South-South FDI flows: how big are they?", *Transnational Corporations*, Vol. 13.
10. L. Cotton and V. Ramachandran (2001), "Foreign Direct Investment in Emerging Economies: Lessons from sub-Saharan Africa", *Discussion Paper No. 2001/82*, United Nations University, WIDER.
11. "*Zouchuqu*" (literally "going out"), usually referred to in English as "going global".
12. Zhao Wei (2004), *Chinese Enterprises "Going Out" – An Analysis of Government Policy Orientation and Typical Examples* [in Chinese], Economic Science Publishing House, Beijing
13. For example, foreign exchange reserves totalled USD 659.1 billion at the end of March 2005 [*www.chinability.com*].
14. K. Kalotay (2004), "Outward FDI from Central and Eastern European Countries", *Economics of Planning*, Vol. 37.
15. The figure of USD 4.2 billion is based on data reported by the Federal Service for State Statistics (*www.gks.ru*). These data provides more detailed information on geographical breakdown of investment flows but traditionally differ from data reported by the Central Bank of Russia within its balance-of-payment statistics due to specificities in data collection and methodologies adopted by the two institutions.
16. K.N. Gusev: Scope and structure of Russian investment abroad, in "*Bankovskoe delo*" (in Russian), available at *www.bankdelo.ru/1204Gusev.htm*
17. Economic Commission for Latin America and the Caribbean (2005), *Foreign Investment in Latin America and the Caribbean*, United Nations.

18. UNCTAD estimates the total number of bilateral investment treaties as being above 2300 agreements.
19. With Singapore, Thailand and the United States.
20. OECD (2005), *Economic Globalisation Indicators*, Paris. However, this publication does not include specific information about OECD-based enterprises' activities outside the OECD area.

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ANNEX 1.A1

International Direct Investment Statistics

Table 1.A1.1. **OECD direct investment abroad: outflows**

USD million

	1990	1991	1992	1993	1994	1995	1996	1997	1998	1999	2000	2001	2002	2003p	2004e
Australia	992.3	1 199.4	5 266.9	1 947.0	2 816.5	3 281.8	7 087.6	6 427.9	3 344.8	–420.7	3 158.5	12 072.1	7 873.2	14 306.2	16 707.9
Austria	1 627.2	1 285.3	1 697.5	1 190.5	1 257.2	1 130.6	1 935.0	1 988.2	2 745.2	3 300.7	5 740.9	3 137.9	5 812.0	6 782.6	7 168.6
Belgium/Luxembourg	5 956.0	6 066.2	10 955.9	3 850.5	1 205.4	11 728.4	7 811.3	7 884.5	29 107.8	132 325.8	218 364.4	100 624.7	. .	. .	. .
Belgium	. .	. .	. .	. .	. .	. .	. .	. .	. .	. .	. .	0.0	12 705.4	36 932.9	26 141.1
Canada	5 235.2	5 832.3	3 589.2	5 699.9	9 293.5	11 462.3	13 094.3	23 059.2	34 349.2	17 250.1	44 678.5	36 037.2	26 745.9	21 463.9	47 446.2
Czech Republic	. .	. .	. .	90.2	119.6	36.6	152.9	25.2	127.1	89.8	42.8	165.4	206.5	206.7	546.3
Denmark	1 618.2	2 051.8	2 236.0	1 260.5	3 955.1	3 063.5	2 519.1	4 206.6	4 476.6	16 433.9	23 093.2	11 615.5	5 179.8	1 271.1	–11 067.0
Finland	2 708.5	–124.0	–751.7	1 407.1	4 297.8	1 497.3	3 596.5	5 291.7	18 641.5	6 615.5	24 034.7	8 372.0	7 629.1	–2 592.1	–1 028.3
France	36 228.4	25 137.6	30 407.1	19 736.1	24 372.3	15 758.1	30 419.5	35 580.9	48 612.7	126 859.2	177 481.6	86 783.3	50 486.1	53 197.0	47 829.5
Germany	24 231.9	22 947.0	18 595.1	17 196.1	18 857.8	39 051.6	50 806.3	41 794.1	88 837.2	108 691.6	56 567.5	39 691.1	15 185.0	–3 573.2	–7 271.5
Greece	. .	. .	. .	. .	. .	. .	. .	. .	–275.6	552.1	2 136.5	616.1	655.3	46.5	606.9
Hungary	. .	. .	. .	10.6	48.3	59.1	–3.6	461.9	278.3	250.1	620.2	368.1	278.1	1 646.5	537.9
Iceland	11.5	28.6	6.3	14.3	23.7	24.8	63.4	56.0	74.1	123.1	392.6	341.8	320.0	352.5	2 446.9
Ireland	364.7	192.6	214.4	217.8	436.3	819.8	727.9	1 013.7	3 902.1	6 109.1	4 629.6	4 066.1	10 341.9	3 546.1	11 415.1
Italy	7 611.7	7 325.9	5 948.5	7 230.6	5 108.8	5 731.4	6 464.9	12 244.7	16 077.6	6 721.7	12 318.5	21 475.9	17 138.3	9 079.3	19 273.2
Japan	50 773.5	31 687.7	17 304.8	13 914.4	18 116.0	22 632.1	23 414.8	25 991.7	24 157.7	22 750.0	31 540.4	38 352.0	32 283.3	28 799.4	30 963.5
Korea	1 051.6	1 488.6	1 161.5	1 340.0	2 461.1	3 552.0	4 670.1	4 449.4	4 739.5	4 197.8	4 998.9	2 420.1	2 616.5	3 425.5	4 792.0
Luxembourg	. .	. .	. .	. .	. .	. .	. .	. .	. .	. .	. .	0.0	126 218.9	101 146.6	59 044.6
Mexico	. .	. .	. .	. .	. .	. .	. .	. .	. .	. .	. .	4 404.0	929.7	1 784.1	3 489.7
Netherlands	13 660.6	12 825.9	12 697.1	10 063.3	17 553.8	20 175.5	32 098.1	24 522.1	36 475.1	57 611.3	75 648.7	47 977.3	33 931.8	37 814.1	1 458.6
New Zealand	2 360.7	1 472.4	391.4	–1 388.7	2 008.2	1 783.5	–1 239.7	–1 565.5	401.4	1 072.5	608.7	911.9	–1 225.0	–92.8	856.8
Norway	1 431.5	1 823.6	394.2	933.0	2 172.5	2 856.2	5 892.5	5 015.3	3 200.7	5 503.6	7 613.8	–1 322.7	4 200.7	2 139.9	1 866.6
Poland	. .	. .	13.0	18.0	29.0	42.0	53.0	45.0	316.0	31.0	16.0	–90.0	230.0	196.0	806.0
Portugal	164.8	473.6	684.2	107.3	282.5	684.6	709.2	2 092.0	4 028.5	3 191.4	8 133.6	6 243.7	155.2	7 332.6	6 182.0
Slovak Republic	. .	. .	. .	12.8	17.7	43.0	62.9	95.1	146.6	–377.2	28.7	64.5	11.2	13.3	152.1
Spain	3 441.7	4 424.4	2 171.0	3 173.6	4 110.8	4 157.8	5 590.1	12 546.8	18 937.7	42 084.5	54 684.6	33 099.5	31 540.2	23 395.0	42 000.0
Sweden	14 748.2	7 057.6	408.7	1 357.7	6 701.1	11 214.3	5 024.8	12 647.5	24 379.4	21 928.6	40 667.3	6 374.9	10 630.0	21 259.8	11 947.2
Switzerland	7 176.9	6 542.5	6 058.5	8 765.4	10 798.0	12 213.9	16 150.8	17 747.9	18 768.8	33 264.3	44 698.1	18 246.6	7 867.9	15 113.9	25 219.6
Turkey	–16.0	27.0	65.0	14.0	49.0	113.0	110.0	251.0	367.0	645.0	870.0	497.0	175.0	499.0	859.0
United Kingdom	17 953.8	16 412.1	17 740.9	26 063.1	32 205.7	43 560.0	34 055.9	61 620.0	122 861.2	201 436.7	233 487.7	58 885.2	50 346.5	66 726.2	65 436.1
United States	37 183.0	37 889.0	48 266.0	83 950.0	80 167.0	98 750.0	91 885.0	104 803.0	142 644.0	224 934.0	159 212.0	142 349.0	154 460.0	140 579.0	252 012.0
Total OECD	**236 516.1**	**194 067.1**	**185 521.7**	**208 175.1**	**248 464.9**	**315 423.1**	**343 152.5**	**410 296.1**	**651 722.2**	**1 043 175.4**	**1 235 467.8**	**683 780.1**	**614 928.4**	**592 797.9**	**667 838.7**

Notes: Data are converted to US dollars using average exchange rates; p: preliminary; e: estimate.

Source: OECD International direct investment database.

Table 1.A1.2. **OECD direct investment from abroad: inflows**

USD million

	1990	1991	1992	1993	1994	1995	1996	1997	1998	1999	2000	2001	2002	2003p	2004e
Australia	8 115.8	4 302.1	5 719.8	4 281.7	5 024.6	11 963.2	6 111.0	7 633.4	6 002.6	3 268.4	13 949.9	4 627.5	15 626.5	6 843.3	42 221.0
Austria	650.9	351.3	1 432.7	1 136.5	2 102.9	1 904.2	4 428.6	2 655.6	4 534.1	2 974.6	8 841.7	5 920.5	357.0	7 358.8	4 867.7
Belgium/Luxembourg	7 516.0	8 919.4	10 957.3	10 467.8	8 313.2	10 894.2	13 924.4	16 510.1	30 146.9	142 512.3	220 987.8	84 717.6	. .	. .	. .
Belgium	. .	. .	. .	. .	. .	. .	. .	. .	. .	. .	. .	. .	15 640.5	32 127.2	34 386.9
Canada	7 580.3	2 880.0	4 721.6	4 730.3	8 204.1	9 255.4	9 632.6	11 522.0	22 802.8	24 747.2	66 795.5	27 669.9	21 497.5	6 352.5	6 291.9
Czech Republic	. .	. .	. .	653.4	868.3	2 561.9	1 428.2	1 301.1	3 716.4	6 326.2	4 980.2	5 644.6	8 483.5	2 108.7	4 464.0
Denmark	1 206.7	1 459.9	1 014.7	1 669.0	4 897.6	4 179.8	768.0	2 798.6	7 725.7	14 657.1	31 305.8	11 587.2	6 855.6	2 698.7	–11 417.8
Finland	787.5	–246.6	406.2	864.4	1 577.7	1 062.9	1 109.0	2 115.8	12 140.7	4 610.2	8 835.6	3 732.2	7 926.7	3 299.3	4 650.5
France	15 612.6	15 170.9	17 849.2	16 442.7	15 574.0	23 679.1	21 959.5	23 171.5	30 984.5	46 545.9	43 258.4	50 485.1	49 078.7	42 538.4	24 332.2
Germany	2 962.0	4 729.3	–2 088.9	368.3	7 133.9	12 025.4	6 572.8	12 243.4	24 596.7	56 077.3	198 313.0	26 419.0	50 564.0	27 289.8	–38 580.8
Greece	1 688.4	1 718.1	1 588.6	1 243.6	1 166.1	1 197.7	1 196.4	1 088.6	72.1	561.5	1 108.1	1 589.4	50.3	661.3	1 351.4
Hungary	312.1	1 474.4	1 477.2	2 446.2	1 143.5	5 101.9	3 300.4	4 170.9	3 337.1	3 313.1	2 763.0	3 936.0	2 993.6	2 161.9	4 169.4
Iceland	22.0	18.2	–12.7	0.4	–1.5	9.2	83.1	147.9	147.8	66.6	170.5	172.6	90.9	341.3	435.0
Ireland	622.6	1 360.8	1 458.1	1 068.5	856.2	1 441.5	2 615.7	2 709.6	8 856.5	18 210.1	25 783.3	9 652.7	29 008.1	26 912.6	14 067.6
Italy	6 343.4	2 481.5	3 210.8	3 751.4	2 235.6	4 816.2	3 534.9	4 962.5	4 279.8	6 911.4	13 377.3	14 873.4	14 558.2	16 430.2	16 824.5
Japan	1 809.4	1 286.2	2 755.2	206.9	890.1	42.5	229.7	3 223.1	3 193.5	12 740.4	8 318.6	6 247.9	9 243.2	6 322.2	7 818.8
Korea	788.5	1 179.8	728.3	588.1	809.0	1 775.8	2 325.4	2 844.2	5 412.3	9 333.4	9 283.4	3 527.7	2 392.3	3 525.5	8 188.6
Luxembourg	. .	. .	. .	. .	. .	. .	. .	. .	. .	. .	. .	. .	117 108.6	92 419.2	57 034.4
Mexico	2 633.0	4 761.5	4 393.0	4 389.0	15 066.7	9 666.6	10 075.8	14 233.6	12 402.0	13 336.9	16 909.6	27 720.8	15 325.2	11 663.6	16 601.9
Netherlands	10 516.2	5 778.9	6 169.4	6 443.1	7 158.4	12 306.8	16 660.1	11 136.5	36 924.9	41 206.1	63 865.6	51 936.8	25 060.3	19 349.3	–4 608.0
New Zealand	1 683.1	1 695.6	1 089.2	2 211.6	2 615.7	2 849.7	3 922.0	1 917.2	1 825.5	940.4	1 344.4	4 219.3	–529.7	670.1	2 581.0
Norway	1 176.7	–48.9	810.4	1 460.7	2 777.6	2 408.0	3 168.5	3 946.4	4 353.7	7 061.7	6 907.7	2 009.3	679.0	3 802.8	2 159.4
Poland	88.0	359.0	678.0	1 715.0	1 875.0	3 659.0	4 498.0	4 908.2	6 365.0	7 270.0	9 343.0	5 714.0	4 131.0	4 123.0	6 159.0
Portugal	2 255.4	2 291.6	1 903.8	1 516.2	1 254.6	660.1	1 343.8	2 361.7	3 004.7	1 156.8	6 636.5	6 299.3	1 769.1	6 564.4	1 112.2
Slovak Republic	. .	. .	. .	179.1	272.9	241.4	395.7	230.6	706.8	428.5	2 383.1	1 584.1	4 126.5	593.8	1 107.5
Spain	13 838.6	12 445.2	13 350.7	9 571.6	9 275.8	6 285.1	6 820.6	6 387.8	11 798.4	15 758.8	37 530.2	28 010.1	35 939.8	25 649.3	9 850.1
Sweden	1 971.4	6 355.8	41.0	3 845.1	6 349.7	14 446.9	5 436.6	10 967.4	19 842.7	60 929.1	23 245.5	11 900.1	11 734.1	1 285.3	–1 852.2
Switzerland	5 484.9	2 642.8	411.2	–83.3	3 368.4	2 223.2	3 078.2	6 641.8	8 941.9	11 714.0	19 266.0	8 858.9	6 283.8	16 565.7	4 480.6
Turkey	684.0	810.0	844.0	636.0	608.0	885.0	722.0	805.0	940.0	783.0	982.0	3 266.0	1 038.0	1 694.0	2 568.0
United Kingdom	30 470.7	14 849.2	15 474.8	14 821.3	9 254.6	19 968.4	24 441.3	33 244.9	74 348.9	87 972.8	118 823.8	52 650.2	24 051.9	20 380.3	78 453.6
United States	48 494.0	23 171.0	19 823.0	51 362.0	46 121.0	57 776.0	86 502.0	105 603.0	179 045.0	289 444.0	321 274.0	167 021.0	80 841.0	67 091.0	106 832.0
Total OECD	**175 314.4**	**122 197.0**	**116 206.5**	**147 986.6**	**166 793.6**	**225 287.3**	**246 284.4**	**301 482.4**	**528 449.0**	**890 857.7**	**1 286 583.5**	**631 993.3**	**561 925.0**	**458 823.5**	**406 550.3**

Notes: Data are converted to US dollars using average exchange rates; p: preliminary; e: estimate.

Source: OECD International direct investment database.

Table 1.A1.3. **OECD direct investment abroad: outward position**

USD million

	1990	1991	1992	1993	1994	1995	1996	1997	1998	1999	2000	2001	2002	2003p	2004e
Australia	30 494.9	30 897.0	34 559.6	40 503.6	47 786.3	53 009.0	66 857.9	71 968.4	78 647.9	89 583.6	85 385.3	92 231.9	93 086.1	126 873.8	156 351.5
Austria	4 746.9	5 993.6	6 584.5	7 974.2	9 514.1	11 832.0	13 059.8	14 011.4	17 468.4	19 127.3	24 819.9	28 510.6	42 483.2	58 729.5	70 829.2
Belgium/Luxembourg	. .	. .	. .	. .	. .	. .	. .	. .	. .	. .	. .	. .	. .	. .	. .
Belgium	. .	. .	. .	. .	. .	. .	. .	. .	. .	. .	. .	. .	. .	. .	. .
Canada	84 812.7	94 387.4	87 867.3	92 469.1	104 308.0	118 106.1	132 321.9	152 959.3	171 784.7	201 446.8	237 646.9	250 691.0	274 362.7	312 185.0	369 758.4
Czech Republic	. .	. .	. .	181.4	300.4	345.5	498.0	548.2	804.1	697.9	737.9	1 135.6	1 473.1	2 283.5	3 059.9
Denmark	. .	15 612.0	16 305.7	15 799.2	19 613.7	24 702.5	27 601.6	28 127.7	30 728.7	41 236.5	60 450.1	62 604.1	63 995.8	73 844.1	. .
Finland	11 227.3	10 845.3	8 564.6	9 178.2	12 534.0	14 993.2	17 666.0	20 297.5	29 405.9	33 850.3	52 108.7	52 224.4	63 920.9	76 127.8	80 940.5
France	110 120.6	129 900.5	156 326.6	158 750.3	182 331.8	204 430.3	231 112.8	237 248.9	288 035.9	334 102.9	445 087.0	508 842.0	586 306.6	720 209.3	816 866.9
Germany	130 760.3	150 517.4	154 741.3	162 365.0	194 523.4	233 107.4	248 634.1	296 274.9	365 195.7	412 881.3	486 749.8	550 306.7	615 885.1	718 081.2	. .
Greece	. .	. .	. .	. .	. .	. .	. .	. .	2 792.2	3 935.0	6 094.0	7 020.4	9 000.6	11 271.0	13 056.0
Hungary	. .	. .	223.6	224.6	291.2	278.1	265.3	646.6	785.1	924.2	1 279.1	1 554.5	2 165.8	3 537.6	4 475.1
Iceland	75.2	101.1	98.1	113.5	148.5	177.2	240.1	275.0	360.5	451.8	662.9	840.2	1 255.0	1 715.8	3 893.3
Ireland	. .	. .	. .	. .	. .	. .	. .	. .	20 314.4	25 232.1	27 925.0	40 818.7	54 024.7	64 457.2	. .
Italy	60 195.3	70 419.3	70 382.3	81 086.6	89 688.3	106 318.6	117 278.0	139 437.2	176 985.2	181 855.5	180 273.6	182 373.3	194 488.3	238 887.6	280 481.1
Japan	201 440.0	231 790.0	248 060.0	259 800.0	275 570.0	238 452.0	258 608.9	271 905.7	270 037.5	248 778.0	278 444.1	300 116.4	304 234.1	335 503.3	370 541.7
Korea	. .	. .	. .	. .	. .	. .	. .	. .	. .	. .	. .	19 967.0	20 734.5	24 986.4	. .
Luxembourg	. .	. .	. .	. .	. .	4 703.3	4 695.4	5 022.3	7 982.8	8 467.8	7 927.0	8 810.2	16 446.4	. .	. .
Mexico	. .	. .	. .	. .	. .	. .	. .	. .	. .	. .	. .	12 077.5	12 900.0	17 185.3	22 515.2
Netherlands	106 896.1	117 262.8	121 052.5	120 116.2	142 944.0	172 675.1	194 015.6	198 539.0	228 983.2	263 761.3	305 459.2	332 151.2	398 611.6	544 350.5	. .
New Zealand	. .	. .	5 899.0	4 430.7	5 896.2	7 675.6	9 293.1	5 646.0	5 490.8	7 006.2	6 065.1	7 608.6	7 494.7	9 058.9	9 619.4
Norway	10 889.2	12 149.1	11 794.4	12 717.7	17 648.0	22 520.7	25 439.1	27 494.5	31 578.2	31 871.3	33 651.4	. .	. .	. .	. .
Poland	. .	. .	101.0	198.0	461.0	539.0	735.0	678.0	1 165.0	1 024.1	1 018.0	1 156.0	1 457.0	1 855.0	. .
Portugal	. .	. .	. .	. .	. .	4 406.3	3 953.9	5 536.7	9 941.9	10 685.5	17 255.6	21 642.3	22 173.1	35 614.6	45 555.1
Slovak Republic	. .	. .	. .	. .	166.4	138.5	185.0	236.4	408.2	346.0	379.1	506.6	485.6	633.2	. .
Spain	. .	. .	22 046.8	24 014.3	30 044.8	36 227.2	40 537.1	50 276.1	70 056.4	112 804.2	159 957.8	184 460.2	224 101.5	281 297.1	348 082.4
Sweden	50 719.5	54 797.6	48 844.6	45 522.5	60 309.0	73 142.5	72 187.8	78 201.2	93 533.7	106 273.8	123 234.0	123 268.1	146 509.8	179 229.7	204 084.7
Switzerland	66 086.9	75 880.8	74 412.2	91 570.3	112 588.0	142 481.4	141 586.8	165 354.1	184 237.1	194 598.5	233 385.2	253 551.6	293 346.2	342 566.6	393 018.6
Turkey	. .	. .	. .	. .	. .	. .	. .	. .	. .	. .	3 668.0	4 581.0	5 847.0	6 138.0	. .
United Kingdom	229 306.7	232 140.8	221 678.9	245 628.9	276 743.8	304 864.9	330 432.5	360 796.3	488 372.0	686 420.4	897 844.8	869 700.5	994 135.7	1 235 897.6	1 378 129.6
United States	616 655.0	643 364.0	663 830.0	723 526.0	786 565.0	885 506.0	989 810.0	1 068 063.0	1 196 021.0	1 414 355.0	1 531 607.0	1 686 635.0	1 839 995.0	2 069 013.0	. .
Total OECD FDI	**1 714 426.5**	**1 876 058.6**	**1 953 372.9**	**2 096 170.1**	**2 369 976.0**	**2 660 632.4**	**2 927 015.8**	**3 199 544.5**	**3 771 116.6**	**4 431 717.3**	**5 209 116.5**	**5 605 385.5**	**6 290 920.1**	**7 491 532.5**	**. .**

Notes: Data are converted to US dollars using average exchange rates; p: preliminary; e: estimate.

Source: OECD International direct investment database.

Table 1.A1.4. **OECD direct investment from abroad: inward position**

USD million

	1990	1991	1992	1993	1994	1995	1996	1997	1998	1999	2000	2001	2002	2003p	2004e
Australia	73 615.1	77 077.7	75 821.7	82 877.7	95 543.8	104 074.3	116 797.2	101 089.0	105 961.7	120 625.7	111 138.5	107 997.3	134 751.0	186 764.3	245 812.7
Austria	10 971.8	11 510.1	12 040.8	12 105.5	14 636.0	19 721.0	19 629.2	19 522.2	23 564.8	23 471.6	30 430.8	34 328.0	43 506.7	60 624.0	70 829.2
Belgium/Luxembourg	. .	. .	. .	. .	. .	. .	. .	. .	. .	. .	. .	. .	. .	. .	. .
Belgium	. .	. .	. .	. .	. .	. .	. .	. .	. .	. .	. .	. .	. .	. .	. .
Canada	112 850.3	117 031.5	108 500.1	106 869.7	110 210.1	123 182.3	132 970.2	135 935.6	143 348.8	175 000.9	212 722.7	213 755.4	224 194.6	274 285.8	303 802.8
Czech Republic	. .	. .	. .	3 422.8	4 546.6	7 349.8	8 573.1	9 233.2	14 377.1	17 549.5	21 647.0	27 092.8	38 672.3	45 286.3	56 401.9
Denmark	. .	14 747.0	14 387.3	14 617.9	17 846.3	23 800.9	22 337.0	22 267.8	30 552.8	35 568.7	59 416.3	60 714.6	64 924.3	77 552.3	. .
Finland	5 132.4	4 220.5	3 688.9	4 216.7	6 714.1	8 464.5	8 797.5	9 529.8	16 454.8	18 320.4	24 272.3	24 069.8	34 005.9	46 225.0	55 949.4
France	84 930.9	97 450.5	127 881.4	135 077.8	163 451.4	191 433.0	200 095.8	195 913.0	246 215.9	244 672.5	259 773.0	295 308.0	385 186.7	520 242.3	586 186.9
Germany	74 066.8	77 927.8	74 730.1	71 095.4	87 338.1	104 367.2	104 658.1	190 732.9	252 392.5	290 457.1	462 529.1	416 826.5	522 820.9	659 547.4	. .
Greece	. .	. .	. .	. .	. .	. .	. .	. .	13 084.0	15 890.0	14 113.0	13 941.0	15 560.0	21 575.8	27 213.0
Hungary	568.8	2 106.7	3 424.1	5 575.6	7 083.5	11 303.5	13 274.9	17 953.6	20 752.9	23 259.7	22 856.2	27 377.5	36 213.4	48 325.0	60 365.1
Iceland	147.1	165.6	123.8	116.5	127.5	148.7	197.4	331.9	468.7	478.4	491.4	676.5	797.4	1 213.7	1 839.2
Ireland	. .	. .	. .	. .	. .	. .	. .	. .	62 453.1	72 817.0	127 087.6	134 051.3	178 566.5	217 164.0	. .
Italy	60 008.5	61 592.3	49 972.7	53 961.9	60 416.0	65 347.2	74 599.9	85 401.8	108 835.3	108 640.7	121 168.7	113 433.5	130 813.8	180 890.6	220 720.3
Japan	9 850.0	12 290.0	15 510.0	16 890.0	19 170.0	33 507.7	29 937.1	27 077.5	26 064.8	46 115.3	50 322.8	50 319.7	78 142.8	89 728.3	96 987.1
Korea	. .	. .	. .	. .	. .	. .	. .	. .	. .	. .	. .	53 207.5	62 658.3	66 069.7	. .
Luxembourg	. .	. .	. .	. .	. .	18 503.4	18 232.7	17 279.7	20 766.1	20 362.0	23 491.7	26 346.5	34 838.7	. .	. .
Mexico	22 424.4	30 790.0	35 680.0	40 600.4	33 197.7	41 129.6	46 912.0	55 810.0	63 610.4	78 060.0	97 170.2	140 376.0	154 344.0	. .	. .
Netherlands	68 728.8	72 479.6	74 434.3	74 474.2	93 402.9	116 051.2	126 536.4	122 183.1	164 461.1	192 591.9	243 730.3	282 879.2	349 954.9	433 408.6	. .
New Zealand	. .	. .	11 779.5	15 539.1	22 062.2	25 727.6	34 743.7	31 365.3	33 169.9	32 860.8	28 069.8	22 087.1	27 743.9	35 549.8	46 185.2
Norway	12 403.8	15 865.2	13 644.9	13 642.5	17 018.0	19 835.9	20 623.8	20 704.4	26 081.4	29 433.0	30 261.4	32 589.6	42 649.2	48 966.9	. .
Poland	109.0	425.0	1 370.0	2 307.0	3 789.0	7 843.0	11 463.4	14 587.2	22 461.0	26 075.3	34 227.0	41 247.0	48 320.0	55 268.0	. .
Portugal	. .	. .	. .	. .	. .	18 973.4	19 737.9	19 195.3	24 412.1	23 922.8	28 695.5	34 061.9	42 404.4	58 923.9	65 213.1
Slovak Republic	. .	. .	. .	. .	897.0	1 297.1	1 899.8	2 103.4	2 919.6	3 227.6	4 679.4	5 729.8	8 530.6	11 283.9	14 503.7
Spain	. .	. .	85 989.4	80 295.1	96 301.8	109 110.6	107 871.2	100 019.2	118 159.4	116 232.6	144 848.5	165 289.5	236 289.9	314 547.0	356 550.9
Sweden	12 636.0	18 085.0	14 057.0	13 126.9	22 649.4	31 089.3	34 784.1	41 512.7	50 984.6	73 312.5	93 972.5	91 584.0	119 542.1	150 206.3	163 086.2
Switzerland	34 244.6	35 747.2	32 989.3	38 713.5	48 668.4	57 063.7	53 916.7	59 515.2	71 997.1	76 000.2	86 809.8	88 766.3	124 811.9	161 828.6	181 033.2
Turkey	. .	. .	. .	. .	. .	. .	. .	. .	. .	. .	19 209.0	19 677.0	18 732.0	32 455.0	. .
United Kingdom	203 905.3	208 345.5	172 986.4	179 232.6	189 587.5	199 771.8	228 642.5	252 958.6	337 386.1	385 146.1	438 630.7	506 685.6	523 319.2	608 964.6	771 658.2
United States	505 346.0	533 404.0	540 270.0	593 313.0	617 982.0	680 066.0	745 619.0	824 136.0	920 044.0	1 101 709.0	1 421 017.0	1 513 514.0	1 505 171.0	1 553 955.0	. .
Total OECD FDI	**1 291 939.6**	**1 391 261.1**	**1 469 281.8**	**1 558 071.5**	**1 732 639.1**	**2 019 162.9**	**2 182 850.3**	**2 376 358.2**	**2 920 979.7**	**3 351 801.4**	**4 212 782.1**	**4 543 933.0**	**5 187 466.3**	**5 960 852.3**	**..**

Notes: Data are converted to US dollars using average exchange rates; p: preliminary; e: estimate.

Source: OECD International direct investment database.

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Chapter 2

Special Focus: Policy Framework for Investment

This special focus reproduces three of the background documents prepared in support of the work on the Policy Framework for Investment. They include three of the central policies covered by the Framework: trade policy, competition policy and tax policy.

Each article explains the relevance of the policy area in question for investment and articulates issues to consider in governments' efforts to mobilise more and better investment. All three articles have benefited from discussions in the Task Force overseeing the development of the Policy Framework for Investment as well as in the various OECD committees with expertise in the relevant areas.

Trade Policy for Investment*

A country's trade policy influences both domestic and foreign investment and is important for any development strategy. Investment has long been recognised as a key ingredient to economic growth and development. This paper explores how trade policy can:

- Encourage investment – both domestic and foreign. When appropriate, foreign direct investment (FDI) is the focus. The positive role of FDI for development has been recently stressed by the Monterrey Consensus. Trade policy is one of the main determinants of foreign firms in their investment decisions.
- Maximise the contribution of investment to development growth, in particular in the context of trade policy by encouraging technology transfers and other linkages that induce growth.

Following this Introduction, Section 1 discusses the changing interrelationship of investment (domestic and particularly FDI) to trade. Section 2 gives an overview of how trade policies can promote an attractive environment for investment (domestic and foreign) and the considerations of when this could lead to economic growth. This section uses a two-by-two framework analysing export and import policies for host and home countries. Section 3 concludes by outlining issues that policy makers may consider in formulating trade policy. Because the PFI is to be "an operational, practical guide for policymakers", an annex also details a trade policy framework focused on measures and techniques available to trade policy makers which may be used to assess whether national trade policies may reflect "good practice".

1. The changing inter-relationships of trade, domestic investment and FDI

The relationship between international trade, domestic investment and FDI is complex and intrinsically interlinked. To begin, trade can either

* This article was prepared by Jonathan Gage and Sebastien Miroudot of the OECD Trade Directorate. It benefited from comments received during discussions in the Working Party of the Trade Committee, the Investment Committee and the Task Force overseeing the development of the Policy Framework for Investment. It has been published as OECD Trade Policy Working Paper No. 19.

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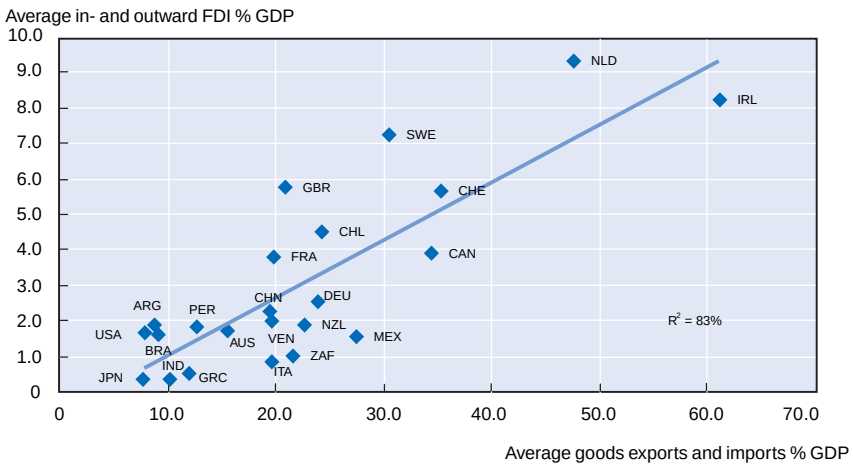
substitute for or complement FDI. Market-seeking firms[1] can serve foreign markets through export sales or through foreign subsidiaries. The latter effectively substitutes FDI for trade. But affiliates of foreign firms in turn create new trade flows with their parent companies or foreign suppliers and can also export to third countries or back to the home country, thus increasing trade. Trade can also draw attention to resources and markets that can highlight investment opportunities. Hence unsurprisingly, greater trade correlates with greater investment flows (Figure 2.1).

Domestic investment can also either substitute for or complement FDI. For a given opportunity, domestic investment may: become non-competitive with FDI; in the case of joint ventures, be used alongside FDI; or in the case of domestic debt, leverage FDI. The tendency when it is complementary (joint ventures or leveraging) is to increase economic activity and induce more trade for a given amount of FDI. Also to the extent that investment (domestic or FDI) positively impacts a host's economic growth, this can also have a trade-enhancing effect.

FDI (and to a lesser extent domestic investment) can induce imports in the short term. An investing firm for instance building a new plant may require capital items only available (or cheaper) from foreign sources. Credit rating agencies evaluating emerging sovereign debt are aware of the impact on the current account and will at times discern between types of imports – pure consumption or non-performing investment *versus* capital imports for an investment that will earn its cost.

Figure 2.1. **FDI and trade correlate**

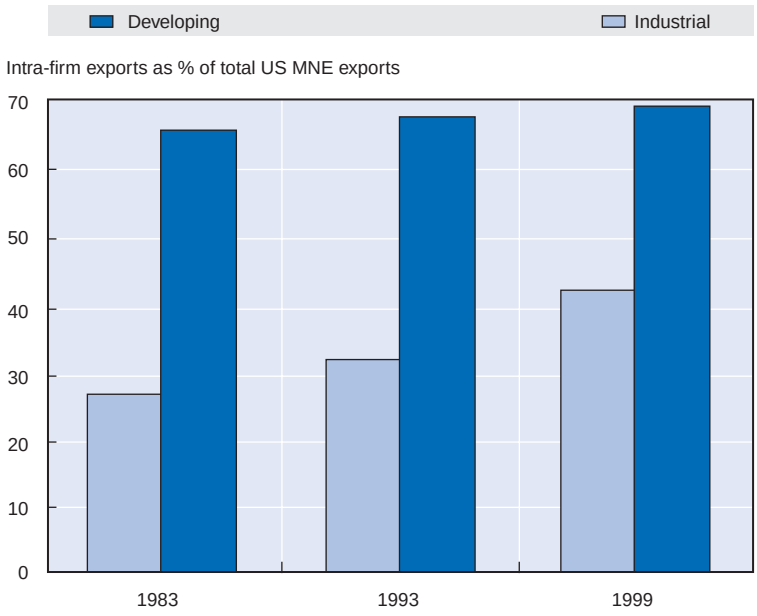


Source: Updated OECD 2002a.

Increasing intra-firm trade between developed and developing countries highlights the trend towards more trade-intensive foreign investment. For instance, US MNE affiliates located in developing countries have increased their exports to other affiliates rather than to the parent (Figure 2.2). This reflects the new multinational enterprise (MNE) strategies of outsourcing and globalised production with a network of subsidiaries in various countries creating a "global value chain" (UNCTAD, 2002) and mirrors a change in the determinants of FDI. Although market-seeking or resource-seeking investments still account for the majority of FDI between developed and developing countries, efficiency-seeking motives have increased over the past decade.

The recognition of the importance of introducing new technologies and management skills – through backward linkages – has refined development thinking. In its narrowest definition, backward linkages are the contracts between the foreign affiliates of a MNE and local suppliers of products used directly or indirectly in the manufacture or provision by the foreign affiliate's product or service. Backward linkages may also include movements of people, demonstration effects and increased competition. MNEs, particularly those adhering to the *OECD Guidelines for Multinational Enterprises*, encourage local

Figure 2.2. **Rising intra-firm exports of US affiliates in developing countries implies trade-intensive FDI**



Source: World Bank, 2003b.

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capacity building.[2] While domestic investment typically dwarfs FDI, FDI in particular linked with trade, can be a catalyst for innovation, improved productivity and sustained growth. Backward linkages are considered the strongest and most consistent positive spillover (OECD, 2002a). Countries have introduced programmes to facilitate such links (Box 2.1).

The influence of e-Business-to-Business (e-B2B) is also changing the global value chain. MNEs are further specializing and establishing e-B2B marketplaces to source components and services in order to benefit from substantial cost savings and efficiency gains.[3] This is an opportunity for host countries. The potential for technology transfer from "backward linkages" with local suppliers in host countries is higher and more worthy to pursue if MNEs start outsourcing more with e-B2B.[4]

Box 2.1. **Ireland's National Linkage Programme succeeded at a critical time**

Since the mid 1980's, Enterprise Ireland (EI) has been operating various linkage programmes to integrate foreign enterprises into the Irish economy. It pursues two tasks: first, to support Irish enterprises to build capacity, innovate and create new partnerships; and second, to assist international investors to source key suppliers in Ireland. EI collaborates closely with foreign affiliates, their parent MNEs, and the various government agencies involved with local suppliers.

Between 1985 and 1987, an estimated 250 foreign affiliates were actively involved in the linkage programme. During that period, affiliates operating in Ireland increased their local purchases of raw materials fourfold, from Irish £438 million to I£1 831 million, and more than doubled their purchases of services from I£980 million to over I£2 billion. In the electronics industry alone, the value of inputs sourced locally rose from 12% to 20%. On average, suppliers saw their sales increase by 83%, productivity by 36% and employment by 33%.

EI's matchmaking worked closely with foreign affiliates to ensure suppliers were *capable* of achieving the demand and quality requirements. One of EI's key criteria used for selecting local suppliers was their management team's attitude and potential to grow. Also noteworthy is that EI's matchmaking is no longer seen as so critical. The need diminished over time as the composition of affiliates, their motivations for locating in Ireland, and their local knowledge, changed. Ireland's competitive advantages in the global value chain became generally recognised.

Source: UNCTAD, 2001.

With such expanding use of trade-intensive FDI and changing nature of the global value chain, host and home countries may need to be ever more diligent to renew policies to ensure that best practices are in place to capture value for their constituents.

2. Trade policies affecting imports and exports of host and home countries

To analyse which trade policies could help a country foster investment and growth, policies affecting imports and exports in both the host and home countries are considered. A two-by-two approach has been used: the rows distinguish the export and import policies; and in the columns, whether the policies are being used by the host country (host of the investment project) or the "home" country. Home traditionally means the source of the FDI funds but where applicable, this definition is broadened to also generally include the recipient of the final product or source of capital or intermediary goods. This is assumed so as to explore the impact of FDI- or *domestically*-financed projects. The host and home countries are not necessarily assumed to be developed or developing countries.[5] Generally the issues are the same in developed or developing countries although sometimes emphasised differently.[6] Where appropriate, trade policies targeting developing countries are the special focus in this paper because they are the host countries most in need of economic growth and the PFI is an initiative for development.

Table 2.1. **Two-by-two taxonomy of trade policies**

	Host Country	Home Country
Affecting imports	Tariff and non-tariff barriers	Market access for host products
	Barriers on importing capital and intermediate goods	Trade remedies
	Restrictions on services	Trade preferences
	Regional trade agreements[1]	Access to service markets
	Customs administration, technical regulations and trade facilitation	
Affecting exports	Export restrictions	Export subsidies
	Export promotion strategies	Export controls
	Export of services	
	Custom procedures for exports	

1. Occasionally policies can be mentioned in more than one quadrant. Regional Trade Agreements (RTAs) can for instance be mentioned in all four quadrants. To avoid duplication, RTAs have been placed only in the first quadrant.

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2.1. Trade policy in the host country affecting imports

2.1.1. Tariffs and non-tariff barriers (NTBs) on imports might attract, but will typically discourage, investment.

High barriers to imports can induce tariff-jumping FDI – FDI as an alternative to trade. There is evidence that firms tend to substitute FDI sales for exports when tariffs are high. However, empirical studies show that while tariffs were positively correlated with FDI in the past, they are now negatively correlated. This change is in line with the new organisation of international production where MNEs choose to locate their activities in different countries to take advantage of cost differences and scale economies. Tariffs and NTBs can negate the competitive advantages offered by a host economy and negatively affect investors' choice of location.

As suggested by the growth experience in some East Asian countries, strategic trade policies using barriers can also encourage (largely domestic) investment by compensating the firm for its adaptation costs and risk (especially when starting a new activity). The externality faced by pioneering firms is corrected by a temporary market power in the host economy. But nurturing such "infant industries" has problems: *i)* host governments must predict their *future* comparative advantage – a difficult task; *ii)* the industry must become internationally competitive otherwise resources are misused. Infant industries have difficulty growing up. Free entry helps rationalise the market and keep only efficient firms producing at world prices. Even the East Asian countries which adopted strategic trade policies and proactive industrial policies have resorted to open-oriented strategies; and, *iii)* host governments must have identified a market failure where investors do not see an opportunity – an uncertain practice. Other policy instruments are available to correct this externality faced by pioneering firms without resorting to trade policies which create distortions.

Restrictive trade policies also will weaken the positive effects of investment on the host economy. Barriers to imports, like other barriers to entry, can encourage the exercise of market power by firms (foreign or domestic) in the domestic market, which in turn is generally associated with lower efficiency, higher consumer prices and sometimes the use of "second-generation" technology. Therefore those FDI-induced backward linkages with domestic firms and technological spillovers will be less if there are restrictive trade policies. Moreover, small domestic markets with high barriers to imports hinder realisation of scale economies even further limiting the potential gains from trade and its interaction with investment.

Trade openness positively correlates with investment in most empirical studies. Sensitivity analyses of cross-country regressions indicate that trade openness is more likely to be correlated with FDI than any other explanatory

Box 2.2. **Chile's tariffs: uniform and signalling with scheduled reductions**

Many developed and developing countries escalate tariffs – higher tariff rates for processed and higher-value-added products but with low rates for raw inputs, see Figure 2.4. They also frequently apply tariff peaks to specific products. Such is intended to encourage domestic production in these higher valued products and thereby support greater productivity and wages. Broadly, Chile does not use tariff escalation or peaking. Chile has a uniform applied MFN rate for nearly all products. This tariff rate has been ratcheting down from 11% in 1996 to today's 6% rate effective since January 2003, in clearly scheduled reductions.

The uniform tariff has several benefits:

- Distortions are created not only by the level of the tariffs but the dispersion. If Chile had a 20% tariff on beef but no tariffs of wines, then resources would tend to be reallocated from wine production – perhaps their comparative advantage – to beef which may be neighbouring Argentina's comparative advantage. Chileans may not have looked for, and diversified into, other competitive industries like say farmed fish. The reallocation and oversight could be averted if there was a flat 10% tariff. Disparate tariffs penalize efficient activities (often exports), foster inefficiencies and increase costs within the economy thereby reducing the country's overall competitiveness. Tariffs on imports can in essence be taxes on exports because of the inefficiencies and increased costs. A uniform nominal tariff will usually improve resource allocation and thereby raise economic welfare.*
- The uniform tariff is easier to administer. Customs officials need not worry about the tariff rates of different products.
- The administration is less prone to lobbying or rent-seeking activities of questionable (if not negative) value to the economy. It is easier for the Chilean government to reject pleas for special treatment.
- The process is less prone to potential corruption. Custom officials make fewer judgments of tariff classification which will affect the amount of tariff paid; the incentives for corruption are less.
- Disparate tariffs lead to local consumer prices which are distorted – *i.e.* that do not reflect the true relative costs of production in a free market. A uniform tariff levels the relative pricing amongst imported goods leaving conceptually only distortions between the domestic and foreign products collectively. Depending upon how much imported products constitute of all consumption, it could be a precursor for eventually adopting a flat-rate broadly-based consumption tax. Such a tax approach is usually deemed more beneficial by economists and may be the subject of other policy areas covered by the PFI.

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Box 2.2. **Chile's tariffs: uniform and signalling with scheduled reductions** *(cont.)*

The importance of a uniform tariff schedule has been recognised by some rating agencies. For instance, the Fraser Institute includes a measure for the standard deviation of the tariff rates, see Box 2.A1.2.

By pre-announcing their schedule of reductions, the Chileans also were able to lock in a schedule which would allow their domestic industries (and foreign companies) to adapt. Such "signalling" allows the Chilean economy to adjust gradually.

* Some theoreticians argue to optimize welfare may require tariffs to reflect the demand elasticities of the products but this is more hypothetical than practical.

Source: World Bank (2003b).

variable.[7] Trade liberalisation encourages investment based on comparative advantage with efficiency gains through greater specialisation and dynamic gains through scale economies. Once impediments to trade (and FDI) have been removed, economic factors can become the main determinants of an investor's choice of location (UNCTAD, 2003). A commitment to free trade ensured by bindings under regional and multilateral agreements increases the foreign (and domestic) firms' confidence to invest in the host economy.

2.1.2. Barriers on imports of capital and intermediate goods can be particularly damaging

One important issue regarding market access concerns capital and intermediate goods. Export competitiveness of companies – particularly foreign affiliates – requires state-of-the-art capital and intermediate goods available at world prices. By providing relatively cheaper capital goods, international trade increases the efficiency of capital accumulation. It is acknowledged that high tariffs on inputs may prompt companies to increase local sourcing but at a cost. Domestic firms may not be competitive internationally and foreign firms may be dissuaded from establishing locally. This explains why these import-substitution strategies have generally failed and been abandoned. To soften the impact on tariffs on capital and intermediate goods while maintaining some protection, duty drawbacks or tariff exemptions can be offered to exporters. These mechanisms can promote export-oriented investments but only if the system is administered efficiently without additional costs for exporters.

Particularly advantageous backward and forward linkages between foreign and domestic firms are more probable when barriers to trade in intermediate goods are low and local affiliates of MNEs are fully integrated in

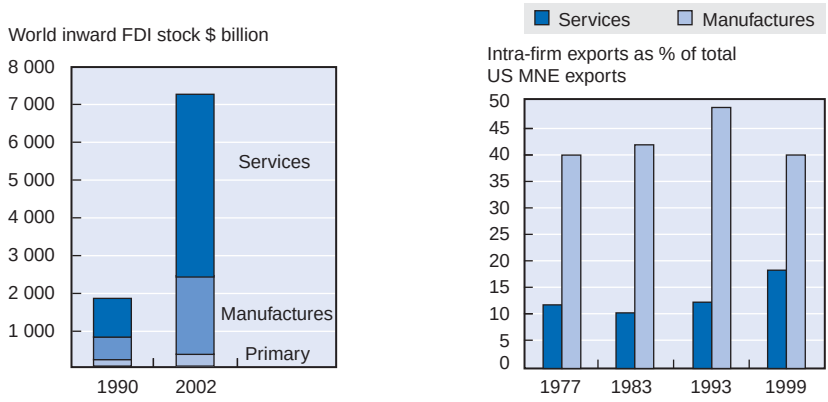
a global chain of production which uses cutting-edge technology. This is because advanced technologies are regularly embodied in the intermediate product imports. Hence local firms may see more opportunities to supply such advanced intermediates and frequently the MNE affiliates seeking to diversify their sources, will help domestic firms and their employees acquire knowledge and capability required for their manufacture and use (hence increasing the "absorptive capacity" of the host economy). This in turn will reduce the cost of learning other applications of this new technology and lower the start-up costs for other new investments. These backward and forward linkages can channel technological spillovers throughout the host economy.

2.1.3. Services are important for the rest of the economy

FDI in services now exceeds FDI in manufacturing (Figure 2.3). Many services are best transferred through FDI (mode 3 in GATS terminology, see Box 2.3). The rapid growth of FDI in services is also explained by technological progress and the globalisation of production which has led to an important increase in intra-firm trade in services (World Bank, 2003b).

On average, developing countries have higher barriers to trade and investment in services than developed countries, especially in telecommunications, banking and financial sectors (OECD, 2004a). Some empirical studies suggest that for developing countries, services trade liberalisation could yield benefits up to four times greater than liberalising trade in goods because its benefits go beyond the services sectors. Liberalising services trade can also help to promote trade in goods and facilitate the diffusion of knowledge in key sectors such as financing techniques (World Bank, 2003b).

Figure 2.3. **Trade in services and in particular intra-firm services trade is becoming more important**



Source: UNCTAD, 2004c; World Bank, 2003b.

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Box 2.3. **The relationship between trade and investment as reflected in the GA**

The General Agreement on Trade in Services (GATS) is the WTO Agreement which defines the relationship of investment and trade in services. GATS defines four modes through which services can be traded:

Mode 1 – Cross-border supply: the supply of a service "from the territory of one member into the territory of any other member". The service crosses the border but both the provider and the consumer stay home.

Mode 2 – Consumption abroad: the supply of a service "in the territory of one member to the service consumer of any other member". The consumer physically travels to another country to obtain the service.

Mode 3 – Commercial presence: the supply of a service "by a service supplier of one member, through commercial presence in the territory of any other member" (*i.e.* investment through the establishment of a branch, agency, or wholly-owned subsidiary).

Mode 4 – Presence of natural persons: the supply of a service "by a service supplier of one member, through presence of natural persons of a member in the territory of any other member". Private persons temporarily enter another country to provide services.

GATS mode 3 thus encompasses FDI as a mode of supplying services. Though mode 3 does not necessarily imply the presence of foreigners working in affiliated companies, mode 4 often accompanies mode 3 as the foreign firm may need to employ non nationals in the host country (for example persons from the parent company entering as "intra-corporate transferees"). Mode 1 and 2 can also be complementary to mode 3 when subsidiaries of foreign companies in developing countries are exporters of services to the parent company (*e.g.* business process outsourcing: a firm creates a subsidiary in a developing country to undertake database services and outsources the management of its databases to the affiliate, an illustration of developed country mode 3 exports leading to developing country exports under mode 1&2). Any effort to liberalise foreign investment in services (mode 3) may need to take into consideration barriers to trade in services through modes 1, 2 and 4.

Source: OECD (2002c, 2004b).

Among these key sectors, infrastructure services are of particular interest for developing countries. The low FDI in developing countries is partially explained by the inadequate infrastructure such as transport services, telecommunications, utilities or legal systems. Imports of infrastructure services (which are often FDI themselves) can compensate for the lack of local infrastructure and facilitate FDI.

The GATS schedules provide a useful framework for committing to liberalising trade in services. The positive list approach allows a host country to specify progressive, scheduled ownership and competition liberalisation commitments by sector. Some Latin American countries used this flexibility in their in telecoms commitments (Box 2.4). As noted before, bindings under

Box 2.4. **Latin telecom GATS commitments "signal" liberalisation**

In the 1997 GATS Agreement on Basic Telecommunications, four Latin American nations committed to phased-in broad liberalisation in the telecoms sector doing away with exclusivity for fixed local and long distance services: Peru (by 1999), Argentina (2000), Venezuela (2000), and Bolivia (November 2001).

Table 2.2. **An example: Bolivia commits effective November 2001**

Sample Sector	Market Access Commitment
Local, domestic long-distance and international voice, data, message or video services for non-public use (services provided to closed groups of users distinct from the service provider): *a)* Voice telephony. *b)* Packet-switched data transmission services. *c)* Circuit-switched data transmission services. *d)* Telex services.	1) Until 27 November 2001, domestic long-distance and international service only using the ENTEL their local monopoly infrastructure. Commercial presence required for local services. 2) None *i.e.* not allowed/not meaningful. 3) Until 27 November 2001, domestic long-distance and international service only using the ENTEL infrastructure. Commercial presence required for local services. 4) Unbound, except as indicated in Section 1 the general limitations on immigration.
Modes: 1) Cross-border supply; 2) Consumption abroad; 3) Commercial presence; 4) Presence of natural persons	

Source: www.wto.org.

Amongst developing country regions, Latin America has the highest mainline penetrations, a measure of telephone availability, and that penetration has been growing at one of the fastest rates. In three of the four countries undertaking phased-in liberalisation, penetration per capita grew an average 9.1% per annum from 1993 to 2001 which contrasts with the lower 6.5% average of for instance Paraguay, Uruguay, Suriname and Guyana which made fewer commitments under the 1997 Agreement.

Signalling allows segments of the economy to adapt. Recent research looking into the sequencing of reforms: privatisation, regulation and competition, emphasises avoiding long periods of non-competition but circumstances might justify some "signalling".

Source: WTO; World Bank (1998, 2002b, 2004d); Secretarial calculations on World Bank WDI database.

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regional and multilateral agreements can increase the foreign (and domestic) firms' confidence to invest in the host economy.

Having noted the *positive list* approach allows flexibility and degree of comfort to make such international commitments, it is not the only approach. A *negative list* approach – where the country identifies sectors and measures to explicitly carve out – holds out the prospect of achieving greater clarity about what is "in" or "out". For services exporters, it may provide more transparency and certainty about the rules for doing their business. The negative list also offers scope to clearly and unambiguously carve out sectors such as public education, health, and drinking water. The preparation of the list also requires the government to carefully assess all their regulations for consistency with disciplines of national treatment, MFN, etc. which in itself may be useful.[8]

2.1.4. *Regional trade agreements create larger markets*

Regional trade agreements (RTAs) help smaller economies attract domestic and foreign investment by creating larger markets and enhancing dynamic gains from trade. Depending upon the industry, such larger markets combined with economies-of-scale can make investment more profitable. In the context of global value chains (with MNEs producing in different locations), market size is no longer defined by national boundaries. Market size will also depend on the network of trade agreements signed by a country which no longer depends upon geography.[9] RTAs can generate both market-seeking and efficiency-seeking domestic and foreign investment (seeking scale economies for investors both inside and outside the RTA).

Tariff-jumping FDI can occur in free trade areas with high external tariffs but this type of investment is not necessarily welfare-enhancing if local costs of production exceed the cost of imports (World Bank, 2000). However, evidence on recent preferential trade agreements suggests that, in addition to their market enlarging effects through trade liberalisation, these agreements include provisions on other issues, such as investment, services, intellectual property or competition policy, which also significantly impact investment and trade. These modern RTAs show little evidence of generating tariff-jumping FDI.

2.1.5. *Facilitating trade can concurrently promote investment and trade*

Efficiency-seeking investment involves large volumes of imports of intermediate products and intra-firm trade between local affiliates and their parent companies. Average customs clearances for imports into India and Ecuador of 10 to 14 days respectively compare unfavourably with the average of only about 2 days for high-income countries. The costs incurred to satisfy customs procedures and technical regulations are sometimes higher than tariffs (World Bank, 2004b). Estimates of border procedure-related trade transaction

costs (TTCs) for international commerce vary widely from 1% to 15% of the traded goods' value. Poor border procedures particularly which increase waiting times, can reduce the number and value of profitable projects dependent on international trade and hinder FDI and investment in general. Even before considering the dynamic gains of inducing such investment, the income gains from reducing TTCs are substantial and particularly for non-OECD countries. Using the minimum estimate of 1% reduction in TTCs on only the goods trade, gross domestic product may gain up to 0.47% on average in non-OECD countries which is seven times higher than in OECD countries because of the former's generally less efficient procedures and composition of their trade (OECD 2003d).

Improving the efficiency of customs administrations can favourably impact on investment decisions by domestic and particularly foreign firms. Transaction costs can be reduced by more transparent and predictable procedures, impartial and uniform administrative border requirements, simplified clearance systems, harmonisation of administrative requirements, the suppression and streamlining of unduly burdensome procedures, co-ordination, risk management and by introducing electronic customs clearance systems. Customs administrations in some developing countries have recently undertaken important reforms with some success in several instances (OECD, 2003a). Also the WTO is currently exploring trade facilitation rules centred on commitments for border and border-related procedures to expedite the movement, release and clearance of goods as well as the development and implementation of a comprehensive technical assistance program.

Trade facilitation is critical to attract investment (in particular FDI) and beyond just customs procedures and technical regulations. Better infrastructure for sea, land and air transport are associated with higher volumes of trade. Importantly, efficient ports explain bilateral trade patterns better than preferential margins. With regards to telecommunications, the supply response to reducing import tariffs on goods is larger the higher the penetration rate of telecommunications. Just-in-time supply chain management may require good infrastructure combined with procedure and regulation improvements (WTO, 2004). For investment in projects depending upon trade, such trade facilitation can be crucial as evident in Costa Rican's relationships with Intel (Box 2.5).

In building infrastructure, a host country may consider public-private partnerships (PPPs). PPPs have been used successfully for clearly defined projects with (or arranged) attributable and delineated revenue. PPPs can be particularly attractive for public entities under tight fiscal constraints and additionally if the private partner brings expertise to the project. Risks, costs and profits can be shared between the public and private entities. Such FDI can foster competition but with the host's influence on ownership control. In particular, PPPs can promote trade in services in sectors where public

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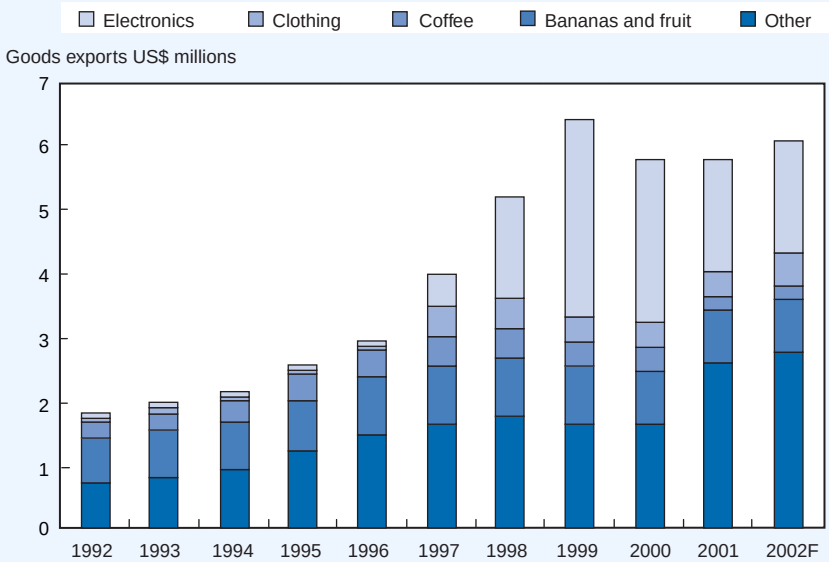
Box 2.5. **Costa Rica and Intel – Using trade promotion and facilitation**

The US computer industry giant Intel Corp. constructed a USD 300 million plant that began operation in 1998 in Costa Rica. A small country of only 3.5 million inhabitants with an industry-specific promotion and export orientation was able to lure a major player and build a world-class high technology "cluster".

Many lessons can be learned from this success but as far as trade policy is concerned, noteworthy is that the Costa Rican investment promotion agency (CINDE) used trade and investment promotion along with trade facilitation to persuade Intel. While Costa Rica listened attentively for infrastructure and operational needs and showered Intel with attention and information, many observers felt that it did not offer excessive concessions to Intel and when concessions were offered, they were applied to all other firms as well. These included waiving a 1% tax on assets (extended to all firms in the Export Processing Zones), upgrading road access, increasing the number of foreign air carriers allowed to fly to Costa Rica so that imports and exports could meet just in time requirements, tweaking the electricity pricing and power arrangements, and expanding the training in electronics and English. Such was to address "legitimate concerns" of Intel.

Although Intel was not the first electronic foreign investor, it has been the catalyst: Intel's arrival dramatically reduced the perceived risk for new investors. With Intel, numerous other companies such as ACER, ALCATEL, Baxter Healthcare, Panasonic, Lucent, Conair, Siemens, and Hitachi, have diversified Costa Rica's economy away from its bananas and coffee dependence. Even though chip prices declined rapidly in 2000 and Intel retooled in 2001, revenues have been coming back. Electronics represent about one third of Costa Rica's exports in 2002.



Source: World Bank FIAS 1998 Occasional Paper 11.

authorities want to remain in charge of the sector opened to private participation. They have been used as an effective tool to promote private investment in sectors of public interest. When competition is opened to foreign companies, PPPs encourage new trade flows through contracts between public and governmental entities and foreign companies.

2.2. Trade policy in host country affecting exports

2.2.1. Anti-export bias can discourage investment

Although using quantitative restrictions is generally prohibited by WTO Agreements, some export restrictions such as licensing or export permits still exist in countries for some products (OECD, 2003d). These policies create an anti-export bias that discourages investment, especially export-oriented FDI which is potentially the most beneficial for the host economy.[10]

2.2.2. Export promotion strategies can help attract investment

Export orientation attracts FDI and FDI contributes to export competitiveness. Costa Rica (Box 2.5) combined trade facilitation and export promotion to what many acknowledge as a beneficial outcome. Because developing countries can have difficulties launching new exports where they have a comparative advantage, export promotion policies are often proactive. Care is needed to ensure concessions (if any) are not excessive. An appropriate export promotion strategy may need to be "trade neutral" or "bias free" and does not necessarily imply government support measures. Trade neutral policies which remove anti-export bias may be sufficient to attract export-oriented investment.

Some countries have policies to target export-oriented FDI in sectors with potentially high productivity gains and backward/forward linkages with domestic firms. This strategy could be justified on the grounds of trade theory once scale economies and dynamic gains of trade are accounted for. However:

- Trade policy is generally not regarded as a first best instrument to target investors because it can induce costly trade distortions.
- WTO's Agreement on Trade-Related Investment Measures (TRIMs) prohibits members from using local content or trade balancing requirements to enforce backward linkages.
- WTO members are also subject to the Agreement on Subsidies and Countervailing Measures (SCM) which prohibits linking subsidies to export requirements.
- Several regional trade and bilateral investment agreements prohibit mandatory export or technology transfer requirements.[11]

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Box 2.6. **Banning log exports is unlikely to induce FDI**

Timber-producing nations have enacted bans on export of logs arguing that this will expand downstream wood processing, improve the scale efficiency of domestic processing, create jobs, retain more value-added nationally and reduce deforestation.

The evidence has not been good for the industrialisation strategy. Cambodia's forest product output fell 40% in one year after imposing a log export ban in 1995 and has shrunk since. Bans on log exports at various times in Malaysia have increased wood-based manufacturing but some observers note there has been little evidence that most of these industries are ever going to become internationally competitive, meaning that they constitute a welfare loss. One estimate of the impact of eliminating the Costa Rican log ban, suggests it would be pareto improving and could generate USD 14 million per year in economic gains.

The domestic value added of sawmilling is frequently negative at world prices in economies with log export bans. Sawmilling USD 100 of logs locally in Indonesia has been estimated to net USD 85 of lumber after the expenses of milling. Such will not induce FDI. Either the domestic mills are inefficient behind protectionist barriers and/or they may be cutting species or grades ill-suited for their mills. The latter problem disappears if mills can trade for logs.

Such log bans also lowers the value of standing timber due to the market constraint imposed by the log export ban. There is a pool of pension investment capital well suited for the long term capital appreciation dynamics of owning timberlands. Institutional investment in timberland increased from about USD 1 billion in 1989 to about USD 14.4 billion in 2002.* This potential source of FDI will generally view log export bans unfavourably.

Empirical evidence also has not been encouraging for the impact of log export bans on forest conservation. For trade liberalisation to increase resource overexploitation and be damaging to welfare may require that the resources are a common pool subject to open access. As integrated forest management schemes are increasingly strengthened in recognition of the problem of the commons, such a scenario is becoming rarer. At best, a log export ban is a second-best policy tool for reducing deforestation and addressing the associated environmental externalities.

* Timberland investment management organisations based in the USA currently manage over 18 million acres of land valued at over USD 14.4 billion, including international holdings (*http://research.yale.edu*).

Source: FAO database; Kishor *et al.*, "Economic and Environmental Benefits of Eliminating Log Export Bans – The Case of Costa Rica" The World Economy, Apr. 2004; Pearce, *Ready for a Change – Crisis and Opportunity in the Coastal Forest Industry*, Nov. 2001; Ferreira, "Trade Policy and Natural Resource Use: The Case for a Quantitative Restriction", University College Dublin; Sundaram and Rock, "Resource Exports And Resource Processing For Export In Southeast Asia", UNU, Tokyo.

- Empirical evidence on the effectiveness of export and technology transfer requirements is mixed. Several studies have concluded local content requirements can be costly and inefficient in terms of resource allocation and growth (UNCTAD, 2004b).

Export processing zones (EPZs) enable a country to liberalise trade in a limited area and to grant specific advantages to exporting firms (such as tax and administrative regulations). EPZs have been created in many developing countries to attract FDI with mixed results for the host economy.[12] Besides EPZs there are other forms of selective liberalisation to try to attract foreign investors while continuing to protect domestic producers from foreign competition. Some countries have succeeded by following this type of strategy but others have not.

2.2.3. Exports of services can be particularly beneficial for developing countries

Developing countries have important export potential in services (UNCTAD, 2002). Besides tourism, some developing countries have been particularly successful in sectors such as port and shipping services, audiovisual services, construction services and health services (OECD, 2004a). As exemplified by India's software industry, computer and related services (Box 2.7) and other highly-skilled activities can also be of export interest to developing countries. These service exports often build on FDI. Many of the firms in developing countries undertaking work outsourced from developed countries are themselves subsidiaries of developed country companies (OECD, 2004a). The subsidiary can then not only provide services to the parent company but also to other markets.

Export-oriented FDI in services has increased considerably. While developed countries dominate services trade overall, developing countries have been particularly successful in some sectors such as audiovisual, port and shipping, construction and health services. They would benefit from considering such strategic sectors in their export promotion policies. A strong domestic market and substantial intra-regional trade helps develop export capacity in services (OECD, 2004a).

2.2.4. Customs procedures and informal export barriers may be burdensome

As noted earlier with regards to imports, efficient customs procedures help a country to offer a business-friendly environment for companies. Export procedures and clearance systems which are not too burdensome facilitate export-orientated projects. In one estimate for Moldova, halving the informal export barriers like cumbersome customs practices, costly regulations and bribes would lift 100 000 to 180 000 individuals out of poverty (World Bank, 2004e). Efficient export procedures (Box 2.8) are crucial to the success of EPZs.

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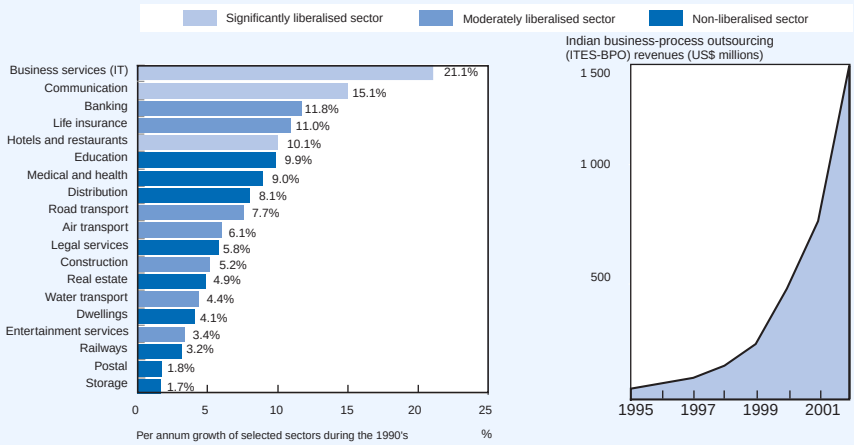
Box 2.7. **International business service outsourcing to India has created value**

India's USD 1.5 billion outsourcing business illustrates how foreign investment and trade have benefited the country. Along with IT and software, business-process outsourcing is perhaps the most open sector. In 2002, it attracted 15 per cent of total foreign direct investment and accounted for 10 per cent of all exports. By 2008, it is expected to attract one-third of all foreign direct investment and to generate USD 60 billion a year in exports, creating nearly a million new jobs in the process.

Being a liberalised sector combined with some investments by a few key MNEs, the outsourcing industry took off. Pioneers such as British Airways, GE and Citigroup were among the first to move IT and other back-office operations to India (entered 1996, 1997 and 1998 respectively). The success of these companies demonstrated that the country was a credible outsourcing destination. The MNEs trained thousands of local workers, many of whom transferred their skills to Indian companies that began in response. For instance, Tata Consultancy Services, recently went public in India valuing the company at USD 8.8 billion with USD 1.2 billion in total revenues (growing at 30% per annum since 1997 and of which more than 90% are exports) and 28 000 employees (growing at 17% p.a.). Now Indian outsourcing firms control over half of the intensely competitive global IT and back-office outsourcing market. Many of the leading ones started as joint ventures or subsidiaries of MNEs or were founded by managers who had worked for them.

Liberalised sectors have grown faster and business process outsourcing has taken off

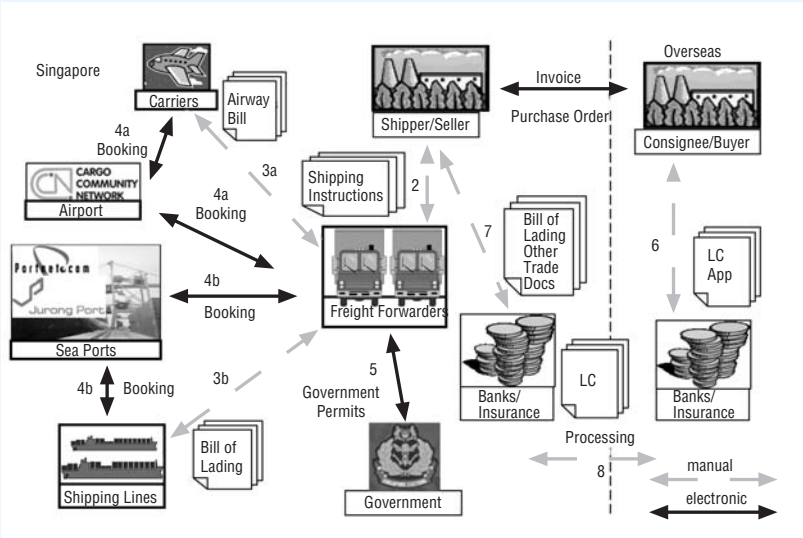


Source: McKinsey Quarterly, 2004; World Bank, 2004c; OECD 2004c.

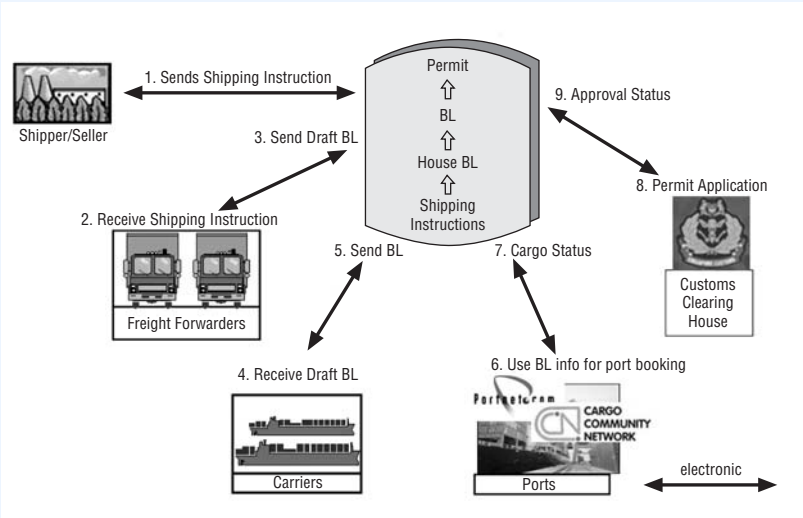
Box 2.8. **Singapore's trade and documentation logistics is becoming even more integrated**

Exporting using traditional shipping documentation is a complex and lengthy process and can involve as many as 25 different parties and 30-40 different trade documents including bookings, shipping instructions, bills of lading, letters of credit, government permits, etc. One UN study reports up to 60-70% of the data used in one form is re keyed into another form.

The current logistic documentation



The future



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Box 2.8. **Singapore's trade and documentation logistics is becoming even more integrated** *(cont.)*

Singapore developed in 1989 the world's first nationwide electronic trade documentation system TradeNet to receive permits from Singapore Customs and other government authorities almost instantaneously. Turnaround time for processing typical trade documents was reduced from 2-4 days to as little as 15 minutes. This system increased efficiency and lowered business costs for the trading community as well as provided benefits to the Customs administrators. In June 2004, a new integrated trade and logistics information and technology platform was announced to centralise all information for shipping in, to and from Singapore. Companies will no longer need to access multiple systems to enter the same or similar information. Singapore anticipates saving potentially USD 400 million over 20 years. In addition new logistics value added services like multi-country consolidation may generate five times that savings in new revenue. Companies operating in Singapore's export platform should benefit.

Source: OECD, 2003a; Harvard Business CAER Paper 72, April 2000; Singapore IDA Media Portal.

2.3. Trade policy in the home country affecting imports

2.3.1. Market access for developing country products can create new opportunities

Export-oriented domestic and foreign investment in developing countries depends upon market access in developed countries or other countries with large markets. If host country firms face high trade barriers to their main markets, there will be less investment – domestic or foreign into the host country. Even developing countries' traditional advantages of low labour costs and abundance of natural resources can be negated.

High home country barriers can be detrimental to the home's own MNE's integration and global production strategies. That can jeopardise their ability to compete internationally. More generally, any slowdown in the multilateral liberalisation process hinders the opportunities of efficiency-seeking investment.

Two market access policy techniques are worthwhile emphasising: *i) tariff peaks* are often used by countries to protect domestic producers from new competitors and tend to be concentrated on products such as[13] certain types of tobacco, nuts and fruits, grains, prepared meats and leather and footwear – products that developing countries export or could export (World Bank, 2002); and *ii) tariff escalation* occurs when tariffs on processed goods are higher than tariffs on related raw materials. Figure 2.4 demonstrates tariff escalation for representative wood products, cotton textiles and passenger cars. As value is

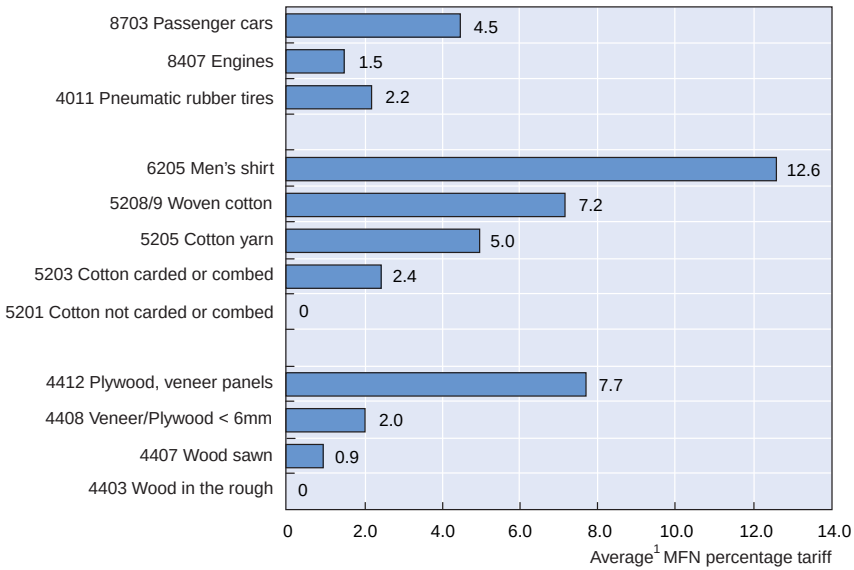
Box 2.9. **The elimination of MFA quotas could dramatically alter "competitive advantages"**

Multi-Fibre Arrangement quotas in the textile and clothing industry illustrate how protectionist policies in industrialised countries affect FDI location in developing countries. Countries with under-utilised quotas have benefited from higher FDI flows and dynamic gains from new activities that otherwise might have been located in more competitive countries. Binding quotas on the most competitive exporters have reduced their welfare gains from specialisation and economies of scale. Besides being dependent upon picking "winners and losers", these policies introduced trade distortions that lead to an overall loss for the world economy.

There was also a risk that countries have specialised in sectors where they had no true comparative advantage or sectors with potentially less dynamic gains. The scheduled elimination of quantitative restrictions at the end of 2004 could dramatically alter the economics of textile and clothing production. Many expect that the current international fragmentation between the textile and clothing phases of the supply chain will integrate and the attraction of outward processing programmes will fade. The planning for the post 2004 market has already encouraged a reordering of investment and production plans towards the most competitive and integrated suppliers, especially in China.

Source: OECD 2004d; World Bank 2002.

Figure 2.4. **Tariff escalation: higher tariffs for higher valued products in the same value chain**



1. Mean of USA, EU, Jappan and Canada for sub-headings under this HSC heading in 2000.

Source: Data from UNCTAD TRAINS; OECD Secretariat calculations.

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added, tariffs tend to be higher. Such escalation can threaten the diversification and upgrading of exports in developing countries and discourage export-oriented FDI.

Barriers applied to imports entering developing countries are on average higher than in developed countries. They include high tariffs, quantitative restrictions, import controls, import bans, etc. These barriers between developing countries can be particularly damaging. More than half of the additional welfare for developing countries created by removing the remaining post-Uruguay Round trade barriers may come from liberalising trade with other developing countries (*i.e.* South-South trade) rather than developed countries (*i.e.* North-South trade).[14] Barriers between developing countries reduce intra-regional trade which can prevent the creation of larger markets. This will discourage foreign investors but also discourage even the formation of developing country efficiency-seeking MNEs. Possibly more than one-third of FDI into developing countries comes from other developing countries and such South-South FDI may have grown faster than developed country sources and also have remained relatively more resilient in the post-Asian-crisis period (UNCTAD 2004c).

2.3.2. Trade remedies cause investor concerns

Anti-dumping procedures, safeguards and countervailing measures are trade remedies used to protect an industry threatened or injured by foreign competition. In some cases, they may have an economic value.[15] They are legal measures accepted in WTO agreements but can be a major concern for exporters. These measures tend to be assessed against higher valued products and designed to offer relief to industries which are facing increased competition. Hence they can have the effect of preventing developing countries from advancing up the value chain.

Anti-dumping procedures, along with safeguards and countervailing measures, are sometimes described as having a "chill effect" on investment as they introduce uncertainty concerning market access for products exported from host countries. Even the threat of such measures can redirect FDI from a possible host to the home country, a case known as "*quid pro quo*" investment.[16] Investors seek predictability.

2.3.3. Trade preferences may benefit developing countries

Trade preferences encourage investment by giving developing countries better market access. Preferences can influence investor's choice of location by increasing the profitability of investment in selected countries.

Sometimes trade preferences may not be effective. As noted with the MFA quota elimination (Box 2.9) if the preferences do not reinforce a comparative

Box 2.10. **African exports under AGOA are increasing, and some evidence of FDI too***

Imports from Sub-Saharan Africa to the USA have risen dramatically. The price of oil is only part of the reason. Since its inauguration in 2000, the African Growth and Opportunity Act (AGOA) provides duty- and quota-free access into the USA to various exports from selected African countries. US imports under AGOA could exceed USD 20 billion in 2004, a figure that has grown from under USD 9 billion in 2002.

While the increased trade is reasonably clear, the link to more FDI entering Africa has been more anecdotal. In their 2004 Comprehensive report, the USTR identified seven example textile/apparel projects that are in various stages of start-up requiring about USD 500 million in FDI from various international sources. Also tabled was the USD 350 million Chad-Cameroon oil pipeline. AGOA has also been identified in the past as a contributor to create 38 000 South African jobs (many in the auto industry). Mauritius did well from textiles and tourism before AGOA was launched, but many of its textile companies are investing in other parts of Africa including a cotton thread factory in Mali. Mauritius also plans a factory to spin yarn, to take advantage of AGOA III.

AGOA III, the latest enactment signed July 2004, extends preferential access for imports until 2015 and allows more third country fabric sources for three years. With the longer time frame, investment may make more sense. With the ability to source fabric from more non-USA sources, losing the cost disadvantage of shipping fabric from the USA may make the African textile/clothing industry more competitive.

* AGOA is not the only such opportunity for Sub-Saharan Africa. Many developed countries offer preferential treatment including the EU under GSP and Economic Partnership Agreements.

Source: The Economist; AGOA Web site, USITC May 2004 Comprehensive Report; OECD (2003b, 2004d).

advantage then there is a risk that if these preferences are eroded, the investment will be uncompetitive. Investment will be particularly sensitive to this risk if its payback period exceeds the term of the granted preference.

Rules of origin in relation to preferences and RTAs also affect investment decisions of companies. When they prevent a company from importing inputs from the most efficient countries, rules of origin discourage efficiency-seeking FDI (UNCTAD, 2002). Preferences granted to developing countries may be undermined by the rules of origin as most products exported from these countries will be excluded from the preferential treatment if they incorporate inputs from third country suppliers (OECD, 2004d).

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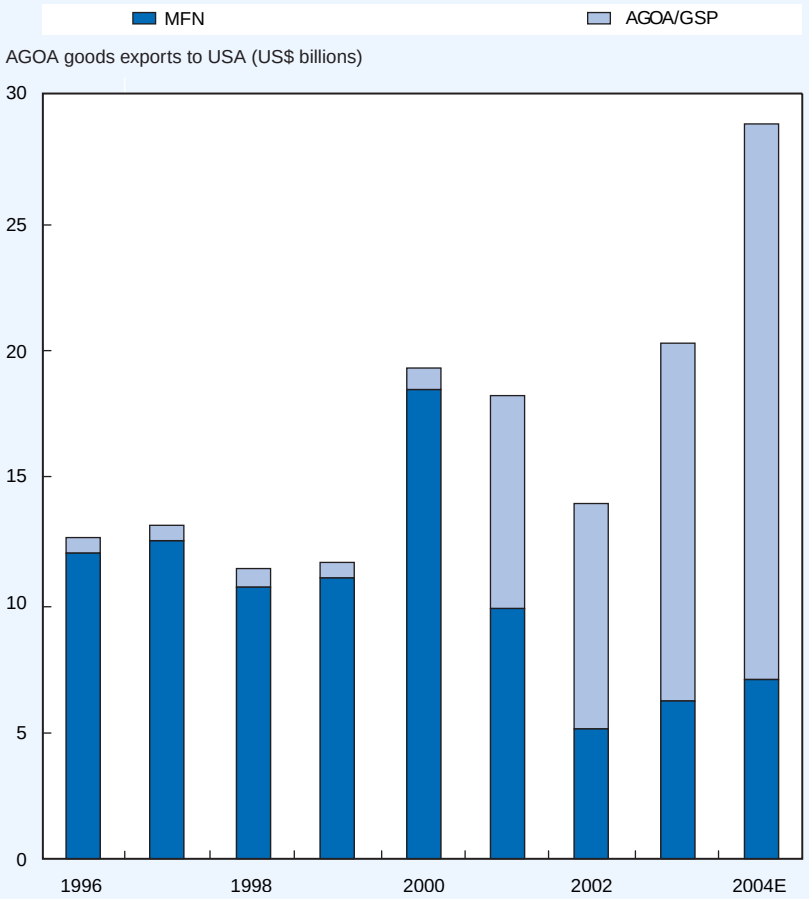
Box 2.10. **African exports under AGOA are increasing, and some evidence of FDI too*** *(cont.)*



Source: USITC trade database; OECD.

* AGOA is not the only such opportunity for Sub-Saharan Africa. Many developed countries offer preferential treatment including the EU under GSP and Economic Partnership Agreements.

2.3.4. Access to services markets can be critical

Access to services markets also matters to encourage export-oriented FDI in developing countries. To provide services via mode 1 or 2 and take advantage of outsourcing opportunities, developing countries need market access in sectors where they have a strong potential.

Liberalisation of mode 4 in home countries can also contribute to increase investment and to create linkages in host countries. Temporary workers of developing countries working in developed countries can return home and help foreign or domestic companies start new activities, Box 2.11.

The temporary movement of natural persons as service suppliers can also make businesses in the home country aware of the pool of skilled labour in the host country and lead to the cost effective outsourcing of work and create value. The Indian business processing outsourcing (Box 2.7) exemplifies how value can be created in developing countries in services which allow the MNEs in the developed countries to become more efficient, globally competitive and assuming their business is competitive, pass the benefit largely to consumers potentially worldwide.

2.4. Trade policies in the home country affecting exports

2.4.1. Home export subsidies may discourage host investment

Export subsidies (as well as domestic supports) in the home country for goods that could otherwise be imported from developing countries discourage export-oriented investment in these countries. Subsidised products sold on third-country markets also harm developing countries producers and reduce incentives for firms to invest in their industries. This may be a rare example where more trade may occur, some may benefit, investment may be redirected, but overall the scenario would be welfare damaging.

Export subsidies on capital goods and intermediate inputs (the latter if there is confidence the subsidies will be ongoing) could lead to investment. Such may improve the return on the investment in the host country. Also, potentially there may be market failures in financing which might be better addressed in the more established credit and securities markets of a home rather than host jurisdiction. If such is the case, then home government export credit, insurance or trade finance may make sense if commercial sources are unavailable. Such a case is becoming rarer if capital markets continue to deepen and broaden in the credit they will finance.

2.4.2. Export controls and restrictions while often required can impede technology transfers to hosts

There are international obligations which require countries to apply export restrictions.[17] Some export controls[18] are designed to avoid disseminating sensitive technologies that may have repercussions for national and international security. In implementing these controls, balance between security and trade is required to be in line with international obligations. This balance is needed between legitimate security concerns at home and the host countries' trade interests.

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Box 2.11. **Taiwan's Hsinchu Science based Industrial Park entrepreneurs return home**

Two thirds of all notebook computers are made in Taiwan. Taiwan owes much of its export success in electronics to two factors: *i)* its close links with the US, particularly through the thousands of young people that go each year to study at American universities and end up working in Silicon Valley; and, *ii)* the commoditisation of the PC in the early 1980s such that the likes of Dell and Hewlett Packard sell their brand name equipment from Original Equipment Manufacturers (OEMs) like those in Taiwan. It was the Taiwanese working in Silicon Valley who spotted this commoditisation first, and recognised that their home country was a good place for all those no-name companies.

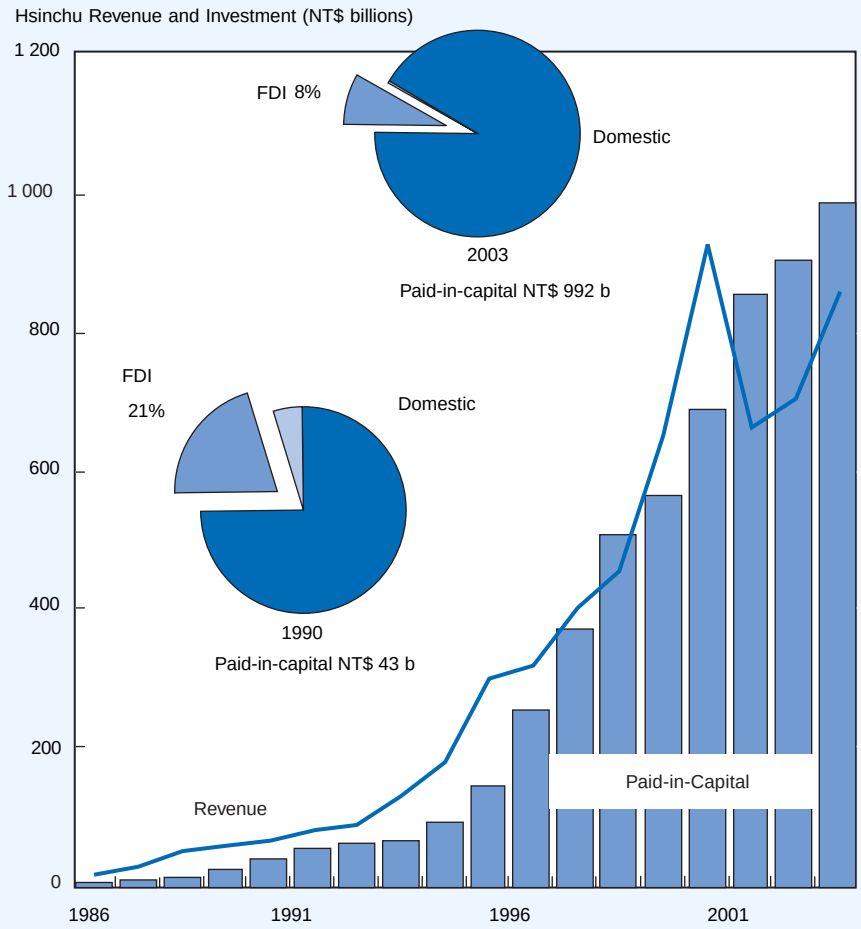
Government officials travelled regularly to America in the 1970s and early 1980s, seeking the advice of Taiwanese-Americans in industry and academia and luring back some of the best. Taiwan had already gone through the usual development phases of attracting export-oriented foreign firms and developing its own export industries. But as its labour was no longer cheap, it needed higher valued exports. With ex-Silicon Valley entrepreneurs, the government built the beginnings of Hsinchu; helping companies settle by offering tax incentives, shared factory space and a location beside a national laboratory from which many of Taiwan's most successful high-tech firms have been spun off. They further encouraged a venture-capital industry, convincing a Taiwanese executive from Hambrecht and Quist, one of Silicon Valley's top investment banks, to set up a venture fund in Taiwan which spurred many imitators.

Since Hsinchu began in 1980, the park has become home to 369 companies exporting integrated circuits, personal computers and other electronics for total of USD 25 billion per year. Paid-in-capital has grown to USD 29 billion of which now only 8% is foreign sourced, down from 21% in 1990.

The mode 4 workers were crucial to the success of Hsinchu but the Taiwanese host country has not been the only beneficiary. Home country consumers have benefited with lower cost laptops while Dell and Hewlett Packard – Home MNEs – concentrate on their competitive advantages of design, marketing and distribution.

Source: The Economist; Market Intelligence Center; Hsinchu Web site.

Box 2.11. **Taiwan's Hsinchu Science based Industrial Park entrepreneurs return home** *(cont.)*



Source: Hsinchu Web site; 1 USD = 34 NT$ as at 19 Aug. 2004.

It is also possible that an export control or restriction may induce an investment in a host country that would have otherwise made sense in the home country. This would be the counterpart of "tariff-jumping" FDI in the context of export restrictions rather than import tariffs.[19]

As capital and trade move more freely, what home governments do with their export policies and how it impacts development in host countries becomes less critical – the host country's policies tend to be more crucial.

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Hence it may not be surprising that very little work has been done on the impact of home country trade export policies on investment patterns.

3. Issues for consideration

Both domestic- and foreign-sourced investment is important for host countries and recent studies stress their complementarity. Generally liberalizing trade policies will encourage FDI and will also encourage domestic investment.

Circumstances change. Trade policy makers may need to adapt and revise government policies as needs and the relative competitive advantages change. Usually it is not the trade policy that defines competitive advantage but rather sets the framework for competitive industries to develop.

Among the main issues with respect to the contribution of trade policy to creating an attractive environment for investment and growth generally, policy makers may consider to what extent their trade policies:

1. restrict the size of potential markets for investors and how domestic reforms and international policy dialogue can create new investment and FDI opportunities by enlarging local/regional markets and giving access to new export markets in third countries;
2. towards imports are discouraging investment by restricting the access of prospective investors (particularly foreign) to intermediate inputs, including services, that are not available locally at the prices and quality required for internationally competitive production;
3. are adding to the costs of customs and administrative procedures that may make them out of line with international norms and unnecessarily discouraging investment;
4. are incoherent or inconsistent that could discourage investors by creating an anti-export bias or introducing distortions between the most efficient modes of supplying goods and services – an import tariff may have a similar effect to an export tax;
5. may curtail developing country exports, reducing the developing country's ability to purchase imports and ability to source investment including FDI;
6. may curb imports from other countries that may benefit the home country's consumers including intermediary products used by their own efficiency-seeking MNEs; and
7. deter creation and expansion of their own (home) country's efficiency-seeking MNEs that may need to become internationally competitive using a foreign host's competitive advantage but needing at least initial market access in the home jurisdiction.

In many countries, a virtuous circle of trade liberalisation, investment and welfare enhancement has been observed. Liberalizing trade policies can be both an incentive for investment and a catalyst for its positive effects on growth and this is true from the perspective of both the host and home countries. Liberalizing trade is not a panacea but in coherence with other policies, it is integral to both, attract investment and best utilise that investment for growth.

Notes

1. FDI is often classified into four types according to the investing firm's motives: market-seeking (to get access to new foreign markets), resource-seeking (to get access to resources not available at home), efficiency-seeking (to take advantage of cost differences/scale economies and rationalise production), and strategic asset seeking (to acquire strategic assets or prevent competitors from obtaining them). Dunning, J. (2002), "Determinants of Foreign Direct Investment: Globalization Induced Changes and the Role of FDI Policies", paper presented at the ABCDE-Europe Conference, Oslo, June 24, 2002.
2. Under the Guidelines, MNEs should "encourage through close co-operation with the local community, including business interests" (General policies #3) and encourage transfer and rapid diffusion of technologies and know-how (Science and Technology #1 to #5) (OECD, 2000).
3. After some high profile failures in 2002, e-B2B statistics have been increasing. Of firms surveyed spending USD 100 million or more on goods, 11.7% of *intermediary inputs* were purchased online in 2003 and surpassed the figure for indirect materials, such as office supplies for the first time. Online sourcing can bring year-on-year cost savings of 5%. (Financial Times/Forester Research, October 2003).
4. Some technologies may benefit small firms in poor countries more. For example, credit available to small firms in poor countries increases more than average when credit information sharing technology is applied (World Bank, forthcoming). As costs fall for many new technologies, benefits may accrue more to smaller and poorer participants.
5. While FDI inflows to developing countries come primarily from developed countries, there is a significant share from other developing countries. South-south investment is estimated at about 36% of total FDI inflows to developing countries in 2000 and is growing faster than North-South FDI (World Bank, 2003a).
6. In Figure 2.A1.2 of Annex A, trade impediments considered serious or very serious by firms are similar for developed or developing countries but predictably for instance, the "impediments to mobility of business people" is more an issue for firms of developing countries, and "foreign investment restrictions" is more an issue for firms of developed countries.
7. Chakrabarti, A. (2001), "The Determinants of Foreign Direct Investment: Sensitivity Analyses of Cross-Country Regressions", Kyklos, vol. 54, 1, pp. 89-114.
8. For a discussion of the potential benefits, New Zealand outlines the reasons for adopting the negative list approach in their Chile and Singapore *Closer Economic Partnership* agreements. *www.mfat.govt.nz/foreign/tnd/ceps/cepchilenzsing/*

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infobulletinjuly04.html. OECD, *Regionalism and the Multilateral Trading System*, 2003, pages 33-37 also discusses the negative vs positive list approaches.

9. There is a trend to more cross-regional RTAs. As at October 2003, 40% of the proposed RTAs notified to the WTO were cross-regional (WTO Regionalism workshop, 2003).

10. Some theoreticians argue if the host country is a "large" exporting country which can affect the terms of trade for the product exported, then an export tax can be welfare enhancing. This is largely hypothetical because few countries can influence their exports' long-term world market prices.

11. For instance NAFTA 1106(1) states that host countries can not oblige a company of a partner to export a given level or percentage of goods or services or to transfer technology, a production process or other proprietary knowledge (subject to competition issues).

12. The competition in incentives can cause a "prisoner's dilemma" for any individual state. Such has been an argument for a multilateral agreement to limit the proliferation and escalation of location incentives. In addition, local labour legislation may not be fully enforced in the EPZs.

13. Listing is of products whose tariff rate exceed 50% in any 8-digit subheading in any of USA, EU, Japan or Canada. Many other goods exceed 15% – a frequently-used criterion to identify peaks.

14. 57% estimated by Anderson, K., "Agriculture, Developing Countries and the WTO Millennium Round", CEPR/CIES, December 1999.

15. Some argue that such measures are *ex ante* instruments that allow countries to commit to international agreements they would otherwise be unable to sign without such "escape" clauses.

16. Blonigen, B. A. and R.C. Feenstra (1996), "Protectionist Threat and Foreign Direct Investment", NBER Working Papers No. 5475, March. See also Bhagwati *et al.*, "Quid Pro Quo Investment", American Economic Review, 82(2), May 1992.

17. Including for example CITES, Montreal Protocol on the Ozone Layer, Nuclear Non-Proliferation. For an illustrative list of restrictions adhering to such obligations, see Table 3, OECD TD/TC/WP(2003)7/FINAL.

18. Such as the export controls of "dual use" items as recommended by UNSC Resolution 1540 of 28 April 2004.

19. As an example, in May 1981, the Japanese (home) voluntary export restraint of automobiles into the USA (host) may have induced Honda, Nissan and Toyota to invest in plants in the USA.

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ANNEX 2.A1

Framework Considerations for Measuring the Effectiveness of Trade Policies and "Good Practices"

A.I. Foreword

The Policy Framework for Investment is to be a non-prescriptive, flexible, operational and practical guide for policymakers. The body of this paper identifies and explores specific trade policies and their impact on investment and growth. This annex is a possible framework for a flexible, operational guide to *trade* policy making.[1]

Box 2.A1.1 introduces the underlying participants of a project and reiterates the importance of trade policy. The next section provides a trade policy framework addressing appropriate tools and measures. The final section focuses on the role of governments in trade policy and how some of the examples discussed in the text may illustrate "good practices".

A.II. The trade policy framework

Trade policy making is iterative, interactive and evolving

Almost all the good practices documented in this paper were iterative and interactive; governments, entrepreneurs, investors and other concerned parties co-operating and negotiating to provide the right environment for successful projects. There is a loop at work. Throughout the loop, the trade policy makers need to consider "have circumstances changed?" and if so, what such changes imply for the country's attributes, opportunities and appropriate policies.

Good trade policies will not necessarily be identical for all countries. This is particularly true for smaller, less-endowed countries that may need to target their resources most effectively. Small countries in particular can

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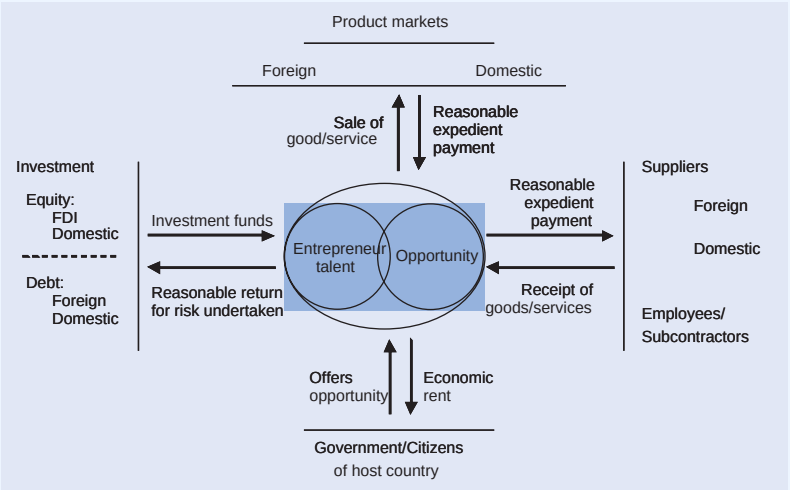
Box 2.A1.1. **The confluence of an entrepreneur with a FDI opportunity will involve trade**



A project is the confluence of an opportunity (be it a market, resource, efficiency, or M&A opportunity) and entrepreneurial talent. The "knowledge-capital MNE model" recognises that *MNEs transfer entrepreneurial talent rather than financial resources*. But entrepreneurial talent is not necessarily supplied solely by the foreigner or a domestic participant, it can arise from a joint venture or franchise whereby the talent is supplied by both domestic and foreign participants; as for example the entrepreneurs of Taiwan's Hsinchu Park (Box 2.11).

With very few exceptions, a project will require investment capital. The entrepreneur must promote the opportunity to the financiers and choose the most cost effective instruments offered so as to minimise the cost of capital for the project. The entrepreneur must market the merits of the project – minimising the perceived risk. Not only may the project's viability and initiation depend upon that "selling" but also the return to the entrepreneur/opportunity.[1]

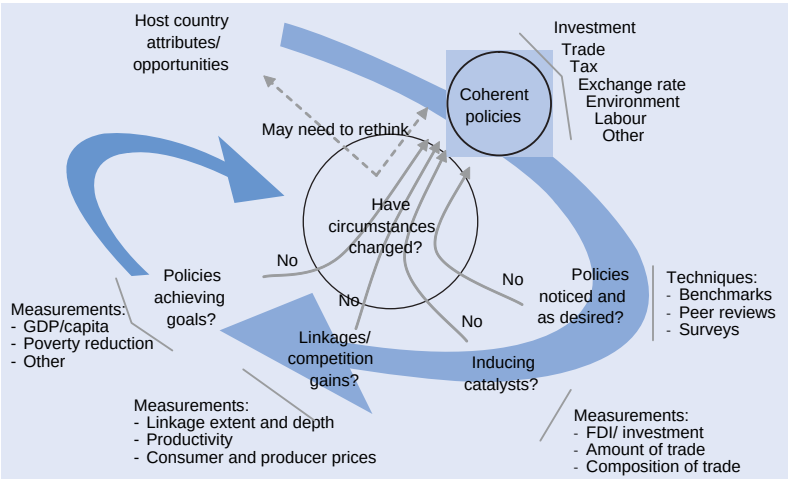
The entrepreneur will "sell" the merits of the project using a business plan. All business plans must – and usually it is the first item – describe the product market. *For a FDI-financed project today, that product market will be international with rare exceptions*.[2] Therefore trade is involved and a liberal trade policy is likely to be essential for the project to be viable.

Box 2.A1.1. **The confluence of an entrepreneur with a FDI opportunity will involve trade** *(cont.)*

The project will typically require supplies of raw materials, goods and services usually during all phases of the project (building, start up and operating). *For FDI-financed projects, some supplies must be foreign* except for the rare occasion.[3] Therefore again trade is involved and a liberal trade policy is once again integral for the project.

1. Note that the host government's interests and the entrepreneur's can be largely considered the same. Negotiation between the two can frequently assume a positive-sum game. This was one of the lessons of Costa Rica (Box 2.5). There will be negotiation to split the economic rent from the entrepreneur's reasonable return but that should be secondary to the value that can be achieved through a successful project.
2. The product market will be international recognising the arguments in the text of this paper. Resource seeking FDI and the ever more present efficiency-seeking FDI both by definition involve international product markets. Only market-seeking FDI may be focused solely on domestic product markets but more frequently now, scale economics require serving a regional trade area, *i.e.* international product markets.
3. For efficiency-seeking or market-seeking FDI, this international component/product supply is self-evident. For resource-seeking FDI, some foreign-source equipment is likely to give the foreign company the credibility to do the project otherwise investors will question what advantage the foreign company brings to the project. Note that these considerations taken with those in Note 2 above imply that almost every FDI financed project must have some trade-related aspect.

Figure 2.A1.1. **The trade policy-making loop; measuring up and sensing change**



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benefit from trade and investment. No developing country is "too small" or "too poor" to attract FDI (OECD, 2004e), but they may need to plan. Especially for small countries, the host country may need to realistically assess their comparative advantage. What are the country's attributes and what opportunities should the host government emphasise? When possible, host governments may let market forces identify the successful businesses and not preclude sectors by "picking winners and losers". A level playing field for trade policies is often best even for small economies.

While not necessarily being the same for all countries, trade policies need to be coherent with the rest of the policies of the country.[2] Liberal trade is no panacea. Trade policy alone will not achieve higher GDP/capita, poverty reduction and those other ultimate goals without coherence with investment, tax and other policies.

Nonetheless there are some interim steps and measurements that can guide trade policy makers in assessing whether the economy is moving toward those ultimate goals. Are the trade policies: *i)* getting noticed and will the reactions to those policies attract investment, trade and growth?; *ii)* inducing the catalysts, in particular those entrepreneurs and financiers referred to in the prior section to invest in the economy?, and; *iii)* contributing to growth in the domestic economy through linkages and a more competitive atmosphere? These are interim considerations, each having their own measurements, but often interlinked. Inducing potential catalysts may depend upon sourcing those domestic suppliers and competitively priced component parts. The following three sections focus on these interim steps.

Are the trade policies getting noticed and appreciated?

To be effective, trade policy reforms need to be seen. Small countries in particular may have to be proactive to get noticed. There are three techniques whereby trade policy makers can get noticed and at the same time make sure that the message is the one they want.

Trade policy reforms will influence benchmarks

Annex B lists twelve benchmark indices that are influenced by trade policy.[3] Such ratings are used comparatively across countries as well as over time to reflect improving or deteriorating investment conditions, of which one contributor will be trade policy. An improving and comparatively good relative index would assist a country to attract domestic and foreign investment. They have been used by entrepreneurs in business plans to reassure investors. An improvement and comparison in these measures can also tell trade policy makers if a country's efforts to improve policy are working.

Frequently the benchmark indices will use proprietary statistical techniques. Also qualitative judgment is sometimes used as in the case of Standard and Poor's sovereign ratings. Hence it is commonly impossible to be definitive on how trade policies eventually flow into the rating score. This underscores the importance of trade policy makers being proactive and marketing their country's attributes and policies to the rating agencies themselves.

Some of these benchmarks have been statistically analysed by the OECD and provide mixed but potentially useful predictions of inward FDI. Overall indices themselves may predict poorly but the sub-indices – in particular the indicators of regulatory quality and restrictiveness, government intervention, macroeconomic stability and technological advancement – correlate more

Box 2.A1.2. **An illustration: how trade policy affects the *Economic Freedom of the World* index**

As an example of how trade policy impacts such indices, the Fraser Institute's *Economic Freedom of the World* index includes five "Freedom to Trade Internationally" measures (one of 5 areas scored):

Measure	Converted to a score of 0 to 10 with	
	0 if	10 if
1) Taxes on International Trade		
a) Revenue from taxes on internal trade as a percentage of exports plus imports	No taxes	Taxes ≥ 15% of total trade
b) Mean tariff rate	No tariffs	Average ≥ 50%
c) Standard deviation (SD) of tariff rates	Uniform tariffs	SD ≥ 25%
2) Regulatory trade barriers		
a) Hidden import barriers	Uses GCR*	
b) Costs of importing including tariffs, license fees, bank fees, and time required for administrative red tape of importing equipment using GCR*	Cost ≤10% of equipment cost	Cost ≥ 50%
3) Actual trade compared to expected using regression.	Actual trade twice predicted	Actual trade half predicted
4) Official *versus* black-market exchange rates	No black market	Black market ≥ 50% premium to official
5) International capital market controls		
a) Access of citizens to foreign capital and foreign access to domestic capital markets	Uses a survey within the GCR*	
b) Restrictions on engaging in capital market exchange with foreigners	Uses the IMF report on 13 types of capital controls.	

* GCR: Global Competitiveness Report.

Source: www.freetheworld.com.

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closely with FDI inflows (OECD, 2004e). Hence trade policy which in some cases impacts these sub-indices more may be more influential in attracting FDI than implied by trade policy's effect on the overall index itself.

The benchmarks tend to explain different economic characteristics and differ in the level of generalisation (OECD, 2004e). It is also probable within the set of benchmarks provided in Annex B, that some benchmarks are more sensitive to the type of investment instrument and circumstance. Noteworthy, the rating agencies are particularly influential for large projects involving "investment-grade" debt financing but probably less influential in more risky circumstances. Hence, countries may need to focus on different benchmarks depending upon their particular circumstance and the type of projects they are trying to attract.

For the practical aspects of a trade policymaker, they may wish to track the benchmark scores of particular interest over time and relative to their neighbouring countries in terms of geography and income. They may also consider defining which policy changes could make the most impact for the least effort. These could often be simplifications to regulations (World Bank, 2004b). They may also wish to contact the agency or group responsible for the index to discuss the particulars of their circumstance. This is a two-way communication – the policy maker may understand what drives the rating (and investors) at the same time the agency understands how motivated the country is to modify and improve the trade and investment environment. It can be a virtuous circle.

Most benchmark indices overlook the importance of *services* trade. Noticeably absent in the *Freedom to Trade Internationally* is any measure of the restrictiveness for trade in the service sectors, particularly for the banking and telecommunications sectors. As such, trade policy makers (also rating agencies and investors) may seek other indices being developed, including those in the OECD Trade Directorate.[4]

Peer reviews can guide effective policy making

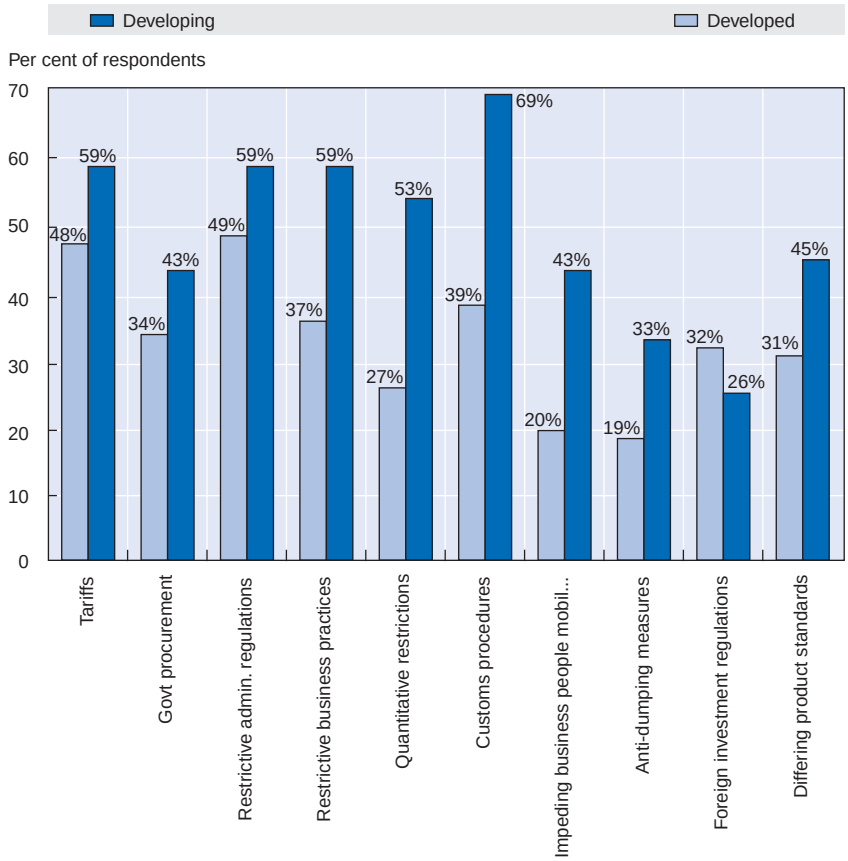
Peer review is a process whereby the quality and efficiency of a country's policies, laws, regulations, processes and institutions are examined and assessed *vis-à-vis* those of their peers, in a non-adversarial context. Effectiveness of peer reviews derives from the influence of the peers during the process: *i)* mix of recommendations and dialogue with the peer countries; *ii)* public scrutiny, comparisons, and ranking among countries; and *iii)* the impact of the above on domestic public opinion, national administrations and policy makers. The ultimate goal of peer reviews is to help or encourage the reviewed country to: improve its policy making; adopt best practices; and comply with established standards and principles.[5]

The most directly applicable peer review for trade policy is the WTO's Trade Policy Review Mechanism. Peer reviews carried out by other international organisations which cover elements of trade policy include: OECD EDRC Economic Surveys; APEC Individual Action Plan (IAP); IMF Country Surveillance Mechanism; IMF/World Bank Financial Sector Assessment Program (FSAP); and the UNCTAD Investment Policy Reviews.

Surveying businesses can give insights

Several benchmarks above assess policies in part by surveying businesses. Trade policy makers may also survey businesses and other parties themselves. APEC surveyed 461 firms in 21 countries (Figure 2.A1.2):[6]

Figure 2.A1.2. **Trade impediments considered serious or very serious**



Source: APEC Business Facilitation Survey; Sept. 2000.

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- Trade impediments were consistently considered higher in developing countries (*vis-à-vis* developed countries) except for foreign investment regulations – 26% of the respondents of developing *versus* 32% of developed-country firms identified foreign investment regulations as a serious or very serious trade impediment.
- Developing country firms (*vis-à-vis* developed) were impacted visibly more by customs procedures, the impediments to mobility of business people, quantitative restrictions and restrictive business practices.
- The highest scoring impediment for developed country firms was restrictive administrative regulations.

Are the trade policies inducing the potential catalysts?

Surveying businesses can lead to insights. It hopefully can also lead to those entrepreneurs that can bring together the elements for successful projects. Success in inducing catalysts will increase two key statistics: the inflow of FDI and trade. As explained in Section 1 of the main text, sometimes FDI can lead to current account deficits. Hence the composition of the imports can also be important. If the imports are capital items that will earn a return rather than simply be consumed, then the trade policy maker and the benchmark rating agencies may be less concerned.

Some trade policy reforms have negligible costs; others are suited to cost-benefit analysis

Some trade policy reforms need not be fiscally costly. Applying uniform tariffs (as per Chile, Box 2.2), can be fiscally neutral. Listening attentively (as per Costa Rica, Box 2.5) is cheap and yet a host government may find infrastructure opportunities beneficial to both MNEs and themselves. For Costa Rica, some improvements such as the increased frequency of international air carriers benefited more than just Intel. Also some of the infrastructure improvements were jointly-financed by Intel and the Costa Rican government to the benefit of both Intel and the residents of Costa Rica.

But if concessions are given or expenses are incurred for trade facilitation or trade promotion, then care is appropriate. One tool available to the trade policy maker is a traditional cost-benefit analysis. As an example of the potential difficulties, estimates of expanding the Czech investment and trade promotion suggest that the social price may exceed USD 40 000 per job created (UNCTAD, 2004a).

Are we getting the backward linkages and competition gains?

There are two concepts when measuring the effectiveness of linkages (UNCTAD, 2001). For measuring the *extent* of linkages, three measures (or

variations thereof) have been studied: a simple count of the number of domestic firms that supply a foreign affiliate; the value of local contracts supplied; and, the share of value-added by local suppliers to the total value added by the foreign affiliates. All three measures rise as linkages to foreign affiliates to domestic firms increase. If they do not, then the host government may need to be proactively strengthening these links as was the aim of Ireland's National Linkage program (Box 2.1).

Measuring the *depth* of linkages is more complex. Good linkages should increase supplier productivity, improve quality, intensify the amount of technology used and shift the supplier to higher-value products. To attribute any improvement in these measures to linkages rather than say technology advances is difficult. Surveys of foreign affiliates and their suppliers may give some insight. These may identify a further education or technology strategy that the host government may need such as Costa Rica's trade promotion and facilitation co-ordination with Intel (Box 2.5). Listening to the entrepreneurs in India and Taiwan (Box 2.7 and 2.11 respectively) identified productivity gains.

Another factor in assessing whether the economy is achieving the competitiveness gains of liberalisation is to measure consumer and producer prices (over time and relative to neighbouring countries). Lower relative prices can indicate improving competitiveness for local industries – since local industries also consume – as well as being beneficial to final consumers in the economy. Increased consumer surplus can be a general benefit of the trade induced by the foreign investment.

A.III. The governments play an essential role

The host government (typically acting on behalf of the citizens) offers the opportunity for which they would receive benefits in the form of taxes (income, resource or other). The entrepreneur needs fair compensation but to the extent that there is excessive profit (economic rent), conceptually *a good practice would pass these excessive returns to the host government/citizens*. It is easier said than done.

In an ideal world, policies and agreements between the host government, entrepreneurs and others, are well defined and determined preferably before major expenses are incurred by the entrepreneur. Few dispute a host's right to regulate, but many consider it inappropriate to change the rules or have conflicting rules. This requires a balanced assessment.

Just the perception of policy uncertainty can be detrimental. Uncertainty will increase the return on investment required by investors if not cancel the investment altogether. Policy – including trade policy – uncertainty can be a major concern in developing countries, Figure 2.A1.3.

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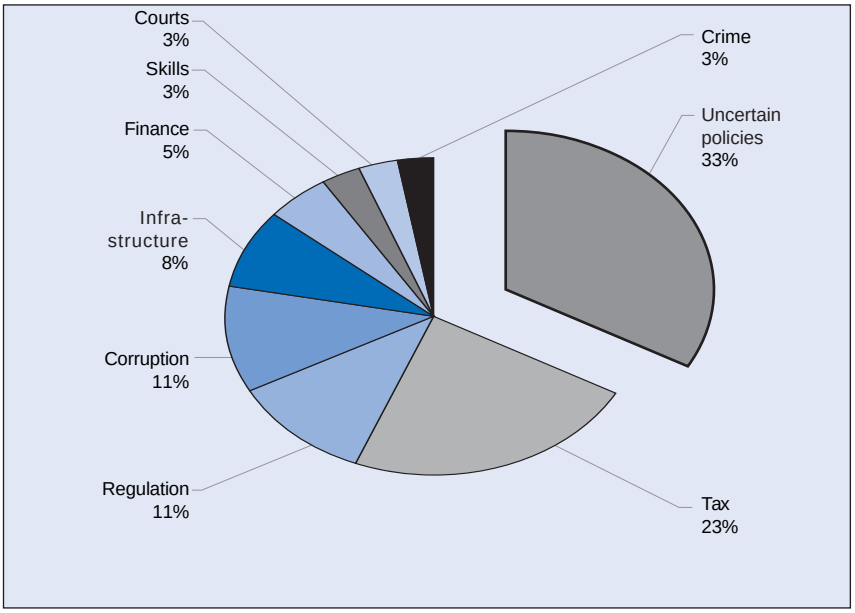
Figure 2.A1.3. **Policy uncertainty matters**

Concerns identified by firms operating in developing countries



Source: World Bank; WDR 2005 (forthcoming).

Good trade policy practices as they relate to investment

In developing this policy framework, what then may constitute "good practices" for trade policy? In the following table, each row identifies: an illustrative list of examples of "good practices"; why such a practice might be considered important in the context of trade and investment, and; examples that were used in the body of the text.

Table 2.A1.1. **Examples of "Good Practices" in the context of this trade policy framework**[1]

Examples of "Good Practice"	Why it is important in a trade and investment context	Examples highlighting this "Good Practice" as provided in the Text
Eliminating inefficient practices	Cut red-tape costs as they will deter entrepreneurs and foreign financiers and will discourage projects in the host jurisdiction.	The average customs clearances for imports into India and Ecuador of 10 to 14 days respectively compare unfavourably with the average of only about 2 days in high-income countries. New technologies can automate much of the traditional paperwork as per Singapore's integrated logistics documentation, Box 2.8.
Encouraging trade neutral policies	Allow the entrepreneurs to choose projects compatible with comparative advantages for the host country.	Chilean's uniform tariff schedule (Box 2.2) is potentially ideal for all countries. Policies should not encourage projects built upon superficial competitive advantages as per the MFA quotas (Box 2.9) or log export bans (Box 2.6).

Table 2.A1.1. **Examples of "Good Practices" in the context of this trade policy framework**[1] *(cont.)*

Examples of "Good Practice"	Why it is important in a trade and investment context	Examples highlighting this "Good Practice" as provided in the Text
Improving market access for host products	Give the entrepreneurial talent a market to sell into.	AGOA (Box 2.10) makes a special effort to open access for African developing countries.
Allowing competitive sourcing	Let the entrepreneur source capital and intermediary products at internationally competitive prices and quality.	The elimination of MFA quotas will require some clothing manufacturers to consolidate with their textile source (Box 2.9).
Promoting linkages	Provide the circumstances that foster domestic suppliers to supply intermediary goods and services to the project and potentially from that base become an international supplier. This will increase a host's and MNE's productivity.	New technologies may promote such backward linkages in the new framework of e-B2B marketplaces (paragraph 9). Matchmaking was particularly successful by Ireland in the initial phases of development (Box 2.1).
Appreciating the value in services specialisation	Recognise the value of services for an entrepreneur to create value for the host country and make the home's MNEs globally competitive.	India's software services, (Box 2.7).
Improving labour mobility for entrepreneurial talent	Allow the entrepreneurial talent to apply their talent in foreign jurisdictions. It can create a win-win for both host and home country.	Taiwan's Hsinchu Park, (Box 2.11).
Avoiding policy uncertainty	Reduce policy uncertainty so that the required rates of return to investors decrease. Policy uncertainty will lower the returns to the entrepreneur/opportunity, if not cancel the project entirely.	Such should encourage practises like Chilean's scheduled reductions in their uniform tariffs (Box 2.3) and Latin America's telecom GATS pre-commitments (Box 2.4).
Helping market the project(s)	Support the entrepreneur to "sell" the project to financiers. It may improve the returns to the entrepreneur and opportunity.	Listening to legitimate concerns of entrepreneurs and investors was a highlight in Costa Rica's success in attracting Intel (Box 2.5).
Avoiding excessive concessions	Promotion may be necessary for a small host country to become noticed but expenditures may need to be analysed against benefits. It would be typically inappropriate for the host government to guarantee a project's commercial outcome.[2]	The Costa Rican example (Box 2.5) suggests concessions do not need to be excessive.
Identifying market failures	Recognise the limitations of some host countries. For instance, some projects may need the financing of more established securities markets of home rather than host markets. Such a case is becoming rarer if capital markets continue to deepen and broaden in the credit they will finance.	Such may be the case for African states in which AGOA, Box 2.10 has links to US Export-Import Bank.
Facilitating trade	When appropriate, allow the entrepreneurial talent to use local resources for pre-shipment approvals for entry into a home jurisdiction. This can help integrate global value chains.	Costa Rica has improved their logistical infrastructure to accommodate Intel's just-in-time requirements (Box 2.5).

1. An illustrative list, not necessarily applicable to all circumstances.
2. It is a general principle in finance that the party that is best able to judge, manage and accept a particular risk is the party that assumes that risk. It usually would not be in a host's best interest to guarantee a commercial outcome and could lead to problems of moral hazard.

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Notes

1. By focusing on trade policies, this document does not attempt to address *general* good policy-making practices like having clearly defined objectives, measures against objectives, and participant buy-in as will be found cited in for instance the World Bank's Poverty Reduction Strategy Papers (PRSPs).
2. Not precluding the possibility that coherent policies may also require international co-operation such as defined in multi, regional or bilateral trade agreements.
3. This listing was created by inspecting the internet descriptions of fifteen indices analysing the environment for doing business identified by the World Bank (2004b), adding one about to be introduced and two investment-related indices. Of those, the twelve that explicitly refer to trade policy are listed in Annex B. The other six indices are also likely to be influenced by trade policy.
4. Description of the OECD banking and telecommunications restrictiveness indices can be found at TD/TC/WP(2004)32/REV1.
5. For a paper considering the practical options for implementing a peer review mechanism, see OECD, "Practical Modalities of Peer Review in a Multilateral Framework on Competition", CCNM/GF/COMP/TR(2003)10.
6. A limitation of this survey was that responses from foreign affiliates (if any) were not separated from domestic companies. Also, it was not explicitly asked whether the impediments were caused by the host or home countries although some impediments may be considered self-evident.
7. Another useful source of European business attitudes to international investment rules (some with trade policy implications) was published in 2000, *http://europa.eu.int/comm/trade/issues/sectoral/invesment/index_en.htm*.

ANNEX 2.A2

Benchmark Indices for Evaluating Trade Policy

Table 2.A2.1. **Benchmark indices which explicitly mention "trade policy" in their Web description**

Index	Source	Measurement for	Trade Policy Implication to the Index
World Competitiveness Yearbook	Institute for Management Development; *www.imd.ch*.	Competitiveness of 49 countries using hard data and perception surveys.	Besides various measures of trade (gross, balance, % of GDP), several trade policy measures are found in business survey questions including whether: customs' authorities help facilitate the efficient transit of goods; protectionism affects business conduct; immigration laws prevent businesses from employing foreign labour; cross-border transactions are freely negotiated with foreign partners; and, foreign investors can acquire control in domestic companies.
Global Competitiveness Report	World Economic Forum; *www.weforum.org*.	Competitiveness of 80 countries using hard data and perception surveys.	This index has several aspects of trade policy which contribute to an overall score. One of the more interesting aspects is the "technology technology transfer-in-trade" subindex. The technique varies depending upon whether the country has a core competence or not. Countries with a higher technology-based export sector are deemed to have a greater propensity to absorb technologies from abroad. Regression is used to make this estimate.
Index of Economic Freedom	Heritage Foundation and Wall St. Journal; *www.heritage.org*.	Assessment by in-house experts drawing on many sources for 161 countries.	The index measures how well countries score on a list of 50 independent variables divided into 10 broad factors of economic freedom. One such factor is "trade policy".
Economic Freedom of the World	Fraser Institute; *www.freetheworld.com*.	Assessment by in-house experts drawing on many sources for 123 countries.	See Box 13 in Annex A.
Country Risk Service	The Economist Intelligence Unit; *www.eiu.com*.	Investment risk ratings for 100 countries.	The business rankings model examines ten separate categories of which one is "foreign trade and exchange controls" using a 1 (very bad for business) to 5 (very good). In that category, there are four sub-questions. Two involve capital account items. Two involve clear trade policy issues: *i)* Tariff and not tariff protection use average tariff levels (1⇔ average tariff > 20%; 5 ⇔ average tariff < 5% with an adjustment to the score of "at least 1 point if licensing and import inspection is significant"); and *ii)* actual trade as a % of GDP *versus* expected by regression (1⇔ actual < 0.6 expected; 5 ⇔ actual > 1.5 expected).
Business Environment and Enterprise Performance	EBRD and World Bank; *www.info.worldbank.org/governance/beeps2002*.	Government effectiveness, regulatory quality, rule of law, and corruption in 27 transition economies.	The regulation quality index combines three aspects with equal weights. One of them is customs and trade regulations.

Table 2.A2.1. **Benchmark indices which explicitly mention "trade policy" in their Web description** *(cont.)*

Index	Source	Measurement for	Trade Policy Implication to the Index
International Country Risk Guide	Political Risk Services; *www.prsgroup.com.*	Investment risk ratings for 140 countries.	PRS Country Reports forecast the risk of doing business and include *Tariff Barriers* – the average and range of financial costs imposed on imports; *Other Import Barriers* – formal and informal quotas, licensing provisions, or other restrictions on imports; *Payment Delays* – the punctuality, or otherwise, with which government and private importers pay their foreign creditors, based on government policies, domestic economic conditions, and international financial conditions; *Taxation Discrimination* – the formal and informal tax policies that either lead to bias against, or special advantages favouring international business.
Foreign Policy Magazine Globalization Index	A.T.Kearney; *www.atkearney.com.*	Incorporates 16 key indicators of global integration for 62 countries.	The index incorporates 16 key indicators of global integration in four baskets. The economic integration basket includes data on trade and FDI. FDI measures are double-weighted "due to its particular importance in the ebb and flow of globalisation".
FDI Confidence Index		Attractiveness of 60 countries for FDI based upon company surveys.	The FDI Confidence Index is based on an annual survey of CEOs, CFOs and other top executives of Global 1000 companies. Country and sector coverage among the participating companies reveals a normal distribution compared to the Global 1000 population. Although trade policy is not explicitly addressed, trade policy will influence whether a surveyed executive will consider a country for FDI.
2004 Offshore Location Attractiveness Index		Attractiveness of 25 countries for offshore services.	Besides using both the above indices, it weighs extent of bureaucracy and some trade facilitation measures.
Sovereign Credit Ratings	Standard and Poors; Moody's; Fitch; and others *www.standardandpoors.com*; *www.fitchratings.com*; *www.moodys.com.*	About 100 countries have been rated for the ability and willingness to service debt. Notable is the S&P/ UNDP initiative in rating seven HIPC African countries.	This description is from the Fitch guide to sovereign ratings. Specific measures of "trade and foreign investment policy" include: the principal measures taken to control imports (quotas, tariffs, non-tariff barriers) by sector; average tariff applied to manufactures weighted by category and an estimate of the overall degree of effective protection; description of the agricultural import regime, including variable levies etc; export subsidies including loans available at below market rates and any other export promotional measures; policy towards trade liberalisation with a timetable for removal of any measures. There are other measures which focus on investment.
Doing Business in 2006	World Bank; *http://rru.worldbank.org/DoingBusiness/.*	The 2005 index considered 145 countries on (largely regulatory) obstacles to growth.	One of the new topics to be featured in the upcoming *Doing Business in 2006* index is trade logistics assessing the procedures, time and cost for an exporter to bring goods from factory to the ship, train or truck and across the border, and also to import a good: customs, pre-shipment inspections and technical and quality certification.

Source: World Bank 2004b which identified 12 indices; this listing was pared down to those that most clearly integrated "trade policy" in their description.

Competition Policy for Investment*

Competition policy has come to play an increasingly important role within the context of the global development agenda. For example, the Monterrey Consensus, the values and objectives of which underpin the OECD *Initiative on Investment for Development* and its *Policy Framework for Investment* project, emphasised "the promotion of a competitive environment" in order to allow "businesses, both domestic and international, to operate efficiently and profitably and with maximum development impact" (paragraph 21). The Monterrey Consensus also called on members of the WTO to implement the commitments made in the Doha Development Declaration, which recognised "the needs of developing and least-developed countries for enhanced support for technical assistance and capacity building in [the area of competition policy], including policy analysis and development" (paragraphs 23-25).[1] Work undertaken at the OECD, UNCTAD, the World Bank and the WTO, among others, has underscored the relevance of competition policy from a development perspective. Furthermore, developing countries have been adopting competition laws and policies in ever-increasing numbers, pointing to benefits that these would seem to associate with doing so. While approximately 27 developing countries adopted some form of competition law during the 1990s,[2] an additional 35 were in the process of implementing competition laws as of February 2004.

The primary objective of competition policy is to enhance consumer welfare by promoting competition. Economic efficiency is generally enhanced by encouraging competition, and thus one of the key links between competition policy and development has been the role that competition policy plays in increasing economic efficiency. The efficient use of resources is especially important in the development context where resources are

* This article was prepared by Michael Gestrin, Investment Division, OECD Directorate for Financial and Enterprise Affairs. In addition to benefiting from comments received during discussions in the OECD Competition Committee, Investment Committee and in the Task Force overseeing the development of the Policy Framework for Investment, Patricia Heriard-Dubreuil, Jeremy West, and Michael Wise from the OECD Competition Division, Oliver Solano from the OECD Trade Directorate, and Pierre Poret and Hans Christiansen from the OECD Investment Division provided helpful comments on earlier drafts.

particularly scarce, an issue emphasised in the Monterrey Consensus. The economics literature generally distinguishes between static and dynamic economic efficiency. Competition policy has variously been ascribed a role in promoting both. The main static effects of competition are to reduce the ability of firms to raise price above marginal cost and to ensure that firms produce at the lowest possible costs. The dynamic consequences of competition can include incentives to innovate, to imitate, and to invest in the development of new technologies and know-how. Competition policy reinforces economic efficiency by preventing or providing remedies for market structures and business practices that weaken the degree of inter-firm rivalry in markets.

In addition to the potential benefits of the implementation and enforcement of competition law and policy in terms of static and dynamic efficiencies, competition authorities have also been ascribed a more general advocacy role. Although the advocacy role of competition authorities defies a precise definition, it has been associated with public education and awareness activities, development of a competition culture, research documenting the need for market-opening measures, and involvement in policy formulation and implementation beyond competition law itself. It has been suggested that these activities "may be among the most useful and high payoff activities undertaken by [competition authorities]", especially insofar as the removal or reduction of regulatory impediments to market entry across a range of policy areas (*e.g.* trade policy, investment policy, regulated industries, etc.) "can be central to the establishment of healthy market economies in developing and transition economies" (Anderson and Jenny, 2002, p. 7, cited in WTO, 2003, p. 14).

In addition to these overarching links between competition policy and development, a number of more specific contributions of competition policy to development have been identified in work undertaken by the OECD, UNCTAD, the World Bank and at the WTO, among others. These include:

- the promotion of consumer welfare;
- preventing excessive concentration levels and resulting structural rigidities;
- addressing anti-competitive practices of enterprises (including MNEs) that can negatively affect the trade performance and competitiveness, on both the import and export sides, of developing countries;
- reinforcing the benefits of privatisation and regulatory reform/deregulation initiatives;
- establishing an institutional focal point for the advocacy of pro-competitive policy reforms and a culture of competition; and
- increasing an economy's ability to attract and maximise the benefits of investment.[3]

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It is this last issue that this article addresses, including issues that are particularly relevant with respect to the relationship between competition policy and the creation of an attractive environment for FDI in the development context.

1. The relationship between competition policy and an attractive environment for investment

1.1. Barriers to entry constitute an important impediment to investment

Within the context of efforts by governments to create an environment which is attractive to investors (both foreign and domestic), a key challenge consists in identifying and eliminating unwanted barriers to entry.[4] Barriers to entry consist in a wide array of factors that discourage investment. Some barriers to entry discourage investment directly, such as, for example, government prohibitions on investment in certain sectors. Other barriers to entry are less direct but nonetheless can also be prohibitive. For example, trade restrictions can make a national market too small for certain investments that require minimum economies of scale to be viable. More generally, and apart from outright government prohibitions on investment, barriers to entry usually consist in the various costs faced by prospective investors in the relevant market. Barriers to entry are different from ordinary costs that are a natural part of the everyday business calculus of firms in a market economy (*e.g.* the cost of capital). These "natural" costs provide important economic signals to market participants, allowing these to make rational economic decisions. Barriers to entry, however, involve costs that are borne uniquely by entrants, as opposed to incumbents. They impede market entry and, indeed, are sometimes avoidable. For example, restrictive agreements might make it difficult for new airlines to obtain landing slots at some airports. An important role for governments is to identify and to try to eliminate or reduce unnecessary barriers to entry that unduly serve to discourage investment (*e.g.* onerous administrative requirements for new entrants).

1.2. Barriers to entry can take the form of structural barriers…

One type of barrier to entry consists in what is usually referred to as structural barriers. Structural barriers to entry pertain primarily to the various sunk costs (*i.e.* costs that can not be recovered by the firm in the event of exit from the industry) that firms must bear upon entry. In other words, sunk costs represent the investment that is put at risk by the investor.[5] Generally speaking, sunk costs act as a barrier to entry when these push the total cost of the project (variable costs, plus sunk and non-sunk fixed costs) above the expected net present value of the investment in question.[6] Other structural

barriers to entry can include absolute cost advantages enjoyed by competitors (*e.g.* if the competitor has an inimitable technological advantage), economies of scale, and large capital requirements, including those associated with network industries (*e.g.* telecommunications).

1.3. … or behavioral barriers

Another type of barrier to entry is generally referred to as behavioural in nature. Behavioural barriers to entry consist of the various ways in which incumbent firms (domestic, foreign or state-owned) can impede market access by abusing their market power. For example, if a firm maintains exclusionary arrangements with retail or wholesale distributors in a given market (reciprocal exclusivity), and access to this distribution network is essential for serving the market in question, this effectively acts as a barrier to entry (assuming that the cost of establishing a second distribution network is prohibitive). Another type of behavioural barrier concerns predatory behaviour, which involves undercutting rivals with a view to eliminating these from the market in question (or "foreclosing" the market to new entrants). This can and usually does involve selling products below their cost of production with a view to recouping losses once weaker rivals (or new entrants) have been eliminated and monopoly pricing can be implemented or resumed. Predatory behaviour can have both an immediate and a more long-term impact on new investment insofar as the threat of predatory behaviour by a powerful incumbent (*e.g.* based upon precedent and reputation) could act to discourage prospective investors.

In practice, the distinction between structural and behavioural barriers to entry is not clear cut, with behavioural barriers usually being facilitated by structural barriers (and both often underpinned by aspects of the regulatory or policy environment). In the absence of structural barriers to entry, new firms will normally respond to any abnormal profits being earned by incumbents by entering the market, thus bringing prices back down to competitive levels. One of the challenges faced by governments has been to sort out, between various structural and behavioural market barriers, those that do not unduly harm competition and those that can and should be eliminated.

A good example of the sorts of trade-offs that competition authorities have to deal with involves policies towards intellectual property rights (IPR). At the highest level of analysis, IPR and competition policies are complementary because they share a concern to promote technical progress to the ultimate benefit of consumers. Firms are more likely to innovate if they are at least somewhat protected against free-riding. They are also more likely to innovate if they face strong competition. The problem is that even completely legitimate use of IPR can restrict competition at least in the short run, thus producing a trade-off between the benefits of increased competition and the

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gains from further innovation. The protection of IPR is an example of a limit to competition that is generally considered beneficial. The difficulty for competition authorities lies in determining at what point such limits to competition begin to encounter negative marginal returns to society.[7]

1.4. Open trade and investment regimes can significantly reduce barriers to entry…

It has been argued that one of the best ways of ensuring that structural and behavioural barriers to entry do not impede investment is to simply maintain open trade and investment policies.[8] The reasoning behind this line of argumentation is that competition from potential foreign investors or from imports will naturally act to discipline firms that would seek to exercise some form of market power. In effect, by maintaining open trade and investment regimes the relevant market is no longer limited to the national market. For example, a firm that enjoys a monopoly position in a given country (in the sense that it is the sole producer located in the country) will nevertheless not be able to behave like a monopolist if monopoly pricing and above normal rents attract international competition which, in turn, drives prices back down. Alternatively, restrictive investment (and trade) policies are probably one of the "best" ways of establishing impediments to entry that enable incumbents to exercise market power.

1.5. … but experience suggests that open trade and investment policies are not sufficient to ensure that incumbents act competitively

However, experience suggests that open trade and investment regimes are not sufficient for ensuring the maintenance of contestability in national markets (*i.e.* the threat of new entrants in response to signals indicating abnormally high rents). Structural characteristics in any given economy can act to "buffer" incumbent firms from competition, even in the context of liberal trade and investment regimes. These can include, *inter alia*, the inherently local nature of some markets, the non-tradability of certain products and services, and regulations that are not *per se* restrictive from a trade or investment perspective (*e.g.* standards and licensing requirements). Furthermore, private restrictive practices, such as collusion in an adjacent (upstream or downstream) market, may inhibit trade and investment. Indeed, a number of countries with relatively open trade and investment regimes have reported on the need to complement open trade and investment regimes with active enforcement of competition laws (see Box 2.12 on the experience of Argentina).

1.6. Some barriers to entry are particularly relevant with respect to FDI…

One source of investment that has become increasingly important for developing countries consists of FDI. Although many of the barriers to entry identified above are "neutral" insofar as they do not "discriminate" between foreign and domestic investors (*i.e.* they will discourage both), some barriers to entry are more specifically relevant with respect to their potential negative impact on FDI. In some cases this is because foreign and domestic investors are provided different levels of treatment. In other instances barriers to entry are *de facto* pertinent to FDI because the latter is a major, if not the main, source of the type of prospective investment in question. An important policy implication of this observation is that competition authorities, in their capacity as advocates of a culture of competition, including competition from foreign investors, need to cast their nets wide in order to identify potential policy impediments to the entry of foreign investment, even where these are not labelled as such or directed at foreign investors.

1.7. … such as the granting of exclusivity as a form of FDI incentive…

As mentioned above, structural and behavioural barriers to entry often complement each other. In many instances, government regulation underpins this relationship. For example, one unusual issue at the inter-face of competition policy and FDI that has emerged in recent years concerns the granting of exclusivity to foreign investors as a form of FDI incentive. From the perspective of the firm offered this type of concession, the advantage lies in being able to exercise market power in the market in question (*i.e.* the firm enjoys some control over pricing and can therefore charge above marginal cost). From the perspective of government, the appeal of this type of incentive is that, at least on the surface, there is no immediately obvious financial cost and a firm that is granted some form of exclusivity is likely to be willing to pay more for the assets in question than would otherwise be the case. Indeed, the ultimate costs of this type of incentive are difficult if not impossible to calculate since these are borne by the customers of the supplier in the form of the above-normal prices the latter is able to charge and by the economy more generally in the form of the forgone benefits of subsequent investment, including FDI (*i.e.* subsequent investment that is barred as part of the exclusivity contract granted to the original investor).

For example, in 1995, the Sri Lankan government privatised the Colombo Gas Company through the sale of 51 per cent of the company to a foreign investor. As part of this deal, the foreign investor was given a five year monopoly for natural gas in the Sri Lankan market, protected from both import and foreign investment competition. As in most cases involving

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exclusivity as an incentive to attract FDI, the foreign investor was immune from the Sri Lankan competition authority and competition law until the end of the term of the agreement (UNCTAD, 1997).

Setting aside the question whether the granting of exclusivity to attract FDI is a good idea or not, competition authorities should be involved in decisions such as these since they bear directly upon the competitive structure of an economy. Competition authorities have come to play an increasingly important advocacy role such that their mandate extends beyond merely enforcing competition law, and in the case of incentives for FDI based upon exclusivity this advocacy role should involve, at a minimum, an evaluation of the (largely hidden) costs associated with such arrangements.[9]

1.8. … granting privileged market positions to SOEs or other regulated firms…

One of the most important areas of government regulation that can impact negatively on the ability of MNEs to enter a national market through FDI concerns regulated industries, including industries dominated by state owned enterprises (SOEs). Regulated sectors occasionally fall outside the reach of competition law. Indeed, certain types of firm behaviour and industry structures that would normally be considered anti-competitive (or potentially anti-competitive) in the private sector are sometimes permitted in the public sector. The most obvious instance of SOEs or otherwise highly regulated firms acting as impediments to FDI is when these have a mandate to act as the sole supplier in a particular industry (*i.e.* private firms, either foreign or domestic, are simply not allowed to enter this market). This has been the case, for example, in the energy and telecommunications sectors in a number of countries. However, regulated firms can also serve to impede entry to the extent that they are able to engage, through their linkages to the private sector either as buyers or suppliers, in many of the restrictive business practices associated with private firms (see Box 2.12). While recognising that legitimate differences exist between countries with respect to the relative roles ascribed to the private and public sectors,[10] it remains that competition authorities can play an important role in shedding light on the costs and benefits of policies that limit competition, thus contributing to more transparent, and informed policy formulation.

Competition authorities have sometimes found themselves at the margins of policy formulation and oversight of regulated industries,[11] including with respect to the wave of privatisations that swept through many regulated sectors during the 1990s. The motivation for many privatisations has been the recognition that many activities can be run more effectively and efficiently by the private sector. However, a concern of governments and competition authorities has been to avoid replacing public with private

Box 2.12. **The experience of Argentina with competition law and policy in the context of trade and investment liberalisation**

In 1989, the Government of Argentina launched a radical reform of the economic system, involving, among other reforms, the lowering of trade barriers, the privatisation of the majority of state enterprises, the elimination of many industrial regulations, and the complete deregulation of foreign direct investment. During the early stages of this reform process, competition law and policy played a minor role in the expectation that the deregulation of markets and the liberalisation of trade and investment would be sufficient to provide competitive discipline and to achieve economic efficiency. However, over time, competition policy came to play a more important role as it became clear that, although the liberalisation of trade and investment did serve to encourage competition and economic efficiency in many sectors, this was not the case in all sectors. Examples of structural constraints and private business practices that served to constrain competition despite trade and investment liberalisation, and for which investigation by the Argentine National Commission for the Defence of Competition was deemed necessary, included:

- Concentration in the liquefied petroleum gas industry, including control over key parts of the value chain (port facilities in particular), was associated with domestic prices remaining abnormally high.
- Suspected collusion among incumbents within MERCOSUR in certain industries aimed to keeping out new entrants.
- Apparent "stickiness" of response by potential new (especially foreign) entrants into the market in response to liberalisation due to structural barriers, including extremely strong brand dominance in one industry and the small size of the domestic market in another.
- Suspected differential pricing by a quasi-monopolistic supplier, according to which a key customer was offered the international (competitive) price and smaller customers, for whom international sourcing would have been more difficult, were offered a much higher price.
- Suspected discriminatory pricing by the subsidiary of an MNE with a dominant position globally for the product in question.

Source: UNCTAD (1997). See also OECD (2004) for similar examples from Russia.

monopolies. This challenge has sometimes been complicated by conflicting objectives associated with privatisations, namely the desire to create more efficient industry structures, on the one hand, and the desire to sell state owned assets at the highest possible prices, on the other. Bidders for publicly owned companies, including MNEs, will be willing to pay more if they believe

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that they are buying a monopoly position in a particular market. However, as with the provision of exclusivity as a form of incentive to attract FDI, the primary consideration of competition authorities should be the long-term competitive benefits that FDI can bring to an economy rather than possible short-term budgetary windfalls.

1.9. … and in efforts to promote "national champions"

Within the context of their development strategies, some governments have sought to promote "national champions", which, by definition, involves granting preferential treatment to some firms over others on the basis of nationality.[12] Although not SOEs, *per se*, national champions often do involve significant state involvement (both financial and with respect to management), and are usually granted some form of exclusivity (*i.e.* protection from trade and investment-based competition) in the national market. The arguments for national champions usually rely on considerations of dynamic (versus static) efficiency. They include arguments to the effect that economies of scale cannot be attained without restrictions on competition, these economies of scale allow for more spending on research and development, and, by extension, only once such economies of scale have been reached can firms realistically expect to be able to compete on international markets. The issue of national champions has been contentious and underlies one of the key difficulties in incorporating dynamic efficiency objectives into competition policy – how to find the right balance between static and dynamic efficiencies without reducing competition to such levels that any potential dynamic gains are completely eroded through "slack" – the inefficient use of resources within firms resulting from a lack of external market discipline, *i.e.* competition.

As in the case of "exclusive contracts" and regulated industries, efforts to promote national champions generally entail specific provisions aimed at limiting FDI. This is usually done on the grounds that the costs to the economy associated with limits placed on competition are outweighed by some other, either dynamic (*e.g.* promoting innovation) or social (*e.g.* provision of essential services) benefits. However, it remains that any policies specifically aimed at limiting competition in particular sectors run the risk of creating inefficiencies, reducing welfare in parts of the economy due to the exercise of monopolistic or monopsonistic market power, reducing investment in sectors of the economy that depend on protected firms due to the knock-on effects of higher costs, and creating powerful vested interests opposed to any reduction in protectionism. As such, there is a strong case to be made for the on-going involvement of competition authorities in the formulation and implementation of policies that would limit competition, especially with a view to ensuring that the costs of such limits (as difficult as these are to evaluate) do not outweigh any hoped-for benefits.

1.10. In addition to these general pre-establishment issues, FDI by MNEs can give rise to additional competition issues…

To this point, the discussion of the relationship between competition policy and the attractiveness of an economy for investors has focused on various barriers to entry that can impede domestic and foreign investment. In the second half of the discussion, several barriers to entry that are particularly relevant from an FDI perspective, such as "exclusive contracts", regulated industries, and efforts to promote national champions, were highlighted. However, once FDI takes place, a number of additional issues can come into play. The main reason for this relates to the fact that many MNEs have considerable financial resources at their disposal, they operate in industries that are often dominated globally by a handful of large firms, and they are able to establish dominant positions in many national markets through their foreign investments (even when this dominant position is not offered by the government as an incentive). Within the development context, the two main concerns of governments and competition authorities with respect to MNEs have been; 1) that MNEs expressly seek to exploit particular national markets, and 2) that the activities of MNEs can have structural implications with potentially negative effects on competition in some national markets.

1.11. … such as international market sharing arrangements…

With respect to the possibility that MNEs expressly seek to exploit their positions in particular national markets through FDI, this issue has received increasing attention in recent years as competition authorities have become more active in prosecuting various anti-competitive practices, and as evidence that MNEs are able to engage in market sharing arrangements at the global level has come to light. Many examples of successful prosecution in competition cases have involved competition authorities in developing countries, indicating that the implementation *and enforcement* of competition laws is not limited to developed economies (see, for example, WTO, 2003). Furthermore, empirical studies indicate that countries that have implemented competition laws have generally experienced less egregious price gouging at the hands of international cartels than countries without competition laws, indicating that these can serve as an important deterrent to abuse of market power (see, for example, WTO, 2003, section III).

1.12. … and issues of concentration relating to mergers and acquisitions

With respect to structural issues, one of the key links between competition policy and FDI pertains to the involvement of competition authorities in reviewing proposed mergers and acquisitions. The potential importance of this issue is highlighted by the fact that mergers and acquisitions constitute the predominant mode of MNE expansion into foreign

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markets, accounting for 57 per cent of FDI inflows in 2002 (UNCTAD, 2003). Mergers and acquisitions are routinely reviewed by competition authorities with a view to determining whether particular combinations might give rise to levels of concentration that could be inimical to competition and, hence, efficiency.

Although the role of competition authorities in reviewing cross-border mergers and acquisitions has been limited predominantly to developed countries, in some cases competition authorities in developing countries have intervened where a merger between firms based outside the country has had implications for industry structure and competition in the host economy. For example, the proposed acquisition of one United States multinational by another in 1996 would have given their Mexican affiliates up to 67 per cent combined market share for certain products. The Mexican Federal Competition Commission therefore ordered the acquiring multinational to divest five major brands, thus reducing the combined company's market shares to around 50 per cent or less.

In another case of an international merger having implications for levels of concentration between existing foreign affiliates, two leading tea suppliers to Pakistan fell under common control of a major multinational. The Pakistan Monopoly Control Authority found that the prices paid by the companies for tea imported from related suppliers were higher than prices paid to unrelated international suppliers and therefore required that the multinational withdraw one of its brands and reduce its shareholding in one of the affiliates to 40 per cent.

Apart from a few fairly specific issues raised in the context of mergers and acquisitions involving MNEs and the possible implications of such transactions for market structures in countries in which the firms involved previously competed, generally FDI does not present challenges for competition authorities that require these to distinguish between foreign and domestic investors.[13] Indeed, competition law in most countries implicitly embodies the national treatment principle insofar as no distinction is made between domestic and foreign firms. As argued above, one of the overarching links between competition policy and an attractive environment for investment consists in ensuring that structural and behavioral impediments to market access do not discourage investment, irrespective of whether the investment is domestic or foreign. However, it remains that MNEs, by definition, operate across borders and thus create cross-border policy issues. Consequently, international co-operation among competition authorities has become more common with a view to addressing competition issues that span jurisdictions.

Notes

1. A number of existing WTO agreements already contain provisions that are relevant from a competition and investment perspective. For example, the TRIPS agreement (the Agreement on Trade-Related Intellectual Property Rights) stipulates that members of the WTO may take "appropriate measures… to prevent the abuse of intellectual property rights by right-holders or the resort to practices which unreasonably restrain trade or adversely affect the international transfer of technology" (article 40). A number of regional agreements that deal with trade and investment issues have also incorporated provisions dealing with competition issues. For example, the North American Free Trade Agreement (NAFTA) contains provisions that address competition issues related to SOEs and also has provisions on co-operation between competition authorities (chapter 15). *See* Trade and Competition Policies for Tomorrow, Ch. 4, "Competition Elements in International Trade Agreements: A Post-Uruguay Round Overview of WTO Agreements" and Ch. 5, "Implications of the WTO Agreements on Basic Telecommunications", OECD (1999).
2. By 2001, approximately 80 countries in the world had some form of competition law, WTO (2003).
3. One of the dynamic benefits associated with competition concerns the continuous investment in newer, more efficient technologies that supplant older products and processes. As such, competition policy is not just associated with the quantity of investment but (perhaps more importantly) the quality of investment that an economy is able to attract.
4. In some cases, barriers to entry are intentional and aim to serve particular policy objectives, as, for example, in sectors of the economy reserved for state-owned enterprises.
5. Sometimes regulatory barriers to entry are treated as a distinct type of barrier to entry. However, many regulatory barriers can be seen as a specific type of sunk cost. For example, many performance requirements or requirements that attach conditions to entry, such as testing for product safety, represent sunk costs for firms that must bear them.
6. In other words, an investor will want to at least break even, *i.e.* the expected returns over the life of the investment need to at least cover sunk plus variable costs.
7. "Roundtable on Intellectual Property Rights", Competition Committee Roundtable, OECD, 2004 (forthcoming); "Synthesis Report on Parallel Imports", [COM/DAFFE/COMP/TD (2002)18/Final], OECD, 2002; *Competition and Intellectual Property Rights*, OECD, 1998.
8. Indeed, it has even been argued that, especially for smaller economies, open trade and investment regimes can effectively substitute for competition law and policy.
9. Including the possibility that a position of market dominance may last much longer than the formal period of exclusivity, unless special measures are taken to encourage new entry when that period ends.
10. Indeed, the Policy Framework for Investment recognises a country's sovereign "right to regulate".
11. It should be noted, however, that in a number of economies competition authorities have come to play a greater role in policy-making and formulation concerning regulated industries.

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12. Such as protection from competition through restrictions on FDI and trade protection, exemptions from competition law and various fiscal advantages.
13. *See* Trade and Competition Policies: Options for a Greater Coherence, Ch. 5, "Merger Review and Market Access," OECD (2001).

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Tax Policy for Investment*

A country's tax regime is a key policy instrument that may negatively or positively influence investment. Imposing a tax burden that is high relative to benefits realised from public programmes in support of business and high relative to tax burdens levied in other competing locations, may discourage investment, particularly where location-specific profit opportunities are limited or profit margins are thin. In addition, the host country tax burden is a function of not only statutory tax provisions but also of compliance costs. A poorly designed tax system (covering laws, regulations and administration) may discourage capital investment where the rules and their application are non-transparent, or overly-complex, or unpredictable, adding to project costs and uncertainty over net profitability. Systems that leave excessive administrative discretion in the hands of officials in assigning tax relief tend to invite corruption and undermine good governance objectives fundamental to securing an attractive investment environment. Policy makers are therefore encouraged to ensure that their tax system is one that imposes an acceptable tax burden that can be accurately determined, keeps tax compliance and tax administration costs in check and addresses rather than contributes to project risk.

A modern, competitive, stable and transparent tax system, one that links host and home country tax systems through a well established tax treaty network to avoid double taxation, can send a strong positive signal to investors, both domestic and foreign. Investors generally prefer a low host country tax rate applied to a broadly defined profit base. At the same time, special incentives may play an important role in certain cases. Where tax incentives are used, care must be taken to ensure that incentive types and design features are chosen that are less likely than others to result in unintended and excessive revenue losses to non-targeted activities.

Balancing revenue losses from tax relief against the possible investment response is an important consideration in the majority of cases where

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companies can manage a modest host country tax burden. This recognises that tax relief may be too generous, in excess of that necessary to provide a tax environment that is supportive of investment. Where corporations are able to contribute to the financing of infrastructure development (*e.g.* roads, airports, telecommunications networks, and legal frameworks) that they benefit from, and are required to do so under a competitive but not easily manipulated set of tax rules, the tax system can serve to both attract investment and support parallel efforts to build a strong industrial base.

A central challenge for policy makers endeavouring to encourage domestic and foreign direct investment, but with limited financial resources to commit, is a careful weighing of relative advantages and disadvantages of alternative tax policy choices and design options in meeting the twin goals of attracting investment while at the same time raising revenues to support infrastructure development and other pillars of an enabling environment for direct investment.

This article explores these issues with the objective of providing background information and a summary "checklist" to guide policy makers when formulating a tax policy strategy that is supportive of investment, taking a "holistic" view of the role of the tax system.

Section 1 begins by sketching out various economic decisions influenced by taxation, decisions that impact the path of a country's economic development. Section 2 takes focus on the impact of taxation on investment, and highlights not only direct effects on after-tax rates of return (and thus possible effects on investment location and scale decisions), but also "budget effects" linking taxation to non-tax government programs in support of investment financed out of tax revenues. Section 3 elaborates tax considerations for policy makers to consider when assessing the possible need for reform towards a tax system better able to support investment.

1. Tax policy and development

Tax policy influences economic development through its influence over a number of economic decisions, including employment decisions, decisions over how much to invest in skills (human capital), as well as scale and location decisions involving investment in plant, property and equipment. Taxation also influences the relative attractiveness of purchasing or leasing tangible business property. The tax treatment of research and development (R&D) in different countries, and of payments under licensing agreements, impacts decisions over whether to produce intangibles (and if so, where) or purchase them or license them from others, with special tax-planning considerations arising in the case of intra-group transactions.

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Some of the key linkages between tax policy and development may be highlighted as follows:

- *Employment.* Tax policy affects labour supply and labour demand decisions. Labour supply is influenced by the personal income tax (PIT) system (marginal PIT rates, thresholds, non-wastable earned income tax credits), and the social security contribution (SSC) system (employee SSC rates, thresholds). Labour demand is influenced as well by the SSC system (employer SSC rates, thresholds) and by tax effects on investment.
- *Investment in education and training(e.g. post-secondary education, skills upgrading).* Tax factors in by influencing the benefits of (returns on) investment (with PIT and SSC contributions reducing, or augmenting with employment tax credits, wage income), and influencing the costs of investment incurred by firms (*e.g.* where firms are provided with special tax breaks to help defray the cost of training) and/or individuals (*e.g.* tax relief for education expenses).
- *Investment by firms in tangible and intangible assets.* Taxation alters the after-tax rate of return on investment by influencing after-tax revenues, net acquisition costs of assets and costs of equity and debt finance, leading to direct effects on investment.
- *Access to intangible assets through purchase or license agreements.* Rather than investing in R&D to develop intangible assets, influenced by the availability (or not) of special tax deductions and/or tax credits for R&D, a firm may purchase intangibles from others, or acquire the rights to use such assets. Taxation influences the optimal amount of intangible capital to hold, as well as the relative attraction and reliance on alternative means to acquire such capital (with possible implications for the scale of "spillover" effects on the domestic economy).

Tax policy also plays a role in influencing whether economic development is sustainable:

- *Income distribution effects*: Tax policy influences income distribution (*e.g.* progressive *versus* flat PIT rate structure, basic allowances, non-wastable tax credits). As sustainable economic development places constraints on inequality in income distribution, tax policy may hinder or help underpin support for a growth agenda.
- *Environmental effects*: Tax policy may be used as a market-based instrument to address environmental degradation (*e.g.* so-called "green" taxes). The use of market based instruments (environmental taxes, tradable permits) is now widely recognised as a more efficient means to address certain environmental concerns (*e.g.* global warming), than regulatory approaches.
- *Budget effects*: Tax policy, covering the tax treatment of investment, employment, other economic activities, transactions and assets, has

indirect "budget" consequences, by influencing the amount of tax revenue available to fund public expenditures including programmes identified by investors as of critical importance in shaping the investment environment.

2. Taxation and investment – what are the linkages?

In examining tax effects on investment, one can distinguish effects on direct investment representing a significant active equity interest, from effects on portfolio investment by those holding a passive equity interest. This article focuses on effects on direct investment, including business expansions, branch investment, investment in subsidiaries, and mergers and acquisitions.

One can also distinguish tax effects in the "pure" domestic case (resident shareholders investing in domestic assets) *versus* cross-border investment, both inbound foreign direct investment (FDI) in domestic assets by non-resident shareholders, and outbound direct investment abroad (DIA) in foreign assets by resident investors. This article does not address special considerations relevant to the influence of home country taxation on outbound direct investment.[1]

A further distinction is between tax effects on direct investment of various types: in physical capital [*e.g.* plant, property and equipment (PP&E)]; investment in intangible assets (*e.g.* patents) through R&D; and investment in human capital (*e.g.* education, training). This article concentrates on tax effects on physical capital, and in particular PP&E scale and location decisions. Special tax considerations relating to the development and use of intangibles are not covered.

In examining the linkages between taxation and direct investment in physical capital, one is confronted with a range of taxes that form part of the tax system of developed (*e.g.* OECD) countries, as well as developing countries on an established transition path. The taxes include corporate income tax, non-resident withholding taxes, customs duties, personal income tax, social security contributions, value added tax, and other (generally less relevant) taxes. Home as well as host country taxes may factor in.

Focusing on domestic and inbound direct investment in physical capital, this article concentrates on primarily host country considerations, and highlights two main linkages between taxation and investment.[2] The first is the direct effect of taxation on the after-tax hurdle rate of return on investment. The second is the "budget effect" which recognises the basic role of tax in funding government programs, and the importance placed by business on adequately funding infra-structure development and skills development programs and public governance initiatives central to creating an enabling environment for investment.

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2.1. Direct effects of taxation on investment

The taxation of profit derived from investment in a given host country (in the pure domestic case, or in the case of foreign direct investment (FDI)) may directly affect the amount of investment undertaken by influencing after-tax rates of return on investment.[3] In theory, a high (low) effective tax rate on domestic source income could be expected to discourage (encourage) domestic investment by resident investors, as well as inbound foreign direct investment.[4]

However, as in other areas, theory must be resolved with practice. It is clear that in general host country taxation adds to investment costs, particularly in the pure domestic case.[5] However, the predicted direct effect – that investment would fall if host country taxes are increased, and would increase if taxes are reduced – is not always observed.

Most would agree that a host country tax burden that is very high relative to other countries – influenced by statutory/legal provisions and by compliance costs – generally is discouraging to investment and could, in certain cases, be a deciding factor in not investing or reinvesting in a host country.

The more difficult issue is when – that is, under what circumstances and by which means – can a relatively low host country tax burden discourage capital flight, encourage additional investment, and swing location decisions in a country's favour? When, for example, can reduced statutory tax rates or incentives be expected to attract additional investment? As elaborated in section 3, by identifying the factors that condition whether host country tax relief or subsidies can be expected to deliver additional investment, policy makers can assess how best to design an overall policy approach, one with mutually reinforcing elements, to provide an environment encouraging to direct investment.

While statutory tax provisions are clearly important, policy makers are also encouraged to consider difficult to measure (yet potentially impeding) business compliance costs associated with the level of transparency of the tax system.

2.2. Budget effects of taxation on investment

Host country taxation also impacts investment indirectly by contributing to, or constraining, the financing of the expenditure side of the budget equation. This point recognises that investment may be encouraged or discouraged by the state of infra-structure in a country (*e.g.* roads, airports, seaports), the skills profile of the workforce, the state of public governance, and other aspects of the investment environment that are supported by tax revenues.

It is often rightly emphasised that non-tax factors are of central importance to investment decisions – however often overlooked is the fact that public infra-

structure, education and public governance policies and programmes and other key aspects of an enabling environment for investment require financing. And in many if not most countries, tax revenues are an important if not main source of funds (recognising that printing money to finance projects is inflationary, while borrowing funds is also subject to constraint).

Corporate tax and other taxes derived from investment contribute to general tax revenues used to finance government expenditure. While these taxes may form a relatively small percentage of total tax revenues, the absolute amounts may be large and should be seen as a potential source of revenue that may be used to help address non-tax investment deterrents identified as seriously impeding investment activity.

As noted, a central question facing policy makers is, under what circumstances and conditions can a relatively low host country tax burden operate to discourage capital flight, attract additional investment, and swing location decisions in a country's favour? Behind this question rests a central trade-off – by reducing taxes on host country investment and subsidizing investors, revenues are foregone that could instead be used to build up infrastructure, improve labour skills, strengthen governance, and address what in many country contexts are the real impediments to investment.

Thus the focus in most country contexts should be on the twin goals of designing tax systems and investor packages that are attractive to investment, while at the same time not foregoing funds that could be more usefully applied to fund public expenditures identified by investors as of critical importance.

3. Taxation and investment – a review of main considerations

The following provides a list of issues that policy makers are encouraged to consider when assessing whether a given host country tax system, and in particular corporate tax system, is supportive of direct investment in real productive capital, while also adequately addressing other tax policy objectives.

3.1. Comparative assessment of the tax burden on business income

1. What is the current tax burden on domestic profit, on average, taking into account statutory provisions, tax-planning opportunities and compliance costs?

The statutory host country tax burden on domestic profits should be assessed with reference to both quantitative measures and qualitative information, taking into account main statutory provisions and effects of tax-planning strategies commonly employed by domestic and foreign-owned business to lower the host country tax burden (*e.g.* thin capitalisation, non-arm's length transfer prices). Compliance costs from excessive complexity, non-transparency and unpredictability should also be factored in.

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3.1.1. Assessment of host country tax burden

On the quantitative side, corporate marginal effective tax rates (METRs) and corporate average effective tax rates (AETRs) are commonly used to assess the net effect of (certain) main statutory provisions in determining effective tax rates by type of capital asset (machinery and equipment, buildings, inventories, intangibles) and by investor type (taxable resident, tax-exempt resident, non-resident). Such measures may be finessed by factoring in effects of tax-planning strategies employed in the host country to strip out taxable profits (*e.g.* thin capitalisation, non-arm's length transfer prices) to tax havens.

An attraction of measuring corporate marginal and average effective tax rates is that they can be modelled with reference to statutory tax provisions alone, found in tax legislation and regulations (*i.e.* they do not require information on actual tax revenues collected). However, as such summary measures cannot readily incorporate the effects of all relevant tax provisions bearing on the average host country tax burden, they need to be qualified with regard to such effects (*e.g.* the impact of rules governing the carry-forward of business losses, and capital losses).

Furthermore, where taxpayer-level information is available (*i.e.* taxpayer financial statements, tax returns), a stratified sample of corporations should be chosen and relevant micro-data examined in order to obtain measures of the tax burden on domestic firms, on an aggregate and disaggregate basis (profitable and taxable, profitable and non-taxable, non-profitable; small, medium and large with reference to total assets; main industry sector; region). As examined elsewhere, results based on micro-data provide a much stronger basis to analyse tax burdens across sectors and over time.[6]

Compliance costs should also be factored in, at least on a qualitative basis. Too often, policy makers assess a host country tax burden with reference to only the direct effects of statutory provisions. A *more appropriate measure takes into account tax compliance costs*, which in some cases may be quite significant, depending on the degree and sources of complexity, transparency and predictability.[7]

3.1.2. Tax burden linked to an excessively complex business tax system

In addressing today's complex business structures and transactions, a certain degree of complexity in the tax system is to be expected. However, where investors view a tax system (laws, regulations and/or administration) to be excessively complex relative to other tax systems, the added expense to project costs incurred in understanding and complying with the tax system would tend to discourage investor interest.

Such a review would begin by identifying the various sources of complexity – including those linked directly to tax policy, those relating to mechanisms by which policy is implemented, and those linked to tax administration – and examining whether the degree of complexity is avoidable with consideration given to approaches adopted by other countries.

One area to consider is whether the structure of the depreciation system for tax purposes (number of classes of depreciable capital cost, assignment of depreciation methods) is consistent with international norms. If the depreciation system has been characterized frequently by business as overly complex, then serious consideration should be given to possible simplification.[8]

As an illustration of possible trade-offs when addressing complexity, consider integration of corporate and personal income taxation of equity income to reduce or eliminate double taxation of domestic profits. Where double taxation relief is desirable (*e.g.* creates investment (host country benefits) that more than outweigh tax revenues foregone), it is important for policy makers to recognise the advantages that a simple approach could bring. In this example a relevant trade-off could be between efficiency, calling for a variable imputation tax credit at the personal level that depends on the amount of corporate tax actually paid on distributed income, and simplicity, which may call for partial inclusion of dividend income, or a fixed dividend tax credit based on a notional or assumed level of corporate tax.

3.1.3. Tax burden linked to a non-transparent business tax system

Another important aspect of tax compliance costs concerns transparency. In considering this issue, it must first be recognised that even a relatively simple system may lack transparency, as for example where tax laws and terms are unclear, tax returns and information materials are difficult to obtain, and taxpayer compliance support is weak. As with complexity, a lack of transparency contributes to project costs. It also raises concerns of fairness, and may lead to suspicion that the tax system is tailored to the interests of a subset of taxpayers, including those earning higher incomes, able to afford professional tax advice and possibly benefiting from special tax treatment. Perceptions of unfairness challenge tax systems based on voluntary compliance, as they tend to encourage non-compliance and transition of business activity to the "underground economy", raising revenue concerns and concerns of the weakening of government performance more generally.

Policy makers are therefore encouraged to satisfy themselves that tax laws and regulations are drafted clearly and preferably by those trained in legal drafting of tax provisions. Tax returns, explanatory notes and information circulars should be readily available to taxpayers (*e.g.* electronically), and

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services should be available to provide advance rulings on the tax treatment of transactions where tax outcomes are unclear.

Another important "transparency" issue is whether business tax liability in certain cases is established at the discretion of tax authorities (*e.g.* through individual rulings, or informal dealings), rather than through uniform application of tax laws and regulations. Where administrative discretion is provided, the policy reason for providing this discretion should be questioned, as a key concern is whether administrative discretion contributes to or invites corrupt practices on the part of tax officials (*e.g.* the taking of bribes). Where it does, administrative discretion may contribute to investor uncertainty over final tax liability and the tax liability of other firms. Where corruption is a problem and administrative discretion contributes to project risk due to uncertainties over tax treatment, the potential benefits of such discretion (*e.g.* tighter control over tax relief) should be weighed against the various costs including those linked to reduced transparency.

3.1.4. Tax burden linked to an unpredictable business tax system

Non-transparency in the tax area contributes to investor difficulty in gauging with some degree of certainty future after-tax returns on host country investment. So too can frequent reforms of tax systems, even where they are relatively simple and transparent. While a certain degree of unpredictability may be associated with all tax systems, a system may be judged to be relatively or excessively unpredictable if the host country has a history of frequent and dramatic changes to important elements of the tax system, that is, elements bearing significantly on investment returns.

Relevant questions on this issue include: what elements of the tax system have contributed to unpredictability and how can these be best avoided? Is responsibility for tax legislation governing the taxation of business income assigned to a single ministry of the central government (*e.g.* Ministry of Finance), recognising difficulties that arise where this is not the case? Are (all) income tax laws/regulations contained in a single body or act of legislation, recognising difficulties that arise where this is not the case? Is a single ministry, department, or agency of central government responsible for the administration of corporate income tax and personal income tax (*e.g.* with local/regional offices)? If income tax legislation and administration are not centralized, what problems of co-ordination have arisen, what has been the impact on taxpayer tax compliance costs (in relation to complexity, predictability, transparency), and what reforms are desirable?

2. Has the government evaluated the level of tax burden that would be acceptable generally to investors? Is this level consistent with the actual tax burden?

A central issue in gauging what host country tax burden would be expected to be acceptable generally to investors is whether the country offers attractive risk/return opportunities, taking into account framework conditions, market characteristics and location-specific profits of the host country, ignoring tax considerations.

Important to potential investors are questions over costs and non-diversifiable risks associated with securing access to capital and profits, adjusting to macroeconomic conditions, and complying with laws and administrative practices. Also centrally important to investors are considerations of output demand and factor input supply. Another fundamental issue is the degree to which the host country offers location-specific profits (profits that require a physical location in the host country).

Investors are generally willing to accept a higher host country tax burden the more attractive are the risk/return opportunities the host country presents, taking into account host country framework conditions, market characteristics and opportunities for location-specific economic profits. Absolute and comparative assessments with regard to competing jurisdictions are relevant.

3.1.5. *Framework conditions*

Important to potential investors are questions over costs and non-diversifiable risks associated with securing access to capital and profits, adjusting to macroeconomic conditions, and complying with laws, regulations and administrative practices, including the following:

- How stable is the political system? How stable and accessible is the legal system protecting property rights including, in the foreign investor case, the right to withdraw capital and repatriate profits? Do capital controls exist?
- How stable is the monetary system and fiscal framework and what is the accumulated public debt? What are expectations over future inflation, interest and exchange rates?
- In what areas is public governance weak and where is corruption a problem?
- How significant are the costs and risks to business associated with the preceding considerations?

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3.1.6. Market characteristics

Also centrally important to investors are considerations of output and factor market demand and supply:

- What is the domestic market size? How large is the domestic consumer market (number of households, average level and distribution of per capita income)? How large is the domestic producer market (number of firms, asset size, input requirements)? How large and accessible are markets in other (*e.g.* neighbouring) countries?
- What labour force skills are available in the host country and what employee benefits (*e.g.* social security) are provided by the state? What energy sources and raw materials are available in the host country? Are labour costs (wages plus mandatory employer social security contributions), energy costs, raw material costs high/low relative to competing jurisdictions?
- What is the state of the host country's infra-structure covering transportation services (airports, seaports, rail systems, roads), telecommunications (phone/fax/internet services), other services important to business? Are private costs of using/purchasing infra-structure services high/low relative to competing jurisdictions?

3.1.7. Prevalence of location-specific profits

Assessments by investors of the risk/return on investment in a host country would normally factor in framework conditions and market characteristics of the country (or a region of the country where market characteristics vary by region). Assessments would be made in absolute terms, and relative or comparative terms (to examine risk/return differences when serving a market from one or more alternative locations).[9] In other words, a central question is how location-specific are the potential profits and risk when locating in/operating from a given host country?

For many if not most investments, levels of profit and risk associated with undertaking a given business activity part of a value-added chain, or meeting a particular market demand, may vary significantly across alternative locations, and may in certain cases be "location specific" – that is, may require a physical presence in a particular location. Examples of the latter would include privatisations, the extraction of natural resources, and the provision of restaurant and hotel services. In such cases, if profits can be expected at levels of risk investors are willing to assume, the profits are location-specific – that is, they cannot be realised by locating in another country or jurisdiction. This is not to say there would not be other similarly attractive (or more attractive) projects in other markets. It simply recognises that such investment projects could be expected to be undertaken if profitable, at acceptable levels of risk.

At the other extreme, investment projects to serve particular markets (*e.g.* investments to support the provision of "head office" or intra-group financial services) may be carried out from any one of a large number of alternative locations, at roughly the same profit/risk.

In between these extremes would be projects where there are several locations for a particular investment that offer similar economic profit at the roughly same level of risk (or alternatively, higher/lower profits at higher/lower levels of risk). Examples include R&D facilities and manufacturing plants producing outputs (*e.g.* pharmaceuticals, computer chips) for export markets.

3.1.8. Implications for tax policy

In general, investors are willing to accept a higher host country tax burden the more attractive are pre-tax profits for a given risk when investing in that country, with reference to framework conditions, market characteristics and location-specific profit opportunities. As emphasised in this article, the attractiveness of investment opportunities in a host country depends, in small or large part, on the type of business activity, on past and current public expenditure allocations towards public programs (*e.g.* education) and projects (*e.g.* infrastructure) supportive of framework conditions, and other market characteristics.

Where a profitable investment opportunity is specific to a particular host country, the tax burden may be largely irrelevant to an investment decision. Indeed, in principle, the tax burden on location-specific profit could be increased up to the point where economic profit is exhausted without discouraging investment.[10] Moreover, tax comparisons across locations (states/countries) generally would not factor in (with profit being specific to a particular location). Thus, where an economy offers an abundant set of location-specific rents, policy makers may understandably resist pressures to adjust to a relatively tax burden, to avoid tax revenue losses and windfall gains to investors (and to foreign treasuries in the case of inbound investment). Reducing the effective host country tax rate (*e.g.* to levels observed in competing countries) while possibly attracting capital in elastic supply, would give up tax revenues without impacting investment capital in inelastic supply.

In the context of economic profit that is not location-specific, comparisons with tax burdens imposed in competing locations would be expected to factor in. Where the number of competing locations is many (few), then the number of relevant tax comparisons would be many (few). If a given business activity can be carried out in a competing location that imposes tax on business at a relatively low rate, while offering as attractive a pre-tax risk/return profile as location A (taking account of all benefits, non-tax costs and

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risks associated with each location choice), then in theory investors would be unwilling to bear a tax burden in location A in excess of that rate.[11] Where a competing location offers a less attractive pre-tax risk/return profile, then investors may be willing to pay a higher tax burden in location A without being encouraged to invest elsewhere. However, where a competing location offers a more attractive pre-tax risk/return opportunity, it does not follow that a relatively low tax burden in A could be expected to compensate for investment impediments and swing investment in location A's favour. This is particularly true where tax incentive relief is low relative to additional costs incurred in investing in A, and/or contributes rather than reduces project costs and risks.

These generalisations, while helpful in considering possible outcomes of different host tax burdens, gloss-over practical assessment difficulties, and must be qualified on several counts. Under the simplified predictions remain difficulties over how to asses the relative significance to business profits of business framework and market considerations in competing locations. Where investment conditions in a given location are on balance more attractive than those elsewhere, the question arises as to how much higher the tax burden at source may be set without significantly impacting investment. And where investment can be expected to decline, at what rate and in what sectors? There also remains the fact that for inbound investors resident in countries operating residence-based tax systems, significant scope may exist for such investors to partially or fully offset host country tax using foreign tax credits provided by the home country. Whether this type of relief applies depends on the relative setting of host and home country tax rates, rules on the pooling or separate treatment of different sources of foreign income, as well as the current needs of the investor for repatriated earnings.

3. If framework conditions and/or market characteristics are weak, is it reasonable to assume that a low tax burden can impact investment decisions?

Policy makers are encouraged to reflect on the disappointing experience of transition economies that have attempted to rely on a low tax burden (typically targeted at foreign investment) to boost investment. Where framework conditions and/or market characteristics are relatively weak, evidence suggests that a low tax burden cannot be expected to swing investment decisions in the country's favour. The more commonly observed outcome is the creation of unintended and unforeseen tax planning opportunities. Moreover, where framework conditions are weak, a low host country tax burden achieved through the use of special tax incentives may operate to *discourage* rather than encourage investment, by contributing to project cost and risk. This is especially the case where the introduction of and subsequent changes to incentive schemes give the impression of an unstable tax system.

A corollary to this is that a host country with weak framework conditions and following a special tax incentive strategy may be giving up significant tax revenues that could collected without discouraging investment that has been made in the host country for reasons unrelated to tax – revenues that could be used to help strengthen the enabling environment for investment.

A further issue concerns the method by which a low tax burden is achieved, and in particular, whether tax relief applies to returns on marginal or infra-marginal investment. To varying degrees, tax relief will result in windfall gains – that is, tax relief to investors (or increased revenues to foreign treasuries) that does not result in additional investment, but supports investment that would have gone ahead in the absence of that relief – even where such relief is specifically targeted at additional investment.

Consider for example incremental tax credits, where tax relief is tied to some percentage of current investment in excess of average annual investment in prior years. Even in such cases, some fraction of qualifying investment would be expected to occur in the absence of the credit. Windfall gains are more likely where flat credits are used (that provide tax relief equal to some percentage of current investment), chosen for simplicity or to avoid certain distortions with the incremental model. Windfall gains are even more likely for incentives that provide tax relief equal to some percentage of profit derived from new and existing capital. A tax exemption for a certain fraction of profit, or a reduced statutory corporate income tax rate, would be examples of relief in respect of returns on new and existing capital. As existing capital is already in place, relief granted in respect of such capital provides a pure windfall gain.[12]

4. Is the tax burden on business appropriate with reference to the set of policy goals and objectives of the tax system?

In choosing the tax burden to levy on domestic profit, the analysis should weigh in the various objectives guiding overall tax policy design, including efficiency concerns, equity or redistribution concerns, compliance costs and revenue requirements. Where different goals suggest different tax burden levels, an appropriate balancing of competing objectives should be sought.

Choice over an appropriate host country tax burden on investment, shaped by balancing considerations, may begin with a fixed overall revenue requirement (to fund a given set of public expenditures including transfers to other levels of government, with revisions to overall revenue targets and expenditures possibly required). Given revenue requirements, policymakers would normally rely on a mix of taxes to meet those needs (*e.g.* taxes on income and profits, taxes on property and wealth, consumption taxes, trade taxes, other taxes) for reasons of equity, as some taxes tend to be borne more by some taxpayers compared with others, and efficiency, as various tax bases

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respond to a greater or lesser extent differently to taxation. In other words, there are limits to reliance on a given tax base, so a variety of taxes are typically included in the "tax mix". In addition to efficiency and equity concerns, other considerations (*e.g.* taxpayer compliance costs, tax administration costs, as well as others) factor in.

Efficiency concerns, based on an assessment of individual utility derived from income, leisure and other factors impacting individual welfare (*e.g.* a clean environment) consider the extent to which the underlying activity of a tax responds to changes in the level of taxation. In general, efficiency is judged to be reduced where a productive activity such as labour or investment, generating returns in excess of opportunity costs, is reduced, for example by a tax on wages or profits. In contrast, efficiency or welfare may be enhanced where pollution is reduced, for example with the introduction of an environmental tax.

Equity concerns generally call for an equal sharing of the tax burden across different taxpayers with roughly the same income or purchasing power (horizontal equity), and a progressive tax burden as income is increased, with those earning more income paying a higher percentage of their income in tax.

A balancing of considerations finds support in most countries for tax on business income at the personal and corporate level – primarily for horizontal equity reasons (between employees earnings wage income, self-employed earning wage and capital income, owners of unincorporated businesses, and shareholders). Given a desire to tax income from capital, for equity and efficiency reasons, a corporate income tax provides a withholding function, taxing income that could otherwise be avoided (by profit retention) or difficult to tax under accrual rules.

Efficiency considerations in policy choices over the appropriate tax burden on business hinge on the sensitivity of the business income tax base to taxation. Where the tax base is sensitive, generally lower levels of taxation would be called for on efficiency grounds. That is to say that in setting the level of the tax burden on domestic business income, policy makers must factor in limits to taxation of business income, with higher taxation tending to encourage capital flight and non-reporting.

5. Where the tax burden on business income differs by firm size, ownership structure, industrial sector or location, can these differences be justified? Is the tax system neutral as between foreign and domestic investors?

Tax systems may impose a non-uniform effective tax rate on different businesses, depending on their size, ownership structure (*e.g.* domestic *versus* foreign-owned), business activity or location. Certain firms may be specifically targeted to receive preferential tax treatment. Where tax relief is targeted, policy makers should examine and weigh arguments (*e.g.* market failure) in

favour and against such treatment, and ensure that the different treatment can be properly justified in order to respond to pressures for a broader target group. Where justifications are weak (*e.g.* where corporate tax relief is targeted at foreign investors to the exclusion of domestic investors), consideration should be given to a non-targeted approach.

In addressing this issue, the analysis could include an assessment of the average effective tax rate (AETR) on profits of *i)* small and medium-sized enterprises (SMEs), *ii)* large enterprises majority-owned by residents, *iii)* large multinational enterprises (MNEs) controlled by foreign parent companies, taking into account main statutory tax provisions?[13] Such an approach could be used to inform an assessment of whether tax-driven variations in AETRs across businesses of different size, ownership structure, and industrial sector can be justified, taking into account unintended distortions and other costs that they create.[14]

3.2. Determination of taxable business income (profit/loss)

6. Are rules for the determination of corporate taxable income formulated with reference to a benchmark income definition (*e.g.* comprehensive income), and are main tax provisions generally consistent with international norms?

In dealing with any given corporate tax system, investors expect basic tax provisions that adequately reflect business costs, including loss carry-forward provisions that are consistent with those commonly employed elsewhere. Investors also view negatively the double taxation of income within the corporate sector, and generally expect zero taxation of, or tax relief on, inter-corporate dividends particularly when paid along a corporate chain. In short, policy makers are encouraged to ensure that recognition is taken of reasonable expectations of main design features of the tax system.

Tax officials of Governments wishing to retain and attract investment should be encouraged to address (and weigh, within the set of overall policy objectives) various concerns of investors with respect to tax base rules. These concerns may be raised by the following set of questions:

- Do tax depreciation methods and rates adequately reflect true economic rates of depreciation of broad classes of depreciable property (serving as benchmark rates) and account for inflation?
- Are possible time limits on the carrying forward (and possibly back) of business losses, to offset taxable income in future (prior) years, sufficiently generous/consistent with international norms? [The case for generous carry-forward is particularly strong where depreciation claims are mandatory, rather than discretionary. Also important to consider is the interaction between depreciation and loss carry-forward rules.]

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- Are inter-corporate dividends (paid from one resident company to another) excluded from corporate taxable income to avoid double/multiple taxation? Are domestic dividends paid to resident individuals subject to classical treatment, or is integration relief provided in respect of corporate tax on distributed income (*e.g.* partial inclusion of dividend income, or imputation or dividend tax credit)? Is there evidence that such relief lowers the cost of funds for firms? Or is such relief intended to encourage domestic savings? Where integration relief is given in respect of distributed profit (dividends), is similar relief provided in respect of retained profit (*e.g.* partial inclusion of dividends and capital gains)?
- Where capital gains are subject to tax on a realization basis, are taxpayers allowed a deduction for capital losses (*e.g.* against corresponding taxable capital gains)? Do "recapture" rules apply to draw into taxable income excess tax depreciation claims on depreciable property?
- Is the tax treatment of wage income, as well as interest income, dividends and capital gains (realised at the personal or corporate level) designed to minimise incentives to *i*) characterize one form of income as another, and *ii*) choose one organisational form over another (incorporated *versus* unincorporated) for purely tax reasons? In other words, are efforts made to minimise tax arbitrage possibilities?

At the same time as addressing investors' concerns, policy makers should be encouraged to:

- Limit windfall gains (*i.e.* the provision of tax relief that does not achieve desired goals) to investors and, in the case of inbound direct investment, foreign treasuries;
- Minimize scope for the exploitation by business of the tax system (*e.g.* through tax arbitrage);
- Ensure single taxation of income sourced in the host country (*e.g.* through enforcement of domestic tax rules, and negotiation of tax treaties)
- Keep tax administration costs in check.

3.3. Prudent use of targeted tax incentives

7. Have unintended tax-planning opportunities created by targeted tax incentives been explored and taken into account in assessing the cost-effectiveness of such incentives? Have other problems associated with targeted tax incentives been explored and taken into account in assessing their cost-effectiveness?

Unfortunately, tax incentives are all too often viewed as a relatively easy "fix" by those working outside the tax area, and those with limited experience working in it. A tax incentive may be quickly incorporated into a budget

announcement, and holds out the apparent advantage of not requiring a cash-equivalent outlay, in contrast with an infrastructure development, manpower training, or other programme introduced to foster investment. The reasoning goes as follows: by targeting tax relief at new investment, a tax incentive will only reduce the amount of tax revenue raised on additional investment – revenue that would not have been raised anyway in the absence of the incentive.

However, this perception misses the fact that tax incentive relief, even when targeted at new investment, will always be sought by businesses outside the target group. Existing firms will attempt to characterize themselves as "new", and other similar tax-planning strategies can be expected that will deplete tax revenues from activities unrelated to any new investment attributable to the tax relief, with lost revenues often many multiples in excess of original projections. In contrast, direct cash grants, while raising possibly greater concerns over inviting corruption (unless significant administrative discretion is also involved in the granting of targeted tax incentives), may offer greater control over various types of abuse.

Tax holidays and partial profit exemptions, in particular, offer significant scope for tax relief unintended by tax authorities. Other forms of targeted tax relief may also create unintended scope for tax-planning, and result in revenue losses well in excess of levels originally anticipated (*e.g.* where the relief spills over to benefit non-targeted taxpayer groups). While notoriously difficult to predict, policy makers are encouraged to consult widely to sharpen estimates of the revenue losses from a given incentive.

Tax holidays and partial profit exemptions are typically targeted at "new" companies. However, it is hard for tax administrators to determine if a newly-established company is actually financed by new capital, or instead by capital already invested in the host country. In other words, much of the "new" capital may in fact be previously existing capital that has been re-characterised as new (*e.g.* through liquidation of an existing company, with the capital invested temporarily in an offshore holding company, then re-invested in the host country with the appearance of new investment by that offshore company).

Provisions providing for a partial or full profit exemption also open up transfer pricing opportunities to artificially shift taxable income of business entities in the host country that do not qualify for special tax relief to entities that do. Aggressive transfer pricing techniques essentially involve the use of non-arm's length prices on intra-group transactions, and non-arm's length interest rates on intra-group loans, to shift taxable income to low or no-taxed entities. The shifting of tax base in such cases is artificial in the sense that it takes the underlying business structure as given, and simply manipulates prices to shift the taxable income associated with the structure to obtain the most tax efficient outcome. As guarding against such abuse of the tax system is becoming increasingly difficult with increased trade in intangibles (for which an arm's

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length price is often difficult to fairly establish by tax authorities, due to limited or non-existent second markets to look to), so too is it becoming increasingly difficult to guard against excessive revenue losses stemming from incentives providing for a full or partial profit exemption.

It should also be pointed out that where a tax incentive is in place and previously unforeseen tax-planning opportunities become all too apparent, it is not without cost for the government to withdraw the incentive to protect the domestic tax base from further erosion. While cancelling incentive relief for future investment may be accepted by investors, cancelling relief tied to prior investment decisions – that may have been based on the expectation of tax incentives previously on offer – can carry a significant cost. In particular, policy credibility is seriously undermined, weakening the ability of government to influence investment behaviour in the future through policy adjustment. Given this, where tax incentive relief linked to investment expenditure (*e.g.* enhanced or accelerated depreciation, investment tax credit) is cancelled, tax relief tied to prior investment generally should be respected (not withdrawn) – unless the costs are so exorbitant that respecting past commitments would be devastating to public finances.

To varying degrees depending partly on the instrument used, reduced host country taxation will provide tax relief in respect of investment that would have been undertaken in the absence of such relief – so-called "*windfall gains*" to investors and, in the case of FDI, foreign treasuries. Windfall gains arise even where tax relief is targeted at "incremental" investment in excess of some average of past investment. Avoiding windfall gains, however, generally comes at the cost of increased complexity.[15]

Within the context of a general policy goal to avoid windfall gains (and losses), *transitional considerations* related to the introduction and removal of tax incentives should be addressed. Where tax relief is provided, a general aim is to target tax relief to incremental investment, that is, investment that would not have occurred in the absence of the incentive. Conversely, where tax relief is withdrawn, it is important to attempt to ensure that past investments are not penalised.

Targeted tax incentives may create *unintended distortions* to the allocation of productive capital, and to corporate financing and repatriation decisions, implying welfare losses.[16] Accelerated depreciation rates, for example, may create welfare losses where they do not adequately reflect variations in true economic rates of depreciation across capital asset classes (serving as benchmark rates). Similarly, reinvestment allowances providing a tax deduction equal to some percentage of reinvested (pre-tax) profit would tend to discourage investment financed by new equity, and may raise the overall cost of funds, implying welfare losses.[17]

Unintended distortions may also be created where inter-actions between tax incentives and other provisions of the tax code (*e.g.* depreciation treatment, loss treatment) are not adequately addressed. Furthermore, policy-making, if not properly co-ordinated, may result in the "stacking" of multiple tax (and non-tax) incentives on offer by different Ministries, at the same level or by different levels of government (*i.e.* targeted at the same or similar business activities, assets, or regions), creating unintended distortions including possible over-investment in certain cases.

Tax incentives, even those held out as simplifying measures, may also create *additional complexity* and add to compliance and tax administration costs. For example, some argue that tax holidays are a simple incentive to administer, as there is no need for corporations (or government) to worry about maintaining financial records to support tax returns over the holiday period. However, in order for firms to claim tax deductions (*e.g.* business loss carryovers) following the holiday period, a full record of revenues and costs over the holiday period would normally be required. Assembling and verifying this data post-holiday may be more difficult and time consuming than had the required financial records been maintained all along.

Tax incentives may also *encourage corruption* and aggravate concerns raised by poor public governance. When used, targeted tax incentives should be designed to be as automatic as possible in their application, to avoid the involvement of tax officials in the determination of the application of provisions to individual taxpayers. Also to be avoided are situations where tax officials undertaking audits have the power to withdraw tax incentive relief, without special safeguards against corrupt practices. Frameworks should be in place to discourage bribery of tax and customs officials in such cases.

Lastly, targeted tax incentives may be *inconsistent with international obligations* (*e.g.* national treatment obligations, State Aid Rules applicable for member countries of the European Union)).

8. Where targeted tax incentives do not meet a cost-benefit test owing to investment impediments linked in part to government policies, what alternative strategies have been considered?

Where strong political pressure is felt for introducing tax incentive relief – despite analysis indicating limited investment response relative to revenue losses and administrative costs entailed (implying failure to meet a cost-benefit test) – full attention should be given to alternative strategies, including addressing investment impediments directly. Relative pros/cons of other approaches should also be considered.

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3.3.1. Addressing main impediments to investment

When considering the use of targeted tax incentives to support investment, due attention should be paid to scope for addressing investment impediments directly. Attention to tackling real impediments unrelated to tax should be addressed prior to, or at a minimum parallel with, attempting a tax solution.

Where weak framework conditions (poor budget management, poor public governance, corrupt practices on the part of tax and customs officials) and/or high project costs (linked to poor infrastructure, high labour costs or other factor costs) are impeding to investment, certain public officials may be attracted to the option of recourse to tax incentives. In such cases, policy makers should be encouraged to consider what policy and administrative changes may be implemented to address investment impediments directly, beginning with areas where progress can be achieved quickly. Where policy adjustments require additional tax revenues, priority areas should be identified and revenues bases examined.

3.3.2. Broad-based tax relief and non-tax relief

When considering possible tax strategies to attract investment, consideration should be given to non-targeted relief measures to avoid the problems encountered with targeting. Such approaches could include a reduced statutory corporate tax rate applied to a broadly-defined corporate tax base (in order to avoid unintended consequences and revenue losses) as an alternative strategy of narrowing the tax base through a reliance on targeted tax incentives. Consideration should also be given to addressing possible impediments in the tax system owing to restrictive provisions (*e.g.* limited loss carry-forward rules), or provisions contributing to compliance costs.

Finally, it is important for tax officials to recall that financial assistance to business may be delivered outside the tax system. This more transparent mechanism may be more desirable, particularly where the tax administration system is relatively inexperienced, or weak and open to corruption.

3.4. Tax expenditure reporting and evaluation

9. Are tax expenditure accounts reported, are tax incentive evaluations carried out, and are sunset clauses used to properly manage and inform the budget process?

Tax expenditure accounts reporting tax revenues foregone by targeted tax incentives and other departures from a benchmark tax system should be a cornerstone of fiscal policy in countries where attracting capital and addressing public governance issues remain high on the political agenda.

Such accounts should be subject to public scrutiny, for example by an appointed auditor of public accounts, and/or by independent research institutions, to hold the government to account for public use of funds. Tax expenditure amounts should be considered alongside direct expenditure amounts targeted at similar activities, to properly inform the budget process and positively influence ongoing fiscal reform.

Tax expenditure assessment requires the Ministry of Finance or Tax Administration Department maintaining a micro-simulation model to estimate tax revenue and income distribution effects of proposed and actual tax reforms, drawing on a representative sample of personal and corporate income tax returns. Assessing foregone revenues should take into account, to the extent predicted, likely tax planning responses. Such analyses should be based on a variety of inputs, including consultations with business and findings of other countries that have tested similar measures (taking into account different host country conditions in shaping outcomes).

For proper management of public finances, tax incentives targeted at investment should be assessed in advance and following implementation if introduced, to gauge whether such measures pass or fail a cost-benefit test. To enable such evaluations, the specific goals of a given tax incentive need to be made explicit at the outset to enable a proper assessment of the degree to which stated goals are met.

When introducing tax incentive legislation, "sunset clauses" should be included calling for the expiry of the incentive (*e.g.* 3 years after implementation), to provide an opportunity for assessment in order to establish whether the incentive should be extended or not.

3.5. International co-operation

10. Are tax policy and tax administration officials working with counterparts in other countries to expand their tax treaty network, enhance exchange of information for tax purposes, and counter abusive cross-border tax planning strategies that artificially reduce the domestic host country tax base?

A wide tax treaty network is helpful to countries seeking to attract investment in several ways. First, and perhaps foremost, tax treaties operate to avoid double taxation of cross border returns – with the prospect of double taxation on cross-border returns being a major concern in the cross-border investment context. In the absence of a tax treaty between a host and home country, double taxation of returns will normally arise where the two countries treat a given return differently. For example, countries may take different views on the source or origin of income, and/or the type of income paid (*e.g.* interest *versus* dividends), with different characterisations triggering

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different tax treatment. Tax treaties operate to avoid these different characterisations and thereby minimise the scope for double taxation, thereby reducing project costs (with tax viewed as a business cost).

Tax treaties, by providing greater transparency over the tax treatment of cross-border investment, also help reduce investor uncertainty over tax treatment. Indeed, certain articles of tax treaties are specifically aimed at establishing procedures (*e.g.* mutual agreement procedures (MAPs)) to help resolve disputes over the allocation of taxing rights between host and home countries. A wide tax treaty network therefore tends to make countries more attractive, in relation to tax considerations, both as locations for business activity, and as places from which to conduct global business operations, by lowering projects costs as well as project risks.

Third, tax treaties generally stipulate lower non-resident withholding tax rates on dividends, interest and royalties. Indeed, treaty negotiated rates are often significantly lower than statutory withholding tax rates that would otherwise apply. This aspect of tax treaties also serves to lower project costs.

At the same time, tax treaties provide a framework to enable exchange of information amongst tax authorities to counter more aggressive forms of tax-planning in relation to foreign source income as well as domestic source income (that may be stripped out to tax havens through the use of special corporate structures and financing and repatriation strategies).

Notes

1. The tax treatment of foreign source income generally would be an important tax consideration when deciding where to locate a corporate base from which to hold foreign assets. However, a discussion of the special tax considerations arising in this context are beyond the scope of this article, which concentrates on investment for production purposes rather than management/co-ordination purposes.
2. The term "host country" is commonly used in the context of cross-border (inbound or outbound) investment to refer to the country in which a productive asset is located (*e.g.* where a company is located and income is sourced), with the term "home country" used to refer to the country in which the investor (owner of the productive asset) resides. In this article, we also use the term "host country" to refer to the country in which a company is located, and apply this term both in the context of inbound foreign direct investment (non-resident investor in a domestic enterprise) and pure domestic investment (resident investor in a domestic business). Thus use of the term "host country" need not imply FDI.
3. Both the level of the effective tax rate on profit and the method (types of tax, and their design features) by which that effective tax rate is set may be relevant.
4. Similarly, home country taxation of foreign source income may directly impact investment – the higher (lower) the net home country tax rate on foreign profit, generally the lower (higher) the level of direct investment abroad (DIA) by domestic firms in instances where tax impacts investment decisions. Effects on domestic investment of home country taxation of foreign source income are less

than clear – whether an effective tax burden on foreign source income that is low relative to that on domestic income discourages or encourages domestic investment depend, in part, on whether DIA is a substitute for or complement of domestic investment.

5. In the cross-border situation, this need not be the case. In particular, private investment costs generally would not be affected where increased (decreased) host country taxation is offset by an increased (decreased) foreign tax credit being allowed by the home country tax system of the investor.

6. See for example OECD 2003, Using Micro-data to Assess Average Tax Rates, OECD Tax Policy Studies No. 8.

7. In addressing this issue, one can measure for SMEs and MNEs, the average amount of professional time (of tax accountants, tax lawyers, tax administrators) per year required to comply with the tax code. This can be converted to an average annual compliance cost to business, with reference to the average hourly wage of a tax professional, and included in the calculation of total tax liability of a representative sample of firms.

8. A related tax policy issue is whether depreciation rates adequately reflect true economic rates of depreciation of broad classes of depreciable property (serving as benchmark rates) and account for inflation.

9. Exceptions to this general approach would include certain privatisations where potential pure economic profit is both location and time-specific.

10. An eventual exhaustion of economic profit recognises that not all revenues raised from an increase in host taxation would be allocated to public expenditures that directly support business (*e.g.* education, infrastructure). In principle, where revenues from taxes on business are allocated to programs that provide direct and immediate support to business, a higher tax burden could be levied without discouraging investment. However, this presumes that relevant program spending is as efficient as private spending, ignores lags between tax collection and the delivery of benefits to business, as well as other uses of public funds.

11. Transaction costs in decoupling business activities should be taken into account in considering alternative location choice.

12. Where additional investment is constrained by cash flow, tax relief on profit derived from previous investment may encourage current investment by supplying a source of funds. However, where such financing constraints do not exit, tax relief on returns to installed capital (*e.g.* through a reduction in the statutory corporate tax rate) will provide a pure windfall gain.

13. In modeling effective tax rates on SMEs, consideration should be given to enterprises structured in corporate and unincorporated form (information on the relative (asset) size of the incorporated *versus* unincorporated sector would indicate the relative importance of alternative measures). For incorporated firms (SMEs and possibly large resident-owned firms) with limited access to international capital markets, consideration should be given to average effective corporate tax income rates inclusive of corporate and personal income taxation to incorporate possible personal tax effects on the cost of funds. In modeling FDI, consideration should be given to inbound investment from several different countries. This could include a non-treaty case where a statutory (non-treaty) dividend withholding tax rate would apply, and where one could assume no home country taxation. In considering treaty cases, the sample should include a major capital exporting

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country operating a source-based system (dividend exemption), as well as one or more operating a residence-based tax system (dividend gross-up and credit).

14. This bullet concerns differences in effective tax rates that arise from the application of different tax rates and rules to similar transactions (*i.e.* it does not concern differences that arise from the application of similar rules to different transactions). For example, rates of capital depreciation, for tax purposes, typically differ by type of capital asset. This means that effective tax rates will differ across sectors to the extent that capital stocks of firms in one sector differ in composition from stocks of firms in another. Such differences may be viewed as structural, rather than tax driven. An example of the latter would be where the same type of asset is depreciated at a different rate depending on the sector. This bullet concerns tax-driven differences of this sort.

15. For example, avoiding windfall gains on accelerated depreciation requires that the balance of undepreciated capital cost, at the time of introduction of this incentive, be depreciated at pre-reform as opposed to accelerated rates to avoid tax relief in respect of pre-reform capital stocks. Windfall gains are inevitable in certain cases, depending on the mechanism used to deliver tax relief. For example, in general it is not practically possible to target a new reduced corporate tax rate to profits from new investment alone (i.e. not practically possible to ring-fence such profits, to the exclusion of profits from prior investment).

16. This paragraph concerns unintended distortions, recognising that tax incentives generally are intended to influence or distort the allocation of capital away from patterns that would be observed in the absence of the incentive. Whether intended distortions created by tax incentive use are welfare improving depends on whether the incentive corrects a true market failure.

17. In contrast, an enhanced investment allowance providing a deduction equal to some percentage of qualifying investment, providing relief regardless of the source of finance, would not raise the same problem.

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Chapter 3

Encouraging Public-Private Partnerships in the Utilities Sector: The Role of Development Assistance*

Adequate physical infrastructure is a key element of a sound investment climate and development agencies can help countries mobilise private investment through ODA spent on relevant infrastructure. However, the developing world needs far more financing for infrastructure than can be provided through ODA and domestic public finances alone. Given the shortage of public funds in most developing countries, the obvious solution is to invite greater private sector participation, but this too is problematic since investing in infrastructure projects in many parts of the world is not financially viable from a private sector perspective. One solution is to expand the use of public-private partnerships (PPP) in utilities, relying on ODA to enhance the quality of projects, reduce risks and raise profitability.

The present article reviews recent experiences with private participation in infrastructure in developing countries, enumerates some of the obstacles that have been encountered and proposes ways in which development agencies may overcome the obstacles to maximise the benefits of PPPs for development.

* This article was prepared by Stephen Thomsen, an external consultant to the Investment Division, OECD. The views expressed are those of the author. They are not necessarily shared by the OECD or by the Organisation's member countries.

The forms public-private partnerships (PPP) in developing countries have taken are legion, ranging from the construction of physical infrastructure, to public administration, to the provision of health and social services. (A frequently quoted example of the latter is foreign-owned companies' partnership with the South African government to provide treatment of HIV/AIDS.) The focus of this article, however, is on physical infrastructure. PPPs have provided a principal vehicle for foreign direct investment (FDI) into public utilities and infrastructure in developing countries, with OECD-based multinational enterprises participating in most of the largest PPPs in this area.

Adequate physical infrastructure is a key element of a sound investment climate and development agencies can help countries mobilise private investment through ODA spent on relevant infrastructure. However, the developing world needs far more financing for infrastructure than can be provided through ODA and domestic public finances alone. The cost of maintaining existing infrastructure and undertaking necessary extensions of its coverage is estimated at 7% of developing country GDP, equivalent to about 600 billion US dollars (USD) per year. Public spending on infrastructure in developing countries is presently around 3%. Also, bilateral ODA for infrastructure has dropped from USD 15 billion in 1996 to USD 8 billion in 2002, and international financial institutions' lending for infrastructure has dropped precipitously.

Given the shortage of public funds in most developing countries, the obvious solution is to invite greater private sector participation, but this too is problematic since investing in infrastructure projects in many parts of the world is not financially viable from a private sector perspective. One solution is to expand the use of PPPs in utilities, relying on ODA to enhance the quality of projects, reduce risks and raise profitability. The economic rationale for doing so, in effect subsidising private enterprises, rests on the presumption of market imperfections:

- One category of imperfections relates to the fact that many developing countries lack the administrative and regulatory capacities to provide an adequate environment for PPPs. Insofar as this relates to public governance in general, the ODA-based remedies are essentially the same as the ones applied the context of the overall investment climate and development agencies' private sector development programmes. Conversely, if the problem

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is a lack of specific knowledge on how to conduct PPPs a much more targeted approach to address the market imperfection is feasible.

- A second market imperfection is political and other non-commercial risk in developing countries. This should not be confused with the quantifiable likelihood of defaults or failure of a number of projects, against which large and internationally diverse investors can provision on their own. Risk, in the sense of truly unforeseeable events, is in practice closely related with county's administrative and regulatory capacities. The chance of political or social "events" throwing a long-term contractual relationship into jeopardy is far greater where public governance is weak and the rule of law not firmly entrenched. Risk mitigation measures may therefore often be a second-best to addressing other market failures, or a "quick fix" while waiting for these failures to be addressed.
- Even where the host country's regulatory environment is adequate, and residual risk has been dealt with, many projects will nevertheless have a positive social rate of return, and a negative private one. This gap can be bridged by a public subsidy such as ODA, for instance through targeted subsidies to the service providers or by subsidising consumption during a transitory period to full cost recovery pricing.

Over the past two decades governments in developing countries (and several developed countries as well) have embarked on radical structural reforms, encompassing restructuring and privatisation of infrastructure sectors and a new approach to regulation. One prong of this new strategy involves public-private partnerships to provide infrastructure. PPPs were responsible for USD 786 billion in infrastructure investments between 1990 and 2003. Some of this money obviously came from the public purse, but the private sector nevertheless contributed significantly to infrastructure development over the period – far in excess of what governments could have financed on their own – and assumed several of the risks (*e.g.* commercial and currency risk) that would otherwise have befallen the public sector.

This article considers the role of the private sector and the donor community in helping to overcome shortfalls in both the quality and quantity of infrastructure in developing countries. While PPP is in principle a somewhat less encompassing concept than private participation in infrastructure (for instance, private investors can invest on fully commercial terms), the two concepts are in practice used interchangeably in the remainder of the article. So are the words "public utilities" and "infrastructure". Section 1 provides an overview of the most common forms of PPP. Section 2 reviews recent geographic and sectoral trends in private participation in infrastructure.

1. The most common forms of PPP in utilities

In public-private partnerships, the public and private sectors join forces to design, finance, build, manage or maintain infrastructure projects. Such partnerships can take many forms, depending upon the exact allocation of risks and responsibilities. These include:

- *Service contracts*. The private sector provides a bundle of specific services to a public utility, but the public sector retains overall operational responsibility. Service contracts can in practice take many forms, but two of the most common ones are:
  - *Management support*. The private operator supplies the public authority with human and technical resources for a fee. It provides technical know-how on all operational and financial aspects of project management remaining within the jurisdiction of the public authority.
  - *Operation and management (O&M)*. The private operator is in charge of daily maintenance of the facilities. The private operator is paid for its services by the public authority according to specific and qualified performance criteria. Unlike management support, the private operator may in some cases take on the responsibility for operating the facilities.
- *Delegated management contracts*. In his type of contracts the public sector retains overall ownership of the assets, but delegates the responsibility for their operation to a private operator for a definite (often long) period of time. Two of most commonly seen models are:
  - *Affermage or lease agreement*. The private operator manages the services for a period (often five to fifteen years) and is responsible for maintaining and renewing the facilities according the terms of the contract. In this capacity, it takes charge of all personnel and existing assets but is not responsible for financing new facilities. The public authority remains responsible for all new investment and compliance to existing norms. The private operator invoices the end-users directly.
  - *Concession*. The public authorities fully entrust the private operator with management of the services and all necessary investment for a period of 20 years or more. The private operator invoices the end-users directly, the public authorities retaining strict control over service terms as well as all key decisions related to applicable rates and targets.
- *Construction support*. In the most wide-ranging form of PPP contracts the private operator is involved in the design and construction phases of new infrastructure and carries at least some of the risks associated therewith. Some of the main forms of construction support have been:
  - *Build Design Operate (BDO)*. The public authorities entrust the private operator for a fixed period of time with design, construction and operation

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of new facilities which remain the property of the public authorities. The private operator assumes the risks linked to design and management of the facility. It is paid a fee by the public authorities and commits to an overall cost for the facility's construction and operation.

- *BOT (Build Operate Transfer)*. The private operator designs, finances and builds infrastructure. While formal ownership of the assets is assigned to the government, the private sector operates the project long enough to service any debt incurred and to earn a suitable return.
- *BOO (Build Own Operate)*: In contrast to the BOT case, the private investor retains ownership and control of the project.

Table 3.1 illustrates, based on the assessments of Gruber (2003), how the main forms of PPP differ in terms of the allocation of ownership, investment and commercial risk between the private and public sector. The table is interesting for a couple of reasons. First, the two main considerations for countries seeking private participation in their infrastructure mentioned above (efficiency; funding) can only be realised jointly where at least part of the investment is private. Where it remains public, only efficiency gains can be hoped for. Second, in the case of failing or distressed PPPs it is frequently a matter of concern whether the commercial risk rests with the public or the private sector.

Table 3.1. **Characteristics of alternative forms of PPP**

	Operation and maintenance	Ownership	Investment	Commercial risk	Duration (years)
Management support	Public and private	Public	Public	Public	1-2
O&M	Private	Public	Public	Public	3-5
Leasing	Private	Public	Public	Semi-private	8-15
Concession	Private	Public	Private	Private	20-30
BDO	Private	Public	Public	Private	20-30
BOT/BOO	Private	Public/private	Private	Private	20-30

Source: Gruber (2003) and OECD Secretariat.

The following sections mostly focus on kinds of PPPs that involve an element of private investment or, at least, commercial control over assets. Given that the host authorities are willing to accept private investment – in practice often foreign direct investment – in their utilities sector, the hoped-for benefits can in principle be achieved regardless of the entry mode of the private operator. That said, the main modes of entry for private participation in infrastructure have been:

- *Joint ventures*. The public and private sectors jointly finance, own and operate a project to provide infrastructure. Risks and responsibilities are

shared according to the division of ownership between the investors and depending on any contractual agreements between or among partners.

- *Greenfield projects.* These involve new projects usually built and operated by the private sector which takes on the commercial risk. Political and exchange rate risk can sometimes be shared with the public sector. Such projects can take many forms, but the most common are BOT and BOO. Others include Build-Own-Operate-Transfer (BOOT), Design-Build-Finance-Operate (DBFO) and Build-Lease-Transfer (BLT).
- *Divestiture or asset sale*. State assets are privatised either through public offerings of shares or through the direct sale of the assets themselves. The State retains responsibilities as regulator and sometimes customer and might subsidise certain activities which are socially desirable but unprofitable for a private company to undertake (such as the provision of services to the poorest segments of society or to remote regions). Forms of private participation where the State entirely dissociates itself from a utility cannot be properly described as PPPs.

2. Recent trends in PPPs in developing countries

Almost all developing countries have undertaken public-private partnerships in infrastructure since 1990. Some countries and sectors, as well as some forms of PPP, have been much more prominent than others, but this should not disguise the quasi-universal nature of the phenomenon. Differences across regions and sectors have nevertheless been significant and provide valuable policy lessons from the PPP experience. The present article focuses on the utilities sector (telecommunications, energy, transport and water and sewerage) and on all developing and transition countries. Much of the data comes from the World Bank's Private Participation in Infrastructure (PPI) Project database. Note that it includes complete privatisations with little or no element of PPP.

Investment in infrastructure projects with private participation in developing countries took off in the early 1990s, growing from USD 18 billion in 1990 to peak at USD 131 billion in 1997 (Figure 3.1). Faced with the growing perception that existing infrastructure was both insufficient and inefficient, developing countries began to open up the sector to foreign participation beginning in the early 1990s. In some cases, public assets were sold off outright while in others private firms were allowed to participate through greenfield projects and concessions.

This upward trend eventually proved unsustainable, both because privatisations are by their nature a one-time occurrence – except for subsequent investment in expansion and upgrading – and because the earnings projections on which many projects were based proved unfounded. Private investors,

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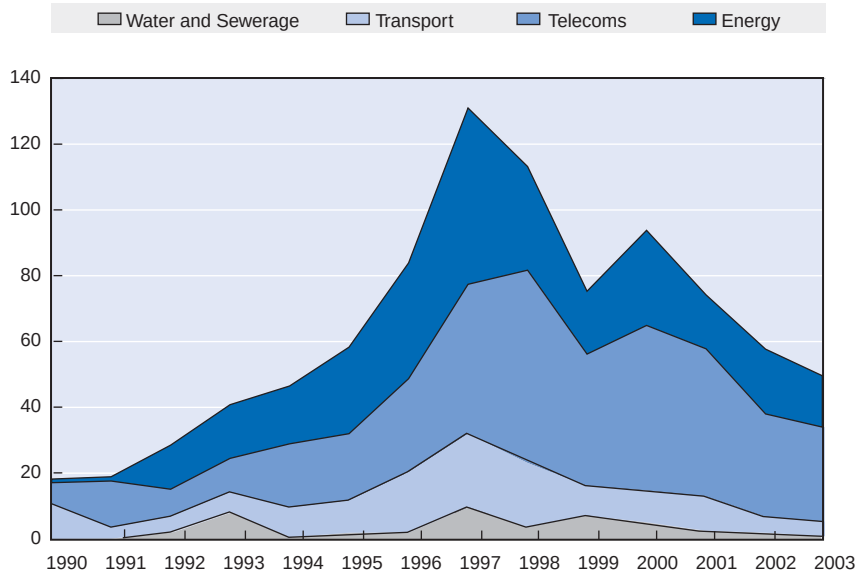
Figure 3.1. **Investments in PPPs, total and by sector 1990-2003**
USD billion



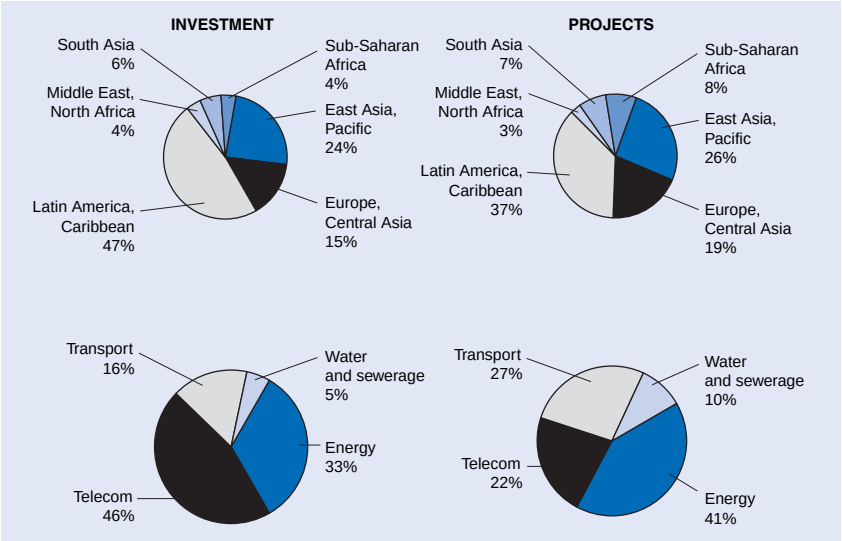
Source: World Bank PPI database.

notably in telecommunications and energy, also began to experience financial difficulties at home which dampened enthusiasm for investing in high risk developing countries.

Infrastructure projects involving PPPs are now back to the level of a decade earlier, before the real takeoff. Just as the growth of PPPs was universal, so too has been the decline: all regions and sectors have been affected. Investments continued to fall in all sectors in 2003 and in almost all developing regions with the exception of the Middle East and North Africa. As discussed below, the prospects for a revival of flows back to the levels of the mid-1990s are, at least in the short to medium-term, not compelling. The Asian crisis increased international investors cautiousness and raised competition among developing countries to attract foreign investments.

Between 1990 and 2003, there were over 2750 projects with private participation in infrastructure in developing countries, with total public and private investment in these projects amounting to USD 786 billion.[1] Figure 3.2 compares the regional and sectoral distribution of PPPs by amounts invested and by the number of projects. As a general rule, the number of projects tends to be relatively more evenly distributed across sectors and regions, reflecting the fact that invested amounts are influenced by a few very large investments

Figure 3.2. **Distribution of PPPs by sector and by region, 1990-2003 (%)**



Source: World Bank PPI database.

notably in Brazilian telecoms. For this reason, Latin America represents 47% of investment but only 37% of projects. Similarly, telecommunications is first in terms of investment but only third when ranked by project numbers.

2.1. Sectors

In telecommunications, technological innovations – in particular the advent of cellular networks – have allowed for new entrants thus dramatically transforming the competitive structure in national markets. Traditional public telephone companies have been privatised in Latin America and parts of Europe and Central Asia but much less in other regions. Overall, divestitures of government assets have in the past been slightly more important than greenfield projects, and much of the recent decline in investment can be explained by the completion of privatisation programmes in Latin America. Investment in expansion within this sector has held up better, averaging USD 19 billion in each of the past five years. The GrameenPhone company in Bangladesh is an example of a PPP which offers mobile phone services and has sidestepped many of the constraints imposed by existing transmission networks (Box 3.1).

The energy sector has seen the largest number of projects over the period since 1990, and the second-highest amounts of investment. Electricity figured prominently. Once again, Latin American countries have been more prone to privatise state assets while Asian countries have mostly invited greenfield ventures in the form of independent power producers (IPPs) to satisfy their

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Box 3.1. **GrameenPhone – Providing mobile phone services in Bangladesh***

The much-publicised example of GrameenPhone's provision of mobile telephone services in rural areas in Bangladesh provides a perfect example of the potential synergies which exist among local enterprises, foreign investors and international donors. It also demonstrates a cost-effective strategy for providing infrastructure services to the poor.

Fixed-line services are provided by the state-owned, and inefficient, Bangladesh Telegraph and Telephone Board (BTTB). Bangladesh has one of the lowest telephone penetration rates in the world, and customers must wait from 5 to 10 years for an installation. While local calls are in effect subsidised, long-distance and international calls are expensive. Private competition exists only from mobile operators which, with no interconnection capacity to the main fixed network, offer mostly mobile-to-mobile services in the urban areas. Foreign telecom companies have stayed away from the market for the "usual" reason: high administrative costs in terms of handsets sales, bill collection and maintenance were estimated to exceed any potential returns from entering the market.

In 1997, a joint-venture named GrameenPhone was formed between a Norwegian operator (Telenor MC), a local micro finance company (Grameen Bank) and other investors. Grameen Bank set up an independent non-profit organisation to hold shares in GrameenPhone and thus had no direct ownership stake, but its participation was nevertheless essential to the success of the venture. Telenor provided hardware, technology and management expertise, and Grameen Bank offered its extensive local network, understanding of the economic requirements of the rural population, and a local partner to negotiate effectively with the government. Bilateral and multilateral aid contributed to the installation of 700 base stations. GrameenPhone was the largest private investor in Bangladesh in 2002 and the second largest corporate taxpayer.

Up to this point, the story may be interesting but not unusual. What makes the venture special is the Village Phone Programme which was created by GrameenPhone. Under the Programme, a female shopkeeper or equivalent in each village within reach of a base station borrows money from Grameen Bank to purchase a telephone and then repays the loan by selling mobile phone services to the local population. This strategy fulfils two important development goals: empowering women and providing infrastructure services to the poor. There are now 45 000 "Village Phone Ladies" in 39 000 villages throughout Bangladesh. The Programme is profitable for GrameenPhone, even if it offers phone connections to the Phone Ladies at a 50% discount.

Box 3.1. **GrameenPhone – Providing mobile phone services in Bangladesh*** *(cont.)*

The Programme is also instructive for its synergies between donors and investors. In addition to the ODA provided for expanding the base station network, donors shared initial business risks with private investors by providing financial guarantees and advice. They also supported the social-responsibility dimension by ensuring that the company included access to the poor in its business plan and by providing socio-economic impact assessments.

* This section draws on OECD (2004).

growing energy demands. In electricity, 70% of all investment has gone into generation alone, with another 13% going into integrated utilities or some combination of generation and transmission or distribution. Private participation in transmission and distribution has come about almost exclusively through privatisation.

The transport sector represents only 16% of total investment but 27% of projects. One half of this investment has gone into toll roads, with the rest in railways, seaports and airports. Unlike in telecommunications and energy, concessions are by far the most important form of PPP in this sector, owing partly to the political sensitivity of transferring public assets to the private sector. In the 1990s, three quarters of toll road concessions involved expansion or rehabilitation of existing roads rather than the construction of new networks. Divestitures have been rare and have mostly occurred in China where minority stakes were sold in several state-owned toll road companies in order to finance future road construction.[2]

In the water and sewerage sector, the relative scarcity of projects stems from both host government reticence and a lack of investor interest. Fears of a political backlash against private ownership and the relatively greater role played by sub-national governments have dampened enthusiasm for PPPs. The top eight projects account for one half of all investment and the top two (Aguas Argentinas, Manila Water and Wastewater) represented almost one third of total investment. As in the transport sector, concessions are the most popular form of PPP, accounting for over two thirds of total investment.

2.2. Regions and countries

The prominent role of Latin America as a host to PPPs reflects the greater degree of liberalisation undertaken in that region relative to the rest of the world combined with the size and wealth of the regional market. Private

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investment in existing government assets represented one third of all investments in Latin America but only one fifth in East Asia. Privatisation was also an important component of PPPs in Europe and Central Asia. Where state assets were sold off in East Asia, they tended to be in the telecommunications sector. In energy, 88% of investment in PPPs in East Asia went towards greenfield investments in the form of IPPs.

Almost all developing countries have witnessed some form of private investment in infrastructure since 1990, but private investors in infrastructure have tended to favour the same countries chosen by investors more generally: relatively large, wealthy or fast-growing markets. Table 3.2 shows the top 25 destinations for investment in PPPs in infrastructure in developing and transition economies. Together these countries account for almost 90% of total PPP investment in the developing world. The 64 countries at the bottom of the list account for only one per cent of total investment in PPPs in developing and transition economies since 1990 or USD 8.2 billion.

Table 3.2. **Top 25 countries for PPPs, 1990-2003**

	USD million	%
Brazil	157 098	19.7
Argentina	72 858	9.1
China	61 170	7.7
Mexico	59 753	7.5
Malaysia	36 695	4.6
India	33 108	4.2
Philippines	31 017	3.9
Indonesia	29 210	3.7
Thailand	23 662	3.0
Chile	22 003	2.8
Poland	18 025	2.3
Turkey	17 719	2.2
Hungary	17 415	2.2
Czech Republic	16 388	2.1
South Africa	15 959	2.0
Russia	14 784	1.9
Colombia	13 779	1.7
Peru	13 762	1.7
Morocco	12 812	1.6
Venezuela	11 858	1.5
Pakistan	7 487	0.9
Slovak Republic	5 837	0.7
Egypt	5 689	0.7
Romania	5 321	0.7
Bolivia	4 848	0.6
Total Top 25	**708 257**	**88.9**

2.3. PPPs by type

Table 3.3 shows the prevalence of each type of PPP across sectors and regions. Most concessions contracts were seen in the transport sector and most divestitures in telecoms. Greenfield projects were fairly evenly divided between energy and telecoms, as were management and lease contracts between telecoms and transport. The largest share of both concessions and divestitures has arisen in Latin America, while greenfield investments are much more evenly distributed. Almost one half of the management and lease contracts (measured by amounts) have been in Sub-Saharan Africa.

Unsurprisingly, measured in terms of contract values divestitures and greenfield projects, which involve actual investment, have taken the lion's share of PPPs (86% of totals). The latter tend to be most prevalent in the energy sector, divestitures in telecoms, and concessions in both transport and water and

Table 3.3. **PPPs by type and by sector and region**

USD million; per cent

	Total	Concession	Divestiture	Greenfield project	Management and lease contract
Type of PPP by sector and region					
Total	**785 758**	**112 653**	**319 732**	**352 489**	**884**
Energy		10%	34%	40%	2%
Telecom		5%	62%	45%	44%
Transport		62%	2%	13%	40%
Water		24%	2%	2%	15%
East Asia and Pacific		27%	12%	33%	0.2%
Europe and Central Asia		5%	18%	15%	8%
Latin America		57%	62%	31%	43%
Middle East, North Africa		7%	3%	4%	2%
South Asia		1%	1%	11%	0.0%
Sub-Saharan Africa		3%	3%	5%	48%
Sector and region by type of PPP					
Total	**785 758**	**14%**	**41%**	**45%**	**0.1%**
Energy	**260 224**	4%	42%	54%	0.0%
Telecom	**362 194**	1%	54%	44%	0.1%
Transport	**123 553**	57%	6%	37%	0.3%
Water	**39 787**	67%	15%	18%	0.3%
East Asia and Pacific	**186 729**	16%	21%	63%	0.0%
Europe and Central Asia	**118 580**	5%	49%	46%	0.1%
Latin America	**373 592**	17%	53%	29%	0.1%
Middle East, North Africa	**30 958**	25%	28%	47%	0.1%
South Asia	**45 026**	2%	8%	90%	0.0%
Sub-Saharan Africa	**30 879**	12%	34%	53%	1.4%

Source: World Bank PPI database.

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sewerage. In regions policy makers appear to have a preference for greenfield projects, which allow new infrastructure to be built without necessarily having to embark on major structural reforms. Only in Latin America and transition economies were divestitures more prevalent, again reflecting major privatisation programmes in many countries in these regions. The greater prevalence of greenfield projects in Asia and of divestitures in Latin America has led some observers to suggest that private investment has tended to supplement public expenditure in Asia and supplant it in Latin America.

2.4. Home countries and corporate participants

The market for private participation in infrastructure is highly concentrated and dominated by large multinational enterprises. First, owing partly to uncertainties arising from the legacy of public ownership of infrastructure, and partly to the capital-intensity of the sector, the number of investors willing to undertake projects in several countries at once is limited. Second, on the corporate side there are relatively few players, and these are domiciled in even fewer home countries. Table 3.4 shows that the top five home countries typically comprise the majority of total private investment in PPPs, ranging from three quarters in water and sewerage to one half in telecommunications. Sometimes these private investors are actually quasi-public monopolies at home.

Not surprisingly, companies domiciled in countries with close cultural or linguistic links – or in geographic proximity to – a particular developing country are more likely to invest there. French, Spanish and Portuguese firms, for example, have tended to invest in the utilities sectors of former colonies, German firms in Central Europe and Japanese and Korean firms in the rest of Asia. American firms have a greater geographic coverage, although they (too) have a bias toward the regional Latin American market. In addition to this proximity bias, private participation in utilities projects also reflects home country infrastructure "culture". As an example a survey by FIAS (Attracting Foreign Direct Investment into Infrastructure) shows that US companies

Table 3.4. **Share of firms from top five home countries in total PPP investment, by sector**

Sector	Concentration (%)
Water and sewerage	74
Transport	68
Natural gas transmission	58
Electricity	52
Telecommunication	50

Source: World Bank (2003), various pages.

account for 45% of FDI inflow in the electricity sector, while French investors account for nearly 50% of FDI in transport and water sectors. On another hand, infrastructure providers located in developing countries are sometimes also active within their region. Chilean companies, for example, have been able to capitalise on their early national experiences with privatisation to participate in other privatisations within Latin America. In spite of this pronounced regional bias, East Asia is the only region where eight of the top ten sponsors of PPPs were regional companies.

The average project size varies greatly across sectors, from USD 152 million in water and sewerage to USD 604 million in telecommunications. There is a tendency for larger investment size to imply a greater tendency for projects to be dominated by multinational players. In telecommunications, the top 20 investors account for over 60% of total investment and in the energy sector almost 40% (Table 3.5). Together they represent only one per cent of private investors, but 30% of total investment. In other words, infrastructure projects are dominated by a small group of large firms. As also seen from Table 3.5, the overwhelming majority of these companies are multinationals, domiciled in

Table 3.5. **Top 20 private sponsors of PPPs in developing countries**

USD million; %

Company	Country of origin	Sector	Investment (USD million)	Share of total PPPs (%)
Telefonica SA	*Spain*	*Telecoms*	44 332	3.7
Carso Group	*Mexico*	*Telecoms*	34 394	2.8
Telecom Italia	*Italy*	*Telecoms*	33 774	2.8
Suez	*France*	*Multi-sectoral*	32 973	2.7
America Movil	*Mexico*	*Telecoms*	19 292	1.6
AES Corporation	*US*	*Energy*	19 272	1.6
Deutsche Telecom	*Germany*	*Telecoms*	17 449	1.4
France Telecom	*France*	*Telecoms*	16 928	1.4
Portugal Telecom	*Portugal*	*Telecoms*	16 578	1.4
Construtora Andrade Gutierrez	*Brazil*	*Multi-sectoral*	15 025	1.2
Electricité de France	*France*	*Energy*	14 576	1.2
Inepar	*Brazil*	*Multi-sectoral*	12 767	1.1
Endesa	*Spain*	*Energy*	12 266	1.0
Enron	*US*	*Energy*	11 689	1.0
Telecom Malaysia	*Malaysia*	*Telecoms*	11 327	0.9
SBC Communications	*US*	*Telecoms*	11 022	0.9
Verizon	*US*	*Telecoms*	10 723	0.9
TeliaSonera	*Sweden*	*Telecoms*	10 644	0.9
RWE	*Germany*	*Water*	10 602	0.9
Banco Opportunity	*Brazil*	*Telecoms*	9 187	0.8
Total – Top 20			**364 820**	**30.2**

Source: World Bank PPI database.

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OECD countries. PPPs have been an important vehicle for these companies' investment and participation in developing countries' utilities and infrastructure sectors.

This also implies that, for example, a government negotiating the terms of private participation is not necessarily faced with an "atomistic" group of suppliers, and may in practice be dealing with one corporate entity with a market power comparable to its own. This fact needs to be kept in mind when surveying (below) the experiences so far with PPPs in developing countries.

3. The experience with PPPs

The ultimate success of ODA-backed public-private partnerships for development will be determined by their impact on sustainable development relative to their cost to the public purse. However, such partnerships cannot go ahead unless they yield a positive rate of return over their duration from the individual perspective of all participants. A number of PPPs in developing countries unravelled in the last five years in the face of public protests, investor withdrawal or government dissatisfaction. It is not clear whether these projects were well conceived from a developmental viewpoint, but they obviously failed to satisfy the success criteria of their individual participants.

Among the potential benefits of PPPs mentioned in the introduction, both efficiency gains and additional funding should be directly felt by consumers (at least if the latter is used to making services more widely available), who weigh these benefits against possibly higher prices and connectivity fees. A special problem arises from the fact that consumers are a heterogeneous group – for instance when a PPP leads to a broader coverage of services, coupled with higher tariffs charged on the existing consumers. The success criterion of private investors or contractors is relatively straightforward. They look for their participation to show positive rates of return – or, as it is often expressed, to "generate a sufficient cash flow" – within a given period following their entry, while safeguarding their initial investment.

The public sector is arguably the one that is confronted with the most complex set of success criteria. On the one hand, it has interests that conform with those of the consumers insofar as it is also in the interest of the public sector that the availability of utilities services is boosted and that they are provide more efficiently. On the other hand, it has to contrast this not only with the cost to the public purse but also to the affordability of services more generally; to the distributional aspects of tariff changes; and to the possible social costs associated with efficiency gains. In weak governance zones extra "costs" may include a loss of opportunity to use utilities as a source of patronage.

3.1. Efficiency gains

State-owned enterprises (SOE) in the infrastructure sector often suffer from overstaffing, waste owing to insufficient attention to cost-recovery pricing and tariff collection, and a tendency to view the government, rather than consumers, as their real client. As a result, many people who live in areas that are in principle covered by utilities have in practice no access to services, have to wait years to be connected or face erratic and unpredictable provisioning. A high share of supplies, for instance in the water sector, is also lost through poor infrastructure quality.

By reducing employment levels, moving to sustainable pricing policies and driving a wedge into political patronage, private investors have often dramatically improved efficiency. A World Bank study concludes that "[p]rivate sector in infrastructure improves efficiency and, often, quality of service. The most detailed studies of private participation have shown substantial welfare gains, and measurable impacts on important social indicators such as child mortality."[3] The fiscal gains to the host government can also be significant, not only from the one-time sale of state assets and the reduced public outlays for infrastructure but also from the tax revenues as the private firm starts to make profits. This compares with a situation prior to privatisation where losses amounted to as much as five to six per cent of GDP.[4]

The extent of efficiency gains also depends strongly on the competitive structure of the market. A private monopoly can, for instance, be just as sclerotic as a public one, and a public provider can also be made subject to market tests. That said, attempts by governments to impose private sector discipline on public sector firms – whether by "contractualising" the relationship between the government and the public entity or by allowing minority stakes for private investors – have resulted most often in backsliding and failure.[5] For example, performance contracts were attempted in some countries including Senegal, but the government routinely defaulted on its financing obligations and supervision was poorly carried out.[6] The largely successful Senegalese experiences with private participation in the water sector are reviewed in Box 3.2.

Evidence of improvements in the quality or productivity in infrastructure provision as a result of private participation is abundant. Some of it reflects the benefits of privatisation – itself a proxy for more fundamental structural and regulatory reforms – rather than PPPs *per se*, but some examples are nevertheless instructive. Within the transport sectors of developing countries, privatisations and, more importantly, concessions, have induced private firms to participate in 76 rail projects worth USD 29 billion between 1990 and 2001. These projects achieved significant efficiency gains in several areas. In all but one case (in Africa) railway output per employee at least doubled, and in many

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Box 3.2. **Private participation in the water sector in Senegal**

A decade of experience with public-private partnerships based on an innovative contract and with financial and technical assistance from international donors shows how PPPs can be used both to improve services and to expand coverage of infrastructure in a low-income country. The Senegal experience also highlights the importance of a government with the political will and commitment to carry out reforms and to address the issue of accessibility of infrastructure services by the poor.

In the early 1990s, prior to reforms, little more than one half of Senegal's urban population had access to a safe supply of piped water. Another 42% were dependent on public fountains and the rest on vendors. In rural areas, only 65% of the population had access to any form of safe and reliable water. Drinking water quality in the cities was poor and supply erratic. Poor collection rates and mounting debt meant that the public operator – though relatively efficient by African standards – had barely enough resources for operations and maintenance, with little left over for future investments.

Since reforms in 1995, the amount of water supplied has increased by 20% and the number of connections by 35%. Consumers have also seen a more rapid response to complaints, longer hours of service and better quality water. From the point of view of the government and the investor, water losses have been reduced and bill collection has improved. The private operator, a French company, lost money in each of the first two years but has since turned a profit. It is the first water company in Africa to be awarded the ISO 9001: 2000 certification signifying that it meets a set of international quality management standards. The State holding company which owns the assets and undertakes investment is well on its way to achieving financial equilibrium and has been successful in borrowing in private capital markets.

The choice of contract for the water sector was the result of a year-long "process of planning and design in order to put in place an innovative arrangement of contracts, incentives and institutions".[1] Aided by international donors, this process helped to develop institutional expertise within the government and to build a consensus for private participation. To avoid the kind of political backlash seen in other countries, the government retained ownership of the assets through a State holding company, as well as decision-making powers in setting tariffs. The type of contract chosen was of the affermage or hybrid lease kind under which the private operator is paid a fee for the quantity of water produced and sold. The operator collects the revenue from users and forwards it to the holding company after deducting its fee, unlike a concession where the operator would retain the full amount of the tariff. Commercial risks are lower under the affermage contract because the fee is independent of actual tariff levels. The fee structure also includes an incentive to reduce leakages and increase the rate of tariff collection.

Box 3.2. **Private participation in the water sector in Senegal** *(cont.)*

One advantage of this form of contract is that, in theory, it does not require a sophisticated regulatory framework since all necessary provisions are built into the contract. In practice, it is not so simple and requires cooperation and flexibility on the part of all parties. For example, when it was discovered that initial asset valuations and cost estimates proved erroneous, early renegotiations restored the financial health of the operator.

An important goal of the reform process was to increase accessibility for the poor through targeted subsidies. These included subsidised connections, the construction of public fountains in areas where connections were not yet available and subsidised tariffs at low levels of consumption. Under this latter system, tariffs increase with the quantity of water consumed, with all households receiving a lower tariff on the first ten cubic metres of water. Heavy users and business and government clients in effect subsidise low volume users. Such targeting is not necessarily effective, since "household water consumption is a notoriously poor proxy for poverty status".[2] Not only are the very poorest still dependent on the relatively expensive public fountains, but they might also share a connection with other poor families, thus pushing up their average tariff. But since all targeting methods have certain drawbacks, this method at least has the advantage of simplicity and transparency.

1. Brocklehurst and Janssens (2004), p. 5.
2. Brocklehurst and Janssens (2004), p. 42.

it grew by 200-300%. User prices are also now significantly lower in many cases: in Latin America, rates dropped by between 8 and 54%.[7]

These efficiency gains are important but do not necessarily imply that the private firm is satisfied with the profitability of the project or the government and local consumers with the quantity, quality and societal costs of service provision. To assess this, it is useful to review the record of PPPs in more detail.

3.2. Failed or otherwise disappointing PPPs

Between 1990 and 2003, 91 projects worth USD 27 billion were cancelled, representing only three per cent of total PPPs and of total investment – a relatively small share given the crises to which many prominent developing countries have been subjected since the mid-1990s. A more complete picture can be obtained by including projects which are distressed in the sense that at least one partner has requested termination or the project has been submitted to international arbitrage. Cancelled and distressed projects amount to five

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per cent of projects and nine per cent of investment. The discrepancy between these two shares suggests that larger projects have a greater likelihood of encountering difficulties.

The greatest number of troubled projects has been in the energy sector, followed by toll roads and telecommunications (Table 3.6). As a share of total investment in each sector, water and sewerage has had the least favourable experience with over one third of investment in cancelled or distressed projects. In contrast, the telecommunications sector has one of the highest success rates in terms of investment in on-going projects.

By number of projects there is little difference in the failure rates, ranging from four per cent for management and lease contracts to seven per cent for concessions. Measured by investment value, however, concessions are three times more likely to fail than greenfield projects and twice as likely as divestitures. While this might suggest that concessions are inherently more risky, it seems more likely that they are preferred in those sectors with the greatest political sensitivity since they allow the host government to retain ownership of infrastructure assets. The greater failure rate is thus more an indication of the sectors in which concessions are used than the legal form of the project itself. Most failed projects have tended to be terminated relatively early in their life, on average four and a half years after financial closure.

Table 3.6. **Cancelled or distressed projects by sector and by type, 1990-2003**

Sector	Cancelled or distressed projects		Share of total	
	Number	Committed investment (2003 USD billion)	By number	By investment value
Energy	59	29.8	5.3%	11.4%
Natural gas	8	7.1	4.3%	16.7%
Electricity	51	22.7	5.5%	10.4%
Telecommunications	21	13.4	3.5%	3.7%
Transport	47	14.9	6.4%	12.0%
Airports	3	0.7	3.4%	5.9%
Ports	3	0.2	1.4%	0.1%
Rail	4	2.0	4.9%	7.4%
Toll roads	37	11.9	10.3%	18.9%
Water and sewerage	15	14.3	5.7%	35.9%
Total	**142**	**72.3**	**5.2%**	**9.2%**
Concession	37	21.3	6.5%	18.9%
Divestiture	36	28.4	5.8%	8.9%
Greenfield project	63	22.0	4.5%	6.3%
Management or lease contract	5	0.7	4.4%	0.0%

Source: World Bank PPI database.

It is more common for a project to be renegotiated than to be cancelled outright. Renegotiations of contracts are commonplace in business, so from a corporate perspective having to renegotiate a set contract can be construed as a commercial risk. However, when the opposite contractual party is the regulatory authority, distinctions between the political and commercial spheres can get blurred. In fact, the government has in the past been far more likely than private firms to initiate renegotiations. Among the factors that influence the likelihood of renegotiations are the opacity of the original tendering process, the lack of expertise in the public sector leading to the terms of individual contracts being belatedly understood and the absence of independent regulators.

Excluding telecommunications, over 40% of concessions in Latin America between 1989 and 2000 were renegotiated, including over 70% of those in the water sector.[8] In the region's water and transport sectors, 58% of renegotiations were initiated by the government, compared with only one third by private investors. It can of course be argued that contracts lasting 15 to 30 years are perhaps bound to encounter changing and unforeseen circumstances, but 60% of all renegotiations took place within the first three years of the concession.[9]

Finally, over time the value of investments which are either cancelled or subject to termination proceedings or international arbitration in any given year has dropped precipitously from a peak of USD 13 billion in 1997 to only USD 500 million in 2003. This trend suggests that the financial crises of the late 1990s may have run their course in terms of deleterious effect on project profitability.

3.2.1. Competition and the awarding of contracts

A frequently heard complaint about the early phases of PPP projects is that host country authorities lack the administrative capacity to deal properly with the process of evaluating and awarding contracts. Civil servants may have a good technical understanding of their sector, but little knowledge of complex financial transactions such as those involved in BOT projects. At any given point, there are a significantly larger number of projects under negotiation than those beginning operations, and many potential projects, complete with Memoranda of Understanding, are abandoned after lengthy negotiations. According to one estimate of 860 potential greenfield investments, only 98 (11%) were concluded.

Even when projects reach the stage of negotiations, potential investors often encounter delays. Since the development phase of private infrastructure projects absorbs between two and five per cent of total projects costs, these delays can be costly for both parties.[10] In the assessment of a recent study, "… completing better preparation of transactions before inviting investors to

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participate can help reduce processing delays and the related opportunity costs for investors."[11]

The lack of administrative capacity, taken together with the sectoral and regional concentration of utilities companies mentioned earlier, creates a risk that bidding may not always be fully competitive. A World Bank study on the transport sector estimates that the typical number of bidders for a concession or greenfield project in the transport sector is two to three.[12] While competition can be fierce even between two bidders, it seems unlikely to be sufficient in many cases – especially given the diminishing interest of these firms in developing countries. At the very least, such competition is considerably improved by the presence of foreign bidders.

Another area where bidding might not be fully competitive concerns the construction phase of the project. It is estimated that six companies control 50% of this market and sixteen share 90% of construction projects.[13] But since private companies often construct infrastructure for the public sector as well, this potential problem is not the result of private participation *per se*.

3.2.2. Failing demand and consumer dissatisfaction

Purely commercial failures involving investors critically misjudging the market or underestimating their production costs have been relatively rare. Examples include some large-scale projects in transport and telecommunications, where demand forecasts turned out to be unfounded. For example, several projects involving toll roads in Mexico were cancelled after the actual use turned out to be only one half of the predicted volumes. While such risk rests properly with the private participants, they nevertheless point to a need for improved data collection, not only on the actual demand for the specific service and shape of the network, but as well on the position of potential competitors.

Once the firm has invested, the primary concern is cash flow: generating revenue, enforcing collection and setting tariffs at cost-recovery levels. Investors wish to be free to realise profits without government interference, but if they encounter difficulties in collecting revenue or public hostility to raising tariffs, they expect the government to be responsive to their needs. It is in the face of such difficulties that the extent of government commitment to private participation in infrastructure becomes critical. Private operators can neither adequately enforce collection nor raise tariffs abruptly such as during a currency crisis without the support of the government.

The emphasis on cash flow suggests that renegotiations and cancellations are not just, or even mainly, a regulatory problem. Investors have been known to put up with numerous frustrations in their dealings with host governments as long as the project earns a satisfactory return. Many conflicts

between private and public partners arise because a macro shock, such as a massive devaluation, means that the project is no longer profitable or – in cases where the investor has a guaranteed return indexed to the exchange rate – no longer affordable for the government.

In sectors where services had historically been subsidised and/or the collection of tariffs lax (*e.g.* in electricity or water) private investors have confronted opposition to price increases and have faced difficulties in tariff collection. As regards the price levels, the largest water concessions in developing countries, in Buenos Aires and Manila, ran into difficulties when major devaluations triggered tariff increases which were politically infeasible to implement.[14] In Cochabamba, Bolivia, tariff increases of 35% set off widespread popular unrest which resulted ultimately in the cancellation of the project.

3.2.3. Non-compliance with contractual terms

The issue of public resistance cannot, in practice be separated from that of compliance with contractual terms. Consider the example of Argentina, one of the most popular destinations for investors in the 1990s. A water concession to the French company Suez "worked well until the steep fall of the peso in early 2002. Suez then pulled out and went to arbitration after the authorities did not agree to higher charges to offset the devaluation."[15] Largely as a result of the devaluation of the peso, there were 28 proceedings against Argentina under the International Convention for Settlement of Investment Disputes (ICSID) as of early 2004.[16] Ill-feelings tend to linger for years after the devaluation. Out of ten foreign investors in the power sector in Argentina in 2002 surveyed by the World Bank, nine were very dissatisfied with their investment experiences and only one was satisfied. This compares with neighbouring Chile where five out of eight respondents were very satisfied with their experience and only one very dissatisfied.[17] Possible solutions to the serious problem of exchange rate risk are provided later.

Similar problems have been encountered where the public sector acts as the main direct purchaser of utilities services. One example is power purchase agreements, with the government agreeing to purchase electricity at specified tariffs usually indexed to the exchange rate. These contingent liabilities for the government have in several cases proven to be unsustainable in the face of macroeconomic shocks, which helps explain why contracts are often renegotiated in the wake of a financial crisis. Moreover, in many countries the continuing state control over transmission and distribution has meant that the full benefits of private participation in this sector have not been realised, notably with respect to efficiency in downstream activities and to expanding coverage to poorer areas.

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Host governments have equally complained of "frequent conflicts with operators in complying with contract clauses… abandonment of the concession by the operator or the taking over of the concession by the government as a result of claimed bankruptcy of the operator, discontent with price levels and services, poor attention to users and, particularly, the perceived high incidence of renegotiation of contracts shortly after the award of the concession, often in detriment of consumer welfare."[18] These problems are not unfamiliar in OECD countries either. Infrastructure providers, especially where greenfield investment is concerned, have been known to understate the expected costs in order to win contracts and subsequently claim "special circumstances" to demand an adjustment of contractual terms. Many governments provision against such practices, or build safety mechanisms into contracts, but developing country authorities may face financial and other difficulties in emulating such practices.

3.2.4. Summing up

It appears that the large number of PPPs that have left the contractual parties dissatisfied indicates that either developing country authorities, or investors (or both) may have had too high expectations to what could be achieved. Conceivably, some contracts have been granted under circumstances (*e.g.* subject to corrupt practices or contingent upon political links between home and host governments) that made them susceptible to changes in the political environment. But the large majority of *bona fide* PPPs have also suffered from inflated or unrealistic expectations.

Many governments in developing countries have seen private investors simply as a source of financing to be used to supplement dwindling public funds. In doing so they have failed to recognise the minimum expectations, including to the legal and regulatory systems, that companies have to the business environment and without which they are unlikely to maintain their commitment. Conversely, utilities companies may have relied overly on contracts and failed to realise that developing country authorities lack the capacity to underwrite large risks – including the consequences of macroeconomic shocks and public upheavals – that they have come to take for granted in their home countries.

The best that developing country authorities, acting on their own, can do to enhance the chances of successful PPPs is developing a better knowledge of the obstacles, take steps to address these and prepare better all levels of the public administration before embarking upon such partnerships. Based on a study by Sader (2000) and the Camdessus Report, which focused on the experience with partnerships in the water sector, the main obstacles within

developing countries would seem to include (their relative importance has been the subject of recent empirical research – Box 3.3):

- *Conflicting aims*. Often one objective (that is, one PPP project) has been expected to serve several policy objectives, from financial, to macroeconomic, to social, to environmental. Protests by local communities and non-governmental organisations against individual projects have rebounded on investors rather than the initiating authorities.
- *Award procedures*. The award procedures often lack transparency and are not based on objective evaluation criteria. Corruption has been a problem – in general, and in the specific context of awards. Also, some projects have been compromised by official preference for local participation, preferred sub-contractors or suppliers and the employment of weakly qualified local staff.
- *Regulatory frameworks*. A weak legal environment necessarily leads to concerns for non-state underwriters of long-term contracts. Existing legislation in many countries was designed to define public sector responsibility in infrastructure and is inadequate in a situation of private participation. In addition, human capital such as relevant regulatory expertise is in short supply in many countries without much experience in privately operated utilities.
- *Public governance*. Many private investors have had to contend with conflicting public authorities, for instance central *versus* sub-national governments, or regulatory bodies *versus* ministries. In addition, non-existent or inexperienced regulators created avoidable uncertainty about price and tariff setting.
- *Existing service providers*. Where incumbent service providers, often state owned, remain in the market they are often the subject of preferential treatment. This goes hand in hand with a tendency, in many countries, to invite private participation in the absence of a commitment to overall sectoral liberalisation.
- *Political commitment*. In countries where the rule of law is not firmly entrenched governments have reneged on contracts signed by previous administrations. There also have been several cases of governments reneging on contractually agreed terms (*e.g.* the right to levy cost-recovering tariffs) in the fact of public dissatisfaction.

4. The use of ODA to ensure the commercial viability of PPPs

The thinking on ODA has evolved in line with more general economic policymaking. Throughout much of the post-World War period and up to the late 1980s, development assistance for infrastructure tended to focus on "bricks and mortar" such as dams, pipelines and electricity grids. While ODA helped to provide these inputs, output in terms of infrastructure services was left in the hands of the public sector in the country concerned. Insufficient attention was

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Box 3.3. **Factors influencing failure rates of PPPs according to recent research**

In an effort to understand which contract structures and country characteristics make renegotiations more likely, Guasch *et al.* (2002) perform an econometric analysis of the various factors associated with *firm-led* renegotiations in Latin America since 1989. Their findings have implications for the potential role of development assistance in facilitating successful PPPs. Renegotiations are more likely in countries without a regulator at the time the contract was signed and also with poor institutional quality and a high incidence of corruption. A specialised and experienced regulator is more likely to avoid obvious mistakes in contract design and signals a greater commitment on the part of the host government to the project.

Contracts with price caps – 75% of all concessions in Latin America – are more likely to be renegotiated, as are those financed exclusively by the private sector. Significantly, the existence of a minimum income guarantee fails to reduce the likelihood that the private investor will later seek to renegotiate the contract. Contracts for which there were several prospective bidders tend to face fewer renegotiations, suggesting that the benefits of greater due diligence exceed the risk of overbidding in these cases. Lastly, both political and economic cycles increase the risk of renegotiation.* Elections bring with them the greater risk that policies will be changed, and macroeconomic shocks curtail demand and often lead to depreciations which reduce profits when expressed in the home country currency.

* Quoted in Estache and Serebrisky (2004), p. 13.

paid – by either the donor or the public entity – to efficiency considerations, to access for the poor and to the environment. The result was often "white elephant" projects with adverse social and environmental consequences and a general dissatisfaction with the record of development assistance.

It is now widely recognised that the public sector has often been a poor provider of infrastructure services in terms of both efficiency and access. The trend towards privatisation and to greater private participation in infrastructure has led to a radical rethinking of the most effective use of ODA. Donors have shifted away from providing financing for public-sector firms and for major stand alone projects towards facilitating private participation in infrastructure and ensuring that social and environmental goals are not neglected. The result is an ODA strategy that focuses on outputs – *i.e.* what infrastructure investment is designed to achieve – rather than inputs.

Creating an environment in which PPPs can prosper and where greater attention is paid to the coverage and efficiency of infrastructure are the

central pillars of this new ODA. Private participation in infrastructure requires a new set of tools for host governments in the form of autonomous regulatory agencies – an area where these countries lack institutional experience. Many of the poorest developing countries lack the capacity to create viable regulatory bodies or even sometimes simply to monitor whether investors are fulfilling their contractual obligations.

As a result, development assistance has moved towards technical assistance, capacity building and the role of "honest broker" between the public and private sectors. Financing of infrastructure projects is no longer the priority, but it has not disappeared completely, particularly in least developed countries. Where donors do provide funding, however, it is now intended to complement private financing either by supporting those projects for which no private investor has come forward or by helping to absorb some of the potential risks faced by the private investor, thus increasing the overall level of private investment.

4.1. Strengthening institutional capacity

4.1.1. Technical assistance and capacity building

The renewed potential for infrastructure development offered by PPPs has spawned myriad initiatives by multilateral and bilateral donors to encourage and enhance private participation through technical assistance and capacity building. Prominent among these endeavours is the multi-donor Public-Private Infrastructure Advisory Facility (PPIAF) described in Box 3.4. Other multi-donor initiatives include the Energy Sector and Management Advisory Programme and the Water and Sanitation Programme which provide technical assistance for poverty alleviation and economic development.[19]

In parallel, the World Bank approved in 2003 a new Infrastructure Action Plan which in part will help to strengthen the overall knowledge base as well as country analytic work. As part of the plan, an infrastructure assessment termed "Recent Economic Developments in Infrastructure" will analyse infrastructure performance and needs in developing countries. The World Bank Group has also created the Infrastructure Economics and Finance Department to strengthen the understanding of the practical implications of analytical infrastructure economics and to develop instruments and approaches for infrastructure finance. Within the Department, a dedicated infrastructure advisory group will provide advice and support in the efficient design and development of PPP schemes.

The cost of technical assistance can be substantial: World Bank technical assistance to reform the power sectors in Orissa and the Ukraine, for example, cost USD 50 and USD 100 million respectively.[20] Furthermore, "advice is often more acceptable and credible when linked to resource transfer".[21] Multilateral

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Box 3.4. **The Public-Private Infrastructure Advisory Facility**

The Public-Private Infrastructure Advisory Facility (PPIAF) was launched in July 1999 as a multi-donor technical assistance facility aimed at helping developing countries improve their infrastructure through private sector involvement. Its mission is to channel technical assistance and to identify, disseminate and promote best practices on matters relating to PPPs in developing countries. The PPIAF was developed jointly by the UK and Japanese governments in collaboration with the World Bank. It is now supported by eleven donor governments and three multilateral organisations. PPIAF assistance can facilitate private involvement in the financing, ownership, operation, rehabilitation, maintenance, or management of eligible infrastructure services. To ensure that assistance is demand driven, PPIAF requires recipients of country-specific assistance to provide some co-financing or other credible evidence of commitment to the project.

The PPIAF can finance global and country-specific advisory activities in the following areas:

- *Regulatory and Institutional Reform*: providing guidance in developing detailed strategies for involving the private sector, restructuring industries to facilitate competition, and designing and establishing legal, regulatory and institutional frameworks.
- *Infrastructure Development Strategies*: Country Framework Reports provide comprehensive reviews of a country's general environment for PPPs, including recommendations and an action plan to help guide governments in putting in place the laws, policies and institutions needed to attract private investment. While the final published CFR is important, experience shows that the participatory process of preparing the report also yields benefits.
- *Consensus Building*: To promote understanding, cooperation and commitment from a range of stakeholders – consumers, service providers, government officials, politicians, trade unions, non-governmental organisations and domestic and foreign investors – the PPIAF holds workshops, seminars, study tours and public awareness campaigns.
- *Capacity Building*: The PPIAF assesses needs and provides detailed recommendations, sponsors workshops and seminars on sector-specific themes and underwrites initial investments in regional capacity-building programmes.
- *Pioneering Transactions*: supporting pioneer projects and transactions is part of the PPIAF mandate but accounted for only two per cent of approved activities through FY2003.

Box 3.4. **The Public-Private Infrastructure Advisory Facility** *(cont.)*

- *Emerging Best Practices*: To identify and disseminate best practice, PPIAF supports case studies, model documents, empirical analysis and regional and international conferences.

By the end of March 2004, PPIAF had provided grants of more than USD 70 million for 310 activities in 88 countries. It supported the drafting of 32 sets of laws and regulations, the execution of 45 transactions, the formulation of 14 sector reform strategies, the establishment or strengthening of 28 institutions, and the training of more than 1 500 regulators and officials. It also supported 80 international workshops with over 9 000 participants, along with the preparation of numerous toolkits and case studies to assist in the dissemination of emerging lessons of experience.

Source: www.ppiaf.org/ and World Bank (2004), p. 193.

donors could, for example, help to finance the salary of an on-site specialist to advise the host government on every aspect of the project implementation process. Having a specialist on-site rather hiring external consultants on a project-by-project basis helps to promote knowledge spillovers within the regulatory agency.

Some initiatives have focussed specifically on the more than 200 regulatory agencies which have been established since the early 1990s in 130 countries. The World Bank created the International Forum of Utility Regulation (IFUR) in 1996 to serve as an umbrella structure for learning and networking initiatives. It offers two-week training courses aimed at building capacity within regulatory agencies and also within the research centres, universities and private sector firms that work with such agencies. Since 1997, more than 1 000 regulators from 115 countries have attended.[22] This approach has since spawned regionally-focussed training programmes, like the South Asia Forum for Infrastructure Regulation (SAFIR) in 1999 which received financial support from the PPIAF. An African forum was established in 2000 and an East Asian one in 2003. A complementary programme also exists for transport regulators.

Through these training programmes, the IFUR also helps to build networks of utility regulators to facilitate ongoing information sharing and mutual support. "A key policy recommendation is to retrain government staff. This does not necessarily mean rich countries providing more technical assistance or technical cooperation – it means them paying for transfers of skills and exchanges of experience among poor countries."[23]

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4.1.2. Contracting out regulatory functions[24]

Given the steep learning curve for many new regulatory bodies and the resulting information asymmetry between the investor and the regulator, a cost-effective option in the short term is sometimes to contract out certain regulatory functions. Contracting out can add credibility to the regulatory process, strengthen the hand of the regulator in dealing with a more experienced operator and reassure investors that important decisions are made or at least influenced by competent and independent parties. In some cases, such as in a water and electricity concession in Gabon, independent, non-binding advice is paid for out of the concessionaire's revenue, but it could also be financed partly through donor assistance.

A recent survey of 51 regulatory agencies worldwide found that three quarters contract out certain tasks to external parties, particularly tariff reviews, compliance monitoring and dispute settlement. In only 15% of cases were external opinions binding on the regulator. Respondents to the survey highlighted the importance of contracting out in improving competence (92%), building trust with key stakeholders (71%) and ensuring independence (62%).[25]

To lend credibility in cases where the investor doubts the autonomy and independence of the regulator from political interference, dispute settlement can be contracted out to international bodies like the International Centre for the Settlement of Investment Disputes. In some cases, several countries can share a regulatory body, such as the Eastern Caribbean Telecommunications Authority which serves the Eastern Caribbean States.

To address the problems of weak governance in the water sector in developing countries, the Swiss government has proposed Policy Principles and Implementation Guidelines to build trust among partners and to guide the "design and implementation of transparent, effective, efficient and equitable projects in water supply and sanitation services".[26] Rather than a one-size-fits-all solution for water contracts, the Principles stress ten key factors for successful water and sanitation projects.

4.2. Mitigating private risk through donor assistance

While many infrastructure sectors are no longer considered to be natural monopolies, it is still the case that prices are often the outcome of contractual negotiations rather than of supply and demand. In addition, infrastructure services usually involve substantial initial investments in hardware which are only recouped slowly over a long period. For these reasons, private participation in infrastructure projects is often considered to involve significant risks for the investor, as well as for the host government, which explains in large part why private investors have not been more forthcoming

since the financial crises in Asia and Latin America and why renegotiations are so common.

These risks are described in Box 3.5. They are apportioned to each party as established in the contract, and which risks an investor is most likely to face will depend on the outcome of negotiations. In some cases, a risk which is mitigated in one area will reappear in a different form elsewhere. For example, a currency risk that is assumed by the host government quickly translates into political risk in the event of a major devaluation if the government can no longer honour its commitments. Distinguishing among risks is nevertheless useful because it allows for aid to target more directly the specific factors which influence each risk.

At a conference on private sector participation in the water sector in developing countries, participants from the private sector "demand[ed] that donors and international financial institutions take over all risks not directly related to operations, including currency risk, regulatory risk, payment risk, sub-sovereign risk and affordability risk".[27] Donors cannot afford to assume all risks for the private sector, and to do so would remove some of the reasons for promoting private participation in the first place. But given the pressing need to finance infrastructure projects to meet the Millennium Development Goals and the potential resources which the private sector could bring to bear in this area, there are many ways in which donors could help to alleviate various risks facing investors.

Where projects are undertaken without sufficient preparation on both sides, the risk of renegotiation at a later date is higher. Donors can help in the preparation of projects by financing pre-feasibility studies, as well as detailed legal, financial and technical feasibility studies. In the Philippines, in spite of considerable experience with BOTs in the energy sector, the agencies responsible for the transport and water sectors lacked the expertise and financial resources to conduct feasibility studies. As a result, funding for these studies had to be solicited on a case-by-case basis from multilateral or bilateral donors.[28]

To reduce the risk of a popular backlash, other than through subsidising consumption by the poor, donors can help finance environmental impact assessments or, for example, provide loans for severance payments in cases where the private investor takes over a bloated public-sector enterprise. In Argentina, for example, World Bank loans helped to finance severance payments in the rail sector, allowing the investor to reduce the workforce by 80%.[29] Multilateral donors can also help to ensure that negotiations provide for the greatest possible transparency, as this will help to minimise legal challenges and public opposition at a later date.

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Box 3.5. **Risks faced by private investors in developing countries**

Design and construction risk: Given the size of many infrastructure projects, cost overruns and delays are common, especially if there are subsequent modifications to the design as a result of political or environmental concerns. The private sector typically bears this risk, even when the project will ultimately be run by a public entity.

Operating risk: When the private firm takes over the assets of a previous provider, usually the public sector, the quality of such assets is never completely known in advance. In the water sector, for example, most assets are underground. This risk can be reduced if the private operator initially enters the market through an operations and maintenance contract with the public sector provider.

Commercial risk: As with any investment, demand might not prove sufficiently robust at price levels necessary to ensure long-run profitability or might be subject to a macroeconomic shock. This risk is greatest in those areas where there has not previously been an infrastructure provider and hence potential demand is unknown or where tariffs were formerly subsidised and collection poor. In some contractual arrangements, the government accepts responsibility for tariff collection or agrees to buy the infrastructure service from the PPP at a fixed price. While this reduces the risk for the investor, it opens the way for almost certain renegotiations if a crisis means that the government can no longer afford its financial obligations.

Regulatory risk: Very few developing countries have a well-established and autonomous regulatory agency to deal with infrastructure. With no track record, such agencies might not apply regulations in a consistent pattern, especially if those laws and regulations are themselves untested.

Political risks: The support of the national government is often cited as a crucial factor in the success of a project. If this support wanes in the face of popular discontent at the cost of private provision or if a new regime disavows certain policies of its predecessor, the private operator might find that contractual obligations of the government are no longer being honoured. Political risks might also involve litigation or bureaucratic barriers.

Currency risk: Perhaps the greatest risk to the profitability of a project involves the risk of devaluation. Infrastructure projects in developing countries are often financed in part through international lending. These debt repayments, together with payments of dividends, must be made in foreign currencies while profits usually accrue in the local currency. As a result, any sudden devaluation can completely modify the profitability of a project. This was the case for many PPPs in the 1990s, notably in Latin America and Southeast Asia, and helps to explain the diminished enthusiasm for such projects on the part of the international investment community.

Multilateral involvement in PPPs can also reassure private investors that they will have support should the government change its infrastructure policies. "Because of the increased risk perception in international financial markets following the … currency crisis [in Asia], such support mechanisms will probably play an even more important role in the near future."[30] Implicit guarantees may not be enough to rescue all projects, however, as the World Bank participation in IPPs in Pakistan demonstrates. Nevertheless, some projects are unlikely to have gone ahead without the presence of multilateral donors.[31] In a World Bank evaluation of lending for a power project in Mauritius, for example, it was argued that "although the Bank's contribution solely in financing terms was small and its involvement by completion minimal, its advisory and 'honest broker' role was critical in facilitating the launch and implementation of the [project]".[32]

Some political risks can be insured against, such as through the Multilateral Investment Guarantee Agency or MIGA. MIGA insurance covers currency transfer restriction and inconvertibility but not depreciation, expropriation, war and civil disturbance and breach of contract in the event of non-payment of a settlement on the part of the government or malfunctioning of the dispute resolution. The multilateral nature of MIGA gives it leverage in trying to resolve dispute between the public and private partners. MIGA guarantees are limited to USD 50 million per project and USD 225 million per country. Bilateral agencies, like the US Overseas Private Investment Corporation (OPIC), can also provide coverage.

MIGA has issued 119 guarantees for infrastructure projects worth over USD 2 billion. Between 1990 and 2001 MIGA issued 72 guarantees for investments in 39 electric power projects in 25 countries, mostly in Latin America and to a lesser extent in East Asia. Eight of these projects were subsequently evaluated by the World Bank and most were found to be dependent on political risk insurance.[33] This insurance is more in demand when investors are entering a new market or developing a new business model – such as independent power producers. To date, only six guarantees have been agreed in the water sector worth USD 225 million. MIGA recently agreed for the first time to guarantee a performance bond posted by a Dutch water company investing in Ecuador. The bond specifies that the investor will fulfil certain obligations covering water quality and coverage, and the MIGA coverage protects against the wrongful call of the bond by the government.[34]

Export credit agencies can also provide political cover through guarantees on part of the debt. Their principal role is to provide financing and insurance for home country equipment exports, but they have also supported BOT projects in electricity in China, for example, and provided 75% of the lending for a BOT project in Turkey.[35]

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PPIAF financed a feasibility study for a new facility to assist in financing private infrastructure in Africa by allowing lenders to pool and partially mitigate risks by subordinating donor funds to commercial funding. Subsequently in early 2002, the Emerging Africa Infrastructure Fund was launched to provide long-term debt finance to commercially viable private sector infrastructure projects in 44 sub-Saharan African countries. Most of the funding was provided by bilateral development agencies, particularly DFID of the United Kingdom.

Risks can also be lowered through risk guarantee instruments which reassure investors and host governments that the terms of the contract will be honoured, including the adjustment of tariffs. Partial credit guarantees cover risks of non-payment of parts of the loan financing. For a power project in the Cote d'Ivoire, an IDA partial risk guarantee of USD 30 million was used for the first time to increase the amount and maturity of private financing for the project.[36] In a World Bank survey of energy investors, "availability of credit enhancement or guarantees from the government or from a multilateral agency" was the second most important consideration when investing in a developing country.[37]

4.2.1. Currency risk

One of the greatest risks to any foreign investor is that of rapid currency depreciation. With revenues mostly in the weak local currency, and debt and equity payments in hard currencies, a massive devaluation of the local currency can undermine profitability and severely strain even the best crafted project. In some cases, currency risks may be borne by the host government if it agrees to purchase infrastructure services from the private investor at a currency-adjusted price or by local consumers if tariffs for infrastructure are indexed to the exchange rate. The nature of most financial crises is such, however, that the local government is obliged to pay these contingent liabilities at precisely the time when its resources are at a minimum. In these cases, the government is no longer able to honour its contractual obligations and a costly process of renegotiation ensues. In cases where consumers must bear the burden, a popular backlash against the investor is a common occurrence.

Given the long-term nature of infrastructure contracts, a large depreciation of the local currency is almost certain. "Over the past 25 years developing country currencies lost 72% of their value relative to the US dollar on average – about a fifth lost more than 99% of their value."[38] With relatively higher inflation in developing countries, a gradual depreciation over time is to be expected. But in many developing countries, currency swings are sudden and abrupt: Indonesia's currency lost 80% against the dollar in only one year during the Asian financial crisis.

If indexing tariffs to the exchange rate is not a realistic option, a foreign investor can do very little to hedge against currency fluctuations. In developing countries, hedging is restricted to very few currencies and only for limited periods. In some larger developing countries or those – like in East Asia – with high savings rates, debt finance is sometimes available locally, thus avoiding exchange risk but most developing countries do not have deep enough capital markets to permit such large expenditures. The disadvantage with local financing is higher initial borrowing costs owing to higher nominal interest rates. While this might discourage both public and private partners in PPPs, the "benefits may be longer-lived and more robust investments that can weather the vagaries of emerging markets".[39]

Multilateral and bilateral donors can assist in mitigating currency risks. For a power project in Brazil, for example, the US Overseas Private Investment Corporation (OPIC) offered a liquidity facility on which the investor could draw if exchange rate depreciation meant that the project had insufficient liquidity in order to service its debt. Under this agreement, the private investor was to sell power at prices indexed to local inflation, with no possible adjustment for exchange rate changes. The OPIC loan would be repaid once inflation had risen sufficiently to offset the currency depreciation.[40]

One proposal put forward by the World Panel on Financing Water Infrastructure is for a Devaluation Liquidity Backstopping Facility which would assume some of the foreign currency obligations (such as debt servicing) of the investor in the event of a major devaluation. Any payments by the Facility would be treated as long-term loans to the government (*i.e.* sovereign debt) to be repaid through a gradual surcharge on water tariffs over time. In essence, the facility represents a method of rescheduling foreign debt service "over a time period that is politically and socially feasible".[41] It would be provided by a multilateral financial institution or an export credit agency which would guarantee the foreign loans and finance the additional debt service. The Facility would not intervene below a threshold "affordable exchange rate". It would cushion the project against sudden shocks in a sector in which tariff can only be adjusted gradually if a political backlash is to be avoided.

4.3. Output-based aid

Private firms have not always found it profitable to supply services to poorer or more remote communities since distances and low population density, together with limited spending power and a poor record of payment, make it difficult to recuperate the cost of the investment. Even in areas where infrastructure already exists, PPPs have had difficulties setting a tariff which is both affordable to the consumer and profitable for the investor. Donors can help through targeted subsidies which encourage foreign or local investors or

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community-based schemes to fill the gap or which subsidise consumption during a transition period to full cost recovery pricing. This approach has come to be known as output-based aid.

Output-based aid derives its name from its emphasis on outputs rather than inputs. Its aim is to improve delivery of infrastructure services through carefully targeted subsidy payments in cases where there are positive externalities from public participation, such as when the investor will not have a sufficient incentive to provide services to the poorest consumers. The investor in this case will usually be a private firm although not-for-profit operators, nongovernmental organisations and small-scale local suppliers could also provide some services. This aid can come in many varieties, depending on the nature of the service and the rationale for public funding. Examples include:

- To expand access to network services, disbursements may be tied to the number of new connections made.
- To bring retail prices in line with costs, declining transition subsidies may help ease tariffs towards cost recovery levels.
- To enhance competition and performance between service providers, voucher-type arrangements may allow consumers a choice of provider.
- To improve the affordability of ongoing consumption for an under-served group, funding may be tied to services delivered to eligible beneficiaries.[42]

The effectiveness of output-based aid depends largely on the clarity of its design. What is the desired output? What should the form, level and structure of subsidy be? Mis-specified or incomplete indicators can lead to counterproductive or biased behaviour by service providers.[43] To improve the design and implementation in this area, the Global Partnership of Output-Based Aid was created in early 2003 as a multi-donor trust fund administered by the World Bank. The GPOBA finances pilot demonstration projects and documents recent output-based approaches for supporting the sustainable delivery of basic services, including the targeting of eligible beneficiaries, definition of performance requirements, the determination of payment structures and the design of monitoring arrangements.[44]

Output-based aid is now pursued at both the bilateral and multilateral level. The Swiss government, for example, has developed a grant-based financing instrument for PPPs. The aim is to promote cost-recovery pricing in order to avoid over-consumption and waste while supporting those least able to pay the full price. As at the multilateral level, the Swiss approach recognises that the biggest constraint for the poor is the cost of connection rather than of infrastructure services. To this end, a pilot project in El Alto allows poor people wanting to connect to the electricity or water grid to obtain an interest-free loan from a Swiss financed fund with a long period for repayment.[45]

Many governments have applied the techniques of output-based aid either to expand coverage or to reduce the possibility of a backlash against private provision of infrastructure. Following privatisation in Chile, the government subsidised telephone services to rural regions.[46] Severance payments to employees in the rail sector in Argentina were provided by multilateral donors.

5. Summary and experiences so far

PPPs have provided a principal vehicle for FDI into public utilities and infrastructure in developing countries, with OECD-based multinational enterprises participating in most of the largest PPPs in this area. Almost all developing countries have engaged in public-private partnerships in infrastructure since 1990 – albeit a number of them have relied on forms of PPP that allows a transfer of private expertise without actually mobilising funds for investment (*e.g.* service agreements and leasing contracts). The actual investment in infrastructure projects with private participation in developing countries took off in the early 1990s, growing from USD18 billion in 1990 to a peak of USD131 billion in 1997.

But private participation in infrastructure has declined since 1997. While this is partly due to a corporate retrenchment following financial crises in the second half of the 1990s, it also reflects a more widespread disappointment on the part of investors and public authorities. A large number of existing projects have either been terminated, are classified as "distressed" or their terms have had to be renegotiated under duress.

The reasons that PPPs have sometimes performed below expectations vary from case to case. However, one commonly heard complaint from host governments is that investors have reneged on their contractual obligations, especially regarding the coverage of services. One commonly heard complaint from enterprises is that public authorities have failed to provide an environment in which they can provide their services according to sound commercial principles. The latter problem often manifests itself as a lack of willingness by public authorities to accept the social and political cost of private operators' measures to boost productivity and set tariffs at market levels. Also, PPP contracts have often been poorly written, weakly enforced (often against the background of generally weak legal frameworks in the host country) and awarded and implemented in an un-transparent, or even corrupt, manner. In consequence, private investors have often had to shoulder not only the commercial risk of utilities projects, but for example also political risks (*e.g.* resistance from the public and incumbent operators) that would most commonly have been borne by host country authorities.

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Three channels have been identified through which ODA can enhance the environment for PPPs and contribute to their more socially and commercially satisfactory outcome:

- *Technical assistance and capacity building.* ODA can be used to fund a host of educational and experience-exchange programmes to build authorities' capacity to deal with PPPs. Several initiatives by bilateral and multilateral agencies are underway, including the Public-Private Infrastructure Advisory Facility, the Energy Sector and Management Advisory Programme and the Water and Sanitation Programme. An alternative to building capacities in-house is to support the outsourcing of regulatory functions to outside specialists. A recent survey indicates that as many as three fourths of national regulators contract out certain tasks to external parties.
- *Risk mitigation.* Most foreign investors already have access to market-based insurance against risks such as "regulatory takings" through home country export credit agencies and multinational bodies such as MIGA. However, risks go well beyond this and they are in some cases so high that PPPs are unlikely to take place in the absence of subsidised risk mitigation. A kind of risk that has attracted particular attention in the aftermath of the financial crises of the 1990s is currency risk. Some contracts are written to allow investors to collect tariffs or fees in international currency, but in the event of a currency crisis they are often rendered unenforceable. A case can be made for development agencies providing extra risk coverage, benefiting *inter alia* from the fact that they (unlike more market-based insurance schemes) partner directly with the host country authorities.
- *Output-based aid*. Even if host country regulatory capacities and risks can be dealt with satisfactorily, a number of infrastructure projects will have a positive social and negative private rate of return. This gap can be bridged by ODA, for instance through targeted subsidies to the service providers or by subsidising consumption during a transitory period to full cost recovery pricing. Such "output-based aid" can be highly effective in meeting specific targets – contingent upon the clarity of objectives and project design. To improve the design and implementation in this area, the Global Partnership of Output-Based Aid, a multi-donor fund, was created in 2003. Several national development agencies provide grant-based instruments to promote cost-recovery pricing while supporting those least able to pay the full price.

Summing up, official development assistance can play a vital role in ensuring that host countries have the institutional capacities to benefit fully from PPPs, in mitigating risks for investors and in creating the appropriate incentives for all parties to enable investment in infrastructure to address the critical issues of poverty alleviation and sustainable development. Improving

regulation in host countries will, in turn, reassure the local population that the government is not "giving away" too much to the private investor. ODA can also help to achieve a balance between private profitability and public acceptance, sometimes through targeted subsidies, sometimes by assuming part of the risk for the investor or through the creation of a devaluation facility to insure against rapid depreciations in the local currency. The examples of successful projects described in this document suggest that ODA can play a powerful role in capacity and confidence building, in support of private participation in public utilities and infrastructure.

Notes

1. All dollar amounts in this section are expressed in 2002 dollars.
2. Silva (2000), p. 2.
3. Clive (2003) quoted in Perset (2004), p. 21.
4. Kikeri and Nellis (2002), p. 1.
5. See Kikeri and Nellis (2002) for a discussion of these options.
6. Brocklehurst and Janssens (2004), p. 2.
7. World Bank (2004b), p. 201-202.
8. Guasch *et al.* (2002), p. 5.
9. It should also be noted that, since almost all concessions are still ongoing, the share of contracts renegotiated at least once will almost certainly grow over time.
10. Sader (2000), p. 28.
11. Lamech and Saeed (2003), p. 4.
12. Estache and Serebrisky (2004), p. 24.
13. Estache and Serebrisky (2004), p. 24.
14. Izaguirre (2004), p. 3.
15. UNCTAD (2004), p. 63.
16. UNCTAD (2004), p. 194.
17. Lamech and Saeed (2003), p. 7.
18. Guasch *et al.* (2002), p. 5.
19. See World Bank (2004a), p. 216 for a brief description of these programmes.
20. Manibog *et al.* (2003), p. 43.
21. Goldin *et al.* (2002), p. xvii.
22. World Bank (2004a), p. 75.
23. UNDP (2003), p. 118.
24. For a more complete discussion of contracting out, see Bertollini (2004).
25. Bertollini (2004), p. 3.

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26. Rothenberger *et al.* (2004), p. 4.
27. OECD/World Bank (2003), p. 4.
28. Sader (2000), p. 68.
29. Sader (2000), p. 64.
30. Sader (2000), p. 95.
31. Sader (2000), p. 95.
32. Manibog *et al.* (2003), p. 47.
33. Manibog *et al.* (2003), p. 27.
34. "MIGA and Water", *www.miga.org*.
35. Sader (2000), p. 44.
36. Manibog *et al.* (2003), p. 34.
37. Jointly with "consumer payment discipline and enforcement" and behind "legal framework defining the rights and obligations of private investors". Lamech and Saeed (2003), p. 9.
38. Gray and Irwin (2003a), p. 1.
39. Gray and Irwin (2003b), p. 4.
40. Gray and Irwin (2003b), p. 4.
41. Camdessus (2003), p. 41.
42. *www.gpoba.org*.
43. Brook and Petri (2003), p. 7.
44. *www.gpoba.org*.
45. Seco note.
46. Kikeri and Nellis (2002), p. 19.

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Chapter 4

The Role of Development Assistance in Mobilising Investment: Recent Experiences in Vietnam*

The focus of the present article is the linkage between official development assistance (ODA) and private investment in Vietnam. The evidence that it reviews relates to the period following the introduction of Doi Moi (Vietnam's economic reform programme) in the late 1980s. During this period economic growth rates have been impressive and Vietnam has been a major recipient of ODA.

ODA has been helpful in overcoming obstacles to economic growth such as a scarcity of resources and know-how, outdated technology, poor infrastructure and institutional failures. It has also helped build the competence, or inclination, at different levels of government to correct these problems. The success stories so far include an ODA-backed revision of enterprise legislation that is credited with creating hundreds of thousands of jobs in the formal economy and a small number of infrastructure projects that spurred an explosive enterprise creation in the concerned areas. Macroeconomic evidence of the linkage from ODA to investment, however, remains elusive.

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Vietnam is one of Asia's foremost recipients of ODA and it has figured regularly among the world's top-10 destinations for development assistance over the last 1½ decades. At the same time, the economy of Vietnam has been one of the fastest-growing in the world. This naturally raises the question how much foreign factors have contributed to the country's success. The full answer to that question goes beyond the scope of the present study, which addresses the more limited issue of the effect of ODA on FDI and domestic investment.

The focus of the present article is the linkage between official development assistance (ODA) and private investment in Vietnam. The evidence that is reviewed relates to the period following the introduction of *Doi Moi* (Vietnam's economic reform programme) in the late 1980s. The study draws on data for ODA and investment covering the period from 1993 to 2003.

The *Doi Moi* was launched at a special time of Vietnam's history. It followed a century of warfare and civil strife and a decade of unsuccessful stewardship by a government with limited economic credentials. Like several other countries at the time, the economy of Vietnam was a centrally planned. The agriculture was comparatively unproductive, the (small) industry was inefficient and the war-torn infrastructure was badly lacking. The poverty rate of Vietnam was about 70 per cent.[1] The road to prosperity was expected to be long and difficult – unless foreign capital could be mobilised for development.

The obstacles to economic growth were legion, including a scarcity of resources and know-how, outdated technology, poor infrastructure, institutional failures and many others. As was the case in many other developing countries, the Vietnamese government lacked the resources, and in some cases the competence or inclination, to correct these problems. Domestic and foreign private sector actors were equally unable to enhance the situation, which essentially concerned market failure. Thus, there was a convincing rationale for the using ODA flows to address obstacles economic growth – though most donors at the time were principally motivated by more "high-minded" motives than spurring private investment.

This article is organises as follows. Section 1 provides an overview of recent trends in ODA into Vietnam. Section 2 discusses the experiences with using ODA to enhance the investment climate. The investment climate is for the purpose of the present article defined broadly to include "institutional" and "physical" elements. The "institutional" investment climate includes legal

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and institutional environments, policies related to production and trade and public governance more broadly. The "physical" investment climate depends largely on infrastructure as conventionally defined. Section 3 analyses synergies between ODA and FDI from a broader, more macroeconomic perspective. Section 4 concludes, including a brief discussion of how to improve the effectiveness of ODA/investment strategies.

1. A history of ODA to Vietnam

According to the definition of the Vietnamese government, development assistance is a "cooperative activity for development between Vietnamese Government and the donors, including foreign government and intergovernmental or international organisations" (Decree 17/2001/ND-CP of 4 May 2001). ODA is received mostly in the form of non-refundable aid and preferential loans, of which the latter has been the most common. There are seven broad target areas for aid: *i)* economic infrastructure; *ii)* human development; *iii)* rural development; *iv)* policy and institutional support; *v)* natural resources and environment protection; *vi)* emergency relief; and *vii)* general disbursement-facilitating assistance. ODA is provided as balance of payments support; programme support; and project support, which may range from technical assistance to individual investment projects.

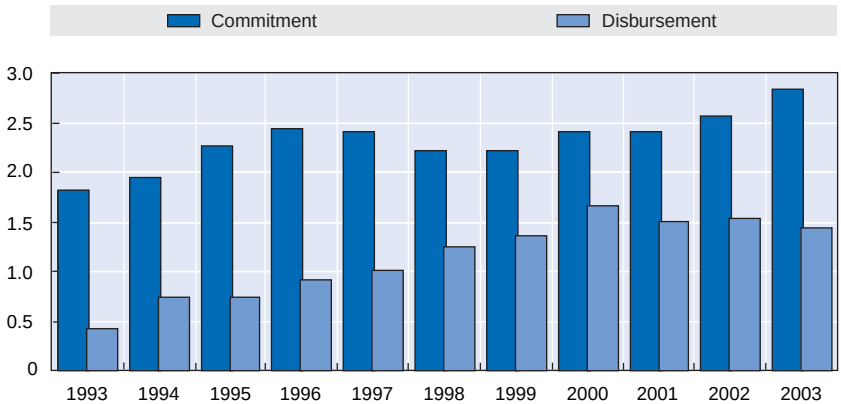
Prior to the collapse of the communist block, Vietnam received ODA mainly from the Former Soviet Union, Eastern European countries and China. (The few "outside" donors included countries like Sweden and some international organisations.) In consequence, the political events in Eastern Europe around 1990 made the main source of foreign economic aid dry up and represented a major challenge for the Vietnamese authorities.

In the early 1990s, ODA flows into Vietnam consisted mainly of small contributions by UNDP and SIDA (Sweden),[2] mostly in the form of technical assistance to the Government. As relations between the United States and Vietnam improved, the landmark Paris meeting of donors in November 1993 established a full cooperation between Vietnam and the international financial community. Since then the donors meetings have become first an annual, next a semi-annual, event. At the forums the Vietnamese government and donors exchange views on socio-economic policies and the implementation of the ODA committed by the donors. The stability of the committed amounts may be taken to indicate a persistent confidence in Vietnam by the donor community (Figure 4.1).

Figure 4.1 also indicates that the inflow of ODA may be trending upward, but it is not always growing. The decline in commitments in 1997 and 1998 was a reflection of the Asian financial crisis. During the period 1993-2003, donors committed 25.4 billion US dollars (USD) in ODA to Vietnam. The total

Figure 4.1. **ODA committed and disbursed, 1993-2003**

USD billion



Source: MPI (2004).

amount of disbursed funds over the period was USD 12.5 billion, or 49 per cent of total commitments. In order to release the committed funds, the Vietnamese government often signs international treaties with the donors. Over the last decade, the total value of the signed international treaties on ODA is estimated at USD 19.6 billion, or of 77 per cent of total committed ODA. Of the sum of the international treaties signed USD 3.7 billion was non-refundable aid, and the rest was preferential loans.

Almost all the ODA loans are long-term and carry preferential interest rates and a long grace period. Almost half (49 per cent) of the loans affected by international treaties have interest rates lower than 1 per cent p.a. and a maturity of at least 30 years, of which 10 years grace period. Another third of the loans are with the annual rate of interest between 1 and 2.5 per cent p.a. (MPI, 2004). Moreover, the large share of loans in ODA should be considered in the light of Vietnam's limited external indebtedness. The country's total convertible currency debt was approximately 37 per cent of GDP in 2001 (World Bank, 2002a), so it would appear that there is no imminent danger of debt crisis in Vietnam.

The providers of ODA to Vietnam include 25 bilateral donors and 15 international organisations. Of all the donors, Japan, World Bank and Asian Development Bank (ADB) have been the three largest donors, providing about 80 per cent of total value of the ODA-related international treaties signed over 1993-2003 (see Table 4.1). Japan is the largest one, accounting for nearly 40 per cent of the total signed values. In addition, there are 350 non-government organisations, which gave Vietnam more than USD 80 million annually in grants.

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Table 4.1. **Major ODA donors to Vietnam**
USD million

	Total ODA	*of which:*	
		Loans	Grants
Japan	7 471	6 457	1 013
World Bank	5 111	5 022	89
Asian Development Bank	3 507	3 391	115
France	749	676	73
Germany	565	288	277
Denmark	473	8	465
Switzerland	413	145	268

Source: MPI (2004)

ODA resources have mostly been allocated in accordance with the priority the Government places on economic sectors. Infrastructure has been the largest beneficiary of ODA: 22.6 per cent of the source was allocated to transport, 20.3 per cent to electricity generation and transmission and another 8.3 per cent to water supply, drainage and urban infrastructure (Table 4.2). Among the other recipient areas the top scorer was agriculture and rural development with almost 15 per cent of total disbursements. The general area of education and technology received 8.3 per cent and another 5.8 per cent went to health and social development. All the other sectors received slightly less than 20 per cent of disbursed ODA.

Interestingly, the regional distribution of ODA is not biased toward the poor areas of the country (Table 4.3). The formal justification for this has been the higher efficiency of development spending in relatively more "modern" areas in generating economic growth. The underlying hypothesis is that economic growth automatically triggers poverty reduction. Thus, large amounts of ODA were allocated to the relatively prosperous urban centres rather than to the rural and

Table 4.2. **Distribution of ODA in areas**

Areas	ODA shares (%)
Transport	22.6
Electricity Generation and Transmission	20.3
Agriculture and Rural Development	14.9
Water Supply and Urban Infrastructure	8.3
Education, Training, Science and Technology	8.3
Medicine and Social Affairs	5.8
Others	19.8

Source: MPI (2004).

Table 4.3. **Regional distribution of ODA, 1993-2003**

Regions	Poverty rate 2002 (%)	Per capita ODA (USD)
North West	68.0	119.9
North East	38.4	117.0
Read River Delta	22.4	129.5
of which, Hanoi	5.2	440.3
Central Coasts	38.9	128.4
Central Highlands	51.8	82.1
South East	10.6	157.1
of which, HCM City	2.0	274.0
Mekong Delta	23.4	49.6

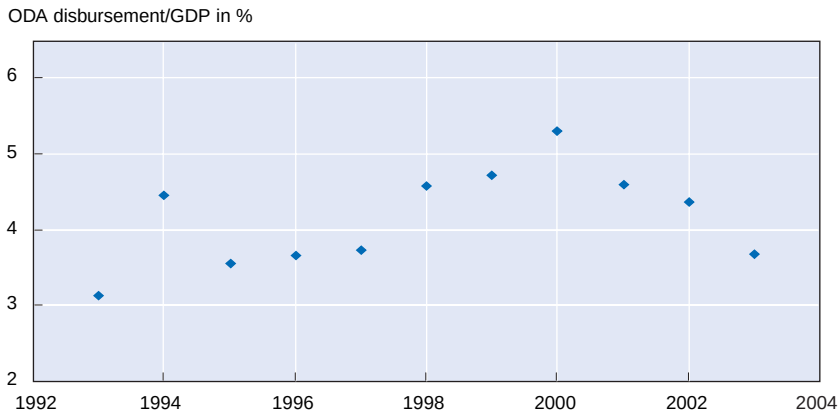
Source: World Bank (2003), MPI, MOLISA, and GSO.

mountainous areas, where poverty concentration is high. The most prosperous South East is at the same time the biggest recipient of ODA, while the North West and the Central Highlands have low levels of ODA.

While the sheer size of ODA inflows to Vietnam has been internationally high, the ratio of aid dependency is relatively low (Figure 4.2). Over the period under consideration the average ratio of disbursed ODA to GDP is 4.2 per cent. For reference, the rate is much higher for a number of developing countries – 10-15 per cent in a number of Sub-Saharan African countries, and almost 30 per cent in the case of Mozambique (UNDP and CIEM, 2003).

Figure 4.2. **The aid dependency ratio of Vietnam, 1993-2003**

Per cent



Source: MPI, 2004.

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2. ODA and the investment climate in Vietnam

Foreign development agencies are aware of the weaknesses of the Vietnamese business environment and many of them have made remedial action in this area a top priority. The shortcomings in terms of relevant capital endowments are comparable to many other developing countries, including a shortage in machines and equipment, relevant human resources and adequate transportation and communication. Moreover, owing in part to Vietnam's status as a transition economy, much remains to be done in terms of institutional infrastructure such as legal and institutional systems that effectively support a market economy. A significant share of ODA so far has been allocated to reforms in areas such as legal system development, institutional improvement and enhancing public governance more generally.

2.1. ODA to reform the legal system, institutions and governance

2.1.1. The ODA inflow and implementation

During the period under review, the signed ODA that went into public governance and institutional support amounted to USD 257 million. That amount does not include programme loans and credits for structural adjustment. If all the programme loans funded by the World Bank and Asian Development Band, together with the Miyazawa loan from Japan, are added to this category, the amount is much higher. Thus counted, it becomes the fourth largest aid category with a funding of USD 1 681 million. The five biggest donors in this area are World Bank (USD 856 million, including USD 794 million from loans), Asian Development Bank (USD 503 million, including USD 445 million from loans), Japan (USD 160 million), Sweden (USD 42 million), and UNDP (USD 40 million).

The country assistance strategy of Japan[3] identifies institutional and legal development support as one of its five key areas. The government of Japan supports areas such as: policy advice to plans and strategies for socio-economic development; facilitating economic and structural reform to promote a market-oriented economy; and improving Vietnam's legal framework, including the Civil Law, Law of Civil Dispute, Law of Commerce, Law of Investment and the Enterprise Law.

The World Bank Group concentrates its assistance program in three areas. First, it supports the transition to the market-oriented economy. The strategy of the WB in this area includes: *i)* financial sector development; *ii)* reform of state-owned enterprises (SOE); *iii)* domestic private sector support; *iv)* corporate governance and social responsibility; and *v)* international trade promotion. Second, it aims to create a level playing field for private and state enterprises and improve the efficiency of SOEs. Third, it supports regulatory reform and enhancement of public governance.

ADB has been supporting private sector development through programmes to enhance the business climate and develop the local financial sector. In this context, the Bank has funded a number of projects for institutional and policy development and good governance. ADB has provided two loans in banking and financial sector and one for SOE reform and corporate governance. The World Bank and ADB have moreover provided major programme loans to enable the Vietnamese government to fulfil far-reaching policy commitments toward macroeconomic stability and structural reform.

UNDP has also been active in providing support the business climate. Notably, it has been involved in numerous processes of enhancing the legal system. Various laws have been drafted or revised with the assistance of UNDP, including the Enterprise Law, Competition Law, the Law on Cooperatives, Law on Investment, SOEs Law, Trade Law. With the participation of UNDP, in 2003 alone around USD 10 million was raised to assist ongoing efforts toward public administration reform, and the Legal System Development Strategy and Natural Disaster Alleviation Strategy. In addition, UNDP, jointly with AusAid, and DFID, assisted the government in drafting the Revised Law on State Budget and in measures to implement this Law.

Demark has contributed to the government's efforts toward SOEs reform, both under DANIDA administration and under administration by multilateral donors (such as the World Bank, IFC and other). For example, under DANIDA administration Demark provides supports to enterprise restructuring and development in formulating equitisation plans and providing post equitisation assistance. Under World Bank administration, Demark has provided advisory services on implementation of the Decree on divesture and establishment and use of Support Funds for Equitisation and Restructuring.

In the area covered by the Vietnamese government's Public Administration Reform (PAR), ADB, Netherlands and UNDP are the major donors. Since 1997, UNDP has been supporting 6 PAR projects, of which 4 with the co-financing from Netherlands. In addition to four grants for institutional and capacity building in PAR, ADB provided a program loan to support the PAR Master Program for the period 2001 to 2010. Other contributors to PAR are Canada, Norway and Sweden.

The geographical distribution of ODA commitments to policy and institutional support is becoming more balanced, shifting from a concentration in the major urban centres such as Hanoi and Ho Chi Minh City to other provinces. This reflects a joint objective by the government and donors to ensure a better spread of enterprise development. However, distribution among the provinces remains uneven, and some areas are largely neglected.

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2.1.2. Improvement of public resource management

The Public Administration Program of Vietnam has four major components: legal and institutional matters, organisation, human resources and public finance. Under the program a cross-cutting piece of legislation, the "Law on organisation of the Government", was amended in 2001. A number of policies aimed at decentralisation have been formulated, including the following:

- A one-stop-shop model for registration of new enterprises has been implemented in 28 out of 61 provinces. The purpose is both to simplify administrative procedures and to change the mindset of public officials. The new model has been overwhelmingly welcomed by all parts of the Vietnamese society, as well as the foreign business community. The central government is developing a legal framework for extending the model to all provinces.
- The introduction of block budgeting and staffing policy and result-oriented management in 19 provinces, 3 central agencies and a number of other administrative units. The measures are believed to curb waste and enhance staff efficiency and motivation.
- The State Budget Law, which was amended in December 2002, provides the People's Councils[4] with the authority to distribute the budget.

With the assistance of UNDP, the Law on SOEs was revised and enacted in November 2002. In addition to this and other efforts at restructuring and reorganising SOEs, formal auditing had been undertaken for 43 such enterprises by the end of 2003. It must, however, be noted that even though there has been great public and political pressure to speed up reform in SOEs, the process has been slow. Moreover, the scale of state ownership in the economy makes it more difficult to renovate the banking sector, because the state owned enterprises depend for their finance on state-owned commercial banks (SOCBs) which continue to dominate the banking industry.

During the past decade, four SOCBs have been reformed from fulfilling assignments of administratively decided lending to operating on a commercially sounder basis. The Government has embarked on a multiyear restructuring and recapitalisation program with the support of International Monetary Fund (IMF) and World Bank Group. Other measures taken include deregulation in the banking sector, including freedom to set interest rates; drawing up restructuring plans for unreconstructed SOCBs, establishing asset management companies for non-performing loans resolution; phasing in SOCB re-capitalisation; and phasing out directed lending ordered by the state. SOCBs have become more independent from the State Bank of Vietnam and have begun to make a profit.

Sponsored by World Bank and DfID, the recently approved Public Financial Management Reform Project aims to ensure that budget execution and reporting by governmental agencies are accurate, timely, relevant, transparent and in compliance with international standard. One of the components of the project will support the strengthening of the government's ability to manage Vietnam's public debt and to begin monitoring the fiscal risks that originate form the liabilities of SOEs.

2.1.3. The enterprise law: a success story

The project VIE/97/016, which was funded by UNDP and AusAID, is considered as an example of ODA money well spent. The cost of the project was relatively small – about USD 2.3 million over four years. The money was used to hire a number of foreign experts to work with Vietnamese officials during the preparation of the law. The new Enterprise Law was approved by the National Assembly and came into effect at in January 2000. There is a consensus among economists and policy makers that the Enterprise Law is among most important reforms achieved in Vietnam over the past ten years.

The most important achievement of the Enterprise Law is the simplification of registration procedures for new private enterprises, involving the elimination of over one hundred business sub-licenses. Business representatives have referred to the new Law as a permission "to register first, then to check". Alongside with reducing the time and expense needed to establish a business, the Law has also improved the confidence of business community in local authorities and limited the opportunity for corruption. On the whole, the Law is seen as having created better opportunities for all businesses, but in particular for small enterprises.

As at the end of September 2003, less than four years since the Law was enacted, Vietnam had witnessed the creation of 72 601 new enterprises – or 1.6 times the number of enterprises registered over the previous nine-year period. Just as important, private investment has spread to all regions, including the poorest ones, rather than concentrating on those with favourable geographic conditions as was the case prior the introduction of the Law. In the poorest Northern provinces (Hoa Binh, Bac Kan, Lai Chau and Bac Giang) and the North-Central coastal province Thanh Hoa, the number of enterprises grew four to eight-fold compared to that of the 1991-99 period.[5]

Unsurprisingly, most of the new private enterprises are small. Seventy per cent of them have an average capital of VND 50 million (about USD 3 300) and employ 10-15 persons. Even so, the total employment creation has been astonishing. In 2000, the total employment created by newly established enterprises was about 400 000, and the following years this figure increased to

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500 000 and 800 000, respectively.[6] Table 4.4 shows that, during 2000-2003, the annual growth rate of the private sector was close to 20 per cent, which is higher than that of state and foreign sectors.

Table 4.4. **Industrial output growth rate of private and other sectors in Vietnam**

Per cent

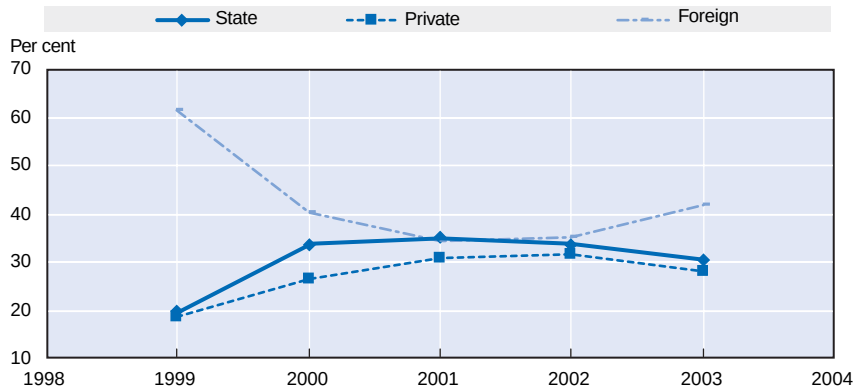
	1999	2000	2001	2002	2003
Private sector	8.8	18.3	20.3	19.2	18.7
State sector	4.5	12.2	12.7	11.7	12.4
Foreign sector	20.0	18.6	12.1	14.5	18.3
Total	10.4	15.7	14.2	14.5	16.0

Source: GSO.

In other words, the revitalised private enterprises contribute increasingly on the overall growth of the economy. While the share of domestic private sector has increased for few percentages in total industry output (22 per cent in 1999 to 25 per cent in 2003), the contribution of the sector to total annual growth of industry sector has grown at a remarkable high rate. Figure 4.3 indicates that the contribution to total industrial output growth of the private sector increased from just 20 per cent in 1999 to close to 30 per cent in 2001 and 2002.

Figure 4.3. **Distribution of industrial output growth by ownership**

Per cent



Source: Statistical Yearbook 2002 and GSO.

Notwithstanding remaining obstacles to the implementation of the Enterprise Law, it is safe to say that a small amount of ODA funds has brought about a big achievement for the economy. Probably reflecting this, UNDP is

committed to implement another project for developing the domestic private sector by establishing favourable business environment, improving the capacity of private firms and increasing competitiveness.

2.1.4. Overall evaluation

Despite the generosity of international donors and the remarkable successes of some particular programs such as the project VIE/97/016 which contributed greatly to the formation of the Enterprise Law, the overall effectiveness of the ODA program in the area of institutional infrastructure has been mixed. A multitude of different issues have been addressed and the scale of ODA programmes in this area is generally not large. Unsurprisingly, therefore, programme effectiveness has varied from case to case. Moreover, sensitivities within the public administration have sometimes prevented the success of ODA programmes in this area.

Business people have often complained about obstacles to their operations emanating from public governance. Given the transitional state of the Vietnamese economy, such obstacles are to be expected, but removing them can help greatly increase economic efficiency. Certain irrationalities in the existing institutions and system of public administration cannot be easily addressed because they are related to politically sensitive areas. For instance, the financial state of SOEs and certain state agencies is considered as classified information. Some officials may also invoke national sovereignty against a requirement of budget transparency. While such practices can sometimes be unavoidable in an economy with predominance of the state sector (including an unclearly defined role of state in providing material goods and public security to its citizens), they may equally reflect administrative inertia and vested interests.

In short, many programs in this area have not found "local ownership" and failed to generate enthusiasm among domestic partners. The result has been slow progress in some areas such as SOE reform. Also, the improvements in public administration, especially in budget management, have been less than expected.

2.2. ODA and foreign trade policy

Greater participation in trade carries developmental benefits in its own right and, in a world where multinational enterprises becomes increasingly dependent on their access to trade across boarders among related enterprises and with subcontractors, it is crucial to attract investors as well. Moreover, for a transitional economy like Vietnam, the benefits of a greater participation in the world markets are not limited to the direct effects on foreign trade and inward investment. Considerable additional gains are expected from the

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process of aligning the country closer with international standards, and that has justified an engagement by foreign governments and international organisations to promote the foreign trade of Vietnam. The ODA in this area includes, among other things, assisting trade policy reforms, building trade capacity and working toward solutions to trade disputes. Recently, a number of donors provided broad-based assistance to help Vietnam fulfil the WTO membership criteria.

Total assistance for trade reform in Vietnam has been a relatively small proportion of total ODA over period 1993-2003. The two most important ODA-backed projects in this field are the EU's Multilateral Trade Policy Assistance Program (MUTRAP – see Box 4.1) and the United States' Support Trade Acceleration Project (STAR – see Box 4.2). Individual donor countries include Australia, Canada, Denmark, France, Sweden and Switzerland.

2.2.1. ODA for trade policy reform

Trade reform, an important component of Vietnam's economic reform programme, has walked ahead of other parts of *Doi Moi*. The government has taken note of a strong correlation between openness to trade and high growth

Box 4.1. **The Multilateral Trade Policy Assistance Program (MUTRAP)**

MUTRAP is the biggest technical assistance programme for trade reforms in term of funding, and its coverage is quite extensive. It was initiated in 2001, but came into operation only in 2003. After the completion of the first phase in March 2004, the second phase is scheduled to commence at the end of 2004.

During the first phase, the programme offered training on sanitary/phytosanitary issues, which are related to problems of seafood exports, and on technical barriers to trade (TBT) to officials from the relevant ministries. Under the programme technical assistance was also provided for Vietnam's participation in WTO negotiations on services trade. Furthermore, experts were designated to help the Ministry of Finance, Ministry of Trade and Ministry of Industry build analytical capacity in scenarios of tariff reduction and anticipation their impacts on the economy. Finally, the programme includes awareness-raising measures to provide Vietnamese policymakers and the general public with information on trade under WTO. Three business seminars on economic integration have been held in which about 500 corporate representatives participated.

Box 4.2. **Support for Trade Adjustment and Reform Project (STAR)**

The US government's intention with this project is to assist Vietnam in reforming its policy for better implementation of the commitments in the bilateral trade agreements (BTA) between the two countries. It is the largest US technical assistance project in Vietnam since the war, and the first USAID-contract in coordination with the US Trade Representative to assist in implementing a trade agreement. STAR began operations in Hanoi in mid-October, 2001, before the BTA took effect.

Over 2001, STAR helped to conduct 23 training workshops and policy seminars, organised 4 study tours and reviewed in detail more than 9 laws and regulations. These activities have reached directly more than 2 000 government officials and business representatives, targeting key senior and mid-level government officials responsible for reforms relevant to implement the BTA.

In 2002 and 2003, STAR focused on supporting Vietnam's efforts in amendment or adoption of number of laws and administrative procedures. In particular, *i)* bringing Customs into conformance with WTO Standards; *ii)* raising awareness of Vietnamese people about the conformance with international conventions in intellectual property protection and with the WTO Agreement on TRIPS; *iii)* establishing a registration system for investment licensing procedures; and *iv)* expanding market access for services such as value-added telecommunications, accounting, architectural, engineering, computer and banking.

rates in the most successful economies of East Asia. Thus, the political motivation for carrying out trade reform is strong. The major beneficiaries of technical assistance in this area have been the legislative National Assembly, the Ministry of Trade, the Ministry of Finance, the Ministry of Industry, the Ministry of Agriculture and Rural Development and a few other ministerial agencies.

One illustrative example is the Swedish-funded Rule of Origin (ROO) project. Internationally, Rules of Origin have been the subject of trade disputes, and so the purpose of the project was to help the National Committee for International Economic Cooperation and relevant ministries in preparing draft legislation on ROO. The work included the sharing of Swedish experience in developing legal texts on ROO, training sessions and a study tour to Swede. It is expected that the Ministry of Justice will prepare draft regulation on ROO and make it the subject of comments and consultation with Sweden experts before the end of 2004. There are other important projects as well. For example, the AFD/DREE (France) has provided EUR 3 million the Programme of Enforcement of Vietnamese Commercial Capacities (2003-2005).

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2.2.2. Facilitating WTO accession

The Vietnamese government submitted its application to join the WTO in 1995 and currently has an observer status. Given the prospect of Vietnam acceding WTO in the near future, many donors provide their assistance to train on contents of the WTO agreements. So far, all technical assistance efforts for trade reforms have concentrated mainly at central level. However, donors have raised questions about the need for spreading the assistance over provinces.

The donor community has been implementing a number of projects in the areas of trade negotiation and facilitation. It is the express policy of Japan's government to support Vietnam with WTO-related capacity building. More specifically, the Japanese development assistance focuses on developing the trade-related aspects of the legal system, strengthening export competitiveness and trade facilitation. CIDA (Canada) has been funding a project for strengthening the capacity of the Ministry of Justice in identifying and developing legislation in conformity with WTO accession requirements. The Italian authorities have assisted in formulating a policy for subsidies and countervailing measures, and Switzerland provides general policy advice towards Vietnam's WTO accession.

International trade promotion is also part of the World Bank's country assistance strategy. The Bank's total technical assistance toward Vietnam's WTO accession was about USD 57 million.[7] The World Bank provides financial and technical support for the Vietnam Institute of Economics to study "Vietnam's Readiness for WTO Accession" as well as a number of workshops with participation by National Assembly members and officers from the ministries. In the workshops, international and domestic experts present their analyses of the potential impacts of WTO accession on the economy.

2.2.3. An assessment of the effectiveness ODA in foreign trade policy

Modern Vietnam has emerged from a planned economy, under which trade policy was simple, since trade was mostly centrally decided and the notion of trade disputes was not relevant. ODA projects like MUTRAP, STAR, ROO and others were all part of the effort toward changing the country trade policy to what is deemed internationally acceptable, including by WTO rules. The fact that the openness of the Vietnamese economy has increased from 61 per cent in 1994 to 118 per cent in 2003 (Table 4.5) serves as an indicator of the improved trade policy environment.

STAR has certainly contributed to the successful implementation of the Vietnam-United States BTA – and a report by Riedel *et al.* (2003) indicates that Vietnamese exports to the United States increased more than four-fold over two years following the BTA. Over this period, exports to the United States

Table 4.5. **Openness of the Vietnamese economy, 1994-2002**

Per cent of GDP

	1994	1995	1996	1997	1998	1999	2000	2001	2002	2003
Export	24.9	26.3	29.4	34.3	34.5	40.2	46.5	46.2	47.5	51.0
Import	35.8	39.3	45.2	43.3	42.4	40.9	50.2	49.9	56.1	66.7
Total trade	60.7	65.6	74.6	77.6	76.6	81.2	96.6	96.1	103.6	117.6

Source: GSO, IMF, MPI and the World Bank.

contributed to over half of Vietnam's overall export growth. The authors of the study argue that most of the growth in exports to the United States was the result of export creation, rather than a consequence of diversion away from export to other countries.

2.3. ODA and infrastructure development

Nearly half of the signed ODA commitments over the last decade have gone into infrastructure development. Within this group, transportation is the sector receiving the largest share. Most of the ODA resources for transport are loans. Grants have been given to transport projects mostly for helping the government undertake loan feasibility studies or enact policy adjustments. A big part of the ODA to infrastructure has been allocated for rehabilitating highways and building bridges. The support for the largest projects has come from a few donors, namely Japan, the World Bank and Asian Development Bank.

Japan is the biggest donor in supporting infrastructure development. The following priorities are part of this country's operational strategy for ODA to Vietnam:

- Upgrading and improving transport and traffic system such as ports, national roads, bridges, airports and railways.
- Improving bridges in the provinces in Northern Mountain, Central Coasts and Me Kong Delta areas.
- Improvement of urban infrastructure such as improvement of traffic system in Hanoi and the Northern Thang-Long area.
- Thermal power stations. Japan provides loans for building and upgrading six power stations, which will upon completion have a 20 per cent share in the nation's power generating capacity.

The second largest donor of World Bank has been supporting projects in improving infrastructure access for the Northern mountainous regions, the Mekong Delta and the Central coasts through provincial road improvement, rural electrification and community- based rural infrastructure development. ADB has provided numerous loans to projects in national and provincial road

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improvement, clean water supply and urban development. Developing the energy is moreover a priority for ADB. Its policy is to support a "balanced" power generation, combining hydropower (in combination with water resources management), and gas and coal power stations.

2.3.1. Major ODA projects in transportation

Vietnam's backward and, still, war-damaged infrastructure is an obstacle to attracting FDI and to investment more generally. The government recognises this and has, over last ten years, spent large amounts of state funds conjointly with ODA on the infrastructure sector. During 1996-2000, about 40 per cent of the total public investment (state budget, state credit and SOE investment) was directed to transport and power infrastructure. Moreover, since 1996/97 major infrastructure has received the largest portion of ODA, particularly in transport and energy sectors.

Over the period, many of large ODA-funded infrastructure projects such as National Highway No. 5 and Hai-Phong Harbour (Box 4.3), My-Thuan Bridge (Box 4.4), National Highway No. 1, National Road No. 10 and National Road No. 18 have been completed and have significantly improved the country's infrastructure. At the more local level, a large number of provincial and rural

Box 4.3. **The National Highway No. 5 upgrade and Hai-Phong Harbour rehabilitation**

The projects for upgrading National Highway No. 5 and rehabilitation of Hai-Phong Harbour were agreed upon between the Vietnamese and Japanese governments soon after the resumption of Japanese ODA loans to Vietnam in 1992. The two projects were intended to meet the needs of the rapidly increasing road traffic in the Red River Delta of Northern Vietnam and to strengthen the capacity of Hai-Phong Port. JBIC provided USD 175 million to Highway No 5 project (implementation period: 1994 to 2000) and USD 33 million to the Hai-Phong Harbour rehabilitation (phase 1: 1994 to 2000).

The National Highway No. 5 is 100 kilometres long, connecting the economic centre Hanoi to the country's most important harbour Hai-Phong. The harbour enjoys the commercial advantage of proximity to Japan, Korea, Hong Kong and mainland China. The highway is the route for transportation of raw materials, input goods and final products produced in Northern Vietnam.

According to the research done by GRPIS (2003a) and Mitsui (2003), thanks partly to the National Highway No. 5 Upgrade and Hai-Phong Harbour Rehabilitation project, travel time between the Hanoi and Hai Phong was cut by half (from 3.5-4 hours to 1.5-2 hours), and the traffic volume on the Highway doubled during 1999-2003.

Box 4.4. **My-Thuan Bridge and National Highway No. 1, linking Ho-Chi-Minh City to Can-Tho**

The first component of this project was building the first-ever bridge across the Tien River. This project was jointly financed by the Australian and Vietnamese governments at a capital cost equivalent to USD 60 million. The second component was the rehabilitation of the part of National Highway No. 1 that connects Ho-Chi-Minh City and Can-Tho. The cost of this component was USD 176 million, provided by the World Bank. The road project was completed half year before the inauguration of the My-Thuan Bridge in 2000.

Tien River is one of the two main branches of Mekong. Prior this project, none of them has ever been crossed by bridge. From Can-Tho, the centre of the Mekong Delta, to Ho-Chi-Minh City trucks and cars had to be carried on ferryboats, causing a major slowdown of economic activity in the Mekong Delta from where most of the Vietnamese rice export originates. After the opening of the bridge, the travel time between the two cities was reduced by 1-1½ hours. Between 1999 and 2001, traffic volume at the My-Thuan river crossing doubled. The daily traffic flows have increased from an average 3 980 vehicles in 1994 to 20 100 in 2002.

roads have been built or upgraded. Saigon Port, Cai-Lan Deep Sea Port, and about twenty fishing ports have also been upgraded with the help of ODA.

As regards the economic impact of the National Highway No. 5 and Hai-Phong Harbour project (Box 4.3), a report by GRPIS (2003a) indicates that, as of mid-2003, the four industrial zones around Hanoi and Hai-Phong account for about 85 per cent of total FDI to northern zones. Two-thirds of the investment arrived after 1999. The report includes an investor survey that suggests that nearly 90 per cent of the new FDI to the North would not have materialised without the improvement of the two transport facilities. Encouraged by the experience, authorities have established a number of industrial close to the National Highway, namely in Hai-Duong and Hung-Yen.

Domestic investment in these areas increased as well. The better transport system led to an expansion of the tourism industry at Ha Long Bay. The number of tourists (both Vietnamese and foreign) quadrupled from 1995 to 2002, with a particular increase after 2000. Thus, the total private investment that followed this project is very large. Even though not all of the changes can be reasonably accredited to the project, it is seen as the main factor.

The My-Thuan Bridge and the National Highway No. 1 project (Box 4.4) are given credit for the fact that the Can Tho area is now the fastest growing province in the Mekong Delta. Moreover, its economic activity, previously

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largely agricultural, increasingly involves industry. The province currently has three industrial zones (Tra Noc I and II, and Hung Phu Industrial Zones). Taken together they host about 80 firms (including about 20 foreign-invested ones) employing 13 000 workers. Easier transport has also promoted tourism development in Can Tho, particularly since 2000.

The outcome of the project has been deemed so satisfactory that another bridge (across the Hau River, which runs parallel with the Tien) is now under preparation. The expected benefit of this second bridge is, as the Can Tho economy gains momentum, to spread the effects more widely across the Mekong Delta.

2.3.2. The power sector

Power generation in Vietnam is entirely in the hands of Electricity of Vietnam (EVN), a state-owned monopoly, which is, in turn, administered by the Ministry of Industry. Due to the lack of competition, combined with limited a generation capacity, electricity prices are high compared to neighbouring countries. For instance, the price paid for electricity by businesses in Hanoi and Ho-Chi-Minh City is higher than in Singapore and Kuala Lumpur, twice the price in Shanghai, and more than twice the price in Bangkok and Jakarta. The current status of the energy sector is arguably one of the factors holding back private investment.

In order to overcome that problem, institutional reforms in the power market are necessary – and so are large amounts of money for expanding the power generation capacity. Primary sources of finance for the investment are from ODA grants and loans committed by Japan, the World Bank, ADB, other foreign governments and Vietnamese authorities. Between 1996 and 2000 donors provided USD 2.9 billion for developing the power sector, of which JBIC (Japan) USD 1.9 billion, the World Bank USD 694 million, ADB USD 180 million, and SIDA and other bilateral donors about USD 150 million. According to EU Economic and Commercial Counsellors (2004), over the last decade foreign loans provided 46 per cent of the total investment by the EVN. Domestic credits supplied only 18 per cent of the funds and other sources accounted for the remaining 36 per cent. Thus, without ODA it would be hard to see how the problem with high energy price could be solved.

Counting only the projects completed before 2002, Japan had contributed to the construction of 1 865 MW worth of generating capacity, or 23 per cent of the electric power supply in Vietnam of which, between 1992 and 2001, Japanese ODA contributed 38 per cent of the increased capacity. The power generating projects built with the assistance from Japan include Phu My Thermal Power Plan, Pha Lai Thermal Power Plan, Ham Thuan-Da Mi Hydropower, Dai Ninh Hydropower.

2.3.3. An assessment of the effectiveness of ODA in infrastructure

The state investment and ODA funds caused a strong development in the infrastructure services of Vietnam. Over the period 1990-1999, the total amount of goods transported on roads more than doubled. The marine transportation increased six times. For the five-year period 1996-2000, more than 1 200 km of new roads have been constructed, and more than 4 000 km of old road upgraded. By the end of 2000, about 95 per cent of Vietnam's municipal centres were accessible by car (for comparison: 99.9 per cent in the Red River Delta; 99.4 per cent in the Southeast Region and 72.4 per cent in the Central Highland).

Energy generation capacity has tripled over the period 1990-1999, and the share of the population with access to electric power source increased from 47 per cent in 1990 to 75 per cent in 1999. By the end of 2003, 93 per cent of municipalities nationwide, including 83 per cent of the rural households, have access to the national grid.[8] Notwithstanding the progress, Vietnam needs to increase its power generation capacity for a number of years to come. Electricity prices remain high even though the share of renewable energy is relatively high compared to neighbour countries.

A Report by Hanoi Management Board of Industry Zones suggests that one of the main problems for starting enterprises in Vietnam is shortage of land suitable for industry or service production – that is, with electricity and adequate road access. Limitation of suburban land has led to property prices that are prohibitively high for many potential investors. The extension of road and electric grids into rural areas helps solve this twin-shortage, and in fact investment has been observed to spread into rural area for precisely as far as far as the new electric grid and roads go.

The change in infrastructure between 1993 and 2003 is a substantial alleviation of the congestion in the national highways and therefore in creased the connectivity between regions and to world market. The progress of electrification and development of rural roads have "expanded grounds" for enterprises that would otherwise be crowded out. Given that domestic private investment in infrastructure in Vietnam[9] has been relatively negligible in the total and the share of roads and power generating projects in the state investment is almost the same as that in ODA.[10] Taken together with the indication that ODA is on average one fourth of State investment (Table 4.7) this allows for a rough estimate: ODA would seem to have been responsible for one fourth of the change mentioned above.

2.4. ODA and human resource development

Vietnam has done relatively well in terms of the percentage of literate adult population. As of 2002, the literacy rate was 91 per cent – an achievement

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for a low income country. However, as indicated by the World Bank (2001), the quality of education is an issue. For instance, primary schooling averages 500 hours per year, which is one half of the international average, and the curriculum and style of learning has been described as outdated. Almost one-third of children do not complete fifth grade.[11] Potentially more important from a business viewpoint, Vietnamese tertiary education is far from meeting the demands of an increasingly international labour market.

The government's growth strategy emphasises the importance of education and human capital development; one of its main targets is making lower secondary education universal. A challenge in this respect is to deliver quality education to everyone, especially girls and young people in remote rural and mountainous areas. Along with schooling, vocational training is seen as key to developing a skilled workforce. The government outlay for education and training is projected to be raised from 15 per cent of total state budgets (or 3.5 per cent of GDP) in 2000 to 20 per cent in 2010, alongside with strengthening public-private partnership in human resource development.

2.4.1. Concrete projects and experiences

According to MPI, from 1993 to the end of 2003, the total committed ODA signed for the area of education and training was about USD 1 100 million, of which USD 600 million was in loans and USD 500 million in grants. The loans to this sector are not a big proportion of total ODA loans (slightly above 5 per cent), but the grants make up for almost 12 per cent of the total. Most of the ODA in this area are intended for education as opposed to vocational training.

Major donors in the education and training sector are World Bank, ADB, Japan, Australia and the United Kingdom. The World Bank has provided USD 354 million, principally toward primary and higher education. In the coming years, the World Bank assistance in this area will focus on the consolidated national "Education for All" programme.

Japan and ADB are the second largest donors, each of them having provided about USD 240 million. Most of the funds from Japan have been allocated to primary school facilities. As at the end of 2003, nearly two hundred elementary schools had been constructed by means of Japanese ODA, most of them in municipalities with a high poverty rate.[12] Japan has yearly been providing scholarships to Vietnamese students and government officers to study in higher education institutions of Japan.

Social development is one of the four strategic priorities of ADB, and within this priority education and training is given much emphasis in the Bank's assistance to Vietnam. For instance, ADB has provided major loans in co-financing with France and the Nordic Development Bank for "Technical and Vocational Training" project to help the General Department of Vocational

Training (GDVT) restructure the whole vocational training system (ADB: USD 54 million, NDB: USD 7 million and France: USD 15 million). This project focuses on curriculum development, institutional strengthening, industry and school partnership development, and improvement of access (through supporting the facilities upgrading for 15 technical colleges and schools).

For the last decade Australia has been one of major donors toward education and training in Vietnam. For example, the AusAid scholarship has been given for hundreds of Vietnam student every year to go to Australia for undergraduate and graduate study. The funds provided by other countries such as South Korea, France and Switzerland may not be large by comparison, but these countries have contributed significantly to vocational training in Vietnam. They have financed various vocational training centres and supported GDVT in building capacities on vocational training. South Korea has provided three grants to support the technical schools in Hanoi, Nghe-An, and Quy-Nhon. Switzerland has provided grants to support three phases of the "Strengthening Vocational training centres in Vietnam" (see Box 4.5).

2.4.2. Impacts of ODA on human resource development

The coordinated efforts of the government and the assistance of international donors made significant progress for Vietnam over last ten years. The target "Education for All" is gradually being realised. The enrolment rate at the primary level rose from about 80 per cent in 1990 to nearly 94 per cent in 1999. The upper secondary education enrolment rate increased as well. The number of students in the 2002/03 academic year is 2.3 times higher than the one in 1992/93 academic year for lower secondary education and 4.3 times for the upper secondary education. By the end of 2002, 15 out of 61 provinces/cities have reached the goal of universal lower secondary education. The school facilities such as classrooms, teaching aid, laboratories and libraries have been upgraded substantially. The reformed national curriculum for primary and lower secondary schools (grades 2 and 7 respectively) continues to be phased in.

For the vocational training sub-sector, most of the projects are small and cover one or some specific schools or colleges. Also, there has been little coordination among donors, and between donors and the government. The "Technical and Vocational Training" is the only project working with the technical and vocational training nationwide system. The project, however, has been delayed for a number of times. More than half the time foreseen for the project has elapsed, and less than 20 per cent of the allocated funds have been disbursed.

A project in this area that is commonly considered as having been successful is the Swiss-funded "Strengthening Vocational Training Centres in Vietnam" (see Box 4.5). Encouraged by good performance of the project, the

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Box 4.5. **"Strengthening Vocational Training Centres" project**

Funded by Switzerland, the project has three phases. Phases 1 (1994-1997) and 2 (1998-2001) were with Ministry of Education and Training (MOET) and phase 3 (2001-2004) with Ministry of Labour, Invalidity and Social Affairs as counterparts. The objective of the project is to support the socio-economic reform in Vietnam through providing skills to unemployed young people to get jobs and to improve the skills for the unskilled and semi-skill workers.

Five specific objectives of the project are: *i)* upgrading the vocational training equipment in classrooms and workshops; *ii)* curriculum development based on the newest knowledge of subjects; *iii)* teacher training capacity development; *iv)* strengthening the technical and vocational training centres' management capacity; and *v)* making contribution to the policy dialogue on informal vocational training system. Impacts of the project include the following:

- Improved the technical and vocational training capacity at vocational training centres that reflected in modernised vocational training curricula, upgraded equipment; improved training quality and strengthened management capacity. The enrolment of the centres covered in this project has increased by 15-20 per cent.
- Build administrative capacity in state management agencies at local levels though involving local authorities (provincial and district levels) and the National Institute for Education Development Studies into the project's working groups or training workshops on management skills.
- Introduced the best practice of a vocational training centre to disseminate it national-wide through sharing with policy makers on good experience and lessons learned from the centres participating in the project.

Government of Switzerland has expanded its support for phases 2 and 3 of this project. The project has helped strengthening 18 vocational training centres through providing equipment, curriculum development, teachers training and management capacity improvement.

2.4.3. An assessment of the use of ODA in human capital formation

With the assistance of the international donors, many new skills have been introduced in vocational teaching centres, and the overall quality of training in those centres has been also improved. The graduates from ODA-supported schools have generally better met the demand of competitive industries such as telecommunication, airplane and airport service, oil and gas, garment, foot-ware, mechanical, electric and electronics industries. One

indicator that the human capital provided by the technical and vocational education system has become more marketable is the fact that it has become steadily more popular with education-seeking youths.

However, while the benefits of educational spending are certain from a societal point of view, evidence of an immediate and visible impact on private investment may be less persuasive. Few of the projects include some sort of "graduates tracing" follow-up, and even in the big-loan projects the follow-up mechanisms largely concerned monitoring rather than a broader economic evaluation.

There had generally been a wide gap between the newly emerged market economy and teaching contents technical-professional schools in Vietnam, and ODA has been helpful in closing the gap. Most of curricula have been redeveloped to make the training more relevant to market needs. Teachers training competences in this respect have also been improved. The management capacity of technical and vocational training centres has been strengthened. Overall, given the moderate funding of ODA projects in the education and training sector, aid effectiveness has been high. The technical expertise transferred as part of the ODA programmes is potentially very valuable for a lowly developed economy. Nevertheless, the direct benefits from the ODA projects in the education and training sector in attracting investment are likely to continue to defy measurement in the short term.

Finally, a word of caution is in place. Since the government remains the dominant employer (at present, if not necessarily in the future), young people may be biased in their choice of education. Vietnamese youths continue to try hard to gain acceptance to universities that are commonly perceived no longer to provide the most relevant education, and, at the same time, do not sufficiently appreciate the value of technical or vocational educations.

2.5. The reform of state-owned enterprises

At the end of the Indochina war in 1954, the state owned enterprise sector of was established by both nationalising the existing private enterprises and establishing new SOEs. By the end of 1960, all industrial establishments and more than 99 per cent of commercial establishments and transportation facilities had been transformed into SOEs. In their operation, SOEs were under direct control of ministries or agencies of central and local government. The function of the SOEs was to receive and carry out plans given to them. The plans specified detailed production targets, sources of inputs and distribution. After the unification of North and South Vietnam in 1975, the private and public business establishments in the South were also transformed into Northern-style SOEs.

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After it had been clear that the SOEs were inefficient, partial measures to the problem had been applied. In November 1991, the Council of Ministers enacted Decree 388/HDBT on the regulations for setting up and closing down of SOEs, which forced an SOE to be dissolved or merged with another if they were judged to be inefficient or lacking capital or technology or did not have sufficient market demand for their outputs. The state sector was further reorganised with Government Decisions on establishment of General Corporations in 1994. In 1995, the law on SOEs was enacted, providing the first legal basis for the operation of SOEs.

Further reforms of the state sector received assistance from foreign donors. ADB has provided two parallel projects with the aim of enhancing the institutional capacity of key agencies in diagnostic audit of SOEs and in review and approval of SOEs seeking equitisation and to formulate and implement a strategy and practical method for transforming SOEs into corporations. In addition, ADB helps to implement and to enforce the adoption of international best practice in corporate governance. ASEM has also provided support for a number of projects in this area. The ASEM programmes have three components: *i)* social safety net to deal with labour displaced by SOE; *ii)* acceleration of equitisation and restructuring SOEs in the Ministry of Transport; and *iii)* implementation of SOE reform in three line ministries (industry, agriculture, and construction) and two provinces/municipalities, one of which is Hanoi.

Danida (Denmark) assistance has covered a wide range of the process of SOE reform. The agency administered a project "Support to Industry Restructuring and Enterprise Development" implementing equitisation plans and providing post equitisation assistance. Moreover, Japan, Australia, Denmark and UNDP have provided large funds fore more general facilitation of SOE reform activities such as data collection and monitoring system for SOEs, diagnostic audits to assess financial health and performance of selected SOEs, and strengthening the capacity of the General Department for the Management of State Capital and Assets in Enterprises.

In addition to the reforming at the macro scale, similar programs have been applied in specific segments of economy. For instance, DfID of the United Kingdom assisted a pilot restructuring of three individual corporations and GTZ (Germany) has supported the restructuring of SOEs in agriculture of local areas by providing advice in implementing equitisation plans.

2.5.1. Assessment

It is the policy of the Vietnamese government to retain a decisive role for the public sector in the national economy, and this implies certain (not yet defined) limits to privatisation. According to World Bank (2002b), after a good start in 1990-1992, the number of transformations was very low between 1993

and 1997. From 1998 onwards, thanks to the implementation of the equitisation mechanism, the process regained some momentum. From 1998 to September 2002 almost 900 SOEs were transformed into limited companies. Equitisation does also to a greater extent go hand-in-hand with privatisation. Of the equitisation taken place between January 2001 and September 2002, seventy per cent involved the sales of two thirds or more of the equity to non-state shareholders.

Slow progress of SOE reform held back private investment. Nevertheless, the moderate success, thanks partly to the ODA in this area, has revealed the way SOE privatisation affected the growth of the private economy. First, by closing down some of the loss making SOEs, it reduced the financial burden for the SOCBs, which therefore can shift to financing private activities. This also reduces the pressure that held back long-overdue reforms in banking industry. Second, the inefficiently used factors become available in the market and that benefit private enterprises, mostly human resources and production ground, which is, as mentioned earlier, scarce in Vietnam. A large body of research indicates that land has been the main asset of the liquidated SOEs.

3. Taking the broader view: overall evidence of ODA/investment linkages

3.1. The impact of ODA on FDI

Apart from the shock to the world or regional economy such as the Asian financial crisis (*i.e.* the drop around 1998), the real factors have generally been improving. Three inferences can be drawn from the figure. First, following the initial euphoria in the early to mid-1990s the amount of registered FDI capital has declined. Second, this has not affected the total FDI implemented capital that has been remarkably stable. And finally, the shift in investors' perceptions in the late 1990s may have led them to reduce their project sizes, but the number of committed projects increased strikingly. One may speculate that the decline in the average project size has to do with sectoral shifts in the context of Vietnam's approaching WTO membership (discussed earlier).

This in turn raises the question whether ODA, which as seen earlier has been a definite factor in mobilising domestic investment, has had a significant impact on inward FDI as well. A regional-by-region analysis may shed some light on how historic differences in ODA have influenced the ability to attract FDI.

3.1.1. Regional co-variation between ODA and FDI

The ultimate goal of FDI is profit, which means that foreign investors (to some extent contrary to domestic investors who may be attached to their location of residence) allocate their assets to areas where the expected return

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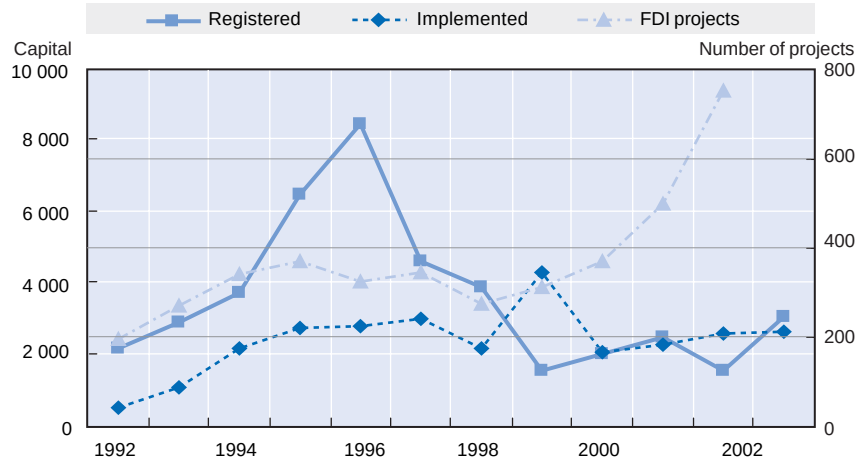
Figure 4.4. **FDI trends 1992-2003**



Source: Number of projects, capital: Statistical Yearbooks: 1996-2001; others: Vietnam Economic Times.

is highest. An important factor for attracting FDI is a developed infrastructure and a skilled workforce. The Red River Delta and the South East region are ahead of the rest of the country in terms of the amount of FDI they attract. These regions also have the nation's highest number of new enterprise registrations per capita. Still, their local economies continue to be reinforced by large ODA inflows.

A high concentration of ODA in Ho-Chi-Minh City, Ha Noi, Dong Nai, Binh Duong, Ba Ria-Vung Tau, which have availed themselves of a relatively modern infrastructure, could be a major factor causing the inflow of FDI into these provinces. There is, however, an exception that is the province of Binh Duong, which has been a leading province in FDI attraction but has received very little ODA. In addition, public investment tends to favour more prosperous provinces, as the cost of providing basic services to these regions is cheaper than in remote isolated areas, owing to economies of scale.

At first glance there seems to be a strong correlation between provincial data on FDI and ODA. However, further analyses do not verify a direct causal relationship between the two. More likely, there is some third factor (perhaps, more than one factor) causing high amounts of both ODA and FDI in some of the provinces. Statistically, the connection between ODA and FDI exists, but is not always significant. The statistical significance varies substantially across sources and samples. On Table 4.6, we list the top ten FDI receivers-provinces and their amounts of FDI and ODA, which have a correlation coefficient of 0.82.

Table 4.6. **Foreign Direct Investment by provinces, 1988-2004**[1]

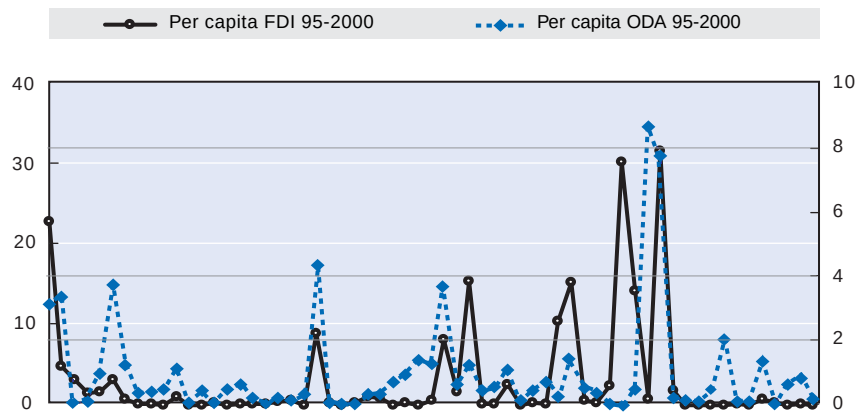
Province/City	Registered FDI (USD million)	ODA committed (USD million)
HCM City	10 994.11	736.06
Hanoi	7 763.25	641.34
DongNai	7 018.07	65.24
BinhDuong	3 895.79	29.17
Baria-Vungtau	2 081.87	71.22
HaiPhong	1 698.31	197.85
LamDong	881.18	27.21
LongAn	596.66	16.20
HaiDuong	583.68	89.78
VinhPhuc	560.52	29.17

1. Data set counts all the funds available at June 2004.
Source: MPI, 2004.

Even though economic rationale supports a strong correlation between ODA and FDI, the causality cannot be robustly established. Both variables are dependent on other economic factors, and after the relative population sizes are taken into count, the correlation weakens substantially. Figure 4.5 shows a more comprehensive data set including 61 provinces and cities. For this particular data set over years 1995-2000, the correlation coefficient is 0.42.

In an attempt to detect causal relationship a regression analysis was undertaken, trying to explain FDI by province (covering the period 1995 to 2000) by a number of independent variables. The regression attempted to control for the initial conditions of the province by including provincial GDP

Figure 4.5. **Correlation of provincial per capita ODA and that of FDI (1995-2000)**



Source: MPI.

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per capita of 1995 and the degree of urbanisation in the same year. Other explanatory variables are the pubic infrastructure investment in the province and ODA over the period 1995-2000. It was expected that ODA, together with the public investment, might contribute to explain the variation in FDI. However, the outcome of the regression (Table 4.7) does not support the expectation of the causal relationship between ODA and FDI. It turns out that the initial conditions decide FDI but the recent investment, whether financed by ODA or by national authorities, do not. The provincial GDP is strongly significant, and the degree of urbanisation may also be.[13] Against economists' expectation, neither ODA nor state investment is statistically significant in explanation of FDI.

The overall conclusion must be that there is a group of provinces having high concentration of both ODA and FDI, which both may be influenced by factors such as the pre-existing conditions including infrastructure, geographical position and purchasing power of local population in those provinces. That could explain why the correlation is more significant for the group of provinces in Table 4.6. However, there has been weak, if any, evidence of a causal relationship between these two variables over the period.

This sobering result should not be overstated: one difficulty for researchers is that so many shifts taken place in the Vietnamese economy have taken place – ranging from the Asian Financial Crisis to the numerous policy reforms – that a snapshot in time may provide an inadequate basis for econometric analysis. Secondly, much of the economic payoff from ODA is expected to materialise in the long run (*e.g.*, the investment in transport, education, and healthcare) and therefore more sophisticated models, and long time series, may be needed to capture it.

Table 4.7. **An OLS regression of FDI on ODA**
Provincial data 1995-2000

Dependent variable: per capita total FDI 1995-2000 of 61 provinces			
Variables	Coefficient	t-Statistic	Probability
Constant	–2.8137	–2.3927	0.0201
Per capita gross provincial product 1995	1.6475	5.7753	0.0000
Urban percentage 1995	9.6743	1.6853	0.0975
Per capita total ODA 95-00	–0.1872	–0.3882	0.6993
Per capita total state[1] investment 95-00	0.3428	0.4488	0.6553

Note: R-squared: 0.56; Probability for F-statistic: 0.00.
1. The state investment in regression is the total government investment in transport, power and urban water projects.

Source: Authors' calculation on MPI data.

3.2. Macroeconomic aspects of ODA

As mentioned earlier, a shortage of capital has been a major bottleneck for the private economy. The resources needed to solve problems such as Vietnam's inadequate infrastructure are so big that the Government alone cannot provide them in the near-to-medium term, and so far there has been little private sector participation.

A simple, though admittedly not always accurate, way of measuring the importance of ODA in this respect is its share in total investment in the economy. In Table 4.8, the content of the third column are the implemented ODA funds. Over the period 1995-2002, ODA can be said to have "financed" around one fourth of state investment. Since ODA is just marginally more focused on infrastructure than state investment at large,[14] and given again the fact that domestic private participation in infrastructure has been negligible, this implies that about one fourth of the change in the infrastructure over the period can be accredited to ODA. The ODA funds allocated to other sectors than such as in legal system reform, institutional improvement, or human resource development have also had their impacts on private investment and FDI. Some of these projects were extraordinarily effective.

Moreover, even as the roads, bridges, electric generators and classrooms built in consequence of the ODA programmes have been recognised as to contribute greatly to the economic growth of Vietnam, the total contribution of ODA is far above the sum of individual projects. According to recent report by UNDP, the most important contribution of ODA in Vietnam over the past 15 years has been in the transfer of knowledge, skills and valuable experience from elsewhere to help facilitate the *Doi Moi* process which has been initiated, led and managed by Vietnamese government since 1986.[15] No doubt, the

Table 4.8. **The public sector investment and implemented ODA, 1995-2002**

	State (USD million)	ODA (USD million)	ODA/State (%)	ODA/Total investment (%)
1995	2 758	737	0.27	0.11
1996	3 888	900	0.23	0.11
1997	4 585	1 000	0.22	0.11
1998	4 902	1 242	0.25	0.14
1999	5 519	1 350	0.24	0.14
2000	5 898	1 650	0.28	0.16
2001	6 452	1 500	0.23	0.14
2002	6 178	1 528	0.25	0.13
Average			**0.25**	**0.13**

Note: ODA is in disbursed amount.
Source: MPI (2003).

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knowledge, skills and valuable experience have been an important factor mobilising domestic private investment and FDI. However, it is difficult to quantify the effects knowledge transfers and tacit learning – even as these sources of productivity gains have become increasingly important in the modern economy – and an impact analysis of ODA will therefore necessarily be incomplete.

That said, some useful guidance can be drawn from the literature on the impacts of Japanese ODA in Vietnam. A survey was conducted by CONCETTI, a consulting and research firm, in 2001-2002 to evaluate the impact of Japan's ODA to Vietnam. The survey was conducted in Hanoi and Ho-Chi-Minh City and focused on two groups of respondents: *i)* businesses having import/export relation with the Japanese market; and *ii)* government officials involved in Japan's ODA. Within the first group, 25 per cent were foreign-invested enterprises and 41 per cent were domestic privately-owned companies. Some of the survey's main findings are reproduced in Table 4.9.

According to the respondents, by far the most "welcome" change as a result of ODA is the enhanced infrastructure, followed by the direct business opportunities in consequence of the ODA-related activities. Beyond this, the impacts of Japanese aid have, apparently, been only moderately felt by businesses. However, this finding must be interpreted with caution: the sample of businesses with import/export links to Japan is not representative. Other things equal, one would expect countries engaged in international trade to place greater emphasis on infrastructure than purely domestic operators. Had the sample contained a large number of newly created SMEs one may speculate that the responses would have put greater emphasis on administrative reform.

A more comprehensive study by the International Development Centre of Japan (IDCJ) tells a more encouraging story. The Report by the IDCJ (2003)

Table 4.9. **Perceived impact of Japan's ODA projects on companies**

Question:	Affirmative answers
Your business benefits from better infrastructure	50.0%
Your business has benefited from the opportunity to supply goods and services to Japanese ODA projects	37.5%
Your business befits from the more "open" policies due to the impact of Japanese-funded administrative reform programmes	25.0%
Export to and import from Japan has become easier	25.0%
Japanese investment to has Vietnam increased	22.9%
Others benefits	8.3%
Your business has received direct support from Japan's ODA projects	6.3%

Source: Evaluation Results and Recommendations on Japanese ODA for Vietnam, IDCJ(2003).

Table 4.10. **Impact of Japan's ODA Loans**

	Real GDP (%)	Export volume (%)	Import volume (%)	GDP deflator (%)	Trade balance (USD million)	Utility (%)
Japan	–0.10	–0.12	–0.01	0.03	–387	–0.07
China	0.12	0.14	0.05	–0.06	139	0.08
Indonesia	0.50	0.59	0.35	–0.22	67	0.41
Malaysia	0.20	0.19	0.16	–0.13	13	0.14
Philippines	0.71	0.90	0.54	–0.60	6	0.49
Thailand	0.49	0.34	0.20	–0.29	29	0.42
Vietnam	1.65	2.53	1.24	–0.69	28	0.99
World	0.00	0.02	0.02	–0.01	0	0.00

Source: Kawasaki (2004).

demonstrates that, "Japanese ODA pushed up the Vietnamese GDP by 1.57 per cent, capital stock by 4.65 per cent, imports by 5.94 per cent and exports by 3.84 per cent in the year 2000." A study by Kawasaki (2004) uses a GTAP (Global Trade Analysis Project) model to perform a simulation of the impacts of Japan's ODA loans over 1996-2000. The main results of Kawasaki's simulation are presented in Table 4.10. It demonstrates that the effect of Japan's ODA on Vietnam accounted for 1½ per cent increase in real GDP, and 2½ per cent increase in export volume. The trade balance of Vietnam improved as well.

Thus, while an assessment of the overall effectiveness of all ODA in Vietnam has not been attempted there has been evaluation of performance of the ODA projects funded by Japan. Japanese aid may not be representative of the ODA from other agencies, but it does after all account for about 40 per cent the total. According to IDCJ (2003), even though not all the hoped-for effects have fully materialised, "Japan's ODA has generated a sufficiently concrete impact to motive a decision to invest". The IDCJ report estimated that the "macroeconomic internal rate of return" for Japanese ODA to Vietnam over the period 1991-2000 was no less than 19 per cent. According to business surveys Japanese companies place Vietnam on fourth place in the world in terms of favourable investment environment. Some firms opined that the Vietnamese business environment is "improving and poised to become Southeast Asia's best place to do business".

4. Summary and conclusions

The Vietnamese economy was in the doldrums in the 1980s and until a certain progress had been made in the context of *Doi Moi* there was little incentive for businesses to invest. The following reasons are commonly given for the sluggish economic activity: a lack of appropriate infrastructure (causing market disconnectedness even within the country); weak links to the

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world market; a shortage of skilled labour and managerial capacity; and an inefficient or business unfriendly public administration. ODA to Vietnam was allocated in such a way that to remedy these obstacles and the donors' well designed strategies are seen as a major factor behind the success of ODA.

National ownership, an important feature of ODA programmes, has mostly been strong in ODA to Vietnam. Most of the activities of the past were closely aligned with the Vietnamese government's development priorities. It should nevertheless be recognised that some ODA projects have aroused little enthusiasm among public authorities, but this does not necessarily imply a lack of national ownership. Public administrative and institutional reform in particular tends to evoke principal-agent problem. For instance, ODA-backed efforts to audit the SOEs and achieve budget disclosure met with resistance in part of the public sector. This has been a factor contributing to slowing down a number of other programmes, including SOE privatisation.

Consequently, "institutional infrastructure projects" which built upon a basis of sufficient domestic buy-in and political support have performed very well, while the effectiveness of others has varied from nil to mediocre. Generally, ODA in this area has had a profound impact on capacity building in central and local governments and has contributed to the upgrading of Vietnam's workforce. The present study concludes that the legal and institutional systems have greatly benefited from ODA projects – not least in the area of corporate law. Small and medium-sized enterprises have grown almost explosively in response to these efforts. Government attitudes toward private business have also improved in the course of the process.

The ODA projects aimed at bolster physical infrastructure, which accounted for slightly less than half of the total amounts, seem to have performed effectively. The major donors in this area have assisted Vietnam to substantially improve its transport system, made the most populous regions connected to harbours and, by extension, to the world's economic centres. The increased generating capacity, expanded rural electrification, together with newly built rural roads have spread the territory suitable for business private investment. Considerable private business investment, domestic as well as foreign, has been generated in consequence of many of the projects – not least in industrial zones localised near the new or upgraded roads. For a reasonable estimation, ODA is responsible for one fourth of the impact by physical infrastructure.

Effectiveness in some ODA project could have been higher. According to a survey by CIEM and JICA (2003), most participants in the ODA delivery process expressed the view that internal Vietnamese procedures for project appraisal and approval of new projects were complicated and generally not harmonised with donors' practices. A government decree aimed at redressing this problem was seen by many as having been so far been insufficiently implemented. A

remaining challenge is to ensure transparency and accountability of aid management on the Vietnamese side.

Limited capacity of the government staff is a factor hindering the effectiveness of many ODA projects. Poor coordination between the government and donors and between the government agencies themselves leads to delays in various steps of project design and implementation. This is the kind of situation that can easily lead to waste and inefficiencies. In order to improve ODA effectiveness, a greater investment in capacity building in local administration will be necessary.

Summing up, the rationale for a continuation of ODA to Vietnam remains strong. The internal rates of return from road, bridge and power generating projects have been so high that further allocation of funds into this area is justified. Foreign assistances in education and human resource development has had positive long-lasting effects on the business climate and have moreover produced spillover effects to a range of other societal activities.

With respect to ODA in institutional infrastructure, private enterprise representatives are bringing to the attention of authorities a number of unnecessary obstacles to business that they continue to face. Much remains to be done to improve a regulatory system that even today contains business regulations that directly contradict each other. ODA in this area can potentially have an extraordinary effect on private investment and value creation. It is necessary that a good partnership between donor and local agent to be formed in early stage in order to look hard at the state of affaires for choosing where money will be best spent.

Notes

1. Dollars and Litvack (1998) estimate that poverty rate in 1994 was as high as about 75 per cent.
2. *Assessing Aid – What works, what doesn't and Why*, The World Bank policy research report, Oxford University press, 1998, p. 105.
3. Japanese Embassy.
4. These are local bodies and used to have no authority to distribute budget, which come from central government.
5. Vietnam News, 22/10/2003.
6. Vietnam News, 14/12/2002.
7. World Bank Reports.
8. Vietnam Development Gateway, 2004.
9. The private funds were used exclusively for rural roads and count for minor part of the total.

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10. For ODA, the share was about 43 per cent. During 1996-2000, the ratio the infrastructure in total domestic public investment was about 40 per cent.
11. Of which 70 per cent of dropouts are girls, see UNDP Development Co-operation Vietnam 2002 Report.
12. In addition to the educational purpose of this aid, many of the schools, being very solidly built, provide shelter for local residents against typhoons that frequently hit the localities (IDCJ, 2003).
13. This is consistent with the findings of working paper (Christiansen, 2004) undertaken in the context of the same OECD exercise as the present article.
14. 43 per cent in ODA against 40% in State investment.
15. Vietnam Investment Review, No. 675, 20 September, 2004.

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International Investment Perspectives

International direct investment has in the past been perceived either as a matter of rich countries reinvesting their "surplus cash", or in terms of bouts of cross-border corporate takeovers between the most highly developed economies. However, the nature of international investment is rapidly changing, and countries commonly classified as "developing" have emerged as important outward direct investors. Many developing countries also partake in the process of globalisation – not simply as low-cost production sites but as full-fledged partners in international enterprises' global value chains and trading networks. This contributes a new global architecture in which policy challenges tend to converge across geographic boundaries and levels of economic development.

The special focus of the present issue of *International Investment Perspectives* is policies bearing on the investment climate. The articles in this section are based on the ongoing work to establish a Policy Framework for Investment, including a checklist of recommendations for policy makers aiming to create a good environment for attracting investment and maximising its economic benefits. The work is done by a Task Force including representatives of OECD and all interested non-member countries. The present issue includes articles covering foreign trade, competition and fiscal policy.

The remainder of the publication addresses challenges arising from the Monterrey Consensus' emphasis on international investment, especially foreign direct investment, as a key source of financing development. One article looks into the experiences with private participation in infrastructure, including development agencies' efforts to promote it. Another addresses in detail Vietnam's experience with more than a decade of using development assistance as a tool for enhancing its investment climate.

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