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Investment provisions in regional integration agreements for developing countries

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Investment Provisions in Regional Integration Agreements for Developing Countries

by

Oliver Morrissey

Abstract

Investment is a major determinant of economic growth, both in reference to the level of the capital stock and its productivity, but has been deficient in poor developing countries. A particular concern for poor countries has been relatively low levels of foreign direct investment (FDI), and a low impact of such investment on growth. The paper focuses on sub-Saharan African (SSA) countries and on FDI to cover four issues related to measures to promote investment: the types of investment measures included in bilateral, regional and multilateral agreements; evidence for effects of provisions on investment, especially FDI; the type of regulatory and business environment most conducive to growth-enhancing investment; and the implications for 'best practice' in promoting investment, in particular measures that can be incorporated in regional agreements. Investment provisions can be used to serve a number of purposes - investment promotion and cooperation, liberalisation and market access, and investment protection – and evidence suggests that their incorporation in agreements does increase foreign investment.

Key Words: Investment Provisions, Regional Integration

JEL Classification: F14, F15, F17

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1 Introduction

Investment is a major determinant of economic growth, both in reference to the level of the capital stock and its productivity. In general, poorer developing countries have relatively low levels of investment, and the productivity of investment tends to be low (often very low), and this is one of the reasons why their growth performance has been lower than desired. Increasing the level and productivity of investment is essential to delivering increased and sustained growth (UNCTAD, 2006a). Three broad types (or sources) of investment can be distinguished – domestic public investment, domestic private investment and foreign direct investment (FDI). Although related, the determinants and the primary concerns in developing countries differ for each type, and the focus here is on FDI. We concentrate on evidence that including regulatory and investment provisions in regional integration agreements can contribute to strengthening the investment-growth links, in particular because regional cooperation and coordination can help in attracting FDI but more generally in enhancing the 'business environment' for investment. The paper is broadly concerned with Africa, Caribbean and Pacific (ACP) countries to assess the role for investment measures in the Economic Partnership Agreements (EPAs) they are negotiating with the EU (see Morrissey and Zgou, 2007), although the focus is on sub-Saharan African (SSA) countries, where investment concerns tend to be more pronounced.

Public investment is essential to provide national (and regional) infrastructure: in low-income countries (UNCTAD, 2006a, pp. 207-13), especially SSA, it is largely financed by aid, the level has been rather low, and the real problem is low productivity; in middle-income countries (such as in the Caribbean and Pacific) the level may be about right, but productivity is lower than desired. Although increasing the level and productivity of public investment is a concern of governments and donors, including the EU, EPAs are not directly relevant: negotiations on EU aid commitments are de-linked from EPAs, and the issues of regulatory reforms to promote investment relate to private and especially foreign investment. However, the regional integration agreements within EPAs do have potential (beneficial) effects on regional public infrastructure (see UNCTAD, 2006a, p. 216). To the extent that measures related to promoting competition policy and transparency in government procurement may reduce costs and corruption, there may be some increase in productivity (Falvey *et al*, 2008).

For most ACP countries, especially SSA, the major concern for private investment is that the level is so low. This is attributable to a variety of reasons. One critical factor is the relatively small size of the formal private sector, especially in manufacturing, and the difficulty in gaining access to funds for investment. Another factor is that many ACP countries can be characterised as subject to relatively high levels of economic and political instability, which discourages investment (private domestic and foreign). The factor that is most amenable to influence by regional integration agreements is the generally unfavourable business environment associated with excess bureaucracy and corruption (e.g. high costs of starting a business or obtaining licences) and weak property rights (e.g. difficulties in enforcing contracts). The types of regulatory reforms that may be proposed in EPAs (as discussed here), even if often more specifically oriented towards foreign investors, should improve the business environment and make investment more attractive. To the extent that regional integration increases the effective size of the local market, investment may also be more attractive. Furthermore, the reduction in trade transactions costs associated with trade facilitation measures (Milner *et al*, 2008) may also attract private investment (even if not engaged in exporting, firms typically import intermediate inputs).

The problems ACP countries face in respect of FDI are that the level is generally very low and typically highly concentrated in particular countries and/or sectors, with low levels of technology transfer and low linkages or spillovers for the rest of the economy. The reasons for low FDI are quite similar to those for low private investment: relatively small markets hence few investment opportunities; corruption, bureaucracy and weak property rights; and relative instability. These factors also explain why FDI is highly concentrated in those countries and sectors with valuable resources, predominantly oil and minerals, where returns can be obtained fairly quickly (rates of return on FDI in SSA tend to be high because it is concentrated in extractive sectors). An adverse feature of low FDI concentrated in sectors with weak economy-wide linkages is that FDI 'has not had strong positive linkage effects that have generated higher levels of private domestic investment' (UNCTAD, 2006a, p. 117). Regional integration and regulatory reforms associated with EPAs provide an opportunity for ACP countries to attract higher levels of more diversified FDI: larger markets, lower transactions costs associated with trade and investment, and generally a more favourable business environment. The focus of this paper is on regulatory measures that may attract more and diversified FDI that has positive linkages with the economy and private investment.

The Commission for Africa (2005) places emphasis on investment as essential for a 'big push' to invest in people (especially health and education) and infrastructure (e.g. section 7.3 on 'Policies for Growth' including agriculture and infrastructure), whilst also improving governance and reducing corruption to create a favourable business climate. Trade has two functions in this, export-led growth and increased imports to absorb foreign exchange (associated with the increased aid, particularly to finance investment). For a variety of reasons, the impact of trade policy reform on growth has been muted for SSA countries (Morrissey, 2005); to benefit from more liberal trade regimes, SSA countries require investment, economic restructuring and institutional reform (Commission for Africa, 2005).

This paper covers four issues within the broad aim of identifying the types of investment measures and regulatory reforms that could be included in EPAs to encourage increased investment that is sustainable, productive and contributes to economic growth. First, looking at existing bilateral, regional and multilateral agreements, we identify what types of investment measures have been included. Second, we consider the evidence for effects of investment agreements, or investment provisions in trade or integration agreements, on investment, especially FDI, and aim to identify particular measures that appear to encourage investment. Third, we consider the broader regulatory and business environment: what type of environment is most conducive to growth-enhancing investment? Finally, we outline the implications for 'best practice' in promoting investment, which can be related to identifying appropriate regulatory reform in ACP countries.

2 Types of Investment Measures

Most international agreements that relate to investment, including specific investment agreements, do not provide an explicit definition of investment. Usually the focus is on FDI, for which there are operational definitions (typically acquiring at least a 10% management interest). The Agreement on Trade-related Investment Measures (TRIMs) does not define 'investment' while the General Agreement on Trade in Services (GATS) defines 'investment' as a 'commercial presence'. International agreements use three types of definitions - asset-based, transaction based and enterprise-based (te Velde and Fahnbulleh, 2003). Asset-based definitions are widely used in investment protection agreements, e.g.

Bilateral Investment Treaties (BITs). It covers asset and capital flows, movable and immovable property, interests in companies, claims to money, intellectual property rights and concessions. The transaction-based definition is common in agreements dealing with the liberalisation of cross-border financial flows through which an investment is made. Enterprise-based definitions, as used in GATS for example, specifically refer to FDI. We will consider investment provisions in any agreement quite broadly, i.e. they may relate to foreign portfolio investment or to domestic investment, although it should be emphasised that the literature is typically concerned with FDI.

Investment provisions in agreements can be used to serve one or more of three purposes - investment promotion and cooperation, liberalisation and market access, and investment protection. At the multilateral level, investment provisions cater for all purposes; investment promotion is dealt with generally, liberalisation is dealt with through agreements such as GATS/TRIMS, and investment protection is dealt with through agreements such as GATS and BITs. There are three types of agreement that may relate specifically to investment or include provisions on investment (te Velde and Fahnbulleh, 2003).

- Bilateral investment treaties (BITs). These typically include conditions on treatment of foreign firms and tend to concentrate on investor protection. There is evidence that BITs raise FDI, but the effect is small (Neumayer and Spess, 2005).
- Regional integration agreements (RIAs) may include provisions for investment although they are predominantly trade agreements (and trade effects may influence attractiveness of investment). Some include a common policy towards investment (e.g. ANDEAN in the early 1970s), with provisions that stimulate regional investment cooperation and promotion. Some include comprehensive investment provisions including effective investor-state dispute settlement mechanisms (NAFTA).
- Multilateral treaties may relate to investment. Three WTO agreements are relevant. The GATS includes the right to establish a foreign presence (FDI) and market access principles for sectors where commitments are made. The TRIMs Agreement prohibits the use of most performance requirements that restrict the actions of foreign firms. The WTO agreement on Subsidies and Countervailing Measures (SCM) limits subsidies given to exporting firms so could be invoked to limit investment subsidies. There is little hard evidence on the effects of these agreements on investment decisions.

The trade, tariff and market access preferences embodied in RIAs are expected to encourage investment, whether domestic or foreign (te Velde and Bezemer, 2006): market opportunities are increased, and there is some degree of policy lock-in so the investment climate is made more secure. The specific details of the trade agreements will affect the type of investment, but the general effect is to increase the level. Few RIAs include specific investment agreements which, like BITs, would be expected to exhibit direct effects on investment, in particular FDI. For example, the East Africa Community includes no common policy on investment measures; each member country has its own investment incentive schemes, which are quite similar, and has signed BITs, although the number varies from a couple in Kenya to almost 20 in both Tanzania and Uganda (WTO, 2007). We focus on the types of measures included in investment agreements (BITs or as part of an RIA). Table 1 gives a summary of the types of measures most commonly observed. Whereas RIAs tend to focus on investment promotion and liberalisation, BITs tend to focus on investment protection.

Table 1: Investment Provisions Coverage in International Agreements

Type	BITs	RIAs	Cotonou	Multilateral
Investment Promotion	No	Yes, usually	Yes	Yes, in very broad terms
Liberalisation	No, except for US	Yes	No	Yes, but limited
Investment Protection	Yes	No, except in some recent cases	No, except for a commitment	Yes, but limited

Source: Adapted from Table 1 in te Velde and Fahnbulleh (2006).

Measures relating to investment tend to refer to cross-border investment, such as rules on the treatment and protection of foreign investors, although the broad objective is to promote a favourable 'investment climate' (which should in principle include domestic investment). Investment rules (e.g. treatment of performance requirements) may apply only to nominated sectors (positive list) or to all with nominated exceptions (negative list). Some RIAs provide national treatment for foreign firms and therefore go further than most multilateral or bilateral investment treaties.

Rather than attempting a comprehensive summary of all types of investment provisions, we consider the main types that are most common in existing RIAs for the ACP (Table 2). Although these RIAs do not specifically grant national treatment, there is a commitment not to introduce restrictions on foreign ownership. They all permit some performance requirements, most facilitate cross-border transfer of funds and all offer some investment protection (usually through dispute settlement procedures). However, it should be noted that these RIAs are not associated with high degrees of integration, and in the African cases actual integration is relatively low.

Some RIAs include reference to performance requirements imposed on the operations of multinationals (i.e. FDI), in particular stipulating if they cannot be applied and whether any distinction is made between new and existing investment. So-called 'trade-related' performance requirements, such as any relating to export or import shares and domestic content (local sourcing) are prohibited under the TRIMS Agreement (in principle covering domestic and foreign investment). However, requirements that are not trade-related are not covered by the TRIMS Agreement and are permissible, such as any relating to employment, R&D (or technology transfer) equity and, more generally, those applied in service sectors (Morrissey and Rai, 1995).

The general aim of performance requirements is to encourage greater linkages between foreign investment and the host economy (Morrissey and Rai, 1995). For example, requirements to provide technology transfer or training for local workers should increase the benefits of FDI for the local economy. In general, they restrict the activities of investors and would therefore be expected to discourage investment, *ceteris paribus*. Thus, if a region offers some attraction to

foreign investors, abolishing performance requirements should attract increased investment at the margin. However, it may reduce the beneficial impact of such investment on the economy because linkage effects are diminished.

Table 2 Investment Related Provisions in RIAs in ACP

	<i>CARICOM</i>	<i>SADC</i>	<i>COMESA</i>
National Treatment			
Applies all sectors pre-establishment	No	No	No
Restrictions on foreign ownership	No	No	No
Performance requirements			
Full prohibition	No	No	No
Transfers of funds			
Free cross-border capital flows	Yes	No	Yes
Investor Protection measures	Yes	No	Yes
Dispute Settlement			
State-to-state	Yes	Yes	Yes
Investor-state	Yes (some)	No	No
Independent Arbitrator	Yes	Yes	Yes
Rules of Origin	Yes	Yes	Yes
Degree of Integration	Medium	Low	Low

Source: Adapted from te Velde and Fahnbulleh (2003).

Investment protection provisions, such as limiting the threat of expropriation or supporting the security of property rights, encourage investment (because investors prefer a secure and predictable investment climate). Such provisions are most effective if there is also a stipulated dispute settlement mechanism, especially if this allows for some regional or international panel or an independent arbitrator. Investor-state procedures are generally considered stronger than the state-state procedures common in ACP RIAs (Table 2), perhaps because the investor has a more direct role in the process. The existence of dispute settlement procedures also support investment guarantees against non-commercial risks.

Rules of origin (ROO), which are trade rules essentially relating to the local and regional share in value added to ensure that an export can avail of trade preferences (or, equivalently, that an import is granted the correct treatment), may affect investment. The direct effect is on location decisions, although this is only likely to be significant where the ROO are easily met, i.e. the product in question is essentially local in the sense of using more than the minimum share of local (which may include regional) inputs. In the presence of (non-regional) imported inputs, ROOs are in effect similar to performance requirements, in the sense that they require a minimum share of local inputs and a maximum share of imported inputs (from outside of parties to the agreement). One way in which they can encourage FDI (by multinationals whose home country is a party) is if inputs from the home country (parent) meet the ROO. However, ROOs do increase the transaction costs of trade, as it is necessary to provide proof that the

product meets the requirements. In some cases this can be relatively simple, but for products that go through many stages of production, often in different countries, and where cumulation clauses are in place, ROOs can be complex.

Overly restrictive ROO can potentially undermine the effects of trade liberalization between the partners by setting origin requirements that are too costly to comply with, hence deterring exporters from availing of preference entitlements. Given increasing numbers of RIAs, exporters are faced with the complexity of ROOs for different markets that may vary not only in their substance but also in their procedural requirements. In such a situation, the exporter may have to face the decision of choosing between markets and foregoing preferential access in some markets. ROO may also encourage a producer to change its source of inputs from a cheaper source to a more expensive local or partner source if the intention is to export under preferential rates.

There are few studies assessing the impact of ROO on trade flows. Estevadeordal and Suominen (2003) develop an index of ROO restrictiveness and, using gravity model estimates, find that the more restrictive are the ROO, the less trade takes place. A similar conclusion is reached by Anson *et al* (2005) who find that restrictive ROO in NAFTA also had negative effects compared to the use of preferences. The general view in the literature is that while ROO may be justified to prevent third parties benefiting from preferences, as the complexity of the rules increases the likelihood of adverse distortion effects also increases.

Table 3: Investment Provisions in the Cotonou Agreement

Type of Provisions	Examples mentioned
Investment promotion	<ul style="list-style-type: none"> encourage development of private sector promote a predictable and secure investment climate support capacity building for investment promotion agencies encourage EU private sector investment
Co-operation	<ul style="list-style-type: none"> facilitate partnerships and joint ventures through co-financing sponsor investment forums promote national, regional and ACP-EU private sector business forums
Investment finance	<ul style="list-style-type: none"> financial assistance, loans and credit risk capital for (quasi)-equity investments
Investment guarantees	<ul style="list-style-type: none"> providing risk insurance and risk-mitigating mechanisms re-insurance schemes and guarantee funds
Investment Protection	no specific examples

Source: Adapted from Table 3 in te Velde and Fahnbulleh (2006).

The Lomé Conventions contain provisions related to investment, mostly aimed to promote the level and effect of investment generally (rather than FDI specifically) by means of instruments and measures that serve to establish an investment-friendly climate. Investment provisions in the Cotonou Agreement signed in 2000 cover similar issues, as summarised in Table 3. In terms of what may be appropriate to include in EPAs, the principal omission is any specific measures relating to investment protection.

3. Integration, Investment Provisions and Investment Levels

There are a number ways in which RIAs can attract FDI. A larger integrated market means there is more opportunity to produce for the host market, and if external tariffs are increased the incentive for tariff-jumping FDI is increased. Integration may also encourage investment relocations within the region to avail of country-specific assets or factors, to produce for export or the home market. This suggests that within regional ACP groups, FDI is likely to be concentrated in the larger, relatively more developed countries (e.g. Jamaica and Trinidad in the Caribbean, Kenya in East Africa, South Africa in Southern Africa and Ghana and Nigeria in West Africa). Multinational (foreign) enterprises may be attracted into sectors where the larger market is associated with firm-level economies (relative to plant-level economies) or that have characteristics conducive to foreign firms, for example services such as banking and insurance.

Various studies elaborate the effects of RIAs on FDI inflows, although often in the context of developed countries (Pain, 1997; Brenton *et al*, 1998). Medvedev (2007) investigates the effects of preferential trade agreements (PTAs) on net FDI inflows of member countries, and finds that PTA membership encourages increased FDI, with an effect increasing in the market size of the PTA partners and their proximity to the host country. Market size effects (joining a larger and faster-growing PTA) are more important than threshold effects (signing the agreement) as determinants of FDI inflows, but this may be driven by North-South PTAs.

These studies do not analyse explicitly the role of investment provisions in determining FDI flows. Dee and Gali (2003) incorporate the role of investment provisions in preferential trade agreements in gravity models of trade and investment between pairs of countries covering the period 1988-97. The analyses include two types of unweighted average score indices: (i) covering 'traditional' trade provisions in agriculture, and (ii) covering industrial products and provisions affecting services and investment rules (the latter are often referred to as 'new age' because services and investment were only brought into the multilateral system in the Uruguay Round, and specifically the WTO). The gravity models use the usual control variables and three dummies for each RIA provision to capture intra-regional effects, extra-regional effects on inward FDI and extra-regional effects on outward FDI. Empirical results showed that intra- and extra-regional inward FDI stocks were influenced by traditional trade provisions in the South Pacific Regional Agreement (SPARTECA) leading to investment creation, but only extra-regional outward FDI in the EU and US-Israel RIA (investment diversion). The 'new age' investment provisions played a significant role in influencing net investment creation in EFTA, the EU, NAFTA, MERCOSUR and SPARTECA, and net investment diversion in the Asian FTA, but had no significant effect in ANDEAN (Tables 4 – 7 in Dee and Gali, 2003).

Few studies address RIAs involving African countries. An exception is te Velde and Bezemer (2006) who include dummies for ANDEAN, ASEAN, CARICOM, COMESA, SADC among other variables in a gravity model. They find that participation in an RIA can lead to further extra regional FDI inflows, the RIA effect is stronger where RIAs include certain trade and investment provisions, and

that FDI inflows are stronger (weaker) for smaller countries situated closer (further away) to the largest country in the RIA. There is some evidence that RIA provisions which stipulate free movement of people and transfer of capital facilitate the establishment of intra-regional FDI. Some RIAs have specific provisions that aim to establish regional enterprises by promoting joint ventures (e.g. ANDEAN, ASEAN, MERCOSUR).

It is sometimes argued that while investment provisions in the RIAs are important for FDI, it is more often the predictability of the investment climate that comes with the RIAs that also plays an important role. RIA can (depending on the strength of the region vis-à-vis individual members) lock-in reforms related to regulation, competition policies, property rights, contract enforcement and dispute settlement, guaranteed access to members' markets and stable trade policies. In this way the RIA renders policy reversal less likely.

Table 4 Effects of Provisions on Investment

Provision	Domestic Investment	FDI
Tariff reductions	Positive: lower tariffs increase market access, encourage growth and investment.	Positive: market access encourages growth and attracts investment.
Rules of Origin	Generally weak, most likely to be positive if rules are simple	Positive if inputs from parent included (multinational better able to deal with complex rules)
Investment incentives	Positive only if associated with access to investment finance	Positive only at the margin (if country already attractive)
Investment protection	Positive	Positive
Performance requirements	Positive (but small), if they encourage local linkages	Mild deterrence

The evidence for effects of various provisions in RIAs on investment (domestic and FDI) are summarised in Table 4. In general, it is the positive effects of trade liberalisation (especially reductions in tariffs) that have the greatest impact in stimulating investment, in particular because market size (and access) increases. Investment protection measures seem to be the most important investment provisions; incentives may only have marginal beneficial effects, while ROOs and performance requirements appear to have only mild effects (positive or negative).

However, all of these effects are contingent on the prevailing investment climate, the underlying economic fundamentals and the institutional environment (see Section 4 below).

Empirical studies on the impact of RIAs on investment suggest a positive effect, and relatively larger countries in more integrated regions benefit most. OECD (2006) suggests that investment provisions in RIAs are positively associated with both trade and investment flows, and that they matter more for FDI flows than trade flows. Te Velde and Bezemer (2006) attempt to account for the 'intensity' of investment provisions; they find that the greater the number of provisions the greater the effect on FDI, and effects tend to be greater in more integrated regions. In other words, the extent of integration and scope of investment provisions matter.

Bilateral Investment Treaties (BITs)

The past several years have witnessed a proliferation of Bilateral Investment Treaties. Tobin and Rose-Ackerman (2004) investigate the effects of BITs on FDI and the domestic business environment. Specifically, they seek to ascertain whether BITs stimulate FDI flows to host countries, and if the treaties have any impact on the environment for domestic private investment. Their results show a weak relationship between BITs and FDI (stronger in high risk countries, perhaps because BITs include investor protection), and between BITs and the domestic investment environment. Thus, while BITs may not alter the domestic investment environment, they also may not be fulfilling their primary objective of stimulating FDI – the empirical evidence is inconclusive.

Most studies do not find a significant impact of BITs on FDI (UNCTAD, 1998; Hallward-Driemeier, 2003; Tobin and Rose-Ackerman, 2005), although Neumayer and Spess (2006) find that having multiple BITs raises FDI inflows to a developing country. These studies do not attempt to assess if different types of FDI are affected differently or if any specific types of provisions in BITs have stronger effects (the studies tend to focus on investment protection rather than promotion).

Investment Incentives

Various types of investment incentives are often included in industrial policies, ranging from fiscal and financial incentives to providing industrial parks and export processing zones or R&D and technology centres. While these can relate to domestic investment, they are typically aimed at FDI. Incentives specifically directed at FDI promotion are commonly divided into three categories, namely fiscal, financial and regulatory incentives. Regulatory incentives are policies for attracting foreign investors by means of offering them derogations from national or sub-national rules and regulation. Such incentives are almost exclusively granted in connection with targeted strategies, or they are specially negotiated as part of the 'improvised' strategies for luring large individual investment projects.

Policies of offering financial FDI incentives are often formally motivated by one of three considerations. First, a host area may be perceived as being disadvantaged relative to comparable sites elsewhere, e.g. because of poor infrastructure. In this case, authorities often argue in favour of a targeted effort at assisting investors, which is construed as a policy of levelling the playing field. Second, authorities often argue that the costs that enterprises incur when relocating or establishing new subsidiaries at a distance from previous sites may hold them back from choosing the most suitable locations. Third, in addition to the above two categories of FDI incentives that are justified by the aim to correct for market

imperfections and overcome transaction costs, authorities may attempt to simply reap the supposed externalities of foreign presence through a policy of targeted incentives.

The most commonly used inducements are fiscal incentives, specifically:

- Reduced direct corporate taxation – General measures aimed at easing the corporate tax burden are used to attract foreign investors. These include reduced rates of corporate income tax, tax holidays and special tax-privileged zones.
- Incentives for capital formation. These are policies for tying lower taxation to corporate investment to encourage foreign enterprises to invest. Examples include investment allowances (deductions from taxable income based on some percentage of new investment) and investment tax credits or deductions against profits that are reinvested in the host country.
- Reduced impediments to cross-border operation. Companies are attracted to locations where the fiscal system imposes minimal costs on the cross-border transfer of funds, goods and services and manpower. Some of the incentives offered are Withholding Tax, lower taxation of foreign trade (e.g. tariff exemptions) or of employees.

Table 5 Number of countries using investment incentives 2000

	Africa (14)	Asia-Pacific (17)	LAC (12)
Tax holidays	14	16	12
Reduced tax rate	4	10	6
Investment allowances	10	11	12
Duty/VAT exemption	11	11	11
R&D Allowances	2	10	1
Deduction for qualified expenses	6	8	4

Source: UNCTAD (2000)

Fiscal incentives are varied and complex (see UNCTAD, 2000, 2006b). Table 5 summarises their prevalence in some developing country regions. The point to emphasise is that they are, to varying degrees, quite widely used because countries compete to attract FDI. There is some evidence that such incentives are successful in attracting FDI. Goodspeed *et al* (2006) investigate the determinants of FDI using a sample of 47 countries for 1995-2002 and 37 countries for 1996-2002, including among the determinants of FDI government expenditures (both investment in infrastructure and consumption), tax rates, location factors, institutional factors that may discourage investment (e.g. corruption) and agglomeration effects. They find that lower taxes, lower corruption and better infrastructure all attract FDI (to a similar extent), whereas government consumption spending is negatively associated with FDI inflows. The latter should not be stressed given *ceteris paribus* concerns (generally, higher consumption spending is intended to suggest higher taxes and/or corruption).

4. The Regulatory Environment, Investment and Growth

Economic fundamentals are generally regarded as the key determinant of investment. These include market size and market growth (on the demand side) and availability of good quality and appropriate human resources and infrastructure. The availability of strategic or natural resources and/or skilled labour (especially if costs are low relative to productivity) tends to attract investors. Given these fundamentals, government policies can be important and countries that provide a welcoming 'investment climate' will attract more investment (see *World Development Report 2005*). Investment climate is a broad term, which includes the regulatory and administrative framework. This differs markedly across countries, affecting the competitive advantage of economies:

- Heavier regulation of business entry is associated with higher corruption and higher business start-up costs, both of which may deter investment.
- The flexibility and regulation of the labour market is important. Although evidence shows that foreign-owned firms tend to pay higher wages than local firms (te Velde and Morrissey, 2003), foreign investors nevertheless favour countries where hiring and firing costs are relatively low.
- Property rights and the efficacy of the legal system in enforcing contracts are of concern as investors want reassurance that their assets are secure. Foreign investors also want the ability to repatriate profits.
- Foreign investors are also concerned with the costs of closing a business, including firing costs but also any restrictions on withdrawing their capital.

Governments can help to establish the right conditions for attracting FDI, by improving general economic conditions such as macroeconomic stability or the provision of general economic structural factors such as the presence of an appropriate infrastructure and skilled workforce. They can also set effective and efficient industrial policies and an efficient regulatory framework that, together with the macroeconomic conditions, make up an enabling environment for the attraction of FDI. Specific examples include (see UNCTAD, 2003):

- International agreements can help to attract FDI (as discussed above). For example, Lesotho availed of such opportunities in attracting Korean investors.
- Whatever the level of development, the macroeconomic investment climate or other factors, the availability of natural resources alone has attracted FDI in countries such as Botswana, Nigeria, Bolivia and Indonesia.
- There is conflicting evidence on the effectiveness of macroeconomic stability on attracting FDI. FDI in Ecuador showed resilience during a crisis with high inflation and low growth in the late 90s, while FDI in Tanzania picked up in the late 90s after macroeconomic conditions had improved.
- Many countries have state-owned utilities and/or restrict foreign involvement in business services, which tends to increase the 'costs of doing business' and discourage investment. For example, Nepal reserved activities including accounting and legal professions for local firms, contributing to a generally unfavourable climate for investment.
- When privatisation is successful, it can improve the general operating conditions for other firms through improved services and lower costs in power or communications. This can attract further FDI. In Tanzania the establishment of new foreign owned hotels, banks and financial services firms followed privatisation.

- Many countries maintain high general taxes coupled with specific fiscal incentives for priority areas, involving frequent changes in the taxation regime. Some incentives seem very generous, unclear, or prone to change, casting doubts about their effectiveness as well as overall benefits and efficiency. For instance, Egypt has a high general corporation tax rate coupled with a long-term tax holiday for up to 20 years in manufacturing in the industrial zones. Such a dual approach can lead to widespread use of incentives, creating distortions and additional administrative barriers for investors. The income and tax credits in Mauritius are worth 40 per cent of total corporate taxes but were poorly designed hence somewhat ineffective. Lesotho had a much lower tax rate in manufacturing compared to other sectors, hampering the ability to attract FDI into those other sectors.
- Labour market flexibility is also important. In Ghana, labour-rights are generally negotiated under firm-specific collective bargaining agreements that can involve a lengthy and difficult process. Labour disputes contributed to the decision of a foreign investor in the garment sector to leave the country altogether. Lesotho, on the other hand, introduced new labour regulations with the help of a tripartite Industrial Relations Advisory Council to handle impartial industrial disputes. This tripartite model is considered successful in attracting FDI.
- Investors in Lesotho argued that obtaining work permits was an important obstacle to general operating conditions. On the other hand, countries such as Mauritius have incentives to attract specialised skills because they actively promote investment in services which require such skills.
- The experience of Mauritius suggests that the creation of Export Processing Zones was instrumental in attracting FDI to avail of trade preferences for garments in the EU market. However, free zones are not always successful in attracting FDI, and Mauritius (also Madagascar) is rather an exception than the rule in Africa.
- While external factors, general economic conditions and specific industrial and regulatory measures are often treated separately, this is often the right combination of factors for attracting FDI. For instance, in Tanzania the availability of natural resources attracted FDI in mining only after a critical mass of policy changes had taken place, securing a more stable macroeconomic performance, as well as a new and competitive mining code (this included mining investment from Ghana where the mining code was less competitive). With the interdependence of many factors, it becomes difficult to assess the effectiveness of one particular factor.

Issues in FDI, Investment and Growth

Although there is strong evidence of an association between FDI and growth, it is often difficult to identify the direction of causality, and cross-country studies showing an effect of FDI on growth tend to be driven by developed or relatively rich countries in the sample. The evidence that FDI *contributes* to growth in Africa, and low-income developing countries generally, is quite weak. In part, this is due to the type of FDI – resource-seeking FDI in extractive industries tends to exhibit weak linkages with the economy (few positive spillovers are generated), while FDI associated with privatisation may not lead to an increase in the capital stock (although, over time, there may be a benefit from lower cost and more efficient provision of services and utilities to the economy, especially important for the private sector). In part it is due to the circumstances in host countries: the effect of FDI on growth is stronger in countries with a policy of export promotion, where the quality of human capital is above a certain threshold, where

the financial system is relatively developed, and broadly speaking where the quality of institutions and governance is greater. These favourable conditions tend to be lacking in Africa and although conditions tend to be better in the Caribbean, those countries (like the Pacific) suffer from being small (limited attractiveness to FDI). Furthermore, ACP countries tend to be unstable, economically and/or politically, which renders FDI volatile, and this has been shown to reduce the impact of FDI on growth (Lensink and Morrissey, 2006). More generally, for SSA countries FDI does not appear to contribute to productivity growth. Ng (2007) analyses the effect of FDI on total factor productivity growth, decomposed into technical change and efficiency change, in 14 SSA countries. In a few cases FDI leads to increased efficiency (perhaps through providing skills and better management), but there is no evidence that FDI contributes to technological change (consistent with the view that FDI in SSA is not associated with technology transfer).

Evidence is also inconclusive on links between FDI and domestic investment. The existing empirical literature on sources of financing and the level of investment has tended to focus on whether FDI crowds-in or crowds-out domestic investment. There is some evidence of crowding-in for Africa, i.e. FDI tends to encourage increases in domestic private investment, so that overall investment levels increase by more than the amount of FDI. A possible reason for this is that much of the FDI to Africa associated with privatisation and liberalisation is to utilities and business (especially financial) services. Poor levels of business services (e.g. financial, telecommunications, electricity) are a known constraint on business performance, so improved services facilitate increased productivity, competitiveness and private investment in the economy (see Arnold *et al*, 2006 for African manufacturing).

A number of recent studies consider the effect of governance and the regulatory environment on investment and FDI. Using the World Bank's governance indicators and annual aggregate data over the period 1995-2001 for 36 developing countries, Gorg *et al* (2006) assess the responsiveness of total investment to sources of finance under favourable and unfavourable regimes, where favourable regimes are defined as those with below average levels of regulatory burden and corruption or above average levels of accountability and political stability. Each governance indicator is tested separately and all are significant with the expected sign; regulatory quality tends to have the largest impact, and all have a slightly greater impact on FDI than on private domestic investment. They find that in unfavourable regimes, the impact of private investment on total investment is greater than that of FDI, whereas in favourable regimes, private investment and FDI have similar effects on total investment; governments that provide a business-friendly environment for investors do appear to achieve higher levels of investment, as might be expected, especially in respect of FDI.

Busse and Groizard (2006) argue that countries need a sound business environment, as represented by relatively non-restrictive government regulations, to benefit from FDI in terms of a positive impact on income growth. They consider the regulatory environment in five areas – ease of starting a business, labour market flexibility (hiring and firing), contract enforcement, creditor rights and insolvency regulations (ease of closing a business) – and provide analysis based on a composite index and for individual components. Their evidence suggests that excessive regulations restrict the growth effect of FDI in the most regulated economies only. The adverse effects are most pronounced if the costs of starting a business are high, labour markets are inflexible and contract enforcement is weak; costs of closing a business did not appear to affect the beneficial impact of FDI. This does not imply that all regulations reduce the impact of FDI on growth for all countries, rather that the growth benefit of FDI is limited in the most

regulated economies. Measures to attract FDI, including investment provisions as discussed here, will only support a growth-enhancing impact of FDI if the regulatory environment is favourable.

This suggests that regulatory reforms in ACP countries offer potential to not only increase investment but also to enhance the growth impact of investment. Africa is a relatively risky high cost environment, and this limits private sector investment and production, especially export manufacturing. Iwanow and Kirkpatrick (2007) estimate a gravity model for a panel of 124 developed and developing countries for 2003-04, to assess the impact of trade facilitation and regulatory constraints on manufacturing export performance. They find that improved trade facilitation (such as more efficient customs procedures) can improve export performance in Africa, although measures relating to the regulatory environment and the quality of the transport and communications infrastructure may be more important. The effects can be quite large. For example, 'a 10 per cent rise in either infrastructure availability, contract enforcement regulation or trade facilitation environment would increase African exports by around 17 per cent' (Iwanow and Kirkpatrick, 2007, p. 18). This is a significant impact, although it should be noted that one is starting from a low base of manufactures exports.

5. Conclusion: 'Best Practice' Provisions for Promoting Investment

Investment is a major determinant of economic growth, both in reference to the level of the capital stock and its productivity. In general, ACP countries have relatively low levels of investment, and the productivity of investment tends to be low, and this is one of the reasons why their growth performance has been lower than desired. For example, many factors help to explain poor growth performance in SSA, including natural and structural characteristics (which increase trade costs), poor governance and weak political will for market reforms (that make investment less attractive) and a lack of resources for financing investment; Gomanee, Girma and Morrissey (2005) show that low productivity of investment has also been an important factor.

Increasing the level and productivity of investment is essential to delivering increased and sustained growth. With a focus on sub-Saharan African countries and FDI, we reviewed four issues to identify the types of investment measures and regulatory reforms, in particular those that could be incorporated in regional integration agreements that may encourage increased (foreign) investment. The discussion has indicated a number of issues relevant for attracting FDI, or encouraging investment more generally. Effective and efficient policies will depend on country circumstances but lie in four broad areas:

- Policies that provide political stability (e.g. governance) and enhance economic fundamentals, such as stable macroeconomic management, to provide a more attractive private sector environment.
- International policies conducive to investment, including integration and/or investment agreements.
- Policies that streamline regulatory and administrative procedures so that it is easier to do business, e.g. reducing start-up costs, flexible labour markets, protecting property rights and contract enforcement.
- Specific investment measures and incentives that are well designed, targeted and implemented consistently.

The key factors related to attracting FDI, which also encourage investment, are summarised in Table 6. Individual countries may have a limited ability to 'engineer' some of these factors (such as in the first two of the areas listed above), but they do help to identify policies to focus on. To summarise briefly, a number of regulatory reforms are likely to encourage investment, especially FDI, and competitiveness, thereby enhancing the growth impact of investment. It must be emphasised that the objective is not to eliminate regulation; in fact, to the extent that effective competition is limited (either because a local or foreign firm is dominant), effective regulatory control is an element of competition policy (Falvey *et al*, 2008). It is important that regulatory mechanisms are appropriate, transparent and not excessive.

Table 6 Key factors in Attracting Investment (FDI)

Factor	What helps investment	Implications for policy
Political stability	A stable business climate	Reduce conflict and corruption and impose rule of law and accountability
International factors	Home country measures Investment agreements	Not under control of host country BITs and investment provisions in integration agreements at least contribute to a more predictable investment climate
Economic fundamentals	Market size and growth Infrastructure and skills	Macro policies conducive to growth and competitiveness Provide appropriate and good quality infrastructure and skills
Regulatory and administrative	Business friendly regulation	Cut red tape, e.g. facilitate trade by streamlining customs
Investment promotion	Clustering EPZs	Consensus view is that specific policies are not as important as general investment policies, but when implemented and targeted well they can be useful. Employ an industrial policy which includes technology and skills.
Investment incentives	Fiscal and financial incentives	Target incentives well so that they fit in an overall development strategy. Offer a stable and a competitive corporate tax rate (but not zero). Target incentives to (new) investment in capital equipment.
Implementation issues	Clear and predictable rules are important	Implement policies consistently Create sufficient capacity at an adequate government level to execute projects

The problems most developing countries face in respect of FDI are that the level is generally very low and typically highly concentrated in particular countries and/or sectors, with low levels of technology transfer and low linkages or spillovers for the rest of the economy. Regional integration and regulatory reforms associated with EPAs provide an opportunity for ACP countries to attract higher levels of more diversified FDI: larger markets, lower transactions costs associated with trade and investment, and generally a more favourable business environment. Furthermore, as EPAs will impose adjustment costs that require new resources for gaining sectors and/or to provide employment for released labour (Milner *et al*, 2007), increased foreign investment will be needed. Certain areas for regulatory reform seem to be most important, and suggest issues to include in EPA negotiations:

- Trade facilitation reduces transactions costs and encourages production and investment (Milner *et al*, 2008).
- Measures that make it quicker and easier to establish a business or make an investment (i.e. reducing red tape).
- Improved access to finance and financial services. Access to credit is a major constraint on domestic investment in Africa.
- Improvements in the legal system that make property rights more secure, e.g. contract enforcement and investor protection.

While provisions facilitate investment, it is more important for attracting investors (domestic and foreign) to create a favourable business and regulatory environment. Certain areas for regulatory reform are particularly appropriate for ACP countries, and hence are candidates to include in EPA negotiations: measures that make it quicker and easier to establish a business (reducing red tape); improved access to finance and financial services; and making property rights more secure (e.g. contract enforcement and investor protection). Alone these may not attract significant investment, but they can be an important part of a coherent strategy to increase the attractiveness of a country to investment, foreign and domestic.

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