ITC BUSINESS BRIEFING Trade Policy

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National Trade Policy for Export Success

Part 2.5: Strategies to attract foreign capital

We are serialising ITC's publication National Trade Policy for Export Success. This is the sixth part of the series which will be carried every week.

Foreign investors are attracted to investing abroad by three main factors:

- Opportunities for profits;
- Macroeconomic stability determined by a mix of monetary, fiscal and exchange rate polices;
- A business-friendly environment, including protection of investors, attractive tax rates, ease of trading across borders, contract enforcement, rule of law, etc.

While profitability is clearly the necessary condition to invest, both macroeconomic stability and a business-friendly environment play important roles in investors' decisions to the extent that they affect the costs of investing and the need for insurance coverage.

Targeting foreign investment

This is arguably the most controversial area of policymaking with regards to foreign investment. Given that FDI contributes to a country's competitiveness, it may be tempting for governments to pursue policies targeting FDI for specific local industries. However, the experience of countries has been quite negative except in very special circumstances. The conditions for the success of these policies are so stringent and country specific that it would be extremely risky and expensive to imitate them elsewhere. There are many examples of countries that have succeeded in attracting FDI without special foreign incentives or other 'targeting' policies.

Financial incentives should not discriminate against domestic investors. The discrimination would encourage domestic consumption rather than savings and possibly encourage capital flight, none of which is in the interest of developing countries. Moreover, government investment policies should not be seen as 'picking winners' by making investment decisions on the basis of the government's judgement of the relative profitability of individual projects. These judgements are best made by private investors who have the experience and skills in the given areas and risk their money and businesses to succeed.

There are few areas in which developing countries can consider government interventions. Where there are serious market failures or distortions, it is unadvisable to target foreign investment. At the same time, trade and investment barriers in developing countries are relatively high. Targeted incentives might be used temporarily to overcome anti-export bias in such circumstances.

Developing countries are often unable to attract foreign investment due to shortages of technical or other labour skills, for example, in the financial services sector. Governments should consider more proactive support to develop these skills under labour policies.

In many countries, setting up foreign businesses can be excessively costly due to a range of issues, including complying with business start-up procedures and regulations, minimum capital requirements, labour shortages and other factors. Under such circumstances, governments are justified in providing financial support as an incentive to foreign investors to compensate for such costs.

Good governance, key to investment promotion

Transparency results in improvements in overall governance standards. For simplicity, good governance for investment promotion can be reduced to four main principles: predictability, accountability, transparency and participation. Table 1 outlines these principles together with examples of how to improve governance and the necessary mechanisms to achieve good governance.

Table 1: Good governance in investment promotion

Requisites for good governance	Examples of how to improve governance	Mechanisms/instruments/practices
Predictability	Clear policies and a legal framework for investment Streamlined and simple rules and regulations governing investments Effective investment facilitation services	Strong advocacy role of investment promotion agencies (IPAs) Online road maps for investors IPA investment implementation support services
Accountability	Introduction of ethical standards for civil servants Anti-corruption instruments and measures Dispute resolution mechanisms for investors	Code of conduct Client charters Anti-corruption legislation and enforcement (anti-corruption board) Investment ombudsman
Transparency	Easy availability of information for investors Timely disclosure of information on changes in the investment regime Information collection and sharing of national data on FDI and impact of international investment on the economy	Investment regime data on website Investment guides Online application and tracking system for permits and licences Client charters Analysis of FDI data by IPA and frequent publication of FDI trends and impact
Participation	Regular public-private sector dialogue on efforts to improve the investment environment Consultations with civil society on legislative and regulatory changes that will influence businesses	National business council and local chamber of commerce and industry Involvement of NGOs and labour organizations in consultations on policy decisions

Source: Notes on Good governance in Investment Promotion, Strengthening the Investment climate: a blue book on best practices, UNCTAD, 2004. Available at: http://www.unescap.org/tid/publication/indpub2402_chap5.pdf

Transparency is key

Transparency is key to overcoming foreigners' disadvantages when investing in a host country. Transparent information on how governments implement and change rules and regulations concerning investment is a decisive factor in the investment decision. Transparent policy environments compensate for what foreign investors may consider as disadvantages when investing in a host country with very different regulatory systems, cultures and administrative frameworks. Policies implemented in a transparent manner help to avoid hidden costs that may increase the perception of risk by foreign investors.

A transparent and predictable policy and regulatory framework assists businesses in the evaluation of potential investment opportunities on a more informed and timely basis, reducing the period before the investment becomes productive. Transparency conditions have also been endorsed in almost all recent international investment agreements, including regional agreements and most bilateral investment treaties and various WTO agreements. Countries can provide a clear indication of their commitment to transparency by signing international, regional and bilateral agreements.

Transparency is also related to higher flows and quality of investment. A 2007 OECD study shows that there is a strong relationship between international investment flows and the quality of governance against FDI inflows.

Barriers to transparency reform

A fundamental challenge in seeking to improve transparency is similar in all countries; it is the desire to protect 'concentrated benefits at the expense of broader wellbeing'. A lack of transparency also protects government officials from accountability. The OECD describes some obstacles to reform:

Many actors – both inside and outside the public sector – can have a stake in non-transparent practices. It is for this reason that, despite the broad apparent agreement in principle about their benefits, actual implementation of transparency-enhancing reforms is likely to involve painful shifts in the way policies are made and implemented, especially in countries with highly opaque policy environments. The difficulty will be to develop the political momentum for pro-transparency reform and to prevent backsliding.

A further obstacle to reform is that it entails technological, financial and human resources and requires administrative costs. The main transparency actions entail the creation of registers, websites, the development of 'plain language texts', and other mechanisms for making legal and regulatory codes, and any changes or new regulations being made accessible to interested parties.

Implementing such measures can be particularly burdensome, particularly for developing countries often lacking financial and technical resources. Even when legislation has been introduced to reform the investment climate, implementation difficulties often remain, commonly due to resource constraints. In other examples, corruption has impacted adversely on the rule of law and integrity of the host country.